Dillon Capital Management
Economic & Capital Markets Strategy 1Q-2021

Highlights

- **Economic growth is accelerating off low base.**
- **Value style has outperformed growth.**
- **Bond yields nearly tripled off 2020 low.**

Economy

Seemingly never-ending monetary stimulus, joined more recently by fiscal injections, are boosting economic growth, enabling the federal reserve to raise its 2021 GDP growth estimate 6.5%. That's the highest level of growth since the mid-1980's.

There is a cascade of economic data to support the estimate as the nation heads out of the Covid-19 lockdown. Our own Philly Fed's Business Outlook Survey hit 51.8 in February, the highest since 1973. New orders and shipments soared but 66% of respondents reported shortages in both materials and labor. March manufacturing indexes, PMI and ISM hit 59 and 65, respectively, a 40-year high for the latter.

Growth appears to be only limited by capacity shortage, not demand. Commodities and finished goods are in short supply following years of underinvestment and recent shutdowns but also because capital flowed into technology and the service sector, not the manufacturing space.

With nowhere to go for most of the last 12-months, including commuting to work, and the government making direct deposits right into bank accounts, consumers' savings and wealth skyrocketed. Checking account balances are at record levels. The US consumer added over $1. trillion to savings over the last year and experienced a 10% gain in wealth, including asset growth.

With demand, fueled by stimulus, inflation has picked up. We measure CPI monthly, on a rate of change basis, versus the prior year, and then annualize the change. Prices were nearly flat in 2Q-2020 period, but they are not flat now – CPI is already running 3% vs. last June and the annualized year-over-year comparisons will start to look large.

A key input to watch is energy prices. If travel picks up and oil producers stick with their new, low capital spending discipline, inflation could go higher, still.

Government central banks, led by the US, have tried to soften the impact of recessions over the last 20-years and aim for a steady-state of growth. Its good for political regimes but bad economics. In retrospect, it artificially raises asset prices and prevents price discovery. In Henry Kaufman's new book, he summarizes Modern Monetary Theory and the coming wealth transfer as a trend of "Capitalism being used for Statism."

We see key risks to the current economic nirvana as: higher inflation through summer, lower demand after the initial splurge, and potentially higher taxes.

Capital Markets

Stocks continued their ascent in the 1st quarter, piling onto to late 2020 returns, while the decades long bond market rally officially ran out of gas.

Major Indexes	1Q-2021	1-Year
Short-Term Treas. (1-3 Yr.)	-0.1%	0.3%
Barclay's Aggregate Bond	-3.4%	0.7%
S&P 500 Index	6.2%	56.4%
Russell 2000 (Small Cap)	12.7%	94.9%
MSCI EAFE (International)	3.5%	44.6%
MSCI Emerging Mkts.	2.3%	58.9%
Wilshire REIT (Real Estate)	8.8%	34.7%

Growth stocks headed to the sidelines late in the recovery last year after being the team's leading scorer and MVP for multiple years. While profits continue to impress, valuations headed higher, reaching historical valuation differences versus slower growing value stocks. A lack of capital investment in the materials (mining and chemicals) sector in recent years, coupled with across-the-board spending cuts by energy companies, and a rise in interest rates that helped banks, raised investor interest in these forgotten stocks. As the recovery took hold, the rate of change in earnings expectations for the forgotten lot gained the attention of investors and value stocks soared in the 1st quarter. Underperforming small cap companies in the Russell 2000 Index experienced an even stronger renaissance. The recovery outside the US has been slower; valuations remain lower.

Yields have nearly tripled on the 10-year US treasury note since last April's all-time low of 0.60%. The 7.5% gain in the broad bond market index (Bloomberg Barclays Aggregate) for 1Q-2020 has all but disappeared. Interest rates rise when an economy gains speed as inflation concerns surface and overexpansion leads to credit default risk.

Real assets were a mixed bag. Gold and real estate (REITs) tend to decline in the early months of higher interest rate regime because higher trending bond yields begin to compete for capital vs. no-yield gold and temporarily locked-in yield from real estate income. But if inflation develops, both gold and real estate will catch a defensive bid.

Investment Strategy

We've followed the script of the strategy laid out at year-end and made changes to portfolios accordingly.

We maintain that the bulk of the recovery is behind us. Equities may still rise over the near-term, supported by even more stimulus than we anticipated, but stocks serve as a discounting mechanism. Economic growth is well anticipated and has accelerated as the Covid vaccine rescues stranded commerce and consumers. The value constituency, mentioned in the Capital Markets section, should continue to rise but the basic materials and energy sectors make up a small percentage (under 3% each, financials make up about 11%) of the S&P 500, making it difficult for the broad indexes to move up much more.

Changes we made to diversified portfolios during the quarter, included:

1. Reduced the duration (interest rate risk) in our fixed income allocation.
2. Swapped a portion of the allocation to value stocks from growth stocks,
3. Incrementally added to real estate, again.

In our equity portfolios, we reduced exposure to utilities and gold miners; and boosted the allocation to value sectors: basic materials, industrials, and financials. These were small percentage moves in the context of our long-term investment approach.

The fed is committed to keeping interest rates low and the Biden administration is talking about infrastructure investments. Barring other drastic socio-political changes, these should be good for stocks.

G. Foley – April 2021

Please call or email with questions or comments!

Past performance is not an indication of future returns. All investing is subject to risk, including the possible loss of money you invest.