BOYD WATTERSON ASSET MANAGEMENT

Quarterly Investment Outlook

April 2017

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THE MACRO VIEW: On-Trend and Cautiously Optimistic

Chances of recession receded amidst a favorable economic backdrop as the slow-growing US economy continues in its 8th year of post-crisis recovery. Unemployment of 4.7% at quarter end remains low and continues to trend lower. US stock market indexes have posted robust returns and reached record-high levels, consumer confidence surged to a level not seen in 16 years, and the US Leading Economic Index reached its highest level in more than a decade.

Growth: "Expansions Don't Die of Old Age"

Much of investors' exuberance has been attributed to the Trump Administration's proposed economic policies, yet the economy has been picking up steam since mid-summer. The current recovery is long compared to the average expansion of five years, but post-World War II recoveries have lasted as long as ten years. Expansions don't die of old age, as Yellen famously noted, and we expect the post-crisis recovery to continue through 2017.

Since the second quarter of 2009, the US economy has grown at a respectable annualized rate of 2.0%. Factors prolonging the expansion's duration include a mild, trend-like average growth rate, a lack of excessive leverage and spending, and declines in oil and commodity prices. With inflation and growth in check, there has been no need for aggressive Federal Reserve rate increases, traditionally a recession-starter.

The Federal Reserve's 2.1% 2017 GDP growth estimate is based on the economy's current strength; the new administration's proposed stimulus package is not factored in. We believe Republican proposals to reduce regulation, repatriate corporate cash holdings, and allow immediate capital spending write-offs should be additive to real growth. At the same time, it will likely be difficult for President Trump to achieve much of his agenda during 2017. We are mildly more optimistic than the Fed with a forecast of 2017 economic growth in the area of 2.2%.

	Performance for periods ending 3/31/2017					
	QTD	YTD	1-Yr	2-Yr	3-Yr	5-Yr
2-Year Treasury	0.23	0.23	0.07	0.42	0.62	0.55
10-Year Treasury	0.77	0.77	-3.97	-0.52	2.83	2.00
Bloomberg Barclays Aggregate	0.82	0.82	0.44	1.20	2.68	2.34
Corporate Investment Grade	1.42	1.42	3.41	2.19	3.69	4.04
Corporate High Yield	2.71	2.71	16.75	5.92	4.59	6.82
Leveraged Loans	1.20	1.20	9.74	4.18	3.72	4.88
Mortgage Backed Securities	0.46	0.46	0.18	1.29	2.67	2.02
S&P 500	6.07	6.07	17.17	9.21	10.37	13.30
MSCI EAFE	7.25	7.25	11.67	1.21	0.50	5.83

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

Interest Rates and Inflation: Turning the Corner

After a slew of positive economic data, hawkish comments from San Francisco Fed President John Williams and New York Fed President Bill Dudley propelled market expectations for a March fed funds hike to 82% from 32%. On March 15, the FOMC raised the fed funds target rate for the third time by 25 bps to a range of 0.75% to 1.00%. The market and the Fed are uncharacteristically in alignment with an expectation for two additional hikes in 2017. Barring significant deterioration in inflation, labor market indicators, risk assets, or geopolitical events, we agree with this forecast.

As the Fed continues to push up the front end of the yield curve, we expect the 10-year Treasury to remain in a broad trading range of 2.0% to 3.0%. Ultra-low international interest rates should support demand for US Treasuries and dollar strength, keeping inflation and interest rates in check. The PCE Index surpassed the Fed's 2.0% target for the first time in five years, reaching 2.1% in February on higher energy costs. Although core inflation remains at 1.7%, we expect inflation to increase in a measured fashion along with interest rates.

Following the announcement of the Fed's third 25 bps rate increase came another long-awaited monetary policy milestone: The Fed stated its intent to begin shrinking its balance sheet later this year, by allowing securities to mature and roll off rather than through outright sales. The FOMC further indicated that it will telegraph new developments well in advance to avoid disrupting markets. Interest rates and credit spreads took the news in stride despite speculation surrounding the topic for much of the past year.

Caveats: Political Concerns at the Forefront

Our biggest concerns center on event risk related to the new administration, geopolitical risks, and elevated asset valuations. Republicans' failure to pass a revised healthcare bill is an example of how future policy disappointments may affect stocks and bonds—in the wake of the failure, the S&P 500 suffered its greatest decline in five months as money flowed from equities into bonds. The healthcare reform setback also raised concerns that Republicans will be unable to realize the administration's stimulative tax, infrastructure, and regulatory reform policies, resulting in lower growth than what the markets have been expecting.

In addition to Trump-related event concerns, other political issues to monitor include heightened geopolitical risks related to Syria, Russia, and North Korea and the ongoing trend in sentiment away from globalism and toward populism in Europe.

Despite the elevated political uncertainty, many risk assets are priced to perfection, particularly worrisome in an environment where volatility has been lower than average. High asset prices coupled with low volatility suggest that asset prices may be out of line with risk. In addition, we note that some areas of the economy fall short of exuberance with weaker-than-average numbers, including nonfarm payrolls, inventories, consumer consumption, real hourly earnings, and industrial production.

Although we don't foresee a recession or significant slowdown, we would not be surprised to see a pullback in risk assets. We would view a retreat in risk prices as a buying opportunity as opposed to a prelude to sharply lower asset prices.

Conclusion: More Growth, More Inflation, More Fed

In January, we laid out a case for "a little more growth, a little more inflation, and a little more Fed." Overall, the majority of economic indicators remain consistent with a slow-growth economy trending in the range of 2.00%–2.25%. We believe the factors underlying this base-case scenario are still in place.

QUARTERLY REAL GDP GROWTH DURING US EXPANSIONS

Expansion Period	Real GDP Growth
4Q 1949 - 2Q 1953	7.6%
2Q 1954 - 3Q 1957	4.0%
2Q 1958 - 2q 1960	5.6%
1Q 1961 - 4Q 1969	4.9%
4Q 1970 - 4Q 1973	5.1%
1Q 1975 - 1Q 1980	4.3%
3Q 1980 - 3Q 1981	4.4%
4Q 1982 - 3Q 1990	4.3%
1Q 1991 - 1Q 2001	3.6%
4Q 2001 - 4Q 2007	2.8%
2Q 2009 - 4Q 2016	2.0%

Source: Bureau of Economic Analysis

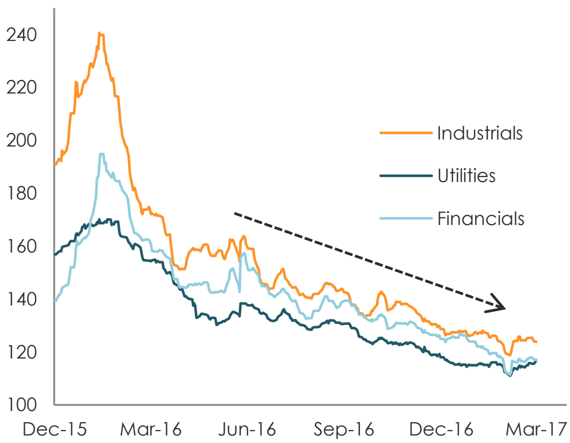
Macro Expectations	
Domestic Growth	Centered on 2.2%
Inflation (PCE core)	1.9% - 2.0%
10-year Treasury	2.0% - 3.0%

Source: Boyd Watterson Asset Management

2017 Expected Returns	
Broad Investment Grade Fixed Income	Low single digits
Real Estate	6.0% - 8.0%
Domestic Equities	6.0% - 8.0%

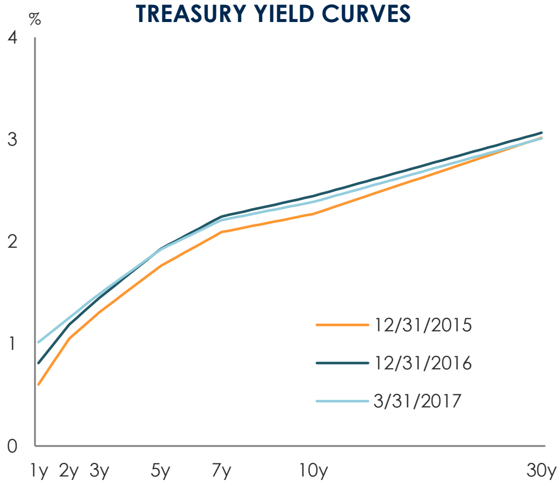
Source: Boyd Watterson Asset Management

INDEX SPREAD SECTORS



Source: Bloomberg Barclays Live

TREASURY YIELD CURVES



Source: Bloomberg

FIXED INCOME: Federal Reserve Back in the Game

Two major influences on the fixed income markets during the first quarter were the renewed actions of the Federal Reserve and volatility emanating from President Trump's first "100 days." The 10-year Treasury traded in a roughly 20 bps range throughout the quarter until the days before the Federal Reserve raised the fed funds rate on March 15th, when the yield spiked to 2.63% from a low of 2.31% in late February.

The sudden surge in yield appeared to be due to the market's anticipation of a more aggressive Fed for the remainder of 2017, based on hawkish comments from two Fed presidents. Volatility and yields subsided as the quarter came to a close and the Treasury curve responded in a historically classic manner to the Fed's March move: Short rates rose and long rates fell slightly, flattening the yield curve.

By late March, 10-year Treasury yields had once again dropped below 2.35%. Influencing the decline in long rates was the failure of Republicans to pass a bill overhauling healthcare legislation, signaling the market's worry that the Trump Administration's tax reform and regulatory relief might be in jeopardy as well. Without this added fiscal stimulus, expectations of more robust growth will fall short. Still, the recovery was in solid form before Trump economics, growing independently of future White House policy. Fixed income investors, however, responded to near-term psychology by covering short positions while taking stock of where to go from here.

Risk Sectors: Small—But Meaningful—Gains

The first quarter of 2017 unfolded as a risk-on quarter. From a longer-term outlook, the risk rally is the continuation of a spread-tightening trend that began more than a year ago in February, 2016. Both high yield and investment-grade credit exhibited spread tightening and produced positive excess returns. The asset-backed and commercial mortgage-backed sectors also performed well throughout the quarter as investors sought yield across the curve. Residential agency mortgage-backed securities, however, did not have a positive impact on performance; MBS experienced spread widening on a nominal spread and an option-adjusted spread basis.

One reason for the lackluster performance was likely the renewed talk of the Fed reducing the size of their balance sheet as they normalize rates. Investors have been wary of overexposure to MBS, speculating whether balance sheet reduction would take the form of MBS selling or cessation of re-investment, causing the MBS sector to cheapen. On April 5th, the FOMC announced the intention to taper reinvestment this year, though with details disclosed "well in advance." The subsequent lack of spread movement in MBS confirms the markets already had priced this scenario into spreads.

Outlook: The Only Certainty is Uncertainty

With the Fed on a mission to raise interest rates, it becomes difficult to pick up yield by extending duration. Overweighting spread sectors has provided a performance advantage, although this advantage comes with diminishing returns as credit spreads once again approach historically tight levels. In the current environment, portfolio performance may be driven more by a focus on issue selection than broad sector exposure.

With the expectation of ongoing political volatility filtering down to the markets, holding a long-term outlook of the economy helps investors overcome the short-term swings that are more "noise" than "trend." Portfolios that generate income through higher coupons, sustain a yield advantage relative to the benchmark, and maintain a defensive curve positioning should fare well in the upcoming months.

REAL ESTATE: Supply-Demand Factors Override the Effects of Rate Rises on Cap Rates

Speculation over rising interest rates and the resulting effect on cap rates has been the chief topic of discussion in the real estate industry for some time. Yet nearly six months have passed since rates spiked, and rates have hovered near peak levels since December without a noticeable increase in cap rates or decrease in transaction volume. These recent rate rises appear to have been priced into the market and have been easily digested by investors.

With the topic of interest rates set aside, the focus of real estate conversations has become protracted high prices and the ongoing real estate bull market cycle. The real estate market bottomed in 2009 and is in its eighth year of recovery. Thus far, cap rates have shown no signs of a pullback.

A strong US economy and persistently low unemployment are supporting the demand for commercial real estate space. A relative lack of development, due in part to financing regulation, restraint from lenders, and construction labor scarcity, has dampened supply. These supply-demand factors have converged to increase rental rates and decrease vacancy rates across most real estate asset classes and markets nationwide.

Cap rates are at historically low levels, and although future rate increases could push them higher, fundamentals and investor demand—both domestic and international—are likely to keep them in check near-term. With cap rates range-bound, asset values could flatten in 2017 and investors may have to rely on income for real estate returns.

REAL ESTATE CAPITALIZATION RATES FROM 2000 – 2016

Year	All Properties	Office	Industrial	Retail	Apartment	Hotel
2001	8.75	8.87	9.08	8.77	8.47	NA
2002	8.50	8.76	8.81	8.55	8.16	NA
2003	8.05	8.49	8.56	8.10	7.55	NA
2004	7.48	7.95	7.99	7.52	6.96	NA
2005	6.88	7.30	7.61	6.96	6.34	9.00
2006	6.64	6.86	7.08	6.71	6.26	8.92
2007	6.51	6.57	6.85	6.53	6.30	8.84
2008	6.81	7.13	7.47	6.85	6.41	9.01
2009	7.32	8.05	8.24	7.61	6.77	9.55
2010	7.27	7.78	8.31	7.81	6.67	8.21
2011	6.88	7.43	7.76	7.49	6.34	7.94
2012	6.75	7.19	7.48	7.22	6.20	8.13
2013	6.70	6.98	7.49	7.04	6.23	8.15
2014	6.48	6.85	7.12	6.77	6.07	8.13
2015	6.30	6.77	6.83	6.55	5.92	8.36
2016	6.11	6.60	6.81	6.49	5.71	8.50
2017	**All Properties**	**Office**	**Industrial**	**Retail**	**Apartment**	**Hotel**
Jan	6.11	6.65	6.74	6.54	5.54	8.64
Feb	6.08	6.64	6.72	6.42	5.47	8.47

Source: Bloomberg Finance L.P.

EQUITIES: Fundamentals Support Global Growth

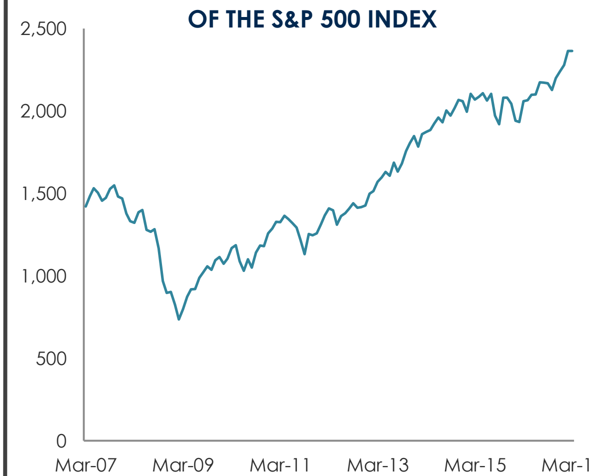
The S&P 500 Index is off to a strong start to the year with a first-quarter return of 6.1%. Initially, financials and industrials—beneficiaries of the so-called Trump trade—performed well based on the new administration's proposed programs, but failure to reform the Affordable Care Act cast doubts over the White House leadership. In March, the market rotated out of financials and industrials and into technology stocks, sending the NASDAQ up 9.8% to its best quarter since 2013.

The current environment of very low interest rates and inflation and exceptionally low volatility mostly supports the market's historically high valuations. Strong consumer confidence, a projected recovery in capital investment, and President Trump's proposed business agenda are also supportive for equities if Congress is able to enact his agenda. With that said, temporary weakness in the equity markets is not unlikely given the uncertainty surrounding the administration's progress.

The European expansion has lagged the US expansion and is still being supported by the European Central Bank's monetary easing. European shares, which are less expensive than their US counterparts, should continue to improve in price as rising confidence and supportive financial conditions favor higher-risk assets. The Japanese economy is improving as well. Japanese exports, especially to Asia, have been very strong. The pick-up in private consumption and the expectation of greater public investment bode well for Japanese stock market appreciation.

Finally, emerging markets have made a very strong showing. Dollar weakness combined with firming commodity prices have led to improving valuations in this underperforming region. In general, equity markets worldwide appear to be supported by favorable economic fundamentals and low interest rates.

10-YEAR CUMULATIVE GROWTH OF THE S&P 500 INDEX



Source: Bloomberg