SAGE FINANCIAL GROUP
Investment and Wealth Management

SAGE INSIGHTS
MONTHLY ECONOMIC & MARKET ANALYSIS

December 2016

U.S. Stocks Surge, but Domestic Bonds and Foreign Assets Retreat in November

Overview

After the widely unexpected election of Donald Trump as the next president, U.S. stocks rose sharply, but bonds sold off both because of increased inflation expectations and the anticipation of a Fed rate hike later in December. Foreign stocks and bonds also retreated as the U.S. dollar gained strength against many other currencies and due to uncertainty about the effects of a Fed hike and the incoming administration's trade policy. In this edition of *Insights*, because there remains much uncertainty about the specific policy initiatives that the Trump administration will pursue, we seek to provide a preliminary 2017 outlook on what we observe now and what we think the potential economic and investment implications may be. Despite the murkiness of the political backdrop, it bears reminding ourselves that the U.S. economy continues to show signs of modest expansion. The government's revised estimate of third quarter GDP had the economy growing at a 3.2% annualized rate. The employment market also continues to be strong. The official unemployment rate is at 4.6%, a level close to what the government considers full employment. The Federal Reserve is likely to raise its key interest rate on December 14, but the Fed funds rate is low, currently within a range of only 0.25 to 0.50%.

Performance

U.S. stocks rose and bonds declined in November. The Russell 1000 Index of large company stocks gained 3.94%, and the Russell 2000 Index of small companies surged 11.15%. Core U.S. bonds fell sharply as yields rose, but high yield bonds, which have less interest-rate sensitivity than core bonds, declined much less.

Index Name	Nov	2016 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	-3.73	-0.92	3.43	4.09	US Muni Bonds
BarCap US Agg Bond TR USD	-2.37	2.50	2.43	4.27	US Taxable Bonds
BoAML US High Yield Master II TR USD	-0.39	15.22	7.46	7.25	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	-4.09	8.70	5.86	6.81	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	-7.03	7.92	-1.94	3.86	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	1.47	-0.08	2.71	-1.07	Hybrid/Hedged Equity
DJ Industrial Average TR USD	5.88	12.62	12.51	7.38	US Equity -- Large
S&P 500 TR	3.70	9.79	14.45	6.89	US Equity -- Large
NASDAQ Composite TR USD	2.80	7.59	16.67	9.31	US Equity -- Large
Russell 1000 TR USD	3.94	9.99	14.45	7.02	US Equity -- Large
Russell Mid Cap TR USD	5.39	12.52	14.43	7.74	US Equity -- Mid-sized
Russell 2000 TR USD	11.15	18.00	13.98	6.81	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	-2.31	1.89	4.24	1.02	Int'l Equity -- Comprehensive
MSCI EM NR USD	-4.60	10.94	0.99	2.27	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	1.33	9.79	-9.97	-6.19	Commodities
HFRX Global Hedge Fund USD	0.87	1.63	1.38	-0.51	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 11/30/2016

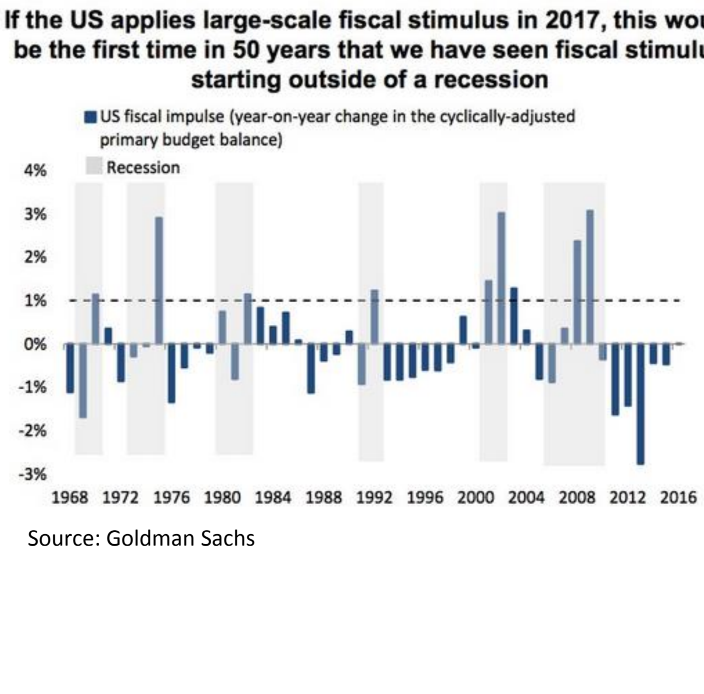
Foreign developed market and emerging market stocks were also notably negative during the month. The MSCI Emerging Market Index, for instance, dropped 4.60%. Year-to-date, however, emerging market stocks continue to be one of the strongest-performing asset classes with a 10.94% return. High yield bonds have also performed well; the Bank of America/Merrill Lynch High Yield Master Index remains above 15% for the year. And after surging in November, U.S. small cap stocks have risen 18% YTD through November.

Outlook

Now that December is upon us, we are looking ahead to the likely economic and investment landscape in 2017. We will distribute a full 2017 outlook in early January. For now, as we see it, the 2017 landscape itself is situated within a geo-political context that includes hints of potential catalysts and themes, yet remains shrouded in a considerable degree of uncertainty. Some of these unresolved matters involve Europe. The path toward and terms of Great Britain's likely exit from the EU are murky. What effect, if any, will French presidential elections on April 23, 2017 have on the EU negotiating position and the climate of continental commerce? These and other questions are important, but most immediately on our minds and that of many of our clients is closer to home. What are likely effects on the economic and investment climate of the incoming Trump administration?

1) U.S. Fiscal Policy. One general area of *agreement* between the major party candidates during the heated U.S. presidential campaign was for increased infrastructure spending. The aim of the spending would be to repair, renew, and expand critical infrastructure components like roads, bridges, pipelines, energy grids, and airports. Differences existed on the details and the scale; however, there seems sufficient interest in a package of government infrastructure spending that the push for some legislation is likely in the early part of next year. The implementation of such a plan, if passed, would probably boost cyclical economic growth in the short-term, although the timing and magnitude of the stimulus effect remain uncertain. Nevertheless, the expectation of the passage and implementation of a deal may prompt businesses to pre-empt the government with their own capital expenditure and growth projects. These would also help to lift GDP growth. This policy might contribute to inflationary forces.

Although there is bipartisan support for some deal, perhaps the largest risk to stimulative fiscal policy comes from legislators who ran on platforms of fiscal discipline. To these fiscally conservative lawmakers, the prospect



Source: Goldman Sachs

of higher budget deficits would be unwanted in theory and politically dangerous in practice when re-election time arrives. From an investment perspective, energy-related investments, including master limited partnerships (MLPs) to which Sage allocates, should in our view benefit.

2) U.S. Tax Policy. Also relatively high on the President-elect's legislative agenda is reform of some tax policy areas, including corporate and individual tax rates. Corporate tax reform is another topic that has generally received bipartisan backing, although details divide proponents and can derail passage. The U.S. has one of the highest corporate tax rates (35%) among major developed nations within the Organisation for Economic Co-operation and Development (OECD). This elevated cost to business operations is one reason that many companies in recent years have moved headquarters or shifted many business units overseas. The thought behind reform is that lowering the corporate tax rate will either entice businesses back home or lure new businesses to American shores. If legislation includes a corporate tax repatriation holiday for multinational companies, business investment domestically may receive an additional shot in the arm. Companies may also use repatriated funds to increase share buybacks and dividends, which could be positive for their stock prices.

Source: OECD, Statistica

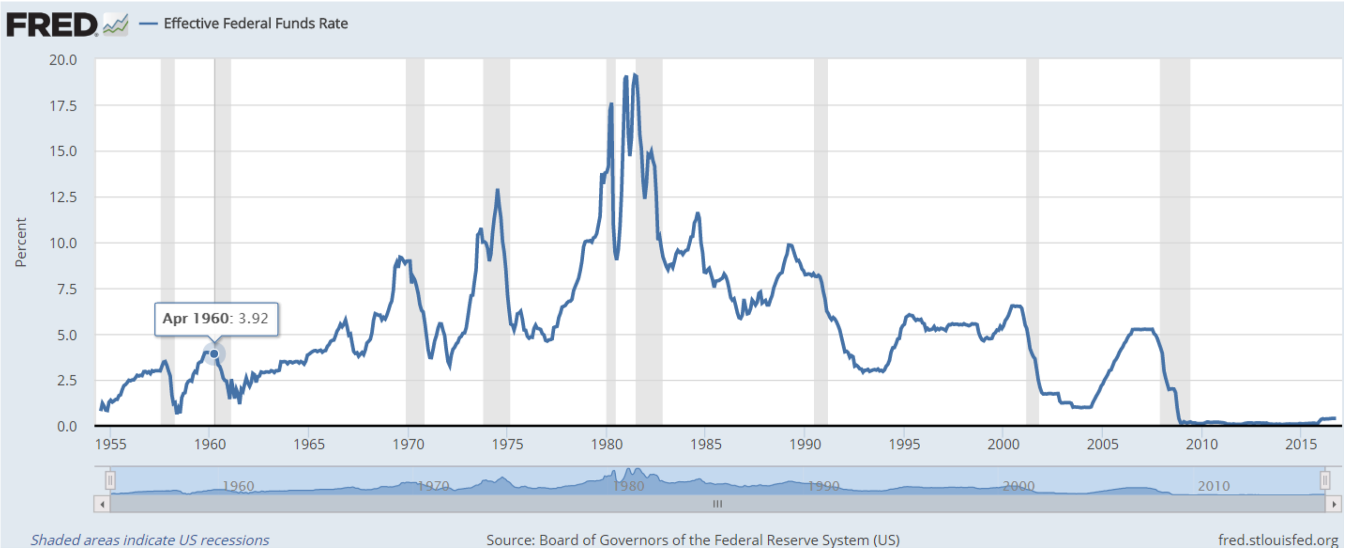
Corporate tax reform seems more probable than personal income tax reform. The latter (personal tax reform) is likely to be opposed by most Democrats, and in the Senate the Republicans have the barest of majorities (currently 51 seats, perhaps 52 after the Louisiana runoff). Any Republican defections, perhaps because of deficit concerns or pork barrel provisions, could threaten passage. In 2003, Vice President Cheney, as President of the Senate, cast the tie-breaking vote in a Republican Congress to pass that year's tax cut legislation. There may be few clear specific investment implications by company or industry from tax reform; however, in general lower corporate taxes would likely benefit the overall business climate and economic growth over a longer period than would any potential boost to personal spending in the economy from individual income tax reductions.

3) U.S. Regulation. Most likely under the Trump administration is the enactment of deregulation policy measures that do not require Congressional approval since they can be implemented, just as in the current Obama administration, through executive branch authority. Some rule changes may go to work immediately, but many others will take time both because of administrative requirements and some inevitable legal challenges. Still, overall there is likely to be a more business-friendly administrative stance toward regulations spanning from the financial sector and bank oversight to energy infrastructure, pharmaceutical research, and environmental provisions. Banks and energy companies are likely, in our estimation, to benefit.

4) U.S. Trade Policy. The largest area of Trump administration policy uncertainty in our minds involves global trade agreements. The U.S. dollar has strengthened post-election relative to other currencies, notably the

Mexican peso, because of concerns that protectionist policies such as tariffs on goods will disrupt existing commerce between nations. The U.S. exit from the still pending Trans-Pacific Partnership, which Secretary Clinton also threatened to scuttle during her campaigning, was expected under President-elect Trump. Of greater concern are existing trade deals like NAFTA (the North American Free Trade Agreement) that was supported by Presidents George H. W. Bush and Bill Clinton and approved by the Senate in 1994. At present it seems likely that the Trump administration will seek to renegotiate terms of existing deals rather than exit them completely or conduct a full-scale trade war. His stated picks to be Secretaries of the Commerce and Treasury Departments, Wilbur Ross and Steve Mnuchin, have both benefited from and understand the indispensability of global trade. Still, the risks of gaffes that compromise potential deal breakthroughs or of protectionist pandering to a single constituency is high. In our view, it would be economically misguided to inflame global trading tensions and enact sweeping protectionist policies that could undermine the pro-economic growth agenda that the administration is pledging to pursue. We believe that voices within the incoming administration recognize this, and we are cautiously optimistic that trade policy will be better in practice than widely feared. If this is indeed the case, we may see a bounce in emerging and developed market equities, which are still positive year-to-date, but have experienced some negative trading after the election.

5) Federal Reserve Monetary Policy. The U.S. economy has remained in largely stable, low growth mode for some time, and in recent months, inflation has firmed in a good way. Much of the central bank's monetary policy over the last several years has been designed to battle deflationary forces. The Fed has stated that economic, inflationary, and employment conditions have improved so that now an increase in the benchmark Fed funds rate at the meeting on December 14 seems nearly certain. Chairwoman Yellen has previously indicated that she and the other Fed governors expect the pace of rate hikes to be gradual and data-dependent. Fears that the Fed's "raising rates" is ominous may turn on the assumption that increases will be fast and large. That assumption may be overstated, but there is now a heightened risk for fixed income investments that are very sensitive to interest-rate movements. That is one reason that we have both reduced that sensitivity in our core bonds and increasingly used unconstrained bond strategies that have additional tools to mitigate this risk. The graph below illustrates how exceptionally low the Fed funds rate is now and has been since 2008, which helps to explain why we have positioned our core bonds defensively.



The other implication of a program of higher interest rates is a stronger dollar. U.S. dollar strength affects global trade, for instance, by making it more expensive for overseas consumers to purchase U.S.-made goods (exports).

In this sense, if the dollar is too strong relative to other currencies, it can hamper the multinational revenues of domestic manufacturers and producers. Further, a strong dollar relative to other currencies can attract global capital away from countries that might depend upon foreign sources to finance their budgets by purchasing their government's bonds. This can put pressure on the economic conditions in those countries and therefore act as a drag on corporate revenues and their stock prices. Overall, we presently expect the Fed in 2017 to increase rates at a gradual pace, perhaps 3-4 times and to remain extremely cognizant of complicating geopolitical and financial conditions.

6) Emerging Markets (EM). Emerging market assets, both debt and equity, have retreated a bit since the November U.S. presidential election because of worries about potential trade policy and the Fed's likely December rate hike. A positive surprise on U.S. trade policy, as we earlier suggested is possible, would likely help to lift emerging market assets. Those assets have points in their favor apart from U.S. policy, but their prices may remain under pressure for a while until there is greater clarity than at present. Most immediately, emerging markets (EM) may find some direction from the tone and particulars of the Fed's next policy statement. If the tone is less hawkish than current market prices may reflect, then EM assets could breathe a sigh of relief and rally back upward toward or past their pre-election levels. Demographic, inflationary, and structural reform factors are broadly positive in the emerging world, and EM economic growth is expected to be higher than both developed markets on average and the United States in particular in 2017. We currently anticipate 2.5% to 3.0% GDP growth next year, whereas we think that emerging markets on average can grow GDP at a 4.5% to 5.0% pace.

As 2016 comes to a close, we not only look ahead; we also look back. Despite widely unexpected political election outcomes (Brexit, Trump's victory) and often volatile market conditions, the year looks set, barring a major unforeseen reversal, to end with many equity indices, especially in the U.S., markedly positive. Non-core fixed income allocations like those in taxable high yield bonds and debt from emerging markets have generated returns in the high single and mid-double digits often associated with stocks. MLPs bounced back from a steep drawdown in January and February to rise into double-digit return territory as well. We are grateful for these portfolio performance results and more. Most of all, we remain deeply appreciative of your confidence to entrust us with the privilege of helping you with your financial goals. We look forward to partnering with you yet again in 2017.

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