BLACKSUMMIT FINANCIAL GROUP, INC.
A Registered Investment Advisor
395 Chandamere Way, Nicholasville, KY 40356
+1-859-305-0602
www.blacksummitfg.com

REMEMBERING THE FUTURE

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2016 Market Outlook

Joel Charalambakis, Research Analyst

Introduction

As our recent commentaries suggest, we remain optimistic regarding the investment opportunities at the dawn of 2016. At this point last year there were a number of variables (bond market liquidity, monetary policy divergence, international growth concerns and political risks in Europe, among others) that led us to approach 2015 with caution. Several of these issues still loom large over markets going into 2016 but their impact has started to get priced into assets heading into the year. More importantly, investor psychology and expectations as a whole are more prudent and less exuberant which should allow for some opportunities over the coming year including the market turmoil of the first few trading days in 2016.

Fundamentally, a number of small improvements and greater clarity in multiple areas should add up to a better year for investors. In the U.S. economic growth has continued its slow but steady pace. The labor market is exhibiting greater levels of confidence, as more and more employees are willing to leave their jobs with the certainty of finding a new one. Debt has continued to fall at the household level while remaining manageable at the corporate level. Lower fuel costs continue to support the consumer and monetary policy is providing a needed tightening in a gentle manner.

Overseas, China brought attention to a number of vulnerabilities, chief among them its own excesses in the industrial sectors and its huge debt level. The resulting volatility in currencies and commodities impacted all asset classes and geographies. But markets have become accustomed to these narratives and thus the marginal change in 2016 is less likely to warrant severe asset price declines. Concurrently, easier credit conditions in Europe and stronger consumption habits in Japan should help buoy markets over the year.

The rest of this outlook will go into greater detail over each major market area and then be followed by our thoughts regarding specific asset classes and sectors.

The Global Macroeconomy

United States

At first glance, U.S. markets look to be in a similar place as a year ago, relative to other major developed markets. While maintaining an overall bullish tint going into 2015, investors and analysts had a number of worries (valuations, oil prices, volatility, etc.) without fearing about the economy's fundamental stature. As a result, many investment professionals advocated Europe and Japan as having better prospects for the year.

A similar dynamic has formed heading into 2016. Concerns over China, monetary tightening, and turmoil in the energy sector are a few frequently mentioned today. As a result, several analysts favor Europe and Japan going into 2016 for their more favorable valuations and the easy money policies employed in each area.

While the contrast has some validity they are not as poignant heading into 2016 and we wouldn't expect a similar divergence in performance between the major indices among the three markets (where Germany and Japan both posted 9+% returns versus the flat performance of the S&P 500). First, the largest factors weighing on U.S. equities have been more fully digested compared to this point last year. There are fewer guessing games regarding how low oil can go. The dollar, while remaining strong, isn't expected to rise to the same degree, to the relief of firms with major international exposure. And markets finally saw the Federal Reserve increase interest rates. While there are plenty of questions heading into this New Year, markets have a clearer understanding of the above dynamics and priced in their effects to a large degree.

In addition, there are a number of positive catalysts boosting the U.S. economy and its capital markets. First, the U.S. still has room to run in its credit cycle relative to history and monetary policy will remain accommodative. While the Fed currently forecasts four rate increases for 2016, we believe two is more likely due to global growth concerns. This slower pace will continue to propel asset prices while providing easier access to credit for the general economy.

The corporate sector also remains strong in the U.S. Through Q3 of 2015 each sector (with the exception of energy) posted cash flows above its 10-year average and overall estimated earnings growth of about 8% is healthy. Household deleveraging has continued while quarterly corporate profit growth is in line with levels over the past 15 years and current consumer confidence levels are near a post crisis high (Figure 1).

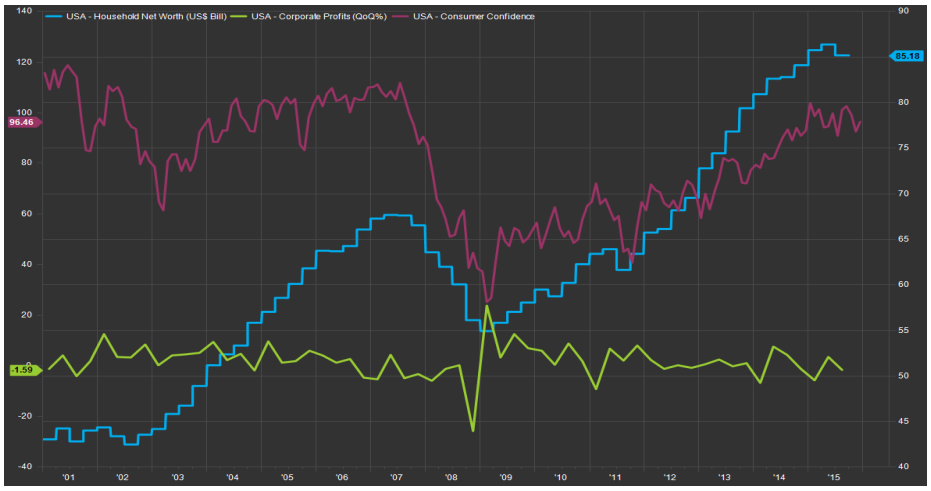


Figure 1: Corporate Profits (Green), Consumer Confidence (Red) and Household Net Worth (Blue), Source: Factset

Corporate investments (when including research and development) are at robust levels and near 10-year highs, while concurrently offering record amounts of free cash flow in several sectors. Every sector in the economy currently possesses cash amounts in excess of their 10-year average, except for energy where cash levels are in line with history.

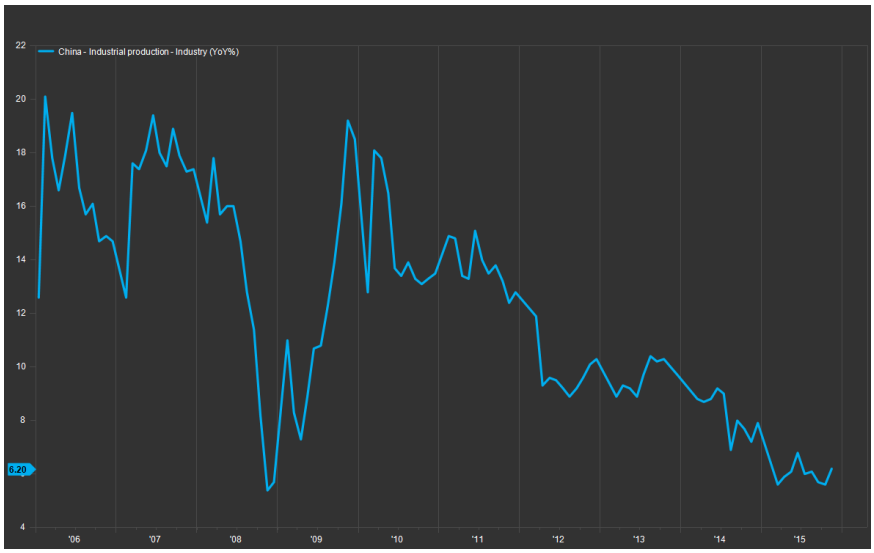
One of the most promising developments in the U.S. is the rate of household formation. Adults aged 34 and under are seeing employment growth of 30% faster than the rest of the population. At the same time wages continue to rise incrementally while the quits rate shows the labor market has greater confidence in finding employment. All these factors combined with low mortgage rates has led to renewed strength in housing

coming out of the crisis. High rates of household formation provide strong demand for new homes, construction jobs, and increase the overall demand in the economy. Household formation was abysmally low for many years after the financial crisis but the turnaround seen over the past 18 months provides a considerable tailwind and foundation for the overall economy moving forward.

China

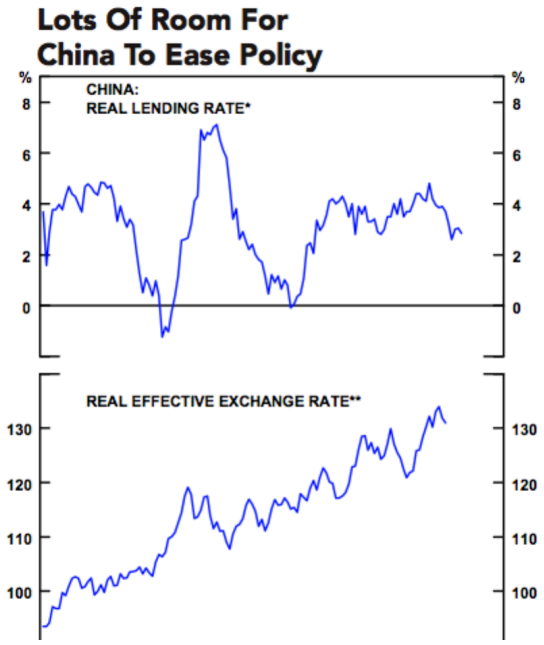
China will be a leading character across a number of market themes in 2016. Its decelerating growth is most tangibly impacting commodities and currency markets but reverberates to affect global fixed income and equity markets as well. The makeup of the Chinese economy continues to evolve, deemphasizing industrial and manufacturing activities and prioritizing the maturation of consumer and service sectors. The country sits with enormous excess capacity in the industrial sector thanks to its investment stimulus during the Financial Crisis. As a result, there is limited new investment in fixed assets (Figure 2), which has put downward pressure on commodities and their source economies. Industrial excesses are also a prime contributor to credit risks within China's corporate sector.

Figure 2: Chinese Industrial Production (Yearly Change) 2005-2015, Source: FactSet



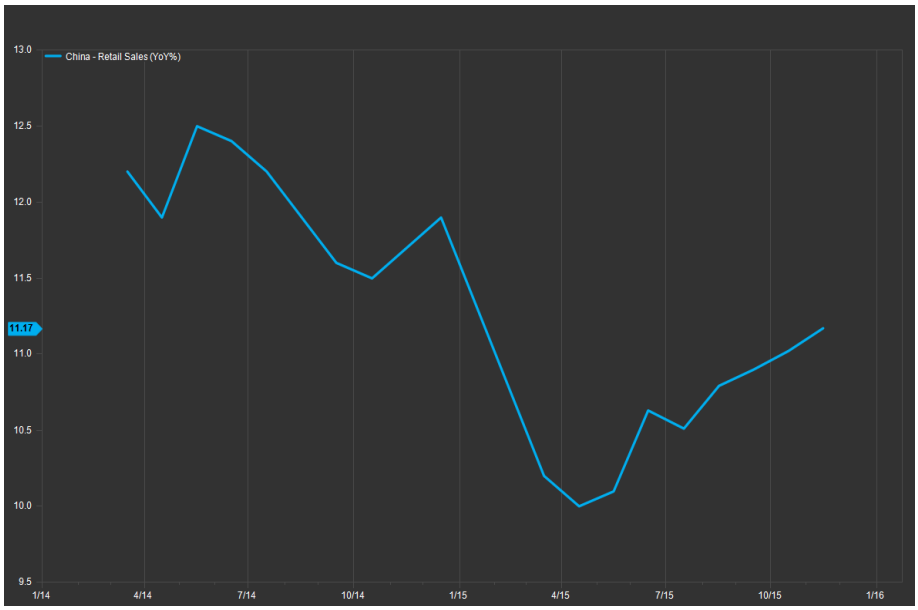
At the heart of the market's fears regarding China is the fact that credit growth is still outpacing economic growth. Historically, such a trend is dangerous for an economy, as credit is unlikely to be put to productive use and/or simply used to refinance existing obligations. With China's economy slowing down to less than 7% in GDP growth (in our estimates and opinion the real number might be below 4.5%) rapid credit growth will continue to be needed to cushion against corporate defaults. In addition, China's relative economic weakness has sparked capital outflows, putting pressure on monetary conditions. As a result, further rate cuts and weaker yuan are expected in 2016, as we previously noted in our commentaries (see Figure 3 below).

Figure 3: Monetary Tightness in China (Source: BCA)



Despite the clear corporate and credit risks in China we do not foresee a hard landing in 2016 for two main reasons. First, the state has the appetite and available resources to counter severe downside risks. China's ample foreign exchange reserves and low general government debt (about 40% of GDP) provide it the means to grind through a severe breakdown, including potential corporate defaults (the total debt in China is one of the worst in the world). Second, the transition of China's economic model is more pronounced than most realize. Despite the weakness in the manufacturing and industrial sectors, services in China continue to record growth. In addition, the consumer in China now accounts for about 60% of GDP growth, higher than ever before. Retail sales have grown over 10% year-over-year for the past 24 months (see Figure 4 below).

Figure 4: China's Resilient Retail Sales Growth (Source: Factset)



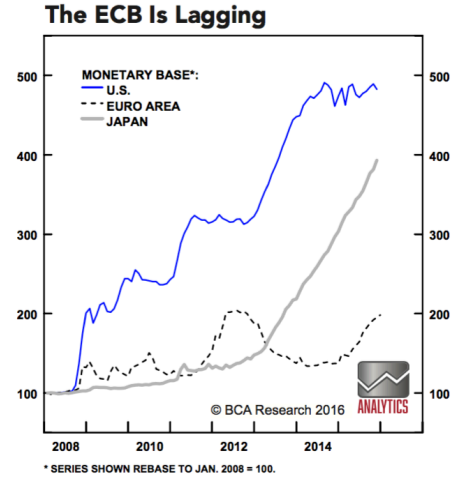
Europe and Japan

The other two major developed markets, Europe and Japan, remain mired in slow growth. Yet both regions are a telltale example that capital markets can diverge from macroeconomic fundamentals. In Japan, GDP growth slowed over the course of 2015, yet the Nikkei expanded by over 8% even after hedging out currency effects. The government's debt to GDP ratio stands at over 200%, demographic pressures worsen, and the central bank has had to resort to more unconventional measures in the hopes of resuscitating growth. However, opportunities may still remain for investment in 2016.

Wages in Japan over the past six months have stabilized and started to rise, which should translate to greater consumption and earnings. Business sentiment has improved markedly since the tax increase in 2014. A further sales tax increase set for 2017 could bring consumption forward. Anticipated additional stimulus measures, both fiscal and monetary, combined with low valuations have several investment professionals advocating that Japan will once again post higher returns than the U.S. The Nikkei trades at 13x forward earnings according to recent data, lower than the U.S.' 16x and offers faster earnings growth as well (9.5% versus 7.5%). Wall Street projections are also touting progress in corporate governance reform and a more favorable corporate tax regime as further catalysts for Japan's markets in 2016.

Similar dynamics are at work in Europe. Tighter monetary policy is nowhere on the horizon as the ECB is still in the relatively early stages of reviving money supply and the monetary base throughout Europe (see Figure 5 below). Credit conditions overall have eased in the Eurozone and demand for credit has picked up over the past couple of years.

Figure 5: ECB Still Has Room to Ease, Source: BCA



Lower energy costs should also boost Europe even moreso than the U.S. given the higher dependence on imports. Europe's competitive position is improved over this time last year thanks to the sharp fall in its currency. The overall result should see GDP growth pick up across the Eurozone compared to years past although an output gap is still present and debt burdens are excessive across the periphery.

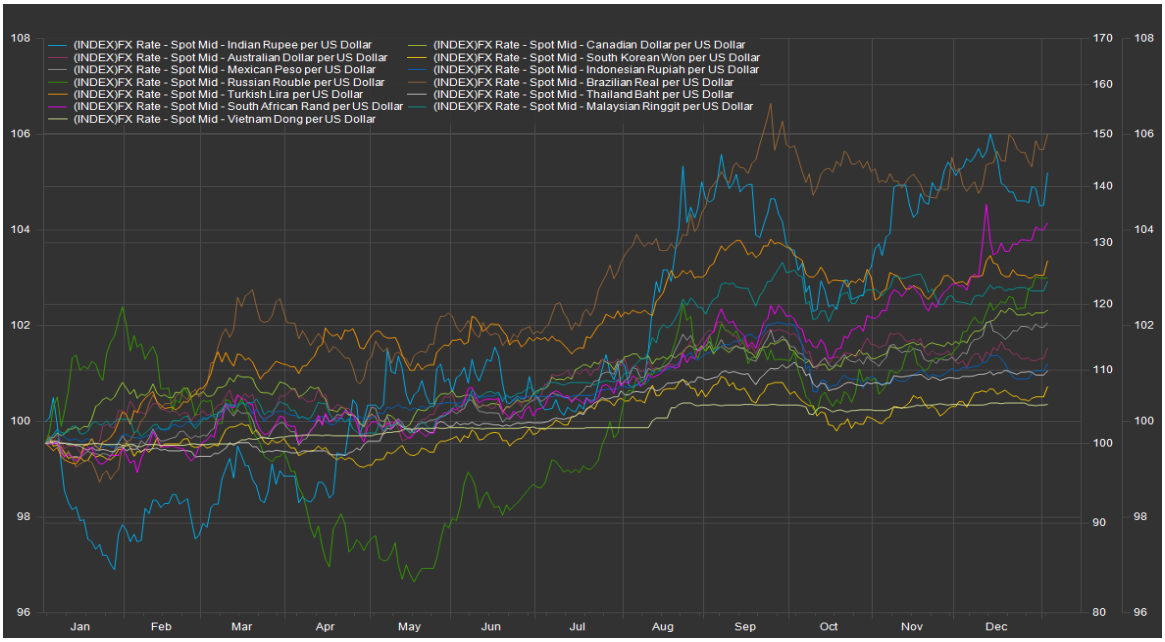
The improved economic momentum stands to benefit corporate earnings over the coming year; earnings growth projections for Europe range from 8%-11%. The German, French and Spanish markets, to name a few, all trade at lower valuations compared to the U.S. despite the faster projected growth in profits.

As was the case last year, political drama could introduce more volatility into European markets. The refugee crisis stretches state budgets that were due to become more accommodative relative to recent years. In addition, commentary surrounding a possible Brexit doesn't do markets any good and can distract from other factors that should normally drive investor returns, such as growth and earnings. Finally, additional tension with Russia is not out of the question given a recent default by Ukraine and a need to renew state support for sanctions.

Emerging Markets

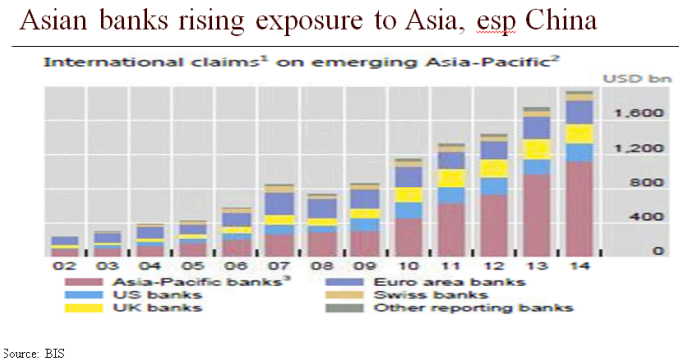
The turmoil in Emerging Markets was one of the biggest macro stories of 2015. China's weak 2015 and declining growth rate revealed the dependencies countries such as Brazil, Russia, and South Africa (among others) had built up to China. With China shifting its growth model to something more sustainable for the long-term Emerging Market countries must now do the same.

Figure 6: The Dollar's Strong Gains versus EM Currencies (Source: Factset)



In addition, while global growth is expected to improve for 2016 demand is not near strong enough to pull along every other weak economy. Several Emerging Market countries are aware of this and embarked on their own competitive devaluations to protect their share of growth as much as possible. Additional devaluations, especially in the Asian-Pacific region (where dollar-denominated debts and financial sector exposure to China is greatest) cannot be ruled out over the next year, which would dilute investor returns. Figures7 below shows the exposure of Asian banks to China. As the graph shows such exposure could shake up those banks as long as Chinese tremors continue.

Figure 7: Asian Banks Exposure to China, Source BIS



Source: BIS

While we are generally cautious and a bit pessimistic regarding Emerging Markets as a group, there are a few bright spots that we hold favorable opinions of, specifically India, Mexico, and Poland. All three have taken measures to improve their competitiveness and remove inefficiencies in their economies. India is our favorite over the very long-term while Mexico and Poland stand to benefit from growth in the bordering U.S. and E.U. respectively. (It should be noted however, that we will be reviewing the cases of Argentina, Brazil, Russia in the second half of the year).

Asset Class/Sector Thoughts

Fixed Income

Despite the rate increase markets got in December we don't foresee an aggressive tightening cycle commencing in 2016. We believe that the dovish nature of the Federal Reserve Board, weak global growth and asset price volatility will limit the central bank to two additional rate increases versus the four they currently project. Furthermore, major developed economies such as Europe and Japan remain considerably weak and could embark on additional stimulus measures. Thus yields on Japanese JGBs and core European bonds would remain capped and draw capital to U.S. bonds. As a result we think sovereign bonds have more price support than most Wall St analysts project, and we believe that the 10-year Treasury yield will range between 1.8% and 2.4% whereas the consensus expects yields of 2.5% or higher.

The corporate side of U.S. fixed income markets in 2016 will be dominated by delineation in quality. High-yield debt saw considerable volatility throughout the past year, including steep declines over the past two months. The illiquidity dynamics in bonds plagues high-yield debt moreso than higher quality assets. In addition, default rates are projected to rise from the current 2%. Expectations are that it will rise to 5% in 2016 but we wouldn't rule out the possibility that it creeps slightly higher. Junk debt is also most susceptible to rate increases from the Fed. In 2014 and 2015 firms were able to refinance current obligations thanks to easy credit but with the weakness in the energy sector being so severe and more rate increase to come, rolling over debt will be more difficult. Given its often speculative nature, our fear is that high-yield volatility could spill over into other asset classes, including equities and damage returns or investor confidence regardless of positive fundamentals.

Investment grade debt on the other hand should post better returns in 2016 than the -0.7% levels offered over the past year. Economic growth is strong enough to support credit assets without overheating too much to spark an aggressive tightening cycle. In addition, current credit spreads are at their highest level in three years

thanks to the volatility sparked by high-yield over the past few months. With revenues and cash flow healthy, the high cash levels of much of the corporate sector, and better liquidity conditions for investment grade bonds compared to high-yield securities, we expect quality corporate bonds to have a decent 2016.

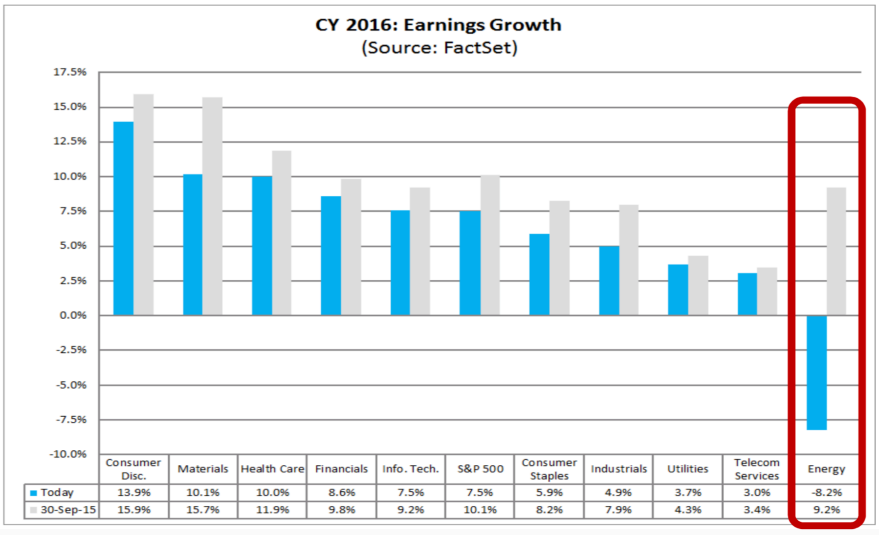
Internationally, the fixed income landscape is divided between the developed and developing worlds. The slow growth and easy monetary measures of both Japan and Europe should keep yields near zero (net of inflation) for core bonds in both regions. Each region could embark on expanded easing measures to accelerate economic growth though we think this is more likely in the case of Japan than Europe, where some benefits from QE, a cheaper Euro, and low energy prices are apparent. Regardless, we expect returns from sovereign bonds in both Europe and Japan to remain low and see little reason for investing in near-zero rate bonds in these areas while the U.S. offers better safety and higher yields.

For emerging markets, we think their fundamental weaknesses will be most apparent in fixed income and currency markets over the coming year, much as they have over the past few months. Elevated rates in the U.S. will continue to attract capital and weak global growth is hitting Emerging Markets (Brazil, Turkey, Russia, South Africa, etc.) harder than other parts of the world. Continued currency volatility will mean that interest rates in these markets will continue to fluctuate. Despite their surface appeal (rates in several emerging markets are at their highest point in several years) we think continued deterioration is likely for the first part of the year, and that better investment opportunities are ahead for emerging market bonds.

Energy

The decimation of the energy sector in 2015 sets up a low bar for the coming year. Even though the fall of oil has been a top market story for well over a year, pessimism has rapidly grown over the past few months (Figure 8 below). At the end of September, with oil in the mid-$40s,earnings growth was expected to be north of 9% for the sector. Today, with oil in the high-$30s, that earnings growth has turned to a contraction of -8% for 2016. This is despite the fact that oil projections range from the mid -$40s to the low-$60s for next year. Risks in energy still exist, especially for producers with high amounts of leverage, but the rapid turnaround in sentiment over the past few months may be overdone.

Figure 8: Revisions in Earnings Estimates (Source: Factset)



	Consumer Disc.	Materials	Health Care	Financials	Info. Tech.	S&P 500	Consumer Staples	Industrials	Utilities	Telecom Services	Energy
Today	13.9%	10.1%	10.0%	8.6%	7.5%	7.5%	5.9%	4.9%	3.7%	3.0%	-8.2%
30-Sep-15	15.9%	15.7%	11.9%	9.8%	9.2%	10.1%	8.2%	7.9%	4.3%	3.4%	9.2%

Healthcare

The Healthcare sector is no longer simply a defensive allocation. The sector is projected to provide the greatest sales growth for all parts of the market in 2016 along with earnings growth of over 10% once again. Most importantly, the sector is most promising from a long-term perspective. The secular trends in ageing and healthcare expenditures are undeniable. While pockets of excesses exist within the space, there are a large number of opportunities that offer innovation, competitive advantages, strong margins, and trade at a reasonable valuation.

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Real Estate

As mentioned before, the strong, upward trends in household formation bode well for the economy and assets tied to real estate, both equities as well as REITs. In addition, credit availability and continued expansion in the economy bodes well for commercial real estate assets as well. Some analysts fear a rising rate environment as being detrimental to REITs and real estate assets in general. Historically, the record is mixed as Figure 9 below shows. In addition, REITs have seen their valuations come down throughout 2015 and now sit closer to 2014 levels, when they posted returns of over 25%.

Figure 9: REITs Have a Mixed Record Amidst Rising Rates, Source: Ben Carlson, A Wealth of Common Sense

REIT Performance in a Rising Rate Environment		
Period	REIT Performance	10 Year Treasuries
1979-81	133.8%	9.1% to 15.3%
1987	-6.6%	7.1% to 9.0%
1994	2.7%	5.7% to 7.8%
1996	37.1%	5.6% to 6.3%
1999	-2.6%	4.7% to 6.7%
2003-07	131.4%	3.3% to 5.0%

**Wilshire REIT Index (source: FRED)*

Consumer Discretionary

A year ago we, like many, touted consumer discretionary stocks thanks to the relief offered by lower fuel prices. The sector was by far the strongest in the market in 2015 and we continue to remain optimistic. Fuel prices will remain low throughout the year and the trends in household formation will buoy overall consumption demand in the economy. In addition, through Q3 of 2015 consumer discretionary firms were some of the most aggressive investors in capital expenditures due to promising demand trends and still sit on cash levels far above their 10-year average.

Technology

The technology sector sits upon the highest cash levels of any other sector in the economy. The sector's strong balance sheets help cushion any blows from international volatility and weakness. In addition, a more favorable currency environment will allow for better sales growth relative to this past year when revenues were largely flat. Finally, tech stocks trade at a 16 Price to Earnings multiple, equal to the S&P 500. But while the market as a whole is estimated to grow earnings by 7%-8% in 2016, the tech sector is projected to grow by over 10%. This faster growth warrants a slightly higher premium in our view.

Financials

Financial stocks are a preferred sector among a number of investment analysts. Rising rates help boost margins for banks and a stronger economy means greater loan growth. The sector also trades at a low valuation and a number of firms are seeing strong overseas growth. Low interest rates will also remain supportive of M&A, a key driver of revenues for the sector. However, we would point out that if the lower end of our estimate for bond yields comes to pass in 2016, then financials could suffer despite good fundamentals.

Telecommunications and Utilities

Telecommunication and Utilities stocks are often analyzed together due to their high dividends and tendency to act as bond proxies. With the Fed having finally lifted interest rates, few analysts are enthusiastic with either of these sectors. Since our view on U.S. bonds is a bit contrarian we wouldn't be surprised to see these two sectors do better than consensus. While we prefer other, cyclical sectors considerably more, the low valuations of Telecoms and high yields of Utilities could come to attract funds if the more bullish end of our range for bond yields comes to fruition.

Concluding Remarks

Overall, we are more constructive on global markets and general investment prospects in 2016 compared to where we sat a year ago. Markets and investors alike have seen enough episodes of volatility to have a more conservative temperament this year. Earnings growth is reviving in the U.S. and other developed markets as is the general economy.

While we have our own convictions as to the best investment opportunities for 2016 any investment strategy should be diversified and flexible to revisiting the original thesis.

Happy New Year!