A Tough Market Environment For Bulls and Bears Alike

DT
INVESTMENT
PARTNERS

Second Quarter 2018 Financial Markets Commentary

July 2, 2018

RISK-BASED ASSETS PERFORMANCE SUMMARY

- U.S. stocks managed to overcome fears of a global trade war, rising interest rates, the sustainability of the European Union, and the potential for Fed policy mistakes to generate respectable, positive returns in the second quarter. The resurgence in volatility that began in early February after a nearly two year hiatus continued throughout the quarter and has bent, but not broken investors' conviction in the aging bull market.

- All broad market U.S. stock indices were higher during the quarter led by Small Cap stocks thanks to a stronger U.S. dollar and a rosy outlook for U.S. economic growth alongside expectations that smaller companies, which get less of their revenue from abroad, would be shielded from trade wars. After performing the worst during the first quarter, Real Estate (REITs) rebounded as the second best performing risk-based asset class in the second quarter thanks to a flattening yield curve for bonds. REITs are viewed as a bond proxy so when intermediate to long maturity bond yields fall, REITs look more attractive on a relative and absolute basis (See Page 6).

- Emerging Markets stocks were the worst performer followed by International Developed Markets stocks due to a stronger U.S. dollar, rising interest rates, softer economic growth in Europe, Japan, and China combined with trade tensions with the U.S. Gold also declined, despite rising geopolitical uncertainty, thanks to the strengthening U.S. dollar and higher interest rates (See Page 6).

- Within U.S. Large Cap markets, the Energy sector led the way as oil prices rose above $70. It was followed by the Consumer Discretionary and Technology sectors as investors continued to focus on companies and sectors that benefit from stronger economic growth in the late stages of the business cycle. Industrials led the decliners over fears that global trading relations are becoming increasingly fractured. They were followed lower by Financial stocks due to a flattening yield curve (See Page 6).

BOND PERFORMANCE SUMMARY

- The yield on the 10 year U.S. Treasury note rose for the fourth straight quarter, briefly topping 3% before concerns about escalating trade tensions and slower global growth drove investors to the relative safety of government bonds. For the quarter, yields finished slightly higher across the maturity spectrum of the curve. Yields of shorter maturity bonds (3 months-3 years) rose more than longer maturities (7-30 years) as the Fed raised rates for the second time this year in June and signaled two more increases in 2018, followed by three in 2019. In addition to rising Treasury yields, investment grade credit spreads widened due to fewer foreign buyers, rate volatility, and trade tensions resulting in flat to marginally positive returns for most bond sectors (See Page 6).

- The yield curve (10 year –2 year maturities) continued to flatten during the quarter finishing at +33 basis points (0.33%). Although frequently a warning sign of future economic weakness, the flattening of the curve this year can be attributed to expectations for higher short-term interest rates due to improving economic data while longer maturity yields have been anchored thanks to flight-to-quality demand from trade tensions.

- Municipal bonds outperformed all other traditional fixed income asset classes for the second quarter as the market continued to benefit from a supply and demand imbalance. Elevated demand and limited supply caused municipal rates to remain depressed relative to taxable fixed income bonds yields.

CONTRIBUTORS & DETRACTORS TO PERFORMANCE

- Performance contributors versus the benchmark index during the quarter included our overweight allocations to U.S. Small and Mid Cap stocks and REITs. In addition, our underweight to International Developed Market stocks helped relative performance. Detractors to performance versus the benchmark during the quarter included our outside of benchmark index allocation to High Yield bonds and Gold along with our underweight in U.S. Large Cap stocks.

GLOBAL MARKETS & ECONOMY

- Although the U.S. economy is growing above trend and corporate earnings have been strong, we are starting to see fundamental warning signs that need to be respected. In Europe, both hard and soft economic indicators are under pressure. China's central bank recently announced a relaxation of reserve requirements for banks aimed at strengthening economic activity.

- Many investors still believe that a global trade war is avoidable and that current tensions are part of a negotiating process that could lead to fairer trade. However, the level of uncertainty and risk of mistakes has recently risen. It's difficult to assess the odds of a full-blown trade war given President Trump's negotiating strategy that utilizes sharp rhetoric and bluster. If it were to occur, most likely the U.S. dollar and U.S. Treasury prices would rally as investors became more risk averse and business uncertainty increased. We don't believe an all-out trade war with China or any other country will happen. It would be highly irrational and globalization is too deeply entrenched between the U.S. and its trading partners, especially China. There are no winners in a trade war, only losers. 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 tweets.

- Over the past year, the yield curve (difference between 10 year and 2 year U.S. Treasury Notes) has continued to flatten (shrink). When the spread between long rates and short rates declines, it becomes more difficult for banks to make money by taking in short-term deposits and paying lower rates and lending them longer for more profitable spreads. While not negative, the yield differential continues to decline and currently stands at positive 33 basis points (0.33%). The economy has never escaped a recession when this spread turns negative. One thing that's different this time in regards to a flattening yield curve is that yields of longer maturity (7-30 years) bonds have been kept lower since the Great Recession in 2008 thanks to trillions of dollars of central bank purchases while the Fed has been raising short-term rates, making a yield curve flattening inevitable.

GLOBAL MARKETS & ECONOMY

- While not yet restricting economic growth, monetary policy is becoming less accommodative. The Fed has stopped expanding its balance sheet and is on a clear path of raising rates. At its June 13th Federal Open Market Committee meeting, the Fed raised interest rates for the second time this year and upgraded its forecast to four total rate increases in 2018 from three. The Fed indicated that even though they are stepping up their pace of interest rate hikes, economic growth should continue above trend and they expect further gradual increases consistent with the sustained expansion of economic growth, strong labor market conditions, and inflation remaining at or near their 2% target objective.

- The Fed is now very close to achieving its dual Congressional mandate of full employment and low, stable inflation. However, they felt the need to lift their 2018 outlook to four rate hikes from three while maintaining their forecast for three rate hikes in 2019. In past economic cycles, the Fed would justify these preemptive moves by saying they were trying to engineer a soft landing. In our view, the danger in this set of actions, when circumstances don't warrant tightening, is pushing short-term rates higher while long rates remain stable. This is the equivalent of a self-induced flattening of the yield curve and the potential for a subsequent self-imposed recession. We believe that globalization, technological advancement, and demographic changes mean a low-unemployment economy may not face the same price pressures (inflation) that occurred in the 1960s when the unemployment rate was as low as it is today.

- We continue to believe that the pace and magnitude of the rise in bond yields will be limited. Demand for bonds should remain strong due to rapidly aging populations in Japan, Europe, and the U.S. that need income and portfolio stability. Inflation should remain in check thanks to globalization and technological advances. There is an abundance of global savings that needs to

- find a home and will not/can not all go to stocks. U.S. Treasuries provide a safe haven benefit in times of volatility, uncertainty, and elevated geopolitical risks. 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. Lastly, and perhaps most importantly, we believe the Fed will continue to be very gradual in raising interest rates because they have been very successful so far in achieving their dual mandate of full employment and price stability. The U.S. is currently experiencing trend-like economic growth, stable inflation, and low unemployment which should all reduce the need for the Fed to increase its pace of monetary policy tightening.

PORTFOLIO STRATEGY & OUTLOOK

- We are now in the longest running stock bull market in this country's history and our focus has turned to the bull market's longevity and sustainability. The reason for our concern at this point is not that we think the world is on the precipice of disaster, but that we are entering a time of growing downside risks which is typical in the latter stages of the business cycle. This is usually the time when unemployment falls, inflation heats up, and the Fed raises rates to cool the economy down, often going too far and leading investors and consumers to pull back.

- Potential risk factors that could lead to the next economic slowdown and possible recession include escalating trade conflicts with China and Europe, higher inflation leading the Fed to accelerate its pace of interest rate increases, higher oil prices, federal government budget battles, and populist uprisings in Europe. Global economic growth is no longer synchronized. With the exception of the U.S., many of the developed economies in Europe have hit a lull. Corporate earnings growth may have peaked in the first quarter at 25%, as most analysts expect 19% earnings growth in the second quarter.

PORTFOLIO STRATEGY & OUTLOOK

- Absent a global trade war, which we believe is still very unlikely, an economic recession in the U.S. does not appear to be imminent. Although the yield curve has been flattening (its still positively sloped at 33 basis points), we believe the flattening has been more a result of a flight-to-quality bid for longer maturity bonds thanks to protectionist rhetoric and other geopolitical risks i.e. North Korea, Brexit, Italy. Institutional pension fund demand for longer maturity bonds has been strong, keeping longer maturity yields lower/prices higher due to portfolio rebalancing needs. Furthermore, global central banks have been buying longer maturity bonds since the Great Recession of 2008 to keep long rates lower, while the Fed has been gradually raising short rates over the past 3 years.

- In addition to the flattening yield curve, other recession indicators we routinely review include the U.S. Leading Economic Indicators Index, which has been steadily rising since June of 2016. The state of the U.S. business cycle is strong as evidenced by the ISM Manufacturing index at 58.7 (>50 is considered to be expansionary). U.S. financial conditions as measured by several indices are still considered to be fairly accommodative.

- The current market environment is very difficult to navigate. If you trim risk too early, then you may miss the last big bull market run before a recession hits. If you wait too long to reduce risk, then you may bear the brunt of the initial steep decline. Nearly every asset class we cover is overvalued compared to historical averages. When making tactical moves, one of the factors we analyze is asset class valuation. Undervalued asset classes can be over-weighted in an attempt to capture relative performance as valuations normalize. Historically, valuation is not the best indicator to rely on in isolation when making tactical moves, but it definitely has merits during periods of economic transition.

- Given the high degree of uncertainty related to global trade tensions, along with the aforementioned growing downside risks, a few weeks ago we felt it was prudent to reduce exposure to risk-based assets. This was primarily accomplished by moving from an overweight to an equal-weight position versus the strategic target in international developed market stocks. We continue to evaluate the risks that surround us and make necessary changes as circumstances warrant. Our investment process focuses on the benefits of asset class diversification, which typically brings lower volatility. Striking the balance between risk and return is critical.

- In times like these we look to the fundamentals of the economy, which say it's too early to call an end to the bull market in stocks. Thanks to easy fiscal policy from tax reform and the promise of government infrastructure spending along with very gradual monetary policy tightening by the Fed, we do not believe a material slowdown in the U.S. economy will develop until at least late next year. While volatility may increase, risk should still win over the next 12-18 months. Historically, stock bear markets and recessions almost always overlap. In other words, stocks rarely enter a bear market without an economic recession.

- Our current tactical positioning reflects all of these factors. We are slightly underweight risk-based assets and particularly asset classes with the richest valuations (i.e. real estate and high yield debt). We are slightly overweight fixed income and cash. Given the ongoing flattening in the U.S. Treasury yield curve, the risk reward tradeoff for holding a longer portfolio duration than the benchmark index has become much less compelling and with confirmation from our technical analysis model, we decided it was prudent to reduce bond portfolio durations below the benchmark index (<4 years) during the quarter.

- Municipal bond purchases continue to be focused in the intermediate to long end of the yield curve where relative value is most attractive. Fundamentally, municipal credit remains relatively strong. Although long-term credit concerns such as underfunded pensions remain a source of angst, we expect market pricing to remain firm.

Andrew Zimmerman, Chief Investment Strategist
DT Investment Partners, LLC

Asset Class Total Rate of Return Performance Summary as of 6/30/2018

Stock Indices	Asset Class	2Q Return	YTD Return	1 Year Return
MSCI AC World Daily TR N	Global Equities	0.53%	-0.43%	10.73%
S&P 500 INDEX	U.S. Large Cap Equities	3.43%	2.65%	14.36%
S&P 400 MIDCAP INDEX	U.S. Mid Cap Equities	4.29%	3.49%	13.49%
RUSSELL 2000 INDEX	U.S. Small Cap Equities	7.75%	7.67%	17.56%
MSCI EAFE	International Developed Market Equities	-1.06%	-2.40%	7.40%
MSCI EM	Emerging Market Equities	-7.90%	-6.60%	8.53%
FTSE E/N All Eqty ReitTR	Real Estate (REITs)	8.50%	1.27%	4.93%
U.S. Large Cap Sector Stock Indices				
S&P 500 ENERGY INDEX	U.S. Large Cap Equities - Energy Sector	13.48%	6.81%	20.99%
S&P 500 HEALTH CARE IDX	U.S. Large Cap Equities - Health Care Sector	3.09%	1.83%	7.11%
S&P 500 CONS DISCRET IDX	U.S. Large Cap Equities - Consumer Discretionary Sector	8.17%	11.50%	23.53%
S&P 500 CONS STAPLES IDX	U.S. Large Cap Equities - Consumer Staples Sector	-1.54%	-8.55%	-3.93%
S&P 500 INFO TECH INDEX	U.S. Large Cap Equities - Information Technology Sector	7.09%	10.87%	31.30%
S&P 500 UTILITIES INDEX	U.S. Large Cap Equities - Utilities Sector	3.74%	0.32%	3.41%
S&P 500 INDUSTRIALS IDX	U.S. Large Cap Equities - Industrials Sector	-3.18%	-4.69%	5.32%
S&P 500 TELECOM SERV IDX	U.S. Large Cap Equities - Telecom Sector	-0.94%	-8.35%	1.39%
S&P 500 MATERIALS INDEX	U.S. Large Cap Equities - Materials Sector	2.58%	-3.08%	9.90%
S&P 500 FINANCIALS INDEX	U.S. Large Cap Equities - Financials Sector	-3.16%	-4.09%	9.61%
S&P 500 REAL ESTATE IDX	U.S. Large Cap Equities - Real Estate Sector	6.13%	0.81%	5.02%
Commodities Indices				
ISHARES GOLD TRUST	Gold	-5.58%	-3.92%	0.67%
S&P GSCI Tot Return Indx	Broad Commodities	8.00%	10.36%	30.04%
Bond Indices				
U.S. Aggregate	Core Bonds	-0.16%	-1.62%	-0.40%
US Intermediate Gov/Cred	Intermediate Government & Corporate Bonds	0.01%	-0.97%	-0.58%
US Corp High Yield	High Yield Debt	1.03%	0.16%	2.62%
U.S. Treasury	U.S. Treasuries	0.10%	-1.08%	-0.65%
US Agency	U.S. Government Agencies	0.00%	-0.53%	-0.14%
U.S. MBS	Mortgage-Backed Securities	0.24%	-0.95%	0.15%
U.S. Intermediate Credit	Corporate Debt	-0.08%	-1.45%	-0.36%
Municipal Bond	Municipal Debt	0.87%	-0.25%	1.56%

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.