BOYD WATTERSON
ASSET MANAGEMENT

July 2021

Investment Outlook

Our Firm:

Boyd Watterson Asset Management, LLC is an SEC-registered investment advisory firm with approximately $15.2 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 website, www.boydwatterson.com

Check out our blog:
www.boydwatterson.com/insights/

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The Macro View

With over half of the U.S. population having received at least one vaccine dose and daily case rates and reported deaths significantly lower than the peaks witnessed in the first quarter, states continue to rapidly reopen their economies. The return to some sense of normalcy is to be celebrated, but with it comes an element of uncertainty for investors as politicians and central bankers prepare to remove some of the extraordinary fiscal and monetary policies that were put in place to counteract the pandemic. The interplay between incoming economic data, the Fed's messaging and investors' expectations will undoubtedly create a challenging landscape to navigate over the coming quarters.

Performance for Periods Ending June 30, 2021

	QTD	YTD	1-Yr	3-Yr	5-Yr
2-Year Treasury	-0.08	-0.11	0.01	2.62	1.47
10-Year Treasury	3.23	-4.10	-5.89	5.86	1.74
Bloomberg Barclays Aggregate	1.83	-1.60	-0.33	5.34	3.03
Corporate Investment Grade	3.60	-1.06	3.62	7.79	4.94
Corporate High Yield	2.75	3.59	15.48	7.13	7.28
Leveraged Loans	1.44	3.48	11.67	4.36	5.04
Mortgage Backed Securities	0.32	-0.83	-0.39	3.87	2.33
S&P 500	8.55	15.25	40.79	18.67	17.64
MSCI EAFE	5.17	8.83	32.35	8.27	10.28

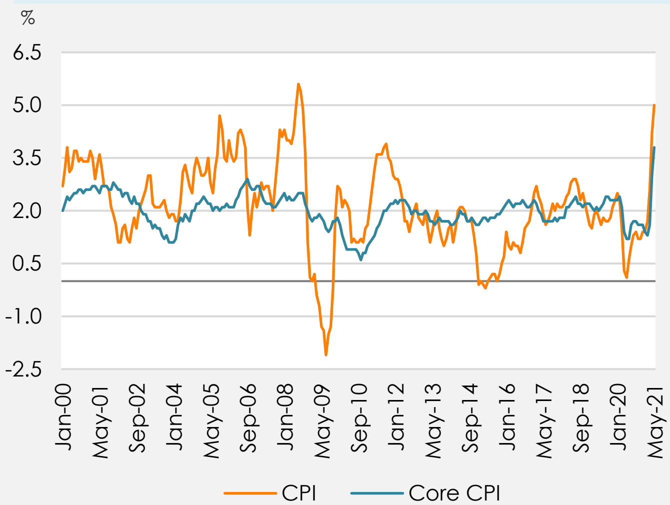
Source: Interactive Data, Credit Suisse, Bank of America/Merrill Lynch/Bloomberg.

Economic activity is increasing due to increased mobility and a consumer base flush with stimulus cash. The Bloomberg consensus estimate for annualized GDP growth is 10% for the second quarter and 6.6% for 2021. For much of the pandemic, consumption was concentrated more in durable goods as restricted mobility caused consumers to focus on updating their homes and the like. Now, with the easing of these restrictions, consumption is turning to the service sectors with restaurants, entertainment venues and hotels returning to capacity. While positive for growth, the rapid increase in demand has created some challenges on the supply side, both in terms of employment and materials. As a result, the Federal Open Market Committee's (FOMC) dual mandate of stable prices and maximum employment is likely to be a difficult balancing act as the economy transitions through this recovery phase.

With the unemployment rate having peaked at 14.8% in April 2020, significant progress has been made in getting people back to work. The current rate of unemployment stands at 5.9%, still well above the 3.5% level that was achieved prior to the pandemic. To date, the recovery in employment has been uneven, due in large part to the combination of expanded unemployment insurance benefits and the slow return to in-person work and schooling. We expect the transition back to in-person to likely accelerate on both fronts, thus hastening the pace of payroll gains later this summer and into the fall.

On the other hand, the inflation side of the FOMC's mandate shows the opposite dilemma, as current readings are the highest we have experienced in many years. While base effects can explain a portion of current readings, the combination of increasing demand, supply-chain disruptions and elevated commodity prices are also exerting upward pressure on both producer and consumer prices. While investors debate whether the current inflationary environment is transitory, we agree with the FOMC that inflation levels are most likely to moderate back toward the two percent level over time. We do acknowledge that wage pressures are notable and will continue to monitor the ability of companies to pass these higher labor costs on to consumers.

Consumer Prices YoY



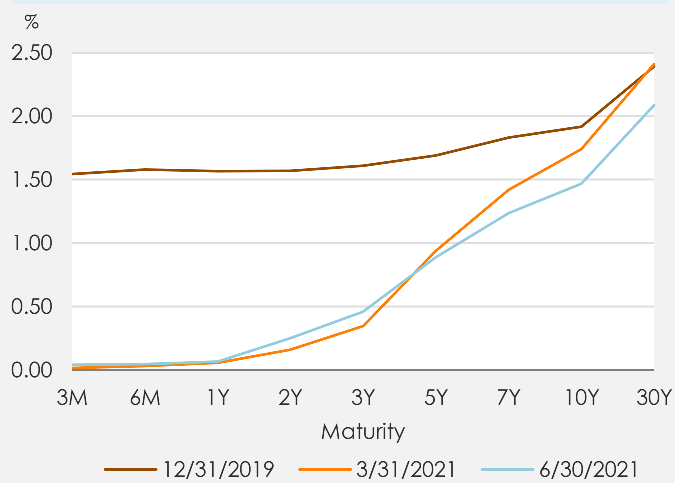
Source: Bloomberg.

The FOMC has made it clear, given the change in their policy framework, they will remain patient in adjusting policy until they are confident that trends in observed economic data reflect "substantial further progress" toward their dual mandate objectives. Given our expectation for robust GDP growth, elevated near-term inflation and stronger payroll growth in the coming months, we do expect the FOMC to announce a bond purchase tapering program relatively soon with its inception likely by year-end. Additionally, some members of the FOMC are slowly adjusting their interest rate projections higher for 2022, but the median estimate for rate increases to begin remains a 2023 event. While the FOMC's Summary of Economic Projections and the 'dot plot' are informational, the Committee's focus on economic outcomes will guide policy and these data points are deserving of the most attention from investors when evaluating future policy adjustments.

Fixed Income

The trend of higher interest rates and a steeper yield curve experienced in the first quarter was short lived, as the second quarter saw a reversal of these trends. Elevated inflation readings were tempered by the uneven pace of payroll growth during the quarter. This, coupled with the FOMC's consistent message of transitory inflation and patient, transparent policy adjustments, resulted in a significant rally in intermediate and long-term interest rates. Perhaps most interesting was the upward movement in two-year and three-year Treasury notes following the FOMC's June policy meeting, which showed a somewhat more hawkish movement in the 'dot plot.' For the quarter, the yield on the two-year Treasury note increased 9 basis points, while ten-year and thirty-year notes declined 27 and 33 basis points, respectively. As a result, the yield differential between two-year and thirty-year Treasuries decreased 41 basis points during the quarter yet remains 31 basis points steeper year-to-date. Given our expectation for a broadening of the recovery over the coming quarters, we anticipate interest rates will gradually move higher and the yield curve will likely reestablish its steepening trend, led by pressure on longer-term maturities.

U.S. Treasury Yield Curve



Source: Bloomberg.

The second quarter was another solid quarter for risk assets within the fixed income markets, with spreads relative to Treasuries continuing to tighten. Similar to the first quarter, all primary sectors of the fixed income market posted positive excess returns, with the lone exception being agency mortgage-backed securities.

The corporate bond market continued to see strong demand, further compressing risk premiums in both the investment grade (IG) and high yield (HY) sectors. Year-to-date, investment grade issuance has totaled nearly $800 billion according to Bloomberg, a pace that is 34% ahead of this time in 2019. Despite heavy issuance, investor demand remained strong, driving both investment grade and high yield index spreads to their tightest levels since prior to the financial crisis. Excess returns relative to Treasuries for the quarter were stronger as investors moved down in credit quality or longer in maturity. While we recognize valuations in this space are stretched, we believe credit spreads can remain in a tight trading range for an extended period given the improving fundamentals and supportive technical backdrop.

On the securitized product side, asset-backed and commercial mortgage-backed securities have continued to be steady outperformers, while agency MBS was the lone sector to underperform. Agency mortgage-backed securities continued to struggle and have been negatively impacted by interest rate volatility and increasing speculation about the ending of the Federal Reserve's bond purchases in that sector.

Despite the cross currents of incoming economic data, Fed messaging and investor expectations, we do not feel this is the time to abandon risk assets in fixed income. We continue to believe the FOMC will move slowly with policy adjustments and investors' quest for yield will continue, particularly given there remains over $13 trillion of negative yielding debt globally. A common theme among our portfolios is to maximize our relative yield advantage while maintaining a bias to be short duration relative to the benchmark. To accomplish this, we remain overweight spread product and have begun to incorporate floating rate notes and bank loans into our portfolios. We will remain keenly focused on inflation and the labor markets as we evaluate future actions from the Fed and will actively adjust our portfolio positioning as warranted.

Real Estate

The effective rollout of a COVID-19 vaccine has led to a recovery within commercial real estate which appears to be accelerating. The reduction of COVID-19 regulations has unleashed significant pent-up demand for goods, services, and travel, and has increased the number of workers returning to offices. All of this has benefitted commercial real estate which is seeing rapid improvement in nearly every segment of the industry. We expect a few trends to have a meaningful impact moving forward.

First, there appears to be plenty of liquidity in the marketplace which we think will likely continue as there is significant availability of capital. Many real estate investors and asset managers are flush with equity after a year spent largely sitting on their dry powder, allowing a build up to record levels within closed-end funds ($356B) according to Preqin. As more capital is allocated to real estate by large investors seeking yield, there likely is only going to be more competition for deals and more liquidity. Lenders are also flush with cash and are aggressively seeking to deploy it. This has resulted in rapid tightening of spreads and easing of underwriting standards. This capital availability combined with the reopening of the country is leading to an increase in transaction activity, with various mega-deals announced in the past few weeks. The combination of extra liquidity, competition for deals, availability of cheap financing and low interest rates is likely to lead to further cap rate compression and higher pricing across asset classes. Perhaps the only asset class where we are still seeing significant caution is in large multi-tenanted office buildings with existing vacancy or short remaining lease terms, where investors are still in wait-and-see mode regarding remote work.

Another evident trend that has accelerated as COVID has receded is rapid rent growth in many asset classes. Industrial, multi-family, single-family rentals, self-storage, and hotels are all seeing rapidly growing rates. While industrial has been strong throughout the pandemic, there does not appear to be an end in sight to rental growth in that sector. The shortage of housing combined with booming demographics have pushed rents in multi-family and single-family rentals (plus the single-family owned market) to new heights that have surpassed pre-pandemic levels more rapidly than expected. This increased demand for housing and for more space has benefited the self-storage market, which has seen rates increase by 56% from June of 2020 and is 15% above its all-time peak in 2016 according to Radius+. Lastly, the pent-up demand for leisure travel has led to high rates in the leisure hotel market as well as vacation rentals. The only major areas of the industry not seeing rapid improvement are in the office market (due to a slow return by workers) and the business travel hotel sector (though it is improving). With the demand drivers continuing to increase in nearly all of these sectors, we anticipate rents and property values to continue their upward trend across these already improving sectors.

Lastly, despite this increased demand, we have yet to see big increases in development because construction costs have risen due to a shortage of labor and rapid increases in building materials. Lumber hit an all-time high of $1,670 per thousand board feet in May. It has since dropped by more than 50%, which is still nearly double its pre-pandemic pricing. This increase in lumber costs has a particular impact on housing, which more frequently uses lumber in the construction of homes and garden apartment buildings. According to the Bureau of Labor Statistics, other building materials such as steel, plastics, gypsum, wallboard, insulation and cement have all seen significant price increases as well. Compounding the issue is long lead times for delivery of materials, which is causing delays and uncertainty about timing of projects. All of this has led to a delay or stoppage of many projects because the numbers do not pencil out for construction. The impact of all of this will be limited new supply, which should push up rents and the values of existing buildings as market fundamentals improve.

The boom in commercial real estate should benefit owners of existing assets. Boyd Watterson's portfolio generally consists of properties with long-term leases to the federal government, which has been insulated from the pandemic and we believe is fairly well-insulated from broader remote work trends. The increased investor demand, increased demand for space in many asset classes and the lack of new supply coming onboard should all likely lead to increased pricing for existing assets, which offer stable income yields and high-quality credit, such as those in Boyd's portfolio.

Equities

The Dow, S&P 500, and NASDAQ equity indices all reached new highs during the second quarter, driven by low interest rates, significant fiscal and monetary stimulus, a recovering economy and an improving corporate earnings environment. The NASDAQ led the way, up 9.68% for the quarter, while the Dow was the laggard, up a very respectable 5.08%. The second quarter marked a reversal from the first quarter as growth stocks outperformed value stocks by more than a 2-to-1 margin. The second quarter return of the S&P 500 Growth Index was 11.83% while the S&P 500 Value Index was up 4.91%.

As measured by market capitalization, large cap stocks led the way, followed by mid-cap stocks, with small caps coming in a distant third. The Morningstar Large Core Index was up 8.33% for the quarter, while the Morningstar Mid Core and Small Core Indices were up 6.67% and 4.02%, respectively. Year-to-date, small cap stocks have led the way and are up 18.90%, while large caps are up 12.06%.

According to FactSet, the forward 12-month P/E ratio for the S&P 500 is 22.4, well above its 5- and 10-year averages of 18.0 and 16.1, respectively. Although the market is trading at a high P/E ratio, valuations can remain elevated if earnings growth continues to be strong and monetary policy remains accommodative.