Dillon Capital Management
Economic & Capital Markets Strategy 4Q-2019

Highlights

- Recession risk fades with the fed's mid-cycle adjustment.
- Stocks markets respond to stimulus
- Health care and energy sectors recover

Economy

In 2019, economic activity and the capital markets were influenced by trade wars and weakness in global production.

Investors grew more concerned about the tariff wars and all the experts declared that the inverted yield curve was a forebearer to recession coming soon.

Then the "noise" turned positive. Almost simultaneously in the 4th quarter, the fed stepped in and cut rates for the 3rd time, progress on a phase-one trade deal with China was announced, and Boris Johnson won a landslide victory for Brexit in the UK.

Evidence that the recession was postponed came when the yield curve "normalized" as the yield on the 10-Yr treasury spiked toward 2.00% and short-term rates declined.

Gross Domestic Product (GDP) growth for 3Q came in at 2.1%, weak but ahead of expectations. The unemployment rate remains low, but inflation has ticked up, somewhat unnoticed, and corporate profits advanced moderately.

Capital investment is still on a slow track, but consumer spending and housing development are strengthening – two important components for US domestic growth. So, for now, it looks like the expansion will continue until the next crisis.

Capital Markets

All global stock markets were positive in the final quarter and for the full year 2019, led by the S&P 500 which gained 31.5%percent for the year resulting in a 13.6% average annual return for the decade.

Major Indexes	4Q-2019	YTD
Short-Term Treas. (1-3 Yr.)	0.5%	3.6%
Barclay's Aggregate Bond	0.2%	8.7%
S&P 500 Index	9.1%	31.5%
Russell 2000 (Small Cap)	9.9%	25.5%
MSCI EAFE (International)	8.2%	22.0%
MSCI Emerging Mkts.	11.9%	18.9%
S&P/GS Commodity	8.3%	17.6%

The Russell Midcap Index gained 31% in 2019, and the small cap Russell 2000 index gained 25.5%.

Large cap index constituents regained momentum, yet dividend yield and dividend growth stocks were also strong.

By mid-year, the end of Mario Draghi's reign as President of the ECB, foreign markets were thought to be bottoming. EAFE gained 22.0% for the year with an 8.2% rally in 4Q. Major European markets were up high single digits in the fourth quarter; over 20 percent for 2019.

Emerging markets sparked to a 12% gain in 4Q (tops globally) and a 19% return for the full year. Russia led EM with a 53% gain for 2019; China and Brazil jumped 14% in 4Q.

Real estate stocks declined, and gold rose when long-term yields jumped.

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Bonds were strong through the first three quarters of 2019, following the fed's flip on monetary tightening and a forecast for more cuts. But the yield curve steepened in the final months; evidence of a strengthening economy pushed long-rates back-up near 2.00%. The Barclays aggregate bond index gained 8.7% on the year while long maturity US treasuries jumped the most with a gain of 15%.

Last quarter I suggested that the energy and health care sectors had underperformed the broad market for some time; we saw them as opportunities, along with Europe. Health care stocks roared back in 4Q (tied for best with tech at +14.4%) as politics declined. Oil stocks got going late but energy was the top-performing sector in December (+6.0%) – not because the companies have turned profitable, but because the price of oil has climbed by 35% for the year, more than the S&P 500 gained. Excess US shale production and poor capital management amidst a crowded field of drillers has soured investors' appetite. Production has been cut back and capital spending reigned in. Mix in a bit of good-ole middle east tension, and you get a rise in energy prices and eventually stock prices - maybe.

Investment Strategy

Performance in 2019 and the 'teens decade' will be tough to beat. Returns for both periods were well above the long-term historical average of about 10%. Investor sentiment was near record levels by year-end, creating a large gap the trajectory of corporate profits. This gap will narrow in 2020 when stock prices correct and earnings rise – the question is which indicator will move the most.

The end of a decade does not usher in a new game; trends transcend the calendar.

Technology is increasingly pervasive in our daily lives, advances in health care are accelerating, and the alternative energy revolution is gaining momentum. These form the engine for future growth and prosperity.

We continue to favor large-cap US stocks that are proven leaders in their respective businesses. Small caps have underperformed but offer good opportunity, and foreign markets may have bottomed.

Bonds will struggle in this low yield environment but provide a safe-haven in the overall portfolio. It's too hard to predict what interest rates will do over the short-term but the range of possible returns is wide (i.e. yields could rise, resulting in bond price declines; or yields could fall if the fed senses the economy is slowing, pushing bond prices higher), but with a 2020 current yield of 1.90% for the 10-Year treasury, it's difficult to foresee index total returns higher than mid-single digits over the next 3-5 years.

Risks still exist; stock and bond markets are overvalued relative to history and the economic environment that exists. There will be one or more corrections to stock prices in 2020. High levels of corporate debt could cause a ripple of effect from defaults, an energy supply disruption could impact prices and the supply of goods, underpinning a rise in inflation. Evaluate the conditions and invest with the long-term in mind.

G. Foley – January 2020

Please call or email with questions or comments!