DT INVESTMENT PARTNERS, LLC

# Q1 2022
# FINANCIAL MARKETS COMMENTARY

*In Search of a Soft Landing*

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# RISK-BASED ASSETS PERFORMANCE SUMMARY

- Most Risk-Based Assets, with the exception of Gold and Australian stocks, declined in value during the quarter. Stubbornly high inflation caused the Fed to pivot towards more aggressive monetary policy tightening, making investors reluctant to add to risk positions (See Page 5). Inflation is at its highest level in 40 years driven by supply-chain constraints lasting longer than many expected and unprecedented levels of fiscal stimulus that was unleashed in the past two years.

- Following the Russian invasion of Ukraine on February 24th, most risk-based assets, except for Emerging Market stocks, rallied in price. Stocks have usually performed well in years when the Fed begins raising interest rates. Historically, military conflicts tend to have short-lived impacts upon financial markets. Sharp sell-offs are followed by stabilization over periods of weeks, not months. In this case, there was no immediate sharp stock sell-off. Most stock markets were already in, at, or near correction territory (decline of more than 10% from the 52 week high) prior to Russia's invasion.

- Investors sold U.S. Small Cap and Emerging Market stocks during the quarter. Small Cap stocks are very growth dependent and investors are forecasting that supply-side constraints and higher inflation may reduce demand and soften growth expectations. Emerging Market stocks struggled as parts of China went into lock-down due to the Omicron variant. A slowdown in Chinese economic growth, increased Chinese government regulation, and tighter monetary policy in the U.S. made this highly volatile asset class less attractive. When the Fed starts raising rates, borrowing costs for emerging market countries rise and their currencies decline.

- With the exception of Energy, Utilities, and Financials, all U.S. Large Cap sectors fell in price during the quarter. With multiple interest rate increases on the horizon, inflation at multi-decade highs, and the likelihood of lower future economic growth, investors rotated into sectors expected to perform better in such an environment. Energy led the way higher thanks to booming oil and natural gas prices.

# BOND PERFORMANCE SUMMARY

- U.S. Bond market performance for the quarter was the worst since 1980 as yields surged to their highest level since 2019. Investors sold bonds in anticipation of higher rates. Hawkish comments by Fed Chair Powell in March led investors to price in much faster policy tightening than what was expected at the start of the year.

- All fixed income sectors fell in price during the quarter, led lower by Investment Grade Corporate Bonds (See Page 5). The U.S. Treasury yield curve continued flattening (2 year yields rose more than 10 year yields). The Fed ended its monthly bond buying program March and raised interest rates by 0.25% in March for the first time since 2018. During remarks delivered to the National Association for Business Economics on March 21st, Chair Powell said the central bank was prepared to "move more aggressively by raising the federal funds rate by more than 25 basis points at a meeting or meetings" to curb inflation, which is the highest it's been in 40 years. Traders quickly moved to price in at least seven quarter-point rate increases by year-end. It's important to note that even though nominal bond yields and interest rates are rising, the real policy rate (nominal rate – inflation rate) is negative meaning monetary policy is not restrictive. Therefore, we believe that it's too early to assume a yield curve inversion (2 year yields higher than 10 years) means an economic recession is near.

- Municipal bonds followed the broader bond market selloff. Subsequent large fund outflows have seen municipal bonds underperform, though the market now offers the highest relative yield to taxable bonds since 2020. The current selloff has not put undue strain on the credit fundamentals within the municipal market.

## CONTRIBUTORS & DETRACTORS TO PERFORMANCE

- Contributors for the quarter versus the Global Stock/Intermediate Bond blended benchmark index included our underweight allocation to Emerging Market stocks, our overweight to Australian stocks, our outside-of-benchmark allocation to Gold, and our shorter bond duration than the benchmark (3.6 years vs. 4.0 years).

- Detractors to performance included our overweight allocation to investment grade corporate bonds and our outside-of-benchmark allocation to U.S. Small Cap stocks.

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- At its March 16th meeting, the Fed voted to lift interest rates and penciled in six more increases by the end of 2022. This pace of tightening is the most aggressive in more than 15 years as inflation runs hot at its highest level in four decades. Chair Powell said the Fed is prepared to raise interest rates high enough to slow the economy if it determines that is needed to bring down inflation. Officials expect to lift the overnight fed funds rate to nearly 2% by the end of 2022. The rate was 1.75%, prior to the onset of the global pandemic two years ago when it was swiftly cut to 0%. The Fed's median projections show the fed funds rate rising to around 2.75% by the end of 2023, which would be the highest since 2008.

- According to the Fed's preferred gauge – Personal Consumption Expenditure Core Price Index (excludes food and energy), the inflation rate for the trailing twelve months ending in February was 5.4%. Fed officials project core inflation to end the year at 4.1% and they believe interest rate increases will bring inflation down to 2.6% at the end of 2023 and to 2.3% in 2024.

- In their quest for a soft economic landing, the Fed's ideal scenario is for inflation expectations to stay anchored and price pressures to decline while the rate of unemployment remains steady . This would allow the Fed to slow their pace of interest rate increases and avoid a recession.

- However, the longer the war in Ukraine lasts, the more difficult achieving a soft landing will be. Even before Russia's invasion of Ukraine, U.S. labor markets were tightening with the unemployment rate dropping to 3.8% in February. Commodity prices have been rising steadily since the re-opening of most global economies over the past year. Sanctions against Russia by the West are pushing those same commodity (oil, gas, wheat, industrial metals) prices even higher. In addition, new pandemic lockdowns in China thanks to rising Omicron cases are further pressuring global supply chains and keeping inflation elevated.

- With no end or probable outcome to the war in Ukraine in sight, commodity prices are likely to remain elevated for awhile longer. ***The level of uncertainty as a result of this war is very high, making any economic forecast extremely difficult at this current time.***

- Investors, via implied fed funds futures, are forecasting two more hikes than the Fed to the tune of 8 additional interest rate hikes of 0.25% over the next 9 months bringing the overnight fed funds rate to 2.50% by the end of 2022. Since there are only 6 Federal Open Market Committee meetings left this year, the funds rate would have to be raised by more than 0.25% for at least 1 and most likely 2 of the remaining 6 meetings. ***Based upon recent trends in economic data and longer term macro headwinds, we are very skeptical that the Fed will actually raise rates as high as investors are currently projecting.***

- Over the past three months, durable goods and factory orders, manufacturing data, housing starts, pending home sales, and retail sales have all been trending lower. Although employers are struggling to fill the 11.3 million job openings at the end of February and the March unemployment rate fell to 3.6%, the pace of wages growth has started to slow over the past few months. This suggests that employers are feeling less pressure to offer pay increases as more people return to the workforce which may help to ease inflation pressures. Corporate earnings growth is starting to decelerate and firms are lowering future earnings guidance.

- Perhaps higher prices are starting to cool economic growth. The cure for higher prices is eventually higher prices because they lead to demand destruction. Higher fuel costs and energy market volatility may be starting to strain budgets for consumers and businesses, dimming the outlook for economic growth.

- Inflation measures the rate of change in prices. 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, as we have said before, the macro headwinds to a sustainable uptick in inflation are very powerful. 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. Employment and inflation are lagging indicators. Once the job market and inflation begin to weaken, an economic slowdown may well be on its way.

# GLOBAL FINANCIAL MARKETS COMMENTARY & PORTFOLIO STRATEGY

- Over the long run, geopolitical events typically have minimal impact on the financial markets and global economy. However, in the short run, the war in Ukraine is disrupting commodities supplies and adding to inflationary pressures around the world. ***The Fed currently faces the conundrum of moderating economic growth with a red hot labor market and high inflation while investors are left hoping that the Fed can tame inflation without raising interest rates high enough to halt the economic recovery.*** Needless to say, financial market volatility is likely to be elevated for the remainder of the year.

- We remain slightly overweight risk-based assets and cash and slightly underweight bonds. Even after the S&P 500 fell 15% from its all-time high on January 3rd to its year-to-date low on March 8th, bearish investor sentiment readings remained above their historical average. Stock markets have typically performed well in the early stages (6-12 months) of monetary policy tightening. Although nominal rates are rising, monetary policy is still not restrictive as real rates (nominal rate minus inflation rate) remain negative. Corporate earnings are still growing, albeit at a slower pace. Stocks are cheaper than bonds on an earnings yield basis. There is plenty of liquidity on the sidelines as evidenced by the $4.6 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.

- After their worst quarterly sell-off in over 40 years due to continued high inflation and rising expectations for more aggressive Fed rate increases, bond yields are starting to look attractive. The yield on the 10 year maturity U.S. Treasury Note is more than two standard deviations oversold and is currently trading above its trailing ten year average. A bond rally may be near since economic growth is showing signs of moderating, while a number of previously mentioned macroeconomic headwinds to future inflation remain.

- We are overweight our strategic targets for U.S. Large Cap stocks, International Developed Market stocks, Gold, and U.S. Government bonds. Low U.S. unemployment, strong consumer spending, and earnings yields that are higher than bond yields are positives for stocks. In addition, institutional investors are sitting on large cash balances (approx. $3.1 trillion) and recent surveys of finance executives suggest many large corporations are planning on spending even more in 2022 on share buybacks and dividends.

- We are overweight our strategic target for International Developed Market stocks due to our investment in Australian equities. Australia is benefitting from commodity price inflation as the country is rich in natural resources. It is a major exporter of agricultural products, particularly wheat and wool, minerals such as iron ore and gold, and energy in the forms of liquefied natural gas and coal.

- Gold should provide a portfolio hedge due to high anxiety and uncertainty regarding the war in Ukraine and the economic outlook given stubbornly high inflation and the Fed's aggressive monetary policy tightening forecast. Government bonds are a safe haven and relatively cheap after having their worst performance quarter ever.

- We are equal-weight U.S. Small Cap stocks and Cash and are underweight U.S. Mid Cap stocks, Emerging Markets stocks, Real Estate, High Yield bonds, Investment Grade Corporate bonds, and Mortgage-Backed Securities.

- As we approach more palatable yield levels, we would expect municipal demand to level off, helping the Municipal Bond market stabilize. The YTD sell-off has not put undue strain on the fundamentals within the municipal market (credit quality). We will continue to focus on credit and preservation of capital and look to take advantage of the back up in yields.

**Andrew Zimmerman, Chief Investment Strategist**

# ASSET CLASS TOTAL RATE OF RETURN PERFORMANCE SUMMARY AS OF 3/31/2022

| Stock Indices | Asset Class | QTD Return | 1 Year Return |
|---|---|---|---|
| MSCI AC World Daily TR N | Global Equities | -5.36% | 7.28% |
| S&P 500 INDEX | U.S. Large Cap Equities | -4.60% | 15.63% |
| S&P 400 MIDCAP INDEX | U.S. Mid Cap Equities | -4.89% | 4.56% |
| RUSSELL 2000 INDEX | U.S. Small Cap Equities | -7.53% | -5.82% |
| MSCI EAFE | International Developed Market Equities | -5.77% | 1.70% |
| MSCI Daily TR Net Austra | International Developed Market Equities - Australia | 7.25% | 13.48% |
| MSCI EM | Emerging Market Equities | -6.99% | -11.13% |
| **U.S. Large Cap Sector Stock Indices** | | | |
| S&P 500 ENERGY INDEX | U.S. Large Cap Equities - Energy Sector | 38.99% | 63.97% |
| S&P 500 HEALTH CARE IDX | U.S. Large Cap Equities - Health Care Sector | -2.58% | 19.10% |
| S&P 500 CONS DISCRET IDX | U.S. Large Cap Equities - Consumer Discretionary Sector | -9.03% | 9.79% |
| S&P 500 CONS STAPLES IDX | U.S. Large Cap Equities - Consumer Staples Sector | -1.01% | 16.10% |
| S&P 500 INFO TECH INDEX | U.S. Large Cap Equities - Information Technology Sector | -8.36% | 20.90% |
| S&P 500 UTILITIES INDEX | U.S. Large Cap Equities - Utilities Sector | 4.77% | 19.93% |
| S&P 500 INDUSTRIALS IDX | U.S. Large Cap Equities - Industrials Sector | -2.36% | 6.13% |
| S&P 500 COMM SVC | U.S. Large Cap Equities - Communication Services | -11.92% | -0.93% |
| S&P 500 MATERIALS INDEX | U.S. Large Cap Equities - Materials Sector | -2.38% | 13.91% |
| S&P 500 FINANCIALS INDEX | U.S. Large Cap Equities - Financials Sector | -1.48% | 14.64% |
| S&P 500 REAL ESTATE IDX | U.S. Large Cap Equities - Real Estate Sector | -6.32% | 25.57% |
| **Commodities Indices** | | **QTD Return** | **1 Year Return** |
| ISHARES GOLD TRUST | Gold | 5.80% | 13.25% |
| S&P GSCI Tot Return Indx | Broad Commodities | 33.13% | 64.55% |
| **Bond Indices** | | | |
| U.S. Aggregate | Core Bonds | -5.93% | -4.15% |
| Intermediate | Intermediate Government & Corporate Bonds | -4.51% | -4.10% |
| U.S. Corporate High Yield | High Yield Debt | -4.84% | -0.66% |
| U.S. Treasury | U.S. Treasuries | -5.58% | -3.67% |
| U.S. TIPS | U.S. TIPs | -3.02% | 4.29% |
| U.S. Agency | U.S. Government Agencies | -4.20% | -3.94% |
| U.S. MBS | Mortgage-Backed Securities | -4.97% | -4.92% |
| Corporate | Corporate Debt | -7.69% | -4.20% |
| Municipal Bond Index | Municipal Debt | -6.23% | -4.47% |
| S&P PREFER STOCK IX CME | Preferred Stock | -9.37% | -7.90% |

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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

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