SAGE FINANCIAL GROUP
Investment and Wealth Management

SAGE INSIGHTS
MONTHLY ECONOMIC & MARKET ANALYSIS

July 2016

Stocks and Bonds Positive in June despite "Brexit"

Overview

The main event in June was Britain's referendum vote to leave the European Union, commonly referred to as "Brexit." Despite significant volatility leading up to and following the vote, which came as a surprise to both investors and political pundits, U.S. and emerging market stocks closed the month higher than at the end of May. International developed market equities finished the month lower, but they recovered from initial steep losses in the wake of the decision. Bond yields continued to drop, as investors continued to pour money into fixed income markets in response to political uncertainty.

In prior editions of *Insights*, we have discussed the British referendum and the potential effect it may have on markets, whether the result was a vote to leave or to remain in the EU. We noted that, while various polls and betting markets seemed to favor a "Remain" vote, if there was a surprise outcome for "Leave," markets could experience volatility as a result. That has been the case and will likely continue as Britain sorts out its next steps. In the interim, the Federal Reserve has lowered its forecast for rate hikes this year, and economic growth in the U.S. has shown continued signs of growth. Also, despite volatility in developed markets, emerging market stocks and bonds have been some of the best-performing investments this year.

Performance

U.S. stocks and bonds generated positive returns during the month and are positive for the first half of the year.

Index Name	June	2016 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	1.59	4.33	5.33	5.13	US Muni Bonds
BarCap US Agg Bond TR USD	1.80	5.31	3.76	5.13	US Taxable Bonds
BarCap US Corporate High Yield TR USD	0.92	9.06	5.84	7.56	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	3.37	10.31	6.45	7.97	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	5.89	14.02	-2.23	5.72	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	-1.47	-3.92	-0.43	-0.93	Hybrid/Hedged Equity
DJ Industrial Average TR USD	0.95	4.31	10.41	7.66	US Equity -- Large
S&P 500 TR	0.26	3.84	12.10	7.42	US Equity -- Large
NASDAQ Composite TR USD	-2.06	-2.66	13.18	9.48	US Equity -- Large
Russell 1000 TR USD	0.23	3.74	11.88	7.51	US Equity -- Large
Russell Mid Cap TR USD	0.46	5.50	10.90	8.07	US Equity -- Mid-sized
Russell 2000 TR USD	-0.06	2.22	8.35	6.20	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	-1.53	-1.02	0.10	1.87	Int'l Equity -- Comprehensive
MSCI EM NR USD	4.00	6.41	-3.78	3.54	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	4.13	13.25	-10.82	-5.59	Commodities
HFRX Global Hedge Fund USD	0.20	-0.83	-0.46	-0.33	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 6/30/2016

The S&P 500 Index was up 0.26% in June despite heightened volatility at month-end. The MSCI All Country World Ex US Index, a benchmark for international large cap stocks, was down 1.53% as the U.K. and European equity markets fell in response to Brexit. Despite developed market volatility, the MSCI Emerging Markets Index of stocks returned 4.00% in June and is now up 6.41%, YTD. We have in the past encouraged patience with emerging market equities and are pleased to see them performing so well this year. Fixed income investments continue to perform well as yields have declined further due to their "safe-haven" status and because of comments from central bankers that indicate rates will not rise as quickly as their initial forecasts.

Outlook

Of most importance to markets in the short-term is the recent British referendum vote on membership within the European Union. Many had expected a vote for "Remain" with polls fairly consistently favoring staying within the EU and betting markets putting 70-80% odds on Britain staying in the union. Thus, when the slight majority "Leave" result occurred on the night of the vote, markets were caught off guard and sold off sharply. Despite sharp declines in U.S. and international markets in the following two days, stocks rallied to close the final three trading days of June on an up note. In the next few pages, we will look at the main reasons why a majority of Britons voted to leave, the potential next steps for Britain and the EU, and what it means for an investor holding a diversified portfolio.

Great Britain's membership within the European Union is predominately centered on the trade agreement between EU member states, which allows for free trade among its members. While this is positive for economic development and revenue growth within the EU, it also required a monetary contribution to the EU, shared business legislation, and free movement within EU countries, which allowed for a greater degree of immigration. In effect, those who were advocating most vocally for Britain to exit the EU were saying that the issues of business regulation, political and judicial interference, and unchecked immigration were greater in cost or objectionability than the potential economic and investment risks from exiting the trade union.

What is important to clarify is that Britain's referendum was not a function of some significant financial hardship akin to the way in which Greece has been on the cusp of leaving the European Monetary Union due to its debt crisis. There has not been a similar level of volatility and concern heading into this referendum as there was with Greece and its various clashes with European councils over the last few years. The British situation is distinct from Greece's in another significant way. Britain has kept its own currency, the pound, despite joining the European Union. Britain's currency sovereignty is important going forward because it allows for a less complicated path than if a country with euros as its currency were to leave the EU.

Britain's Referendum on EU Membership

The Vote

- 52% voted to leave
- 48% voted to remain

Why Did the Majority Favor Leave?

- A growing sentiment that political and business independence would be favorable to free trade and migration.

How Did Markets Respond?

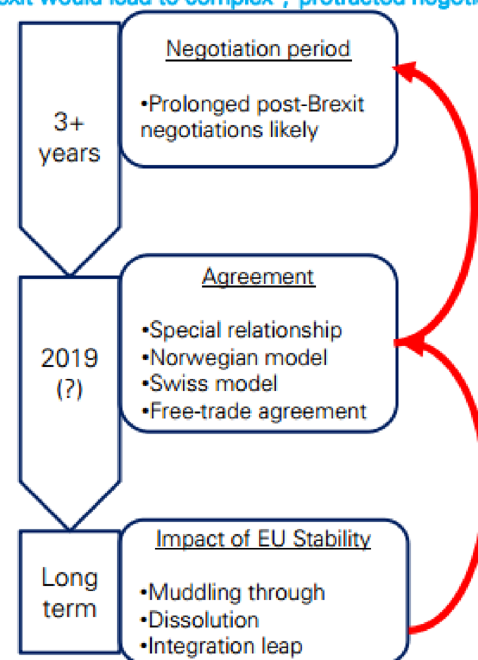
- Initially with a move lower, but with a quick, subsequent bounce. The S&P 500 had a positive return in June.

What Happens Next?

- The vote was not legally binding, and as a result, Britain may still stay in the EU.
- A move to exit the EU, if it does occur, will not happen immediately.
- The exact path forward is unclear and, if Britain invokes Article 50 of the Lisbon Treaty to exit, it will take at least two years to unfold.

With that in mind, it is important to assess some of the possible ways forward for Britain and the EU. The most important point -- and one reason why markets rebounded so quickly from their initial, post-Brexit sell-off -- is that the referendum was *non-binding*. The vote in and of itself did not legally trigger the exit process from the EU. That is put into the hands of the Parliament to approve first and then the Prime Minister to enact. David Cameron, England's Prime Minister heading into the referendum, has announced that he will step down by the end of September as a result. He strongly advocated for the "Remain" campaign, and has left it to his successor to decide whether or not to push forward with officially exiting the EU. Until that point in time, all current trade agreements and political ties with the EU will hold.

Although this element may seem to muddy the course, markets have actually looked at this favorably. Given the volatility that occurred after the vote, combined with a distinct lack of planning from leaders advocating for a "Leave" vote and the possibility of recession, there are few people in leadership who want to bear the weight of saying that they officially pushed the "Exit" button, particularly if a UK recession is a direct result. The longer Britain goes without officially beginning the "Leave" process, and the more that British business uncertainty rises, job markets take losses, or any other economic malaise occurs, the less actual likelihood there is, in our view, that Britain will exit. Very few politicians will have the political will power to pull the trigger on a move that was a result of a coin toss election result for which some swing voters may have voted out of protest and about which many others are having buyer's remorse.



Source: DB European Economics and FX Strategy

If Britain does in fact move forward to exit the EU, it will be a long, drawn out process that may take many years. Under the EU's current treaty structure, a country that files for exit has two years to renegotiate its trade and immigration terms with EU member countries. During this period, details would be hammered out on what Britain's trading agreements with both EU and non-EU countries would look like. In an ideal world, Britain would come to an agreement similar to the Norwegian or Swiss model, whereby they have favorable trade terms with the EU but maintain parliamentary sovereignty over their own justice system. Under punitive terms, should the EU impose them, the UK would face harsh tariffs meant to deter other dissenting EU members from leaving the economic union. Given how large a trading partner the UK is with the EU, negotiating terms of trade is obviously a fine line to walk because it will affect how the future relationship is managed. Talking tough but negotiating a little more softly may be in both parties' best long-term interests.

If Britain does continue down the path towards exiting the EU, there are two primary potential flash points that might trigger additional market volatility. First, Great Britain's member countries, such as Northern Ireland and Scotland, may advocate strongly for remaining in the EU and push for independence from the United Kingdom if it does in fact decide to exit the EU. Second, political waves in other European countries could advocate for an exit from the EU. Given the trading ties and banking links between countries, including those who share the

common Euro currency, any increasing divisiveness within key European Union member states would likely be accompanied by increased market volatility.

It is important to note that neither the UK's ultimately remaining in the EU nor the disintegration of the UK and the EU is a base case outlook; we merely highlight some of the possible scenarios that could emerge either way Britain proceeds. If Britain decides to remain in the EU and there is an increased push for greater unity within the EU, markets would welcome the removal of uncertainty. Recent elections in Spain, which has been experiencing underlying currents of an anti-EU movement, actually surprised political watchers because of a greater-than-expected support for *pro-EU* candidates. The upcoming presidential election in France, which is scheduled for next April, will provide the next big milestone for gauging European Union sentiment.

Investors may wonder why they should stay committed to international equities if there is likely to be continued geopolitical uncertainty. The current stretch of international equity underperformance and ongoing volatility may tempt investors to move away from international stocks. To do so, however, would ignore the fact that attractive future return opportunities often do not occur when confidence is at its highest. Low valuations and the possibility for future strong returns often accompany market volatility and investor unease. The following table shows just how deep the discounts within international stocks are.

Investment	Current Valuation	Historical Median	Premium / Discount
S&P 500 (U.S. Stocks)	26	16	38.46%
MSCI EAFE (International Stocks)	13	22	-69.23%

Valuation data is Shiller Cyclically Adjusted P/E, provided by Research Affiliates

Whereas the U.S. stock market (via the S&P 500 Index) is trading at a premium to its historic valuation level (and some would argue that valuation is justified given the stability and resiliency of our economy compared to other regions), international developed market equities are trading at a substantial discount to historic valuations. European stocks have also underperformed U.S. equities over the last three calendar years. The following chart illustrates the relative performance between U.S. and European stocks, which is currently at a 60-year high favoring U.S. stocks. As you can see by the swings up and down, some periods favor European stocks and some favor U.S., but the main point is that outperformance swings back and forth between both regions.

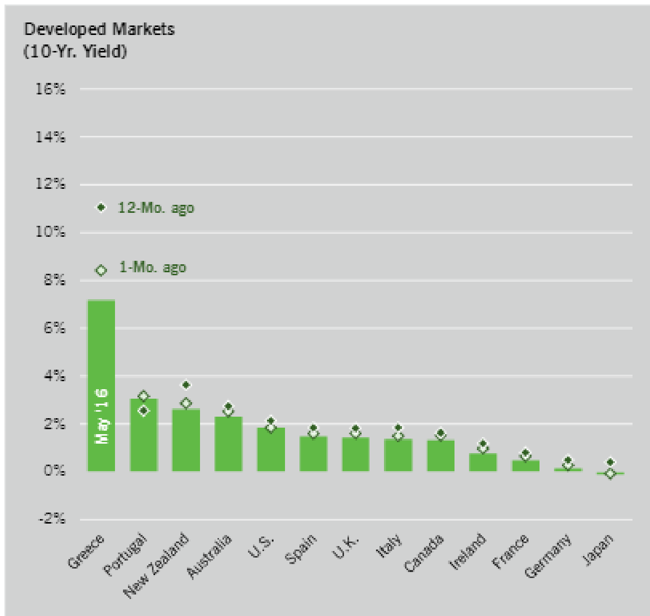
Given the current attractive valuations and negative sentiment about Europe, combined with a history of performance reversion between the two regions and the recent outperformance of US stocks, we would encourage investors to be patient with their international equity exposure despite the political difficulties faced in Europe.

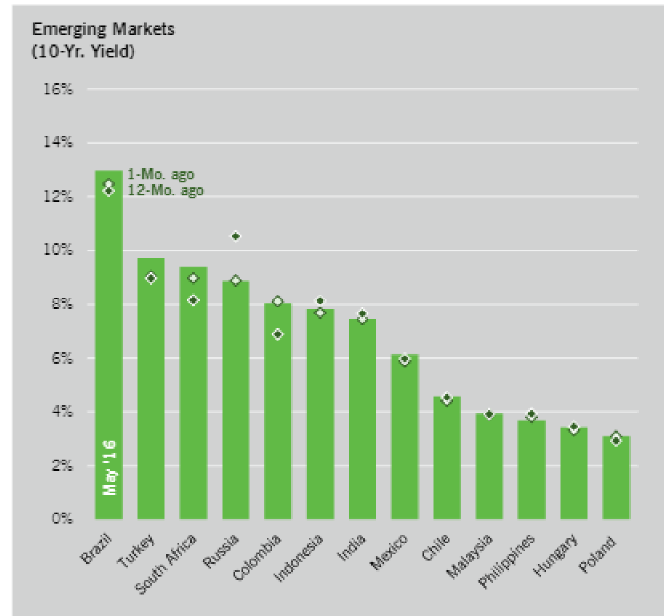
One area of investment markets that has rewarded patience has been emerging market stocks and bonds. The MSCI Emerging Market Equity Index has returned 6.41%, YTD through June, and was up 4.00% last month despite significant volatility in the stock market. Somewhat similarly to Europe, emerging markets possess discounted valuations and have been working through headline risk with China's economic deceleration. After sharp underperformance in 2015, it was also tempting to some investors to be pessimistic on emerging market growth prospects, yet they are one of the best performing asset classes in 2016. In our February edition of *Insights*, we cited a quote from the Wall Street Journal's "Intelligent Investor" column that spoke to the opportunity in emerging markets, "A century's worth of investment returns shows that emerging markets deliver their best results not when hopes are highest, but after they break investors' hearts."

Investment	**YTD Returns**
Barclays US Agg (U.S. Bonds)	5.31%
JP Morgan Emerging Market Bond Index	**12.17%**
S&P 500 (U.S. Stocks)	3.84%
MSCI Emerging Market Equity Index	**6.41%**

Patience has paid off so far this year, and we have confidence that emerging market stocks and bonds can provide very attractive future returns to investors going forward. With increasing concern placed on Britain and the European Union, their currencies have fallen and led to strengthening returns from emerging market currencies, which has helped to boost investor returns this year. There has also been improvement in China's economic stability, which has led to increased investor confidence. Meanwhile, valuations are still attractive, with price-to-book valuations in emerging market equities at a 28% discount to their historical average, according to JP Morgan.

Emerging market bond yields are also trading at significant premiums to developed market government bonds. Much has been made about the plunge into negative yields for areas of the fixed income universe such as Japanese and German bonds. By comparison, emerging market bond yields range from 3-12% across the asset class and are substantially more attractive than yields in the U.S. or Europe.





Source: Bloomberg as of 5/31/16. Data provided is for informational use only. Past performance is no guarantee of future results. See end of report for important additional information.

Where the average yield on a traditional U.S. bond index such as the Barclays US Aggregate Index is currently 1.91%, the yield on emerging market bonds (local currency and U.S. dollar denominated) is 5.98%. The present yield premium has started to reward investors in 2016, and we believe it will continue to do so in the future.

Many of the investment headlines in 2016 have revolved around volatility and political risk. However, investors with a diversified portfolio have benefited from having exposure to traditional safe-haven assets like core bonds, which have performed very well, but also from having exposure to some of the more beaten up investment areas like emerging markets and commodity sensitive investments like MLPs. Other investments, like managed futures, can provide positive returns during periods of extreme volatility. We believe a wide array of investments provides investors with a diversified investment return stream that are not likely to be knocked off course from events like “Brexit” or other political happenings.

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