From Inflation Fears To Deflation Worry, The Fed Goes On Hold And Financial Asset Prices Soar

DT INVESTMENT PARTNERS

First Quarter 2019 Financial Markets Commentary

April 1, 2019

RISK-BASED ASSETS PERFORMANCE SUMMARY

- In the first quarter, stocks rebounded from their fourth quarter 2018 slump following the Fed's announcement at its January 30th meeting that it will be "patient" on any future interest-rate moves. This announcement represented a substantial pivot away from its December 2018 bias towards raising interest rates. Although slowing global economic growth and uncertainty about trade policy with China and Britain's split from the European Union remained, the Fed's pause in raising interest rates lifted confidence in growth-oriented assets.

- All major stock market indexes rallied in the first quarter despite a slowing global economy, particularly in China and Europe. Declining inflation expectations and concerns that the U.S. economy may not be able to remain immune from weakening global growth abroad resulted in the Fed indicating that they are finished raising interest rates this year and may be done with their monetary policy tightening campaign that began more than 3 years ago. U.S. crude oil prices rose 29% to their highest level since November of last year.

- All Risk-Based asset classes generated positive returns with U.S. stocks (Large Cap, Mid Cap, and Small Cap) outperforming International Developed and Emerging Market stocks. The S&P 500 Index (U.S. Large Cap stocks) had its strongest first quarter since 1998 (See page 5), helped in part by news and hopes of a potential trade deal ending tensions between China and the U.S.

- All primary sectors of the S&P 500 index finished in positive territory for the quarter thanks to the Fed indicating that the monetary policy tightening cycle may be over. Fast growing Technology sector stocks along with sectors tied to economic cycles such as Industrials, Energy and Consumer Discretionary led the way along with the Real Estate sector (See page 5). Real Estate rallied into quarter-end thanks to the relative attractiveness of its dividend yield when bond yields fall.

BOND PERFORMANCE SUMMARY

- U.S. Treasury securities rallied across the yield curve (maturity spectrum) due to growing anxiety about the health of the world economy and amid investor bets that a Fed interest-rate cutting cycle is coming. The yield on the 10 year maturity U.S. Treasury Note, used as a reference point on mortgages and student debt, declined from 2.68% at the start of the year to 2.42%. Investment Grade Corporate Bonds generated the highest total returns for the quarter thanks to significant spread tightening after a difficult year in 2018 (See page 5).

- Performance in the Municipal bond market for the first quarter continued to be driven by a (reduced) supply and (increased) demand imbalance. While supply is not far off historic norms, demand skyrocketed during the quarter driving municipal bond performance to its best quarter since 2014.

CONTRIBUTORS & DETRACTORS TO PERFORMANCE

- Performance contributors versus the Global Stock/Intermediate Maturity U.S. Bond blended benchmark index during the quarter included our overweight allocations to U.S. Large Cap stocks, U.S. Mid Cap stocks, Investment Grade Corporate bonds, and Municipal bonds. In addition, our outside-of-benchmark allocation to Mortgage-Backed Securities contributed to performance versus the benchmark index.

- Detractors to performance versus the Global Stock/Intermediate Maturity U.S. Bond blended benchmark index included our underweight allocation to risk-based assets, specifically International Developed stocks, our taxable bond duration shorter than bond benchmark index duration, and our overweight to Bonds and Cash.

GLOBAL MARKETS & ECONOMY

- The quarter/year began with worries about slowing global economic growth, fear that the U.S. Federal Reserve would tighten monetary policy too much, and concern about steep U.S. tariffs on China. The financial markets then rallied after the Fed backtracked, trade talks with China appeared to be making progress, and economic growth fears moved from recession to just a slowdown. As the quarter came to an end, stock price gains followed Fed monetary policy and went on hold while U.S. Treasury prices climbed/yields fell as concerns over global economic growth re-emerged.

- Bond market investors expect that the Fed is done raising rates and increasingly expect officials could lower them. As we neared quarter-end, for a few days the yield on 3 month maturity Treasury Bills was higher than the yield on 10 year maturity U.S. Treasury Notes. This marked the first time the yield curve had inverted since 2007. Historically, such inversions have tended to precede major economic slowdowns by 12 months. However, the labor market is solid with the rate of unemployment at the lows of the past 50 years. When people have jobs they make money. When they are making money, they are spending money by consuming goods and services which leads to economic growth. On the last day of the quarter, the yield on the 10 year maturity U.S. Treasury Note moved higher than the yield on the 3 month U.S. Treasury Bill (2.42% vs. 2.39%).

- In our view, the recent yield curve inversion is not the result of an imminent economic recession. Instead, it's the result of negative bond yields in Europe and Japan, the Fed's complete reversal in monetary policy, and structural forces keeping inflation low. One-fifth of global investment grade bonds (approx. $10 trillion), have negative yields. This phenomena places downward pressure on U.S. bond yields because of the interconnectedness of global financial markets and investment flows. The Fed's declaration at its March 20th policy meeting that there would be no more rate hikes this year led investors to begin pricing in a rate cut before year-end.

GLOBAL MARKETS & ECONOMY

- Structural forces such as technological change, globalization, population aging, an abundance of global savings, and the diminished role of labor unions are keeping long-term inflation expectations and bond yields well anchored while the Fed has raised short rates by 250 basis points over the past 3 years.

- The quarter ended with stocks recouping most of their late 2018 losses. Going forward, we do not expect a recession because of historically low unemployment, low inflation, solid, although lower corporate earnings, an accommodative Fed, sturdy bank balance sheets, and supportive financial conditions.

- The next move higher in global stock prices will likely require some combination of a rebound in global economic growth, a weaker U.S. dollar, and lower interest rates. China's economic slump since 2018 may be ending as economic growth appears to be stabilizing. Chinese bank loans are accelerating while the government is increasing fiscal stimulus which should lead to a rebound in China's economy later this year. A clear resolution to trade policy with the U.S. would also be highly supportive to the Chinese economy.

- A weaker U.S. dollar would help to stimulate the U.S. economy and stock market by increasing U.S. export growth which in turn, helps boost corporate profits and economic growth. A Fed that is no longer raising rates and perhaps even cutting them would reduce borrowing costs and encourage more corporate spending.

- A rebound in global economic growth, a weaker U.S. dollar, and lower interest rates would all serve as catalysts for stronger corporate earnings. This in turn would help prolong the earnings cycle and could push stock prices higher. In the meantime, financial markets are likely to trade sideways to slightly lower until such catalysts materialize.

PORTFOLIO STRATEGY & OUTLOOK

- Our base case outlook remains that U.S. economic growth will continue, but at a slower pace than in 2018. Inflation will stay low and corporate earnings will fall from all-time highs, but continue to grow at mid-to-high single digit rates. At its January 30th policy meeting, the Federal Reserve left interest rates unchanged, said it will be "patient" on any future interest-rate moves, and signaled flexibility on the path for reducing its balance sheet. At its March 20th policy meeting, the Fed once again left interest rates alone and surprised financial markets by reversing its rate outlook from 2 interest rate increases this year to no rate increases.

- Since December of 2015, the Fed has raised interest rates on the premise that falling unemployment would eventually generate stronger price pressures. However, that has not been the case as the Fed's preferred inflation measure, the U.S. Core Personal Consumption Expenditures Index (currently 1.8%), has remained below 2% for the past 7 years. Chairman Powell noted in his press conference following the March meeting that "It's one of the major challenges of our time, to have downward pressure on inflation, globally." As a result, the Fed indicated that they are unlikely to raise interest rates this year and may be finished with this monetary policy tightening cycle since U.S. economic growth is now slowing. Inflation fears have given way to deflation worries.

- The Fed's new policy stance represents a more dovish approach to future monetary policy actions and is bullish for stock prices. We believe the Fed's next move will be to embark on a series of interest rate cuts as concerns grow over global deflation. For now, we remain cautious and await signs of a firming in global economic growth and corporate earnings along with a resolution to trade policy negotiations between the U.S. and China before increasing our allocation to risk-based assets. We continue to be underweight to the strategic target for risk-based assets and overweight bonds and cash.

PORTFOLIO STRATEGY & OUTLOOK

- In terms of specific asset classes, International Developed and Emerging Market stocks look more attractive than U.S. stocks based upon cheaper relative valuations. The slowdown in global economic growth has already been reflected in current pricing. If global growth accelerates later this year and the U.S. dollar weakens, international stocks could greatly benefit. We'll continue to be neutral on International Developed and Emerging Market stocks until China's government embarks upon significant policy stimulus and a trade resolution is reached with the U.S.

- 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 will not rise/prices decline in a significant and lasting way until inflation turns markedly higher. It may be very difficult for inflation to rise because of the previously mentioned structural forces that are at work and the fact that the U.S. economy is in the late stages of a business cycle and appears to be slowing along with the global economy. The bull market in bonds is not over.

- We will continue to favor U.S. Investment Grade Corporate bonds and Mortgage-Backed Securities over Government bonds and keep portfolio duration near benchmark index duration (4 years). We expect the Municipal bond market to cool off from its brisk spread tightening (higher prices) pace in the first quarter and more closely track moves in U.S. Treasury prices.

- Historically, stock bear markets and recessions almost always overlap. In other words, stocks rarely enter a bear market without a recession. The surprise for the year may be that the widely talked about and much anticipated recession is not nearly as imminent.

Andrew Zimmerman, Chief Investment Strategist

Asset Class Total Rate of Return Performance Summary as of 3/31/2019

Stock Indices	Asset Class	QTD Return	1 Year Return
MSCI AC World Daily TR N	Global Equities	12.18%	2.60%
S&P 500 INDEX	U.S. Large Cap Equities	13.65%	9.48%
S&P 400 MIDCAP INDEX	U.S. Mid Cap Equities	14.49%	2.58%
RUSSELL 2000 INDEX	U.S. Small Cap Equities	14.57%	2.01%
MSCI EAFE	International Developed Market Equities	10.15%	-3.20%
MSCI EM	Emerging Market Equities	9.90%	-7.11%
FTSE E/N All Eqty ReitTR	Real Estate (REITs)	17.17%	20.46%
U.S. Large Cap Sector Stock Indices			
S&P 500 ENERGY INDEX	U.S. Large Cap Equities - Energy Sector	16.43%	1.32%
S&P 500 HEALTH CARE IDX	U.S. Large Cap Equities - Health Care Sector	6.59%	14.89%
S&P 500 CONS DISCRET IDX	U.S. Large Cap Equities - Consumer Discretionary Sector	15.73%	13.19%
S&P 500 CONS STAPLES IDX	U.S. Large Cap Equities - Consumer Staples Sector	12.01%	10.48%
S&P 500 INFO TECH INDEX	U.S. Large Cap Equities - Information Technology Sector	19.86%	15.44%
S&P 500 UTILITIES INDEX	U.S. Large Cap Equities - Utilities Sector	10.84%	19.33%
S&P 500 INDUSTRIALS IDX	U.S. Large Cap Equities - Industrials Sector	17.20%	3.20%
S&P 500 COMM SVC	U.S. Large Cap Equities - Telecom Sector	13.98%	7.69%
S&P 500 MATERIALS INDEX	U.S. Large Cap Equities - Materials Sector	10.30%	-0.43%
S&P 500 FINANCIALS INDEX	U.S. Large Cap Equities - Financials Sector	8.56%	-4.68%
S&P 500 REAL ESTATE IDX	U.S. Large Cap Equities - Real Estate Sector	17.53%	20.99%
Commodities Indices			
ISHARES GOLD TRUST	Gold	0.73%	-2.75%
S&P GSCI Tot Return Indx	Broad Commodities	14.97%	-3.04%
Bond Indices			
U.S. Aggregate	Core Bonds	2.94%	4.48%
Intermediate	Intermediate Government & Corporate Bonds	2.32%	4.24%
U.S. Corporate High Yield	High Yield Debt	7.26%	5.93%
U.S. Treasury	U.S. Treasuries	2.11%	4.22%
U.S. TIPS	U.S. TIPs	3.19%	2.70%
U.S. Agency	U.S. Government Agencies	1.81%	3.73%
U.S. MBS	Mortgage-Backed Securities	2.17%	4.42%
Intermediate	Corporate Debt	3.55%	5.00%
Municipal Bond Index	Municipal Debt	2.90%	5.38%

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.