SAGE FINANCIAL GROUP
Investment and Wealth Management

**SAGE INSIGHTS**
MONTHLY ECONOMIC & MARKET ANALYSIS

November 2015

# October Provides a Bounce for Many Investments

## Overview

After experiencing a significant downturn in the third quarter, U.S. and international stocks rebounded sharply in October. The rebound across many assets was driven by a number of factors, including the promise from central bankers across the globe to keep monetary policy easy for the near future and a perception that the volatility experienced in August and September was excessive. Although volatility was noticeably absent from the stock market for the last few years, and a correction was long overdue, the speed with which markets turned lower was extreme, and the bounce in October helped to reverse some of that. U.S. economic data continues to show signs of a modestly expanding economy. The government's initial estimate of third-quarter GDP showed the U.S. economy growing at a 1.5% annualized pace, down from the 3.9% pace registered in the second quarter. Consumer spending, aided by lower oil prices and an improving labor market, expanded at a 3.2% pace in the third quarter. Inflation continues to be very subdued, growing at just 1.2%, annualized, over the last quarter. The Federal Reserve kept its interest rate policy on hold during the month, and the European Central Bank indicated that it was willing to expand its stimulus to boost economic growth and asset prices. Whether or not the Fed begins its rate hiking program this year remains an open question, and the lack of clarity on the timing of that decision will likely lead to continued uncertainty in both fixed income and equity markets.

## Performance

Stocks, bonds, and alternative investments all advanced in October, but many are still negative YTD.

| Index Name | October | 2015 YTD | 5-Year Annlzd | 10-Year Annlzd | Category |
|---|---|---|---|---|---|
| BarCap Municipal TR USD | 0.40 | 2.17 | 4.28 | 4.74 | US Muni Bonds |
| BarCap US Agg Bond TR USD | 0.02 | 1.14 | 3.03 | 4.72 | US Taxable Bonds |
| BarCap US Corporate High Yield TR U | 2.75 | 0.23 | 6.18 | 7.62 | US Corporate HY Bonds |
| JPM EMBI Global Diversified TR USD | 2.74 | 2.67 | 4.91 | 7.34 | Int'l/Emerging Bonds (USD) |
| JPM GBI EM Global Diversified TR USI | 4.53 | -11.06 | -2.95 | 5.11 | Int'l/Emerging Bonds (Local) |
| | | | | | |
| HFRX Equity Hedge USD | 1.90 | -1.28 | -0.12 | 0.21 | Hybrid/Hedged Equity |
| | | | | | |
| DJ Industrial Average TR USD | 8.59 | 1.04 | 12.51 | 8.18 | US Equity -- Large |
| S&P 500 TR | 8.44 | 2.70 | 14.33 | 7.85 | US Equity -- Large |
| NASDAQ Composite TR USD | 9.44 | 7.68 | 16.42 | 10.17 | US Equity -- Large |
| | | | | | |
| Russell 1000 TR USD | 8.09 | 2.43 | 14.32 | 7.98 | US Equity -- Large |
| Russell Mid Cap TR USD | 6.20 | -0.01 | 13.91 | 8.85 | US Equity -- Mid-sized |
| Russell 2000 TR USD | 5.63 | -2.53 | 12.06 | 7.47 | US Equity -- Small |
| | | | | | |
| MSCI All Country World Index ex-US | 7.44 | -1.82 | 2.60 | 4.16 | Int'l Equity -- Comprehensive |
| MSCI EM NR USD | 7.13 | -9.45 | -2.80 | 5.70 | Int'l Equity -- Emerging |
| | | | | | |
| Bloomberg Commodity TR USD | -0.45 | -16.18 | -9.85 | -5.10 | Commodities |
| HFRX Global Hedge Fund USD | 1.46 | -1.63 | 0.10 | 0.58 | Multi-Asset Alternative Invm't |

*Source: Morningstar Direct. Data through 10/31/2015*

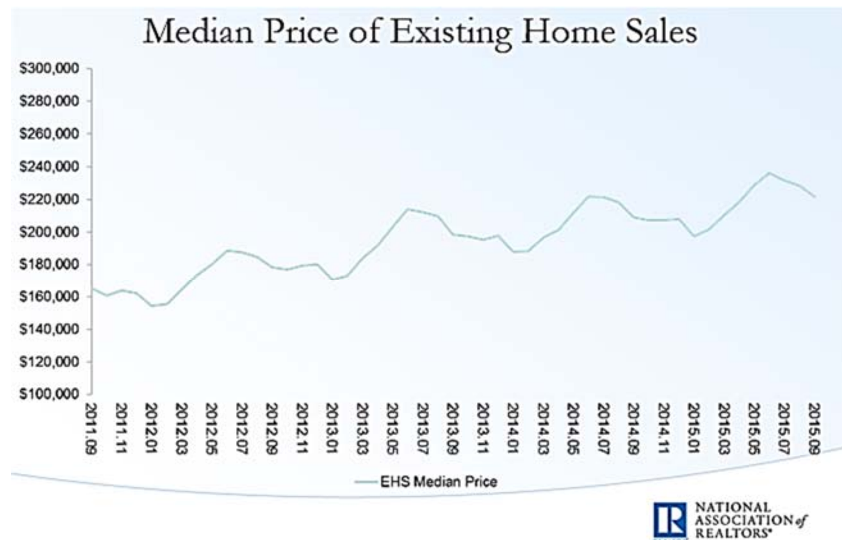
Both U.S. and international equity indices jumped in October, as markets recovered much of the ground lost in August and September. Little changed in the underlying data or economy; rather, investors seemed to offer the verdict that the drawdown experienced in the prior two months went too far too fast. The S&P 500 rose 8.44% in October, while the MSCI Emerging Market Index gained 7.13%. Emerging market bonds performed well, with the U.S. dollar and local currency indices returning 2.74% and 4.53%, respectively.

For year-to-date returns through October, most investment returns are slightly positive or negative. Few asset classes have stood out from a return perspective. U.S. stocks are just barely positive, while developed market international equities are slightly negative. U.S. bond investments have been one of the strongest performing investments, but even that is not saying much given the YTD return of just 1.14% from the Barclays U.S. Aggregate Bond Index.

**Outlook**

Investment performance in October was a great start to the final quarter of the year. The S&P 500 Index posted its best monthly return in four years. The MSCI Emerging Markets Index, which has been much maligned given the slowdown in China, generated a return of 7.13%. The EM index is now up 11% from its 2015 low in August. While it is impossible to know where markets go from here in the short-term, the quick snapback rally in October shows how hard it is to time entry and exit points for investments. It also helps to illustrate why we at Sage take a long-term approach that acknowledges the day-to-day changes in the market but does not react to them. Stocks generally reward investors who wait out the ugly news headlines that dominate short-term trading, because over the long-run equities have proven themselves to provide returns that are unmatched in other asset classes. While the short-term swings up and down can be unpleasant and it is impossible to predict how long the current volatility episode will continue, we believe that the extreme volatility will be temporary because the U.S. economy is showing steady signs of growth.

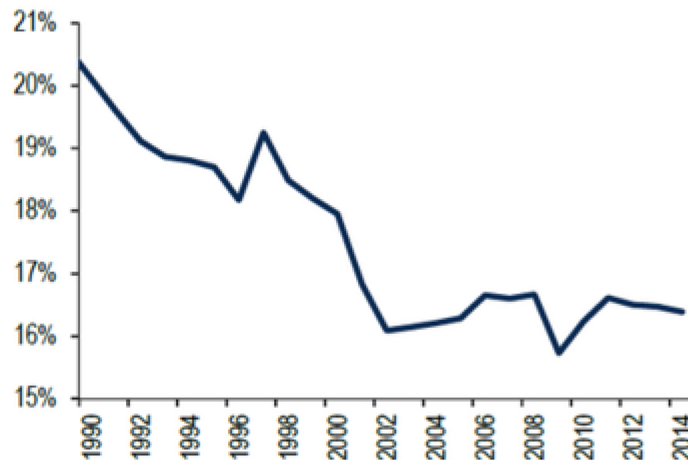
The general trend in U.S. economic data has been modestly higher. Different pockets of the economy have issued mixed reports, but overall there is continued slow growth. Capital intensive areas of the economy like manufacturing, mining, and industrial companies have been under pressure as commodity prices have fallen precipitously and business activity has turned lower. However, areas like retail sales, consumer confidence, and the housing market have all been performing well. According to the National Association of Realtors, existing home sales in September jumped 8.8% from the prior year. The median sales price rose 6.1% from the prior year. The housing market has continued to improve as a result of rock-bottom interest rates and a strengthening labor market. Both the rate of sales and price levels have been improving steadily over the last three years.




The Case-Shiller Composite Home Price Index, another widely-used gauge of housing market health, has increased, year-over-year, for 39 consecutive months. As house prices improve,

consumers feel the wealth effect of an appreciating asset and thus are often inclined to spend more in other areas of their budget or reinvest in their property. Housing is also a major driver of GDP growth, with some estimates putting its share of total GDP growth around 15%.

On the negative side, a downturn in spending in the industrial portion of the global economy has created some grim headlines. Caterpillar has announced layoffs, as have large oil companies like Chevron. The layoffs in heavy industrial companies have dragged down GDP growth and earnings results for certain sectors of the market. The drop in commodity prices creates a ripple effect for the companies that either extract those commodities or are directly involved in the supply chain. Growth in capital goods orders and various manufacturing indices have been tepid. However, the U.S. is not as dependent on heavy industrial production as it once was. For instance, the following chart shows that the industrial sector's share of GDP has fallen from 20% in 1990 to 16% today.




The U.S. has shifted to a service-oriented economy that is primarily fueled by growth in consumption, along with an increasing reliance on health care and technology. Consumer spending is about 69% of our nation's GDP. The broader point is this: the drop in commodity prices has resulted in worrisome headlines about lower spending and layoffs in the manufacturing sector. But consumers remain both the largest benefactor and the largest contributor to economic growth in the U.S., and lower commodity prices are a benefit to them.

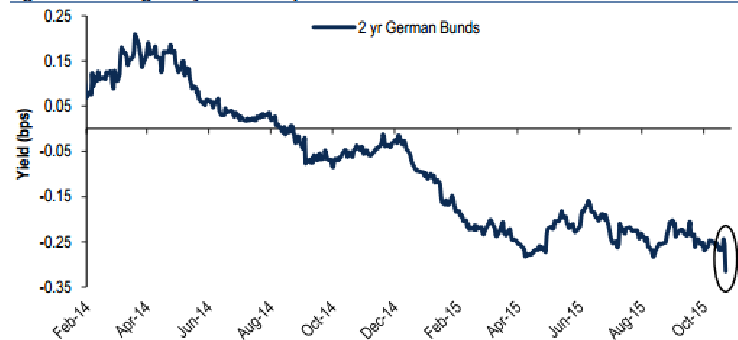
Steady growth in the job market, improving home prices, and lower commodity prices should continue to drive consumption in the U.S. and keep economic activity expanding. This is the primary reason why we believe that short-term volatility should be noticed but ultimately overlooked as that volatility relates to a portfolio's allocation to stocks. Because the Fed is not as readily providing liquidity now as it has formerly through measures such as QE, and because the Fed is likely to start raising interest rates, equity returns are most likely not going to rocket higher at the same pace that they have over the last three years. However, a continued expansion should be supportive for stock prices, which means that stocks should continue to be a dominant part of a diversified investor's portfolio.

**Building Blocks for International Equity Outperformance:**

- Lower Valuations
- Higher Dividend Yields
- Supportive Central Bank Policy

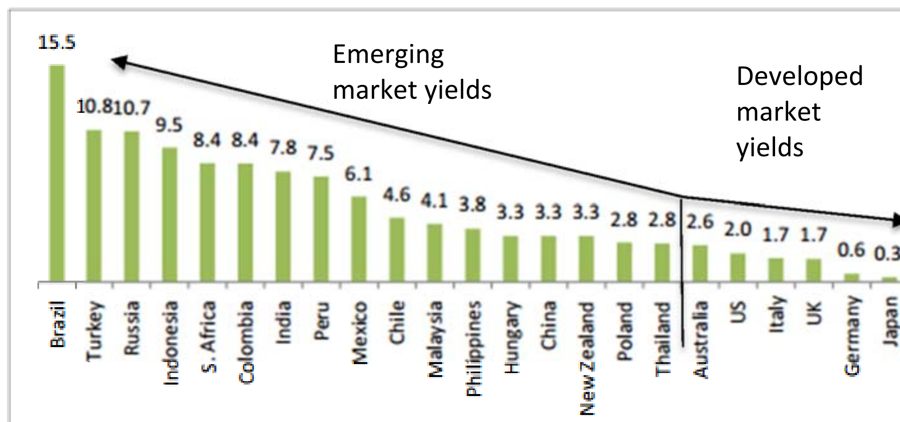
Though U.S. equity returns may be modest in the future, we continue to believe that international equity returns will provide relatively stronger returns than U.S. stocks going forward. International equities, including emerging markets, have a number of tailwinds that could provide support for future returns. We believe that the key building blocks to superior, long-term returns include attractive valuations, dividend yields, and supportive central bank policy. The MSCI EAFE Index trades at a forward P/E of 13.7 times compared to S&P 500 at 15.4 times, a discount of 11%. The MSCI EM Index has a forward P/E of 10.7 times, a discount of 31% to the S&P 500. International equities also have higher dividend yields than U.S. equities. The MSCI EAFE Index has a dividend yield of 3.32% compared to just 2.00% for the S&P 500. The MSCI Emerging Markets Index has a dividend yield of 2.98%. Lastly, foreign central banks, be it the European Central Bank, the Bank of Japan, or the People's Bank of China, have either been lowering interest rates and/or putting excess liquidity into the market via quantitative easing. By comparison, the Federal Reserve has discontinued QE and is on the verge of hiking rates. Again, this is not to say that U.S. stocks are dead in the water and international stocks are about to take off. Rather, we highlight these relative tailwinds to underscore the need to remain committed to international equities as part of a diversified portfolio.

Emerging market *bond*s are also another part of investor portfolios that have underperformed recently but remain a key ingredient to help generate positive returns in the future. A recent statistic provided by BofA Merrill Lynch helps illustrate the challenge faced by investors in fixed income markets. According to their analysts, *52% of all global government bonds yield less than 1.0%*. Fixed income is a necessary part of a portfolio because of the brake it provides to overall returns when stocks experience volatility. However, because government bonds across the developed world are trading at such low yields (as you can see in the chart in Figure 8 to the left), investors must either accept that future returns from traditional fixed income will be low or possibly negative, or they must wade out into other areas of the fixed income market that offer better return prospects.




Emerging market bonds are one such area that has experienced volatility in recent years, but, over time, should offer a return that outweighs the risk. The chart below, from Van Eck, shows the value proposition offered in EM government debt.

**10-Year Local Currency Sovereign Bond Yields (%)**




Source: FactSet as of 09/30/15

Even though emerging market bonds have underperformed traditional fixed income over the last few years, the asset class has shown before that it can bounce back following periods of stress. In 1998, during the emerging market financial crisis, the JP Morgan USD EM Bond Index plunged 8.11%, while the U.S. Barclays Aggregate Bond Index rose 8.69%. Returns snapped back quickly the next year, with the EM Bond Index rising 19.56% in 1999, while the Aggregate Bond Index fell 0.82%.

| | Returns Can Quickly Rebound | | | | |
|---|---|---|---|---|---|
| **Bond Index** | **1998** | **1999** | | **2011** | **2012** |
| Emerging Market Bonds | -8.11% | **19.56%** | | 2.80% | **17.10%** |
| US Core Bonds | **8.69%** | -0.82% | | **7.84%** | 4.21% |

*EM Bonds represented by JPM EMBI Global Diversified index (USD) in '98-'99, and a 50/50 split of JPM EMBI Global Diversified index (USD) and JPM GBI-EM Global Diversified index (Local) in '11-'12 due to local index data starting in 2003. U.S. Core Bonds represented by Barclays US Aggregate Bond index*

In 2011, emerging market bonds sharply underperformed traditional bonds. A blended EM bond index (50% JP Morgan Local EM Bond Index, 50% JP Morgan USD EM Bond Index) returned just 2.8%, while the Barclays US Aggregate Bond Index gained 7.84%. However, in 2012, that same blended EM bond index jumped 17.10%. We do not profess to know exactly when emerging market bonds may turn around relative to traditional bond indices. Volatility may continue in the asset class, but we believe that in a fixed income environment where so many bonds are yielding next to nothing, it is necessary to incorporate emerging market bonds into a diversified portfolio allocation to benefit from the discounts offered.

In order to achieve their financial goals, most investors' time horizons are measured 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. The short-term swings 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 would 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 trading at attractive valuations (or yields) that have underperformed.

As hard as it is right now to own out of favor investments like international stocks and bonds, investors would do well to use history as a guide. In 1999 it was extremely difficult to own out of favor investments, which was anything outside of the tech sector. We remember how well that turned out for those who abandoned other asset classes and moved into a tech heavy allocation. (It turned out very poorly for tech-heavy investors after the turn of the millennium when the bubble burst.) In the mid-2000's, emerging market stocks were generating sensational returns for investors, only to move into their present slump. In 2007, housing and financial stocks were the hot sector of the market, only to collapse in the crisis. Over the last five years, U.S. stocks and bonds have performed incredibly well and many have asked, "Why own anything else?" While U.S. stocks remain a necessary part of any long-term portfolio allocation, Sage wishes to remind clients that investment market stories and themes don't always repeat, but they often rhyme, and a diversified portfolio would do well to hang on to out of favor assets.

*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.*

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