SAGE FINANCIAL GROUP
Investment and Wealth Management

SAGE INSIGHTS
MONTHLY ECONOMIC & MARKET ANALYSIS

July 2015

Diversified Portfolios Hold Up as Regional Dramas Take Global Stage

Overview

June was notable in large part for debt and central bank-related developments. The U.S. Federal Reserve provided the most specific guidance to-date about its future interest rate policy, specifically the path to raising rates. China's central bank lowered interest rates and bank reserve requirements on the same day, an attempt to boost economic activity, and the Chinese government announced several efforts to support recent equity price declines. Puerto Rico's governor announced what most investors already knew, that the island territory's debt was not payable. The Greek government, in fact, did not make debt payments due creditors on June 30 and now has until Sunday, July 12, to submit its new debt assistance and restructuring plan. Against this backdrop, most asset classes, stocks and bonds, declined in June. Nevertheless, U.S. and European economic data remained generally solid. Healthy economic trends in these areas have continued, although headlines related to the hot-button matters noted above have largely obscured the fundamental picture. In this edition of *Insights*, we discuss not only the Fed, China, Puerto Rico, and Greece. We also seek to affirm the stable underlying economic conditions in the U.S. and Europe, we comment on the performance of diversified portfolios through mid-year, and we address potential investment implications of current events for long-term investors.

Performance

Major stock and bond benchmarks generally declined in June.

Index Name	June 2015	2015 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	-0.09	0.11	4.50	4.45	US Muni Bonds
BarCap US Agg Bond TR USD	-1.09	-0.10	3.35	4.44	US Taxable Bonds
BarCap US Corporate High Yield TR USD	-1.49	2.53	8.61	7.89	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	-1.56	1.67	6.76	7.45	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	-1.22	-4.88	0.94	5.91	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	-0.84	2.37	1.99	0.67	Hybrid/Hedged Equity
DJ Industrial Average TR USD	-2.06	0.03	15.41	8.32	US Equity -- Large
S&P 500 TR	-1.94	1.23	17.34	7.89	US Equity -- Large
NASDAQ Composite TR USD	-1.56	5.90	20.18	10.35	US Equity -- Large
Russell 1000 TR USD	-1.88	1.71	17.58	8.13	US Equity -- Large
Russell Mid Cap TR USD	-2.07	2.35	18.23	9.40	US Equity -- Mid-sized
Russell 2000 TR USD	0.75	4.75	17.08	8.40	US Equity -- Small
MSCI EAFE NR USD	-2.83	5.52	9.54	5.12	Int'l Equity -- Developed
MSCI EM NR USD	-2.60	2.95	3.68	8.11	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	1.73	-1.56	-3.91	-2.62	Commodities
HFRX Global Hedge Fund USD	-1.24	1.27	1.54	1.00	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 6/30/2015

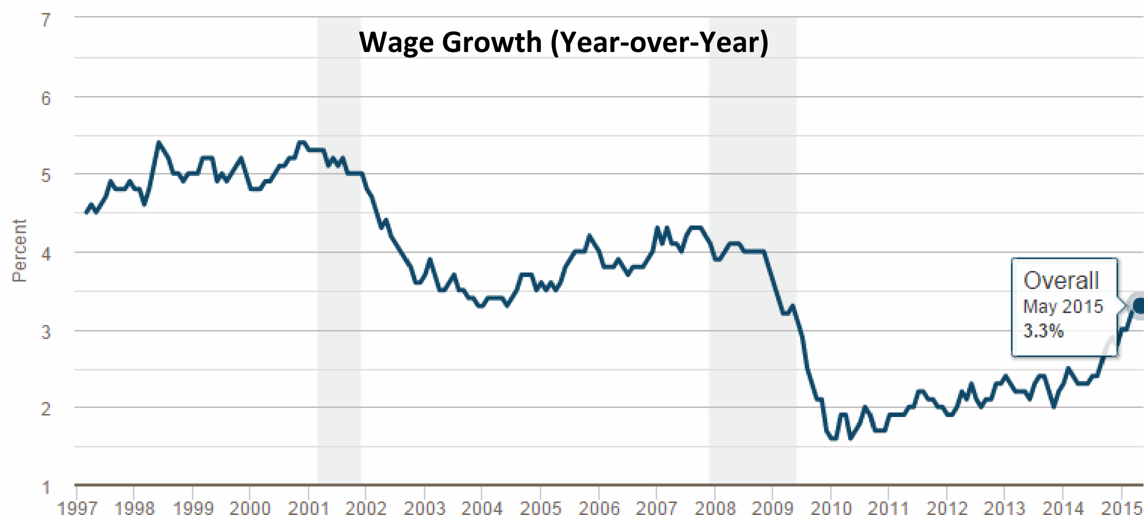
U.S. core bond prices fell as yields rose in anticipation of Federal Reserve interest rate increases later this year. Year-to-date, the returns of the Barclays U.S. Aggregate Bond Index is slightly negative after having lost ground in four of the first six months. Unconstrained bond strategies, which can shorten duration and use other exposures and tools, have fared better than the U.S. Aggregate Index. These are flexible bond investments that Sage has used for clients and plans to continue to emphasize in portfolios.

Although developed market international stocks declined the most in June (the MSCI EAFE was down 2.83%), they still boast a 5.52% return so far this year, second only to the NASDAQ's 5.90%. Both developed (+5.52%) and emerging market foreign stocks (+2.95%) have returned more than the domestic S&P 500 Index (+1.23%) this year through June, a theme we have highlighted in previous months.

Outlook

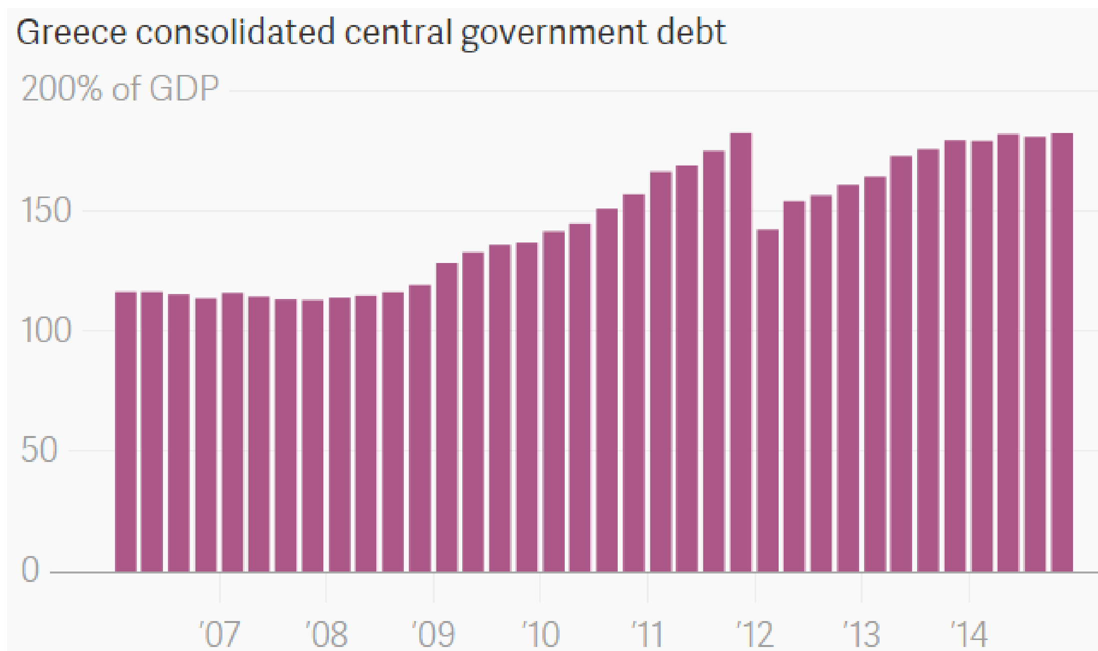
The declines in June in U.S. bonds (because of higher yields prompted by potential Fed policy) and in domestic and foreign stocks (largely because of headline worries about Greece and some emerging market slowdown) obscure the fundamental economic picture in advanced economies. That is one of our main messages this month: headline obsession with, and near-term market volatility around, Greece, Puerto Rico, and China do not significantly affect the basic economic strength in the developed world that will inform longer-term investment gains.

First-quarter economic activity in the U.S. (GDP) was revised higher to -0.2%, which means that the contraction was much shallower than previously estimated. June saw solid reports in the U.S. in construction spending, homebuilding activity, consumer sentiment, and wage growth. The following chart displays the three-month moving average of median wage gains in the U.S. this year through May, 2015. You can see the steeper slope (i.e., greater gains) over the last year.



In our view, wage growth should continue to improve slowly. U.S. inflationary pressures are likely to remain modest in the near-term. Together, this means that consumption, which is now nearly 70% of U.S. GDP, could receive a boost as households, after accounting for prudent savings, become more active in the economy. By and large, we do not believe that events in Europe in particular will alter this.

That brings us to the situation in Greece. In various communiques over the last week we have reported on the events that are quickly unfolding there. Because the saga has been ongoing for five years, and because various persons and proposals are bandied about in the press, it is possible to lose sight of the underlying issue. That underlying issue is debt – a lot of it. As you can see from the chart below, consolidated Greek debt is approaching 200% of GDP.



Source: Eurostat, Quartz.com

Most of this is owed to the International Monetary Fund (IMF) and the European Central Bank (ECB). Important to note, most of the debt is not owed to private-sector financial institutions (i.e., banks) in Europe. This fact distinguishes it from debt exposures that were complicit in the global financial crisis of 2008. Greece is not that.

As for our present outlook, we remain of the mind that the uncertainty surrounding Greece's debt and status in the EU/Eurozone will continue to result in fits and starts in the market. This ongoing drama will likely nurture a general level of angst for some time, but the proceedings remain unlikely to send equities spiraling into a bear market.

After Sunday's "No" vote on the referendum for whether Greece should accept the European bail-out package with its previous conditions, the odds of an eventual exit of Greece from the EU and/or the euro currency are higher than previously thought. Any exit, however, would not likely be immediate; it would be well-planned and take time to execute. Pressure has been on European heads of state and financial chiefs to respond to the vote decisively. They have temporarily shifted the burden to Greece, giving it until Sunday, July 12, to offer realistically constructive proposals for additional multi-year assistance. We believe there will likely still be continued negotiation over a bailout package.

It may seem simplest for the EU to say to Greece at this point, "Fine; just exit and deal with the fallout on your own." However, two very important points will keep both sides within arm's length of the negotiating table:

pride and money. The EU does not take an exit from its union lightly. There is great pride in the European Union experiment, and there is little desire to experience a fracturing. This drama has been going on for five years already. Moreover, Greece also owes Germany, France, and Italy a combined $135 billion. Although these nations would survive if Greece defaulted since they have easy access to debt markets at record low interest rates, nobody just walks away from a 12-figure sum of money. The debt situation between the Europeans and Greece puts a modern twist on the old saying, "If you owe the bank a thousand dollars, that's your problem. If you owe the bank $135 billion dollars, that's their problem."

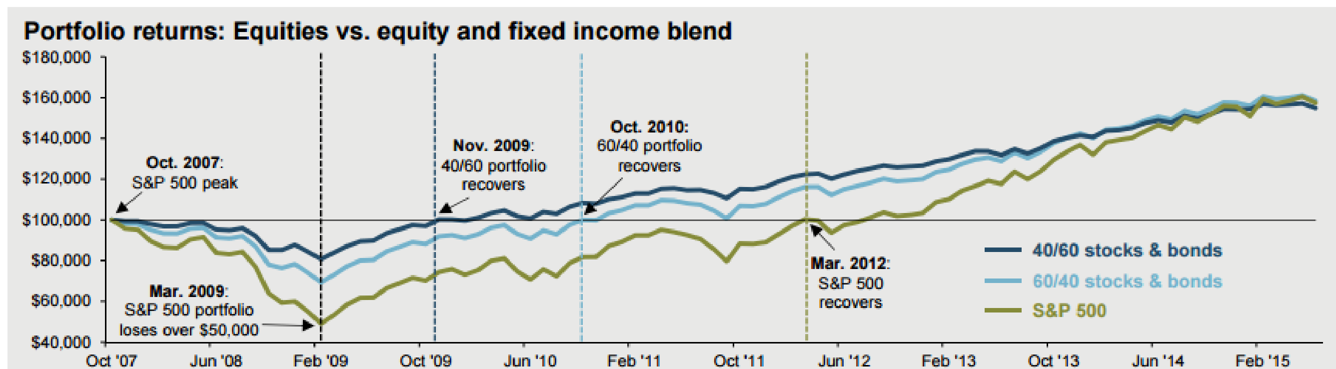
All told, it seems to us that the most likely situation is for the drama to play on with uncertain and halting progress. There will be Euro in-fighting for sure and a discussion over whether or not a deal should be worked out with Greece and, if so, how it should be structured. The European authorities walk a political tightrope: on the one hand, how can they maintain credibility and respond to Greece with appropriate toughness, and, on the other hand, how can they do this so as both to preserve the integrity of their economic and monetary union and not to create a moral hazard that would encourage political elements in places like Spain and Portugal to seek their own default/restructuring debt deals? A face-saving compromise for both sides is possible to envision, but pride, politics, and personalities will not make that easy to achieve. Greece faces a painful future whatever transpires.

Across the Atlantic, Puerto Rico faces its own work-out negotiations with creditors over its debt. The island territory has structural economic growth difficulties just as Greece does, and in many ways its problems are more significant in terms of total obligations. Puerto Rico is already beginning to enter into negotiations about default and restructuring deals with its creditors. Like Greece, Puerto Rico faces hard times ahead, but we do not expect much spillover to the broad U.S. economy or most investors. Sage's municipal bond managers have shunned Puerto Rican municipal bonds for some time, a portfolio detail that we have monitored closely. There could be some broad muni bond market volatility at times as headlines hit, but overall any lasting effect on the broad market is likely to be minimal.

The other main market that has been on our radar is China. We intend to send a separate and more focused briefing on this subject, but it may be helpful here to provide a summary. China's economic growth has slowed significantly since the end of the global financial crisis. Much of this has to do with a healthy and needed long-term shift in the structure of the Chinese economy from being export-oriented to consumer-driven, from infrastructure investment to domestic services. Real estate investment has also slowed, and individual Chinese citizens have in the last 18 months turned their attention to the Chinese stock market for investment purposes. After soaring more than 100% last year, the domestic Chinese equity market has fallen sharply in the last month, although it remains up around 15% this year. The Chinese government has loosened monetary policy and taken measures to shore up the slumping stock market. The government has the resources, the will, and the ingenuity to address its enormous economy and markets. One lesson that students at Harvard's Business School learn well is never to bet against the Chinese government. We take that admonition seriously. Nevertheless, the recent sell-off seems more psychologically-driven than fundamentally-driven. It is difficult to know when investor psychology will change or how government measures may begin to steady markets. We mention the situation in China as part of our outlook, because a mixed picture in China portends a mixed picture in emerging markets generally given the extent to which some EM countries and developed-market multinational companies have economic ties to China.

Nevertheless, through mid-year, emerging market stocks are performing better as a whole this year than the S&P 500 Index: they are +2.95% versus the S&P's 1.23% as of June 30. That points to the diversification within asset classes. It also points to some of the benefits that accrue to diversified portfolios that include multiple

asset classes. It is always important for investors to keep in mind the differences between diversified portfolio and single asset class returns during periods such as the last month when many asset classes lost ground. We noted above that a well-diversified portfolio, in part because it contains foreign stocks, has performed better than large cap domestic stocks (the S&P 500) this year. The graph below reinforces the point about the benefits that even a simple U.S.-focused diversified portfolio brought to a disciplined investor through and after the global financial crisis that began in 2007 after the S&P 500's market peak. The two diversified portfolios limited the decline during the worst of the crisis and have produced into this year similar returns as the all-equity index.



Source: JPMorgan, Morningstar Direct, Delbar, Inc. The diversified portfolios are comprised of the S&P 500 Index (stocks) and the Barclays U.S. Aggregate Bond Index (bonds), and they are rebalanced annually.

This year, therefore, it has been better to have a portfolio that is diversified beyond only U.S. stocks, and during drawdown periods for equities it is better to have a portfolio that is diversified away from only stocks in general. These are some of the fundamental investment principles that inform Sage's approach to portfolio management for our clients. It is what helps clients, during periods in which pockets of uncertainty are particularly prominent, remain disciplined with their investment program. Discipline helps investors to avoid adverse behavioral decisions. Avoiding those sorts of decisions as much as possible is also, then, a fundamental component of the miracle of compounding. Together, our aim is to help our clients both to achieve their long-term investment objectives and to do so in a way that reduces their worry when market dramas, Greek or otherwise, seem to take center stage.

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