New Castle Investment Advisors, LLC

Mid-Year 2017 Market Outlook

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July 6, 2017*--The English romantic poet John Keats once wrote, "You must bring your philosophy to bear..." For the past several years, we have been doing just that, twice/year offering clients our beginning of year as well as mid-year market outlook so as to bring our philosophy to bear concerning the financial markets. Most analysts don't offer outlooks because doing so may show they could be wrong or they don't have a firm opinion, but we feel it's helpful to offer perspective and guidance. This is not to say we will always be right--and we are careful to be diversified in our portfolio management-- but we spend several thousand dollars each year on original research, listen to Web casts of company quarterly earnings reports, and place a lot of emphasis on analysis. Below is this year's New Castle Investment Advisors, LLC 2017 Mid-Year 2017 Market Outlook.*

First Half 2017

Many clients have recently been asking, "is it time to sell, yet." They feel that way because the Post-Great Recession-Bull Market is now looking long in the tooth and given the experience of the first decade of this century, where the economy was roiled dramatically twice by economic downturns, resulting in depressed stock returns--such a question and concern makes sense.

The short answer to this question is, not yet.

The stock market entered 2017 in full bull market mode. The unexpected Republican sweep in November was viewed by the market as ushering in good tidings due to a perceived revamping of regulations, new infrastructure funding, tax reform and tax reductions. Between Election Day to the end of 2016, the S&P 500 Index increased 4.6%.

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However, as we now review the first six months of 2017, Washington remains deadlocked and the new Trump Presidency has few legislative wins. But why hasn't this stalemate and political upheaval resulted in a downward equity market so far this year? Because it is reacting to two key tenants: the market likes certainty, and Washington's inaction is viewed as a positive. But more important to the market than political inaction is the fact that corporate earnings are better than expected this late in the bull cycle.

First-quarter S&P 500 earnings increased 14% from a year earlier--the best growth since 2011. The best performing index, the Nasdaq, had its best showing since 2009, driven largely by the Technology Sector, up some 14% year-to-date. A survey of analysts show corporate earnings growth continuing and expect double-digit profit growth this year as well as 2018.

Counter to prevailing wisdom, the so-called "Trump Trade" is not particularly relevant to market performance. Consider this: the market sold off during the first several weeks of 2016; and beginning mid-February until Election Day 2016, the global stock market increased over 17%. What is quite interesting in considering such outperformance is the U.S. stock market is not leading the charge this year, as typically has been the case since the end of the Great Recession.

Global, non-US markets are now rising in sync and so far during 2017 out-performing those here. Over twenty-five of the thirty major world stock market indexes are up this year and about one-half these thirty major global stock indexes are at or near their all-time high water marks. The last time this happened was eight years ago.

Europe, in particular, is evidencing strong performance, driven by a better than projected economic outlook, and Euro-zone business and consumer sentiment is now at its highest level since before the onset of the financial crisis.

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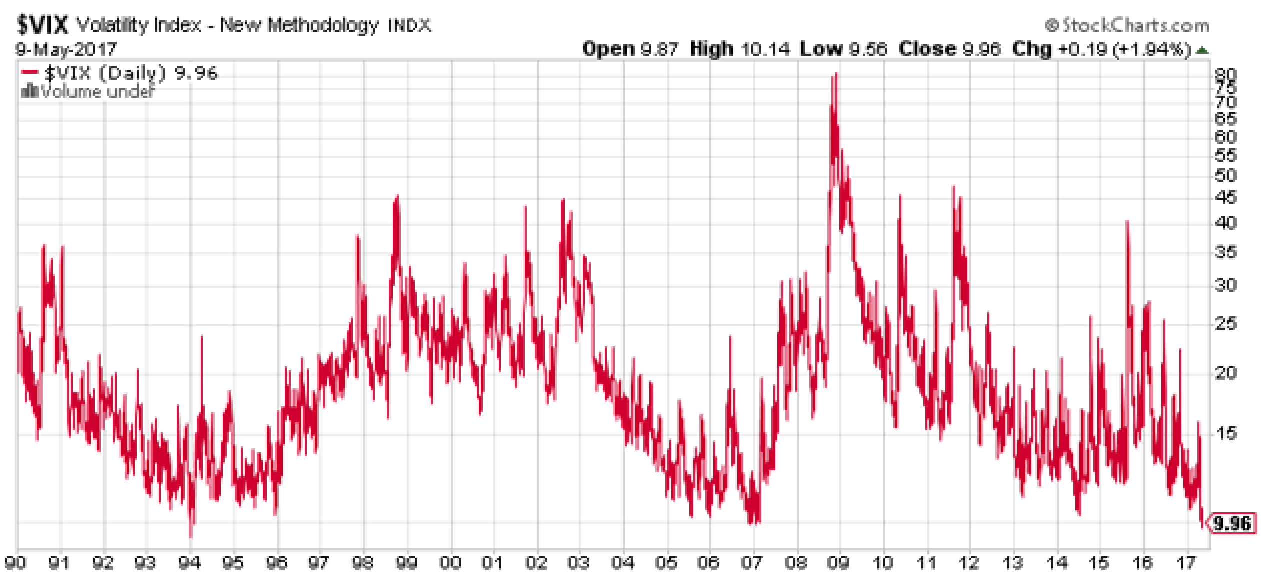
In the U.S., all three major stock indexes, i.e., the Down Industrial Average, the S&P 500 and the Nasdaq Composite, have been hitting new highs as the year has unfolded, an unprecedented feat given we are now in the ninth year of a bull market--the second longest on record. Of note, the typical bull market lasts about one-half this length of time.

So far this year, the market is also remarkably less volatile than typically is the case. Nearly halfway through 2017, the average level of the CBOE Volatility Index (the VIX), an index traditionally used to track near-term market volatility expectations, stands at 10.6, historically very low. In fact, the VIX Index, which measures the implied volatility on the S&P 500 Index, is currently at lows not seen in some twenty-five years.



When viewing the VIX Index trend-line above, keep in mind lower volatility implies higher stock prices--historically, there exists an inverse relationship between market returns and changes in the VIX. That is, lower directional movements in the VIX typically results in positive changes in stock prices.

Given the current state of political uncertainty both in the US and abroad, many financial professionals are puzzled why the markets are so relatively strong and volatility low. Our view is elevated global stock prices is indicative of an improving world economy and increasing corporate profits, and this trend is likely to continue through the second half 2017.

However, having said this, it is unlikely low market volatility will be uniform or stay this low. Expect periods of episodic volatility. Short-term politics and geo-political concerns can and will have an influence on market perception. In addition, economic indicators--both in the U.S and globally-- are generally positive and upward sloping but recent trends have not all been uniform.

Economic trends and stock market returns are seldom in one direction. Expect fits and starts. Plus, the summer months are traditionally the worst market performing season of the year. It has been over a year since the market has traded off some 5% or more, and we expect a sell-off of some magnitude to occur (5-8%) sometime between now and early next year. This s quite normal and healthy for the market.

The Stock Market

US equities are above their average historical valuations. But how overvalued are they? The current P/E (Price-to-Earnings) ratio now stands at 21.3%. This compares to a twenty-five year median of 18.6%. Other metrics, such as Price-to-Book (P/B) ratio and Enterprise Value (EV) to Earnings Before Interest, Taxes, Debt and Amortization (EBITDA) ratio are also at elevated levels relative to their 25-year median level. However, when considering such measures, two important points must be kept in mind: first, the market traditionally trades on forward values, meaning looking outward some 6-12 months. Analyst earnings estimates for 2018 now indicate a forward P/E value of 18.4%; second, when judging relative value, one must also factor in such measures as prevailing inflation and interest rates--both at multi-year lows, thus supportive of a higher P/E ratio and the like. Also, in recent quarters, analyst earnings projections have been under-valuing actual results. The remainder of this year we see earnings likely surprising to the upside instead of disappointing.

In judging market direction, one must also factor in where we are in the bull cycle. Every market bottom is typically followed by four distinct phases, with the fourth one being "euphoria," or the blow-out phase, where the feeling becomes, "it's different this time, a la , 1999, where the S&P 500 P/E ratio topped off well over 30% before tumbling. We are now likely in the third phase of a bull market, which is typically characterized by doubt, i.e., "The market has really moved, should I be selling now?"

During the third phase, the market gyrates higher, climbing the proverbial "Wall of Worry." Typically, it's when investors are nervous when staying the course makes sense. However, when investors want to be all in (the fourth phase) is the warning bell to engineer an exit strategy.

Where are the opportunities now in the stock market? In the US, there are some--for example, the financial sector, which currently trades below its 20-year Price to-Book average and still offers a relative valuation play versus the broader S&P 500 Index. It has lagged largely because the sector was so severely damaged during the Great Recession as well as the fact that during the past several years interest rates have been flat--banks, in particular, profit from a wider net interest margin (the difference between what they borrow and lend) and insurance companies hold a large amount of fixed income debt in their portfolios, hamstringing earnings when rates are low like today.

Tech stocks have been the best performing sector so far this year and have lately been volatile but they still offer relative value. Even after a great first half-year performance (up 14%), the Tech Sector trades on par with its twenty-year Price-to-Book valuation versus the S&P 500, and based on current Price-to-Earnings (P/E), offers a valuation some 22% below its twenty-year historical average to the S&P 500. As a whole, we like the Financial and Technology sectors as well as Health Care. Sectors we are not as bullish include Utilities, Real Estate (equity-held real estate), and Energy.

We still favor large companies over smaller ones as typically lower capitalized companies outperform in the initial stages of recovery and larger ones tend to outperform in the later bull market. There are exceptions, like when the US Dollar strengthens sharply--in such a case, larger companies can under-perform on a relative basis because they will not be as competitive on the world scene and typically smaller US companies are not export-driven. So far this year, the US

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Dollar has weakened, boosting large company earnings, but this could change fast if interest rates start increasing and the yield curve steepens.

The US Dollar deserves special attention in terms of gauging US corporate performance. The last four months the Dollar has traded downward, in effect zeroing out its post-November Election gain. Furthermore, during the first six months of this year, the Dollar dropped some 6.6%, the largest six month drop for the US currency since the second-half of 2010.

US Dollar weakness can largely be blamed on a lack of Washington action regarding key economic initiatives, like corporate tax reform. While a declining US Dollar can eventually cause economic problems, currently the US economy has no meaningful inflation (which a declining dollar can acerbate) and for now, a depreciating Dollar is a positive force for large export-driven US companies--leading to higher than expected quarterly earnings.

So far this year, growth stocks have outperformed value ones. Growth (think tech) typically outperforms in the early-to-mid stages of a bull market and value (think banks) outperforms in the later stages. But not all bull markets--or bear ones--are uniform in duration. Many market observers (including us) saw this year as being one where value would outperform its counterpart. We maintain our preference for value over growth but now view this as a mild conviction. In our view, Growth-Value relative performance will likely be driven by trends in the Financial and Technology sectors in the back half of the year/early 2018, as well as the direction of interest rates and US Dollar. Thus, in general, we include both growth and value stocks in the portfolio mix.

The best relative stock opportunities now exist outside the US, particularly in the Euro-zone. Opportunities also exist in emerging markets as well as in the developed world-EX US. In large measure, international outperformance is overdue. Over the past several years, the US stock market has outperformed its international peers. We see this outperformance primarily as a function that the Federal Reserve acted more quickly than other central banks, and the US economy improved much faster than the case globally.

In terms of valuation, based on Price-to- Book measures, the Ex-US regions are trading near or below their 15-year median. Additionally, on a relative basis to the

S&P 500 Index, each region still trades at a larger discount than historically is the case. As mentioned above, we particularly like the Euro-zone, as it now offers attractive valuations, plus it presents a more positive policy framework following the results of the recent French elections. Even after the European markets reacted to “Macron Momentum,” the Euro-zone still trades at a 17% discount to its 15-year median relative Price-to-Book to the S&P 500.Additionally, Euro- zone GDP is now growing faster than that of the US.

In addition, Euro-zone inflation is accelerating, leading to better pricing power and higher profit margins for companies in the region. We are also seeing strengthening consumer sentiment in Europe as well as improving economic confidence and manufacturing prowess, which will likely further boost Earnings-Per-Share (EPS) growth for Euro-area companies.

The Bond Market

Compared to the stock market, politics plays a relatively more heavy hand in influencing the direction of bond prices. As discussed above, so far in 2017 political distractions in the US have delayed policy decisions. As a result, the market has turned less confident President Trump's proposed campaign promises will be implemented, e.g., health care reform, tax reform, infra-structure spending. As a result, over the course of the past six months, inflation expectations have not budged, interest rates have generally fallen, the yield curve (meaning long-term rates relative to shorter ones-- or 30-year, 20-year and 10-year Treasuries versus 1-3-5 year treasuries) have flatten, and the high yield market is now historically expensive. Yes, interest rates are higher than was the case a year ago, i.e., the 10-Year Treasury stood at 1.46% on July 1, 2016 and is now 2.35%, but by any historical measure, the bond market remains expensive and fixed income opportunities remain challenging.

Depending on the client, bonds typically constitute a weighting of 30-40% in a given portfolio. Today, however, because bond prices are historically elevated our preferred allocation is closer to 20-25%--and for certain clients, less. The reason is quite simple: with the dividend yield of the S&P 500 nearing 1.95%

and many quality stocks offering yields in the 2.25-2.5% level as well as the 10-Year Treasury now at 2.35%, the question becomes this: what is a more sure bet looking out 5-10 years from now? That is, which security type offers a higher adjusted duration yield as well as principal appreciation? Absent a pronounced long, major economic downturn, today stocks offer better relative value and in fact have so far outperformed bonds this year.

Having said this, it is now evident that given today's historically low inflation rate and no meaningful near-term pick-up in wage rates, the likelihood is bond yields will remain suppressed for the foreseeable future. Thus, from a portfolio diversification viewpoint, bonds should remain part of most investment plans. But in doing so, we recommend credit products that offer predictable cash flow and portfolio stability. As short-term rates are likely to go up once or twice more this year and possibility several times further over the next two-plus years, we have been adding floating rate instruments to most portfolios--the principal adjusts to interest rate movements. And we favor more active management than passive but do purchase passive instruments as long as they are of shorter duration.

Because we foresee the economy containing to improve and inflation kicking in at some point, we see the 10-Year Treasury ending the year in the 2.5-2.75% range this year and likely 3.0-3.25% or more by year-end 2018.

In terms of the stock market, we see the S&P 500 finishing the year higher from here, probably reaching +/-2525, or up 3-5% from the current level of 2430. One federal move that could bump this range even higher would be passing legislation to lower corporate tax rates, thus "repatriating" cash, or encouraging American companies to bring money held abroad back to the US. It is estimated some +/-$2.5 trillion is held overseas by American companies, largely because the prevailing US corporate tax rate is higher than most developed nations. Should Congress and President Trump agree on a lower tax rate for corporations--and in our opinion this one is the easiest lift of all the proposed policy measures--a transfer of cash back to the US would likely drive stock prices upward immediately, causing the S&P 500 to likely end the year in a range 6-10%, or more, higher from here.

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What could cause our stock and bond market predictions to be off? An economic slowdown, causing consumers to hold back spending, wage rates stagnating, leading to a deflationary economy. But we do not see this as a likely scenario**.**

In summary, we view the Second Half 2017 as being more volatile than the First Half but with stock prices ending higher from here and bond prices edging lower. Thank you for your business. This constitutes our Mid-Year 2017 Market Outlook. If you have any questions or need further information, please do not hesitate to write us at mark@newcastleinvestments.com, or call the office at 603-319-4563.