Dillon Capital Management
Economic & Capital Markets Strategy 1Q-2022

Highlights

- **The fed is in motion, finally**
- **We're in the storm, before the calm**
- **Watch the 3-macro trends**

Economy

Gross Domestic Product (GDP) for 2021 showed a 6.9% growth rate, the highest in decades. Unemployment dropped below 4% during the 1st quarter, arguably the level of full employment for the US, as demand for products and services forced businesses to scramble for workers as the pandemic came to an end. But this activity pushed inflation to 7.9% in February, the highest since the early 1980's.

Demand has been fueled by excess monetary and fiscal stimulus for years, heightened in the last 2-years now, since the outbreak of Covid. With too much money chasing too few goods since production was shuttered, incoherent government policy opened the door for inflation.

By mid-quarter, pressure built rapidly on the fed to do something. After admitting that inflation is a problem, the fed raised interest rates by 0.25% in March and laid out a plan to hike rates for the remainder of 2022.

Capital Markets

The market reaction has been swift and volatile. Bond yields skyrocketed, pushing prices down by 6% and pressuring stocks.

Growth stocks led the decline in the S&P 500, with tech stocks, representing the largest sector in the index, down over 8%. The Communications and Consumer sectors, although not as big, and recently repopulated with former tech names, dropped 12 and 9%, respectively.

Commodities, including oil & gas are in short supply, helping the energy sector gain 39% in the quarter. Energy and utilities were the only positive sectors in Q1, the latter offering defensive positioning for investors.

Major Indexes	1Q-2022	1-Yr
Bloomberg 1-3 Yr. T-note	-2.5%	-3.1%
Barclay's Aggregate Bond	-5.9%	-4.2%
S&P 500 Index	-4.6%	15.7%
Russell 2000 (Small Cap)	-7.5%	-5.8%
MSCI EAFE (International)	-5.9%	1.2%
MSCI Emerging Mkts.	-6.9%	-11.1%
Bloomberg Commodity	25.6%	49.3%

As the fed stepped-up to fight inflation with higher rates, the US Dollar rallied against most major currencies and took the wind out of international assets.

Quantitative easing (QE) policies, employed by the fed since the financial crisis, artificially pressured interest rates. Short-term rates went to zero and the 10-year treasury note hit an all-time low yield of 0.60% in 2019. Without this intervention, the 10-yr would probably have been in the 2.5-3.0% range or higher. Extremely low rates fueled an asset bubble and now the stimulus is being removed. Every market cycle over the past 60-years ended with a rise in interest rates. And most fed tightening has led to a recession.

The fed is aiming for an economic soft-landing, but it will be difficult to achieve. They are now facing a choice: fight inflation by raising rates or, support further economic growth and save jobs.

I think the fed fights inflation, so we'll be watching economic growth carefully.

Investment Strategy

Our focus is now on macroeconomic data trends impacting the capital markets: the rate of inflation (peaking in 2Q), interest rates (rising through 2022), and economic growth (slowing).

The directional trends will enable the economy to transition to more normal times.

Inflation appears to be the catalyst that turns the fed from a stimulative monetary policy to a tightening policy. Higher prices will dampen demand just as supply continues to recover. Inflation should peak in 2Q.

Unfortunately, the medicine for inflation is higher interest rates. The rapid rise in bond yields in reaction to the fed's plan to raise rates has decimated the bond market. Yields will likely move even higher through the rest of the year, unless the economy stumbles or the level of yields jumps way ahead of the fed, into the 4-5% range for the 10-year Treasury.

Artificial stimulus, over the past decade, boosted stocks (and bonds) to record highs. The S&P 500 has averaged 14.6% for the last 10-years and 19% for the last 3-years, far outpacing economic growth - this was not normal and is unsustainable.

The reaction in the capital markets, to the trends above, has been swift.

In client balanced portfolios we have continued to reduce duration to limit interest rate risk. As yields rose, we moved cash into short-term treasuries to capture income. We plan to hold these until maturity. So even though the prices may decline in client reports, we'll get our principal back upon maturity. But it's also important to maintain exposure to intermediate bond funds as insurance against deflation if things deteriorate rapidly.

We have also increased the allocation to bond-proxies such as oil and gas pipelines, utilities, and real estate debt.

Valuations are still under pressure for growth-related stocks and the tech sector. We reduced exposure to growth stocks late in 2021, in favor of value stocks and sectors that have been starved of capital for years (a major influence on the supply shortages that contributed to inflation as the economy recovered from the pandemic). In the equity portfolios, we remain overweight energy production, basic materials (mining and chemicals) and real estate.

The world has observed that the fed is committed to fighting inflation by raising interest rates. This has attracted foreign capital to the US dollar, which in turn has hurt foreign markets for US investors (even though foreign companies are recovering, too, the exchange rate has gone the other way, negatively impacting total returns). Investors should remain underweight international equities, even though they are cheap, for now.

The transition to normal is creating new winners and exposing losers. But its important to keep the long-term in perspective. Many of the winners won't be able to maintain their momentum, and good companies with recent poorly performing stocks prices will get cheap enough to invest in for potential superior returns over the long term.

Please call or email with questions or comments!

G. Foley – April 2022