Dillon Capital Management
Economic & Capital Markets Strategy 1Q-2018

Highlights

- Fiscal policy is replacing monetary policy as the new economic stimulus.
- Fed hits the auto-hike interest rate button.
- 2018 corporate earnings will be boosted by tax cuts.

Economy

Synchronized global growth took hold by year-end and was confirmed by strong economic reports around the globe early in the new year. Employment, manufacturing and consumer sentiment measures hit cycle highs. The January employment report, out in early Feb, confirmed the trend; however, it also revealed a spike in average hourly earnings (AHE) – a rare sighting of inflation.

Simultaneously, President Trump's tax policy had just passed, while the Fed's Janet Yellen was handing over the Chair job to Jerome Powell. In her exit speech, Yellen warned of inflation, committing her old employer to a fixed stream of interest rate hikes for 2018-19. The markets expected Powell to be OK with this and the stage was set - the long run of low interest rate monetary policy was coming to an end. With details on the tax policy, fiscal policy was emerging.

Critics questioned the timing of the fiscal policy initiative: why provide stimulative fiscal policy tax cuts just as the Fed is signaling that it's time to take away accommodative monetary policy – the economy is supporting itself? This should have been done in 2010, but wasn't, and US tax policy needed a fix. This could throw gas on the fire, raising the fear that the economy could of overheat and give the fed cover for moving rates up faster.

That's what's concerning the markets and tariff talk isn't helping forecasts.

Capital Markets

Stocks declined in the quarter after hitting all-time highs in January, and 13-months of unprecedented low volatility. The S&P 500 was down 0.8% for the quarter while the tech-heavy NASDAQ, which had a big lead in January, held onto a 2.6% gain.

Major Indexes	1Q-2018	1-Year
Short-term Treas. (1-3 Yr.)	-0.2%	0.4%
Barclay's Aggregate Bond	-1.5%	1.2%
S&P 500 Index	-0.8%	14.0%
Russell 2000 (Small Cap)	-0.1%	11.8%
MSCI EAFE (International)	-1.5%	14.8%
MSCI Emerging Mkts.	1.5%	25.4%
Bloomberg Commodity	-0.4%	3.7%

Large foreign markets reacted similarly but for different reasons. Concern over the sustainability of growth emerged in Europe along with a rise in the value of the Euro and Yen vs. the US Dollar – a challenge for foreign exports. For varying and unique geo-political reasons, emerging markets gained 1.5% with strength in Latin America and Eastern Europe, including Russia.

The tech sector held onto a 3.5% gain but was much higher before volatility reemerged in February. The consumer discretionary sector was the only other group in positive territory for 1Q, up 3%, led by a recovery in badly beaten retail and strength in housing related companies.

Growth stocks beat value stocks led by consistent rise in tech stocks and a mild correction in the ascent of banks (largest sector of value stocks) as investors continue to question whether rates will rise which is a positive for banks and insurance companies.

Small cap stocks were flat in the quarter but strong support exists for smaller company stocks. Valuations have come down relative to large caps, performance has trailed large caps, tax cuts are meaningful, and sentiment that domestically focused businesses may fare better if trade wars emerge.

Bonds declined in price across the board in the US, pressured by the fed's plan to raise rates. Foreign government bonds were positive for US investors with most of the return coming from the currency market.

Many commodities gained in the quarter, rising from very low bases, as the economy heated up. This often occurs later in cycles and should be supported this time by a long period of underinvestment and commodity production.

Investment Strategy

Clouds are building from a top-down perspective due to high stock valuations, an upturn in volatility from unsustainable levels and now the tariffs discussion. Nevertheless, there is plenty of positives from a bottom-up view: economic growth is accelerating, tax cuts are supportive of higher earnings, and the consumer is feeling good.

Earnings are expected to grow by nearly 20% in the 1st quarter. This, along with rolling corrections in the indexes is reducing price-to-earnings (PE) ratio valuations – the numerator (share price) has declined as the denominator (earnings per share) is rising.

Sector leadership may shift over the next couple of quarters, spreading from tech to other sectors and industries that haven't participated as much. With the tech/ semi-conductor cycle approaching its later stages, earnings will be solid but the growth rate will eventually peak. Look for consumer, energy and financials to pick up the pace.

A diversified portfolio should continue to own large cap, US stocks but the allocation should be expanded beyond just index ownership to reduce the risk that momentum, enjoyed by the largest tech companies, could turn down.

We like a healthy allocation to small caps and foreign markets, both developed and emerging, and would add slowly to real estate.

There is risk that inflation accelerates by late 2018, and we believe the fed will continue to raise short-term rates, so we'll maintain a low duration profile in bonds. As we get to the second-half of the year, if yields are higher, we'll start to move out on the yield curve and raise the duration profile – even if bond prices decline further from there income collection form higher coupon yields will offset further price declines.

If you want to lower your risk profile methodically reduce your equity allocation in favor of short bond investments. If the inflation storm get worse, consider adding gold.

G. Foley – April, 2018

Please call or email with questions or comments!

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