Dillon Capital Management

April, 2014

1Q-2014 Economic And Capital Market Review

Overview

Following a very strong year for stocks and weak year for bonds, returns during the 1st quarter of 2014 were positive but modest in comparison.

The US economy continued to grow at a sluggish pace. But despite headwinds from geo-political forces, an expectation that interest rates will rise, and modest consumer sentiment, we think 2014 will be a good year for the capital markets.

Economy

US economic growth slowed in the 4th quarter of 2013 and estimates for 1Q-2014 are heading lower. GDP in the final quarter of 2013 came in at 2.6%, well below the year high of 4.1% in 3Q which seemed to have been supported by inventory building.

1Q-2014 estimates in the range of 1-2% are problematic for the recovery. It's no doubt the harsh winter will have an impact on 1Q growth and probably push some growth into 2Q, but headwinds exist. Corporate capital spending is not growing, the Fed is signaling higher interest rates, and fiscal policy between tax hikes and Obama Care are having an impact on consumer spending.

The Federal Reserve is in a tough spot. It has committed to ending excessive monetary stimulus that has been in place for nearly five years but is wrestling with the reality of slowing growth and declining inflation – two conditions that would normally suggest an increase in monetary stimulus, not a withdrawal.

The Fed's target for inflation is 2% but prices are running below 1% in recent months. Deflationary pressures have not been extinguished. It's worse in Europe where ECB President Draghi has voiced concern about "price stability," and deflation.

But there is good news. While the current recovery has been slow, it may last longer than recent cycles of 5-6 years. So if we are really at around the mid-point of this cycle, and account for the tremendous amount of deleveraging that has taken place, it's not difficult to predict that consumer spending should rise from here. Furthermore, Leading Economic Indicators (LEI) have actually been rising, suggesting positive economic growth in the 5% area, well above current GDP guesses.

Capital Markets

2014 started with profit taking in the major stock markets following a very strong 2013 leading the S&P 500 to a decline in January of -3.5%, a recovery in February of 4.6%, and a 0.8% gain in March to settle the quarter up 1.8%.

Major Index Returns	1Q-2014	1-year
Barclays 1-3 Mo Tsy.	0.01%	0.1 %
Barclays Agg Bond	1.8%	-0.2%
London Gold Fix	7.4%	-19.2%
S&P 500	1.8%	21.8%
MSCI EAFE	0.7%	17.5%

Small cap stocks gained 1.1% in the quarter, while mid-caps were in line with the S&P 500. The valuation difference between small cap, led by small technology and bio-tech companies, and large cap stocks (Intel, JNJ, Exxon) was near an historic high and prone to contraction.

Stocks that had been running on momentum were challenged by mid-quarter, leading to the end of the long run outperformance by growth stocks. Value oriented stocks took over by March, led by Utilities, Health Care, and old-Tech companies.

International markets were volatile with large, developed markets slightly behind the US indexes, but international small caps rose about 3.4%, while the emerging markets declined -0.4%.

Bonds rebounded by quarter-end, resulting in returns similar to stocks as interest rates rose then retreated on weak economic data and geo-political disturbances. The long-term treasury sector was the best, up 7.7%, followed by high yield (non-investment grade) gaining 2.7%,

Gold was up 7.4% on a technical rebound after falling -27% in 2013. Real Estate rebounded as well, gaining 8.7% in 1Q. Broad commodity baskets were up between 3.5-6.3% from a heavy, positive influence from oil and gold, and moderate gains in agriculture.

Strategy

Forecasts for 2014 have moderated from 2013 year-end predictions for another year of double digit gains in stocks and losses for bonds – current predictions are closer to long-term average returns for stocks and flat to slightly positive for the broad bond market.

We continue to think the optimism is best explained by the slow, steady nature of this recovery which extends the up cycle well beyond historic time horizons. Profits expectations were high coming into 2014 but have moderated.

Expect valuations to have more influence through mid-year as momentum stories fade. Although it didn't reach "bubble" status, the new social media and cloud tech phenomenon, along with bio-tech stock price levels defy conventional investment valuation techniques – a condition that developed during the dot-com bubble of 2000.

The likely re-rating of these high fliers that fueled the long run in growth stocks will result in a flow of funds to stocks with more reasonable valuations. The price-to-earnings ratio (PE) for the Russell 1000 Growth Index is over 21x trailing 12 months reported earnings, while the PE on the Russell 1000 Value Index is 16X. It's time for value stocks to outperform, and when they do, value strategies tend to lead for longer periods.

High corporate profits coupled with low GDP growth suggests that corporations are slow to reinvest in their businesses. Strong balance sheets and solid cash flow has led companies to raise the return of capital to shareholders in the form of dividend increases and share buy-backs. We think dividend paying stocks will be part of the outperformance of value stocks.

An opportunity for outperformance exists in international markets as they remain much cheaper than US markets but hindered by slower growth.

The bond market is likely to generate total returns that are less than their yield to maturity as coupon interest will only partially offset price decline due to the expectation for higher interest rates. Nevertheless, if the economy sputters, bonds will help preserve principal.

Our overall asset allocation strategy going into 2Q will be neutral to slightly overweight equities as the slow spring-summer seasonal patterns play out. We'll remain underweight bonds with a focus on short duration and high yield.

Within equities we favor international and large cap value, and expect an opportunity to reallocate to small cap during modest corrections.

G. Foley – April, 2014

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