FLAGSTONE

FINANCIAL ADVISORS, INC.

MARKET REVIEW
SECOND QUARTER 2016

What Happened:

You may recall that 2016 started out poorly as the market fell 15% by mid-February. Since then, we've seen a nice, albeit, choppy recovery. Investors are looking for direction, but it is elusive.

Economic data are weak, but not awful. The upcoming presidential election features two of the least popular presidential candidates in history. Britain voted to leave the European Union, raising fears about the viability of the EU going forward. Given all that is going on, it's no wonder that pessimism and uncertainty among investors is the highest it has been in the past 30 years.

It may seem counterintuitive, but low investor sentiment is actually the most compelling argument for future stock advances. In fact, history shows that when sentiment hits such low levels, the market's average return over the subsequent twelve months is in excess of 20%. Add in expectations for improving corporate profits and it seems plausible that the market may break through to higher levels in the coming months.

Bonds showed surprising strength in the first half of 2016 with gains in excess of 5%, beating stocks. The good returns for bonds are the result of falling interest rates which recently hit new record lows. Rates may remain low through the end of the year as the Federal Reserve is expected to postpone raising rates until economic conditions improve.

YTD Performance Through 6/30/16:

S&P 500 Index (large stocks)	3.8%
Russell 2000 Index (small stocks)	2.2%
MSCI EAFE Index (international stocks)	(4.4)%
Barcap Aggregate Bond Index (bonds)	5.3%

Prognosis:

Amid the economic and political chaos and confusion that bombards us daily, it is important to remember that the primary driver of stock prices is corporate earnings. Nothing else, including the upcoming elections, is as important to the market.

After four quarters of declining earnings due to a sharp decline in oil prices and the strong dollar, we are now seeing a shift. Oil prices have rebounded by 90% since February 2016 and the dollar's value has dropped about 4%. This should boost corporate earnings significantly, and that will be positive for stock prices going forward.

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