Third Quarter 2023

Financial Markets Commentary

DT INVESTMENT PARTNERS

Markets Reprice Monetary Policy That's Tighter For Longer, While Interest Rate Risk Grows

Summary

- Since early 2022, the consensus view has been that a recession is imminent. We continue to await the most widely forecasted recession in the history of economics. The U.S. economy is still growing, and the jobs market is still strong, although slowing.
- On July 26th, the Fed raised the overnight funds rate for the 11th time in the last 12 meetings but hinted that they could pause interest rate increases. As widely anticipated, the Fed did just that at its September 20th meeting, while leaving the door open for one more interest rate increase in either November or December. ***After being at odds with the Fed for much of this tightening cycle, investors are starting to realize that while the Fed is near the end and may even be done raising interest rates, they are still not close to cutting them. The Fed may keep interest rates higher for longer to keep fighting inflation or because they see no pressing need to reduce them.*** As a result, during the quarter bond yields resumed their rise/prices fell across the yield curve for every maturity.
- The highest bond yields since 2007 and the potential for a prolonged higher interest-rate environment dragged stock prices lower. Surging Treasury yields reduce the appeal of stocks relative to bonds and increase borrowing costs for companies, which hurt corporate earnings. The global economy is slowing while energy prices (tax on economic growth) have risen sharply over the past three months. Debt levels and debt servicing costs are significantly higher and work stoppages in the auto industry are not bullish for economic growth.

Global Economy

Resilient Economic Growth in the U.S. May Be Hitting a Wall, While Germany and China Stagnate:

- ***Despite the fastest pace of Fed rate hikes in 22 years beginning in March 2022, the U.S. economy continued to grow during the third quarter. However, as the quarter came to an end, consumer confidence fell to a four-month low in September.*** Since the Fed began tightening monetary policy in March of last year, the labor market remained remarkably strong, which supported consumer incomes, spending, and household balance sheets. Recently, the pace of hiring has slowed, and gas prices have risen over 30% since June. Consumers have spent down their savings, while the highest borrowing costs in the past 40 years have hampered the purchase of homes and autos. Credit card balances have been rising steadily since the first quarter.
- In the first year of the pandemic, many borrowers locked in low-cost funding for many years, effectively delaying any day of reckoning. ***As that debt matures, higher interest costs will start to hurt, unless rates unexpectedly fall back to their old lows.***
- Federal debt held by the public soared from 35% of GDP at the end of 2007 to 93% in the first quarter of this year. U.S. government debt currently stands at more than $32 trillion. In 2022, government debt was 124% of GDP.
- The burden of that debt has been relatively low because the Treasury could borrow so cheaply. But 67% of the debt matures within 5 years, according to TD Securities. Meanwhile, more than $1.5 trillion in commercial-property loans come due by the end of 2025 and refinancing that debt will be a drain on profits for many property owners. U.S. companies have $600 billion in corporate debt set to mature this year, a total that will grow to more than $1 trillion a year from 2025 until 2028. The debt loads, coupled with the rising costs of new financing for companies, may cut into corporate profits, investor returns, spending on new ideas, spending on hiring, and could lead to less-healthy balance sheets. ***None of this is bullish for economic growth.***
- Europe's largest economy is set to be the world's only major economy to contract in 2023. Germany's heavy reliance on manufacturing and global trade have magnified the negative impacts from the war in Ukraine, supply-chain disruptions from the global pandemic, soaring energy prices, and rising inflation and interest rates. Despite early signs of recovery, China's economy is still saddled with rapidly aging demographics, slowing productivity growth, a bursting real estate bubble, and consumers' focus on paying down debt rather than purchasing goods and services.

Inflation Continues to Cool While the Labor Market Gradually Softens:

- Headline CPI has fallen from a high of 9.1% in June of 2022 to 3.7% in August of 2023 on a year-over-year basis. Consumer prices have peaked and are moderating across most areas of the economy. However, the Fed is targeting a 2% inflation rate, and their preferred inflation measure (Core PCE) is still running at elevated levels (3.9%). Given the slowing trend in inflation, the Fed can afford to take a wait and see approach to future interest rate increases.
- At their September 20th meeting, Fed officials released updated projections for annual core inflation, which excludes volatile food and energy prices, which show it moving lower to 3.7% for the fourth quarter. They also see it falling to 2.6% next year.
- The labor market is softening as the share of workers who are quitting their jobs eased in July and is returning to pre-pandemic levels. In their projections released on September 20th, the Fed now sees the unemployment rate, which was 3.8% in August, rising to 4.1% at the end of next year.

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

- Despite 5.25% of Fed rate increases since March of 2022, a robust U.S. economy has resulted in the Fed keeping interest rates higher for longer than many have believed prior to June. A majority of Fed members favor one more rate hike this year and forecast only one rate cut (0.25%) by the end of next year. Despite significantly higher interest rates/financing costs in a heavily indebted world, along with work stoppages in the auto industry, the resumption of student loan payments, and rising oil and gas prices, the Fed still fears ending rate hikes too early. They think that if they end rate hikes too early and are wrong, it could be very disruptive to financial markets.
- After a strong first half of the year, most Risk-Based Assets (except for commodities and energy stocks) declined in value over the past 3 months. The rise in bond yields to 16-year highs across the entire yield curve unnerved stock investors. Higher bond yields reduce the appeal of stocks relative to bonds and raise borrowing costs which negatively impact corporate earnings. Stocks were led lower by U.S. Large, Mid, and Small Cap growth companies whose future profits are worth less relative to risk-free returns from holding Treasuries until maturity. U.S. Large Cap stock valuations look expensive relative to government bond yields. The idea of higher for longer interest rates also helped the value of the U.S. dollar strengthen during the quarter. International stocks struggle when the dollar rises in value because a stronger dollar decreases the relative purchasing power of foreign countries, making imports more expensive and exports cheaper. The dollar's rise in value makes the debts that international governments and companies have taken out in U.S. dollars more costly to pay back.
- Energy and Communication Services stocks were the only sectors in the S&P 500 Index to rise in price during the quarter. Energy led the way higher thanks to rising oil and gas prices resulting from Saudi Arabia and Russia's restrictions on output.
- All investment grade bond sectors (Treasury Notes/Bonds, Government Agencies, Corporates, Mortgage-Backed Securities, & Municipals) finished the quarter with slightly negative total rates of return, primarily due to the slide in Treasury prices as investors forecast tighter monetary policy for longer, if the economy remains stronger. The yield curve remains inverted (2-year maturity Treasuries yield more than 10-year maturity Treasuries) and has occurred before each of the last 8 recessions.

Outlook and Portfolio Strategy

- The overall rise in the global debt burden means that interest rate risk is very potent. Fed Chair Powell signified caution about further rate hikes by mentioning the phrase "proceed carefully" a total of 6 times in his most recent press conference following the Fed's September meeting. Nevertheless, ***the range of possible outcomes remains highly uncertain.*** Despite the steepest pace of rate hikes since the early 1980s, the Fed's nearly unprecedented ability to cool inflation without significantly driving up the unemployment rate and sending the economy into recession is still a possibility. However, as risk managers, we remain skeptical that the Fed can generate a soft landing for the economy and are focused on a few potentially negative outcomes.
- Our ***biggest question remains 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, thereby keeping monetary policy too tight for too long. If consumer spending and business activity show signs of re-accelerating, the Fed might think that cooling inflation might reverse unless they raise rates even higher and risk recession. Oil prices are 40% higher since March. Rising oil prices, which act as a tax on consumers and businesses, threaten to drive inflation higher and reduce economic growth. Higher gasoline prices could also raise expectations of future inflation by consumers and businesses.
- Cash balances in money market mutual funds currently sit at an all-time high of $5.6 trillion. This represents a significant amount of dry powder that will eventually be used to purchase stocks and bonds. In the meantime, we believe investors should continue to embrace the benefits of diversification while taking advantage of higher-than-normal U.S. Treasury Bill yields for a portion of fixed income (bond) allocations. 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. We are slightly overweight bonds and believe that regardless of whether the Fed raises rates one more time or remains on hold indefinitely, we are likely near the peak in bond yields. Eventually, the Fed will begin to ease monetary policy by cutting interest rates in response to a slowing economy and bond yields will fall/prices rise.
- As for risk-based assets, we remain slightly underweight strategic target allocations. More specifically, we are equal-weight U.S. Large Cap stocks and slightly overweight the cyclically-sensitive Mid and Small Cap stocks as equity analysts raise quarterly corporate earnings estimates for the first time in the past 2 years. In addition, we are overweight international developed market stocks because as interest rates peak, the price of the dollar should decline which will benefit International stocks. We continue to not own any direct exposure to Emerging Market stocks as China struggles with deflation, massive indebtedness, and a slowing economy.

Asset Class Total Rate of Return Performance Summary as of 9/30/2023

Stock Indices	Asset Class	QTD Return	YTD Return
MSCI AC World Daily TR N	Global Equities	-3.40%	10.06%
DOW JONES INDUS. AVG	U.S. Large Cap Equities	-2.10%	2.73%
NASDAQ COMPOSITE	U.S. Large Cap Equities	-3.94%	27.11%
S&P 500 INDEX	U.S. Large Cap Equities	-3.27%	13.06%
RUSSELL 1000 GROWTH INDX	U.S. Large Cap Growth Equities	-3.13%	24.97%
RUSSELL 1000 VALUE INDEX	U.S. Large Cap Value Equities	-3.17%	1.77%
S&P 400 MIDCAP INDEX	U.S. Mid Cap Equities	-4.20%	4.24%
RUSSELL 2000 INDEX	U.S. Small Cap Equities	-5.14%	2.51%
MSCI EAFE	International Developed Market Equities	-4.04%	7.63%
MSCI EM	Emerging Market Equities	-2.85%	2.07%
S&P 500 Sector Indices	**S&P 500 Stock Sectors**	**QTD Return**	**YTD Return**
S&P 500 ENERGY INDEX	U.S. Large Cap Equities - Energy	12.22%	5.99%
S&P 500 HEALTH CARE IDX	U.S. Large Cap Equities - Health Care	-2.65%	-4.09%
S&P 500 CONS DISCRET IDX	U.S. Large Cap Equities - Consumer Discretionary	-4.80%	26.58%
S&P 500 CONS STAPLES IDX	U.S. Large Cap Equities - Consumer Staples	-5.97%	-4.76%
S&P 500 INFO TECH INDEX	U.S. Large Cap Equities - Information Technology	-5.64%	34.72%
S&P 500 UTILITIES INDEX	U.S. Large Cap Equities - Utilities	-9.25%	-14.41%
S&P 500 INDUSTRIALS IDX	U.S. Large Cap Equities - Industrials	-5.16%	4.50%
S&P 500 COMM SVC	U.S. Large Cap Equities - Communication Services	3.07%	40.43%
S&P 500 MATERIALS INDEX	U.S. Large Cap Equities - Materials	-4.76%	2.61%
S&P 500 FINANCIALS INDEX	U.S. Large Cap Equities - Financials	-1.13%	-1.65%
S&P 500 REAL ESTATE IDX	U.S. Large Cap Equities - Real Estate	-8.90%	-5.51%
Commodity ETF/Index	**Type of Commodities**	**QTD Return**	**YTD Return**
ISHARES GOLD TRUST	Gold	-3.85%	1.16%
S&P GSCI Tot Return Indx	Broad Commodities	15.98%	7.24%
Bond ETFs/Index	**Fixed Income Sectors**	**QTD Return**	**YTD Return**
ISHARES CORE U.S. AGGREGATE	Core Bonds	-3.22%	-1.03%
ISHARES INTERMEDIATE GOVERNM	Intermediate Government & Corporate Bonds	-0.84%	0.67%
SPDR PORTFOLIO HIGH YIELD BO	High Yield Debt	-0.02%	5.30%
ISHARES 3-7 YEAR TREASURY BO	U.S. Treasuries	-1.24%	-0.07%
ISHARES MBS ETF	Mortgage-Backed Securities	-3.95%	-2.11%
ISHARES 5-10Y INV GRADE CORP	Corporate Debt	-2.84%	0.78%
ISHARES NATIONAL MUNI BOND E	Municipal Debt	-3.28%	-1.10%
TREASURY BILL	Cash	1.29%	17.79%

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Notes

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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