BOYD WATTERSON ASSET MANAGEMENT

October 2022

Investment Outlook

Our Firm:

Boyd Watterson Asset Management, LLC is an SEC-registered investment advisory firm with approximately $17.5 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 latest blog posts:

www.boydwatterson.com/insights/

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The Macro View

Two major themes from the first half of this year, uncertainty and volatility, continued to dominate the financial markets in the third quarter. Not only has inflation around the globe proven to be more persistent, but geopolitical tensions also remain elevated, further darkening the clouds on the economic horizon. Unfortunately, while expectations for a slowdown in global economic growth are increasing, many central banks are continuing to aggressively tighten monetary policy to combat inflation. As a result, many investors, in both fixed income and equities, experienced negative third quarter returns.

Performance for Periods Ending September 30, 2022

	QTD	YTD	1-Yr	3-Yr	5-Yr
2-Year Treasury	-1.70	-4.63	-5.12	-0.61	0.46
10-Year Treasury	-6.19	-16.83	-16.20	-4.53	-0.77
Bloomberg Aggregate	-4.75	-14.61	-14.60	-3.26	-0.27
Corporate Investment Grade	-5.11	-18.33	-18.19	-3.50	0.06
Corporate High Yield	-0.68	-14.58	-13.98	-0.67	1.40
Leveraged Loans	1.19	-3.31	-2.62	2.12	3.00
Mortgage Backed Securities	-5.38	-13.67	-14.03	-3.68	-0.89
S&P 500	-4.88	-23.87	-15.47	8.16	9.24
MSCI EAFE	-9.36	-27.09	-25.13	-1.83	-0.84

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

On the geopolitical front, the war in Ukraine is now in its eighth month, and Putin continues to escalate tensions with the recent efforts to annex Russian controlled Ukrainian territories while also hinting at a willingness to use nuclear weapons. Furthermore, the recent explosions in the Nord Stream pipeline will likely increase the energy crisis faced by the Eurozone in the coming months and further escalate tensions between Russia and the West. Recent visits by U.S. politicians to Taiwan have fueled more friction between the U.S. and China. Finally, the September election outcome in Italy raises questions about the future direction of the Eurozone's third largest economy, while also bringing more investor focus on the upcoming midterm elections here in the U.S.

The economic picture is equally unclear following two consecutive quarters of negative GDP growth in the U.S. While the Atlanta Fed's GDPNow forecast is pointing to a resumption of growth in the third quarter, the impacts of persistent inflation and higher interest rates are weighing heavily in many areas of the economy. After easing modestly in July, core inflation metrics as measured by both the CPI and PCE indices moved higher once again in August, with the core CPI index increasing to 6.3%, its highest level since March. The elevated levels of inflation have kept the Fed on an aggressive path of policy tightening, which has resulted in significantly higher rates for consumers on credit cards, and auto and residential mortgage loans. For example, by the end of the third quarter, 30-year mortgage rates were approaching 7%, doubling from the beginning of this year. This has pushed home affordability lower and slowed purchase activity as evidenced by seven consecutive monthly declines in existing home sales. Positively, the labor market remains strong with both the unemployment rate and weekly initial unemployment claims hovering near cycle lows, while payroll growth has posted a monthly average of 360,000 over the last six months. The downside to a strong labor market in the current environment is the potential for wage growth further fanning the flame of broader inflation metrics, an issue the Fed continues to highlight.

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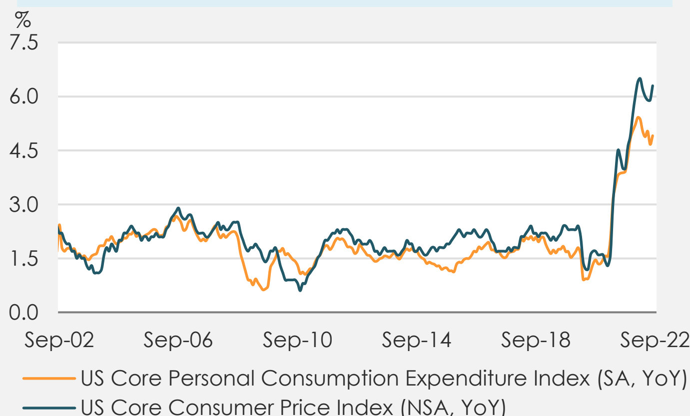
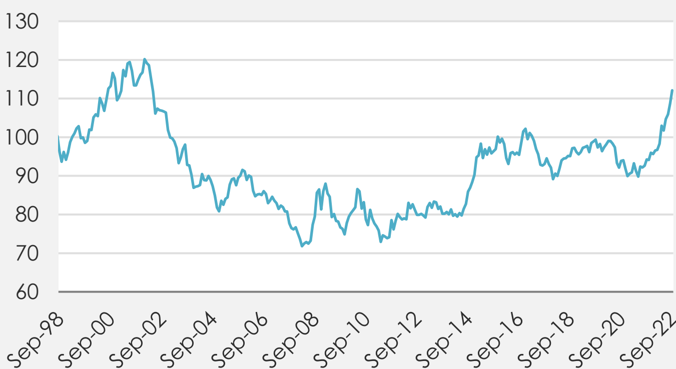
U.S. Core Inflation



Source: Bloomberg.

The combination of higher interest rates and the U.S. economy fairing better than many other developed economies has propelled the U.S. Dollar Index nearly nineteen percent higher in the past twelve months, to a twenty-year high. A move of this magnitude presents challenges on many fronts as revenues from U.S. companies generated outside the U.S. are negatively impacted, while goods exported from the U.S. could fuel higher inflation abroad. Furthermore, emerging market countries that raise debt in U.S. dollars will likely find it more expensive to service that debt. The near-term effects of the dollar strength will only present further dilemmas for global central banks and governments while fostering higher volatility in global foreign exchange and interest rate markets.

U.S. Dollar Index



Source: Bloomberg.

Despite all the uncertainty and volatility, the Federal Open Market Committee (FOMC) has remained steadfast in their quest to bring inflation back under control with the magnitude of interest rate increases not witnessed in several decades. The FOMC has raised their key policy rate at each of the last five Committee meetings, the last three of which were each seventy-five basis points. Now, with three-hundred basis points of tightening under their belt year-to-date, the Committee has indicated there is more yet to come. For perspective, the FOMC's 'dot plot' at the end of 2021 indicated a median federal funds rate of 0.9% at year-end 2022, while their most recent median projection now indicates a federal funds rate of 4.4% by year-end 2022 and 4.6% by year-end 2023. Fed Chair Powell has made it clear the Committee is committed to tightening financial conditions to the extent necessary to bring inflation back to their target and appears willing to sacrifice growth and tolerate a higher level of unemployment to achieve their inflation goal.

Investors have become accustomed to the Fed's willingness to reverse their policy course if the markets and/or economy deviate too far from their intended path. At least on the surface, this time feels different due to the strong and consistent messaging from the Committee. Given the lagged effects of monetary policy, we are questioning if/when something will have to give way as the longer-term impacts of the aggressive policy moves will not be known for several more quarters. Yet market volatility, combined with the topics highlighted above, suggest it might be time to pause and evaluate how much additional tightening is necessary. Regardless of the policy path going forward, we believe the confluence of current economic trends, geopolitical risks, and central bank tightening have made it much more difficult for the Fed to orchestrate a soft landing in this economic cycle. Just as there were many unknowns at the onset of the pandemic, there are likely to be some unintended consequences as policymaker's reverse course.

Fixed Income

Fixed Income: An Investable Asset Class Once Again

Despite the disappointing returns realized for the fixed income markets thus far this year, there is a silver lining for investors. With yields at levels not seen since the global financial crisis, fixed income has begun to look increasingly attractive and a bit more relevant in this uncertain environment. For investors concerned about increased equity volatility or the potential for a further rise in yields, short-term bonds can be a nice place to hide while we wait for more clarity on the macro front. Additionally, with the S&P 500 dividend yield at 1.80%, and the 2-year Treasury yield at 4.27% at quarter end, bonds are a compelling alternative to other major asset classes, both traditional and alternative.

Fed Sings a New Tune

Federal Reserve Chairman Jerome Powell ended September's meeting by acknowledging the pain the markets are likely to feel going forward, while continuing to reiterate the Fed's commitment to achieving their 2.0% inflation target. Powell has made it clear the Fed will be data dependent and will continue to fight inflation at the expense of growth. The Fed's hawkish commentary not only resulted in

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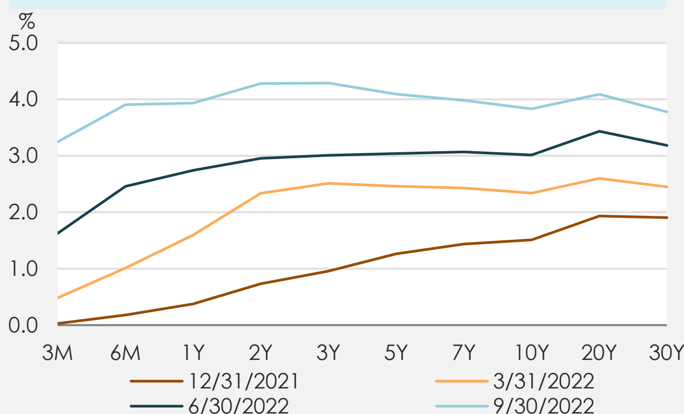
higher interest rates, but also had a significant impact on the shape of the yield curve. Portions of the yield curve remain inverted, with the 2-year to 10-year yield differential reaching -52 basis points at its low point and finishing at -45 basis points to end the quarter. Yield curve inversions such as this have historically been an indicator of impending recessions, and we believe that this time is likely to be no different.



Source: Bloomberg.

Q3 Market Review

The continued rise in interest rates and geopolitical instability have kept total returns negative throughout Q3. The option-adjusted-spread (OAS) of the ICE Bank of America U.S. Corporate Index widened three basis points during the third quarter, resulting in a total return of -5.11% and an excess return relative to duration equivalent Treasuries of 0.10%. The OAS of the ICE Bank of America High Yield Index tightened 44 basis points, posting a total return of -0.68% and an excess return of 2.81%. Despite the negative returns, credit spreads have held up relatively well when compared to other asset classes this quarter. New issuance was again less than forecasted for the third quarter, as companies held back deals due to higher interest rates and market volatility. Investment grade issuance sits at $1.02 trillion year-to-date, down 13% from last year's pace. High-yield issuance has slowed significantly more with $86.7 billion of supply this year, lagging 77% behind 2021's figures at the end of the quarter.

The securitized sector was not immune to the pain of rising rates but held up relatively well in some areas of the market. Asset-backed securities (ABS) finished the quarter with a total return of -1.31%, while commercial mortgage-backed securities (CMBS) returned -3.49%, and agency mortgage-backed securities (MBS) returned -5.38%. While ABS and CMBS generated positive excess returns, agency mortgage-backed securities were one of the few spread sectors to underperform Treasuries for the quarter.

Portfolio Positioning

The duration positioning in our Core and Intermediate strategies had a defensive bias throughout most of the quarter. We adjusted the duration profiles in these strategies during the quarter by taking advantage of the volatility within the Treasury market, operating within a range of approximately 94% to 100% of the benchmark's duration. In short-term portfolios, our duration strategy remains defensive at approximately 85% of their respective benchmarks, as we anticipate further pressure on rates at the front end of the yield curve. We continue to utilize a barbelled maturity strategy in the face of a flattening/inverted yield curve, which has helped limit downside risk throughout the quarter. In addition, we have remained committed to reducing credit exposure in some of our strategies and retain an up in quality bias as economic growth continues to slow.

Looking forward, we expect volatility in financial markets to likely remain elevated throughout the remainder of the year as central banks struggle to bring inflation down, and heightened geopolitical tensions in Europe and Asia reach levels not seen since the 1940's. As a result, we continue to place an emphasis on improving credit quality in our portfolios and having readily available dry powder for the other side of this bear market.

Real Estate

The third quarter of 2022 was similar to the second quarter in that macroeconomic conditions continued to worsen for commercial real estate. Inflation has remained elevated for longer than anticipated, leading to rising interest rates. The Fed has taken a hawkish stance and has indicated it will continue to push the Fed Funds rate up as high as necessary to bring down inflation, regardless of its impact on the greater economy. This has caused the commercial real estate market to slow significantly as buyers continue to pull back on pricing, moving cap rates higher. The higher rates and the prospect of a looming recession is weighing heavily on the market. Compounding the issue is less availability of debt capital as lenders have tightened standards and banks face tougher stress test requirements. This dour outlook for commercial real estate has been most evident in the public markets (REITs are down approximately 30% for the year as of this writing) but has not yet been reflected in private sector returns.

The office market has been hit particularly hard by the pandemic as a significant portion of tenants have moved to hybrid schedules or gone fully remote. Office market vacancies are at or near all-time highs in many markets and landlords are having to offer heavy concessions to keep or attract tenants. With the odds of a recession increasing, the office market is facing the prospect of job losses in the office-using workforce which has led many companies to delay expanding until they have a better sense of their future growth and office needs. This is in spite of a surprisingly resilient job market, which has remained strong through current macroeconomic headwinds. Tenants continue to migrate to higher-quality, well-located Class A assets, leading older Class B and C properties to struggle. There has not

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been significant distress as of yet in the office market, but it is anticipated that loan defaults will increase as rates rise and refinancing becomes difficult, which could lead to more opportunities and a resetting of pricing. This may eventually lead to more residential conversions of older obsolete office buildings which could help bring more stability to the market.

With the prospect of a recession looming, Boyd Watterson's real estate strategies look to be well positioned with strong government credit and countercyclical government spending. The strategies have strong balance sheets with little maturing debt and largely long-term fixed rate liabilities, so there is little exposure in the near term to rising interest rates. While not totally immune to macro factors, these real estate strategies are designed to have lower volatility and correlation to the economy than the general commercial real estate market. Additionally, many of Boyd's properties and tenants have specialization and in-person requirements that make it more difficult than the broader office market to downsize. We believe this creates further insulation in our strategies as compared to the broader real estate and office markets should there be a recession or a pullback in pricing.

Equities

Equity markets struggled in the third quarter as the Fed continued to raise the fed funds rate and remains committed to doing so if inflation persists above their target rate of 2.0%. The S&P 500 was down 4.88% for the quarter and 23.87% year-to-date. The tech heavy Nasdaq was down 3.91% for the quarter and 31.99% year-to-date.

Though both generated negative returns for the quarter, the S&P 500 Growth Index outperformed the S&P 500 Value Index, yet still trails on a year-to-date basis as the Growth Index was down 30.42% while the Value Index declined 16.59%.

The S&P 500 Index is now trading at 15.3 times 2023 earnings estimates, well below the five-year average of 22.8 times. The dividend yield is currently 1.80%, up from 1.27% at the end of last year.

The Fed's aggressive stand against inflation as demand is clearly falling will likely continue to put pressure on corporate profits and equity valuations. More attractive yields in the bond market may limit asset allocation rebalancing that would normally take place when equities underperform.

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