First Quarter 2024

Financial Markets Commentary

DT INVESTMENT PARTNERS

The Resilient U.S. Economy Shines and Stock Prices Hit All-Time Highs

Summary

- An historic first quarter of 2024 resulted in a continuation of the stock market rally that began in October of 2022. U.S. stocks led the way higher as the S&P 500, Dow Jones, Nasdaq, & S&P Midcap 400 indices reached all-time highs. Any weakness in the stock market during the quarter did not last for long as investors bought the dips sending the S&P 500 index to 22 all-time closing highs. Unlike last year when Mega Cap Technology companies dominated the markets' performance, the breadth of this year's rally has been strong with 10 of the 11 sectors in the S&P 500 rising in price. Corporate profits have been stronger than expected and investors seem convinced that the Fed will be able to bring inflation under control without sending the U.S. economy into recession. Credit spreads for both non-investment grade and investment grade bonds declined/prices rose. The U.S. economy remains the shining star around the world. While many European economies are at or near recession, China is experiencing subpar growth, and Japan is slowly rising out of a 30 plus year period of deflation, the U.S. kept on rolling with signs of a productivity boom starting to emerge and developments in artificial intelligence growing by the day.
- As we entered the year, the Fed forecast three interest rate cuts of 0.25% each in 2024, while investors were projecting six cuts via the implied fed funds futures market. However, stronger economic data in January and February along with various comments from Fed members led investors to adjust their overly optimistic view of the number of rate cuts from six to three for the year. Inflation is still coming down, but at a slower pace than many had expected at the start of the year. To no one's surprise, the Fed left the fed funds rate unchanged in March for the fifth consecutive meeting and did not significantly change its outlook for delivering three rate reductions (0.25% each) later this year.
- ***Investors are still focusing on which of three potential economic scenarios evolves.*** The leading candidate among investors is a **"Soft Landing,"** whereby Fed rate hikes cause inflation to slow, while unemployment remains low, and no recession occurs. However, recent economic data are starting to point towards a **"No Landing"** scenario in which interest rates stay higher for longer without a significant rise in unemployment and economic slowdown – a stronger for longer economy in which bond yields stay elevated and the potential for higher stock prices is good. The third scenario is 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. At this point, it appears the least likely of the three scenarios.
- With current equity valuations stretched and indications that pension funds could start selling stocks as part of a re-balancing back to asset class targets, the stage may be set for a short-term pullback/correction. We remain slightly overweight bonds and slightly underweight risk-based assets. Given that three Fed rate cuts are already priced into the markets, the near-term upside for intermediate to long maturity bond prices is limited. However, eventually intermediate and long bond yields will fall/prices rise as the Fed reduces the overnight fed funds rate to below 4% in response to slowing inflation and rising real rates (bond yield minus inflation rate) which tighten financial conditions. Bond yields are currently at their highest levels since September 2008. In risk-based assets, we continue to favor U.S. stocks, particularly Large Cap because they contain many of the world's most stable, productive, reliable, and fastest growing companies. These companies are best positioned to take advantage of slowing inflation in a growing, service-oriented U.S. economy that is less susceptible than years ago to higher interest rates.

Global Economy

- Despite the highest level of inflation in the past 40 years leading to a Fed response of hiking interest rates to the highest level in the past 22 years, the U.S. economy has continued to grow while inflation has declined. The labor market has remained remarkably strong as monthly net job gains have averaged 312,000 over the past two years, 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. Case in point, fourth quarter 2023 revised GDP (Gross Domestic Product) came in at 3.4%, while Gross Domestic Income rose by the most in two years at 4.8%. It's no wonder that consumer sentiment in March climbed to its highest level since 2021.
- Outside the U.S., the global economy is struggling. Europe is stagnant with its largest economy (Germany) stuck in a mild recession for more than a year. Europe'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, and rising inflation and interest rates. China's economy is deflating, and its stock market has plummeted. It 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. So far, its government has been unable to revitalize falling demand and growth. Japan has seen its stock market soar this year buoyed by nominal growth, rising inflation, and corporate governance reforms. However, it still faces rapidly aging demographics, and its underlying economy has been unable to grow on a sustained basis.
- This global divergence from a strong U.S. economy and a weak rest of the world suggests that the U.S. dollar could remain stronger for longer. A strong dollar should limit price upside for broad commodities, particularly oil and copper, which would be supportive of lower inflation.

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

- Except for Real Estate (REITs), all Risk-Based Assets rose in value during the first quarter. 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. Even if rates stay higher for longer, stocks should continue to perform well in a growing economy without a significant rise in unemployment. The Fed has clearly indicated on multiple occasions, beginning in their December 2023 meeting, that rate hikes for this economic cycle are over and their next policy move will be a reduction in the fed funds rate.
- During the first quarter, stocks were once again led higher by U.S. Large Cap, particularly growth-oriented stocks (Communication Services & Technology companies). In addition, U.S. Mid Cap stocks generated strong performance, driven by cyclical sectors such as financials, energy, and industrials. This broader market participation beyond big technology companies is a very healthy sign for future gains. Imminent Fed rate cuts, additional easing in inflation, and better and broader earnings growth this year have all served as catalysts for stock market gains.
- The U.S. economy's resilience so far this year has enabled the Fed to delay the start of their easing (reducing interest rates) campaign. As a result, the value of the U.S. dollar has remained strong, rising 3% during the first quarter. International and Emerging Market stocks suffer when the value of the dollar rises because a stronger dollar decreases the relative purchasing power of foreign countries, making imports more expensive and exports cheaper. The dollar's rise makes the debts that international governments and companies have taken out in U.S. dollars more costly to pay back.
- All investment grade bond sectors (Treasuries, Government Agencies, Corporates, Mortgage-Backed Securities, & Municipals) finished the quarter with negative total rates of return, primarily due to the rise in Treasury yields/decline in prices across the yield curve as investors re-priced bonds to reflect three Fed rate cuts this year, rather than six. The yield curve remains inverted (2-year maturity Treasuries yield more than 10-year maturity Treasuries), the longest this has ever happened without an economic recession. Thanks to the rise in Treasury yields across the curve, Municipal bond prices fell during the first quarter, but continued to perform well on a relative basis versus other fixed income sectors, primarily due to a lack of supply.

Outlook and Portfolio Strategy

- ***Over the past 80 years, the Fed has never managed to bring down inflation without causing an economic recession. The most dangerous phrase in investing "this time is different" is so far holding true.*** The current U.S. unemployment rate of 3.9% is just off historical lows. The February Core PCE on a year-over-year basis was 2.8%, down from a peak of 5.4% early last year and slowly trending towards the Fed's 2% target. While a soft-landing scenario in which Fed rate hikes cause inflation to slow, while unemployment remains low, and no recession occurs seems possible, it feels like we are currently in a no-landing scenario in which rates stay higher for longer without a significant rise in unemployment and economic slowdown, while bond yields stay elevated and the potential for higher stock prices is good. ***We believe that it is possible to have a strong economy and good stock market performance in a rate environment that is relatively high compared to the past 15 years.*** According to Dow Jones Market Data analysis of index performance since 1950, when the S&P 500 adds 8% or more in the first quarter, it finishes the rest of the year higher 94% of the time. Additionally, since 1950, the S&P 500 has risen in a presidential-election year 83% of the time and has averaged a 7.3% gain in those years.
- While the U.S. economy has proven more robust than just about anyone thought back in 2022, there remains a high level of uncertainty going forward regarding the global economy, the geopolitical situation, and when and by how much the Fed will reduce interest rates. We firmly believe that investors should continue to embrace the benefits of balance and diversification in their portfolios as it can help mitigate the risks associated with the highs and lows of economic and market cycles.
- We continue to be slightly overweight bonds and slightly underweight risk. The Fed's response to reduce inflation has resulted in the highest bond yields since September 2008. Current bond yields look more attractive than some segments of the stock market. As for Municipal bonds, weaker seasonal demand in the months of April and May could provide an opportunity to purchase tax exempt bonds at some of the cheapest levels in the past year.
- In risk markets, we continue to favor U.S. stocks, particularly Large Cap. As long as the economy grows while the jobs market stays strong and inflation remains contained, U.S. Large Cap stocks can continue to perform well. If the Fed's interest rate forecast for 3 rate cuts later this year comes to fruition, stocks should perform even better. We are also overweight U.S. Small Cap and International Developed Market stocks. An eventual end to the Fed's tightening cycle and the likelihood of 3 rate cuts later this year will reduce interest expense for Small Cap borrowers. It should also cause the value of the strong U.S. dollar to decline, which benefits international companies and economies. We remain overweight government bonds and long duration while avoiding direct exposure to Emerging Market stocks, Real Estate, and historically expensive Gold and High Yield bonds.

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Asset Class Total Rate of Return Performance Summary as of 3/31/2024

Stock Indices	Asset Class	QTD Return	1 Year Return
MSCI AC World Daily TR N	Global Equities	8.20%	23.22%
DOW JONES INDUS. AVG	U.S. Large Cap Equities	6.14%	22.18%
NASDAQ COMPOSITE	U.S. Large Cap Equities	9.32%	35.14%
S&P 500 INDEX	U.S. Large Cap Equities	10.55%	29.86%
RUSSELL 1000 GROWTH INDX	U.S. Large Cap Growth Equities	11.41%	38.99%
RUSSELL 1000 VALUE INDEX	U.S. Large Cap Value Equities	8.99%	20.24%
S&P 400 MIDCAP INDEX	U.S. Mid Cap Equities	9.94%	23.29%
RUSSELL 2000 INDEX	U.S. Small Cap Equities	5.17%	19.66%
MSCI EAFE	International Developed Market Equities	5.94%	15.94%
MSCI EM	Emerging Market Equities	2.41%	8.50%
DJUSslct REIT Trust	Real Estate	-0.39%	10.45%
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	13.69%	17.61%
S&P 500 HEALTH CARE IDX	U.S. Large Cap Equities - Health Care	8.85%	16.09%
S&P 500 CONS DISCRET IDX	U.S. Large Cap Equities - Consumer Discretionary	4.98%	28.73%
S&P 500 CONS STAPLES IDX	U.S. Large Cap Equities - Consumer Staples	7.52%	7.19%
S&P 500 INFO TECH INDEX	U.S. Large Cap Equities - Information Technology	12.69%	46.01%
S&P 500 UTILITIES INDEX	U.S. Large Cap Equities - Utilities	4.57%	0.42%
S&P 500 INDUSTRIALS IDX	U.S. Large Cap Equities - Industrials	10.97%	26.64%
S&P 500 COMM SVC	U.S. Large Cap Equities - Communication Services	15.82%	49.76%
S&P 500 MATERIALS INDEX	U.S. Large Cap Equities - Materials	8.95%	17.57%
S&P 500 FINANCIALS INDEX	U.S. Large Cap Equities - Financials	12.45%	33.48%
S&P 500 REAL ESTATE IDX	U.S. Large Cap Equities - Real Estate	-0.55%	9.60%
Commodity ETF/Index	**Type of Commodities**	**QTD Return**	**1 Year Return**
ISHARES GOLD TRUST	Gold	7.64%	12.42%
S&P GSCI Tot Return Indx	Broad Commodities	10.36%	11.14%
Bond ETFs/Index	**Fixed Income Sectors**	**QTD Return**	**1 Year Return**
ISHARES CORE U.S. AGGREGATE	Core Bonds	-0.74%	1.59%
ISHARES INTERMEDIATE GOVERNM	Intermediate Government & Corporate Bonds	-0.18%	2.47%
SPDR PORTFOLIO HIGH YIELD BO	High Yield Debt	1.71%	10.26%
ISHARES 3-7 YEAR TREASURY BO	U.S. Treasuries	-0.65%	0.98%
ISHARES MBS ETF	Mortgage-Backed Securities	-1.14%	1.11%
ISHARES 5-10Y INV GRADE CORP	Corporate Debt	-0.09%	4.74%
ISHARES NATIONAL MUNI BOND E	Municipal Debt	-0.26%	2.66%
TREASURY BILL	Cash	3.47%	3.21%

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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