DT INVESTMENT PARTNERS

Second Quarter 2016 Financial Market Commentary

July, 2016

The Bulls and the Bears are Mutually Frustrated

The rebound in stock prices that began near the end of the first quarter continued for much of the second quarter until the June 23rd Brexit (the British exit from the European Union) vote. In the two trading days following the vote, stocks sold off swiftly, but then rallied back to close the quarter slightly higher than where they stood the day before the vote.

Since the start of the year, U.S. stocks have seen a double-digit decline followed by a double-digit recovery. The S&P 500 index has rallied since bottoming in mid-February and closed the second quarter within 32 points of its all-time high. Political and financial confusion from the Brexit vote combined with uneven global economic growth, mixed corporate earnings, and uncertainty regarding the timing and magnitude of future Federal Reserve interest rate increases has left most global financial markets searching for a direction while mutually frustrating both the bulls and the bears.

Commodities, REITs, and High Yield bonds were the top performing asset classes during the second quarter. U.S. stocks, Preferred stocks, and Emerging Markets stocks all generated positive returns while International developed market stocks was the only risk-based asset class to have a negative return for the quarter and year-to-date ending 6/30/16 **(See Table #1)**. This asset class was led lower by European equities, particularly U.K. stocks. Japanese stocks also declined.

The rebound in most risk-based assets occurred during the quarter despite the fact that the fears gripping investors early in the year have not gone away. Global economic growth is still sluggish while corporate earnings are moving in the wrong direction and valuations remain above historical averages. However, with interest rates around the globe at such low levels while approximately 45% of the world's sovereign debt market has negative yields, investors view stocks as a better relative value to bonds and cash.

All primary bond sectors were higher for the quarter led by Investment Grade Corporate bonds and U.S. Treasuries. **(See Table #2).** Defying previous expectations for multiple Federal Reserve interest rate increases this year, long-term U.S. Treasury yields have drifted lower since the beginning of the year. Following the Brexit vote, yields have reached historic lows as central banks around the world signaled a readiness to act should the Brexit vote roil global financial markets. Fed funds futures indicate the Federal Reserve is more likely to cut interest rates than raise them this year. In fact, traders have pushed back bets on U.S. rate increases, indicating higher borrowing costs are unlikely before 2018.

Due to the drop in bond yields and interest rates during the first half of this year, defensive stocks with relatively attractive dividend yields like utilities, REITs, and consumer staples have been rallying in price. In addition, the rebound in commodity prices ranging from oil to iron ore has helped the prices of high yield bonds and given investors hope that the worst may be behind us. As a result, energy and basic materials have joined the most defensive sectors in leading the market higher in 2016.

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TABLE #1: 2016 1st Quarter and 1 Year Ending June 30th - Asset Class Index Total Returns*

	Large Cap Stocks	Mid-Cap Stocks	Small Cap Stocks	Int'l Stocks	Emerging Stocks	Intermediate Bonds	High Yield Bonds	Real Estate (REITs)	Preferred Stocks	Commodities	Cash
2Q 2016	2.45%	3.98%	3.78%	-1.20%	0.76%	1.57%	5.62%	7.41%	3.43%	12.67%	0.07%
YTD 6/30/16	3.79%	7.89%	2.17%	-4.05%	6.47%	4.05%	8.78%	13.68%	5.09%	9.86%	0.15%
1YR 6/30/16	3.98%	1.33%	-6.74%	-9.64%	-11.75%	4.29%	1.29%	23.62%	10.61%	-26.08%	0.19%

*Source: Bloomberg and Bank of America/Merrill Lynch Indices

TABLE #2: 2016 1st Quarter and 1 Year Ending June 30th – Bond Sector Index Total Returns*

	U.S. Treasuries 1-10yr	U.S. Agencies 1-10yr	Corporate Bonds 1-10yr	Mortgage-Backed Securities (MBS) 0-10yr	Municipal Bonds 1-10yr
2Q 2016	1.24%	0.75%	2.28%	1.12%	1.17%
YTD 6/30/16	3.59%	2.28%	5.16%	3.09%	2.30%
1 YR 6/30/16	3.97%	2.52%	5.16%	4.38%	4.22%

*Source: Bloomberg and Bank of America/Merrill Lynch Indices

During the quarter we completed two tactical moves across asset allocation strategy accounts. First, in May we re-established an allocation to Gold by buying IAU (IShares Gold Trust). The purchase was funded from cash and brought all accounts to an equal-weight to the strategic target for Gold. It appears that Quantitative Easing and Negative Interest Rate Policy have reached the limit of what they can do to stimulate demand. The longer the European and Japanese economies are mired in deflation, the more likely their central banks will begin active money-printing to monetize government deficits and /or to transfer cash directly to households. Active money-printing should lead to higher inflation in the Euro area and Japan while causing the euro and yen to weaken versus the U.S. dollar. Although we don't believe that the U.S. economy will need active money-printing, a strengthening U.S. dollar relative to the euro and yen will greatly curtail the ability of the Fed to raise interest rates. Active-money printing by Europe and Japan should help to inflate their stock markets and lead to further gains in gold.

Our second tactical move during the quarter happened in early June and involved the elimination of all direct exposure to European stocks by selling IEV (IShares Europe ETF). Proceeds from the sale were invested in cash. While at the time, we didn't think the U.K. would leave the EU, the odds had risen significantly in the week prior to the June 23rd vote. We did not want to underestimate public will given the magnitude of anti-political establishment views currently sweeping across the developed world. With no real way to assess the likelihood that Britain would indeed leave the EU, from a risk management perspective we felt it was prudent to eliminate all direct exposure to European stocks.

To the surprise of most investors around the globe including ourselves, on June 23rd the U.K. did indeed vote 52% to 48% in favor of leaving the European Union (EU) after more than four decades in a stunning rejection of the continent's postwar political and economic order. Prime Minister David Cameron resigned, stating that he would serve another 3 months until his replacement is elected. Financial markets around the globe responded with stocks selling-off while bonds and gold rallied in price in the two days following the vote. Markets then rebounded to close the quarter with price levels on U.S. stocks at higher levels than the day before the vote.

The result of the vote is important for a number of reasons, but none more than the fact that global economic growth has been fragile since the Great Recession of 2008. The Brexit vote is a confidence shock to global economic growth. The U.K. voted for an exit without having a clear exit plan and now faces a period of long and drawn-out divorce talks with the EU. Under EU laws, the highly-negotiated process of withdrawal has up to 2 years to be completed. **The level of uncertainty and volatility in financial markets will likely remain elevated for quite some time.** Fortunately, global central banks and monetary authorities stand ready to maintain and if need be, increase liquidity in the financial system. **We believe the Fed will continue to hold off on raising interest rates, perhaps for the remainder of this year and much of next.**

Brexit is not a done deal. If the people who voted to "Leave" begin to have buyer's remorse, they may rethink their decision and public opinion polls could cause the British government to hold a second referendum. Regardless, there is optimism that policymakers are committed to limiting the fallout from the U.K.'s withdrawal from the EU. It's too early to tell if an economic recession in the U.K. can be avoided or if Brexit can lead to another crisis in the EU. Many investors now expect major central banks to act to counter a potential drag on the global economy with some predicting rate cuts from the Bank of England and further stimulus from the European Central Bank.

Even with such an uncertain economic and political backdrop, we continue to believe that stocks will outperform bonds and cash this year. However, the recent divergence between bonds (prices rising/yields falling) and stocks (prices rising) deserves close examination. Bouts of volatility will likely continue until there is more clarity on Brexit and global economic conditions and corporate earnings improve. Until such time, we will remain defensively positioned and wait for further strengthening in global economic fundamentals and confirmation from our proprietary technical analysis model before moving to an overweight position in risk-based assets.

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