BOYD WATTERSON
ASSET MANAGEMENT

July 2019

2019 Market Outlook

Our Firm:

Boyd Watterson Asset Management, LLC is an SEC-registered investment advisory firm with $9.4 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. 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.

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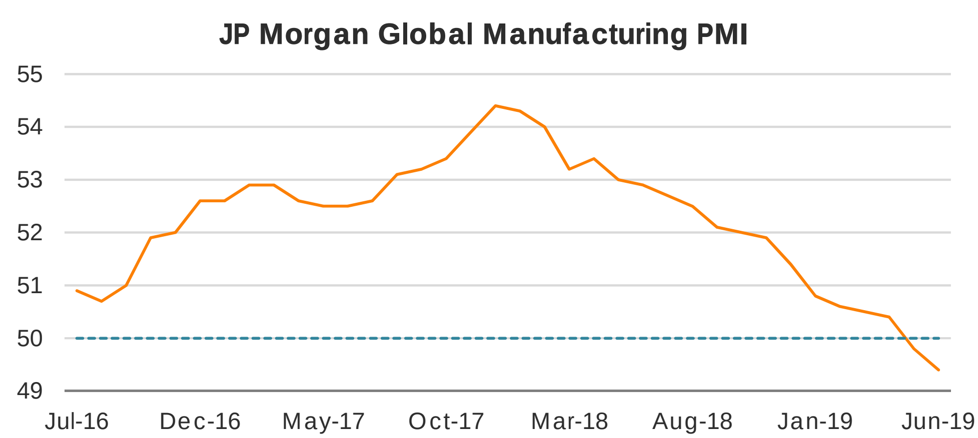
The Macro View

The quarter ended on a positive note as optimism heading into the G20 meeting (June 28 - 29) became reality. A trade truce was reached between the U.S. and China, leading to a 90-day period in which no new trade tariffs will be levied. Later came news that President Trump made a historic visit to North Korea, becoming the only sitting President to do so.

Looking back on the quarter, risk assets did very well. The S&P 500 was up 4.30%, while the Bloomberg Barclays Aggregate Bond Index was up 3.08%. Both the equity and bond markets were driven higher due to falling interest rates and the expectation that the Fed would cut rates, beginning at the July meeting. In fact, the bond market is projecting three Fed rate cuts in 2019.

The market believes lower rates will lead to higher profits and an extension of the business cycle, which has driven stock prices higher. What's interesting is that lower interest rates are often driven by an expectation that the economy is slowing, which often times is detrimental to corporate profits and, therefore, to equity and other risk asset prices.

Interest rates have been driven lower during the quarter for a number of reasons: economic growth has slowed in the U.S. and the rest of the world, inflation has been well below 2%, and trade tensions have increased the risk to economic growth going forward. Even though real GDP growth in the U.S. was 3.1% in the first quarter of 2019, it is expected to slow to an annual growth rate of 2.1% for the year, according to the Fed's projections. Economic growth in other developed markets is even more subdued. Looking at the JP Morgan Global Manufacturing PMI Index, this indicator peaked at the end of 2017, and has been in steady decline ever since. In May it actually dropped below 50, meaning global manufacturing is contracting at this point. The lack of growth, coupled with benign inflation, has led to more than 13 trillion dollars in global debt trading with negative yields. Like the Fed, ECB officials have signaled a willingness to ease financial conditions later this year which has driven rates even further negative.



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

If the economy is viewed through the lens of the consumer, corporations, governments and real estate, we find a mixed growth picture. The consumer, which is responsible for approximately 70% of GDP, is showing some signs of weakness, but overall is in good shape. We have seen defaults on a number of consumer loans rise, however, the employment picture remains robust with unemployment near 50-year lows and wage growth increasing at a respectable pace.

Corporations, on the other hand, generally have increased their debt levels since the Great Recession due to low interest rates. Higher levels of debt are not necessarily a bad thing; it depends on what those corporations do with the debt. Unfortunately for bond holders, many corporations haven't used those funds to increase business investment. Instead, they generally have opted to increase shareholder friendly activities such as stock buybacks, increasing dividend payouts and even pursued mergers and acquisitions, all leading to higher leveraged balance sheets. The good news is that lower interest rates allow them to service the added debt without too much concern. The bottom line is that corporations overall do not have the balance sheet capacity to be a major driver of future economic growth over the medium term.

Governments seem to be in the same boat as corporations. High and growing levels of debt from years of stimulus have left governments with little ability to push economic growth going forward. However, they too should benefit from lower interest rates as the cost of servicing new debt decreases.

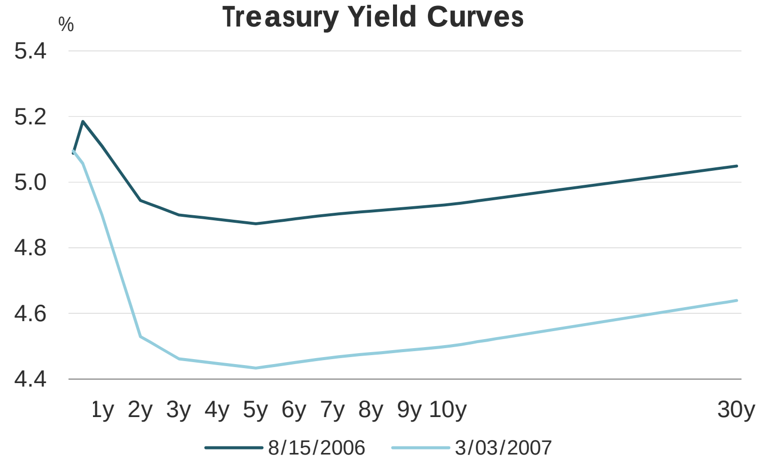
We currently view commercial real estate as a bright spot. We are constructive on the sector as supply and demand remain in balance. In general, credit is available and the balance sheets of lenders are strong. One area of concern is the retail mall segment. Store closings have been the norm for a few years and that does not seem to be subsiding.

Our expectation for economic growth has not changed for 2019, as we believe that the pace of growth will slow versus 2018 as the benefits of the tax cuts wear off. We continue to expect inflation to come in below the Fed's stated 2% target and believe the Fed is being bullied into cutting interest rates this year. However, we believe the market may be ahead of itself as we do not expect the Fed will cut rates three times this year.

Fixed Income

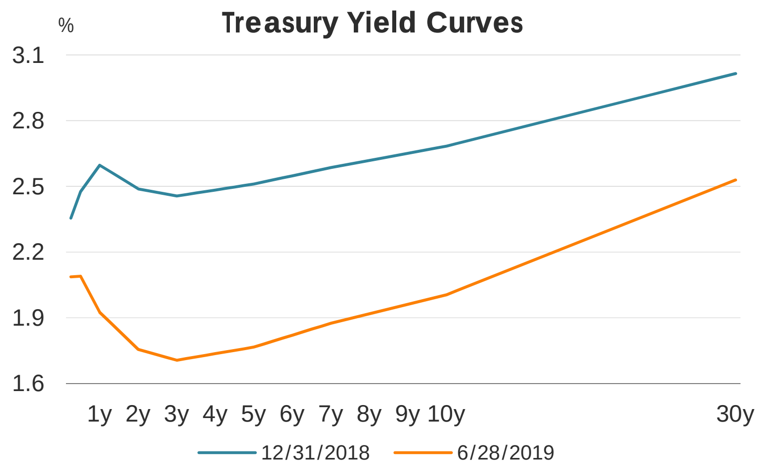
Divergent is defined in Webster's dictionary as "moving or extending in different directions from a common point." Déjà vu is defined as "a feeling that one has seen or heard something before." Why is this relevant? During the second quarter of 2019, the broad fixed income markets adopted the mentality of an easing Fed with a continued rally to lower rates. However, the Fed had not yet changed their patience rhetoric, clinging to the possibility of one more rate hike. Only in June did the Fed blink, and opened the door to a potential rate cut this year. The path that interest rates took and resulting shape of the yield curve were very much in contrast to the Fed's posture at the end of March. This divergence put the markets well ahead of a Fed ease. The 10-year Treasury traded below 2%, having fallen more than 40 basis points since March 29th, while 2-year Treasuries fell as much as 53 basis points during the same period.

At what point has the market gone too far in anticipation? What if a data dependent Fed does not cut rates soon enough? Looking back at the early 2007 markets may prove helpful. The Déjà vu moment comes when you examine past yield curves after the Fed stopped raising rates. Looking at Aug 15, 2006 (a time when the Fed was on hold) and looking again at the yield curve a little over six months later when the markets anticipated a Fed rate cut, we experienced a steepening rally (except for the very short end).



Source: Bloomberg.

If you look at today's yield curve, essentially six months after the last Fed rate hike in December, the market reaction function looks very similar to early 2007.

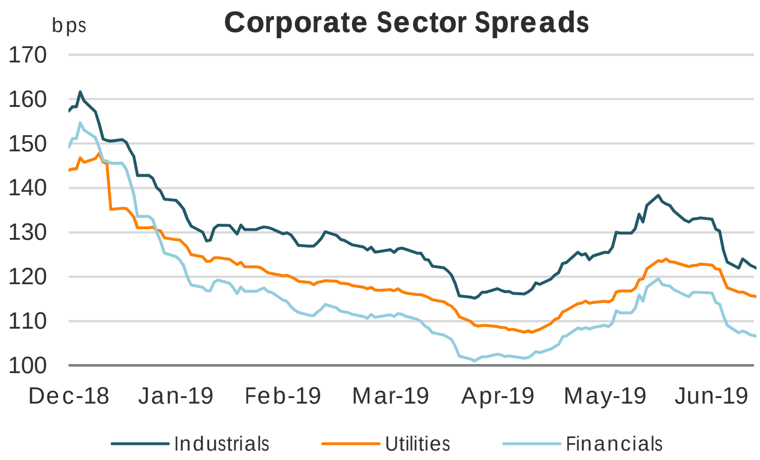


Source: Bloomberg.

It is this market price anticipation that largely drove returns for the quarter, albeit with added volatility related to China trade talks and increased tensions with Iran. So, while interest rates diverged dramatically from the Fed's first quarter stated outlook, the current move fits into place if the Fed begins easing in the next month.

Review of Second Quarter and Current Positioning

Corporate investment grade spreads finished the 2nd quarter only a few basis points tighter in spread, but not without intra-quarter volatility. By late May, spreads widened out to levels not seen since January, only to recover in June to produce moderate excess returns for the quarter.



Source: Barclays Live. Data as of June 30, 2019.

High yield followed a similar pattern to investment grade corporates, which basically mirrored equity performance for the quarter. ABS and CMBS also produced moderate excess return, but without the credit spread volatility. MBS continued its lackluster performance for the quarter and the year. Returns for the sector were hampered by spread widening as prepayment fears escalated due to the decline in interest rates.

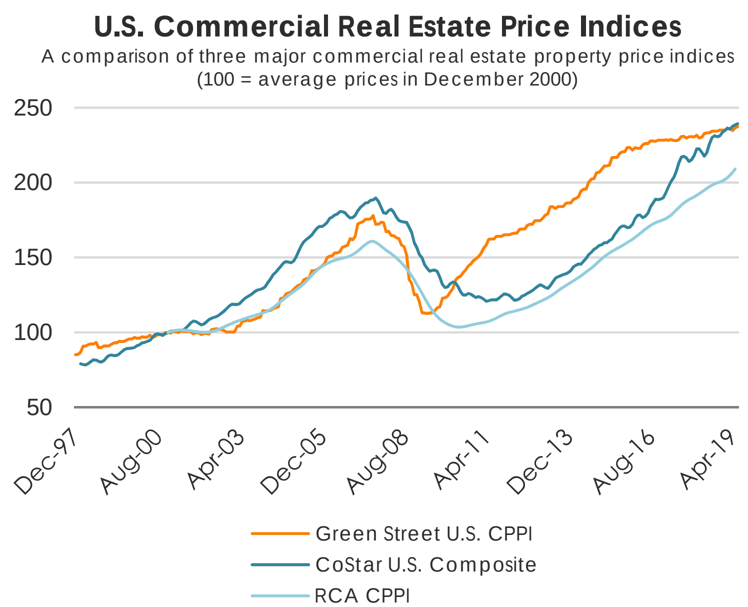
From a portfolio positioning perspective, earlier in the year we reduced some higher-risk credit exposure, taking gains while re-allocating to MBS which had been an underweight position. We also maintained a longer duration posture throughout the quarter, which benefitted overall performance. Given our outlook for an accommodative Fed, with a slowing, but positive growing economy, we continue to see some value in an overweight to spread sectors. However, if credit valuations become over-extended, then a reduction in our risk profile would be warranted as we diversify into higher-quality securitized sectors, while maintaining a positive yield advantage.

Real Estate

Amid a still-strong economy and a rapid drop in interest rates, the outlook for the real estate sector remains positive and there are no readily apparent issues that are expected to change this outlook in the near term. Transaction activity still appears to be fairly strong, though a little slower than last year, amid steadily rising prices. In general, there is strong demand from investors for commercial real estate and there are highly liquid and aggressive capital markets on the debt side of the equation in a declining interest rate environment. Fundamentals remain solid with high occupancies, growing rents and supply that has been added in a measured manner. Fears of a recession have been fueled by an inverted yield curve but we are not forecasting a recession anytime in the near future.

We are anticipating an increase in transaction activity in the second half of the year. Throughout the first half of the year, a common theme was the sellers' pricing expectations not being met by the market. The drop-in interest rates in recent months has increased the spread between cap rates and borrowing levels, which will likely result in a closing of the bid-ask gap on many transactions as borrowers can now hit their targeted yields more easily. This may result in continued modest price appreciation in the real estate space. There is evidence this is already occurring as Real Capital Analytics' U.S. National All-Property Index indicates that pricing rose by 1.1% from April to May and 7.2% year-over-year. There has been growth in all four major real estate sectors, ranging from 3.1% in retail to 11.8% in industrial.

With construction costs remaining high and keeping supply in check, we expect fundamentals to remain in balance, which should continue to make the real estate sector an attractive and stable arena to invest capital in the near term. There also appears to be significant capital sitting on the sidelines waiting to be invested, which combined with the drop-in interest rates, should result in keeping a lid on cap rates and a possible continued decline in cap rates and thus higher pricing.



Source: Green Street, CoStar, Real Capital Analytics (RCA). Data as of May 31, 2019.

Equities

After a difficult finish to the year for equities in 2018, the first six months of 2019 rewarded investors who stayed in the market. The S&P 500 finished the best first half of a year in over two decades, by rising 18.54%. The turnaround can partially be attributed to a single word from the Federal Reserve. That word is - (wait for it) - "patience". It was the addition of the word "patience" by the Fed earlier in the year that helped propel the turnaround, and it was the removal of the word by the Fed in late June which helped reignite the rally. The Fed has essentially done a full pivot this year, from potentially raising rates, to exercising "patience" and pausing, to now indicating a possible reduction in rates. The Fed's current easing bias, combined with many other central banks around the world standing ready to deliver more stimulus if needed, has benefited the equity markets and may continue to do so. We are experiencing an investing environment where bad news has seemingly been perceived as good news and the uncertainties about trade, growth, and politics have been overlooked in favor of a dovish Fed. Now, it appears the Fed is on the clock and will have to live up to the markets' expectations for this rally to have any chance to continue.

Despite many uncertainties on the horizon, we are exercising our "patience" and are not quite ready to give up on equities. We expect volatility to remain elevated as the upcoming earnings season has the potential to provide some headwinds. Additionally, the progress (or the lack thereof) in trade negotiations will keep investors on edge. Despite these uncertainties, we believe investors can still profit from equities as the Fed attempts to extend the business cycle. Lower interest rates should continue to provide corporations with cheap access to credit which may then be used to continue to buy back shares and increase dividends. Additionally, as interest rates have moved lower, investors will have a harder time finding a stable source of yield. One potential solution in the search for yield is to focus on high quality, dividend paying stocks. Our focus in this area remains on companies with clear visibility, quality earnings, and an innate ability to withstand a downturn in the economy. We therefore, are exercising our "patience" and are holding onto equities in the current environment, but are doing so with a much more cautious approach.

Performance for Periods Ending June 30, 2019

	QTD	YTD	1-Yr	3-Yr	5-Yr
2-Year Treasury	1.46	2.44	3.92	1.14	1.10
10-Year Treasury	4.21	7.44	10.37	0.46	2.88
Bloomberg Barclays Aggregate	3.08	6.11	7.87	2.31	2.95
Corporate Investment Grade	4.32	9.55	10.54	3.95	4.03
Corporate High Yield	2.53	10.12	7.57	7.52	4.69
Leveraged Loans	1.58	5.42	4.15	5.43	3.85
Mortgage Backed Securities	1.99	4.30	6.30	2.10	2.56
S&P 500	4.30	18.54	10.42	14.19	10.71
MSCI EAFE	3.68	14.03	1.08	9.11	2.25

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