April 2016

Markets Rally to Finish the First Quarter

Overview

The first quarter ended on a positive note as stock market indices staged a strong rally in the month of March. After sharp declines in January and February, many indices bounced back just as sharply as they fell and are now positive for the year. The S&P 500 Index is in positive territory for 2016, and indices that lagged in 2015, such as the MSCI Emerging Market equity index, are now some of the best performers this year.

It is impossible to pinpoint one single factor that explains a decline or rally in the stock market; rather, there are a few considerations that shed light on the recent bounce. First, the Federal Reserve formally reduced its forecast for rate hikes in 2016. We noted in the last edition of *Insights* that the markets have been forecasting a less aggressive pace of rate hikes than the Fed had earlier signaled. Part of the reason behind the sharp volatility early in the year was a concern that the Fed may be moving too aggressively with its rate policy. March's meeting of Federal Reserve officials saw them come closer to the market's rate hike expectations, and this fueled the rally. Second, data released over the course of the month continued to show reasonable growth in the U.S. economy. In the first month of the year, questions arose over whether the U.S. was on the cusp of a recession, yet the job market has continued to improve, and the bounce in oil prices has brought some relief to oil and gas sectors.

Performance

Most investment indexes were up in March, and many have crossed into positive territory for the year.

Index Name	March	2016 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	0.32	1.67	5.59	4.86	US Muni Bonds
BarCap US Agg Bond TR USD	0.92	3.03	3.78	4.90	US Taxable Bonds
BarCap US Corporate High Yield TR USD	4.44	3.35	4.93	7.01	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	3.27	5.04	6.22	7.20	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	9.06	11.02	-2.00	4.95	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	2.79	-2.93	-1.34	-1.13	Hybrid/Hedged Equity
DJ Industrial Average TR USD	7.22	2.20	10.27	7.54	US Equity -- Large
S&P 500 TR	6.78	1.35	11.58	7.01	US Equity -- Large
NASDAQ Composite TR USD	6.94	-2.43	13.22	8.71	US Equity -- Large
Russell 1000 TR USD	6.97	1.17	11.35	7.06	US Equity -- Large
Russell Mid Cap TR USD	8.19	2.24	10.30	7.45	US Equity -- Mid-sized
Russell 2000 TR USD	7.98	-1.52	7.20	5.26	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	8.13	-0.38	0.31	1.94	Int'l Equity -- Comprehensive
MSCI EM NR USD	13.23	5.71	-4.13	3.02	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	3.82	0.42	-14.15	-6.16	Commodities
HFRX Global Hedge Fund USD	1.24	-1.87	-1.18	-0.51	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 3/31/2016

The S&P 500 Index rose 6.78% in March, and the MSCI Emerging Market equity index jumped 13.23%. Emerging market equities are now up 5.71% in 2016. Small cap stocks, measured by the Russell 2000 Index, rallied 7.98% in March but are still down slightly YTD. High yield bonds, which we highlighted in last month's *Insights*, rose 4.44% during the month and are now up 3.35% for the year. Core bonds continue to perform well, with the Barclays US Aggregate Bond Index up 3.03% through the first quarter. Treasury bonds have been boosted by the promise of continued low interest rates from the Federal Reserve.

Outlook

With one quarter in the books, 2016 has seen a sharp spike and subsequent decline in volatility. The market decline through early February was dramatic and a little nerve-racking for those watching the daily changes in stock market prices. The ensuing market turnaround from late February through March has been equally exciting given the breadth in positive returns across many asset classes. Simply looking at return figures for the first three months of the year could make it seem as though very little has happened. For instance, the S&P 500 has returned just 1.35% YTD, which seems pretty tame. The Russell 2000, an index of small cap U.S. stocks, is down very slightly, with a minus 1.52% return. The MSCI ACWI Ex US, an index of developed foreign equities, has fallen 0.38%. If you have paid close attention to your portfolios, it has seemed like a wild ride. If you only glanced at the portfolio at the end of the quarter, it has seemed like nothing eventful has happened. It can be very easy to focus on the day-to-day, or even month-to-month changes in the market and become overly cautious or euphoric about one's portfolio. Yet many times, the short-term movements in the market end up being nothing more than noise in the long-term trajectory of investment returns.

We noted above that the Fed's willingness to take a more accommodative approach toward monetary policy pleased investors in March. This is not because an additional rate hike would be disastrous for funding costs or the housing market, to name two areas. It likely wouldn't have a material effect on the consumer, and it may even be better for bank earnings, which are a significant part of financial markets. Rather, there were concerns that the Fed's projection of four rate hikes this year when the European Central Bank and the Bank of Japan were taking their respective interest rate policies into *negative* territory would send the U.S. dollar soaring higher. The dollar's recent ascent has been partly to blame for the decline in oil prices, as well as some of the challenges that U.S. equities have faced, considering that about half of the S&P 500's sales are generated outside of the U.S. A stronger dollar puts a headwind in front of the market, and the concerns that the dollar would continue to strengthen helped to contribute to heightened volatility in the market.

The Federal Reserve's moves to back off from its initial guidance for rate hikes and to take an easier policy stance reduce the pressure on the dollar. After hiking rates in December to a range of 0.25% to 0.50%, the Fed initially projected that it would hike rates four times this year and end 2016 with interest rates in a range of 1.00% to 1.25%. The Fed is now projecting a range of 0.75% to 1.00%, which suggests that it will likely raise rates just two more times in 2016. Less pressure on the dollar means a positive tailwind for overseas revenue, which, as we noted, makes up around half of the S&P 500's sales. A weaker dollar could lead to higher oil prices (which are denominated in dollars). In the long run, higher energy prices may not be beneficial to consumers, but in the short run a rise to oil prices could help some of the most beaten-down sectors of the market. Finally, a weaker dollar also helps to boost emerging market currencies, which in turn helps the returns of EM bonds and stocks.

U.S. Dollar Index (April 2015 – March 2016)

Source: Bloomberg

The Federal Reserve's keeping policy loose is not a panacea for all that ails the market, but it can certainly provide a jump start to risk assets, which we have seen over the last month. It is not a coincidence that U.S. stocks and emerging market stocks, high yield bonds, corporate credit markets, and Master Limited Partnerships all rallied once the Fed toned down their earlier hawkish projections.

The bounce in asset prices is welcome, but we would caution that investors should still anticipate volatility sticking around for the rest of the year. If inflation picks up at a faster pace than some are anticipating -- either through a continuation of the recent oil rally, or from a jump in home prices, wage pressures, or retail goods pricing -- it could prompt the Fed to act more aggressively than it is currently projecting. Policymakers do not have a silver bullet to guarantee positive returns across all investments. We have highlighted in previous commentaries that we expected volatility to pick up this year as the Federal Reserve embarked on its first rate hike cycle in more than a decade. This has certainly been the case in the first quarter, and we continue to anticipate that volatility will stick around as each Fed meeting will bring about questions of "Will they or won't they hike rates?"

Emerging markets have performed particularly well as the Fed has stepped away from its initial forecasts. The MSCI Emerging Market equity index has returned 5.71% YTD, through the end of March and is now up *21%* since its recent low on January 20. A combination of overly negative sentiment, cheap valuations, and improving commodity markets has sparked significant inflows during the first quarter. There have also been improvements in some Chinese data points, which have helped to boost sentiment. Chinese manufacturing index reports have beaten expectations recently.

Australia, which is one of the largest trade partners with China, has seen a number of economic areas begin to improve. For instance, Australia's manufacturing gauges have recently accelerated, which is a good sign for Chinese economic stabilization.

Source: The Daily Shot Newsletter

The turnaround in some regional economic data, combined with the tailwind of a weaker dollar, has helped contribute to positive short-term returns from emerging market equities. Looking forward, emerging markets still possess deeply discounted valuations and favorable demographics, which should be key factors for future long-term outperformance of developed market equities.

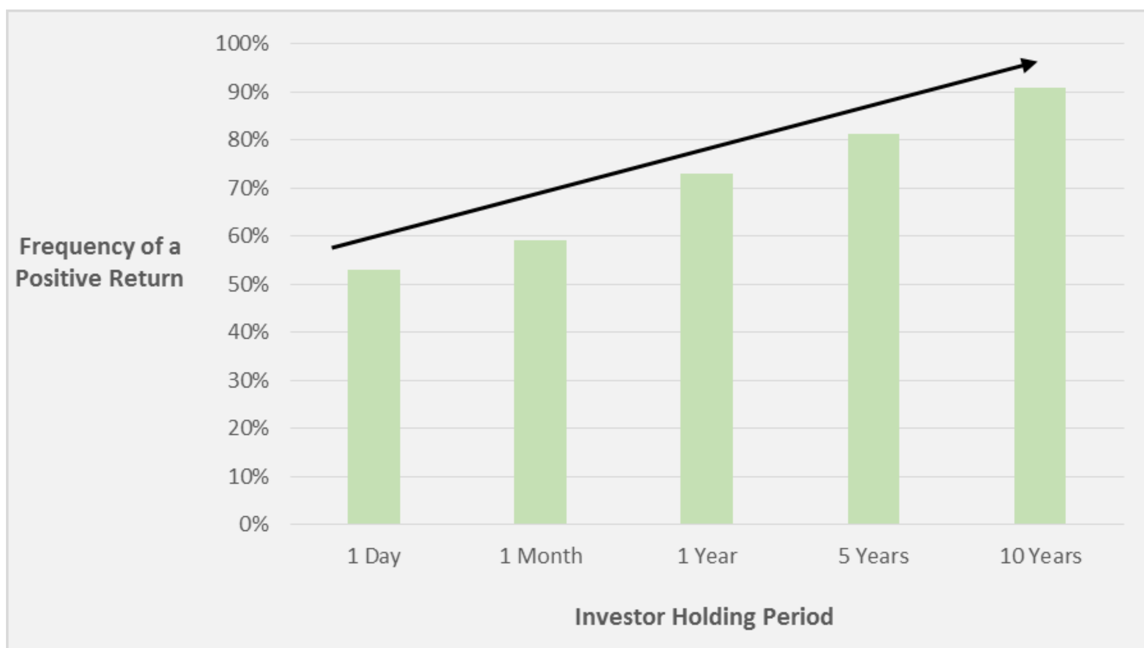
One notable geo-political development that has been gaining increasing prominence is the possibility of a British exit from the European Union, which is sometimes referred to as "Brexit" by the press. Britain is divided on the issue. Some members of the political class, such as current Prime Minister David Cameron, are campaigning to stay in the EU, while others, such as London mayor Boris Johnson, are campaigning to leave the EU. Britain has scheduled a referendum vote on EU membership on June 23. Both the likelihood of an exit and the immediate effects are uncertain. MFS Investment Management sees current odds of Britain leaving to be around 30%.

There could be an outflow of capital, though this is likely to occur over a multi-year period as companies and investors wait until the dust settles from the referendum before making any major capital expenditure decisions.

Another consideration is whether a Brexit would spark an exit from the EU by other countries. This seems even less certain than whether Britain will leave. For instance, there is the issue of currency. Britain does not share a common currency with the EU. The UK is part of the European Union but, like Sweden, for instance, not a part of the European *Monetary* Union, as are France and Germany. The majority of other EU members share the euro, and that shared currency significantly complicates any potential attempts by a monetary member to exit. Further, there is the element of identity. Britain has always been detached, both geographically and psychologically, from the European mainland. Attachment to Europe simply does not have the same historical weight for Britain as it does for say France, Germany, or Italy. All that being said, the Brexit referendum will likely bring additional volatility to investment markets as we move closer to the voting date.

In closing, we want to make a point that reinforces the benefit of taking a long-term investing approach. When markets experience quarters like the one that we have just witnessed, it can be difficult for investors to stomach the prospect of continued volatility. Earlier, we noted the sharp swings that occurred throughout the quarter, while also mentioning that if one looked at just the point-to-point returns over the first three months, it may seem like not much had happened. We highlight the seeming contradiction in perspective for an important reason. Many times, short-term movements in the market end up being nothing more than noise in the long-term trajectory of investment returns. Investors can save themselves from at best anxiety, and at worst harmful portfolio decisions by not focusing on the day-to-day moves in the market.

One of our favorite data points on market movements looks at the difference in short-term returns and long-term returns. In effect, the longer a timeframe an investor has, the greater the chance of earning a positive return. The following table illustrates the frequency of positive returns over increasingly longer holding periods for the S&P 500 Index going back to the 1950s.



Since the 1950's, on any given day, there was a 50% chance that the market would go up or down. The odds were no greater than a coin flip that stocks would rise or fall if you wanted to make a bet on the market. Yet for investors who held onto their positions for 10 years, U.S. stocks generated a positive return *90%* of the time. One's time frame may not be that long. Even if the holding period was just one year, stocks went up over 70% of the time, a remarkably higher likelihood of a positive return than the daily odds. We say this because it is easy to see ominous headlines and get caught up in the short-term moves that are highlighted in the Wall Street Journal or on CNBC. Yet by doing so, it can cause an investor to make a drastic change to his portfolio, and ultimately lead a portfolio to miss out on the longer-term positive returns that the market often provides. In conclusion, we would encourage investors to keep their attention on the long-term investment goals even in the face of the choppy markets we are currently experiencing.

S&P 500 return data from 1/1/1950 to 3/31/2016. The information and statistics contained in this report have been obtained from sources we believe to be reliable but cannot be guaranteed. Any projections, market outlooks or estimates in this letter are forward-looking statements and are based upon certain assumptions. Other events which were not taken into account may occur and may significantly affect the returns or performance of these investments. Any projections, outlooks or assumptions should not be construed to be indicative of the actual events which will occur. These projections, market outlooks or estimates are subject to change without notice. Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. All indexes are unmanaged and you cannot invest directly in an index. Index returns do not include fees or expenses. Actual client portfolio returns may vary due to the timing of portfolio inception and/or client-imposed restrictions or guidelines. Actual client portfolio returns would be reduced by any applicable investment advisory fees and other expenses incurred in the management of an advisory account. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from Sage Financial Group. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. Sage Financial Group is neither a law firm nor a certified public accounting firm and no portion of the newsletter content should be construed as legal or accounting advice. A copy of the Sage Financial Group's current written disclosure statement discussing our advisory services and fees is available for review upon request.

© 2016 Sage Financial Group. Reproduction without permission is not permitted