Investments in harmony with you℠

Quarterly Commentary

March 31, 2023

Executive Summary

WILLIAM PIEL, CFA
President
Opus Institutional Markets

MARKET COMMENTARY

Following a year where investors witnessed an extraordinary pace of monetary policy tightening, the hope was for volatility to subside as the lagged effects of higher interest rates took hold and pulled inflation down towards the Fed's target of 2%. With the first quarter behind us, questions remain unanswered as to how quickly inflation will slow and volatility – specifically regarding interest rates – reached levels similar to the Great Financial Crisis. Much of the rate volatility can be explained by the swift collapse of Silicon Valley Bank and Signature Bank, the second and third largest bank defaults in U.S. history, and the subsequent test of confidence that cascaded through the banking sector. Despite the turbulence, both equity and fixed income markets generated positive returns for the quarter with the S&P 500 up over 7% and the Bloomberg U.S. Aggregate Bond Index returning 2.96%.

The large bank failures and the resulting squeeze on the sector may have wide-ranging implications for the months ahead. It logically follows that the acute stress on the banking system from the rapid movement of deposits and the subsequent need for liquidity may result in tightening lending standards and lower bank earnings, both negatives for economic growth. To provide liquidity and confidence to the sector, the Federal Reserve introduced a borrowing mechanism that provided banks with greater flexibility on government securities used for collateral to minimize difficulties accessing liquidity. Though this facility has not seen widespread adoption, borrowings from the Federal Reserve's main liquidity tool have skyrocketed and surpassed peaks from the Great Financial Crisis highlighting the pressure faced by an industry that relies heavily on confidence to function properly. For the time being, and after a forced merger of Credit Suisse and UBS, conditions have seemingly stabilized.

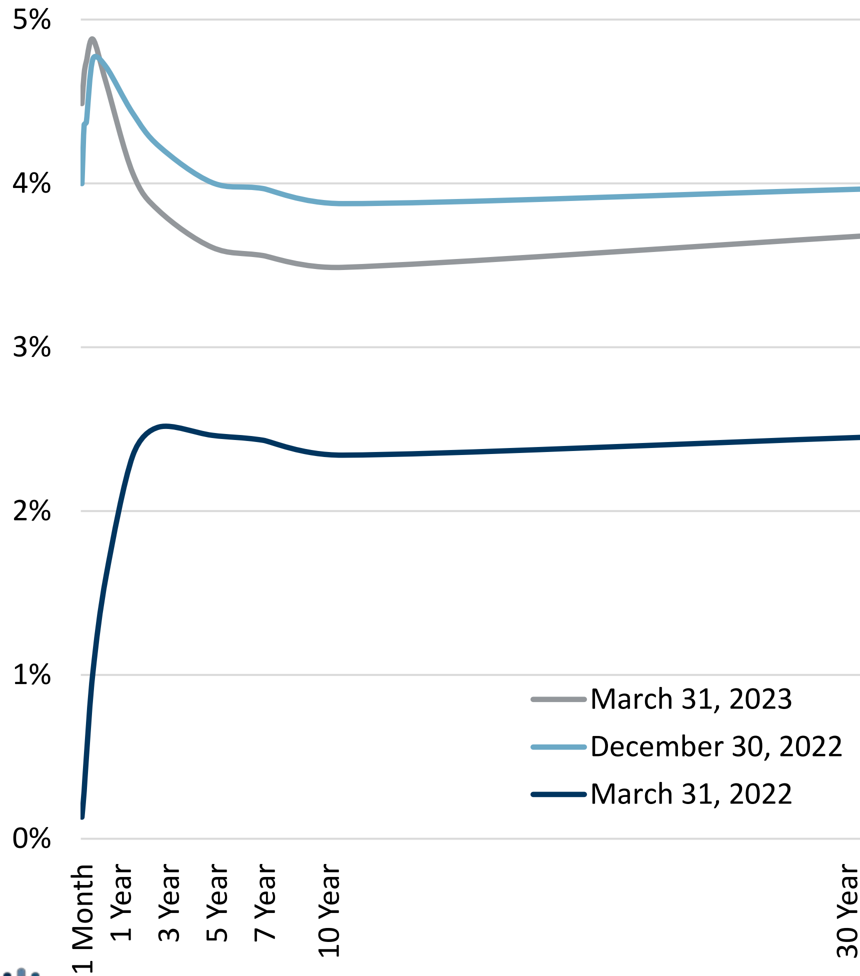
In terms of economic data, releases generally proved to be resilient and stronger than consensus causing sizable shifts in Federal Reserve rate hike projections as the market was positioned for slower growth and a recession rather than a soft landing; though, rate expectations would reverse again following the bank failures. What was originally expected to be a 50 basis point hike by the Federal Reserve at its March meeting turned into a 25 basis point move higher with the difference a casualty of tighter financial conditions. However, and not to be deterred from stemming high inflation, the Federal Reserve kept its year end rate expectations unchanged. Now, the unenviable task of reigning in inflation in the post-Covid era has been made more challenging by the recent financial turmoil. Encouragingly, unemployment remains low, and jobs continue to be added at a good pace which hopefully will provide the Federal Reserve time to see inflation fall to its target.

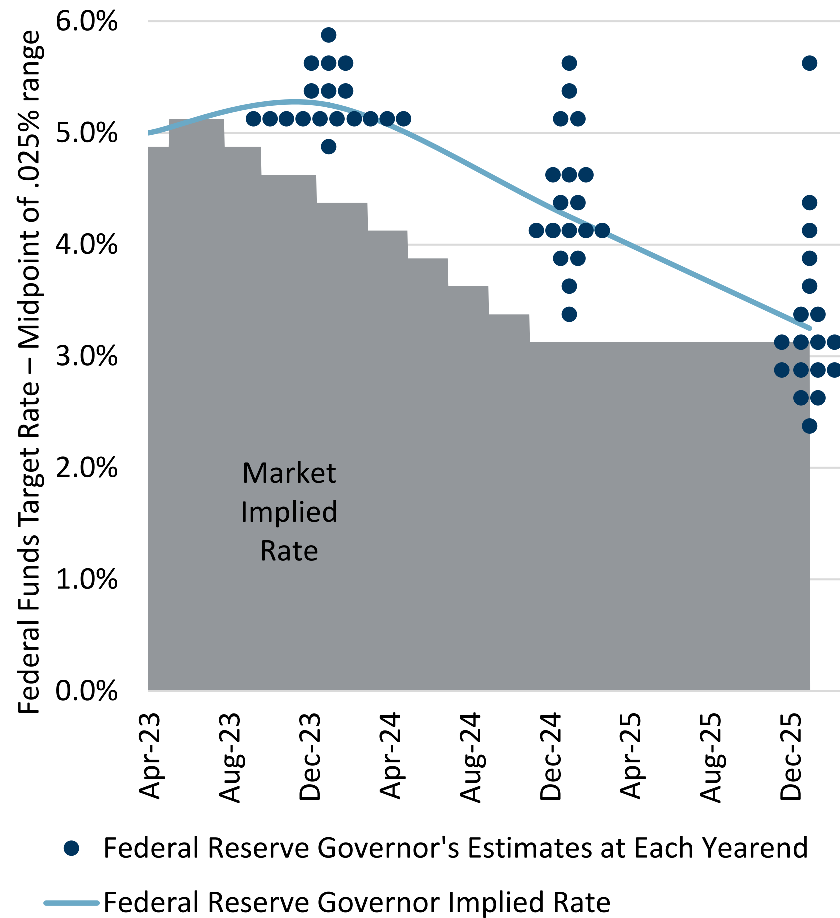
Looking ahead, the investor community will be watching economic data with keen interest to see how the stress the banking industry experienced impacts the economy. Once again, a large gap in rate expectations has materialized with the Federal Reserve projecting to keep rates elevated while market derived probabilities suggest rate cuts by the second half of the year. Further, first quarter bank earnings may provide another test for the markets as eyes will be focused on deposit flows, loan performance, and earnings. All said, 2023 is not lining up to be the calm year investors were hoping for.

Bill

Economic Outlook

The FOMC hiking cycle may be approaching an end in the near future, though expectations differ on the timing and pace of future potential rate cuts

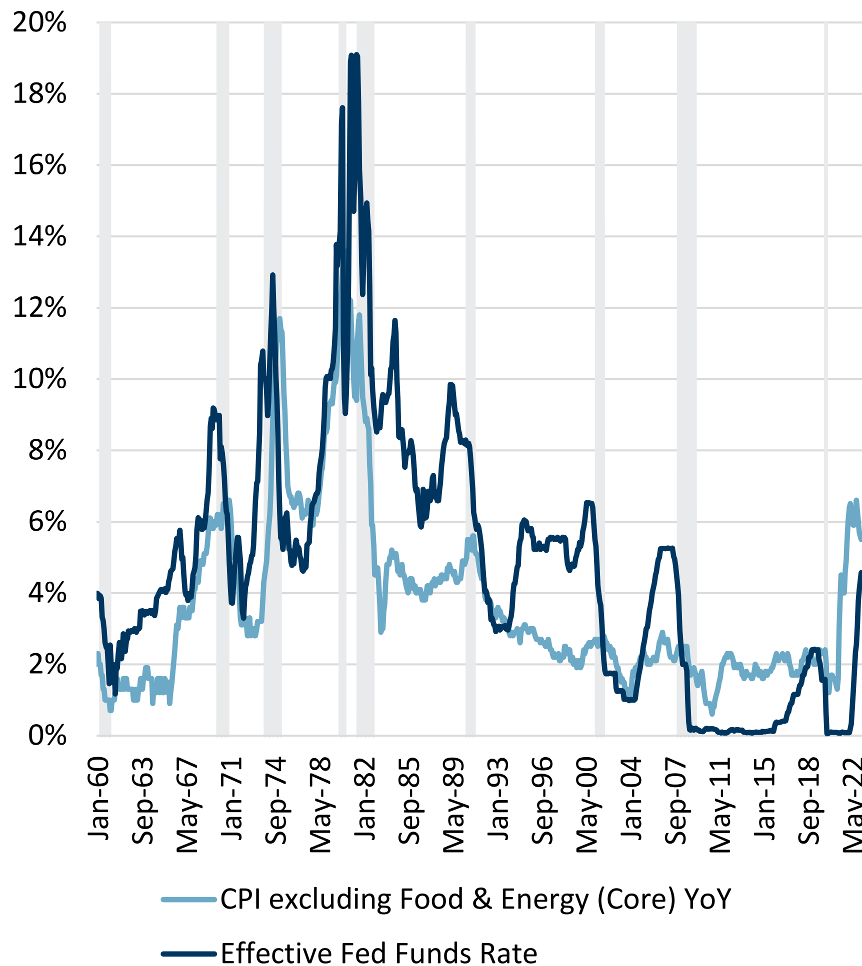


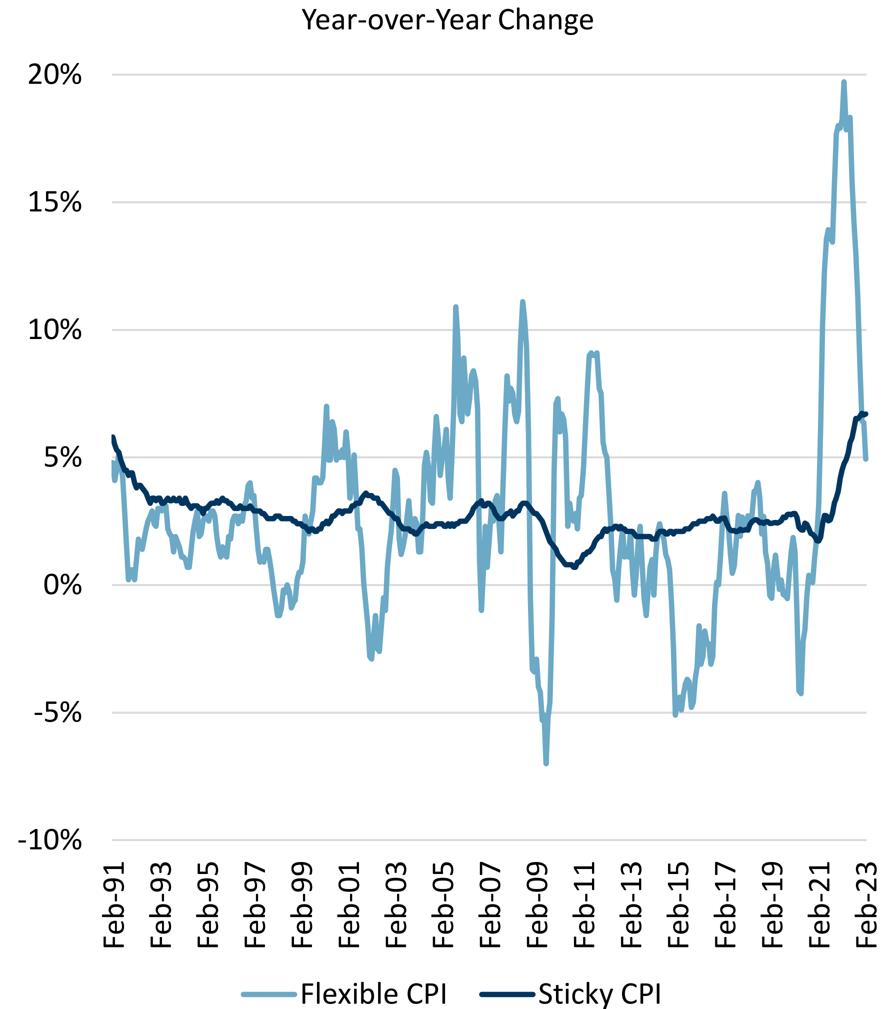


Source: Opus, Bloomberg, Federal Reserve

Economic Outlook

Historically, the Federal Reserve has had to increase its target rate above inflation in order to successfully bring down core inflation which remains above 5.5%



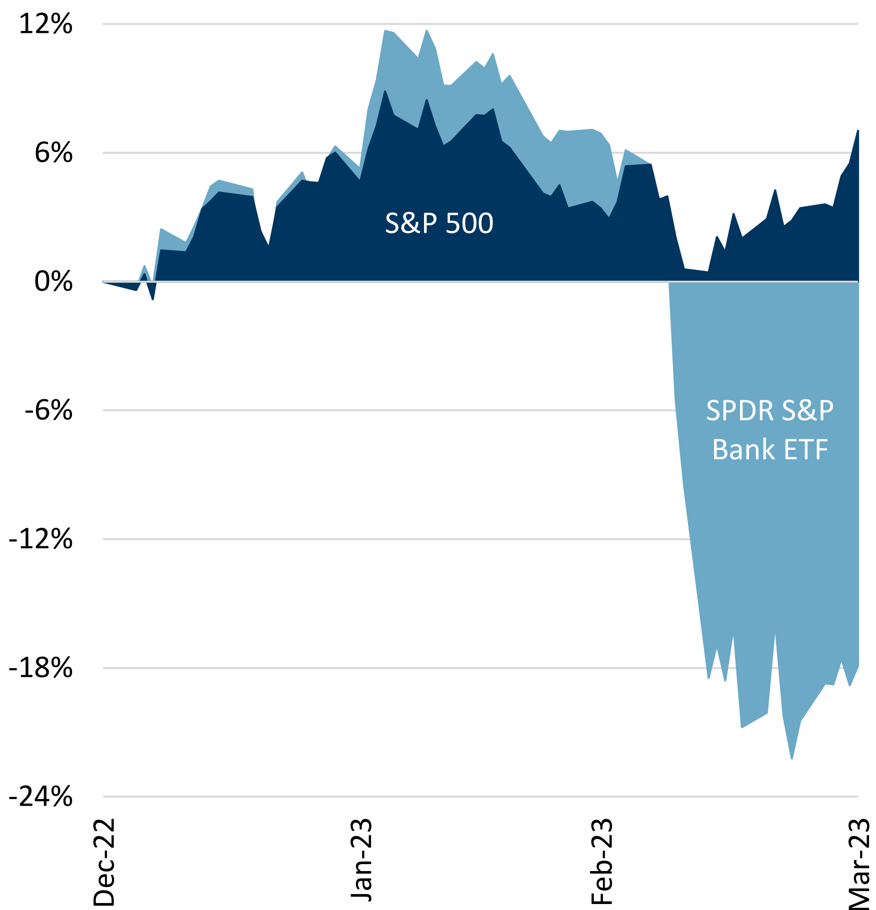


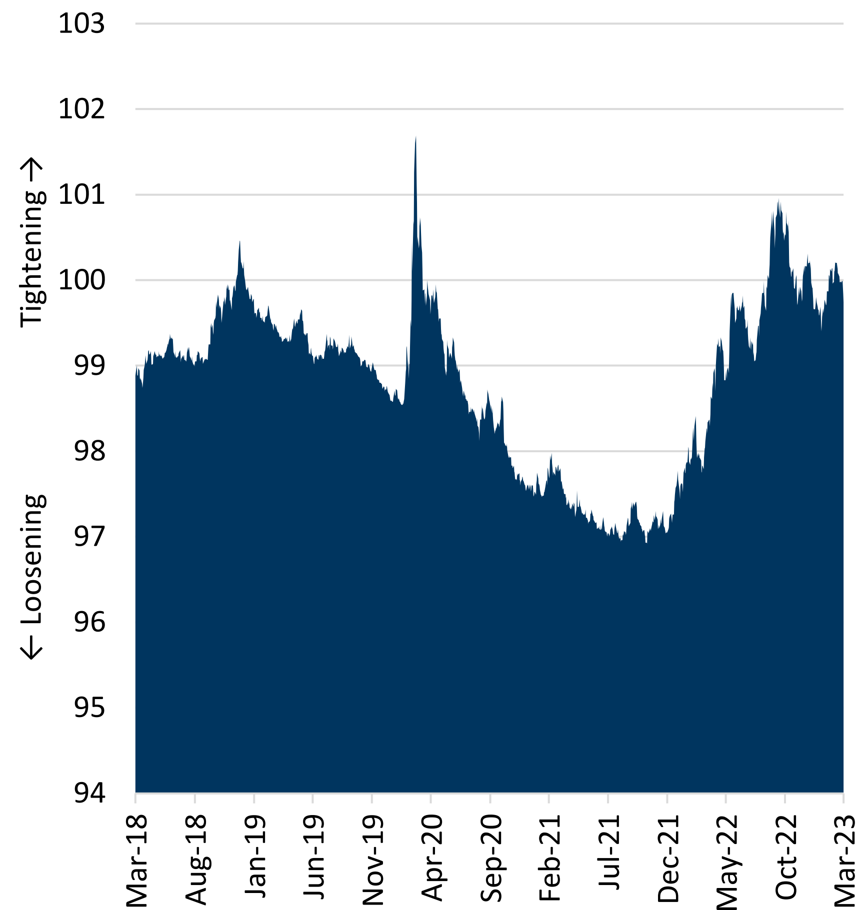
Source: Opus, Bloomberg, Federal Reserve, Bureau of Economic Analysis

Confidential and proprietary. For one-on-one use only. Not for distribution to the public.

Economic Outlook

Recent banking stress is expected to lead to further tightening of financial conditions; which should have a cooling effect on inflation and economic growth

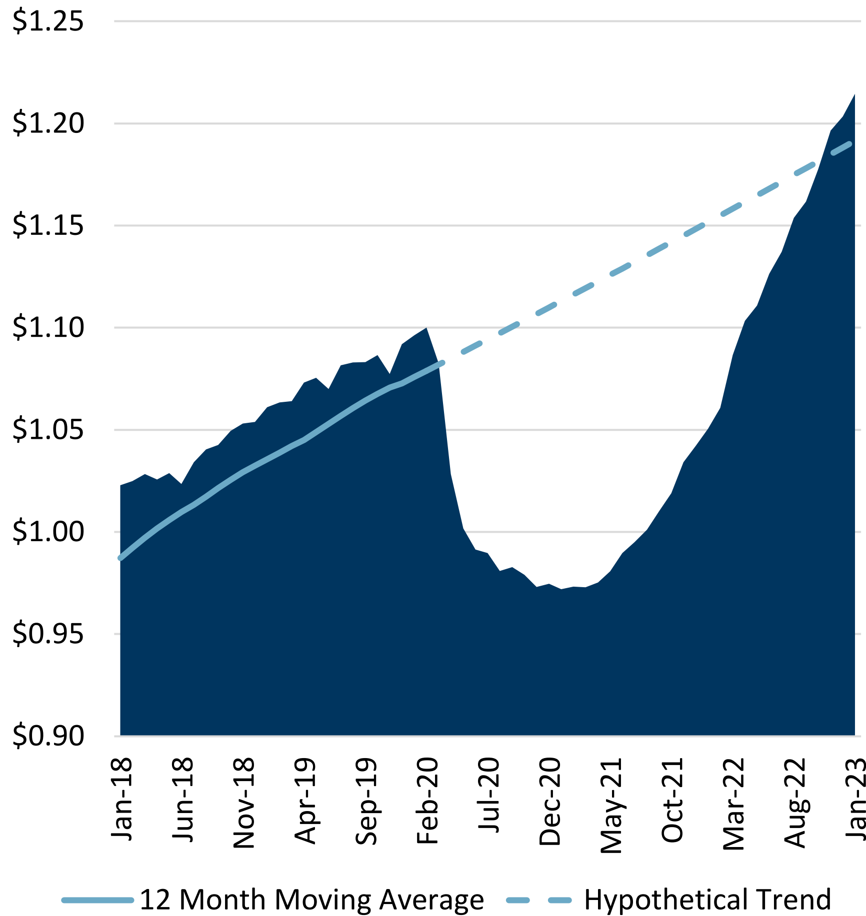


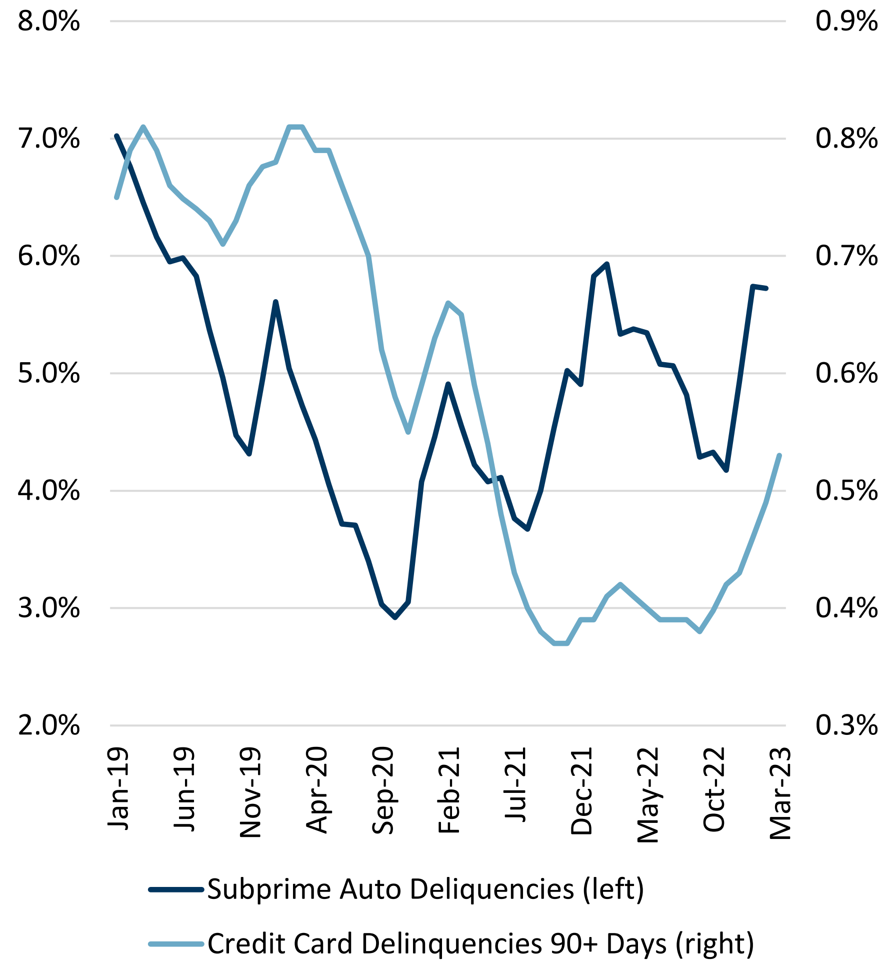


Source: Opus, Bloomberg, Goldman Sachs

Economic Outlook

Consumers continue to fund spending using revolving credit; however, delinquency rates are beginning to trend higher

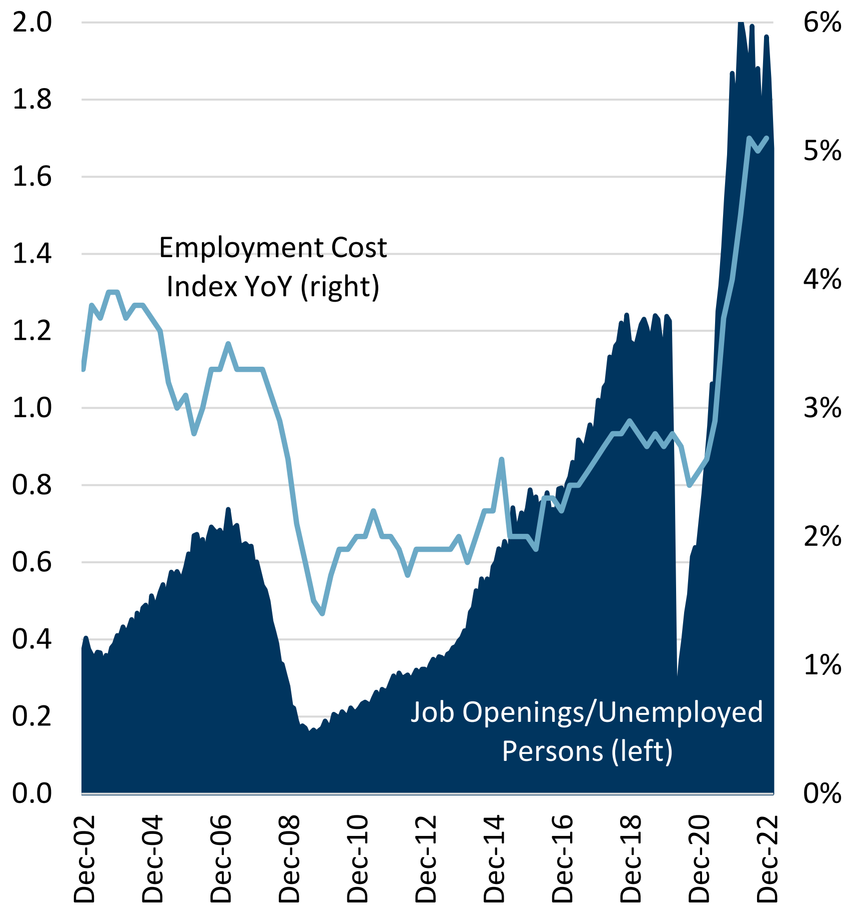


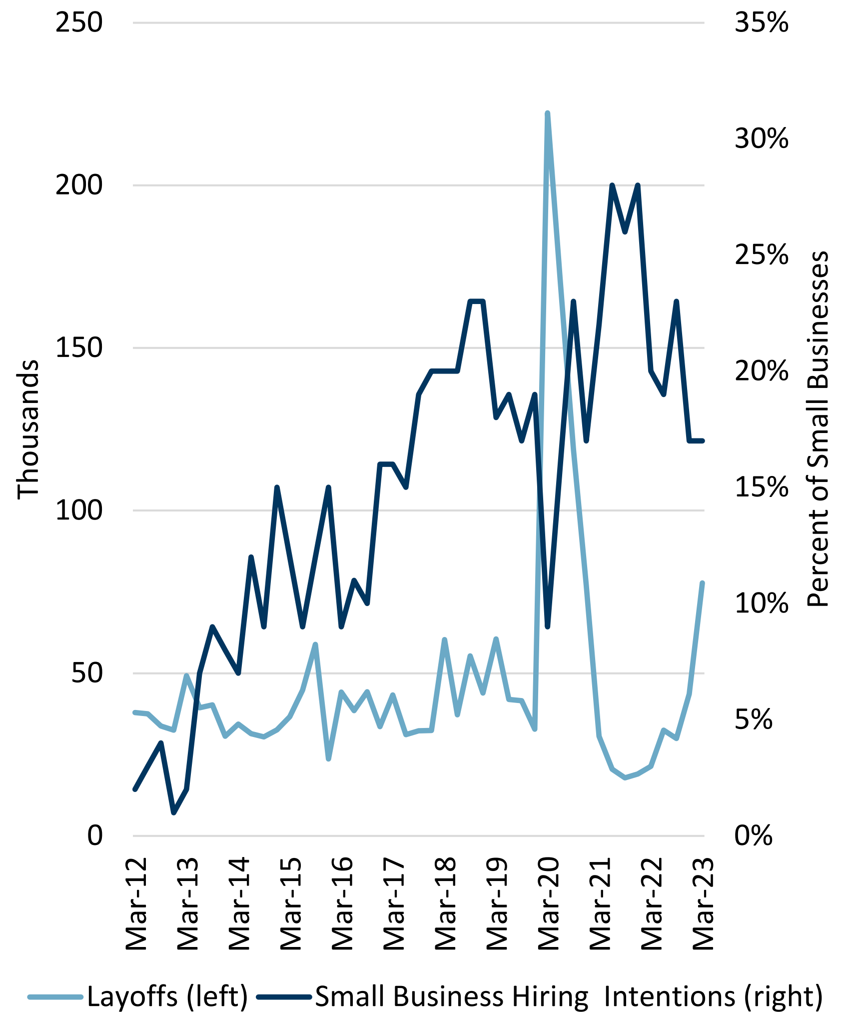


Source: Opus, Bloomberg, Federal Reserve, JP Morgan, Morgan Stanley

Economic Outlook

Elevated job openings and limited workers available drove wages higher in 2022; however, increasing layoffs and slowing demand from businesses may cause wage growth to slow



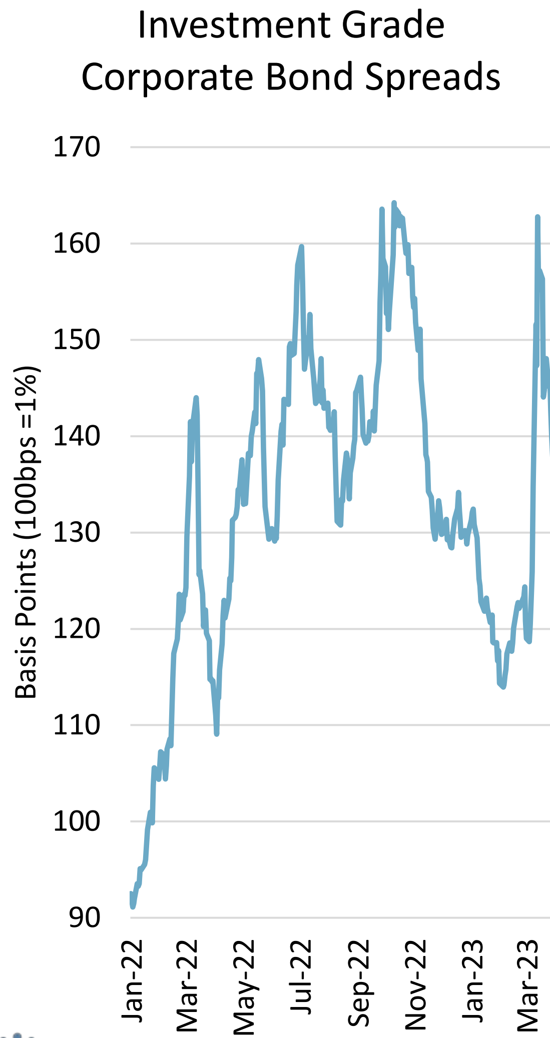


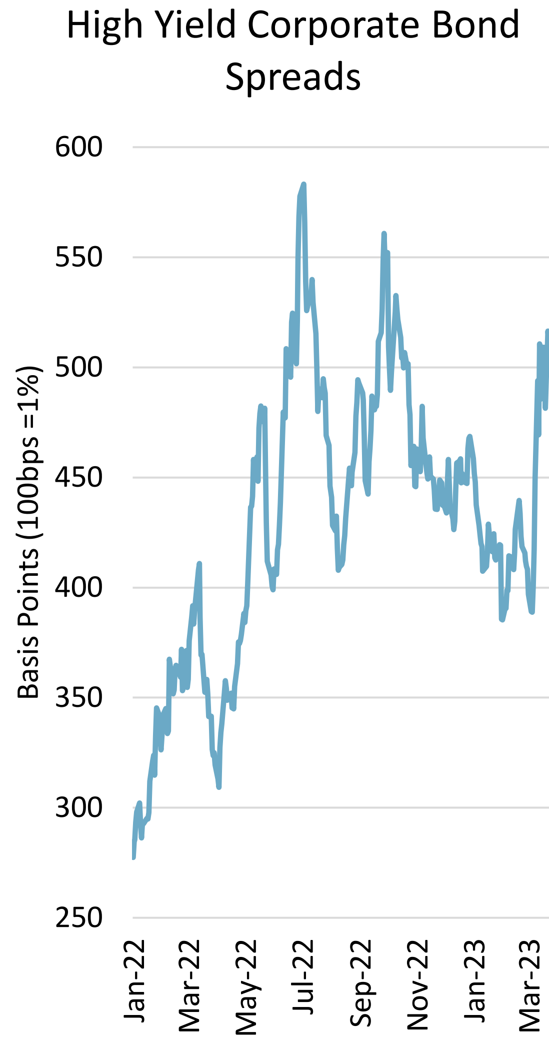
Source: Opus, Bloomberg, Bureau of Labor Statistics, National Federation of Independent Business (NFIB)

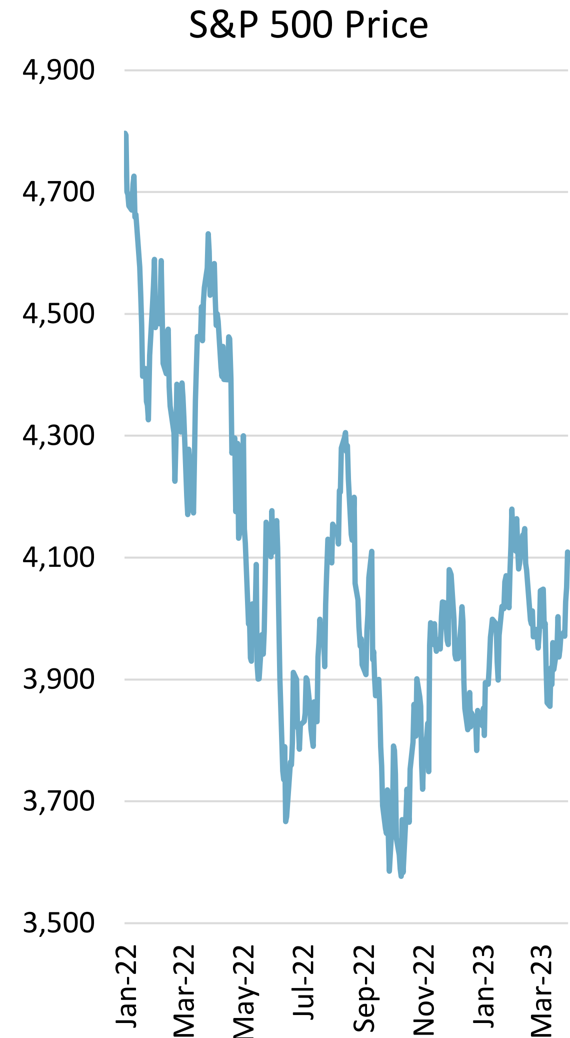
Confidential and proprietary. For one-on-one use only. Not for distribution to the public.

Economic Outlook

Corporate bond spreads widened quickly in response to the failure of Silicon Valley Bank and Signature Bank; they have not yet fully recovered







Source: Opus, Bloomberg

Economic Outlook

Restrictive monetary policy is firmly in place, all eyes are now on the banking sector

FOMC path forward uncertain given banking sector weakness

- Inflation has moderated, but with sticky CPI still near 40-year highs, core inflation remains well above the FOMC's long-term target
- Markets are expecting multiple rate cuts by the FOMC later this year and through 2024; however, the FOMC forecast indicates rates will remain elevated
- Instability in the banking sector may lead to weakness in other areas of the economy

Tightening financial conditions should further cool the economy

- Interest rate sensitive areas of the economy could see further slowing due to tighter lending standards
- Remaining pandemic-related benefits are or have recently expired which could pressure consumers' balance sheets while inflation growth remains high
- Cracks in the labor market may arise as layoffs and continuing unemployment claims increase, and small businesses slow hiring

Heightened risk of potential U.S. recession may not be priced in

- Market expectations of an end to rate hikes and the potential for cuts later in the year, led the S&P 500 to rally 7.5% in the first quarter
- Spreads on corporate bonds spiked quickly to 163bps in response to banking instability, but have stabilized lower
- Many potential sources of volatility and geopolitical risk could bubble up; U.S. debt ceiling debate, Russian Ukrainian conflict, tensions with China, to name a few

IMPORTANT INFORMATION

ADDRESSEE ONLY: This document is issued to investment professionals and institutional investors only. It is intended for the addressee's confidential use only and should not be passed to or relied upon by any other person, including private or retail investors. This document may not be reproduced or circulated without prior permission.

NO OFFER: The document is for informational purposes only and is not an offer or solicitation for the purchase or sale of any financial instrument in any jurisdiction. The material herein was prepared without any consideration of the investment objectives, financial situation or particular needs of anyone who may receive it. This document is not, and must not be treated as, investment advice, investment recommendations, or investment research.

INFORMATION: Opus Investment Management, Inc. is a registered investment adviser with the U.S. Securities and Exchange Commission under the Investment Advisers Act 1940, as amended.

Indices are unmanaged, do not reflect fees and expenses, and are not available for direct investment.

Past performance is no indication of future results. To the extent that certain of the information contained herein has been obtained from third-party sources, such sources are believed to be reliable, but Opus has not independently verified the accuracy of such information.