BOYD WATTERSON
ASSET MANAGEMENT

April 2024

Boyd Watterson Investment Outlook

Our Firm:

Boyd Watterson Asset Management, LLC is an SEC-registered investment advisory firm with $18.2 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/

Our Offices:

Headquarters

Cleveland, OH	1301 East 9th Street Suite 2900 Cleveland, OH 44114
Main Phone	(216) 771-3450
Advisor Channel	(866) 771-2693
Chicago, IL	One North Wacker Drive Suite 4025 Chicago, IL 60606
Bloomfield Hills, MI	121 West Long Lake Road Suite 350 Bloomfield Hills, MI 48304
Denver, CO	1200 17th Street Suite 600 Denver, CO 80202
Tampa, FL	101 East Kennedy Boulevard Suite 1490 Tampa, FL 33602
Washington, DC	905 16th Street, NW Suite 450 Washington, DC 20006

The Macro View

The first quarter began with the expectation that the Federal Open Market Committee (FOMC) would cut its policy rate at least six times in 2024, beginning as soon as March. This was double the number of rate cuts the FOMC guided toward in their 'dot plot' from December. Over the course of the quarter, the market's rate cut expectations were halved and, in March, the policy rate was left unchanged at 5.25% - 5.50% for a fifth consecutive meeting. The FOMC's latest Summary of Economic Projections (SEP) featured upward revisions to real GDP and Core PCE inflation, and a downward revision to the unemployment rate, tilting the range of probabilities for interest rate policy firmly toward the 'higher for longer' camp.

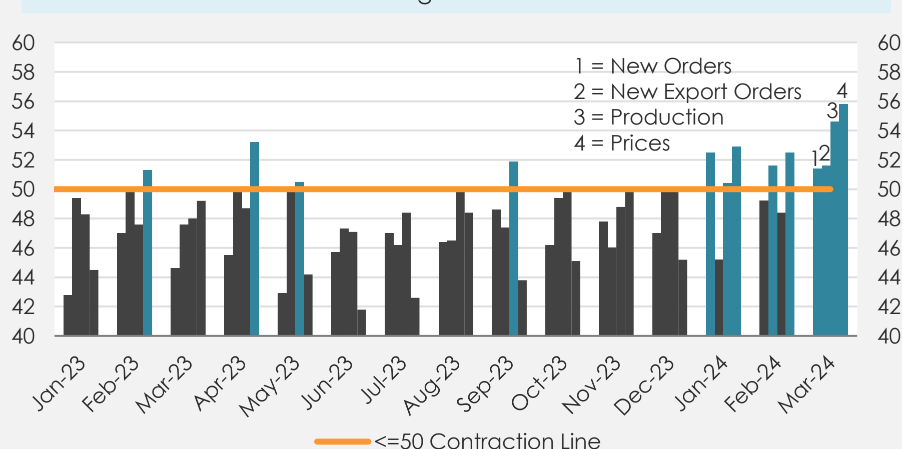
Performance for Periods Ending March 31, 2024

	QTD	YTD	1-Year	3-Year	5-Year
2-Year Treasury	0.21	0.21	2.25	-0.38	0.86
10-Year Treasury	-1.61	-1.61	-2.44	-4.24	-0.96
Bloomberg Aggregate	-0.78	-0.78	1.70	-2.46	0.36
Corporate Investment Grade	-0.08	-0.08	4.70	-1.70	1.62
Corporate High Yield	1.47	1.47	10.98	2.23	4.03
Leveraged Loans	2.52	2.52	12.40	5.82	5.30
Mortgage Backed Securities	-1.07	-1.07	1.36	-2.93	-0.40
S&P 500	10.56	10.56	29.88	11.49	15.05
MSCI EAFE	5.78	5.78	15.32	4.78	7.33

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

On the growth front, leading indicators for industrial production have been ticking up. The S&P Global Manufacturing PMI has been in expansionary territory over the last three months and the ISM Manufacturing PMI increased to 50.3 in March, marking its first expansionary reading in seventeen months, supported by improvement in key components like production and new orders. This shifting sentiment, and an easing base effect setup, point toward the prospect of positive year-over-year growth for industrial production in the second quarter. Meanwhile, the S&P Global Services PMI has cooled off slightly on a rate of change basis but remains in expansion at 51.7 for the month of March.

Manufacturing Business Sentiment



Source: Institute of Supply Chain Management (ISM), Macrobond.

The views expressed herein are presented for informational purposes only and are subject to change without warning. This material is not intended as a recommendation to invest in any particular asset class or strategy or as a promise of future performance. For financial professional use only.

Over the next few months, we will be looking for further confirmation of improving economic activity from the labor market. As expected, the pace of hiring has slowed on a rate of change basis, but month-to-month payroll growth has continued at a solid pace, which has resulted in the unemployment rate remaining below 4.0%. Wages and salaries have continued to grow in nominal terms at a healthy clip of 5.8% year-over-year. Importantly, average hourly earnings have moved back into positive territory on an inflation-adjusted basis. If economic activity continues on its current trajectory, the consumer should likely be in an increasingly stronger position to spend and/or pay down existing debt with each incremental real dollar earned. Further supporting the outlook for the consumer, the University of Michigan Consumer Sentiment Index, and the related Expectations Index, both improved significantly on a quarter-over-quarter basis, reaching their highest levels since July 2021.

Turning to inflation, the Personal Consumption Expenditures (PCE) Price Index has improved to levels last seen in the first quarter of 2021, increasing at a 2.5% rate year-over-year. The Core PCE Price Index has followed a similar path lower in the last twelve months, slowing to 2.8% year-over-year growth in February. The important takeaway from this inflation setup is that both measures of inflation are still above the Fed's 2.0% target, while the pace of disinflation has slowed recently. Additionally, as the year-over-year comparison set eases, it will become tougher from a mathematical standpoint for inflation readings to continue decelerating at a pace that would justify the magnitude of rate cuts in the timeframe the market had expected at the beginning of the year.

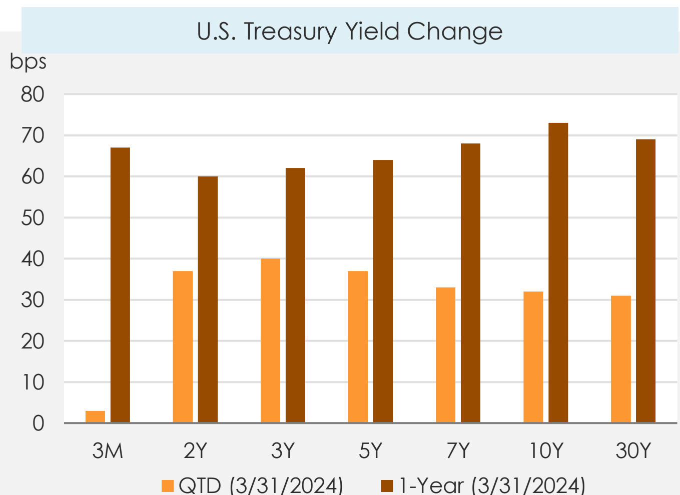
Considering the FOMC's updated economic projections for 2024, combined with a rising probability that economic growth reaccelerates, and inflation stays above the Fed's target, we have adjusted our view away from a bumpy landing and more toward a soft-landing scenario. As noted in our previous quarterly Outlook, we observed that the market may be underestimating the patience of the FOMC, and we are reiterating that view as the Committee navigates better-than-expected growth and stickier-than-expected inflation. Since the March 20th meeting, there have been a handful of Fed officials emphasizing the potential need to remain restrictive for longer than previously thought. By the end of the quarter, the market appeared to be coming to grips with the increasing probability of a later start to the easing cycle, coupled with the possibility of fewer rate cuts this year, a view we currently share.

Fixed Income

Following the sharp decline in interest rates over the fourth quarter of 2023, investors began the new year with elevated expectations for significant easing of monetary policy and an increasing likelihood the FOMC would successfully orchestrate a soft landing for the U.S. economy. While geopolitical tensions remained high, investors' focus remained largely on U.S. economic data and the impact that could have on the direction of the FOMC's policy path this year.

Interest rates remained volatile in January as economic data continued to support a solid U.S. economic outlook, while the personal consumption expenditures (PCE) inflation report late in the month fueled speculation that the first policy rate cut could occur as early as March. The FOMC's message following their January policy meeting, combined with a strong payroll report two days later, tempered that speculation. That messaging emphasized the need to see additional data to solidify the Committee's confidence that inflation was on a sustainable path toward their 2% target level, thus underscoring a heightened degree of patience regarding their outlook for interest rate cuts. Over the remaining two months of the first quarter, the economic data remained relatively solid, while the inflation reports generally proved to be stickier. As a result, by the end of the first quarter, interest rates were higher across the yield curve and market expectations for policy easing this year had declined sharply, to fewer than three cuts, the first of which was likely to occur toward the middle of this year. Late in the quarter, the FOMC struck a similar tone following their March policy meeting. The Committee's balanced communication included an updated 'dot plot' continuing to reflect a median estimate of three rate cuts this year, while simultaneously increasing their real GDP, inflation, and unemployment rate estimates for 2024.

Treasury yields ended the first quarter generally thirty-to-forty basis points higher between two-year and thirty-year maturities, most of which occurred following the January FOMC meeting. Despite the relatively uniform increase in interest rates, the yield curve inversion increased somewhat further. The two-year Treasury yield was up thirty-seven basis points, while the ten-year Treasury yield increased thirty-two basis points, resulting in a five basis point increase in the two-year to ten-year yield differential. While we continue to expect the yield curve to steepen as the year progresses, we recognize the higher degree of patience exhibited by the FOMC could slow any material progress in this area until later this year.



Source: Bloomberg.

The views expressed herein are presented for informational purposes only and are subject to change without warning. This material is not intended as a recommendation to invest in any particular asset class or strategy or as a promise of future performance.

While total returns in the fixed income market were mixed for the quarter, excess returns relative to comparable maturity Treasuries for risk assets were broadly positive, with the lone exception of agency mortgage-backed securities. Despite setting a quarterly record for new issuance of nearly $530 billion, investment grade corporate bonds generated an excess return relative to Treasuries of 1.03%, as measured by the ICE BofA U.S. Corporate Index. The option-adjusted spread (OAS) of this index declined to ninety-four basis points, ten basis points tighter during the quarter and its tightest level in over two years. Higher all-in yields, solid fundamentals and positive earnings growth continued to support the credit markets.

Similarly, high yield corporate bonds, as measured by the ICE BofA U.S. High Yield Index, posted an excess return relative to Treasuries of 1.68%, as the index OAS tightened twenty-four basis points in the first quarter, to 315 basis points. According to Bloomberg, high yield new issuance of $85 billion in the first quarter was the busiest first quarter since 2021, with the pace of new issuance up over 117% compared to the same time last year. With prospects of interest rate cuts on the horizon and a supportive economic outlook, we expect issuance to remain strong and credit spreads to possibly tighten modestly further for both investment grade and high yield corporate bonds.

According to the ICE BofA indices, performance in the securitized sectors was mixed in the first quarter and, surprisingly, was led by commercial mortgage-backed securities (CMBS) with an excess return of 2.07%. Despite all the negative press surrounding declining valuations and the magnitude of upcoming loans that need to be refinanced in the commercial real estate market, performance in this sector was led by lower quality, with the single-A and BBB-rated securities posting the strongest total and excess returns. Asset-backed securities (ABS) posted positive excess returns for the fifth straight quarter (+0.92%), while agency mortgage-backed securities (MBS) posted a negative excess return of -0.51%, following their standout performance in the prior quarter.

Our portfolio positioning was relatively stable during the first quarter, with only minor adjustments. Our Core and Intermediate strategies began the quarter with a modestly short duration bias relative to their respective benchmarks. However, as the ten-year Treasury yield approached 4.25%, we lengthened the duration to a neutral position. The yield curve structure in these strategies continues to reflect a bulleted position, which we transitioned to in the fourth quarter of last year. In hindsight, we were early in our expectation for the yield curve to steepen, yet we maintained this bulleted positioning given the approaching period within which we expect the FOMC to begin cutting their policy rate. The Short-Term strategies continued to reflect a neutral to slightly short duration bias relative to their respective benchmarks. Our risk positioning was relatively unchanged with overweight positions in corporate bonds and asset-backed securities and an underweight position in Treasuries. However, during the quarter we added exposures in agency MBS as valuations became more compelling. Finally, we are maintaining risk exposures at current levels due to the supportive technical and fundamental environments but maintain a willingness to increase risk positioning on any sustained weakness in credit spreads given our more optimistic outlook for the U.S. economy.

Real Estate

As the economy continues to hum along and inflation seems largely tamed, there is some optimism returning to the real estate markets. The Fed continues to signal that it will cut rates in the second half of this year, with market projections at three rate cuts this year. The economy remains strong, with unemployment remaining below 4% and GDP growth in Q4 of 2023 at a healthy 3.4%, and the consumer has continued to spend, though it remains to be seen if that is sustainable given the rise in credit card debt. Given this economic backdrop, the outlook for commercial real estate looks fairly healthy as occupancy levels are usually driven by demand caused by economic growth.

However, there are a few factors tempering the enthusiasm for commercial real estate despite the strong economic setting- still elevated interest rates, elevated valuations, and challenges in the office sector. It has been about two years since the Fed started raising interest rates and although they stopped raising rates in 2023, they still remain elevated which continues to cause pain in the real estate market. Many owners have loans that have matured or are set to mature in the next 12-24 months and will be forced to either take a new (likely smaller) loan at a higher rate and come to the table with an equity infusion, sell their assets at a discount, or hand over the keys to the lender. All of these come with sacrifices that can only be remedied by lower rates in the near term, but it is uncertain if and when the Fed will begin to cut rates.

The second issue is still elevated valuations for many building owners. Many owners are subject to quarterly appraisals which have lagged the reality on the ground in the marketplace and do not reflect true market value. For instance, the NFI-ODCE index is still valued at an implied cap rate of 4.75%, well below the cost of borrowing today, which would suggest it still has more pain to come. GreenStreet estimates market values have declined by 22% since March of 2022 but that market values have reached or are approaching a bottom, with its index flat for several months in a row. Thus, if appraised valuations can catch up to the reality on the ground and reset at a new baseline, the real estate market will see growth from there. Boyd Watterson believes that will likely happen by the end of the year but that we are not there yet.

Lastly, the office sector still remains the most challenged of the different asset classes. Despite the strength in the economy and growth in office-using jobs, the continued rise of remote and hybrid work has reduced the amount of space most tenants require and thus there remains strong headwinds in the space. The good news for the owners of higher-quality space is that most of the vacancy is concentrated in a small

The views expressed herein are presented for informational purposes only and are subject to change without warning. This material is not intended as a recommendation to invest in any particular asset class or strategy or as a promise of future performance.

percentage of lower-class buildings. JLL estimates that 60% of the market vacancy across the country is concentrated in just 10% of the buildings. As these older, obsolete buildings are converted to other uses or are otherwise moth-balled, there may be more stability in the office market. Little new space is being developed nationally on the supply side and on the demand side, CBRE believes that we are nearing the end of the current "right-sizing" movement that began prior to the pandemic but which accelerated during and continued since the end of the pandemic. It is projected that the market vacancy will peak at around 20% sometime in 2025. Thus, there could be some light at the end of the tunnel for the office sector.

We remain optimistic that our strategy of targeting well-occupied, highly specialized government buildings will remain a likely safer harbor for investors with lower volatility, strong income generation, and less sensitivity to the broader movements in the marketplace. As the economy continues to grow and valuations approach reality on the ground, we likely expect to see growing returns in the real estate sector and its strategies in the future.

Equities

The U.S. equity markets started off the year not only in positive territory but setting new all-time highs during the quarter. The S&P500 Index posted a return of 10.56% for the quarter, followed by the NASDAQ Index up 9.32%, and the Dow Index up 6.14%. As has been the case lately, large technology stocks such as Super Micro Computer, Nvidia, and Micron Technology, led the way, all up more than 38% for the quarter.

Growth stocks outperformed value stocks for the quarter, even though interest rates rose and market expectations for six rate cuts abated. For the quarter, large cap stocks outperformed both mid and small cap stocks, as measured by the returns of the Morningstar indices.

Source: Bloomberg Index Services Limited. BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). Bloomberg or Bloomberg's licensors own all proprietary rights in the Bloomberg Indices. Bloomberg does not approve or endorse this material or guarantee the accuracy or completeness of any information herein, nor does Bloomberg make any warranty, express or implied, as to the results to be obtained therefrom, and, to the maximum extent allowed by law, Bloomberg shall not have any liability or responsibility for injury or damages arising in connection therewith.