OUR FIRM

Boyd Watterson Asset Management, LLC is an SEC-registered investment advisory firm with $8.2 billion of assets under management. For nearly 90 years, we have successfully managed a broad range of fixed income, real estate, and equity strategies for institutions and individuals alike.

With a singular focus on the management of money and a dedication to the satisfaction of our clients' expectations, we offer the benefits of a boutique firm but with the resources usually attributable to a much larger asset management firm.

Please visit our website, ***www.boydwatterson.com***, for information about Boyd Watterson's investment strategies, insights, philosophy, and people.

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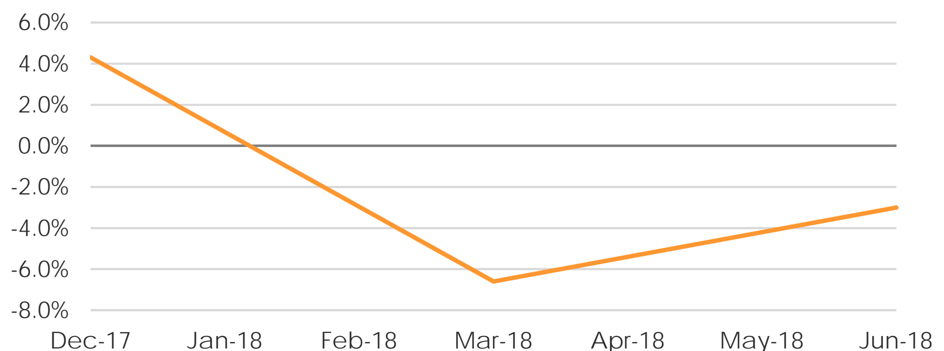
THE MACRO VIEW: OPPORTUNITY REMAINS IN 2018 BUT WORRIES OF RECESSION BEGIN TO RISE

We expect 2018 to be the highwater mark for economic growth before returning in 2019 to levels more reflective of this recovery. U.S. economic data continues to point to positive U.S. growth but has come off recent peak levels. We do not forecast a recession in the next 12 months. Our macro view remains intact:

- Continued economic growth in the 2.8% range due primarily to tax cuts
- Moderate inflation that averages approximately 2.0% and stays in check through year-end
- An active Fed that is trying to raise rates ahead of the next recession
- Low unemployment that nears 3.6% by year-end
- Strong corporate earnings of nearly 20% paired with better than 7.25% revenue growth expected for companies in the S&P

However, there have been some changes this quarter that have turned us a bit more cautious as we look ahead to the second half of 2018 and early part of 2019. We have seen a distinct slowing this quarter in the global synchronized growth story that was in place in 2017 and is expected to continue in 2018. This has led to a longer expected time frame for central banks to back away from bond-buying programs that were integral to their quantitative easing policies. Slower growth in the Eurozone has led to interest rates at levels lower than expected, which in turn is keeping a lid on intermediate and longer-term rates in the U.S., even as the Fed raises short-term rates. Since peaking earlier this year, we have seen declines in the Eurozone PMI. What started as signs of sporadic softening in some technicals looks to be developing into some organic weakness abroad.



Source: Bloomberg. Data through June 30, 2018.

Domestically, economic growth is ramping up versus the first quarter of 2018. According to the Atlanta Fed GDPNow Forecast, second quarter GDP is expected to reach 3.8%, a level we have not seen since the third quarter of 2014. Small business optimism is running at levels not seen since November 2004 and consumer sentiment is still strong. Although the growth story remains intact in the U.S., we are watching for signs that may derail it, such as:

- A Fed that hikes interest rates at a pace not anticipated by the market
- Trade tensions resulting in higher inflation and a decline in business investment
- The impact of increasing debt at the Federal level as a result of the recent tax cuts and the ability to service the debt in a rising interest rate environment

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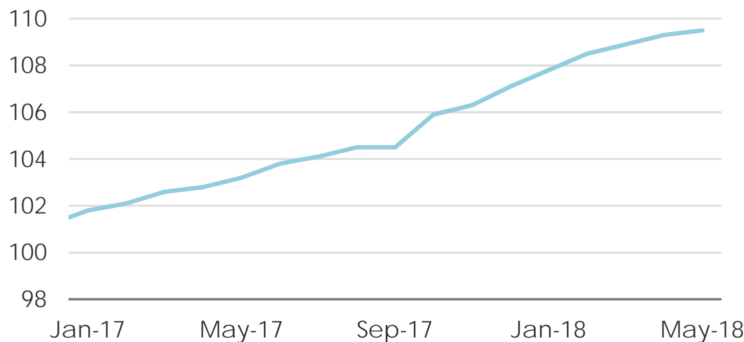
COMPOSITE INDEX OF 10 LEADING INDICATORS



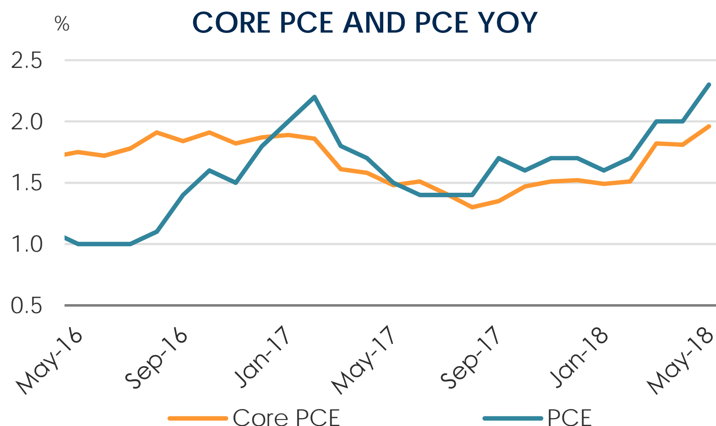
Source: The Conference Board. Data through May 31, 2018.

THE FED, INTEREST RATES AND INFLATION

In its continued step back from post-crisis policy, the Fed raised interest rates an additional 25bps in June, bringing the fed funds rate to 1.75%-2.00%, noting strong GDP growth and low unemployment. The Fed indicated another two moves are likely in 2018, followed by three in 2019 and then two in 2020. If they stay that course, it would land the fed funds rate in the 3.50%-3.75% range by the end of 2020. We think the Fed will be forced to act more moderately, continuing its gradual course with two more moves in 2018 and two in 2019 (rather than three), landing the fed funds rate at 2.75%-3.00% by the end of 2019. We believe it would be difficult for the Fed to continue raising rates into 2020 without marked improvement in economic growth outside of the U.S., mainly in Europe and Asia. It is difficult to imagine the fed funds rate exceeding 3.0% in the U.S. while other central banks remain at or near zero.

On the inflation front, Core PCE, the Fed's preferred measure of inflation, sits just slightly below the Fed's target level of 2.0%, coming in at 1.9%. Core CPI has been a little higher, growing at 2.2%. Federal Reserve Chairman Powell made it clear at the June meeting that the Fed is willing to let inflation exceed its target level, apparently focusing more on the pickup in economic growth and a tightening labor market versus slowing global conditions, a strengthening U.S. dollar, and potential trade disputes.

CORE PCE AND PCE YOY



Source: Interactive Data Corporation. Data through May 31, 2018.

CONCLUSION: NEAR-TERM OPTIMISM BUT A FEW MORE TECHNICAL WORRIES TO WATCH

We see continued growth for the rest of 2018 and equity markets should continue to climb as well. However, markets are vulnerable to volatility spurred by geopolitical events and trade issues. In our view, real estate will likely outshine equities for 2018, while fixed income will remain the performance laggard this year as rising rates impact price performance. With that said, given today's higher yields, we believe portfolios are protected a little more than they were a year ago against the impact higher rates have on principal values.

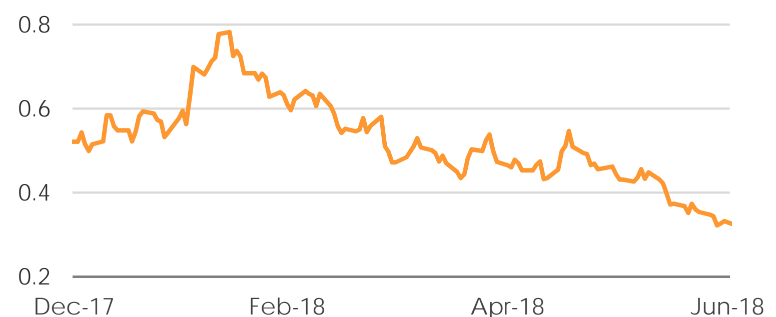
Despite our opinion that the market has more to offer investors in 2018, we see growing risks in the backdrop. The increasingly negative outlook for certain European and Asian regions coupled with some domestic softening have us leaning in a slightly more defensive posture.

THE OVERVIEW BY MARKET

FIXED INCOME

During the second quarter, interest rates moved along the path of least resistance and rose across the curve. More pressure was felt at the front end of the Treasury curve as the Fed continued raising interest rates. The increase in rates at the long end of the curve was held in check over concerns about the distinct slowdown in the global synchronized growth story and benign inflation expectations. As a result, the yield curve continued its flattening trend, with the spread between the 2- and 10-year Treasury ending the quarter at 33bps.

2-YEAR AND 10-YEAR TREASURY SPREAD



Source: Bloomberg. Data through June 30, 2018.

The credit sectors had an interesting quarter, especially when examining the investment grade and high yield segments of the market. Within investment grade, lower quality underperformed higher quality as reduced foreign demand and escalating trade tensions put pressure on credit spreads. However, the opposite was true on the high yield side, as lower quality significantly outperformed higher quality due to less technical pressures and reduced supply.

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The securitized sectors showed resilience during the quarter and escaped some of the underperformance shown in the credit sectors. Agency mortgage-backed, commercial mortgage-backed, and asset-backed securities all outperformed Treasuries and generated positive excess returns.

We are approaching the second half of 2018 positioned for higher interest rates and flat-to-tighter spreads. Our focus continues to be on income generation and maintaining a yield advantage relative to the benchmark. A summary of our main fixed income investment views and themes is listed below:

- Our forecast for four rate hikes aligns with FOMC expectations, although the strength of the dollar and economic activity outside the U.S. may start to have greater influence on the timing and path of future Fed activity
- We expect short-term rates to increase more than long-term rates, leading to a flatter yield curve
- Credit valuations have cheapened and are fairly valued by most measures. Credit technicals have been weakening, but fundamentals remain very supportive
- Credit should be overweighted based on income generation and modest spread-narrowing expectations
- Floating-rate notes remain a good way to take advantage of anticipated rising short-term rates
- TIPS provide an inexpensive option to mitigate against an unexpected increase in inflation

Performance for periods ending June 30, 2018

	QTD	YTD	1-Yr	3-Yr	5-Yr
2-Year Treasury	0.18	0.04	-0.12	0.24	0.48
10-Year Treasury	-0.30	-2.68	-2.69	0.20	1.44
Bloomberg Barclays Aggregate	-0.16	-1.62	-0.40	1.72	2.27
Corporate Investment Grade	-0.94	-3.12	-0.69	2.95	3.55
Corporate High Yield	1.00	0.06	2.50	5.53	5.49
Leveraged Loans	0.78	2.38	4.67	6.07	4.33
Mortgage Backed Securities	0.31	-0.90	0.15	1.48	2.25
S&P 500	3.43	2.65	14.37	11.93	13.42
MSCI EAFE	-1.24	-2.75	6.84	4.90	6.44

Source: Interactive Data, Credit Suisse, Bank of America/Merrill Lynch/Bloomberg. Data through June 30, 2018.

REAL ESTATE

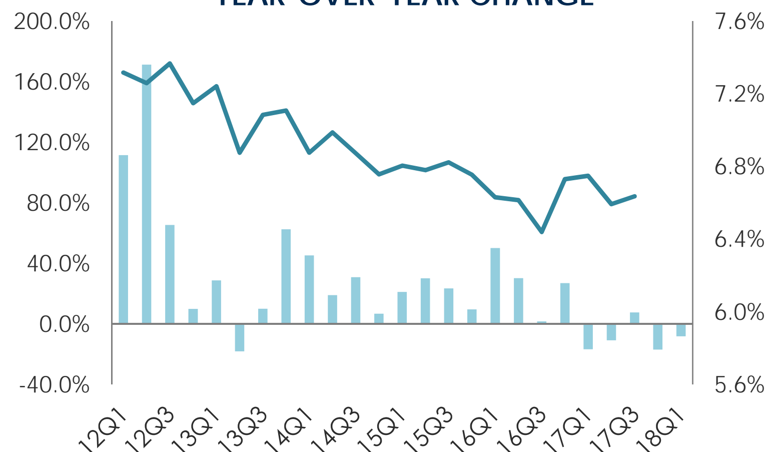
In the first half of 2018, the real estate sector modest returns, with equity trailing the returns of the S&P 500. Fundamentals remain strong along with liquidity, and we see no imminent sign of downturn for the remainder of 2018.

- Occupancies generally remain high
- Demand for rental property generally remains high, outpacing supply and driving rental prices and income higher
- According to the 2018 Preqin Global Real Estate Report, a record amount of dry powder remains, providing a floor for cap rates and prices
- Ample supply of debt and equity capital remain with no sign of deals seizing up or downturn

Despite our optimism, there are a few potential headwinds that we are watching:

- Equity REITs have traded at a discount to NAV, prompting mergers and acquisitions as well as consolidation activity, which could add pressure to buy back stocks and dispose of properties to bolster share prices
- Strong debt liquidity allowing for refinance could push transaction volumes down to a point that puts further pressure on cap rates
- Rising labor costs, fewer skilled laborers, and tariffs on steel could negatively impact construction costs
- Higher interest rates will likely serve to whittle down some of the income component to returns as the Fed continues to gradually raise rates, driving the potential for some investors to tactically shift to riskier assets in order to maintain yields

COMMERCIAL REAL ESTATE QUARTERLY TRANSACTION VOLUME YEAR-OVER-YEAR CHANGE



Source: Real Capital Analytics. Data through March 31, 2018.

Despite the pressures of a maturing cycle and some mounting headwinds, we see returns in the real estate sector remaining strong for the balance of 2018 and likely through the first half of 2019. We believe that healthy balance sheets and fundamentals are likely to keep assets performing solidly in the

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near-term. However, rising construction costs due to tariffs, coupled with continued Fed rate hikes could begin to temper some of the income generated. For the remainder of 2018, high quality income generation remains the primary contributor to real estate returns and we expect overall returns to be on pace with that of 2017.

At a sector level, whether the headwinds represent a mere shift to less robust returns or an actual downturn, we are anticipating a much softer landing to the end of this cycle than prior cycles. Practically speaking, as this cycle has matured it has been met with more stringent underwriting standards, more conservative use of leverage and a more defensive posture by portfolio managers. And unless standards fall, which we think is unlikely to happen at a pandemic level as it did in earlier cycles, we see little risk that residential or commercial property will overheat in 2018 or cause a flashpoint decline. The outlook at this point is more positive than prior cycles and we believe the fundamentals are supporting a smoother ride for real estate investors, even as the current cycle shows signs of waning.

EQUITIES

Despite a far more volatile ride than last year, our outlook for the U.S. equity market in 2018 remains positive. Reported corporate earnings remain high (in the 15%-20% range) and thanks to the tax cut, we think they will remain that way through year-end. The S&P 500 has a YTD return of 2.65% through June 30. Growth continued to outperform value throughout the quarter and small cap returns outpaced larger cap stocks.

As noted earlier, there are some growing signs of weakness developing which have turned our 12-month outlook a bit more bearish than in prior quarters.

- Synchronized global growth appears to be evaporating in Europe and in many emerging markets as evidenced by declines in MSCI EAFE and MSCI ACWI
- Underperformance in certain cyclical industries (e.g. financials, industrials, materials) is beginning to surface, raising concerns about the organic strength of the U.S. market
- Fed rate hikes in the U.S. have caused the yield curve to continue to flatten, causing some concern for the market

Although this is the ninth year of expansion for the U.S. economy, we don't see it as the ninth inning. Based on strong fundamentals, we believe it is important to take advantage of all the market has to offer, but remain vigilant for any signs of weakness.

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