DILLON CAPITAL MANAGEMENT

October, 2014

3Q-2014 ECONOMIC AND CAPITAL MARKET REVIEW

Overview

- US Gross Domestic Product rebounded +4.6%
- Pressure mounted on the Fed to raise rates
- US large cap stocks hit record highs in September
- Foreign markets dropped
- Europe lowered rates and stepped up stimulus

Economy

US economic growth bounced back with strong 2Q-GDP (+4.6%) while economic activity in Europe was weak. The US continues to lead all major, global economies. The unemployment rate is declining, and inflation is still below the Fed's 2% target. The US appears to be moving beyond the recovery stage, into expansion.

Capacity utilization is rising, and signs of bank lending are improving - even the consumer appears to be doing better. Consumer confidence is at its highest level since 2007, and retail sales, although volatile, are heading higher.

But can we expand alone? Germany reported -0.2% GDP for 2Q, while France and Italy remain in recession. With the European economies retreating badly in 3Q, the ECB was compelled to act, driving interest rates to zero. It will now cost European banks a fee to leave excess reserves in the system, an intended coercion to increase lending and spur growth.

Despite significant policy change in Japan, the economy has not improved. China's slowdown has had a ripple effect not only across Asia but into Australia, Brazil, and other supply-partners.

Late in the quarter, a combination of Fed tightening talk and ECB easing led to drops in the Euro and Yen versus the Dollar. Weaker currencies are usually expected to have a positive impact on export competitiveness, but with foreign domestic markets having deteriorated so much, and deflation a renewed concern, we don't expect much of a fight from abroad for some time.

Capital Markets

The S&P 500 gained 1.1% in 3Q. Small-caps continued to decline (-7.4%) after reaching near-record high valuations vs. large caps.

Major Index Returns	3Q-2014	YTD
Barclays 1-3 Yr. Tsy.	0.0%	0.4%
Barclays Agg. Bond	0.2%	4.1%
London Gold Fix	-8.5%	0.6%
S&P 500	1.1%	8.3%
MSCI EAFE (Int'l.)	-5.9%	-1.4%

The health care, tech and financial sectors were positive; industrials and basics declined, and energy dropped -9.1% on declining oil prices.

From a style perspective: growth outperformed value mostly on strength in bio-techs and internet related stocks.

With heavy geo-political headline news, international markets were mostly down across the board. Europe dropped over -7% and Japan declined -2.2%. Nearly half of the decline can be attributed to currency changes (dollar up, euro down).

The rally in emerging markets was halted due mostly to Russia and China, but Mexico and India were up just over 2% on hopes for leadership change. Overall, the emerging markets index dropped -3.4%.

The debate in the bond market is over when the Fed will start to raise rates, not if. Under this condition, most investors expect bonds to fare badly as bond prices drop when rates rise. But rates aren't rising as expected. In fact, longer-term US treasuries have actually performed quite well. With foreign central banks obliterating yields on their sovereign issues, and driving down their currencies, foreign investors have little recourse but to buy US Treasuries. This has placed a ceiling on US rates despite current sentiment that the 10-year treasury will rise above 3% in the near future.

Despite the strength in government bonds, the corporate and hi-yield markets have not experienced the same fame. There has been a flight from non-investment grade issues for most of the summer, but it appears overdone at this point, especially if treasuries trade in a tight range.

Real estate trimmed its YTD gains during 3Q, despite a pick-up in commercial activity, as valuations got a little rich. Commodity baskets got slammed, led by declines in oil, grains, and metals; only coffee and cattle were positive.

Strategy

Our current set of expectations includes:

- *Steady job growth and higher wages*
- *Low but rising inflation*
- *Higher interest rates to come in the US*
- *Economic growth (GDP) between 2-3%*
- *(New) Worsening conditions in Europe*

The Fed will reduce monetary stimulus slowly, which will push short-term interest rates higher. Supply/demand dynamics for long-term treasuries suggests that longer-term rates will not rise as much as the market expects. Nevertheless, 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 long-term maturities. Given the stimulus pressure by foreign central banks, the global bond sector should remain attractive unless conditions lead to credit defaults.

US stocks are at all-time highs with economic conditions that continue to be supportive. Profit margins are high; dividend payouts are rising; and companies will continue to buy-back their stock as long as interest rates remain low.

We prefer Asia to a still declining Europe, but as we've witnessed in the past, eventually Europe will be too cheap (and US valuations too rich) to ignore – though that may take some time.

We still favor value over growth, large over small caps, and see sector opportunities in the health care and financial sectors - both large constituents in the value indexes. Oil and gas stocks have been weak, reflecting a drop in the commodities.

With stocks at these levels, partial hedges in the alternatives space, such as long-short and market-neutral strategies, may be useful.

Overall, things look good in the US heading into mid-term elections. Risks include: the Fed raising rates too quickly; dollar strength that raises the costs of imports for foreign buyers and reducing the competitiveness of US multi-nationals; and increased Russian aggression.

If a material correction develops, we'll look to Europe and small cap US companies to add to the portfolio.

G. Foley – October, 2014