# BOYD WATTERSON ASSET MANAGEMENT

January 2024

# Boyd Watterson Investment Outlook

## Our Firm:

Boyd Watterson Asset Management, LLC is an SEC-registered investment advisory firm with $18.4 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*

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## The Macro View

The fourth quarter began with expectations that the Federal Open Market Committee (FOMC) would maintain its 'higher for longer' interest rate policy stance while keeping open the possibility of an additional rate hike by year end. However, at their December policy meeting, Committee members voted to leave their policy rate unchanged, signaling the need for more rate hikes has most likely ended while revising growth and inflation expectations lower for 2024. As a result, investors' focus regarding the 'higher for longer' messaging shifted toward the 'longer' component.

Although the probability of rate cuts in 2024 has increased meaningfully, the market may be underestimating the patience of the Fed. Following the Fed's more dovish stance, the market's expectations for rate cuts increased to include six 25-basis point cuts in 2024 beginning in March, three more than the 'dot plot' indicated in the FOMC's December Summary of Economic Projections.

Performance for Periods Ending December 31, 2023

| | QTD | YTD | 3-Year | 5-Year |
|---|---|---|---|---|
| 2-Year Treasury | 2.44 | 3.50 | -0.46 | 1.01 |
| 10-Year Treasury | 6.60 | 2.83 | -6.05 | -0.03 |
| Bloomberg Aggregate | 6.82 | 5.53 | -3.31 | 1.10 |
| Corporate Investment Grade | 7.91 | 8.40 | -3.17 | 2.63 |
| Corporate High Yield | 7.08 | 13.40 | 2.01 | 5.22 |
| Leveraged Loans | 2.85 | 13.04 | 5.64 | 5.56 |
| Mortgage Backed Securities | 7.37 | 4.98 | -2.96 | 0.26 |
| S&P 500 | 11.69 | 26.29 | 10.00 | 15.69 |
| MSCI EAFE | 10.42 | 18.24 | 4.02 | 8.16 |

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

From a market sentiment perspective, the probability of a soft landing appears to have increased due to better than expected growth, a resilient labor market, moderating inflation, and strengthening equity market performance. While the market seems to be anticipating a lower rate environment that will act as a catalyst for interest-rate sensitive sectors and potentially lead to a soft landing, we remain skeptical. Our base case economic scenario remains for a bumpy landing as we acknowledge the continued headwinds for private sector activity and consumption growth alongside an uncertain inflation setup. Additionally, the geopolitical landscape and upcoming presidential election cycle present further risks to the economic outlook.

On the growth front, industrial production has been negative on a year-over-year basis across the four months ending in November and one of the key forward-looking indicators for production, ISM Manufacturing New Orders, has been in contraction for sixteen months. Contrary to the goods economy, services have held up much better and the ISM Non-Manufacturing New Orders Index signaled expansion in each month of 2023, exemplifying the durability of the U.S. economy over the last year. Outside of private sector activity, it will be important to monitor government spending given its larger than average contribution to GDP growth over the last few quarters. With the U.S. Presidential election on the horizon, there could be increased scrutiny of budgets and a propensity to put actual spending on hold.

In terms of a read into future consumption, nominal wages and payrolls remain in positive territory and initial jobless claims remain low. On the surface, this should provide a positive setup for continued nominal spending growth. However, there


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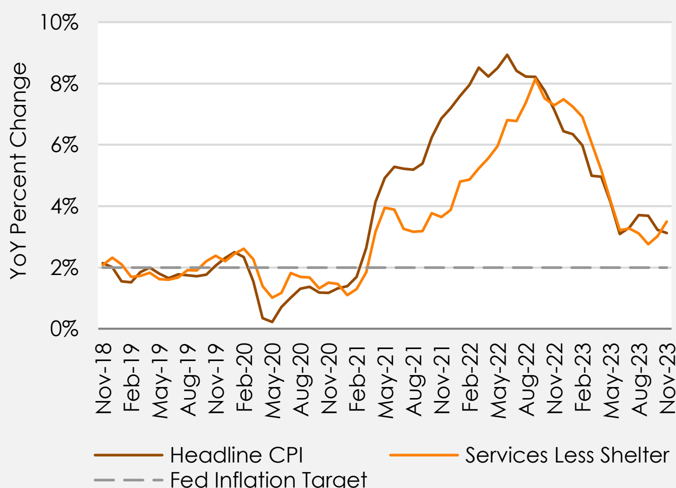
remains risk related to consumer credit card debt and the cost of carrying that debt. Delinquency rates have been accelerating despite the better-than-expected labor and wage data. While student loan payments are technically back online, delinquencies will not be reported to credit bureaus until the fourth quarter of 2024 per government policy, which may provide further temporary relief to consumers with student loan debt. Lastly, despite the lackluster consumer sentiment data from the University of Michigan, the observed spending data has been remarkably strong for this stage of the cycle.

Turning to inflation, the various measures the Fed has signaled are important in their process for policy decision making remain uncomfortably above the Committee's 2% target level. Thus, declaring victory over inflation at this point seems to be a bit premature. Indeed, the Consumer Price Index (CPI) for Services excluding Shelter has accelerated by 75-basis points since September, to 3.50% in November year-over-year, while headline and core CPI remain above target at 3.10% and 4.00%, respectively. To highlight the uneven distribution of consumer price growth, the CPI All Items Excluding Shelter Index has been at or below 2.00% since June 2023, registering 1.40% in the latest release. Factors such as movements in the shelter component and the volatility of energy prices will likely keep the inflation story more interesting than its current trajectory would indicate. Critically, a leveling-off around 3.00% - 3.25% at the headline level could cause the Fed to revisit its recent pivot, thus pushing out the 'longer' piece further than the market currently expects. From our perspective, the magnitude of deceleration in inflation that would lead to three, let alone, six rate cuts in 2024, would be the result of a sizable decline in demand and therefore be more reflective of a bumpy landing. We believe this fragile setup underscores the difficulty of the task at hand for the Fed as they maneuver policy around these narrow inflationary/disinflationary pathways.

Key CPI Measures Remain Above Fed Inflation Target




Source: Macrobond.

While economic data continues to send mixed signals, we see a somewhat similar imbalance from Fed officials. Although the bulk of their messaging and action has turned more dovish, there are still a few FOMC members that are not content with the forward-looking inflation setup. The resulting uncertainty over the economic outlook and path of monetary policy will likely keep financial market volatility elevated for the foreseeable future. As such, until the line of sight for inflation returning to the Committee's 2% target becomes clearer, the probability of a bumpy landing remains our base case for 2024.

## Fixed Income

Following the third quarter's strong economic growth, the hawkish September message from the FOMC, and the spike in interest rates, investors braced for a tumultuous fourth quarter. While those expectations were met, it may not have been for the reasons many expected, nor in the direction witnessed by the financial markets in the prior quarter. U.S. economic growth did appear to slow from the third quarter's blistering 4.9% annualized pace and inflation continued to gradually improve, yet geopolitical risk remained high with the war in Gaza reigniting tensions in the Middle East, while Presidents Biden and Xi met face-to-face in an effort to ease increasing friction between the two superpowers. However, it was the economic picture that took center stage, as the slowing (but still positive) trend of fourth quarter growth, combined with further moderation in inflation, prompted the FOMC to soften their messaging to the financial markets in December. The addition of the single word 'any,' included in the reference to 'additional policy tightening' was viewed as dovish by the markets, while the updated 'dot plot' indicated the terminal policy rate appears to have been reached and the magnitude of policy easing for 2024 was modestly higher relative to the September projections.

Recall, bond investors experienced a sharp increase in interest rates across the yield curve in the third quarter, given stronger economic trends, increasing Treasury supply, and the FOMC's 'higher for longer' messaging. While the trend higher in yields continued early into the fourth quarter, it did not last long. In early November, the Treasury indicated that coupon auction size increases were only expected for one more quarter beyond the November announcement, and that increases in longer maturities would occur at a more moderate rate. This announcement occurred on the same day the FOMC concluded their November policy meeting, where the Committee once again decided against further policy tightening. With investors now increasingly convinced the FOMC was done raising interest rates, a sharp decline in yields ensued, centered on two-year and longer maturities. Finally, their December policy meeting seemed to confirm investors' expectations for a policy 'pivot,' adding more fuel to the rally in yields and risk assets broadly.

Consistent with the first nine months of 2023, interest rate volatility remained high in the fourth quarter of the year. With the FOMC appearing to be finished raising their policy rate, investors drove the level of interest rates lower, the yield curve

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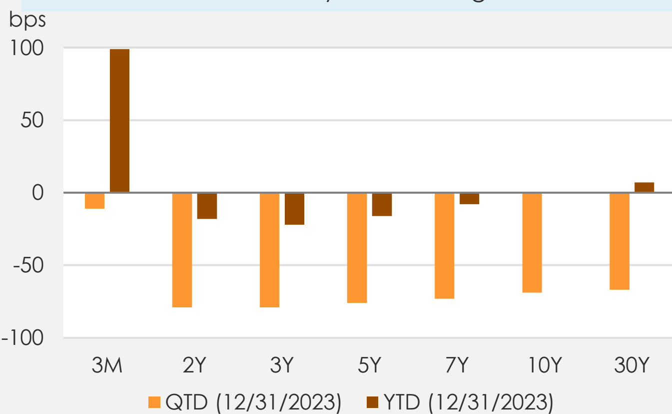
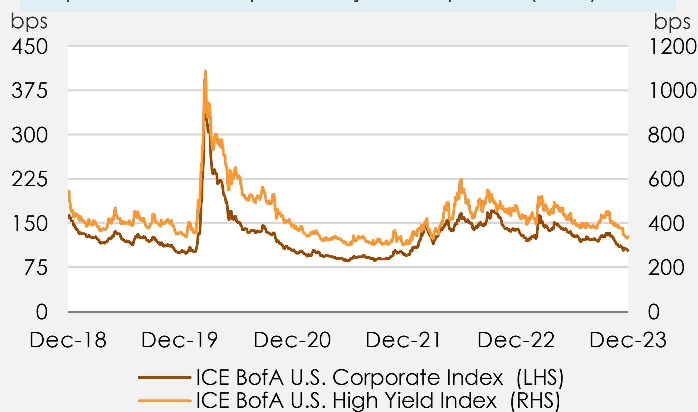
modestly steeper, credit spreads significantly tighter, and equity indices sharply higher. The tug of war between bond investors and the FOMC did not let up, as the year closed with the market expecting six 25-basis point rate cuts in 2024, while the FOMC's median projection in December reflected only three cuts. The widely followed ten-year Treasury note yield declined 69 basis points in the quarter, to end the year at 3.88%. For the full year, the ten-year traded in a 168-basis point range, reaching a closing high of 4.99% in October and a closing low of 3.31% in April. Ironically, despite a year fraught with risk and uncertainty, the ten-year Treasury yield finished 2023 virtually where it began.



Source: Bloomberg.

The yield curve, as measured by the yield differential between two-year and ten-year Treasuries, steepened ten basis points during the fourth quarter. This relationship, which has been inverted for nearly eighteen months, ended the year at -37 basis points, after reaching a maximum inversion of -109 basis points in March. We expect the yield curve to continue to normalize in 2024 as the FOMC shifts to cutting rates, which we currently anticipate will begin in the middle of the year.

The sharp drop in yields during the fourth quarter sparked a risk rally that encompassed investment grade and high yield credit, as well as all three primary securitized sectors. Within investment grade credit, the ICE BofA U.S. Corporate Index posted an excess return of 4.65% relative to Treasuries for 2023, as its option-adjusted spread (OAS) tightened 34 basis points, ending the year at 104 basis points. Like interest rates, credit spreads were volatile as well, as the OAS traded in a 60-basis point range over the year, only to finish at its tightest level in nearly two years. On an excess return basis, lower quality handily outperformed higher quality, while longer duration credit outperformed short duration by a wide margin. The ICE BofA U.S. High Yield Index generated an excess return of 9.11% for the year, resulting from 147 basis points of spread tightening. Elevated volatility was evident in high-yield credit as well, as the OAS of this index traded in a 190-basis point range during 2023, reaching a high of 522 basis points and a low of 332 basis points, closing the year at 334 basis points. High-yield performance was led by the CCC-rated cohort, where spreads tightened 319 basis points, resulting in an excess return of 16.04%. We believe the move tighter in credit spreads in 2023, across both investment grade and high yield, further underscores investors' increasing confidence in the Fed's ability to orchestrate a soft landing for the U.S. economy.



Source: Bloomberg - ICE BofA Bond Indices.

The securitized sectors also posted solid results for the year, with the respective ICE BofA indices showing asset-backed securities (ABS) leading the group, with an excess return of 1.89% for 2023. Both agency mortgage-backed (MBS) and commercial mortgage-backed (CMBS) securities generated positive excess returns as well, 0.87% and 0.57%, respectively. Of note, MBS posted the strongest fourth quarter excess return of the group as the sharp decline in interest rates likely sparked renewed interest in the sector that had been plagued by higher rates throughout the tightening cycle.

Our portfolio positioning continued to reflect modest changes in both duration and yield curve positioning over the fourth quarter. We continued to transition the maturity structure of our Core and Intermediate strategies from a barbelled position to a bulleted position given our expectation for further steepening (normalization) of the yield curve in 2024. Additionally, given the rapid move lower in interest rates, we allowed the portfolio durations in these strategies to drift modestly short of their respective benchmarks, from a neutral position at the prior quarter end. While we believe the FOMC is finished raising interest rates, we also are of the opinion that the rapid move lower in interest rates is overdone and the Committee is likely to ease policy less than the market is currently pricing for 2024. Duration positioning in our Short-Term strategies now reflects a target of 95% - 100% of their respective benchmarks, as we expect the steepening of the yield curve to be led by declines in shorter maturity yields. Our risk positioning continues to emphasize overweight allocations to corporate bonds and asset-backed securities, a generally neutral allocation to agency MBS, and an underweight to Treasuries. We allowed our relative spread duration to drift lower over the quarter, leaving us with significant dry powder

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to add risk opportunistically. As a result of the recent decline in interest rates and tightening of credit spreads, we currently believe the market is priced for near perfection given the economic and geopolitical uncertainty that remains. Therefore, our highest conviction alpha driver heading into 2024 is yield curve positioning as we expect the pace and magnitude of normalization to increase over the near-term.

## Real Estate

After a highly challenging 2023 largely driven by higher interest rates and slowing demand, we are expecting the commercial real estate market to continue to decline, though at a slower pace. With interest rates declining into year-end after a rapid runup in the late summer and early fall, there is some optimism that we are near the bottom when it comes to the commercial real estate market. The Fed has signaled they are likely to start cutting interest rates in 2024 which has given hope to investors' that there will be more liquidity and transactions in the market, leading to more certainty. Lower rates should also put less pressure on upcoming debt maturities and result in less distress for borrowers. Investors are also increasingly confident that the economy could achieve a soft landing and avoid a recession, which could benefit the demand side of the equation.

The office sector continues to be hit the hardest as the rise in remote work has led to sharply reduced demand for office space and record-high vacancy rates throughout the country. Major markets have been hit hard, with the west coast suffering the most. According to CBRE, Los Angeles just hit a new record high vacancy of 25% and San Francisco's vacancy rate is now 36%, also a record. Seattle, Silicon Valley, and Portland are also struggling. Though no market is immune to the challenges facing the office sector, other major cities are in slightly better shape as vacancy rates in Chicago and Washington DC hit 21% and in New York, the rate hit 15%. These are nonetheless highly elevated from pre-pandemic levels.

There are several trends within the office sector that have been consistent across the country. As corporate tenants roll off their leases in commodity multi-tenant buildings, we have seen most renewing tenants seeking less space than their existing leases. Thus, while they are still leasing office space, their space requirements have been significantly reduced by remote and hybrid work. This has been a primary factor in the rise in vacancies and "shadow" sublet vacancy. This trend has been less pronounced in the government sector. Secondly, there has been a flight to high-quality, well-located office buildings. Class A space and highly specialized space has largely held up well thus far in the post-pandemic world, but Class B and C space have suffered, particularly those in inferior locations or lacking amenities. Class A space has always commanded higher rents but the gap between it and Class B/C space is widening, as are occupancies between the two. A major element of our investment strategy has been to buy either highly specialized properties where we have seen tenants largely maintain their leased square footage upon renewal or best-in-class properties which have been more attractive to tenants. This strategy has continued to pay off as evidenced by the outperformance of our funds.

Looking forward, we are expecting to see attractive opportunities. There have been fewer than expected distressed office sales thus far in this down cycle despite reduced valuations and rising interest rates. This is because many owners locked in longer-term, low-interest rate loans prior to the rise in rates in 2022 and are not facing distress at this time, particularly if they have well-occupied buildings. However, a significant amount of debt is maturing in 2024 and most owners seeking a refinance will need to come to the table with equity to pay down a portion of their existing loans. This will likely cause distress for many owners who cannot or will not put more equity in and these properties will either be sold or foreclosed upon. We have been strategically waiting for these distressed properties to surface and preserving liquidity in order to capitalize on the opportunities. Some of the best returns are often generated coming out of a real estate recessionary environment, and we are now seeking and well prepared to react when the timing is right.

## Equities

The major U.S. equity indices ended the year near all-time highs, with the S&P 500 Index up over 26% and the NASDAQ Index up over 44%. Much of the gains were driven by large cap technology stocks like Nvidia, Meta Platforms, and Tesla, all up over 100% for the year. However, the fourth quarter did see a broadening of participation, as ten of the eleven S&P 500 sectors generated positive returns, while energy was the lone sector to remain in negative territory. For the year, three of eleven sectors generated negative returns as staples returned -2.16%, energy -4.80%, and utilities -10.20%.

Value stocks outperformed growth stocks for the fourth quarter, a reversal of what happened for the year. The S&P 500 Value Index was up 13.04% for the quarter while the S&P 500 Growth Index was up 9.75%, much of this driven by the Fed signaling an end to the tightening cycle and the market's expectation for aggressive rate cuts in 2024.

For the quarter, small cap stocks outperformed both large cap and midcap stocks, as measured by the returns of the Morningstar Core indices. However, for the year, large caps led the way, followed by small caps and midcaps.

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