

Fourth Quarter 2016 Financial Market Commentary

January, 2017

Politics Become the Driving Force Behind Financial Markets

Asset Class Performance Summary

- > U.S. stocks set multiple all-time highs in price during the quarter as investors poured money into companies that benefit from stronger economic growth and fiscal stimulus following Donald Trump's presidential victory on November 8th. Stocks have shrugged off Brexit (British exit from the European Union) and rallied since the U.S. presidential election as economic data is beating estimates at the fastest rate in the past 2 years while oil prices have risen 50% since the low on January 20th. It was the best quarter of the year for stocks and marked the fifth consecutive quarterly gain for the S&P 500 Index. Global data during the quarter has indicated that the economic outlook is improving in the developed (U.S., Europe, Japan) world. The dollar has jumped to a decade high relative to major peers and three major U.S. stock indexes last month reached records on the same day for the first time since 1999.
- > U.S. Small Cap stocks led the way on the prospect of lower taxes, fewer regulations, greater infrastructure spending, and restrictions on imports and global trade. They were followed higher by U.S. Mid Cap stocks, Gold, and U.S. Large Cap stocks. Despite the strong dollar, Gold performed well during the quarter thanks to political uncertainty, rising inflation expectations, and continued easy monetary policy (see Table 1).
- > In hopes of fiscal stimulus, deregulation, and higher interest rates and inflation following the November 8th election, investors bid up the prices of U.S. Large Cap cyclical stock sectors (Financials, Telecom, Energy, Industrials, and Materials) while selling the more defensive, income-oriented, bond-proxy sectors such as Healthcare, Real Estate, Consumer Staples, and Utilities (see Table 2).
- > Emerging Markets stocks were the worst performer during the quarter thanks to the strengthening dollar weakening their exchange rates and increasing the cost of U.S. goods and services. Trump's campaign pledges of trade protectionism and de-globalization are also not stock-friendly for Emerging Markets. International developed market stocks were also hurt for similar reasons during the quarter (see Table 1).

- > Bonds sold off abruptly during the quarter with yields rising too far, too fast in our opinion. The potential for fiscal stimulus and an increase in inflation expectations based upon Trump's victory led investors to sell bonds and buy stocks. All sectors in the investment grade bond market declined during the quarter led by U.S. Treasuries and Municipal bonds (see Table 3).

Total Rates of Return (%) as of 12/31/16

TABLE 1

Broad Asset Classes	U.S. Large Cap Stocks	U.S. Mid Cap Stocks	U.S. Small Cap Stocks	Intl. Developed Stocks	Emerging Market Stocks	Intermediate Bonds (1-10yr)	High Yield Bonds	Real Estate (REITS)	Preferred Stock	Gold	Cash
4Q 2016	3.82	7.41	8.82	(0.62)	(4.31)	(2.07)	1.62	(3.28)	(3.81)	5.76	0.08
1YR	11.95	20.73	21.28	1.59	11.27	2.08	16.65	8.63	2.32	11.37	0.33

*Source: Bloomberg and Bank of America/Merrill Lynch Indices.

TABLE 2

U.S. Large Cap Sectors	Materials	Consumer Discretionary	Consumer Staples	Energy	Financials	Healthcare	Industrials	Real Estate	Tech.	Telecom	Utilities
4Q 2016	5.88	2.31	(2.07)	7.14	13.34	(3.75)	5.94	(3.11)	1.36	7.38	0.49
1YR	20.27	6.03	5.15	26.26	17.23	(2.44)	0.00	7.56	14.22	22.27	17.06

*Source: Bloomberg and Bank of America/Merrill Lynch Indices.

TABLE 3

Fixed Income Sectors	U.S. Treasuries (1-10yr)	U.S. Agencies (1-10yr)	Corporate Bonds (1-10yr)	Mortgage-Backed Securities (0-10yr)	Municipal Bonds (1-10yr)
4Q 2016	(2.26)	(1.11)	(1.84)	(1.97)	(2.25)
1YR	1.17	1.13	4.04	1.67	(0.05)

*Source: Bloomberg and Bank of America/Merrill Lynch Indices.

Recap

The fourth quarter began with global stocks trading sideways to lower in price while bond yields rose slightly across the curve during the month of October. Then the election happened and Donald Trump's win sent a \$2 trillion shock wave through global markets during the month of November. A great rotation out of bonds and into stocks occurred as global equities rose by \$2 trillion while global bonds fell by a similar amount. November was the worst month for global bonds in dollar terms on record. The yen plunged the most in 21 years against the U.S. dollar. The dollar strengthened 4.5% since the November 8th election reaching a 14 year high. It all amounted to a complete reversal of the playbooks mapped out by most analysts and investors who had anticipated a Brexit (the British exit from the European Union)-style rush to safe-havens (U.S. Treasuries & Gold) in the event of a surprise Republican presidential victory. The strong rally in U.S. stocks has been the biggest surprise in post-election financial markets. Especially given the distinct lack of clarity in regards to what policies Trump will actually pursue. However, the most important story overall is the huge sell-off in bonds. We view this sell-off as another case of when financial markets, in this case the bond market, discount the headlines long before the actual news occurs.

In December 2015 the Fed raised interest rates for the first time since 2006 and provided a forward guidance that included projections of 4 – 0.25% fed funds rate increases for 2016 and 4 more 0.25% increases in 2017. Its tightening plan was derailed by slow global growth and low inflation as well as political events such as the U.K.'s Brexit vote in June to leave the European Union. U.S. Treasury yields plunged to record lows of 1.36% on the 10 year maturity note on July 8th following the Brexit vote. However, recent months have seen solid economic data from China, the U.S. and Europe. Mr. Trump's victory in the Nov. 8 election has produced a surge of optimism, causing investors to rush out of government bonds and into riskier assets such as stocks. The yield on the 10 year U.S. Treasury Note rose from 1.83% the day before the election to 2.44% at year-end as prices fell.

With this sudden post-election back-up in yields, the bond market has reached extremely oversold levels as investors speculate that Trump's spending plans will boost economic growth and inflation, which in turn will cause the Fed to raise rates faster than what is currently priced in the market (3 – 0.25% interest rate increases in 2017). *The timing and the extent to which Trump will be able to follow through on some of his campaign promises such as infrastructure spending and tax cuts is still very much in question.*

Similar to the December 2015 Federal Open Market Committee (FOMC) meeting, on December 14, 2016 the Fed raised the overnight Fed Funds rate 0.25% to the new range of 0.50%-0.75%. *It signaled that it expects to raise the rate further in the months ahead, but reiterated its desire to raise the rate at a gradual pace moving forward. The Fed's updated projections now imply there will be three rate increases of a quarter point each in 2017, up from September's projection of two increases.*

It is important to keep in mind that the Fed does not have a very accurate track record projecting the timing and magnitude of future interest rate increases.

How much the Fed raises interest rates next year will depend upon how the economy performs and how the economy performs may depend upon the size and type of fiscal spending and tax cuts the President-elect Donald Trump and Congress put into place next year. There is a great deal of uncertainty surrounding such fiscal programs and therefore, the Fed may move very cautiously until it receives a little more clarity. Fed officials made little change to their projections for growth, inflation and hiring at the December FOMC and Chairwoman Janet Yellen emphasized that she would take a wait-and-see approach before deciding how to react to President-elect Trump's economic agenda.

Bond yields can rise in the short run for any number of reasons. However, we are not so sure that the economy is fundamentally strong enough for yields and rates to stay higher in the long run. The President-elect's plans call for more deficit spending. In the long run, deficit spending is contractionary and hampers economic growth. In addition, since the November election, the U.S. dollar has risen to a 14 year high. This serves as a de facto monetary policy rate increase as it tightens financial conditions. Bottom line is that we don't believe interest rates can rise much higher and remain at such levels.

Before making any meaningful changes to the fixed income allocations across our strategies, we will wait for further details to be released that would better define what the actual numbers (spending increases, tax cuts) are proposed to be and the timing and likelihood of such. However, as those details play out, it is our longer-term view that the 35-year bond bull market is likely drawing to a close as we have most likely already seen the lowest lows in bond yields and the highest highs in bond prices. This process of bottoming in yield levels may take a few years to play out.

The bond allocation (comprised of individual bonds and bond ETFs) across all of our investment strategies is currently positioned so that interest rate risk (duration) can be reduced, if called for, with just a few trades. The nice thing about investing in individual bonds is that tactical adjustments are easy to make and individual bonds mature at par while paying the investor semi-annual coupons. The nice thing about investing in bond ETFs is that they are traded on an exchange and are very liquid.

We believe that structural challenges such as aging demographics, high debt levels, budget deficits, and the abundance of global savings will significantly limit the pace and magnitude of interest rate increases over the next few years. It is our view that Fed interest rate increases will be very gradual and limited because of low inflation, economic weakness in Europe, Japan, and China, reduced investment demand relative to desired savings, a strong U.S. dollar, and our belief that the U.S. and

global economies cannot withstand a successive series of interest rate increases over the next year or two.

Trade Summary for the Fourth Quarter

- > Early in the quarter we raised exposure to U.S. Large Cap stocks to equal-weight to the strategic target from underweight. We accomplished this through the purchase of more SPY (SPDR S&P 500 ETF). This purchase was funded by cash and sales proceeds from reducing exposure to the Real Estate sector by selling a portion of ICF (iShares Cohen & Steers REIT ETF).
- > Given the rich valuations in the REIT sector combined with the fact that the Federal Reserve was very likely to raise interest rates at the December Federal Open Market Committee (FOMC) meeting, we felt it was prudent to further reduce our underweight position in the real estate asset class. REITs are bond proxies because of the relatively high level of income that they generate. When interest rates are anticipated to rise, price gains in REITs are usually limited. In addition, back on September 1st, the REIT sector was carved out of the broader Financials sector within the S&P 500 Index and became the 11th sector in the S&P 500. This served to make us more exposed to the real estate sector than we wished and therefore, warranted reducing our position in ICF.
- > Just before Election Day, we reduced exposure to High Yield bonds by selling approximately half the position in JNK (SPDR Bloomberg Barclays High Yield Bond ETF). Proceeds from the sale were invested in cash (money market weep fund). High Yield bonds have been one of the best performing asset classes YTD returning over 11% as of our trade this week. On a yield spread basis, High Yield bonds are trading 21% richer than their 10 year average. Our proprietary technical analysis model was generating a maximum bearish sell signal. We decided it was prudent to reduce risk exposure until at least after the election.

Andrew Zimmerman – Chief Investment Strategist

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