SAGE FINANCIAL GROUP
Investment and Wealth Management

SAGE INSIGHTS
MONTHLY ECONOMIC & MARKET ANALYSIS

December 2015

November Sees Mixed Returns Across Investments

Overview

Following a surge higher in U.S. and international equity prices in October, investment returns were mixed in November. Markets in various ways digested strong employment data and the increasing likelihood of a Federal Reserve rate hike in December. The U.S. Labor Department reported that the U.S. economy added 271,000 jobs in October and 211,000 in November, and that the unemployment rate has fallen to 5.0%. The strong jobs report puts the Fed closer to raising interest rates. During the November, Janet Yellen told Congress that a December rate hike was a "live possibility" if U.S. economic data continued to be supportive. Other economic data released during the month shows the U.S. economy to be steadily growing. Third-quarter GDP estimates were revised higher from an initial 1.5% estimate of growth to a 2.1% estimate of growth. According to the *Financial Times*, Federal Funds futures market contracts are anticipating a 74% likelihood that the Fed will raise rates on December 15 (the date of their next meeting).[1] In anticipation of the Fed's raising rates, short-term Treasury yields rose during the month, and core bond indices fell. The Two-Year Treasury Yield climbed to 0.93% during the month, its highest level of the year. Correspondingly, the Barclays U.S. Aggregate Bond Index (representing investment-grade rated bonds) declined 0.26% in November.

Performance

U.S. stocks were up very slightly during the month while international equities were down slightly.

Index Name	November	2015 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	0.40	2.58	4.79	4.73	US Muni Bonds
BarCap US Agg Bond TR USD	-0.26	0.88	3.09	4.65	US Taxable Bonds
BarCap US Corporate High Yield TR USD	-2.22	-2.00	5.95	7.32	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	-0.06	2.61	5.56	7.18	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	-2.16	-12.98	-2.45	4.67	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	0.04	-1.24	-0.14	-0.05	Hybrid/Hedged Equity
DJ Industrial Average TR USD	0.71	1.76	12.81	7.84	US Equity -- Large
S&P 500 TR	0.30	3.01	14.40	7.48	US Equity -- Large
NASDAQ Composite TR USD	1.28	9.05	16.76	9.73	US Equity -- Large
Russell 1000 TR USD	0.33	2.77	14.32	7.61	US Equity -- Large
Russell Mid Cap TR USD	0.25	0.25	13.56	8.40	US Equity -- Mid-sized
Russell 2000 TR USD	3.25	0.64	12.02	7.31	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	-2.06	-3.85	2.99	3.60	Int'l Equity -- Comprehensive
MSCI EM NR USD	-3.90	-12.98	-3.05	4.45	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	-7.25	-22.26	-11.14	-5.84	Commodities
HFRX Global Hedge Fund USD	-0.72	-2.34	0.01	0.34	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 11/30/2015

[1] "When Interest Rates Rise," *Financial Times*, https://ig.ft.com/sites/when-rates-rise/#what-is-happening. Accessed 11/30/2015.

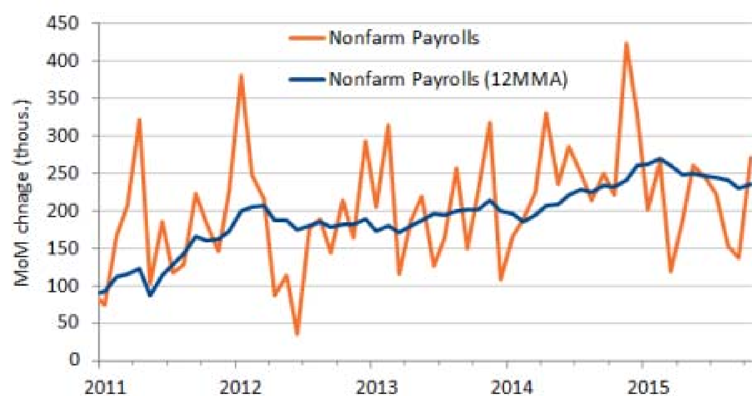
As previously mentioned, the Barclays U.S. Aggregate Bond Index fell during the month, while the Barclays Municipal Bond Index rose slightly. The BarCap U.S. Corporate High Yield Index had a particularly weak month, falling 2.22%, as both fears over higher interest rates and rising concerns over energy bond defaults sent high yield bond prices lower.

For year-to-date returns through November, most investment returns are either slightly positive or slightly negative. Few asset classes have stood out from a performance perspective. U.S. stocks are just barely positive, while developed market international equities are slightly negative. We have noted previously that U.S. bond investments have been one of the strongest-performing investments this year, relative to other investment assets, but the *absolute* returns have been lackluster, with the Barclays U.S. Aggregate Bond Index up 0.88% through November. Ultimately, what this means for diversified investment portfolios is that overall returns are close to flat due to slightly positive returns in U.S. bond and stock investments and slightly negative returns in developed international bond and stock investments.

Outlook

Heading into the final month of the year, we believe that it is instructive to observe where the economy is at present and how the Fed might move in response to economic growth. There have been many significant developments this year in the U.S. and global economy, and investment markets have fluctuated up and down as a result. In many ways, however, broad stock and bond indices (with the exception of emerging markets) are very close to where they started the year. The point-to-point returns from January 1 to November 30 would not tell you very much about what has transpired, with the S&P 500 up just 3.01% and the Barclays U.S. Aggregate Bond Index barely in positive territory.

Regarding the economy, the U.S. labor market progressed significantly since the start of the year. The unemployment rate has fallen from 5.7% in the beginning of the year to 5.0% through October (the latest reading). For those who have a bachelor's degree, the unemployment rate is just 2.5%. The twelve-month moving average (as seen in the blue line below – 12MMA) is measured to gauge the long-term momentum of a particular data point. You can see in the graph below that even though the month-to-month readings of nonfarm payroll gains can be choppy and volatile (as illustrated by the orange line), the longer-term labor market trend (measured by the blue line) has been steadily improving over the last five years.

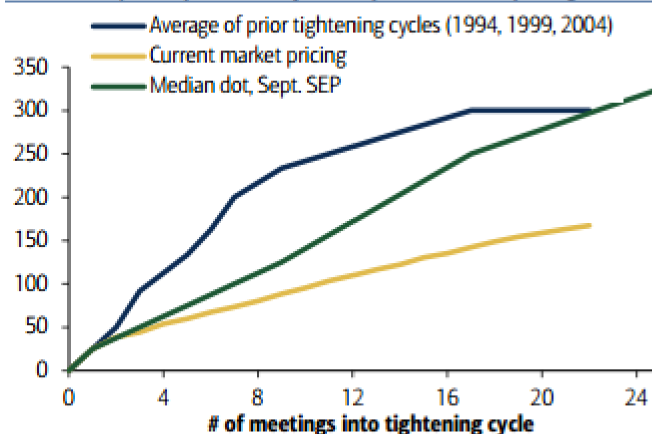


The Labor Department's broad measure of unemployment – which tracks those out of work as well as those who are discouraged and not looking for work – is currently at 9.8%, down from 11.1% last year and an all-time high of 17.1% in 2009. No matter how you slice it, the job market in the U.S. has improved remarkably from the last recession and is the main factor in prompting the Fed to consider raising rates for the first time in nine years.

A key focus of Sage's ongoing economic research is the labor market because it provides a frequently updated, easily accessible look into the overall health of the economy. If jobs are plentiful, if companies are hiring, and if wages are improving, then it bodes well for the consumer and the overall health of the economy. If job losses begin to mount, then we would start to have concerns about the overall direction of the economy. Stock markets move up and down and can be volatile, but they are too noisy on a day-to-day basis to accurately reflect the underlying economic growth trend. By comparison, the labor markets provide key weekly and monthly reports that help us to gauge the strength of the economy on an ongoing basis. So far, through the first eleven months of the year, the labor market has steadily improved. Unemployment is in line with the Federal Reserve's long-run target. Weekly jobless claims, a measure of ongoing layoffs in the job market, are at their lowest levels in the last 43 years. By multiple measures, the job market is showing signs of strength even if the stock market is muddling along this year.

The labor market is one of the Federal Reserve's preferred tools for gauging the strength of the economy. Along with inflation levels, job market health is a key factor that influences monetary policy. With the job market performing well, the Fed is likely to initiate rate hikes at its meeting on December 15. Nevertheless, the *pace and magnitude* of rate hikes is likely to be slower than historical rate hiking cycles. The following chart shows the average historical pace of rate hikes in blue, the Fed's current projection of rate hikes in green, and the market's expectation for rate hikes in yellow.

Historically, the pace of rate hikes (blue line) has started out quickly. …



… But the Fed (dark green line) has signaled that they will hike rates more slowly this time. The bond market's expectation (the yellow line) is forecasting an even slower pace.

A slower, more deliberate path in this rate hiking cycle would signal an effort on the Fed's part to not disrupt markets in a significant manner. Federal Reserve board members know that both bond and stock markets have become accustomed to rates near zero and have little desire to see what potential destruction might occur if they aggressively hike rates. While taking a slow path to hiking rates will not spare traditional bond investments from *weak* returns (bond prices move inversely to yields), it will also not likely subject them to *terrible* returns.

For instance, the market currently anticipates that the Fed will raise rates only by 0.75 percentage points over the course of 2016. If the Fed increased at the same pace as historical cycles, the total increase in 2016 would be around 2.25 percentage points. In the table below, we show a hypothetical return in the more likely, cautious scenario (which the market is anticipating) and the more aggressive scenario (which we think is very unlikely).

	Hypothetical 1 Year Return If…	
Investment	**The Fed *Catiously* Hikes by 0.75%**	**The Fed *Aggressively* Hikes by 2.25%**
Barclays U.S. Aggregate Bond Index	-1.78%	-10.31%

Hypothetical returns assume duration of 5.69 years, a yield of 2.49%, and a uniform rise in yield across all bonds in the index. Duration and yield data via Barclays

Under the scenario that the market presently assumes, returns for core intermediate-term bonds are negative, but not disastrously so, with a hypothetical return of negative 1.78%. For a recent comparison, in 2013, when yields jumped significantly, the Barclays U.S. Aggregate Bond Index fell 2.02%. If the Fed were to surprise the market and hike very aggressively by 2.25%, core bond returns would be sharply negative, with a hypothetical return of negative 10.31%. Again, the more aggressive scenario is in our view very unlikely. The Federal Reserve has not held interest rates at zero for 7 years only to send them significantly higher with no forewarning. The central bank governors have spent the last two years preparing the market for the inevitable move of raising rates off of zero, and they have explicitly stated that the pace will be slow and the path gradual.

Regardless of how quickly the Fed does hike rates, one of the reasons that Sage has emphasized both short duration bonds and unconstrained bond strategies in client portfolios is to move away from interest rate risk as the Fed prepares to lift interest rates off of zero. Short duration bonds have less interest rate risk and thus tend to fall less severely than an intermediate duration bond (represented by the Aggregate Bond Index in the table above) would in a rising rate environment.

Unconstrained bond managers can incorporate areas that are not interest rate sensitive, like floating rate bonds, or invest in fixed income sectors that have been recently discounted, like high yield bonds. A Five-Year U.S. Treasury Bond is yielding only 1.65%. By comparison, the average floating rate bond yields 5.35% and has no interest rate sensitivity. The average high yield bond yields 8.07% and has less interest rate sensitivity than a traditional bond investment. To be fair, these areas contain additional credit risk than traditional bonds. However, it is Sage's view that the economy is in solid shape, which should help riskier companies repay their bonds, and that a modest degree of credit risk is a necessary component of a portfolio when interest rate risk is as high as it presently is.

Looking towards equity markets, in last month's Insights, we noted that for investors to achieve their financial goals, they often need to measure their time horizon in years and decades. Unfortunately, the speed with which financial news and updates hit the headlines happens in minutes and seconds and can cause investors to lose sight of their long-term objectives. In 2014 and 2015, many asset classes with attractive long-term return potential have underperformed U.S. stocks and bonds. One such area is emerging market equities.

The short-term swings in EM stocks have caused investors to question the long-term viability of their investments. However, in some cases the underlying fundamental health of these investments has not changed at all; the prices have merely moved lower and valuations have improved. We recently read an article by Dr.

Burton Malkiel, a renowned economist, which focused on the opportunity within emerging market equities. In that article, he perceptively notes, “Emerging markets today present an opportunity for investors to both mitigate risk and increase reward. … [O]nce deemed too risky, emerging markets now present a hidden gem that is too risky to avoid” (*ThinkAdvisor*, November 2015 – “Why Emerging Markets Are Worth the Risk”).

Emerging market economies have two characteristics that will likely propel long-term returns going forward: (1) favorable growth rates and (2) discounted valuations. On growth rates, the World Bank estimates that EM countries will grow at 4.8% in 2015, 5.3% in 2016, and 5.4% in 2017. By comparison, developed countries are growing at just 2.2% in 2015, and are estimated to grow 2.4% next year, and 2.2% in 2017.

World Bank GDP Growth Forecasts

Region	2015	2016	2017
Developed Countries	2.2%	2.4%	2.2%
Developing Countries	4.8%	5.3%	5.4%
World	3.0%	3.3%	3.2%

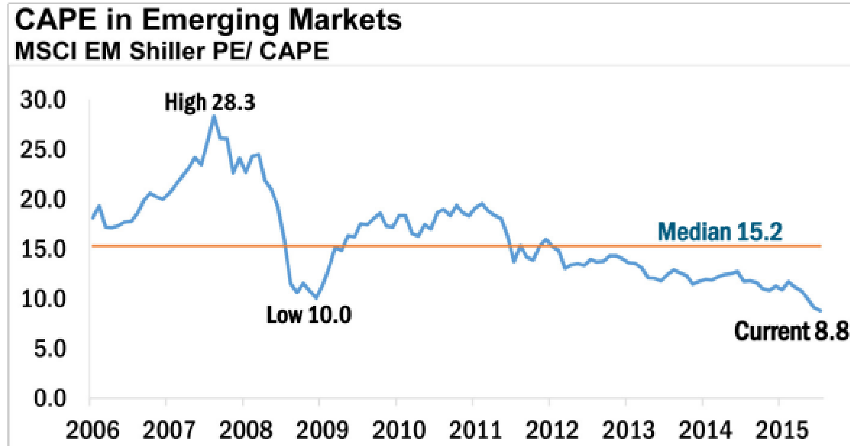
The primary reason why developing (emerging) market economies are expected to grow at more than double the rate of the developed world in the next two years is because their populations are much younger. The working class in EM countries is growing, and this helps to drive long-term economic success.

Ratio of Working-Age to Non-Working Population, 2010 to 2025

	Developed Economies			Emerging Economies		
	U.S.	Germany	Japan	China	Brazil	India
2010	2.0	2.0	1.8	2.6	2.1	1.8
2020	1.8	1.8	1.4	2.5	2.3	2.0
2025	1.7	1.6	1.4	2.4	2.2	2.1

When you have a greater percentage of a country’s population out of work, instead of gainfully employed, it creates a bigger drag on the long-term growth of that country. Baby boomers are retiring in the U.S. and Japan’s working population has been on a steady decline for decades. By comparison, emerging economy demographics are young and growing. The difference in demographics between emerging markets and developed markets should help boost earnings in emerging market countries over the long-term.

However, earnings are just one part of the story. An investment company could grow earnings spectacularly but have a stratospheric valuation that is *already* pricing in that earnings growth. Fortunately, emerging market equities are trading at deeply discounted valuations. One valuation measure we follow closely is called the CAPE ratio. CAPE stands for Cyclically Adjusted Price to Earnings Ratio and is a valuation method that factors in earnings over a ten year period to adjust for a full market cycle. Low CAPE ratios have historically preceded strong long-term returns. The CAPE ratio for EM equities is currently at 8.8 compared to a historical median of 15.2, a discount of 42%, as you can see in the graph on the next page. By comparison, the U.S. equity market is trading at a CAPE ratio of 25.1.



Other valuation measures tell a similar story. The current Price-to-Book ratio for EM equities is 1.38 compared to a historical average of 1.83, a discount of 25%.

We encourage investors to have patience with areas that have underperformed recently and to keep their eyes on the long-term opportunity that can come as a result of owning investments with solid growth prospects trading at attractive valuations. U.S. economic growth has been steady and solid. That fact warrants a continued allocation to U.S. equities. However, growth opportunities and valuation discounts abroad are too significant to pass up. Even though the short-term underperformance of these areas, relative to U.S. stocks, has been disappointing, we believe that investor portfolios will be rewarded by allocating to them over the long-term. As always, we appreciate the confidence and trust you have placed in us and look forward to 2016 and another year of helping you pursue your goals.

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