Dillon Capital Management
Economic & Capital Markets Strategy 2Q-2019

Highlights

- Current expansion nears a record
- Bond and stock gains reflect lower rate expectations
- Tech and financial sectors led stocks higher in 2Q

Economy

The US economy continued to grow through the 1st half of 2019. Gross Domestic Product (GDP) improved to 3.1% in 1Q (latest number) on the back of government spending and inventory builds.

Nevertheless, leading economic indicators have headed lower for 2Q and 3Q. An obvious culprit is the Trump administration imposition of additional tariffs on China in 2Q, but global business activity was already on the decline.

The forecasted slowdown causes a problem for the Federal Reserve, the gatekeeper of monetary policy and interest rates in the US. The Fed's assignment is to manage the level of inflation and unemployment through monetary policy; for now, both are at desirable levels: unemployment is 3.6%, and inflation is about 1.6%.

Mission accomplished? At the moment perhaps, but the fed wants to do more. It wants to get in front of possible problems (higher inflation or unemployment) to soften the impact or prevent it all together. If the economy remains strong, wage inflation may appear requiring a hike in rates; if the economy weakens, unemployment might rise demanding lower rates.

The markets are betting the Fed's next move will be to cut rates and save the economy from decline; that's what's fueling the recent rise in stock and bond prices.

Globally, economic growth has stalled again. Problems in Europe led the ECB to increase monetary stimulus and bond yields moved further into negative territory. Japan is also flat, and China's rate of growth continues to decline.

Capital Markets

Trade talks with China broke off in May and equities dropped sharply (S&P 500 -6.5% top to bottom). The fed softened its tone further, permitting strategists to conclude that rate cuts were coming; bond yields plummeted, and stocks jumped to record-highs in June.

For the 10-years ending June 30, tracking the current recovery/expansion period, the DJIA has returned an annualized 15.0% (S&P 500 +14.7%), surpassed only by the Tech-heavy NASDAQ (+17.3%) among major indices.

However, if we go back 20-years, to capture the 'dot.com' bust and the more recent financial crisis, the Dow's annualized return is less than half that, at 7.0%. Busts are followed by booms and vice versa!

Major Indexes	2Q-2019	YTD
Short-Term Treas. (1-3 Yr.)	1.5%	2.5%
Barclay's Aggregate Bond	3.1%	6.1%
S&P 500 Index	4.3%	18.5%
Russell 2000 (Small Cap)	2.1%	17.0%
MSCI EAFE (International)	3.7%	14.0%
MSCI Emerging Mkts.	0.7%	10.8%
S&P/GS Commodity	-1.4%	13.3%

Growth stocks outperformed of value stocks in 2Q and YTD, but financials was the leading sector in 1Q (+8.0%), followed by tech and materials.

Small caps were up but have not gotten back to record levels of mid-2018. Real estate has fully recovered from the December drop. Malls may not be as attractive but other parts of real estate are more than making up for it; warehouse, apartments and data centers have been strong and the low cost of financing is compressing cap rates, pushing valuations higher.

International stocks were solid in the quarter despite trade restrictions, uncertainty over BREXIT, and generally weaker domestic economic conditions.

The bond market is projecting a cut in rates, and soon. The yield on the 10-yr Treasury was over 3.00% las fall, dropped to 2.6% after the fed-pivot on rates at year end, and hit 2.00% in June. The quick drop in yield caused the yield curve to invert (10-yr yields falling below 3-month yields) in the quarter. An inverted yield curve has preceded every recession in the last 90-years, but also resulted no recession.

Corporate and high-yield spreads have widened a bit. Expectations are for much wider yield spreads if a slowdown materializes.

Emerging markets were flat but appear supported by the prospect of lower oil prices and a weaker US dollar.

Investment Strategy

With US stocks at record levels and bond market vigilantes casting doubt, second quarter earnings season takes on a level of heightened importance for this cycle.

Analysts have already taken down estimates for 2Q and 3Q, blaming lower company guidance and trade tariffs. While we acknowledge lower corporate guidance, companies may be holding back until they get clarity on talks with China and what the fed's next move might be.

In the US, technology and in particular software looks to maintain momentum. Banks have just passed regulatory tests and have announced large dividend hikes and stock buy-backs.

Defensive sectors have had a good run, but valuations are extended for utility and consumer products companies.

We're warming-up to the healthcare sector on the grounds of innovation and consolidation. Valuations have come down in most parts of the sector, sidelined by rhetoric from both sides of the political spectrum.

Overall, active management may be positioned to find opportunities as indexed investments move from one side of the boat to the other, all at once.

If the fed cuts rates, dividend stocks should continue to be attractive. Lower US rates should also be constrictive for international markets, particularly the emerging economies. Long-term commitments might be opportunistic in India, China and Brazil.

We reduced total equity exposure modestly during the quarter and exit the 1st-half slightly underweight the US and developed international markets. With the 10-year US Treasury heading below 2.00%, we suggest taking gains in corporate and longer-term bond strategies as well.

If we get a slowdown, opportunities to reload will be abundant.

G. Foley – July 2019

Please call or email with questions or comments!