July 2013

Dillon Capital Management

Q2-2013 Economic & Capital Market Review

Economy

The US economy continued to make progress in its recovery during the 2nd Quarter. Employment increased and gross domestic product (GDP) rose, but in both cases at very modest levels. Although the subdued level of activity hardly suggests overheating, it was enough to get the Federal Reserve to start talking about "tapering" monetary policy stimulus.

The Fed's stimulus is made up of two monetary policy initiatives: a commitment to keeping short-term interest rates low into 2015, and Quantitative easing (QE3) under which, each month, it buys $85 bil. of government bonds and mortgage backed securities (MBS). Tapering refers to a reduction of the latter and affects long-term interest rates, while the former will remain in place. This suggests that yields on longer maturity instruments will rise but short-term rates will remain low for some time.

Most major central banks are carrying out similar forms of monetary stimulus. The most recent to get aggressive are Japan and China – Japan is trying to dig itself out of a multi-decade deflationary spiral while China's initiatives are aimed at maintaining its global-leading economic growth of the past decade.

The Europeans have focused more on austerity and financial failure of banking systems across the Union while negotiating complex solutions at the country level.

Capital Markets

The talk of Fed tapering gained momentum after capital market strength of the 1st quarter and it seemed like any acknowledgement by fed Chairman Ben Bernanke would lead to a run for the exits – perhaps in both stock and bond markets. That's what we got in late May. But bond prices had already started to deteriorate; the US Aggregate Bond Index dropped nearly -5% from its high in late April to its low in late June.

The reaction in stocks was delayed but of equal scope with a decline of -5.5% in the S&P 500 from late May to late June, before snapping back to finish Q2 up 2.91%.

Major Index Returns	Q2-2013	YTD
Barclays 1-3 Yr Tsy.	0.01%	0.03%
Barclays Agg Bond	-2.32%	-2.44%
London Gold	-25.42%	-28.37%
S&P 500	2.91%	13.82%
MSCI EAFE	-0.98%	4.10%

US markets were led by a 3.2% gain in the large cap value style, followed by small caps, up 3.1%. It's been a solid 9-month run for value over growth resulting in over 400 basis points outperformance YTD. Not surprisingly, the value style has been led by the financials and health care sectors which seem to have room to run given the changing shape of the yield curve and the Obama health care plan. Nevertheless, according to our research, the trend-run of value over growth since September, 2012 has surpassed its historical average of 7.5 months and its mean rate of outperformance. A slow but steady switch to growth might prove rewarding before year-end.

Collectively the BRIC markets were the weakest in 2Q, led down by Brazil (-17%) and China (-7%).

A recently robust Brazilian economy has slowed dramatically after the central bank raised rates excessively just a couple of years ago. To make matters worse, the focus has shifted to the government's failure to deliver on much anticipated infrastructure reform. The REAL has declined vs. the USD, and is further hampered by dollar strength. All this has decimated Brazilian equities.

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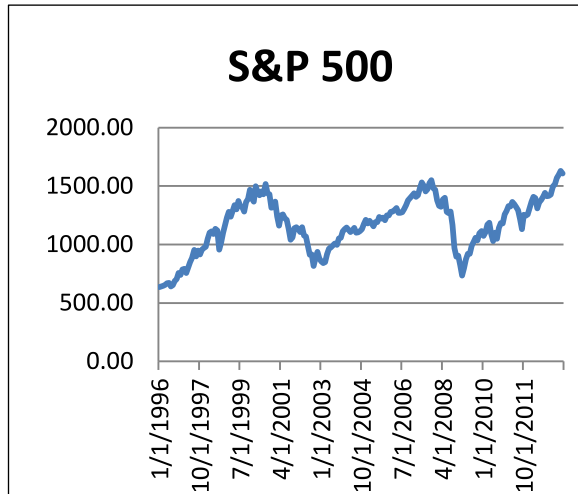
Fixed income markets really got hit in Q2, after a weak Q1 and further Fed tightening talk. Investors are anticipating that yields have nowhere to go but up, pushing bond prices down. The broad market indexes lost money in Q2, mostly in long maturities. The Barclays Broad Market Index declined -2.32%.

The quarter was a mixed bag for commodities with oil strengthening, but metals and mining declining, and agriculture weak. Commodity prices overall are reflecting the slowdown in China and flat import activity in other major markets.



Source: iShares.com

Strategy

Our asset allocation continued to favor equities over bonds, US assets over foreign markets, and value over growth right up to the end of the 2nd quarter. This was again directionally correct despite a small drag on performance from higher than average cash positions. But a zero return on cash was better than losses on a full bond allocation.

An overweight to the value style and small cap market was positive for performance, but despite reducing our position in the international markets, it was still a small drag on diversified portfolios.

The Global Dividend Portfolio was affected by the sell-off in “bond-like equities,” a new term that may be around for a while. But we expect high dividend paying stocks to recover as concern over slow economic growth materializes in the second half. Additionally, we think the bond market is now oversold, discounting Fed tapering of QE3 by the 4th quarter, and should stabilize at modestly higher levels in Q3.

With the major indexes at all-time highs, and bond yields rising, risk will increase from here. The economy is stabilizing, but growing at a slow rate. It’s difficult to see significant improvement in employment and wage growth, especially in a low inflationary environment and still formidable fiscal policy hurdles established in Washington.

While the major indexes have recovered, sub-components at the sector level remain at depressed valuations. Even though financials have been among the sector leaders, most of the banks trade at, or below book value. This is even more pronounced outside the US. Technology remains historically cheap and operating performance is better than it’s been and appears sustainable. Safe and reliable consumer staples and utilities are bouncing up against high, historic valuations and although they offer steady growth, it’s hard to expect more than low single digit growth.

As the global recovery twists and turns, we are slowly getting more interested in Europe and Latin America. Japan has rallied mightily but valuations are not high. A stronger US Dollar makes foreign companies more competitive and attractive at recent valuations.

We prefer a neutral weighting in US stocks, underweight long-term bonds, and look for tactical opportunities in foreign markets.

G. Foley – July, 2013

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