May 2016

Stocks Continue to Move Higher in April

Overview

After a rally to close the first quarter, both stocks and bonds continued to generate positive returns in April. International developed markets were the best-performing equity investment during the month, with the MSCI ACWI Ex US Index returning 2.63%. Despite the significant volatility experienced in January and February, many equity indices – large and small, developed and emerging –now have positive year-to-date returns. Economic data in the U.S. has continued to show signs of modest growth. The initial government estimate of first quarter GDP reported that the U.S. economy advanced at a 0.5% annualized rate. Other areas, such as the job and housing markets, continue to reflect improvement.

While the pace of growth in the U.S. is not rapidly accelerating, it is also not flashing warning signs of a recession. We noted in last month's *Insights* that much of the volatility in the early part of the year seemed indicative of the market's fearing an imminent recession in the U.S. economy. The market's advance from February lows has been aided by data's being better than expected and by a more lenient outlook on interest rates from the Federal Reserve. In this version of *Insights* we explain why the low first quarter GDP does not overly trouble us, discuss the likelihood of a British exit from the European Union, and provide an update on the Federal Reserve.

Performance

Most investment indices were up in April, which continued their trend higher from March.

Index Name	April	2016 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	0.74	2.42	5.37	4.94	US Muni Bonds
BarCap US Agg Bond TR USD	0.38	3.43	3.60	4.95	US Taxable Bonds
BarCap US Corporate High Yield TR USD	3.92	7.40	5.41	7.35	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	1.77	6.90	6.30	7.39	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	2.57	13.87	-2.41	4.94	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	0.03	-2.91	-1.23	-1.19	Hybrid/Hedged Equity
DJ Industrial Average TR USD	0.62	2.83	9.52	7.34	US Equity -- Large
S&P 500 TR	0.39	1.74	11.02	6.91	US Equity -- Large
NASDAQ Composite TR USD	-1.89	-4.27	12.05	8.58	US Equity -- Large
Russell 1000 TR USD	0.54	1.72	10.81	6.99	US Equity -- Large
Russell Mid Cap TR USD	1.06	3.33	9.88	7.49	US Equity -- Mid-sized
Russell 2000 TR USD	1.57	0.03	6.98	5.42	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	2.63	2.25	-0.13	1.70	Int'l Equity -- Comprehensive
MSCI EM NR USD	0.54	6.29	-4.61	2.36	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	8.51	8.96	-13.32	-6.01	Commodities
HFRX Global Hedge Fund USD	0.41	-1.47	-1.19	-0.58	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 4/30/2016

The S&P 500 Index rose 0.39% in April, although declines in shares of Apple and Google particularly dragged on the NASDAQ Composite Index, which fell 1.89%. The MSCI ACWI Ex US Index, which tracks large cap equities in developed countries like the U.K., Japan, and Germany, jumped 2.63%. Emerging markets, which were much maligned at the start of the year, are one of the best-performing investments this year with one of the sharpest bounces since markets bottomed, and this despite political turmoil in Brazil, rampant fears of a Chinese currency devaluation, and commodity risks in Russia. The MSCI Emerging Market Equity Index is up 6.29% YTD and has returned *18.29%* since February 11.

Commodities continued to rally in April. The Bloomberg Commodity Index gained *8.51%* during the month. This has helped to propel higher the energy sector and investments like Master Limited Partnerships (MLPs). MLPs operate the pipelines that transport oil and natural gas, and they are an investment Sage made midway through 2015 *after* a substantial price decline from their peak in 2014. As commodity prices continued to decline, MLPs also continued to participate in the downside. Yet they have been one of the best-performing investments since the market's recent low in February. Since February 11 through the end of April, the Alerian MLP Index has jumped *48%* and is now up 6.42%, YTD, outperforming the S&P 500 by 4.68 percentage points in 2016. MLPs are an asset from which we have been expecting attractive long-term returns because of its compelling income stream -- the Alerian MLP Index yields 7.74% -- and the potential for capital appreciation due to a growing need for improved energy infrastructure to deliver energy commodities to end-users.

In summary, investment markets have staged an incredibly rally from the lows in February. While the drawdown in equity investments was rapid, the bounce back has been just as quick, and it has served as a reminder of how difficult it can be to time entry and exit points. For most investors, it has been better to remain committed to the long-term view on their investments and ignore the short-term volatility.

Outlook

On the U.S. economy, we want to highlight a few reasons why we are not overly concerned with the trajectory of U.S. growth despite how long the current expansion has lasted (nearly 7 years) and how slow the first quarter growth rate may appear. First, growth has not been remarkable, but relative strength, including a better than expected result, can be quite sufficient even if the growth number looks weak on an absolute basis. Many investors have come to expect weak growth in the first quarter. In fact, there have been two negative Q1 GDP reports in the last four years. Second, the current economic expansion has been characterized by slow growth that is below the historical average pace. One reason is that consumers have continued to exhibit conservative spending habits as the expansion has progressed, rather than more aggressive spending as they have in prior economic booms. We will examine these two elements more closely below and offer some insight into why we are optimistic on the current economic state of the U.S.

First, when we analyze the current expansion (i.e., since the last recession ended in 2009), we observe that the first quarter of each year notoriously produced a weak GDP figure. Part of this may result from the decline in spending and productivity from the fourth quarter, which is fueled by holiday shopping, and another part of it may be weather-related since many storms occurring in January and February can disrupt business activity. The following table shows average GDP growth in the first quarter, compared to quarterly growth during the rest of the year, since the start of the current economic expansion.

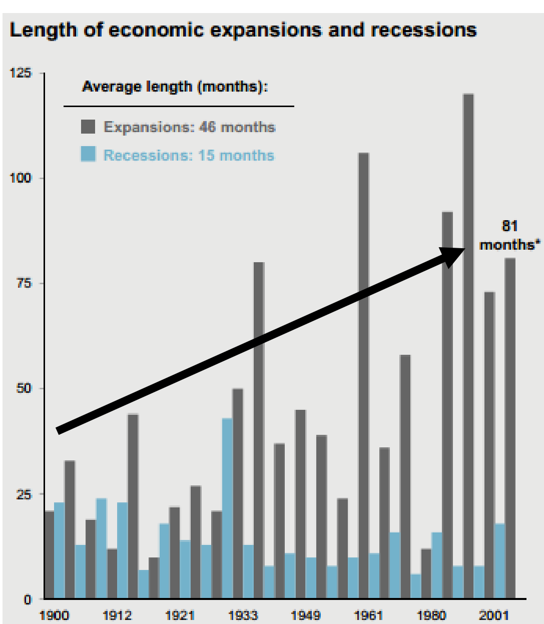
Average Annualized GDP Growth	
First Quarter	Remaining 3 Quarters
0.71%	2.53%

Source: St Louis Fed, data from 4/1/09 to 3/31/16

You can see in the table above that since 2009 the average growth in the first quarter is just 0.71% compared to 2.53% for the rest of the year. While the government tries to smooth out the effect that seasonal forces may have on the data, it has struggled to get Q1 right. The first quarters in 2011 and 2014, for instance, showed a GDP *decline.* Although the most recent first quarter 2016 GDP report of 0.5% was not spectacular, it was fairly close to what the economy has experienced in other recent first quarters, and the market seems to have come to expect this annual pattern.

Second, another reason why sluggish first quarter growth is not especially worrisome is the fact that since the end of the financial crisis growth has been substantially below historical levels. This is another way of saying that slow growth has been par for the course. Since the U.S. exited the 2008 recession, GDP growth has averaged 2.1%, annualized. By comparison, the U.S. has historically (since the BEA started recording data in 1947) grown at a 3.1%, annualized rate. Since 2009, there have been fits and starts, fears of a "double dip" recession, and a hesitancy on the part of both businesses and consumers to spend money. Rather than take out increasing amounts of debt as the economy continued to grow, as has been the case in previous expansions, many consumers have either saved their income or used it to pay down excess debt that lingered from the financial crisis.

To cite one example, the plunge in oil prices over the last two years accompanied a jump in the personal savings rate from 4.6% to 5.4%. Previous expansions witnessed an increasing level of risk-taking and spending as the expansion progressed. Conversely, this expansion has seen consumers stay committed to staying conservative. As with a slow start to the year, economic growth that is consistent but at levels less than the long-term average seems to be part of the current healthy baseline. It is also worth pointing out that the U.S., despite below-average growth, has still been growing at a faster and more consistent rate than other parts of the developed world.



Source: JP Morgan

The nearby chart from JP Morgan helps to illustrate our thinking about the current economic outlook in an interesting way. On the chart on the left, you can see that economic expansions have been progressively getting longer and longer since the early 1900's.

> ***Expansions have gotten longer as the U.S. economy has evolved from an industrial economy to a service economy.***
>
> ***Cyclical booms and busts are not as prominent in areas like health care, which are a larger part of our economy, as compared to manufacturing or industrial sectors.***

A key reason why expansions have gotten longer is due to a greater resiliency within some of the core industries in the American economy. Health care, which depends more on durable trends like an aging population, is a greater part of our economy than areas like manufacturing, which are easily susceptible to booms and busts. We can see this dynamic playing out in some of the jobs market data that has been recently released. For instance, despite widespread layoffs in the oil and gas industry due to the downturn in commodity prices, the initial jobless claims rate in the U.S. (which measures layoffs) just recently hit its lowest level in 42 years. GDP may be slow, but it is not pointing to a recession in our view. This is not to say that we will not experience a recession again in the U.S. Rather, it is to point out that it is not entirely surprising that the current expansion has lasted so long given how modest the boom has been, and the economy may continue to grow at a modest rate going forward.

Looking abroad, one area of increasing interest in the investment market's eyes is that of the potential British exit from the European Union, which has been coined "Brexit" by the media. The United Kingdom faces a significant referendum on June 23 this year when British citizens will vote on whether to leave or remain in the European Union. We touched on this in last month's *Insights* but want to provide an update, with greater detail, on some of the recent news.

Britain's Independence Party (which received about 13% of the vote in the most recent election) is campaigning for Brexit, while current British Prime Minister David Cameron is championing for the U.K. to remain in the EU. His Conservative Party has pledged to be officially neutral on the matter, while the Labour Party has specifically campaigned to remain in the EU. International leaders have also weighed in favor of Britain's remaining in the EU. Barack Obama claimed that Britain would move to the back of the queue for trade deals if it exited the EU, and Angela Merkel, the prime minister of Germany, said that Britain would receive no special treatment in future negotiations if it leaves the EU. While there has been internal, political division within Great Britain whether to remain in the EU, notable developed world prime ministers have made their case that Britain should stay in the EU.

Public polling within Britain has shown a majority of participants voting to *stay* in the EU over the last six months. At present, according to the Financial Times' rolling average poll figures, 46% would vote to stay, 44% would vote to leave, while 9% remain undecided. Since the Financial Times began tracking polling in September 2015, the "Stay" vote has consistently held the majority opinion.

Polling & Betting Markets Show Britain Staying in EU

	Stay	Leave
Betfair Prediction Mkts (probability)	71%	29%
Financial Times Polling	46%	44%

Source: Financial Times as of 5/2/2016.

Betting markets have increasingly favored a "Remain in the EU" outcome for Britain and put greater weight on Britain's remaining in the EU than the polls may indicate. According to the British betting site Betfair, which the news media has widely cited, current betting market odds show a 71% probability of Britain's staying in the EU. The British currency, the pound, has in some ways been telegraphing the market's prediction of the outcome. The British pound has increased 2.7% against the U.S. dollar over the last month as investors have placed increasing confidence in Britain's staying in the European Union. In our view it seems likely that Britain will remain in the EU going forward.

If the vote does swing for an exit from the EU, the follow-on events are not entirely clear, because there is little precedent. It is likely that the British pound would decline in value. It is also likely that British equity investments, and financial center banks in particular, would decline in value due to increased uncertainty over the immediate economic impacts and financial market transaction volumes. Some analysts have estimated that Brexit will put an immediate 0.5 to 1.0 percentage point negative drag on British GDP. The British Treasury estimated that overall GDP would be 6.2% lower than potential levels after 15 years. That is not to say that British trade would grind to a permanent halt because numerous countries that trade with Europe – Sweden, Switzerland, Canada, Turkey, etc. – are not members of the EU. But there certainly would be significant short-term volatility if there was a surprise vote to exit the EU.

Although we do not expect an exit as our base case, it is an important event that investors should note as the referendum date of June 23 approaches. Broad equity market volatility may increase simply because of the uncertainty heading into the vote, even if the market anticipates that the monetary union status will remain at the status quo.

Lastly, on the Federal Reserve, we have noted previously that its willingness to forecast a slower pace of rate hikes in the future has helped to alleviate some of the pressures on equity markets this year, and this is one of the reasons stocks have bounced so feverishly over the last two months. However, it is important to point out that the Fed has not completely taken future rate hikes off the table. While it gave little indication that it would hike at its next meeting in June, there is still a reasonable chance that the Fed will hike at some point this summer. If economic data improves in the interim, or oil prices and other inflationary pressures continue to move higher, such improvement and price increases could bring rate hikes to the forefront, which may reintroduce equity market volatility.

To be clear, we are not of the mindset that raising rates would derail the economy. In some senses, it would improve consumer returns from savings accounts and may actually incentivize borrowers to take out leverage, which is beneficial for spending and investment, if borrowers believe they are running out of time to lock in rates near zero. However, tighter monetary policy does mean the Fed is increasingly taking the proverbial punch bowl away from the stock market. As we saw in the beginning of this year, perceptions of such a step could bring volatility back into play. In any event, we believe that the uncertainty surrounding this decision makes the case for having a variety of investments in one's portfolio aside from just U.S. stocks and bonds. In international markets, easy monetary policy continues to be the name of the game, and we continue to believe that international stocks should benefit from the tailwind of easier money and improving economic growth.

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