

Quarterly Commentary

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Fourth Quarter 2015

Bond investors experienced negative total returns in the fourth quarter as interest rates rose in anticipation of the long-awaited Fed tightening that took place on December 16. Total return for the broad market as measured by the Barclays Aggregate Index was -0.57%. The yield curve flattened during the quarter, with yields on 2 year Treasury notes rising by 42 basis points but by only 23 for 10 year notes. Total return for the full year for the Barclays Aggregate was slightly better at 0.55%.

Economic overview: *low everything*

Full year domestic growth will likely come in **lower** than expected (~ 2.1%) and inflation remains **low**: inflation has averaged close to zero in the past year in the G7* countries. Median growth of the 152 emerging economies as tracked by the IMF was an estimated 3.2%, the **lowest** since 2009 and the late 1990's when an Asian crisis hit. **Low** population growth is thought to be a major factor in explaining this phenomenon (one source indicates the world's working age population will decline by 0.3% per year over the next decade, the **slowest** growth in modern history). **Low** oil (and indeed many other commodity) prices are symptomatic of both new supply as well as declining demand growth. As a result, bond yields remain **low** (in some cases negative) around the world.

One thing that's not low is debt: governments around the world remain mired in heavy debt which has held them back from fiscal stimulus, leaving monetary policy the only real tool to combat slow growth. Still, despite low (or negative) interest rates, in most places there is still a lack of robust credit growth since consumers are loathe to borrow after the extreme financial crisis of 2008 and without adequate debt growth, an economy is confined to the pace of income growth.

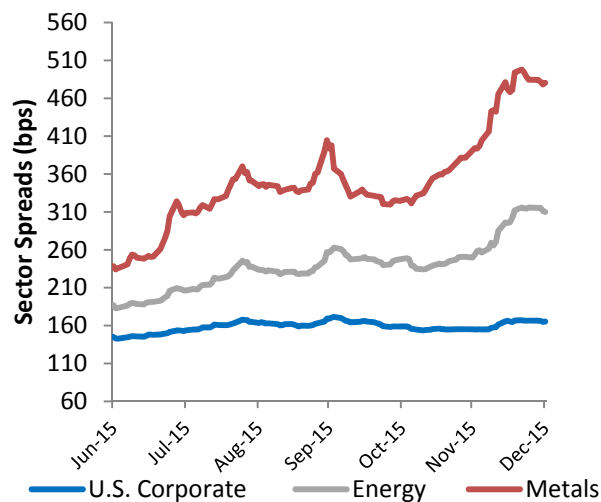
For bond investors, low growth and low inflation are advantageous, particularly since bond yields are low: if growth or inflation accelerated rapidly and

began to worry the Fed, a swift series of rate increases would be in store and bond prices would decline, similar to 1994. Instead, bond investors are likely to experience a very gradual rise in interest rates that could still allow overall total returns to remain positive even as the Fed moves short term rates higher.

Spread widening has affected nearly all sectors due to increasing risk and uncertainty

While we are pleased to be receiving more compensation for taking risk, the path to getting there is never smooth. As spreads move wider, prices of existing bonds are of course affected as well, so total return is negatively impacted --- all-in yields are moving higher which leads to declining bond prices.

Exhibit 1: Energy and Metals & Mining continued to widen significantly in Q4



Source: Barclays

Spreads have moved wider throughout much of 2015 for a variety of reasons. In the corporate sector, weak commodity prices have caused significant revenue and profit shortfalls in the large energy sector as well as metals and mining and many companies have seen their ratings

downgraded as a result. Rising defaults from the weakest energy companies, which already carry junk bond ratings, are expected to occur in 2016 which add to the sense of uncertainty and gloom. Also, companies have gone on a debt binge due to low yields, borrowing huge sums to either buy back shares or buy other companies. Much of this activity has led to declining credit fundamentals, albeit from a strong starting point, which is causing bond investors to push spreads wider as compensation for the additional risk. Earnings of many companies have also been hurt by the strengthening US dollar which impacts earnings from overseas, while labor costs (benefits and wages) continue to creep higher and pose a threat to margins.

In the securitized sector, commercial MBS and asset-backed spreads have moved wider as well, partly in sympathy with corporates and partly due to the more onerous regulatory landscape in both the US and Europe. Agency RMBS spreads remain uninspiring due to the continued influence of the Fed, but that could change late in 2016 if they put an end to reinvestment of paydowns.

The critical question for 2016 is this: how much of this negativity is already reflected in current spreads? The answer depends on the sector and outlook for each of the factors noted above, but in many cases we believe spreads are attractive and now offer a much better risk-reward framework for investors.

Concluding thoughts

Slow growth and low inflation makes for a bond-friendly outlook for 2016. Still, the Fed has started to raise rates so it will not be smooth sailing and the “friendly” adjective really only means “not negative” or perhaps “not very negative.” After seven years with a 0-0.25% fed funds rate and with the unemployment rate about to move through 5%, it seemed fairly obvious the Fed needed to act. Moreover, there are several encouraging factors that should allow the domestic expansion to continue for longer: more people are working, energy is cheap, and the banking system is healthy. However, the global economy is no longer enjoying fast, smooth growth from China and the world is now adjusting to this reality.

Other risks noted above leave us cautious but hopeful on the prospects for spread sectors in 2016. While many of the risks *may* be priced in, there still appears to be too much negative momentum to feel upbeat about adding risk in the immediate days ahead. Still, bonds should provide steady, reliable income and prove to be a good store of value since interest rates are not likely to move dramatically higher.

From all of us at Opus Investment Management, we thank you for your continued confidence in our stewardship of your assets and we wish you a prosperous new year!

* G7: The Group of Seven (G7) is an informal bloc of industrialized economies: US, Canada, UK, Germany, France, Italy, Japan.

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