DT INVESTMENT PARTNERS, LLC

# Q4 2021
# FINANCIAL MARKETS COMMENTARY

*The Fed Walks a Tightrope as Virus Uncertainty Persists*

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## RISK-BASED ASSETS PERFORMANCE SUMMARY

- U.S. Large Cap stocks once again led the way higher during the fourth quarter despite stubbornly high short-term inflation, the emergence of the Omicron variant, and the Fed accelerating its bond purchase tapering while projecting three interest rate increases for 2022. ***Hopes that the Fed can tame inflation without raising interest rates high enough to halt the economic recovery spurred investor buying*** in the largest and most transparent of the risk-based asset classes. The S&P 500 Index closed at record highs a whopping 70 times in 2021 – more than 25% of all trading days. Although the rise in Covid-19 cases has spurred concerns about economic growth, signs that vaccine boosters offer protection against the fast – spreading Omicron variant have allowed for investor optimism and hope that the pandemic is moving to an endemic (native) state.

- The U.S. economy is booming as consumers devour imports, which stresses global supply chains and pushes prices higher. Businesses and consumers continue spending despite high inflation, rising virus cases, supply constraints, and labor shortages. The Atlanta Fed's GDPNow model estimates fourth quarter U.S. GDP (economic growth) to be 7.2%. Economists are looking for U.S.  output to surpass pre-pandemic growth in early 2022.  Following the December 15th Fed meeting, Chair Powell said "we threw a lot of support at the economy and what's coming out now is really strong growth, really strong demand, high incomes and all that kind of thing."

- Investors sold Emerging Market stocks during the quarter in the midst of renewed lockdowns in Europe and business closures from Omicron. The Fed announced plans for the wind down of its monthly bond buying program and telegraphed the potential for interest rate increases next year. Higher rates can lead to a strengthening U.S. dollar at the expense of emerging market currencies (See Page 5).

- With the exception of Communication Services, all U.S. Large Cap sectors rose in price during the quarter led by Real Estate, Technology, and Materials on hopes that neither the virus nor the Fed will derail the U.S. economic recovery.

## BOND PERFORMANCE SUMMARY

- The U.S. Treasury yield curve flattened (2 year yields rose more than 10 year yields) during the quarter. The Fed began to reduce (taper) its monthly bond buying in November and announced its purchase program would end in March 2022. The Fed also signaled that the majority of officials expect three – 0.25% increases in the fed funds rate next year due to "inflation developments and the further improvement in the labor market."

- Despite a rise in 6 months – 7 year maturity bond yields during the quarter, U.S. Treasuries and Investment Grade Corporate Bonds were still able to generate positive total returns led by U.S. Inflation-Protected securities (TIPs). Municipal bonds finished in positive territory as strong investor demand continued, even as yields remain near historic lows (See Page 5). By not pushing up yields (selling bonds) at the long end (10-30 year maturities) of the yield curve, bond investors may be viewing the Fed's recently revised economic growth and inflation projections as too high/optimistic.

- Government Agency bonds and Mortgage-Backed Securities (MBS) generated flat to negative returns as concerns over slowing economic data and the continued lack of stability in the interest rate markets pressured prices in these spread sectors. MBS prepayment speeds have slowed as homeowner refinancing's declined.  Following the Fed's November meeting, investors anticipated more slowing in MBS prepayments in anticipation of the Fed raising rates sooner than many expected. As a result, the average life of MBS securities extended, locking owners of these bonds into lower yields for longer.

### CONTRIBUTORS & DETRACTORS TO PERFORMANCE

- Performance contributors for the fourth quarter versus the Global Stock/Intermediate Bond blended benchmark index  included our overweight allocation to U.S. Large Cap stocks and our outside-of-benchmark allocation to Gold. Our underweight to Emerging Market and International Developed Market stocks and our shorter bond duration than the benchmark also contributed to performance.

- Detractors to performance included our underweight allocation to U.S. Mid Cap stocks and our outside-of-benchmark allocation to U.S. Small Cap stocks.

- At its November 3rd meeting, the Fed announced the beginning of monthly bond purchase tapering, to be completed by June 2022. Following the December 15th meeting, Chair Powell said the Fed will accelerate the tapering of asset purchases to be finished in March 2022. When describing the current state of inflation, the Fed decided to retire the term "transitory." Chair Powell noted that the economy is very strong and inflationary pressures are high, and it was therefore appropriate in his view to finish the taper of asset purchases a few months sooner.

- After their September meeting. Fed officials were evenly split on the need for any interest rate increases in 2022, However, projections at the December meeting revealed a change in rate increase expectations. A majority of officials now expect three - 0.25% rate increases in 2022 after the completion of monthly bond purchase tapering, three more in 2023, and two in 2024.

- The Fed is clearly pivoting from an unprecedented level of accommodative monetary policy to a more hawkish (tighter) stance amid the emergence of the Omicron variant. It is too early to say what effect Omicron will have on the economy. Many economists believe its threat to economies will likely be less severe than the initial wave of Covid-19 in March 2020 and the Delta variant this summer because each new virus strain has had a reduced impact on the global economy.

- In the near term, financial markets will need to navigate the dual risks of another COVID variant and reduced monetary policy accommodation from the Fed due to inflation. The prices of goods and services this year certainly look very high when compared to last year's COVID-depressed levels. There is a multitude of reasons for recent higher inflation readings brought on by the global pandemic in March of 2020. In addition to the frequently mentioned supply chain disruptions, they include ultra-easy monetary policy, historically massive government-spending (stimulus) programs, increased demand for workers as economies re-opened, higher commodity (energy and raw materials) costs, consumer and business spending of accumulated savings from when the economy was shut down last year.

- We are still in the midst of a global pandemic as evidenced by the recent emergence of the Omicron variant. Severe supply-related dislocations are likely to continue well into 2022. Supply chain disruptions and shortages take time to play out. Recently, some have shown signs of easing. Purchasing managers' surveys in the U.S. and Europe have indicated that delivery times for firms ordering supplies have stopped getting longer while global shipping rates have peaked. The rate of vaccinations is much higher than earlier in the year, which will likely reduce the health risks posed by Omicron and governments are less likely to impose widespread shutdowns again. This should allow the manufacturing of goods to catch up with demand. Historically, periods of sharp declines of goods tends to result in overproduction, which eventually causes prices to fall.

- We do not believe that inflation primarily caused by a supply-side disruption, thanks to an exogenous shock (global pandemic) to the global economy, will be fixed by raising interest rates. The only way for the Fed to ease supply side-induced inflation would be to shrink the economy by reducing demand. This would surely have a negative impact upon the jobs market and would be counter to the Fed's dual mandate of promoting maximum employment and stable prices. Although the unemployment rate has quickly declined to 4.2% in November, it is still higher than its pre-pandemic low of 3.5%. Five million fewer people are employed now than if the pre-pandemic trend had persisted. ***The Fed will be walking a tightrope as it attempts to cool inflationary pressures without ending the economic recovery.***

- Inflation measures the rate of change in prices. In order for the rate of change to stay high, price levels would need to increase for a long period. Any stabilization in prices would cause the rate of inflation to decline. Additionally, we believe the macro headwinds to a sustainable uptick in inflation are too great. Aging demographics, declining fertility rates, massive global debt levels, rapid technological innovation, and a global savings glut make periods of deflation, rather than inflation, more likely once production catches up to demand.

# GLOBAL FINANCIAL MARKETS COMMENTARY & PORTFOLIO STRATEGY

- Despite the high level of uncertainty regarding the course of the newest COVID-19 variant and the Fed's shift to less monetary policy accommodation, stocks rallied into quarter-end on the belief that U.S. economic growth will continue accelerating, while the bar to raise interest rates is much higher than for tapering bond purchases.

- Going forward, financial market volatility is likely to remain elevated as investors focus on the Omicron variant and the government reaction. Market direction will likely depend upon further research into the virus. If Omicron turns out to be mild, or at least no worse than existing variants, investors can get back to focusing on inflation and the Fed's reduction of monetary policy stimulus.

- We still favor an overweight to risk-based assets. Stock markets have historically performed well in the early stages (6-12 months) of monetary policy tightening. The economic backdrop is still supportive for risk in the developed world. Leading Economic Indicators are suggesting that the economy will grow over the next 2-3 quarters. Fiscal stimulus from the recently passed government infrastructure spending program and the potential for the passage of some version of President Biden's Build Back Better program should be bullish for the U.S. economy.

- Financial conditions remain easy. Monetary policy should remain accommodative as the virus remains front and center, reducing the likelihood of a policy mistake that disrupts the recovery. Corporate earnings have been strong. Bond yields and interest rates are low. Stocks are much cheaper than bonds on an earnings yield basis. There is plenty of liquidity on the sidelines as evidenced by the $4.64 trillion currently invested in money market funds. These funds are currently earning next to nothing and represent a potential buying source for stocks and bonds.

- We are overweight U.S. Large Cap stocks. The stability and higher quality of U.S. Large Cap stocks should enable this risk asset class to benefit from institutional investors sitting on large cash balances (approx. $3.8 trillion). Recent surveys of finance executives suggest many large corporations are planning on spending even more in 2022 on share buybacks and dividends, than in 2021.

- We are also overweight International Developed Market stocks, Gold, and Government bonds, equal-weight U.S. Small Cap stocks and underweight U.S. Mid Cap and Emerging Markets stocks, High Yield bonds, Investment Grade Corporate bonds, and Mortgage-Backed Securities.

- International Developed Market stocks currently offer better relative value than U.S. stocks. The availability of booster shots is a positive development helping make the case for a continued global economic recovery in the developed world.

- Gold should continue to provide a portfolio hedge due to high anxiety and uncertainty regarding the global economy and rising geopolitical risks throughout Europe and Asia.

- While demand for Municipal bonds should remain strong, supply is projected to pick up as we move into 2022. At current yields, reaching for lower rated credits does not offer much in the way of added spread, nor are Municipal bonds attractive on a relative basis for most investors when compared to taxable corporate bonds. Our focus remains on credit and preservation of capital first and foremost.

Andrew Zimmerman, Chief Investment Strategist

# ASSET CLASS TOTAL RATE OF RETURN PERFORMANCE SUMMARY AS OF 12/31/2021

| Stock Indices | Asset Class | QTD Return | 1 Year Return |
|---|---|---|---|
| MSCI AC World Daily TR N | Global Equities | 6.68% | 18.54% |
| S&P 500 INDEX | U.S. Large Cap Equities | 11.02% | 28.68% |
| S&P 400 MIDCAP INDEX | U.S. Mid Cap Equities | 7.97% | 24.73% |
| RUSSELL 2000 INDEX | U.S. Small Cap Equities | 2.12% | 14.78% |
| MSCI EAFE | International Developed Market Equities | 2.74% | 11.86% |
| MSCI EM | Emerging Market Equities | -1.36% | -2.47% |
| **U.S. Large Cap Sector Stock Indices** | | | |
| S&P 500 ENERGY INDEX | U.S. Large Cap Equities - Energy Sector | 7.89% | 54.39% |
| S&P 500 HEALTH CARE IDX | U.S. Large Cap Equities - Health Care Sector | 11.17% | 26.13% |
| S&P 500 CONS DISCRET IDX | U.S. Large Cap Equities - Consumer Discretionary Sector | 12.84% | 24.43% |
| S&P 500 CONS STAPLES IDX | U.S. Large Cap Equities - Consumer Staples Sector | 13.31% | 18.63% |
| S&P 500 INFO TECH INDEX | U.S. Large Cap Equities - Information Technology Sector | 16.69% | 34.52% |
| S&P 500 UTILITIES INDEX | U.S. Large Cap Equities - Utilities Sector | 12.93% | 17.67% |
| S&P 500 INDUSTRIALS IDX | U.S. Large Cap Equities - Industrials Sector | 8.62% | 21.10% |
| S&P 500 COMM SVC | U.S. Large Cap Equities - Communication Services | -0.01% | 21.57% |
| S&P 500 MATERIALS INDEX | U.S. Large Cap Equities - Materials Sector | 15.20% | 27.28% |
| S&P 500 FINANCIALS INDEX | U.S. Large Cap Equities - Financials Sector | 4.52% | 34.87% |
| S&P 500 REAL ESTATE IDX | U.S. Large Cap Equities - Real Estate Sector | 17.50% | 46.14% |
| **Commodities Indices** | | **QTD Return** | **1 Year Return** |
| ISHARES GOLD TRUST | Gold | 4.19% | -4.00% |
| S&P GSCI Tot Return Indx | Broad Commodities | 1.51% | 40.35% |
| **Bond Indices** | | | |
| U.S. Aggregate | Core Bonds | 0.01% | -1.54% |
| Intermediate | Intermediate Government & Corporate Bonds | -0.57% | -1.44% |
| U.S. Corporate High Yield | High Yield Debt | 0.71% | 5.28% |
| U.S. Treasury | U.S. Treasuries | 0.18% | -2.32% |
| U.S. TIPS | U.S. TIPs | 2.36% | 5.96% |
| U.S. Agency | U.S. Government Agencies | -0.58% | -1.31% |
| U.S. MBS | Mortgage-Backed Securities | -0.37% | -1.04% |
| Corporate | Corporate Debt | 0.23% | -1.04% |
| Municipal Bond Index | Municipal Debt | 0.72% | 1.52% |
| S&P PREFER STOCK IX CME | Preferred Stock | -0.19% | 0.98% |

Sources: Bloomberg and DT Investment Partners. Investors cannot invest in a market index directly, the performance of an index does not represent any actual transactions and its performance does not reflect the deduction of any fees or expenses associated with actual investing. Market performance information is included on this slide solely to demonstrate the potential benefits historically associated with long-term investing in a portfolio of well-diversified asset classes and does not represent or suggest results DT Investment Partners would or may have achieved when managing client portfolios

# 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. 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.*