Fourth Quarter 2023

Financial Markets Commentary

DT INVESTMENT PARTNERS

The Fed Ignites A Financial Markets Melt Up As Inflation Slows. Which Economic Scenario Will Unfold?

Summary

- Early in the fourth quarter, we noted that given the recent rise in bond yields, financial conditions tightened considerably. Debt levels and debt servicing costs were significantly higher around the globe. The lagged effects of Fed rate hikes to the highest level in the past 22 years were beginning to negatively impact economic activity in the U.S. and abroad. Inflation was showing signs of a sustained slowdown. Europe and China's economies were rapidly weakening. Geopolitical tensions remained high as wars were being fought in Ukraine and the Middle East. Given this backdrop, we felt the Fed was done raising interest rates. We also believed they may need to begin reducing rates sooner than when fed funds futures markets were forecasting (May 1, 2024). ***The Fed's final meeting of the year on December 13th marked a seminal moment in their most aggressive tightening cycle in the past 40 years.*** To no one's surprise, policymakers left their target range on rates on hold for the third consecutive meeting. However, much to investors' delight, the Fed's statement explicitly acknowledged how far inflation had fallen, and their new projections implied that they expect to cut interest rates by 0.75% next year. Investors reacted by pushing the prices of all financial assets higher. Bond yields plunged/prices soared and some of the stock market's most beaten-down sectors on a year-to-date basis such as real estate and banks along with small cap stocks, led the way higher. This "Everything Rally" continued into quarter-end raising the S&P 500 Index close to its all-time high.
- ***Investors are focusing on which of three potential economic scenarios comes to fruition.*** The leading candidate to start the new year appears to be the **"Soft Landing,"** whereby Fed rate hikes cause inflation to slow, while unemployment remains low, and no recession occurs. However, it's too soon to rule out a **"No Landing"** scenario in which interest rates remain higher for longer without a significant rise in unemployment and economic slowdown or a **"Hard Landing"** resulting from the Fed's aggressive pace and magnitude of rate hikes leading to a significant rise in unemployment and a slowdown/recession.
- It is very important to understand that financial market and economic performance do not always move in sync. For example, strong/weak stock market performance does not always signal a growing/contracting economy. We firmly believe that diversifying portfolios across many asset classes can help mitigate the risks associated with the highs and lows of economic and market cycles. ***Given the current high level of uncertainty in the global economy, investors should continue to embrace the benefits of balance and diversification in their portfolios.***
- We are slightly overweight bonds and slightly underweight risk-based assets. Eventual Fed interest rate cuts should help 2–5-year maturity bonds perform well as the yield curve steepens. In risk-based assets, we favor U.S. stocks, particularly U.S. Large Cap because they contain a disproportionate number of the world's most stable, productive, reliable, and fastest growing companies.

Global Economy

Resilient U.S. Economic Growth, Weakening Global Economy, and Cooling Inflation:

- ***Despite the Fed hiking rates to the highest level in the past 22 years, the U.S. economy continued to grow during the fourth quarter. As the quarter came to an end, consumer confidence was near the peak level over the past two years.*** Since the Fed began tightening monetary policy in March 2022, the labor market has remained remarkably strong, supporting consumer incomes, spending, and household balance sheets. When people have jobs, they are making money. When they are making money, they are spending money, and the economy is growing.
- However, the global economy outside the U.S. is struggling. Europe is on the brink of recession. Its heavy reliance on manufacturing and global trade have magnified the negative impacts from the war in Ukraine, supply-chain disruptions from the global pandemic, 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.
- On a year-over-year basis, the headline Consumer Price Index (CPI) has fallen from a high of 9.1% in June of 2022 to 3.1% in November of 2023. The Fed's preferred measure of inflation, the Core Personal Consumption Expenditures Index (Core PCE) for November showed that underlying inflation barely rose. The Core PCE excludes the volatile food and energy components.
- When annualizing the last six months, the Core PCE was 1.9%. For the first time in more than three years, the Core PCE on an annualized six-month basis is below the Fed's 2% target. This data reinforces the Fed's pivot toward interest-rate cuts in 2024.
- Following the Fed's December 13th meeting, Chair Powell said that "inflation keeps coming down, the labor market keeps getting back into balance, and it's so far so good. We kind of assume that it will get harder from here, but so far it hasn't."
- Falling inflation should benefit economic growth by raising household purchasing power and enabling global central banks to

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

- After falling in value during the third quarter thanks to rising bond yields, all Risk-Based Assets, except for Energy stocks, soared in price during the fourth quarter. In November, investors started to get a feeling that the Fed's July rate hike was going to be the final one of this tightening cycle. Their suspicions came to fruition at the December 13th Fed meeting as slowing inflation prompted Fed Chair Powell to pivot away from raising interest rates and toward considering when to cut them. Investors are now convinced the Fed can pull off a soft landing by slowing the economy and inflation without tipping it into an extended recession and spike in unemployment. In a complete 180 from the third quarter, U.S. Treasury yields sharply declined/prices rose during the fourth quarter. This further energized the stock market, igniting the "Everything Rally." Lower bond yields increase the appeal of stocks relative to bonds and reduce borrowing costs which positively impact corporate earnings. Stocks were led higher by U.S. Large Cap Growth (Technology companies) and beaten down Real Estate stocks. As interest rates fall, investor's view growth stocks more favorably because their long-term discounted cash flows improve and their ability to secure low-cost debt financing becomes less difficult. Real Estate Investment Trusts are bond proxies because of their relatively high dividend yields, which look more attractive when bond yields decline. U.S. Small Cap stocks also generated strong returns during the quarter. They tend to be heavily reliant upon bank loans for financing. Lower interest rates reduce their debt service costs and improve cash flows.
- The Fed's pivot to cutting rates sooner and more frequent than what Chair Powell had indicated prior to the December meeting continued to push the value of the U.S. dollar lower during the quarter. International stocks benefit when the value of the dollar falls because a weaker dollar increases the relative purchasing power of foreign countries, making imports less expensive and exports richer. The dollar's decline makes the debts that international governments and companies have taken out in U.S. dollars less costly to pay back.
- All sectors of the S&P 500 Index, except for Energy, rose in value during the quarter. The International Energy Agency slashed its oil production estimates as global oil demand is slowing down sharply due to weakening economic activity in China, Europe, Russia, and the Middle East. The value of oil fell 16% during the quarter.
- All investment grade bond sectors (Treasuries, Government Agencies, Corporates, Mortgage-Backed Securities, & Municipals) finished the quarter with positive total rates of return, primarily due to the slide in Treasury yields/rise in prices as investors forecast an end to the Fed's fight against inflation. The yield curve remains inverted (2-year maturity Treasuries yield more than 10-year maturity Treasuries), but a steepening trend (2-year yields decline more than 10-year yields) may soon emerge.

Outlook and Portfolio Strategy

- ***Over the past 80 years, the Fed has never managed to bring down inflation without causing an economic recession. Could this time be different?*** The current U.S. unemployment rate of 3.7% is near historical lows. The November Core PCE was 3.2%, down from a peak of 5.4% early last year. When you annualize the last 6 monthly prints, the Core PCE Index has fallen to 1.9%. This is below the Fed's 2% inflation target and further validates their decision at the December meeting to pivot towards easing monetary policy.
- While a soft-landing scenario in which Fed rate hikes cause inflation to slow, while unemployment remains low, and no recession occurs seems possible, we are concerned that the overall rise in the global debt burden since 2008 means that interest rate risk is very potent. Especially when interest rates have just been raised to the highest level in the past 22 years. ***We remain focused on two key questions - 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.*** A no-landing scenario in which interest rates remain higher for longer without a significant rise in unemployment and economic slowdown and a hard-landing scenario resulting from the Fed's aggressive pace of rate hikes leading to a significant rise in unemployment and a recession are still possibilities.
- The range of economic outcomes remains highly uncertain. We believe the most prudent investment strategy is to embrace the benefits of balance and diversification in portfolios. We are slightly overweight bonds and slightly underweight risk-based assets. The Fed's response 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 stock market. Although we likely saw the peak in bond yields during the quarter, rates are still relatively high, and the Fed will soon begin to reduce them causing bond yields to fall/prices rise.
- In risk markets, we favor U.S. stocks, particularly U.S. Large Cap, because they contain a disproportionate number of the world's most stable, productive, reliable, and fastest growing companies. In addition, we are overweight international developed market stocks because an end to the Fed's tightening cycle has caused the value of the dollar to decline which benefits International stocks. Cash balances in money market mutual funds currently sit near an all-time high at $5.9 trillion. This represents a significant amount of dry powder that should eventually be used to purchase stocks and bonds.

Asset Class Total Rate of Return Performance Summary as of 12/31/2023

Stock Indices	Asset Class	QTD Return	1 Year Return
MSCI AC World Daily TR N	Global Equities	11.03%	22.20%
DOW JONES INDUS. AVG	U.S. Large Cap Equities	13.09%	16.18%
NASDAQ COMPOSITE	U.S. Large Cap Equities	13.84%	44.70%
S&P 500 INDEX	U.S. Large Cap Equities	11.68%	26.26%
RUSSELL 1000 GROWTH INDX	U.S. Large Cap Growth Equities	14.16%	42.67%
RUSSELL 1000 VALUE INDEX	U.S. Large Cap Value Equities	9.47%	11.41%
S&P 400 MIDCAP INDEX	U.S. Mid Cap Equities	11.66%	16.39%
RUSSELL 2000 INDEX	U.S. Small Cap Equities	14.02%	16.88%
MSCI EAFE	International Developed Market Equities	10.47%	18.95%
MSCI EM	Emerging Market Equities	7.84%	10.12%
S&P 500 Sector Indices	**S&P 500 Stock Sectors**	**QTD Return**	**1 Year Return**
S&P 500 ENERGY INDEX	U.S. Large Cap Equities - Energy	-6.99%	-1.42%
S&P 500 HEALTH CARE IDX	U.S. Large Cap Equities - Health Care	6.41%	2.06%
S&P 500 CONS DISCRET IDX	U.S. Large Cap Equities - Consumer Discretionary	12.42%	42.30%
S&P 500 CONS STAPLES IDX	U.S. Large Cap Equities - Consumer Staples	5.54%	0.52%
S&P 500 INFO TECH INDEX	U.S. Large Cap Equities - Information Technology	17.17%	57.84%
S&P 500 UTILITIES INDEX	U.S. Large Cap Equities - Utilities	8.56%	-7.08%
S&P 500 INDUSTRIALS IDX	U.S. Large Cap Equities - Industrials	13.00%	18.08%
S&P 500 COMM SVC	U.S. Large Cap Equities - Communication Services	10.95%	55.80%
S&P 500 MATERIALS INDEX	U.S. Large Cap Equities - Materials	9.69%	12.55%
S&P 500 FINANCIALS INDEX	U.S. Large Cap Equities - Financials	13.98%	12.10%
S&P 500 REAL ESTATE IDX	U.S. Large Cap Equities - Real Estate	18.83%	12.27%
Commodity ETF/Index	**Type of Commodities**	**QTD Return**	**1 Year Return**
ISHARES GOLD TRUST	Gold	11.55%	12.84%
S&P GSCI Tot Return Indx	Broad Commodities	-10.73%	-4.27%
Bond ETFs/Index	**Fixed Income Sectors**	**QTD Return**	**1 Year Return**
ISHARES CORE U.S. AGGREGATE	Core Bonds	6.75%	5.65%
ISHARES INTERMEDIATE GOVERNM	Intermediate Government & Corporate Bonds	4.44%	5.14%
SPDR PORTFOLIO HIGH YIELD BO	High Yield Debt	7.13%	12.80%
ISHARES 3-7 YEAR TREASURY BO	U.S. Treasuries	4.49%	4.42%
ISHARES MBS ETF	Mortgage-Backed Securities	7.27%	5.01%
ISHARES 5-10Y INV GRADE CORP	Corporate Debt	8.38%	9.22%
ISHARES NATIONAL MUNI BOND E	Municipal Debt	6.74%	5.56%
TREASURY BILL	Cash	-2.16%	-100.00%

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*