New Castle Investment Advisors, LLC Mid-Year 2018 Market Outlook

As we head into the second half of the year, investors are increasingly getting wary. Market volatility is higher this year than was the case in 2017, and several of the trends that have primed the pump of the current bull market cycle are starting to fade, i.e., historically low interest rates/oil prices.

Looking back the last six months, January's market performance was stellar, driven largely by the December 2017 federal tax cut, resulting in an upward jolt of projected U.S. corporate earnings. But this spurt was short-lived. In February, market volatility pounced on the market, resulting in sudden and violent downward shifts, with the S&P 500 selling off over 10% over a ten-day period between January 28-February 8. Since then, the market has gyrated between sharp drops and sudden increases—the bull market seeking its footings in a frenetic economic and political landscape.

As referenced in our *2018 Market Outlook*, the era of market stability witnessed during 2017 is over. What's driving the market volatility of 2018 is largely due to shifting economic currents, namely, the FED raising interest rates, inflationary pressures re-emerging, trade tariff jitters, Brexit issues festering, Europe economic growth stalling, and the general synchronized international growth trend of 2017 uncoupling.

These trends are worrying investors, many of whom say, "how far can this market go? Should I go to cash now before it ends?" Let's address that angst after we see what has happened so far this year.

EQUITY AND BOND RETURNS (through June 22, 2018):

Equities	**Close**		**Week**		**YTD**		**1-Year**
S&P 500	2,755	▼	-0.87%	▲	4.0%	▲	15.4%
DJIA	24,581	▼	-2.03%	▲	0.5%	▲	17.5%
NASDAQ	7,693	▼	-0.68%	▲	12.0%	▲	23.8%
Foreign Stocks		▼	-0.95%	▼	-1.3%	▲	8.4%
Emerging Markets		▼	-2.26%	▼	-5.2%		10.6%

Top Three S&P 500 Equity Sectors		YTD
Consumer Discretionary	▲	13.6%
Information Technology	▲	13.3%
Energy	▲	5.7%

Bottom Three S&P 500 Equity Sectors[2]		YTD
Telecommunication Services	▼	-9.4%
Consumer Staples	▼	-8.3%
Industrials	▼	-3.4%

Bonds		Week		YTD		1-Year	Yield
10-Yr. Treasury[4]	▲	0.24%	▼	-3.2%	▼	-4.3%	2.90%
US Bonds	▲	-0.01%	▼	-2.0%	▼	-1.3%	3.33%
Global Bonds	▲	0.11%	▼	-1.6%	▲	1.1%	2.01%
Munis[5]	▲	0.11%	▼	-0.4%	▲	0.9%	2.68%

Source: Franklin-Templeton

With the exception of smaller companies and the technology sector, the market was basically flat the first half of 2018. And while domestic bond yields have been stable of late resulting from a flight to U.S. assets due to “trade war talk,” U.S. bond yields are now higher than the beginning of the year, and the trend line remains for increasing interest rates.

Bad news and uncertainty are good for the market, underscoring the proverbial wall of worry accompanying all bull markets. Here is what we know: Corporate earnings remain strong, and the market is not overvalued. First quarter earnings increased 26% over Q1 2017. And 78% of companies reported earnings above projections. This trend line is similar to Q1 2018 earnings results with both quarters markedly above the historical long-term averages of analyst earnings projections. However, we do not see this trend line continuing, as such a high growth rate is unsustainable, but we do view corporate earnings (US) remaining strong, and as I have said many times in our outlook pieces: earnings drive market direction. Market valuation remains fair value, with the forward P/E ratio (price-earnings) of the S&P 500 slightly under 17, which is about the historic average.

In terms of portfolio construction, we continue to favor technology, health care, industrials and financial services. Industrial companies like Boeing, Caterpillar and Deere are great investments but lately have been roiled by the Trump Administration's trade policy saber rattling. As outlined in our *2018 Market Outlook*, we view a trade tariff impasse as the one issue that could derail what should otherwise be a positive market for 2018. However, on other political issues the president has demonstrated the tendency to initially cast a wide net of bombast to later reign it in when things go off the tracks. As the Administration heads into the November midterm election, one area it touts and watches closely is the U.S. stock market. It just makes little sense politically to let trade policies sink one area the president has going in his favor.

Financials have not outperformed as yet this year, in large part because of the yield curve (the interest rate differential between 1,3,5,10,20, and 30-year bonds). Short term rates have increased the most, with the 2-year treasury climbing 62 basis points (.62%), the 10-year Treasury increasing 41 basis points, and the 30-year Treasury up some 21 basis points. This has led to a flattening of the yield curve, as the 30-year Treasury has only advanced half the rise of its 10-year counterpart and 1/3 that of the two-year Treasury. A compressed yield curve is not favorable to banks in particular. But bank balance sheets are strong and fee income is good but to really get profitability up, the yield curve will have to steepen, and this is likely over the next year. Sectors like utilities, telecom, and REITS do not particularly do well in an increasing interest rate environment because companies in these sectors traditionally carry a lot of debt.

The economic indicators we follow, like the ISM Manufacturing Index, remain solid. In addition, consumer confidence remains high, personal consumption strong, household debt levels relatively low, wage growth increasing, and business confidence at a multi-decade high. While late in the business cycle, the end game is not yet in sight. Typically, when the economy runs hot and the stock market runs upward fast, there typically follows a froth phase, where everything looks rosy and the old adage, "it's different this time" creeps into the media parlance. We are nowhere near that point—yet. If a screw-up happens short-term, meaning the remainder of this year, it will be self-imposed. The politics of the Trump presidency need close monitoring, which we watch like a hawk, and we have sources we monitor closely to make sure we are on top of it.

Global synchronized growth and corporate profits may have already topped out, but global economic indicators remain positive. Monetary policies still remain accommodative in Europe as well as the developed world and any tightening will likely be gradual. We should witness increasing inflation and interest rates both in the U.S. and the developed countries, but they will remain below historic averages, and over the next several months we should continue to see cyclical stocks outperform the more defensive sectors.

Typically, during the later stages of a bull market, international stocks outperform U.S. ones--such has been the case in five of the last six global economic cycles. However, trade skirmishes, Euro fiscal policy and a rising U.S. dollar have negatively impacted international stock market performance this year. While the resolution on trade will remain an important determinant for multi-national companies, we believe the dollar is over-extended, international economic growth remains positive, and the bellicose trade talk will calm--resulting in international equities regaining their traditional outperforming footing at this juncture of the market cycle.

After more than a decade of easy monetary policy, conditions may be tightening but they are doing so gradually. And although the late 2017 US fiscal policy package hasn't yet boosted GDP growth rate as yet, it likely will do so later this year, and we see real GDP hitting 3% and higher the remainder of the year. And, while interest rates and inflation are rising, both remain well below historical averages.

With the Q1 2018 earnings growth rate having likely reached the high-water mark of the year as well as the current market cycle, this translates into a market that will call for more selectivity as certain sectors and stocks will outperform—the ones with improving earnings growth.

As we have written before, the multi-decades bullish bond market is over, and increasing interest rates mean decreasing bond prices. We favor short duration assets, floating rate instruments and market neutral debt—meaning keeping bond exposure in portfolios below historic averages and viewing cash as a bond equivalent.

Bottom Line—stay the course. At times you will see the market down some 300, 400, 500+ points in a day or two or more. You will hear the talking heads make a big deal of the issue of the day—North Korea, Greece, trade wars, etc.—and it will feel it's time to exit the market. But the economic cycle remains intact. Corporate earnings really good. Wage growth evident. We still view the market ending the year in high single digits and actually could be overly conservative in this viewpoint. If I had to predict, the majority of that return will be back-year loaded, or after the November election. The market likes certainty, and we will get that once another political season is over. Have a good summer—***Mark Connolly***

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