It’s Tough to Keep a Good U.S. Stock Market Down

Third Quarter 2018 Financial Markets Commentary

October 2, 2018

RISK-BASED ASSETS PERFORMANCE SUMMARY

- Despite ongoing U.S.-China trade tensions, a rout in emerging market stocks, fears of higher interest rates, and the potential for Fed policy mistakes, U.S stocks rose to all-time highs during the third quarter. Booming economic growth, a run of strong corporate profits, corporate tax reform, and record company stock buybacks have underpinned U.S. stock market advances. In late August, stocks entered the longest-running bull market in U.S. history following the worst financial crisis since the Great Depression in 2008.

- All broad market U.S. stock indices were higher during the quarter led by U.S. Large Cap stocks as economic data and earnings growth were solid across most industries. U.S. Mid Cap and Small Cap stocks were the second and third best performers for the quarter respectively, as many investors that were worried about trade disputes have bet on companies that have a larger share of domestic earnings and stand to receive a greater benefit from corporate tax reform (See Page 6).

- Gold was the worst performing asset class during the quarter as interest rates rose in the U.S. while inflation remained low. For the second consecutive quarter, Emerging Markets stocks declined due to softer economic growth in China, falling commodities' prices, and escalating trade tensions between the U.S. and China (See Page 6).

- All U.S. Large Cap sectors generated positive returns during the quarter as earnings growth rose 25% on average across a very broad array of businesses. Healthcare was the top performing sector followed by Industrials and Telecom companies. The Healthcare and Telecom sectors are somewhat insulated from trade disputes since a very large share of their earnings are derived from domestic customers while shares of Industrial companies rebounded during the quarter as investors bet that a strong economy would offset uncertainty from global trade policies. (See Page 6).

BOND PERFORMANCE SUMMARY

- The yield on the 10 year U.S. Treasury note rose for the fifth straight quarter, topping 3% due to growing optimism about the global economy and expectations for tighter monetary policy. Bond 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 third time this year in September and signaled one more increase in 2018, followed by three in 2019. Investment grade credit spreads tightened thanks to a robust U.S. economy and strong demand from foreign buyers. As a result, corporate bonds were the top-performing bond sector (See Page 6).

- The yield curve (10 year –2 year maturities) continued to flatten during the quarter finishing at +24 basis points (0.24%) reflecting the expanding U.S. economy and tightening monetary policy. Yields on 2 Year U.S. Treasury Notes reached their highest level in the past 10 years as investors began moving closer to the Fed's projected path of one more rate hike this year in December and three rate hikes next year.

- After outpacing all traditional fixed income asset classes last quarter, the municipal bond market took a step back and trailed all bond sectors except for the U.S. Treasury market for the third quarter. A combination of low redemptions (maturities) and higher supply largely fueled the sell-off.

CONTRIBUTORS & DETRACTORS TO PERFORMANCE

- Performance contributors versus the benchmark index during the quarter included our overweight allocations to U.S. Mid and Small Cap stocks and investment grade corporate bonds along with our underweight to International Developed Market stocks. Detractors to performance versus the benchmark included our outside of benchmark index allocation to Gold, our allocation to real estate (REITs), and our underweight in U.S. Large Cap stocks.

GLOBAL MARKETS & ECONOMY

- Desynchronization describes the state of the current global economy as the U.S. is outperforming the rest of the world. The U.S. economy is booming thanks to rising household spending and business investment, low interest rates, a tight labor market, strong corporate profit growth, and consumer and small business confidence hitting record highs.

- Economic growth in Japan has been solid compared to its recent history, while in Europe, both hard and soft economic indicators are under pressure. The Chinese economy has recently been struggling with trade tensions adding to a growth slowdown. The Chinese stock market is in bear market territory and industrial production, retail sales, and fixed asset investment all have fallen below consensus forecasts. China's economic surprise index remains in negative territory.

- Absent a nasty trade war, the U.S. economy should continue to lead world economic growth. Political uncertainty (Brexit & Italy) and structural challenges such as high debt levels and poor productivity growth in both Europe and the emerging markets, particularly China, may not go away for quite some time. As a result, the value of the dollar may remain elevated, at least until growth in the U.S. slows and/or the Fed pauses its rate increases.

- Early last week the Trump administration slapped tariffs on $200 billion in Chinese goods. China responded with tariffs of its own on $60 billion in U.S. products. The Chinese government also called off planned talks with U.S. officials on the basis that substantive discussions will only be possible after U.S. midterm elections in November. 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 risen. Tariffs have yet to have a meaningful impact upon the U.S. economy because of the small amounts that have so far been imposed. Trade tensions remain the biggest risk to the U.S. economy. We are closely monitoring the situation and may make investment adjustments as rhetoric becomes reality.

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 September 26th Federal Open Market Committee meeting, they raised interest rates for the third time this year and the eighth time since December 2015 when they began the current tightening cycle. The Fed reaffirmed its outlook for further rate hikes, calling for another one at the December meeting and three more next year, despite the lack of any pickup in inflation. Financial markets are pricing in four more rate increases followed by an extended pause.

- The Fed is now very close to achieving its dual Congressional mandate of full employment and low, stable inflation. The challenge for the Fed will be to avoid excessively raising interest rates next year as the fiscal stimulus from tax reform begins to diminish. 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 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.

PORTFOLIO STRATEGY & OUTLOOK

- During the quarter we rebalanced all portfolios to bring total risk-based asset exposure to slightly below the strategic target allocation. We are equal-weight U.S. Large Cap, Mid Cap, Small Cap, International Developed, and Emerging Markets stocks. We are also equal-weight Gold and underweight Real Estate and High Yield Debt due to their extremely rich valuations. We are slightly overweight fixed income and cash.

- Given the ongoing flattening in the U.S. Treasury yield curve and the Fed's tightening bias, the risk reward tradeoff for holding a longer portfolio duration than the benchmark index has become much less compelling. We have maintained bond portfolio durations slightly below the benchmark index (<4 years).

- 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.

- 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. We are hopeful that Fed Chair Jerome Powell will remain very pragmatic and orchestrate a soft economic landing. In other words, the Fed will stop raising interest rates on signs of a slowing economy.

PORTFOLIO STRATEGY & OUTLOOK

- Although the Fed's preferred inflation measure (Core Personal Consumption Expenditure Index) has finally reached their 2% annual target for the first time since 2012, we believe that inflation should remain in check thanks to globalization, technological advances, and aging demographics. While average hourly earnings rose 2.9% in August on a year-over-year basis, overall inflation has been holding steady at low levels.

- Absent a full-blown global trade war, 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 24 basis points. The U.S. Leading Economic Indicators Index 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 61.3 (>50 is considered to be expansionary). U.S. financial conditions as measured by several indices are still considered to be fairly accommodative. Oil prices are at a 4 year high. Corporate earnings are strong and bank balance sheets are well capitalized.

- The current market environment is very difficult to navigate. With the exception of International Developed and Emerging Markets stocks, nearly every asset class we cover is overvalued compared to historical averages. 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, we do not believe a material slowdown in the U.S. economy will develop until at least late next year. While volatility may increase with the upcoming midterm Congressional elections, risk-based assets should still perform well in the fourth quarter. Historically, stock bear markets and recessions almost always overlap. In other words, stocks rarely enter a bear market without a recession.

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Asset Class Total Rate of Return Performance Summary as of 9/30/2018

Stock Indices	Asset Class	QTD Return	YTD Return	1 Year Return
MSCI AC World Daily TR N	Global Equities	4.28%	3.83%	9.77%
S&P 500 INDEX	U.S. Large Cap Equities	7.71%	10.56%	17.90%
S&P 400 MIDCAP INDEX	U.S. Mid Cap Equities	3.86%	7.48%	14.19%
RUSSELL 2000 INDEX	U.S. Small Cap Equities	3.57%	11.51%	15.23%
MSCI EAFE	International Developed Market Equities	1.42%	-0.99%	3.26%
MSCI EM	Emerging Market Equities	-1.00%	-7.49%	-0.50%
FTSE E/N All Eqty ReitTR	Real Estate (REITs)	0.50%	1.78%	4.31%
U.S. Large Cap Sector Stock Indices				
S&P 500 ENERGY INDEX	U.S. Large Cap Equities - Energy Sector	0.61%	7.46%	13.94%
S&P 500 HEALTH CARE IDX	U.S. Large Cap Equities - Health Care Sector	14.53%	16.63%	18.35%
S&P 500 CONS DISCRET IDX	U.S. Large Cap Equities - Consumer Discretionary Sector	8.18%	20.62%	32.52%
S&P 500 CONS STAPLES IDX	U.S. Large Cap Equities - Consumer Staples Sector	5.69%	-3.35%	2.93%
S&P 500 INFO TECH INDEX	U.S. Large Cap Equities - Information Technology Sector	8.80%	20.62%	31.49%
S&P 500 UTILITIES INDEX	U.S. Large Cap Equities - Utilities Sector	2.39%	2.72%	2.93%
S&P 500 INDUSTRIALS IDX	U.S. Large Cap Equities - Industrials Sector	10.00%	4.84%	11.16%
S&P 500 COMM SVC	U.S. Large Cap Equities - Telecom Sector	9.94%	0.75%	4.39%
S&P 500 MATERIALS INDEX	U.S. Large Cap Equities - Materials Sector	0.36%	-2.73%	4.01%
S&P 500 FINANCIALS INDEX	U.S. Large Cap Equities - Financials Sector	4.36%	0.09%	8.69%
S&P 500 REAL ESTATE IDX	U.S. Large Cap Equities - Real Estate Sector	0.86%	1.67%	4.95%
Commodities Indices				
ISHARES GOLD TRUST	Gold	-4.91%	-8.63%	-7.15%
S&P GSCI Tot Return Indx	Broad Commodities	1.34%	11.84%	22.91%
Bond Indices				
U.S. Aggregate	Core Bonds	0.02%	-1.60%	-1.22%
US Intermediate Gov/Cred	Intermediate Government & Corporate Bonds	0.21%	-0.76%	-0.96%
US Corp High Yield	High Yield Debt	2.40%	2.57%	3.05%
U.S. Treasury	U.S. Treasuries	-0.59%	-1.67%	-1.62%
Global IL: US TIPS TR U	U.S. TIPs	-0.82%	-0.84%	0.41%
US Agency	U.S. Government Agencies	-0.01%	-0.54%	-0.56%
U.S. MBS	Mortgage-Backed Securities	-0.12%	-1.07%	-0.92%
U.S. Intermediate Credit	Corporate Debt	0.73%	-0.73%	-0.62%
Municipal Bond	Municipal Debt	-0.15%	-0.40%	0.35%

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.