BOYD WATTERSON
ASSET MANAGEMENT

January 2020

2020 Market Outlook

Our Firm:

Boyd Watterson Asset Management, LLC is an SEC-registered investment advisory firm with approximately $11 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 and real estate 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 advisory-only unified managed accounts. SEC registration does not constitute an endorsement of the Firm by the SEC nor does it indicate that the Firm has a particular level of skill or ability.

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

What a difference a year can make. Investors entered 2019 on edge following a sharp equity market decline to end 2018. At that time, the Federal Reserve was seemingly intent on raising interest rates further, the U.S. government was shut down and President Trump was ramping up pressure on China's trade practices. Now, as 2019 draws to a close, the Fed has reversed course and eased monetary policy several times, the U.S. and China have reached a 'phase one' trade deal, prior recession fears have abated and risk asset returns have exceeded even the most optimistic of expectations.

The Fed's recognition in January that a 'patient' policy stance was appropriate marked the dovish pivot the market was looking for and provided the fuel for risk asset values to begin their march higher. The ensuing months saw the U.S. economy slow from its 3.1% growth pace in the first quarter, international growth slowed even further, and trade uncertainties increased into the middle of the year. The weakening global growth picture coupled with inflation falling below the Fed's 2% target resulted in the Federal Open Market Committee (FOMC) lowering their overnight lending rate 3 times in the second half of the year, further propelling risk markets as this 'mid-cycle adjustment' was expected to provide additional runway for the economic expansion. The S&P 500 Index generated a total return in excess of 31% in 2019 while the Bloomberg Barclays U.S. Aggregate Bond Index returned 8.72%, the Aggregate's strongest year since 2002.

Performance for Periods Ending December 31, 2019

	QTD	YTD	3-Yr	5-Yr
2-Year Treasury	0.45	3.49	1.71	1.25
10-Year Treasury	-1.77	8.91	3.58	2.29
Bloomberg Barclays Aggregate	0.18	8.72	4.03	3.05
Corporate Investment Grade	1.15	14.23	5.94	4.60
Corporate High Yield	2.59	14.40	6.32	6.12
Leveraged Loans	1.68	8.17	4.48	4.54
Mortgage Backed Securities	0.66	6.51	3.29	2.60
S&P 500	9.07	31.49	15.27	11.70
MSCI EAFE	8.17	22.01	9.56	5.67

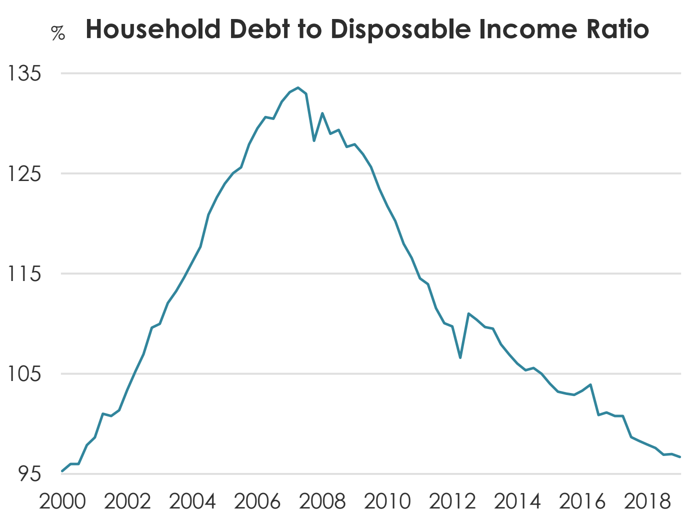
Source: Interactive Data, Credit Suisse, Bank of America/Merrill Lynch/Bloomberg.

As we look forward to 2020, there is a little more reason for optimism regarding the growth outlook, yet downside risks remain. The lack of obvious imbalances in major parts of the economy suggests to us that a recession in the U.S. is unlikely over the near-term. In our view, the U.S. economy remains in better shape than most other developed economies given our lower reliance on trade and manufacturing output, a consumer that remains a strong contributor to growth and an accommodative central bank with a greater degree of policy flexibility. Economic data is more mixed now than it has been over the last twelve months as the manufacturing and cyclical areas of the economy are at lower absolute levels, but there are some tentative signs that growth may be bottoming and could reaccelerate in the New Year.

In our opinion, the most consequential change of 2019 was the policy shift at the Federal Reserve from a tightening to an easing policy stance, as well as from balance sheet reduction back to expansion. Many other central banks eased policy further as well, notably in Europe and China as global growth weakened on the heels of elevated trade tensions. Following the 75 basis points (0.75%) of easing this year, the FOMC has made it clear the threshold for a policy move in either direction will be predicated on a material deviation from their economic and/or inflation forecasts. As such, we expect monetary policy to take a back seat in 2020 with policy likely on hold, yet we would expect further easing should economic conditions warrant. In addition to lowering short-term interest rates, the FOMC is now expanding its balance sheet again by reinvesting principal payments from their portfolio. Furthermore, the Fed is increasing their purchases of Treasury bills and conducting additional overnight and term repo operations in an effort to increase system reserves and mitigate the risk of additional funding pressures in the money markets.

In assessing our economic outlook, we focus our analysis around four primary areas: the **consumer**, **corporations**, **government** and **real estate**.

We believe the **consumer** has been and will continue to be the driver of economic growth in the U.S., accounting for nearly 70% of economic activity. Personal consumption is driven by a healthy labor market and rising wages. From this perspective, the U.S. economy is in the sweet spot with record low unemployment of 3.5%, wages rising at a respectable 3.1% annualized pace and muted levels of core PCE inflation. Payrolls have expanded on average by 184,000 jobs per month through November, a healthy clip for an expansion in its eleventh year, and consumer confidence remained at elevated levels. Additionally, household debt as a percentage of disposable income is near an 18-year low. These factors leave us optimistic that the consumer can continue to support our modest 2% growth expectation for the coming year. Risks to this positive outlook on the consumer include an equity market correction, labor market weakness or the outcome of the upcoming Presidential election, all of which could negatively impact spending.



Source: Bloomberg. Data as of September 30, 2019.

In contrast, the economic contribution from **corporate** America, or lack thereof, is where we have the most concern. Earnings growth slowed in 2019 relative to the prior year and debt levels as a percentage of GDP remain high, most visibly in the leveraged loan market. Trade tensions have weighed negatively on business confidence this year which has translated into reduced business fixed investment. Capital spending is usually a leading indicator of corporate profits and hiring trends and will need to be watched closely following the presumed 'phase one' trade agreement with China to see if reduced tensions improve CEO confidence and, in turn, result in higher levels of corporate spending. The linkage between corporate sector behavior and the impacts on labor and spending (as it relates to the consumer) cannot be understated, particularly given the lower levels of growth around the globe today. Further deterioration in the corporate outlook will likely result in cost cutting which has negative implications for many consumer-focused areas of the economy.

Government finances remain in difficult condition around the world as lower levels of growth and business activity pressure revenues and increase fiscal deficits. The U.S. budget deficit now tops $1 trillion and continues to grow, a bit unusual in times of positive economic growth. The expanding deficit has resulted in a significant increase in Treasury supply which may also be a contributing factor to some of the stress in funding markets witnessed in the fourth quarter of 2019. As interest rates decline and monetary policy becomes potentially less effective, fiscal policy may be a necessary tool to drive growth. Unfortunately, the current size of the deficit and gridlock in Congress may stall efforts on both fronts. Furthermore, with tariffs now the Trump administration's primary weapon of choice in managing foreign policy, risk within the government sector has escalated making policy effectiveness much less predictable. These factors, combined with a Presidential election on the horizon, cause us to expect fiscal policy to contribute only marginally to growth in 2020.

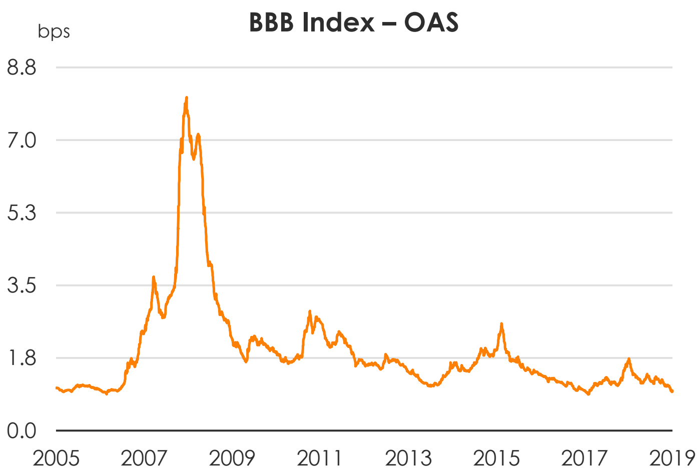
The **real estate** market continues to display strong fundamentals and, in our view, the market remains in balance as there are few signs of oversupply. Additionally, leverage levels remain healthy, causing us to view the potential for large scale defaults or refinancing difficulties as remote over the near-term. Further support is provided by a continued abundance of capital with relatively attractive terms. Real estate is sensitive to the overall economic cycle, yet with the decline in interest rates and the competitive pricing environment, we remain constructive on the outlook for this sector.

In summary, we expect growth to center around 2% in 2020 with inflation continuing to trend below the Fed's 2% target. Interest rates are likely to be range bound with the 10-year Treasury yielding between 1.50% - 2.25% and the FOMC on hold barring a significant divergence from their forecast. We believe the most significant wildcard for interest rates and risk markets is the upcoming Presidential election in 2020. Given the polarization of candidates and range of possible outcomes, at a minimum, volatility is likely to increase markedly as the campaigning and primary season hits full speed. Depending on the election outcome, there could be significant changes to tax policy, regulation, foreign relations, trade policy, etc., all of which have a wide variety of potential impacts on the economy and financial markets. We have no doubt that 2020 will be an interesting year for investors to navigate.

Fixed Income

Starting out the calendar year 2019 with a Fed 'pause', followed by a Fed 'pivot' and subsequent rate cuts during the summer and early fall, the broad fixed income markets, as measured by the Bloomberg Barclays Aggregate Index, returned a remarkable 8.72%. We say remarkable because 12 short months ago the projected economic outlook and presumed Fed response would not have painted a picture allowing anything close to the total and excess returns investors experienced across the full spectrum of fixed income sectors. Declining interest rates coupled with credit spread compression created a beneficial environment for portfolio managers who were long duration and overweight risk assets.

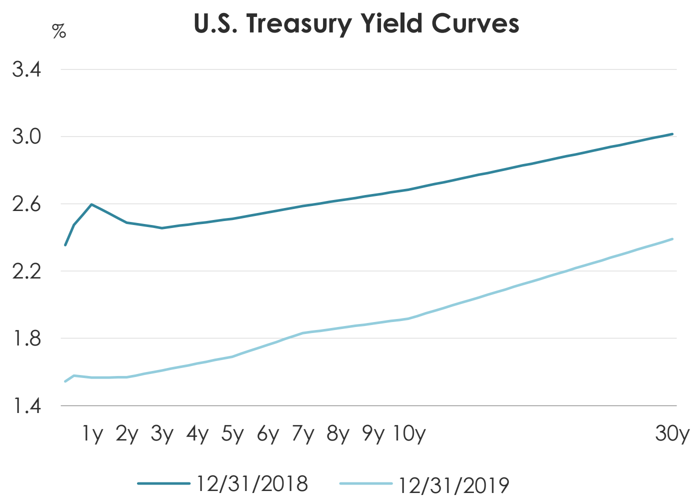
As with all markets, it was not a simple call as credit spreads experienced two widening episodes during the second and third quarters. However, this volatility ultimately gave way to tighter credit spreads during the fourth quarter, inching closer to the 10-year tights last seen in February 2018. While the market rewarded investors who stayed in the lower quality segment of investment grade, the same was not the case in high yield. Single-B and BB-rated bonds significantly outperformed CCCs, which struggled during the second half of the year.



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

The securitized sectors (ABS, CMBS, & MBS) also performed well, surpassing their 2018 performance in both total and excess returns, however the MBS sector was more challenged this year with rapidly falling interest rates. Concerns surrounding a pickup in prepayment speeds were the primary hinderance to performance while the ongoing Fed balance sheet runoff (in MBS) put modest pressure on spreads. By year end, with the expectation of the Fed 'on hold' and cheaper valuations, the mortgage market regained some ground to finish the year with positive excess returns.

Shortly after the Fed's first interest rate cut on July 31st, the Treasury curve, as measured by the 2-year – 10-year spread, inverted to -5 basis points (-0.05%). The more closely watched 3-month T-bill – 10-year spread had already moved into negative territory, reaching a maximum inversion of -50 basis points (-0.50%). At that time, the historical record of this relationship stirred up recession fears as previous curve inversions have preceded economic downturns. Two additional Fed eases put both spread relationships back into positive territory as the curve returned to a more normalized shape.



Source: Bloomberg.

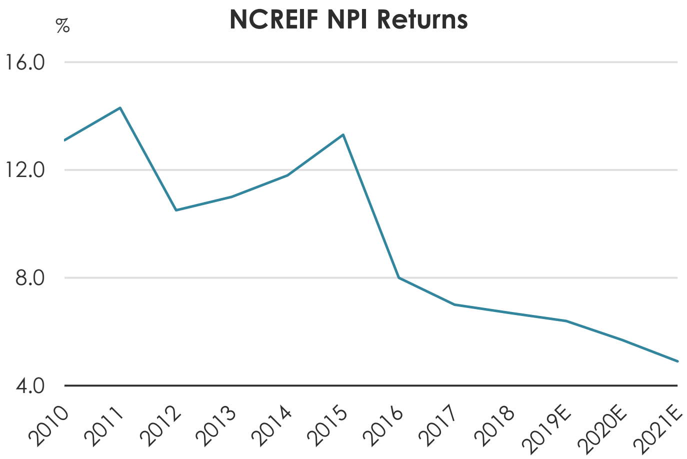
During the year, we gradually reduced corporate bond exposure across portfolios as we adopted a more conservative view on credit. At the same time, we increased overall credit quality and liquidity with a move to an overweight allocation to agency mortgage-backed securities. Portfolio durations were positioned slightly longer than their corresponding benchmarks across all strategies as we looked to protect against headline risk, volatility and risk-off environments that precipitate periodic flight-to-quality rallies that punctuated the last couple years.

As we look forward, the remarkable performance of last year has reduced the prospects for outsized returns in 2020. We have positioned our portfolios with a focus on three areas: positive carry/yield advantage, higher credit quality and an emphasis on liquidity. Our duration position continues to be on the longer side of our benchmarks. This portfolio structure will allow us to be more tactical should an increase in volatility present more attractive opportunities to add value.

Real Estate

The commercial real estate market has seen cap rates largely flatten out over the past few years after a long period of compression. Cap rate compression drove strong returns in the real estate sector since 2010 with Total Returns in the NCREIF National Property Index (NPI) averaging 10.6% over that time frame. However, each of the past three years, returns have dipped into single digits and are expected to only reach 6.4% for 2019. With interest rates already very low, income growth muted and cap rates not expected to decrease much, if at all, there isn't much anticipated appreciation expected in the real estate sector in the near term.

PREA's quarterly survey of investment managers released in December of 2019 reflects these low expectations for appreciation in the commercial real estate sector. Total returns for the years 2019 to 2023 are only expected to reach on average 5.6% per year. The survey forecasts total returns of 5.7% in 2020 and only 4.9% in 2021, which implies appreciation of only 1.3% and 0.4% in each of those two years, respectively. Retail is expected to lose value in that time frame, with appreciation projected to be -1.3% and -0.4% in
in 2020 and 2021, with modest appreciation in the other asset classes.



Source: NCREIF, PREA Survey.

Given this outlook for limited appreciation in the coming years, Boyd Watterson believes that investment vehicles which are oriented more to income generation and less reliant on appreciation return generally will carry less risk and should be better positioned to outperform the market in terms of total returns for the next few years.

Equities

The equity markets followed up a difficult end to 2018 with exceptionally strong performance in 2019. The markets exceeded even the most optimistic expectations in 2019, as the S&P 500 ended the year with a 31.49% return. An accommodative Fed, sharply lower interest rates, and slightly better growth prospects have been supportive of equity valuations. Today, valuations appear fairly valued as optimism over trade talks has propelled the recent rally even higher. Having said that, we do not believe it is time to get out of equities. Rather our recommendation is to stay the course, but to temper future return expectations. The economic and monetary policy backdrop remains supportive of equities while the sharp decline in interest rates has made dividend paying stocks look more attractive for yield focused investors. Our biggest concern with the equity market is that volatility may remain elevated in 2020 as the upcoming presidential election and the polarity of candidates creates a backdrop of increased uncertainty. Therefore, our focus remains on building a slightly more defensive portfolio, of high quality, dividend paying companies that would be expected to perform better in an uncertain environment, while also staying alert for potential opportunities that may arise from an increase in volatility.