SAGE FINANCIAL GROUP
Investment and Wealth Management

SAGE INSIGHTS
MONTHLY ECONOMIC & MARKET ANALYSIS

October 2015

All Eyes Turn to the Fed as the Third Quarter Ends

Overview

The last day of September was particularly good for many markets, but global stocks and bonds continued to face pressure last month. While concerns over international economic growth and the effect of China's slowdown continued to reverberate throughout investment markets, the focus shifted to the Federal Reserve and whether the committee would or would not hike rates for the first time in nearly a decade. Ultimately, the Fed decided not to hike rates, indicating that members were closely monitoring global economic developments and their effect on U.S. growth and inflation. Because inflation pressures have been so low, the Fed believes that it can wait a bit longer before increasing its interest rate benchmark. It is important to note that the Fed provided a positive assessment of the U.S. economy. Additional commentary from Fed Chairwoman Janet Yellen indicated that there is significant likelihood that the Fed will still raise rates this year. Economic data released during the month continues to show modest growth in the U.S., improving consumer spending, and a strengthening labor market. In short, stock prices have fallen in the U.S., but economic activity has continued to grow. In this issue of *Insights,* we will address recent volatility, the Federal Reserve, and developments in the U.S. and global economy.

Performance

Stocks, bonds, and alternative investments all declined in September and many indices are now negative, YTD.

Index Name	September	2015 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	0.72	1.77	4.14	4.64	US Muni Bonds
BarCap US Agg Bond TR USD	0.68	1.13	3.10	4.64	US Taxable Bonds
BarCap US Corporate High Yield TR U	-2.60	-2.45	6.15	7.25	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	-1.29	-0.07	4.73	6.89	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USI	-2.97	-14.91	-3.56	4.45	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	-2.08	-3.13	-0.18	-0.25	Hybrid/Hedged Equity
DJ Industrial Average TR USD	-1.35	-6.95	11.38	7.17	US Equity -- Large
S&P 500 TR	-2.47	-5.29	13.34	6.80	US Equity -- Large
NASDAQ Composite TR USD	-3.21	-1.61	15.66	9.02	US Equity -- Large
Russell 1000 TR USD	-2.74	-5.24	13.42	6.95	US Equity -- Large
Russell Mid Cap TR USD	-3.60	-5.84	13.40	7.87	US Equity -- Mid-sized
Russell 2000 TR USD	-4.91	-7.73	11.73	6.55	US Equity -- Small
MSCI All Country World Index ex-US/	-4.64	-8.63	1.82	3.03	Int'l Equity -- Comprehensive
MSCI EM NR USD	-3.01	-15.47	-3.58	4.27	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	-3.42	-15.80	-8.89	-5.67	Commodities
HFRX Global Hedge Fund USD	-2.07	-3.05	0.03	0.24	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 9/30/2015

Both U.S. and international equity indices declined in September, as volatility continued to rise and concerns over a global slowdown hit stocks. Core bonds were the one asset class that was positive during the month, with yields falling as investors sought the cover of investment grade fixed income.

For year-to-date returns through September, core bonds have been the one source of shelter for investors. The Barclays US Aggregate Bond Index has returned 1.13% while the Barclays Municipal Bond Index has returned 1.77%. Fixed income returns, despite being positive, have been paltry given how low yields are and the concerns regarding a potential Federal Reserve rate hike. For a diversified portfolio, with exposure to U.S. and international stocks and bonds, returns have been negative through the first three quarters of the year. U.S. stocks, both large and small, have fallen while international equities have also turned lower. The S&P 500 Index has fallen 5.29% this year while the MSCI ACWI Ex US has declined 8.63%. Emerging Market stocks, measured by the MSCI EM Index have fallen the furthest, declining 15.47%.

Outlook

With three quarters in the books, many themes have vied for investors' attention in 2015. Chief among them are the return of volatility to the markets, the improvement in the U.S. economy, the Fed signaling that it was ready to raise interest rates for the first time since 2006, attempts by China to manage the slowdown in its economy, and the fallout from the collapse in commodity prices. In this issue of *Insights,* we will walk through the aforementioned items and discuss some of their wider-ranging effects on portfolios.

First, on the return of volatility to the markets, we think it is important to remind investors that volatility is a normal and healthy part of investing. It can just feel so unwelcome right now because it has been absent from markets for *four years*. In order to invest in stocks and benefit from the positive returns that they provide to portfolios, one must accept the periods of volatility that come along with stock ownership. It is often easy to say this during the up periods, but it is harder to remember when we enter a correction (when stocks fall 10% or more from their peak) phase like we are in now and the media is blasting out headlines of "Meltdown!" and "Crash!"

We would encourage investors to keep in mind the big picture, and an illustration may help. If you had approached an investor ten years ago, in 2005, and asked him to pick stocks or cash while bearing in mind that the next decade would see house values lose 40%, the economy experience a once-in-a-lifetime recession, a member of the Eurozone be pushed to the brink of default, a flash crash wipe out 1,000 points from the Dow in a single day (twice!), and investment taxes increase, he most likely would have said, "No, thanks. I'll sit on cash!" Yet from September of 2005 to September of 2015, the S&P 500 returned a cumulative *93%* while cash returned 14%.

In 2005, the U.S. stock market had looming before it:

- **A massive downturn in house prices;**
- **The worst recession in a generation;**
- **Two flash crashes in the Dow of 1,000 points each; and**
- **A default in a Eurozone member state.**

Yet the S&P 500 still returned 93% cumulatively over the ensuing 10 years.

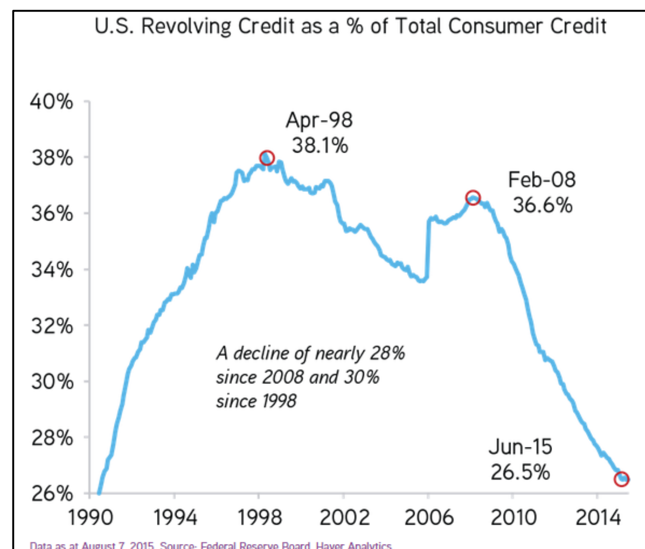
On a day-to-day basis, guessing where the market is going is no easier than predicting a coin flip. But over a ten-year period, since 1950, the S&P 500 has generated positive returns 90% of the time. Stocks reward investors who wait out the ugly news headlines that dominate short-term trading, because over the long-run humans innovate, populations increase, and economies grow. While the short-term dislocation can be unpleasant, and although it is impossible to predict how long the current

volatility episode will continue, we believe that it will be temporary because the U.S. economy is showing steady signs of improvement.

Second, regarding the U.S. economy, after a sluggish start in the first quarter, the Bureau of Economic Analysis (BEA) estimated that growth rose at an annualized rate of 3.9% in the second quarter. The BEA noted improving consumer spending, housing investment, and capital expenditures from businesses. Since the end of the last recession, growth in the U.S. has been positive and modest. U.S. GDP has been growing at an average annual rate of 2.2% since 2009, and analysts currently expect the third quarter growth rate to come in around 2.5%, annualized. Despite moving in the right direction, the pace of U.S. economic growth has felt sluggish not only because it has come in fits and starts, with a negative quarter in both 2011 and 2014, but also because it has been lackluster compared to the 3.5% pace experienced in the 1990's.

However, the modest growth rate since 2009 gives us a more optimistic outlook for future growth. In our view, for starters, the slower rate means that the economy may continue to grow and that the expansion will last longer than the historical average may suggest. Typically, economic expansions last around six years, which is the age of the current expansion. But simply because we have hit the average age of an expansion is not cause in and of itself for the economy to turn. An example may illustrate this further.

If a car has 60 miles to reach a destination, and the car is driving at a constant rate of 60 mph, it will reach that destination in an hour. If, however, the car is traveling below its potential cruising speed of 60 mph, it will take longer to reach its destination, and vice versa. The U.S. economy has been "driving" at such moderate speeds that it is going to take longer than the typical business cycle length to reach the end of the road (i.e., the end of an economic expansion phase).



A large part of the reason why the current expansion has been so subdued in pace has been a result of consumers paying down debt and saving greater amounts. You can see in the chart to the right that revolving credit (credit card debt, short-term loans, etc.) has declined significantly since the recession as consumers tightened up their budgets. While this is good news because it means that consumers are in better financial shape and not overleveraged like they were at previous points in the last twenty years, it also means spending has declined as a result. At present, however, it seems to be the case that, with employment picking up speed, wages increasing, and energy prices at low levels, the U.S. consumer is more likely to spend at a higher rate going forward. This bodes well for the economy because consumption growth is a key driver for economic acceleration and because its reemergence is a signal that the current expansion still has a few years left in the tank.

The current improvements in the economy are one of the primary reasons why the Fed has been signaling that it is willing to raise rates. While the Fed has consistently stated that it would only raise rates if the economy was able to handle such a move, we believe that the Fed has done a fairly poor job of conveying that message to investors. As a result, the market has become obsessed with the *initiation* of rate hikes (which will only have a marginal impact on interest costs) and relatively uninterested in the improvements in areas like wage growth

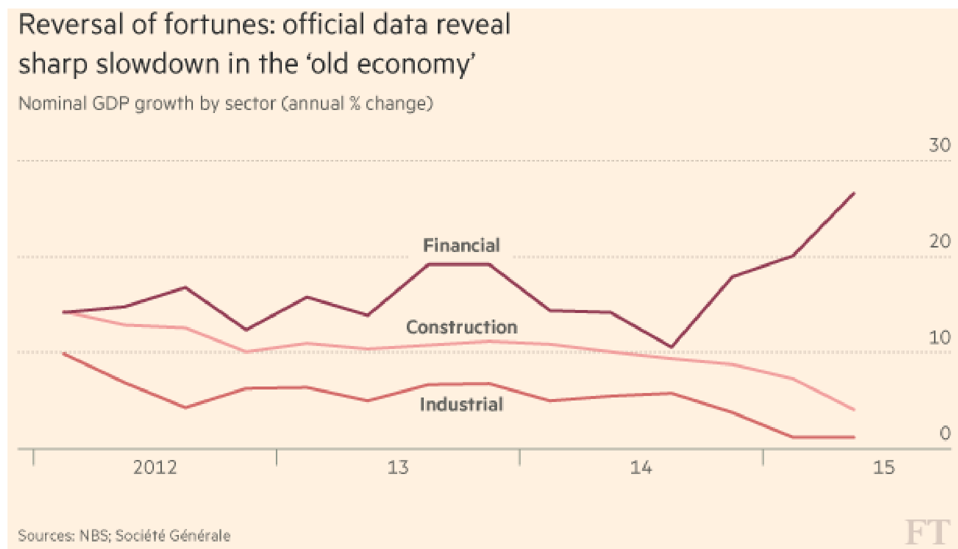
and consumer spending. One such example of this development can be seen in Fed statements themselves. For instance, 20 years ago, a Fed statement that announced an increase in rates totaled just 71 words. The most recent September statement, which announced no change to policy, was *524* words.

Fed Statement Length		
Year →	1995	2015
# of Words →	71 Words	524 Words
More talking, less clarity		

Source: Federal Reserve

In an effort to become more transparent than it was perceived to be during the Greenspan years, the Fed's recent messaging has only become more confusing. Markets moved lower after the Fed kept rates on hold not because they think the economy is in bad shape, or because low interest rates are bad for growth. They moved lower because the Fed's statement only raised more questions about when the central bank would eventually raise rates. The point is this: markets are likely to remain choppy until the Fed finally pulls the trigger on raising interest rates. Investment markets may still face volatility afterwards. However, with unemployment in line with the Fed's long-run forecast, inflation low, and corporate earnings (outside of the energy sector) increasing, there is ample bandwidth for the Fed to begin a slow hiking cycle. If and when the Fed does embark on raising rates, it is likely going to be at a very slow and gradual pace. We continue to remind investors that Sage has positioned portfolios to prepare for higher interest rates.

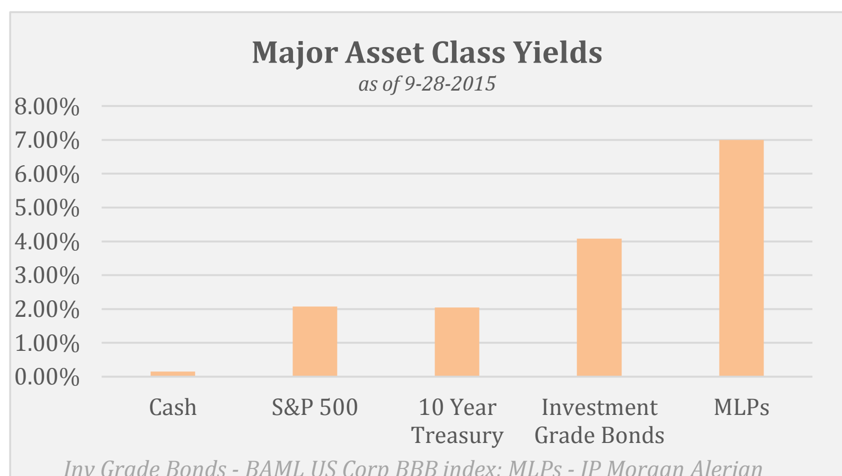
Third, there is the matter of the economic conditions in China. In last month's *Insights*, we pointed out how China's economic slowdown is a result of a necessary shift from a manufacturing and industrial economy to a goods and services economy. Manufacturing and mining industries grew at a 1.2% rate in the second quarter, while services grew at an 8.4% rate, an improvement over last year. China's is a multi-speed economy. The economy is transforming, or being transformed, from one driven by capital investment and infrastructure build-out to one that will be increasingly driven by domestic consumption and the service sector. The following chart shows a little more clearly how construction and industrial growth has fallen while financial growth has begun to accelerate.



Even though the U.S. and Europe's direct exposure to China is fairly small, it still remains the world's second-largest economy, and a slowdown does have consequences for global growth. The lack of visibility and transparency into the health of the economy also creates a bit of a vacuum. In a state-managed economy such as China's, if the state appears to be in control and putting in place orderly solutions to manage a slowdown, there would not be much of a concern. Responses by the government to the stock market downturn, however, and the government's surprise devaluation of the currency were neither telegraphed nor done in a manner that inspired confidence. China may continue to export volatility to outside investment markets in the short-term, but we continue to remind investors that we measure our investment time frame in years and not quarters. Moreover, it is important to stay the course with emerging market investments even though they have faced volatility recently.

Lastly, we believe the decline in oil prices represents both a boon for consumers that will provide a tailwind for spending and a longer-term investment opportunity in the form of master limited partnerships (MLPs). Energy prices, especially crude oil prices, continued to sell off throughout the third quarter. Crude oil prices are now trading about 56% below their levels from a year ago, and they have only marginally recovered from multi-year lows hit in early September. Volatility may continue in the final quarter of the year. MLP prices have suffered as investors have sold stock prices down in conjunction with the entire energy asset class.

Longer-term, however, we are optimistic about the future and sustainability of the U.S. energy renaissance, and we believe that the recent declines in energy-related company stock prices presents a good entry point for long-term investors. Energy usage in the United States is not declining, and there is a real need for the infrastructure to transport, process, and store oil and natural gas. According to Reuters, gasoline purchases in the U.S. through the first half of the year rose at their fastest rate since 1985. U.S. natural gas usage in the first half of the year increased 3.2% over last year. Businesses that operate in this "midstream" space, particularly those organized as MLPs, are poised to benefit from the next phase of this domestic energy renewal as it matures.



We like these midstream MLP companies as investments because of both their potential to appreciate in price from such current low levels and their relatively high income distributions (about 7% for the JP Morgan Alerian MLP TR Index). Business models for these MLPs are less commodity-sensitive than major integrated oil companies like ExxonMobil. The recurring "toll-based" revenue from these operations do not immunize MLPs completely from stock market price fluctuations, but they do insulate them so that, over longer periods of time, they have tended to experience less volatility than other energy related investments.

In closing, we want to reiterate that stock market volatility, while sometimes painful, is to be expected by investors. At any point in history, there have been numerous short-term reasons for investors to sell stocks: global recession, credit crisis, emerging market slowdowns, rampant inflation, etc. The list goes on. Yet despite these events and the short-term turbulence that happens as a result, stocks have a solid long-term track record

of providing positive returns for investors who are patient and disciplined. A diversified portfolio can help to cushion against the downturns in the equity markets. One of the many reasons that we include investments like managed futures or core bonds within Sage's diversified portfolios is to provide a buffer during episodes of volatility such as we are currently experiencing. Looking forward, we remain confident that the U.S. economy is on firm footing. We continue to believe that even if the Fed does raise interest rates this year, it will do so in a slow, cautious manner and it is important to remember that they have little desire to upset the markets or economy. We appreciate the confidence you have placed in us in helping you to achieve your long-term goals, and we encourage you, as always, to reach out to us if you have any questions or matters to discuss.

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