Dillon Capital Management

October, 2013

3Q-2013 Economic And Capital Market Review

Economy

US economic growth is stuck in second gear at an annual rate no better than 2%. This is despite all-out monetary stimulus from the Federal Reserve, but ineffective fiscal policy by the Obama administration and Congress.

Since May when the Fed first hinted at "tapering" (the reduction of open market bond purchases by the Fed also known as "QE3") we have heard that the economy is doing better, employment is picking up, and the need for continued economic stimulus is declining. So why did they not taper in September as the markets expected? It's because the Fed fears what's happening in Washington could harm the economy and they might have to reinstate monetary stimulus.

Historically, the combination of monetary policy with effective fiscal policy has had immediate effects on economic growth. This time around, it's been longer and the recovery has been anemic. Now five-years after the financial crisis began, vigilant monetary stimulus is ineffective. Is it really helping, or is it just that over time, things get better on their own?

The US has not cut back on its spending but in Europe, the original aggressive austerity plans have been delayed. The careful approach, while not committing to too much stimulus either, has boosted recent results, even in Spain and Italy.

Asian economies, especially those dependent on China, which is most countries, are more fragile. The Chinese have encouraged domestic spending through policy actions. Japan has been more US-like at least in talk, pushing a quantitative easing monetary plan of its own.

Latin America and the emerging markets other than China have responded poorly to US Dollar strength as well as local political issues. Stagflation is the economic environment to overcome.

We still believe that this global phenomenon of easy monetary policy is aimed at asset price recovery, or deflation to be more concise, and it has seemed effective. It may not have produced rapid GDP recovery growth, but firming up the assets and the banks that are leveraged against them is a good starting point.

Capital Markets

While the Fed spooked the bond markets in May when they brought up the idea of tapering their bond purchases later in the year, they shocked investors in September by not tapering. Bonds prices were down 5% or more since June, rallied back partially on the news, finishing the quarter with a gain. But YTD they remain negative.

Major Index Returns	3Q-2013	YTD
Barclays 1-3 Mo Tsy.	0.01%	0.04%
Barclays Agg Bond	0.59%	-1.87%
London Gold Fix	12.50%	-19.41%
S&P 500	5.88%	20.52%
MSCI EAFE	12.65%	17.27%

US stock indexes continued their climb after a brief mid-summer slowdown, led by small-cap companies (Russell 2000 gained +8.6% in 3Q; +27.7% YTD).

But the big winner in 3Q was the international developed markets (MSCI EAFE) which gained +12.7% in the quarter. Spain, Finland, and Italy were each up over 20% off very low levels. Collectively, Europe gained 17% in the quarter. The laggards, globally, were the smaller economies of Turkey,

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Chile and India which are represented in the emerging index which declined -3.2%.

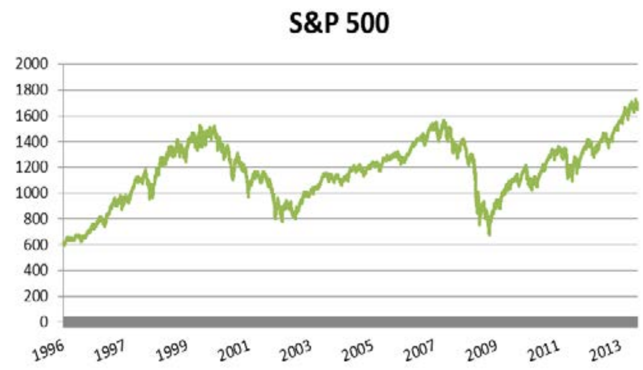
On the style front, growth led value in all major indexes this quarter, finally taking the lead from value in US large caps as we suspected might happen in our 2Q-2013 Report. Banks and techs were the fulcrum. US banks failed to keep pace with the broad markets, hurting US value indexes, while foreign banks rallied on regulatory delays and better earnings reports. Tech got a boost in the US as social media stocks gained.

Other categories were mixed. Oil prices and stocks were up; metals gained through a combination of higher expectations for economic growth (China), and gold recovering out of fear caused by Washington politics. But overall commodities were weak again. Real Estate remained weak in the US but was strong in most other parts of the world-understandable since real estate in the US has recovered faster than the rest of the world and Fed tapering will not help returns in the US over the near term.

Strategy

We expect bonds to hold steady until the budget and debt issues are solved in DC and the Fed gets another opportunity to taper. Expect bond market volatility to pick up by late October or when tapering does actually occur. This could lead to a range in yield on the 10-Year Treasury of 2.5-3.5%.

Stock indexes in the US are at all-time highs and the risk is to the downside via a modest correction. The Russell 2000 Small Cap Index now trades at a historically very large premium to the large cap indexes. Additionally, the growth sub-index of small caps has outperformed the value component by over 12%-points YTD. These trends will correct and it could be sizable.



The run in international markets is not over as valuations still have a ways to go to catch up to the US indexes, but there is risk here too. Europe has delayed austerity and structural reform but has not solved EU-level political and economic problems. Japan is still cheap but its policy effectiveness is met with skepticism. And no one really believes China.

With lots of monetary stimulus still in place, even if the fed tapers its bond buying, equities are a good placed to invest. Nevertheless, economies are weak, consumers are stretched, and corporate profits will be challenged to maintain top line revenue growth along with margins.

As most of our readers know, we don't like predicting the direction of the markets, preferring instead to evaluate the odds within the context of mean reversion expectations. At this stage, the indexes are above the mean or average return levels.

We remain overweight cash, underweight bonds, and neutral to slightly overweight equities. Within equities, we favor large caps and growth over value from a style perspective. We are still slightly underweight international but adding on dips and prefer an active rather than passive index strategy for now.

G. Foley -- October, 2013

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