INVESTMENT MANAGEMENT

PERSPECTIVES

2022 Outlook

Bond yields rose in 2021 as re-opening sentiment pervaded the market. Inflation was more pronounced, and despite early warnings regarding the "transitory" nature of inflation, we continue to see above-average CPI year-over-year prints. This has caused the FOMC to announce a taper of asset purchases, to be completed by early 2022, with market participants further speculating that the Fed will raise rates in 2022 to combat persistent inflation. This view, combined with the expectation for a continuation of strong economic growth, informs our view that U.S. Treasury yields will continue to rise in 2022.

Relative value in credit sectors finished 2021 at close to record low levels, based largely on a bullish macro forecast. Despite a small correction going into year-end, corporate spreads ended the year close to year-end 2020 levels.

Economic Outlook

The U.S. economy exhibited very strong growth in 2021, a sharp reversal from the 2020 pandemic period. Real GDP growth is projected to continue in 2022, with Wall Street consensus estimates in the 4-5% range. Factors which support this level of growth include:

- An abundance of cash on corporate and household balance sheets
- A shift to greater private sector investment, away from the fiscal stimulus measures during the pandemic period
- A recovery in the service sector
- Continued growth in the labor market

Monetary policy: The Fed has already begun to taper its asset purchases, with an expected cessation of purchases in early 2022. In addition, FOMC Members' projections for 2022 show a median expectation of three rate hikes next year. This follows comments by FOMC members, notably Chairman Powell, regarding a shift away from "transitory" treatment of inflation.

Fiscal policy: After the passage of major fiscal stimulus packages in 2021, notably the American Rescue Plan and the more recent Investing in Infrastructure and Jobs Act, further spending by Congress is expected to be met with greater scrutiny. This issue is compounded by the upcoming midterm elections in 2022. Passage of President Biden's Build Back Better Act will likely be an early 2022 issue.

Foreign economies: UK and Eurozone GDP growth rates are expected to keep pace with the U.S. due to similar factors. Major foreign central banks are expected to begin tightening monetary policy. Emerging markets growth could be challenged due to higher inflation expectations – Latin American countries are increasingly exploring tighter monetary policy.

Inflation: Forecast and risks: The consensus forecast for inflation appears to be that CPI and PCE year-over-year prints will continue to be high for several months into 2022 before declining toward more normal levels. However, inflation will likely continue to be pushed upward by reopening-related trends, such as growth in wages and rent. The composition of pricing pressures will shift away from pandemic-related sources, toward inputs such as energy prices, transportation costs, and labor. Additionally, any pressures on the supply chain, such as those experienced in 2021 with the cargo backups at major ports, should be closely monitored.

Corporate Sector

The credit market has made substantial progress recovering from the shock COVID-19 had on GDP, corporate profits, credit quality and valuations in 2020. During 2021, strong economic growth and corporate earnings led to positive credit fundamentals, more favorable credit rating activity, higher market values, fewer higher risk credits (i.e., credits of concern and potential fallen angels), and lower impairment activity. Looking into 2022, ongoing economic recovery underpinned by strong consumer spending and businesses eager to invest are expected to lead to solid corporate

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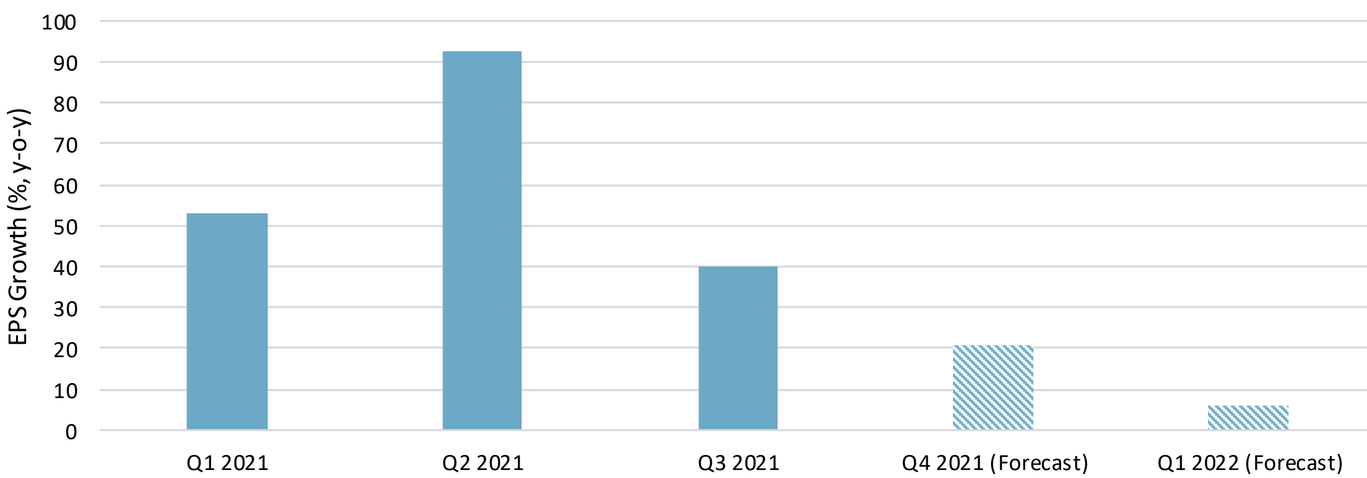
earnings, positive credit fundamentals, and more favorable ratings actions. The strong backdrop should allow non-financial companies to repair most, if not all, of the balance sheet damage that resulted from the pandemic. For the last twelve months as of Q3 2021, credit ratios for non-financials have recovered to near pre-COVID levels. In addition, market technicals are expected to remain strong, supported by solid investor demand, comparative yield advantage of U.S. high-grade credit versus overseas high-grade credit, and modestly lower new supply issuance expected in 2022. This should keep borrowing costs for issuers low and capital markets accessible, allowing companies to refinance their debt as needed. However, valuations are rich and the strong rally in spreads leaves limited room to absorb unforeseen weakness, which makes it more difficult for investors trying to generate investment income. Finally, in the event of a severe downside scenario (e.g., COVID-19 flare-up), policymakers are expected to provide liquidity and stimulus to support the economy and markets as needed, as has been the case in prior crises.

Credit Fundamentals: 2021 earnings growth has been strong, reflecting re-opening measures and the economic recovery that followed. Earnings strength has been broad-based with more than 80% of the companies in the S&P 500 and all 11 sectors reporting solid revenue and earnings growth. These results are the strongest string of quarterly results in more than 10 years (52.8% in Q1 2021, 92.4% in Q2, and 39.9% Q3). Earnings are expected to grow 20.7% in Q4, and next year remain solid too, but may settle to a more normal level of 6% in Q1 2022 (against a very strong y-o-y comparison) and 9% for full year 2022 (versus 45% growth for full year 2021).

Exhibit 1: Earnings growth of companies in the S&P 500 has been historic and is expected to remain strong in 2022



Source: FactSet Estimates as of January 13, 2022, Opus

Companies have weathered input cost inflation, wage inflation and hiring difficulties, and supply chain disruptions better than expected as evidenced by near-record high net profit margins of 12.9% for Q3 2021. This is well above the five-year average of 10.9% and slightly below the Q2 2021 record of 13.1%. Companies in many sectors have been able to raise prices to pass through higher input costs, and the rise of input costs and wages has been slower than top line revenue growth. Companies attribute their pricing power and the strong demand in the face of rising prices to the strength of the consumer's balance sheet.

For the last 12 months as of Q3 2021, credit ratios for non-financials have recovered to near pre-COVID levels. In future quarters (with both strong GDP growth now, and as the weaker 2020 data continues to fall out of LTM calculations), these trends will likely remain very strong and supportive for continued positive ratings momentum. In our view, the primary risks in the credit sector are as follows: 1) A rise in inflation leads to higher rates (negative returns, outflows), volatility, and causes the Fed to tighten monetary policy sooner than expected. 2) Various supply chain and labor market imbalances and spread of COVID-19 could lead to higher inflation and setbacks in GDP growth and corporate earnings. 3) A new risk at year end was the discovery of Omicron, a new strain of COVID-19. At this point there are still more questions about it related to the impact on public health, response from government officials, and potential damage to economic fundamentals than we currently have answers. Two widely identified risks include weaker economic growth due to government-imposed restrictions on consumers' behavior and travel, and higher inflation. 4) While credit metrics have improved, non-financial leverage and BBB debt outstanding remain high, so any setbacks to growth and earnings or upticks in debt-funded M&A and/or shareholder initiatives could weaken credit ratios back to 2020 levels. 5) Economic recovery remains uneven with many lower income workers facing hardship and fundamental conditions in certain corporate sectors remain challenging, such as the lodging and hospitality sectors, which still face lower than pre-pandemic levels of demand.

Municipal Sector

Municipal credit has recovered significantly from the pandemic period. This is largely due to an unprecedented amount of fiscal stimulus, with the CARES Act in 2020 being dwarfed by the American Rescue Plan providing $350 billion in direct aid alone to state and local governments. Furthermore, governments experienced growth in key tax revenues in FY 2021, largely due to home price appreciation benefitting property tax receipts for locals and continued income growth for top earners benefitting state income tax collections. This, combined with the impact of municipal issuers implementing large expenditure reductions going into FY 2021, afforded governments the capability to build reserves and pay down unfunded liabilities.

These positive trends are expected to continue into 2022 due to the continuation of strong economic growth providing a tailwind to tax revenues. Similar to the corporate credit market, municipals have seen net positive ratings movement in 2021, and the potential for more favorable financial and debt metrics provides positive momentum for further upgrades. Unlike in other sectors, key challenges in the municipal sector are long-term in nature and require long-term solutions. Specifically, fixed costs of entitlement programs continue to represent a large percentage of state and local government budgets. This, coupled with demographic shifts, will continue to crowd out spending for critical needs such as infrastructure and education funding. Positively, pension funded ratios should improve due to recent strong investment returns, while more issuers become cognizant of using a reasonable discount rate for unfunded liabilities, given the current rate environment.

Our focus will continue to be on the taxable municipal market, given current tax-exempt/taxable ratios, the prevailing corporate tax rate, and the effect of proration. However, we continue to monitor these trends over time. Should ratios of high-grade tax-exempt bonds become attractive vs. similar taxables, on a tax-equivalent yield basis, we would be eager to add to this asset class. Ratios are not expected to exceed this threshold in the near-term, due to a combination of general lack of volatility in the municipal market combined with ongoing solid demand from retail buyers. The latter point is informed by the fact that the value of the tax exemption is significantly higher for high-income individual investors because of their meaningfully higher marginal tax rate. There is no indication that the corporate income tax rate will increase meaningfully in the near term.

Taxable supply is expected to remain robust in 2022, though lower than in 2021 and significantly lower than in 2020; the latter was the heaviest year for taxable issuance since Build America Bonds (BABs) were first issued. The primary reason for the decline is that, with higher interest rates, taxable advance refundings of tax-exempt debt are becoming less attractive. However, issuers should continue to take advantage of attractive financing costs in the municipal market, particularly for infrastructure projects.

Maintaining an allocation to municipal bonds within a fixed income portfolio enhances diversification through exposure to different risk factors, improves overall portfolio quality, and provides an alternative method of capturing spread and yield. In 2022, we will remain thoughtful in our approach and adhere to the following strategies in the municipal sector:

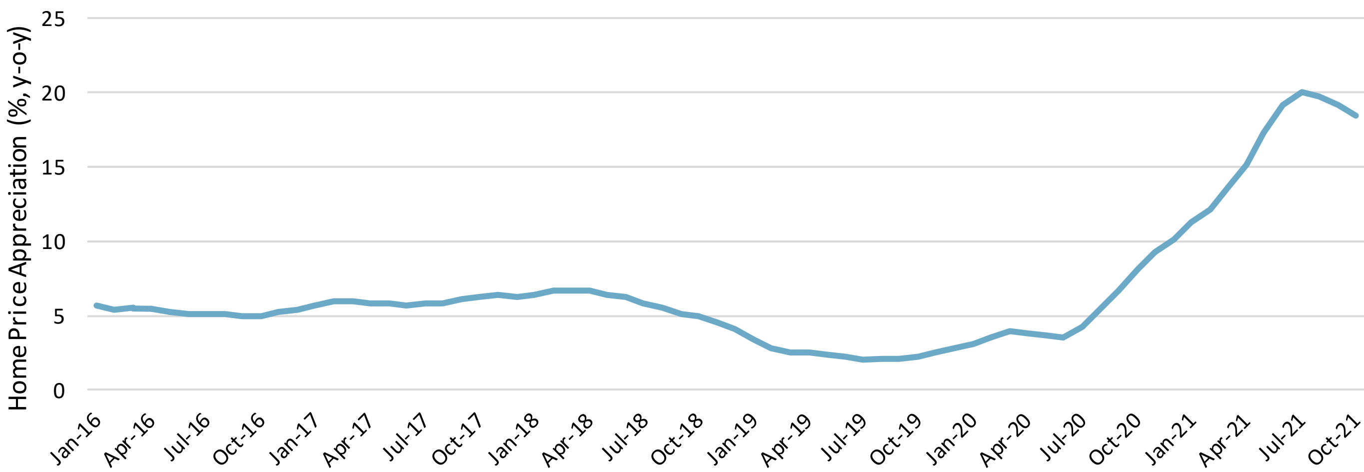
- Currently favor the revenue sector given dedicated revenue sources for debt service payment that have fared better in rare bankruptcy proceedings and are ring-fenced from state and local entitlement program liabilities.
    - We will opportunistically consider sectors which are poised to benefit from a continued pandemic recovery, specifically hospitals, higher education, and airports.
- For general obligation bonds, the focus remains on states and local governments that have:
    - A large and growing tax base, diversified economy, favorable wealth and employment metrics, low taxpayer concentration, and manageable retiree benefit obligations, and
    - Historically demonstrated responsible management of municipal finances in the form of structurally balanced and timely budgets, solid reserves, historical growth in tax revenue collections, and good transparency.
- Diversify by region, sub-sector, and issuer to the extent possible, recognizing that debt issuance is driven by demographics, tax policy, constitutional limits, and other regional factors.

From our perspective, the primary risks in the municipal sector are: 1) Economic debt burden, impacted by direct debt in combination with pension and OPEB liabilities, straining state and local budgets. 2) Demographic shifts, particularly COVID-influenced movement out of major cities, impacting key tax revenues. 3) A potential prolongation of the pandemic, due to new virus variants and/or poor vaccination rates, causing an unanticipated economic slowdown. 4) Inaction at the federal level in response to further fiscal distress in the municipal market, to support municipal issuers in a manner similar to the pandemic period.

Residential Mortgage-Backed Securities (RMBS)

2021 carried over strong technicals from 2020 with continued demand from both the Federal Reserve and domestic banks. Despite the largest amount of supply on record hitting the market, demand was sufficient to keep spreads contained and Agency MBS at historically rich valuations. 2021 provided three spats of 30-year current coupon nominal spread widening to the tune of 10 – 15 bps during a given one-month period. The first period of widening occurred during Q1 when there was an uptick in interest rate volatility and a rate sell-off over fears of inflation/stagflation. The second instance occurred in late Q2 following the June FOMC meeting, when the market began to price in a late 2021 monetary policy adjustment where the FOMC would announce asset purchase tapering. Spreads inevitably retraced tighter after each of those events and approached the Thanksgiving holiday with modestly tighter spreads versus the beginning of the year. In early December, in a testimony before congress, Federal Reserve Chair Powell struck a hawkish tone after having been dovish for several years when he admitted that the word "transitory" should be retired when describing the current inflation environment. He also expressed his view that the pace of asset purchase tapering may need to be faster than first announced at the November meeting. These comments caused not only a widening for MBS spreads, but also a flattening of the yield curve.

Exhibit 2: Home price appreciation has been fueled by low mortgage rates, limited inventory, and strong demand



Source: S&P CoreLogic Case-Shiller 20-City Composite Home Price NSA Index, Opus

Prepayments in 2021 continued at a record pace, although they trended slower throughout the year. A new record low mortgage rate (30-year primary rate of 2.65%) was hit during the beginning of 2021, which enticed borrowers to evaluate refinancing existing mortgages and/or cash-out equity that had built up over the past several quarters. The increase in cash-out refinance activity was the direct effect of a housing market that saw record home price appreciation (HPA) during the year of nearly 20%. It is expected that this trend will continue into 2022 even in the event of higher mortgage rates. HPA forecasts from several Wall Street housing market analysts suggest another robust year in 2022 of near double-digit percentage gains compared to the 30-year average of 4.2%.

Current valuations are historically rich, but 2022 introduced several themes which could move spreads. The Federal Reserve taper, strong expected issuance volumes, and growth in conforming loan limits (due to HPA) will likely put upward pressure on MBS spreads. However, bank demand should remain a strong positive as loan to deposit levels are extremely low, meaning a large stockpile of investable cash from this buyer base should find its way into the Agency MBS sector. Beyond the bank investor base, the next marginal buyer is money managers, and it is expected they will need wider spreads before increasing their allocation to the sector. Taken all together, it is probable that nominal spreads could widen 15 – 20 bps by the end of 2022.

Our positioning in the sector will have a bias towards storied pass-throughs over generic and collateralized mortgage obligation (CMO) structures into an environment of potential spread widening, tighter monetary policy, and higher interest rates. We will utilize storied specified pass-through collateral to help mitigate interest rate risk in the portfolio and provide more stable cash flows across different interest rate scenarios. We are unlikely to add CMO exposure near-term given current spread levels and the structure and collateral types being created, though we will continue to evaluate CMOs and will add when we find the right combination of collateral and structure.

Commercial Mortgage-Backed Securities (CMBS)

Underlying fundamentals in the Commercial Real Estate (CRE) sector steadily improved as 2021 progressed. There was variance between sectors with urban office, retail, and lodging underperforming suburban office, multi-family, and industrial collateral types. However, delinquencies declined across all sectors. Spreads had largely tightened to pre-COVID levels by the end of 2020. As a result, the AAA last cash flow (LCF) new issue spent 2021 in a relatively tight range of 63 – 70 bp.

As we look forward, COVID is ever-present, but the impacts seem to be more manageable as each wave hits. Issuance in conduit CMBS is likely to be flat in 2022 as solid borrowers have multiple channels of funding in both public and private markets. In the medium term, there are still uncertainties surrounding the remote work impact on office properties, and the full extent of the recovery (or lack thereof) in some parts of retail and lodging. However, over the period it has been clear that high-quality, well-located properties of all types have weathered the storm well. Focusing on quality, location, and diversification has always been a hallmark of our CMBS investing strategy and that will continue. Given market fundamentals and supply dynamics, it is likely that AAA conduit new issue spreads will remain rangebound as we saw in 2021.

Asset-Backed Securities (ABS)

The key indicator for consumer credit performance has historically been the level of unemployment. Most market participants expect the unemployment rate to fall in 2022, which would imply that charge-offs and negatively related consumer metrics (e.g., delinquencies) should also continue to improve. However, these metrics currently sit at some of the lowest levels in decades. Coupled with four consecutive quarters of relaxing underwriting standards and record used vehicle prices, our 2022 expectation is for stable to modestly weaker performance for prime auto and credit card ABS, and moderately weaker performance for subprime auto. Delinquency and net loss rates are currently near historic lows for both the prime and subprime auto loan ABS sectors and therefore can withstand modest deterioration. Credit metrics will be more likely to move to higher levels rather than lower levels, but at a gradual pace.

Supply is forecasted to be ~$250 billion in 2022, slightly below 2021 supply of ~$275 billion. Consumer debt is expected to increase in 2022 as lenders are increasingly willing to lend and consumers are increasingly willing to borrow. Higher spending, looser lending standards, and the fading impact of pandemic related stimulus should support loan growth. This, along with lenders' continued need to fund via the ABS market, should be supportive of supply of consumer related ABS in 2022. Spreads for ABS in 2022 have the potential to move modestly wider with the broader structured products market, reflecting uncertainty around inflation and monetary policy. Spreads have already started to move off the lows of 2021 and may continue to drift wider until a clearer picture emerges on the macroeconomic front.

For data center ABS, we view the growth in data, broader adoption of cloud and the continued growth of data center outsourcing as key secular drivers that will support sustained growth for data center landlords over the next 5 years. The mandated national shutdown in response to the COVID-19 pandemic accelerated economic digitization, cloud adoption, and the need for connectivity. This further strengthened the demand for long-term data centers and highlighted their essential nature. For the whole business sector, going into 2020, the sector's performance was mixed due to tepid economic conditions and weakness at certain restaurant operators. Amid the COVID-19 pandemic, there was a large shift toward delivery options as consumers followed stay-at-home orders, which led to an increase in delivery orders and ticket sizes. With the rollout of several vaccines globally and the easing of the pandemic-induced lockdowns, we would expect the shift to delivery to slow in 2022. With labor and commodity pressure being at the forefront of whole business pressure points as quick service restaurants (QSRs) increase menu prices and shift hours due to lack of labor availability, QSRs will be pressured to maintain quarter-over-quarter same store sales (SSS) and annual unit volume (AUV) growth. Tier 1 QSRs with strong coverage ratios will fare better than others as the labor and commodity pressure should ease into Q2 2022, based on management expectations.

As we see it, the primary risks in the securitized sector are: 1) Interest rate risk and duration contraction/extension ultimately resulting in income variability. 2) Continued economic impact of the pandemic on consumer and CRE health.

IMPORTANT INFORMATION