BOYD WATTERSON
ASSET MANAGEMENT

October 2021

Investment Outlook

Our Firm:

Boyd Watterson Asset Management, LLC is an SEC-registered investment advisory firm with approximately $16.7 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

The third quarter opened with continued optimism and further clarity on the return to normalcy, both in terms of policy and economic activity. Unfortunately, slowing vaccination rates were met with a rapid rise in COVID infections as the Delta variant spread rapidly throughout the U.S. The resulting slowdown in activity in some areas of the economy, coupled with continued supply chain bottlenecks and labor shortages, caused many economists to reduce their growth estimates for the U.S. economy. Late in the quarter, the Evergrande debt crisis, along with the budget and debt ceiling battle in Washington, only added to the uncertainty.

While the U.S. continues to experience above trend economic growth, the easy part of the recovery is likely in the rear-view mirror. Supply chain issues are a growing problem in many industries, while companies' inability to hire and retain workers continues to plague many of the same areas of the economy. Furthermore, the combination of these two problems, coupled with elevated energy and transportation prices, have resulted in rising input prices on the production side and rising output prices for consumers. As a result, we, like many others, have begun to question the transitory nature of the current inflation picture. We believe payroll growth is the key to alleviating a large portion of these pressure points and expect the recent expiration of the enhanced unemployment benefits will likely provide some clarity on this in the coming months. While economic activity will likely be influenced by the path of the virus, we do expect these issues to be gradually resolved and remain optimistic on the growth outlook into next year.

Performance for Periods Ending September 30, 2021

	QTD	YTD	1-Yr	3-Yr	5-Yr
2-Year Treasury	0.09	-0.01	0.05	2.60	1.52
10-Year Treasury	-0.31	-4.40	-6.22	6.14	1.83
Bloomberg Barclays Aggregate	0.05	-1.55	-0.90	5.36	2.94
Corporate Investment Grade	-0.06	-1.12	1.84	7.42	4.63
Corporate High Yield	0.94	4.55	11.30	6.60	6.33
Leveraged Loans	1.13	4.65	8.46	4.09	4.64
Mortgage Backed Securities	0.05	-0.79	-0.46	3.92	2.21
S&P 500	0.58	15.92	30.00	15.99	16.89
MSCI EAFE	-0.45	8.35	25.73	7.62	8.81

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

The monetary and fiscal policy outlooks reflect diverging trends, with the Fed's path becoming somewhat clearer, while fiscal policy is back to a game of brinksmanship over the federal budget and the debt ceiling. We have seen several of these fiscal policy debates in recent years and, as was the case before, an eleventh-hour compromise was reached to avoid a government shutdown at quarter end. We anticipate a similar outcome with the debt ceiling in October. President Biden's $3.5 trillion fiscal agenda will likely need modifications to get through Congress and include an increase in the debt ceiling. Treasury Secretary Yellen recently indicated mid-October as the time frame in which the government could have trouble meeting its financial obligations if the debt ceiling were not lifted. It was ten years ago when this issue

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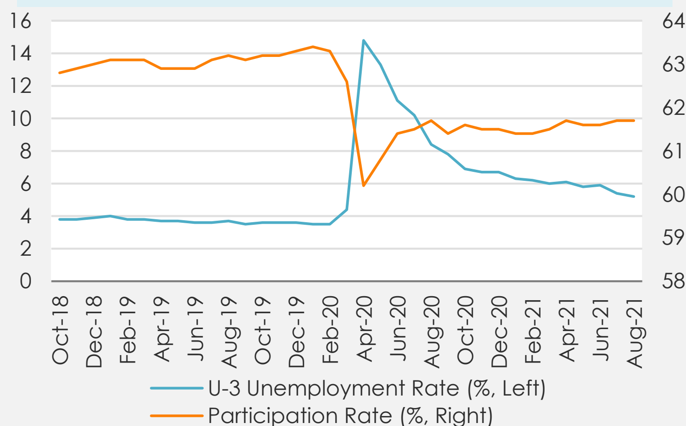
was pushed to the limit and was a factor in Standard and Poor's downgrading the United States' sovereign rating from AAA to AA+. We remain optimistic the debt ceiling will be resolved, however the path to resolution will likely have some bumps along the way.

On the monetary policy front, the Federal Open Market Committee (FOMC) began to provide more clarity to the financial markets during the third quarter. In the context of their dual mandate of price stability and maximum employment, the policy objective regarding their average inflation target has likely been met. Despite the FOMC continuing to characterize this year's elevated levels of inflation as 'largely reflecting transitory factors', inflation is expected to remain above target well into next year. This, in conjunction with the continued decline in the unemployment rate, has allowed the Committee to indicate they are likely to begin tapering their asset purchase program soon, possibly as early as November.

While enough progress appears to have been made to begin reducing asset purchases, we believe any adjustments to their policy rate are at least twelve-to-eighteen months away. Assuming the recovery remains on its current trajectory, we believe improvement in the labor market will drive decisions on the timing of increases in the federal funds rate. Thus far, the pace of payroll growth has been uneven, and we believe the unemployment rate and labor force participation rate will need to be much closer to pre-pandemic levels before the FOMC begins raising short-term interest rates. The FOMC's updated 'dot plot,' released late in the third quarter, indicated the possibility of the first interest rate increase in late 2022, earlier than prior forecasts. Given the subsequent increase in Treasury yields, this movement in the 'dots' was somewhat surprising to investors, yet in line with our expectations. It is important to remember when evaluating the FOMC's statements and forecasts that policy adjustments will be based on realized outcomes, not adjustments to published forecasts.



Source: FactSet Research Systems.

Our current view centers around a near-term deceleration in economic growth. We expect inflation will likely remain elevated for the next several quarters as the supply side of the economy normalizes, and payroll growth accelerates, helping to bring the unemployment rate back toward pre-pandemic levels. We believe that the supply chain and labor issues are the largest risk to our outlook as they could drive inflation higher for longer, which, in turn, could force the FOMC's hand to raise rates sooner than currently anticipated. While this is not our base case expectation, we do question if some of the pandemic-related side effects have resulted in structural changes to the labor market, supply chains, and corporate and consumer behavior more broadly. Unfortunately, only time will ultimately answer these questions.

Fixed Income

If an investor were to look quarter-to-quarter at the modest movement in interest rates, yield curve shape, and excess returns, one could easily conclude the third quarter had been relatively uneventful. It was anything but that. Surging COVID infections, rising inflation, slowing growth, the Evergrande debt crisis, fiscal policy uncertainty in Washington, and a more hawkish FOMC message all contributed to market volatility. Yet, investors appear confident the FOMC has inflation under control, policy will transition gradually, and the recovery has sufficient runway such that risk assets should remain the focal point of fixed income strategies.

Intermediate and long-term interest rates declined early in the quarter as COVID infections rapidly increased, raising concerns about the recovery and whether monetary policy could remain accommodative for a much longer period. The nearly 30 basis point (0.30%) decline in ten-year and thirty-year Treasury yields through early August resulted in a sharp flattening of the yield curve, with the two-year to ten-year yield differential narrowing from 122 basis points to 97 basis points. Interest rates continued to oscillate with the quarter's news flow, yet it wasn't until the FOMC's September policy meeting that a renewed move higher in rates took hold. With the Fed indicating that the conditions for the tapering of asset purchases had nearly been met and the 'dot plot' showing a somewhat more hawkish view, interest rates moved higher across the maturity spectrum and the yield curve steepened back out to levels near the prior quarter end.

Investors' appetite for risk did not wane much during the quarter as both investment grade and high yield corporate bond issuance remained very active and credit spreads traded in a relatively narrow range. According to ICE BofA indices, the investment grade U.S. Corporate Index widened 3 basis points during the quarter, resulting in slightly negative absolute and excess returns. Similarly, the U.S. High Yield Index widened 11 basis points, however the shorter duration and higher coupons of this index resulted in positive absolute and excess returns for the quarter. Within investment grade, lower quality once again outperformed higher quality and, in contrast to last quarter, shorter maturities outperformed longer maturity bonds.

Like the second quarter, the ICE BofA indices show Treasury

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Inflation Protected Securities (TIPS) handily outperformed nominal Treasury securities, returning 1.63% for the quarter. Inflation breakeven rates are below the peaks witnessed in the second quarter, yet the breakeven yield curve remains inverted, indicating investors' confidence in the FOMC's message of transitory inflation and their willingness to adjust policy to contain inflation should it prove to be more than transitory.

For the first time since the fourth quarter of 2020, all three securitized sectors generated positive absolute and excess returns. We continue to have a positive view of the ABS market yet remain cautious on agency MBS, as we believe this sector may struggle as the FOMC draws closer to slowing their purchases, combined with the increasing prospects for higher interest rate volatility.

During the third quarter, we made some incremental changes to our portfolios by modestly reducing the risk positioning in certain alpha drivers. While we continue to have a short duration bias relative to the benchmark, we slightly lengthened portfolio durations in our core and intermediate strategies as a hedge against a more uncertain risk environment. Following this move, these portfolios still reflect a modestly bulleted maturity structure. Additionally, we made a minor adjustment to the credit exposure in these strategies with a focus on reducing higher beta issuers given the richer valuations. Despite these slight changes, our duration position remains defensive and our view on corporate credit is constructive. As such, our primary overweight positions are in corporate bonds and asset-backed securities, while we continue to be underweight both agency mortgage-backed securities and U.S. Treasuries. Given the growth outlook, accommodative Fed, and declining trend of COVID infections as we end the quarter, we have maintained allocations to risk assets yet will continuously evaluate our positioning in light of incoming data and fiscal and monetary policy developments.

Real Estate

The office market appears to have finally turned a corner for the better despite the continued spread of the Delta variant of COVID-19 which has dramatically slowed the long-expected return to the office. Signs have been pointing to an improved leasing environment as vaccinations continue to rise, employer mandates increase, and the Delta variant appears to be spreading less quickly.

Despite taking longer than expected, tenants physically occupying their space have increased as the number of employees returning to the office continues to rise. According to Kastle, which makes office keycard systems, average physical occupancy of offices across ten major cities has risen steadily throughout the month to 35.0% during the last week of September, up from 30.9% in the first week. In Texas, major cities are experiencing occupancy in the 45-50% range, while New York and San Francisco are still below 30%. While this is a slower pace than many investors in the office sector were expecting and hoping for, the increase is a positive sign for market improvement. In our discussions with many government tenants, most are already occupying their space or are planning to by January 1st, if not sooner.

On the leasing front, activity has picked up significantly. According to Cushman and Wakefield, recent touring activity has been at approximately 90% of pre-pandemic tour activity. Perhaps more importantly, the shedding of space has slowed to the point where one third of office markets nationally had positive net absorption in the second quarter and it's thought that the third quarter will look even better. Many tenants are unsure of what their future office needs will be and have therefore renewed in place, particularly because the costs to move to a new space today are exceedingly high due to higher construction costs and materials shortages. This has lent some stability to the market and reduced the amount of capital expenditures required by landlords, though concessions are still fairly aggressive. It will take continued significant improvement to make up for the increased vacancy in the market. According to Colliers, more than 150 million square feet of space have been vacated nationally during the pandemic. Sublease space has also weighed on the market, though the amount of sublease space available has continued to slow for three straight quarters.

Investment activity and pricing in the office sector has continued to improve. Transaction activity is back to fairly normal levels with suburban office deal activity actually exceeding pre-pandemic levels according to Real Capital Analytics (RCA). Pricing on these suburban deals is up 14.8% over a year ago according to RCA, though this is likely somewhat a product of only strongly leased sales occurring with lesser product waiting on the sidelines. Central business district (CBD) transaction volume is still well below pre-pandemic levels, but well above the levels of a year ago. According to the RCA CPPI index, pricing in CBD markets is down nearly 4% from a year ago. Investors are still nervous about what the slow return to offices means for the future of downtown markets. Very little multi-tenanted product with existing vacancy to lease up is trading as investors are not willing to take on leasing risk, nor sell at a lower price, causing a stalemate in the market. On the flip side, activity is taking place in the long-term leased, high credit tenant market, such as the government-leased market that Boyd operates in.

Boyd Watterson's funds invest primarily in government-leased product where the investment thesis is largely about the tenant rather than the market. Boyd's funds focus on specialized properties with sticky tenancy so that our investments are somewhat insulated from office market forces. While not totally immune to these market forces, in many cases the competition is new construction and replacement cost rather than the threat of a competitor building. We believe with construction costs at all-time highs and with a tenant base that is largely working in-person, our portfolios are generally resilient despite the challenging office market today.

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Equities

The performance of the three major US equity indices (the Dow, the S&P 500, and the NASDAQ) ended mixed for the quarter. The Dow and the NASDAQ had negative returns of -1.46% and -0.22%, respectively, while the S&P 500 posted a modestly positive return of 0.58%. Growth outperformed value for large-cap equities as measured by the S&P 500 Growth Index versus the S&P 500 Value Index for the quarter and now year-to-date (16.43% vs 15.30%). That was not the case for mid-cap and small-cap equities, where value has outperformed both for the quarter and year-to-date. In fact, the S&P Midcap 400 Value Index is up 21.01% year-to-date while the S&P Midcap 400 Growth Index is up only 10.09%. Within small-cap stocks, that differential is even larger, with the Russell 2000 Value Index up 22.90% year-to-date, and the Russell 2000 Growth index up a modest 2.82%.

Coming off a low base established during the height of the pandemic, we expect corporate profits likely will peak this quarter, but we expect earnings to remain strong in 2022. However, elevated valuations, slower economic growth out of China, and less accommodative monetary policy from the Fed, may provide a near-term challenge to equity markets. This is partially offset by our expectation of continued improvement in the labor markets and relief of supply chain bottlenecks.

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