SAGE FINANCIAL GROUP
Investment and Wealth Management

SAGE INSIGHTS
MONTHLY ECONOMIC & MARKET ANALYSIS

October 2016

International Equities Lead the Way in September

Overview

Stocks continued to move higher during the month of September. Strong returns came from international equities in both developed and emerging markets. At the Federal Reserve's widely anticipated September meeting, the committee decided to keep rates unchanged but gave a nod to a likely rate hike in December. Overseas investments welcomed the continued delay in rate hikes, which meant a favorable climate for foreign currencies, as reflected in total returns.

Economic data released during the month showed continued gains in job markets, with the U.S. economy adding 151,000 jobs in August. The unemployment rate has held steady at 4.9%, well below its historical average rate of 5.8%. Consumer confidence improved in September with wages increasing and interest rates still low.

Performance

The S&P 500 index was essentially flat during the month (up 0.02%); however, the Russell 2000 small cap index returned 1.11%. The MSCI ACWI Ex US Index, a benchmark for international equities, rose 1.23% during September.

Index Name	Sept	2016 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	-0.50	4.01	4.48	4.75	US Muni Bonds
BarCap US Agg Bond TR USD	-0.06	5.80	3.08	4.79	US Taxable Bonds
BarCap US Corporate High Yield TR USD	0.67	15.11	8.34	7.71	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	0.40	14.77	7.75	7.73	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	2.02	17.07	0.06	5.52	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	-0.18	-2.18	1.26	-0.77	Hybrid/Hedged Equity
DJ Industrial Average TR USD	-0.41	7.21	13.77	7.39	US Equity -- Large
S&P 500 TR	0.02	7.84	16.37	7.24	US Equity -- Large
NASDAQ Composite TR USD	1.96	7.09	18.54	10.08	US Equity -- Large
Russell 1000 TR USD	0.08	7.92	16.41	7.40	US Equity -- Large
Russell Mid Cap TR USD	0.20	10.26	16.67	8.32	US Equity -- Mid-sized
Russell 2000 TR USD	1.11	11.46	15.82	7.07	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	1.23	5.82	6.04	2.16	Int'l Equity -- Comprehensive
MSCI EM NR USD	1.29	16.02	3.03	3.95	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	3.13	8.87	-9.37	-5.33	Commodities
HFRX Global Hedge Fund USD	0.16	0.78	0.59	-0.19	Multi-Asset Alternative Invm't

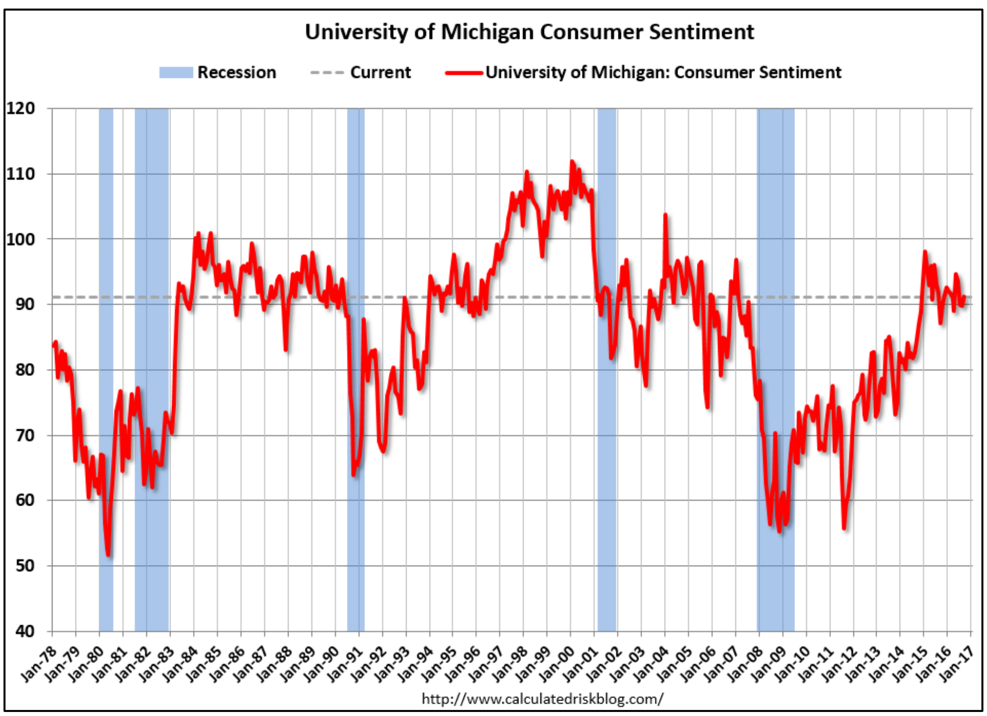
Source: Morningstar Direct. Data through 9/30/2016

Emerging market stocks continued to perform well in September, with the MSCI EM Index returning 1.29% and increasing its YTD return to 16.02%. By comparison, the S&P 500 Index is up 7.84% YTD.

Bond returns were mixed during the month. The Barclays US Aggregate Bond Index declined slightly, and the Barclays Municipal Bond Index fell 0.50%. U.S. corporate and foreign emerging market bonds, however, are both positive YTD and continue to perform very well in 2016. The BarCap US Corporate High Yield Index, for instance, is now up 15.11% for the year.

Outlook

Heading into the final quarter of the year, 2016 has proven very favorable for both equity and bond investors. The S&P 500 Index has generated strong returns of nearly 8%, and emerging market equities have been one of the best-performing asset classes with returns that are more than double that of large cap U.S. stocks. Investors have benefitted from the Federal Reserve's continued easy monetary policy as well as steady improvement in the U.S. economy. While U.S. economic growth has been modest, investors have placed greater importance on the fact that the economy did not tip into recession after the downturn in manufacturing that began in 2015. Indeed, the U.S. consumer has proven fairly resilient thanks to low unemployment rates, favorable energy prices, and continued improvement in the housing market.



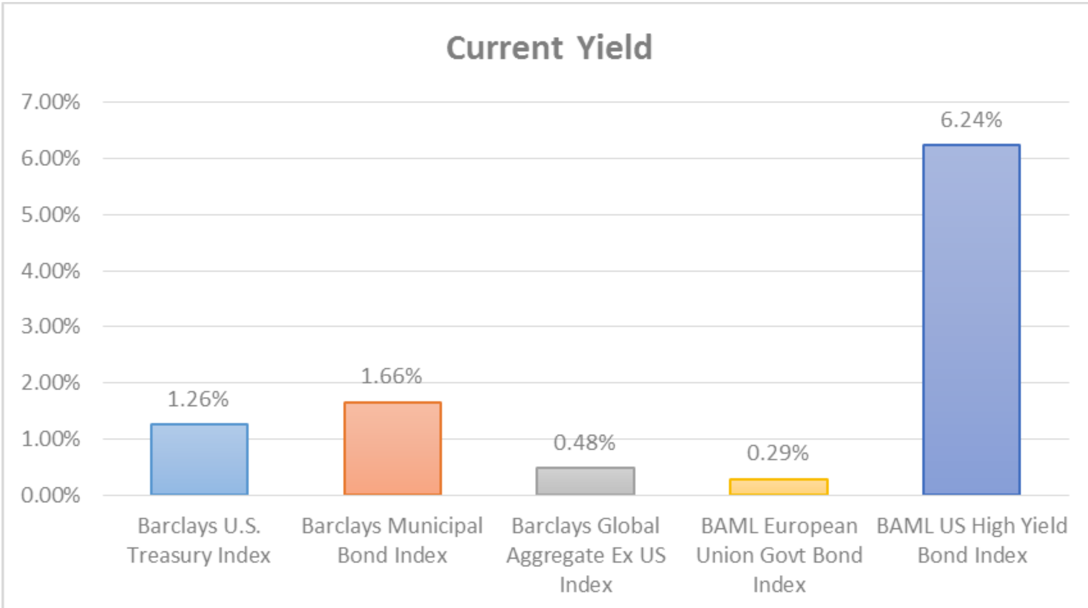
Consumer sentiment is holding up well despite modest economic growth

From the Federal Reserve's perspective, the U.S. economy is strong enough to handle a rate hike, but the economy is not overheating with respect to inflation or other measures that would require an aggressive approach to hiking rates. The continuation of low oil prices has given the central bank more room to wait on hiking rates, since headline inflation (as measured by CPI) has only averaged, according to information compiled by the St. Louis Federal Reserve Bank, a year-over-year increase of 0.5% in 2016, through the end of July (most recent data). Core inflation, which excludes the volatile food and energy components, has averaged a year-over-year increase of 2.0% in 2016. Although this is in line with the Federal Reserve's target of 2.0%, the fact that growth has been modest and energy prices have remained subdued has given the Fed more leeway to take its time on raising rates.

Also allowing the Federal Reserve to keep rates low has been the aggressive behavior of other central banks, such as the European Central Bank (ECB) and Bank of Japan (BoJ), which have pushed their benchmark interest rate levels into negative territory. As a result of unprecedented central bank policy, bond yields around the world have sunk to record low levels, so that nearly $12 trillion in bonds are trading with *negative* yields.

Negative bond yields have raised a number of questions for investors. The first question usually revolves around returns. Somewhat ironically, yields moving below zero has helped out *current* returns this year. For example, the Barclays US Aggregate Bond Index has returned more than 5% in 2016. However, although plunging bond yields may help current returns, they do so at the expense of *future* returns. With many bond yields trading near all-time low levels, investors must diversify away from traditional fixed income, where yields are often below 2.0% (suggesting that future returns will also be below 2.0%).

Sage has been doing exactly that, namely, diversifying away from traditional fixed income, by emphasizing strategies such as unconstrained fixed income, where managers can invest across traditional government and corporate bonds, and high yield bond strategies where yield premiums are significant. For instance, at present, the Bank of America High Yield Master Bond Index currently yields 6.24%. By comparison, the Barclays US Treasury Index yields just 1.26%, and the Bank of America European Union Government Bond Index yields just 0.29%.



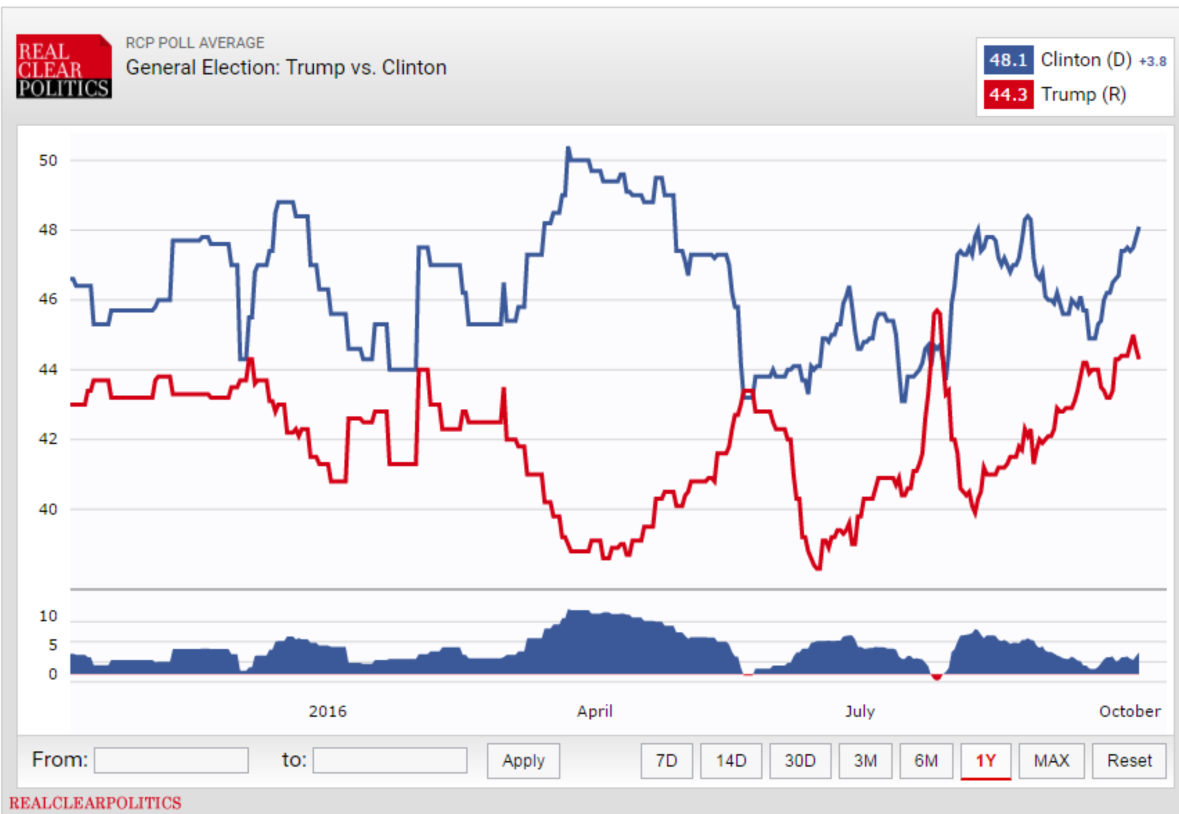
Source: Sage Financial, Eaton Vance, St Louis Federal Reserve

High yield bonds also have a favorable fundamental profile going for them. Inflation is modest, which keeps a core component of business costs relatively tame. Also, the Federal Reserve is taking a very slow path towards raising rates. As a result, refinancing costs are extremely low and should stay low for the foreseeable future. The Fed's easy monetary policy, combined with a market hungry for yield, makes it easier for high yield companies to finance their ongoing business needs and capital expenditures. Investors do take on greater price volatility by owning high yield bonds, but we believe that they will be rewarded by the significantly higher return opportunity embedded in high yield bonds than traditional government debt.

Towards the end of the month, one pocket of volatility emerged in the stock market with an increasing focus on European bank stocks. In particular, shares of Deutsche Bank have fallen nearly 50% this year as the bank has struggled with declining revenues in investment banking operations and has faced numerous fines for past business dealings. It has also seen weak lending activity because the ECB move to push rates into negative territory has hurt its business model by forcing deposits out of savings accounts. Stress tests by the ECB, designed to help prevent a banking crisis, have only raised concerns that these banks may need additional funding. Until the banks can either get their capital ratios in order or receive some explicit backing from the ECB or European governments, they appear to be the most likely candidates for any short-term market volatility that may arise. Bank valuations are a confidence game, and Euro banks are severely lacking in material catalysts for turning around their ships. Sometimes the market decides to "shoot first, ask questions later" which seems to be the case with European bank shares. Some observers have compared Deutsche Bank to Lehman Brothers, which collapsed in 2008 and brought added fuel to the financial crisis fire. While we expect that volatility from European bank stocks may continue until capital is raised, we do not believe this is a parrallel to 2008 for a few reasons.

First, lawmakers have spent the last eight years increasing financial system regulations in order to prevent another crisis. Bank liquidity and funding mechanisms are vastly improved, and measures are in place to keep a disorderly default from occuring. In 2008, much of the panic in share prices stemmed from questions over whether the financial system would find a back stop. At present, central banks have explicitly designated themselves as the lender of last resort. Policymakers love to fight the last war, and regulatory moves since 2008 have been specifically geared towards avoiding another Lehman moment. Second, the problems with Deutsche Bank seem limited to its stock rather than seem to extend to the rest of the financial sector. Although Deutsche shares have fallen precipitously this year, shares of JP Morgan, Morgan Stanley and Bank of New York Mellon, to name a few large money center banks, are holding steady this year. Deutsche's problems do not appear to be echoed by other banks in the market and overall because the financial system is significantly healthier than it was eight years ago.

As the final quarter of the year begins, the most dominating news event will likely be the U.S. presidential election. Thanks in part to constant media coverage and no shortage of colorful statements, the election news cycle is likely to gather more steam as November nears. In terms of broad polling, Clinton has fairly consistently led national polling, trailing only shortly after the Republican National Convention. Although national poll numbers showed a close race before the September 26 debate, polls have again widened to favor Clinton since then. The Real Clear Politics average of national polls shows Clinton at 48.1% and Trump at 44.3% (as of October 3, 2016).



While the national popular polls are fairly close, state-by-state polling as it fits into the Electoral College currently favors Clinton by a fairly wide margin. According to the website FiveThirtyEight, a popular election statistics site, recent polls in Florida and Pennsylvania, which are key swing states that Trump would need to win in order to swing the overall Electoral College vote in his direction, have been mixed. Florida's most recent polls favored Clinton by 2-7 percentage points, while Pennsylvania's most recent polls favored Clinton by 6 percentage points. Ohio, another key swing state, saw its most recent poll favor Trump by 3 percentage points. To put it simply, Trump would need to gain significant ground in these key states like Florida, North Carolina, and Pennsylvania to overtake Clinton in the Electoral College vote.

Of greatest interest to Sage's clients is likely to be the potential market reaction to the election outcome. It is impossible to handicap the short-term moves in the market for any outcome event, particularly one as fluid as Presidential, Senate, and House elections. Nevertheless, we will make some broad observations regarding the current likelihood of certain outcomes, the potential policy path that would result, and the market's perception of that policy path.

The House of Representatives

The Republican Party currently holds 247 seats in the House, 29 more than the 218 needed for a majority. According to *The New York Times*, a House of Representatives takeover by Democrats is "no small task." In order to regain control of the House, Democrats would need to pick up 30 seats and the *Times* indicates that it is very hard to identify 30 seats that are a serious risk to Republicans. As a result, the House is likely to stay in the GOP's court.

The Senate

There are 34 senate seats up for grabs in 2016, 23 of which are held by Republicans. According to *The New York Times*, Democrats have a 60% chance of winning the Senate. Democrats need to gain four or five seats to win control of the Senate. Currently, nine of the Republican seats up for reelection are closely contested and could flip Democratic.

Given the challenge that faces a number of Republicans Senators up for reelection, many who have seen recent poll numbers falling in line with Trump's recent poll numbers, it seems reasonable to suppose that the Senate could shift to the Democratic Party and that there could be a divided Congress following the election.

The Presidential Election

As we noted above, current national and Electoral College polls seem to suggest that, if voting were held today, Hillary Clinton will win the presidential election. Assuming the current polls are correct, and if the Senate reverts to the Democrats, then the most likely political outcome would be a Democratic President and a split Congress with a Democratic Senate and Republican House of Representatives.

How would the market respond to this scenario?

If this scenario were to play out, it would most likely lead to continued gridlock from a policy perspective. Although gridlock may seem bad in that there would be little productive activity from Washington, D.C., markets may actually welcome it with positive trading given that it would remove a significant degree of uncertainty about the policy pathway. Trump has promised some pro-growth measures such as reducing taxes and increasing fiscal stimulus, but his unpredictability would likely lead towards greater geopolitical uncertainty, which the markets would most likely not welcome. Gridlock among legislative and executive branches would remove some policy uncertainty due to legislative inaction, which could boost markets in the short-term, but would also likely result in a continuation of the status quo, which is a muddle along growth trajectory for the economy.

More controversial measures, such as major tax reform, would likely be punted because the Democrats seem keen on raising tax rates for the highest earners and Republicans are loathe to pass any measure to do so. As for an infrastructure or fiscal stimulus package, there may be greater odds of a bill's being passed if Republicans can work in pro-business/growth elements to the deal. One example of this would be the repatriation of corporate cash held outside of the U.S. At present, U.S. companies hold approximately $1.5 trillion in cash offshore in countries with favorable corporate tax rates, such as Ireland. The current repatriation rate of 35% has incentivized companies to keep that tax offshore rather than reinvest it in the U.S. (or buy back shares and raise dividends). If the government held a repatriation holiday, which they did in 2004 at a 5.25% tax rate, it would likely be a positive event for the market because it would free up cash to be used for shareholder friendly activities.

In short, a divided Congress and Clinton in the White House, if both of those eventualities came to pass, would likely result in a short-term positive boost for the market given that uncertainty would be reduced. Over the long-term, it is difficult to project the implications for the market due to the likely gridlock that would take place. If there is a move towards the far left side of the political spectrum, which strong support for Bernie Sanders during the primary season seems to indicate is a possibility, there could be some long-term jitters in the market over increased regulation and tax hikes.

In closing, despite heightened volatility to start the year, combined with geo-political uncertainty around Brexit and now the U.S. election, investment markets have performed very well. Although volatility may rise as the U.S. presidential election draws near, or as the Fed signals increased willingness to hike rates, we believe that a diversified portfolio is the best strategy to manage the potential volatility that may occur. Though there is a risk that volatility may increase in the coming months as election uncertainty might increase, we believe a diversified portfolio is the best approach to manage this potential risk and do not intend on making significant changes to our investment approach. One area we are addressing is within fixed income, where Sage has actively managed the portfolios to reduce exposure to traditional bonds, which have paltry yields, and is increasing exposure to more attractive return opportunities such as high yield bonds. We appreciate your continued trust in us and look forward to speaking with you soon regarding your portfolio.

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