Quarterly Commentary

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Third Quarter 2017

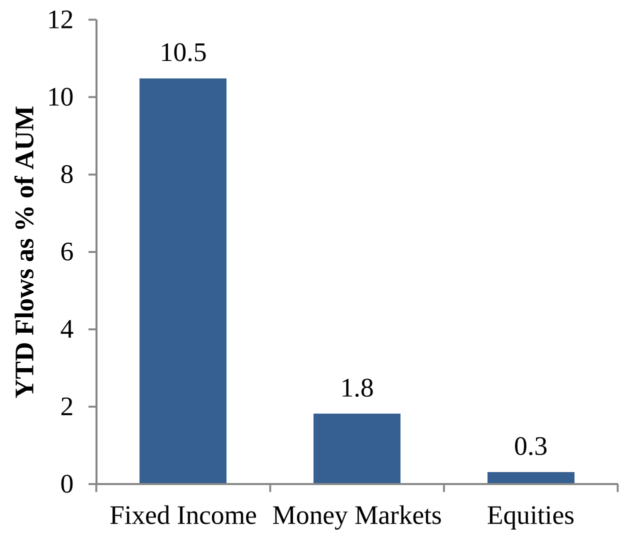
The summer of 2017 will be remembered for record-breaking hurricanes, missile launches from a rogue dictator, failed policy reforms, and plans for a balance sheet unwind. Domestic markets took this in stride – equity markets hit new highs, interest rates remained stable, and fixed income risk premiums contracted. Demand for fixed income remains robust, no wonder with the 10-year Treasury yielding more than some European High Yield bonds. The end result was a modest return of 0.85% for the Bloomberg Barclays US Aggregate Bond Index during the third quarter of 2017.

The great unwind has begun

In order to support the economy during the Financial Crisis, the Federal Reserve embarked on a bond buying program – called Quantitative Easing – which resulted in the expansion of their balance sheet from just under $1 trillion to roughly $4.5 trillion today. After months of telegraphing their intentions and strategy, the Fed announced they will reduce their reinvestment of securities beginning in October by $10 billion per month ($6B Treasuries, $4B MBS) with further pull-back every quarter until the number reaches $50 billion per month. Investors, long wary of this expected policy change, appeared well-positioned for the announcement and stepped into the RMBS sector, resulting in positive excess returns (duration-adjusted performance) during September. Almost ten years after the Financial Crisis began, the Fed has started unwinding its balance sheet.

After consecutive months of decelerating inflation rates, investors began to question if there would be a third rate hike this year. Given the transparency around balance sheet normalization, it could be argued there was more focus on the rate policy and Dot Plot in September. Probabilities for a December rate hike were only in the mid-40%* range prior to the Fed meeting, but after release of the September minutes, probabilities increased to 67%*. This messaging indicates the Fed remains determined to continue raising rates and move further away from the zero bound, which will provide some cushion to cut rates should the need arise in the near future.

Exhibit 1: Demand for US fixed income remains strong as measured by mutual fund and ETF flows



Source: Wells Fargo Securities, EPFR Global, as of 10/19/17

Expansion keeps pace

Growth bounced back in the second quarter following the typical first quarter weakness we have witnessed over the last few years. Unemployment remains low, optimism surveys continue to look stellar, and manufacturing indices again reported expansion. Investor confidence is allowing the stock market to hit new highs, which if sustained, should maintain the high levels of optimism in consumer and small business surveys.

While hurricanes Harvey and Irma were, and will continue to be, devastating for millions of families in the South, the long-term impact on growth should be minimal. Disruption from the hurricanes is expected to result in a short-term hit to growth, but as impacted communities recover, restore, and repair, a subsequent rebound over the following quarters is likely to ensue. Given the level of diversification in the issuers and structures Opus invests in, we have minimal concern for a significant deterioration in credit quality for our portfolios.

As we saw in the first six months of the year, policy reform continues to be a challenge for our President and Congress. The latest attempts for healthcare repeal and reform were stymied by a handful of senators and now future prospects look bleak. A deal to push off the debt ceiling debate until December has given the federal government an opportunity to put tax reform on the table, which the administration released at the close of the quarter. While this release had more details than anything seen or discussed in the past, key items are missing to determine the impact of the proposal. However, there are a number of hot-button issues, like the elimination of state and local tax deductions, which will make this policy difficult to pass in its current form.

Concluding remarks

As observed in past years, the US economy is expected to grow in the low-to-mid 2% range, a level that we feel will result in stable, consistent growth, for the foreseeable future. With inflation in check, low interest rates globally, and demographics fueling demand for fixed income assets, we see little reason for domestic rates to rapidly climb higher. Corporate America remains healthy by many measures, and the consumer is benefiting from high equity values and signs of wage inflation, which should continue to contribute to growth. Although we do take pause when looking at risk premiums in fixed income, we remain confident in our portfolio positioning as we head into the final months of the year.

*Fed Fund Future probability calculated from Bloomberg as of 10/2/17

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