Second Quarter 2017 Financial Markets Commentary and Outlook

The Inflation (or Lack Thereof) Watch is On

Second Quarter 2017 Recap and Outlook

- Stocks around the world have spent most of the year climbing and government bond yields have stayed ultralow. For the fourth straight quarter stocks rose to all-time highs as corporate earnings continued to strengthen, the global economy grew, and inflation and interest rates remained low. Bond prices also rose thanks to falling inflation expectations and investor realization that ***the timing and extent to which the Trump administration will be able to follow through on some of its campaign promises such as healthcare reform, deregulation, immigration restriction, infrastructure spending, and tax cuts is still very much in question.***

- Within U.S. markets, Healthcare stocks led the way higher during the quarter followed by Industrials, Utilities, and Technology as investor focus turned toward companies and sectors that benefit from stronger economic growth and low interest rates **(See Page 3).** The Energy sector was the worst performer for the quarter as oil prices entered a bear market on June 20th. Investor bets that global exporters could ease a supply glut through a historic agreement to cut output have been undermined as production has increased in the U.S., Libya and Nigeria.

- In terms of broad asset classes, International Developed Markets stocks led the way thanks to the continued weakening of the U.S. dollar strengthening the Euro which lowers the cost of U.S. goods and services. At its June policy meeting, the European Central Bank (ECB) cut its inflation outlook because of weaker energy costs while raising its forecasts for economic growth. They were followed higher by U.S. Large Cap stocks which remain in a sweet spot thanks to a lack of inflation which keeps long-term interest rates low while the economy is slowly growing and corporate profits have been rising.

- Bond prices rose during the quarter led by Municipals, Mortgage-Backed Securities, and intermediate and long-dated maturity U.S. Treasuries as traders grew concerned that the economy is slowing and fear that the Fed may raise interest rates by more than the global economy can withstand. **(See Page 4).**

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Second Quarter 2017 Recap and Outlook – Performance Summary

Total Rate of Return % as of 6/30/2017

Security Name	U.S. Stocks	QTD Return %	YTD Return %	1 Year Return %
SPDR S&P 500 ETF TRUST	Large Cap Equities - S&P 500	3.07	9.17	17.78
ISHARES RUSSELL 1000 ETF	Large Cap Equities - Russell 1000	3.06	9.15	17.95
ISHARES CORE S&P MIDCAP ETF	U.S. Mid Cap	1.95	5.91	18.32
ISHARES CORE S&P SMALL-CAP E	U.S. Small Cap	1.67	2.60	22.24
ISHARES COHEN & STEERS REIT	Real Estate	2.14	3.07	(2.87)
ISHARES US PREFERRED STOCK E	Preferred Stock	2.67	7.86	3.92
SPDR BBG BARC HIGH YIELD BND	High Yield Debt	2.24	4.58	10.69
	U.S. Large Cap Sectors			
ENERGY SELECT SECTOR SPDR	Energy Sector	(6.50)	(12.70)	(2.55)
CONSUMER STAPLES SPDR	Consumer Staples Sector	1.44	7.64	2.30
UTILITIES SELECT SECTOR SPDR	Utilities Sector	2.08	8.66	2.40
HEALTH CARE SELECT SECTOR	Healthcare Sector	6.98	15.82	12.27
FINANCIAL SELECT SECTOR SPDR	Financial Sector	4.36	6.90	35.18
TECHNOLOGY SELECT SECT SPDR	Technology Sector	3.06	14.05	28.26
CONSUMER DISCRETIONARY SELT	Consumer Discretionary Sector	2.22	10.78	16.65
INDUSTRIAL SELECT SECT SPDR	Industrial Sector	5.18	10.48	24.16
MATERIALS SELECT SECTOR SPDR	Materials Sector	3.15	9.12	18.41
SPDR S&P TELECOM ETF	Telecom Sector	(0.01)	2.66	23.59
	International and EM Stocks			
VANGUARD FTSE DEVELOPED ETF	International Equities	6.37	14.85	20.23
ISHARES EUROPE ETF	Euro 350 (IEV)	7.88	16.33	20.38
ISHARES MSCI JAPAN ETF	Japanese Equities (EWJ)	4.85	10.51	18.76
VANGUARD FTSE EMERGING MARKE	Emerging Markets Equities	3.44	15.03	18.84

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Second Quarter 2017 Recap and Outlook – Performance Summary

Total Rate of Return % as of 6/30/2017

Security Name	Fixed Income	QTD Return %	YTD Return %	1 Year Return %
ISHARES CORE U.S. AGGREGATE	Core Fixed Income	1.58	2.40	(0.41)
ISHARES 3-7 YEAR TREASURY BO	Treasuries	0.79	1.45	(1.68)
ISHARES AGENCY BOND ETF	Agency Debt	0.95	1.58	(0.34)
ISHARES INTERMEDIATE CREDIT	Corporate Debt	1.38	2.54	1.10
ISHARES MBS ETF	Mortgage-Backed Securities	0.84	1.43	(0.28)
SPDR DOUBLELINE TR TACT ETF	Mortgage-Backed Securities	1.47	3.01	1.76
ISHARES NATIONAL MUNI BOND E	Municipal Bonds	1.65	2.78	(1.18)
SPDR BBG BARC INTL TREASURY	Int'l Sovereign Debt	3.72	6.35	(3.30)
POWERSHARES EM MKT SOVR DEBT	Emerging Markets Debt	1.99	6.25	4.04
	Commodities			
POWERSHARES DB COMMODITY IND	Commodities	(5.00)	(8.78)	(5.86)
UNITED STATES OIL FUND LP	Oil	(10.71)	(18.94)	(17.89)
ISHARES GOLD TRUST	Gold	(0.58)	7.76	(6.43)
	Benchmark Indices			
MSCI AC World Daily TR N	Global Stocks	4.27	11.48	18.78
US Intermediate Gov/Cred	U.S. Intermediate Term Taxable Bonds	0.94	1.73	(0.21)
Muni 1-10Y Blend Idx Val	Municipal Bonds (1-10 year)	1.39	2.96	0.16

Sources: Bloomberg and Bank of America/Merrill Lynch

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- Municipal bonds continued their strong year with another positive quarter. The strong performance was largely attributable to supply and demand dynamics as well as an overall shift in rates across markets. While rates have largely backed up heading into quarter end, we expect supply and demand dynamics to continue to support the market in the near term. From a credit perspective, the two biggest issues currently are the State of Illinois and public pensions. During the quarter, Illinois was downgraded to the lowest possible investment grade rating and remains on negative watch with an S&P/Moody's credit rating of BBB-/Baa3. Regarding pensions, imbalances continue to grow across the country in the public sector where promises made years ago are becoming increasingly more difficult to deliver on. We continue to emphasize quality and balance that should continue to set us up for success in an increasingly volatile municipal credit market going forward.

- Contributors to performance versus the benchmark index during the quarter included our overweight to Municipal bonds, Mortgage-Backed Securities, and Investment Grade Corporate bonds, as well as our ½ year longer bond duration than the benchmark index.

- Detractors to performance versus the benchmark index during the quarter included our underweight to International Developed Market stocks, our over-weight to U.S. Mid Cap and U.S. Small Cap stocks and our outside-of-benchmark index allocation to REITs, Preferred stocks, and High Yield bonds. While all these asset classes generated positive returns during the quarter, they trailed the returns of U.S. Large Cap and International Developed Market stocks. Historically, International Developed Market stocks have generated much lower risk-adjusted returns than all these asset classes. Therefore, International Developed Market stocks have a lower target allocation in each of our investment strategies than U.S. Large Cap and Mid Cap stocks.

- This year's stock market rally has boosted price valuations near the highest levels in the past 13 years. Many investors believe the true test will come once multiple central banks pare back their stimulus efforts. The Federal Reserve has raised interest rates twice so far in 2017 and forecast in its policy meeting earlier this month plans to boost rates again by year-end. The Fed also is about to embark on the unwinding of its $4.5 trillion, balance-sheet debt, which has helped push investors into risk-based assets by keeping bond prices high/yields low. European Central Bank President Mario Draghi hinted on June 27th that the ECB could also begin to dismantle its stimulus efforts before 2018.

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- We continue to believe that structural challenges such as aging demographics, high debt levels, budget deficits, and the abundance of global savings will significantly limit the pace and magnitude of interest rate increases over the next few years. It is our view that Fed interest rate increases will be very gradual and limited because of economic weakness in Europe, Japan, and China, reduced investment demand relative to desired savings, and most importantly, a continuation of low actual inflation and low inflation expectations.

- Low inflation has persisted throughout the global economy for years. It has run below the Fed's 2% target almost continuously for the past 5 years and shows little sign of rising. Recently, consumer price inflation excluding food and energy slipped to 1.7% in May. The Fed's favorite measure of inflation, the Personal Consumption Expenditure Core Price Index, is growing year-over-year at just 1.4%.

- Despite growing concerns over weak inflation, the Fed at its June 14th Federal Open Market Committee meeting raised the overnight Fed Funds rate for the third time in 6 months, maintained their outlook for one more hike in 2017 and set out some details for how they intend to reduce their $4.5 trillion balance sheet. In its statement at the conclusion of the meeting, the Fed said "Near-term risks to the economic outlook appear roughly balanced, but the committee is monitoring inflation developments closely." In addition, "the committee currently expects to begin implementing a balance sheet normalization program this year, provided that the economy evolves broadly as anticipated." The Fed also forecast 3 more quarter-point (0.25%) interest rate increases in 2018. It is important to note that the Fed has a history in recent years of forecasting more rate increases than it ends up enacting.

- Fed Chairwoman Janet Yellen reiterated that the Fed still believes falling unemployment should push inflation higher via rising wages. However, with the unemployment rate (4.3%) at a 16 year low and the current economic expansion being the third longest on record, wage growth still remains low at 2.5-3% over the past year. Meanwhile, Japanese unemployment is the lowest in decades and labor shortages are widespread. Yet wage growth is near 0%. Germany has the tightest labor market in the past 20 years, but pay gains are under 2%.

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- Although employers are having trouble finding workers, they are unable to pay more to attract workers because it is difficult for them to raise prices and worker productivity growth has averaged only 0.6% over the past 5 years. Corporations are facing stiffer competition from technological breakthroughs, globalization, and reduced demand from slowly-growing and rapidly aging populations. As a result, their ability to raise prices is very limited and so they are focusing on managing costs. In order for wage growth to accelerate at a sustainable pace, either prices, productivity, or both have to grow much faster than their current pace.

- The longer inflation remains low, the more skeptical investors will be that it's going to arrive, making it more difficult for the Fed to keep raising interest rates. Already, we're seeing signs of that as fed funds futures are currently forecasting only a 44% chance the Fed lifts rates again in 2017.

- Besides concerns over the potential for higher rates of inflation, the Fed's is also worried about easy-money policies fueling a seemingly endless rally in risk-based assets and the lack of ammunition it has to lower interest rates the next time the economy weakens.

- During the ECB's June meeting President Mario Draghi said the euro region still isn't generating enough inflation. "The economic expansion has yet to translate into stronger inflation dynamics. So far, measures of underlying inflation continue to remain subdued. Therefore, a very substantial degree of monetary accommodation is still needed." "We need to be patient," Draghi said. "We need to continue to accompany the recovery with our monetary policy."

- The Fed is currently in a difficult spot. It is trying to normalize interest rate policies at a time of mediocre economic growth while fellow central bankers in Europe and Japan are maintaining ultra-easy monetary policies. ***What the Fed needs to validate its moves is inflation which is proving to be very elusive.***

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- Bond traders are worried that the Fed may be on a path to making a policy error which could harm the nation's prospects for growth. The yield on the 10-year Treasury note fell 2.13% on June 14th, its lowest closing level since November of last year. The difference between 2-year and 10-year Treasury yields, which tends to shrink when the outlook for growth and inflation are lower, has been doing just that during the quarter falling from 1.26% at the start of the year to 0.93% at quarter-end.

Summary

During the second quarter no changes were made to our investment strategies' tactical allocations. We are investing very close to the strategic targets for all broad asset classes in each of our asset allocation strategies. The reason for doing such is that the economy is slowly growing, corporate earnings are strengthening, unemployment is low and inflation is tame. The Fed is gradually re-normalizing monetary policy. There are no significant economic imbalances. We believe the current economy is as close to a normal functioning economy as it has been in the last 20 years. Although no broad asset class is particularly cheap right now, with the exception of commodities, we still believe that stocks will continue to outperform bonds and cash for the remainder of this year thanks to all of the previously mentioned factors which favor a pro-growth investment stance. At some point in the next 12-24 months we may be facing a very mild economic recession at which time we will move to a more defensive position. For now we are very comfortable leaning on our proprietary optimization process and our analysis of the current economic fundamentals to keep all asset allocation weightings close to their respective strategic targets.

Andrew Zimmerman – Chief Investment Strategist

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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.