BOYD WATTERSON
ASSET MANAGEMENT

January 2022

Investment Outlook

Our Firm:

Boyd Watterson Asset Management, LLC is an SEC-registered investment advisory firm with approximately $17.3 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 nearly two years of the pandemic behind us, many had expected to see COVID-19 fade into the background in 2021 and life to return to more normalcy. While considerable progress was made toward normalization throughout the year, 2021 ended with the worst surge yet of the pandemic, compliments of the Omicron variant. Positively, with nearly 73% of the population 18 years and older fully vaccinated, society appears to be learning to live with the presence of COVID-19, as evidenced by the continued improvement in economic activity and further declines in unemployment. In addition to the pandemic, the financial markets had plenty to digest on both the fiscal and monetary policy front. A stronger economy, coupled with inflation readings at multi-decade highs, prompted the Federal Reserve to begin removing monetary policy accommodation in the fourth quarter. In Washington, President Biden's infrastructure and Build Back Better stimulus plans were highly contentious, as was the debate over a necessary increase in the debt ceiling to avoid a U.S. default. Looking forward, we expect fiscal and monetary policy to likely remain focal points for investors as the Fed aims to further tighten monetary policy and Democrats continue work on passing the Build Back Better legislation ahead of the mid-term elections coming up later this year.

Performance for Periods Ending December 31, 2021

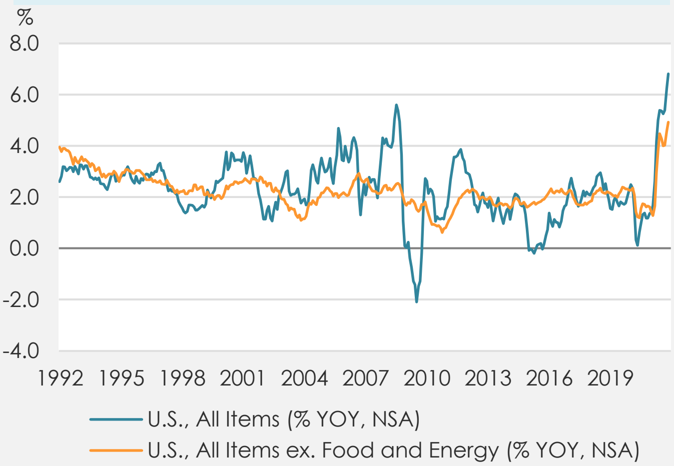
	QTD	YTD	3-Yr	5-Yr
2-Year Treasury	-0.51	-0.52	1.98	1.52
10-Year Treasury	0.75	-3.68	5.07	3.43
Bloomberg Aggregate	0.01	-1.54	4.79	3.57
Corporate Investment Grade	0.17	-0.95	7.50	5.28
Corporate High Yield	0.71	5.29	8.56	6.09
Leveraged Loans	0.71	5.40	5.43	4.32
Mortgage Backed Securities	-0.42	-1.21	3.08	2.53
S&P 500	11.03	28.70	26.07	18.47
MSCI EAFE	2.69	11.26	13.54	9.55

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

The highly transmissible Omicron variant resulted in record daily coronavirus infections by year-end, a trend that is expected to likely get worse in early January, before hopefully peaking nationally within the weeks following. We expect any negative growth impact from Omicron to be temporary given the strong momentum the economy had coming into this surge. Service sector activity reached a record high in November, the manufacturing PMI index remains well into expansionary territory, and capacity utilization was back to pre-pandemic levels. Furthermore, the labor market has made significant strides with the unemployment rate back down to 4.2%, the 4-week moving average of initial unemployment claims now below pre-pandemic levels, and payroll growth averaging 378,000 per month over the last three months through November. Further supporting our view, the Bloomberg consensus estimate for GDP growth in 2022 is 3.9% and the Federal Open Market Committee's forecast calls for 4% growth, both well above pre-pandemic growth rates. However, with the effects of fiscal stimulus fading, personal savings rates back to pre-pandemic levels, and supply chain disruptions normalizing, we agree with expectations for growth to settle back into a 2.0% - 2.5% range beyond 2022.

We view the current inflation picture in the U.S. as the largest risk to the outlook given its impact on so many facets of the economy, as well as its direct influence on the direction of monetary policy. Many of the factors that have driven above trend growth are also resulting in levels of inflation not seen in several decades; most notably, pent-up demand coupled with record fiscal and monetary stimulus, supply chain disruptions, and rising commodity prices. We initially anticipated higher inflation would be transitory in nature but, in fact, it has become more persistent and broader based. The most recent readings on consumer inflation showed year-over-year increases of 6.8% and 4.9%, respectively for the headline and core Consumer Price Indices. These were the highest readings for the headline and core indices since 1982 and 1991, respectively.

Consumer Price Index



Source: FactSet Research Systems. Data as of November 30, 2021.

The risk of inflation remaining elevated well above the FOMC's 2% average inflation target creates risks of longer-term inflation expectations moving higher, an environment the Fed will work more aggressively to avoid. This was evidenced by the FOMC's sharp policy pivot and updated 'dot plot' at their December policy meeting. While the FOMC had begun reducing asset purchases in November, the Committee announced a doubling of the pace of purchase reductions, likely ending their balance sheet expansion by March. Furthermore, the FOMC's updated 'dot plot' indicates a median estimate of three interest rate increases in 2022, followed by three more in 2023 and two in 2024. This path of policy tightening is more aggressive than their prior estimate, yet over the three-year 'dot plot' horizon, still does not reach the FOMC's longer-run median estimate of a 2.5% federal funds rate. Ending the asset purchase program earlier provides the Committee greater flexibility to utilize rate increases to manage the inflation outlook. Given the continuous economic uncertainty created by the pandemic, we are skeptical that rates will rise at this pace but applaud the Fed's willingness to rapidly adjust their policy perspective given the multitude of factors currently influencing their dual mandate of price stability and maximum employment.

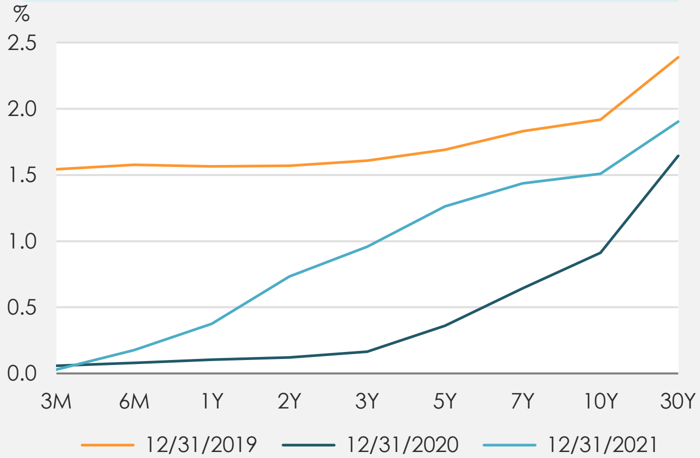
While the outlook for 2022 remains uncertain, rising vaccination rates and growing immunity in the population will hopefully result in the pandemic having less influence on people's lives and the economy as we navigate the new year. Rising wages, a tightening labor market, and consumer's desire to re-engage in normal activities leaves us optimistic on the outlook for the U.S. economy.

Fixed Income

Fixed income investors had a bumpy road to navigate in the fourth quarter as both fiscal and monetary policy contributed to an uptick in volatility and uncertainty. On the fiscal side, partisan debates over the infrastructure package, an increase in the debt ceiling, and President Biden's Build Back Better plan made for constant headlines. While an infrastructure package was finally agreed upon and the debt ceiling raised to avert a default, the Build Back Better legislation did not make it through Congress. We expect a modified version of the plan to be debated in the coming months, with passage likely prior to the mid-term elections. Similarly, the Fed's dramatic pivot in monetary policy had the greatest impact on fixed income markets. In the fourth quarter, the FOMC announced the tapering of asset purchases in November and followed that up in December with a doubling of the pace of reductions, coupled with a steeper path of potential interest rate increases in 2022. This policy pivot resulted in higher short-term interest rates, a flatter yield curve, and wider credit spreads.

Short-term interest rates moved higher throughout the fourth quarter on stronger economic data as well as the hawkish policy indications from the Federal Reserve. Conversely, ten-year yields were relatively stable while thirty-year yields declined, with explanations ranging from strong foreign demand, to pension fund rebalancing, to concerns over the economic outlook resulting from Omicron. As a result, the yield curve, as measured by the yield differential between two-year and ten-year U.S. Treasuries, flattened from 121 basis points to 78 basis points during the quarter, although it was virtually unchanged on a year-to-date basis. This flattening trend was driven by a 46-basis point increase in two-year yields, while the ten-year yield increased a mere two basis points. The two-year Treasury closed 2021 with a yield of 0.73%, up 61 basis points for the year. With the FOMC's 'dot plot' now showing a median estimate of three interest rate increases in 2022, we believe short-term yields now largely reflect this policy path. However, if inflation readings do not begin to moderate in the second half of 2022, it is likely that short-term interest rates could move meaningfully higher as the Fed may need to tighten policy faster to combat inflation. The FOMC has a challenging road ahead as they need to control inflation at the same time the economy is likely moving beyond its peak growth phase for this recovery. With CPI inflation above 6% and the ten-year Treasury yield at 1.51%, we believe the market is indicating the FOMC may find it difficult to raise short-term interest rates back to pre-pandemic levels.

U.S. Treasury Yield Curve



Source: Bloomberg.

The Bloomberg U.S. Aggregate Index returned -1.54% for 2021, its first negative annual total return since 2013. The move higher in interest rates resulted in negative total returns for nearly all investment grade sectors for the year, while spread tightening led to positive excess returns for these same sectors, with the lone exception being agency mortgage-backed securities.

The ICE BofA U.S. Corporate Index tightened five basis points given improving fundamentals and investors' continued appetite for risk. This index returned -0.95% for the year as a result of higher interest rates, while tighter credit spreads drove stronger performance relative to comparable maturity Treasuries. Lower quality continued to outperform higher quality and longer duration credit posted stronger excess returns than shorter maturities. The U.S. High Yield Index tightened 76 basis points for the year, generating a positive total return of 5.36%. Within high yield, CCC rated bonds led performance with a total return of 10.42%.

Performance in the securitized sectors was mixed, with only asset-backed securities generating positive total and excess returns for the year. While all three sectors saw tighter spreads, agency mortgage-backed securities were the only sector to post negative total and excess returns for 2021. The combination of higher interest rates extending mortgage durations and the Fed reducing purchases in this sector likely drove the underperformance. Commercial mortgage-backed securities had modestly negative total returns, yet the strongest excess returns of the securitized sectors, aided by triple-digit spread tightening in the single-A and BBB rating cohorts.

Our portfolios continue to reflect a short duration bias relative to the index and a modestly bulleted maturity structure. We remain overweight corporate bonds, with an emphasis on BBB rated issuers and high yield where permissible. Strong fundamentals and low default rates support our favorable view of this sector. Additionally, we are overweight the asset-backed sector and continue to underweight the agency mortgage-backed and U.S. Treasury sectors. With heightened uncertainty as we enter the new year, we expect interest rates and credit spreads to likely remain volatile as investors navigate the ever-changing landscape fueled by the pandemic and evolving policy shifts.

Real Estate

The returns in the commercial real estate market in 2021 were among the highest on record, experiencing a massive snapback from a dismal 2020 caused by the COVID-19 pandemic. REIT shares returned 36% which was the highest since 1976 in a single year and outperformed the S&P 500's 27% return by a healthy margin. Additionally, through the first three quarters of the year, the NFI-ODCE index had returned 11% and was likely to end the year in the mid-teens for 2021 total return. These strong returns have largely been driven by record returns in the industrial sector, with the trailing twelve months of industrial returns hitting 31.4%, the highest twelve-month return recorded by the index for a sector. To a lesser extent, the apartment sector also contributed to the strong returns, with a 12.8% trailing twelve months return. Office and retail have lagged as the pandemic has caused more damage to those sectors, with 4.4% and 1.7% returns, respectively.

We believe the outlook for the coming year in commercial real estate is still quite bright despite the continued pandemic and the emergence of the Omicron variant. The industrial sector continues to boom, and the multi-family sector has fully recovered with rents in most markets now surpassing pre-pandemic levels. Retail has seen foot traffic revert to near-normal levels. The office sector, while challenged, has seen upticks in office occupancy and leasing and the expectation is that many companies who have been working exclusively from home will return to the office in early 2022. With expected returns in other asset classes expected to remain muted, capital continues to flow into real estate which will help keep a lid on cap rate increases. Additionally, rising construction costs and potentially rising interest rates could hold down new supply, which should positively impact existing owners.

While commercial real estate as a whole is fairly healthy, we do not feel that last year's market returns are sustainable and believe they will come down considerably in 2022. In particular, despite record occupancies and a strong rent growth environment, we do not feel that the industrial sector will repeat its 2021 performance, which will bring down total returns in the ODCE index and likely keep REIT returns from such lofty levels. Additionally, there are some headwinds facing the commercial real estate sector. Rising inflation is eroding some of the real return generated by properties and could lead to rising interest rates. If rates rise on the long end of the yield curve, cap rates could come under some upward pressure, which will negatively impact holders of properties. Rising rates will also likely negatively impact cash flows for most REITs. For value-add investors, improvements to properties are also expensive given the rise in construction costs.

Our funds have been conservative with regard to their balance sheets which we believe will help weather a rising rate environment and maintain returns in targeted ranges. Our funds have used fixed rate debt almost exclusively and have laddered out debt maturity schedules so there isn't much exposure in the short- to medium-term to rising rates. Additionally, our low leverage profile will likely make the funds less sensitive to rising rates and/or cap rates than riskier, higher leverage vehicles. We feel that we are well-positioned to excel in the current environment with our excellent credit, conservative balance sheets, and fully occupied mission-critical buildings which have all led to low volatility and low correlation to other asset classes.

Equities

In contrast to the bond market, 2021 was a great year for equities. Accommodative fiscal and monetary policy and strong corporate earnings drove the 28.68% return for the S&P 500, while the technology heavy NASDAQ was up 22.21%. The S&P 500 was led by energy, real estate, and information technology, while consumer staples and utilities were the weakest performing industries. In terms of market capitalization, large cap stocks outperformed both mid-cap and small-cap stocks on the year, yet small-caps outperformed mid-caps. The S&P 500 Growth Index, up over 32% for the year, outperformed the S&P 500 Value Index, which was up just under 25%.

For the quarter, the S&P 500 was up 11.03% and the NASDAQ was up 8.47%. Similarly, growth outperformed value for the quarter, up 13.37% versus 8.31%, as measured by the S&P 500 Growth and Value indices, respectively.

Going forward, the expectations of Fed policy becoming more restrictive, higher levels of inflation, lower corporate earnings growth, and elevated equity valuations may provide a more challenging environment for the equity markets. Companies that are best able to withstand higher interest rates and pass along higher costs to customers may be the market leaders in the coming year.