DILLON CAPITAL MANAGEMENT July, 2016
2Q-2016 ECONOMIC AND CAPITAL MARKET REVIEW

Overview

- Stocks and bonds gained in the 2nd quarter
- Valuations are high for US stocks and bonds
- Oil prices recovered; UK "brexited"

Economy

The two main events in the quarter were the Fed's decision not to hike rates, and the UK's referendum vote on June 23 to exit the European Union – both surprises from early-2016 forecasts.

The Fed's decision appeared to be a reaction to slower US economic growth, in the 1-2% range, and coupled with a slightly weaker, interim employment report.

Other than that, things look good in the US. The consumer, which accounts for about 2/3rds of economic activity, continues to exhibit the strength we expected. US housing, an important component of our economy, is clearly in an uptrend and should get even better in an extended period of low mortgage rates. And with the unemployment rate just below 5%, we can declare full employment in the US. Even LEI (Leading Economic Indicators) and PMI (Purchasing Managers Index) monthly releases gained. Inflation is up only slightly, toward the Fed's target of 2%.

Most of the rest of the world is still years behind the US recovery. We view the UK's BREXIT as more of a political statement than an economic one, but it could further hamper recovery efforts in Europe.

The immediate impact was a decline in British Sterling as expectations for a recession in the UK rose. The rationale is that following the decision to exit the EU, British exports to Europe will decline, in anticipation of that, British companies will slow their hiring and business investment plans, leading to an economic contraction. Lower priced Sterling should underpin the competitiveness of British exporters, but harm domestically focused businesses.

As a political statement, Brexit stokes the fires of discontent with the EU government in other EU members. If that sentiment gains momentum, the question of the EU survival is raised, leading to further apprehension about future business investment and prospects for an all-out slow-down.

Capital Markets

US stocks were up, across the board in 2Q, except for a -0.2% drop in the tech-heavy NASDAQ. This advanced the YTD gain in the S&P 500 to 3.8%.

Bonds also gained in the wake of another decision by the Fed not to raise interest rates. Long-term treasuries rocketed 6.8% in the quarter and are up 16% for the year. Short-term treasuries returned a more realistic 0.5% and 1.4% YTD. High yield bonds were up 5.5%.

Major Index Returns	2Q-2016	1-Yr.
Barclays 1-3 Yr. Tsy.	0.5%	1.3%
Barclays Agg. Bond	2.2%	6.0%
London Gold Fix	6.7%	12.2%
S&P 500	2.5%	4.0%
MSCI EAFE (Int'l.)	-1.5%	-10.2%

Energy was the top-performing sector, gaining 12%, as oil prices steadily climbed by over 50% from the February low, to nearly $50 per barrel. Telecom and utility stocks gained 7% as investors chased yield in the declining interest rate environment brought to us by the Fed. Tech and consumer discretionary stocks

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

were negative as recent high-flying tech companies slowed their ascent and retail results dropped significantly.

The recovery in oil stocks and for a while, banks, pushed “value” stocks way ahead of “growth” stocks. This trend we follow and report on regularly, turned in favor of value late in the 1st quarter and probably has enough fuel to continue late into the 2nd half.

Small caps caught a momentum waive, outpacing large caps in 2Q. The 3.8% gain pulled the Russell 2000 index into positive territory for the year.

Real estate remained strong and commodities spiked by 13% due to rises in oil, gold, and a few agricultural products, all off very low levels.

International markets were not so fortunate. Overall, the developed markets declined 1.5% (now-4.4% YTD), due to weak results in Europe, led by the sinking banking sector. Emerging markets were up 1% (+6.6% YTD) on US Dollar weakness and recoveries in Brazil and India.

Strategy

Despite the turmoil, not much has changed for our outlook. Economic growth is slow but a recession is not in sight. Accommodative monetary policy remains at risk of reversal, which would negatively affect stocks and bonds, but probably not prior to the fall elections.

US stock indexes are trading at high valuations (PE, price/book, price/cash flow), but certain large sectors, such as financials and health care, offer value that could push the broad market higher, similar to what we experienced in the energy sector as oil prices recovered. Technically, we’re slightly underweight traditional US equities since we count the hedge strategies as “alternatives.” Adding the alternatives allocation gets the portfolio to a neutral position in the US

The valuation gap between the US and beaten-down European and Asian equites is growing, raising the probability that those markets will outperform the US in the future. The recovery in those regions trails the US by 2-years and headwinds remain, so we are proceeding cautiously. We recommend accumulating international exposure for an eventual overweight in the portfolios.

While interest rates in the US may drop closer to zero, where most of the rest of the world is, the lower they go, the greater the risk of loss when rates turn around. Our preference is toward a more defensive, shorter duration allocation favoring mortgage backed security strategies and high-quality corporates.

The rally in real estate asset valuations may have run its course for now, and yields are at the bottom of their historic range. Start to reduce.

We continue to endorse overall portfolio hedging as a means to dampen volatility. Low volatility, high quality, long/short equity strategies and precious metals should all be considered.

G.Foley – July, 2016

gfoley@dillonone.com

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