OPUS
INVESTMENT MANAGEMENT

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Quarterly Commentary

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Executive Summary

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MARKET COMMENTARY

The toxic cocktail of persistent inflation, higher rates and declining growth expectations continued to roil the capital markets over the summer resulting in the third consecutive quarter of negative returns for both fixed income and equity markets. Despite a period of relative calm at the outset of the quarter that saw Treasury yields decline and equity prices rise, asset prices easily reversed these gains on stronger inflation data and revised projections by a resolute Federal Reserve committed to taming inflation. As of the end of the quarter, 2-year Treasury yields had risen an astonishing 355 basis points year-to-date while the 10-year Treasury rose 232 basis points over the same period. Although it's not a perfect harbinger of a recession, these rate moves have resulted in an inverted yield curve (short-term yields being higher than longer-term yields) which generally precedes a recession and can shake investor confidence – which it did as most credit sensitive fixed income sectors underperformed. In the end, the Bloomberg U.S. Aggregate Bond Index declined 4.75% during the quarter.

After peaking at 9.1% in June, the Consumer Price Index (CPI) showed some early signs of cooling – though it remained elevated – mainly due to declining commodity prices, specifically oil and gasoline. However, what troubled investors and Fed governors was the rise in core inflation data (CPI excluding energy and food) which reversed a series of declines that began back in March. Most of the pickup in core inflation data came from rising shelter costs. With mortgage rates currently close to 7% and after consecutive years of strong home price appreciation, a lack of affordability may cool the housing market; though this could be offset by higher rents as the demand for rental properties may grow.

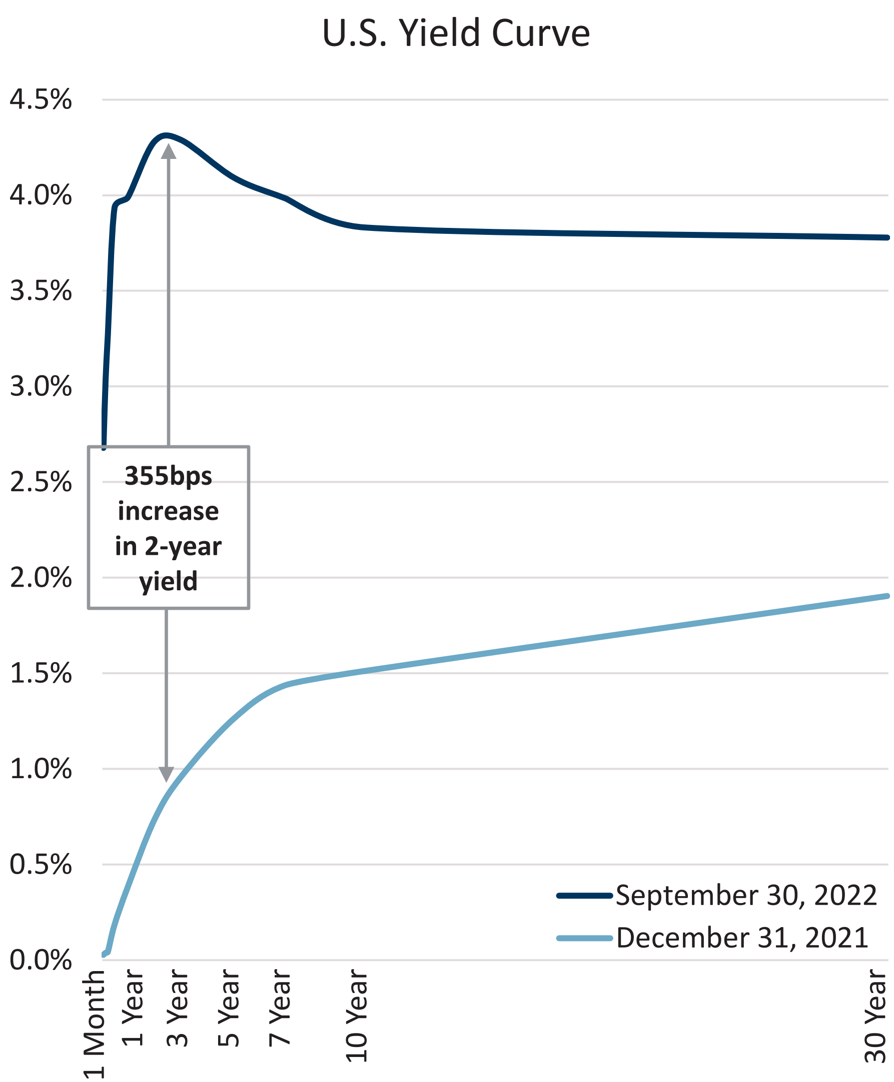
With a strong labor market providing cover to take a firm stance to combat inflation, the Fed increased the overnight rate an additional 75 basis points in both July and September, bringing the cumulative rate hikes to 300 basis point for the year. The September meeting also included updated projections by the Fed governors which indicated that there could be an additional 125 basis points of rate increases before year end. Interestingly, the Fed's projections show one additional hike in 2023 before forecasting a reduction in rates taking place in 2024. Correspondingly, the Fed's projections of economic growth were revised downward with real GDP growth expected to be only 0.2% for 2022 and below 2% for the next two years. This highlights investor concern of the difficulty in engineering a soft landing and helps explain the volatility we have witnessed this year. Clearly, the evolution of monetary policy – both rates and balance sheet – will be the focus of investors for the foreseeable future.

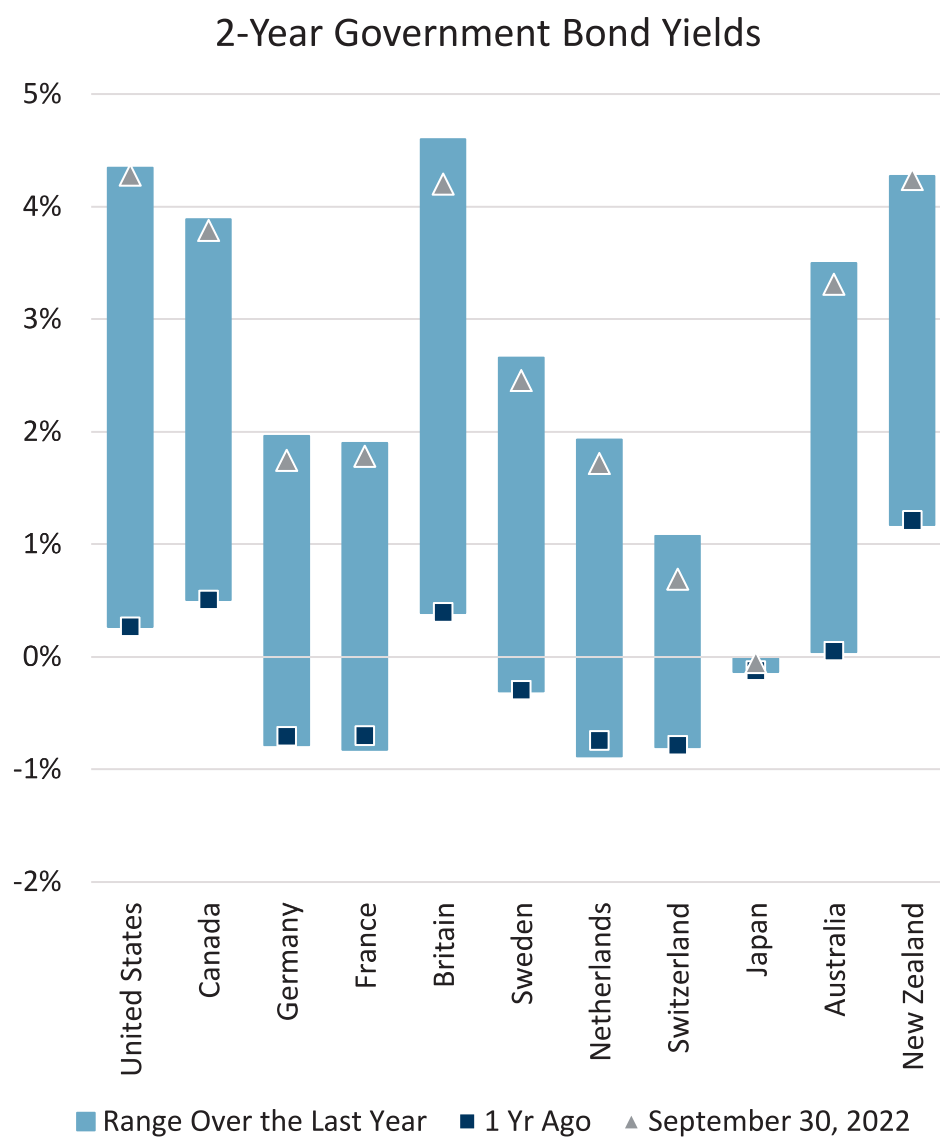
Offsetting the outlook for slower growth and the rising probability of a recession is the strength so far exhibited by the consumer. With excess savings from fiscal policies during the pandemic and rising wages, consumer spending has been resilient. Credit metrics for investment grade corporations are strong and balance sheet discipline has been a focus with companies experiencing slowing revenue and earnings growth. As fixed income investors who anguished through years of low investment yields, the ability to invest at higher yields in highly rated securities is a welcome opportunity.

Bill

Economic Outlook

Interest rates have shifted higher globally as central banks battle high inflation

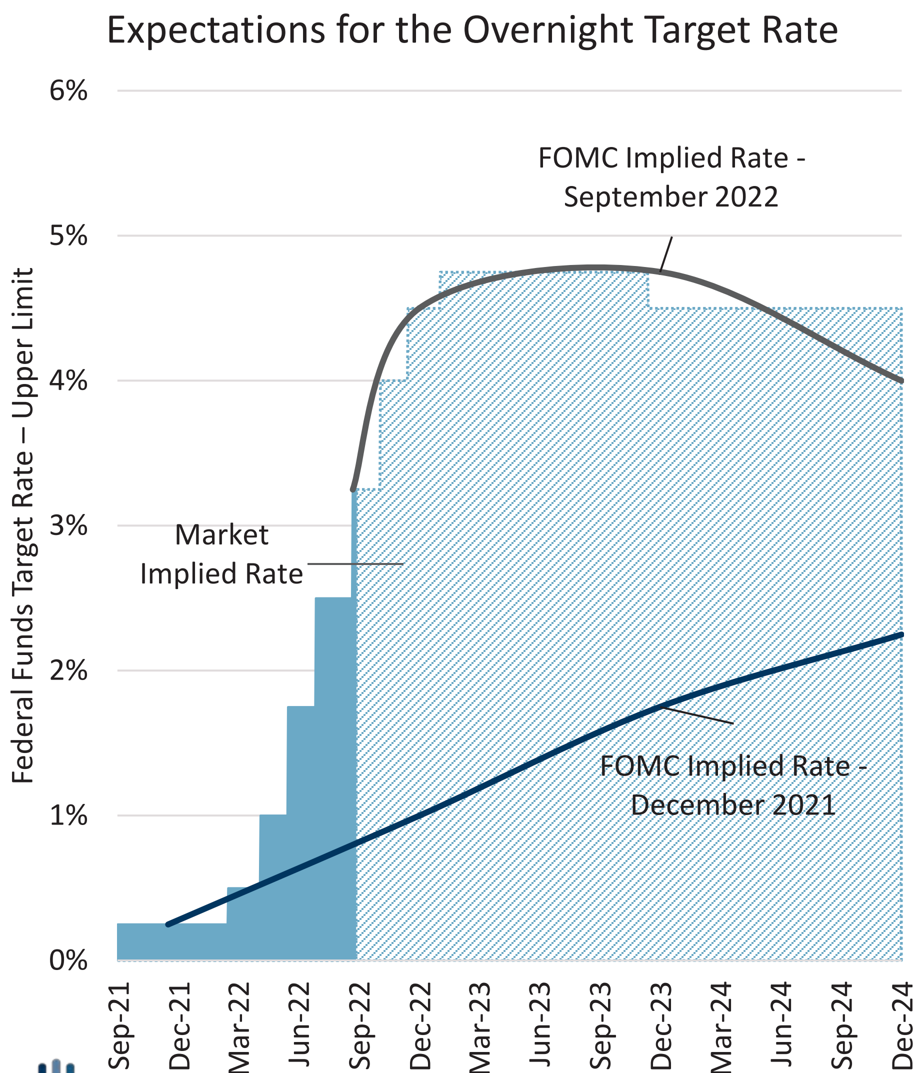


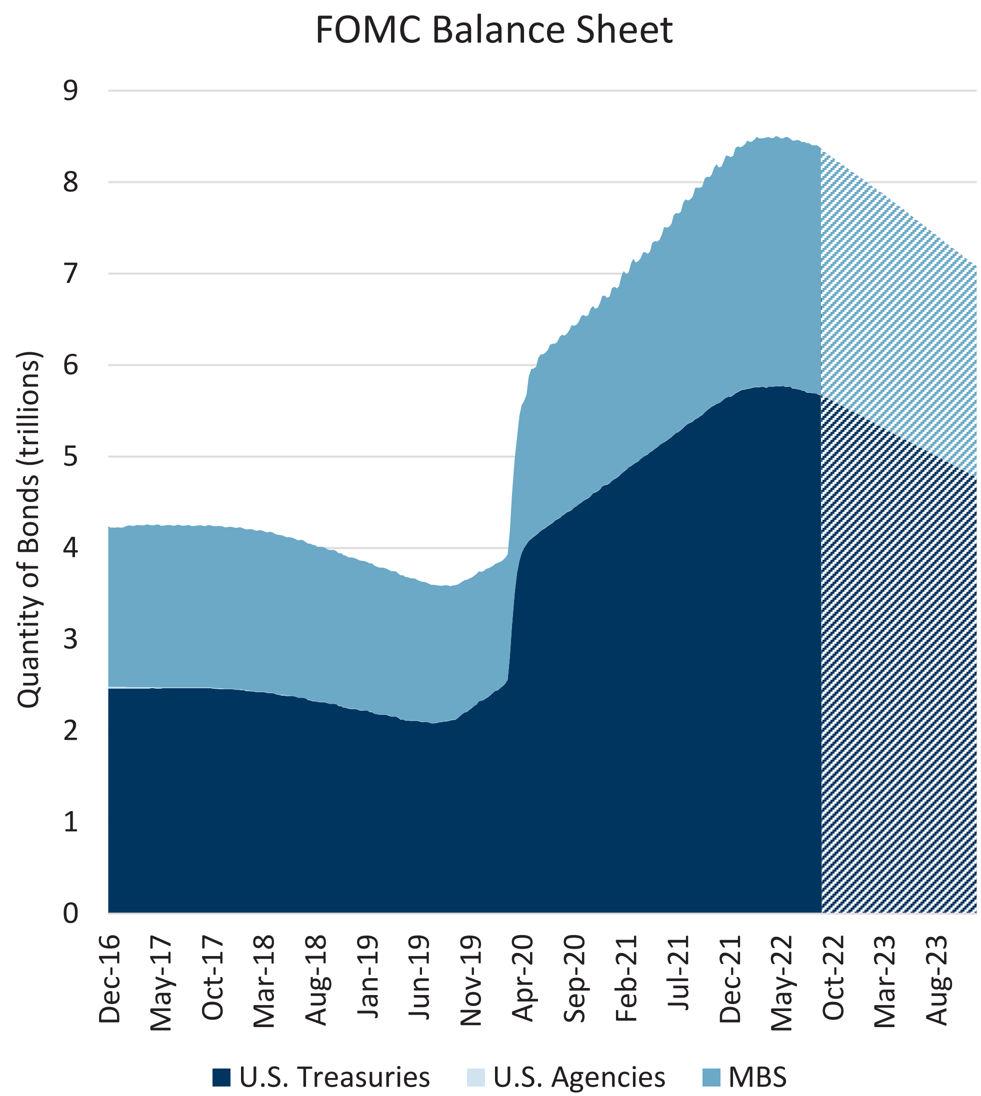


Source: Opus, Bloomberg

Economic Outlook

Monetary policy tightening is expected to continue into 2023 through rate hikes and the wind down of securities held by the Federal Reserve

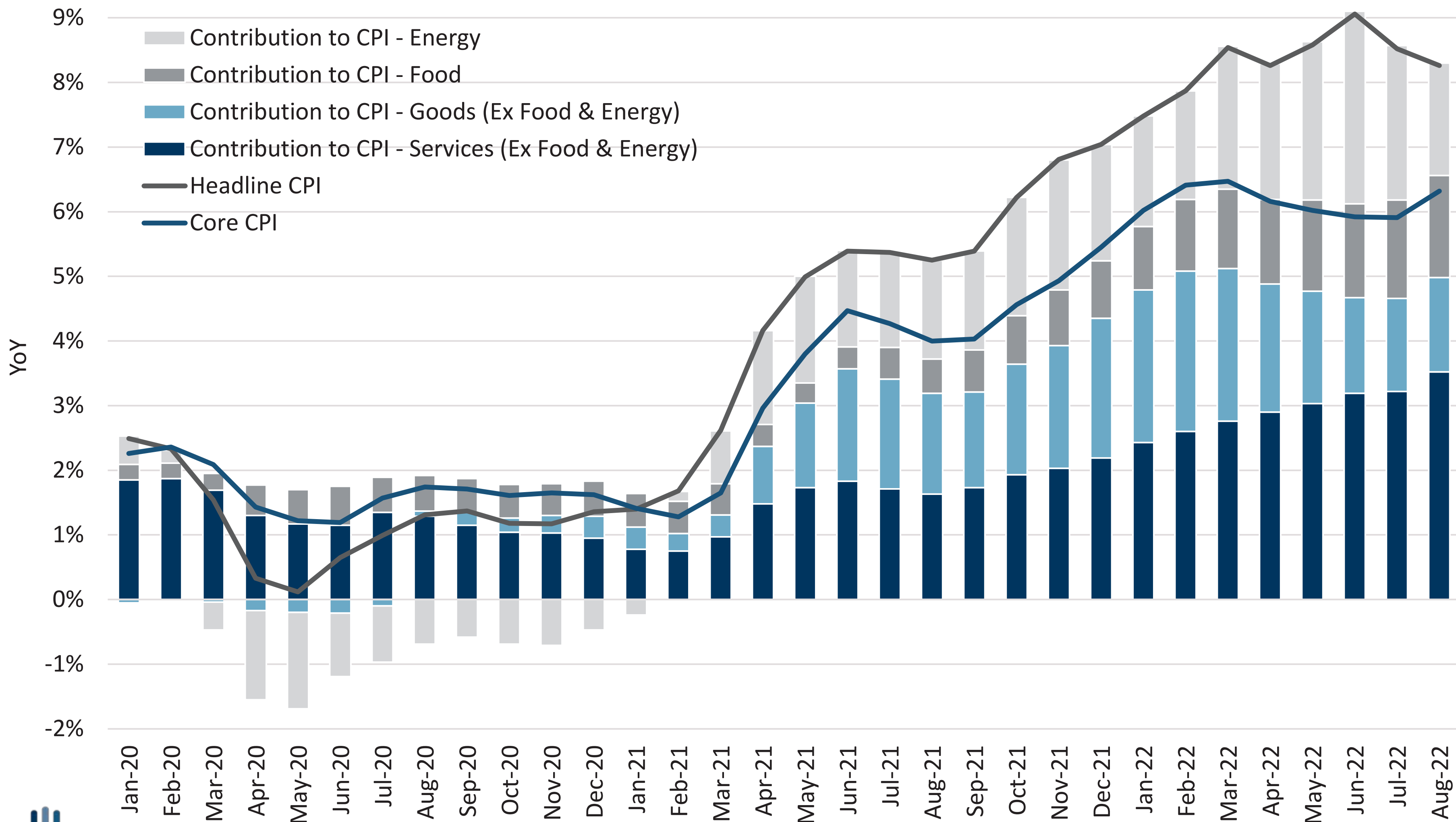




Source: Opus, Bloomberg, Federal Reserve, Bank of America

Economic Outlook

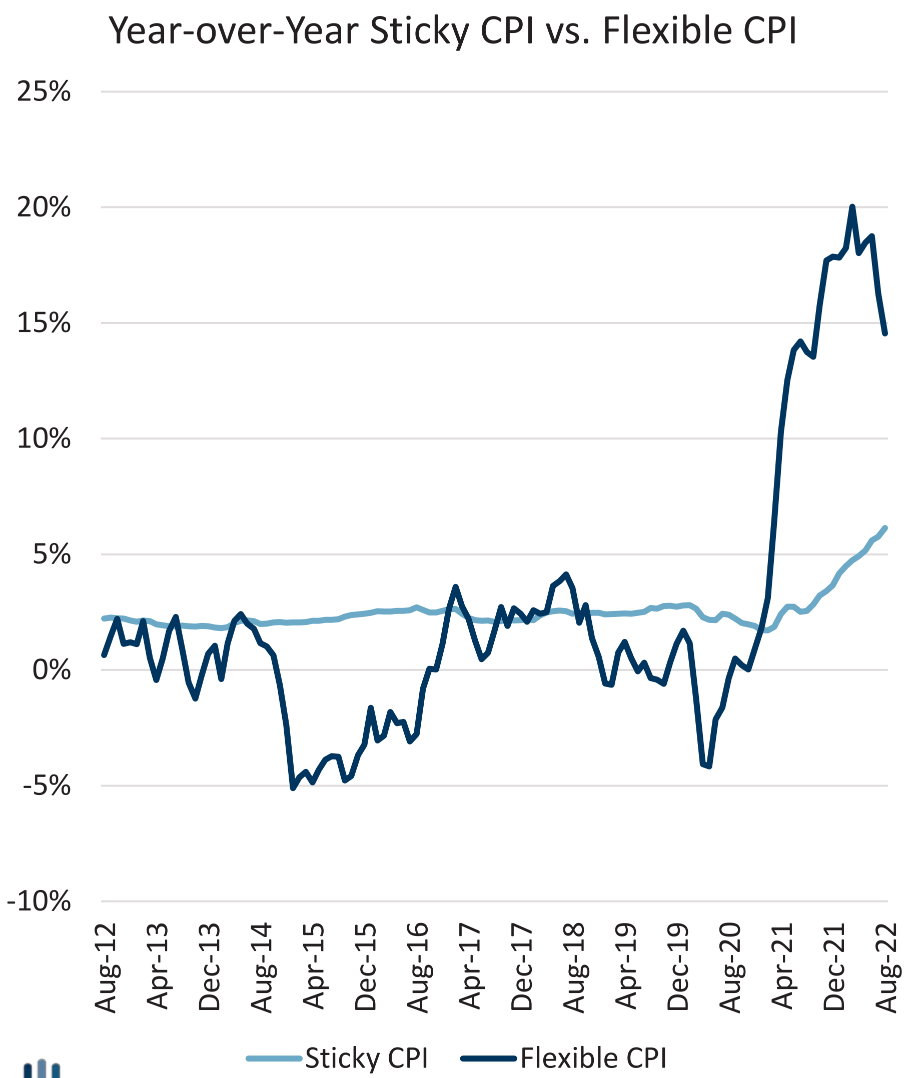
Consumers are seeing some relief through lower energy prices; however, core CPI surprised to the upside in August as inflation in services pushed higher

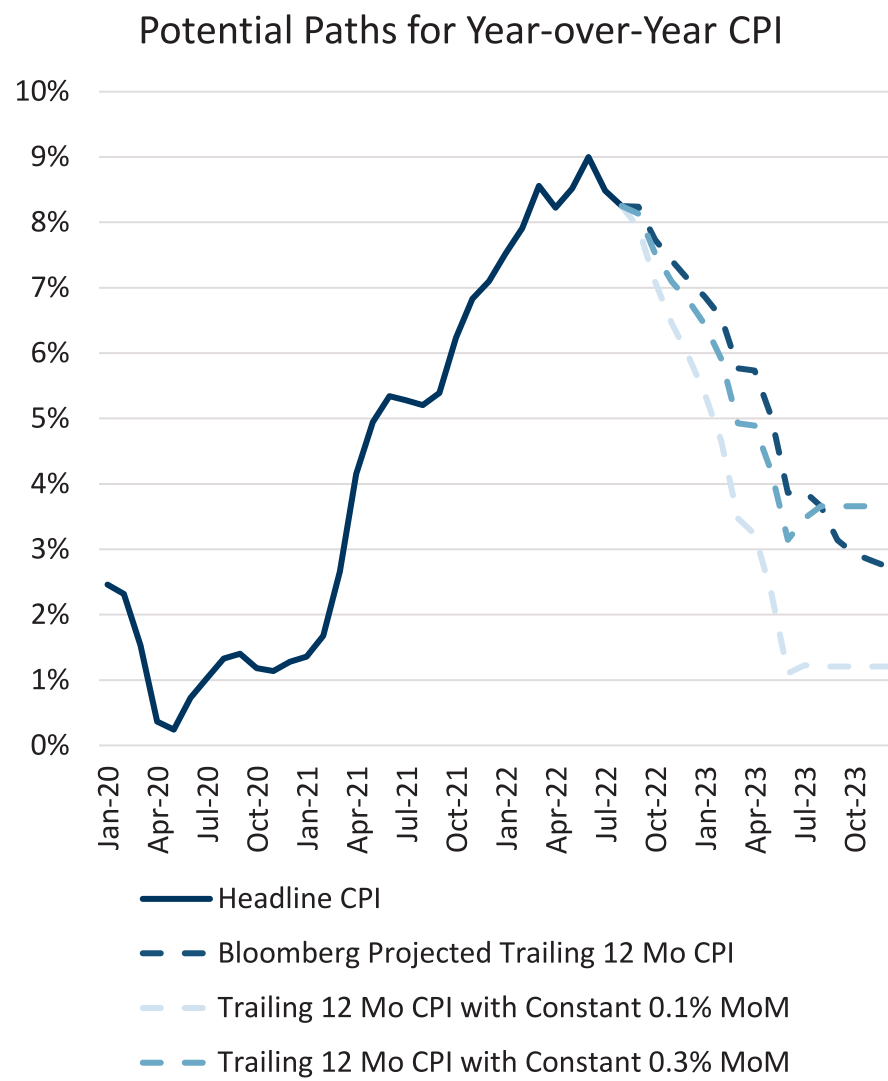


Source: Opus, Bloomberg, Bureau of Labor Statistics

Economic Outlook

Sticky inflation reached a 40-year high in August, implying core inflation levels may remain elevated; however, the decline in Flexible CPI could indicate moderating headline CPI

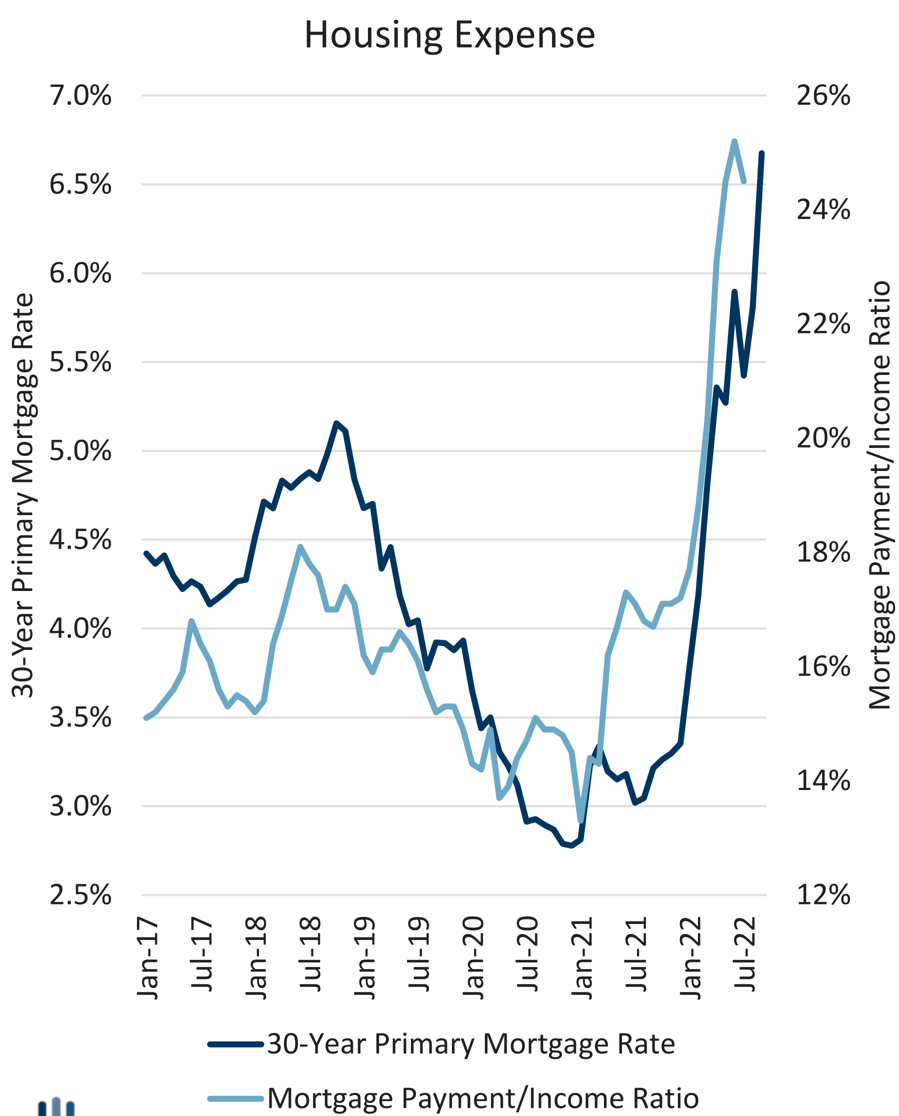


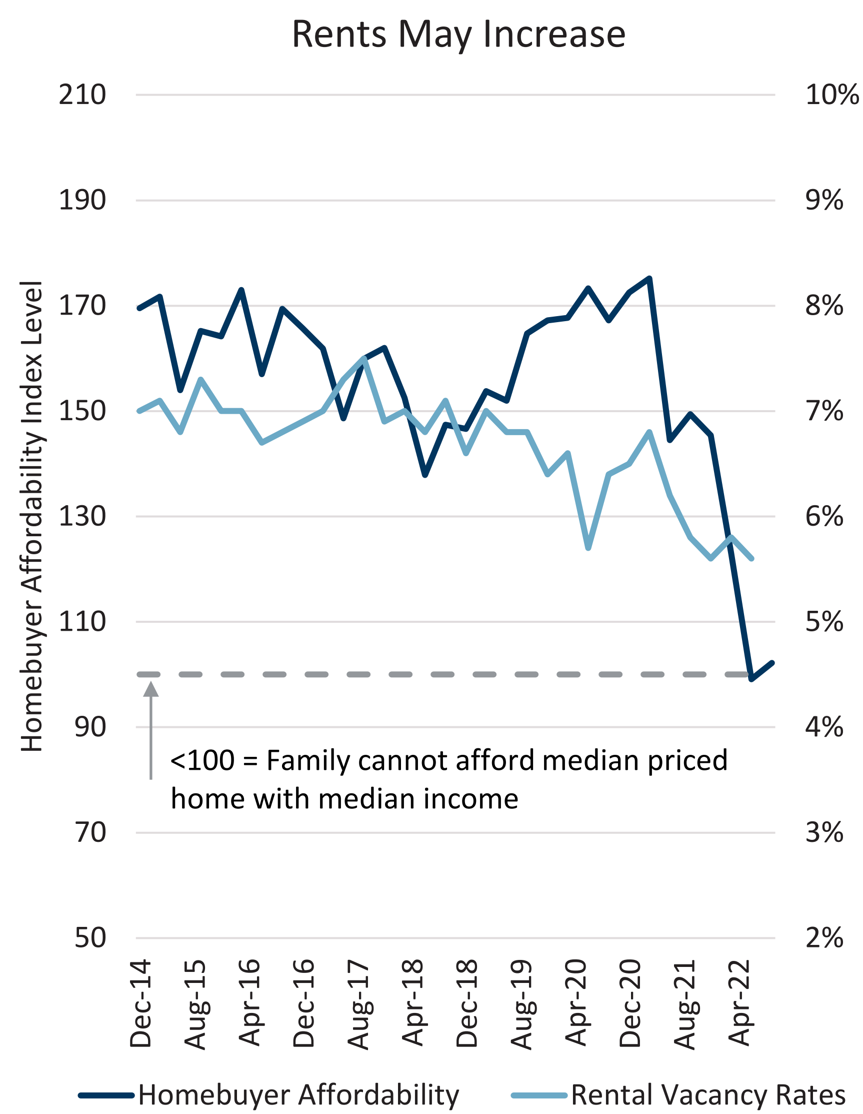


Source: Opus, Bloomberg, Federal Reserve Bank of Atlanta, Bureau of Economic Analysis

Economic Outlook

Home affordability is beginning to weigh on the housing market

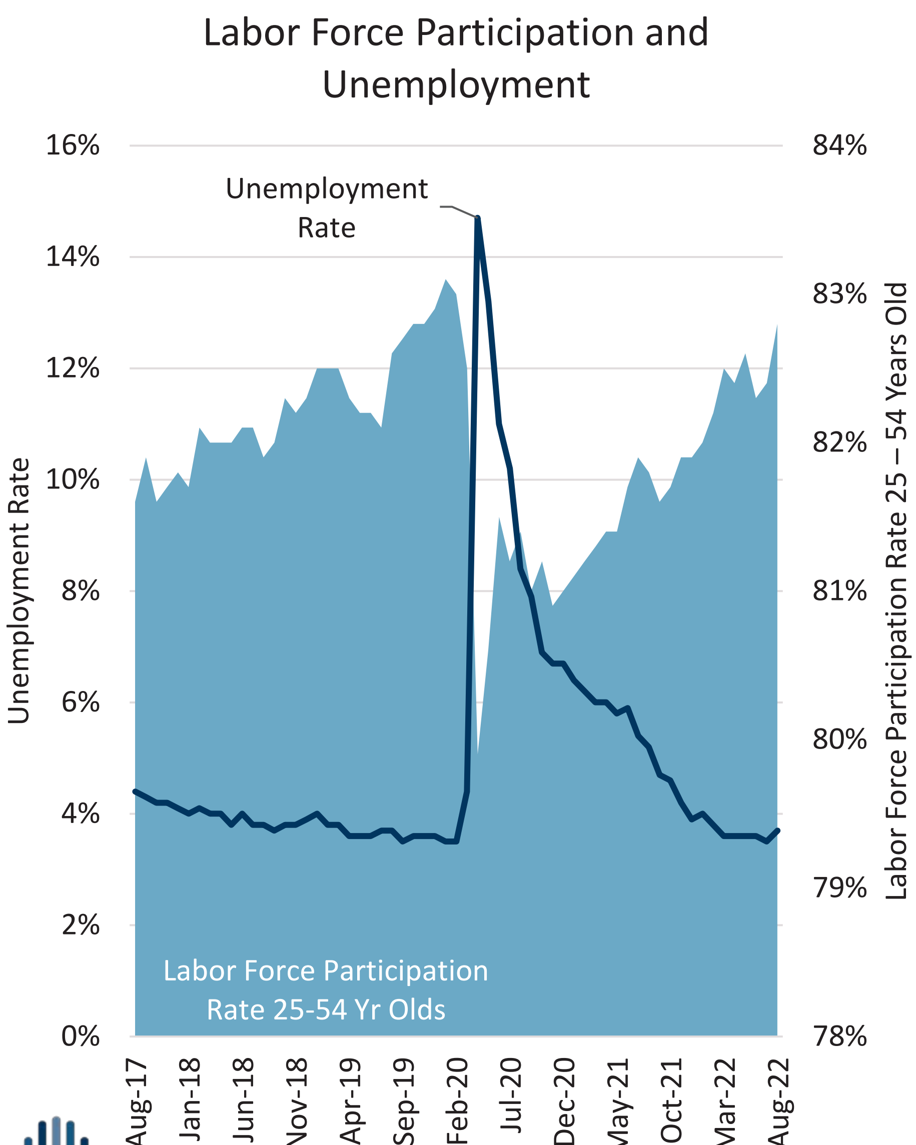


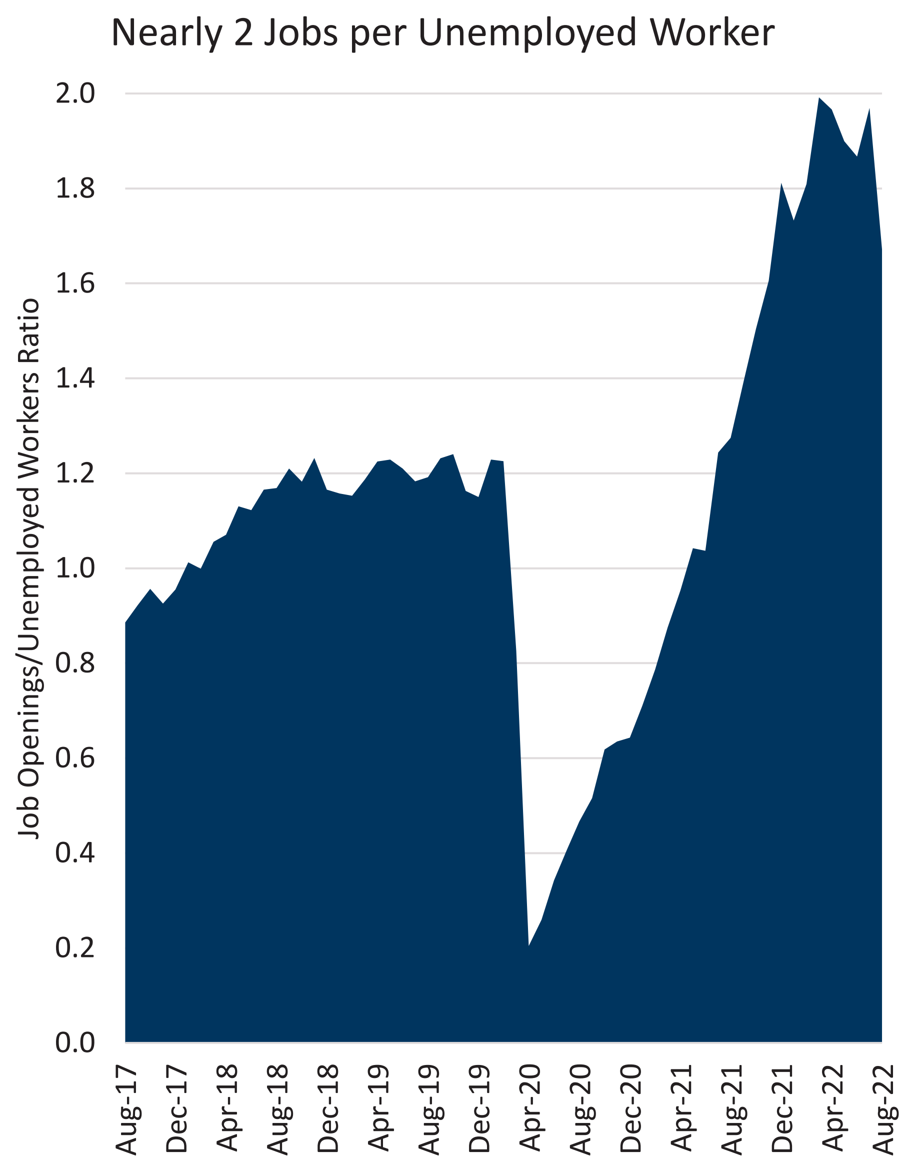


Source: Opus, Bloomberg, National Association of Realtors, U.S. Census Bureau

Economic Outlook

Strong labor market gives the Federal Reserve room to continue tightening monetary policy

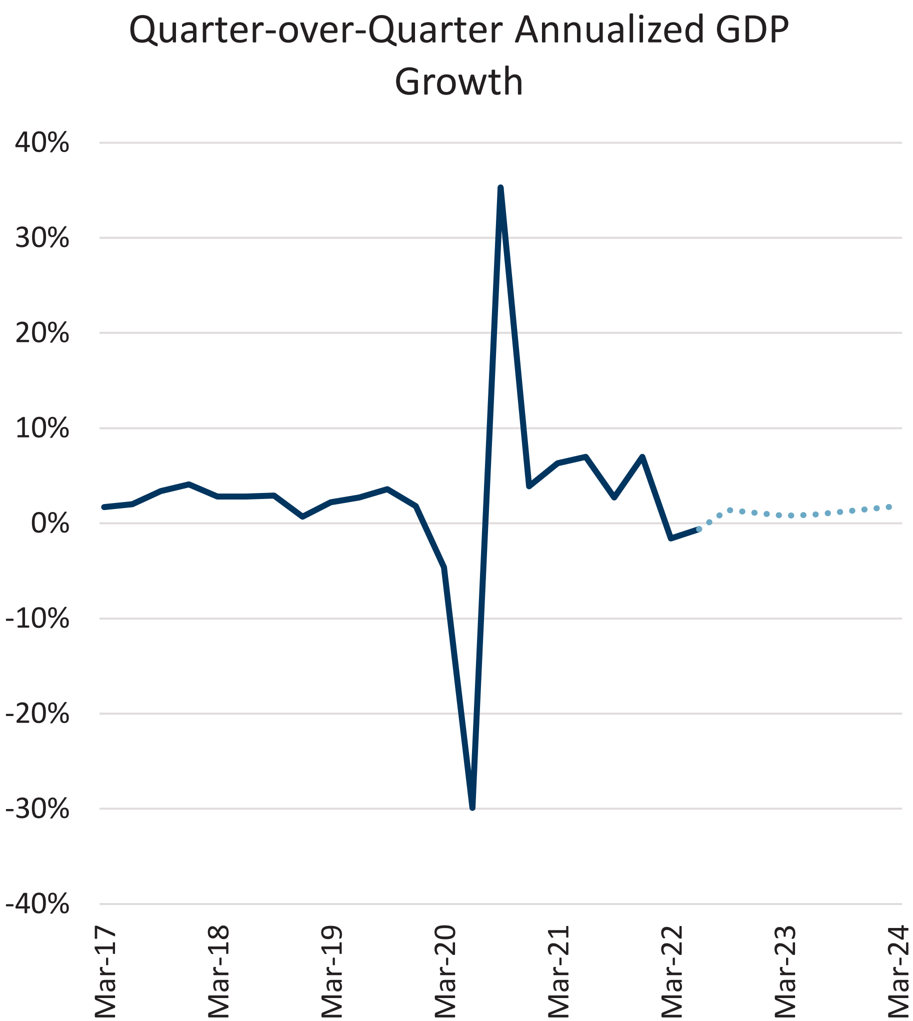


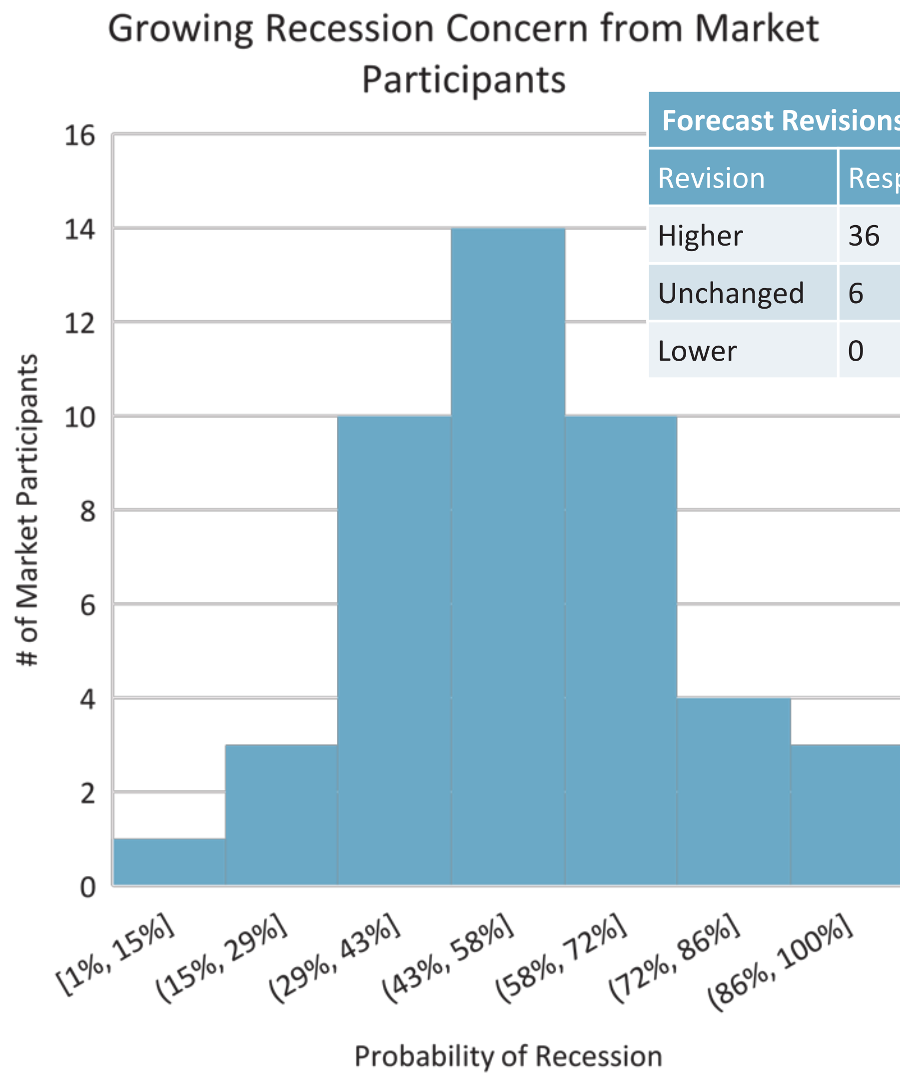


Source: Opus, Bloomberg, Bureau of Labor Statistics

Economic Outlook

Market participants believe the probability of a recession due to Federal Reserve actions has increased to 50% from 33% in June



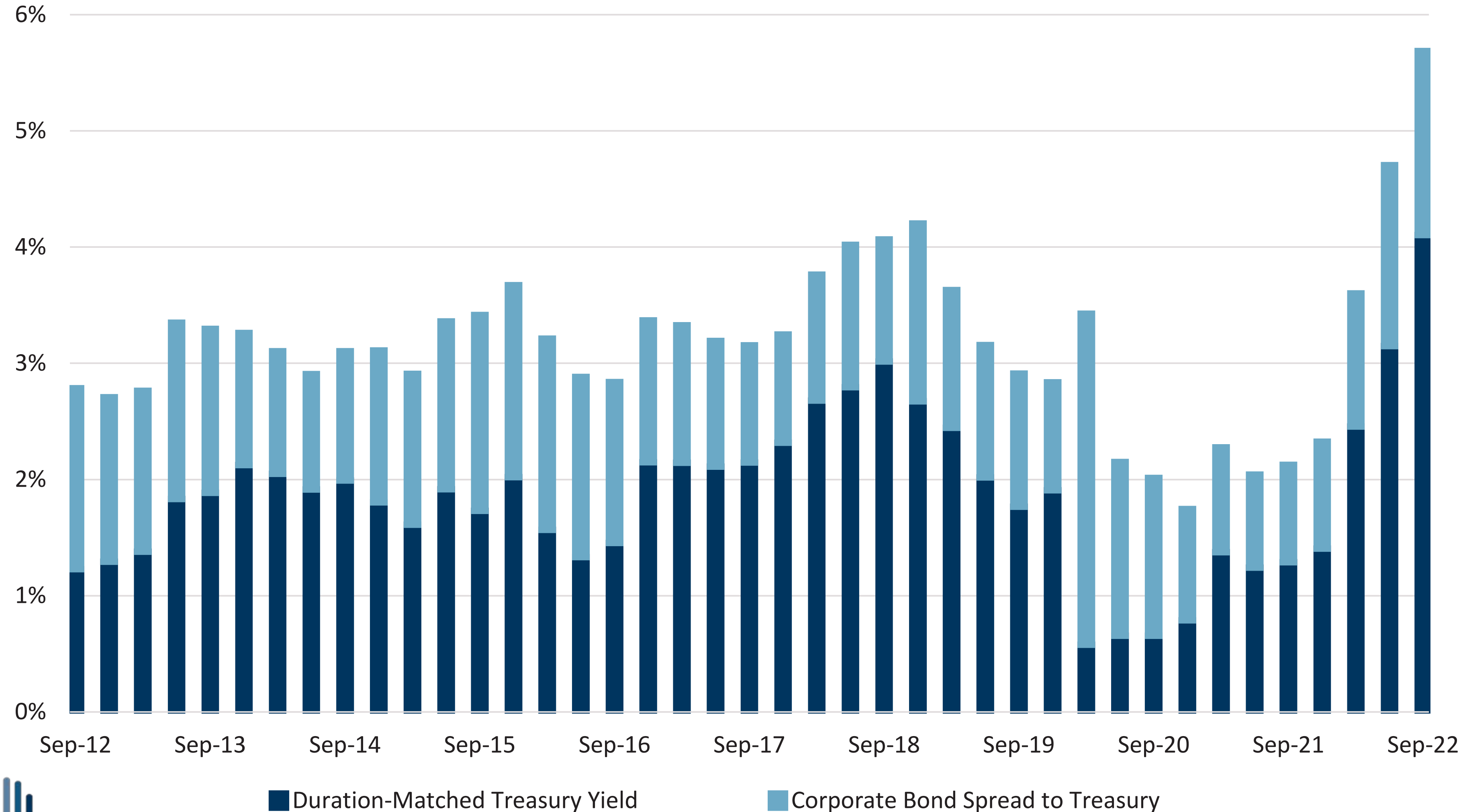


Forecast Revisions since June	
Revision	Respondents:
Higher	36
Unchanged	6
Lower	0

Source: Opus, Bloomberg, Bureau of Economic Analysis

All-in yields on corporate bonds have reached levels not seen in more than a decade due to rising Treasury yields and spreads

Historical Investment Grade Corporate Yield Components



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 moderate, but remain above the Federal Reserve's 2% target through 2023
- The FOMC raised their overnight target rate by 3.00% cumulatively year-to-date, and is forecasted to increase rates by another 1.25% before year end
- Commodity price pressures moderated during the quarter, but stickier components of inflation are at levels not seen in 40 years

Consumer trends shifting in response to higher prices

- Consumers have seen relief through lower energy prices during the third quarter; however, with winter fast approaching they may face elevated heating costs
- Consumer balance sheet erosion continues, but relative strength to prior periods of economic weakness has also persisted
- The prime participation rate reached a post pandemic high as workers may have been incentivized to return by higher wages and prices

Concern of policy misstep has amplified market volatility

- The S&P 500 remains in bear market territory as concern over the possibility of a U.S. recession increased
- The yield curve inversion deepened as Treasury yields pushed higher in response to increasingly hawkish sentiment from the Federal Reserve
- 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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