BOYD WATTERSON
ASSET MANAGEMENT

October 2023

Boyd Watterson Investment Outlook

Our Firm:

Boyd Watterson Asset Management, LLC is an SEC-registered investment advisory firm with $18.1 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

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The Macro View

From a macro perspective, the 'higher for longer' sentiment appears to be one of the few themes that investors mostly agreed upon as the third quarter of 2023 ended. At the September Federal Open Market Committee (FOMC) meeting, the target rate was left unchanged at 5.25% - 5.50%, but the 'dot plot' left room for another hike by year-end. The Summary of Economic Projections featured upward revisions to growth and inflation, and downward revisions to the unemployment rate. These projections, coupled with modest improvements in economic data, have re-ignited the debate around a soft-landing. In our view, the probability of achieving the elusive soft-landing has increased, yet the looming consumer headwinds, persistent core inflation, and tightening credit conditions keep us in the bumpy landing camp.

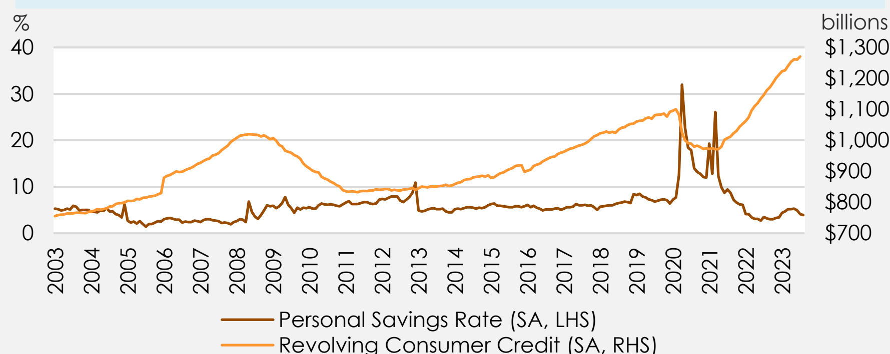
Performance for Periods Ending September 30, 2023

	QTD	YTD	1-Year	3-Year	5-Year
2-Year Treasury	0.53	1.02	1.48	-1.24	0.79
10-Year Treasury	-5.16	-3.54	-2.91	-8.62	-0.55
Bloomberg Aggregate	-3.23	-1.21	0.65	-5.21	0.10
Corporate Investment Grade	-2.71	0.44	3.98	-4.67	1.07
Corporate High Yield	0.51	5.88	10.19	1.80	2.80
Leveraged Loans	3.37	9.91	12.47	5.91	4.31
Mortgage Backed Securities	-4.08	-2.23	-0.22	-5.13	-0.75
S&P 500	-3.27	13.07	21.62	10.15	9.92
MSCI EAFE	-4.11	7.08	25.65	5.75	3.24

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

Beginning with the consumer, revolving credit growth continued to increase year-over-year at a rate north of ten percent to a new all-time high, while the average interest rate on that debt also reached a record high. Incomes remain strong, with average hourly earnings up 4.3% year-over-year, outpacing the rate of inflation growth. At the same time, the unemployment rate is hovering close to historical lows and payroll growth remains healthy as goods-producing and service-providing industries continued to add jobs in July and August. Retail sales have moderated from their peak growth rates but posted back-to-back record highs on a dollar value basis to start the third quarter. Finally, while consumer confidence remains well above the lows seen in 2022, the resumption of student loan payments and recent acceleration of gasoline prices could pose significant headwinds to consumption and economic activity broadly.

Personal Savings Rate and Revolving Consumer Credit



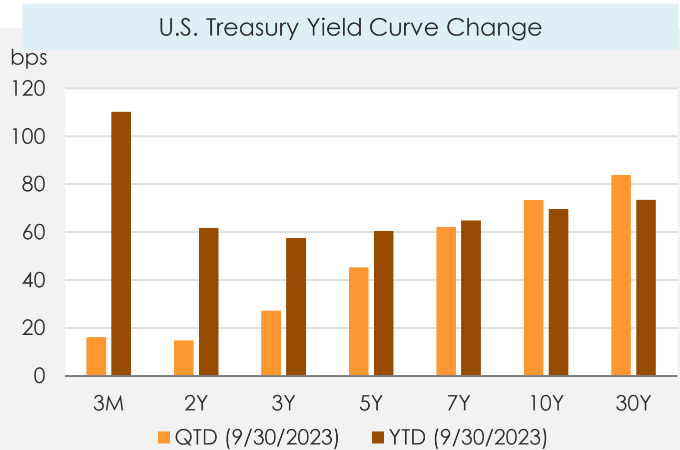
Source: Macrobond.

On the inflation front, we saw an acceleration in headline consumer prices in the third quarter, driven largely by energy prices. Though it may seem counterintuitive, the jump in gas prices could bring other categories of inflation down as the broader demand setup becomes challenged. Indeed, the Core Consumer Price Index, which excludes food and energy, took another step in the right direction, decelerating to its slowest pace in nearly two years. A key driver of the slowing core inflation trend has been the deceleration in shelter prices, which should continue to move lower over the next few months. We believe the Federal Reserve's monetary policy response has, for the most part, been successful in drawing the rate of inflation down over the last twelve months, but the recent re-acceleration of energy prices and continued strength in the labor market underscores the uneven inflation dynamic and the challenge the Fed may have in achieving their 2% target anytime soon.

Rounding out a generally positive economic backdrop, GDP growth has held up better than expected. After increasing at a 2.1% seasonally adjusted annualized rate in 2Q23, the latest GDP print points toward an economy that has lost some steam but has not given up nearly as much ground as many expected coming into 2023. Looking at what may be ahead, the Atlanta Fed GDPNow, a dynamic factor model that aims to estimate real GDP growth, is forecasting third quarter GDP to come in at 4.9%, well above the Blue Chip consensus estimates. While this number can be revised from now until the official release date, GDP growth of that magnitude may increase the probability of another hike by year-end. One caveat to reaching that blistering GDP estimate would be the resolution of the UAW strike, which would likely weigh on industrial production if it is not resolved in short order. Between work stoppages and a possible government shutdown in November, we recognize there is still some imbalance across different pockets of the economy. 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.

Fixed Income

Fixed income investors hoping for a quiet summer were disappointed yet again as market volatility remained elevated throughout the third quarter. The U.S. economy continued to defy expectations for more pronounced weakness to emerge which, coupled with higher oil prices and an increasing supply of U.S. Treasury securities, resulted in interest rates increasing to levels not seen in over 15 years. Additionally, the FOMC delivered another policy rate increase in July while still indicating they may not be finished tightening policy this year. In August, Fitch Ratings downgraded the credit rating of the United States from AAA to AA+, citing continued political brinksmanship over the U.S. debt ceiling and federal budget agreements as well as a growing debt burden. This downgrade was nearly twelve years to the day from when S&P took the same rating action in 2011. As the quarter closed, politicians were once again threatening a government shutdown over disagreements on spending bills. While a 45-day temporary extension was approved, a shutdown in November remains a distinct possibility. As a result, we expect market volatility to remain high as the level of uncertainty over many of these issues is unlikely to be resolved in the near term.



Source: Bloomberg.

Until last year, the widely followed Bloomberg U.S. Aggregate Index had never posted two consecutive years of negative total returns. This Index generated a total return of -3.23% for the third quarter, which flipped its year-to-date total return into negative territory once again (-1.21%). Without a stabilization/decline in interest rates, this broad fixed income index is on the cusp of an unprecedented third consecutive year of negative returns.

The FOMC indicated at its June meeting there was the potential for another fifty basis points of policy rate increases this year. In July, the Committee delivered an additional twenty-five basis point increase in their policy rate, bringing the range up to 5.25% - 5.50%, while simultaneously emphasizing the future path of policy is highly data dependent. Despite not raising rates at their September policy meeting, the updated economic projections proved to be the catalyst for another move higher in interest rates. The FOMC's median economic projections reflected stronger GDP growth, lower unemployment, and inflation trends that were similar to or slightly higher than their June projections. The surprise came through in the 'dot plot,' which continued to show an unchanged median peak policy rate of 5.60%, however, the median projection for 2024 was fifty basis points higher than the June projection, indicating fewer rate cuts next year. This is the Committee's effort to signal they are nearing the end of the tightening cycle, while emphasizing that interest rates are likely to stay 'higher for longer,' as they remain resolute on bringing inflation back to their 2% target level.

Interest rates increased across the yield curve during the third quarter, most notably for intermediate and longer-term maturities where a sizable portion of the increase occurred following the mid-September FOMC meeting. This was the

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result of the FOMC's 'higher for longer' messaging, an economy that continues to outperform expectations and increasing Treasury supply. Not only did this impact the level of interest rates but also significantly changed the shape of the yield curve. The yield on the two-year Treasury notes increased fifteen basis points during the quarter, while the ten-year Treasury note yield increased a staggering seventy-three basis points, to a sixteen year high of 4.57%. As a result, the yield differential between two-year and ten-year Treasuries became less inverted, declining to -47 basis points from -106 basis points at the end of June. If the economic and Treasury supply trends remain on their current paths, we expect the yield curve inversion will continue to normalize.

Source: Bloomberg.

The increase in interest rates resulted in negative total returns in many areas of the fixed income market for the third quarter, however, excess returns relative to Treasuries were mixed. Notably, both high yield corporate bonds and asset-backed securities generated both positive total and excess returns for the quarter. Investors continued to embrace risk as evidenced by the positive excess returns in the credit-related sectors of the fixed income market, likely driven by the combination of both the economy and corporate earnings exceeding more downbeat expectations. Credit spreads for the ICE BofA U.S. Corporate Index tightened six basis points in the third quarter, which resulted in an excess return of 1.04%, while the total return for this Index was -2.71% due to the rise in interest rates. The comparable ICE BofA U.S. High Yield Index saw credit spreads tighten by only two basis points, yet both total and excess returns were positive for the quarter. The high yield total return was supported by the higher coupons which provide some cushion to the negative price movements as interest rates increase. Similar to last quarter, both the investment grade and high yield corporate sectors saw lower quality outperform higher quality. Looking at credit across the maturity spectrum, shorter-duration credit outperformed Treasuries and produced positive total returns. In contrast, longer-term credit performed the best on an excess return basis but had a negative total return due to the rise in long-term interest rates.

The ICE BofA indices for the securitized sectors showed mixed results for the quarter. Asset-backed securities (ABS) led performance with positive total and excess returns, while commercial mortgage-backed securities (CMBS) posted a negative total return and positive excess return, and agency mortgage-backed securities (MBS) posted negative total and excess returns. The combination of rising interest rates and pressures within the commercial real estate market likely contributed to the underperformance of the latter two securitized sectors.

Like the second quarter, the largest portfolio positioning changes were centered around duration and yield curve positioning. With the 'higher for longer' messaging from the FOMC and recent steepening of the yield curve, we have started to reduce the barbelled maturity structure of our Core and Intermediate strategies. As part of this action, the portfolio durations have moved from a slightly long position back to a neutral position relative to their respective benchmarks. From a sector allocation perspective, we remain overweight risk, with those allocations focused on corporate bonds and asset-backed securities, while our agency MBS allocation remains generally neutral to the U.S. Aggregate Index. Our short-term strategies continue to have a short duration bias relative to their benchmarks, generally around 95% of the index. Like our Core and Intermediate strategies, we remain overweight both corporate bonds and asset-backed securities and underweight Treasuries in the short-term strategies as we look to maintain a yield advantage over their benchmarks. We remain constructive on risk given the resiliency of the U.S. economy yet acknowledge that valuations are becoming somewhat less appealing in certain sectors, particularly given the ever-present uncertainties stemming from both fiscal and monetary policy.

Real Estate

The commercial real estate market continues to decline as interest rate increases have negatively impacted valuations for assets across the board. The pain has been particularly acute in the office sector as continued telework has hurt fundamentals on top of the impact of higher rates and higher borrowing costs. However, the extent of the decline in valuations is still to be determined as there have been so few transactions taking place that it is difficult to identify what the market pricing for assets is today. Buyers and sellers remain far apart on pricing expectations and the market for borrowers continues to deteriorate to the point where the only buyers in the market are largely those utilizing all-equity with the hopes to recapitalize in a lower-rate environment sometime in the future.

Meanwhile, the interest rate outlook has continued to worsen for borrowers. The Fed has remained steadfast in its goal of pushing inflation back to its 2% target and has indicated it may need to continue to raise rates to achieve that goal. This has resulted in a rapid rise in longer-term rates over the past quarter to the point of ten-year Treasuries exceeding 4.6%, the highest they have been since 2007. Owners who anticipated a quick drop in interest rates in 2024 may be in for a rude awakening as the market is now pricing in 'higher for longer,' which will make borrowing even more difficult and

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expensive and likely continue to drag prices down. Further complicating matters is that banks and other lenders have pulled back dramatically from the market to preserve liquidity and there is little available debt, particularly for office properties. The public and private bond markets have been quiet and only those forced to borrow are doing so at this time as rates have been punitive for those who have issued.

If interest rates remain elevated as the market is now expecting, we anticipate values to continue to decline and more distressed opportunities to hit the marketplace as those with debt maturities will be forced to sell or come to the table with equity to pay down loans. Our real estate strategies remain well-positioned to capitalize on this scenario as we have strong liquidity positions and can provide equity, debt, or mezzanine solutions for owners and partners. We also anticipate seeing more build-to-suit opportunities through partners who have secured leases with government tenants but are having difficulty capitalizing their projects. We anticipate that our access to liquidity will allow us to strategically allocate capital to the best opportunities, which should generate strong risk-adjusted returns for investors.

Equities

The equity markets gave back some of their year-to-date gains in the third quarter as significantly higher interest rates and an uncertain earnings outlook negatively impacted investor sentiment and valuations. The Federal Reserve increased the Federal Funds rate by 0.25% during the quarter to 5.25-5.50%, but ten-year and thirty-year Treasury yields increased by 0.73% and 0.84%, respectively. The NASDAQ Index was most impacted, down 3.94%, followed by the S&P 500, which was down 3.27%, while the Dow was down only 2.10%.

For the quarter, only two of the eleven sectors of the S&P 500 had positive returns. Not surprisingly, energy led the way, up 12.22%, as the price of West Texas Intermediate (WTI) oil increased $20.15/bbl., ending the quarter at $90.79/bbl. Communication services was the other sector in positive territory, up 3.07%.

Year-to-date, equity gains remain strong with the NASDAQ up 27.11%, the S&P 500 up 13.07%, while the Dow is up a more modest 2.73%. S&P 500 returns have been driven by the information technology, communication services, and consumer discretionary sectors. On the flip side, financials, energy, health care, and utilities are in negative territory year-to-date.

Surprisingly, the S&P 500 Growth Index outperformed the S&P 500 Value Index for the quarter as the growth index declined 2.59% while the value index was down 4.09%. Midcap stocks, as measured by Morningstar Core indices, underperformed both small cap and large cap stocks for the quarter.
Equity markets tend to be forward-looking with valuations impacted by earning expectations. The market's realization that the Fed will keep interest rates higher for longer has led to earnings uncertainty and companies modestly lowering their guidance for the next couple of quarters. However, according to FactSet Research, earnings growth of the S&P 500 is projected to increase over 12% in 2024, while revenue growth is expected to exceed 5.5%.

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