DILLON CAPITAL MANAGEMENT April, 2017
1Q-2017 ECONOMIC AND CAPITAL MARKET REVIEW

Overview

- Trump's fiscal policies are being challenged
- Bond yields fell after Fed raised rates
- Foreign stocks are catching up to the US

Economy

The Trump victory in November ushered in a robust fiscal policy agenda, just in time for the twilight of the Federal Reserve's waning monetary policy. But the Fed acts independently, not requiring political approval when it hikes or cuts interest rates, fiscal policy has become increasingly political over the last couple of decades.

Congress yanked its health care reform bill just before its inevitable defeat, adding uncertainty to Trump's agenda and credibility. The next swing at fiscal policy change will be tax reform, which had threads in the failed health care act. Both have serious implications for the budget and consumer spending prospects.

On March 30, the government reported 4Q GDP growth of 2.1%, right in-line with the last 5-6 years of the long, slow recovery. Leading indicators paint a stronger picture for 2017 based on higher ISM and PMI reports, indicating business have rebuilt inventories and ramped up capital spending at a faster pace than we saw in 2014-2015.

Leading indicators have also been strong in Europe and parts of Asia. Japan's fragile economic reform, called "Abenomics," seems to be working. China and Brazil have stabilized a bit, and India is prevailing as a strong, emerging economy under President Modi.

Capital Markets

The S&P 500 is up 13.1% since the election and 6.1% YTD. No doubt some of the rise stems from hope for Trump's policies, but more objectively, first quarter profits are expected to be solid.

International stocks have done even better in 2017, with developed markets gaining 7.3% and emerging markets up 11.5%. Despite near-term political uncertainty over the French and German elections, investors are recognizing value in Europe vs. the US, strength in Asia, and recovery in Latin America.

Major Indexes	1Q-2017	1-Year
Short-term Treas. (1-3 Yr.)	0.3%	0.2%
Barclay's Aggregate Bond	0.8%	0.4%
S&P 500 Index	6.1%	17.2%
Russell 2000 (Small Cap)	2.5%	26.2%
MSCI EAFE (International)	7.3%	11.7%
MSCI Emerging Mkts.	11.5%	17.7%
Bloomberg Commodity	-2.3%	8.7%

Small cap stocks were volatile, following a 26% gain in 2016 and appear more exposed to concerns about rising wages with modest revenue growth ahead.

The bond market seemingly ignored the fed's quarter-point interest rate hike in March. Yields actually declined on the long-end of the maturity curve, from a 2.6% yield on the 10-Yr treasury, to 2.3% at quarter-end, signaling that bond buyers don't expect inflation to rise much, the economy will slow after 1Q, and the Fed will move slowly with future rate hikes.

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Strategy

With recent gains, US stocks have moved above the longer-term trend line, and price/earnings ratios (PE) are extended, pricing in future profits. We think the trend remains in place for stocks but short-term corrections are inevitable.

In our last report, we highlighted that value stocks outperformed growth stocks in 2016 by over 10-percentage points, mostly attributable to gains by banks and energy companies off low valuations. That gap was an outlier in the "Growth vs Value" style, long-term battle.

Banks are priced as if deregulation and higher interest rates will boost future profits, yet consumer stocks are priced as if profits will continue to decline. It's rarely easy to get it right over the short-term, and trends eventually revert to their means. When everyone thinks the same way, it's usually time to look in the opposite direction for safety and opportunity. A contrarian bet might be that expectations don't materialize, and growth becomes hard to find in the stock market. In times like that, investors flock for any growth they can find and drive growth stocks higher. We took profits in our tactical value allocations and increased the allocation to growth.

Foreign markets have lagged the US recovery for years, leading to a wide gap in stock market valuations. The price/book ratio for the S&P is 3.0 versus 1.6 for foreign stocks, and the price/sales ratio in the US is 2.1x versus 1.2x for foreign stocks.

We like the opportunity of a recovering Europe, rising profits in Japan, and strong economic growth in India. Additionally, foreign real estate has lagged the strong trends in the US over the past few years as financing has been readily more available under the fed's cheap money policies. It has taken a long time for prices to settle in foreign real estate, but they have, and financing is increasingly available.

Our fixed income strategy has favored shorter maturity bonds that are less exposed to the risk of rising interest rates. The move toward higher rates will play out slowly and provide an opportunity to adjust allocations to capture higher yields.

It's important to think long-term amidst the daily noise coming from Washington and the rest of the world. It's also important to remain diversified while looking for opportunities to invest.

G. Foley – April, 2017

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P.S.-please email or call with questions or comments!