BOYD WATTERSON
ASSET MANAGEMENT

April 2022

Investment Outlook

Our Firm:

Boyd Watterson Asset Management, LLC is an SEC-registered investment advisory firm with approximately $17.1 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 real estate assets managed in separately managed accounts and advisory-only unified managed accounts (UMA). 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

January 2022 began with growth expected to decelerate, inflation at multi-decade highs, and the path to tighter monetary policy in sight. If this were not enough to deal with, the economic landscape was further disrupted by Russia's military buildup along the Ukrainian border and subsequent invasion in late February. The United States, along with allies from many countries, swiftly placed economic sanctions on the Russian government and key individuals, while numerous American corporations ceased operations in Russia in protest of their unprovoked actions. The convergence of these events further complicates an already troubling inflation picture while clouding the global growth outlook.

Performance for Periods Ending March 31, 2022

	QTD	1-Yr	3-Yr	5-Yr
2-Year Treasury	-2.50	-2.98	0.80	0.96
10-Year Treasury	-6.75	-3.31	1.62	1.84
Bloomberg Aggregate	-5.93	-4.15	1.69	2.14
Corporate Investment Grade	-7.74	-4.31	2.96	3.30
Corporate High Yield	-4.53	-0.28	4.38	4.55
Leveraged Loans	-0.10	3.22	4.10	4.05
Mortgage Backed Securities	-5.04	-5.10	0.56	1.39
S&P 500	-4.60	15.64	18.92	15.99
MSCI EAFE	-5.91	1.16	7.78	6.72

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

The economic impacts of the pandemic severely disrupted global supply chains, while the sanctions resulting from the invasion of Ukraine will likely magnify these impacts given the significant presence of Russia and Ukraine in the energy, precious metals, and agricultural commodity markets. The inflationary environment created may cause countries to rethink strategies around trade, supply chains, and the cost/benefit analysis of producing domestically versus globally. Longer-term, we may see a pivot from globalization in favor of domestic production where there is less reliance on external supply chains. Over the past couple decades, the move toward globalization played a significant role in the low levels of inflation and interest rates experienced, which begs the question as to the impact on inflation and growth resulting from a gradual shift back toward domestic production and less global trade. At a minimum, we believe that a decline in global cooperation and international trade will result in higher levels of geopolitical risk and financial market volatility longer-term.

U.S. consumers currently face the highest inflation rates since the early 1980s, at a time when economic growth is likely to decelerate as pandemic-related fiscal and monetary stimulus fades. While the Federal Reserve has reversed course and begun to tighten monetary policy, they are clearly well behind the inflation curve. Following the Federal Open Market Committee's (FOMC) first rate hike in March, several Committee members are openly advocating for more aggressive policy adjustments, including the potential for rate increases in fifty basis point increments. In fact, the FOMC's updated median projections now reflect a federal funds rate of 2.8% next year. This is an increase of more than one hundred basis points from prior quarterly projections and is also above their longer-run projection of 2.4%.

The combination of the FOMC's transparent communication along with inflation forecasts continuing to move higher has resulted in the market doing much of the work for the FOMC. Interest rates moved substantially higher in the first quarter, with the largest moves in two-year to five-year maturities. This resulted in a notable flattening of the yield curve, with the yield spread between two-year and ten-year Treasuries declining to zero. Historically, a flattening of this magnitude would have the recession warning light flashing yellow. We prefer to monitor the spread relationship between three-month Treasury bills and ten-year Treasury notes, which remains steep at 186 basis points, and is not currently flashing a recessionary signal. Nonetheless, the FOMC's need to aggressively tighten monetary policy into a slowing and uncertain economic environment comes with significant economic (recession) risk, underscoring the importance of monitoring the signaling effects of the shape of the yield curve.

U.S. Treasury Yield Curve – Yield Differential

Source: Bloomberg.

Typically, when the Federal Reserve raises short-term interest rates, it slows demand and keeps a lid on inflation. Our current view centers around a higher probability for a stagflationary environment, as opposed to an outright recession over the next 12-18 months. Within this context, we do not see 1970s-style stagflation, rather a 'stag-lite' environment with moderate but declining GDP growth and above target levels of consumer inflation. Specifically, efforts to reduce dependency on supply chains with an increased emphasis on domestic production could result in higher labor and input costs and lower productivity. This increased demand for labor and energy could result in higher long-term run rates for both producer and consumer inflation, particularly given the current tightness in the labor market. Positively, these same factors could also expedite the shift to green energy sources and further technological advancements to provide some offset to the inflation dynamics. We anticipate inflation could very well run above the FOMC's 2% average inflation target for at least the next several years.

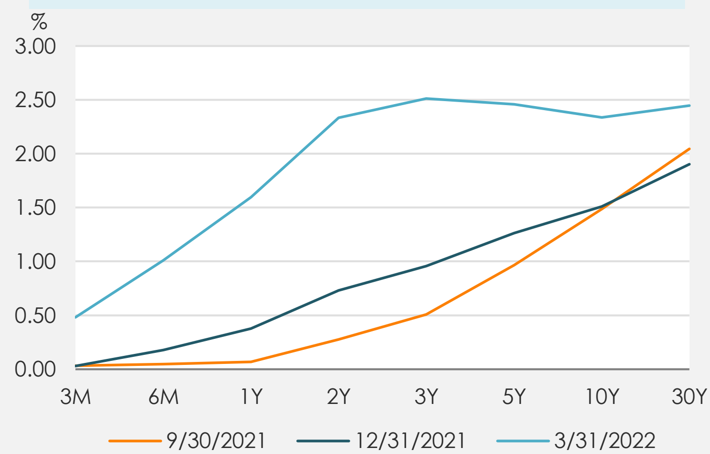
Higher long-term inflation naturally has a crowding out effect for discretionary consumption, particularly when it is centered in essentials such as food and energy. The long-term effects of this translate into lower levels of demand, and hence, lower economic growth rates. While we are not currently calling for a recession within the next year, we do expect growth to slow back toward pre-pandemic levels over the near-term.

Given the multitude of risk factors faced, we remain skeptical as to the Fed's ability to orchestrate a 'soft landing' and simultaneously realize their projected path in the updated 'dot plot.' Notwithstanding these risk factors, we expect the yield curve to continue to flatten and will be watching carefully for the signaling effects of any material inversions within the shape of the curve.

Fixed Income

While both growth uncertainty and war have historically resulted in a flight to quality and driven yields lower, the continued rise in consumer inflation and increasingly hawkish comments from Federal Reserve officials pressured interest rates higher in the first quarter. The resulting uncertainty, increased volatility, and heavy issuance of corporate debt led to wider credit spreads within both investment grade and high yield corporate bonds. For fixed income investors, there was virtually nowhere to hide from negative returns in the first quarter. The Bloomberg U.S. Aggregate Index[1] posted its worst quarterly performance since the 1980s, generating a total return of -5.93%. Additionally, the move higher in interest rates was not confined to the U.S. markets as the amount of negative yielding debt globally declined from $11.3 trillion to just under $3 trillion by the end of the first quarter. As a result, the Bloomberg Global Aggregate Index[1] returned -6.16% for the first quarter.

U.S. Treasury Yield Curve

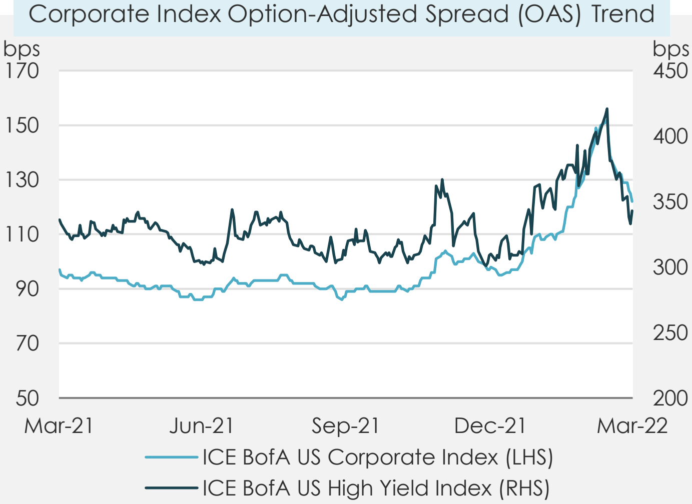


Source: Bloomberg.

While interest rates rose across the maturity spectrum, it was the change in the shape of the yield curve that garnered the most attention from fixed income investors. As the quarter progressed, the Fed's hawkish comments became stronger, prompting concerns that the Fed might tighten too far or too fast, which could result in growth slowing and the economy falling into a recession. Two-year Treasury yields, which tend to lead movements in the Fed's policy rate, increased a stunning one hundred sixty basis points (1.60%), while ten-year Treasury yields were eighty-three basis points higher over the quarter. As a result, the yield differential between the two maturities declined from seventy-eight basis points to zero by quarter's end, a level not seen since the summer of 2019. Yield curve inversions such as this have historically been an ominous sign for the growth outlook, yet while these relationships are worth monitoring, we continue to believe that a recession is a lower probability event over the near-term.

The option-adjusted spread (OAS) of the ICE Bank of America U.S. Corporate Index widened twenty-four basis points in the first quarter which, combined with higher interest rates, resulted in a total return of -7.74% and an excess return relative to duration equivalent Treasuries of -1.77%. Increasing uncertainty coupled with heavy new issue supply pressured spreads wider, as the investment grade corporate bond market saw new supply of $461 billion in the first quarter, the second largest issuance for a first quarter on record according to J.P. Morgan. Similarly, the ICE Bank of America U.S. High Yield Index saw its OAS widen thirty-three basis points for the quarter yet given its shorter duration, this index generated a total return of -4.51% and an excess return of -0.45%. In contrast to the investment grade market, the high yield market saw its slowest first quarter of new issuance volume since 2016 at just $43 billion, according to Bloomberg. The investment grade corporate bond market saw higher quality outperform lower quality on an excess return basis and shorter duration bonds outperform their longer duration counterparts. Conversely, high yield corporate bonds saw lower quality outperform higher quality, with the single-B rated cohort posting a modestly positive excess return for the quarter.

Corporate Index Option-Adjusted Spread (OAS) Trend



Source: Bloomberg.

Similar trends were witnessed in the securitized sectors as asset-backed (ABS), commercial mortgage-backed (CMBS), and agency mortgage-backed (MBS) securities all generated negative total and excess returns for the first quarter. Agency MBS have now underperformed duration equivalent Treasuries in four of the last five quarters, supporting our continued underweight to this sector. The combination of higher interest rates and the Fed ending its purchases continued to be headwinds for MBS. The ABS sector has now posted negative excess returns in back-to-back quarters for the first time since the financial crisis, which we believe was largely driven by the renewed aversion to risk broadly.

Over the course of the first quarter, we transitioned our yield curve positioning from a bulleted structure to a barbelled maturity structure, underweighting the middle portion of the yield curve in favor of a combination of very short and longer maturity positions. This strategy is beneficial in an environment when the yield curve is flattening, a trend we saw in the first quarter and one we expect to continue in 2022. Our sector positioning was relatively unchanged, with continued overweight positions in both corporate bonds and ABS, and underweight positions in U.S. Treasuries and agency MBS. We have reduced the risk profile modestly in our corporate bond holdings, given the heightened uncertainty and our desire to have dry powder should credit spreads move even wider from current levels.

We expect volatility to remain elevated as further changes in monetary policy and heightened geopolitical risk dominate the headlines. Yet, despite the negative returns in the first quarter, the move higher in interest rates, combined with wider credit spreads, have resulted in a more attractive risk/reward profile for fixed income investors. We believe this will provide a more compelling investment landscape as we navigate the remainder of this year.

Real Estate

During the first quarter of 2022, public markets experienced sharp volatility with sell-offs in both equity and bond markets caused by the Fed's signaling a more rapid increase to the Fed Funds rate than anticipated to tackle inflation. Additionally, the geopolitical concerns caused by Russia's invasion of Ukraine caused investors to reassess risk, resulting in increased bond spreads and significantly higher interest rates.

Thus far, the rise in interest rates does not appear to have materially impacted cap rates, with rates still being at or near historic lows. Within the federal government leased sector, the spread between cap rates and ten-year Treasury rates had been at elevated levels of approximately 500-600 basis points for much of 2021. Historically, this averaged approximately 450-500 basis points. As interest rates rise and cap rates remain steady, the spread between the two has been narrowing quickly, now at approximately 350 basis points and potentially converging further. The question facing real estate investors is whether this spread compression will lead to rising cap rates or if investors are going to be willing to accept lower levels of levered returns, leaving cap rates to remain where they are (or even decline). If we look at historical spreads between cap rates and Treasury rates, we find there is not much correlation between the two, with federally leased properties only exhibiting a 33.6% correlation with U.S. Treasury rates. Even when using a time lag of up to 36 months, this correlation only slightly increases.[2]

We believe that at the current interest rate levels there will be a slowdown in transaction activity as buyers and sellers grow farther apart on pricing expectations. However, we do not believe that cap rates will rise materially because there continues to be significant amounts of new capital being allocated to real estate due to the inflationary environment and low yields/returns in other asset classes. This capital, combined with record levels of dry powder from real estate funds, will likely prove to overwhelm interest rate increases, and we anticipate this will keep a lid on how high cap rates can go unless interest rates continue to move materially higher.

Our real estate strategies remain well positioned to weather a higher interest rate environment thanks to large balance sheets and use of long-term, laddered, fixed rate financing. This will allow us to continue to selectively seek acquisition opportunities while maintaining a low overall cost of debt.

Equities

Like the bond market, equity performance struggled in the first quarter, impacted by higher interest rates due to elevated inflation, the war in Ukraine, and high valuations coming into the new year. The S&P 500 returned -4.60% for the quarter, followed by the Dow at -4.10%, and the NASDAQ at -8.94%. For the quarter, value outperformed growth by a large margin while performance based on market capitalization varied more modestly. The S&P 500 Value Index generated a -0.13% return while the S&P 500 Growth Index generated a -8.56% return. According to Morningstar Core indices, large-cap stocks returned -5.07%, mid-caps -5.01%, and small-caps -6.18%.

The most discussed topic in financial circles continues to center around the shape of the yield curve. While some investors are concerned an inverted yield curve may be a good predicator of a slowdown in growth and a potential recession in 2023, the equity markets currently do not appear phased by the situation going on in the bond market. Based on the CBOE Volatility Index, a measure of how much fear is priced into the equity markets, the quarter ended only modestly above where it began the year and was nearly 44% off its intra-quarter peak of 36.45. Some point to the fact that equity prices are usually not as sensitive to early rate hikes and yield curve inversions need to remain in place for several months before equity investors typically heed the warning the bond market is signaling.

With the earnings cycle beginning in a couple of weeks, we are most interested to see how companies faired in the first quarter, as well as management's guidance to gauge the impacts from higher interest rates and the expected actions of the Fed moving forward. The S&P 500 is trading at a price to earnings multiple of 23.6 times, above the 10-year average of 20.1 times. Price to earnings ratios usually decline when interest rates rise, as there is an inverse relationship between the two. We will be watching forward guidance closely for signs of potential weakness from the equity markets.

[1]Source: Bloomberg Index Services Limited. BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). Bloomberg or Bloomberg's licensors own all proprietary rights in the Bloomberg Indices. Bloomberg does not approve or endorse this material or guarantee the accuracy or completeness of any information herein, nor does Bloomberg make any warranty, express or implied, as to the results to be obtained therefrom, and, to the maximum extent allowed by law, Bloomberg shall not have any liability or responsibility for injury or damages arising in connection therewith.

[2]Boyd Watterson calculations.