

2Q-2017 ECONOMIC AND CAPITAL MARKET REVIEW

Overview

- New politics support European markets
- Central bankers are talking yields higher
- Growth stocks were strong in 1st half

Economy

The French election may have saved the European Union. Macron's victory was a vote for the EU, following a nationalist trend that was gaining steam after the UK's vote for Brexit and President Trump's victory in the US. The trend of discontent with global policies was evident in Germany and throughout Europe. Now, the tide has turned and Angela Merkel's policies look safe heading into the German elections. This clears the way for a renewed unification commitment that can take the EU to a new level.

Seizing opportunity, central bankers around the world are declaring victory over deflation and talking interest rates higher to fend-off looming inflation. But evidence of inflation is illusive despite low unemployment and expected wage pressures. Pan-Europe GDP growth has only edged higher to 0.6% and 1st quarter GDP in the US fell back to 1.4%. Japan reported GDP growth of 2.2%.

Economists are concerned that the US economy is stalling while the Fed seems committed to its monetary policy tightening, a move that usually raises the exchange rate of the US dollar. But that was not the case in the 2nd quarter - the dollar has been declining against the Euro and Yen. A declining dollar may help US competitiveness longer term, but near term it's raising the cost of imports and beginning to fuel inflation.

Surprisingly, the yield on the 10-year US treasury

dropped to 2.1% in 2Q, even after the fed raised the fed funds rate in June to its new 1-1.25% target. The decline in yields appears to be an over-reaction to short-term, weaker data. Real rates in the US remain negative (fed funds rate minus CPI), historically a rare occurrence, and the fed wants real rates positive. We expect rates to rise during the 2nd half of the year.

Capital Markets

Stocks and bonds were up solidly again in 2Q, led by the foreign markets. International stocks have ripped higher in 2017, first on the reassurance that monetary policy would remain supportive of the recovery in asset prices and then on the stabilizing effect of the French elections.

Major Indexes	2Q-2017	YTD
Short-term Treas. (1-3 Yr.)	0.2%	0.5%
Barclay's Aggregate Bond	1.5%	2.3%
S&P 500 Index	3.1%	9.3%
Russell 2000 (Small Cap)	2.5%	5.0%
MSCI EAFE (International)	6.1%	13.8%
MSCI Emerging Mkts.	6.4%	18.6%
Bloomberg Commodity	-3.0%	-5.3%

EAFE gained 6% in dollar terms but only 3% in local currencies, indicating that the drop in the US dollar exchange rate represented nearly half of the gain. Asian markets were up about 9%, Europe gained 7.7% in dollar terms. France was up 10% while Germany was up 7%. Chinese stocks fought off regulatory concerns and jumped 10.7%. Taiwan, Korea, and Mexico were up high single digits.

In the US, 1st quarter earnings were strong, up over 14% for the best quarter in over 5-years, leading the

S&P, Dow and NASDAQ to record highs. Small and mid-cap stocks gained but trailed the large company indexes. Large cap tech stocks have led most of the year (+17% YTD, +4.1% in 2Q), but the health care sector was tops in the quarter, gaining 7% on the assumption that Congressional bills won't be able to stop the runaway spending. The industrials sector gained 4.7% and financials remained strong on the hopes of higher interest rates and late-quarter capital requirement test results.

Growth stocks continued to beat value stocks, with the index up 4.7%, led by large techs and bio-techs. YTD, the growth index has outperformed the value index by nearly 10-percentage points (14.0 vs. 4.7%).

The bond market ignored the fed's quarter-point interest rate hike in March and again in June, as yields declined. High yield bonds held onto their gains even as yield spreads vs. treasuries are near cycle lows, suggesting increased risk here.

Strategy

Recent central bank talk and a few cautious actions raise the risk for stocks and bonds, near term. If yields embark on a new trend higher, bond prices will decline. If stock investors begin to model for higher interest rates, they will apply a higher discount rate to future earnings expectations and reduce price targets for equities.

At this point, against the backdrop of a slow but steady global recovery and little evidence of inflation, we expect concerns and price corrections to be short-term. Central bank tightening will be very slow and careful as they try and avoid causing a large financial impact.

We have been talking about the opportunity in foreign stocks for a number of quarters; valuations were low and earnings depressed during the very slow recovery process. Much has changed. The valuation gap has closed materially and earnings

estimates are improving. We still favor foreign stocks over US markets but have become more discriminating. Europe, Japan and select emerging markets look OK.

In the US, while growth stocks have been strong for a while now, the trend may continue if economic growth and inflation remain subdued. In that scenario, investors will continue to pay-up for growth at any price, but the reality is that large cap techs are not all that expensive given their long-term growth forecasts.

For value stocks to work, interest rates will have to rise, inflation must materialize, and earnings in financial and energy stocks must improve. Given a weak dollar, imported inflation and a fed determined to eliminate negative real-rates, a boost in value stocks could become a second half story.

So what do you do? We'll try and stay diversified, maintaining a lower allocation to the US, an overweight to foreign markets, and a tactical allocation to growth stocks and dividend paying stocks (keeping both a growth and value tone to the portfolios). In fixed income, we'll keep the lower duration target in focus (lower interest rate risk if yields rise) but look for spikes in yields or a clear decline in inflation expectations to pick-up longer maturities. We still like the idea of hedges via long-short equity strategies and macro opportunity funds.

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