Quarterly Commentary

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First Quarter 2015

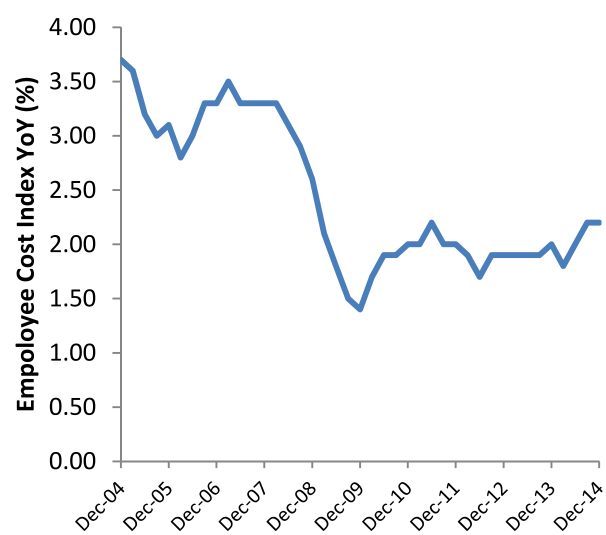
The "low for longer" refrain we have been repeating for some time now was evident yet again this quarter: bond yields declined as investors worried about Greece, currency wars, and deflation. It did not matter that the U.S. unemployment rate fell to 5.5% amidst more and more signs of tightening labor conditions, nor did it matter that the Fed more or less confirmed their plan to begin raising rates this year, assuming no major changes in economic performance. The global phenomenon of slow growth, too-low inflation and quantitative easing policies means that low yields are firmly in place. Lower yields means positive price action: the total return for the broad market as measured by the Barclays U.S. Aggregate Index was 1.61% for the quarter.

Winter weather likely held back growth

Much like last year, severe winter weather proved disruptive for some segments of the economy this quarter and, in addition, the extended labor disruption at West Coast ports also had a negative impact. Combined with the strong dollar's negative impact on exports, these influences should mean first quarter GDP will be lower than expected. Still, job gains have remained impressive as companies continue to gain confidence to add to payrolls so much of this pause can be deemed transitory. Beyond the headline unemployment rate noted above, the broader U-6 rate which includes those marginally attached to the labor force has also declined steadily (now at 10.9%). In past recoveries, wage gains started to accelerate only when this broad measure improved to about 9%-9.5%, so broad wage inflation may still take some time to develop: the average hourly earnings annual growth rate is still just 2.1%.

Higher levels of employment along with modest improvement in home prices and equity markets *should* ultimately lead to greater consumer spending, but so far the evidence points to a tepid, disciplined response. This recovery has been marked by severe angst among both consumers and businesses which is typical behavior following a financial crisis. During the heyday of last decade, consumers boosted leverage by using their homes as virtual ATM machines, taking advantage of any price appreciation by taking out equity in the process of refinancing. Having learned their lesson when home prices later fell, the share of home equity take-outs among those refinancing mortgages is now only about 10% compared to 80+% in 2005/2006. When an economy experiences more income-based growth rather than asset or credit-fueled, the rate of growth will by necessity be limited to the rate of income growth. Real incomes are still only growing at a 2%-2.5% annual rate, so it will be quite difficult to achieve any meaningful improvement until this rate moves higher or productivity improves dramatically.

Exhibit 1: Employee compensation only growing around 2% per year



Source: Bureau of Labor Statistics

Corporate sector warrants increasing caution

With the cost of borrowing remaining so low, companies are beginning to take on more debt for a variety of purposes, often for share buy-backs, special dividends, or acquisitions. Meanwhile, the stronger dollar is hurting the earnings of many companies with foreign sales, so credit improvement is beginning to falter. While this modest erosion in credit fundamentals is occurring from a strong base, it will require close scrutiny. We have been touting selectivity in the credit sector for some time as quality spreads have been compressed and all-in yields have been low, and we remain focused on achieving attractive risk-adjusted yields.

Meanwhile, spreads in other sectors remain disappointingly meager, particularly in the agency mortgage-backed security sector. One reason spreads have remained so compressed is the lack of supply which has been exacerbated by the Fed's quantitative easing program. If low interest rate volatility persists, performance in this sector could be decent, but the risk of higher rates and increasing volatility as the Fed approaches policy changes leaves us wary and therefore we remain modestly underweight. In the short duration realm, the asset-backed security sector offers decent yields, good liquidity and high quality. As for the commercial mortgage-backed sector, underwriting is beginning to suffer so selectivity is again becoming paramount.

Closing comments

Given the prevailing level of interest rates, it does seem difficult to envision rates moving lower. The conditions that would produce such an outcome are likely to be less than pleasant and could involve a heightening in geopolitical tensions, an unraveling of the Eurozone, or persistent deflation in developed economies. In light of the trends in Japan and many European countries for ultra-low yields, however, it cannot be ruled out. Our base case forecast still envisions rates moving higher gradually as economic performance improves and as Fed tightening begins occurring.

Turning points in monetary policy can be challenging, particularly when so much time has elapsed since the last policy change. The Fed's recent policy guidance statement indicates there is growing consensus on raising short term rates, but the actual timing is being left intentionally vague. We believe this alone would suggest that fixed income markets will be "choppy" in the months ahead, and certainly the other issues touched on above will compound this: the debate about Greece remaining in the Eurozone, the battle against inflation that has now enflamed a currency war, and other issues such as China's slowing growth. We thank you for your continued confidence in Opus Investment Management as we steer your portfolio through these choppy waters.