Dillon Capital Management

October, 2015

3Q-2015 Economic And Capital Market Review

Overview

- Global economic uncertainty hurt the markets
- Fed elected not to raise rates
- Bonds outperformed stocks and turned positive for the year, while US and foreign markets turned negative for the year!

Economy

The government revised 2nd quarter economic growth up to 3.9%, unemployment remained around 5.1%, and inflation hovered around 0.2%.

The US Federal Reserve disappointed the markets by not raising interest rates in September after having implied a rate hike since the spring. A 0.25% hike in the fed funds rate would not have hurt. By postponing it, the fed appears indecisive and confused at best; or thinks the economy is too weak to sustain a hike. The stock market likes low interest rates, but over the long-term, would prefer stability in government policies.

The two biggest concerns of the fed seem to be that there is no inflation, suggesting the risk is toward deflation, and, the potential impact that a stronger dollar might have in already weak foreign markets.

Commodity prices slid further, reversing last quarter's spike, led by oil and metals prices – but really every single commodity declined in 3Q except hog prices. Lower commodities result in declining profits for commodity producing companies and countries, lower inflation, but also indicate lower economic growth in the near future.

Capital Markets

With the fed passing on raising rates, bond prices were strong again late in the quarter. Of all the major market indexes we track, the only positive return in the quarter was the Barclay's Aggregate Bond Index. US treasury indexes of various maturities, a component of the AGG, were also positive. At quarter-end, the yield on the 10-year US Treasury benchmark bond had dipped below 2% (bond prices go up when yields go down). Short-term rates are rising, while long-term rates are declining.

Major Index Returns	3Q-2015	YTD
Barclays 1-3 Yr. Tsy.	0.3%	1.0%
Barclays Agg. Bond	1.2%	1.1%
London Gold Fix	-5.0%	-6.2%
S&P 500	-6.4%	-5.3%
MSCI EAFE (Int'l.)	-10.2%	-5.3%

Stocks declined mostly across the board in 3Q which pushed the major indexes into negative territory for the year.

The S&P 500 dropped 6.4%, but less than the international markets decline of 10.2%. Every sector of the index was down except real estate (+4%)and utilities (+2) – both turning reversals from multi-quarter declines.

Small cap stocks, which many perceive to be immune from the slow economies outside the US, shed 12% and are now down 7.7% YTD.

Strength in growth stocks early in the year and through mid-summer, allowed growth to maintain its record outperformance of value stocks, but the trend is poised to reverse. Value is materializing in energy and financial stocks as interest in bio-tech and health care may be waning.

Outside the US, European exchanges mostly tracked the US markets, led by France, -6.4%. Japan, which is a large component of the foreign market index, declined 11.7% on signs of slower economic progress.

Emerging markets were particularly weak, led lower by Brazil (-34%) and China (-23%). Despite material improvement in India, which we think will continue to gain momentum, the market dropped 6.7%.

Gold was down 5% and crude oil dropped 27%.

Strategy

Our view remains the same as it did last quarter….(this text never seems to change), and we have had some vindication during the 3rd quarter on earlier insights:

- *"Stock prices are on the high side of valuations, and we expect corrections."*
- *"…Bonds may rally over the short-term, but returns will be flat-to-negative as interest rates will eventually rise."*
- *"International stocks are cheap…"* But as of today, they have obviously they have just gotten cheaper. We had expected a Fed rate hike by now, which would have boosted the US dollar, positively impacting foreign export profits and stocks.

Following the recent correction, US markets should be positive through the usually seasonally strong 4th quarter and early 2016.

Merger and acquisition activity as well as stock buyback programs will serve as a use of cash for well financed companies in this low rate environment, and boost their profitability going forward.

European markets will get back on the recovery track as the ECB steps up its QE program and accepts the immigration trend.

Japanese stocks have consolidated after solid gains in 2014 and early 2015, and could be poised to move ahead in the 2nd half if global demand can maintain a pulse.

The emerging markets will remain volatile as a result of instability. We still prefer India under its new government, and we expect slightly more stability in China and Brazil into year-end.

Tactically, we are maintaining our neutral weight to US equities, but within this position we have increased the allocation to "Alternatives," specifically, equity-hedge vehicles to dampen volatility.

We'll maintain or add to our international weight, opportunistically, as we expect foreign central banks to provide additional stimulus to the markets.

In fixed income we have reduced credit risk by exiting high-yield and reallocating to intermediate-term maturities of higher quality. Investment grade corporate and municipal bonds have underperformed and are setting up for consideration in the future.

G. Foley – October, 2015

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