Dillon Capital Management
Economic & Capital Markets Strategy 3Q-2018

Highlights

- US Markets return to highs
- US Dollar rise hampers foreign stocks
- Fed hikes short term rates to 2.25%

Economy

US economic growth accelerated in the 2Q; GDP gained 4.2%, the highest level since 3Q-2014. The Inst. of Supply Mgt. (ISM) index hit a 14-yr high, and the Conference Board's Leading Econ. Index (LEI) hit 111.2, the highest since 2006.

The unemployment rate of 3.8% is heading lower. The employment cost index is up 2.8% for the last 12-mos. Inflation has edged up to 2.7%.

The Federal Reserve raised short-term interest rates to 2.25% in 3Q and is poised for hikes in December and early 2019. Nevertheless, "real Interest rates" (inflation - fed funds) remain negative, a rarity during economic expansions.

Critics suggest that current economic growth is boosted by still accommodative monetary policy (low rates), aggressive fiscal policy (Trump's tax cuts), excessive borrowing, and a buying binge ahead of trade tariffs. Rates are too low, and consumers and businesses are spending the tax windfall.

Fed Chair J. Powell has warned that he doesn't fear inflation as the ignition for the next downturn, but excessive debt accumulation. Higher interest rates will hurt margins and future cash flows.

European growth slowed to 0.4% in 2Q and remains mired in attention-absorbing political battels. The Germans are concerned about tariffs, and Italy is acting defiantly toward the EU on immigration and its budget deficits. France appears on the offensive, moving to privatization of government owned businesses to raise capital that will be reinvested in growth initiatives.

The UK's BREXIT negotiations continue to weigh on the domestic economy and its currency.

Emerging market economies may be stabilizing, if only because they could hardly get worse. The two Koreans are talking, China is dealing with lower growth, both self-imposed and trade related, and other Asian countries are benefiting from the turmoil in some ways.

Capital Markets

Stocks in the US have fully recovered from the Jan/Feb downturn on spectacular earnings reports. Large Caps led the way.

Major Indexes	3Q-2018	YTD
Short-term Treas. (1-3 Yr.)	0.2%	0.2%
Barclay's Aggregate Bond	0.0%	-1.6%
S&P 500 Index	7.7%	10.6%
Russell 2000 (Small Cap)	3.6%	11.5%
MSCI EAFE (International)	1.4%	-1.4%
MSCI Emerging Mkts.	-0.9%	-7.4%
Bloomberg Commodity	-2.0%	-2.0%

The glamor of Small Caps began to wane relative to Large Caps in the quarter, as Trump's trade negotiation tactics are improving prospects for US global trade.

International markets were mixed again in 3Q, Japan and France were positive but the developed market index (MSCI EAFE) was dragged down by political turmoil on the Continent and UK.

The emerging markets index failed to recover as China and India were down, but Latin American constituents rallied; Brazil and Mexico gained on upcoming and recent Presidential election hopes, respectively.

Growth stocks continued strong, led by Health Care and Tech. Energy stocks were flat, despite a move up in oil, and Banks gave back some earlier gains in September.

Bond investors began to capitulate to a tightening Fed. The 10-Yr Treasury yield moved above 3.0%, again and investors have reduced interest rate risk by moving to shorter maturity instruments.

US stocks have dramatically outperformed foreign stocks as earnings of US companies have accelerated and gains in the US dollar has hurt investment abroad.

Software and cloud service companies have experienced high rates of growth. Cloud revenue has been growing over 50% the last two years and the transition requires software innovation. At some point, this rate of growth will slow and the lofty valuations the market places on these businesses will decline.

Investment Strategy

Are we at the "this is as good as it gets stage?" We believe that low interest rates and tax cuts have had a positive impact on corporate earnings growth. It's difficult to make the case that this is sustainable. The impact will be smaller in 2019 and result in weak comparisons on year-over-year results, albeit still positive.

Nothing, at the moment, indicates a recession is eminent, but downturns typically occur 9-18 months after the seeds have been planted. Bonds and stocks tend to smell a storm coming but aren't very good at assessing the magnitude.

Wall Street strategists are increasingly suggesting "risk off": moving money from growth stocks into value stocks to reduce volatility; reallocating from the US, which appears overvalued, to cheaper international and emerging markets; and reducing the weight in corporate bonds on rising credit concerns. We prefer shorter maturities for fixed income with a plan to gradually extend maturities, opportunistically.

While we see short-term interest rates rising beyond 3% it won't impact corporate earnings for the next few quarters.

We plan to keep our US equity allocation at a slight overweight, trimming growth when it gets overweight our target, and a neutral-to-underweight position in international until Europe gets things straightened out.

G. Foley – October 2018

Please call or email with questions or comments!

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