Dillon Capital Management
Economic & Capital Markets Strategy 3Q-2021

Highlights

- **Government stimulus is waning**
- **A second wave of recovery may materialize**
- **Cyclicals remain attractive at this stage**

Economy

The recovery from the 2020-Covid driven recession continued into 3Q (2Q GDP growth was reported at 6.7%, among the fastest in decades), but future growth rate estimates are declining.

Unprecedented monetary and fiscal stimulus provided most of the fuel for the economy and markets since April 2020. The money supply and consumer savings accounts exploded higher.

Nevertheless, consumer spending accelerated for goods since the services-side was mostly closed. As inventories drew-down, production bottlenecks appeared. Travel and services began to pick-up then slowed with a new round of government-imposed controls blamed on the Delta variant. While frustrating, this may have set us up for a second-wave recovery in 4Q as COVID cases decline and the demand for services picks-up.

The world is experiencing shortages, from food to semi-conductors, and more recently natural gas outside the US. Some economists are arguing that inflation is now structural and here to stay. But we've been here before. While some higher costs will remain, our guess is it starts to cure by year-end. Three more months of high prices could lead to a contraction of spending.

So, growth looks strong but slightly lower than the past few quarters. A potential problem is that fiscal stimulus has run dry, and the fed has indicated that it will start to "taper" its bond-buying by year-end, before raising rates next year, creating a possible liquidity constraint on recovering demand. We are concerned about that and the potential impact of the budget negotiations and tax policy.

Capital Markets

Stock returns are still above average for the year but concern over high valuations, product shortages and fed tightening has ushered in volatility.

Major Indexes	3Q-2021	YTD
Bloomberg 1-3 Yr. T-note	0.1%	-0.1%
Barclay's Aggregate Bond	0.1%	-1.6%
S&P 500 Index	0.6%	15.9%
Russell 2000 (Small Cap)	-4.4%	12.4%
MSCI EAFE (International)	-0.4%	8.3%
MSCI Emerging Mkts.	-8.0%	-1.0%
Bloomberg Commodity	6.6%	29.1%

A battle between growth stocks and value stocks (cyclicals, commodities and financials) has endured all year. Growth outperformed during 3Q, but value remains ahead for the year.

Bond prices weakened as inflation ripped higher and the fed announced that it will begin to taper by year-end. The yield on the 10-Yr treasury note rose to 1.50%. If this yield rises just another 1-pecentage point, to 2.5%, the broad bond market would lose approximately 5.5%. To put it in perspective, if this happened over-night, it would take over 2-years of income payments to offset the price decline.

Commodities experienced wild swings in prices during 3Q, finishing 6.6% higher. Real estate was up in the quarter and up over 24% YTD. Strength in RE has been broad based, from data centers to apartments. We like real estate as an inflation hedge, longer term, but if interest rates were to rise quickly from here, investors would question the value of real estate yields over the short-term.

Gold, considered an inflation hedge, has strangely declined as have gold mining stocks despite solid cash flows and dividends. If inflation remains stubbornly high or the US dollar drops gold could rise.

The price of oil moved above $75 per barrel on improving demand and headwinds for supply. OPEC has only increased supply incrementally, while decarbonization pressure and lower oil company capital spending has weakened supply growth.

Investment Strategy

Regardless of the current confusion, the best investment for the long-term is owning stock in companies with sustainable, profitable businesses.

For the decade following the financial crisis, the list was populated mostly by technology, industrial and health care stocks. Banks, basic materials (oil and metals companies) and utilities were mostly ignored by investors. That's been changing because under investment has led to shortages.

We now seem to be in a stage where we have both growth and inflation. Opportunities can surface in either group described above when the economic condition changes. This change favors components that are necessary for recovery and in short supply. Cyclicals, like oil, are strengthening on a pick-up in demand.

This can be a problem for the broad market indexes like the S&P 500. Technology makes up over 27% of the index while energy and basics combine for only 5%, too small to drive the index higher even if they continue to outperform. But rotating to sectors with a favorable outlook can work as a tactic in this environment. We have been overweight energy and basics.

So long as interest rates remain low, and if we get this second wave of recovery, a lot of companies can do well, near term. But the stock market tends to look 6-months ahead. That's where problems might develop.

Economic growth will depend on capital. The fed has already said they will begin to pull back on easy money policy. This void could be taken up by bank lending, but borrowing has been low and if interest rates go up, we may not see much loan growth.

Given all of the cross currents, we don't think interest rates will go up much and the timing may take longer. Nevertheless, with current yields so low, bond returns will be flat or negative.

Stocks are still a better choice, but sector and stock selection are important at this stage of the cycle.

In our balanced strategies, we've maintained an underweight allocation to bonds in favor of short-term vehicles with less interest rate risk. We have added to real estate and hedged vehicles in order to lower volatility risk from both bonds and stocks.

Our equity allocation is still overweight. We reduced the allocation to growth strategies with gains throughout the year, in favor of a more value/cyclical exposure.

Our stock portfolio strategies reflect a similar preference while maintaining portfolio positions in sustainable growers.

G. Foley – October 2021

Please call or email with questions or comments!