DILLON CAPITAL MANAGEMENT

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1Q-2016 ECONOMIC AND CAPITAL MARKET REVIEW

Overview

- US stocks dropped 10%, but recovered, to end the 1st quarter up 1.4%.
- Economic growth weakened in 4Q.
- The Fed backed off on its 2016 tightening plan.

Economy

At the start of the year, stocks reacted negatively to deteriorating energy market conditions and slowing corporate profits following the Fed's December interest rate hike, and disclosure of its plan to raise rates four more times in 2016.

The fed panicked and ran to the podium to retract its tightening plan as our markets tanked, and Europe and Japan plowed deeper into negative interest rate policies. There went the credibility we suggested they regained last quarter.

Then the US reported that Gross Domestic Product (GDP) gained 1.4% in 4Q, another sequential decline amid contracting global trade activity.

Inflation is low but inching up and unemployment remains at a comfortable 5% - conditions that historically lead to a tightening of monetary policy. But the nearly 7-year recovery is in the late innings, corporate profits have stagnated, yet none of the traditional leading indicators are suggesting a recession is imminent.

Although certain commodities spiked in 1Q, the gains were off very low levels and will likely subside. Inflation should continue to inch-up as wage pressures rise in an economy that is at near full employment. Our bets remain on the consumer supporting what little economic growth there is as corporations recalibrate.

Capital Markets

Stocks retreated early in the quarter for the reasons we commented on: delayed 2015 profit-taking, Fed policy, lower oil prices (low of $26 bbl. at February stock market low), and concerns over peak earnings and a slowdown in China. The recovery followed the oil price recovery and gained further support from subsequent, sympathetic Fed comments.

Once the Fed backed-off on its tightening strategy, bonds rallied (interest rates declined) and stocks recovered, dramatically.

Major Index Returns	1Q-2016	1-Yr.
Barclays 1-3 Yr. Tsy.	0.9%	0.9%
Barclays Agg. Bond	3.0%	2.0%
London Gold Fix	16.5%	4.0%
S&P 500	1.4%	1.8%
MSCI EAFE (Int'l.)	-3.0%	-8.3%

But different stock market leaders emerged in this snap-back. Stocks with "value" characteristics: low P/E ratio, low price volatility, and high dividends outperformed "growth" stocks, breaking an 18-month trend. Value was up 1.6%; growth was up 0.7%.

Small cap stocks, overall, declined 1.5% but small cap value was up 1.7%. Real estate rose 5.2% and commodities were slightly positive.

International stocks were mixed. Developed markets in Europe and Asia declined between 2-6%, while emerging markets were positive on double-digit gains in Brazil and Russia.

Foreign bonds did well as large central banks moved to a negative interest rate policy (under which, the government not only won't pay interest on a bank's required deposits at the central bank, but will charge the banks a fee for keeping excess deposits out of the economy). The ECB said it will extend its QE asset purchases to corporate bonds, but may not be able to find enough to buy!

Strategy

The S&P 500 was climbing toward all-time high levels, again, as 1Q bounded to a close. Stocks follow corporate earnings, higher or lower. For the markets to move a lot higher, we'll need earnings growth or a willingness by investors to pay higher prices for slow growing companies. With interest rates still near historical lows, it's not inconceivable that prices could climb on flat earnings, resulting in "market multiples" (P/E ratio of about 15 right now) rising to the upper teens.

Expectations are high that earnings growth will be disappointing for 1Q and perhaps through the summer. But these are macro-market earnings predictions, covering all companies in the indexes. As usual, some sectors will do better than others.

We remain convinced that the US consumer is much better off than a few years ago and should incrementally support US growth. Couple that with the potential for oil prices to stabilize at current or higher levels, and housing demand to pick up, and it doesn't take much to convince us that stocks, selectively, could remain a solid place to invest.

The outperformance trend in growth stocks was due to end, as we have been predicting for some time; however, the sharp recovery in value stocks has more work to do before it can be labeled a "trend."

Nevertheless, with analysts predicting lower earnings for the 1st quarter, investors may very well stick with lower risk companies that pay solid dividends. Until these get priced-up too high, picking good growth stocks will be just that, a stock-pickers challenge.

The situation around the world is quite different, however. Europe has become more competitive as the Euro has declined vs. the US Dollar but structural issues remain. Japan may be entering a recession, despite the monetary and fiscal efforts of Abenomics. China's growth is slowing. The corporate loan default rate is rising rapidly, and the government's solution is to throw more funding at it – heightened risk.

The Indian government leadership continues to make progress against opposition and the country is on-track to be an economic growth leader in the future. Brazil is mired with low export growth, inflation, and political problems. The Brazilian markets rallied sharply in 1Q, on the hopes of reform, but even if the process gets under way, it will take time to improve the economy.

Pulling all that together….

- We are slightly underweight US stocks but will add to positions on weakness, particularly in small caps.
- Value is preferable to growth, for now.
- The foreign markets are very much investable, but will be more volatile.
- Bonds should remain safe; credit risk has stabilized, and interest rate risk is low within the context of the Fed's current policy stance.
- We continue to endorse overall portfolio hedging as a means to dampen volatility.

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