Second Quarter 2023

Financial Markets Commentary

"Higher for Longer"

DT INVESTMENT PARTNERS

Summary

- So far, the U.S. economy has held up much better than expected, despite the 5% of Fed interest rate hikes since early 2022. Surprisingly, the jobs market and consumer spending have been much less sensitive to rate increases than anticipated.
- Stocks continued climbing the wall of worry (interest rate increases, inflation, recession, debt ceiling, China, Taiwan, War in Ukraine, etc.) in the second quarter with the S&P 500 entering a new bull market in early June. The U.S. Large Cap stock benchmark finished the quarter 26% higher from its October 12, 2022, low.
- Investor sentiment has risen from historically pessimistic levels to the most bullish levels in the past 1.5 years. The number of stocks participating in the rally (market breadth) finally widened beyond just shares of technology companies. Based upon recent fund flows data, both individual and institutional investors are jumping back into the market as FOMO (fear of missing out) has led to bearish investor capitulation. Hopes that the Fed is near the end of its rate hiking cycle and potential benefits from generative artificial intelligence have buoyed markets. Meanwhile, worries about a potential recession have eased while employers continue to hire, and consumers continue to spend. Both the banking and housing sectors appear to be stabilizing.
- Interest rates are likely to stay higher for longer as economic growth remains solid and price pressures continue. Tight labor markets and wage gains are supporting consumer spending. Measures of core (excludes volatile food & energy prices) inflation have declined much less than non-core, headline inflation. The Fed is focused on non-core because it includes those prices that are likely to be driven by the cost of labor, which the Fed can more directly impact through changes in interest rates.

Global Economy

Labor Market is Cooling, But Still Tight:

- ***The U.S. economy continued to show signs of economic strength during the quarter and consumer confidence is at the highest level in the past year and a half.*** Although manufacturing surveys show the sector is suffering, with inventories rising and new orders falling, while weekly claims for unemployment benefits are up almost 50% from September's low, the jobs market remains strong. Monthly gains have averaged 314,000 year-to-date. Although the U.S. Job Openings Rate has been falling, there are still 1.8 job openings per unemployed person. Demand for workers remains strong and far in excess of supply.
- The US labor market sent conflicting signals in May as payrolls surged along with joblessness. The unemployment rate rose to 3.7%, while wage growth slowed. The jobs report is made up of two reports. The household survey showed people entering the labor force had a tough time finding a job. There was also an increase in previously employed persons who found themselves unemployed. The business survey, however, painted a picture of strength. Payrolls beat estimates for a 14th straight month, and wages among workers who aren't in management roles rose 0.5%, the most in six months.

Inflation May Have Peaked, But Remains Elevated/Sticky:

- Headline CPI has fallen from a high of 9.1% in June of 2022 to 4% in May on a year-over-year basis. Consumer inflation expectations are at their lowest level since 2020. Much of this decline can be attributed to falling energy and food prices and the impact of higher interest rates upon housing and auto sales.
- While inflation has been cut in half since last year's peak, it remains above the Fed's 2% target. The Fed's preferred inflation measure, the Core PCE (Personal Consumption Expenditures Index) was 4.6% in May, on a year-over-year basis.
- Although business surveys point to a slowdown in the pace of businesses raising prices, prices remain elevated thanks to rising wage costs within the services sector (restaurants, hotels, travel, leisure, etc.). Activity in the services segment has remained strong. ***As long as the job market remains robust, allowing consumers to continue to spend, inflation is likely to remain higher than 2%.***

Interest Rates Likely to Stay Higher for Longer:

- In testimony on Capital Hill in late June, Fed Chair Powell said the central bank didn't raise interest rates at its June 14th meeting because it wanted to slow down its historically rapid pace of increases. However, he stressed that the Fed would likely lift rates again in the coming months. ***Since inflation and economic activity have not slowed as much as many officials anticipated this year, there is a great deal of uncertainty about how high they might raise rates.*** At the June 14th meeting, most Fed officials forecast two more rate hikes this year bringing the overnight fed funds rate to 5.50 - 5.75%.
- Implied fed funds futures indicate that investors believe the Fed will only raise rates once more this year. ***Regardless over whether the Fed raise rates one more time or two more times, financial markets appear to be pricing for an economy with lower, but sticky inflation amid continued economic growth. In this environment, it seems very likely to us that interest rates will remain higher for longer.*** In other words, Fed interest rates cuts are unlikely in the second half of this year.

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

- The S&P 500 Index is up 26% since last October's low and entered a new bull market in early June. The bear market that lasted 248 trading days was the longest since 1948. According to Bank of America Global Research, history indicates that stocks keep climbing after beginning a new bull market. Investor sentiment has been rising and market breadth has been widening as individual and institutional investors have been scaling back into U.S. stocks. At first, it was primarily Large Cap, but recently it's been the more economically sensitive Small and Mid Cap stocks leading the charge. Underpinning this rally has been hopes that the Fed is nearing the end of its rate raising campaign along with rising earnings forecasts and excitement about the potential for generative artificial intelligence to reshape the global economy. Recession worries have receded as employers continue to hire, consumers continue to spend, and the banking sector and housing market appear to have stabilized. Despite mortgage rates that have nearly doubled over the past year, home prices have recently rebounded and are rising once again in some areas due to scarcity. Homeowners are unwilling to move and give up their current low mortgage rates. Therefore, demand is moving towards new construction, which benefits construction employment and capital goods purchases.
- In the bond market, uncertainty as to the future direction of interest rates reigns supreme. Implied fed funds futures are priced for Fed rate cuts at most Federal Open Market Committee meetings next year to offset a slowing economy. This is counter to the Fed's hawkish message that two more interest rate increases are likely before pausing and leaving rates higher for longer. Meanwhile, spread markets (corporate bonds & mortgage-backed securities) are not pricing in any sort of significant economic slowdown or recessionary scenario. Yield spreads have remained tighter (lower) than in previous recessions. Municipal bonds continue to remain firmly bid thanks in large part to a continued lack of supply.
- Except for most Commodities, all Risk-Based Assets finished higher in price for the quarter led once again by U.S. Large Cap Growth (technology) stocks. U.S. Small and Mid Cap stocks rose, outpacing International Developed and Emerging Market stocks. All investment grade bond sectors finished the quarter with slightly negative total rates of return (see page 3). Treasury yields rose/prices fell due to persistent signs of economic strength and the easing of stress in the banking sector.
- Technology, Consumer Discretionary, and Communication Services stocks far outpaced the other eight sectors in the S&P 500 Index in the second quarter. The boom in artificial intelligence and hopes that the Fed is almost done raising rates inspired investors to buy these high growth segments of the market.

Outlook and Portfolio Strategy

- There is always uncertainty in financial markets, however, right now it's particularly high. The Fed is grappling with inflation above their 2% target and an economy that remains resilient in the face of the steepest pace of rate hikes since the early 1980s.
- The most widely anticipated recession in the history of mankind has so far failed to materialize. The labor market remains strong, and while inflation has peaked and is beginning to gradually ease, it remains higher than the Fed's target. ***The biggest questions are when will the lagged effects from higher interest rates begin to impact the economy and how will the economy and Fed deal with it going forward.*** The Fed's reliance upon lagging economic data to make current and future decisions almost ensures that they will be behind the curve in lowering interest rates.
- We believe that lower, but sticky inflation amid continued economic growth in an environment where cash balances are very high, and stocks are still under-owned favors a continuation of the new bull market that began in early June. Therefore, we are overweight U.S. stocks, particularly the cyclically-sensitive Mid and Small Cap stocks. In addition, we are overweight international developed market stocks because as interest rates peak, the price of the dollar should continue its downward trend which will benefit International stocks. We continue to not own any direct exposure to Emerging Market stocks. China, which makes up over one third of the asset class, is facing numerous economic challenges. Export demand is cooling while property values are falling and the jobless rate among young Chinese aged 16 -24 years is over 20%. We will be watching closely for how China's economic weakness impacts the global economy, particularly China's largest trading partner - Europe. Given a peak in inflation, real assets such as gold may continue to underperform other risk-based asset classes. Gold should still provide an uncorrelated advantage, but we believe an underweight position is warranted.
- Stubbornly high inflation and the Fed's response in trying to reduce inflation has resulted in the highest bond yields since 2007 and in some cases, has made bonds look more attractive than certain segments of the risk-based asset market. Therefore, we continue to maintain a near equal-weight allocation to fixed income. Yields on short maturity (1-5 years) investment grade corporate bonds look particularly attractive on both an absolute and relative basis. Lastly, a continued lack of supply should drive Municipal bond performance higher to start the third quarter. Tax-exempt yields will likely remain high and broadly follow any larger move in U.S. Treasuries.

Asset Class Total Rate of Return Performance Summary as of 6/30/2023

Index/ETF	Asset Class	2Q 2023 Return	YTD Return
MSCI All Country World	Global Equities	6.18%	13.93%
Dow Jones Industrial Avg.	U.S. Large Cap Equities	3.97%	4.94%
NASDAQ	U.S. Large Cap Equities	13.05%	32.32%
S&P 500	U.S. Large Cap Equities	8.74%	16.88%
Russell 1000 Growth	U.S. Large Cap Growth Equities	12.81%	29.01%
Russell 1000 Value	U.S. Large Cap Value Equities	4.07%	5.10%
S&P 400 Mid Cap	U.S. Mid Cap Equities	4.84%	8.81%
Russell 2000	U.S. Small Cap Equities	5.19%	8.06%
MSCI EAFE	International Developed Market Equities	3.19%	12.16%
MSCI Emerging Markets	Emerging Market Equities	0.97%	5.02%
S&P GSCI Total Return	Commodities	-2.73%	-7.54%
IShares Gold Trust ETF	Gold	-2.62%	5.20%
IShares Aggregate Bond ETF	Core Bonds	-0.94%	2.26%
IShares Intermediate Gov/Credit Bond ETF	Intermediate Bonds	-0.88%	1.52%
SPDR Portfolio High Yield Bond ETF	High Yield Debt	1.21%	5.31%
IShares 3-7 Year Treasury Bond ETF	U.S. Treasuries	-1.51%	1.18%
IShares TIPs Bond ETF	U.S. Inflation Protected Bonds	-1.48%	2.05%
IShares Agency Bond ETF	U.S. Government Agencies	-0.39%	1.78%
IShares MBS Bond ETF	U.S. Mortgage-Backed Securities	-0.73%	1.92%
IShares 5-10 Year Inv Grade Bond ETF	Intermediate Corporate Bonds	-0.45%	3.72%
IShares National Muni Bond ETF	Municipal Bonds	-0.29%	2.25%
S&P 500 Energy	U.S. Large Cap Energy Sector	-0.89%	-5.55%
S&P 500 Health Care	U.S. Large Cap Health Care Sector	2.95%	-1.48%
S&P 500 Consumer Discretionary	U.S. Large Cap Consumer Discretionary Sector	14.58%	32.97%
S&P 500 Consumer Staples	U.S. Large Cap Consumer Staples Sector	0.45%	1.28%
S&P 500 Technology	U.S. Large Cap Technology Sector	17.20%	42.77%
S&P 500 Utilities	U.S. Large Cap Utilities Sector	-2.53%	-5.69%
S&P 500 Industrials	U.S. Large Cap Industrials Sector	6.49%	10.19%
S&P 500 Communication Services	U.S. Large Cap Communication Services Sector		

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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