BOYD WATTERSON
ASSET MANAGEMENT

April 2021

Investment Outlook

Our Firm:

Boyd Watterson Asset Management, LLC is an SEC-registered investment advisory firm with approximately $14.6 billion of assets under management.[1] 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.

[1]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.

For information about Boyd Watterson's investment strategies, insights, philosophy and teams, please visit our new website, www.boydwatterson.com

Check out our blog:
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The Macro View

The first quarter of 2021 was characterized by growing optimism as a contentious election season ended, COVID cases declined, and vaccine supply and administration ramped up rapidly. This impacted the financial markets by driving intermediate and long-term interest rates higher, which, in turn, took some of the steam out of technology stocks. With the Senate evenly split following the Georgia run-off elections, President Biden's fiscal agenda moved to center stage, and the President wasted little time in forging ahead with his large stimulus package to further support the economy's emergence from the coronavirus pandemic.

The passage of the $1.9 trillion American Rescue Plan in March comes on the heels of the $900 billion Response and Relief Act signed into law less than three months earlier. Between the timing of these two stimulus packages being signed into law, COVID-19 cases in the U.S. declined dramatically from their January peak and both the supply and distribution of the three approved vaccines ramped up significantly. According to CDC data, as of April 1st, the U.S. had administered 153.6 million vaccine doses with 30% of the population having received at least one dose and nearly 17% of the population fully vaccinated. The proximity and magnitude of these fiscal support measures, combined with states' renewed efforts to re-open their economies, have resulted in more robust expectations for spending, growth, and inflation over the next several quarters. While we believe the optimistic outlook is justified, it is not without risk and potential longer-term financial consequences.

Undoubtedly, there is a tremendous amount of pent-up demand for consumers to travel, dine out and enjoy other activities that have been restricted to varying degrees throughout the pandemic. Supporting this view, the personal savings rate reached 19.8% in January, the highest pre-pandemic level on record and does not reflect any impact from the most recent stimulus bill. This bill, which includes additional stimulus checks and expanded unemployment insurance benefits, coincides with tax refund season, further adding to the spending arsenal of U.S. consumers. Furthermore, consumer confidence increased substantially in the first quarter and both services and manufacturing sector activity ended the quarter at multi-year highs. As a result, we expect annualized real GDP to grow above trend for the next several quarters.

Performance for Periods Ending March 31, 2021

	QTD	1-Yr	3-Yr	5-Yr
2-Year Treasury	-0.03	0.19	2.70	1.59
10-Year Treasury	-7.10	-8.23	4.64	1.70
Bloomberg Barclays Aggregate	-3.37	0.71	4.65	3.10
Corporate Investment Grade	-4.50	9.30	6.19	4.92
Corporate High Yield	0.81	23.15	6.51	7.90
Leveraged Loans	2.01	20.77	4.13	5.33
Mortgage Backed Securities	-1.15	0.10	3.86	2.49
S&P 500	6.17	56.35	16.78	16.29
MSCI EAFE	3.48	44.57	6.02	8.85

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

Alongside this outlook comes fears of higher inflation, as elevated commodity prices and supply chain disruptions are now met with a potentially overstimulated economy. Given the pandemic-induced decline in core inflation last year, the year-over-year comparisons will likely be elevated over the coming months, yet we continue to expect inflation to moderate back toward (or below) the Fed's 2% target level over the medium term.

For many of the reasons noted previously, the Federal Open Market Committee (FOMC) also raised their outlook for growth, inflation, and the labor markets for 2021, yet forecast growth and inflation to moderate beyond 2021. Fed Chair Powell continues to emphasize that the Committee's policy shift to average inflation targeting to fulfill their dual mandate will result in the FOMC now being more reactionary than pre-emptive with monetary policy adjustments. In other words, policy changes will be driven by trends in hard data and not simply on changes in the Committee's forecasts. As such, the FOMC expects to remain patient with their current policy stance until substantial progress is made toward achieving the policy mandate. We expect the forthcoming economic data to strengthen enough that the FOMC will likely begin to prepare the markets for QE tapering to begin in late 2021 or early 2022, with rate increases to follow in 2023.

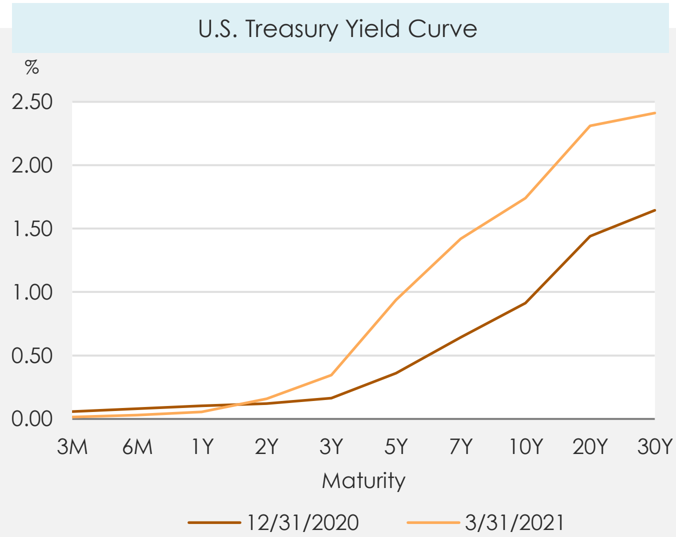
With all the positive news on stimulus, vaccines and the Fed keeping rates low for the foreseeable future, what could possibly go wrong? From our perspective, this list is longer than some may expect. On the fiscal policy front, the Biden Administration has already announced an initial $2 trillion infrastructure spending plan as well as a proposed increase in corporate taxes to fund the program. This alone has implications for the deficit, Treasury supply, corporate earnings, and, therefore, interest rates and equity valuations. If more stimulus becomes a reality and investors push interest rates even higher, the Fed may be compelled to use the QE program to cap interest rates along the yield curve. Furthermore, if inflationary pressures become less transitory and more persistent, the FOMC may be forced to increase the federal funds rate sooner than currently anticipated by financial markets.

Aside from fiscal and monetary policy, there is also the possibility that consumer habits have changed more than anticipated over the last year, such that elevated savings rates may be more than temporary, and consumption, beyond the surge we are experiencing currently, could fall short of expectations. Additionally, it remains to be seen what corporate spending will look like longer term, specifically regarding travel, working from home and hiring needs, all of which play a significant role in the outlook. In such scenarios, the growth outlook could be too optimistic, leaving the Fed on hold for a longer period.

The COVID-19 pandemic compressed a full economic cycle into twelve months, leaving investors with more questions than answers. It will take several quarters, if not years, before we have the answers to many of these unknowns. In the meantime, we continue to evaluate our investment decisions incorporating these questions into our analysis of the economic data and trends we see in the financial markets. As a result, we expect the risk/reward setup in the fixed income markets to remain challenging with elevated volatility over the coming quarters.

Fixed Income

Coming into 2021, many investors expected intermediate and long-term interest rates to increase over the course of the year citing the expectation for a strong economic rebound due to additional fiscal stimulus and vaccine distribution ramping up. A number of firms had a year-end target of 1.75% for the yield of the 10-year U.S. Treasury note. That level was nearly reached in the first three months, as we ended the quarter at 1.74%, up 83 basis points (0.83%). The quick rise in rates took investors by surprise and has led many forecasters to adjust their interest rate targets upward. Our range for the 10-year is 1.50% to 2.25%, with the expectation that the yield will gravitate towards the higher end of the range as the year goes on and the data supports that the economy is expanding at a healthy pace.



Source: Bloomberg.

With the Fed keeping short-term interest rates anchored near zero while intermediate and longer-term rates have risen, the outcome has resulted in a significantly steeper yield curve. The closely watched spread relationship between 2-year and 10-year Treasury notes increased from 79 basis points to 158 basis points in the first quarter as investors started pricing in the prospect for higher inflation over the near term. This is reflected in higher break-even rates of TIPS. The break-even rate of 10-year TIPS started the year at 1.99% and ended the quarter at 2.37%, which means investors now expect inflation to be well above where their expectations had been over the last 20 years, an average of 2.01%.

The spike in yields resulted in negative total returns across much of the broad fixed income universe. In contrast, excess returns were positive across most of the primary fixed income sectors given the modest spread tightening that took place during the quarter. Agency mortgage-backed securities were the exception, as they generated negative excess returns given that mortgages tend to underperform in a rapidly rising interest rate environment. High yield corporate bonds were the bright spot for the quarter, posting both positive total and excess returns, given their shorter relative duration and 50 basis points of spread compression during the quarter.

In the face of sharply higher interest rates, the credit markets performed well from an excess return perspective, with both investment grade and high yield spreads moving tighter during the quarter. The improving economic outlook brought renewed confidence in corporate fundamentals and future earnings prospects. New issuance for both investment grade and high yield was robust yet was readily digested by investors as all-in yields were more attractive given higher Treasury rates. From a quality perspective, lower quality outperformed higher quality in both investment grade and high yield. This was particularly true in the high yield market with CCC-rated bonds posting total returns in excess of 5%, which helped drive the overall high yield index performance. Intermediate and long-term investment grade corporate bonds posted the weakest total returns, yet maturities of fifteen years and longer generated the strongest excess returns of over 2%. Similarly, the commercial mortgage-backed market witnessed significant spread tightening, but it was the lower quality A and BBB-rated issues that posted the strongest excess and total returns.

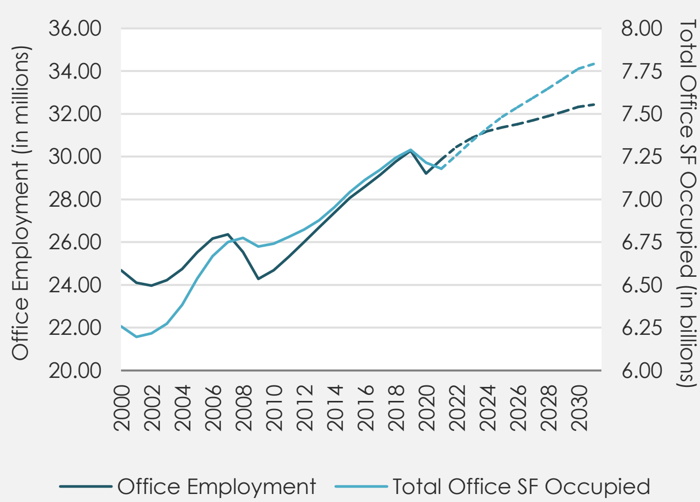
Looking forward, we believe there will be continued upward pressure on interest rates, but not to the same magnitude witnessed in the first quarter. As a result, our duration positioning remains short relative to the benchmark and we are maintaining a bulleted maturity structure as the yield curve could steepen further. While corporate bond valuations are near the tighter end of their recent range, we are maintaining our overweight position to help achieve our desired yield advantage relative to the benchmark. We believe that both industry allocation and issue selection will be the more important drivers of performance as we continue to look for opportunities in the higher beta, COVID-impacted sectors where we believe the risk/reward profile is more attractive.

Real Estate

The commercial real estate sector has suffered for much of the past year from low transaction volumes, weak demand (with the notable exception of industrial real estate), increased financial distress from tenants, a weakened lending environment and dormant downtowns. However, there is now increased optimism for a very strong second half of 2021 as the vaccines have been successfully rolled out to a large percentage of the population and they have proven to be highly effective against COVID-19. This has resulted in increased activity in cities nationwide and a sense of a return to normalcy by this summer.

One of the biggest remaining questions is what will become of the traditional office once the pandemic is over? Will workers return to a pre-pandemic existence where remote work is relatively rare, or will they work almost exclusively remotely? The answer is probably somewhere in between, with most workers returning to the office most of the time, but with a number of employees working remotely anywhere from one to three days per week. If that is the case, there is a likelihood that tenants will require less office space in total and many companies will adopt flexible offices (already popular prior to the crisis) where workers do not have a permanent workstation and can move around to different locations on different days. In this scenario, there is likely to be a decline in demand for office space in the short term, an increase in vacancy rates and a drop in office rents. However, in the long term, we expect demand for office space to likely increase as most job creation in the U.S. is in knowledge-based industries utilizing office space. So, while there may be a short-term dislocation in the office market, we do not believe the office is disappearing permanently. Recent announcements from Google and Amazon, two of the largest office tenants in the world, reinforce this view by indicating their returns to the office should be similar to their pre-pandemic plans. Their position is in-line with our view: employees are more productive and creative in an office setting and a culture is much easier to maintain when people are working together in person.

Historical and Projected Office Employment and Total Office (SF) Demand in the U.S.



Source: Costar.

Boyd Watterson's primary real estate funds invest in offices leased to the federal, state, and local governments. The funds focus on investing in mission-critical offices which we believe insulates its properties from the broader changes to the office sector. Additionally, the government had largely embraced working from home pre-pandemic and, therefore, we believe that most employees who will work from home in the future were already doing so before the pandemic. Dan Matthews, the recent Public Building Services commissioner for the GSA, stated prior to his departure that he believes the federal government will not only continue to lease space, but he believes that the government will lease more space in the future than it does today, which implies growth in demand for office space by the government. For all these reasons, we believe that the outlook for investing in the government office space continues to be strong and that there will likely be continued growth in the sector as the country grows.

Equities

Major equity indices ended the first quarter higher, with the Dow and S&P 500 reaching new highs. The Dow ended the quarter up 8.3%, while the S&P 500 was higher by 6.2%. The technology heavy Nasdaq Composite trailed these two indices, ending the quarter up 3%. Value stocks outperformed growth stocks by over 10 percentage points in the quarter as measured by the return of the Russell 1000 Value Index (up 11.2%) versus the Russell 1000 Growth Index (up 0.94%), the largest outperformance in 20 years.

Equity market volatility ended the quarter lower than where it started the year, but there were several periods when it spiked significantly, mostly due to the surge in interest rates and the expectation for higher inflation. Corporate earnings for the fourth quarter of 2020 exceeded analyst's expectations and the forward-looking outlook is for likely further improvement. The S&P 500 corporate earnings growth rate for the first quarter is forecasted to exceed 23% while revenue growth is expected to exceed 6% according to FactSet. Both earnings and revenue growth rates have been revised higher from earlier estimates. We believe the rapidly expanding distribution of vaccines coupled with fiscal and monetary stimulus should provide a tailwind for the equity markets going forward. One caveat to our outlook is higher interest rates. Should interest rates continue to increase at a rapid pace, equity markets would likely not react well given the elevated amount of debt corporate America is currently maintaining.