Dillon Capital Management

July, 2014

2Q-2014 Economic And Capital Market Review

Overview

The long, slow recovery is celebrating its 5-year anniversary since the last recession, and it's been 2-years since we've experienced a downward correction in stocks. The major market indexes are at record highs despite a nasty but explainable decline in 1Q-2014 US economic growth, and geo-political battles affecting Ukraine and the Middle-East.

All major stock and bond indexes experienced positive returns in the 2nd quarter. Inflation seems to have replaced deflation as a concern of economists, at least in the US, and the US Federal Reserve is slowly withdrawing monetary stimulus.

Economy

Last quarter we wrote about the positive impact of inventory building in the 2nd half of 2013. Well that build-up of supply, when coupled with the "Polar Vortex" (cold, snowy weather) early in the 1st quarter of 2014, resulted in negative economic growth for 1Q of -2.9% (the final 1Q-GDP report came out in late June). In our report we also said to expect 2Q-2014 GDP to recover – expect 3.5% GDP for 2Q.

The only thing slower than the rate of economic growth is the action of the Federal Reserve. Here we are 5-years after a recession, and upon hitting their own targets for unemployment (6.1%) and inflation (2.1%), all they are willing to do is "reduce" the bond-buying program known as QE3 – short term interest rates remain at crisis-remedy levels.

There has been some change in monetary policy outside the US. New Zealand is the first developed market economy to tighten interest rates, but the UK, like the US, has stubbornly resisted. Europe and Japan are providing additional stimulus to their economies. The ECB moved to a negative interest rate for bank deposits at the central bank, essentially telling banks to lend or lose money on reserves. The Japanese are counting on "Abenomics" stimulus to restart growth.

We are sticking with our prediction that the recovery will remain slow but last longer than previous cycles. Supporting this view is the positive momentum in job creation, the bottoming of the deleveraging process, and the eventual increase in capital spending. Continued strength in Leading Economic Indicators (LEI) forecast a solid path of economic growth 6-12 months from now.

Capital Markets

In the US, the S&P 500 gained 5.2% during the quarter, beating the Dow Jones Industrial Average gain of 2.8%. Mid cap stocks were up 5.0%, while small cap stocks (Russell 2000 index) rebounded to a 2.0% gain after a sharp sell off early in the quarter.

Major Index Returns	2Q-2014	YTD
Barclays 1-3 Yr. Tsy.	0.3%	0.4%
Barclays Agg. Bond	2.0%	3.9%
London Gold Fix	3.0%	9.9%
S&P 500	5.2%	7.1%
MSCI EAFE (Int'l.)	4.3%	5.1%

All sectors of the market were positive with particular strength in Energy (+10.9%) and Utilities (+7.6%). The financial sector was the weakest, gaining 1.3% overall, with real estate and insurance companies showing strength but banks declining -2.4%.

From a style perspective, growth and value both returned 5.1% in 2Q. Coming into the quarter, our trend following research indicated a switch to value, a trend that is still in place.

There was some dispersion in the international markets, with Asia outperforming Europe. The overall international benchmark (MSCI EAFE) gained 4.3%.

Emerging markets gained 6.7%overall, led by India (+12.7%), Russia (+10.8%), and Taiwan (+10.4%). Mexico, Brazil, and China were next, with mid-single digit returns and each outperforming the US.

Surprisingly, with so much talk of the need for the Fed to raise interest rates, all sectors of the bond market were in positive territory. The market was led by long-term treasuries (+5.1%, +13.2% YTD), followed by Treasury Inflation Protected Securities (TIPS) and then High Yield bonds, which gained 2.4%.

Gold gained on geo-political fears from the Russia-Ukraine confrontation and battles in the Middle-East. In our opinion, the strength in Real Estate stemmed from a move toward an inflation trade (i.e. higher prices), ignoring the traditional fear of the impact of higher interest rates on property cash flows.

Commodity baskets were generally negative due to weak agriculture prices, but positive when including oil and gasoline.

Strategy

The current set of expectations includes:

- *Steady job growth and higher wages,*
- *Low but rising inflation,*
- *Higher interest rates in the US,*
- *Solid but tempered profit growth,*
- *Economic growth (GDP) between 2-3%*

The Fed will reduce monetary stimulus slowly, which will push short-term interest rates higher. But the supply/demand dynamics for long-term treasuries suggests that longer-term rates will not rise as much as the market expects. But the yield on the long-end is not sufficient for the risk. We prefer a fixed income strategy favoring shorter maturities and an underweight in intermediate to long-term maturities. Given the stimulus pressure by foreign central banks, the global bond sector will remain attractive.

With the DJIA and S&P 500 around all-time highs and most of the profit recovery behind us, our concern turns to valuation. Sentiment over valuation is mixed. The price-to-earnings ratio for the S&P 500 is 16 times estimates for the next twelve months (PE-NTM), only slightly above historic levels, but with inflation and interest rates still well below historic averages, the current valuation is not excessive.

Despite the “value” trend that indicates lower priced stocks will outperform growth stocks, the “risk on” trade is not dead. Look for a number of momentum stocks to recover but volatility to increase as the bull market surges on. Social media and biotech companies have valuations that defy logic and are prone to dramatic correction. If that happens, we’ll look for leadership from recently depressed consumer discretionary and financial stocks to offset the drop and keep the overall market averages from declining to much. Nevertheless, the probability of a correction or two is building with each passing month of gains.

We’ll stick with lower PE, value oriented stocks through the summer. We favor large caps over small caps, for valuation reasons. A larger international allocation seems wise due to a big valuation gap vs. the US and support from the coming ECB stimulus.

Emerging markets will be volatile, but opportunities exist for stock selection by actively managed mutual funds in these markets.

G. Foley – July, 2014

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