New Castle Investment Advisors, LLC
Market Outlook Mid-2016

By Mark Connolly,
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Uncertainty prevails—elections (Hillary-Donald, Britain voting to exit the EU, etc.) currencies, negative interest rates, oil price gyrations, China—once again, the stock market mimics the uncertainty by evidencing increasingly volatility. The first two months of 2016 was nerve wrenching, rebounding by quarter end, finishing down .3% for the first three months of 2016. And now, once again, pundits claim US stocks are overvalued, the economy is slowing, the bull market is near or at its end—
We say, stay the course.

Uncertainty is not bad for markets. Certainty is. Certainty drives extreme behavior. Uncertainty in a market evidencing an improving global economy with an historically high level of liquidity results in our full-year 2016 outlook: *the US equity market finishes the year higher from here*--don't let near-term volatility drive you to make decisions you may regret. It's quite possible and actually probable we may witness a market correction of some 5%-plus over the summer-fall months but we recommend holding tight.

Despite global recession talk, the global economy largely continues an improving trajectory. Liquidity abounds, global yield curves continue to be positively sloping (a negatively sloping yield curve, or shorter-term interest rates higher than their longer-term counter-parts, typically signals recession).

Interest rates are and will continue to be accommodative to retail and corporate consumption and financing.

In addition, lower oil prices should be positive for consumers--certainly, the rapid oil price decline during 2015-early 2016 negatively impacted the global stock market. But oil prices have now stabilized and are likely range bound near-term and energy company earnings should improve. This translates into relatively historically low energy prices leading to expanding domestic consumption.

Baring any further oil price decline shocks, we see the domestic economy continuing to expand. First quarter 2016 witnessed US GDP increase at an anemic rate of .8%. In large measure, this was due to a massive decrease in investment in oil, mining and related commercial industries.

However, broad macro-industrial trends still evidence growth. For example, the broadly watched *Institute for Supply Management (ISM)* indicates its ISM Manufacturing Index coming in at 50.8% in April (a deterioration from the March level of 51.8%, but we attribute that decline largely to the slowdown in the oil sector). A measure above 50% indicates growth.

The US manufacturing sector remains positive, and fifteen of the eighteen industries monitored by the ISM indicate higher orders month-over-month. This trend can and will dip and turn on a short-term basis but the trend line remains positive.

In addition, the ISM Non-Manufacturing Index rose to 55.7% in April from March's level of 54.5%, marking the highest level of 2016. This index surveys industries such as health care, hospitality, retail, finance and technology—all of which employ the majority of American workers.

Export growth remains strong, with the ISM Export Index rising to its highest level since November 2014.

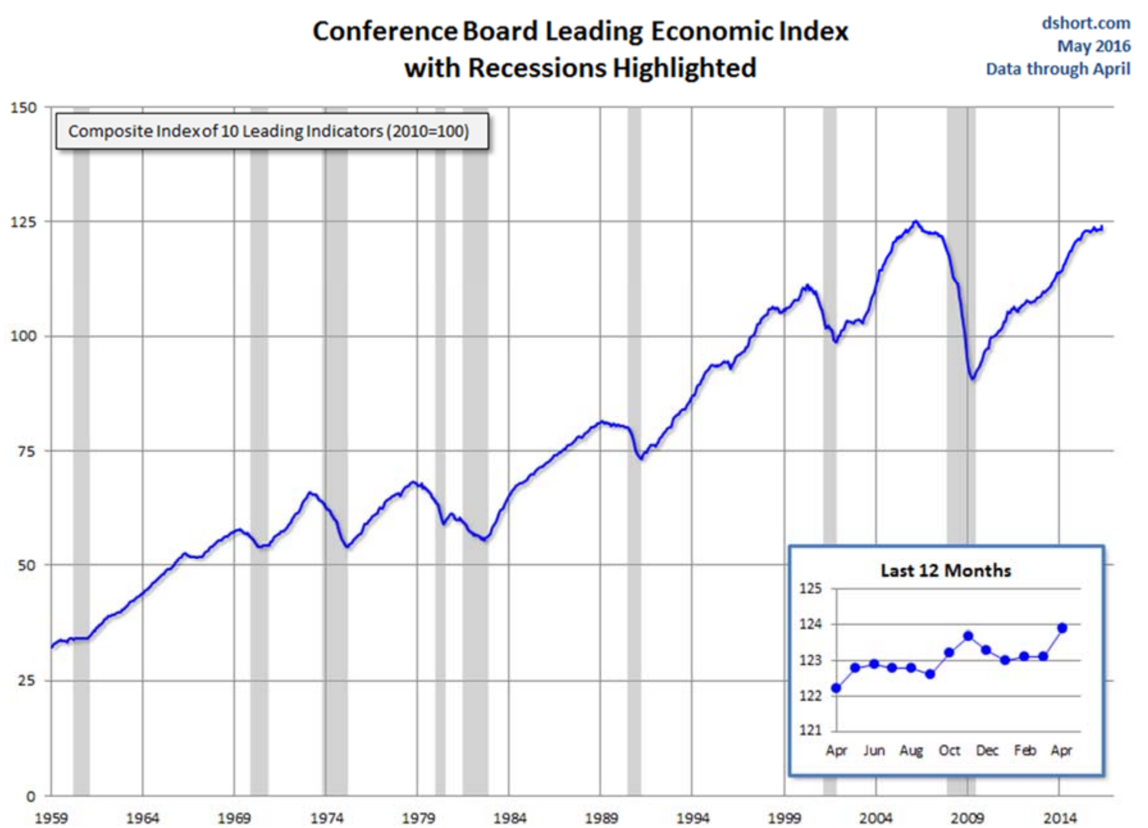
Also encouraging, the U. S. Commerce Dept. recently reported durable goods orders improving 3.4% in April.

And the all-important domestic housing market is strong and strengthening. New-home sales increased at the highest rate since January 2008, with previously owned homes reaching their highest level in nearly a decade. It's worth noting home sales prices are still well below their peak, attained in 2007. Nationally, the median price of an existing home is now about $232,500--in mid-2007, the median price in inflation-adjusted dollars was $263,560.

The relatively weak first quarter GDP report parallels recent prior early-year performance. We see second-quarter US GDP growth rising to a level of 2.8%+. Improving economic data raises the chance of a June Fed hike. If not this June, then a rate hike or more from the current rate is likely later this year. The market could sell off short-term when the FED moves rates upward, but increasing rates are a sign of an improving economy, and higher interest rates will still be below their historic norms.

Economic indicators should not be viewed month-to-month as factors such as weather patterns, i.e., the artic vortex of 2014-2105, or a commodity down-turn (think oil-2015) can impact the economy near-term. But consider this: the Conference Board's Leading Economic Index (LEI) remains on good footing, and no recession in its nearly 60- year history began with such a trend in place.

Source



The stock market is forward-looking, and we see an improving economy translating into a continuing bull market. As mentioned at the outset, its quite likely market volatility will continue because of uncertainty, and there exists the possibility

of dramatic sell-offs as well as the appearance of the oftentimes May-October seasonal market swoon, but timing the market is always a fools-errand. We look at the year in full and see the market closing higher by year's-end, with the likely positive push coming in the back months of 2016.

In the past several years we have targeted annual US market performance but this year there are just too many moving imponderables, so we are not now targeting where the end point will be but foresee the probable increase in US equity markets to be in the mid-single digits (possibly high-single digits).

Many equity analysts claim the market is now overvalued, pointing to a current P/E (Price/Earnings Ratio) of over 20 for the S&P 500. However, we view this ratio as having become elevated because of the depressed level of earnings coming out of the oil sector. The average U.S. P/E ratio since the 1875 has been about 16.7. The market should be viewed as forward-looking, and we see an improving economy resulting in the P/E ratio coming down to historic levels.

This market has now entered the mid-to-late range of a bull market cycle and this one is unusually historically long, but it has not as yet run its course. This bull is old but still snorting. Having said that, the big yearly gains are likely over and market gains this year and next—and the remainder of this decade—will not be stellar.

Given an improving US economy—with a likely increase in interest rates—some wage growth (finally), and pick-up to some degree of inflation, we view banks, insurance companies,

consumer finance entities as worth consideration. Technology, biotech, and energy are also areas we feel will likely out-perform. Sectors looking pricey include utilities, materials, real estate investment trusts (not all), household and staples—or, stocks that acted as bond substitutes in a market where the most meaningful capital gains was in bonds. In our opinion, this dynamic has run its course.

Other Investment Areas:

***Fixed Income*--this part of the market is predominantly being impacted by FED-speak as well as uncertainty concerning real and perceived interest rate movements. Yields have trended down during 2016 but have recently backed up. Because we believe the economy is improving and not decelerating, we see interest rates increasing through the remainder of the year and into 2017. This causes us to remain cautious toward committing new money to fixed income. We suggest keeping portfolio weightings relatively lower in bonds rather than higher. And within this sector we prefer municipals, mortgage backed securities and higher credit quality in corporates. We remain relatively cautious near-term regarding Emerging Market debt.**

***Europe*—Like the US, the euro-area economy continues to improve, now growing some three years consecutively. But prevailing growth rate is not robust, and it is uncertain how additional monetary stimulus will impact the trajectory of economic improvement on the Continent. Having said that, our view is an allocation to European equities remains a good bet as dividend yields there are superior to US ones and offer outperformance characteristics as we look at 2016 and beyond.**

The big near-term issue to watch is the so-called Brexit, or the UK voting to "exit" the European Union. The vote is scheduled for June 23. Right now, it looks like Britain will vote to remain in the EU. However, should the UK decide to depart, the result will be heightened uncertainty and while an analysis of such a result is beyond this particular outlook, we believe it would be a net economic negative for both the UK and Europe.

***Japan*—Japan continues to struggle economically. Its GDP is flat, and its demographic challenges remain daunting. In addition, Japan's Central Bank's continuing efforts to spur economic growth is not yet working. Having said that, Japan remains a global economic powerhouse and even though its economy is sputtering, it offers selective stock opportunities because of prevailing valuations.**

***Gold*—We just aren't buyers. Current economic tends do not meet the historic reason for buying gold. This could all change if there is some sort of unexpected calamity but none is on the horizon.**

***Emerging Markets*—When looking at this area of the market, one thinks of Charles Dickens classic novel, "A Tale of Two Cities- "It was the best of times. It was the worst of times." So far in 2016, the EM stock area (as well as EM debt) is one of the best performing sectors of the global markets, if only because it has been beaten down for so long a positive bounce was long overdue. In fact, over the past five years, EMs underperformed**

Developed Market equities by more than 50% as measured in U.S. dollars.

This is the one area of the global stock market where there is obvious value. For example, as a group, EM stocks trade about 1.4x book value. This represents around a 30% discount to their last ten-year average. Alternatively, developed-market stocks trade around 2.8 times book value, which is about 15% above their respective 10-year average.

Longer-term, we see obvious value in EMs and suggest an allocation for most portfolios to this particular sector. However, more near-term, or over the next several months, this area looks overbought and may well underperform the remainder of the year. EM stocks typically trade in the opposite direction of the US Dollar—EM commodity prices and debt are usually quoted in US Dollars. Given our economic outlook, it's likely the US green-back will recover from its underperformance of the first part of 2016, and the EM sector may well have had a short-term run. Having said that, we do not advise market-timing this or any other market sector. Longer-term, we see obvious value in EMs and suggest an allocation for most portfolios to this particular sector.
