A December Not to Remember

Will the Fed Pause?

Fourth Quarter 2018 Financial Markets Commentary
&
2019 Investment Outlook

January 3, 2019

RISK-BASED ASSETS PERFORMANCE SUMMARY

- In the fourth quarter, risk aversion ruled the day. Investor anxiety outweighed good U.S. economic data as all risk-based asset markets dropped around the globe. Jitters over the trade war with China, the U.K.'s exit from the European Union, heavy staff turnover in the White House, slowing global economic and earnings growth, and confusion regarding future Fed interest rate policy were the primary drivers of the surge in volatility and the drop in prices. Year-end tax loss selling and uncertainty from a government shutdown in the final trading week of the year may be the catalysts for the bottoming-out of the worst performance year in global stocks since 2008.

- The quarter/year-ended with the broad commodities sector along with Emerging Market, International Developed, and U.S. Small Cap stocks all in bear market territory as defined by a price decline of more than 20% from the 52 week high. The broad commodity index, and U.S. Small Cap stocks fell by the most during the quarter. An oil glut, slowing economic growth in China and Europe, tariff concerns, tightening monetary policy in the U.S., and a strengthening U.S. dollar helped contribute to the drawdown in these asset classes. Gold was by far the best performer due to volatile stock markets, a partial government shutdown, and concerns about the 2019 global economic outlook. All investment grade sectors of the U.S. bond market and cash generated positive returns during the quarter as investors reduced risk by indiscriminately selling stocks and reinvesting in bonds and cash. (See page 5).

- With the exception of Utilities, all primary sectors of the S&P 500 index finished in negative territory for the quarter. Energy led the decliners followed by Technology and Industrials as the oversupply of oil, fears of the impact of trade tariffs, and a slowdown in top line sales growth led to double-digit price declines. Utilities held up relatively well thanks to their defensive nature and the relative attractiveness of their dividend yields when bond yields fall. (See Page 5).

BOND PERFORMANCE SUMMARY

- After rising for five straight quarters, the yield on the 10 year maturity U.S. Treasury note fell over 30 basis points due to a dimming outlook for global growth and fears that the Fed is raising interest rates too quickly. Bond yields fell across the 2-30 year maturity spectrum. The yield curve (10 year –2 year maturities) continued to flatten during the quarter finishing at +19 basis points. The U.S. Treasury yield curve flattened because the Fed raised rates four times and short-term rate expectations rose for much of the year due to improving economic data. Meanwhile, strong foreign central bank and U.S. pension fund demand combined with weak inflation data, concerns over global growth, and trade tensions kept longer maturity yields well anchored.

- U.S. Treasuries were the top performing bond sector during the quarter followed by Mortgage-Backed Securities as investors reduced risk exposure by selling stocks and buying high quality investment grade bonds. Municipal bonds also posted a solid quarter thanks to flight-to-quality demand from the risk-off environment and reduced issuance (supply of municipal bonds). (See Page 5).

CONTRIBUTORS & DETRACTORS TO PERFORMANCE

- Performance contributors versus the benchmark index during the quarter included our allocations to asset classes not in the benchmark index such as Gold, Mortgage-Backed Securities, High Yield bonds, and Cash.

- Our allocation to U.S. Small Cap stocks, our overweight allocation to U.S. Mid Cap stocks, our underweight allocation to U.S. Treasuries, and our bond duration shorter than the benchmark index all detracted from performance during the quarter.

GLOBAL MARKETS & ECONOMY

- U.S. Large Cap stocks rose during the second and third quarters of 2018. However, as we entered the fourth quarter, it became apparent that a slowdown in economic growth was underway in Europe and China. Heated trade rhetoric between the U.S. and China intensified and fears that the Fed would go too far in raising interest rates all combined to send investors into risk-off sell mode resulting in a significant market correction.

- The R (recession) word emerged frequently throughout the quarter as solid U.S. economic growth, historically low unemployment, low inflation, strong corporate earnings, sturdy bank balance sheets, and supportive financial conditions gave way to speculative fears of a major economic slowdown in the world's largest economy. Recessions are not typically caused by the factors everyone is aware of and talking about; They are caused by the breakdown of foundational economic factors that are often overlooked or not a focal point by the majority of economic pundits and investors.

- As we begin 2019, investor conviction is very low across all risk-based markets. We believe that the current, extreme level of investor pessimism is not justified by economic reality. While financial conditions have tightened, U.S. economic growth is beginning to slow, and global growth has been weakening for the past few months, the risk of recession remains very low over the next year. A swift and steep stock market decline doesn't always mean a recession is imminent. Since 1929, there have been 20 bear markets in stocks, of which 11 have been followed by recessions. Our continued view is that solid economic fundamentals are still in place to keep the bull market in stocks intact, albeit with increased levels of volatility as we near the latter stages of the longest economic recovery in history.

- The two biggest risks to our economic and financial markets outlook are trade policy with China and monetary policy by the Fed. We are optimistic that trade tensions with China will be resolved this year.

GLOBAL MARKETS & ECONOMY

- President Trump has shown a historical pattern of taking an extreme position and then negotiating it towards a compromise. The revised NAFTA and European tariff negotiations are prime examples. Trump values the job he's doing by the performance of the stock market. Investors spoke loud and clear in the fourth quarter of 2018 about what they think of tariffs and protectionism.

- As for the Fed, the jury is still out on whether the four rate hikes in 2018 and future monetary policy will truly undermine the U.S. and global economy. In his December 19th press conference, Fed Chairman Powell acknowledged that financial conditions had tightened but stressed that the recent stock market turmoil is "a little bit of volatility." He stated that what matters most for the economy are material changes in financial conditions sustained for a period of time.

- By the time material changes in financial conditions have been sustained for a period of time, it may very well be too late for the Fed to orchestrate a soft economic landing. ***This most recent Fed meeting illustrates the current disconnect between forward-looking financial market price action and backward-looking, data dependent Fed policy. While financial markets' behavior and economic data often diverge, the stock and bond markets have a much better historical track record of forecasting economic slowdowns than the Fed.***

- U.S. economic growth should continue in 2019, but at a slower pace. Inflation will remain low and corporate earnings will fall from all-time highs, but should continue to grow in the mid to high single digits. We are hopeful that the Fed will be pragmatic, taking its cue from financial market behavior in addition to the economic data, and proceed with caution. We believe a long pause in rate increases is warranted as the Fed continues its journey into unchartered waters trying to re-normalize monetary policy that saw a 0% fed funds rate and unprecedented Fed bond buying following the financial crisis in 2008.

PORTFOLIO STRATEGY & OUTLOOK

- Bull market corrections are healthy and needed in order for stocks to consolidate and then move higher, especially at this advanced stage of the U.S. business and economic cycle. Fundamentally, the U.S. economy is strong. Everyone that wants a job can find one. When people have jobs they make money. When they are making money, they are spending money which leads to economic growth. We are aware that high degrees of uncertainty and deep and long-lasting stock market declines can make businesses and consumers reduce investment and spending. Although this correction in stock prices has been deep, we do not expect it to be long-lasting. In fact, total U.S. retail sales, excluding autos, rose 5.1% in November/December 2018 from a year earlier. Shoppers delivered the strongest holiday sales increase for retailers in six years. This data suggests the drop in stock prices hasn't dampened consumer confidence and spending.

- With every new year, we approach 2019 assessing whether it will be a green year for stocks (less volatile with a -1 standard deviation or better) or a red year (more volatile with a -2 or -3 standard deviation event). Our 2018 assessment of another green year was looking pretty good until the fourth quarter came along. After undergoing a swift market correction in nearly all risk-based assets, we believe 2019 will be a green year with volatility remaining elevated. After this correction, stocks look even more attractive relative to bonds as measured by earnings yield (% of each dollar invested in the stock that was earned by the company).

- We begin the year underweight to the strategic target for risk-based assets and overweight bonds and cash. We'll await more favorable price action signals from our proprietary technical analysis model before increasing exposure to risk-based assets and reducing cash and bonds. A quick resolution to the trade war with China and more dovish talk from the Fed, particularly FOMC (Federal Open Mouth Committee) members would certainly be huge positives for global economic growth and stock prices.

PORTFOLIO STRATEGY & OUTLOOK

- Structural forces such as technological change, globalization, population aging, and the diminished role of labor unions may be keeping long-term inflation expectations and bond yields well anchored. Although not unquestionably attractive at current yield levels, bonds still provide a stable source of income and act as a low-risk diversifier in balanced, asset allocation portfolios. Bond yields will not rise/prices decline in a significant and lasting way until inflation turns markedly higher. Given that the U.S. economy is in the late stages of a business cycle and appears to be slowing along with the global economy, the potential for higher yields may be limited.

- In terms of specific asset classes, International Developed Market stocks look more attractive than U.S. stocks based upon cheaper valuations and easier monetary policy conditions in Europe and Japan. The slowdown in global economic growth has already been reflected in current pricing. We'll continue to be neutral on Emerging Market stocks until China's government embarks upon significant monetary policy stimulus and a trade resolution is reached with the U.S. We will continue to favor U.S. Investment Grade Corporate bonds and Mortgage-Backed Securities over Government bonds and keep portfolio duration slightly shorter than benchmark index duration (4 years). Supply and demand imbalances should further propel the rally in Municipal bonds that we experienced in late 2018. The yield curve flattening is likely to continue until the Fed indicates a pause in interest rate increases. Historically, stock bear markets and recessions almost always overlap. In other words, stocks rarely enter a bear market without a recession. The surprise for the year may be that the widely talked about and much anticipated recession is not nearly as imminent.

Andrew Zimmerman, Chief Investment Strategist

Asset Class Total Rate of Return Performance Summary as of 12/31/2018

Stock Indices	Asset Class	4Q 2018 Return	2018 Return
MSCI AC World Daily TR N	Global Equities	-12.75%	-9.42%
S&P 500 INDEX	U.S. Large Cap Equities	-13.52%	-4.39%
S&P 400 MIDCAP INDEX	U.S. Mid Cap Equities	-17.28%	-11.10%
RUSSELL 2000 INDEX	U.S. Small Cap Equities	-20.21%	-11.03%
MSCI EAFE	International Developed Market Equities	-12.49%	-13.32%
MSCI EM	Emerging Market Equities	-7.60%	-14.49%
FTSE E/N All Eqty ReitTR	Real Estate (REITs)	-6.06%	-4.04%
U.S. Large Cap Sector Stock Indices			
S&P 500 ENERGY INDEX	U.S. Large Cap Equities - Energy Sector	-23.78%	-18.10%
S&P 500 HEALTH CARE IDX	U.S. Large Cap Equities - Health Care Sector	-8.72%	6.47%
S&P 500 CONS DISCRET IDX	U.S. Large Cap Equities - Consumer Discretionary Sector	-16.42%	0.82%
S&P 500 CONS STAPLES IDX	U.S. Large Cap Equities - Consumer Staples Sector	-5.22%	-8.39%
S&P 500 INFO TECH INDEX	U.S. Large Cap Equities - Information Technology Sector	-17.34%	-0.29%
S&P 500 UTILITIES INDEX	U.S. Large Cap Equities - Utilities Sector	1.36%	4.11%
S&P 500 INDUSTRIALS IDX	U.S. Large Cap Equities - Industrials Sector	-17.32%	-13.32%
S&P 500 COMM SVC	U.S. Large Cap Equities - Telecom Sector	-13.19%	-12.53%
S&P 500 MATERIALS INDEX	U.S. Large Cap Equities - Materials Sector	-12.31%	-14.70%
S&P 500 FINANCIALS INDEX	U.S. Large Cap Equities - Financials Sector	-13.12%	-13.04%
S&P 500 REAL ESTATE IDX	U.S. Large Cap Equities - Real Estate Sector	-3.84%	-2.23%
Commodities Indices			
ISHARES GOLD TRUST	Gold	7.52%	-1.76%
S&P GSCI Tot Return Indx	Broad Commodities	-22.94%	-13.82%
Bond Indices			
U.S. Aggregate	Core Bonds	1.64%	0.01%
Intermediate	Intermediate Government & Corporate Bonds	1.65%	0.88%
US Corp High Yield	High Yield Debt	-4.53%	-2.08%
U.S. Treasury	U.S. Treasuries	2.57%	0.86%
U.S. TIPS	U.S. TIPs	-0.42%	-1.26%
U.S. Agency	U.S. Government Agencies	1.90%	1.34%
U.S. MBS	Mortgage-Backed Securities	2.08%	0.99%
Intermediate	Corporate Debt	0.75%	0.01%
Municipal Bond Index	Municipal Debt	1.69%	1.28%

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.