Castle Investment Advisors

INVESTMENT CONCEPTS
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1st Quarter 2016 in Review

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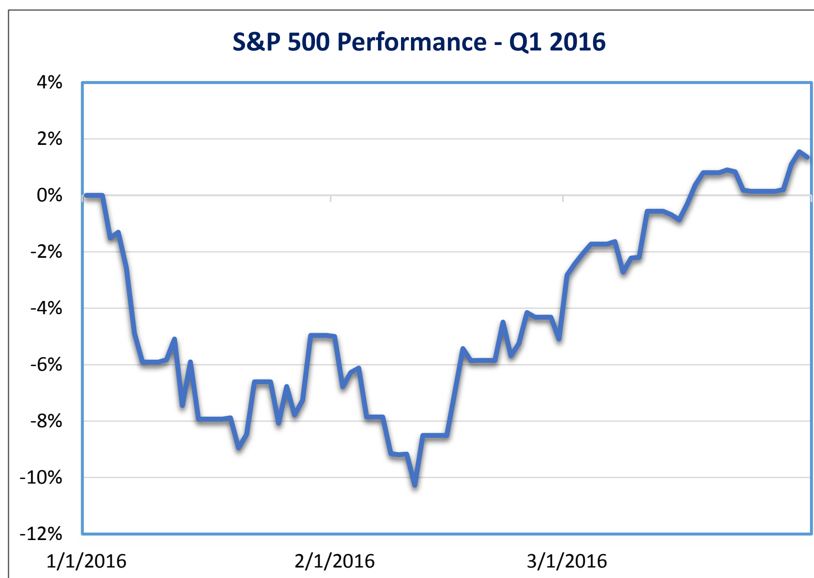
At the risk of utilizing an already overused metaphor in comparing one's investing experience with a roller coaster, I recently imagined the reaction of someone who had never ridden or even seen a roller coaster after having the experience described to him. So you are telling me they strap you into a vehicle that proceeds to take you on a ride that includes large ascents, steep drops, and sharp corners, all at rapid speeds and shortly thereafter returns you to the place where you began?

Well, yeah; investing in the first quarter of 2016 was a lot like that, as the following chart that tracks the daily movement of the S&P 500 shows. The stock market dropped more than 10% during the first 6 weeks of the year, causing many investors who were watching closely to feel anxious and irritated. Then just as quickly, it recovered all of those losses and ended the quarter with a 1.35% gain.



But if we look at the performance of the same index over the same period of time using a bar chart instead of a line chart, the picture looks significantly more serene, just a plain 1.35% return (see chart on next page).

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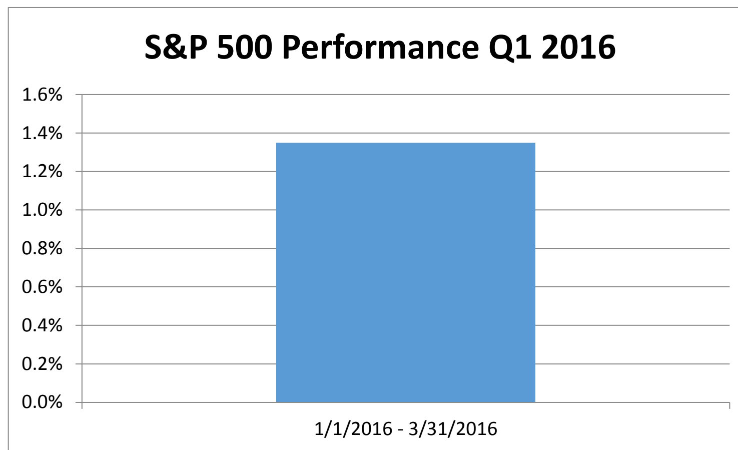

An investor who only looked at his investments at the beginning and end of the quarter would have been spared a tremendous amount of angst. We appreciate that the only looking once a quarter approach is not for everyone, but we do support the attitude that it represents. That is, the perspective that your investment portfolio is a vehicle intended to help you reach long-term goals, but one that does not do so in a linear fashion. There will be ups and downs and twists and turns along the way. The data that shows when investors buy and sell their mutual funds indicates that those who frequently react to market movements often end up underperforming because they sell when the market is down and buy when the market is up; even though everyone intuitively understands that "buy high, sell low" is not a winning strategy.

So to those who decided that the best strategy during the first week of February was to do nothing, we say a hearty congratulations! Have a long-term plan, patiently stick to the plan with discipline, and use market movements to make slight adjustments that take advantage of the opportunities that those movements create.

We talked about the S&P 500, here is how some of the other leading indexes performed:

Index	1st Qtr 2016 Return	1 Year Return	3 Year Annualized Return	5 Year Annualized Return
S&P 500	1.4%	1. 8%	11.8%	11.6%
Dow Jones Industrial Average	2.2%	2.1%	9.3%	10.3%
Nasdaq Composite	-2.4%	-0.6%	15.6%	13.2%
Russell 2000 – Smaller Companies	-1.5%	-9.8%	6.8%	7.2%
MSCI EAFE – International	-3%	-8.3%	2.2%	2.3%
Barclays US Aggregate Bond	3%	2%	2.5%	3.8%

Oil prices continue to be a driving force in the worldwide economy. Part of the reason for the recovery during the second half of the first quarter was the growing belief that oil prices had begun a sustainable recovery. This is reflected in gasoline prices as the national average has now eclipsed $2.00 a gallon after dropping as low as $1.70 in mid-February, and is still about $0.35 cheaper than this time last year.

An interesting phenomena during the past year or so has been the abnormally high correlation between the price of oil and other investment categories. Notice in the following chart how much more correlated the various asset classes have become in the past year compared to the average correlation over the past 10 years. Over time, we would expect these correlations to drop back down closer to their typical levels, but for now it explains a great deal about the performance in these areas of late.

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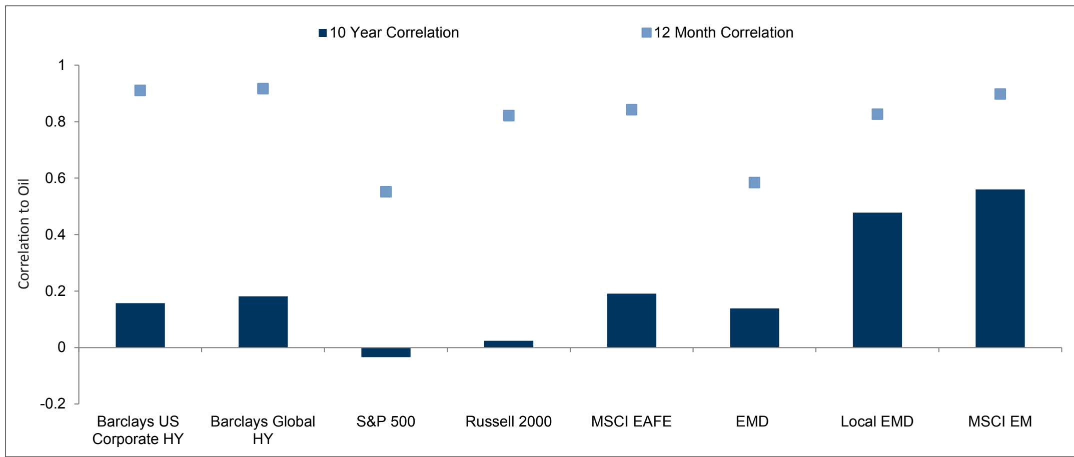
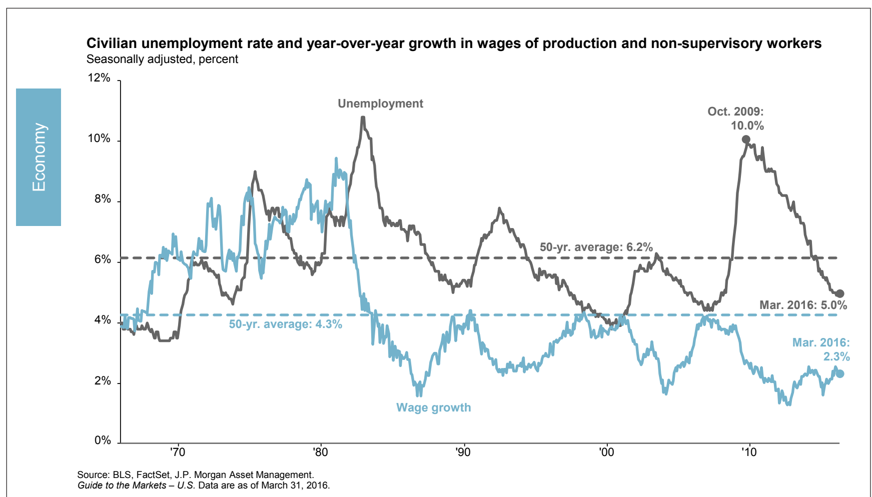
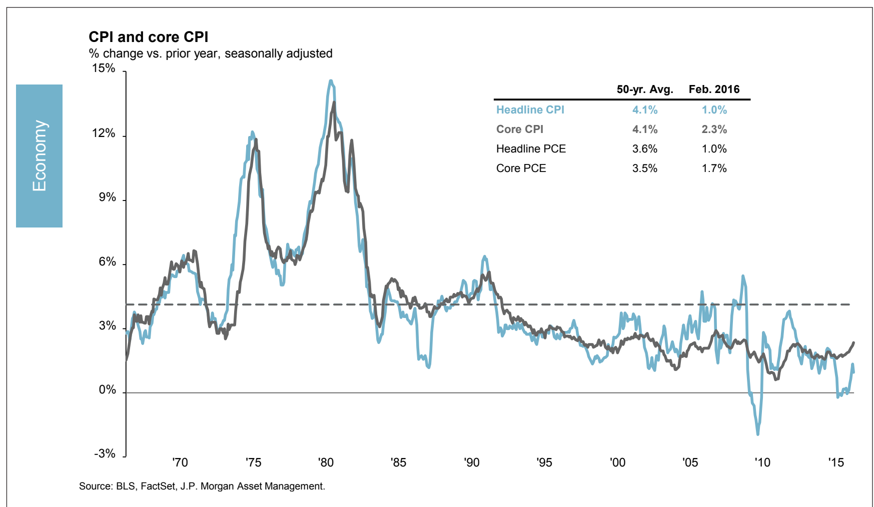


The U.S. economy continues to strengthen, albeit quite slowly, with no real signs of imminent recession. Most economists are expecting growth of around 2% for the year, even though data suggests that when GDP numbers come out for the first quarter, they may be negative. Manufacturing has started to recover and March saw a nice increase of 215,000 jobs, though as more people have been entering the work force (2.4 million have been added since October), the unemployment rate has ticked up higher to its current level of 5%.



Both core inflation and wage inflation remain low, though we have seen them both start to rise. Should this trend continue it will certainly capture the Federal Reserve Board's attention and impact the pace of interest rate movements.



	50-yr. Avg.	Feb. 2016
Headline CPI	4.1%	1.0%
Core CPI	4.1%	2.3%
Headline PCE	3.6%	1.0%
Core PCE	3.5%	1.7%

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When the Federal Reserve raised short-term interest rates in mid-December 2015, they laid out a road map that included 4 rate hikes per year (of ¼ of 1% each) amounting to a total rate increase of +3 percentage points over the next 3 years. Now, just 3 months into that schedule, the Fed announced that due to a sluggish global economy, they will cut in half the number of expected rate hikes in 2016 from 4 to 2, with Chairwoman Yellen reiterating that increases would be slow and gradual.

On the global economic front, things are fine, but not great. Growth in Europe is sturdy and should also be around 2% with unemployment dropping, but things do not look as good in Japan, which has recently implemented a policy of negative interest rates. China continues to deal with slowing growth, and emerging market countries have benefited in 2016 by a recovery in commodities.

Stock market valuations are in the neighborhood of their historical average levels, so if the market is to rise from here it will be on the strength of growing company earnings. Companies should see some benefit if the dollar stops rising and energy companies start growing profits again. Last year, the dollar's rise (a 16% increase) shaved off about 6% of S&P 500 companies' earnings, while in the fourth quarter alone, energy companies reduced the index earnings by about 10%.

In closing, a thought about the presidential election. Certainly the policies of whoever gets elected will have an impact on the investing landscape, but when you look at stock market returns there is no statistically significant connection relating stock market performance with which party occupies the White House, or controls Congress. Don't let how you feel about politics have too much influence on how you feel about investing.

Thanks for reading. Have a great spring!

Sincerely,

The Castle Investment Team

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