Dillon Capital Management
Economic & Capital Markets Strategy 1Q-2019

Highlights

- S&P 500 regained 13.7% from 4Q
- Fed pivots from rate hikes
- 2019 earnings estimates come down

Economy

Economic growth in the US remains in the low and slow lane. GDP for the 4th quarter was adjusted down to 2.2% and forecasts for 2019 aren't any better, but it beats the alternative.

Inflation also remains subdued, just under the Fed's target of 2%, despite average hourly earnings grinding higher by 3.4% in the low unemployment environment.

After raising interest rates to 2.5% in late December, with talk of more to come in 2019, the fed abruptly pivoted in January and moved to the sidelines. Markets read this to mean no-more rate hikes in 2019.

But growth in Europe is negligible with no quick-fix visible. China has experienced a steady decline in the rate of growth but it appears the credit cycle has bottomed. A turn-up in credit should boost economic growth for 2019-20.

Capital Markets

US stocks rallied immediately following the fed's pivot, in early January, from its plan for hiking rates further. The S&P 500 gained 13.7%, reversing the decline of 14% in the prior quarter.

Market corrections occur every year. 2018 was the 5th out of the last 20 calendar years in which large cap US stocks posted a negative return. Three of those were consecutive, from 2000-2002, following the dot-com bubble and recession after the 9/11 attack. The other was 2008, the financial crisis. Calendar year 2018 was the only bad year when the economy was NOT in recession.

In retrospect, the loss recorded for 2018 might be be chalked up to unfortunate timing; if the December correction occurred in, say July, it may have turned out a positive year.

Nevertheless, earnings estimates for 2019 continued to decline to a range of 4-6% for the new year. Valuations (p/e ratio) for 2019 are now lower at 17x.

Bond yields dropped in the wake of the fed's decision to cease rate hikes (when yields decline, bond prices rise). Although yields rose over the last 3-years, the benefit of those yields was offset by bond price declines resulting in no or low total returns for bond investors. With no additional rate hikes on the horizon, bond prices have stabilized, after initially improving, and returns will begin to reflect the imbedded higher yield to maturity. That's approximately 2.5-3.0% for treasuries and 3.5-4.0% for corporate-bonds for 2019.

Major Indexes	1Q-2019	1-Year
Short-term Treas. (1-3 Yr.)	1.0%	2.7%
Barclay's Aggregate Bond	2.9%	4.5%
S&P 500 Index	13.7%	9.5%
Russell 2000 (Small Cap)	14.6%	2.1%
MSCI EAFE (International)	10.0%	-3.7%
MSCI Emerging Mkts.	10.0%	-7.1%
Bloomberg Commodity	6.3%	-5.3%

Growth stocks led the recovery, gaining 16% in the quarter. Technology is the largest sector in the S&P 500 (21%) and led all other sectors with a 20% return. Value stocks gained 12% in 1Q.

Technology (+20%), real estate (+17.5%), and industrials (+17.2%) were the top-3 sectors for

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the quarter. Financials (+8.6%) and health care (+6.6%) were the smallest contributors.

Small cap stocks were up 15% in the quarter, but experienced higher volatility in the 2nd half of 2018 leading to a paltry 2% return for the last 12-months.

Developed international and emerging markets both gained 10% but remained negative for the past year following reports of slowing growth in 2Q-2018.

China led the emerging markets index with a 17.7% return, flowed by Russia (+12%), and Brazil.

All segments of the bond market were up in the quarter. The fed's pivot led bond investors to conclude that the fed sees slowing growth and risk of recession sooner than expected, and perhaps a fed rate cut could be in the cards before long.

High yield and long maturity bonds led the way with gains between 5-7%. High-yield recovered from default-risk fear in 4Q while long-dated investment grade bonds, particularly treasuries, gained as investors moved aggressively to lock in yields before a possible fed cut.

Investment Strategy

Despite growing concerns that the recovery is stalling under a declining rate of growth, we should remember that central banks around the world remain in an accommodative monetary policy. This is supportive for commerce and asset value growth.

The S&P 500 has now gained 16%, on average, for the 10-year period ending 3/31/2018, well above the long-run average of 10.5%. And market forecasters are suggesting lower returns ahead.

Risks are that bubbles are inflating behind the scenes (debt, tech, employment), inflation heats up, a bubble materializes, the fed reverses course and turns off the lights by raising rates.

We remain overweight US equity, underweight international but with a rising allocation to emerging markets.

A short-to-intermediate overweight within an overall neutral allocation to bonds seems appropriate. If market yields rise by mid-year, in anticipation of renewed concern over fed tightening, we'll extend our short-term maturities further out.

G. Foley – April 2019

Please call or email with questions or comments!

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