DILLON CAPITAL MANAGEMENT January, 2017

4Q-2016 ECONOMIC AND CAPITAL MARKET REVIEW

Overview

- Economic growth picked up in the 2nd Half
- Fiscal policy has Trumped monetary policy
- Stocks rallied, post-election, bonds declined

Economy

We laid out a positive forecast for the US economy in our 3rd quarter review and it mostly exceeded our expectations. Gross domestic product broke-out of its 1-2% range with a 3.5% rate for 3Q, employment and wages rose, stocks rallied on business prospects following the Trump victory, and the Fed reacted with a 1/4 –point hike in the fed funds rate.

The biggest surprise came in the Presidential election and the economic and capital market's reaction to the Trump victory. Stocks rallied sharply following the election as investors immediately changed their forecast for corporate profits and economic growth based on Trump campaign promises for the fiscal stimulus we've been crying for, for over 5-years. The markets anticipate that a cut in corporate and personal taxes and the reversal of burdensome regulations instituted by the Obama administration, including restrictions on the energy industry will boost capital investment and profits, and consumer demand.

Implications provided ammunition for the fed to hike rates in December and assume a new vigilante role, using tighter monetary policy to regulate inflation potential. Higher US rates boosted the trade weighted US currency against most trading partners.

But foreign economies experienced little of the excitement. Foreign economic policies are increasingly criticized as ineffective contributing to populist unrest in Britain, Italy, and France. Bombastic trade policy threats from President-elect Trump are lower on the list of concerns but certainly thicken the fog for the global economy.

In 2017, we expect more turmoil in European elections that seem destined to threaten membership roles in the European Union. Japan continues to swim against the tide, and China is realizing the difficulty that comes with trying to switch from an export-driven to domestic consumption economy.

Capital Markets

Despite a late summer recovery in stocks, the S&P 500 was down over 3.5% from the start of the 4Q until early November, then things changed. The index rallied from election-day thru year-end by 4.6%, gaining 3.8% for the quarter and 12.0% for the year. The Dow Jones Industrial Average fared better, with gains of 8.7% and 16.5% for the quarter and year, respectively.

Major Index Returns	4Q-2016	YTD
Barclays 1-3 Yr. Tsy.	-0.5%	0.9%
Barclays Agg. Bond	-3.0%	2.7%
London Gold Fix	-12.7%	7.8%
S&P 500	3.8%	12.0%
MSCI EAFE (Int'l.)	-0.7%	1.0%

The big winners were small cap stocks, expected to be less negatively affected by the rising value of the US dollar. The Russell 2000 Index was up 8.8% in 4Q and 21.3% for 2016.

Value stocks (defined by low valuation ratios such as price/book value), led by financials and energy companies, continued their rout of growth stocks (high earnings expectations and price momentum) gaining 6.7% in 4Q, and 17.3% for the year.

Leaders for the year, from a sector perspective, included financials (+14.6%), energy (+22.7%), and telecom (+18.6%). The weakest sectors were health care (-4.0%) and consumer goods (+2.7%). Leading industry groups included commodities, especially the cyclical metal and mining groups, gaining 60% for the year, and banks, pipelines.

International equities declined about 1% in the 4th quarter but salvaged a 1% gain for the year. Emerging markets were more volatile, gaining 11.6% for the full year, but giving back over 4% in the final quarter as the US $ rose, raising their import costs.

As a fed rate hike became inevitable, the bond market sold off dramatically. Yields rose significantly for shorter maturities and the 10-yr treasury yield climbed from 1.8% yield level to 2.5% by year-end. The broad bond indexes were off 3.0% in the quarter but held onto a 2.7% total return for the year.

Strategy

It's likely that the euphoria in US equity markets will be tested early in 2017 if Trump's policies run into obstacles in Congress. Volatility can be expected in stocks and bonds.

The challenge and remedy for the bond market is time. As yields rise, bond prices decline – that's a fact. So if the fed raises interest rates 2-3 times in 2017, most bond funds will decline in price over the course of the year; however the investor still receives coupon payments, and that interest will be reinvested at higher yields. For example, a $1,000, 5-yr US Treasury bond that yields 1.9% today, could decline in price by $35 if the fed raised rates by ¾ of 1% in 2017 *(a bond maturing later than 5-yrs from now would lose more*). But, as time passes, the investor would earn $40 of interest during 2017, and $53 in 2018, assuming rates remain at the 2017 adjusted level. That's a short time break-even.

Our fixed income strategy shifted in 4Q toward shorter maturity bonds that are less exposed to price declines, albeit at lower yields. We expect the market to price-in additional rate hikes, pushing bond prices even lower (and yields higher) to a level that makes them too cheap, an opportunity to move back into our normal maturity position during the first half of 2017.

Heading into 2017, we remain optimistic about US stocks and, despite their recent underperformance, see good value in foreign markets at these depressed levels.

A lot of the good effects from the Trump policies are being priced into stocks right now. Earnings for US corporations should rise if tax rates decline, but it may take a while to materialize. Disappointments of all sizes could lead to big swings in stocks and bonds over the next 12-months.

If the swings of 2016 didn't make the case for diversification while staying on course, 2017 should. Remember to invest for the long-term; short-term results like the ones we discuss here each quarter are not really that important!

G. Foley – January, 2017

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