Dillon Capital Management
Economic & Capital Markets Strategy 2Q-2022

Highlights

- **The brink of recession**
- **Fixed income yields look more attractive**
- **Focus remains on 3-macro trends**

Economy

The US economy is slowing. 1st Quarter GDP came in at -1.6% and the Atlanta Fed's Now forecast for 2Q is -2.1%, indicating we will be in a recession when the numbers are finalized.

Although Real GDP (adjusted for inflation) is looking negative, Nominal GDP remains in the high single digits and unemployment remains the lowest in decades.

CPI inflation spiked to 8.6% in March and remained above 8% thru May – a 40-year high.

Federal Open Market Committee (FOMC) minutes from June 14-15 indicated many participants were concerned that inflation expectations could become "entrenched" and saw the need to go into a "more restrictive" territory to cool economic growth and prices. The Fed staff upgraded its inflation forecast to 5% personal consumption expenditure (PCE) price inflation in 2022. The labor market was seen as overheated, but the FOMC expected supply and demand to come into better balance.

The Fed has raised interest rates 3-times in 2022 and likely to raise another 0.75% in July, taking fed funds to 2.5%.

The M2-money supply (think savings and checking accounts) flattened in 2Q after a record spike from June-2020 to July-2021 and is likely rolling over. The effect is lower liquidity in the system, impacting spending and investment.

Capital Markets

Stocks and bonds were wacked in the quarter. The S&P 500 has declined 20% YTD, the largest 1st half loss since 1970; and the bond market, measured by the Bloomberg-Barclays Aggregate Index, declined over 10%, the largest decline on record.

Small cap stocks, international stocks and real estate also suffered large declines in the quarter and YTD.

High inflation sparked demand destruction in a growing number of markets. Although oil/gas demand and prices remained high, the broader commodity complex started to decline.

Major Indexes	2Q-2022	YTD
Bloomberg 1-3 Yr. T-note	-0.5%	-3.0%
Bloom-Barc. Agg. Bond	-4.7%	-10.3%
S&P 500 Index	-16.1%	-20.0%
Russell 2000 (Small Cap)	-17.2%	-23.4%
MSCI EAFE (International)	-14.5%	-19.6%
MSCI Emerging Mkts.	-11.3%	-17.5%
Bloomberg Commodity	-5.7%	18.4%

As the fed stepped-up to fight inflation, the US Dollar rallied. Imports became cheaper to purchase and volume surged, but exports, particularly in tech, grew more expensive for foreign buyers. The phenomenon will negatively impact corporate profits in the 2nd half of the year.

The "storm" we discussed in January continues to pound the bond market. Yields are now way ahead of the fed's increases, virtually doing the tightening job for it. Strong winds are clearing the road toward higher yields, but the debris of ridiculously low junk bond yields has yet to be cleared. Nevertheless, fixed income investors can now collect some income even as bond prices languish, for now.

Real estate benefits from rent increases but inflation is running higher than the lease provisions for rent increases and cap-rates (RE valuation factor) are up for the first time in a decade.

Earnings reports released during 2Q were mixed. Inventories of goods finally cleared the ports but no

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longer flew off the shelves as they did during the pandemic. Retailers like Walmart, Target and Home Depot posted higher sales results, boosted by higher prices, but, in most cases, flat profits as the number of units sold and customers declined.

Tech companies reported lower sales and guided future quarters lower due to lingering backlog of parts, but order books spiked (Cisco).

Investment Strategy

Our focus remains on macroeconomic data trends: the rate of inflation (8.6% in May), interest rates (rising through 2022), and economic growth (slowing).

Artificial stimulus over the past decade boosted stocks and bonds to record highs, far outpacing economic growth. Government shutdowns during the Covid-panic led to shortages. Excessive stimulus led to inflation providing catalysts for the current unwinding.

Inflation is shifting from goods to services and is evident in wage growth. Wage inflation will negatively impact profit margins and lead to weaker earnings in the 2nd half.

We can envision a scenario whereby the fed continues to raise rates (July and September), inflation peeks due to demand destruction, corporate earnings decline, and economic growth declines. This could lead to a tic up in unemployment, and lower demand and capital investment at which point the fed's resolve for higher rates fades.

Bond yields have improved thru the summer. And if the above is half right, investors should start to accumulate investment grade fixed income.

Stock valuations have come down dramatically. Tech stocks are down over 30%. In the future, where growth is hard to find, groups within the tech sector will start to look appealing.

The transition to normal could take a lot longer but the stock market tends to predict the future. Once an economic bottom becomes faintly visible, the stock market bottom may already be behind us.

Since last summer, activity in our balanced strategies aimed at reducing risk and included: selling growth funds, buying value and dividend funds, reducing duration (interest rate risk) in our bond fund selections, purchasing US treasuries with short-term maturities, adding bond substitutes (utility and pipeline funds), selling the real estate fund and adding soft hedges via a global macro fund.

In our equity strategies, cash was approximately 15% at quarter-end. We are overweight materials and energy, and underweight financials and tech, for now. While we have exposure to REITs in the dividend strategies, most have been successful, long-term investments with good yields in selective areas of the sector.

Please call or email with questions or comments!

G. Foley – July 2022

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