DILLON CAPITAL MANAGEMENT October, 2017

3Q-2017 ECONOMIC AND CAPITAL MARKET REVIEW

Overview

- Central bankers reiterate cautious policies
- Foreign stock markets were strong, again
- Bonds weakened as interest rates moved up

Economy

The US economy posted stronger economic growth in the 2nd quarter, with 3.1% GDP growth. Inflation remained subdued despite low unemployment and increasing wage pressures, but rose to 1.9% in August. Personal income rose 2.7%, and the Purchasing Managers Index was bullish at 55%.

The Federal Reserve expressed a clear intent, at its September meeting, to reduce monetary policy stimulus in two ways: reducing its balance sheet beginning in October, and raising interest rates again before year-end and three times in 2018.

Politics in developed economies outside the US remained in a steady state following on the path of last quarter's French elections. Angela Merkel's Christian Democrats won a fourth term and Shinso Abe's approval ratings are rising with a recovering Japanese economy. We can expect more drama from the UK as Brexit takes shape, but global steadiness is supporting economic confidence.

The US Dollar declined vs. the Euro and Yen, early in 3Q, as economists questioned the fed's resolve in light of faltering inflation reports. But by late September, bond investors took yields higher over concerns of monetary tightening and the dollar responded. A rising dollar hurts US exporters but takes the focus off the European Central Bank's efforts to slow its stimulus and supports European exports.

Overall, things look pretty good for investors. Inflation is low, economic growth is steady, profits are up, and the global central banks are proceeding to withdraw stimulus, very slowly.

Capital Markets

All major equity market indexes were higher in the quarter. Growth stocks, foreign stocks and emerging markets all gained over 5% for 3Q, and are now up over 20% YTD – see table below.

Bonds gained early in the quarter, doubting the fed's commitment to raise interest rates, but reversed course in September to end only slightly positive.

Major Indexes	3Q-2017	YTD
Short-term Treas. (1-3 Yr.)	0.2%	0.7%
Barclay's Aggregate Bond	0.9%	3.1%
S&P 500 Index	4.5%	14.2%
Russell 2000 (Small Cap)	5.7%	10.9%
MSCI EAFE (International)	5.5%	20.5%
MSCI Emerging Mkts.	8.0%	28.1%
Bloomberg Commodity	2.5%	2.9%

International returns were boosted by recovering sentiment and a weaker US dollar. Nearly half of the MSCI EAFE Index's gains can be attributed to exchange rates. France and German markets were both up over 7% in the quarter and over 25% YTD.

Emerging markets were the strongest sub-asset class, led by a 23% gain in Brazil and an 18% gain in Russia.

Technology was again the leading sector in 3Q, up 8.6%, followed by 1st-half laggards, energy and telecoms, with both gaining 6.8% but still in negative territory for the year. Consumer sectors were the

Dillon Capital Management
809 N. Bethlehem Pike, Ste. F1
Ambler. PA 19002
info@dillonone.com
215-367-5365

weakest with pressure on retailers and food providers.

Growth stocks extended their outperformance vs. value stocks (20.7% vs. 7.9% YTD).

Strategy

Our strategy discussed in last quarter's report hasn't changed and has actually been strengthened by developments at the Fed and ECB.

1. Global central bank talk of tightening has been further defined as cautious, which we view as positive.
2. Foreign equity market valuations are still lower than the US.
3. Growth stocks have gotten more expensive and the growth vs. value trend is extended but not broken; however, corrections should be expected.
4. Value stocks may get a boost if inflation materializes, interest rates rise, and earnings from the financial sector grow. (Value did beat growth in September. An October beat triggers a shift in trend, out of growth stocks.)

A new strategy point emerged in 3Q: small cap stocks in the US have lagged large caps this year. A recovery is underway, perhaps on hopes of tax reform but also from mean reversion following a period of weakness.

We recommend remaining overweight stocks and underweight bonds- but not in a big way. We favor foreign stocks in both the developed and emerging markets, and foreign real estate over the US real estate. We have conviction on the prospects for Europe and, increasingly, Japan.

Tactically, growth can still be held over value, but keep in mind that the broad US market indexes (S&P 500, Russell 1000 indexes) already provide exposure to growth stocks due to the escalating valuations of constituent large technology companies.

Remember, market indices like the DJIA and S&P 500 Index are comprised of stocks, grouped in sectors. Although technology has been the leader, if it falters, new leadership could emerge from financial, energy, and the consumer sector.

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 decline in inflation expectations to pick-up longer maturities. Bonds will prove a safe haven if stocks decline

A WORD OF CAUTION: US MARKETS CONTINUED TO MAKE ALL-TIME HIGHS IN 3Q!

DON'T BE GREEDY. ALTHOUGH WE DON'T SEE ANYTHING THAT COULD DERAIL THIS MOMENTUM IN THE NEAR-TERM, SOMETHING WILL CAUSE IT TO CORRECT AND PRICES WILL DECLINE.

US growth stocks, small cap stocks, and emerging market stocks have historically been among the most volatile sub-asset classes. Higher returns are associated with higher risk.

G. Foley – October, 2017

gfoley@dillonone.com

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