First Quarter 2023

Financial Markets Commentary

DT INVESTMENT PARTNERS

"Nearing the End of Fed Rate Increases"

Summary

- Financial markets were resilient in the first quarter with most Risk-Based Assets rising higher in price led by U.S. Large Cap Growth stocks, followed by International Developed Market stocks and Gold. All Bond sectors finished higher in price led by intermediate maturity (5-10 years) Investment Grade Corporate bonds (see page 3).
- Tighter financial conditions stemming from one of the Fed's most aggressive hiking cycles in decades along with certain idiosyncratic factors led to the collapse of three regional banks and the rescue of two others in March. The situation will likely result in even tighter financial conditions, particularly as bank lending slows and regulatory scrutiny increases. This could have a negative impact upon future economic growth.
- Inflation eased in February but remained stubbornly high, presenting a challenge for the Federal Reserve as it confronts how to slow the economy with higher interest rates at the same time it moves to stem banking problems. The Fed emphasized in their March meeting that the U.S. banking system is "sound and resilient."
- The Fed is in an increasingly difficult position whereby inflation remains stubbornly high, but economic risks and challenges to financial market stability are rising. The capacity for further Fed rate increases has narrowed dramatically with the recent developments in the banking sector. Just a few weeks ago, financial markets were pricing in more rate hikes and a higher terminal fed funds rate. The Fed is likely to raise rates another 0.25% in May to 5.00 - 5.25%, before pausing and possibly cutting interest rates later this year.

Global Economy

Inflation May Have Peaked, But Remains Elevated:

- The U.S. economy showed signs of economic strength during the quarter with average monthly job gains of 350,000 over the past four months and increased consumer spending. While interest rate-sensitive parts of the economy such as housing and autos slowed significantly, activity in the services segment has remained strong. Business activity in the U.S. and Europe rose in March at the fastest pace in a year, driven primarily by services providers. Japan also saw an increase thanks to the arrival of tourists from China as the world's second largest economy finally lifted Covid-19 travel restrictions.
- Business surveys in March pointed to a slowdown in the pace of businesses' raising prices. However, prices remain quite elevated thanks to rising wage costs within the services sector (restaurants, hotels, travel, leisure, education etc).
- The Consumer Price Index (CPI) appears to have peaked in June of 2022. However, at 6% (5.5% when excluding food and energy), it remains considerably higher than the Fed's target of 2%.

Labor Market Remains Tight:

- Although the U.S. Job Openings Rate has been falling, there are still 1.9 job openings per unemployed person. Demand for workers remains strong and far in excess of supply. The unemployment rate currently sits just off the historical low at 3.6%.
- Despite recent layoff announcements by large companies such as Amazon, Meta, & Google, jobless claims remain below their pre-pandemic average. Workers may not be filing for jobless assistance because they are quickly finding new jobs.
- However, wage growth is slowing with average hourly earnings for February making the smallest monthly advance in a year.
- The diffusion index, which shows how widespread employment gains are across industries, fell to its lowest level in February since April 2020. Most of the growth in February payrolls was from hiring in leisure and hospitality, retail, and healthcare.

The Fed:

- The Fed raised rates by 0.25% at their FOMC meetings in February and March. By raising rates, the Fed is continuing its fight against inflation. However, given recent stress in the banking sector, the Fed decided not to raise rates by 0.50%.
- The Fed's Dot Plot, which is a chart that is published quarterly and released at the March 22nd FOMC meeting, summarizes the Fed's outlook for the federal funds rate. ***New projections showed almost all 18 officials who participated in the meeting expect the fed-funds rate to rise to at least 5.1%, implying one more quarter-point increase and no rate cuts this year.***
- Fed Chair Powell noted that recent developments in banks were isolated issues, and the Fed took actions with the support of the Treasury to stabilize the banking sector and economy. Inflation remains too high, and the labor market remains too tight. Events in the banking system over the past few weeks will likely lead to tighter credit conditions that will slow economic activity. It's too soon to know to what extent this will occur. The Fed's primary goal is to restore price stability. The Fed considered a pause after the recent banking system events. However, they deemed it too soon and decided to raise the overnight funds rate by 0.25% and see how much banks will be tightening credit conditions because of recent events. Monetary policy may have less work (rate hikes) to do as banks embrace credit tightening (making less loans).

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Financial Markets (see page 3 for asset class total returns)

- In January investors wagered that slowing inflation would encourage the Fed to begin cutting interest rates later this year. A strong jobs report and stubbornly high inflation data in February quickly dispelled the notion that the Fed would soon pivot. The Fed did slow their pace of rate increases in February to 0.25% from 0.50% back in December 2022. With the economy showing few signs of slowing down from aggressive rate hikes over the past year, the Fed hinted in early March that perhaps going back to a 0.50% rate increase at their next meeting on the 22nd was a possibility. Then came the run-on the regional banks and the collapse of Silicon Valley Bank & Signature Bank. ***In conjunction with the Treasury Department, the Fed enacted a bank-funding facility and emergency lending tools to stabilize the situation.***
- Investor focus shifted from inflation worries and future rate increases to concerns of banking problems potentially hurting the economy. Treasury Notes and Bonds rallied in price/yields fell across the maturity spectrum with the 10-year Treasury yield declining from 3.88% at the end of 2022 to 3.47% as investors sought safe-havens in a highly uncertain environment.
- Bond investors bought intermediate maturity Treasuries in anticipation of a rapidly slowing economy once the full impact of Fed tightening and bank turmoil was felt. ***All bond sectors generated positive total returns for the quarter led by investment grade Corporate bonds.*** Municipals rallied thanks to a lack of supply and a nearing of the peak in interest rates for this cycle.
- Except for broad Commodities, ***all risk-based assets rose in value during the quarter led by U.S. Large Cap Growth stocks.*** Investors are positioning towards a Fed pause and rate cut later this year. Lower interest rates benefit growth companies with strong balance sheets. International Developed Market stocks performed well as the dollar weakened and investors found their relative valuations to be compelling. Gold finished higher in value thanks to nervous investors sheltering in the haven asset and a weakening dollar since early March. In terms of U.S. Large Cap sectors, three of the four worst performing sectors in 2022 were the top three (Technology, Communication Services, & Consumer Discretionary) performers in the first quarter.

Outlook and Portfolio Strategy

- ***The most widely anticipated recession in history has thus far, failed to occur. The labor market remains strong, and inflation has peaked and is beginning to gradually ease.*** The Fed and Treasury acted quickly to stabilize the banking sector following the run-on deposits. Many of last year's biggest winners (value stocks, energy, & broad commodities) have lagged while some of last year's biggest losers (growth stocks, technology, & communication services) have led the way higher this year. Bearish stock investor sentiment is near historical highs, which is typically a good contrarian indicator. ***The biggest question is how well will the economy be able to endure the lagged effects from higher rates and tighter financial conditions.***
- For the past two decades, interest rates have been held very low by the Fed and market forces. This limited the opportunity set for investors to earn bond yields that were competitive with the earnings yields of stocks. However, ***stubbornly high inflation in 2022 and the Fed's response in trying to reduce inflation has resulted in the highest bond yields since 2007 and in some cases, made bonds look more attractive than certain segments of the stock market.***
- ***We feel that we are in the ninth inning of the Fed's interest rate tightening cycle and our current tactical positioning reflects such.*** This should provide portfolio growth opportunities moving forward. We will monitor economic data releases over the next few weeks to reaffirm these beliefs and as always, will remain flexible regarding changing economic conditions.
- ***For the remainder of 2023, there will likely be a downshift in growth, employment, and price pressures. This will cause the Fed to pause rate hikes and eventually stop raising rates. A gradual lowering of rates may begin in late 2023/early 2024.***
- The bearish narrative for stocks has shifted. A few weeks ago, it was persistently high inflation necessitating a more aggressive Fed. Currently, it is fear of recession from the cumulative impact of Fed tightening over the past year along with the recent regional bank turmoil that will hurt corporate earnings. Either way, bears would say common stocks are not worth buying. Bulls would argue that historically, when interest rates start to fall, investors have been rewarded by looking beyond the immediate trough in earnings and buying stocks in anticipation of a better economy ahead. We agree.
- We have tactically positioned for this environment by reducing our overweight allocation in U.S. Large Cap stocks to equal weight the strategic target. We increased our international stocks to overweight because as interest rates peak, so will the price of the dollar, which will benefit International stocks. Lower interest rates will reduce the cost of debt for small and mid-capitalization companies and improve their performance on a relative basis. Therefore, we are overweight these asset classes. Given a peak in inflation, real assets such as gold should underperform other risk-based asset classes. Gold should still provide an uncorrelated advantage, but we believe an underweight position is now warranted. Lastly, a continued lack of supply should drive Municipal bond performance higher to start the second quarter. Any additional decline in U.S. Treasury yields should benefit Municipal bonds on an absolute return basis.

Asset Class Total Rate of Return Performance Summary as of 3/31/2023

Index/ETF	Asset Class	QTD Return	1 Year Return
MSCI All Country World	Global Equities	7.31%	-7.44%
Dow Jones Industrial Avg.	U.S. Large Cap Equities	0.93%	-1.98%
NASDAQ	U.S. Large Cap Equities	17.05%	-13.25%
S&P 500	U.S. Large Cap Equities	7.48%	-7.75%
Russell 1000 Growth	U.S. Large Cap Growth Equities	14.36%	-10.91%
Russell 1000 Value	U.S. Large Cap Value Equities	0.99%	-5.96%
S&P 400 Mid Cap	U.S. Mid Cap Equities	3.79%	-5.17%
Russell 2000	U.S. Small Cap Equities	2.73%	-11.63%
MSCI EAFE	International Developed Market Equities	8.65%	-0.79%
MSCI Emerging Markets	Emerging Market Equities	3.97%	-5.17%
S&P GSCI Total Return	Commodities	-4.94%	-10.04%
IShares Gold Trust ETF	Gold	8.04%	1.47%
IShares Aggregate Bond ETF	Core Bonds	3.23%	-4.99%
IShares Intermediate Gov/Credit Bond ETF	Intermediate Bonds	2.42%	-2.15%
SPDR Portfolio High Yield Bond ETF	High Yield Debt	4.05%	-5.17%
IShares 3-7 Year Treasury Bond ETF	U.S. Treasuries	2.73%	-2.21%
IShares TIPs Bond ETF	U.S. Inflation Protected Bonds	3.58%	-6.75%
IShares Agency Bond ETF	U.S. Government Agencies	2.18%	-1.82%
IShares MBS Bond ETF	U.S. Mortgage-Backed Securities	2.67%	-4.82%
IShares 5-10 Year Inv Grade Bond ETF	Intermediate Corporate Bonds	4.19%	-4.97%
IShares National Muni Bond ETF	Municipal Bonds	2.55%	-0.32%
S&P 500 Energy	U.S. Large Cap Energy Sector	-4.71%	5.00%
S&P 500 Health Care	U.S. Large Cap Health Care Sector	-4.31%	-6.49%
S&P 500 Consumer Discretionary	U.S. Large Cap Consumer Discretionary Sector	16.05%	-24.72%
S&P 500 Consumer Staples	U.S. Large Cap Consumer Staples Sector	0.83%	-2.26%
S&P 500 Technology	U.S. Large Cap Technology Sector	21.82%	-11.94%
S&P 500 Utilities	U.S. Large Cap Utilities Sector	-3.24%	-7.67%
S&P 500 Industrials	U.S. Large Cap Industrials Sector	3.47%	-4.41%
S&P 500 Communication Services	U.S. Large Cap Communication Services Sector	20.50%	-23.36%

Total Rate of Return Sources on page 3: *MSCI, Standard & Poor's, Dow Jones, NASDAQ, Russell, & Blackrock IShares. 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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