Quarterly Commentary

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Fourth Quarter 2017

Positive total returns from the bond market came about this quarter due to the stellar performance of the long end of the Treasury curve, while shorter points along the curve experienced slightly negative results as bond yields rose due to the Fed's rate hikes. The total return for the quarter for the broad market, as represented by the Bloomberg Barclays U.S. Aggregate Bond Index, was 0.39%.

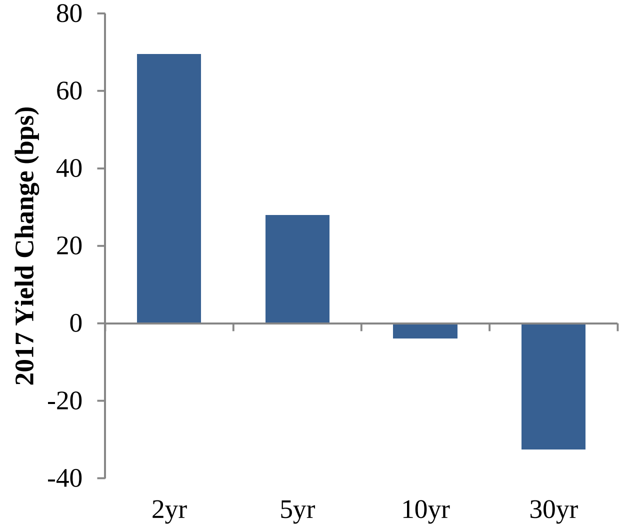
Normalization --- of the economy and of the Fed's balance sheet

Nearly ten years since the start of the financial crisis, the U.S. economy is finally performing well enough to allow the Fed to begin reducing the size of its balance sheet from crisis-induced levels while concurrently raising short term rates. In the immediate aftermath of the crisis, many predicted it might take a decade or more for things to return to normal, particularly since studies have shown recoveries to be slower following financial crises. For most of the time since then, one or more major segments of the economy was in decline which resulted in sub-par real growth rates and which felt to most like stalling out rather than moving forward. Finally, in 2017, a break-out occurred as the recovery became self-reinforcing and an improvement in business spending and net exports led to stronger growth over last year. At the same time, consumer and business sentiment indices rose to 17-year highs, the unemployment rate dipped to its lowest point in 17 years, the equity market rose steadily higher, and economic growth surprised to the upside across much of the globe. This breadth of good news occurred even as the Fed raised rates three times to 1.5%, thus moving further away from emergency levels.

Looking ahead: what's in store for 2018 and beyond

- The balanced pace and breadth of growth that we expect to continue (~2.5% GDP growth) will likely lead the Fed to raise rates two or three more times in 2018 in order to avoid creating asset bubbles and to return the Fed funds rate to a level more consistent with a normally-functioning economy. As always, these moves will be data-dependent and could be deferred if conditions warrant.

Exhibit 1: During 2017, the Treasury Yield Curve flattened as Fed rate hikes pushed shorter rates higher, while limited inflation contributed to lower long duration rates



Source: Bloomberg

- With much of the slack in the labor market now absorbed, we expect wage inflation pressure to build. However, we do not expect the overall inflation rate to pierce the Fed's target of 2% in 2018 (as measured by the core personal consumption expenditure index, or PCE) as powerful deflationary forces remain in play such as the "Amazon effect" of price discovery, Uber, and others. This benign view on inflation is shared by many and is a major reason the yield on the 30-year Treasury bond actually declined last year and the 10-year was basically unchanged.
- We feel the housing market should remain sound since inventories are low and homebuilder sentiment is the strongest since 1999, but price gains may slow owing to

some changes in the tax bill. Rapid price gains have already led to affordability issues in many markets.

- Other features of the tax bill lead us to believe business spending growth will continue on the solid path established in 2017, supported by the bounce in global growth and the reduced regulatory burden now emerging. Favorable financial conditions, strong equity prices, lower corporate tax rates, and repatriation of overseas cash are expected to lead to more mergers and acquisition activity.
- With the savings rate at its lowest since 2007, consumer spending growth may also slow a bit in the coming year, notwithstanding the low unemployment rate and high confidence measures: aging and changes in consumption patterns are persistent challenges.

Risks to the outlook

We would be remiss if we didn't mention several risks to the outlook:

1) China's self-induced slowdown, led by its determination to curtail excessive debt growth, environmental hazards, and industrial overcapacity; **2)** Geopolitical tension, whether from North Korea, Iran, or some other hot spot; **3)** Faster pace of tightening (whether from higher rates or fewer asset purchases) from central banks, perhaps due to a perkier inflation rate; **4)** Domestic political complications stemming from the Mueller investigation; and **5)** Rising protectionist measures such as, at the extreme, an end to NAFTA.

While any of these issues may cause "noise" or short-term volatility, we do not believe any will prove to be disruptive on a *sustained* basis but they do bear watching nevertheless.

Longer term, structural headwinds will likely limit not only how fast the economy can grow but also how much longer growth can continue without undergoing a cyclical downturn, which is another reason long term rates have remained well-behaved. These include low growth of the working-age population, weak productivity gains, high debt levels, and aging populations in most developed economies.

Sector positioning and outlook

We have been cautioning for some time about the relatively poor prospects for outperformance by most sectors due to stretched valuations, but 2017 proved us wrong. All spread sectors generated excess return over Treasuries last year. Corporates benefitted from higher earnings and robust buying from yield-starved overseas investors, while RMBS benefitted from lower volatility and a smooth start to the Fed's balance sheet reduction. Still, this further tightening only reaffirms our view that valuations are simply not compelling. Since we do not believe spreads will widen materially without some major catalyst, a modest overweight to the spread sectors is still in order but we will generally seek to keep risk exposures short and higher in quality.

Summary

In closing, we are optimistic that global conditions will remain supportive of financial markets and that bond market returns can stay positive in 2018 even as the Fed continues to normalize monetary policy. However, we feel that return expectations should be muted due to the absolute low level of bond yields and the expectation that yields will climb some, particularly shorter-dated maturities, due to further Fed rate hikes. We thank you for your continued confidence in Opus Investment Management and we wish you a peaceful, productive new year.

* Sources: Barclays Capital, Capital Economics, Wells Fargo

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