Volatility Makes a Comeback

First Quarter 2018 Financial Markets Commentary

April 3, 2018

RISK-BASED ASSETS PERFORMANCE SUMMARY

- Fear of inflation, rising bond yields, rich valuations, the potential for Fed policy mistakes, U.S. Presidential Cabinet turnover, protectionist trade policies, and doubts whether shares of technology companies can continue to lead major indexes higher all contributed to the re-awakening of stock market volatility in the first quarter of 2018. While this resurgence in volatility after a nearly two year hiatus has shaken investors' conviction in the aging stock bull market, we believe that a long overdo and much needed correction in stocks is underway.

- After one of the best January price gains on record, the S&P 500 finished the quarter with back to back monthly declines for the first time since early 2016. There were eleven days of declines of 1% or more in the first quarter. Rising investor pessimism on the longer-term outlook for stocks has occurred despite the fact that corporate earnings are expected to rise 17% on a year over year basis ending March 31st while global economic growth has been strong, inflation has remained low, and inflation expectations have declined.

- All but one equity asset class fell during the quarter with Real Estate Investment Trusts (REITs) declining the most (See Page 5) as bond yields crept higher across the maturity spectrum. REITs tend to be a bond proxy and are subject to the same price struggles as bonds when yields rise. Only Emerging Market stocks posted gains during the quarter thanks to firmer commodity prices, a falling dollar, low inflation, and easy monetary policy. Gold rose for the quarter thanks to the rise in stock market volatility and the decline in the dollar.

- Within U.S. Large Cap markets, the first quarter was the worst quarter for U.S. stocks since 2015, as only the Technology and Consumer Discretionary sectors generated positive returns (See Page 5). Investors continued to focus on companies and sectors that benefit from stronger economic growth in the late stages of the business cycle. Telecom and Consumer Staples led the decliners.

BOND PERFORMANCE SUMMARY

- Bond investors began the year pricing in the possibility that tax reform might boost economic growth and inflation. U.S. Treasury yields rose across the curve (maturity spectrum) during the quarter with long maturities (10 and 30 years) peaking in late February while shorter maturities (2 and 5 years) peaked in late March as the Fed raised interest rates 0.25% at its March 21st meeting. In addition to rising Treasury yields, credit spreads widened resulting in negative returns for all U.S. fixed income asset classes.

- The yield curve (10 year –2 year maturities) continued to flatten during the quarter finishing at +47 basis points. Although frequently a warning sign of future economic weakness, the primary reason for the flattening this year is because short-term rate expectations have risen due to improving economic data while strong pension fund and foreign central bank demand has kept longer maturity yields well-anchored (prices higher and yields lower).

- Municipal bonds also fell victim to the broad sell-off in the entire bond market during the quarter. Demand for municipal bonds remained strong while existing supply and new issuance were low. Although long-term credit concerns such as underfunded pensions remain a source of angst, we expect market pricing to firm due to a continuation of this demand/supply imbalance.

CONTRIBUTORS & DETRACTORS TO PERFORMANCE

- Performance contributors versus the benchmark index during the quarter included our allocations to Emerging Market stocks, Gold, and U.S. Small Cap stocks.

- Detractors to performance during the quarter included our outside of benchmark index allocation to REITs, our overweight to investment grade corporate bonds, and our bond portfolio duration that is a 1/4 year longer than the benchmark index.

GLOBAL MARKETS & ECONOMY

- Even after a shaky quarter that resulted in an historically large surge in price volatility, most stock indexes remain higher by double digit percentages over the past twelve months (See Page 5). Economists' outlooks remain mostly positive. The U.S. and global economies are expected to continue growing throughout the year with help from the $1.5 trillion tax-cut package that is expected to boost corporate earnings and stock prices.

- Despite President Trump's sharp rhetoric and bluster, we don't believe an all-out trade war with China or any other country will occur. It would be highly irrational and globalization is too deeply entrenched between the U.S. and its trading partners, especially China. President Trump values the job he's doing by the performance of the stock market. Since investors don't like protectionism, every time the stock market sells-off, Trump has toned down his protectionist trade tweets.

- As for inflation, the price index for annual personal-consumption expenditures, the Fed's preferred inflation measure, ticked up to 1.6% for February on a year over year basis. It remains short of the Fed's target of 2%. The most recent inflation data showed a loss in momentum. The Labor Department said on March 13th that the consumer-price index rose 2.2% year over year in February, below the 2.3% estimated by economists. Core prices rose 1.8% for a third consecutive month which was also below economists' expectations.

- The Fed raised its benchmark interest rate to 1.50% - 1.75% at the March FOMC (Federal Open Market Committee) meeting making it the first tightening of the year and sixth rate increase in the current economic cycle. The FOMC reiterated its projection for two more rate hikes in 2018. Fed Chair Powell downplayed inflation concerns saying, "there is no sense in the data we are on the cusp of accelerating inflation." He made the following comment on US wages: "we have seen only modest increases in wages because productivity has been low, inflation has been low."

GLOBAL MARKETS & ECONOMY

- Although inflation is a lagging indicator, we believe the Fed should wait until it sees clearer evidence that weak inflation will move higher before it continues raising interest rates. Otherwise, the Fed runs the risk of making a policy mistake and tightening so aggressively that it slows the economy and causes a sell-off in both risk-based assets and bonds. That is not our base case view, but is a potential risk that we will be closely watching for this year.

- Bond yields across the maturity spectrum rose to four year highs during the quarter. We believe there are several things that should limit a rise in bond yields in the near future. Demand will remain strong/prices high and yields low thanks to the need for income and portfolio stability by rapidly aging populations in Japan, Europe, and the U.S. Inflation remains in check due to globalization and technological advances. The Fed will continue raising interest rates at a very "gradual" and well-telegraphed pace expecting to move two more times this year in 25 basis point increments. Pension fund managers are rebalancing funds by shifting money to bonds after strong stock market performance for most of the past eight years. There is an abundance of global savings that needs to find a home and will not/can not all go to stocks. In times of volatility, uncertainty, and elevated geopolitical risks, U.S. Treasuries continue to be viewed as a safe haven asset. Yields on U.S. government bonds are already some of the highest in the sovereign debt markets and are attractive to non-U.S. buyers on an absolute and relative basis.

- Although not unquestionably attractive at current yield levels, bonds still provide a stable source of income and act as a low-risk diversifier in balanced, asset allocation portfolios. Bond yields should not rise/prices decline in a significant and lasting way until inflation turns markedly higher.

PORTFOLIO STRATEGY & OUTLOOK

- We believe the bull market in stocks is still very much intact. Entering 2018, in technical terms, stocks had been very overbought on a trend and momentum basis while positive sentiment had been sky high making the markets very vulnerable to a short-term correction. We believe this correction began in early February and may continue to play out in the second quarter. It's the fifth stock market correction since 2009. Corrections are necessary course adjustments that keep stock prices on a broader upward trajectory.

- Global financial conditions remain easy and the Federal Reserve has gone to great lengths to telegraph their intentions to gradually raise interest rates. Bond yields are still very low in absolute terms. Corporate profits and revenue are rising and earnings per share estimates for U.S. Large Cap companies are expected to meet or exceed a 20% rate of growth in 2018. Global Leading Economic Indicators are rising and the world is experiencing a period of synchronized economic growth. Tax reform and government spending are likely to provide a boost to the U.S. economy, thereby extending the current business cycle by another year or two.

- Historically, stock bear markets and recessions almost always overlap. In other words, stocks rarely enter a bear market without an economic recession. Stock price declines typically lead a recession by six months. Based upon our analysis of global economic fundamentals and recession indicators, the global economy is nowhere near a recession. Interest rates are rising from a historically low base and are not restrictive. Fiscal policy is easy thanks to tax cuts and new government spending plans. Our outlook for the financial markets in 2018 remains unchanged. Stocks will outperform bonds and cash, although volatility will continue to be elevated after remaining at historic lows for all of last year.

PORTFOLIO STRATEGY & OUTLOOK

- Portfolios currently remain equal-weight to the strategic target for risk-based assets which should outperform bonds and cash in a pro-growth, late business cycle stage. We continue to favor international developed stocks over U.S. stocks based upon cheaper valuations, easier monetary policy conditions, and earlier stages of economic recovery for Europe and Japan than the U.S. We continue to be neutral on emerging markets stocks as China's economy may be slowing. In terms of stock sectors, Industrials, Financials, and Energy typically perform well in the later stages of the business cycle.

- Our municipal bond market purchases will be focused in the intermediate to long end of the yield curve (7-30 year maturities) where relative value is most attractive. Issuer credit quality is becoming more and more important and will continue to shift our investment direction away from state and local general obligation, tax-backed bonds to more revenue sector bonds with dedicated income streams. By focusing on revenue sector bonds, we can largely remove pension system funding concerns and invest in essential services such as water and sewer- backed debt. Opportunities also exist in strong health care, higher education and select transportation bonds.

- We will continue to favor investment-grade U.S. corporate bonds and mortgage-backed securities over government bonds and keep portfolio duration near, but slightly longer than benchmark index duration. The yield curve flattening is likely to continue as we near the end of the current business cycle and approach an economic slowdown and perhaps a mild recession in the later half of 2019 or early 2020.

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Asset Class Total Rate of Return Performance Summary as of 3/31/2018

Stock Indices	Asset Class	YTD Return	1 Year Return
MSCI AC World Daily TR N	Global Equities	-0.96%	14.85%
S&P 500 INDEX	U.S. Large Cap Equities	-0.76%	13.98%
S&P 400 MIDCAP INDEX	U.S. Mid Cap Equities	-0.77%	10.96%
RUSSELL 2000 INDEX	U.S. Small Cap Equities	-0.08%	11.79%
MSCI EAFE	International Developed Market Equities	-1.41%	15.35%
MSCI EM	Emerging Market Equities	1.38%	25.31%
FTSE E/N All Eqty ReitTR	Real Estate (REITs)	-6.66%	-1.09%
U.S. Large Cap Sector Stock Indices			
S&P 500 ENERGY INDEX	U.S. Large Cap Equities - Energy Sector	-5.88%	-0.16%
S&P 500 HEALTH CARE IDX	U.S. Large Cap Equities - Health Care Sector	-1.22%	11.27%
S&P 500 CONS DISCRET IDX	U.S. Large Cap Equities - Consumer Discretionary Sector	3.08%	16.89%
S&P 500 CONS STAPLES IDX	U.S. Large Cap Equities - Consumer Staples Sector	-7.12%	-0.90%
S&P 500 INFO TECH INDEX	U.S. Large Cap Equities - Information Technology Sector	3.53%	27.68%
S&P 500 UTILITIES INDEX	U.S. Large Cap Equities - Utilities Sector	-3.30%	1.89%
S&P 500 INDUSTRIALS IDX	U.S. Large Cap Equities - Industrials Sector	-1.56%	13.93%
S&P 500 TELECOM SERV IDX	U.S. Large Cap Equities - Telecom Sector	-7.48%	-4.86%
S&P 500 MATERIALS INDEX	U.S. Large Cap Equities - Materials Sector	-5.52%	10.54%
S&P 500 FINANCIALS INDEX	U.S. Large Cap Equities - Financials Sector	-0.95%	17.99%
S&P 500 REAL ESTATE IDX	U.S. Large Cap Equities - Real Estate Sector	-5.02%	1.69%
Commodities Indices			
ISHARES GOLD TRUST	Gold	1.76%	6.00%
S&P GSCI Tot Return Indx	Broad Commodities	2.19%	13.83%
Bond Indices			
U.S. Aggregate	Core Bonds	-1.46%	1.20%
US Intermediate Gov/Cred	Intermediate Government & Corporate Bonds	-0.98%	0.35%
US Corp High Yield	High Yield Debt	-0.86%	3.78%
U.S. Treasury	U.S. Treasuries	-1.18%	0.43%
US Agency	U.S. Government Agencies	-0.53%	0.75%
U.S. MBS	Mortgage-Backed Securities	-1.19%	0.77%
U.S. Intermediate Credit	Corporate Debt	-1.36%	1.10%
Municipal Bond	Municipal Debt	-1.11%	2.66%

Notes: The DT Investment Partners' Commentary and Outlook discusses general developments, financial events in the news and broad investment principles. It is provided for information purposes only. The material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. I investments in various asset classes entail different investment risks. For example, small cap stocks tend to be more volatile than large or mid-cap stocks. International and emerging markets stocks have exposure to currency fluctuations, foreign taxes, political instability and the possibility for illiquid markets. Fixed income investments involve interest rate and credit risks among others. Real estate investing includes risks such as declines in value of real estate, changing economic conditions, tax laws or property taxes. Commodities' investing is highly volatile and subject to changing economic conditions and the vagaries of speculators among other risks. One cannot invest directly in an index. Past performance does not guarantee future results.