Market Outlook 2017

New Castle Investment Advisors, LLC
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Executive Summary

The U.S. bull market continues. We expect the domestic stock market to finish up in 2017, probably low double digits (11-14%, as measured by the S&P 500). U.S. economic growth will improve, due in part to simulative policies from the Trump administration--but even before the November election, key economic measures were accelerating, as well as the trend-line for corporate earnings. We see this path continuing, with corporate earnings improving and inflation picking up. Challenges to watch include the strengthening U.S. dollar, which if it continues unabated could particularly sap large multi-national revenues and earnings.

With such a backdrop, we favor cyclical companies, as they typically perform relatively better at this stage of the bull cycle. In addition, mid-and-small companies should continue their 2016 relative outperformance, partly because they do better in a strengthening dollar environment. And what constitutes cyclical companies? Think autos, retailers, airlines--as opposed to utilities and so-called consumer staples (grocery stores).

The multi-year bond bull market is now over, and fixed income holdings should be relatively de-emphasized, with portfolios holding more lower duration bonds (shorter-term interest rates) and increased exposure to variable rate instruments.

International equities hold longer-term outperformance characteristics, particularly in emerging markets, but right now 2017 appears challenging for non-domestic equities. In an interest environment such as the one now facing the market, a U.S currency hedged-biased portfolio for international equities seems prudent.

Many market prognosticators will forecast a down market for equities in 2017--this contrary indicator is actually good for the market, which typically outperforms during a proverbial "wall of worry."

Backdrop

We now have certainty in terms of the 2016 U.S. election cycle--and the market thrives on certainty. Most of the news since the election has focused on the looming Trump presidency and the projected stimulus it could afford, particularly given a Republican Congress. But we caution against an over-emphasis on politics and posit that the majority of market performance in 2017 will be driven by macro-economic factors, which in our view means increasing corporate earnings and a pick-up in inflation. This will lead the FED to implement three or four interest rate increases during 2017.

As noted above, many investors doubt an improving economic environment and view the economy continuing to stagnate. We disagree. We forecast an improving GDP rate in 2017, likely over 3%, and wage (finally) expansion, leading to a pick-up in retail spending and thus corporate investment. While the magnitude of a Trump-Republican stimulus initiative for infrastructure is premature to gauge and its actual impact more likely occurring beyond 2017, what is real and probably expansionary next year is the repatriation of U.S. corporate cash from abroad, which will in turn stimulate domestic spending, inflation, and GDP expansion.

Earnings

Let's be clear: corporate earnings drive market performance. For much of 2016, earnings were flat, in large measure because of a depressed energy sector. This trend shifted during the year, with energy evidencing year-over-year outperformance, leading to real earnings power and thus leading to positive domestic stock growth.

At a forward P/E ratio (price-to-earnings) of around 18 at this time--determined by prevailing earnings estimates for 2017--we view the market as neutrally-priced at year-end 2016. What will likely cause the market to improve next year (and be volatile) will be ever-fluctuating earnings estimates. Our bias is towards earnings improving quarter-over-quarter, thus driving stock returns as the year progresses. But like 2016, the trajectory will not be uniform or predictive. To some degree the unpredictability of earnings will be due to the strengthening U.S. dollar but we see this factor abating as the year progresses due to a commensurate pick-up in the global economy. Just as the developed world has lagged its U.S. counterpart in monetary expansionary policy, so will the global, or non-U.S. economic improvement.

In the near-term, because of investor skepticism concerning an expanding market horizon, we do not see equities becoming overvalued, meaning valuations may well lag an improving economy, and positive market performance in 2017could be back-end loaded, just as it was in 2016.

Portfolio Characteristics

Particular asset classes to overweight during 2017 include small and-mid-sized companies. This is for several reasons: first, on a relative basis, they have entered an outperformance stage; second, they have underperformed because of investor chase for yield in a depressed interest rate environment; and third, as already mentioned, a strengthening U.S. dollar environment is better for smaller company earnings relative to larger, more global-centric ones.

Sectors to overweight for both small and large companies include financial assets, like banks, which benefit from a steepening yield curve; technology companies because of likely increased corporate investment; certain health care concerns because of aging demographics (political unrest concerning inflated drug prices depressed pharmaceutical stock performance in 2016--this trend will likely play-out before mid-2017). Retail companies, like auto parts, airlines, clothing, etc. should outperform in an expansionary environment.

Industrial and material equities should also do well next year, although much of their projected outperformance for 2017 has been pulled forward into late 2016. This is somewhat true of the financial sector, but we believe the trend line is still relatively more favorable for this particular asset class in 2017.

Areas to de-emphasize include utilities, REITs (certain real estate investment trusts), many telecom sectors--in general, those areas of the market that have outperformed in recent years because of a depressed yield environment.

The bond market sold-off in dramatic fashion during November-December 2016. Actually, the negative price trend-line started mid-year, following the 10-year U.S. treasury hitting a generational-plus low of 1.3% and then subsequently rising over 100 basis points to the 2.5%-plus area by year-end. A move like this in such a small period of time can only be characterized as dramatic. But the short-term move has likely gotten ahead of itself, similar to the so-called 2013 "Taper Tantrum," when the FED started "tapering" its purchase of bonds, which had been suppressing interest rates. The bond market immediately sold off but then stabilized once reality set in. We see that as likely happening near-term. Having said that, we do forecast a steepening yield curve over the course of next year, meaning interest rates should continue to increase, albeit in less dramatic fashion.

We do see heightened volatility in the U.S. fixed income market as the FED responds to an improving economy. This means duration-risk, or longer term bonds should be underweighted; lower quality bonds, or lower-rated credit quality ones, should be considered for some clients because they have more equity-like characteristics and will perform relatively well in a strengthening economy.

Fixed income areas that should also be considered include TIPS (treasury inflation securities, or bonds that re-set with the inflation rate), and bonds that emphasize more variable rate instruments than fixed ones. Municipal bond concentration in portfolios should be closely monitored because tax reform at the federal level could result in lower marginal tax rates, thus reducing municipal bond demand.

We see global interest rates increasing as the year progresses, again lagging in tandem with the FED. The goal--and challenge--of the FED will be to increase interest rates in a way that does not acerbate a strengthening U.S. dollar, thus impacting U.S. trade, weakening commodity prices and harming emerging markets . The road out of a zero-interest rate policy will be tricky and while we like the emerging market space longer-term, we are cautious near-term because of the strengthening U.S. dollar.

One final word about fixed income. Given a likely increasing interest rate environment, many investors are tempted to say, "sell" bonds. We don't agree. Keep in mind rising interest rates do result in lower bond prices, but lower bond prices should also be judged in terms of total return, meaning the return of a bond comes from both its yield as well as its principal value. So, overtime, increasing yields will make-up some if not all of the loss of bond principal. In the context of today, bonds should be viewed as a portfolio diversifying element (just less so given in an increasing rate environment)-- and in the near-term weighted more towards lower duration investments.

Concluding Thoughts

Every year since *New Castle Investment Advisors, LLC* has been in business, we have offered an annual market forecast for clients. Herein is ours for 2017. A lot of thought and analysis from areas we place emphasis went into developing our outlook. Not many firms like ours offers annual forecasts, but we believe in telling it like we see it. Keep in mind a forecast is a probability measure and based on assumptions. What could cause us to be wrong--particularly now, when we have entered one of the longest bull runs in U.S. market history--is the real threat of the U.S. dollar strengthening to the point where corporate profits fall. At this point, we don't see that as a likelihood. Another threat to our forecast would be misguided trade policies, resulting in global tariffs and a so-called trade war. But beyond the political rhetoric of a campaign, the reality of economic consequences as well as the give-and-take of the U.S. Congress should result in calmer policies.

If most investors agreed with our outlook, we would be worried. It's when most affirm the direction of a given market when things go wrong. For example, last summer, the market was at its lowest in terms of prevailing interest rates but it was also a period of heightened bond buying--by both individuals and institutional buyers. They got it wrong. When everyone is headed in the same direction, change course.

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