May 2015

U.S. Economic Condition and Prospects Stronger Than First Quarter Figure Suggests

Overview

Foreign stock markets led returns in April. For the year, most major indices are positive. The U.S. economy expanded slightly in the first quarter, growing just 0.2%. This weak first-quarter growth has been a pattern over the last several years -- i.e., first quarter weakness followed by stronger growth the rest of the year -- and it is a fact that should be kept in mind and prevent unwarranted economic pessimism. Economic data in Europe on the whole remains stable, supported in large part by the European Central Bank's quantitative easing program. In this issue of *Sage Insights*, we discuss the U.S. and European economic conditions and the challenges that they pose now and in the future to traditional bond investments. We point out that diversification within bonds (that is, different types of bonds that have different characteristics) is just as important as diversification across asset classes (that is, across stocks, bonds, and alternatives).

Performance

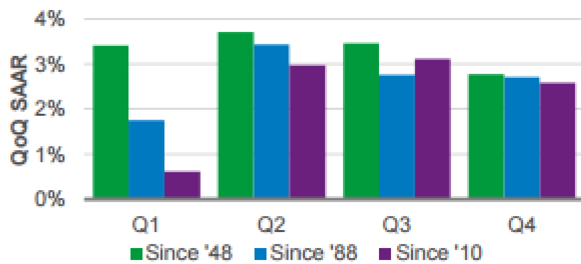
Asset class performance in April was quite mixed. Core bonds declined as yields rose. Large U.S. stocks rose nearly 1%, but U.S. mid caps declined by about the same amount, and small caps fell about 2.5%. In contrast, foreign developed market equities rose 4%, and emerging market stocks performed better, up 5.7%. Emerging market bonds also gained between 1.6% (for US dollar debt) and 2.9% (for local currency debt).

Index Name	April 2015	2015 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	-0.52	0.48	4.80	4.75	US Muni Bonds
BarCap US Agg Bond TR USD	-0.36	1.24	4.46	4.12	US Taxable Bonds
BarCap US Corporate High Yield TR USD	1.21	3.76	2.58	8.35	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	1.63	3.68	6.06	7.27	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	2.92	-1.16	-9.35	1.00	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	1.19	3.42	5.09	1.22	Hybrid/Hedged Equity
DJ Industrial Average TR USD	0.45	0.78	10.11	12.99	US Equity -- Large
S&P 500 TR	0.96	1.92	12.98	14.33	US Equity -- Large
NASDAQ Composite TR USD	0.86	4.68	21.52	16.30	US Equity -- Large
Russell 1000 TR USD	0.71	2.31	13.00	14.47	US Equity -- Large
Russell Mid Cap TR USD	-0.91	3.01	13.30	15.09	US Equity -- Mid-sized
Russell 2000 TR USD	-2.55	1.65	9.71	12.73	US Equity -- Small
MSCI EAFE NR USD	4.08	9.16	1.66	7.40	Int'l Equity -- Developed
MSCI EM NR USD	7.69	10.10	7.80	3.02	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	0.21	2.28	1.31	1.00	Commodities
HFRX Global Hedge Fund USD	5.73	-0.55	-24.69	-5.02	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 4/30/2015

Outlook

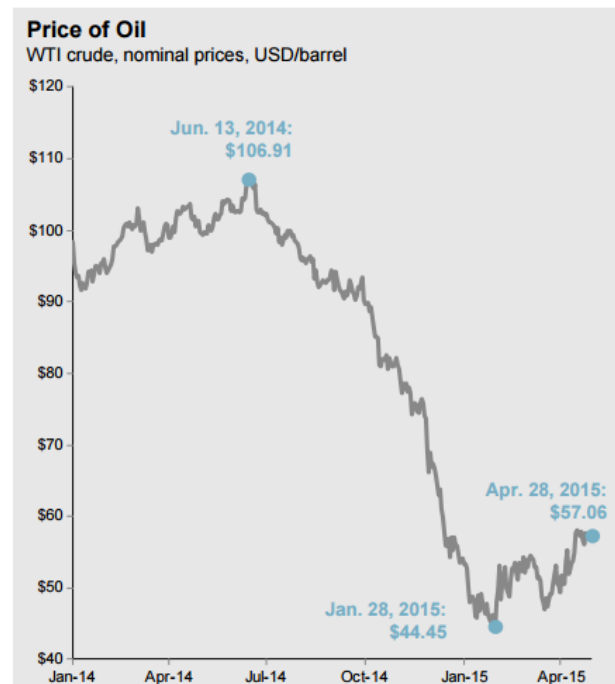
Notwithstanding the slight gain in economic growth in the first quarter, we still believe that the U.S. economy is on firm-footing. We noted last month that soft patches appear in the middle of economic cycles, and the GDP report suggests that we may have had one to start the year. A couple of things may be said. First, as you can see in the nearby chart, since the end of the financial crisis, 1Q GDP growth has been curiously weak relative to growth in subsequent quarters. (Note the size discrepancy in the purple bars for Q2, Q3, and Q4 versus Q1, and note how much lower the purple Q1 bar is from longer-term averages.) As Goldman Sachs noted in a release to clients, "Since 2010, GDP growth has averaged just 0.3% in Q1, compared with 2.9% in the remaining three quarters of the year." There may be various causes and coincidences, some related and some idiosyncratic, for this recent phenomenon. In light of this trend, the main point is simply this: it may be prudent not to over-interpret the weak 1Q GDP report.



Source: BlackRock; Bureau of Economic Analysis.
Data as of 4/2/2015.

Second, although a strong dollar has weakened growth from U.S. exports, it and the decline in oil prices seems to have begun to contribute to an increase in spending. Consumer spending increased $53.4 billion, or 0.4 %, in March (latest available data). Wage growth has also recently started to increase. At the end of March, aggregate real wage income was 4.8% higher than it was a year earlier. Housing is steady. Employment continues to improve. The prospects for continued and mostly steady economic growth in the U.S. are, in our view, good.

The stronger dollar and lower oil prices have hindered 1Q earnings for multinational companies, and softer corporate earnings have led in part to more moderate U.S. stock gains this year, as well as price fluctuations. We still believe that continued economic growth the rest of the year will filter into earnings growth for companies. Earnings growth rates may be more moderate in the future than they have been prior to 2015, but against the economic backdrop that we anticipate earnings should still be positive. This earnings growth should then translate into higher stock valuations, and so the prospect for modest U.S. stock price appreciation over the medium-term is also good.



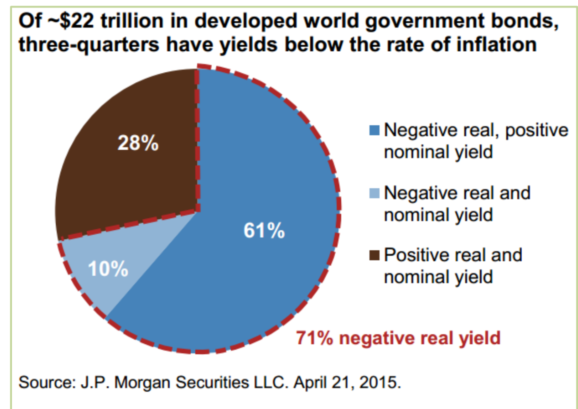
Source: Federal Reserve, Factset, J.P. Morgan Asset Management
Data are as of April 28, 2015.

Earnings growth in Europe has trailed in recent years the growth rate in the U.S. Although quantitative easing in Europe has given European stocks a significant lift this year, an uptick in corporate earnings and a recovery in consumer spending could propel further equity gains there.

The outlook for European or other developed market bonds is murkier. We have spoken at length in the past about the future challenges that the U.S. bond market

faces because of the degree to which unconventional monetary policy (i.e., quantitative easing) has pushed down bond yields. Prices of bonds move inversely to their yields. When the central bank eventually raises rates, and when the bond market anticipates greater organic economic strength, bond yields will likely also rise. The total return for bonds (income yield plus price movement) will be pressured, because price declines may largely offset current low yield rates. This is a key reason that we include in client portfolios unconstrained bond strategies. Because they can eliminate risks associated with or benefit from rising yields, unconstrained bond funds performed particularly well in not only April, but also in February and in 2013 when yields did move higher.

We have in this connection – i.e., low current yields and likely rising future yields -- highlighted the difficult initial conditions in the U.S. that bond investors face. The situation is only more acute for European bonds and, in a different way, Japanese bonds. Many European government bonds are trading at negative yields. As you can see in the nearby pie chart, unconventional monetary policy globally (especially the U.S., Europe, and Japan) has led to a situation in which the *real* yield (i.e., the yield after you subtract the rate of inflation) is also negative. Approximately 71% of the developed world's government bonds currently have *negative real yields,* which means that investors in those bonds are actually losing purchasing power. The income their bonds are generating is less than the rising costs of goods and services.



Sometimes we are asked why we have tilted our foreign bond exposure to emerging market. The pie chart to the right is one reason: Real yields in emerging market debt for developed market investors is both positive in absolute terms and attractive relative to developed market government bonds. There are other reasons, but a *positive real* yield of 2-3 percentage points is a strong one.

The larger point is unconventional central bank monetary policy in general and quantitative easing in particular has pulled forward to the past and present many investment gains. The result is that future investment gains in a number of assets, stocks and bonds, may be lower than they have been in the recent past and over longer historical periods. We have highlighted this many times to help explain both our outlook and our use of non-traditional investment assets. For instance, the likely lower-than-average future returns for core bonds and stocks given their strong gains over the last 5 years informs why we incorporate into our portfolios strategies such as emerging market debt, managed futures, unconstrained bond funds, and multi-asset alternatives.

Using non-traditional investment strategies is not the only way that we seek to help clients capture higher rates of return than traditional U.S. stock and bond strategies might afford. Another way is by the use of non-U.S. strategies. Because of the return divergence last year between U.S. and foreign stocks, it was understandably difficult for some investors to maintain, as we urged, the discipline of diversification and retain allocations to foreign stocks. But maintaining that diversification discipline has paid off this year. Whereas the S&P 500 index, for instance, is +1.92% through April, the developed market MSCI EAFE index is +9.16%, and the emerging market MSCI EM index is +10.10%.

There remain economic and political challenges overseas. The Greek debt problem lingers. China's growth is slowing from recent years, but at 7% in the Q1 it remains enviable. Still, Chinese policymakers have been more actively intervening to support its slowing economy. The summer elections in the United Kingdom could

introduce some uncertainty into European stock markets. On balance, however, we believe that global growth this year should continue. We think that the low first-quarter U.S. economic growth rate does not reflect the (higher) growth rate that will likely prevail this year. And we still judge that non-traditional bond strategies and foreign investments offer opportunity.

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