

Quarterly Commentary

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Third Quarter 2015

Bond investors continued to enjoy a reprieve from higher interest rates this quarter after the Fed declined to raise the Fed Funds rate due to the deteriorating global economic outlook and weak inflation. Most of the Treasury yield curve is now lower than the start of the year which indicates a great deal of doubt as to whether the Fed will act this year, and this doubt increased following the September payroll report which was weaker than expected. Total return for the broad market as measured by the Barclays U.S. Bond Aggregate Index was 1.23%, far better than the -6.44% return for the S&P 500.

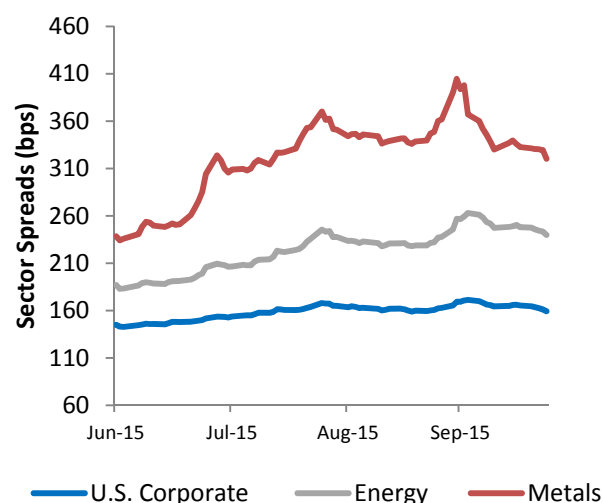
Now that Greece is fixed, China's growth model is in doubt

More signs of a slowdown in China's growth this quarter resulted in the underperformance of most anything involved in energy or mineral extraction. Spreads moved wider nearly across the board but the energy and mining sectors were the true outliers as the weak commodity price cycle appears to be deeper and more lasting than earlier thought. Some of this price action is justified, but some also appears to be driven by media hype and exacerbated by the reduced liquidity in the bond market. China's share of world commodity consumption is massive and some of the supply that has come on-line over the last decade to feed this demand will need to be shut down, but there is still a great deal of urbanization taking place that will keep Chinese demand from completely collapsing.

Meanwhile, most economic indicators for the domestic economy continue to exhibit resilience with the exception of the manufacturing sector. Job growth has remained buoyant and the housing market is solid if unspectacular, while personal consumption is increasing at a 3+% annual pace on the back of strong consumer confidence, lower gas prices, and low financing costs. The spectacular declines in China's equity market in August help explain some of the Fed's decision to remain on

hold, but low inflation is also a factor that could explain their reticence: deflationary forces are still prevalent across much of the globe and the low energy prices noted above continue to keep domestic inflation at bay.

Exhibit 1: Energy and Metals & Mining widened significantly during 3Q



Source: Barclays

Financial engineering more common in a low growth environment

A low growth economy often prompts CEOs to seek mergers and acquisitions (M&A) in an effort to bolster organic growth and the current environment is certainly corroborating that notion. At \$3.2 trillion in deals this year, 2015 is on pace to tie 2007 as the biggest year for M&A and mega-mergers are getting more mega: two \$80 billion deals are now pending along with eight others between \$25 and \$60 billion. This phenomenon is also attributable to extremely low-cost financing and the build-up of overseas cash which is sometimes used to fund acquisitions. We are keeping a wary eye on these transactions as debt piles up and some mistakes will likely be made: witness the recent break-up of eBay as an example of past deal-making gone awry.

Fixed income markets not feeling the love

Spread widening in the corporate sector has been occurring since last fall when commodity prices began sliding and has continued fairly steadily since then even though corporate fundamentals are still strong. Part of this move is driven by the heavy M&A-related supply as alluded to above but part is also due to concern about slow growth (particularly in emerging markets), shareholder-friendly activity, and weaker liquidity in the bond market. This weak liquidity manifests itself as sharper and often instantaneous spread widening on any hint of trouble since there is less balance sheet available by market-makers to institutional investors, so bid-ask spreads widen to compensate dealers who are less able to take risk. The Barclays Credit Index excess return this quarter and year-to-date was -170 basis points and -222 respectively. These results are pretty dismal but could turn rather quickly once some of the issues noted above begin to dissipate.

Since the Fed has embarked on its quantitative easing policies, the Agency mortgage-backed security market has been artificially influenced by the massive holdings locked up on the Fed's balance sheet. This effect --- combined with the threat of the Fed selling its holdings into the market --- has left us lukewarm on the MBS sector for some time now. This decision to underweight MBS

has been a winner: MBS excess return this quarter and year-to-date was -23 basis points and -68 respectively.

Other safe and lower-yield sectors within the Securitized market include ABS and CMBS and these have also seen some spread widening due to changing supply/demand factors and poor sentiment generally.

Concluding thoughts

Central banks have been maintaining extraordinary and unconventional measures to keep the global economy on track but results are mixed at best and some formidable headwinds appear to be resurfacing. As we wrote last quarter, 2015 has been marked by mixed signals and confusing trend reversals that have led most forecasts for equity and bond markets to miss the mark. Recent news on the jobs front only adds to that confusion and makes the probability of a Fed tightening less certain. If domestic strength is confirmed in coming months, the Fed will likely act and spreads may finally stabilize since investors may feel more confident in the recovery. If not, the Fed will remain on hold and rates should be range-bound into 2016 pending further developments in the global economy.

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