SAGE FINANCIAL GROUP
Investment and Wealth Management

SAGE INSIGHTS
MONTHLY ECONOMIC & MARKET ANALYSIS

February 2015

January Sees Asset Class Rotation, Most Asset Classes Outperform U.S. Equities

Overview

A change in calendar-year ushered in a change in asset class performance. In January, leadership in stock performance, for example, changed: U.S. large cap stocks lost ground while foreign large cap stocks gained ground, as we note in more detail below. Meanwhile, as expected, the European Central Bank (ECB) announced the launch of its own quantitative easing program. The size and duration of the ECB's bond purchasing plan (60 billion euros per month through 2016 or until inflation reaches 2%) exceeded expectations. This plan lifted foreign stocks. However, the strengthening of the USD dollar relative to the euro and other currencies cut into revenue reported by U.S. multinational companies. For instance, Proctor & Gamble explained, "Foreign exchange will reduce fiscal 2015 sales by 5% and net earnings by 12%." We have noted previously that in 2015 we expect that global economic and market divergence in economic conditions and market returns will persist, even if the exact factors change from 2014. January was a month in which we saw more global divergence just in a different guise. We also saw why divergence points to the continuing value of portfolio diversification.

Performance

Apart from core bonds, assets classes that performed well in 2014, such as U.S. large cap stocks, fared poorly in January. The S&P 500 index lost 3.00%, and U.S. small caps dropped 3.22% during the month. In contrast, except commodities, asset classes that did poorly in 2014, such as international stocks, fared well last month. Both developed and emerging foreign stocks gained about half of a percentage point. This exemplifies the sort of potential asset class rotation that we have written about previously.

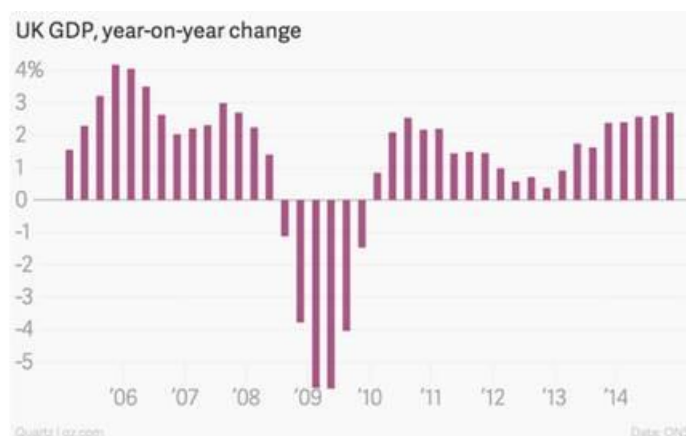
Index Name	Jan 2015	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	1.77	5.42	4.82	US Muni Bonds
BarCap US Agg Bond TR USD	2.10	4.57	4.86	US Taxable Bonds
BarCap US Corporate High Yield TR USD	0.66	8.90	7.82	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	0.93	7.69	7.81	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	0.34	2.65	6.72	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	-0.66	0.85	0.34	Hybrid/Hedged Equity
DJ Industrial Average TR USD	-3.58	14.16	7.80	US Equity -- Large
S&P 500 TR	-3.00	15.60	7.61	US Equity -- Large
NASDAQ Composite TR USD	-2.08	17.98	9.50	US Equity -- Large
Russell 1000 TR USD	-2.75	15.84	7.93	US Equity -- Large
Russell Mid Cap TR USD	-1.56	17.62	9.67	US Equity -- Mid-sized
Russell 2000 TR USD	-3.22	15.66	7.87	US Equity -- Small
MSCI EAFE NR USD	0.49	6.39	4.68	Int'l Equity -- Developed
MSCI EM NR USD	0.60	3.08	8.47	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	-3.34	-4.74	-2.29	Commodities
HFRX Global Hedge Fund USD	-0.29	0.98	0.76	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 1/31/2015

Relative to U.S. stocks, some alternative investments like global hedge funds performed well, -0.29% versus -3.00% for the S&P 500 index. The Morningstar categories of multi-asset alternative investment funds and managed futures strategies did even better, *gaining* between 2.87% and 3.92%, respectively. After a stretch of time in which U.S. large cap stocks seemed to some as the only asset one needed to own, the gains in January of foreign stocks and of alternative investment strategies reinforced, in contrast, the value and prudence of maintaining discipline and portfolio diversification.

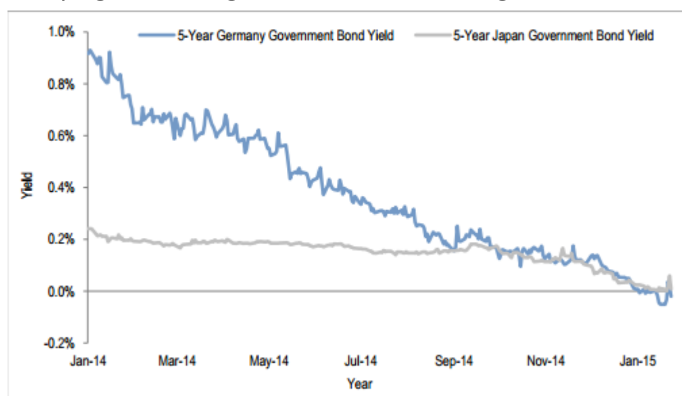
Outlook

Our longer-term economic outlook remains generally solid for the U.S., especially compared to most other major advanced economies such as Japan or the Eurozone. The U.S. economy expanded in the fourth quarter at a 2.6% annualized rate. For all of 2014, it grew 2.4%. It is not alone among developed economies. Although much media attention focuses on the challenges to growth and on declining prices in the Eurozone and Japan, the United Kingdom, like the U.S. has ended its quantitative easing programs and has registered steady economic growth. As you can see in the chart below, aside from lower growth in 2012, the British economy has expanded in the 2% range, just like the U.S, in recent years.



The U.S. economy continues to grow and seems, despite some challenges, to have staying power. Normally, with unemployment having declined to 5.6% and near the Federal Reserve's stated long-term neutral rate, interest rates would be higher than they currently are. However, this is not a normal business cycle. Last week, the Fed stated that it intends to keep interest rates near zero until at least the summer, possibly longer, depending on economic and inflation data. We also think that U.S. dollar strength globally is also a factor that the Fed is considering. It is aware that its actions could further strengthen the greenback, which could hinder near-term economic growth in the U.S.

Bond *yields* could rise even apart from official Fed funds *rate* increases. If it seems as though it is dovish in delaying the raising of rates, investors might sell Treasuries and other bonds to reinvest the proceeds in potentially higher returning assets.



Source: Bloomberg and Goldman Sachs as of Jan. 29, 2015.

At the same time, there remains the possibility that the relative attractions of U.S. government bond yields to global investors may push U.S. yields lower still. As you can see from the nearby graph, other safe-haven assets like German and Japanese government bonds are trading at yields of negative or near zero for 5-year maturities. In contrast, the 5-year Treasury is at about 1.27%, not high in absolute terms, but fetching relative to German and Japanese debt. But at 1.27%, one may be forgiven for wondering how much farther U.S. yields might

decline.

Given global economic uncertainty, however, anything is possible. For instance, the elections in Greece last month brought the Syriza party to power. Some have labeled Syriza the "anti-austerity" party, and many have looked to Syriza's rallying cry in the 2012 Greek election -- calling for an exit from the Eurozone and a default of their debt obligations -- as a precursor to how they will govern now that they are in power. To be candid, we believe that some brinkmanship between Greece and the troika (the three main governing bodies of the European Union) will continue this month. Ominously sounding headlines will likely continue as Greece faces a number of deadlines in the first half of the year, including debt maturities, the ending of the previous bailout package, and approval of a new package by Euro area parliaments.

In our opinion, the reality is likely to be milder than many are worrying about. Syriza was radically leftist in 2012 but has moved more towards the center for this election, which is a primary reason that the party went from being an afterthought to being a ruling party. You can campaign on rhetoric and far-flung ideas, but in order to govern you have to move towards the center. If Syriza does not play ball with the Eurozone and IMF as it relates to restructuring their debt, it will result in economic disaster. While standing up to the Eurozone seemed like a good principle upon which to run for office, the newly elected party ultimately wants to stay elected, and thus it will have to work together with their creditors to keep Greek from economic collapse. While it is important to acknowledge the chance Greece may decide that they want to completely turn away from the Eurozone and go it on their own, that does not seem like the likeliest path forward. Both the Eurozone and Greece have substantial vested interests in not significantly severing the monetary union.

All told, we think that January's elevated stock and bond market volatility relative to 2014 could be representative of the path that markets take for the remainder of 2015. U.S. government bond yields are more likely to rise than to fall by any significant amount, and that suggests the potential value of unconstrained bond strategies that can mitigate the risk of bond price declines that would accompany a rise in yields. Foreign stocks may be poised to compete with U.S. stocks for leadership in returns this year. In fact, foreign stocks already have a leg up in that competition. Alternative investment strategies, such as managed futures and multi-asset alternatives may, as they did in 2014, prove to be a helpful portfolio diversifier to walk the line between stock and bond market volatility, especially now given the stance of the Fed relative to very low bond yields and given a U.S. equity market that has outperformed its foreign counterparts for the last several years.

Asset class rotation occurs, often unpredictably, as we have seen in a small way last month. For this and other reasons, we continue to believe that 2015 may be the year in which portfolios that are diversified beyond traditional U.S. stocks and bonds prove their worth.

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