OPUS INVESTMENT MANAGEMENT

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# Quarterly Commentary

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# Executive Summary

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**MARKET COMMENTARY**

With inflation stubbornly trending higher and a Federal Reserve looking to combat rising prices by accelerating its pace of interest rate hikes, fixed income investors had little to celebrate as yields moved higher and returns trended lower in the first quarter. Negative fixed income returns were not driven by rising Treasury yields alone; performance of credit sensitive sectors also suffered under growing concerns of a monetary policy mistake coupled with the uncertainty brought on by Russia's invasion of Ukraine. Ultimately, fixed income investors experienced a -5.93% loss as measured by the Bloomberg U.S. Aggregate Bond Index. To put this return in perspective, you must go back to 1980 to find a quarterly figure more challenging than the one just experienced.

The year began following a fourth quarter that saw short-term Treasury yields rise after the Federal Reserve revised its rate hike expectations and began, then accelerated, the tapering of additional security purchases. As the new year unfolded, inflation measures not only persisted – they accelerated. Overseas, the Omicron variant caused port delays and closures, placing further pressure on an already fragile supply chain. With inflation reaching levels not seen for 40 years and the unemployment rate back to pre-Covid levels, the Fed updated its projections from 3 rate hikes to 7 (including the rate hike during the March meeting) for the current calendar year. Additionally, Chairman Powell indicated that 50 basis point hikes were on the table if the Federal Open Market Committee felt they were warranted. Recognizing the need to return to a neutral monetary policy stance involves more than interest rate adjustments, the Fed stated that it expects to begin reducing its balance sheet at an upcoming meeting.

While acknowledging the humanitarian crisis underway in Ukraine is difficult to watch, the impact to investors thus far has been more inflation – mainly in energy and agricultural products. This makes the Fed's challenge of orchestrating a soft landing even more problematic as many of the forces driving inflation higher are not rate sensitive, like this conflict. With mounting concerns that inflation may impact economic growth, corporate earnings, and consumer sentiment, investors began preparing by slowly stepping away from risk sectors. According to Bloomberg, corporate spreads – the extra yield investors are compensated to take risk – increased by 52 basis points through mid-March before retracing a portion by quarter end. Growing risk premiums across the investment grade universe further pushed returns into negative territory.

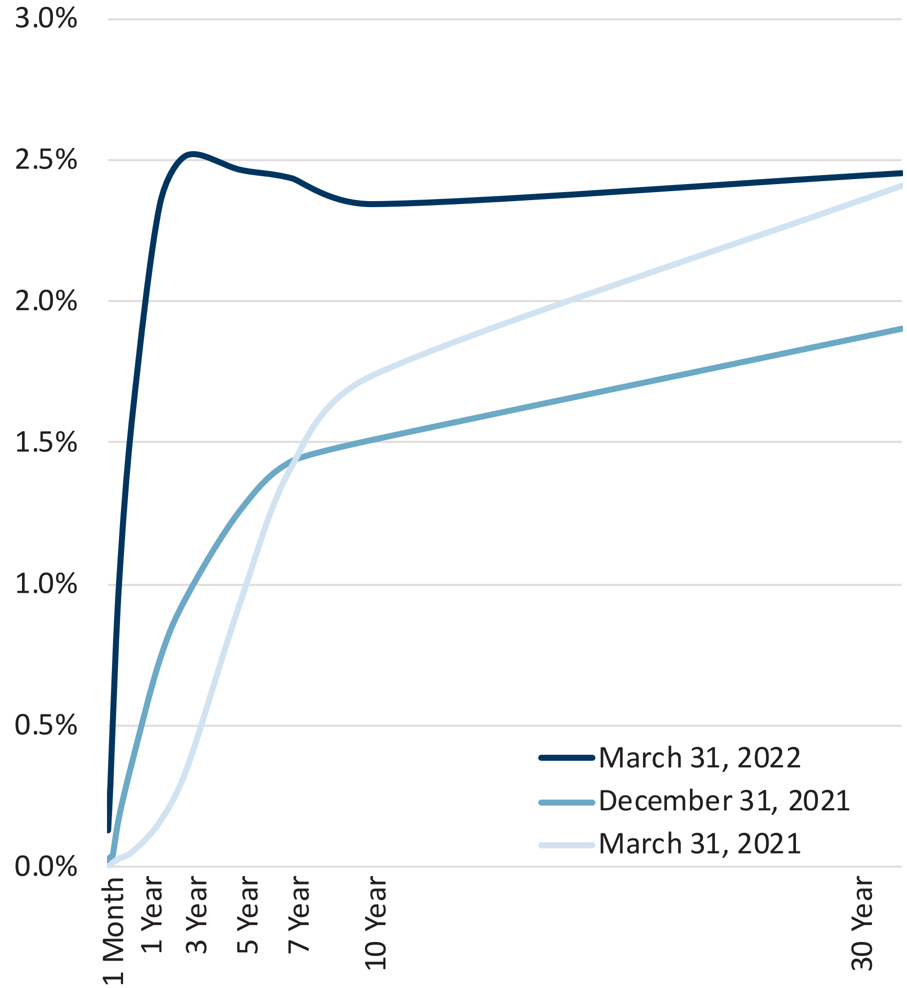
All is not doom and gloom, there is a silver lining to the disappointing returns for fixed income investors. Undoubtedly, higher yields reduce asset prices, but higher yields also create opportunity on reinvestment. Not long ago achieving a 2% yield on investment seemed heroic. Today, attaining mid-3% or even 4% yields is possible. Although economic growth is slowing, domestic expansion is still expected to continue around 3% as unemployment remains low, household net worth is near record highs, and corporate balance sheets remain resilient with high cash levels keeping default expectations low. As we are in the early stages of an unprecedented monetary policy adjustment, the road ahead might be bumpy, but these conditions may provide timely investment opportunities.

Bill

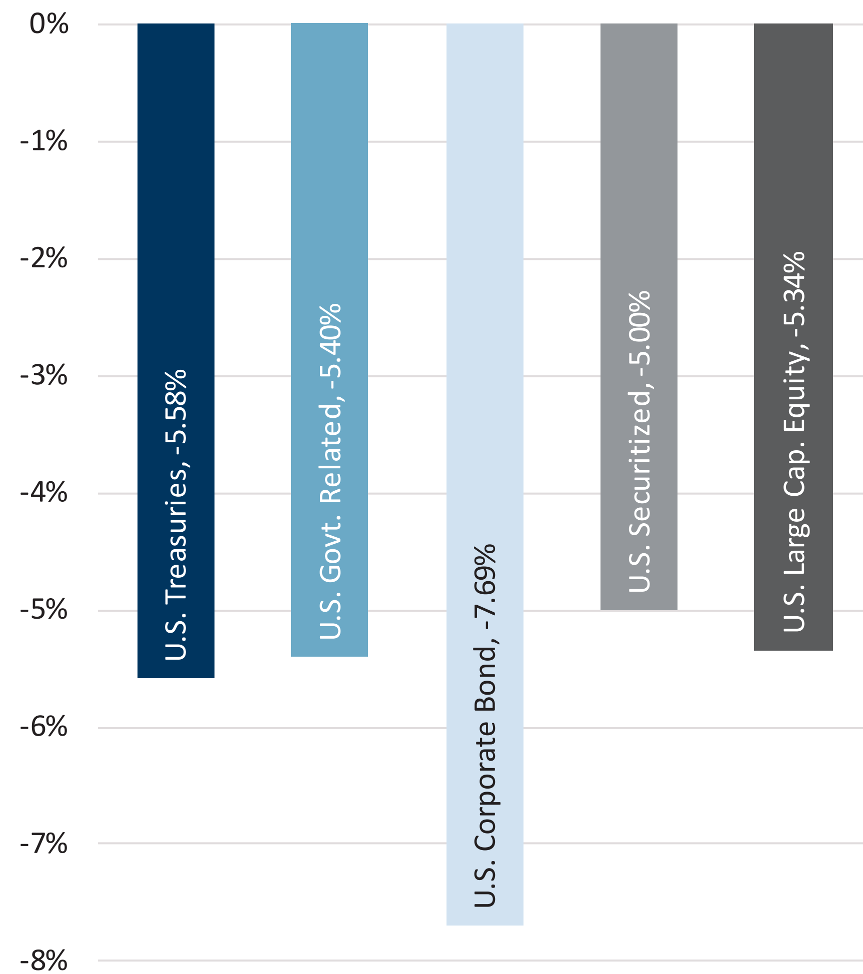
# Economic Outlook

*Dramatic shift in U.S. yield curve resulted in negative returns across fixed income sectors*

U.S. Yield Curve




First Quarter 2022 Total Returns

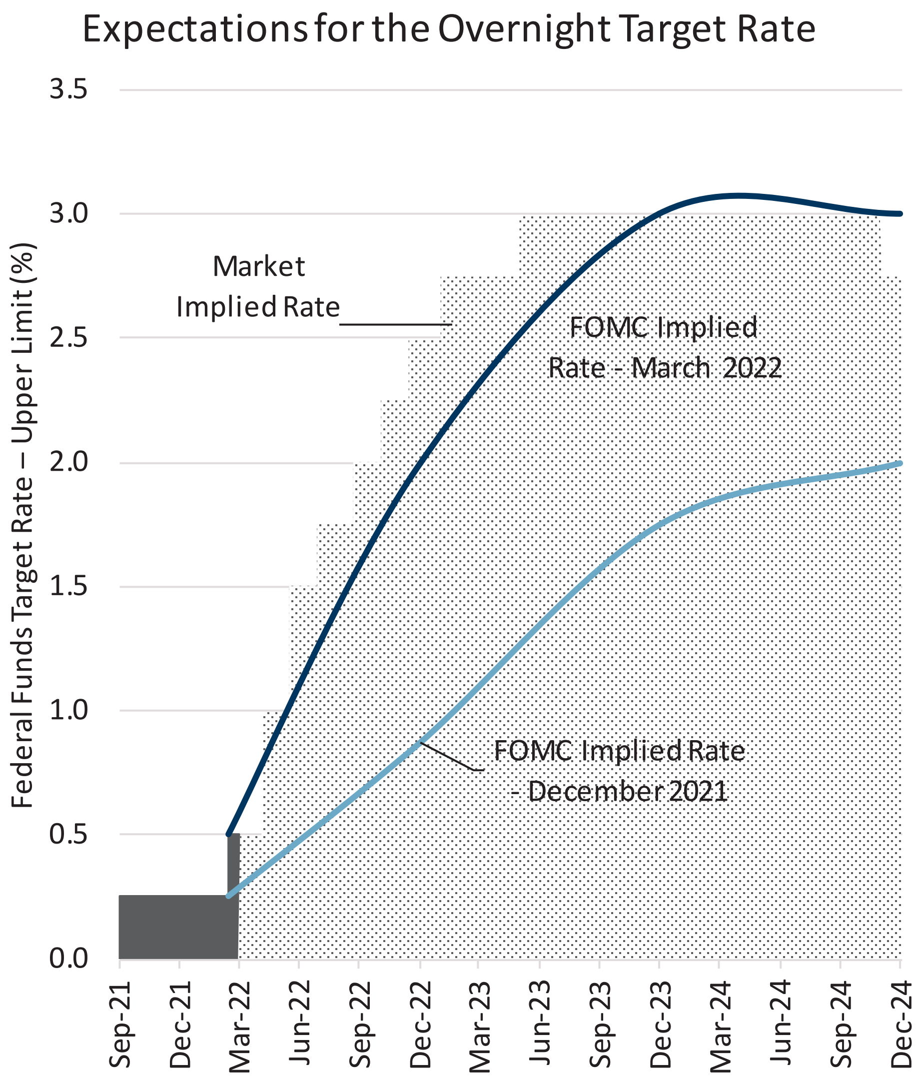


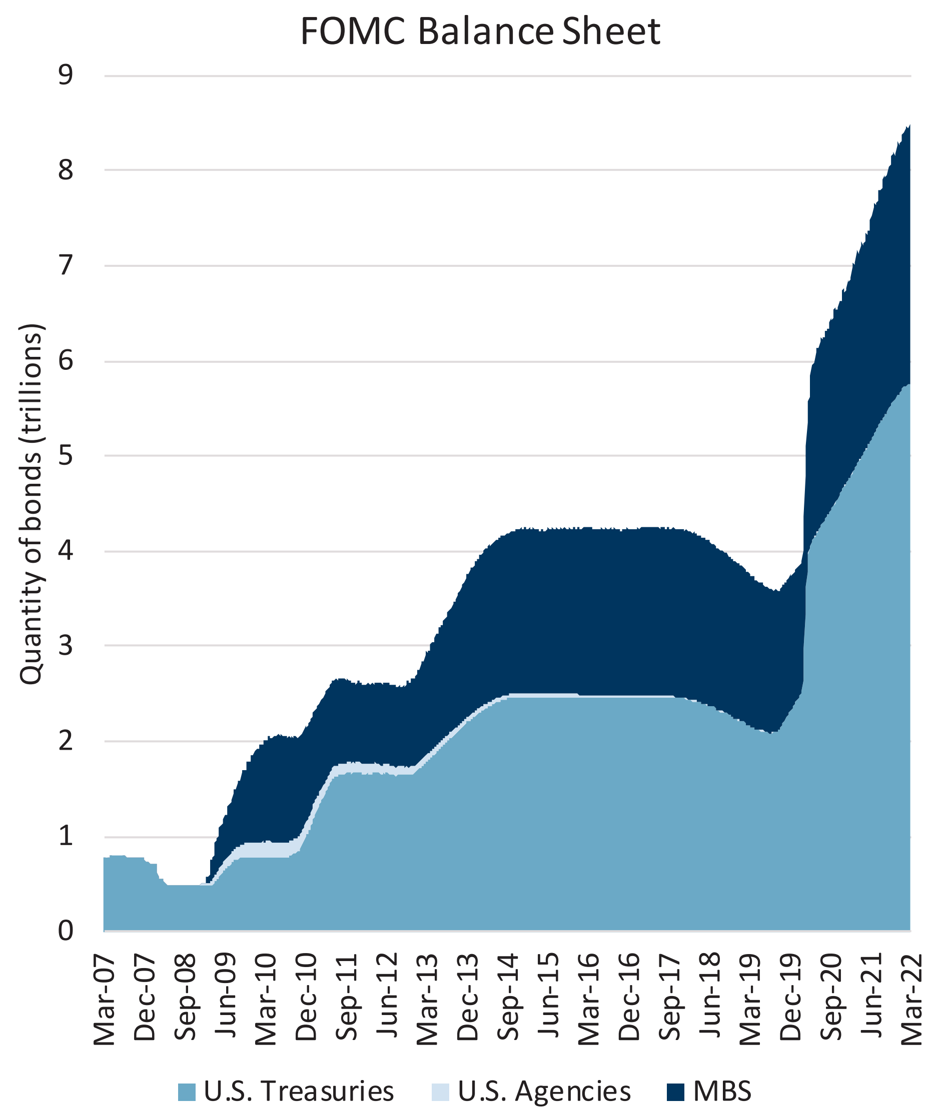

*fixed income sectors shown are components of the Bloomberg U.S. Aggregate Bond Index

Source: Opus, Bloomberg

# Economic Outlook

*Federal Reserve reacting to high inflation in a strong labor market*

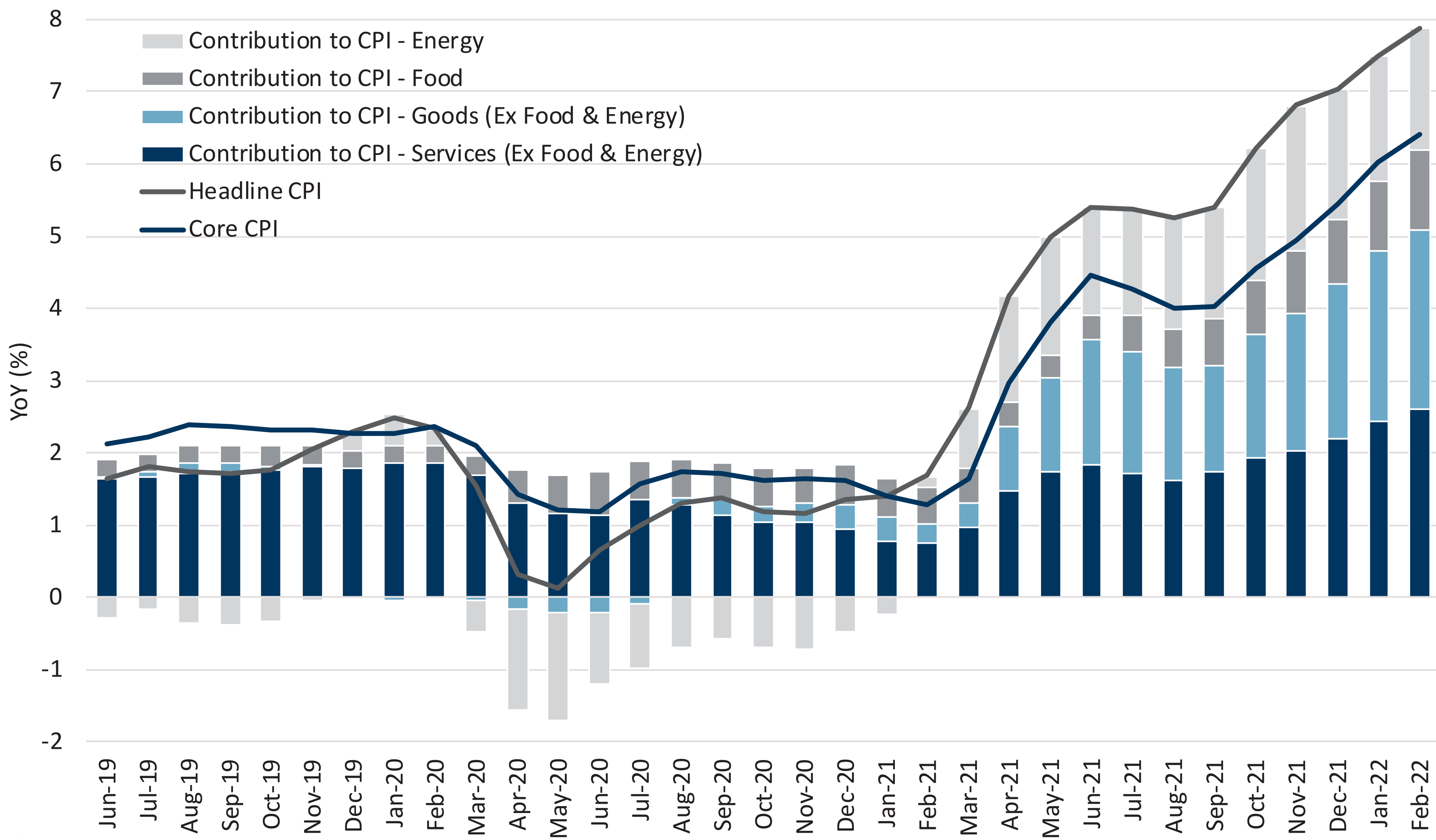



Source: Opus, Bloomberg, Federal Reserve

# Economic Outlook

*Inflation continued to increase in the first quarter and is expected to peak in the near term before declining late in the year*

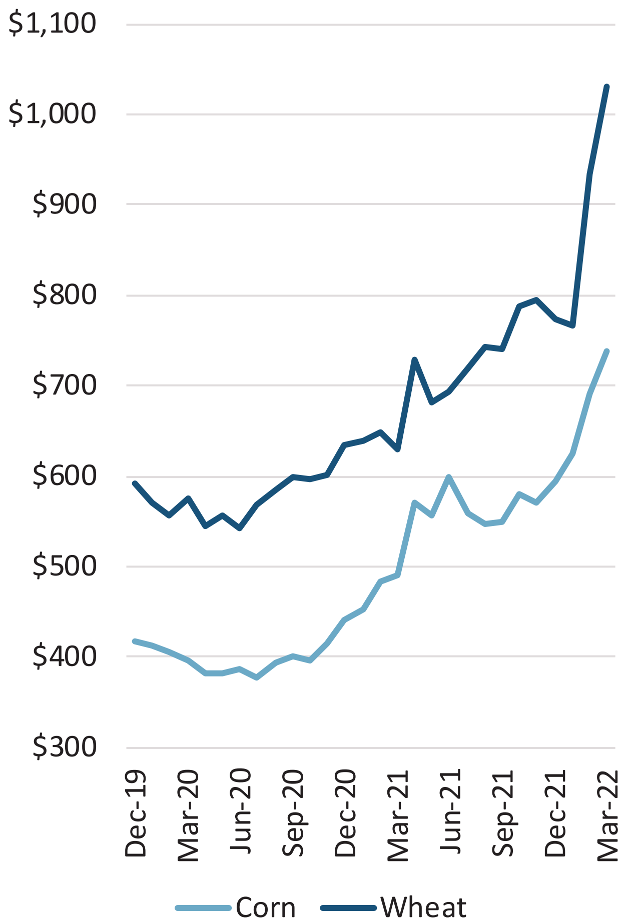



Source: Opus, Bloomberg, Bureau of Labor Statistics

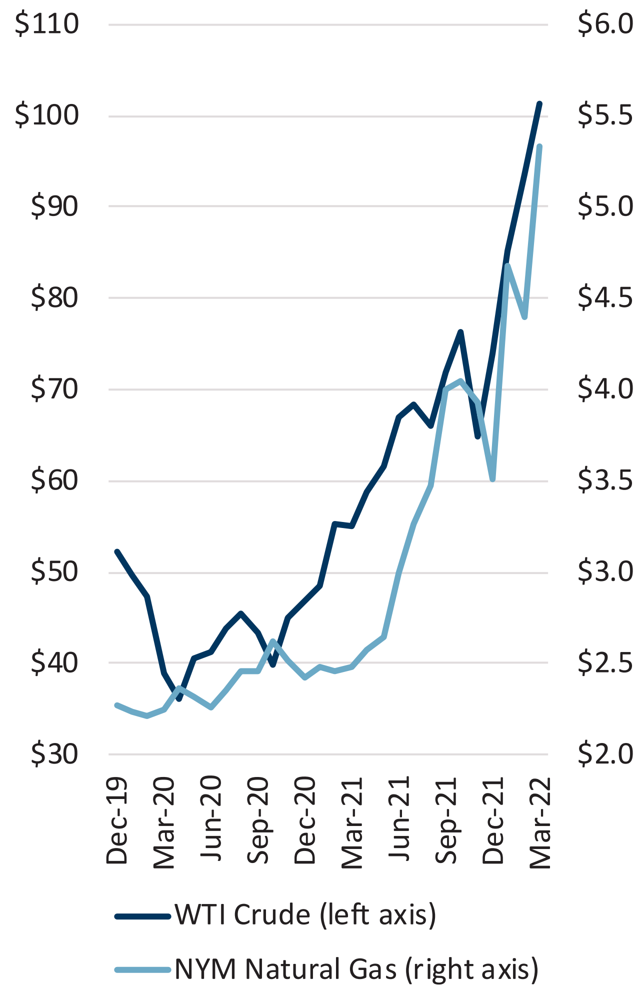
# Economic Outlook

***Conflict between Russia and Ukraine has had a swift and significant impact on commodity prices, which will likely put upward pressure on global inflation***

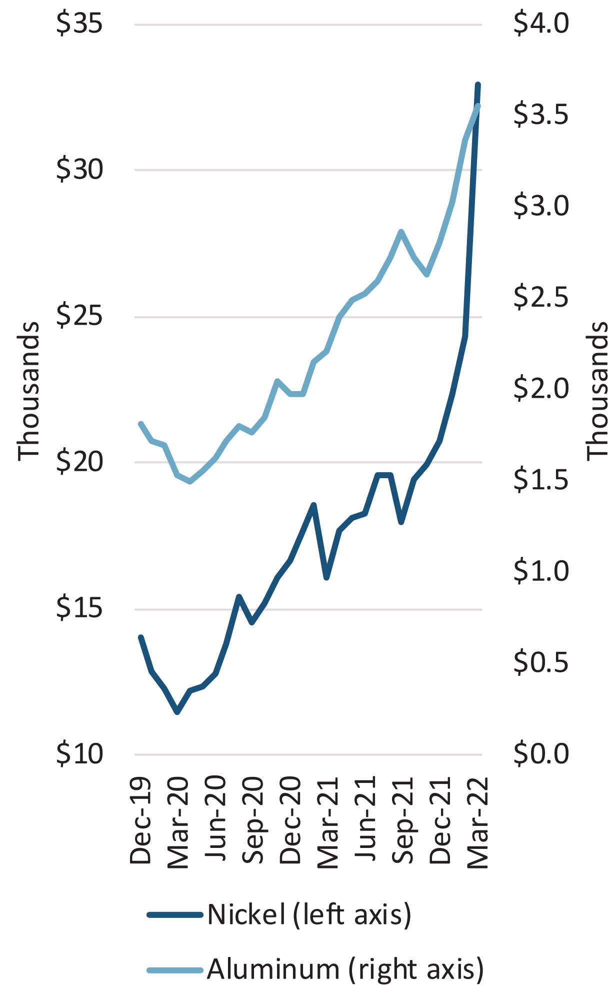
### Agriculture Prices
($/bushel)




### Energy Prices
(WTI $/barrel, Nat. Gas $/MMBtu)




### Metals Prices
($/metric tons)

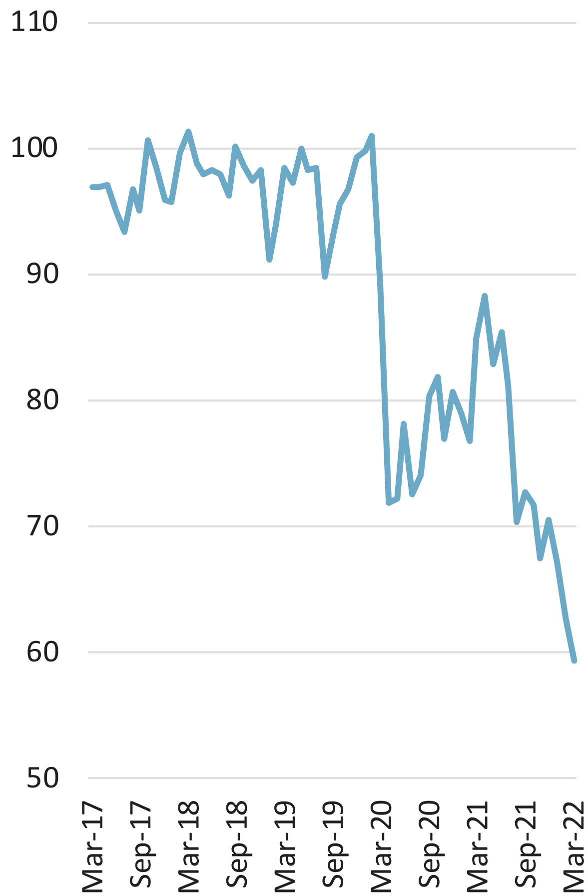



Source: Opus, Bloomberg

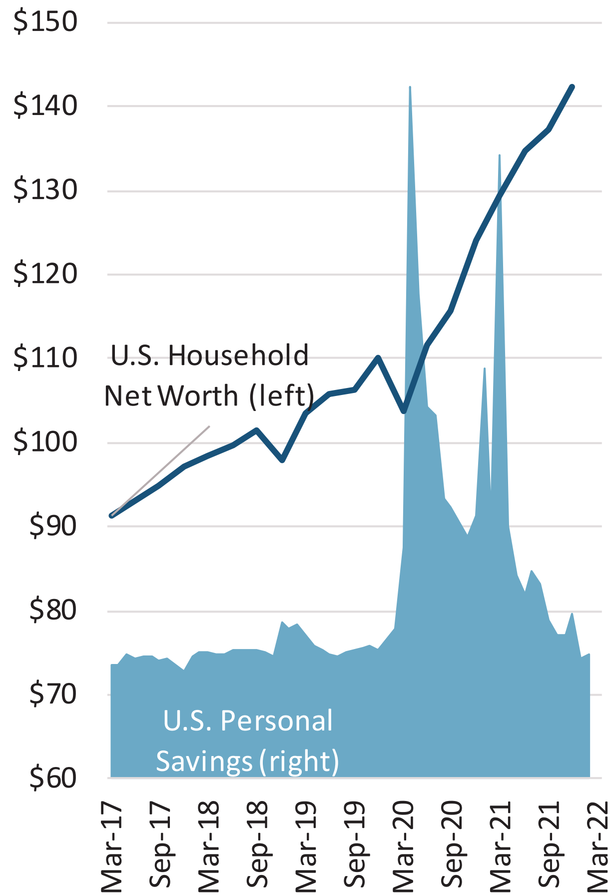
# Economic Outlook

*Elevated inflation is weighing on consumer sentiment and personal savings; however, net worth remains high and employees are returning to the labor force at higher wages*

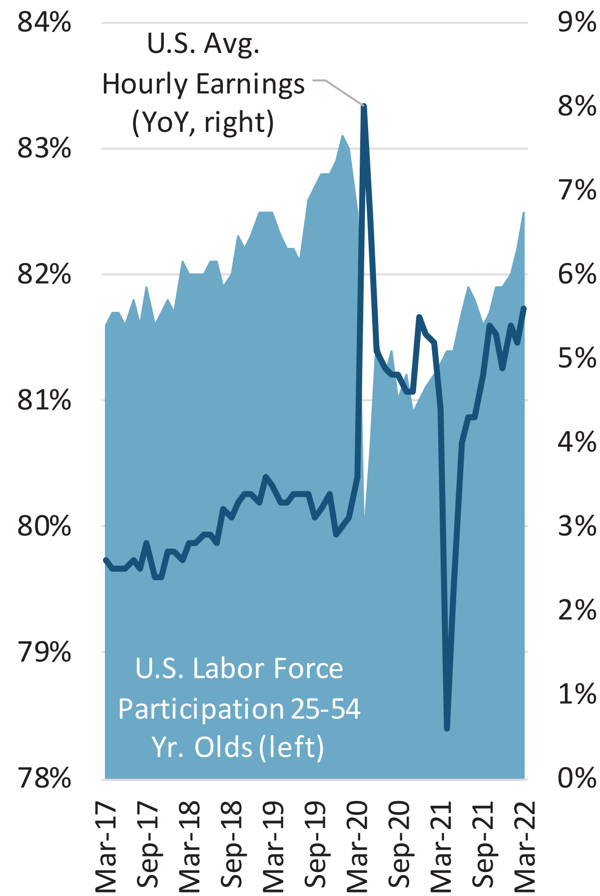
University of Michigan Consumer Sentiment




Personal Savings versus Total Net Worth (trillions)



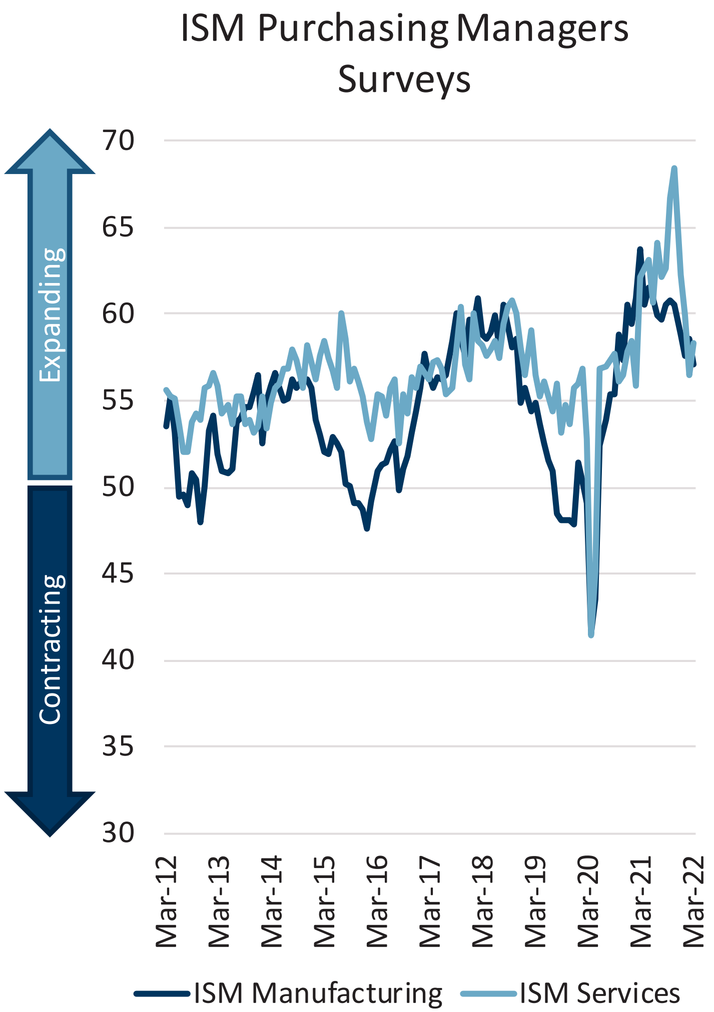

Labor Force Participation versus Avg. Hourly Earnings

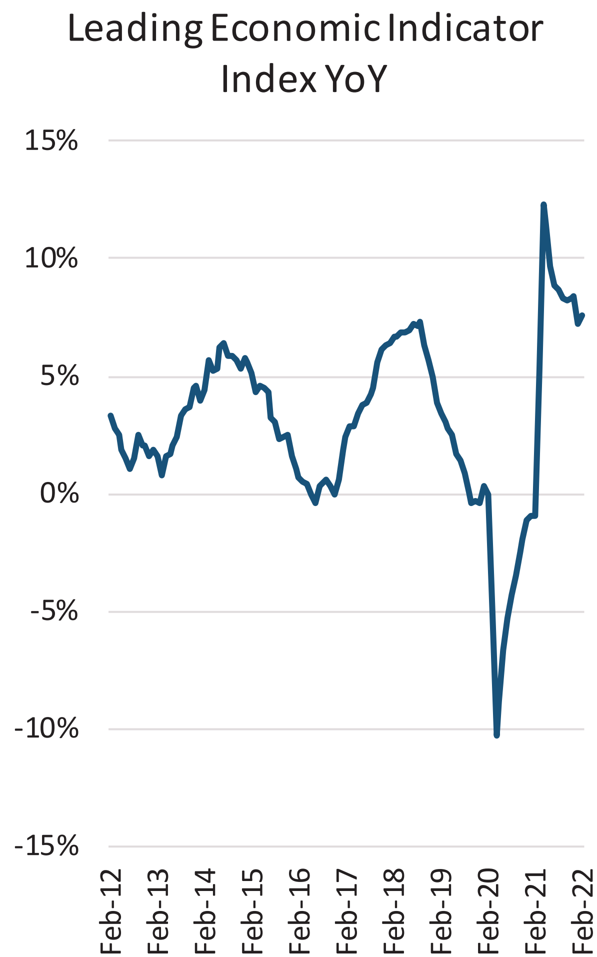


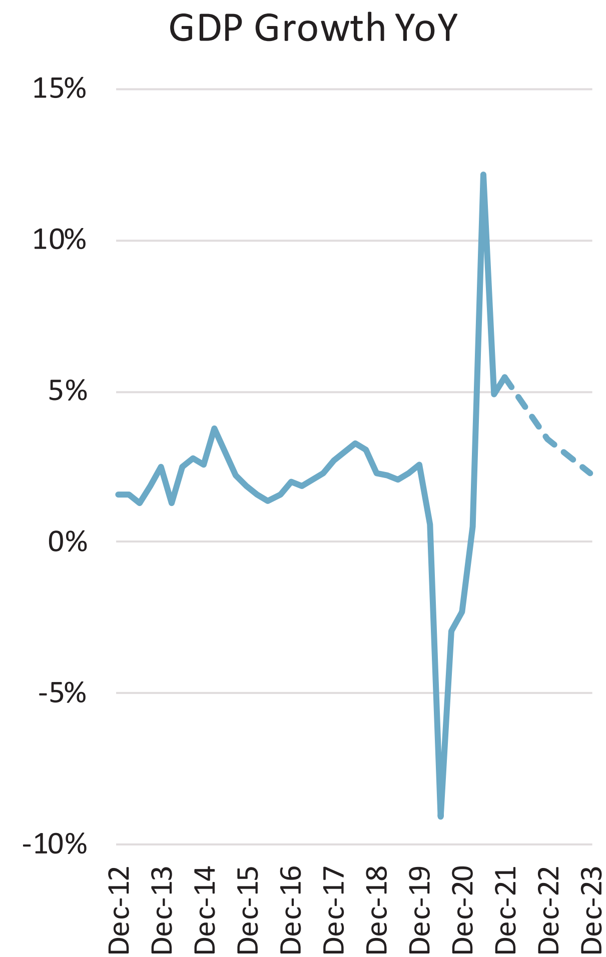

Source: Opus, Bloomberg, Bureau of Labor Statistics, Bureau of Economic Analysis, Federal Reserve

# Economic Outlook

*Expectations for GDP growth have declined; however, some economic indicators continue to show signs of strength*



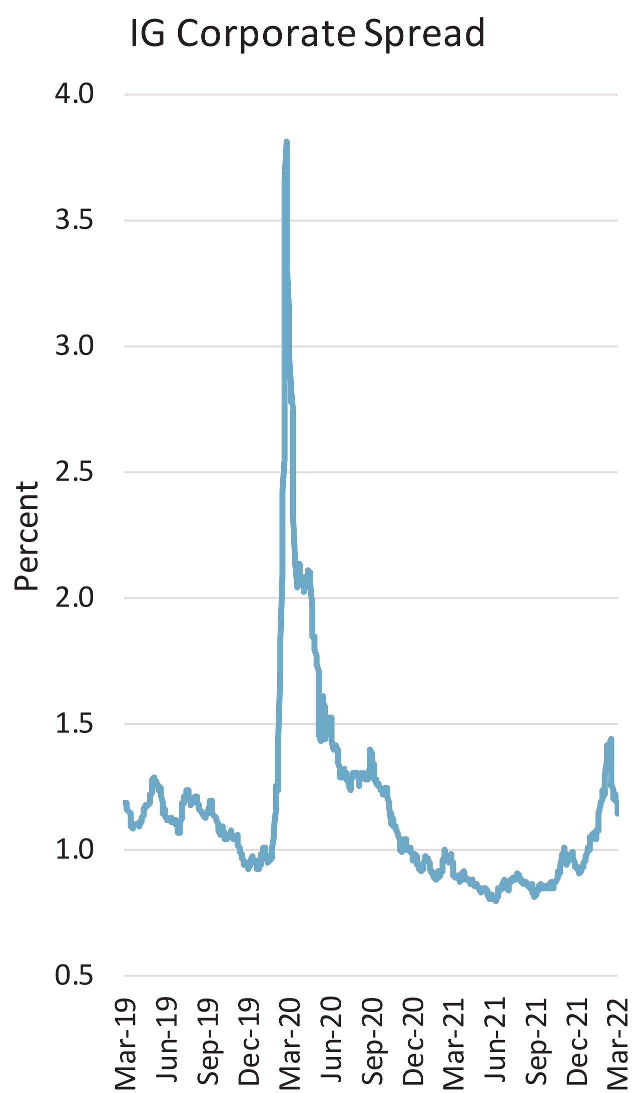



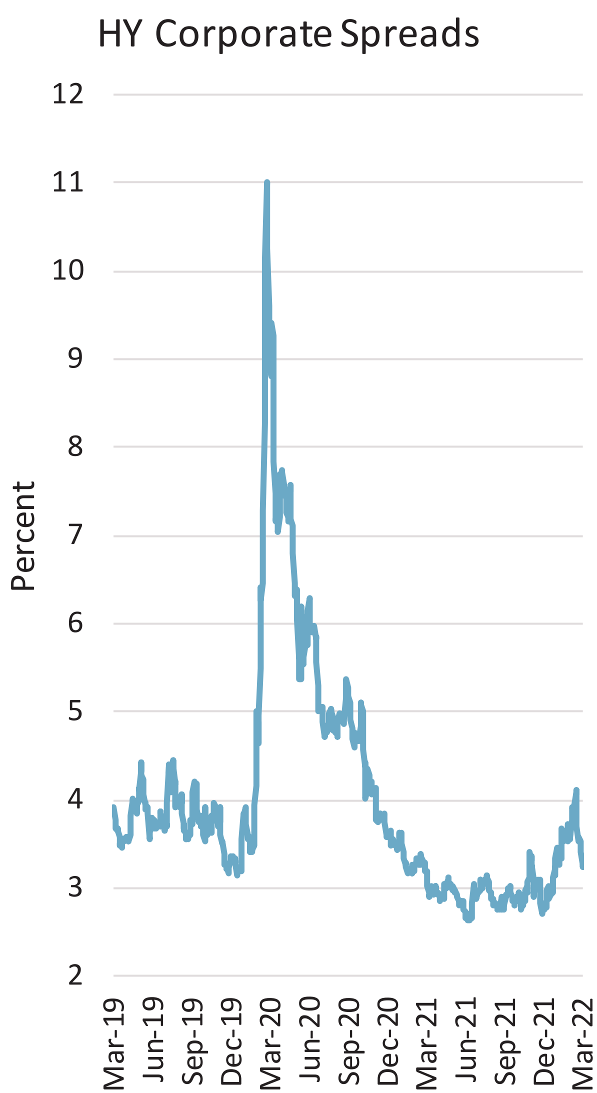



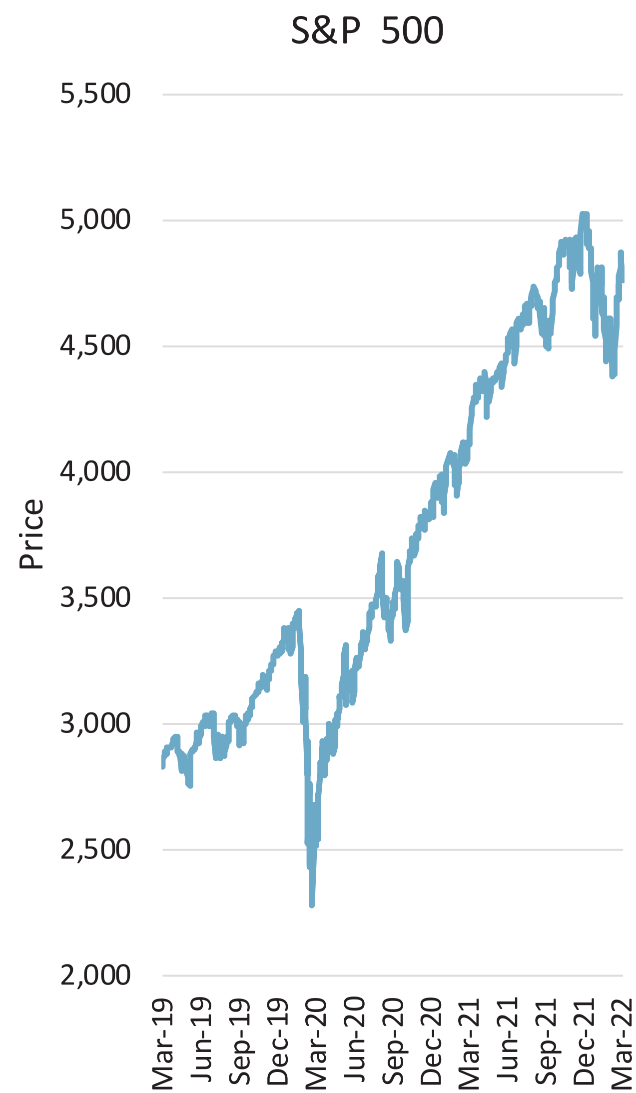

Source: Opus, Bloomberg, Conference Board, Bureau of Economic Analysis, Institute for Supply Management

# Economic Outlook

*Spreads on corporate bonds have decreased off recent highs, but remain above lows*




Source: Opus, Bloomberg

# Economic Outlook

*All eyes remain on the FOMC, as they proceed with policy normalization*

## The FOMC has a difficult balancing act ahead

- At 7.9%, year-over-year inflation is at its highest level in 40 years and could increase before moderating later this year
- The FOMC hiked their target rate by 0.25% for the first time in March and guided toward 6 additional increases this year, though markets are pricing in more
- The conflict in Ukraine is expected to pressure prices higher, creating a difficult dynamic for the FOMC

## GDP growth expected to be more modest due to concern over inflation

- Consumer sentiment has been weighed down by high inflation, but this has yet to be reflected meaningfully in consumer behavior
- U.S. consumers and companies are in sound financial positions due to strong corporate earnings and recent fiscal stimulus
- Corporate bond spreads widened by 52 basis points in the quarter but partially retraced ending 24bps higher

## Heightened volatility over anxiety of possible policy misstep

- After peaking in the first days of the quarter, the S&P 500 moved into correction territory before partially recovering in March
- Yields have moved substantially higher, especially on the front-end, resulting in a flat yield curve
- While uncertainty has increased, fundamentals in the U.S. outside of inflation remain relatively stable

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