Dillon Capital Management

July, 2015

2Q-2015 Economic And Capital Market Review

Overview

- Global economic growth remains slow
- Recent US economic reports should force the Fed to raise rates in 2nd half-2015
- Anxieties in China and Greece roil markets

Economy

The final US GDP report (economic growth) for the 1st quarter came in at a negative -0.2% after a weak 2.2% level in 4Q-2014. Subsequent economic data was stronger, and a recovery is expected for the full year to about the 2.0% level, down from earlier estimates.

Commodity prices rose sharply in the quarter, up from very low levels. They were led by a recovery in oil – up to $64 per barrel after a bottom of $46 in January – and agriculture.

With energy, food, and of course health care costs on the rise, we are starting to see inflation pick up in the US. Employment data continued to strengthen, and housing related statistics were generally higher, too.

Disappointment over the Fed's inaction on rates contributed to a correction in the 'overbought' dollar's rapid ascent against the world's major currencies.

The Greek insolvency saga drags on through quarter-end, and no one really knows how it will end. Our guess is that Greece will remain in the European Union (EU) in some fashion. The deal will focus on the repayment of debt and require drastic changes to the Greek economy. This will prove to be a lot easier under the euro than a new currency after an exit from the EU. And while the near-term disposition of Greece will not have a direct effect on other markets, it is having an impact on Europe's recovery. The ECB was making progress with its new Quantitative Easing (QE) program but the focus has changed to keeping the European Union (EU) together. It's easy to say "just let Greece default…," but that leads the EU into uncharted waters. Greece and other weak countries owe the EU governments a lot of money. Reducing the commitment or letting them walk opens the door to others to do the same, and slows the evolution of the ECB and its tool box for controlling and assisting with EU stability.

In China, a government sponsored initiative encouraging the masses to invest in stocks – the next phase of China's transition to consumerism – hit the rocks late in the quarter. The Shanghai index had spiked to a new 7-year high in May, then dropped 20% in June. Taxi drivers and barbers are 'playing' the markets and volatility has been unprecedented. But a number of large Chinese companies trade in the more stable Hong-Kong and US markets – these stocks were less affected by the volatility.

Capital Markets

Easy monetary policy and the slow recovery continue to underpin the stock market, but bonds have been hurt by the specter of higher interest rates.

Major Index Returns	2Q-2015	YTD
Barclays 1-3 Yr. Tsy.	0.1%	0.7%
Barclays Agg. Bond	-1.7%	-0.1%
London Gold Fix	-1.0%	-1.3%
S&P 500	0.3%	1.2%
MSCI EAFE (Int'l.)	0.6%	5.5%

Earnings estimates for US multinationals are showing weakness. The concern over higher rates has taken a toll not only on bonds (prices go down when yields go up) but certain stock sectors more than others. Real estate (REITS), utilities, industrials, and basic materials all turned in a negative quarter. With four of the markets 10 sectors facing headwinds, the S&P 500 barely finished up for the quarter, gaining 0.3% and is now only up 1.2% YTD.

Health care stocks were tops again (+4.1%), followed by a 1% gain in financials. Utilities dropped -7.2%, and the energy sector was down 3.0%.

Small cap stocks were slightly better than large caps, while mid-caps were surprisingly weak (-1.1%). From a style perspective, growth and value were both up just 0.1% this quarter, but growth has outperformed YTD by a little over 3-percentage points.

The broad international indexes were all up between 0.5-0.8%. Japan and the UK led the developed markets, gaining 3.0% each while Germany declined 5.1%. In the volatile emerging markets Brazil, China, and Russia were all up over 6%, while India dropped 3.6%

Strategy

Our view remains the same as it did last quarter:

US stocks are on the high side of historical valuations, but the economic expansion is supportive – expect corrections, however.

Bonds in the US will be flat to negative due to an eventual rise in interest rates. But over the short-term, bond prices may rally amidst global turmoil.

International stocks, despite the geo-political storms, are cheap and will generally be supported with stimulative monetary policy.

Looking more closely at the details:

It may take a couple of quarters for earnings to catch up with valuations in large cap stocks, particularly the multinationals exposed to a strong dollar. Small caps should continue their climb after their 2014 consolidation. But yield oriented sectors such as REIT's and utilities are seeking a bottom. Bio-techs and social media stocks are stretched and could be a source of pain for the overall markets.

Oil is a wildcard. No one seems to know where the bottom is for crude prices or natural gas. The large multinationals will find opportunities to consolidate the small, weaker companies in the sector, but earnings will be down and affect the broader indexes.

We expect that Greece will remain in the EU and European markets will get back on the recovery track as the ECB steps up its QE program.

Japanese stocks are consolidating after solid gains, and could be poised to move ahead in the 2nd half if global demand can maintain a pulse.

The emerging markets will remain volatile as a result of instability. We prefer India under its new government, but China and Brazil may present value opportunities by year-end.

G. Foley – July, 2015

Dillon Capital Management
1 Hidden Lane Abington, PA 19001
info@dillonone.com – (215) 277-1015