SAGE FINANCIAL GROUP
Investment and Wealth Management

SAGE INSIGHTS
MONTHLY ECONOMIC & MARKET ANALYSIS

August 2015

Core Bonds, U.S. and Developed Market Foreign Stocks Gain in July

Overview

In July, prices of core bonds and large-cap domestic and foreign stocks gained, even though oil price and Chinese stock market declines weighed on the commodity complex and emerging market equities. At its meeting during the last week of the month, the U.S. Federal Reserve adjusted the language of its formal statement slightly. It did so in such a way as to leave the U.S. central bank flexibility to embark upon a rate-hike regime as early as its September meeting and to signal to markets that the chances of a September hike have risen. Low U.S. inflation, a stronger dollar, and emerging market challenges might prompt the Fed to delay somewhat its first increase in years, but improvement in the U.S. labor market might influence the Fed more than those factors. We believe that economic fundamentals in Europe as a whole are stronger than the headline concerns about Greece might suggest. In fact, European stocks gained about 3% in July (as reflected in the FTSE Developed Europe All Cap Index). In this edition of *Insights*, we discuss these matters and specifically how investors might expect U.S. stock markets to respond to interest rate increases when the Fed eventually initiates them. Historically, U.S. stocks in the S&P 500 have retreated initially after the start of an increasing interest rate program, but twelve months later, according to studies by JP Morgan and Goldman Sachs, S&P 500 stocks have often been higher than they were at the start. That is a general pattern that long-term investors should bear in mind.

Performance

Major stock and bond benchmarks generally increased in July.

Index Name	July 2015	2015 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	0.72	0.84	4.39	4.57	US Muni Bonds
BarCap US Agg Bond TR USD	0.70	0.59	3.27	4.61	US Taxable Bonds
BarCap US Corporate High Yield TR USD	-0.58	1.93	7.73	7.64	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	0.49	2.17	6.02	7.51	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	-2.56	-7.32	-0.65	5.57	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	-0.29	2.07	1.48	0.39	Hybrid/Hedged Equity
DJ Industrial Average TR USD	0.52	0.55	13.93	7.98	US Equity -- Large
S&P 500 TR	2.10	3.35	16.24	7.72	US Equity -- Large
NASDAQ Composite TR USD	2.88	8.95	19.25	10.00	US Equity -- Large
Russell 1000 TR USD	1.93	3.67	16.45	7.93	US Equity -- Large
Russell Mid Cap TR USD	0.74	3.11	16.77	8.92	US Equity -- Mid-sized
Russell 2000 TR USD	-1.16	3.54	15.27	7.61	US Equity -- Small
MSCI EAFE NR USD	2.08	7.72	8.01	5.02	Int'l Equity -- Developed
MSCI EM NR USD	-6.93	-4.19	0.58	6.62	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	-10.62	-12.01	-7.27	-4.13	Commodities
HFRX Global Hedge Fund USD	-0.03	1.24	1.28	0.83	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 7/31/2015

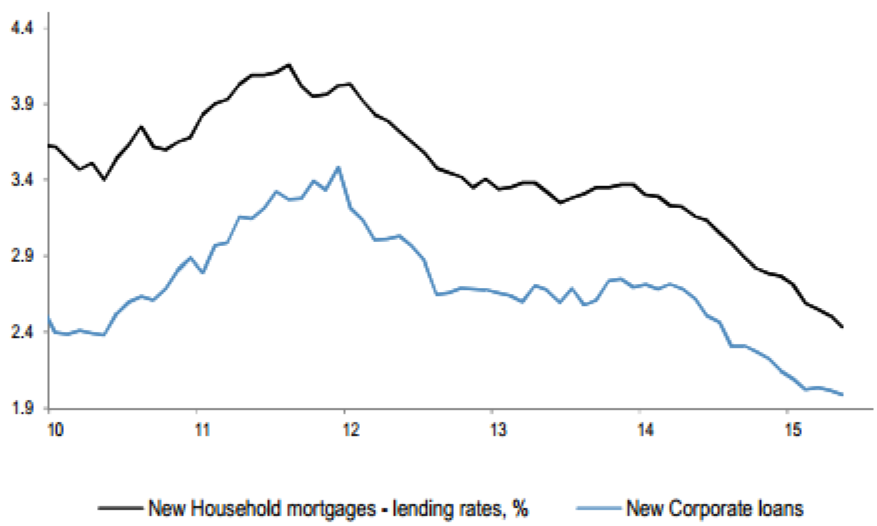
U.S. core bond prices rose as yields fell as many investors sought "safe-haven" assets amid headlines about economic and market difficulties in Greece and China in particular. Emerging market (EM) stocks, local currency EM bonds, and commodities all declined. U.S. large cap stocks in the S&P 500 and developed market foreign stocks in the MSCI EAFE, which is heavily weighted to both Europe and Japan, both rose slightly more than 2% in July. Foreign developed market stocks (+7.72%) and the tech-heavy NASDAQ (+8.95%) have posted the greatest gains year-to-date of the major indices in the table above.

Outlook

In the remaining five months of the year, the key global macroeconomic factors that we believe will influence market action are (1) European economic growth relative to headline/political risk surrounding Greece, (2) China's and emerging market growth, (3) commodity price dynamics, and (4) U.S. economic fundamentals and the Fed's first interest rate increase.

European economic growth and fundamentals are mostly solid. Core Eurozone inflation was up 0.2% month-over-month in July and up 1% year-over-year. Deflationary pressures have been a worry of European Union financial leaders, and that worry in part prompted the European Central Bank to ease its monetary policy in various ways over the last year. That looser central bank policy may be bearing some fruit. Euro-area July manufacturing activity remains in expansionary territory. Lending rates for businesses and mortgages have come down, as you can see in the nearby chart. Lower borrowing costs seem to be sparking some increased economic activity.

Eurozone Bank Lending Rates



Source: ECB, JP Morgan, as of July 27, 2015

Something similar is occurring in Japan, too, in connection with the stimulative monetary policy implemented by the Bank of Japan. The labor force of full-time workers has risen this year, loan growth has remained steady over the last couple of years since the measures commenced, capital expenditures as a share of Japanese GDP is near 14% and above the median level (all data from JP Morgan, as of 7/27/2015). Goldman Sachs estimates that full-year 2015 GDP in Japan will be near 1%, a nice improvement over last year's slightly negative growth rate.

The commodity complex volatility is closely linked to, but not wholly explained by, emerging market economic growth dynamics. Slowing growth and capital expenditures for infrastructure in China and in some other EM countries have blunted the demand for raw materials. That has translated into weaker global commodity prices and weaker economic growth in resource-rich EM countries such as Brazil. At the same time, traditional suppliers and U.S. producers of crude oil and natural gas have created ample, or excess, supply. Energy prices, especially crude oil prices, declined sharply in July. Crude oil prices are now hovering at four-month lows after having recovered somewhat from the sharp decline that began last summer. The potential for additional oil supply from Iran if international sanctions are lifted contributed to oil price volatility in July. Volatility may continue in the second-half of the year.

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. Businesses that operate in this "midstream" space, particularly those organized as master limited partnerships (MLPs), are poised to benefit from the next phase of this domestic energy renewal as it matures. We like these companies as investments because of both their potential to appreciate in their price from such current low levels and their relatively high income distributions (about 6% 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 time, they have tended to experience less volatility than the broad U.S. stock market.

Regarding conditions in and our outlook for the United States, the macroeconomic picture is generally solid, and that is a key reason that the futures market in bonds expects a 50/50 chance of the Fed's starting to raise interests rates in September versus December. Gross domestic product growth in the second quarter was 2.3% annualized, and Q1 GDP was revised up from -0.2% to +0.6%. Consumer spending rose 2.9% in Q2, auto sales increased 5.3% in July, and personal income growth was up 0.4% in June (the last available data). All of this suggests that the foundations of the U.S. economy are strong, which may influence the Federal Reserve to embark upon a measured program of rate hikes as early as September.

A September rate increase is not certain. The main measure of inflation that the Fed uses, the core personal income expenditures price index, is +1.3% year-over-year in June, well shy of the Fed's 2% long-term target. Labor market growth has been steady, at least in terms of the headline jobless rate. Other measures suggest continuing employment slack; however, some of that may be structural, especially the low labor force participation ratio, as Baby Boomers retire. U.S. dollar strength abroad could weigh on the revenues of large U.S. multinational companies. The Fed is also eyeing other global conditions, such as the situation in Europe with Greece and market conditions in China and elsewhere.

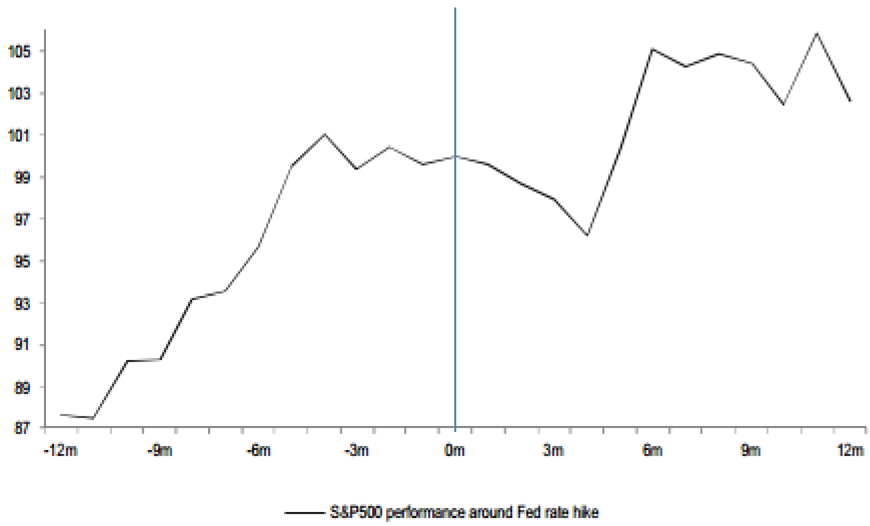
US Cycle Indicator – Mid-Expansion

Source: Morgan Stanley Research, Bloomberg, Haver Analytics, NBER

These and other indicators suggest that the U.S. is somewhere within the middle portion of its economic expansion, after having recovered from the deep recession brought on by the global financial crisis. You can see one depiction, by Morgan Stanley, of the most recent downturn (blue), repair through most of 2009 (green), recovery (orange), and expansion (yellow). Such designations are not exactly precise, but the graph illustrates that based on past history there is still room left for economic growth, particularly with an accomodative U.S. central bank.

The main point that we want to impress upon clients is two-fold: (1) the U.S. economy is basically sound, which is why the Fed believes that the time to raise short-term rates from near zero is approaching; and (2) that, whenever that initial interest rate increase comes, historically the start of such a program has been accompanied by stock market decline. We emphasize that this is not inevitable, but it is common. We want our clients to be prepared for that potentiality, particularly in view of the atypically long period that the S&P 500 Index, for instance, has gone without a pullback of 10% or more. More often than not, stocks comprising the S&P 500 Index have fallen initially after the beginning of a rate-hike program by the Fed, but they also tend to be higher than their initial level 12 months later, as you can see in the chart below.

Median S&P 500 Index Performance around the First Fed Hikes, since 1970



Source: Datastream, Bloomberg, J.P. Morgan

Based on the history illustrated in the chart, domestic stocks rise typically in the nine months and then level off the three months before the first rate hike. Then they have most often fallen in the first three to five months afterward, before marching higher to reclaim lost ground and then make fresh gains. The past does not predict the future. Based, however, on the data from six previous rate increase programs, the median S&P 500 level 12 months after the first rate hike is 3% higher than at the start.

One chief concern of ours as investment advisers is to help clients prepare for and respond appropriately to both expected and unexpected economic and market developments. In this case, with the looming end to the Fed's zero interest rate policy (whenever that precise end might be), we have some data that will help our clients to prepare psychologically and emotionally for what has proven to be the most probable occurrence over time: an initial decline in U.S. stocks followed by recovery and additional, but modest, gains 12 months later.

We believe that, at present, clients should prepare themselves for the potentiality of additional global stock market volatility, as well as some price declines in core U.S. bonds that go hand-in-hand with interest rate increases. We believe the U.S. and European economies are on good and generally improving footing, despite some headline risks. Although the pathway of investment returns the rest of the year may be as rocky as it has been so far in 2015, we believe that clients will do well to remain patient, disciplined, and confident in the soundness of their well-diversified portfolios that it is our pleasure and privilege to manage on their behalf.

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