Dillon Capital Management
Economic & Capital Markets Strategy 4Q-2020

Highlights

- *Stocks reflect hopes for economic recovery*
- *Cyclicals and international equities are attractive*
- *Bond yields are moving higher*

Economy

The economy declined in 2020 and unemployment rose sharply. In reaction, governments provided unprecedented monetary and fiscal stimulus to stabilize the effect. The 4th quarter ushered in improved visibility for economic recovery with vaccine distribution.

Economic growth, measured by Gross Domestic Product (GDP), is now expected to decline 2.4% for 2020, improvement from the prior forecast of -4.8%, and to rise 4.2% in 2021.

The unemployment rate has declined from its worst level and is now expected to be 6.7% at year-end 2020 and 5% for 2021. Inflation, at 1.4% remains stubbornly below the Fed's target 2% rate but should rise in 2021 as the money supply continues to accelerate and demand is rising.

Consumers with jobs received additional liquidity in the form of stimulus payments and from lower costs by working at home. Savings grew, with limited places to spend money. Some spending has gone to purchasing goods in the absence of services, but a lot has gone into financial assets and real estate supported by the federal reserve's monetary policy.

Stock prices have bounced back strongly, but economic recovery remains elusive. Lost workers and small, privately owned businesses are receiving inadequate support from government programs and their near-term future is cloudy.

The Biden administration has an aggressive outlook for change but has many constituents to serve. While optimism for recovery is apparent, headwinds are developing that could make recovery anemic or worse.

If the new administration raises taxes in the early days, companies will be reluctant to add employees. Aggressive environmental policies will further weaken the traditional oil and gas sector just as our hopes for travel and spending are improving.

If the bounce turns into a recovery, jobs come back and commodity prices rise, inflation will return – time will tell if the fed can control it when it shows, but it should have a negative impact on stock and bond prices.

Capital Markets

The S&P 500 has gained 66% from the March low. For the year, it was surpassed by the long- awaited recovery in small cap stocks.

Major Indexes	4Q-2020	YTD
Short-Term Treas. (1-3 Yr.)	0.1%	3.2%
Barclay's Aggregate Bond	0.7%	7.5%
S&P 500 Index	12.2%	18.4%
Russell 2000 (Small Cap)	31.4%	20.0%
MSCI EAFE (International)	16.1%	7.8%
MSCI Emerging Mkts.	19.8%	18.7%
Wilshire REIT (Real Estate)	10.6%	-7.9%

International markets rallied in 4Q in the wake of a declining dollar (approximately 35% of the gain in the MSCI Index in 4Q is attributed to currency change) to turnaround losses thru 3Q.

What led to such strong stock and bond market returns in 2020, despite the lingering effect of Covid-19?

1. *The fed cutting interest rates to zero increased the appeal for risk assets and created a grab for yield.*
2. *The effect of the first round of stimulus led to anticipation for a second and a spike in the money supply.*

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3. *Hope over the vaccine rollout is leading to a return-to-normal effect.*

Historically, value stocks begin to outperform growth stocks as the economy comes out of a recession. That started to gain the attention of investors in 4Q when the bounce led economists to predict positive GDP growth is coming and the recession is over.

Generally, we think there is ample support for equities into early 2021 but deteriorating conditions for bonds.

Stocks have momentum from the rollout of vaccines and additional stimulus, which should lead to spending and improved corporate earnings, as the economy tries to get back to normal.

The outlook for bonds, however, is dismal. If the recovery takes hold, interest rates should rise, resulting in higher yields and a decline in bond prices. The US Aggregate Bond Index has a duration of 6-yrs (duration measures interest rate risk in bonds). If interest rates rise one-percentage point, the Index will decline 6%. So, theoretically, with a current yield of 1.2%, it will take nearly 5-years for a new bond investment to break even.

Investment Strategy

We maintain that the bulk of the recovery rally is behind us. Equities should rise over the near-term but economic and government policies from the new administration will be critical to sustaining the trend.

Valuation levels of US stocks are at historical highs, again, and sector rotation is underway from growth to value.

The tech sector now represents 28% of the market cap of the S&P 500, and 38% if you include Amazon, Facebook and Alphabet, which S&P moved to other sectors last year. The tech sector hit a high of 35% of the index during the dot-com bubble. We think some money will move from tech, toward cyclicals and dividend paying stocks. Not only are the latter cheaper, but they offer a yield replacement option for fixed income investors. But established tech companies have strong businesses, huge market share and remain investable.

The fed is committed to keeping interest rates low. We expect this will continue to pressure the dollar against the Euro, Pound, and a collection of Asian currencies. We have been increasing our allocation to international markets.

We remain overweight stocks and underweight bonds. Short-term bonds and mortgage-backed securities are safer options than long-term bonds, but yields are very low.

The real estate sector declined for most of 2020 due to vacancies and lately, inflation. With REIT prices down, their dividend yields are more attractive. It may be worth starting a small allocation, but if inflation picks up, it will postpone a recovery in real estate.

G. Foley – January 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.

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