BOYD WATTERSON
ASSET MANAGEMENT

# Quarterly Investment Outlook

*July 2017*

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With a singular focus on the management of money and a dedication to the satisfaction of our clients' expectations, we offer the unique benefits of a boutique firm but with the resources usually attributable to a much larger asset management firm.

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### OUR OFFICES


Cleveland, OH — 1801 East 9th Street, Suite 1400, Cleveland, OH 44114, (216) 771-3450

Charlotte, NC — 13024 Ballantyne Corporate Place, Suite 320, Charlotte, NC 28277, (704) 366-1091

Chicago, IL — Real Estate Advisory Group, 303 West Madison, Suite 1925, Chicago, IL 60606, (216) 771-3450


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## THE MACRO VIEW: A Temporary Lull Won't Derail Growth

The expansion appears to be facing several headwinds as we enter the second half of the year. Growth has been slower than expected, expectations for fiscal stimulus have waned, and policy progress has been priced out of the bond market. Consumer and business credit growth have declined. Inflation has receded and productivity growth continues to be subpar. Yet against this subdued economic backdrop we see clear signs of economic resilience and strength that provide a balanced picture of a still-moderately growing economy.

### Growth: A Resilient Economy

The environment for risk assets continues to be favorable. Credit fundamentals remain stable, volatility has been low, and risk assets are benefiting from the ongoing search for yield. Equities have been buoyed by low interest rates, low inflation, good earnings growth, and high optimism. Other indicators signaling economic health include elevated consumer confidence, an upward-sloping yield curve, and advances in the US Leading Economic Index (LEI). Traditional signs of recession are absent, along with signs of potential systemic risk such as excessive leverage or inflation and supply/demand imbalances. Consumer spending is expected to be moderate, and business spending should pick up once uncertainties surrounding regulatory reforms dissipate. Outside the US, the world economy continues to expand.

### Inflation: Two Percent in 2019

Falling energy prices, low wage pressures, and a spate of lower prices among various categories of goods and services pushed inflation down during the quarter. Core PCE inflation, the Fed's preferred inflation measure, slipped to 1.4% from 1.7%. The 10-year TIPS breakeven rate, which implies market expectations over the next 10 years, fell to 1.75% from 1.98%. In contrast to the market, the Fed maintains a forecast of 2.0% inflation by 2019 based on recovering energy prices, eventual higher wages, and the passing of temporary price dips. We also believe that the market is underestimating inflation, and concur that the decline in core PCE will be temporary.

| Performance for periods ending 6/30/2017 | QTD | YTD | 1-Yr | 2-Yr | 3-Yr | 5-Yr |
|---|---|---|---|---|---|---|
| 2-Year Treasury | 0.11 | 0.35 | -0.31 | 0.42 | 0.58 | 0.55 |
| 10-Year Treasury | 1.29 | 2.08 | -5.59 | 1.67 | 2.37 | 1.12 |
| Bloomberg Barclays Aggregate | 1.45 | 2.27 | -0.32 | 2.79 | 2.48 | 2.21 |
| Corporate Investment Grade | 2.42 | 3.88 | 2.33 | 4.82 | 3.54 | 4.05 |
| Corporate High Yield | 2.16 | 4.93 | 12.75 | 7.08 | 4.48 | 6.88 |
| Leveraged Loans | 0.75 | 1.96 | 7.49 | 4.16 | 3.49 | 4.83 |
| Mortgage Backed Securities | 0.90 | 1.37 | -0.03 | 2.15 | 2.15 | 1.98 |
| S&P 500 | 3.09 | 9.34 | 17.90 | 10.73 | 9.61 | 14.63 |
| MSCI EAFE | 6.12 | 13.81 | 20.27 | 3.94 | 1.15 | 8.69 |

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


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## Labor Market: Incremental Improvements

Unemployment continued to decline during the second quarter. June's unemployment rate of 4.4% marked another decade low. In addition, the percentage of underemployed workers has also fallen to pre-recession levels. With the economy at full employment, labor force gains are expected to be incremental. The labor force participation rate, however, remains near a 40-year low. The replacement of jobs by technological advances and a mismatch in the supply versus demand of skills have been steadily reducing the overall participation rate during the past two decades.

Going forward, the stream of retiring baby boomers is expected to put an additional drag on the labor force. The moderation in the US labor force growth rate is supportive for modest economic expansion, though it will be difficult for the economy to achieve the robust growth levels of the past.

## Interest Rates and Monetary Policy: Rates are Heading Higher

Long-term Treasury yields rallied during the quarter based on reduced expectations for growth and inflation. Ten year rates have fallen into a forecasted trading range of 2.00%–2.75%. We believe that the recent rally in bonds is temporary, and that strengthening growth and inflation during the second half of the year should push rates moderately higher. Moreover, as quantitative easing tapers off in developed markets global interest rates should drift upward, shifting some of the demand for US bonds back overseas. Short-term rates should also trend higher; despite the market's lack of conviction, the Fed believes current financial conditions remain accommodative and warrant additional increases in the federal funds rate.

## Caveats

Risks we foresee to economic growth include ongoing lack of fiscal stimulus and persistently lower inflation. Weak consumer spending and bank lending are weighing on potential growth and merit continued monitoring. Geopolitical risks remain elevated, and are at the forefront of our concerns. High valuations in equities leave the market vulnerable to a pullback. A disappointment in reported earnings could trigger a 5%–10% retreat in prices, an event we would consider a buying opportunity. Finally, a slowdown in China would impact global growth in general and emerging markets growth in particular.

## Conclusion: More of the Same

First-quarter growth is known to be seasonally weak; historically, GDP growth increases during the second half of the year relative to the first half. Still, economic growth is unlikely to meaningfully exceed 2.0% for 2017 without significant fiscal stimulus. Yet absent such stimulus, the recent weakness in economic data is likely to be a temporary lull in an otherwise moderately expanding economy.

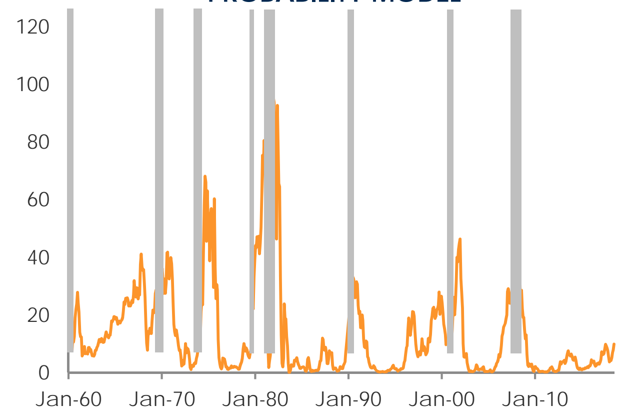
Subpar productivity and labor force growth will keep GDP from returning to the robust levels seen in prior decades, but the economy is stable and on track for continued moderate expansion. It is this slow, steady, trend-like growth that has enabled the economy to continue expanding. In this environment, an overweight in fundamentally sound risk assets and an underweight in interest rate sensitivity should be rewarded over the course of the year. Overall, our expectations for a little more growth, a little more inflation, and a little more Fed have not changed since the beginning of the year.

### 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

### US YIELD CURVE RECESSION PROBABILITY MODEL




Source: Ned Davis Research, Inc., Federal Reserve Bank of New York

| Macro Expectations | |
|---|---|
| Domestic Growth | Centered on 2.0% |
| Inflation (PCE core) | 1.90% - 2.00% |
| 10-year Treasury | 2.00% - 2.75% |

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

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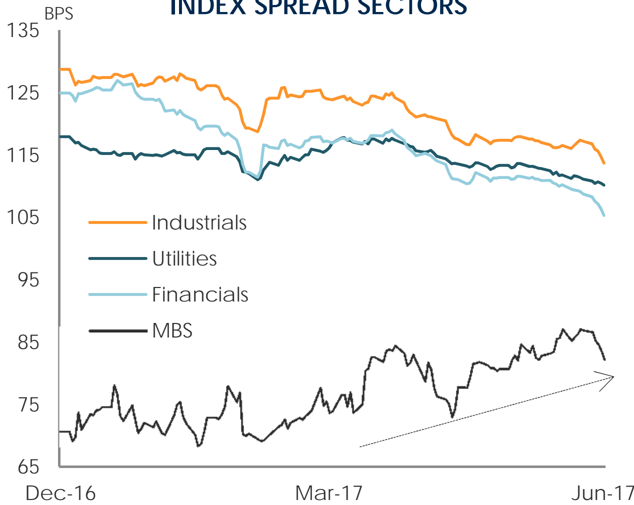
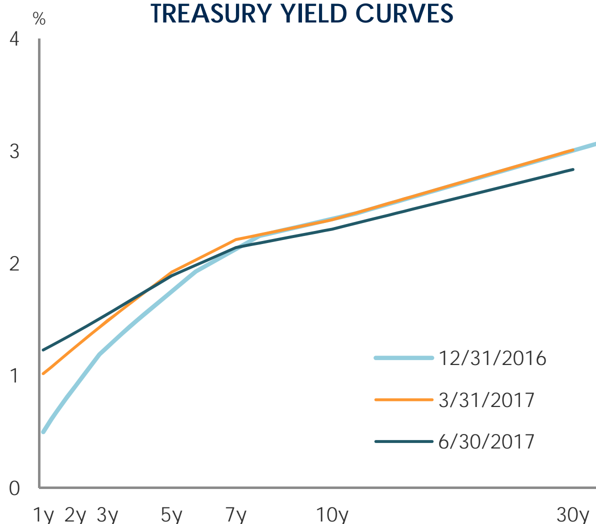


Source: Bloomberg Barclays Live



Source: Bloomberg

## FIXED INCOME: A COUNTERINTUITIVE RALLY

June marked the fourth time the FOMC has raised the federal funds rate during the past 10 years. One year and two quarters into the tightening cycle, short-maturity yields are increasing along with the fed funds rate, as expected. Long-maturity rates, on the other hand, rallied through the Fed's June rate hike—surprising, perhaps, but not unprecedented.

Historically, when the markets have sensed that the end of a tightening cycle is near, interest rates—particularly longer rates—often begin to fall. In January-February 2000, for example, yields fell prior to the Fed's last two fed funds rate increases. In another instance, select Treasury tenors rallied during November 2005 and May 2006, periods that marked the later stages of former FOMC Chair Ben Bernanke's protracted rate increases.

### When the Curve Flattens

When the Fed begins a tightening cycle, rates along the yield curve tend to increase. Short rates typically move higher than long rates, thereby reducing the steepness of the curve. As the tightening cycle progresses to its later stages, long rates may rally in anticipation of an economic slowdown stemming from higher rates and eventual Fed easing due to presumably subdued inflation. A flatter yield curve is the result. History tells us that a flat yield curve is a precursor to an inverted yield curve, and an inverted yield curve tends to lead a recession by one year.

As of June 30, the 2–10 year yield curve, or the difference in yields between the two tenors, is close to its narrowest point of the past nine years. The curve flattened 21 basis points during the second quarter to a spread of 92 basis points at quarter end. At its highest point since the Great Recession the 2s–10s spread reached 291 basis points in February, 2010.

Yet rather than indicating a recession, we believe the curve has room to flatten further before reaching this economic tipping point. According to FOMC minutes and the Fed's widely followed dot plots, additional rate increases are forecasted over the next two to three years. At the end of 2019, the average federal funds rate is projected to be approximately 3.0%, or about 200 basis points higher than the current rate. In this scenario, the yield curve's "bull flattening" move seems premature.

### The Market vs. the Fed

The divergence between the market's assessment and the Fed's assessment seems to hinge on the likelihood of resurgent inflation. According to the Fed's models, the slack in inflation is a short term phenomenon. In contrast, the market is expecting a 10-year inflation rate of 1.75% based on the June 30th 10-year Treasury Inflation-Protected Security (TIPS) yield. If the Fed is correct in its prediction that inflation will progress toward 2.0% over the next few years, the long end of the curve is overpriced and yields are too low.

As the curve reprices for higher inflation, bond prices will fall and yields will rise. It is this scenario that we believe is most plausible. Although we believe the Fed is likely on a slower path to raise rates, we also believe that growth in the second half of the year will strengthen, inflation will resume its path toward 2.0%, and rate increases will continue throughout the curve.

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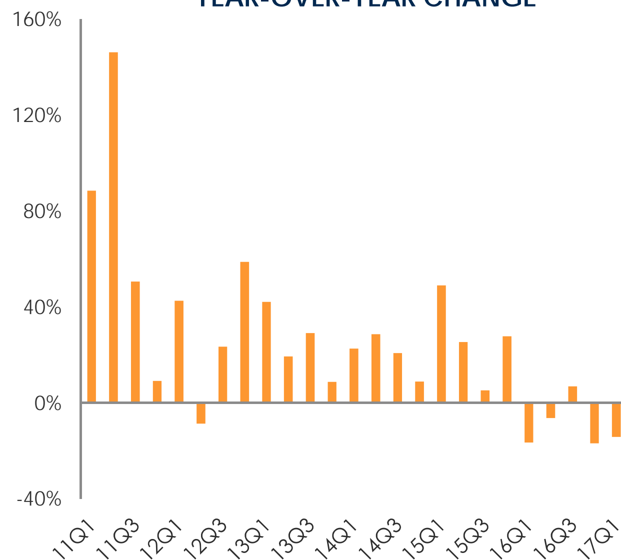
### REAL ESTATE: Deal Volume Softens

Despite the prolonged bull market, erratic interest rates, and potential shifts in US policy under the new Presidential Administration, the commercial real estate industry has been in a period of relative calm. Pricing and fundamentals have been stable, and investors are eager to put dry powder to work. Opportunities, however, are less than plentiful, a trend that shows no signs of reversing.

The number and size of executed deals has decreased. Earlier in the year, slowing deal flow could be attributed to interest rate increases, which made financing more difficult for some deals in progress and added unquantifiable risk. Currently, investor demand for deals in major metropolitan areas is waning due to high prices and low yields. Yet another cause of softening volume can be traced to the more stringent underwriting requirements since the Great Recession. Borrowers are not overleveraged so they have flexibility to hold investments through temporarily adverse conditions such as increasing vacancies.

Deal volume, in contrast, has grown in secondary markets, where prices are lower. With cap rates hovering at all-time lows and income growth decreasing over the past several years, near-term performance will likely rely on creating value in existing holdings, perhaps by physically updating structures or solidifying tenant bases. Once asset owners feel they have maximized profit, and increasing cap rates start to diminish residual prices, deal flow should begin to increase.




Source: Real Capital Analytics

### EQUITIES: Fundamentals Support Growth

New highs in the stock market generally prompt investors to look for indicators as to whether the rally can continue. One such indicator is market breadth, or the number of stocks advancing versus the number declining. When rising prices are limited to fewer stocks, a rally may be unsustainable. The market breadth of the current rally is relatively narrow, concentrated among a handful of technology stocks and somewhat reminiscent of the 1999 tech bubble. Yet two factors suggest that this comparison is misleading.

First, tech stocks do not appear to be overvalued. According to a study done by Northern Trust, the top 10 tech stocks had an average P/E ratio of 68x in 1999 versus 25x today. First-quarter YOY tech stock earnings were strong at 19% versus the broad market, and projected earnings growth of 12% is forecasted to outpace earnings growth in most other sectors. In addition to solid earnings, prices have yet to reach tech-bubble levels. Moreover, tech stocks today have a reasonable dividend payout ratio compared to 1999.

Second, interest rates are much lower than they were in 1999 and are expected to remain relatively low. Low interest rates are supportive for stocks, and stocks with projected good earnings growth can continue to advance in this environment.

On a broader scale, European and Japanese markets are also strong. Overall, the ongoing global recovery along with increasing earnings in a low-rate environment should continue to support stocks despite their relatively high valuations. We foresee the possibility of a minor pullback in prices, but not a full-fledged correction.

Source: Ned Davis Research, Inc.

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