OPUS INVESTMENT MANAGEMENT

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Quarterly Commentary

June 30, 2022

Executive Summary

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MARKET COMMENTARY

Policymakers took unprecedented steps to stabilize the economy in the early days of the fight against COVID-19. With normalization well underway, the unwinding of these policies and the reopening of the economy is proving to be just as historic. While challenging first quarter returns can be characterized by valuations adjusting to higher interest rates brought on by persistently high inflation, second quarter returns suffered from the same inflation threat coupled with growing fears of an economic slowdown or possibly even a recession. Taken together, capital market returns for the first half of the year were some of the worst on record, with only a few pockets avoiding the carnage. Fixed income returns as measured by the Bloomberg U.S. Aggregate Bond Index were -4.69% for the quarter.

Following an aggressive policy response by the Federal Reserve at their March meeting, market volatility temporarily subsided. Expectations had been for inflation to moderate over the spring months as supply shortages alleviated, impacts from COVID variants lessened, and base effects took hold. Instead, inflation continued to be broad-based, with strong consumer demand in cyclical service sectors – not just in supply chain disrupted goods categories. Typically discounted because of the volatility of these categories, food and energy inflation showed no signs of abating, which has led to growing concern of their impact on consumer spending that is beginning to show signs of changes. In response, the Fed raised their overnight rate by 50 basis points in May and 75 basis points in June, resulting in revised expectations that the Fed Funds Target Rate will end the year at roughly 3.4%. This marks a significant change of course from their projections at the beginning of the year.

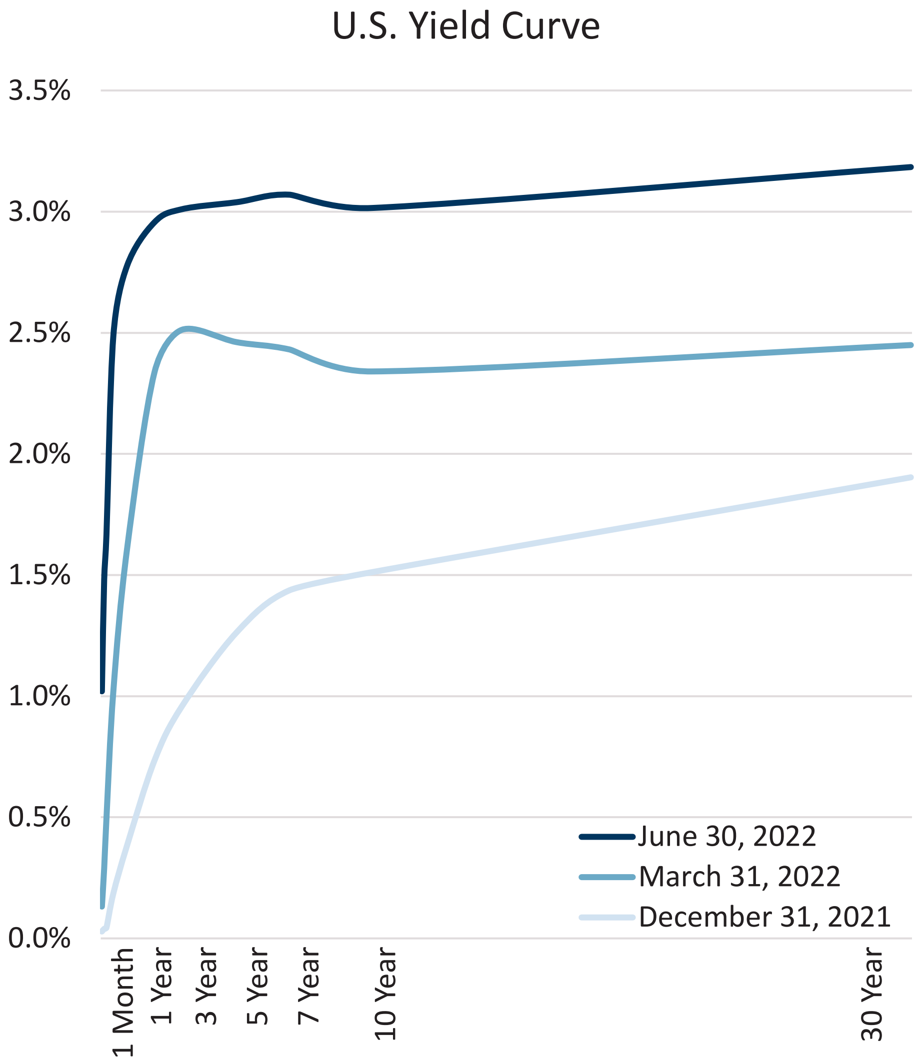
Despite a strong labor market with rising wages and low unemployment, growth expectations for the year continue to be lowered, with current 2022 consensus figures standing at 2.5%. Notably, the Fed reduced their GDP forecast to 1.7% from 2.8% at their June meeting. Costs from higher inflation and rising interest rates are weighing on consumers as indicated by the University of Michigan's Consumer Sentiment Index hitting an all-time low in June. With confidence falling, savings rates declining, and wages not keeping pace with inflation, increasing odds of a recession are taking their toll on the markets. The S&P 500 officially entered a bear market in June and high yield bond risk premiums, which held in remarkably well in the first quarter, have capitulated and are trading at multi-year wides.

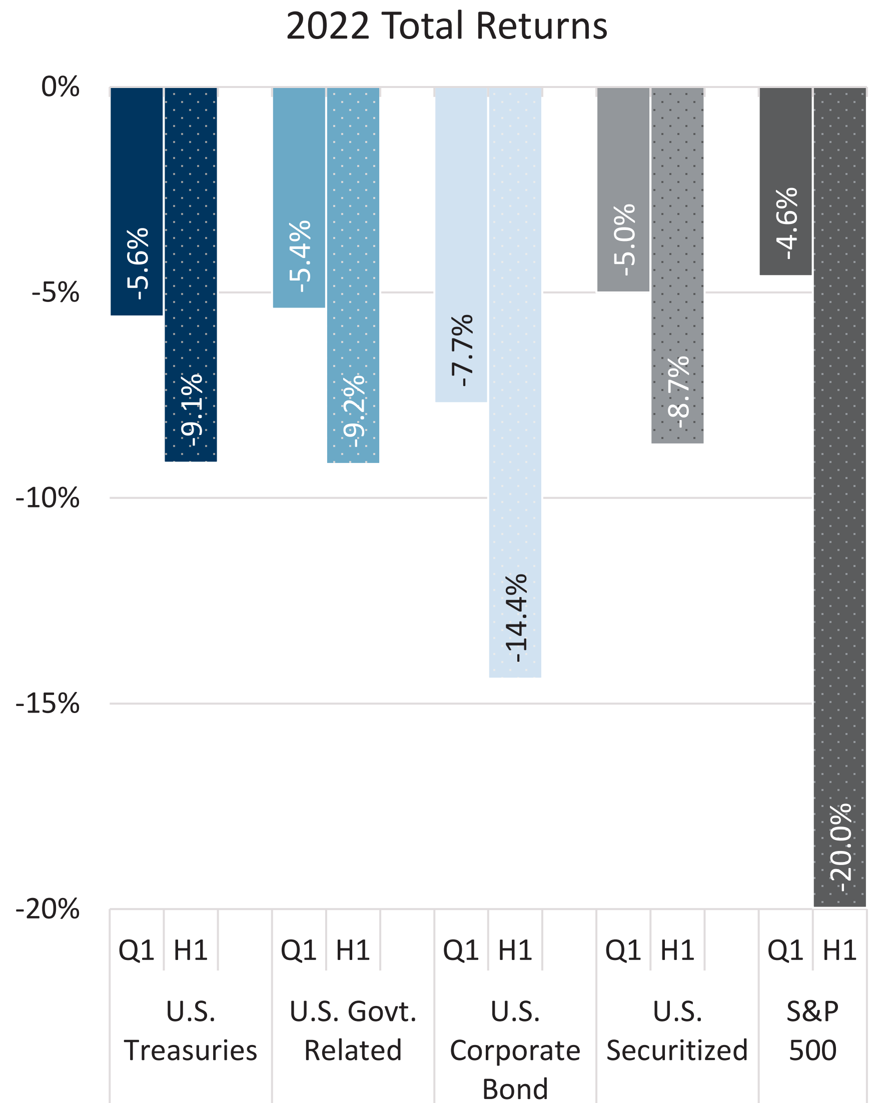
Heading into the summer months, unwavering focus will remain on inflation data and the resulting future path of monetary policy rates as central bankers attempt to engineer an economic soft landing. This will be no easy task, as this year has revealed, balancing the effects of higher interest rates on inflation versus the implications to economic growth. Fortunately, consumers and corporations began the year with favorable financial strength that may provide the Fed with a runway long enough to see inflation eventually return to their 2% target without causing an economic contraction.

Bill

Economic Outlook

Dramatic shift in U.S. yield curve continued in the second quarter, resulting in worsening total returns



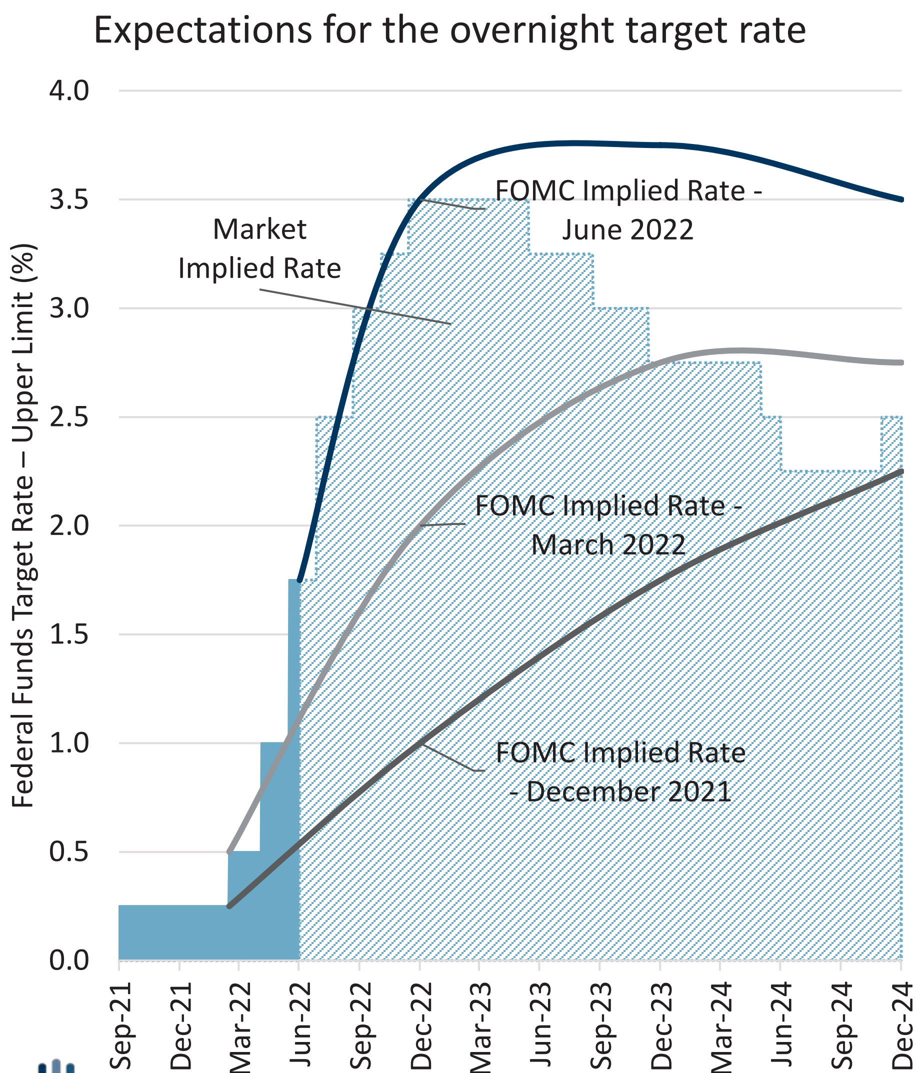


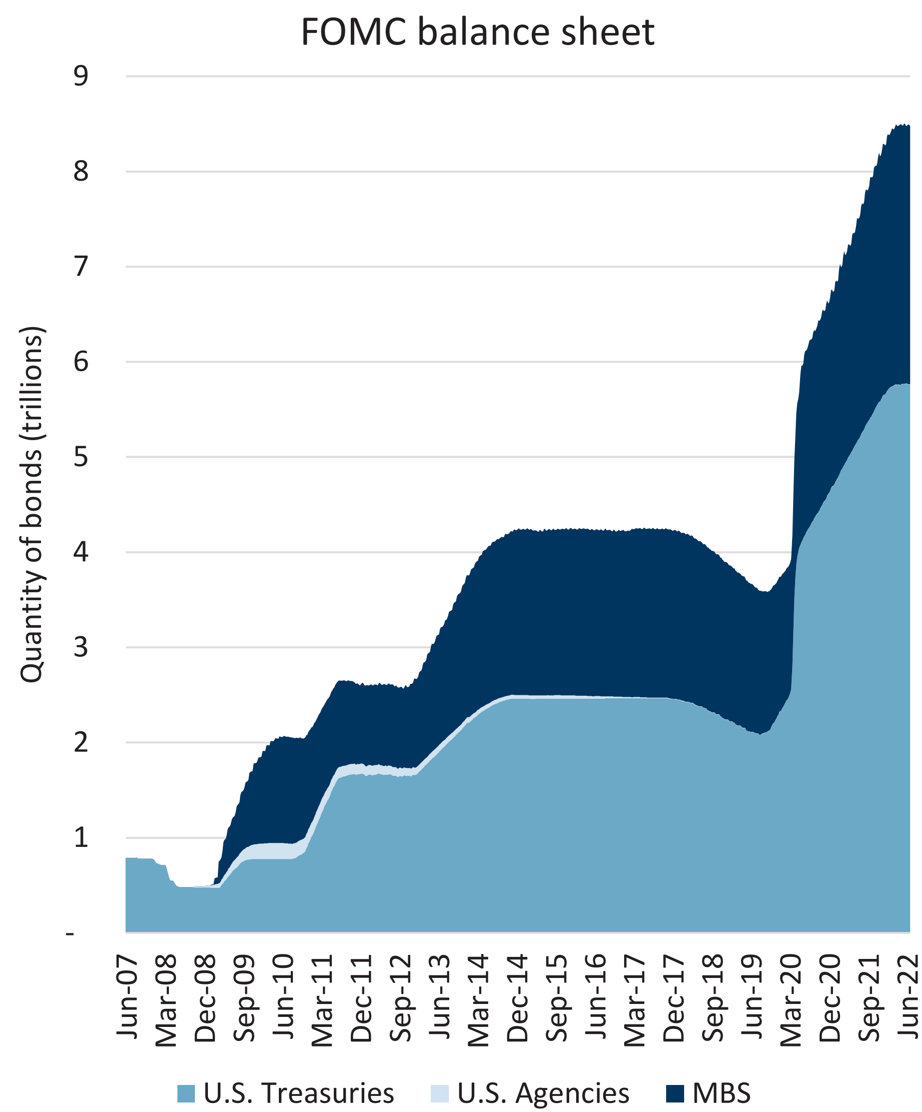
*Fixed income sectors shown are components of the Bloomberg U.S. Aggregate Bond Index

Source: Opus, Bloomberg

Economic Outlook

The Federal Reserve has reacted more aggressively to persistently high inflation than what was expected six months ago

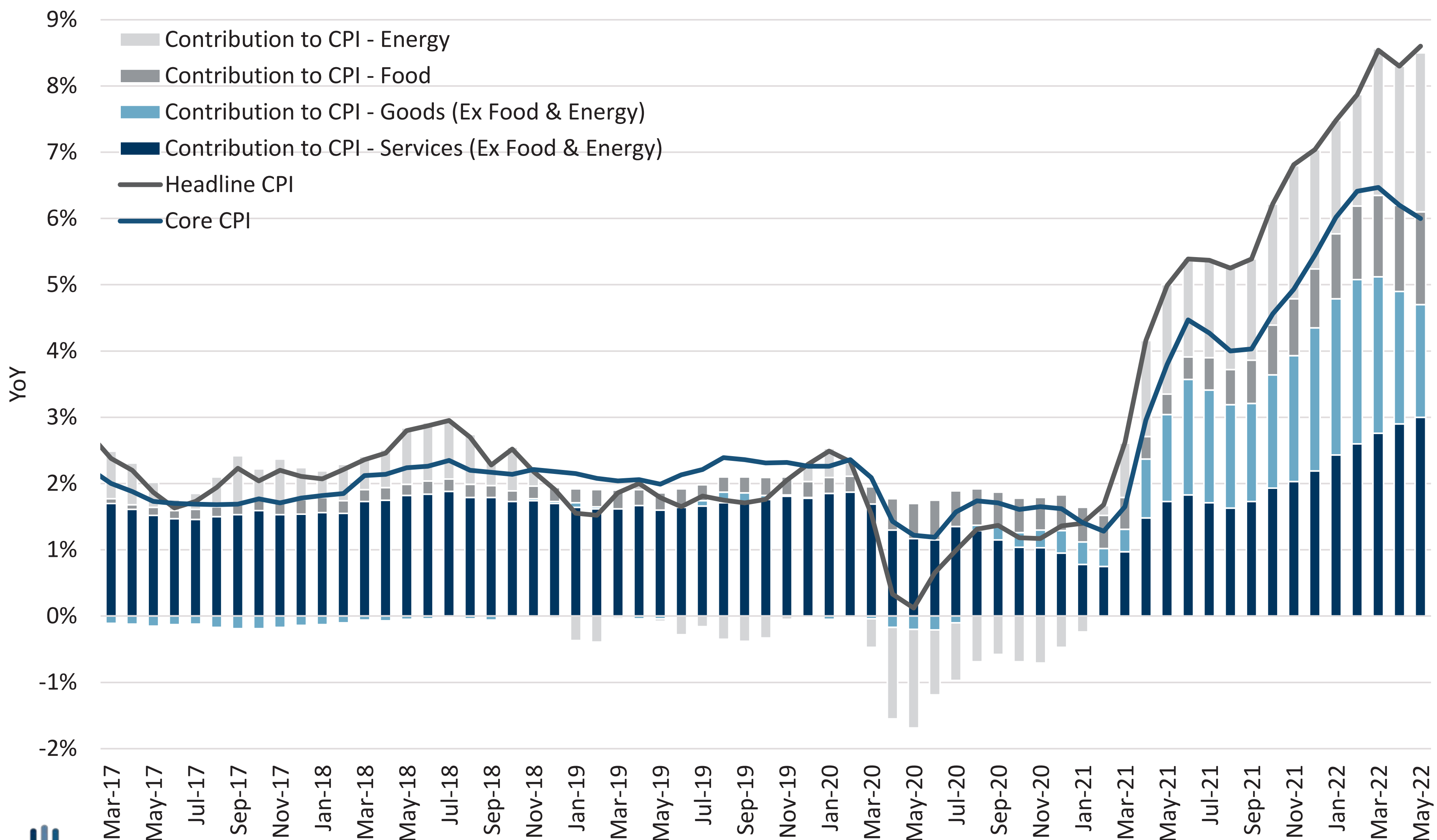




Source: Opus, Bloomberg, Federal Reserve

Economic Outlook

Unexpectedly, headline inflation hit a new 40-year high in May, while core CPI declined for the second consecutive month due to moderating goods prices

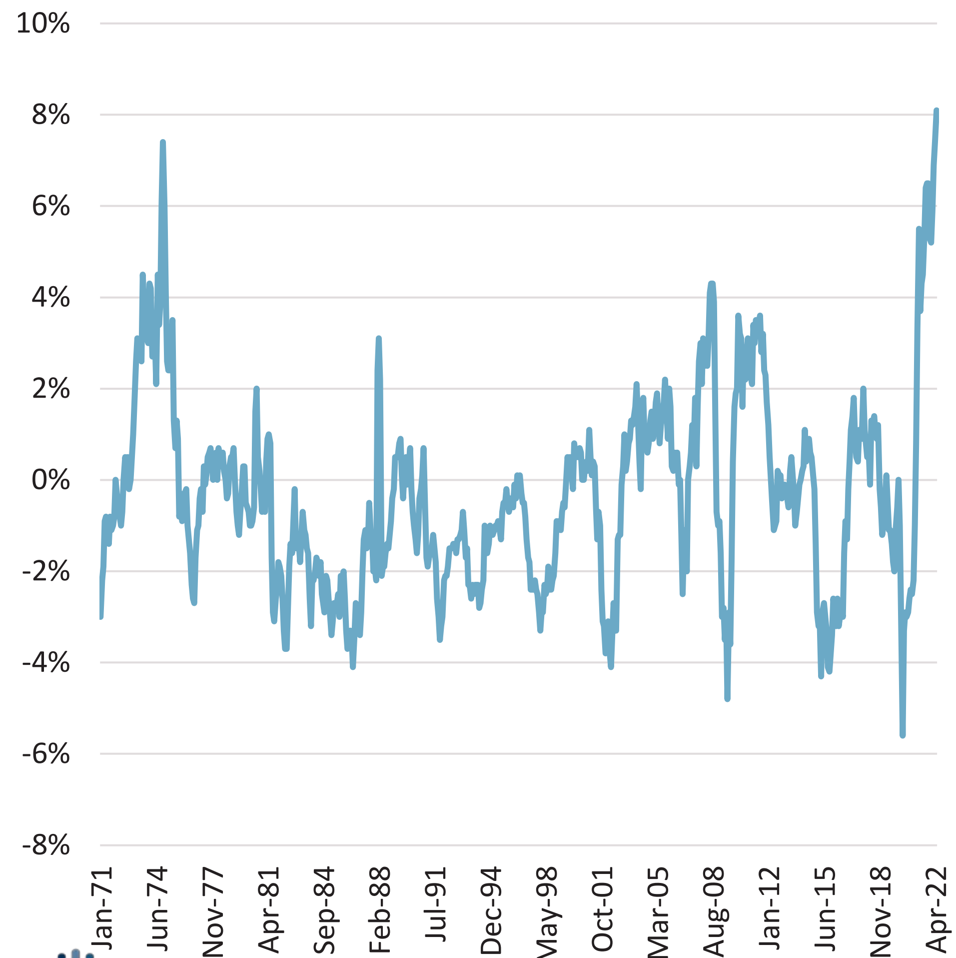


Source: Opus, Bloomberg, Bureau of Labor Statistics

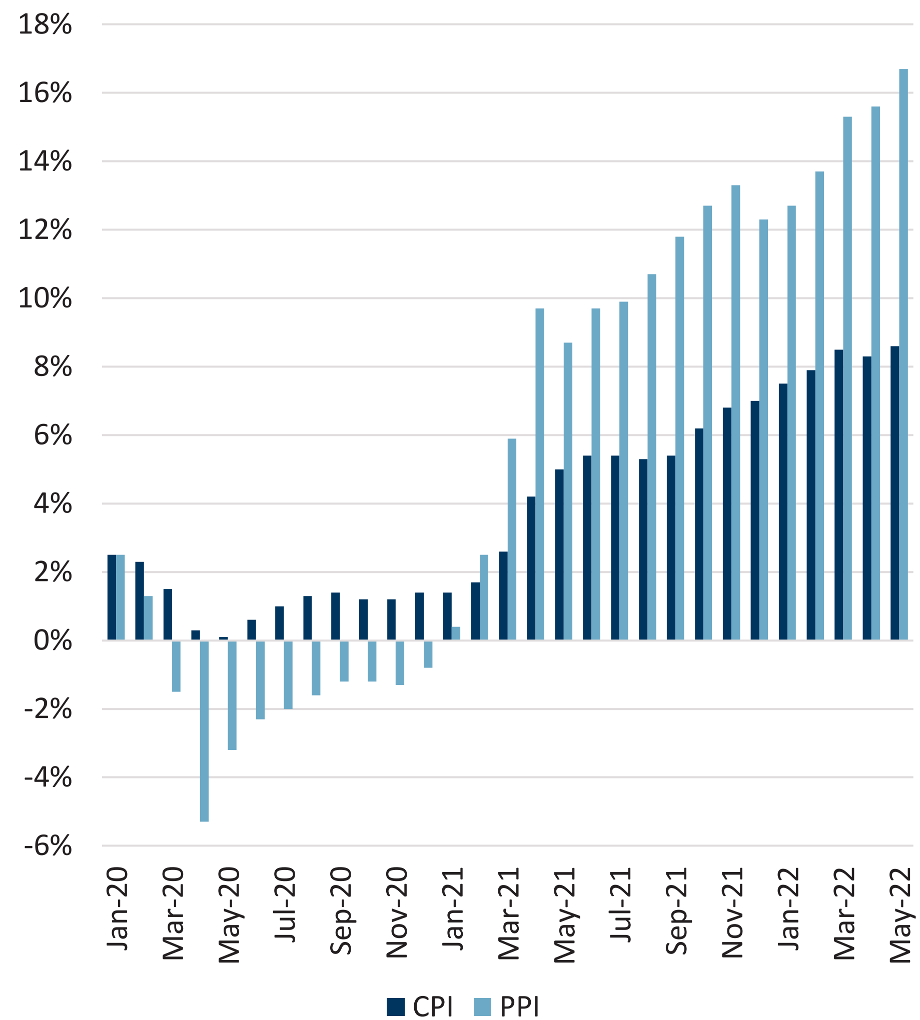
Economic Outlook

Producer prices are rising at a faster pace than consumer prices, indicating the potential for margin compression or the need to pass on price increases to consumers

Difference between producer and consumer prices at all-time high



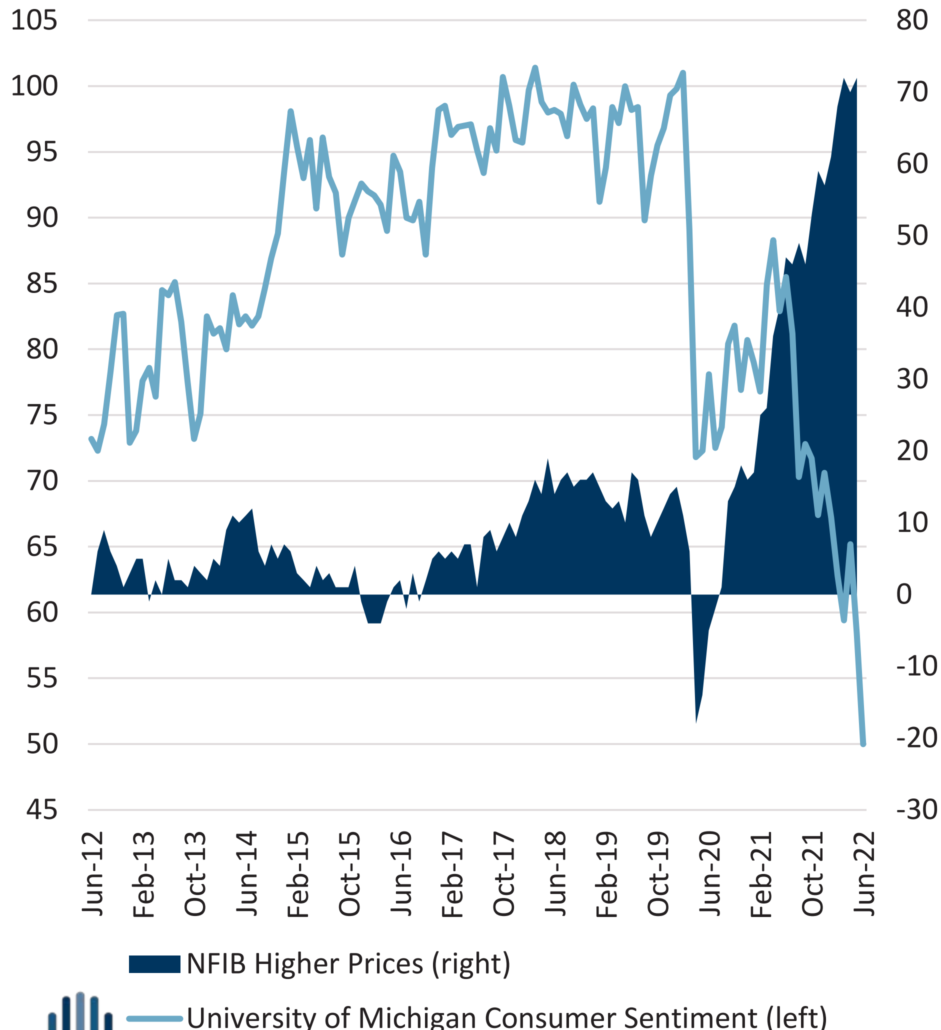
Consumer and producer price indices

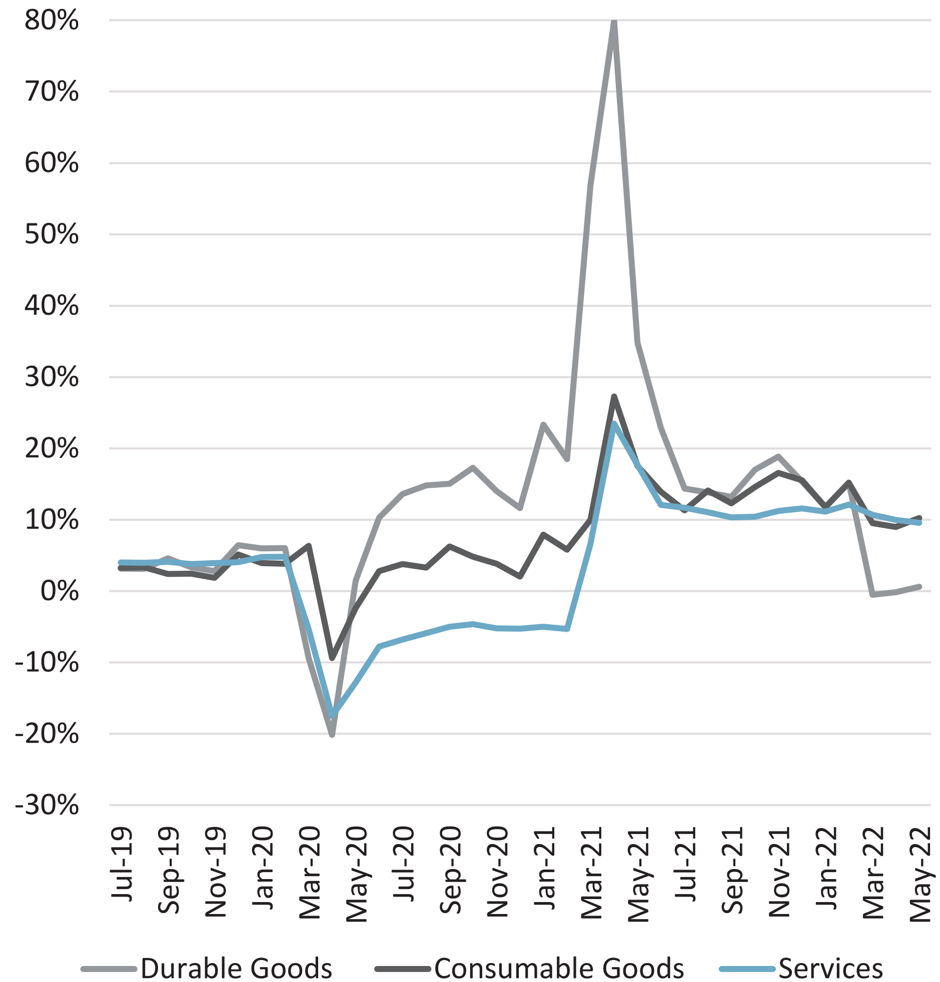


Source: Opus, Bloomberg, Bureau of Labor Statistics

Economic Outlook

In response to higher prices, sentiment hit an all-time low; however, consumer spending continues to grow, though spending patterns appear be changing

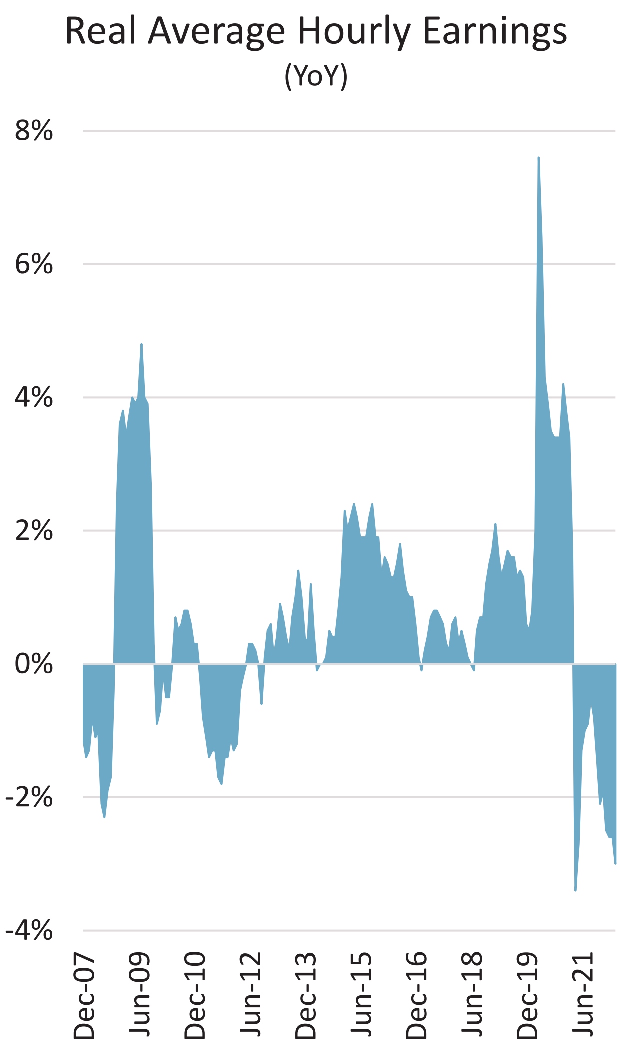


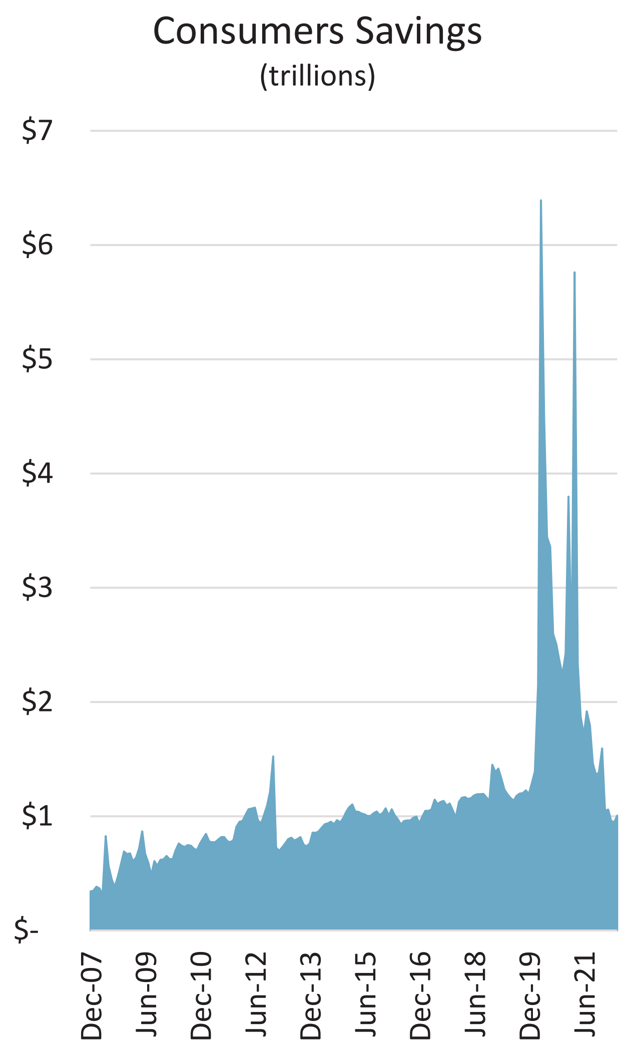


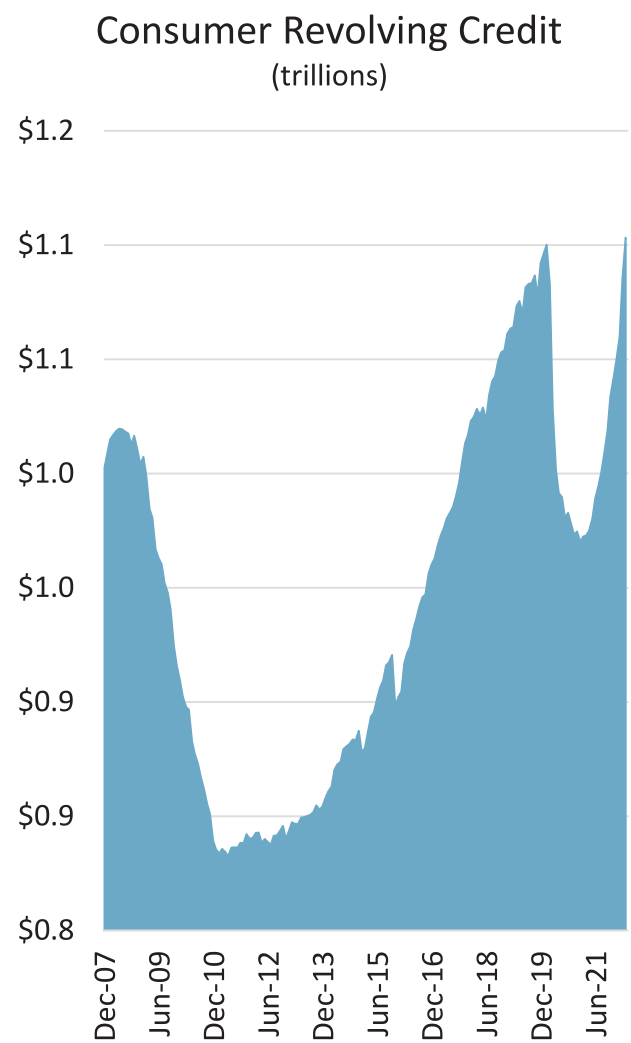
Source: Opus, Bloomberg, Bureau of Economic Analysis, National Federation of Independent Business

Economic Outlook

With inflation outpacing average hourly earnings, consumers have started to use their savings and credit cards to maintain spending habits



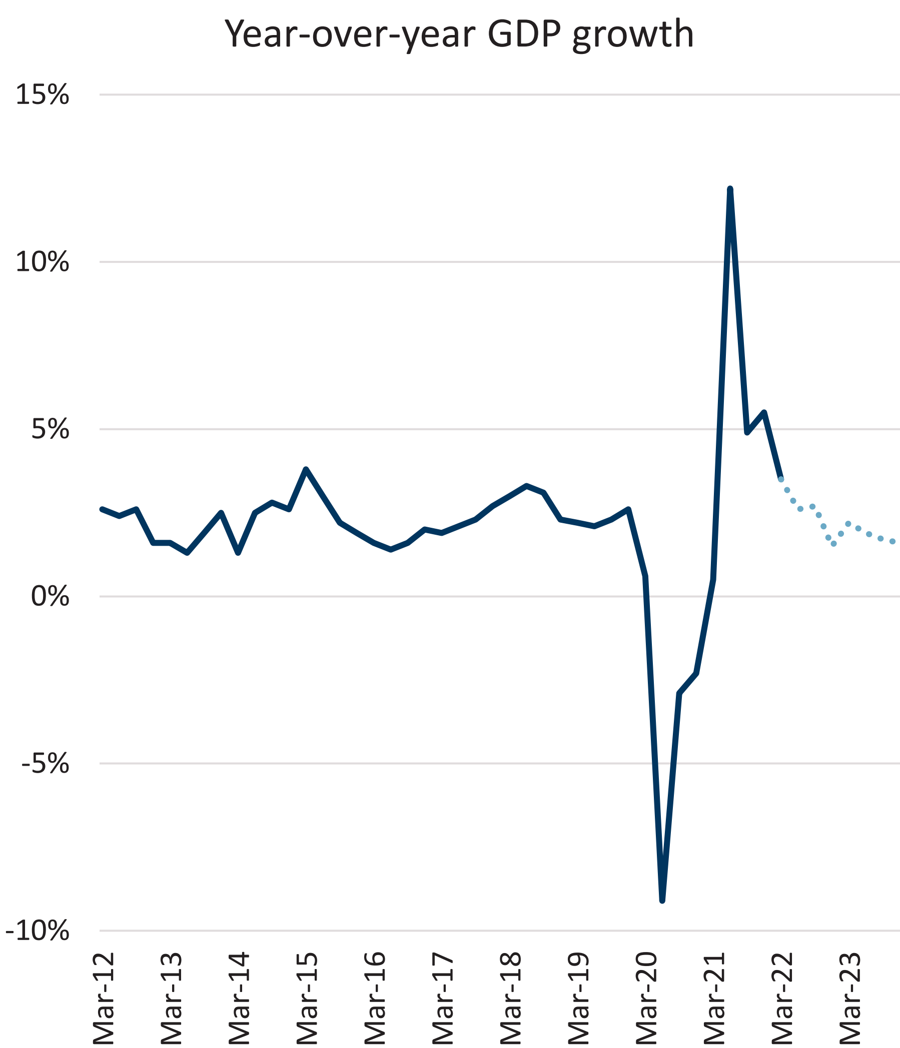


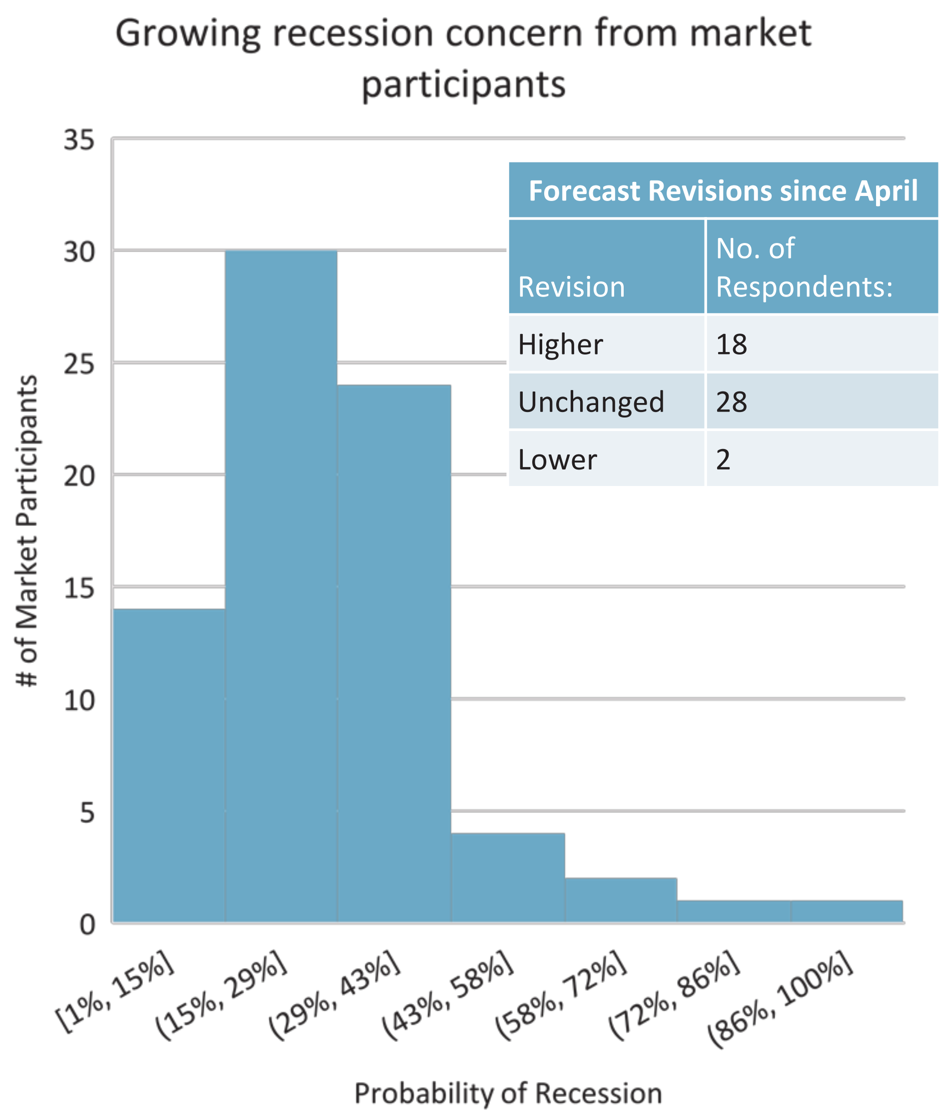


Source: Opus, Bloomberg, Bureau of Economic Analysis, Bureau of Labor Statistics

Economic Outlook

Strong labor market paves the way for more restrictive FOMC policy, dampening growth expectations and increasing forecasts for a potential recession



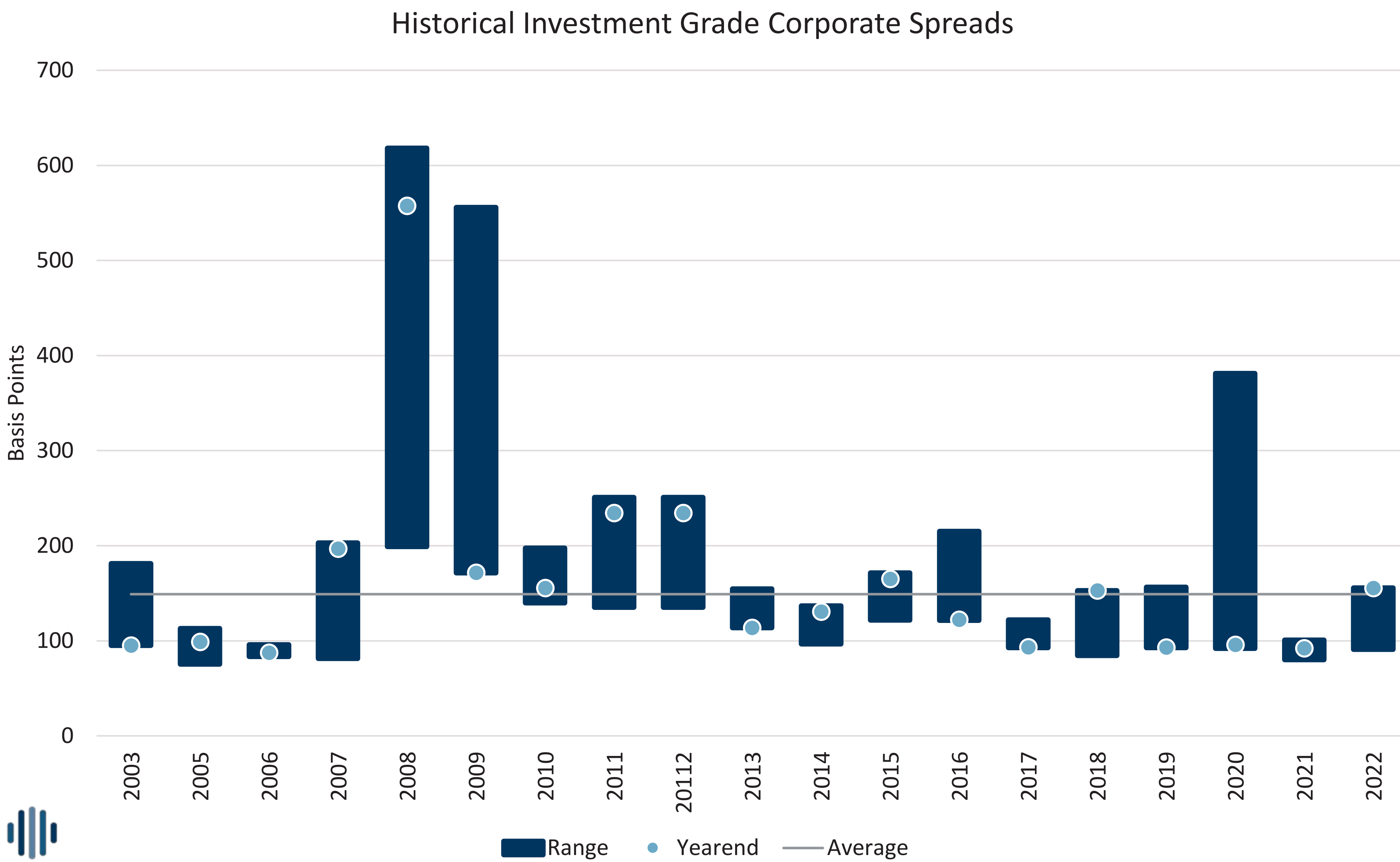


Forecast Revisions since April	
Revision	No. of Respondents:
Higher	18
Unchanged	28
Lower	2

Source: Opus, Bloomberg, Bureau of Economic Analysis

Economic Outlook

Widening corporate bond spreads reflect growing concern that tightening monetary policy could cause a recession



Source: Opus, Bloomberg

Economic Outlook

FOMC removal of accommodative monetary policy remains the primary focus of markets

The FOMC has a difficult balancing act ahead

- Inflation is expected to decline but remain above the FOMC's target during the second half of 2022, after hitting a new 40-year high of 8.6% in May
- The FOMC increased their overnight target rate by 1.5% cumulatively over the last three meetings, and is expected to continue hiking through year-end
- Lingering supply chain issues due to COVID and the war in Ukraine continue to put upward pressure on prices

Consumer trends shifting in response to higher prices

- All-time low consumer sentiment has not yet had a material impact on overall spending; however, where consumers are spending appears to be shifting
- Consumer balance sheet erosion is beginning, but from a position of strength relative to past periods of economic weakness
- Corporate bond spreads moved higher during the quarter, ending 63 basis points wider than 2021 year-end

Concern of policy misstep has amplified market volatility

- The S&P 500 fell into bear market territory during the second quarter as concern over the possibility of a U.S. recession increased
- The yield curve continued to shift higher and flatten in response to the higher-than-expected inflation figures for May
- Upcoming midterm elections during a period of heightened polarization in the U.S. present a potential source of additional market volatility

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