BOYD WATTERSON
ASSET MANAGEMENT

July 2023

Boyd Watterson Investment Outlook

Our Firm:

Boyd Watterson Asset Management, LLC is an SEC-registered investment advisory firm with $17.9 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

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The Macro View

The second quarter of 2023 began under the weight of regional banking concerns and debt ceiling negotiations, coupled with expectations for a slowdown in growth and stubbornly high inflation. Despite a worrisome backdrop at the start of the quarter, risk assets performed well, and interest rates moved higher across the yield curve. Providing a sigh of relief for many, the Federal Reserve voted to hold its policy rate steady at their June meeting after ten consecutive increases. The combination of a stronger than expected economy and a more patient Fed has lifted investor sentiment but risks undoubtedly remain. While the regional banking turmoil seems to have abated and the debt ceiling was resolved, the Federal Reserve has indicated additional rate hikes may be necessary to bring down inflation which could put more pressure on the economy and the banking system.

Performance for Periods Ending June 30, 2023

	QTD	YTD	1-Year	3-Year	5-Year
2-Year Treasury	-0.92	0.49	-0.77	-1.39	0.71
10-Year Treasury	-1.93	1.70	-3.97	-6.98	0.29
Bloomberg Aggregate	-0.84	2.09	-0.94	-3.96	0.77
Corporate Investment Grade	-0.21	3.23	1.41	-3.25	1.82
Corporate High Yield	1.60	5.34	8.88	3.20	3.19
Leveraged Loans	3.12	6.33	10.10	6.16	4.02
Mortgage Backed Securities	-0.53	1.92	-1.57	-3.77	0.05
S&P 500	8.74	16.89	19.59	14.60	12.31
MSCI EAFE	2.95	11.67	18.77	8.93	4.39

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

Despite the mixed signals from the U.S. economy, our expectation for a slowdown in growth remains as the impact from monetary policy tightening continues to work its way through the system and consumers feel the strain of elevated prices. Key growth measures like industrial production, core durable goods orders, and shipments continued to trend lower on a year-over-year basis in the second quarter. Manufacturing sentiment remained weak with the ISM Manufacturing PMI hitting 46 in June, marking its eighth consecutive month in contractionary territory. However, a bright spot over the last few months has been in services, which have held up much better than more cyclical areas of the economy. Real personal consumption expenditures for services have been running at a blistering year-over-year pace of more than 5% for nearly a year. This strong demand has led to robust hiring and payroll growth for the services sector that, unlike durable goods-oriented businesses, has yet to falter. In the near term, this will likely continue to be a source of strength for the U.S. economy.

Inflation decelerated in the second quarter but remains uncomfortably high and there is a growing divergence between the headline and core Consumer Price Indices, with the former falling faster than the latter. While the headline reading decelerated to 4.0% year-over-year in May, the core component has been above 5.0% since December 2021. However, shelter, the largest contributor to core inflation, is just now starting to pull core inflation lower, as the year-over-year deceleration in both home and rental prices is taking place. The All Items Excluding Shelter Index has already decelerated to 2.2% year-over-year. As the negative growth in shelter prices impacts the Index, it will likely result in further declines in the inflation trends in the second half of the year.

Despite a slowdown in cyclical parts of the economy, the labor market remains strong. The unemployment rate continues to hover near historically low levels

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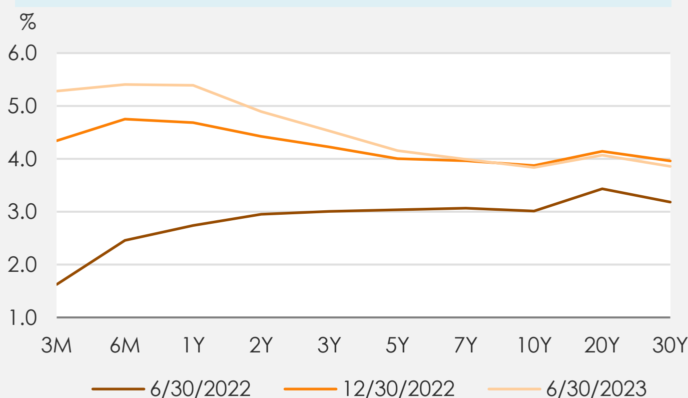
which, coupled with persistent inflation, provides a case for the Fed to raise rates again. However, it is worth noting that the unemployment rate tends to reach its lowest levels at the end of the cycle and the subsequent labor market weakness tends to accelerate at a faster pace than expected. Although we have seen initial jobless claims increase from relatively low levels for much of the year, with several June readings exceeding 260,000, we will need to see readings consistently above 300,000 before they have a significant impact on economic growth going forward.

As the FOMC downshifts the pace of their policy actions and pivots to a more data dependent phase, the market is currently expecting at least one more rate hike by the end of 2023. Despite the improvement in the inflation trends, the road to the Fed's 2% target likely remains long and uneven. As such, we believe the FOMC will hold short-term interest rates higher for longer, with the prospects for rate cuts now pushed into 2024. We continue to expect a bumpy landing for the U.S. economy as the Fed remains acutely focused on the inflation battle while simultaneously hoping to avoid a severe recessionary outcome.

Fixed Income

Bond market volatility remained high in the second quarter as the debt ceiling negotiations went down to the wire, the stress within the banking system improved, but an uncertain economic and inflationary outlook kept the markets on edge over the Federal Reserve's next moves. The quarter ended with the Federal Open Market Committee (FOMC) pouring cold water on the bond market's hopes for an end to the tightening cycle at their June policy meeting. With the Fed indicating further tightening may be on the horizon to address stubbornly persistent inflation, the interest rate markets conceded to the Fed as yields moved sharply higher to end the quarter. While higher interest rates resulted in negative total returns in many sectors for the second quarter, investors shrugged off the uncertainty, driving credit spreads tighter, which led to positive excess returns for all primary non-government sectors of the bond market.



Source: Bloomberg.

The debate surrounding the economic outlook remained lively, with solid arguments for both a soft and a hard landing, yet judging from the performance of risk assets, investors appear to be leaning more toward the Fed successfully orchestrating a soft(er) landing. The FOMC delivered an additional twenty-five basis point hike at their May policy meeting, which included a softening of, but not an end to, their view on further policy tightening.

At the June policy meeting, the FOMC paused their rate hiking campaign but likely surprised many investors with a more hawkish outlook regarding additional policy tightening. The Committee's 2023 median economic projections for stronger real GDP growth, lower unemployment, and higher core PCE inflation relative to the prior quarter's projections were not surprising, yet the updated 'dot plot' likely caught some investors off-guard. The June update reflected the potential for an additional fifty basis points of tightening with the median projection for the federal funds rate increasing from 5.1% to 5.6% for 2023. The most interesting aspect of this outlook is only two of the eighteen participants had their 2023 'dot' at the current range of 5.0% to 5.25%, indicating that nearly all participants did in fact expect additional rate hikes.

Investors quickly adjusted their expectations, pushing interest rates higher across the yield curve in June. For the quarter, Treasury yields increased anywhere from twenty-one basis points to over eighty basis points, with the sharpest increases in two and three-year maturities. With the most pronounced pressure in shorter maturities, the yield curve inverted further as the yield differential between two-year and ten-year Treasuries increased fifty basis points, ending the quarter at -106 basis points, its sharpest inversion in over forty years. Similarly, investors dialed back their expectations for interest rates cuts, acknowledging the increasing probability of a higher for longer outcome for short-term interest rates. Bond investors have persistently underpriced the FOMC through this tightening cycle, yet the FOMC has delivered on their projections thus far. We remain reluctant to fight the Fed and have positioned portfolios for some additional policy tightening and the potential for further yield curve flattening.

The widely followed Bloomberg U.S. Aggregate Index posted a -0.84% return for the second quarter, yet remains comfortably in positive territory year-to-date, at 2.09%. Similarly, nearly all primary sectors of the fixed income market generated negative total returns for the quarter while still positive for the year, yet excess returns relative to U.S. Treasuries were generally positive for both time periods. The most notable exception was high yield corporate bonds, which saw spreads tighten fifty-three basis points for the quarter and seventy-six year-to-date, as indicated by the ICE Bank of America U.S. High Yield Index. This resulted in positive total and excess returns for both the quarter and year-to-date time periods. Underscoring investors risk appetite, the CCC-rated cohort tightened a further 187 basis points during the quarter, posting an excess return of 5.66%, more than twice the excess return of the BB-rated cohort. The strong returns of high yield appear to support the soft-landing view as this performance comes despite higher rates, softer corporate

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earnings, and according to Bloomberg, year-to-date new issuance that already stands at 91% of full year new issuance in 2022.

Within the investment grade corporate bond sector, the ICE Bank of America U.S. Corporate Index tightened fifteen basis points in the second quarter, pushing the Index eight basis points tighter on the year, to end at an option-adjusted spread of 130 basis points. The Index posted a total return of -0.21% for the quarter and, given the spread tightening, an excess return relative to Treasuries of 1.35%, approximately half that of their high yield counterpart. Like high yield, lower quality outperformed higher quality, with the BBB-rated cohort generating an excess return of 1.56%, relative to 1.18% for A-rated corporate issuers. On an excess return basis, financials were the top performer for the quarter, followed by industrials then utilities, while longer duration corporate bonds handily outperformed shorter maturities.

According to the ICE Bank of America Indices, all three securitized sectors posted positive excess returns, while only the asset-backed (ABS) sector posted a positive total return as well. Agency mortgage-backed securities (MBS) led with an excess return of 0.74%, followed by commercial mortgage-backed (CMBS) and asset-backed issuers, both with 0.57% returns. Notably, given all the concerns currently in the CMBS sector, Aaa-rated CMBS saw spreads tighten twelve basis points in the second quarter, while BBB-rated issues saw spreads widen 152 basis points. We expect the heightened volatility in this sector to continue given the large amount of upcoming refinancing needs and potential for further tightening of credit conditions in this space.

We remained active in the markets throughout the second quarter, with the largest portfolio adjustments focused on duration/yield curve and sector positioning. As the ten-year Treasury approached 3.75% during the quarter, we took the opportunity to increase the duration of our core and intermediate strategies to approximately 105% of their respective benchmarks. In doing so, we increased our barbeled maturity structure given our expectation for the yield curve to flatten further. From a sector allocation perspective, after a prolonged period of an underweight allocation to the agency MBS sector, we moved back to a neutral allocation for those strategies with agency MBS in their benchmark. We remain overweight corporate bonds across our fixed income strategies, while recognizing the recent spread tightening tilts the risk/reward profile somewhat less favorably looking forward. The recent performance of the U.S. economy, the FOMC likely nearing the end of their tightening cycle, and a benign corporate default outlook, all provide some support to the current risk/reward set up, in our opinion. Given the FOMC's recent indication for additional policy tightening, we maintained the short duration bias in our short-term strategies, generally in the 90%-95% range relative to their respective benchmarks. While recession odds remain elevated, our current view of that outcome becoming milder than previously thought, leaves us more reluctant to reduce corporate bond exposure further at this point. As such, we will pay particular attention to incoming economic data and clues from the FOMC regarding policy to continually assess our view and will adjust our portfolio positioning to reflect changes in our outlook as we deem necessary.

Real Estate

As the first half of 2023 ends, economic uncertainty remains high for commercial real estate. Geopolitical tensions, market volatility, the interest rate environment, and the future of office space continue to be the biggest considerations for investors when looking at real estate. However, fundamentals for multifamily and the strength of neighborhood, grocery-anchored retail continue to perform well with low vacancy rates and increased sales as the consumer continues to spend post-pandemic. We are seeing the industrial sector begin to stabilize after years of high rent growth and very low vacancy that had driven value increases higher than any other asset type. The pendulum has swung from the times of low-cost financing opportunities and valuation tailwinds for real estate to pricier capital and income generating assets reigning supreme.

The Fed raised interest rates ten consecutive times between March 2022 and May 2023, pausing in June 2023, in order to determine how much past rate hikes have impacted inflation and the economic outlook. The rate hikes have impacted the values associated with real estate assets and we are still sitting in a period of price discovery where the only way to lure buyers is through lower property valuations. As a result, transaction volumes have been lower, as many real estate investors are still paying lower rates than current levels and refinancing activity for financial institutions has slowed as well.

As we look to the second half of the year, transaction volume is likely to remain low and the focus will increase towards refinancing activity for real estate assets with nearly $400 billion in loans coming due this year, with a quarter of that being tied to office assets. This will lead to opportunities for equity investors to acquire sound assets at very attractive prices.

Boyd Watterson's real estate strategies look to be well positioned as defensive, low-volatility vehicles with strong balance sheets that can weather the storm in the lending market. Our strategies have brought leverage down and laddered out debt maturities into the future with fixed rates (as higher interest rates started becoming a factor), therefore the cash flow streams have not been impacted by higher rates. While valuations are not immune to capital markets forces, our strategies have strong credit, little-to-no refinancing risk, and are highly diversified, making them well-designed for the current market environment.

Equities

The second quarter was another strong period for the equity markets even with an active Fed and rising interest rates. The tech heavy NASDAQ led the markets with a gain of over 13% for the quarter, while the S&P 500 was up nearly 9%, followed by the Dow at 4.0%. Year-to-date, the gains are more

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impressive with the NASDAQ up over 32%, the S&P 500 up nearly 17%, while the Dow has returned 4.9%. The year-to-date surge in the NASDAQ and S&P 500 indices was largely driven by the tech sector and enthusiasm for companies that will be at the forefront of artificial intelligence. The biggest underperforming sector year-to-date in the S&P 500 was the energy sector, which was a reversal from 2022 when energy was the only sector in positive territory and was up nearly 60%.

Growth stocks continued to outperform value stocks as the S&P 500 Growth Index was up over 10% in the second quarter while the S&P 500 Value Index was up just over 6%. The P/E ratio of the S&P 500 Index closed the quarter at 19.9 times current earnings and 20.2 times forward earnings.

The equity markets have been able to turn in robust performance year-to-date despite many companies reducing their earnings estimates for each quarter of 2023. For instance, FactSet indicates that the latest second quarter year-over-year earnings estimates are expected to decline by 6.5% for companies in the S&P 500, which is showing further weakness from the 4.7% decline that was estimated as of the end of March. Earnings estimates are also being reduced for the fourth quarter; however, management teams remain extremely optimistic. Earnings estimates for the fourth quarter are expected to increase 8%, down from around 10% at the end of March.

Looking forward, we continue to expect additional downward pressure on earnings estimates for the second half of 2023, which could pressure valuations going forward given the current economic and interest rate environment.

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