DT INVESTMENT PARTNERS, LLC

Q3 2022
FINANCIAL MARKETS COMMENTARY

The Search for Peak Fed Hawkishness

DT INVESTMENT PARTNERS

RISK-BASED ASSETS PERFORMANCE SUMMARY

- ◊ In the third quarter, global stock prices fell and bond yields soared as hope faded that monetary policy tightening would soon ease. After three consecutive years of double-digit gains, the stock market is suffering through a very difficult year. The growing losses and highly uncertain outlook weighed on investor sentiment. Industry surveys showed individual investors were the most pessimistic ever while money managers held unusually high levels of cash.

- ◊ Stubbornly high inflation caused the Fed to turn even more hawkish and aggressively tighten monetary policy by raising the overnight fed funds rate by 1.50% during the quarter. Since it takes time for the full effects of higher interest rates to make their way through the economy, investors are left wondering how the Fed's rate hikes will eventually affect the behavior of consumers and businesses. Corporate profits have held up remarkably well so far as businesses have been able to directly pass along cost increases to customers. However, given the pace of monetary policy tightening, investors have been selling risk for fear that eventually, an economic slowdown will arise and negatively impact corporate earnings.

- ◊ All Risk-Based Assets declined in value during the quarter led lower by Real Estate and stocks in Emerging and International Developed Markets (See Page 5). Rising bond yields and commercial office vacancy rates hampered Real Estate Investment Trust prices. A once-in-a-generation rally in the value of the U.S. dollar, thanks to the Fed's aggressive interest rate increases, encouraged global investors to pull money out of other markets to invest in higher yielding U.S. assets. A rapidly weakening Chinese economy along with geopolitical tensions and shortages of liquefied natural gas in Europe were not supportive of stock prices.

- ◊ Except for Consumer Discretionary and Energy, all U.S. Large Cap sectors fell in price during the quarter led lower by the Communication Services and Real Estate sectors. With more interest rate increases on the horizon, inflation at multi-decade highs, and the likelihood of lower future economic growth, investors sold stocks.

BOND PERFORMANCE SUMMARY

- ◊ Bonds yields rose/prices fell during the quarter at the fastest pace in the past 40 years due to escalating expectations for how high the Fed will raise the overnight fed funds rate to push down the worst rate of inflation since the 1980s. The yield on 10 year maturity U.S. Treasury Notes briefly reached 4% for the first time in more than a decade, before closing the quarter at 3.83%.

- ◊ Short-term U.S. Treasury yields are even more sensitive to Fed rate increase expectations. After beginning the year at 0.73%, the yield on the 2 year Treasury Note finished the quarter at 4.28%. The Treasury yield curve is fully inverted with 2 year notes yielding more than 10 year and 30 year notes. The inverted yield curve indicates that traders expect the Fed will eventually need to reverse course and slash interest rates to counter a slowing economy.

- ◊ At the end of the second quarter (June), the Fed began reducing the size of its Treasury portfolio by letting some bonds mature without replacing them (run-off). When the Fed buys fewer bonds, investors need to own more which can lead to supply/imbalances. In other words, excess supply of government bonds tends to push prices down and yields up. In September, the Fed doubled the speed of its bond maturity run-off, which further pressures prices lower/yields higher.

- ◊ For the third consecutive quarter, all fixed income sectors generated negative total returns (See Page 5). Macro-economic pressures and tighter monetary policy did not leave Municipal bonds unscathed. The sector sold off further during the quarter as investor demand slowed in the face of rising interest rates.

CONTRIBUTORS & DETRACTORS TO PERFORMANCE

- ◊ Contributors for the quarter vs. the Global Stock/Intermediate Bond blended benchmark included our overweight to Cash, our bond duration shorter than the benchmark (3.5 years vs. 4.0 years), our underweight to Emerging Market stocks, and our outside-of-benchmark allocation to U.S. Small Cap stocks.

- ◊ Detractors to performance included our overweight allocation to U.S. Large Cap Value stocks, our underweight to U.S. Mid Cap stocks, and our outside-of-benchmark allocation to Gold.

- Financial markets rallied during July and the first half of August on hopes that the Fed would soon pivot to become less hawkish. Investors bet the Fed would raise the fed funds rate aggressively to 3.25% by the end of 2022, and then begin cutting the rate in early 2023. The thinking was that the Fed would drive the economy to the brink of a recession, before backing off and reducing rates as the economy slowed amid signs of a peak in the inflation rate. After all, the U.S. Consumer Price Index Year-over-Year reached 9.1% in June, before falling to 8.5% and 8.3% in July and August. However, hope is not an investment strategy. While perhaps peaking back in June, inflation remains stubbornly high and the labor market is tight.

- Investor sentiment and outlook changed in a big way during the last day of the Fed's Jackson Hole Symposium on August 26th. Chair Jay Powell and other top central bankers in the world delivered a stern and unified message on the need to curb inflation, declaring that it is broad based, here to stay, and will require their forceful action. They pushed back against suggestions they will waver if their economies falter while price pressures remain too high. Chair Powell basically said the Fed has more work to do. He delivered a hawkish message using words like "forcefully", "purposefully", "unconditional", "cautions strongly", & "far short."

- ***And so the search for peak Fed hawkishness continues as the Fed appears set to keep raising interest rates until they are confident the job is done and inflation is headed lower to their 2% target goal.*** Chair Powell noted that at some point, monetary policy changes will slow down. However, for the time being, the Fed will continue to raising rates and err on the side of tightening too much, rather than too little. Short term economic pain is better than stopping prematurely and then needing to restart interest rate increases.

- At its September 21st Federal Open Market Committee (FOMC) meeting, the Fed gave its clearest signal yet that it is willing to tolerate a recession as the necessary trade-off for regaining control of inflation. After raising the overnight Fed Funds rate by 0.75% for the third consecutive meeting, officials forecast an additional 1.00% - 1.25% of tightening before year-end. The new range for the Fed Funds rate is 3% to 3.25%. Prior to the meeting, investors, via implied Fed Funds futures, were forecasting a year-end rate of 4.25% to 4.50%.

- Also unveiled at the Fed's September meeting were new projections from officials showing a median overnight funds rate estimate of 4.4% at the end of 2022 and 4.6% at the end of 2023. Policy makers expect they will need to reduce rates in 2024 to about 3.9% and then to 2.9% in 2025. They also marked down Gross Domestic Product (GDP) forecasts to 1.2% in 2023 and 1.7% in 2024. Unemployment is expected to rise to 4.4% in 2023.

- Just 6 months ago, the overnight fed funds rate was 0.00 - 0.25%. Now it sits at 3.00 – 3.25% with financial markets forecasting a rise to 4.50% by year end. The speed at which the Fed has raised rates is unprecedented. ***Historically, monetary policy has acted with long lags so the inevitable economic slowdown will take some time to play out. The U.S. economy appears to be on a path of low, but sustainable growth. Given the underlying strength in the labor market, the economy may be on this path for quite some time.*** The unemployment rate currently sits at 3.7% (3.5% is the lowest national unemployment rate on record). Signs of further economic slowdowns will allow employers to eliminate historically high open/unfilled positions first before actually laying off employees. When people have jobs, they are making money. When they are making money, they are spending money and the economy is growing.

- As the Fed faces the challenge of moderating economic growth by enough to slow inflation without driving the economy into recession, financial market volatility is likely to remain quite elevated. The Fed is in a no-win situation. If they raise rates by too much, they risk inducing an economic recession. If they tighten monetary policy too little, they risk inflation spiraling higher for longer. As we end the third quarter, investor sentiment has reached the most pessimistic level on record. In September, 93% of the stocks in the S&P 500 were down for the month. The stock and bond markets are very oversold. Cash balances are at historically large levels. The speed and magnitude of the YTD draw down has been almost unprecedented. ***We believe that stock and bond prices are much closer to bottoming than dropping another 10% or more. A great deal of Fed induced negativity has already been priced into financial markets and the economic data may soon start leaning towards lower inflation.***

- In the current environment, ***individual investment grade bonds present an attractive opportunity to generate income and provide stability to a portfolio.*** U.S. Treasury yields are at some of their highest levels in the past 15 years. The majority of the rise in bond yields/decline in prices for this economic cycle may have already occurred. The 39-year bull market in bonds (1981-2020) likely ended during the height of the global pandemic on August 4, 2020, when the 10-year maturity Treasury Note yield hit an all-time low of 0.51%. Yields remained low for 2020 and 2021 before surging this year.

- In our view, the long-term risk for bond yields is now more to the downside/upside in price. The terminal fed funds rate of 4.5% was already priced in by the financial markets prior to the Fed's September FOMC meeting. Projections by Fed officials confirmed on September 21st that investors were correct in their forecast. The Fed is projecting the funds rate to remain near the 4.5% level for most, if not all of next year before the Fed has to reduce the rate (ease monetary policy) to counter an economic slowdown. U.S. breakeven inflation rates are implying an inflation rate of 2.18% in 5 years. Support for bond prices in the coming years is likely to come from multiple areas. Investor demand should remain strong thanks to the need for income and portfolio stability by rapidly aging populations in Japan, Europe, and the U.S. Inflation, the bond market's biggest enemy, may have already peaked and the Fed will eventually get it under control. The cost of interest payments on the enormous federal debt load incentivizes the government to keep interest rates at a moderate level. Pension fund managers are rebalancing funds by shifting money to bonds after this year's sharp sell-off and the strong stock market performance for most of the past 13 years. There is an abundance of global savings that needs to find a home and will not/cannot all go to stocks. In times of volatility, uncertainty, and elevated geopolitical risks, U.S. Treasuries and the dollar continue to be viewed as safe-haven assets.

- During the quarter we reduced our allocation to International Developed Market stocks and eliminated our direct allocation to Emerging Market stocks. The U.S. dollar has been experiencing a once-in-a-generation rally in price thanks to the Fed's aggressive rate increases. These rate increases encourage global investors to pull money out of other markets to invest in higher yielding U.S. assets. Given that U.S. inflation remains stubbornly high, the Fed will likely continue raising the fed funds rate, pushing the value of the dollar even higher. As the world's reserve currency and the primary currency used in global trade and the pricing of commodities, further strengthening of the U.S. dollar threatens to intensify a growth slowdown and prolong inflation worries for global central banks. A stronger dollar reduces the relative purchasing power of foreign countries making imports more expensive and exports cheaper.

- We are underweight our strategic targets for risk and overweight bonds and cash. In particular, we are overweight U.S. Large Cap and Small Cap stocks and U.S. Government bonds. We are equal-weight Gold, underweight U.S. Mid Cap and International Developed Market stocks and U.S. Investment Grade Corporate bonds, and have no allocation to Emerging Market stocks, Real Estate, High Yield bonds, and Mortgage-Backed Securities. Rising rates are not all bad. In fact, the level of yields offered in today's Municipal bond market are the most attractive in over a decade.

- Financial markets are forward discounting in nature so they have been pricing in a slowdown/recession since March. By the time the economy weakens, markets may rally in price. Given how fast and by how much the Fed has raised interest rates in such a short period and given how oversold stock and bond markets have become, we believe markets are approaching peak fear which usually occurs at market bottoms. ***With our overweight in cash, we continue to search for opportunities to add to risk and bonds at these very cheap levels.***

Andrew Zimmerman, Chief Investment Strategist

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ASSET CLASS TOTAL RATE OF RETURN PERFORMANCE SUMMARY AS OF 9/30/2022

Stock Indices	Asset Class	QTD Return	YTD Return	1 Year Return
MSCI AC World Daily TR N	Global Equities	-6.82%	-25.63%	-20.66%
S&P 500 INDEX	U.S. Large Cap Equities	-4.89%	-23.88%	-15.50%
RUSSELL 1000 GROWTH INDX	U.S. Large Cap Growth Equities	-3.60%	-30.66%	-22.59%
RUSSELL 1000 VALUE INDEX	U.S. Large Cap Value Equities	-5.63%	-17.78%	-11.40%
S&P 400 MIDCAP INDEX	U.S. Mid Cap Equities	-2.48%	-21.54%	-15.29%
RUSSELL 2000 INDEX	U.S. Small Cap Equities	-2.18%	-25.11%	-23.53%
MSCI EAFE	International Developed Market Equities	-9.26%	-26.71%	-24.70%
MSCI Daily TR Net Austra	International Developed Market Equities - Australia	-6.74%	-18.09%	-16.37%
MSCI EM	Emerging Market Equities	-11.46%	-26.99%	-27.86%
U.S. Large Cap Sector Stock Indices				
S&P 500 ENERGY INDEX	U.S. Large Cap Equities - Energy Sector	2.16%	34.49%	45.06%
S&P 500 HEALTH CARE IDX	U.S. Large Cap Equities - Health Care Sector	-5.18%	-13.08%	-3.37%
S&P 500 CONS DISCRET IDX	U.S. Large Cap Equities - Consumer Discretionary Sector	4.36%	-29.89%	-20.89%
S&P 500 CONS STAPLES IDX	U.S. Large Cap Equities - Consumer Staples Sector	-6.62%	-11.83%	-0.09%
S&P 500 INFO TECH INDEX	U.S. Large Cap Equities - Information Technology Sector	-6.21%	-31.44%	-20.00%
S&P 500 UTILITIES INDEX	U.S. Large Cap Equities - Utilities Sector	-5.99%	-6.51%	5.58%
S&P 500 INDUSTRIALS IDX	U.S. Large Cap Equities - Industrials Sector	-4.72%	-20.72%	-13.88%
S&P 500 COMM SVC	U.S. Large Cap Equities - Communication Services	-12.71%	-39.04%	-39.05%
S&P 500 MATERIALS INDEX	U.S. Large Cap Equities - Materials Sector	-7.13%	-23.75%	-12.16%
S&P 500 FINANCIALS INDEX	U.S. Large Cap Equities - Financials Sector	-3.10%	-21.25%	-17.69%
S&P 500 REAL ESTATE IDX	U.S. Large Cap Equities - Real Estate Sector	-11.03%	-28.93%	-16.49%
Commodities Indices				
ISHARES GOLD TRUST	Gold	-8.10%	-9.42%	-5.63%
S&P GSCI Tot Return Indx	Broad Commodities	-10.31%	21.80%	23.64%
Bond Indices				
ISHARES CORE U.S. AGGREGATE	Core Bonds	-4.70%	-14.38%	-14.47%
ISHARES INTERMEDIATE GOVERNM	Intermediate Government & Corporate Bonds	-3.22%	-9.63%	-10.30%
SPDR BLOOMBERG HIGH YIELD BO	High Yield Debt	-1.69%	-16.20%	-15.62%
ISHARES 3-7 YEAR TREASURY BO	U.S. Treasuries	-3.91%	-10.54%	-11.36%
ISHARES TIPS BOND ETF	U.S. TIPs	-5.34%	-13.90%	-11.83%
ISHARES AGENCY BOND ETF	U.S. Government Agencies	-2.82%	-8.39%	-8.95%
ISHARES MBS ETF	Mortgage-Backed Securities	-5.55%	-13.66%	-14.21%
ISHARES 5-10Y INV GRADE CORP	Corporate Debt	-4.74%	-17.06%	-17.35%
ISHARES NATIONAL MUNI BOND E	Municipal Debt	-3.04%	-10.64%	-10.04%
S&P PREFER STOCK IX CME	Preferred Stock	-3.57%	-20.93%	-21.09%

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

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Notes

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