BOYD WATTERSON
ASSET MANAGEMENT

October 2019

2019 Market Outlook

Our Firm:

Boyd Watterson Asset Management, LLC is an SEC-registered investment advisory firm with approximately $10 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.

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The Macro View

The third quarter witnessed many of the same themes that have been with us throughout the first half of 2019. Despite renewed threats of additional tariffs on Chinese goods, only a portion were enacted in September and high-level trade meetings with China have been scheduled to resume in mid-October. In addition to this cautious optimism relating to trade, the Federal Reserve joined other major central banks in easing monetary policy with two rate cuts at back-to-back meetings in the third quarter, as well as an early end to the balance sheet run-off program. This marked the first time the Fed had cut short-term interest rates since December 2008.

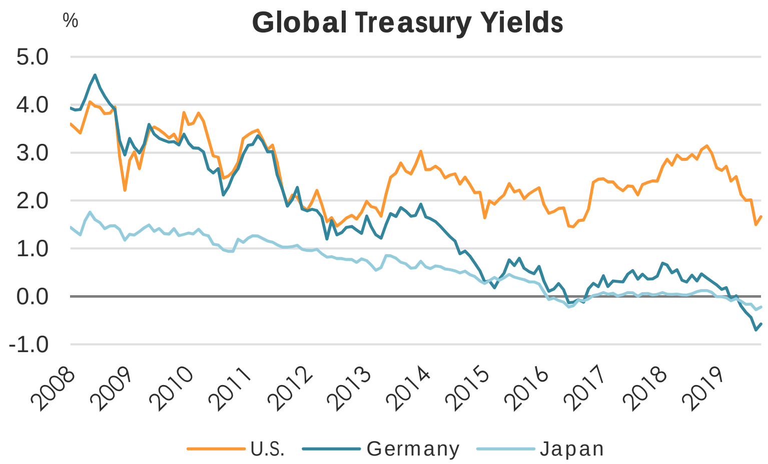
The expectation of ensuing interest rate cuts, stable economic data, and an increase in negative yielding debt outside the U.S., pushed interest rates lower and risk asset values higher. The Bloomberg Barclays U.S. Aggregate Index increased 2.27% during the quarter, bringing its year-to-date return to 8.52%. On the heels of a strong September, the S&P 500 Index was up 1.70% for the third quarter and 20.55% year-to-date. Interestingly, following the rate cut in September, the Federal Open Market Committee's (FOMC) projections for the balance of 2019 as well as 2020 do not indicate further rate cuts as illustrated by the median value on the 'dot plot.'

Interest rates continued to drift lower over the quarter and the yield curve, as measured by the spread between the 3-month Treasury bill and 10-year Treasury note, inverted further, ending the quarter at negative 14 basis points (-0.14%).

Spread Between 10-Year Treasury and 3-Month Treasury

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

One of the FOMC's objectives in cutting short-term rates was to steepen the yield curve, yet the market still believes that monetary policy is behind the curve and judging from the shape, investors are pushing for more cuts. Furthermore, given the proliferation of negative yielding debt, the U.S. term structure remains attractive to foreign investors; short-term rates continue to be some of the highest rates within developed markets, resulting in a stronger dollar. This could have negative economic growth implications if it persists. The inflation picture continues to provide the Fed with cover to ease monetary policy. Core PCE inflation has risen the past several months and currently stands at 1.8% year-over-year, still below the 2% target the Fed desires. We continue to believe that the strong dollar, weaker trade flows, and declining import prices in the U.S. will keep inflation trends below target over the near term.



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

Toward the end of the quarter, funding markets came under pressure as repo rates spiked well above other short-term funding rates. At the outset, this appeared to be technical in nature, however, the Federal Reserve had to step in with daily open market operations to provide additional reserves and bring rates back into line. We believe this is a byproduct of the transition from quantitative tightening to a more steady-state Federal Reserve balance sheet and the process of determining the appropriate level of reserves to keep the overnight funding markets in balance. We intend to continue to monitor this closely as we head into year-end for any further signs of renewed or additional pressure.

As we expected, real GDP growth in the second quarter slowed to 2.0% from the 3.1% pace of the first quarter. Within that however, personal consumption registered 4.6%, one of the strongest readings seen in the last four years. The consumer continues to be supported by solid wage growth and low levels of unemployment. Additionally, consumer confidence readings, remain elevated, leaving us optimistic that these trends will continue to support economic growth. On the flipside, business confidence appears more cautious and the outlook for fixed investment has declined as a result. Trade uncertainty and the nearing presidential election cycle are often cited as the culprits. Similar softness continues to show through in the manufacturing sector as the U.S. PMI index dropped below 50 in August for the first time since 2016.

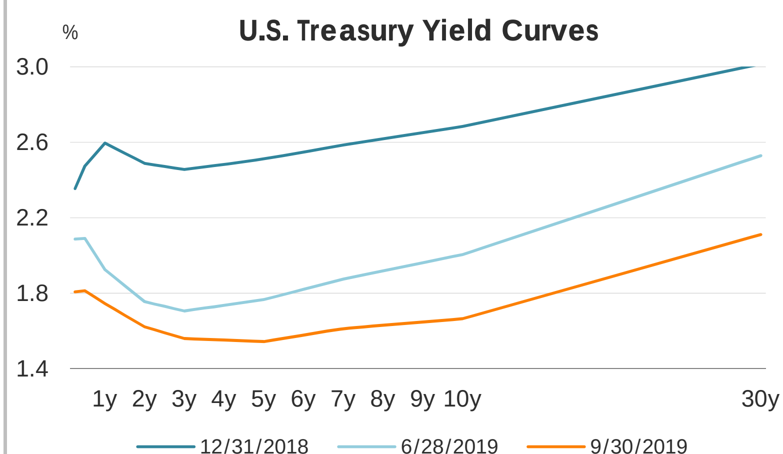
Manufacturing has been in decline globally for many months as a result of trade uncertainties and tariffs and is particularly acute in export-led economies such as Germany. The contraction in U.S. manufacturing could be magnified by the labor strike at General Motors if it is a prolonged situation.

Fiscal stimulus appears much less likely today as the political divide in Washington deepens by the headline. Questions around the passage of United States-Mexico-Canada Agreement (USMCA) or the prospects of an infrastructure spending plan are dimming as election season draws near. Additionally, the Democratic Party is moving to open an impeachment inquiry stemming from President Trump's phone conversation with the Ukrainian president. They contend Trump pressured the president to investigate his potential opponent, former Vice President Joe Biden, thus abusing his Presidential power and soliciting a foreign government to interfere in the U.S. election. Given these dynamics, it's difficult to imagine the parties coming together on anything of a stimulative nature. Furthermore, the U.S. budget deficit rose above $1 trillion in August, which would likely require any fiscal stimulus package up for debate to include cuts to other programs, a compromise unlikely to gain traction.

Our outlook continues to call for modest economic growth around 2% with inflation below target. This outcome should be supportive of risk assets as negative yields force investors around the world to seek higher yields, such as those prevalent in U.S. markets. Additionally, the Fed remains data dependent and is likely to lower short rates further if economic and/or geo-political conditions deteriorate from their base-case outlook.

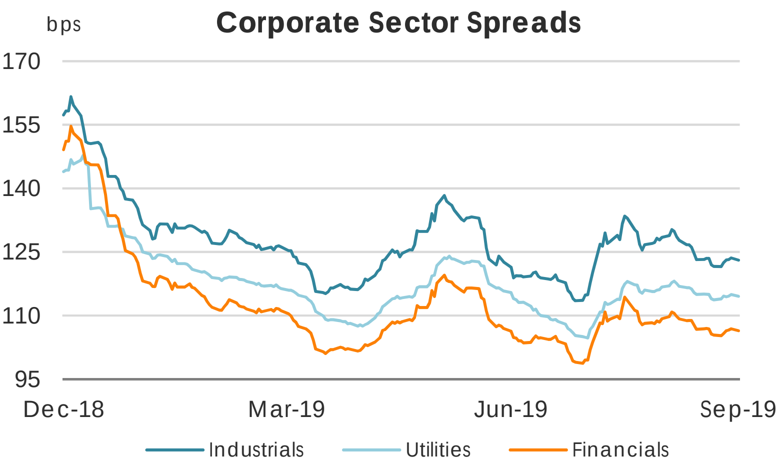
Fixed Income

The broad fixed income markets came into the third quarter with a full head of steam continuing the downward trajectory in interest rates that had been in place for the previous seven months. Momentum finally subsided during the first week of September with 10- and 30-year Treasuries trading as low as 1.45% and 1.95%, respectively; levels not seen in the longer end of the yield curve since 2016. With the long end rally, Treasury curve inversion continued and the closely watched 3-month bill to 10-year note spread hit a new low of negative 50 basis points during the quarter. Relief for the inverting curve came with the highly anticipated Fed Funds rate cut to a new target of 1.75% – 2.00% on September 18th.



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

For the quarter, falling interest rates produced strong total returns across the broad fixed income markets but excess returns were not as uniformly distributed due to spreads widening within certain sectors hampering performance. For example, long corporate credit, which posted a total return for the quarter of 5.61%, also posted a small negative excess return for the period. Spreads ended the quarter marginally wider for long Industrials, Utilities, and Financials. The path of spreads during the quarter was anything but smooth, however, as volatility (measured by the Move and VIX indices) jumped in response to trade headlines and speculation on the Fed's response to global economic uncertainties.



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

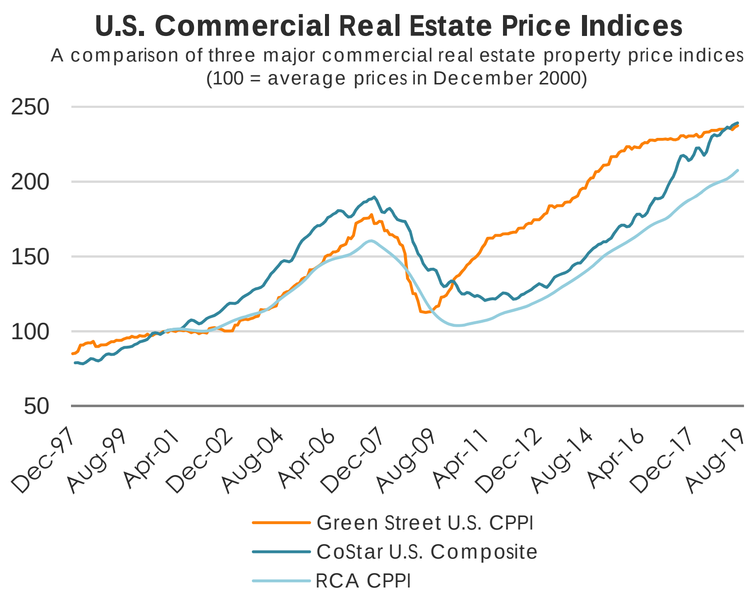
In the securitized sectors, both ABS and CMBS continued to perform well. The mortgage market, which has underperformed all year, had a better quarter, although bifurcated. 30-year MBS showed positive excess returns for the quarter, while 15-year MBS turned further negative. Mortgage durations shortened dramatically with the drop in 10-year Treasury yields, sparking further re-financing fears in the asset class.

Of note for the quarter was the large amount of corporate investment grade new issuance, primarily in September. Not only did the amount of new issuance top $158 billion in September (making it the third busiest month on record), a recent high-water mark, but the number of new issuers (130) jumped significantly indicating the relative attractiveness of the current interest rate environment for raising cash. Investor demand not only for yield, but also for high-quality debt, helped absorb a simultaneously large amount of Treasury issuance during the quarter. While only a piece of the equation, this partially contributed to the repo rate spike referenced earlier.

Looking ahead, we continue to de-risk portfolios on the margin. Fixed income performance has outpaced most forecasters' projections for all of 2019 and into this strength we have reduced credit exposure and overall spread duration while improving credit quality and liquidity. This was accomplished with selected trades out of both high yield and investment grade credit issuers that were trading at tighter valuations or issuers that are prone to higher price volatility. Conversely, we increased our exposure to the agency mortgage market with an overweight to higher coupons in the 30-year sector. Higher coupons generally deliver both higher yield and shorter spread duration. Throughout the quarter we have maintained a modestly longer duration than our benchmarks across product lines which has served as a hedge to any potential "risk off / flight to quality" market scenarios. High-quality, short asset-backed securities and commercial mortgage-backed securities remain a staple in our portfolios, delivering consistent returns in the short duration space. Finally, 10-year TIPS breakevens dipped into the 1.50's range during the quarter as inflation concerns remained muted. Opportunistically, we added a new position back into the portfolios as we currently view the market inflation expectation as low. The bombing of a Saudi oil refinery and the quick response of rising oil prices is only one example of what could drive inflation expectations higher, particularly given the elevated level of geo-political tensions.

Real Estate

In the face of growing global economic uncertainty and extremely low interest rates, commercial real estate remains an extremely attractive investment option. Prices continue to increase across major property types, with Real Capital Analytics' U.S. National All-Property Index rising by 6.7% year-over-year in August, led again by industrial (+12.5%) and multifamily (+7.1%) spaces. We expect prices to continue to modestly increase, as supply remains in check (construction activity has yet to spike apart from a few multifamily markets) and the debt capital markets remain highly liquid and competitive, highlighted by growing year-over-year commercial mortgage LTVs, per RCA.



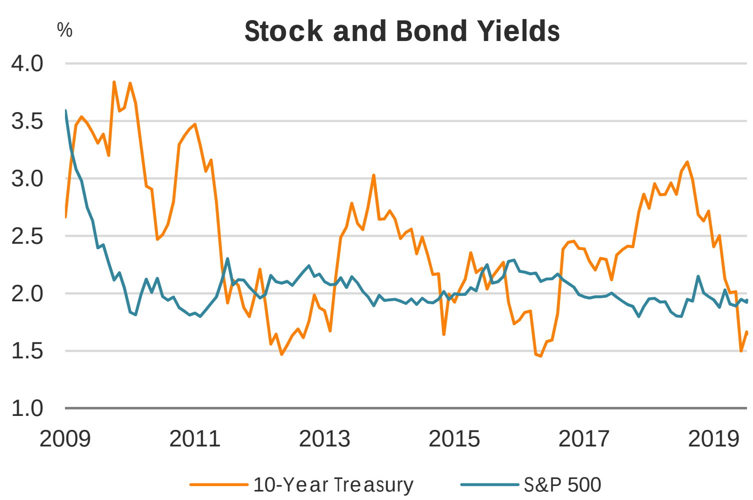
Source: Green Street, CoStar, Real Capital Analytics (RCA). Data as of August 31, 2019.

Despite these positive fundamentals, transaction activity did fall sharply in August, down 54% year-over-year. The decline was largely due to 1) an unrepeatable August 2018 report dominated by entity-level deals and 2) a drop in purchases by overseas investors. Overseas investors tend to focus on larger deals which are currently priced extremely tight with record low cap rates. We view this report largely as an outlier, but it will be worth watching whether the overseas investors remain on the sidelines or begin moving outside their traditional CRE targets. Even if transaction volume were to continue to decline, market fundamentals should continue to hold, making CRE yields attractive given the current state of the market.

Equities

During the first nine months of the year, both stocks and bonds rallied together as the S&P 500 returned 20.55% while the Bloomberg Barclays Aggregate Index was up 8.52%. The implications of the strong start to the year in performance, combined with the precipitous fall in yields around the world, has contributed to a downward adjustment of future return expectations across all asset classes. While the returns this year have been a pleasant surprise, the resulting yield compression has presented challenges for yield starved investors.

In today's low interest rate world, investors now have fewer options to find yield other than moving up the risk spectrum. One potential solution is to look at stocks as an alternative yield play. The yield on stocks has become competitive to the yields available within the bond market. As of September 30th, the dividend yield on the S&P 500 index was 1.96% while the 10-year Treasury yield was 1.67%.



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

Investors who decide to increase equity allocations must accept the realities of taking on greater risk in the face of a slowing global economy. The uncertainties over politics, trade policies, and recession fears will all contribute to elevated levels of stock volatility.

Despite a cautious stance, we continue to believe stocks can perform relatively well, driven by a resilient consumer, a U.S. economy that is in better shape than the rest of the world, and central banks that are ready to provide the necessary accommodation if needed. The search for yield will play an integral role as more investors are drawn to equities for their income component. Additionally, stock buybacks should continue to provide support and any movement on the trade front in the form of a compromise or resolution would also benefit equities. The area within the equity market that we continue to focus on includes high-quality, dividend-paying companies that have a history of raising their dividends, and ultimately would be expected to perform better in a downturn.

Performance for Periods Ending September 30, 2019

	QTD	YTD	1-Yr	3-Yr	5-Yr
2-Year Treasury	0.57	3.03	4.37	1.38	1.19
10-Year Treasury	3.18	10.87	15.16	1.78	3.37
Bloomberg Barclays Aggregate	2.27	8.52	10.30	2.92	3.38
Corporate Investment Grade	3.07	12.94	12.87	4.51	4.65
Corporate High Yield	1.23	11.51	6.34	6.06	5.36
Leveraged Loans	0.92	6.39	3.11	4.68	4.11
Mortgage Backed Securities	1.44	5.82	7.98	2.38	2.83
S&P 500	1.70	20.55	4.25	13.39	10.84
MSCI EAFE	-1.07	12.80	-1.34	6.48	3.27

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