Dillon Capital Management
Economic & Capital Markets Strategy 4Q-2021

Highlights

- **Too much money chasing too few goods**
- **The Fed plans to cut stimulus**
- **A storm before the calm?**

Economy

The US economy has continued to weather the storm surges from Covid. Gross Domestic Product (GDP) is running in the 4-6% range and unemployment is hovering around 4%, arguably at full employment. So, what's the worry?

The Covid pandemic, hit our economy in March-2020, resulting in a government reaction aimed at stopping the spread of the virus to save lives, our economy and political careers – the thought was, we had to do anything it took to fight this unknown attacker. The playbook was simple: 1) support an emergency pharmaceutical solution, 2) reduce personal interaction, 3) provide compensation for those affected by play #2.

All three plays were executed, but they didn't work very well. Vaccines were created in record-time but of questionable efficacy; reduced interaction meant businesses had to close; and once the politicians saw how free money made people happy, they went overboard.

Plays 2 and 3 caused big problems for the economy. The seemingly erratic application of power by government officials (elected and appointed) to close businesses and schools led to wild swings in the supply/ demand balance.

Fiscal and monetary policy excesses like quantitative easing (QE) and excess unemployment compensation are a direct cause of the current shortages and inflation.

When a manufacturer is forced to close, it stops ordering parts, inventories decline and transportation demand drops. Providing excessive money to consumers stimulates demand for products and services that don't exist, so prices go up.

The federal reserve deliberately maintained heavy stimulus despite reaching their goal of 2% inflation and full employment. Only now, with inflation at the highest level since the early 1980's, have they begun to slow the stimulus.

The fed reversed course rapidly during its last few meetings, subsequent to Jerome Powel finding out he was reappointed as fed chairman. They have committed to "tapering" the bond- buying program ($120 billion per month), which artificially depresses bond yields, and raising short-term interest rates 2-3 times in 2022 to fight inflation.

Historically, when the fed hikes interest rates, the economy slows – this sometimes leads to recession.

Capital Markets

US large cap stocks and real estate had above average returns in 2021.

Major Indexes	4Q-2021	YTD
Bloomberg 1-3 Yr. T-note	-0.6%	-0.6%
Barclay's Aggregate Bond	0.1%	-1.4%
S&P 500 Index	11.0%	28.7%
Russell 2000 (Small Cap)	2.1%	14.8%
MSCI EAFE (International)	2.7%	11.3%
MSCI Emerging Mkts.	-1.2%	-2.2%
Bloomberg Commodity	-1.6%	27.1%

Growth stocks pushed the broad indexes up in 4Q and for the year, led by the technology sector. The smaller energy and real estate sectors had the highest returns for the year, gaining 55% and 46% respectively. In contrast, small cap value stocks beat small cap growth, where many of the IPO and "pre-profit" start-ups hangout.

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International markets continued to be affected by Covid and weakened further by a rising US dollar.

Bond yields actually declined (and bond prices rose) when the effects of the latest Covid wave hit, despite the fed's plan to raise rates! But the bond rally began to unravel in late December when investors realized inflation is a problem that must be dealt with more aggressively.

Investment Strategy

Slowly, throughout 2021, we lightened up on growth stocks and withdrew over half of our normal allocation to core fixed income in balanced accounts.

We moved to an overweight in cyclicals or value stocks and real estate in our equity allocation strategies. We got to an underweight in the fixed income segment by mid-year then added bond-proxies with a dual purpose: boost yield and hedge short-term interest rate risk.

If tapering is completed by the end of 1Q, the Fed could move straight to interest rate hikes, we could well have two rate hikes by midyear. As liquidity drains from the markets, and inflation begins to ease, equity valuations could contract and investors reprice for tighter financial conditions. The process could be challenging but we should have a better view of the road ahead by mid-summer.

Inflation will linger but the rate of change, year-over-year, should begin to reside.

Much of the anticipated move in rates is already priced into bond yields, but not yet for stocks. As the 2-year treasury yield moves toward 1.0% and the 10-year yield reaches 2.0%, markets will reassess future economic growth. Stocks and bonds will be volatile and move below their all-time highs.

The fed thinks inflation will retreat to about 3% in 2022. If that comes true, as the fed raises rates and GDP moderates, we'll hear talk of a "soft-landing" for the economy. *Let me be the first to roll-out that phrase in this cycle!*

It's possible. And if the fed can pull it off, while earnings remain good, stocks can move higher. That doesn't mean we won't experience serious corrections along the way, we always do.

We expect a calming effect after the storms, but probably not leading to the 26% annual stock market gains we've enjoyed the last 3-years.

Investors have to remain diversified. A lower-than-normal allocation to bonds is recommended for the first half, until inflation gets tamed. Equity investors should consider a balance between growth and cyclicals, and adding to underweighted allocations in foreign stocks, as the rest of the world recovers. We prefer to lighten-up on real estate after a great run, and slowly moving back into smaller cap stocks.

Please call or email with questions or comments!

G. Foley – January2022