BOYD WATTERSON
ASSET MANAGEMENT

July 2022

Investment Outlook

Our Firm:

Boyd Watterson Asset Management, LLC is an SEC-registered investment advisory firm with approximately $17.4 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

Equity and fixed income investors faced headwinds in the second quarter that were eerily similar to the first quarter, yet to differing magnitudes. Financial conditions tightened as interest rates continued their move higher across the maturity spectrum, while credit spreads widened, equity markets declined, and the U.S. dollar strengthened. Additionally, energy prices increased further, resulting in gasoline prices many consumers have never experienced. This, combined with the on-going war in Ukraine, heightened geopolitical tensions, and unresolved supply chain issues, kept headline inflation at 40-year highs. Coming into this year, many had expected inflation pressures to ease and the economy to gradually slow from its strong rebound in 2021. While the latter has occurred, the persistence of inflationary pressures has created an epic challenge for the Federal Reserve and resulted in a tremendous amount of volatility in the financial markets.

Performance for Periods Ending June 30, 2022

	QTD	YTD	1-Yr	3-Yr	5-Yr
2-Year Treasury	-0.50	-2.98	-3.39	0.15	0.84
10-Year Treasury	-4.92	-11.34	-10.95	-1.45	0.56
Bloomberg Aggregate	-4.69	-10.35	-10.29	-0.93	0.88
Corporate Investment Grade	-6.71	-13.93	-13.83	-0.81	1.39
Corporate High Yield	-9.91	-13.99	-12.57	-0.04	1.95
Leveraged Loans	-4.35	-4.45	-2.68	2.03	2.97
Mortgage Backed Securities	-3.91	-8.76	-9.10	-1.42	0.40
S&P 500	-16.10	-19.96	-10.62	10.60	11.31
MSCI EAFE	-14.51	-19.57	-17.77	1.07	2.20

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

Our macro analysis focuses on four areas of the economy: the consumer, corporations, real estate, and government. Unfortunately, we see growth-related concerns in all four of these areas. Elevated inflation has reduced savings rates and has weighed heavily on consumer sentiment, both of which increase the probability of lower levels of demand in the coming quarters. Similarly, corporations facing higher labor and input costs as well as shifting demand trends will now have to evaluate the impact to future profit margins and prospects for hiring. Furthermore, both small business and CEO sentiment have declined over the last six months. On the real estate side, the sharp rise in mortgage and financing rates, coupled with elevated valuations, could slow transaction activity of residential sales and, within the commercial sector, areas such as industrial properties that saw outsized demand during the pandemic. Finally, the growth impulse from government spending is likely to slow as the pandemic-related fiscal stimulus fades and the mid-term elections approach.

Despite the economic outlook growing increasingly uncertain, our base case expectation is for a stagflationary environment. The labor market remains very tight with unemployment at 3.6% and initial unemployment claims are back near pre-pandemic levels. Furthermore, job openings are near all-time highs and average hourly earnings are growing over five percent on a year-over-year basis. In contrast, both manufacturing and service sector activity, as measured by the S&P Global PMI indices, have slowed significantly during the second quarter and the monthly change in the Leading Economic Indicators index has been negative four out of the first five months of 2022. With first quarter GDP registering 1.6%, investors will likely be keenly focused, not only on the level of second quarter growth, but also the contribution of the various components to that

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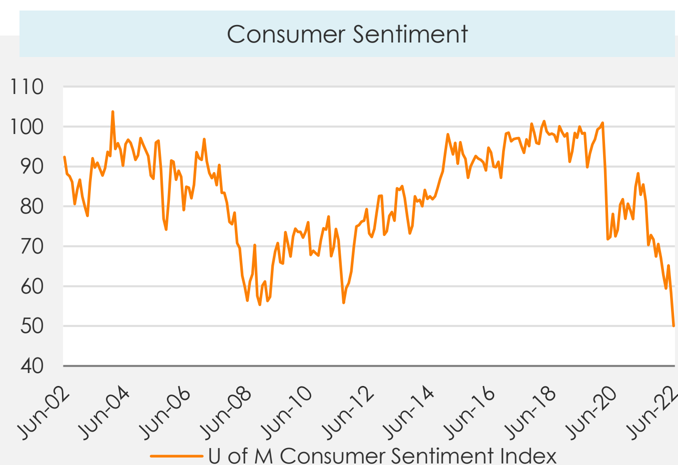
growth for clues as to the future outlook.

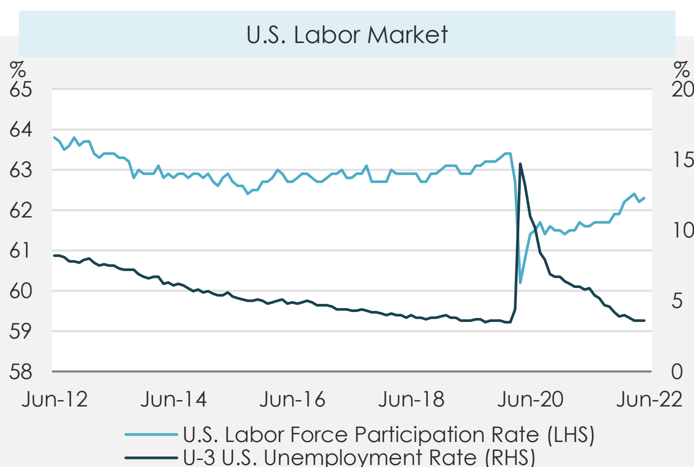
Consumer Sentiment



Source: Bloomberg.

Despite the financial market's more pessimistic view, as reflected in the sell-off of risk assets, the Federal Open Market Committee (FOMC) has remained relatively optimistic with their economic outlook. With the labor market arguably near full employment, Committee members have made it abundantly clear that fighting inflation is their number one policy priority over the near-term. However, the combination of persistently high inflation and an aggressive path of monetary policy tightening complicates the prospects for a 'soft landing,' and raises the odds of an economic recession in the next 12-18 months.

U.S. Labor Market



Source: Bloomberg.

Without question, the Fed fell materially behind on the price stability side of their dual mandate, resulting in this year's sharp pivot to 'expeditiously' tighten policy in an effort to regain control. The most recent increase in the federal funds rate of 75 basis points was the first policy tightening of this magnitude since 1994 and marks the third policy rate increase in the last four months. The latest move brings the overnight federal funds rate to a range of 1.50% - 1.75%.

Yet, based on the Committee's updated 'dot plot,' there is a significant amount of tightening likely to come. The FOMC now projects a median federal funds rate of 3.40% at year-end 2022, and 3.80% by the end of 2023. If realized, this would move monetary policy well into restrictive territory, given the Fed's longer run median estimate of 2.50%. To underscore the Committee's desire to tighten financial conditions and slow demand, this more aggressive path of policy tightening coincides with their economic projections reflecting lower real GDP growth and modestly higher levels of unemployment for 2022 through 2024.

With four Committee meetings left this year, we expect the FOMC to likely deliver policy rate increases in the range of 50 to 75 basis points at each of the next two meetings, with the size of increases declining thereafter. Given the magnitude by which inflation currently exceeds the Fed's target, we believe there is the potential for them to tighten too far in this cycle. The lingering question remains whether the economy can continue to grow through this tightening cycle, or whether the Fed will have to sacrifice growth to tame inflation. As such, we expect volatility in financial markets to remain high as investors reassess risk positions in light of incoming economic data.

Fixed Income

The second quarter of 2022 saw more volatility for fixed income markets as geopolitical tensions remained heightened and outlooks for growth both domestically and abroad soured. All eyes were on the Federal Reserve, as May's Consumer Price Index reading came in higher than expected, at 8.6% year-over-year. This prompted a surprise 75 basis point rate hike, an increase not seen since November of 1994. As a result, the ten-year Treasury yield approached 3.50% in June before finishing the quarter nearly 50 basis points lower, hovering slightly above the 3.00% level. Interest rate volatility was not confined to the United States, as the second quarter brought rate hikes from other central banks around the world including the Bank of England, the Bank of Canada, and many countries in South America. Similar to the first quarter, higher interest rates and wider credit spreads left fixed income investors with little room to hide from negative returns. The Bloomberg U.S. Aggregate Index finished the quarter at -4.69%, bringing its year-to-date return to -10.35%.

Federal Reserve Chairman Powell continues to reiterate his belief that a soft landing is not impossible, while also acknowledging to Congress that the challenge is ever increasing, and recession is not outside the realm of possibility. The market is currently pricing in rate hikes of another 150 basis points before year-end, and the Fed will have to delicately balance their policy against leading economic indicators to monitor for a slowdown. The two-to-ten-year Treasury yield differential best illustrates the rate volatility of this quarter, reaching a high of 44 basis points in early May before finishing the quarter at six basis points, nearly unchanged from the first quarter.

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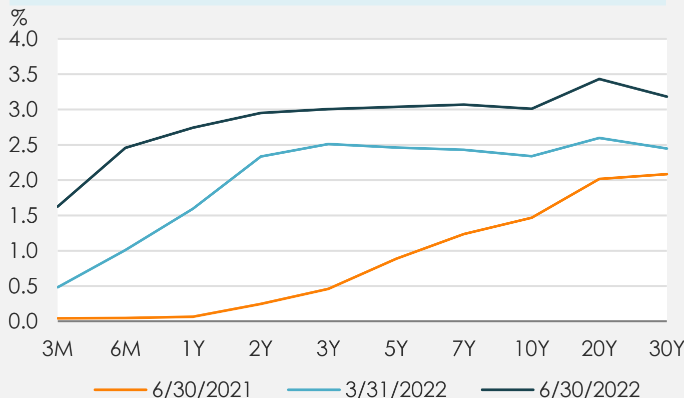

Source: Bloomberg.

The option-adjusted-spread (OAS) of the ICE Bank of America U.S. Corporate Index widened 42 basis points during the second quarter, resulting in a total return of -6.71% and an excess return relative to duration equivalent Treasuries of -2.53%. The OAS of the ICE Bank of America High Yield Index widened 244 basis points, posting a total return of -9.97% and an excess return of -8.11%. The sharp increase in interest rates and continued macro uncertainty were the main catalysts for the widening of credit spreads this quarter. These same factors also dampened activity within the new issue market during the back half of the quarter, as investment grade issuance came in at $716 billion year-to-date, 10% behind last year's pace, according to Bloomberg. High yield issuance also slowed dramatically, with $68 billion issued year-to-date, a 76% reduction from last year's pace. Performance was strongest among higher quality issuers, with single-A's finishing with a total return of -6.01% for the quarter, compared to -7.32% return for BBB's. High yield experienced an identical theme, albeit with more drastic impact as BB's finished with a total return of -8.62% compared to a startling -13.91% for CCC's.

Source: Bloomberg, ICE Data Services.

The securitized sector was not immune to the pain felt amongst corporates this quarter, but it did a better job weathering the storm. Asset-backed securities (ABS) finished the quarter with a total return of -1.25%, while commercial mortgage-backed securities (CMBS) returned -2.97%, and agency mortgage-backed securities (MBS) returned -3.91%.

We continue to deploy a barbelled yield curve structure, which should benefit our portfolios as short-term rates rise from an increasingly hawkish Fed, causing the overall yield curve to remain relatively flat or potentially invert. Additionally, we moved to a neutral duration position in our core and intermediate strategies while maintaining a more defensive duration position in short-term strategies because of the expectation for further upward movement in short-term interest rates. Given the ever-uncertain macro environment, our view on credit markets has turned more cautious as investors continue to reassess their outlooks for risk assets. As a result, we have trimmed our corporate bond exposure and have focused on increasing the credit quality and overall liquidity across our strategies. We have also begun to add agency MBS exposure, despite the Fed reducing its balance sheet in the sector. The sector has begun to look increasingly attractive from a relative value standpoint – we see value in higher coupon mortgages as the Fed's balance sheet holdings in this sector are mostly lower coupon agency mortgage-backed securities.

We believe volatility will likely remain elevated throughout the year as recession fears grow, inflation remains high, and geopolitical tensions are unlikely to subside in the near-term. Therefore, we will continue to focus on improving both the quality and liquidity characteristics of our holdings. In doing so, we are placing heavy emphasis on having readily available dry powder, as we remain patient for a better entry point to begin adding risk back into the portfolios.

In the meantime, despite all these challenges in the current economy, there is a bright side to what has happened to the fixed income markets this year. As interest rates have moved higher and credit spreads have widened, fixed income return profiles have begun to look increasingly attractive.

Real Estate

The second quarter of 2022 saw continued deterioration in macro market conditions which has led to a repricing of risk in the commercial real estate market. This repricing has led to rising cap rates and a slowdown in transaction activity as buyers and sellers have grown further apart in pricing expectations. The primary causes of this deterioration are stubbornly high inflation, higher interest rates (and the fear they could go higher to fight inflation), and the prospect of a potential recession on the horizon as the Fed's tightening slows down demand in the economy. This repricing of risk is already reflected in the public real estate markets but has not been evident yet in private market returns.

Perhaps the place this repricing has been most evident is in

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the industrial and multi-family markets, where fundamentals and returns have been extremely strong. Both have seen robust rent growth, low vacancy, and continued leasing of new developments in the past 18 months. However, there are some cracks starting to appear in both markets. Amazon's announcement that it was pulling back on leasing and may put at least 10 million square feet (and possibly as much as 30 million square feet) up for sublease has sent a shudder through the industrial market. This possible slowdown in demand combined with higher interest rates has put upward pressure on cap rates, which is evidenced by several widely marketed Amazon-leased deals that have not reached expected pricing. The multi-family sector is similarly starting to see a slowdown in rental growth and with interest rates where they are today, many owners who bought at very low cap rates using floating rate debt are finding themselves with negative leverage, hoping they can continue to push rents high enough to break even.

Given this repricing of risk, Boyd Watterson expects that returns in the multi-family and industrial sectors will likely become more normalized (in the single digits) in the coming quarters as compared to the significantly higher levels experienced in the past 12 months. This, along with expectations for low returns in the office and retail sectors, is likely to result in significantly lower returns for the NFI-ODCE index of core funds, which to this date have not been impacted by these lower return expectations. By comparison, the public REIT market (as measured by the Vanguard Real Estate Index Fund-VNQ) is down 19.0% as of July 5, 2022, reflecting these changes in pricing expectations.

Boyd Watterson's real estate strategies consist of government-leased, or government supported properties and are defensive in nature. While not totally immune to macro factors, they are designed to be less volatile, less cyclical, and less sensitive to the economy than the greater real estate market and the expectation is that if there is a recession or a pullback in pricing, Boyd Watterson's real estate strategies will likely hold strong.

Equities

Not surprisingly, equity markets struggled in the second quarter due to a lack of evidence that U.S. inflation has peaked, even though fiscal and monetary policy is working to slow demand. The S&P 500 Index, which was down 16.40% for the second quarter and down 20.56% in the first half of 2022, experienced its worst first-half decline since 1970. The Dow was down over 15% in the first half of 2022, while the Nasdaq composite was down a staggering 29.5%.

Consumer discretionary was the worst performer of the eleven industries that make up the S&P 500 Index, down 26.3% in the second quarter, followed by technology and communication services, both of which were down more than 20%. Consumer staples was the best performing industry, down only 5.2% for the quarter.

The S&P 500 Index is trading at a price-to-earnings multiple of 19 times, slightly below the 10-year average of nearly 20 times. Not surprisingly, the price-to-earnings ratio has been declining as interest rates have risen.

Investors believe the Fed will continue to fight inflation by aggressively raising the federal funds rate, even if the likelihood of a recession increases. Higher revenue growth is being more than offset by higher input costs, making it challenging for companies to reach profitability targets. As demand continues to slow, we believe companies will likely need to adjust downward their earnings forecasts, which is expected to continue to put pressure on stock prices.

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