

March 2016

## Stocks Finish February Flat After a Bumpy Start

### Overview

After a volatile start to the year, many equity indices were effectively flat for the month of February. The Dow Jones Industrial Average was positive for the month while the S&P 500 was slightly negative. After declining in the first half of February, stocks staged a rally in the second half of the month. A few factors drove the rebound in investment markets. Perhaps most notably, expectations increased that the Federal Reserve may take a more cautious approach to raising interest rates this year. This sentiment has spread because numerous Fed officials have acknowledged the increased volatility across investment markets and indicated their awareness that it may have an effect on economic growth.

Concerning economic growth, both in the U.S. and abroad many data points still show modest economic expansion despite the market volatility. Fourth quarter U.S. GDP growth estimates were revised up to 1.0% by the Bureau of Economic Analysis, and the Federal Reserve Bank of Atlanta estimates that *first quarter* growth will rise by 2.1%. Outside of the U.S., JP Morgan currently estimates that Euro Area GDP will grow by 2.0% in the first quarter, led by continued signs of improvement in retail sales and bank lending. Generally speaking, heavy industrial areas of the global economy have slowed as a result of the downturn in oil prices, while service related sectors (retail, healthcare, etc.) have continued to grow.

### Performance

The S&P 500 Index fell 0.13% in February while the Russell Mid Cap Index rose 1.13%.

Index Name	February	2016 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	0.16	1.35	5.45	4.76	US Muni Bonds
BarCap US Agg Bond TR USD	0.71	2.10	3.60	4.70	US Taxable Bonds
BarCap US Corporate High Yield TR USD	0.57	-1.04	4.09	6.61	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	1.91	1.72	5.79	6.68	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	1.44	1.80	-3.12	3.89	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	-1.12	-5.57	-2.50	-1.22	Hybrid/Hedged Equity
DJ Industrial Average TR USD	0.75	-4.68	8.94	6.92	US Equity -- Large
S&P 500 TR	-0.13	-5.09	10.13	6.44	US Equity -- Large
NASDAQ Composite TR USD	-1.03	-8.76	11.72	8.27	US Equity -- Large
Russell 1000 TR USD	-0.03	-5.41	9.92	6.49	US Equity -- Large
Russell Mid Cap TR USD	1.13	-5.50	8.91	6.87	US Equity -- Mid-sized
Russell 2000 TR USD	0.00	-8.80	6.11	4.95	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	-1.14	-7.87	-1.29	1.43	Int'l Equity -- Comprehensive
MSCI EM NR USD	-0.16	-6.64	-5.41	1.83	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	-1.63	-3.28	-14.44	-6.31	Commodities
HFRX Global Hedge Fund USD	-0.32	-3.08	-1.59	-0.52	Multi-Asset Alternative Invmt

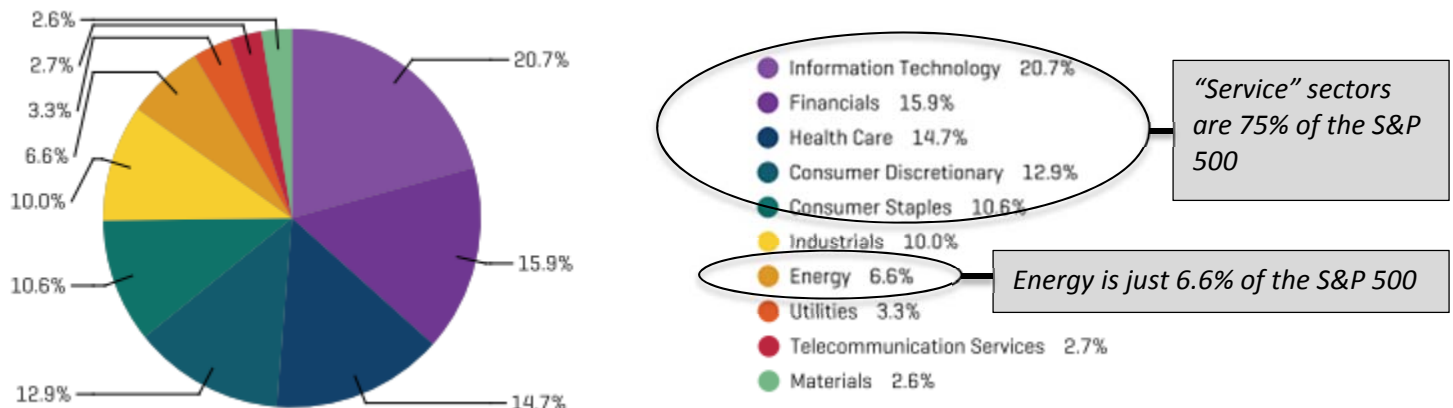
Source: Morningstar Direct. Data through 2/29/2016

Core bonds, as measured by the Barclays U.S. Aggregate Bond Index and the Barclays Municipal Index were up 0.71% and 0.16%, respectively. The BarCap U.S. Corporate High Yield Index gained 0.57% during the month as junk bonds bounced back. International equity markets fell by a slightly greater degree than U.S. large cap stocks, with the MSCI All Country World Ex USA Index declining 1.14%. The MSCI Emerging Market (EM) Index was basically flat for the month, with a minus 0.16% return. Emerging market bonds performed well in February, with the JP Morgan U.S. Dollar EM bond index returning 1.91%.

## Outlook

The first two months of 2016 have seen an unusual, extended correlation between the price of crude oil and the price of equity securities. As oil prices have fallen, so have stock prices. As oil prices have bounced, stock prices have also risen in kind. The Wall Street Journal noted that the correlation between the price of Brent oil and the S&P 500 is the highest it has been in 26 years. In effect, the entire stock market has been following the trail that energy prices have been blazing. However, the energy sector makes up only 6.61% of the S&P 500 Index.

### S&P 500 Sector Weightings

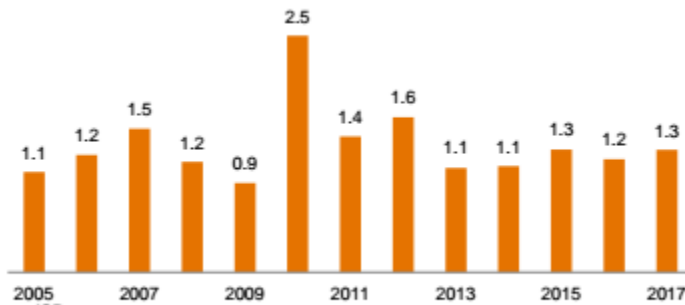


By comparison, the “services” portion of the market -- technology, financials, health care, consumer discretionary, and consumer staples -- makes up 75% of the S&P 500. If you include telecom stocks, the weighting goes even higher.

The natural question then is: *Why is the market being pushed around by such a small sector?* There has been a growing concern that the decline in oil prices is signaling not only that we have an oversupply of crude oil due to the influx of shale drilling, but also that global demand for energy is much lower than anticipated. The former was a given with rapid growth of drilling platforms in places like North Dakota, yet the later scenario has been given greater prominence as volatility has crept into the entire market. Other sectors, led first by materials and industrial companies, and eventually the whole equity market have become transfixed on the price of oil, and correlations among assets began to rise. Slowing demand would bring concerns that a global recession might be around the corner. However, as we have noted in previous issues of Insights, we do not believe that demand is slowing, even in places like China. In fact, gasoline consumption rose 7% last year in China. The following chart

from Macquarie shows steady oil demand growth from non-OECD countries (a basket of emerging markets, including China).

NON OECD Demand Growth [MM BPD]



2016 – 2017 are forecasts.

Source: Macquarie Capital (USA), February 2016

*Emerging market energy demand has been steady*

In short, it appears that global demand for energy, particularly in emerging economies, has continued, which is a positive sign for global growth. So if demand for energy products is continuing, and a growth slowdown doesn't appear in the energy demand data, what about the strength of other areas in the market that have become so transfixed on the price of oil?

An additional reason why markets have fallen is due to the decline in earnings. Operating earnings for the S&P 500 Index fell 10.7% from 2015 to 2014. This is concerning on the surface, and has prompted headlines of an "earnings recession" from the financial press. But digging into the underlying data we see a different story. From 2014 to 2015, the service sectors (more than 75% of the index) in the S&P 500 grew operating earnings at an 8.4% rate. Meanwhile, the industrial sectors (energy, materials, industrials, and utilities) of the index saw earnings decline by 63.8%. While industrial sectors make up a minority weight in the index, their stunning decline in earnings has pulled the entire index lower as a result.

S&P 500	2015 Earnings Growth
Full Index	-10.7%
Service Sectors	8.4%
Industrial Sectors	-63.8%

*Earnings are still growing in the service sectors, which make up over 75% of the S&P 500's composition.*

From 2014-2015, as of 2/29/16. Data via S&P Indices

Outside of energy, earnings growth has been improving at a healthy rate. Of course, there is danger in quoting investment information as excluding, or "ex-anything." During Japan's lost decade, investors often sought Asian investments, ex-Japan. During the financial crisis, statistics citing "ex-financials" started to pop up. Similarly today, we are likely to see many "ex-energy" type figures springing up.

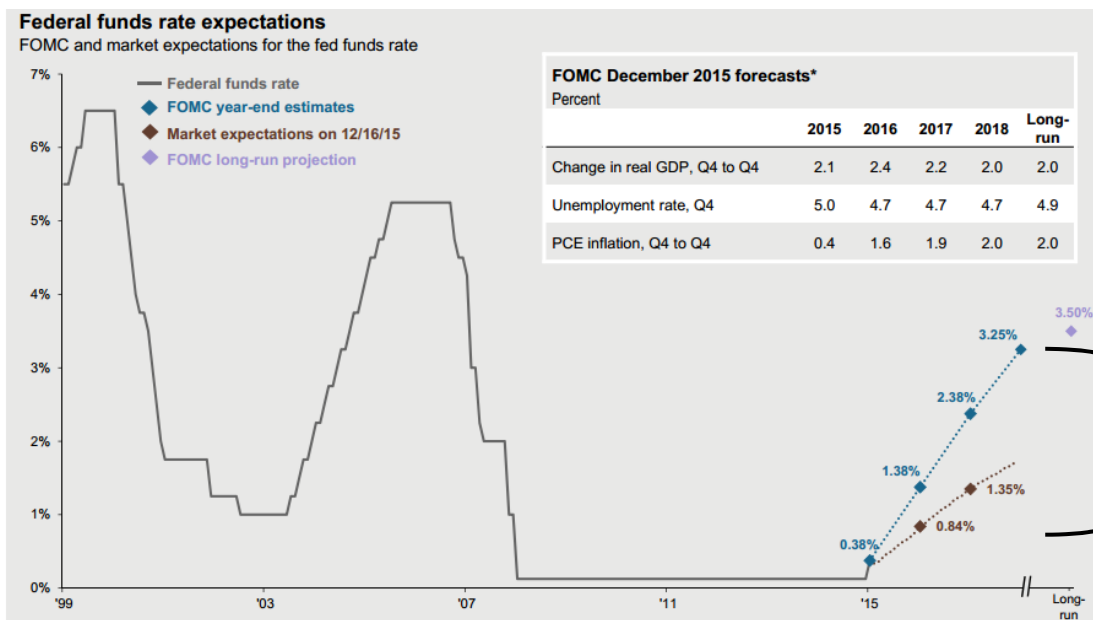
The problem with equating the downturn in energy to those previously cited examples relates to the scope of each area when problems first began to appear. Japan was the second-largest economy in the world in 1990. The financial sector was 20% of the market in 2007, and nearly every area of the economy relied on bank financing. A year ago, the energy sector was just 10% of the U.S. market. While the sector's profits have declined as a result of lower oil prices, and this has hurt the overall market's earnings figures, the rest of the



economy tends to benefit due to lower consumption costs. Businesses that use energy to make goods, ship items, and power retail centers benefit by having lower input costs. Consumers who travel and keep their homes powered benefit by having lower expenses. In that sense, the downturn in energy is different from many other sector/economic recessions that we have seen in the past.

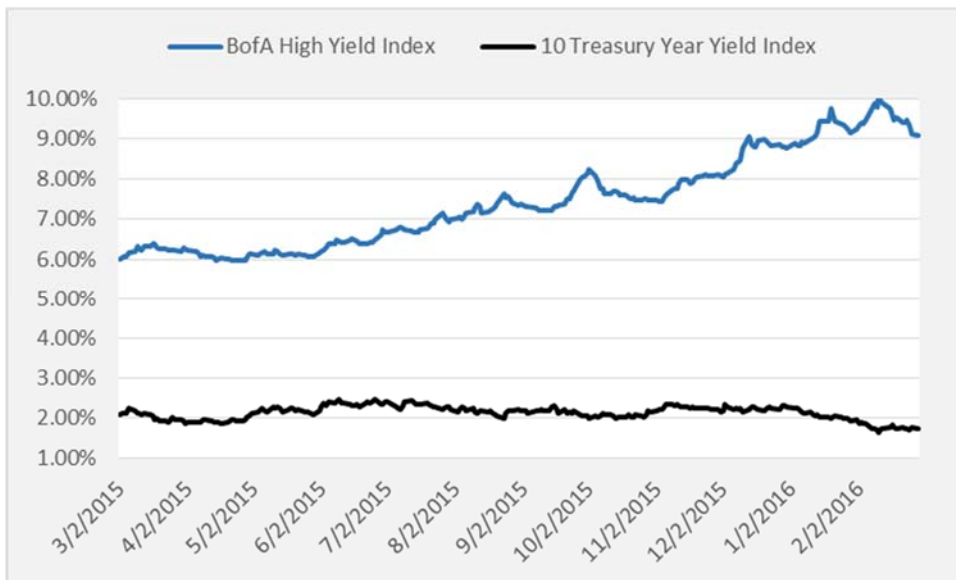
In our view, the market will move past the noise coming from commodity prices and return to focusing on fundamentals -- which are in good shape -- just like it always has. While the commodity sector has captivated the market's attention for the last quarter, we do not think investors should lose sight of the positive trends in other areas of the economy.

Moving to the Federal Reserve, which has been another key area of focus, it seems increasingly likely that it will increase interest rates at a slower pace than originally anticipated. After its December meeting, where the Federal Open Market Committee hiked rates for the first time in 8 years, the Fed released projections showing that it anticipated hiking rates four times this year. That would put its official benchmark interest rate range at 1.25% to 1.50%. However, the market anticipates that the Fed will raise rates at a far slower pace than that projected.



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management.

In some ways, the market seems to be testing Janet Yellen and the Federal Reserve to see if they will keep hiking rates in spite of the recent volatility, or if they will remain more accommodative to investors and put the program on pause. Alan Greenspan was famous for providing the “Greenspan Put” to investment markets in the 1990’s. This refers to his willingness to maintain or loosen monetary policy if markets experienced heightened volatility. Janet Yellen’s willingness to do the same is being tested now. If the Fed takes its foot off of the gas with interest rate hikes, it could likely alleviate some pressure on the dollar, which in turn might be beneficial for stocks, particularly emerging market investments. It could also likely provide support to higher yielding areas of the corporate bond market, which have seen their premiums increase as investor sentiment has fallen.



*High yield bonds offer yields of 9.08% whereas 10-Year Treasury Bonds yield only 1.74%. The spread has widened substantially over the last year.*

Source: St. Louis Federal Reserve, Sage Financial

At present, high yield bonds (commonly referred to as “junk” bonds) yield around 9.0%, a substantial jump from the yields of around 5% that they offered investors two years ago. The rise in junk bond yields has caused this area of the market to underperform traditional, core bonds. It may be easy for some investors to look at their portfolio and wish for greater safety in the form of Treasury bonds. However, the sell-off in high yield bonds has created a much stronger *future return* opportunity even if it comes at the expense of weak short-term results. Simultaneously, the decline in Treasury yields has made their future return prospects even weaker.

Sage currently has an allocation to high yield bonds, both through a dedicated high yield manager and through other fixed income strategies like unconstrained bond funds, which have boosted their credit exposure in recent months to take advantage of the sell-off. If the Fed is not raising its benchmark rates to initially forecasted levels, these areas could become more attractive to investors. Even if the Fed continues along its forecasted path, the substantial premium offered by this part of the market provides an attractive long-term return opportunity.

In conclusion, the volatility across investment markets has resulted in more modest returns, but it has also created opportunities within certain areas of the market like high yield. While it is impossible to know what approach the Federal Reserve may take with its interest rate policy over the next year, there are increasing expectations that they will move more slowly than anticipated. As for the stock market, equities have experienced an extreme correlation with energy prices over recent months. This has been due, in part, to concerns that the decline in commodity prices may reflect a downturn in global economic growth. This response is unwarranted in our opinion, because energy demand seems to be continuing in trend and other sectors of the market have continued to deliver positive earnings growth despite the slowdown in the industrial parts of the economy. Given that “service sectors” make up over 75% of the S&P 500, this is a positive trend that should not be ignored. Short-term dislocations like this spring up from time to time, but the market often reverts to the longer term fundamental trend in the economy. From our perspective, economic growth in the U.S. and abroad continues to grow at a modest pace and should help underpin investment markets going forward.



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