Quarterly Commentary

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In the first three months of the year interest rates fell to almost historical lows, the U.S. Dollar strengthened, commodity prices declined, and transitory factors reduced domestic growth culminating in positive returns for fixed income investors. During the past three months the 10 year Treasury yield rose 50 basis points, the U.S. Dollar weakened, the price of oil stabilized, and U.S. economic data pointed to a nice rebound in second quarter GDP. As a result, fixed income investors lost 1.68% during the quarter (Barclays U.S. Bond Aggregate Index) reversing the gains made in the first quarter of the year. How quickly trends can reverse! However, there remains a somber tone to the markets as struggles with Greece still prevail, Puerto Rico continues to be challenged by a heavy debt-load, and sizable turbulence is being experienced in the Chinese equity markets.

U.S. economic data points to a rebound

With the winter weather and west coast port closings a thing of the past, U.S. economic data is beating consensus expectations. After a minor setback, job growth has returned to adding 200,000 positions per month. Manufacturing data is also showing signs of improvement and consumer confidence is approaching an 8 year high. Nascent wage inflation, something highly sought after, is appearing in the Employment Cost Index and in other wage reports. Examining the myriad of small business surveys also points to growing optimism regarding the U.S. expansion which, noteworthy, is now in its sixth year. Still, there is much debate, both outside and within, on when the Federal Reserve will increase rates for the first time since the Financial Crisis began. Probabilities favor a September lift-off, but this is not set in stone and could be delayed until 2016 – not an unpopular thesis.

From a global perspective, growth expectations are slightly moderating with relative strength in the developed markets (led by the U.S.) offset by weakening in the emerging markets (led by China). A clear demonstration of this dynamic is the diverging central bank policy around the globe. The U.S. and U.K. are contemplating rate hikes, while China is cutting rates to avoid asset bubbles, especially in their real estate market. Europe is somewhere in the middle as quantitative easing and negative deposit rates have appeared to provide a boost to growth, but absolute levels are still very low and the situation in Greece is certainly a wildcard.

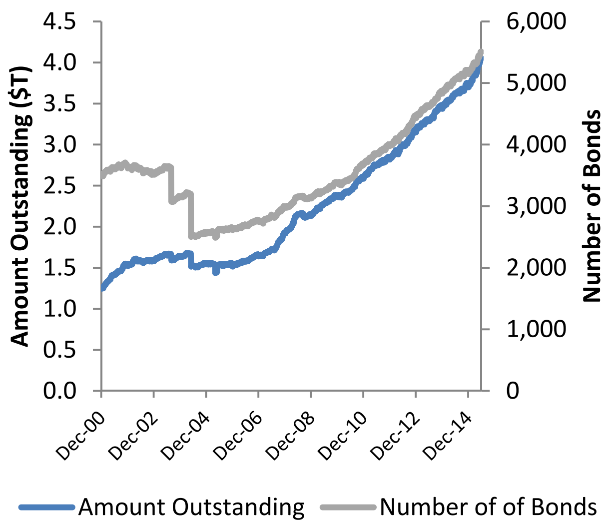
Exhibit 1: Surveys of small business owners indicate continued confidence in economic recovery

Source: National Federation of Independent Business

Less liquidity, more volatility

A growing concern within the fixed income industry is the lack of liquidity, specifically in the corporate bond market. Much has been written about how recent financial regulation has reduced the amount of inventory that banks hold to promote market liquidity due to the capital charges they would incur, however this is not the only driver behind growing illiquidity. Corporations have taken advantage of the low yielding environment by issuing record amounts of debt. In fact, this year is on pace to be the fourth consecutive year of record corporate bond supply. As a result of the low yield environment, the size of the corporate bond sector has exploded since the Financial Crisis in terms of amount outstanding and number of issues. According to Barclays Index data, on December 31, 2000 the size of the corporate bond market was \$1.25T. It took 10 years for the market to double in size, but only an additional 5 years to triple!

Exhibit 2: Growth of U.S. investment grade corporate market contributing to liquidity concerns



Source: Barclays, Opus

Mitigating this market dynamic has been the voracious demand for yield as the economic outlook improved causing spreads to tighten and bond prices to rise. Currently, spreads are somewhat meager compared to the last five years and if the Fed begins to raise rates, will the same demand exist to support bond prices? Glimpses of what the future may hold can be seen today when spreads meaningfully rise on takeover speculation, downgrade concerns, or leveraging transactions without an actual transaction occurring. This illiquidity will be more of a burden for the large fixed income shops that may have to contend with negative retail fund flows, but all investors should expect more volatility as a product of supply growth and smaller bank balance sheets.

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Closing comments

Heading into the second half of the year, market expectations are for a gradual increase in rates by the Federal Reserve, low steady growth, and limited inflation which, on paper, are a healthy backdrop for fixed income. Concurrently, investors will have to contend with the Greek saga, Puerto Rico, Chinese market turmoil, and the possible first rate hike, all of which have the potential to derail market sentiment. Additionally, the quality of corporate balance sheets has peaked with some measures deteriorating to levels last seen during the Financial Crisis.

Where does this leave us? As we have written in previous letters, a cautious approach to risk is justified given fair valuations and an economic backdrop susceptible to a mistake in political policy. Focusing on efficient use of risk will allow us the flexibility to capitalize on opportunities in the future when they appear. As always, we are grateful for your confidence and trust in Opus to manage your portfolio through the times ahead.

IMPORTANT INFORMATION