OPUS INVESTMENT MANAGEMENT

PERSPECTIVES

2020 Outlook

In this issue of 'Perspectives', we offer our thoughts on the year ahead.

Domestic Outlook

Real U.S. GDP growth is anticipated to slow to 1.8% in 2020 according to consensus, with growth bottoming in early quarters before the delayed benefits of monetary policy take effect. While trade-related uncertainty appears to have partially abated, pending elections and lingering foreign challenges to growth will remain.

Monetary policy pivoted to remain accommodative in 2019 with three rate cuts. Fed messaging in the wake of the most recent rate cut indicates no further near-term action is likely. However, markets are signaling an additional cut is expected in the second half of 2020. We expect core PCE inflation to remain below the Fed's target of 2%, thus supporting the view that the Fed will not be raising rates in the near future.

Consumer strength is expected to continue with unemployment in the mid-3% area, the average household saving rate around 8%, and wage inflation pushing towards 3%. In addition, household debt has continued to decline following the Financial Crisis. These factors bode well for the consumer in 2020.

Foreign Outlook

Brexit appears to be nearing a conclusion and China has actively taken additional measures to shore up growth, while portions of Latin America appear to be stabilizing, driving an improved outlook. China will likely continue to address a declining working age population and manage growth while working to ensure financial stability in a transitioning economy. The ECB is expected to remain accommodative as core European nations manage an industrial slowdown and negotiate towards Brexit. Emerging markets should continue to face idiosyncratic challenges through 2020, particularly through South America and Africa where acute economic turmoil has challenged leadership. Escalations in the Middle East have rippled through commodity indices and create incremental tail risks to forecasts.

Corporate Sector

Conditions for corporate credit are expected to be healthy in 2020 based on 1.) steady, low single digit GDP growth (Bloomberg consensus estimates U.S. GDP growth slowing from 2.2% in 2019 to 1.8% in 2020), 2.) accommodative monetary policy, 3.) low unemployment, stable wage growth and healthy consumer, and 4.) rebound in corporate revenue and earnings growth. These factors, in combination with low borrowing costs and accessible capital markets, should provide a supportive backdrop for credit fundamentals and keep default rates benign. One of the more watched themes continues to be high financial leverage across non-financial issuers at a time that many believe to be the late stages of the credit cycle. While forecasts for stronger earnings and lower debt growth next year are expected to be sources of stabilization or improvement in credit metrics, downside could result if GDP growth disappoints, and as a result, the expected support for corporate earnings and fundamentals fails to materialize.

Corporate revenue and earnings forecasts for 2020 are solid at 4.9% and 9.3%, respectively, according to consensus estimates compiled by Bloomberg. If these levels materialize, they will represent a rebound from 2019's full year revenue and earnings estimated to grow 3.6% and 1.6%, respectively. Corporate earnings are expected to benefit from easier monetary policy with the Fed expected to keep interest rates low for the foreseeable future, ongoing strength from consumer spending, easier comparisons versus 2019's weakness, and belief that overseas revenues will rebound.

An important area of focus for credit investors is monitoring the elevated leverage many non-financial issuers have and the increased amount of BBB index debt outstanding during what many believe to be the late innings of the credit cycle. For the past several years, companies took

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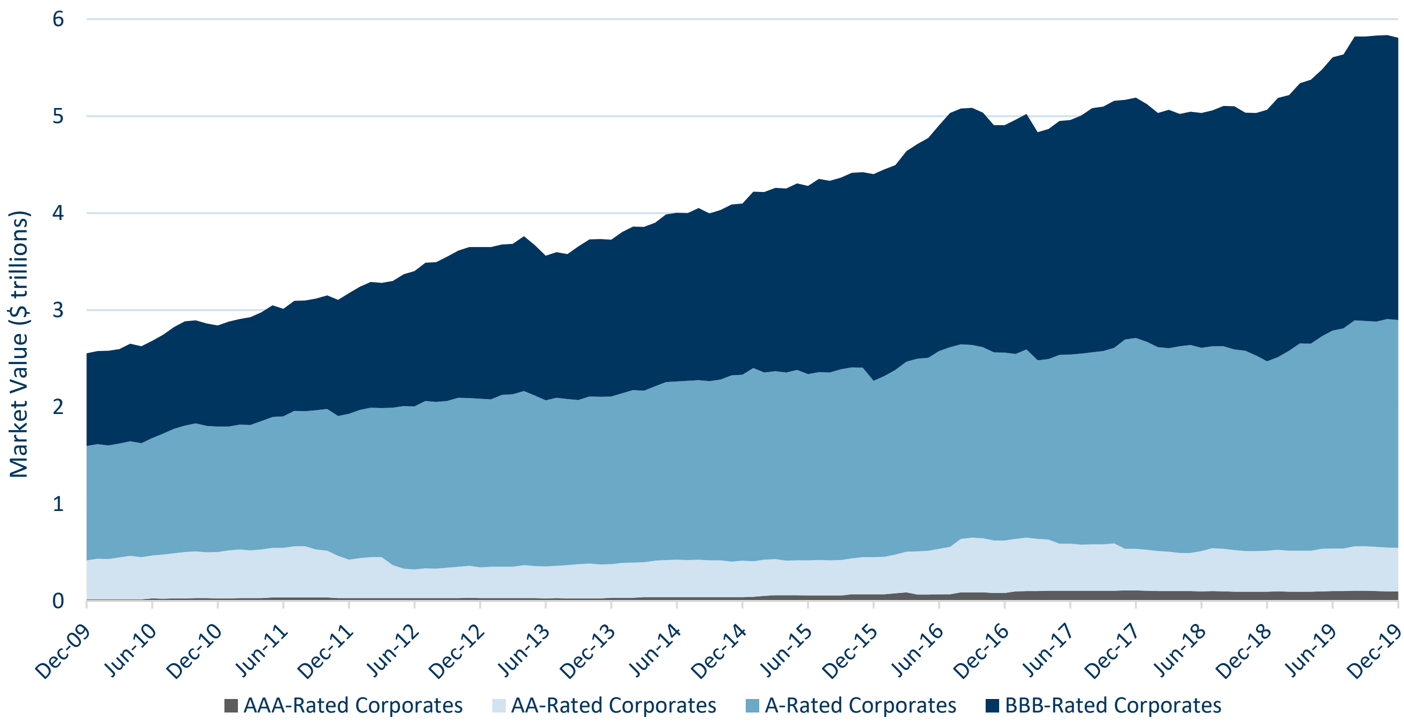
advantage of accommodative monetary policy and cheap debt financing to leverage their balance sheets to support their earnings through M&A, share buybacks and special dividends. However, in the past few quarters there have been signs of encouragement as more issuers have announced an increased focus on deleveraging as the costs of being downgraded to high yield can be a major negative in terms of funding cost and market access.

Three final encouraging trends worth highlighting include:

- More favorable credit trends of BBB issuers than those of A-rated issuers reflecting the efforts of BBB issuers to delever and avoid downward rating migration.
- Consensus expectations for earnings improvement in 2020. If realized, then a pickup in EBITDA growth, in combination with expected lower bond supply, should lead to leverage trends stabilizing or improving next year.
- Expectations for lower M&A activity in 2020 should be helpful in reducing new issuance and since many large debt-financed M&A transactions have contributed to the rise in high grade non-financial leverage and growth of BBB debt outstanding, a reduction in activity should act as a positive influence on credit metrics, all else equal. Several strategists have noted that, as we approach 2020 U.S. elections, increased political uncertainty may reduce appetite for large-scale transactions, especially for deals requiring federal regulatory approval.

Exhibit 1: Corporate bonds hit all-time high level during the fourth quarter of 2019, BBB-rated corporate bonds account for 50.1% near the all-time high at the end of 2019



Source: Factset, Blomberg Barclays Aggregate Index

Municipal Sector

Municipal bonds remain a core allocation in a diversified fixed income portfolio, providing attractive risk-adjusted returns in addition to overall correlation benefits to the portfolio. Expectations for solid economic growth driven by fundamentals, increased tax collections, low unemployment, a healthy consumer, and steadily rising property values support a continued allocation to the municipal sector. In addition, many state and local governments have maintained fiscal discipline with growth in tax collections outpacing that of tax-supported debt. Of note, credit quality remains solid as some issuers have done a better job rebuilding reserves in the years since the Financial Crisis and are viewed as better-positioned to weather the next economic downturn.

Unlike other sectors, core challenges in the municipal sector are long-term in nature and require long-term solutions. Specifically, rising costs of entitlement programs continue to grow as a percentage of state and local government budgets, crowding out spending for infrastructure and pressuring education funding. Shifting demographics coupled with rising Medicaid costs and the threat of reduced federal funding also strain state budgets.

The Tax Cuts & Jobs Act (TCJA) of 2017 had a significant impact on relative value due to the reduction in the corporate income tax rate from 35% to 21% compared to the reduction in the top individual tax rate from 39.6% to 37%. Whereas the corporate and top individual tax rates were relatively similar in past years, the divergence between the corporate rate and the top individual rate created two very different outcomes for each investor. The value of the tax exemption is significantly higher for individual investors as a result of their higher income tax rate. With approximately 70% of the municipal buyer base represented by retail investors (mutual funds, high net worth individuals), relative value reflects their tax status and as such, remains unattractive from a relative value perspective for institutional portfolios.

Securitized Sector

In 2019, residential mortgage-backed security (RMBS) performance volatility was less than the 2013 taper tantrum, but exceeded all other post-crisis periods. During 2019, the performance of mortgages was driven by general systemic factors, as risk assets generally performed well, and technical factors, including declining mortgage rates, increased prepay speeds and supply. As we began 2019, the vast majority of the market was out of the money, but as rates came down that changed. With the July prepayment report, it was clear to the market that we were in a period of increased mortgage refinancing. As we enter 2020, over 40% of the mortgage market has at least a 50 basis point incentive to refinance and prepayment speeds for mortgages are expected to remain elevated.

As we enter the new year, Agency RMBS valuations are attractive relative to their own history, as well as to Corporates. We see no immediate catalyst for the cheapness of the mortgages to correct in the face of continued fast prepayment speeds. However, the consumer remains strong and housing fundamentals are favorable so we expect to increase our exposure to mortgages given the attractive valuations.

Supply for commercial mortgage-backed securities (CMBS) was expected to decline at the beginning of 2019, however, lower interest rates and relatively strong fundamentals led to higher-than-expected supply. New construction remains in check and fundamentals, i.e. rents, occupancies, and valuations, are still attractive. Deal and loan underwriting have not deteriorated and the yields on high quality bonds in which we typically invest have begun to become attractive relative to corporate bonds once again. During 2020, we expect to at least maintain our current exposure to CMBS.

For asset-backed securities (ABS), we are optimistic about the year ahead and we expect the U.S. economy and the consumer to be resilient through the Presidential election. The current positive trends in ABS credit fundamentals should continue with credit losses and delinquencies remaining at very low levels. It is expected that consumer debt will continue to grow but the pace will moderate with a slowing economy.

What was notable in 2019 new issue composition was the drop in credit card and student loan ABS volume, as new issue volume in the former was the lowest since 2011 and the lowest post-crisis for the latter. The share of bank cards in the index has dropped notably while prime auto loan has increased. It is expected that new issues will continue to shift away from credit cards and student loans and into other sectors, especially auto-related and esoterics.

As 2020 progresses, we will keep a close eye on trade relations between the U.S. and China in the hopes that the recent cooperation continues. With a Presidential election taking place this fall, investors could look to reposition their portfolios based on the Democratic nominee or the outcome of the election. More recently, as the Coronavirus continues to spread, it is expected that global growth will be negatively impacted in the first half of the year but will rebound afterwards. Although this conclusion is based on historical analysis, it is challenging to predict as the virus remains uncontained. With these risks in mind, we continue to believe that the expansion will continue in 2020, albeit at a slower pace, and fixed income investors should expect returns similar to coupon rates rather than the performance experienced in 2019.

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