DILLON CAPITAL MANAGEMENT October, 2016

3Q-2016 ECONOMIC AND CAPITAL MARKET REVIEW

Overview

- Weak 2nd Qtr. GDP should improve in 2nd Half
- US and foreign stocks rallied in the 3rd quarter
- Easy monetary policy is poised to change
- Expect the Fed to raise rates in December

Economy

The US remains the strongest economy in the developed world, led by employment growth and consumer spending.

Although the growth rate is still low, with 2Q GDP growth of only 1.4%, a series of strong monthly employment reports and a rise in the employment cost index of 2.3%, over the past year, provides traction. This optimism enabled consumer spending to rise 4.2%, but since overall inventories were low in the wake of cuts in business spending, it's no surprise that GDP was anemic. We expect inventories to be rebuilt going into year-end, leading to a pop in GDP, transportation, and finance activity.

Of course the rest of the world has not had the same experience. Foreign central banks maintained or increased monetary easing and, once again, spooked the US Fed from raising interest rates in September.

England cut rates following the BREXIT vote, pushing the pound to a 25-year low, and German and Italian banks are in crisis mode. The ECB is buying all the corporate bonds it can find. Drug producer Sanofi issued a billion euro, 10-year note with a 0% coupon, and sold it above par! At maturity, investors, if you can call them that, will get back less than they paid.

This silly monetary game is causing real pain to savers, pension plans, and the banking system, and has to stop. We expect the fed to raise rates in December and the rest of the world to begin looking aggressively at more useful fiscal policy stimulus.

Capital Markets

US stocks were up in 3Q, with the S&P 500 and the NASDAQ hitting all-time highs. Bonds were strong early in the quarter but weakened when yields rose following strong economic data.

Major Index Returns	3Q-2016	YTD
Barclays 1-3 Yr. Tsy.	-0.1%	1.3%
Barclays Agg. Bond	0.5%	5.8%
London Gold Fix	-0.7%	23.4%
S&P 500	3.9%	7.8%
MSCI EAFE (Int'l.)	6.4%	1.7%

Small cap stocks gained the most (+9.1%), led by small miners, technology companies, and oil exploration companies that appear to have survived the oil price slump.

Growth stocks edged value stocks in the quarter (4.6% vs. 3.5%) but still trail YTD (6.0% vs. 10.0%). Technology was the strongest sector in the quarter, followed by a recovery in financials and some cyclical industrials. Utilities and telecom stocks gave back a lot of their gains. Both sectors dropped over 6% as valuations got too high and investors began to fear the impact of higher yields. Real estate weakened under the same fear.

International markets staged a solid recovery despite economic headwinds and a fair amount of political volatility. Overall, the developed markets jumped 6.4% and emerging markets rocketed 9.2%. Germany was up 10%, boosted by a weaker euro, and Japan gained 8.8% despite a strengthening yen. Brazil, China, and Russia were al up double-digits.

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Strategy

Our strategy will remain consistent at the macro level, but will be modified tactically to account for the inevitable rise in interest rates we project, again. Our focus will be on reducing duration in the fixed income allocation.

There are two paths to choose from here: maintain a neutral/overweight position in equities, expecting that economic growth and corporate earnings will continue to pick up steam or, succumb to the possibility of recession in other parts of the world that will drag the US down and reduce risk.

The fed has to raise rates and the new administration must adopt a supportive fiscal policy. Higher interest rates will push the US dollar higher, further hurting our export competitiveness and trade deficit. The question then becomes, can the US be self-sustaining?

At best, it results in continued slow growth domestically while the rest of the world catches-up; at worst we enter a recession by 2018 which could lead to “helicopter money” from the fed. Investors would retreat, buying US treasuries and gold.

We don’t see that happening. While interest rates will rise, they won’t go up too much, too fast.

While stock market indexes may appear overvalued (recent all-time highs, above average price/earnings ratios), some important sectors are poised to recover: housing, energy, and banks are at or near all-time low valuations. Furthermore, industrial cyclicals may be at the bottom of the cycle, preparing for the next stage.

The housing supply has been low for a number of years and should grow with demand from household formations. Long-term mortgage rates, and affordability are supportive. We may just need more certainty to get things going.

The oil industry has retrenched, cutting capital spending and exploration, while keeping production flat to lower. Rig counts remain nearly 50% where they were at the peak, and global demand for petroleum continues to grow at a 2-2.5% pace. Energy stocks will perform as oil prices rise.

The banking industry remains on a bloody battlefield, but the war is coming to an end. Global leaders will begin to realize that they cannot summon growth without the velocity of money that comes from lending and borrowing. Regulators have to figure out a way to live and let live.

We prefer a neutral weight in US equities, including an allocation to alternatives (defensive hedge strategies), an overweight for international equities where valuation is low, and an underweight in core fixed income, which translates to owning a portfolio of high-quality, short-maturity bonds, and above normal levels of cash.

We continue to underweight real estate until rates rise and we hear about new fiscal policies.

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