OPUS INVESTMENT MANAGEMENT

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Quarterly Commentary

June 30, 2023

Executive Summary

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MARKET COMMENTARY

Compared to the prior quarter, the second quarter brought relative calm as the U.S. economy showed resilience in the face of the lagged effects of tightening monetary policy and stress in the banking sector. This caused a re-examination of whether the Federal Reserve may be able to achieve a soft landing, defined as an economic slowdown that does not result in a recession. Some economists increased the likelihood of the Federal Reserve achieving their soft-landing objective while others merely shifted the timing of a forecasted mild recession to later periods. Despite the failure and arranged purchase of First Republic Bank in late April, the banking sector continued stabilize and concern of a large-scale banking crisis decelerated. Against this backdrop, the Federal Reserve paused rate hikes in June for the first time after ten consecutive hikes but has maintained a hawkish tone indicating future hikes are likely. In response to this, Treasury yields gradually moved higher; with shorter maturities seeing the largest increase, causing the yield curve inversion to retest the wides seen in early March. Ultimately, this resulted in negative total returns for fixed income sectors. The Bloomberg U.S. Aggregate Bond Index returned -0.84% during the quarter while the S&P 500, returned over 8%.

Within the banking sector, utilization of the Federal Reserve's liquidity programs has gradually decreased throughout the quarter but remains at elevated levels indicating banks are still under pressure. As banks grapple with lower deposit levels, they have tightened lending standards for both individuals and businesses which is likely to limit economic activity. Tighter lending standards combined with higher interest rates are pressuring commercial real estate values and by extension borrowers. Commercial mortgage delinquencies have begun to increase, off a low base. Some commercial borrowers have opted to turn over their keys to lenders, though we do not believe this will become the prevailing trend. We expect high-quality, well-located commercial properties to remain healthy, but more broadly commercial real estate is likely to remain pressured over the near term.

While many leading economic indicators have been signaling an imminent U.S. recession, the U.S. economy has remained resilient in the face of historic shifts in monetary policy and stubbornly high core inflation. Consumers have been the primary source of that strength by continuing to spend, though at a more measured pace than in recent periods. They have been funding this spending by utilizing credit and excess savings from the pandemic years; a practice that is unsustainable over the long term if inflation continues to outpace wage growth. Consumer confidence and willingness to spend are likely buoyed by the persistent strength seen in the labor market. In May, the participation rate for prime working age individuals reached a 20-year high. Notably, this was an all-time high for women. At the same time the unemployment rate remains near 50-year lows. Layoffs however have been increasing at the same time small business hiring intentions have been falling, which may indicate cracks in labor market strength could be forming.

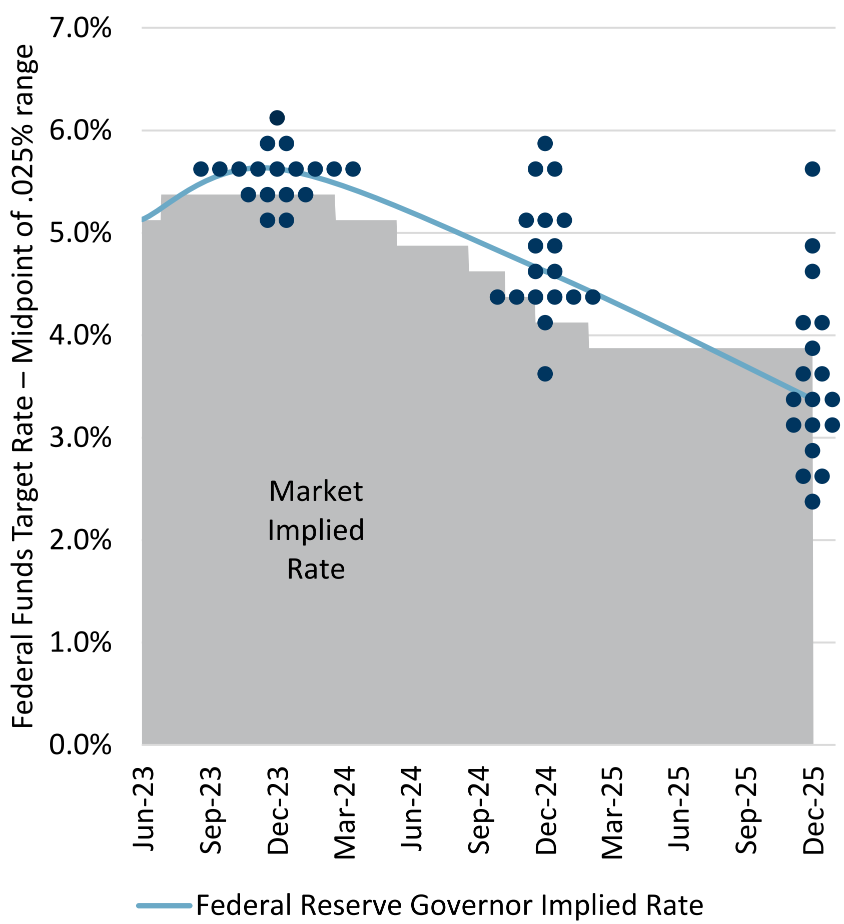
The cumulative effects of these potential headwinds to economic activity could prove a difficult challenge for the U.S. economy to overcome, but it is Opus's belief that the possibility of a soft landing has increased, and any potential recession is likely to be mild and not to occur this year.

Bill

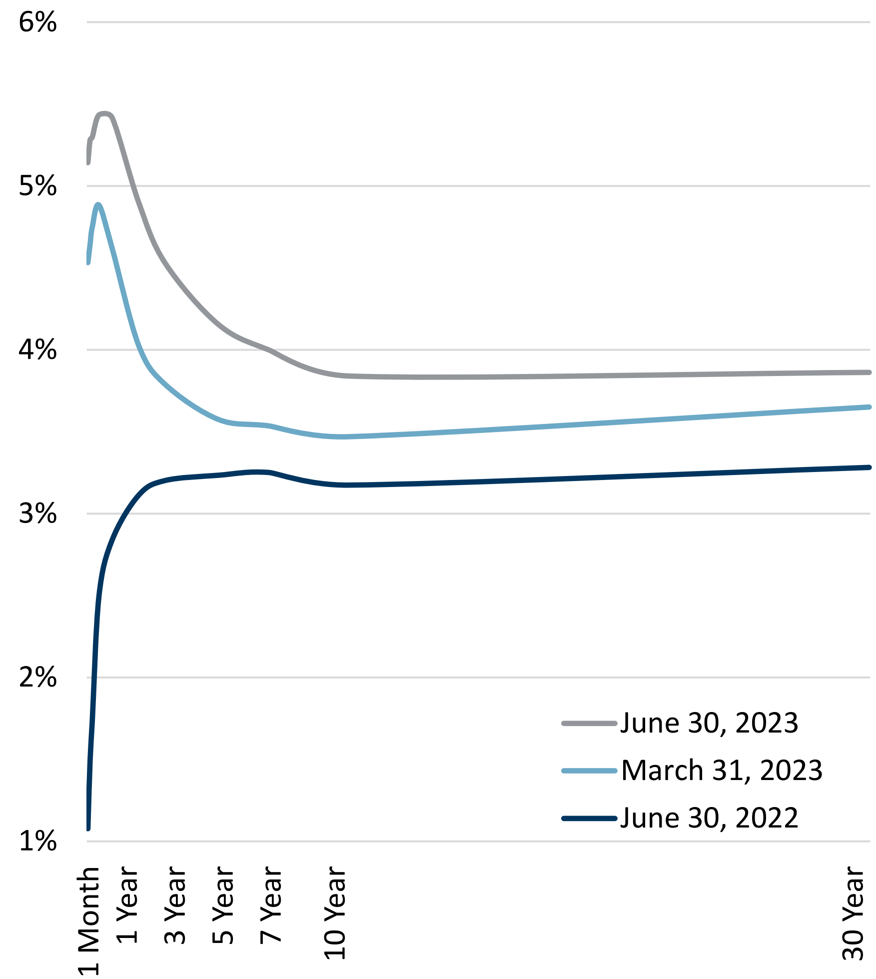
Economic Outlook

As the FOMC messages that additional rate hikes are likely, market expectations have also shifted higher; coming more in-line with FOMC guidance

Expectations for the FOMC Overnight Target Rate



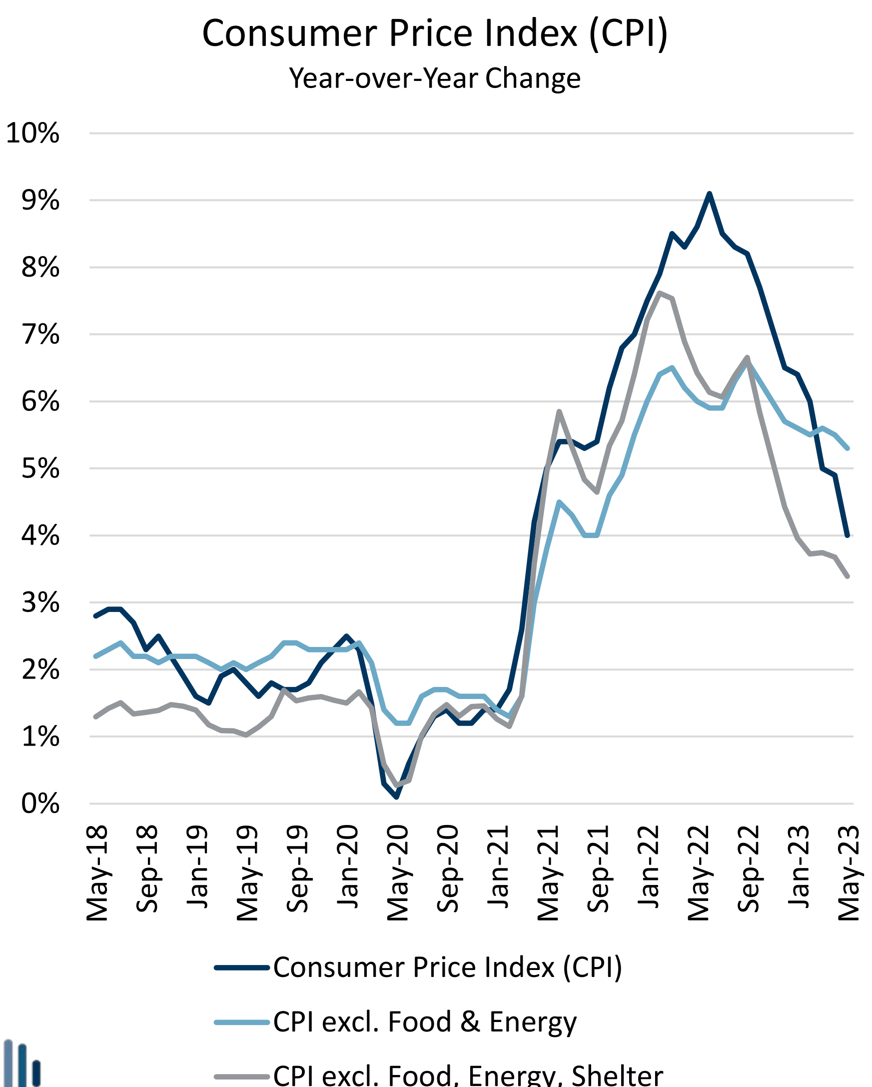
U.S. Yield Curve

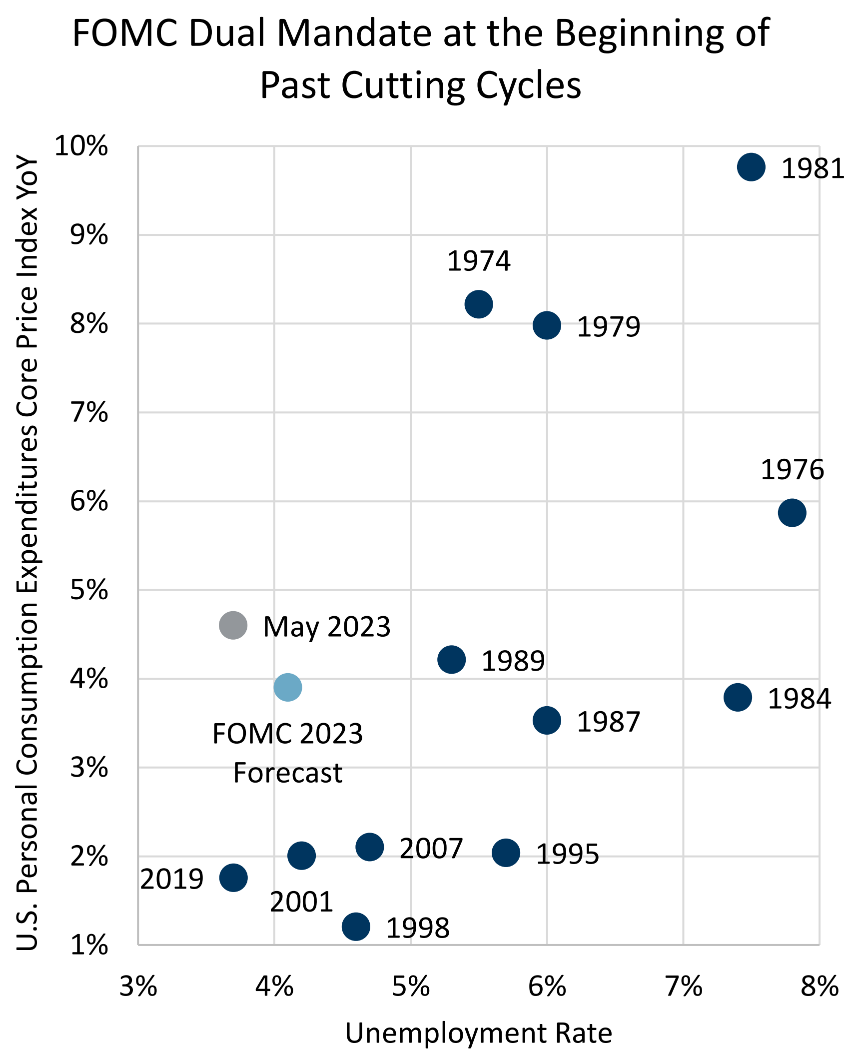


Source: Opus, Bloomberg, Federal Reserve

Economic Outlook

Current levels of core inflation and unemployment do not support rate cuts by the FOMC in the immediate future

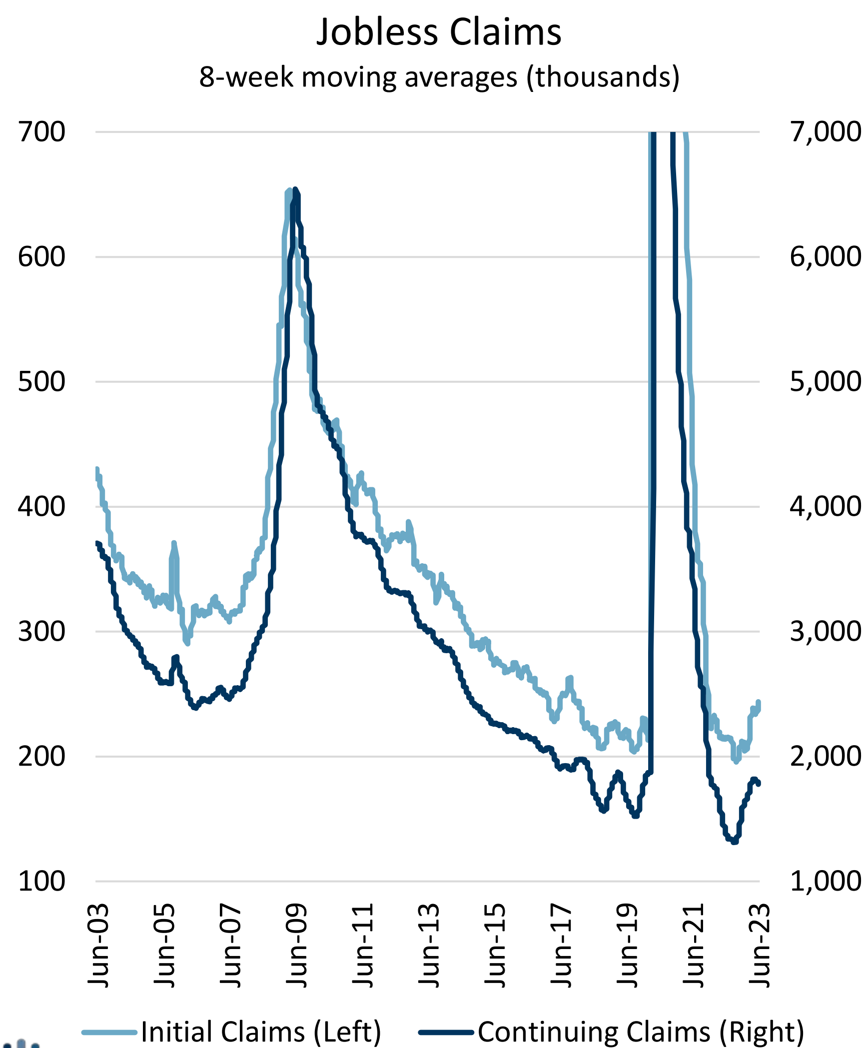


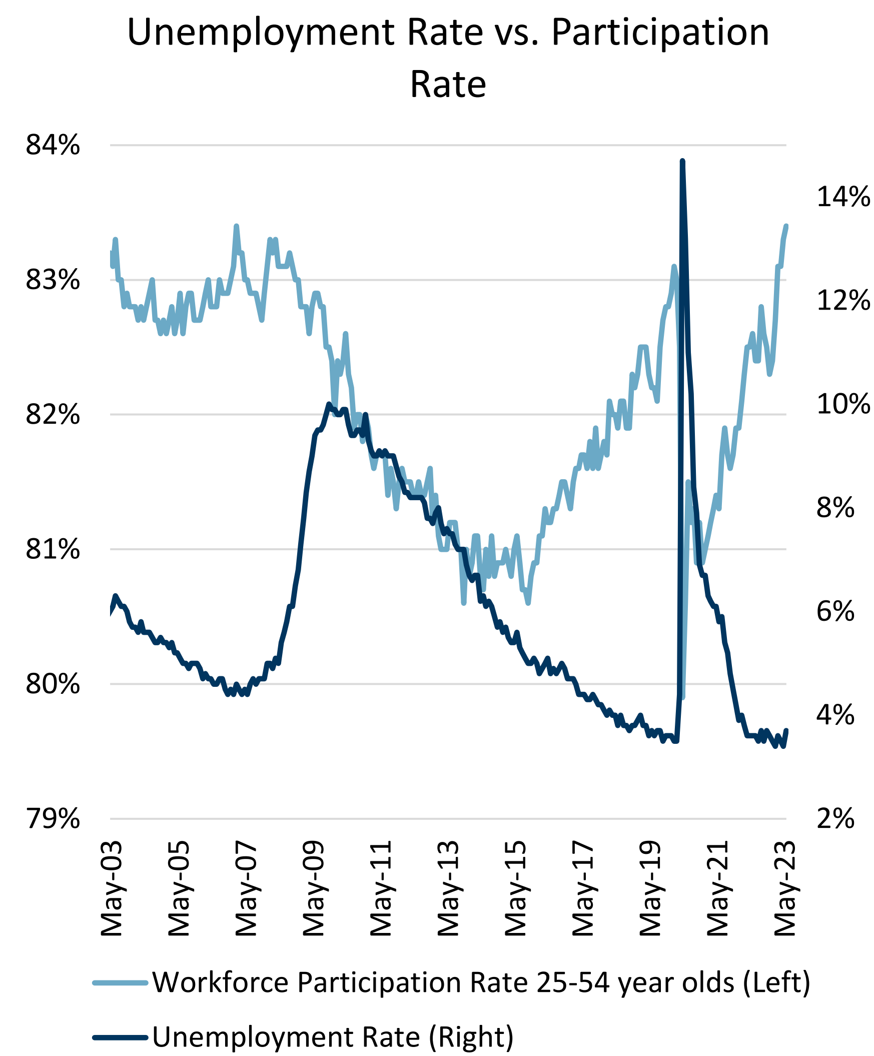


Source: Opus, Bloomberg, U.S. Bureau of Labor Statistics, U.S. Bureau of Economic Analysis

Economic Outlook

Labor market strength persists, supported by the prime participation rate at a 20-year high while the unemployment rate and jobless claims remain near historic lows

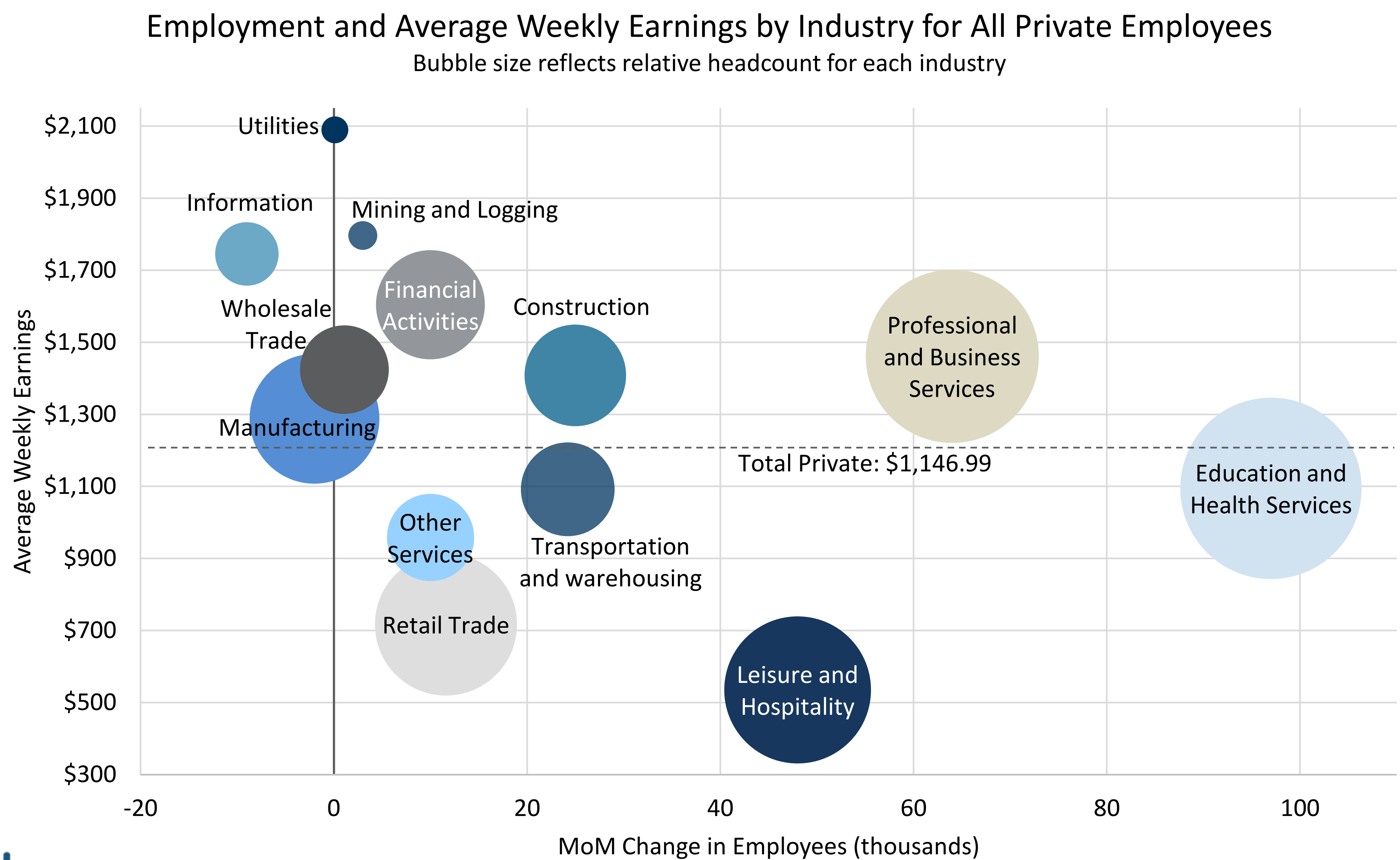




Source: Opus, Bloomberg, U.S. Bureau of Labor Statistics

Economic Outlook

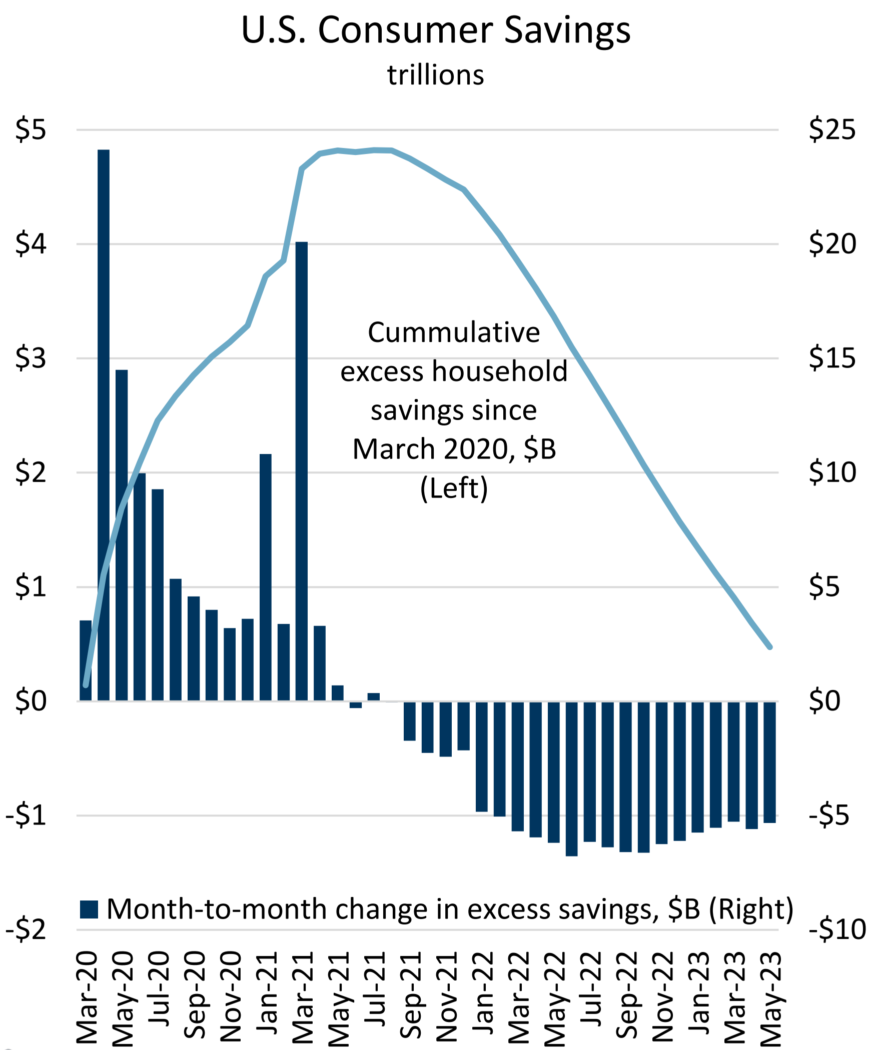
Job losses have largely been focused in industries with high wages, but low headcounts; while industries with lower wages and higher headcounts continue to hire

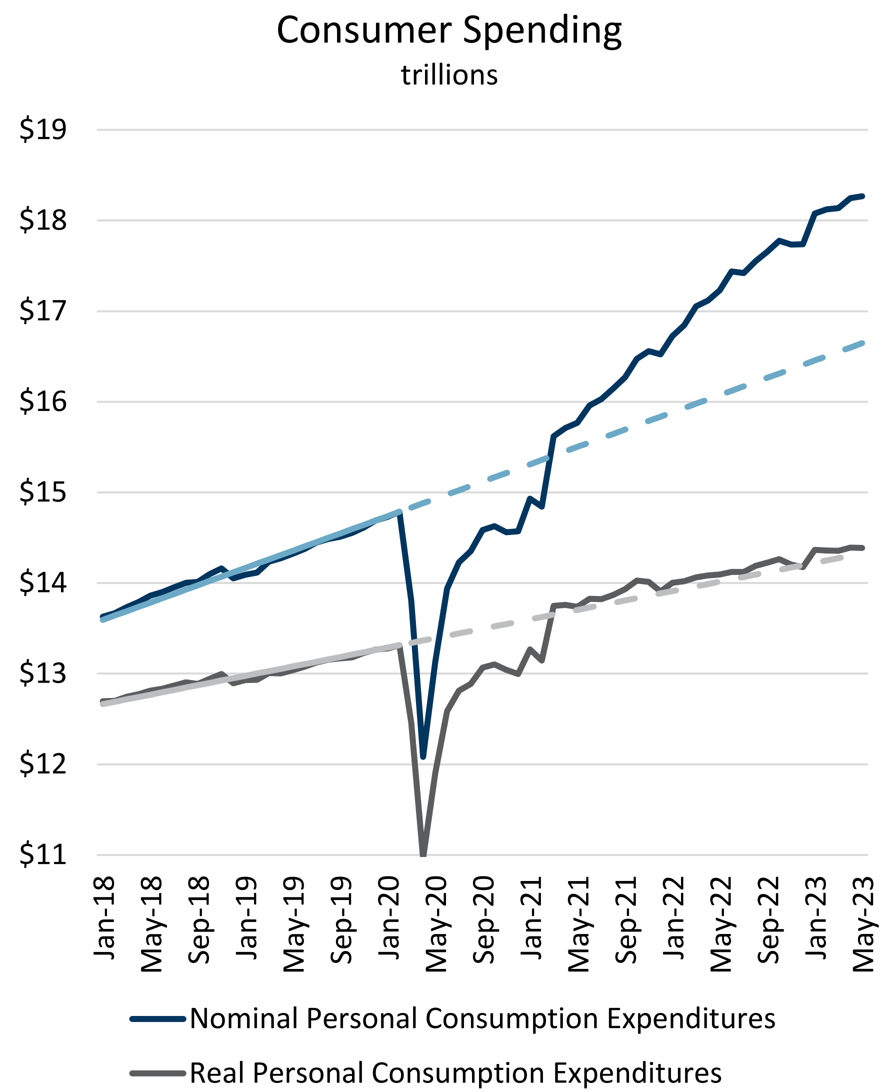


As of May 31, 2023
Source: Opus, Bloomberg, U.S. Bureau of Labor Statistics

Economic Outlook

Consumers are spending down excess savings due to higher prices, not because they are buying more



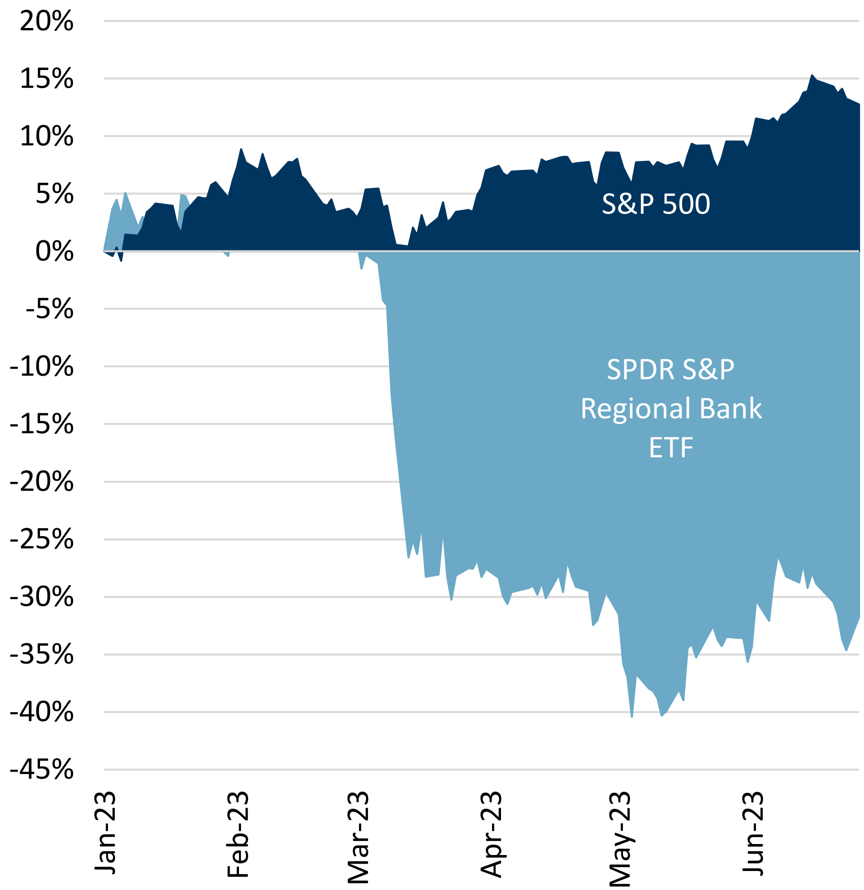


Source: Opus, Bloomberg, U.S. Bureau of Economic Analysis

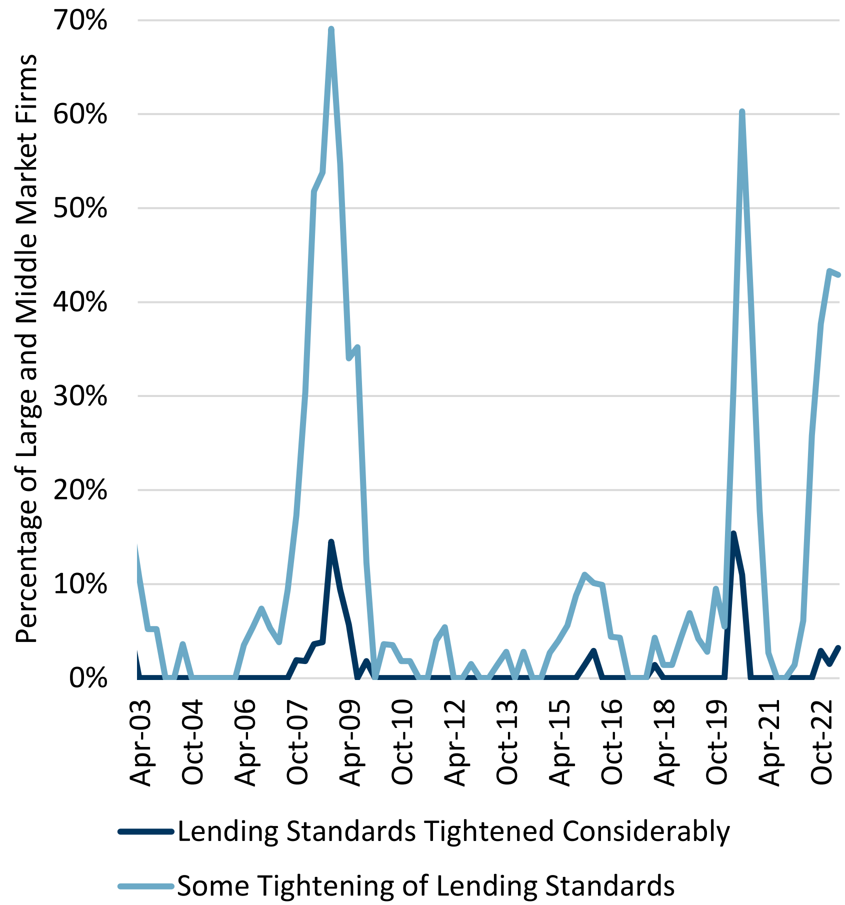
Economic Outlook

Stress at regional banks remains heightened, which could pressure economic activity by decreasing availability of credit to small businesses

Cumulative 2023 First Quarter Equity Price Returns



Senior Loan Officer Survey – Lending Standards for Commercial and Industrial Credit

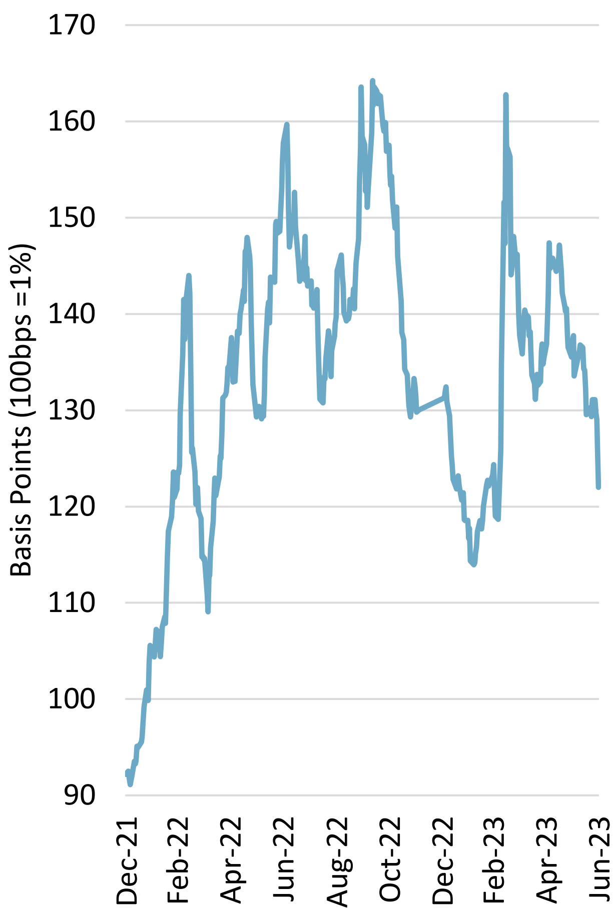


Source: Opus, Bloomberg, Federal Reserve

Economic Outlook

Corporate bond spreads widened quickly in response to banking stress in March, but did not surpass the highs of late-2022; remaining elevated due primarily to financials

Investment Grade Corporate Bond Spreads



As of June 30, 2023	**Current Spread (Basis Points 100bp=1.00%)**					
Duration Bucket	1 - 3 Yr	3 - 5 Yr	5 - 7 Yr	7 - 10 Yr	10 - 15 Yr	15+ Yr
Corporate	**90**	**139**	**174**	**183**	**215**	**191**
Financial Institutions	127	178	214	205	221	201
Industrial	66	115	157	172	213	187
Utility	84	125	157	176	214	200

	Three Month Spread Change (bps)					
Duration Bucket	1 - 3 Yr	3 - 5 Yr	5 - 7 Yr	7 - 10 Yr	10 - 15 Yr	15+ Yr
Corporate	**-26**	**-22**	**-19**	**-14**	**-14**	**-15**
Financial Institutions	-45	-29	-24	-19	-18	-17
Industrial	-16	-19	-19	-14	-15	-16
Utility	-13	-10	-10	-5	-9	-9

Source: Opus, Bloomberg

Economic Outlook

The potential for a soft-landing seems to have increased despite restrictive monetary policy

FOMC hiking cycle is nearing an end, but additional hikes are likely

- Inflation continues to moderate, but core inflation has not declined as quickly as headline and remains well above the FOMC's long-term target
- Additional rate hikes are expected later this year; however, both the FOMC and markets are forecasting cuts in 2024
- Stress in the banking sector and even higher rates could pressure interest rate sensitive areas of the economy further

Consumers have been the ballast of the U.S. economy, though this may be unsustainable

- Consumer spending has remained strong despite high prices; many are utilizing savings and credit cards to do so
- Removal of pandemic-related assistance, such as the resumption of student loan repayment, will further pressure consumers' balance sheets
- Labor market strength persists with unemployment remaining near the 50-year low and job openings remain prevalent

GDP is expected to remain positive but low over the next year

- The S&P 500 rose 16.9% during the first half of 2023, driven higher predominantly by technology stocks
- Spreads on corporate bonds initially rose during the second quarter, but ultimately ended the quarter lower
- We continue to monitor sources of potential volatility and geopolitical risk; such as U.S. election season, Russian Ukrainian conflict, tensions with China

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