SAGE FINANCIAL GROUP
Investment and Wealth Management

SAGE INSIGHTS
MONTHLY ECONOMIC & MARKET ANALYSIS

June 2016

U.S. Stocks and Bonds Provide Positive Returns in May

Overview

U.S. stocks experienced choppy trading during the month of May, but ended the period slightly higher than where they closed in April. U.S. Treasury bonds were flat, with the 10-Year Treasury yield ending the month at 1.84%. There was some pressure on yields towards the end of the month because the Federal Reserve indicated a greater than expected willingness to raise rates at its June meeting. On the economic front, the U.S. economy continues to expand. There is notable strength in the housing and labor markets (currently 4.7% unemployment), and slower activity in areas like manufacturing and industrial sectors. Although GDP growth in the first quarter was fairly weak, showing an annualized growth rate of 0.8%, estimates for the second quarter are stronger, with the Atlanta Federal Reserve forecasting an annualized growth rate of 2.5%.

Against this backdrop, in this installment of *Insights* we discuss three near- to intermediate-term risks facing global investment markets: the U.S. presidential election, the referendum in Great Britain on June 23 about its membership in the European Union, and changes in Federal Reserve policy. We note in particular, first, that returns of the S&P 500 Index have not historically differed drastically in election years from the long-term average and that the party-affiliation of the incoming president has also not corresponded to any significant difference. Second, odds have increased that the UK will remain in the EU. Third, a decision by the Fed to increase interest rates could result in higher stock market volatility, but in our view the U.S. economy is strong enough to absorb the decision.

Performance

Most investment indices were up in May, which continued their trend higher from the first quarter.

Index Name	May	2016 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	0.27	2.70	5.07	4.93	US Muni Bonds
BarCap US Agg Bond TR USD	0.03	3.45	3.33	4.97	US Taxable Bonds
BarCap US Corporate High Yield TR USD	0.62	8.06	5.44	7.42	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	-0.18	6.71	5.94	7.57	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	-5.44	7.68	-3.26	4.84	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	0.49	3.34	9.96	7.55	US Equity -- Large
S&P 500 TR	1.80	3.57	11.67	7.41	US Equity -- Large
NASDAQ Composite TR USD	3.83	-0.61	13.17	9.68	US Equity -- Large
Russell 1000 TR USD	1.75	3.51	11.44	7.50	US Equity -- Large
Russell Mid Cap TR USD	1.64	5.02	10.33	8.03	US Equity -- Mid-sized
Russell 2000 TR USD	2.25	2.28	7.86	6.27	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	-1.69	0.52	0.12	2.01	Int'l Equity -- Comprehensive
MSCI EM NR USD	-3.73	2.32	-4.83	3.11	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	-0.19	8.76	-12.45	-6.12	Commodities
HFRX Global Hedge Fund USD	0.41	-1.47	-1.19	-0.58	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 5/31/2016

With some late month pressure on fixed income yields, the Barclays US Aggregate Bond Index was effectively flat during the month. High yield bonds continue to perform well. The Barclays U.S. Corporate High Yield index rose 0.62% in May, increasing its YTD return to 8.06%. Treasury yields were flat on the month, but jumped in the final trading days as the Fed took a more aggressive tone with their projections for future interest rate policy. This caused a rise in the U.S. dollar during the month, which led to weak performance in international stock markets. The MSCI ACWI Ex US Index, which tracks foreign developed markets, declined 1.69% in May. The MSCI Emerging Markets Index declined 3.73%.

U.S. stocks were positive in May, with the S&P 500 Index rising 1.80% and the NASDAQ Composite Index rising 3.83%. Mid-caps are the best performing U.S. sleeve this year through May, with the Russell Mid Cap Index returning 5.02%.

Outlook

As we head into the summer months, a number of events are top of mind both for Sage and our investors. Among these include the British referendum on membership within the European Union (dubbed "Brexit"), the upcoming Federal Reserve meeting in June at which the Fed may raise interest rates, and the U.S. presidential election in November.

Of particular interest is the U.S. Presidential election, which this year has particularly captured the imagination of many. Although we have no desire to break our practice of refraining from engaging in party politics, we would be remiss not to discuss the election given the specific client interest that it has generated. Many clients have asked whether the candidates on either side of the aisle have contributed to the stock market's volatility over the last six months. While there have been a number of events outside of the political sphere that have contributed the lion's share of volatility to the markets, including the collapse in oil prices and China's slowdown, it is a distinct possibility that pandering to the far ends of each party during the primary debates and in stump speeches has infused some anxiety into the market. Yet as we move closer to the general election, it seems likely that the tone within each party could shift towards more centrist policy prescriptions in an effort to sway independents and center-leaning party members.

This would follow the historical path of presidential campaigns in which broader, more conciliatory plans are typically promoted as the general election nears. Historically, the U.S. stock market has performed fairly well during election years. Over the last 50 years, there have been 14 elections, with an average calendar-year return of 9.81% from the S&P 500 Index during those election years. If 2008 is excluded, the average return during an election year increases to 13.41%. By comparison, the average calendar-year return in *any year* over that same period (including 2008) was 11.18%.

Year	President (Incumbent)	President (Elected)	Full Year Return
1960	Republican	Democrat	0.45%
1964	Democrat	Democrat	16.43%
1968	Democrat	Republican	11.04%
1972	Republican	Republican	18.96%
1976	Republican	Democrat	23.81%
1980	Democrat	Republican	32.45%
1984	Republican	Republican	6.22%
1988	Republican	Republican	16.61%
1992	Republican	Democrat	7.62%
1996	Democrat	Democrat	22.96%
2000	Democrat	Republican	-9.10%
2004	Republican	Republican	10.88%
2008	Republican	Democrat	-37.00%
2012	Democrat	Democrat	16.00%
Average S&P 500 Election Year Return			**9.81%**
Average Return All Years (with and without an election)			**11.18%**

Stock market returns during an election year have been on pace with returns during non-election years

Source: Sage Financial Group, Morningstar Direct. Data including dividends from 1960 to 2015

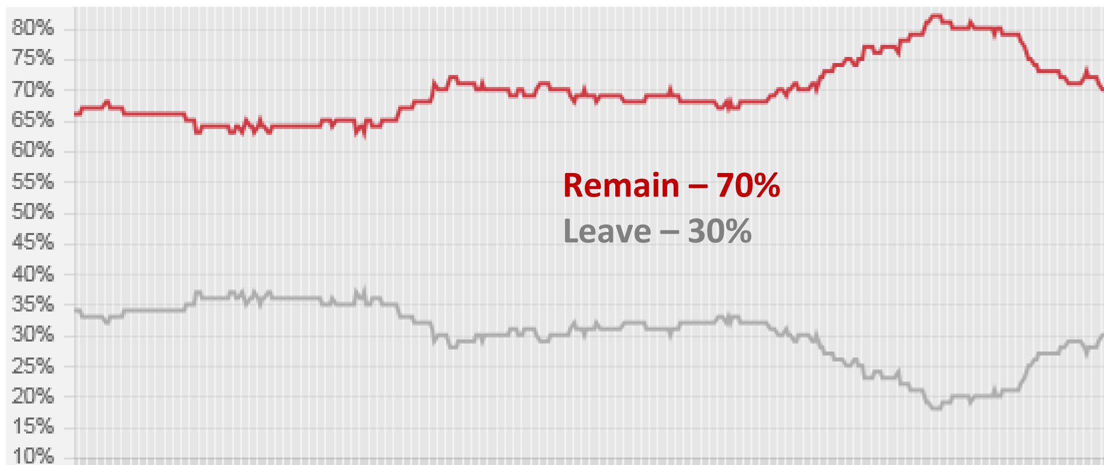
In short, the fact that an election year has occurred has had little bearing on whether or not stocks posted a return that was fairly close to historical averages. It also mattered little whether the incumbent president or newly elected president was a Republican or a Democrat. In election years in which a Democrat was elected, the average return from the S&P 500 was 7.18%. Excluding 2008, that number jumps to 14.55%. In years in which a Republican was elected, the average calendar-year return was 12.44%. *The party affiliation of the incoming President shows no significant bearing on the average long-term market returns.*

These observations strike at the heart of a point we have made in numerous commentaries as well as our ongoing discussions with clients. We at Sage do not manage client portfolios to take advantage of, or to avoid, any one single event; rather we position them to prepare for an array of potential scenarios. Investment market returns over the long-term are influenced by a wide range of events and fundamental factors. To be sure, a single news item or occurrence can cause a sharp swing in an investment. But from our perspective, it is imprudent to try to time investments due to a single event like the presidential election.

To be certain, volatility within the U.S. stock market may increase as the election nears. If the various candidates' rhetoric remains extreme, equities may experience choppy trading due to uncertainty over what specific legislative and executive agendas may result. Nevertheless, we view uncertainty over extreme political posturing as a temporary event. Some may say that this election cycle is bringing out the more extreme ends of both parties, which should have greater bearing on market volatility. Although that may be true, there is still the matter of future gridlock in Congress. Given that Congress is likely to be split even if Democrats regain the Senate, there is going to be a continued reticence on the part of lawmakers to enact policy moves that cater to the extreme ends of either party and that go against their core views. Gridlock may result in few legislative accomplishments in Washington, D.C., but from the standpoint of the stock market, that lack of legislative productivity is often the preferable path because it means a lower chance of the introduction of destructive policy.

Because the general presidential election is still five months away and there is little framework on how to handicap the results, stock markets are currently showing little concern about the outcome. More pressing is the British referendum vote on its European Union membership, which is scheduled for June 23. We have discussed this pending vote in the last few issues of *Insights* and only intend to touch on it briefly now. Recent polling has shown increasing odds that Great Britain will remain in the EU. For instance, PredictWise, a UK betting market shows as of 6/6/16 a 70% probability that Great Britain remains in the EU, up from 65% in mid-April.

Should Britain Remain in the EU?



Source: Predict Wise Betting Market Aggregate Data from 3/31/16 to 6/6/16

In terms of market movements, the Pound/Euro conversion rate, a key indicator of sentiment regarding the vote, has risen 2.9% over the last month as traders also increasingly believe that the UK will remain in the EU. Over the long-term, it is impossible to determine the economic, investment market, and geo-political impact of Britain's exiting the EU. In the short-term, such an event would likely cause significant volatility. For this reason we are encouraged by the fact that the data seems to be showing a decreasing likelihood of such an event.

Of greater interest to the stock and bond markets is June's Federal Reserve Meeting. Earlier in the spring, futures markets were pricing in a mere 3% chance of a rate hike in the June meeting. Many assumed that the weak first-quarter GDP figure, combined with continued uncertainty in international markets, would keep the Federal Reserve on hold. However, over the last month, various Federal Reserve officials have made statements indicating that there indeed was a possibility of a rate hike at the June meeting. As a result, the dollar has strengthened somewhat, and futures markets are now pricing in a 30% chance that the Fed will raise rates.

In our view, a single rate hike will not have a real impact on the economy. Corporate funding costs, outside of the energy sector, are incredibly low, and mortgages rates and auto loans are still priced at very low levels. If the Fed does decide to raise rates, the divide between their interest rate policy and the European Central Bank and Bank of Japan, who have both pushed interest rates into negative territory, will grow even wider. As a result, there could be strength in the dollar, which has given the market some headwinds over the last year.

This brings up an important dynamic. The Fed's willingness to forecast a slower pace of rate hikes earlier in the year helped to alleviate some of the pressures on equity markets in the first quarter, and this is one of the reasons stocks have bounced so feverishly since the middle of February. However, increasing odds of the Fed's raising rates due to strength in labor markets, among other economic data points, may put the stock market into

a bit of a holding pattern. Any additional market volatility may come as a result of rising inflation levels. To be certain, inflation is not at challenging levels. It is, rather, quite muted relative to historical levels. However, the current muted levels provide for easier conditions from which inflation may rise more quickly in the future. Another source of volatility for the market may come from the economy. If economic data improves in the interim, such improvement could bring rate hikes to the forefront, which may reintroduce equity market volatility. Yes; it is a bit counter-intuitive that a stronger economy may actually result in a weaker stock market. Given how intertwined Fed policy has become with stock market dynamics in the current expansion, however, it is not entirely surprising that equity markets hang on their every word regarding policy.

To be clear, it is our opinion that gradually rising interest rates would not have an overly negative effect on economic growth. In some senses, it would improve consumer returns from savings accounts and may actually incentivize borrowers to take on 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 that the Fed is increasingly taking the proverbial punch bowl away from the stock market. As witnessed in the beginning of this year, perceptions of such a step could bring volatility back into play. Uncertainty over future U.S. monetary stands in contrast with in international markets, where central banks continue to be very supportive of equity markets. Valuations are also very favorable. For instance, according to MSCI, European stocks have an average price to book valuation that is 40% lower than U.S. stocks. Dividend yields in Europe are also 69% higher than U.S. stocks. In any event, we believe that the uncertainty surrounding the Fed's path for monetary policy makes the case for incorporating a variety of investments in one's portfolio aside from just U.S. stocks and bonds.

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