BOYD WATTERSON
ASSET MANAGEMENT

April 2019

2019 Market Outlook

Our Firm

Boyd Watterson Asset Management, LLC is an SEC-registered investment advisory firm with $8.8 billion of assets under management.* Over the last 90 years, Boyd Watterson and its predecessor companies have successfully managed a broad range of fixed income, real estate, and equity strategies for institutions and individuals alike.

With a 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.

*Including gross real estate assets under management and unified managed accounts.

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

Check Out Our Blog:
www.boydwatterson.com/blog

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The Macro View

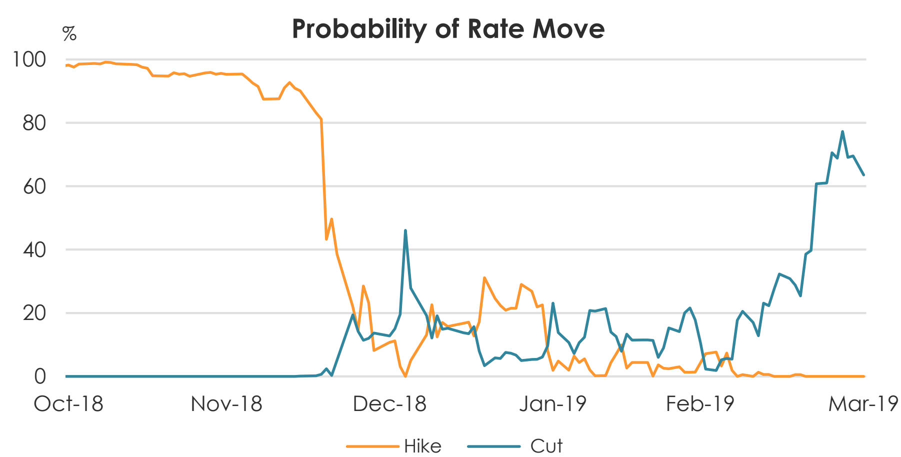
At Boyd Watterson, we take a macro view of the economy to set investment strategy for all of our investment products. We analyze a plethora of economic indicators to determine economic growth, Fed policy, inflation expectations, and where we are in the credit cycle. We believe economic activity centers around the consumer, corporations, government, and real estate.

Economic Growth

The 3.0% economic growth enjoyed in 2018 seems to be a thing of the past. Maintaining a growth rate of 3.0% is a challenge without a substantial improvement in productivity growth given our aging population and labor force growth rate that is flat to declining. Economic data points to a growth rate more in-line with earlier years of the recovery of around 2.0%-2.5% in 2019. We believe the positive momentum from the tax cuts is mostly behind us while we are experiencing headwinds from trade tensions and a downshift in the pace of growth in other developed markets. Another headwind to world economic activity is BREXIT and the uncertainty over how the UK will leave the European Union. This has left the British economy fighting to stay in growth territory while property values are generally declining and companies wait for a hint of certainty before committing to invest in their businesses. With that said, the U.S. economy will set a record for longevity should economic growth continue through July of this year.

Fed Policy

The Fed started the year projecting three rate hikes; moved early in the first quarter to projecting two, and are now stating that they do not expect to raise rates in 2019. The Fed's "pivot" to a much more dovish tone was something the market was expecting as the U.S. Treasury futures market had placed a higher probability on the Fed cutting rates versus raising them in 2019. As of quarter end, the market placed a 69% probability of a rate cut by year-end and a zero probability of a rate hike. We believe the Fed will remain on hold for 2019.



Source: Bloomberg. Data as of March 31, 2019.

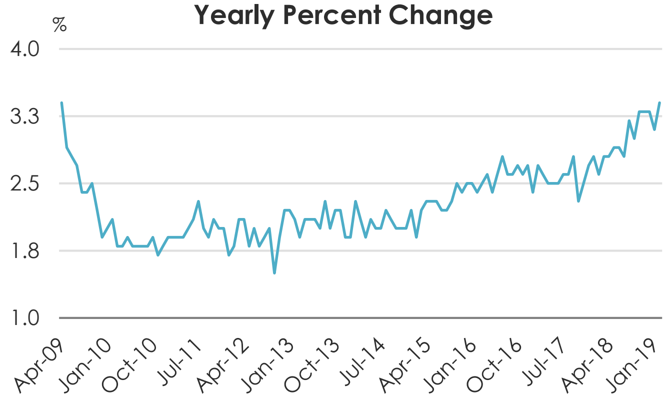
Inflation

Inflation, which peaked in July 2018 at the Fed's target level of 2.0%, has dropped to around 1.75% with few signs of accelerating. The Fed announced that they are willing to let inflation exceed their 2.0% target level, but that doesn't seem likely in the near term.

Consumer

The consumer remains in good health, which is important to note as nearly 70% of economic activity is due to consumer spending. The employment picture is also healthy. The unemployment rate remains below 4.0%, at 3.8%, while the change in non-farm payrolls has averaged over $210,000 per month over the last 12 months. Another positive development has been that we are finally seeing an acceleration in wage growth. Average hourly earnings, which had vacillated between 1.5%-2.5% from late 2009 through late 2015, has finally risen to 3.4% as of the end of February and hasn't been below 3.0% since July 2018. A tight labor market is leading to higher wages.

U.S. Average Hourly Earning Yearly Percent Change



Source: Bloomberg. Data as of February 28, 2019.

The consumer also maintains a healthy personal balance sheet, as household debt to GDP has declined annually since peaking in 2009. An area of concern is the level of student debt, which has been increasing at a rapid pace. The concern is that student debt impacts younger consumers who are relied on to buy homes and automobiles. These levels of debt may lead them to put off large purchases and will therefore impact future economic growth. This is something we are watching closely.

One of the earliest areas of strength in the recovery was the housing market. Low interest rates and low housing prices led to brisk activity and rising home prices, which then led to strong consumer spending. However, existing home sales peaked in late 2016 and have been driving the economy less ever since. A combination of higher interest rates and higher housing prices, while income growth didn't keep pace, has led housing affordability to drop back to levels not seen since 2008. Housing is not slowing the economy, but it isn't driving growth either.

Overall, we believe the employment picture, the recent acceleration in wage growth, and elevated levels of consumer sentiment coupled with healthy personal balance sheets, make the consumer the most likely engine for driving economic growth going forward.

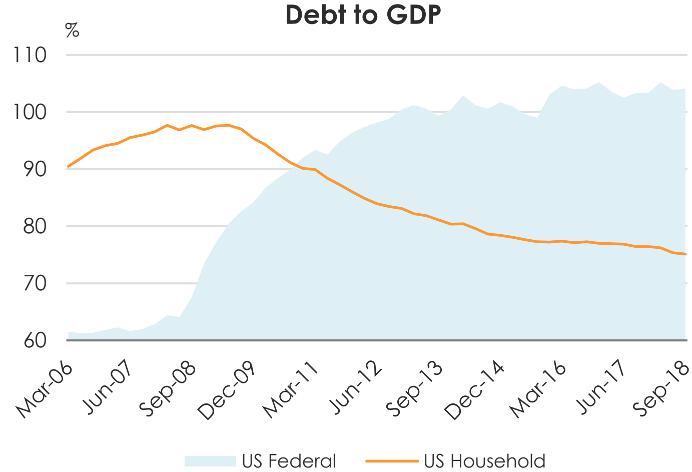
Corporations

Corporations, major benefactors of the tax cuts and repatriation, don't appear to be as strong as the consumer in driving economic growth going forward. High levels of debt, and lower quality earnings growth makes corporate America more at risk to higher interest rates and tighter financial conditions. We are not negative on corporate America, however, we would rather have seen companies use recently generated cash flow from the tax cuts and repatriation to reduce debt levels and increase investment in order to have a lasting impact on growth. Due to many corporations maintaining a high level of leverage, the upside from this asset class is limited as a driver of future economic growth in our view.

Government

Since the Great Recession, governments of developed markets embarked on quantitative easing (QE) programs to lower interest rates and increase the demand for lending which would then lead to stimulating economic growth. The success of QE is up for debate, however, the amount of debt countries are left to service is not. The United States, with a national debt to GDP ratio in excess of 100%, is paying about the same in interest (as a percent of GDP) as it was in 2006 when debt to GDP was only 62%. This is due to lower interest rates. The Congressional Budget Office (CBO) is forecasting that debt service will increase from just over 1.5% of GDP in 2018 to over 3.0% by 2028, due to a higher budget deficit and the expectation of higher interest rates. Should debt service costs rise to that level, it would exceed both the individual costs of Medicaid expenses and defense spending.

Debt to GDP



Source: Bloomberg. Data as of September 30, 2018.

We believe the amount of debt the government currently maintains will keep it from being a driver of economic growth going forward without also driving up the deficit. An infrastructure plan, although much needed, will take our debt to levels we have not seen since the end of WWII at 120% of GDP.

Real Estate

We remain constructive on the commercial real estate market as it seems to be in a goldilocks state – not too hot and not too cold. There are, however, areas of concern which primarily consist of retail malls. Other segments of the market remain in balance and should continue to perform well in the near term as cap rates remain steady and demand for properties continues.

Summary

Economic growth will continue at a slower pace than last year, while inflation will remain in check and the Fed will not be active. We believe the consumer is in stable financial shape while corporations and the government are carrying high levels of debt. In our view, real estate should perform well in the near term, as supply and demand remains in balance.

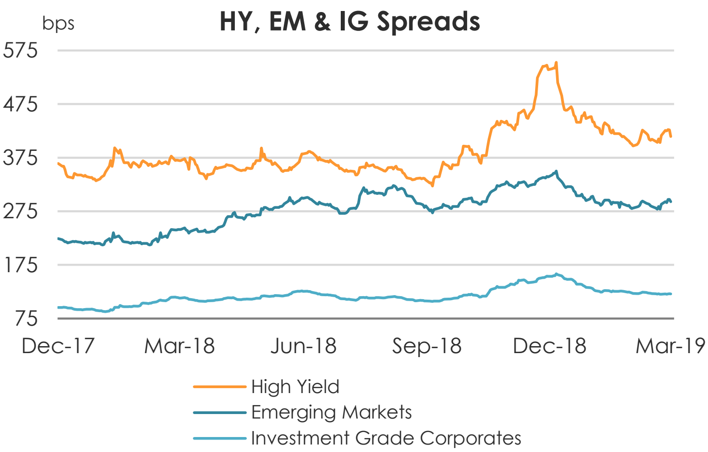
Fixed Income

To begin to account for the market action in Q1 2019, one must look at the previous quarter. The movie "Reversal of Fortune" comes to mind along with what has now been dubbed the Fed "pivot", a reversal of position and language initiated by the chairman in December and more explicitly stated in January. As we moved through Q4 2018, the hawkish tone from the Fed accompanied by the Fed's own dot plots signaled higher rates for 2019.

After an initial bearish assessment from Chairman Powell concerning the Fed's proximity to the neutral rate, a more dovish posture was taken allowing Treasury rates to move lower from their November highs. This rally continued through year-end, picking up momentum as stocks faltered, rumors of Powell being replaced, and mixed headlines on China trade stimulated a move to Treasuries. This came at the expense of both the credit and securitized sectors. December proved to be one of the most challenging months and given the seasonal lack of liquidity, spreads blew out significantly causing negative excess return for the whole year for investment grade, high yield, emerging markets, and MBS. Asset-backed securities fared better, aided by the strength of the consumer and finished the year with positive total and excess returns.

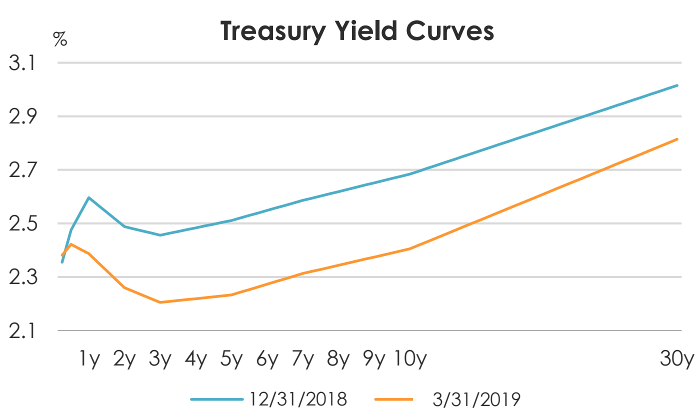
Enter the Fed "pivot" in early January, which set the tone for the ensuing quarter. On January 4th, Chairman Powell expressed a "patient" approach to further tightening. Later that month, the FOMC statement reinforced that opinion. In February, the market learned that the Fed would stop shrinking its balance sheet. At the March 20th Fed meeting, it was revealed that the Fed would likely be on hold for the year and balance sheet reinvestment to buy Treasuries would commence in May.

Stocks, which bottomed on December 24th, after an approximately 19% drop from November highs, began a steady recovery in January and the broader "risk-on" trade started to gain momentum.



Source: Bloomberg Barcap Indices. Data as of March 31, 2019.

"Risk-on" in January manifested itself across all spread sectors that had widened in the fourth quarter. The effect was dramatic enough that returns, both total return and excess returns, were among some of the strongest that the markets have produced in any single quarter. At the sector level, corporate bonds have staged the strongest recovery while mortgage bonds showed moderate improvement. Treasuries continued to perform well, with the 10-year Treasury reaching a low yield of 2.37%, down from a 3.24% close on November 8th, a yield level not seen since late 2017. Short-term rates rallied as well keeping the relative flatness of the curve in tact from all of 2018. Technically, the curve inverted briefly between 3-month T-bills and 10-year Treasuries, albeit for only a short period of time. However, the close-proximity of curve inversion strongly reminds us of the historical precedent of an economic recession, typically out 18-24 months in the future. Curve skeptics, including the Fed, would say that a bullish long-end rally causing temporary inversion is not a precursor to recession, but time will be the judge. We are not calling for a recession at this time. Normally, the Fed causes a curve inversion with continuous hiking of short rates, ultimately forcing them higher, rather than long rates, which precipitates an economic downturn. For now, the Fed is on hold.



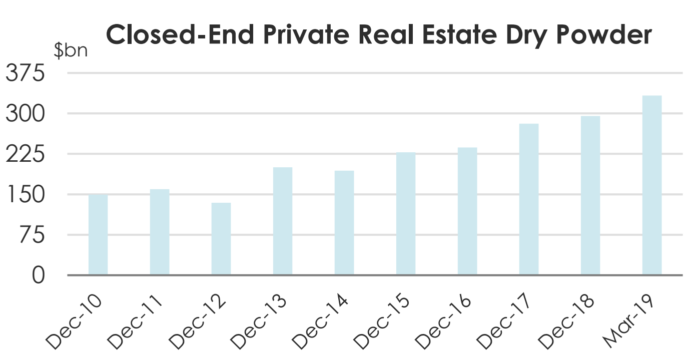
Source: Bloomberg. Data as of March 31, 2019.

We were positioned well for this year's risk-on trade and subsequently took advantage of recent credit spread tightening by reducing our overweight exposure in this sector, both in high yield and in higher beta investment grade names. With the proceeds generated from sales, we swapped into lower risk corporate credit, added high quality ABS, and increased our mortgage exposure across accounts that can hold these sectors. This repositioning increased credit quality and improved liquidity, which we feel is appropriate at this time in the cycle. After the Fed discussed allowing inflation to drift above their 2% target, TIPS became well-bid. We took that opportunity to exit our TIPS position. Along the way, we increased our duration position which serves as a hedge against any sudden moves wider in credit spreads. We continue to enjoy a positive yield advantage across product types. We believe that will be one of several positive contributors to performance for the year.

Real Estate

Following a volatile fourth quarter for the macroeconomy and most asset classes, the outlook for real estate improved in the first quarter of 2019 as transaction volumes were still elevated, interest rates declined, and pricing remained stable. Real estate fundamentals have generally remained resilient this late in the cycle as new construction has continued and most asset classes have seen improvements in occupancy and rental growth. The pipeline of new construction appears to remain in check and there does not appear to be a meaningful slowdown in demand for space.

We do not anticipate significant price appreciation in the real estate markets in the coming year as rental growth is modest at this stage of the cycle for most asset types. Industrial real estate is the one possible exception where it is expected to see fairly strong appreciation as demand from online retailers continues to boom and exceeds supply, despite significant new construction. Retail will remain challenged as there have been numerous bankruptcies and store closing announcements in the first quarter. According to Coresight Research, retailers had announced 5,399 store closures this year as of mid-March (and more are expected to close in the coming months). This is nearly the amount closed by retailers in all of 2018. The only saving grace for retail is limited new supply and retailers backfilling space with lifestyle and experiential users.



Source: Prequin. Data as of March 31, 2019.

Given the significant amounts of capital waiting to be deployed by investment funds (a record $333 billion according to Preqin), lower interest rates, strong fundamentals and readily available debt financing, we expect transaction volumes to be up this year and for prices to remain steady. High construction costs and steady demand are likely to limit new supply and will help keep fundamentals in balance. Industrial rents and prices will continue to grow while retail is expected to decline, with most other asset types remaining relatively stable.

Equities

The equity markets started 2019 on a strong note and provided much needed relief to investors who were stung by the rapid repricing of risk during the fourth quarter of 2018. We went into 2019 believing equity valuations were attractive and that investor sentiment was too bearish relative to the fundamentals. Our expectations for a rebound in the stock market were high. However, we did not expect the rebound to happen so quickly. Thanks to a dramatic reversal in views from the Federal Reserve that included a newfound patient approach and decidedly dovish view on interest rates, the equity markets gained new life and recouped most of returns that were lost during the fourth quarter of last year.

The question we now ask – can this rally continue? In this environment, we have turned more cautious on the equity markets as a sense of complacency has set in. The selling pressure at the end of December appears to have been overdone and the rebound has already proven to be substantial. The signs of weakness seen in the global economy and the spillover effects here in the U.S. give us a reason to pause. With the earnings season about to begin, we expect volatility to increase as companies vulnerable to a slowdown may miss on earnings and provide weak forward guidance. Therefore, our focus will remain on companies with clear visibility, quality earnings, and an innate ability to withstand a downturn in the economy.

Performance for Periods Ending March 31, 2019

	QTD	1-Yr	3-Yr	5-Yr
2-Year Treasury	0.96	2.60	0.82	0.85
10-Year Treasury	3.08	5.57	0.07	2.56
Bloomberg Barclays Aggregate	2.94	4.48	2.03	2.74
Corporate Investment Grade	5.00	4.94	3.67	3.74
Corporate High Yield	7.38	5.94	8.64	4.67
Leveraged Loans	3.78	3.33	5.87	3.83
Mortgage Backed Securities	2.25	4.53	1.80	2.65
S&P 500	13.65	9.49	13.51	10.91
MSCI EAFE	9.98	-3.71	7.27	2.33

Source: Interactive Data, Credit Suisse, Bank of America/Merrill Lynch, and Bloomberg. Data as of March 31, 2019.