SAGE FINANCIAL GROUP
Investment and Wealth Management

SAGE INSIGHTS
MONTHLY ECONOMIC & MARKET ANALYSIS

November 2016

Markets Pull Back in October

Overview

After enjoying strong performance through the end of the summer, equity markets pulled back slightly in October as pre-election jitters set in. Although most national polls still suggest that Hillary Clinton maintains an edge in the presidential election, the ultimate outcome of presidential and congressional elections remains uncertain, and that uncertainty may result in continued choppy trading as we get closer to Election Day.

The U.S. economy continues to show signs of modest expansion. The government's initial estimate of third quarter GDP showed the economy to be growing at a 2.9% annualized rate, above expectations of a 2.6% growth rate. The jobs market also continues to be strong, with the official unemployment rate hovering at 5.0%, which is below the long-term average of 5.8%. The Federal Reserve has maintained its easy stance towards monetary policy, holding its official interest rate within a range of 0.25 to 0.50%. The Fed has signaled through official statements and various speaking engagements that it may hike rates again in its December meeting.

Performance

Both stocks and bonds moved lower in October, with the Barclays US Aggregate Bond Index falling 0.76% and the S&P 500 Index declining 1.82%. Emerging market stocks were notably positive during the month, with the MSCI EM Index rising 0.24%.

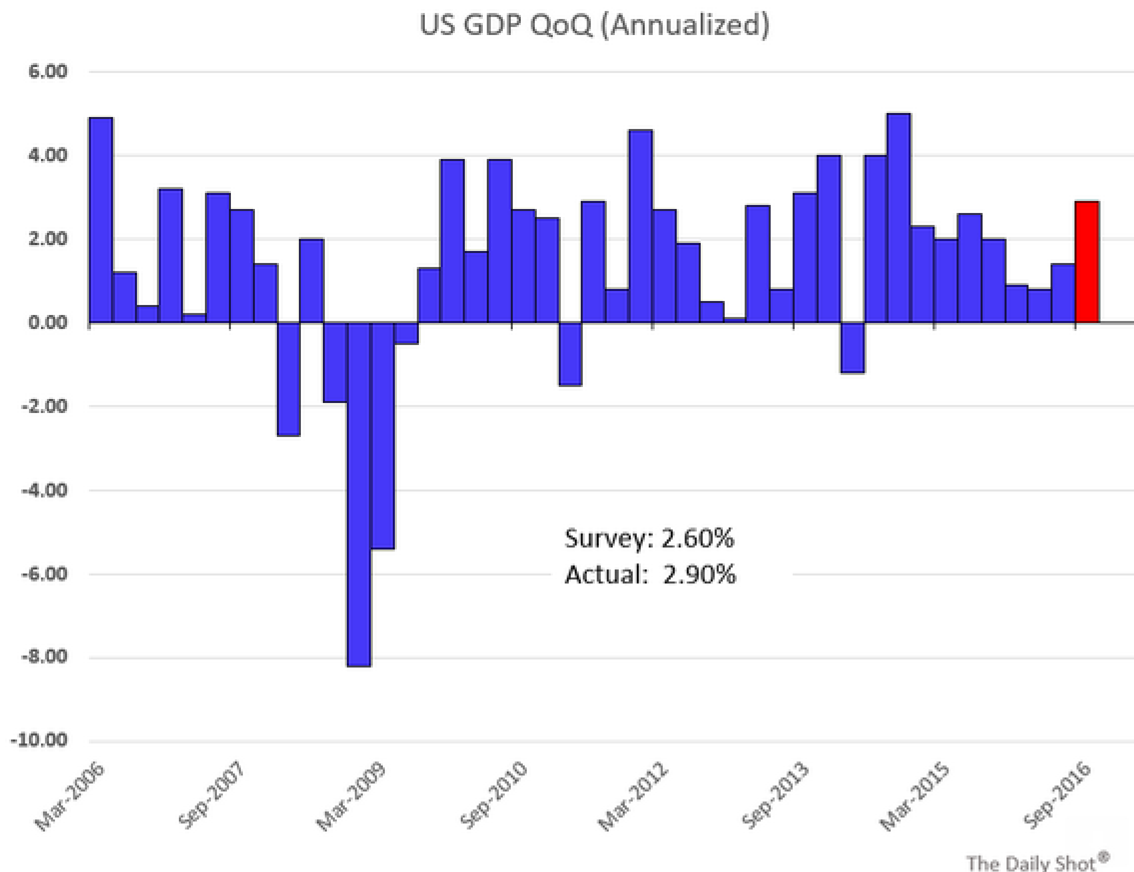
Index Name	Oct	2016 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	-1.05	2.92	4.34	4.57	US Muni Bonds
BarCap US Agg Bond TR USD	-0.76	4.99	2.90	4.64	US Taxable Bonds
BarCap US Corporate High Yield TR USD	0.39	15.56	7.17	7.60	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	-1.24	13.34	6.56	7.38	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	-0.85	16.08	-1.19	4.95	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	-0.84	-1.52	2.14	-1.03	Hybrid/Hedged Equity
DJ Industrial Average TR USD	-0.79	6.36	11.50	6.93	US Equity -- Large
S&P 500 TR	-1.82	5.87	13.57	6.70	US Equity -- Large
NASDAQ Composite TR USD	-2.27	4.66	15.51	9.31	US Equity -- Large
Russell 1000 TR USD	-1.95	5.82	13.51	6.83	US Equity -- Large
Russell Mid Cap TR USD	-3.17	6.76	13.12	7.55	US Equity -- Mid-sized
Russell 2000 TR USD	-4.75	6.16	11.51	5.96	US Equity -- Small
MSCI All Country World Index ex-USA NR	-1.44	4.30	3.64	1.61	Int'l Equity -- Comprehensive
MSCI EM NR USD	0.24	16.30	0.55	3.49	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	-0.49	8.34	-10.61	-5.81	Commodities
HFRX Global Hedge Fund USD	-0.57	0.75	1.03	-0.45	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 10/31/2016

Year-to-date, emerging market stocks continue to be one of the strongest-performing asset classes with a 16.30% return. High yield bonds have also performed well; the Barclays US Corporate High Yield Index returned 0.39% in October and 15.56% for the year.

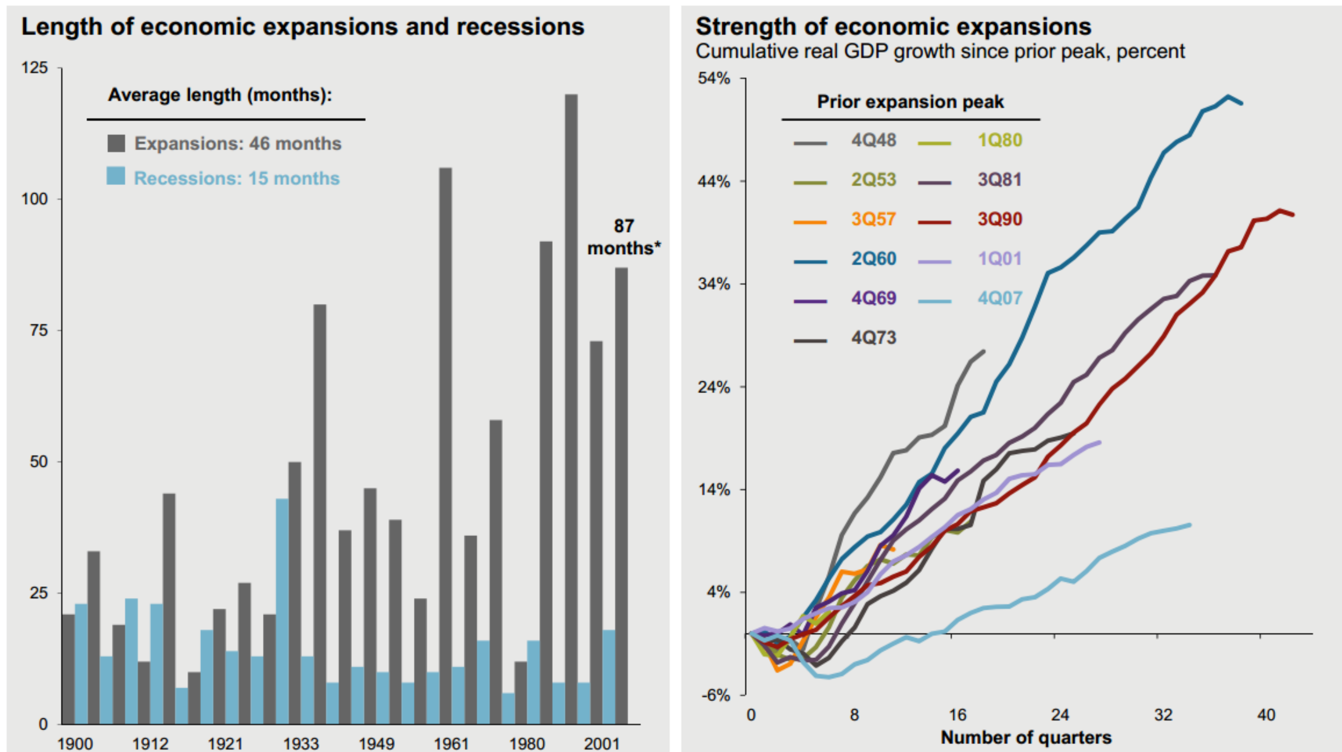
Outlook

The U.S. economy continued to grow at a steady, if unspectacular, rate through the third quarter. The Bureau of Economic Analysis reported that the economy expanded at a 2.9% annualized rate. The growth rate was above expectations and was an improvement from the second quarter, which saw growth at a 1.4% annualized rate. Personal consumption, a key gauge of consumer spending that is closely watched by economists, grew at a 2.1% rate, slightly below expectations of a 2.5% growth rate.



The chart above, which shows quarterly GDP growth over the last ten years, highlights the ebb and flow of U.S. economic growth during the current expansion. There have been only two quarters of 4.0% plus growth, and most quarters have seen the economy grow right around 2.0%. Growth has been mostly positive, but not very strong. While the average growth rate of 2.1% during the current expansion may be disappointing relative to the average growth rate of 3.7% experienced in the 1990's, it also means that the economy has had little opportunity to overheat.

Why do we single out the current growth rate? Primarily because the current economic cycle has lasted seven years, which is notably longer than the historical expansion age of around three years. Some observers may be concerned that the economy could be long in the tooth and that we are due for a market pullback as a result of a possible recession. However, we can see from the following chart that since the 1950's the U.S. economy has become more oriented around services and consumer demand, rather than industrial production, and as a result expansions have generally been getting longer, while recessions have been getting shorter.



Source: BEA, NBER, J.P. Morgan Asset Management. *Chart assumes current expansion started in July 2009 and continued through September 2016, lasting 87 months so far. Data for length of economic expansions and recessions obtained from the National Bureau of Economic Research (NBER). These data can be found at www.nber.org/cycles/ and reflect information through September 2016.
Guide to the Markets – U.S. Data are as of September 30, 2016.

We should also note that expansions do not die of old age alone. We have previously used the analogy of a car traveling across state to understand important dynamics of the current expansion. If the car moves at a slower rate of speed, it will take longer to arrive at its destination. An economic expansion often ends because it moves too quickly, and becomes overheated, thus requiring the Fed to tighten monetary policy and constrict lending and investment. We do not currently face that problem in the U.S. given that the current expansion has been the slowest-growing of the last eleven expansions. Although the Federal Reserve is likely to raise rates at its December meeting, it continues to project a very easy rate-hiking cycle. There is little desire within the Fed to disrupt growth in the U.S. and derail investment markets. As a result, we continue to believe that there is more room to run in the current U.S. expansion.

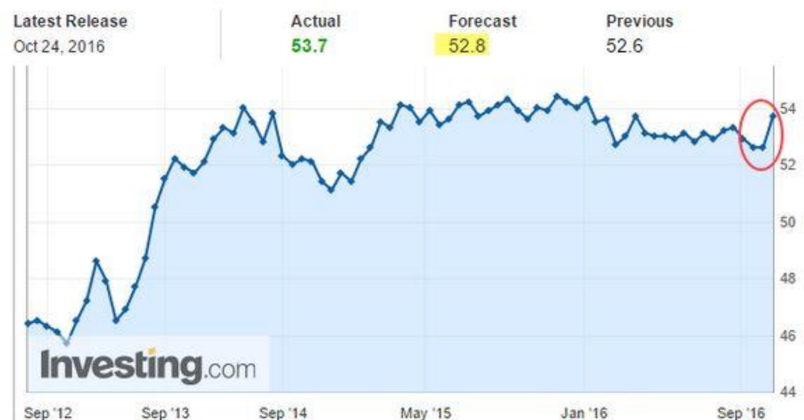
Moving on from the economy, the potential investment consequences of the presidential election on Tuesday, November 8, loom in investors' minds given the news cycle domination combined with poor approval ratings for both candidates. Political risk is one factor out of many that we consider when building portfolios that are designed to reduce risk while also achieving our clients' financial goals. In spite of the greater, more inflammatory rhetoric of this election season, it seems likely that the election will *not* relieve the gridlock in

Washington. As a result, we believe that investors will generally be best-served by sticking with their current investment plans rather than making significant changes in anticipation of particular election results.

National polling in the U.S. presidential election has fluctuated since the major party nominees were finalized, but it has consistently favored Hillary Clinton over Donald Trump. 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. Although Trump has gained ground in polls in Ohio and Florida recently, he still faces an uphill battle in the Electoral College. According to the website FiveThirtyEight, a popular election statistics site, recent polls (taken in October, after the debates) in Pennsylvania, North Carolina, and Colorado, which are key swing states that Trump would likely need to win in order to swing the overall Electoral College vote in his direction, have all favored Clinton. Congressional election polling seems to indicate a divided Congress. As of the first week in October, a statistical analysis of state polling conducted by *The New York Times* pointed to the Democrats taking over the Senate and Republicans maintaining control of the House of Representatives. Be that as it may, the bottom line is this: if current polling across all races holds and Clinton wins the presidency and if the House and Senate divide on party lines (or even if Republicans retain control of both legislative chambers), policy change would still face significant gridlock.

Although gridlock may be frustrating from a policy perspective, markets may actually respond favorably to it because there would be limited scope within which any one party, or candidate, could implement policy perceived as damaging to the economy and investment environment. Gridlock would also likely see the markets breathe a sigh of relief because it would eliminate significant uncertainty with regard to policy actions, a potential trade war, or other perceived risks to the global economy.

Sage has been watching the election closely to determine what, if any, effect the results could have on various investment markets, but we are unlikely to make major changes as a direct response to the election results. This is because our diversified portfolios are constructed to incorporate a wide variety of investments across many assets classes so as to mitigate the risk associated with any single event, while still providing multiple opportunities to generate positive returns. Even if there is increased volatility leading up to or following the presidential election, we encourage investors not to try and "time the market" by moving out of their equity investments. Sitting on the sidelines rarely helps in the long-run, primarily because equity markets often move on quickly from the most recent risk. Although stocks sold-off sharply in reaction to the initial shock of the Brexit vote, many indices have rebounded and are now trading much higher than their pre-Brexit levels, including the FTSE 100 Index, a British equity benchmark.



On the topic of Brexit and Europe, we want to provide an update on some encouraging trends within Europe, which has gotten much attention due to its intermediate-term equity underperformance combined with Brexit headlines over the last six months. In spite of the significant degree of uncertainty revolving around the ongoing Brexit negotiations, economic growth within the Eurozone has continued to improve. The Markit Composite PMI, a broad economic gauge held stable through the summer and improved above expectations in September.

German manufacturing PMI recently hit its highest levels in two years. JP Morgan notes that the Euro area economy is entering the final quarter of the year with strong momentum, as business expectations have recovered to pre-Brexit levels and new manufacturing orders are edging higher.

Emerging markets have also continued to improve, with company earnings swinging to positive territory and currency and EM stock markets leading the way amongst equity indices. Emerging market equities have benefited from two major developments in 2016: (1) the bounce in commodity prices has led to improved performance in many commodity centric EM countries, and (2) many of the bear market fears associated with China's growth slowdown have not come to fruition.

Yearly Growth in Emerging Market Currencies (FX) and Earnings Growth (EPS)

Emerging market earnings estimates and currencies have improved considerably this year.

Much of the rally also has to do with an improvement in China's economic health and that of other regions. For starters, China did not conduct a massive depreciation of its currency, which many feared it would do at the end of 2015. After a surprise currency devaluation in the fall and some other poorly telegraphed policy decisions, many feared that China would continue to shoot investors in the foot. These fears were misplaced, inasmuch as Chinese policymakers have largely stood on the sideline this year, with the exception of an increase to capital spending to help some beaten down industries.

Regarding valuations and future return prospects, emerging markets continue to have the edge over developed markets. Despite the slowdown in emerging market growth over the last year, emerging markets still possess a wide growth spread relative to developed markets. China's GDP has increased by a 6.7% rate in the second quarter of this year compared to a 1.3% growth rate for U.S. GDP in the second quarter. India registered 6.9% growth in the second quarter. Despite fears of an EM slowdown, many EM countries are still growing at rates well above those in the developed world and should continue to do so in the long-run due to more attractive demographics.

On valuations, emerging markets currently trade at a cyclical adjusted price to earnings (CAPE) ratio of 14.4 compared to an historical median of 19.0, which translates to a discount of 31.9%. By comparison, U.S. equities trade at a 25.5 CAPE ratio, which is 37% above its historical median.

Metric	**U.S. Equities**	**Emerging Market Equities**
Current CAPE Ratio	25.5	14.4
Historical Median	16.0	19.0
Premium/Discount to Historical Median	*-37.3%*	*31.9%*

Emerging market equities continue to enjoy a valuation discount to U.S. equities. While these valuation discounts may persist, we anticipate that some of the aforementioned fundamental factors should lead to continued positive performance from emerging market equities going forward. CAPE is not the only metric by which emerging market countries are undervalued. On a price-to-book basis, EM equities are trading at a 1.6x valuation compared to a historical average around 1.8x, a discount of 13%.

As we close out the year, there is increased likelihood of higher volatility due to the uncertainty of the presidential election, combined with the Federal Reserve's November and December decisions on interest rate policy. Though volatility may jump, we believe Sage's portfolio mixture of global bonds, stocks, and alternative investments is well situated to manage this risk, and we do not anticipate making major, immediate investment shifts in response to election results or the Fed's policy. We will, however, continue to assess the economic landscape both in the U.S. and abroad, and seek to identify the proper mix of risk and reward across the investment landscape for your portfolio. We appreciate the trust you have placed in us and look forward to speaking with you soon regarding your financial situation.

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