Dillon Capital Management

January, 2014

4Q-2013 Economic And Capital Market Review

Economy

On December 20, 2013 the US Commerce Department reported final 3Q GDP growth of 4.1%, much higher than earlier estimates, and quite a bit above the slow moving 2% rate of the previous few quarters. Concerns are that the growth can be attributed to inventory building going into year-end. Estimates for 4Q are skeptical, with guesses averaging between 2-2.5%, and 2.6-3.0% for 2014.

The US economy is however moving in the right direction and the same can be said for Europe. Italy and Spain for example, who were in recessions as recently as July, now have positive 2014 forecasts. Growth in Asia is also forecasted to improve, led by China and India, with 7.5% and 5.6% growth estimates.

The Federal Reserve disclosed it will begin to "taper" its bond buying program in 2014, putting interest rates at risk of rising. The bond market has already priced most of this risk in as yields on the 10-year Treasury note rose most of the year from a low of 1.6% in April to 3.0% at year-end.

The combination of US growth and the tug back on monetary policy, while most other economies are still easing interest rates, has served to strengthen the US dollar. A stronger dollar may prove to be a headwind for US multinationals and tonic for foreign company exporters as their products become more price competitive.

Asian economies, especially those dependent on China, are most fragile. The Chinese have encouraged domestic spending through policy actions, while Japan appears to be in the early innings of a long monetary easing initiative. Neither approach has much history of success.

Overall, global economic conditions are supportive of asset values and bank balance sheet recoveries. 2014 should be an extension of the low interest rate, easy money policies of 2012-13.Yet, inflation is only a risk in some emerging markets.

Capital Markets

2013 was the best year for US stocks since 1997, with the S&P 500 returning 32% for the year, and over 10% in 4Q alone. But bonds had their worst year in a long time in the wake of rising interest rates. Gold was decimated as the fear of deflation and currency collapses dissipated.

Major Index Returns	4Q-2013	YTD
Barclays 1-3 Mo Tsy.	0.01%	0.04%
Barclays Agg Bond	-0.14%	-2.02%
London Gold Fix	-9.20%	-27.61%
S&P 500	10.51%	32.39%
MSCI EAFE	5.71%	22.78%

Small Cap stocks continued their torrid pace, gaining 8.7% for 4Q and 38.8% for the year. The developed international markets gained 23% for the year on a mid-year rally in a recovering Europe, but emerging markets were weak, declining -2.6% for the year. The BRIC's were in negative territory for the year due to slowing economic growth and geo-political unrest. Weaker currencies contributed to the slide in US$ terms.

Real estate declined during the 2nd half of the year in anticipation of higher interest rates, but held on to first half-2013 gains, ending the year up 1.8%.

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High yield bonds held up surprisingly well, returning 5.9%, about equal to the coupon yield, despite a decline of -2.0% in the broad US bond market.

On the style front, growth led value in all major indexes in 4Q and for the year, overcoming the rally in financials (a big part of the value style indexes) during the 1st half. Tech stocks (led by social media entrants) and bio-techs were growth-style leaders right into year end. Bio-tech and Aerospace stocks gained about 60% each for the year while gold and silver miners fell over 50%.

Strategy

Forecasters are predicting more of the same for stocks in the coming year, and it may prove correct for the 1st half of 2014, at least. We think the optimism is best explained by the slow and steady nature of this recovery, despite the huge returns we've had. Profits are strong, asset valuations continue to improve, and interest rates are in a slow, upward transition.

Certainly valuations are higher but not stretched to bubble levels. Nevertheless, back-to-back 30%+ equity market returns are unlikely. The S&P has gained 172% from the bottom in March, 2009 and the price/earnings ratio on 2014 estimates is equal to the former October 2007 high of about 15.9.

The probability that US market indexes will be up for 2014 is good, barring a major unforeseen event, but not without corrections along the way –the higher the averages go, the deeper the correction(s) will likely be.

Bonds have already priced-in, or discounted a rise in long-term interest rates, but not short term rates, which we expect will remain low so long as the Fed sticks to its commitment of not raising them until 2015. So while principal will be at risk of deterioration if rates move up at a slow, steady

pace, coupon income can offset a lot of the decline. Furthermore, when the stock market sells off, it will most likely be the result of news about slower economic conditions which may lead bonds to rally.

It's not a zero probability that when the music stops on December 31, 2014 bonds will be ahead of stock returns for the full year. Expect us to slowly rebuild bond allocations from a year-end underweight in a selective and timely fashion.

As we've been saying for over three years now, the US would lead the rest of the world in the recovery, which has been very apparent. Other economies however have now been stabilizing and offer better value ahead. The combination of still low interest rates, lower relative valuations, and cheaper exchange rates abroad supports better stock market performances looking forward outside the US.

We still favor large cap US stocks but are a bit cautious of multi-nationals if the US Dollar strengthens. We'll continue to add to our international exposure in the developed markets, and prefer to underweight US small cap stocks and emerging markets.

G. Foley – January, 2014

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