Dillon Capital Management

April, 2015

1Q-2015 Economic And Capital Market Review

Overview

- Foreign central bank policy is aiding global recovery efforts and international stocks
- Corporate earnings growth is slowing in the US
- A strengthening US Dollar and weaker foreign currencies signal investment allocation change

Economy

US economic growth (GDP) slowed during the 4th quarter to 2.2%. The forecast for 1Q is for a decline to 1.6% yet a jump to 3.2% for the full year, 2015. Inflation, according to the indexes has been zero, year-over-year, and much of the same is expected for 2015 as the US "imports" deflation from the rest of the world.

Unemployment reached a cycle low of 5.5%, consumer confidence is high, and capacity utilization is nearing the upper-end of its historic range.

Commodity prices continued their slide across the board, feeding the deflationary trend.

Foreign economies have begun to respond to all-out monetary stimulus and the resulting currency devaluations. GDP forecasts are positive for 2015 everywhere except Russia.

The US Dollar was up again in 1Q, gaining 11% vs. the euro on the back of Fed tightening talk and foreign central bank easing. The stronger dollar is hurting the profits of US multinational companies as they convert foreign profits back into dollars.

The Fed remains in the jam we discussed last quarter – it has achieved its dual mandate goals of maintaining stable prices and employment. But now, the textbook next-step, raising rates to prevent the economy from overheating creates the risk that such an action may hamper US competitiveness and halt job growth. The Fed wants an inflation rate of 2% but lower import prices are preventing this.

The recent drop in global oil prices is having the predicted negative impact on economic growth and corporate earnings but we expect it will lead to higher domestic, non-energy consumption, over time.

Overall conditions are good for sustained economic growth and should support further capital markets growth.

Capital Markets

US stock indexes are reflecting a concern that earnings growth is slowing. Bond markets rallied late in the quarter following nervous Federal Reserve Bank comments and remain underpinned by foreign buyers who see the US bond market as far more attractive than their own zero yields and declining currencies. Bonds gained 1.6%, the S&P 500 rose 1%, and foreign stocks were up about 5%.

Major Index Returns	1Q-2015	1-Yr.
Barclays 1-3 Yr. Tsy.	0.5%	1.0%
Barclays Agg. Bond	1.6%	5.7%
London Gold Fix	-0.2%	-8.2%
S&P 500	1.0%	12.7%
MSCI EAFE (Int'l.)	4.9%	-0.9%

Health Care was again the top sector in the US (+6.9%), followed by Consumer Discretionary (+5%). Utilities finally corrected (-6%) after a multi-year run, and energy dropped (-3%).

Every foreign stock market gained in 1Q, except Brazil (-15%) and Mexico (-2%). The MSCI EAFE Index that tracks developed foreign economies, gained 5% in USD terms, but was actually up 11% in local currency terms. Japan, Germany, and China were all up nearly 10% for US Dollar investors. We are finally seeing US investors raise their allocations toward the less expensive foreign markets we've talked about for the past two years.

Small and Mid-cap stocks continued their modest recoveries, beating large cap stocks in the S&P. A stronger US Dollar is perceived to be a headwind for larger companies who do a higher percentage of business overseas than smaller companies. Real estate was up over 4% for the quarter.

Growth stocks continued their run over value stocks in 1Q on strength in health care, bio techs, and semiconductors versus weakness in value index constituents like banks and oil stocks.

Strategy

We all know that stocks don't go up forever in a straight line; the 2nd quarter may provide evidence. A confluence of headwinds includes slow economic growth, the threat of rising interest rates, and an earnings slow-down. Furthermore, current cycle returns from the S&P 500 for the past 3 and 5-year periods are above the long-term trend (10%), having risen 16% and 14.5% annually, respectively.

So how should investors adjust their portfolios?

We think the expansion cycle has longer to go. The broad indexes will correct from time to time, but the trend remains in place so long as valuations stay in check and monetary policy is supportive.

Bonds may prove a better place over the short-term if stocks correct, but only from a principle protection stand point – bonds won't deliver 10% returns over the next 3-5 years with yields below 2% presently.

International stocks continue to present an opportunity. Many foreign markets have momentum at the moment, supported by cheaper valuations and central bank policies similar to the ones that worked to raise asset prices in the US. We've moved to a slight overweight in foreign stock strategies.

In the US, growth stocks have had a very good run indeed, and momentum may continue but we are in the late innings of this game. Value on the other hand has been weighed down by a slow recovery in the financial sector and exacerbated by the drop in oil, moving oil stocks to the head of the value class early in 2015.

Proprietary research we've conducted going back to the mid-1990's comparing growth vs. value styles is predictive – there are observable trends where growth stocks beat value stocks and vice-versa over the medium-term.

In the growth index, 63% of the stocks are tech, consumer, and health care companies (bio-tech and insurers have led the group). The value index has over 50% of its constituents in financial and energy sectors. Traditional valuation metrics such as the price to earnings (p/e) ratio, and price to book (p/b) ratio naturally reflect higher valuations for growth over value.

The current growth trend-run (outperforming value) is now over 9- months long and its return differential is approximately 6.5 percentage points. These are extended levels, so we want to be careful here. And we firmly believe that investors do best buying what nobody wants, when it's cheap (think banks and oil companies). But, despite a couple of false reversal signals favoring value, we believe that growth will continue to lead value in the 1st half-2015, or until we see evidence of the trend changing.

G. Foley – April, 2015

Dillon Capital Management
1 Hidden Lane Abington, PA 19001
info@dillonone.com – (215) 277-1015