OPUS
INVESTMENT MANAGEMENT

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Second Quarter Commentary

Starting in July, the U.S. will be in the longest period of continuous economic growth in its history. Recovering from the depths of the Great Financial Crisis in 2009, this period of economic expansion has not been the steepest, but that might be the main reason it continues today. The meandering pace of growth over the past decade has eliminated some of the pitfalls that have been attributed to spurring past downturns, that being periods of excess (tech stocks - 2001, housing bubble - 2009) and the Fed raising interest rates too far in an effort to hold off inflation. With the Fed and other central banks reversing policy toward a more accommodative stance and no outwardly visible pockets of excess, the expansion appears to have room to run.

However, pockets of risk remain. Global growth began to slow toward the end of 2018, negatively impacting financial markets and forcing central banks around the globe to rethink policy. In addition, escalating trade rhetoric between the U.S. and China and geopolitical concerns in the Middle East invited volatility back into global capital markets. As U.S. interest rates rallied on global growth concerns, risk assets thrived, driven by explicit support from global central banks. While the S&P 500 (S&P) recorded an all-time high at the end of the quarter, 10-year interest rates reached lows not seen since before the 2016 election, finishing the quarter at 2.01%. As such, the Bloomberg Barclays U.S. Aggregate Bond Index returned 3.08% for the quarter, bringing the year-to-date total return to 6.11%.

Return of volatility

Investors entered the quarter aware of slowing global growth, driven by fading economic momentum from U.S. tax reform and global trade friction, but supported by central banks pivoting to a more dovish tone. As the quarter went on, escalating trade tensions and unsettling geopolitical events resulted in increased market volatility. As each of these conditions ebbed and flowed, both fixed income and equity markets followed.

The International Monetary Fund (IMF) cut its global growth forecast in early April to the lowest level since the Financial Crisis, warning of increased and significant downside risks to global growth, including trade instability, pockets of political uncertainty, mounting debt levels and increasing inequality. Despite the lower forecast, the IMF also stated its expectation that the global economy would pick up during the second half of the year, supported by accommodative policies from central banks. Markets reacted accordingly with the S&P rising nearly 4% and the yield on 10-year U.S. Treasury rates range-bound between 2.40% - 2.60% during the month. On April 12th, the VIX Index (a measure of volatility) registered a 12.0, the lowest reading of the first half of 2019.

Uncertainty surrounding a potential trade war between the world’s two largest economies weighed heavily in May as rhetoric between the U.S. and China increased. Geopolitical risks also flared up, with Theresa May’s resignation further clouding England’s Brexit process and tensions in the Middle East escalating between the U.S. and Iran. These events triggered a sell-off in risk assets throughout the month as the S&P bottomed in early June and the 10-year rate ended the month at 2.13%.

Central bank easing

If the story of May was the negative impact on global growth caused by trade wars and geopolitical concerns, the theme in June was all about supportive central banks. In response to slowing global growth and increased downside risks, the Fed in its June commentary replaced the word “patient” with very clear signaling, saying that it will “act as appropriate to sustain the expansion.” As a result, at the end of the quarter the market was pricing in an 85.5% probability of a 25 basis point rate cut for the July meeting and a 64.5% probability of a 50 basis point downward move for September according to Bloomberg calculations. As well and in response to slowing European growth, the European Central Bank strongly hinted at an upcoming rate cut to proactively address deflationary pressures in Europe. Lastly, China initiated a second round of stimulus as trade concerns challenged growth. As such, this explicit support from global central banks drove risk

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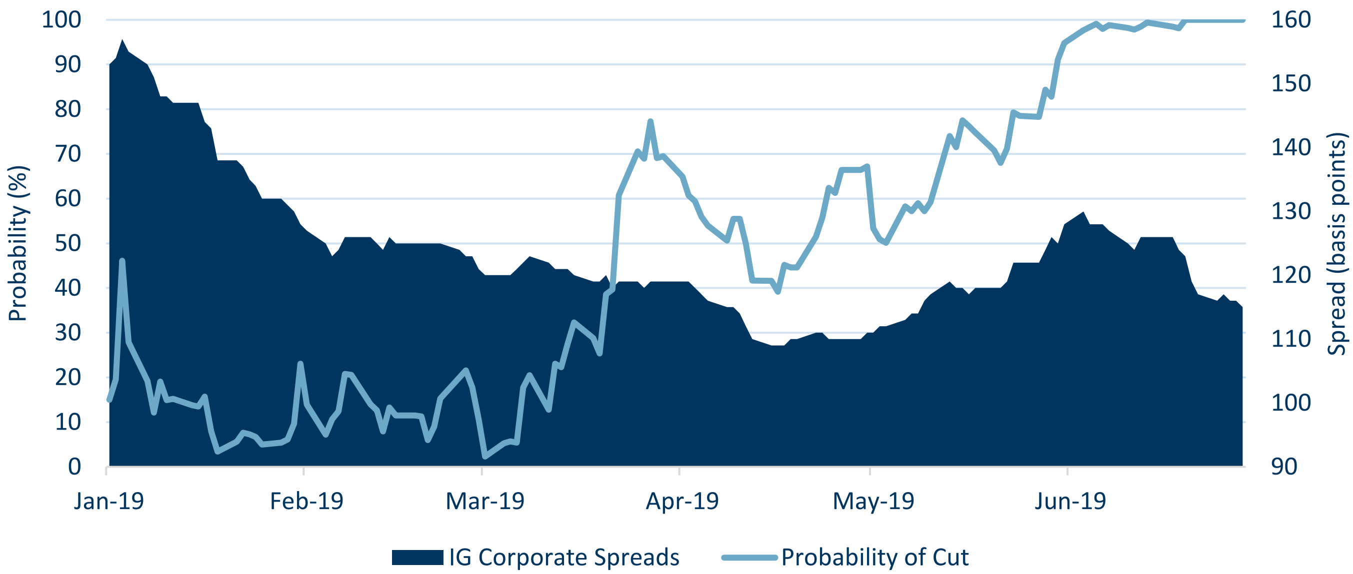
assets higher with the S&P registering an all-time high on June 20th while the expectation of imminent rate cuts led the 10-year to close the month at 2.01%.

Exhibit 1: Corporate bond spreads were able to rally into quarter end as the probability of a rate cut increased to 100% following supportive commentary by Fed governors



Sources: Opus, Bloomberg

U.S. growth returning to trend

It is worth noting that economic metrics remain in expansionary territory, albeit at a slower pace. After expanding 3.1% in the first quarter, consensus estimates have U.S. GDP moderating to 2.4% for full year 2019. Despite a May jobs report that surprised to the downside (but still added jobs), continued economic growth is supported by strong labor markets, with unemployment well below 4%. Inflation has been range-bound between 1.4-2.0% which, while stubbornly below the Fed's 2% target, is positive for economic growth and financial markets. Manufacturing and services measures have slowed but continue to signal expected growth. Lastly, corporate fundamentals remain supportive of the current expansion, with earnings surprising slightly to the upside in Q1 and lower-rated BBB issuers focused on strengthening their balance sheet.

As stated last quarter, we believe growth will stay on trend in the U.S. and that more accommodative central banks, including the Fed, will further extend this period of expansion. We expect monetary policy to be a major focal point for the media and investors, with portions of the yield curve inverted and high implied probabilities of rate cuts by the end of the year. Additionally, we are mindful of investor perceptions and sentiment, which can cause significant swings in valuations as witnessed late in 2018 and throughout the first half of 2019. We maintain our cautious view when investing and allocating portfolios as we attempt to limit the effects of negative price swings while creating the flexibility to seize on opportunities as they present themselves.