Third Quarter 2017 Financial Markets Commentary and Outlook

Let the Good Times Roll

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Third Quarter 2017 Recap and Outlook

- In September, U.S. stocks faced numerous rally-threatening hurdles, from the Fed's decision to reduce its balance sheet to escalating tensions between the leaders of North Korea and the U.S. Even so, unflustered investors pushed the S&P 500 to its 39th record of the year. During the quarter, stocks surged to all-time highs thanks to the continuation of robust corporate earnings and accelerating global growth. The S&P 500 finished with its eighth straight quarterly gain and September, typically the worst performing month of the year, was the least volatile September in the past 66 years. Volatility remained low as this year marks the first time since 2005 that the S&P 500 Index hasn't had a 2% daily move up or down.

- In terms of broad asset classes, Emerging Markets stocks led the way **(See Page 3)** thanks to Asia-Pacific stocks, which rallied on solid earnings and positive risk sentiment despite geopolitical concerns between North Korea and the U.S. They were followed higher by International Developed Market stocks as European shares had their best performance month of the year in September. In addition, Japan's economy grew at its fastest pace in two years and is on its longest expansion streak in more than a decade, spurred by its central bank's easy monetary policy and the global economic recovery. U.S. Large Cap stocks also posted a solid quarter as they 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.

- Within U.S. markets, Technology stocks led the way higher during the quarter followed by Telecom, Energy, Materials, and Finance as investors continued to focus on companies and sectors that benefit from stronger economic growth and gradually rising interest rates **(See Page 3).** The Consumer Staples sector was the worst performer for the quarter as consumer stocks struggle with low U.S. wages, rising import prices, and consumer companies' limited ability to raise prices. Rising rates also diminish the dividend appeal of many consumer stocks.

Third Quarter 2017 Recap and Outlook – Performance Summary

Total Rate of Return % as of 9/30/2017

Index Name	Asset Class	QTD Return	YTD Return	1 Year Return
S&P 500 INDEX	U.S. Large Cap Equities	4.48%	14.24%	18.60%
DOW JONES INDUS. AVG	U.S. Large Cap Equities	5.58%	15.45%	25.45%
NASDAQ COMPOSITE INDEX	U.S. Large Cap Equities	6.07%	21.73%	23.79%
S&P 400 MIDCAP INDEX	U.S. Mid Cap Equities	3.22%	9.40%	17.51%
RUSSELL 2000 INDEX	U.S. Small Cap Equities	5.67%	10.93%	20.71%
MSCI EAFE	International Developed Market Equities	5.47%	20.47%	19.73%
MSCI EM	Emerging Market Equities	8.01%	28.08%	22.87%
MSCI AC World Daily TR N	Global Equities	5.18%	17.25%	18.65%
S&P 500 FINANCIALS INDEX	U.S. Large Cap Equities - Finance Sector	5.24%	12.48%	36.16%
S&P 500 INFO TECH INDEX	U.S. Large Cap Equities - Technology Sector	8.65%	27.36%	28.88%
S&P 500 ENERGY INDEX	U.S. Large Cap Equities - Energy Sector	6.84%	-6.63%	0.16%
S&P 500 HEALTH CARE IDX	U.S. Large Cap Equities - Health Care Sector	3.65%	20.31%	15.49%
S&P 500 CONS DISCRET IDX	U.S. Large Cap Equities - Consumer Discretionary Sector	0.84%	11.93%	14.52%
S&P 500 CONS STAPLES IDX	U.S. Large Cap Equities - Consumer Staples Sector	-1.35%	6.57%	4.42%
S&P 500 UTILITIES INDEX	U.S. Large Cap Equities - Utilities Sector	2.87%	11.87%	12.03%
S&P 500 INDUSTRIALS IDX	U.S. Large Cap Equities - Industrials Sector	4.22%	14.13%	22.34%
S&P 500 TELECOM SERV IDX	U.S. Large Cap Equities - Telecom Sector	6.78%	-4.69%	-0.14%
S&P 500 MATERIALS INDEX	U.S. Large Cap Equities - Materials Sector	6.05%	15.82%	21.26%
S&P 500 REAL ESTATE IDX	U.S. Large Cap Equities - Real Estate Sector	0.93%	7.39%	2.66%

Sources: Bloomberg and Bank of America/Merrill Lynch

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Total Rate of Return % as of 9/30/2017

Index Name	Asset Class	QTD Return	YTD Return	1 Year Return
FTSE E/N All Eqty ReitTR	Real Estate	1.11%	6.04%	2.57%
Fixed Rate Preferred Sec	Preferred Stock	1.27%	10.11%	5.91%
S&P GSCI Tot Return Indx	Commodities	7.22%	-3.76%	1.79%
ISHARES GOLD TRUST	Commodities	3.10%	11.10%	-2.99%
U.S. Aggregate	Core Bonds	0.85%	3.14%	0.07%
US Intermediate Gov/Cred	Intermediate Government & Corporate Bonds	0.60%	2.34%	0.23%
US Corp High Yield	High Yield Debt	1.98%	7.00%	8.88%
U.S. Treasury	U.S. Treasuries	0.38%	2.26%	-1.67%
US Agency	U.S. Government Agencies	0.41%	2.07%	0.07%
U.S. MBS	Mortgage-Backed Securities	0.96%	2.32%	0.30%
U.S. Intermediate Credit	Corporate Debt	0.99%	3.56%	1.58%
Municipal Bond	Municipal Debt	1.06%	4.66%	0.87%

Sources: Bloomberg and Bank of America/Merrill Lynch

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- All major bond market sectors finished the quarter with gains and the yield on the 10 year U.S. Treasury Note ended at nearly the same level that it began the quarter (2.33% vs. 2.31%). It spent the past six months averaging 2.25% as the economy has maintained a slow and steady pace and consumer prices showed few signs of gathering momentum.

- High Yield bonds led the way for the quarter followed closely by Municipals and Investment Grade Corporates **(See Page 4).** Appetite for credit risk remained strong with corporate spreads ending the quarter at a three year low. Issuance of Municipal bonds was 15% below last year's pace while demand remained strong.

- In early August we reduced exposure to U.S. Mid Cap stocks and used the sales proceeds to increase exposure to U.S. Large Cap stocks. These trades moved Mid Cap stock exposure to an under-weight position versus the strategic target, while moving U.S. Large Cap stocks to overweight versus the strategic target. The performance of Mid Cap stocks has been trailing that of Large Cap stocks on a YTD basis as the earnings growth of Mid Cap companies is beginning to stall, while valuations of Mid Cap stocks are extremely rich. Financial conditions may tighten in the U.S. later this year or early next if the Federal Reserve continues raising interest rates. Although we believe the speed and magnitude of interest rate increases will be minimal, Mid Cap stocks have historically underperformed Large Cap stocks at the beginning of a monetary policy tightening cycle.

- Contributors to performance versus the benchmark index during the quarter included our overweight to Corporate Bonds (Investment Grade and High Yield), our ½ year longer bond duration than the benchmark index, and our allocation to Gold.

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- Detractors to performance versus the benchmark index during the quarter included our underweight to International Developed Market stocks and our outside-of-benchmark index allocation to REITs and Preferred stocks. 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 than U.S. Large Cap and Mid Cap stocks in each of our investment strategies.

- Stock markets this year have shrugged off a long list of investor worries, from geopolitical concerns in North Korea, to policy failures in Washington, to weak inflation data. Nearly a year after the presidential election, a lack of volatility has settled over the stock market. The CBOE Volatility Index or VIX Index, an options-based measure that tends to rise and fall alongside expected swings in the stock market, has averaged 11.3 this year, on track for its lowest since the index launched in 1993. While there have been many reasons to expect a correction, there have also been important factors supporting the S&P 500's 14% rise this year. U.S. GDP grew 3.1% in the second quarter, the strongest in two years. S&P 500 earnings grew more than 10% in each of the year's first two quarters. Third quarter earnings are projected to show another period of solid growth. Global central banks have maintained easy monetary policies that have created loose financial conditions, and supported market risk-taking.

- At the September FOMC (Federal Open Market Committee) meeting, Chair Yellen affirmed that the U.S. economy appears strong enough to justify a third interest rate increase December of this year and three more next year. Even though the Fed has well telegraphed its next move over the past eight years, the September 20th announcement initially surprised bond investors who were assigning just a 25% chance of another rate hike this year.

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- Global financial conditions have been easing and economic growth in developed economies looks durable. This suggests that any market impact of higher interest rates may not materialize for several months. It will likely take a few more rate increases in the U.S. before costlier borrowing affects the economy or challenges the notion that there are few alternatives to owning stocks. Inflation and inflation expectations continue to remain low as evidenced by the Core Personal Consumption Expenditure Price Index (Fed's preferred consumer price gauge), which fell to 1.3% in August, a level well below the Fed's inflation target of 2%.

- As resilient as stocks have been, there has been a surprising lack of optimism as evidenced by mutual fund flows and investor sentiment. Approximately $23 billion moved out of U.S. stock funds in the third quarter, while $68 billion went into investment-grade corporate bond funds, according to Bank of America Merrill Lynch. According to the American Association of Individual Investor's sentiment survey for the week ended 9/27/18, only 33.3% of individual investors are bullish on stocks for the next six months. If Sir John Templeton's investment quote, "bull markets are born on pessimism, grown on skepticism, mature on optimism and die on euphoria," holds true, then this 8+ year bull market in stocks still has room to run.

- The typical factors that warn of a bear market or recession are not evident. Corporate earnings have been accelerating for the past three quarters, not decelerating. Global economic growth has been strengthening on a sustained basis, not weakening. Inflation and inflation expectations have remained low. Monetary policy from global central banks has been accommodative, not restrictive, and the yield curve is positively sloped.

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- In summary, this second longest running bull market in history can last as long as the Fed does not get much more aggressive in raising interest rates, actual inflation and inflation expectations remain low, and there is no big and sustained external shock to destroy investor confidence, i.e. geopolitical events. Tax reform Could be a potential boost to the stock market. However, the timing and extent to which it could be legislated is still very much in question. Investment positioning will be based upon enacted policies and not media speculation or political posturing. Our fundamental analysis, validated by our technical models, continues to indicate the global economy should remain in a reflationary sweet spot at least over the next 12 months. Therefore, we favor a pro-risk investment stance across all investment strategies and are happy to continue to let the good times roll.

Andrew Zimmerman – Chief Investment Strategist
October 4, 2017

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.