June 2015

European Economic Activity Picks Up and U.S. Stocks Perform Well

Overview

For the first time in five years, the four major economies of Europe (Germany, France, Italy, and Spain) grew in the same direction in the first quarter: each country posted positive GDP growth. International equities continue to be one of the strongest performing asset classes this year, thanks primarily to renewed economic optimism and the influx of stimulus from the European Central Bank. U.S. stocks performed well in May, with both the S&P 500 and NASDAQ hitting new, all-time highs during the month. Although the U.S. economy contracted slightly during the first quarter, investors looked past the data as largely a seasonal blip in the radar. Various indicators -- including a declining unemployment rate, improving wage growth, and a strong housing market -- point to continuing improvement in the U.S. economy. In this edition of Insights, we will discuss the improvement in Europe, the positive trends in the U.S. economy, as well as the short- and longer-term outlook for U.S. stocks.

Performance

Stocks and bonds had divergent performance in May. U.S. bond prices declined as yields rose and stocks gained. Year-to-date, bond returns are still positive, but they have faced headwinds, particularly in February, April, and May when the Barclays Aggregate Bond index declined. High yield bonds continue to perform well in part because they have less embedded interest rate risk than traditional, core bonds do.

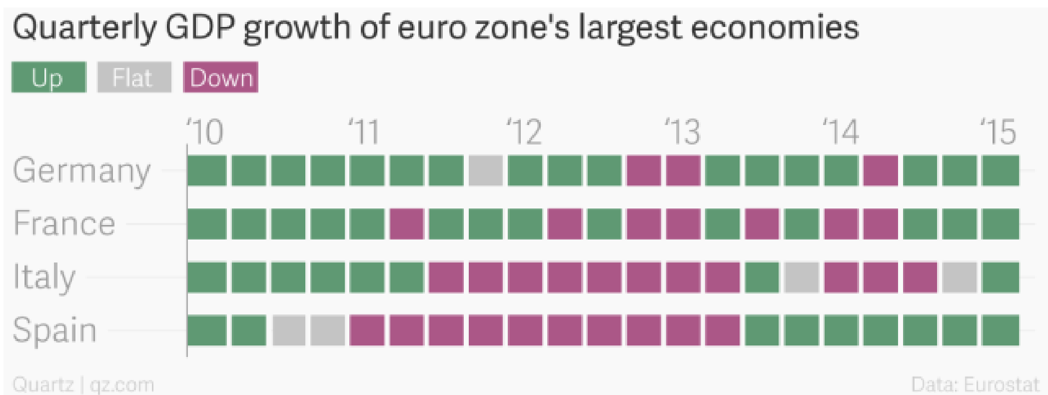
Index Name	May 2015	2015 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	-0.28	0.21	4.53	4.52	US Muni Bonds
BarCap US Agg Bond TR USD	-0.24	1.00	3.90	4.61	US Taxable Bonds
BarCap US Corporate High Yield TR USD	0.30	4.07	9.21	8.26	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	-0.39	3.28	7.51	7.82	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	-2.58	-3.71	1.37	6.29	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	-0.18	3.24	1.88	0.94	Hybrid/Hedged Equity
DJ Industrial Average TR USD	1.35	2.14	15.08	8.36	US Equity -- Large
S&P 500 TR	1.29	3.23	16.54	8.12	US Equity -- Large
NASDAQ Composite TR USD	2.76	7.57	18.95	10.47	US Equity -- Large
Russell 1000 TR USD	1.31	3.65	16.68	8.38	US Equity -- Large
Russell Mid Cap TR USD	1.46	4.52	17.20	9.92	US Equity -- Mid-sized
Russell 2000 TR USD	2.28	3.98	15.04	8.73	US Equity -- Small
MSCI EAFE NR USD	-0.51	8.60	9.95	5.56	Int'l Equity -- Developed
MSCI EM NR USD	-4.00	5.69	4.08	8.76	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	-2.70	-3.23	-4.18	-2.63	Commodities
HFRX Global Hedge Fund USD	0.26	2.55	1.60	1.22	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 5/31/2015

Although international stocks pulled back during the month of May, they remain one of the strongest performing asset classes on a year-to-date basis.

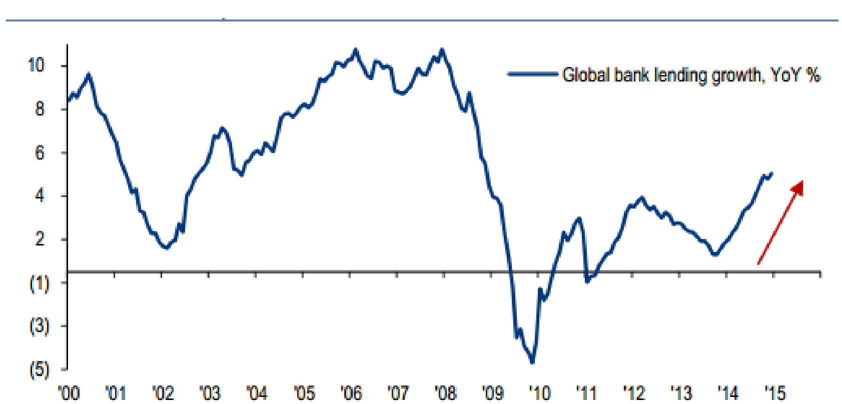
Outlook

May was a positive month for stock market returns; however, economic developments in the U.S. and in Europe diverged. In the first quarter, the U.S. continued to wrestle with the economic hiccups in the first quarter that have characterized recent years, something we discussed in last month's Insights commentary. This is not troublesome in our view; rather, it is more emblematic of the subdued growth environment that the domestic economy continues to work through in the wake of the last recession. European economies, on the other hand, continued to improve throughout the first five months of the year. Germany's economy grew 1.1% in the first quarter (vs. *minus* 0.7% for the U.S. economy). Spain's economy, much maligned in 2011 and 2012, grew at a 3.5% rate during the first quarter, according to J.P. Morgan. Indeed, for the first time since 2010, the four largest economies in the Eurozone are simultaneously growing.



Germany has been the most consistent performer of the four countries, whereas Spain and Italy have faced numerous headwinds from housing and productivity, respectively. It should be noted that the last time these four economies were performing this well, equity returns were similar to or better than U.S. equity returns. The divergence in economic health led to the relative underperformance of international equities over the last few years. However, the return to simultaneous economic growth abroad is encouraging.

Global lending activity has picked up significantly, due in part to the rebound in economic growth combined with the more favorable credit terms due to the suppression of interest rates across the world.



Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg, ECB, Federal Reserve, Bank of Japan, Haver Analytics

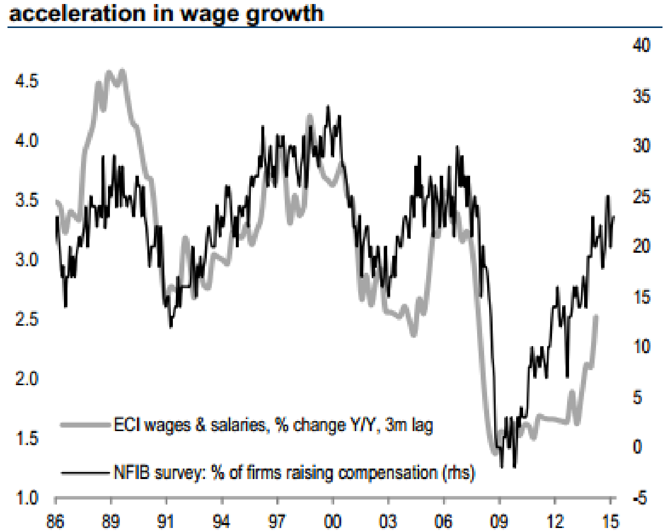
As the ECB ramps up its quantitative easing program, additional demand for credit is created, and thus more money is freed up for investments across various asset classes. It is our belief that the reemergence of economic growth combined with significant stimulus measures from the ECB will lead to continued strength in European equity market returns. We have already seen early signs of a rebound in international equity performance in 2015 and continued strong performance should benefit a diversified portfolio's return and risk profile going forward.

With respect to U.S. markets, stocks continue to hover around all-time highs. Although returns for 2015 are positive, the path has been marked by small ups and downs rather than a consistent advance. Volatility continues to be subdued despite worrying headlines about Greece, lackluster economic data, and the Fed's first rate hike since before the financial crisis. Although we are happy with the lack of volatility in U.S. stocks, one must guard against complacency about the possibility of future corrections in the market. The stock market often enters into pullbacks, or corrections, and a 10% decline is an event that happens, historically, with moderate frequency. According to Deutsche Bank, the average number of days between a 10% correction is 357 days. However, we have been in a prolonged period of positive returns more recently and have, in fact, gone more than *900* trading days since the last 10% correction in the market in October of 2011.

This is the third-longest stretch for the S&P over the observed time period (dating back to 1960). While the extended lack of a correction is not in of itself a reason for a correction to happen, it is a reminder that investors should not become complacent with the strength of U.S. equity market returns. Traditional bonds, which Sage has underweighted in anticipation of Fed rate hikes, still have a place in the portfolio because of their ability to provide stability in times of rising equity market volatility. Put differently, Sage continues to maintain exposure to core fixed income assets because they can provide an anchor to the portfolio during market corrections. Similar to how we have urged investors to maintain their international investment exposure in the face of returns that in recent years have trailed that of U.S. stocks, we remind investors now that bond exposure is a necessary stabilizing force in a diversified portfolio.

Looking toward fixed income markets, we continue to believe that the Fed remains on track to raise interest rates for the first time in nearly a decade. In a speech towards the end of May, Fed Chair Janet Yellen stated that as long as the economy continues to improve, she thinks that "it will be appropriate at some point this year to take the initial step to raise the federal funds rate target and begin the process of normalizing monetary policy." Despite some sluggishness in the first quarter, key economic indicators such as the unemployment rate and initial jobless claims all appear to be signaling that the labor market is finally improving. As the labor market goes, so go inflation and consumption.

Figure 18: The wage component of the ECI is growing by 2.6% Y/Y and the NFIB survey is consistent with further acceleration in wage growth



ECI – Employment Cost Index. NFIB – National Federation of Independent Business

Key to both inflation and consumption is wage and salary growth. The nearby chart from Credit Suisse highlights the acceleration in wages and salaries (the employment cost index, or ECI), as well as the increase in small businesses (the NFIB) that report raising their compensation levels. Currently, wages (the gray line) are increasing at a rate of approximately 2.6% year-over-year (the left-hand scale), which is higher than the rate of inflation. More than 20% of members of the National Federation of Independent Businesses report increasing compensation levels (the right-hand scale). Wage growth is central to overall economic strength, central bank monetary policy decisions, and bond market expectations.

We have pointed out in past editions of Insights the positive news on the labor market that has come from the decisions of Wal-Mart and McDonald's to raise wages because such increases in compensation have significant, broad implications for the economy and fixed income markets. Improving salaries, especially at a time when energy costs are significantly lower than they were a year ago, is a boost to consumption and inflation. Rising inflation generally leads to higher interest rates and bond yields. This is a development for which Sage has prepared portfolios by including investments such as unconstrained bonds and high yield bonds in investors' portfolios.

As we have illustrated in past communications, unconstrained bonds have little to no interest rate risk. Moreover, because unconstrained bond strategies may take positions that increase in value when bond prices fall, they have shown an ability to provide positive returns when rates rise and when traditional bond investments have diminished returns. Year-to-date returns from the Barclays U.S. Aggregate Bond index (Agg), a traditional bond index, have illustrated the early effects of rising yields. The Agg is up just 0.21% year-to-date through the end of May compared to returns of 1.45% from Morningstar Unconstrained Bond fund category and 1.43% from the Barclays US Universal, an index that is more representative of unconstrained credit manager investments. The outperformance from unconstrained bonds versus traditional bond investments is similar to 2013 when bond yields spiked. That outperformance, with the related diversification benefit, is one of the reasons we emphasize them in Sage's portfolios as a hike in interest rate policy from the Fed approaches.

In conclusion, despite a modest contraction in economic growth during the first quarter, we continue to believe the U.S. economy is on firm footing thanks to a steadily improving labor market and strong consumer balance sheets. The Fed remains on track to hike rates later in the year, an eventuality that Sage has prepared for by incorporating unconstrained bond and other flexible fixed income strategies into investor portfolios. We are also pleased with the improving economic signs from Europe and the initial effects of the roll-out of quantitative easing by the European Central Bank. The year-to-date outperformance of domestic stocks by European equities reinforces the need to have a long-term outlook for each asset class in the portfolio. Asset class rotation can occur at any point in time. Lastly, although we believe that U.S. stocks will still most likely deliver positive returns over the long-term, we remind investors that domestic equities have gone a significant period of time without a correction. Volatility has been extremely subdued for the past couple of years, and it is important to avoid complacency and not to expect such atypically high returns to continue indefinitely. Regardless of when or how steep the next correction is, we believe that a well-diversified portfolio remains the best approach to managing ups and downs in the market by providing a multitude of return opportunities as well as assets that mitigate risk.

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