BOYD WATTERSON
ASSET MANAGEMENT

January 2023

Investment Outlook

Our Firm:

Boyd Watterson Asset Management, LLC is an SEC-registered investment advisory firm with $17.6 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

The last twelve months have challenged investors on many fronts, as negative returns proved difficult to avoid. The ongoing war in Ukraine, elevated inflation, supply-chain disruptions, energy supply concerns, and a monetary policy tightening cycle not seen in decades, all contributed to extremely volatile financial markets around the globe. Looking back, we view 2022 as a year of transition and are hopeful the coming year will be one of clarification, specifically as it relates to the Fed's ability to successfully combat inflation while avoiding a severe recession. We acknowledge the probability of a hard landing has increased, yet at this stage believe a bumpy landing remains the most likely outcome - with anemic growth, persistent inflation, and rising unemployment somewhat offset by a resilient consumer.

Performance for Periods Ending December 31, 2022

	QTD	YTD	3-Yr	5-Yr
2-Year Treasury	0.44	-4.21	-0.61	0.62
10-Year Treasury	0.64	-16.29	-3.75	-0.59
Bloomberg Aggregate	1.87	-13.01	-2.71	0.02
Corporate Investment Grade	3.53	-15.45	-2.75	0.53
Corporate High Yield	4.07	-11.11	-0.20	2.14
Leveraged Loans	2.33	-1.06	2.34	3.24
Mortgage Backed Securities	2.06	-11.89	-3.23	-0.51
S&P 500	7.56	-18.11	7.66	9.42
MSCI EAFE	17.34	-14.45	0.87	1.54

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

The hotly debated topic surrounding the need (or lack thereof) for additional monetary policy tightening and its effects on the economic outlook remains the focal point of investors and likely, the primary driver of the financial markets in 2023. Expectations are for growth to continue to slow, if not turn negative, as the impacts of last year's interest rate increases work through the economy resulting in lower consumption, softer payroll growth and moderating inflation. While growth in the U.S. was negative in the first half of 2022, it turned positive in the third quarter and early fourth quarter. As the year ended, incoming economic data was sending mixed signals, fueling the debate about the forward outlook. The most recent ISM surveys indicated slowing activity in both the manufacturing and services sectors, while notable weakness remains in the housing sector. Conversely, the labor market remains tight with low unemployment, solid growth in payrolls, and elevated job openings. Furthermore, the Conference Board's Consumer Confidence Index finished the year at its highest level since April, supported by recent improvement in both the present situations and expectations components of the report.

The most important piece of the economic puzzle for 2023 will be the direction of inflation. More recently, virtually all inflation readings, headline and core, have declined from their 2022 peak levels due to lower energy prices, improving supply chains, and softer demand. The notable exception is wages, which remained elevated, reflecting the continued imbalance of supply and demand in the labor market. While many market participants remain optimistic that tighter monetary policy and slower growth will improve this imbalance in the coming quarters, the elevated level of wage growth remains a focal point of the Federal Open Market Committee (FOMC) as they weigh additional interest rate increases in the coming months.

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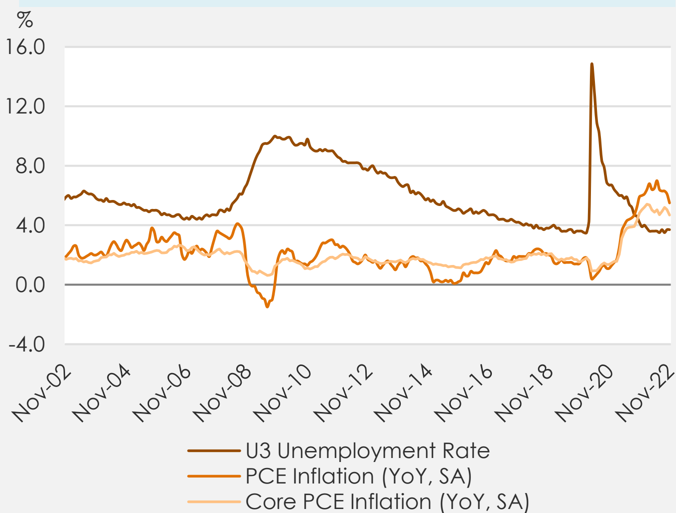
U.S. Inflation and Unemployment



Source: Bloomberg.

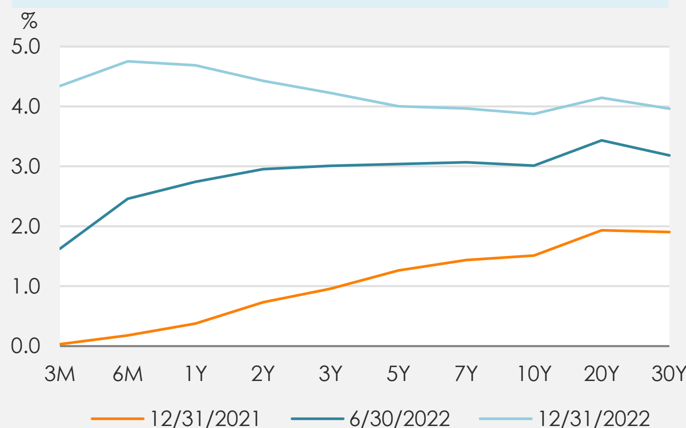
The FOMC increased their short-term policy rate at seven consecutive meetings in 2022, totaling 425 basis points, bringing the current policy rate range to 4.25% - 4.50%. While the aggressiveness of this policy action has some investors and strategists suggesting it may be time to pause and evaluate, the FOMC's December 'dot plot' indicates their belief that more work needs to be done. The Committee's median projection for 2023 is 5.10%, approximately seventy-five basis points higher than the current level. While the market has been looking for a Fed pivot more recently, a pause and hold at these higher levels appears more likely based upon comments coming from Committee members. Additionally, based upon their recent projections, rate cuts appear more likely to occur in 2024, as their median policy rate projection declines to 4.1%, 100 basis points lower than their 2023 projection.

While this debate surrounding monetary policy and the economic outlook will remain lively, the incoming data will determine the ultimate path of policy, requiring patience on the part of investors and resolve on the part of the FOMC to finish the fight against inflation, likely into a slowing economy. We continue to believe in the adage to not fight the Fed, while also recognizing the willingness of the Powell Fed to adjust course when warranted by the economic data. As such, we are cautiously optimistic in their ability to avoid a hard landing (severe recession) yet expect a bumpy approach on the landing.

Fixed Income

What a difference a year makes. Coming into 2022, the FOMC had prepared bond investors for the likelihood of a couple twenty-five basis point interest rate hikes by the end of the year, only to see a policy tightening cycle unfold that turned out to be the most aggressive in more than two decades. It is not often that bond investors experience negative returns, however, the rapid rise in rates in 2022 left virtually nowhere in the bond market to hide. The Bloomberg U.S. Aggregate Index posted a total return of -13.01% for the year, the first double-digit negative return in the history of the Index and the first time this Index has experienced back-to-back years of negative returns. While negative returns are always painful, there is some good news for fixed income investors. Following many years of very low interest rates and a tough 2022, the reset in interest rates provides a more attractive forward looking return profile for bond investors.

U.S. Treasury Yield Curve



Source: Bloomberg.

The aggressive tightening of monetary policy pushed interest rates higher across the yield curve, however, to widely varying magnitudes. The ten-year Treasury yield more than doubled in 2022, to end the year at 3.88%, an increase of 237 basis points. Short-term yields, those most closely correlated to the Fed policy rate, increased substantially more as the two-year Treasury yield increased 369 basis points to 4.43%. Underscoring investors' concerns surrounding the economic outlook as the Fed indicates further policy tightening to come, many key yield curve relationships remain sharply inverted. Following a peak inversion of negative eighty-four basis points in the fourth quarter, the yield differential between ten-year and two-year Treasury notes closed the year at negative fifty-five basis points. Further emphasizing the market's view that the Fed has tightened policy enough, the fed funds futures market reflects a peak rate of 4.97%, below the FOMC's projection, with rate cuts beginning in late 2023. Positively, in a show of confidence the Fed will be victorious against inflation, breakevens in the inflation-protected Treasury (TIPS) market ended 2022 below 2.50% across the maturity spectrum.

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U.S. Treasury Yield Curve Inversion

Source: Bloomberg.

The combination of higher interest rates, geopolitical events, and growing concerns about the economic outlook resulted in negative total and excess returns in virtually every corner of the fixed income markets. As investors shunned risk assets, credit spreads widened in both the corporate bond and securitized sectors. The technical support of lower year-on-year issuance of new corporate debt in both the investment grade and high yield markets was not enough to offset the risk aversion. The ICE Bank of America Investment Grade Corporate (IG) Index widened forty basis points in 2022, resulting in an excess return relative to comparable maturity Treasuries of -1.36% and, when coupled with higher interest rates, a total return of -15.45%. Within the IG sector, higher quality outperformed lower quality bonds and shorter maturity bonds outperformed longer maturity. Similar to IG, the High Yield (HY) index widened 169 basis points, generating an excess return of -3.03% and a total return of -11.22%. Higher quality prevailed within HY as well, as excess returns on BB rated bonds outperformed CCC rated bonds by over 800 basis points.

Similar trends were seen within the securitized sectors, where total and excess returns were negative as well. On a relative basis, the standout performer was the asset-backed sector (ABS) where spreads widened sixty-eight basis points, resulting in an excess return of -0.55% for 2022. Commercial mortgage-backed (CMBS) and agency mortgage-backed securities (MBS) posted excess returns of -1.64% and -2.28%, respectively. ABS securities not only outperformed their securitized counterparts but also IG corporate bonds and government agency securities on an excess return basis.

Given the high degree of economic, geopolitical, and policy uncertainty, we expect 2023 to be another volatile year in the bond market. Our strategies remain defensively positioned, both in terms of relative duration and credit exposure. The Core and Intermediate strategies reflect a shorter duration position relative to their respective benchmarks, a modestly barbelled maturity structure, and an up in quality bias with respect to credit exposure. Our short-term strategies continue to have shorter relative duration as well, given our expectation of additional Fed tightening in the first half of the year. We anticipate credit spreads will widen in the first quarter of 2023 given our expectations for corporate earnings estimates to decline and new issuance to increase, which could provide a more attractive opportunity to add risk to the portfolios. We remain overweight the ABS sector and underweight MBS and Treasuries as the FOMC continues to reduce their balance sheet holdings of these two sectors. We expect to be nimble with our dry powder and will look to opportunistically add risk over the coming year as we gain clarity on the risks discussed herein.

Real Estate

The real estate market continued to face challenges in the fourth quarter of 2022 as rising interest rates and lingering inflation sapped returns and shrinking demand from a slowing economy resulted in weakening fundamentals. Lenders have continued to pullback with less appetite for commercial real estate and widening spreads. This has led to a slowdown in transaction activity as buyers reprice assets, pushing cap rates higher. While this pattern is expected to continue in 2023, there are some signs of improvement in the outlook. Inflation has tempered for several straight months and the Fed has slowed its rate hikes from 75 bps per hike to 50 bps. Employment remains very strong, and the economy is still growing. Still, it is expected that the Fed will remain hawkish until it has conquered inflation, which will likely mean higher short-term rates at a minimum.

A new concern has come to the forefront for many real estate funds: liquidity. A number of core funds have put up the gates or had to create queues for those seeking redemptions as the cash flowing into the funds has been exceeded by demand to get out of those funds. Alarm bells were raised for many investors when Blackstone's BREIT and Starwood's S-REIT both reported in December that they had maxed out their 2% limit for redemptions for the month of November and were likely to hit their 5% quarterly maximums as well. Reports indicated that the majority of these redemptions were coming from Asian individual investors, possibly precipitated by declines in the Asian stock markets as well as currency issues, which would seem to be somewhat isolated. However, there was a fear that these could cause a ripple effect with other investors racing for the exits or seeking to redeem from other funds if their capital wasn't released. Many funds are seeking to preserve liquidity and pulling back on cash outflows even though there seems to be sufficient liquidity in the system to meet redemptions from these funds and the limits are more legal in nature than due to a lack of capital.

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Our real estate strategies have very strong balance sheets with little floating rate or maturing debt, strong access to capital from equity capital queues, large undrawn revolving credit lines, and fund leverage that currently sit below long-term targets. Our strategies have not to this date received significant redemptions. The redemptions that have been made have been covered by inflows from the Dividend Reinvestment Programs, allowing our strategies to preserve liquidity without drawing on cash from investors. Our investor base tends to be institutional in nature and provides more stability than retail investors. Nonetheless, we are also keeping a close eye on the liquidity situation by preserving cash, reducing pricing, and only seeking out the best deals. It is anticipated that there will be attractive opportunities in the coming year, and it will be critical to have dry powder available to capitalize on these opportunities as they arise.

Equities

Higher interest rates, a slowing economy, and lower earnings growth rates led to the worst year for the equity markets since the Great Recession. The Dow generated a return of -6.86%, the S&P 500 -18.11%, and the NASDAQ -32.51%. If it were not for a strong fourth quarter, with the S&P 500 up 7.56%, the year would have been much worse.

Growth stocks suffered more than value stocks, as the S&P 500 Growth Index was down over 20% while the S&P 500 Value Index was down only 5.25%. The significant repricing of growth stocks has led to the estimated price to earnings ratios (P/E ratio) of the S&P 500 Growth and Value Indices to be nearly on top of one another, at 17.9 times versus 17.1 times. Typically, the P/E ratio of the growth index is higher than the value index as investors are willing to pay more for companies that offer a higher earnings growth rate.

Market capitalization had less of an impact on performance relative to growth versus value, as large caps experienced the worst performance followed closely by small caps and mid-caps. It is somewhat surprising that the performance of large caps and small caps was so close as large multinational companies faced a major headwind due to the appreciation of the U.S. dollar versus most developed world currencies, something that is less impactful to small cap companies.

Going forward, we believe equity markets may continue to struggle as earnings growth estimates will need to be adjusted lower, due to the impact from the Fed interest rate moves continuing to dampen demand. We also believe now that bonds offer more attractive yields, we will see investors reallocate money away from equities to bonds, adding another modest headwind facing the equity markets.

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