SAGE INSIGHTS
MONTHLY ECONOMIC & MARKET ANALYSIS

August 2016

Stock Markets Continued to Improve in July

Overview

After many initial misgivings about the Brexit decision in June, both stock and bond markets moved higher in July, generating positive returns both in the U.S. and overseas. International developed equities were lower in June after the Brexit decision but bounced sharply in the month of July. The MSCI All Country World Ex-US Index returned 4.95% during the month, and the international benchmark is now up 3.88% for the year through July. U.S. stocks continued to move upwards and flirted with all-time highs in the S&P 500 index during the month.

The Federal Reserve kept rates on hold at its most recent meeting held in July but indicated that it may still hike rates twice this year. The central bank observed that the U.S. economy has been expanding at a "moderate rate" characterized by strong spending by households, improving labor markets, and low inflation. While the Fed's report on the economy and inflation seems to signal that it had the flexibility to raise rates at its recent meeting, global market moves and political events such as Brexit continue to hold the Fed back from raising rates. If global equity prices continue to rise and job market data reflect steady growth, the Fed may seek to raise rates in September. In this edition of *Insights,* we review some key investment principles before discussing risks and opportunities tied to the U.S. presidential election and the current growth situation in the U.S. and Europe.

Performance

U.S. stocks and bonds generated positive returns during the month and registered strong YTD returns.

Index Name	July	2016 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	0.06	4.40	5.13	5.01	US Muni Bonds
BarCap US Agg Bond TR USD	0.63	5.98	3.57	5.06	US Taxable Bonds
BarCap US Corporate High Yield TR USD	2.70	12.01	6.16	7.74	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	1.80	12.30	6.44	7.83	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	0.60	14.71	-2.38	5.34	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	1.99	-2.00	0.13	-0.64	Hybrid/Hedged Equity
DJ Industrial Average TR USD	2.94	7.38	11.52	7.92	US Equity -- Large
S&P 500 TR	3.69	7.66	13.38	7.75	US Equity -- Large
NASDAQ Composite TR USD	6.65	3.82	14.78	10.60	US Equity -- Large
Russell 1000 TR USD	3.81	7.69	13.22	7.89	US Equity -- Large
Russell Mid Cap TR USD	4.57	10.31	12.73	8.79	US Equity -- Mid-sized
Russell 2000 TR USD	5.97	8.32	10.43	7.17	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	4.95	3.88	1.35	2.26	Int'l Equity -- Comprehensive
MSCI EM NR USD	5.03	11.77	-2.75	3.91	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	-5.11	7.46	-12.27	-6.38	Commodities
HFRX Global Hedge Fund USD	1.45	0.62	-0.15	-0.13	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 7/31/2016

The S&P 500 Index was up 3.69% in July, hitting an all-time high and increasing its YTD return to 7.66% for the year. The MSCI Emerging Market Index continues to be one of the best-performing stock market indices this year; it returned 5.03% in July and is now up 11.77% in 2016.

Fixed income investments continued to perform well as yields continued to move ever lower. The Barclays US Aggregate Bond Index is up 5.98% YTD, and the Barclays US Corporate High Yield Index is up 12%. Emerging market bonds have also notched solid gains, with the JP Morgan Emerging Market US Dollar Bond Index returning 12.30% year-to-date.

Outlook

Despite significant geo-political disruption this year, investment markets have provided strong returns through July. The strength of equity and bond market returns is surprising in light of how 2015 ended. If we think back to last year, U.S. large cap stocks were effectively flat, small cap stocks had negative returns, and international equities were sharply lower, especially within emerging markets. If investors were tipped off on January 1st that in 2016 Britain would vote to exit the EU, a number of terrorist attacks would occur in the Western world, the S&P 500's earnings would continue to fall, and an attempted coup would take place in Turkey, many investors may have been tempted to wait on the sidelines until things settled down. Yet here we are with U.S. stock indices at all-time highs and emerging market equities, the worst equity performer last year, registering the best equity return so far this year. In addition to focusing on recent economic developments in this issue of *Insights*, we think that events taking place in 2016 provide an opportunity to step back and focus on some key investing principles.

There are a number of factors at play here. We have previously discussed two distinct investing axioms that characterize the market: (1) the perennial "Wall of Worry" that investors face, and (2) the penchant for markets to have a greater likelihood of positive returns if investors lengthen their holding period. The "Wall of Worry" is the phenomenon that in the face of what might seem like insurmountable bad news, stocks markets often grind ever higher and reward investors who stick with their equity holdings. As long as risks are present there will always be the temptation for an investor to bail on the stock market. Economic slowdowns, political posturing, and volatility spikes have *always* characterized the investing climate, and 2016 is no different. Yet U.S. and international equity markets have provided positive returns this year, even though some of the risks seem more pronounced than in other years.

Part of the reason is that markets are *forward* looking rather than backward looking, and many of the issues of the day have been already processed by the market. Take, for instance, the earnings slowdown that occurred last year and in first quarter of 2016. Much of the slowdown was attributable to the stronger dollar and the massive decline in commodity prices. As the year has progressed, the dollar has softened, which eases the headwind on international revenues. Conversely, the rebound in oil and natural gas prices will lead back to positive earnings growth for the material and industrial sectors. These two elements should combine to provide the broad U.S. stock market with improved earnings in the second half of the year, which investors have begun to anticipate.

The important lesson for investors this year is that the push and pull between short-term risks and long-term opportunity will always be present within the stock market. The market's ability to move past ugly headlines is a function of a number of fundamental factors that are geared toward positively contributing to the stock market's ability to generate positive long-term returns most of the time. First, stocks often pay a dividend that yields more than cash. While it is not guaranteed income, it is a persistent source of positive returns. At present, the S&P 500's dividend yield is 2.0%, which is well above what a money market account or fund yields. Second, the natural trajectory of a free market economy such as that found in the U.S. is to grow. This is a result of population and productivity growth, which contributes to revenue growth across the broad market. Finally, modest inflation also tends to contribute to revenue and earnings growth. The combination of dividend payouts and growth in population, productivity, and inflation is a key reason for the tendency of the market to deliver positive long-term returns.

The persistency of these long-term factors is why Sage advocates investment patience and not reacting to short-term risks. Although the aforementioned elements of the economy may fluctuate (which leads to recessions and expansions), they generally drift higher over the long-run. It is important for investors to keep this in mind because there will *always* be short-term volatility events in reaction to apparent risks. Yet investors must keep their eye on the long-run. The machine that is the U.S. economy is geared for innovation and growth in spite of short-term setbacks. As a result, the odds are generally, though not always, skewed towards positive long-term returns for investors.

One of the risks that has been dominating the news cycle is the upcoming U.S. presidential election. With lengthy primaries, constant media coverage, and no shortage of colorful statements, the election news cycle is likely to gather more steam as we get closer to November. In a previous edition of *Insights*, we noted that stock market returns during an election year have been on pace with returns during non-election years. In short, election year occurrences from 1960-2015 have had little bearing on whether or not stocks posted a return in that year that was fairly close to historical averages. It also mattered little whether the incumbent president *or* newly elected president was a Republican or a Democrat. In election years in which a Democrat was elected, the average return of the S&P 500 was 7.18%. Excluding 2008, that number jumps to 14.55%. In years in which a Republican was elected, the average calendar-year return for the S&P 500 Index was 12.44%. By comparison, the average S&P 500 in all years (election of no election) was 11.18%. In other words, the party affiliation of the incoming President has no significant bearing on the average long-term market returns.

Regarding the nominees from both major parties, both Clinton and Trump face unique challenges in moving to secure the White House. Clinton's battle in the swing states lies in winning over rust-belt voters who feel they have been left behind by globalization and free trade. She also needs to secure votes from young, millennial voters who were either enthusiastic about a Sanders campaign or who feel a deep-seated distrust in the "establishment," which she represents. Conversely, Trump faces significant challenges in generating votes from non-white voters.

Uphill Battles – Swing States

Clinton Win	
Needed Voters	**Key States**
• Hispanic/Latin American voters who voted for Obama in 2012	Arizona, Nevada, Florida, Colorado
• Young/millennial voters who voted for Sanders in the primaries	Georgia, North Carolina, Iowa, Virginia
• Moderate republicans who disagree with Trump's policies and may opt for a libertarian candidate	New Hampshire, Pennsylvania, Maine, Ohio
• Rust-belt voters, pro-union and anti-free trade supporters	Michigan, Wisconsin, Ohio

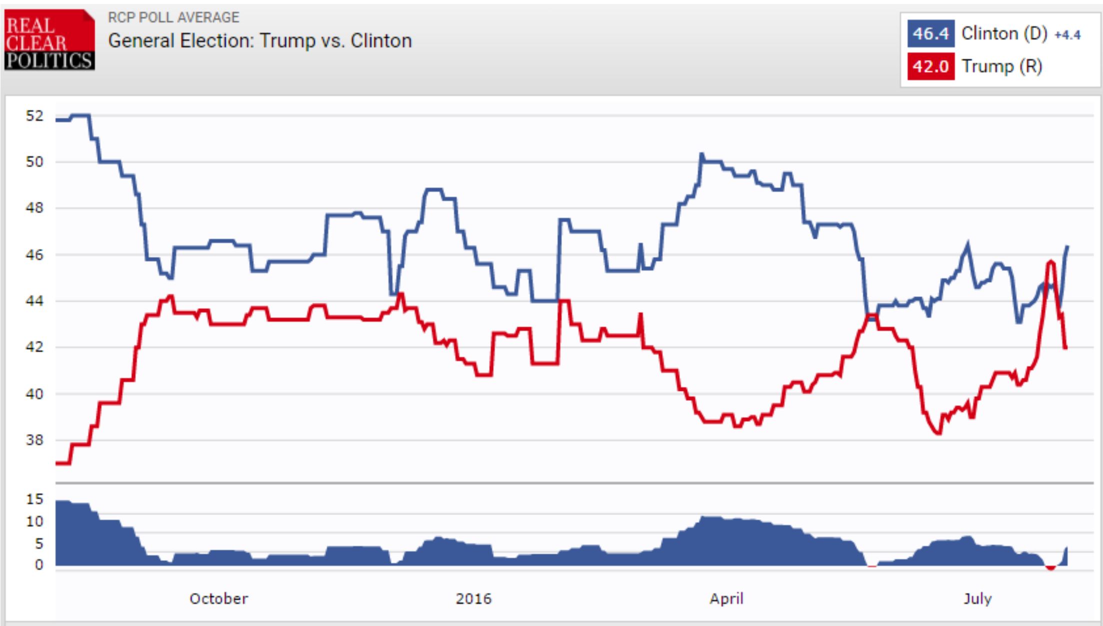
Uphill Battles – Outperforming 2012 Romney Gains

Trump Win	
Needed Voters	**Key Statistics**
• More Caucasian working-class voters than Romney did in 2012	65% Trump vs. 61% Romney
• College-educated Caucasian voters	46% Trump vs. 56% Romney
• Ethnic Minorities, esp. Latin/Hispanic American voters. Trump has made non inroads among African American voters who overwhelmingly voted for Obama in 2012 and Clinton in the 2016 Primaries.	Hispanics have grown from 2% to 10% of voters. Romney won 27% of Hispanic vote in 2012, compared to 43% by Bush in 2004
• Women voters	Women comprise 53% of all voters
• Caucasian Men	69% Trump vs. 62% Romney
• Caucasian Women	47% Trump vs. 57% Romney

Note: Exit polling results 2012 Presidential election and 2016 primaries. Source: Politico, Washington Post, Huffington Post and Citi Research.

Hispanics comprise a growing share of the voting population, and the trends are not in his favor. According to Citi, Bush won 43% of the Hispanic vote in 2004 while Romney won just 27% of the Hispanic vote. Based on early polling, Trump is likely to garner even less of the minority vote than Romney.

In terms of broad polling, Clinton has fairly consistently led national polling, trailing only shortly after the Republican National Convention. After the Democratic National Convention, she has resumed her lead in national poll averages.



As of 8/2/2016

While the national popular polls are fairly close, state-by-state polling as it fits into the Electoral College favors Clinton by a fairly wide margin. According to the website FiveThirtyEight, a popular election statistics site, recent polls in Florida and Pennsylvania, key swing states that Trump would need to win in order to swing the overall Electoral College vote in his direction, have been mixed. Florida's most recent polls favored Clinton by 4 percentage points, while Pennsylvania's most recent polls favored Trump by 6 percentage points. Ohio, another key swing state, saw its most recent poll favor Clinton by 4 percentage points. To put it simply, Trump would need to gain ground in these key states to push the Electoral College in his favor. If he is unable to secure Pennsylvania, Ohio, and Florida, his ability to win the White House seems near impossible.

In terms of policies, each candidate has struck a different path on a number of issues. Trump has opted for more of an isolationist posture, while Clinton's has largely echoed the importance of existing allegiances such as NATO. Trump has promised to simplify the tax code and lower individual and corporate taxes, while Clinton has pledged to raise marginal rates and cap itemized deductions. Trump has advocated scrapping the current trade deals in place, while Clinton has largely but not unequivocally said that she is largely in favor of the existing trade deals such as NAFTA.

What Might the World Look Like After November?

• Domestic Policies

	Clinton	Trump
Infra-structure	A Clinton administration is likely to boost infrastructure spending to create jobs and growth.	Likely to boost infrastructure spending. States that he is committed to rebuilding US infrastructure and although has not put forward a specific proposal, has described his infrastructure plans as "one of the biggest projects this country has ever undertaken".
Healthcare policy & Pharma	Clinton is pro-Obamacare. She has pledged to defend the Affordable Care Act and expand coverage, crack down on the increasing prices for prescription drugs, and protect women's access to reproductive health. Throughout her career, Clinton has focused on expanding access to health care and her administration would continue these efforts. Despite Clinton promising to crack down on rising prescription drug prices, the pharmaceutical industry has donated $589,344 to her campaign, which is more than any other candidate. It is possible that a Clinton administration would have a slightly more toned down approach compared to her current anti-pharma rhetoric. Also note that Clinton has received most contributions overall, not just from pharma.	Trump would try to repeal Obamacare and replace it with reforms that follow "free market principles" – either have significant health care reform or replace Obamacare with individual programs. Trump has criticized the pharmaceutical industry for high drug prices. He wants to renegotiate the prices Medicare pays for drugs.
Taxation	Clinton's tax proposals might increase revenues over the next decade. The Tax Policy Center (TPC) estimates a total increase of $1,077 billion over the 2016-26 span. The Tax Foundation (TF) projects an increase of at most $498 billion, or $191 billion after accounting for their impact on economic growth. This additional revenue comes from (1) higher marginal tax rates, (2) raising taxes on a high-income taxpayers, (2) a cap on itemized deductions; (3) raising taxes on multinationals; (4) repealing fossil fuel tax incentives; and (5) increasing estate and gift taxes. The Tax Foundation (TF) says that Clinton's desire to alter the long-term capital gains rates schedule might reduce revenue due to increased incentives to delay capital gains realizations.	The Tax Foundation (TF) estimates that Trump's tax proposals might reduce Federal government revenue over the next decade by $11 trillion dollars. The Tax Policy Center (TPC) projects a reduction of $9.5 trillion. The reduction in revenue would derive from (1) simplifying the tax code; (2) reducing marginal tax rates and the cost of capital; (3) lowering individual income and corporate income taxes; and (4) increase standard deduction amounts and curtail many tax expenditures.

Source: Citi Research, as of 7/21/16

One interesting area where both candidates agree relates to increased infrastructure spending in the U.S. Both candidates see the need for improving our roads, bridges, and civil structures, and they see the opportunity to take advantage of the country's incredibly low borrowing costs. We highlight the point because this one area of general agreement represents an initiative that would, out of all proposed plans, have the best chance of improving economic growth in this country. Since the end of the financial crisis, U.S. economic growth has been fairly lackluster as consumers have been reticent to spend and have paid down debt. State and local governments have also reigned in spending as tax bases have shrunk. Approving projects to improve the nation's infrastructure would likely increase demand for materials and lift the jobs market. Indeed, various officials at the Federal Reserve have advocated that the government play a meaningful part on the fiscal side of the stimulus equation.

In a speech earlier this year, Federal Reserve Chairwoman Janet Yellen stated, "It certainly would be helpful to see fiscal policy play a larger role, especially investment oriented fiscal policy." This element of economic policy, if pursued, could be a potential positive for investment markets after the election. To be certain, there could be volatility after the election as well. If Trump is elected and he is perceived to threaten existing trade deals or geo-political negotiations, the markets would likely not react favorably to the increased uncertainty. If Clinton is elected and she moves to implement some of the more progressive tax policies she endorsed in the primaries, investors would worry about the effects on consumer spending and business investment.

Notable contributions to Q2 growth

CONSUMER SPENDING
+2.83 pct. pts.

NET TRADE
+0.23 pct. pts.

GOVERNMENT SPENDING
–0.16 pct. pts.

RESIDENTIAL INVESTMENT
–0.24 pct. pts.

BUSINESS INVESTMENT
–0.28 pct. pts.

CHG. IN PRIVATE INVENTORIES
–1.16 pct. pts.

Source: *Wall Street Journal*, 7/29/2016.

Regarding the U.S. economy, there has been steady, if unspectacular growth through the first half of the year. The Bureau of Economic Analysis estimated that the U.S. economy grew at a 1.2% annualized rate in the second quarter of the year. Although this was below analyst estimates of a 2.0% growth rate, much of the expected growth rate was diminished by inventory declines, which in turn may contribute to better than expected growth in the second half of the year. Notably, the change in consumer spending was better than expectations, with personal consumption increasing at a 4.2% rate, its best gain since 2014. With unemployment at 4.9%, gas prices holding steady at low levels, and credit fairly easy to obtain, the U.S. consumer is in a solid position. In its most recent earnings report, Visa noted that "the consumer has remained remarkably steadfast in the face of significant global instability."

On European economic growth, Britain has faced its fair share of road bumps after the Brexit vote. Business confidence has fallen, and various economic gauges have declined due to the uncertainty resulting from the referendum. However, much of the malaise from Brexit has been limited to the UK. Germany's manufacturing output reached its highest level since early 2014 in a recent survey, boosted by a strong jobs market and improving demand. Germany's unemployment rate is at its lowest level since West and East Germany were reunified. European business sentiment has also improved in recent months.

In closing, despite the increase in political risk this year, stock markets have performed very well and have benefitted investors who have been patient with their equity allocations. Nevertheless, volatility may rise again as the U.S. presidential election nears. The major investment takeaway from potential election outcomes is that Sage is not currently recommending any drastic changes to a diversified portfolio. As always, we will observe and assess the risks and opportunities that may arise depending on who the next president is and what the congressional make up looks like. However, we are not in the business of trying to forecast specific events and make bets in anticipation of the outcome. As we highlighted above, the key factors behind the stock market's strong, long-term track record of positive returns are fairly resilient to short-term political uncertainty. Even if there is a spike in volatility in the wake of the election, we believe that there are sufficient buffers within a diversified portfolio to help ease the effect of such volatility.

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