Dillon Capital Management
Economic & Capital Markets Strategy 2Q-2018

Highlights

- Economic growth has overcome a variety of macro headwinds
- Higher Dollar, interest rates, and oil prices
- International equities are wavering

Economy

Economic sentiment in the US is, for now, offsetting various and emerging global concerns including political discontent, rising interest rates, and inflation.

The US economy continued its steady path, logging another 2%-plus GDP growth for 1Q. Forecasts for 2Q GDP have risen to 4%.

Politically, US imposed tariff talk has generated negative headlines but current political trends in Europe, Latin America, and Asia pose more immediate problems.

Populist victories in the Italian elections have heightened the discontent over immigration problems, again putting focus on European Union vulnerabilities. German PM Merkel was forced to compromise her failed immigration policies to gain support at home and address cracks in the EU.

Brazil, Venezuela, Mexico, and Iran continue to experience dramatic political instability at a time when a strong US currency and higher oil price is having a dramatic impact on emerging market economies.

The US is clearly on a monetary tightening road (the Fed raised rates in June to a range of 1.75%-2.00%) and others are starting to consider it. In June, Mario Draghi, the head of the European Central Bank (ECB) delivered a time-table for reversing quantitative easing.

While inflation remains low at around 2% in the developed world, it's been climbing, particularly in the US and Japan where employment has reached historic levels. This partially explains the long-awaited strength in the US Dollar.

Politics don't often have an impact on economic outcomes but it's a problem at the moment as it diverts attention from economic opportunity.

Capital Markets

Stocks in the US were higher in the quarter on the strength of solid earnings growth in 1Q. The broad market, S&P 500 Index, rose 3.4%, while the tech-heavy NASDAQ rose 6.6%.

Major Indexes	2Q-2018	YTD
Short-term Treas. (1-3 Yr.)	0.2%	0.1%
Barclay's Aggregate Bond	-0.2%	-1.6%
S&P 500 Index	3.4%	2.7%
Russell 2000 (Small Cap)	7.8%	7.7%
MSCI EAFE (International)	-1.2%	-2.8%
MSCI Emerging Mkts.	-7.9%	-6.5%
Bloomberg Commodity	0.4%	0.0%

Given the pressure from a strong dollar and the potential impact tariffs might have on export sales from US-based global companies, investors turned to domestic oriented small cap stocks. The Russell 2000 Index gained 7.8%.

International markets were mixed. Developed economies in Europe were up in local currency terms but down for US dollar investors due to the decline in the euro. Emerging markets were slammed by a sell-offs in China and Brazil, a rise in oil prices and a decline in exchange rates.

Growth stocks, led by the tech (+7.1%) and consumer discretionary (+8.2%) sectors, outperformed value stocks, where financials and industrials declined over 3%, each. Energy was the top performing sector in 2Q (+13.5%). Oil E&P stocks rallied on the back of higher oil prices. And, although it happened faster than we had predicted, real estate rallied in 2Q (+6.1%).

Bonds managed a short comeback from 1Q declines but settled lower due the realization that the Federal reserve, under the new leadership of Jerome Powell, would continue to raise short-term rates thru 2018.

Defensive alternatives like long-short equities and managed futures strategies declined over 5% but shorting bonds was a winning strategy.

Investment Strategy

We have entered a challenging stage of this 9-year old economic recovery. While "risk assets" such as growth stocks and small company stocks did well in the 1st half of 2018, risk and volatility have risen. The fed is committed to raising interest rates causing bond prices to decline. Foreign markets will always be good for overall portfolio diversification, but many foreign economies are stalling.

The 2nd-half of the year pits earnings and economic momentum against rising interest rates and increasing margin pressure on profits from wage inflation, and some uncertainty over the impact tariffs might have.

We are less concerned about tariff-talk, more concerned about political trends and the impact their impact on economic progress. When policy makers devote time to maintaining power, all else takes a back seat. This is a real problem in Europe, UK, and South America.

Earnings are expected to grow in the US, adding to the levels turned-in during the 1st quarter. But earnings momentum will begin to slow as the impact of tax cuts fades. Higher interest rates and wage pressures will likely hamper profit margins at companies that led the profits recovery. Success will have to broaden for the indexes to go a lot higher.

From a global perspective, the US equity market looks like the place to be with higher earnings pushing price-related ratios lower – US stocks are now cheaper than they were last year at this time. Banks, industrials and energy companies have room to run.

We suggest reducing the overall international equity allocation - Japan looks favorable, Europe and LatAm are challenged.

Japanese equities have corrected lower over trade concerns, but exports are rising, the economy appears strong, and corporate earnings should be good during the 2nd half.

Despite compelling valuations, Europe lacks consensus leadership. We prefer to reduce our allocation and wait until things stabilize on the continent and in the UK when the focus can return to economic development.

In fixed income, the US is not looking so good. We would maintain a shorter duration at least through year-end. 2-Year Treasury Bills yield over 2.55% and short-term, investment grade corporate bonds are over 3.2%. Going out on the yield curve to get 2.83% on the 10-Year Treasury, a 28-basis point pick up in interest for a significant increase in interest rate risk does not seem to make sense unless you think a recession is imminent – we don't.

G. Foley – July 2018

Please call or email with questions or comments!

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