Dillon Capital Management

January, 2015

4Q-2014 Economic And Capital Market Review

Overview

- The US economic expansion continues, but global growth is stagnant
- US stocks and bonds were strong in 4Q and 2014
- Foreign currency weakness had a negative impact on US investors in international markets
- Commodity prices have continued to decline

Economy

The US economy is 67 months into an expansion, the fifth longest since WWII – there is more to come. US Gross Domestic Product (GDP) surprised to the upside, rising 5.0% in the 3rd quarter. Unemployment has dropped to 5.6% and inflation (CPI) declined to 1.3% for the past 12- months after dropping -0.3% in November.

Producer price indexes in developed Asian markets and throughout Europe have been in a steady decline. Commodity prices, from iron ore to agriculture, and most recently oil, have been severely impacted by strong supply and weak demand.

Global conditions echo the environment of the mid-1980's: declining interest rates, falling commodity prices, and a strengthening dollar. The results were an increase in foreign investment in the US, rising stock prices, and weakness in emerging markets.

The Fed had a clear path back then to lowering interest rates as inflation dropped. Today, the Fed is in a jam – rates are already low. The Fed wrapped up quantitative easing (QE3) in October, setting the stage for a change in policy, but is very reluctant to follow-thru. Economic conditions in the private sector, where asset prices and employment have recovered, indicate the need to normalize monetary policy and raise interest rates. But global conditions are weak and the US is importing deflation from its trading partners.

The concern over deflation is scaring central banks, including the Fed. Someday soon the world will grow tired of ineffective monetary policy. Eventually monetary actions will be replaced by a new breed of fiscal policy.

The recent drop in global oil prices will have a near-term, negative impact on economic growth and corporate earnings (energy related activity is easily 15-20% of the S&P 500's aggregate earnings) but will lead to higher domestic non-energy consumption, over time.

Capital Markets

It was another good year for stocks and bonds in the US. The S&P 500 gained 13.7% in 2015 and bonds were up a surprising 6%, on average.

Major Index Returns	4Q-2014	YTD
Barclays 1-3 Yr. Tsy.	0.2%	0.6%
Barclays Agg. Bond	1.8%	6.0%
London Gold Fix	-2.3%	-1.8%
S&P 500	4.9%	13.7%
MSCI EAFE (Int'l.)	-3.6%	-4.9%

Health care and utilities were the sector leaders, gaining over 23% each. Tech was third with an 18% gain. Energy declined -11.3%; telecom dropped -2.1%.

While the expansion in the US should continue, it's difficult to make the case for investing in bonds -the yield on the 10-year treasury has dropped to under 2% today. Nevertheless, treasuries may prove a good defensive bet in the 1st half of 2015, and remain attractive to foreign buyers.

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International stock indexes were mostly negative as a result of double-digit declines in currencies vs. the dollar. The MSCI EAFE was down -4.9% as the dollar surged against foreign currencies. Ignoring the foreign exchange impact, foreign stocks were actually up for the year. Emerging markets were volatile throughout the year yet beat out the developed markets with a smaller loss. Strength in India and China could not overcome large declines in Russia and Brazil.

Small cap stocks rallied into year-end to post a 4.9% gain after a lot of volatility in 2015.

Real Estate was up over 25% as asset prices recovered, occupancies rose, and investors returned to dividend strategies in this low interest rate environment.

From a style perspective, value edged out growth in large cap stocks for Q4 and the year, but growth led in the small and mid-cap segments.

With the exception of grains, commodity indexes were down again in 4Q, due to the continuing global economic slowdown and excess supply in many products. Although corn and soybean prices spiked in the quarter, the cause can be attributed to stockpiling rather than a pick-up in demand. This marks the fourth year in a row that broad commodity indexes have been negative.

Strategy

Don't confuse economic expansion with stock market expectations. The trend in the economy has been greatly discounted in equity prices. With the majority of the world still in decline, it'll be increasingly difficult for US companies to grow their earnings.

The bond market's message is troubling. Investors have been anticipating a rise in US rates since mid-2013, yet yields remain low along with inflation. The bond market may be forecasting trouble ahead.

The US is still the best stock market, at least for the first half of 2015. But Europe has gotten cheaper and should be supported by additional stimulus.

We are slightly underweight in international and US small caps, for now.

While we expect some change in leadership in the US markets for the first half of 2015, we still prefer the health care and the financial sectors. We also expect domestically-focused consumer companies to show strength.

Bond yields may decline further in the early going of 2015, but we still expect them to rise in the 2nd half. There is not enough reward for trying to time this change, so we're sticking with higher quality, lower duration strategies in anticipation of higher rates by year-end.

If a material correction develops in stocks, we'll look to Europe and small cap US companies to add to the portfolios.

G. Foley – January, 2015

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