SAGE FINANCIAL GROUP
Investment and Wealth Management

SAGE INSIGHTS
MONTHLY ECONOMIC & MARKET ANALYSIS

October 2018

The Fed Raised Rates in September and Sees Additional Growth Ahead

Overview

In September, U.S. stocks and bonds posted mix performance, as did foreign stocks and bonds. Economic data in the U.S. remained generally sound. The Trump administration announced on the last day of September that it had completed a trade pact with both Mexico and Canada. This revision to NAFTA follows two months after the administration reached a conciliatory trade agreement with the European Union in late July. Such an accord with China remains outstanding, and additional tariffs on goods traded between the countries took effect in September. In this installment of *Insights*, we focus on three main areas as the fourth quarter begins: the upcoming U.S. midterm elections, signals from the Federal Reserve on the economic outlook, and the likely next steps in trade negotiations. Although the outcome of the November U.S. midterm elections on the balance of power in Washington is top of mind to many investors, the actual effect of the results on financial markets is likely to be modest. The Federal Reserve met in September and, as was widely expected, raised its key benchmark rate 0.25%, thereby lifting its target range to between 2.00% and 2.25%. This was a fitting response to solid U.S. economic indicators and firming inflation. The Fed signaled its current view of the economic future and its likely policy response. Now that NAFTA is revised, the administration may focus its efforts in the coming months on reaching a trade accord with China, which, if realized, would likely lift global sentiment.

Performance

U.S. and foreign equities posted mixed performance in September, as you can see in the table below.

	Sept.	2018 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	-0.65	-0.40	3.54	4.75	US Muni Bonds
BarCap US Agg Bond TR USD	-0.64	-1.60	2.16	3.77	US Taxable Bonds
BoAML US High Yield Master II TR USD	0.58	2.52	5.54	9.38	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	1.51	-3.04	5.38	7.54	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	2.59	-8.15	-1.68	2.70	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	-1.63	-0.90	2.40	0.80	Hybrid/Hedged Equity
DJ Industrial Average TR USD	1.97	8.83	14.57	12.22	US Equity -- Large
S&P 500 TR	0.57	10.56	13.95	11.97	US Equity -- Large
NASDAQ Composite TR USD	-0.70	17.48	17.72	15.72	US Equity -- Large
Russell 1000 TR USD	0.38	10.49	13.67	12.09	US Equity -- Large
Russell Mid Cap TR USD	-0.64	7.46	11.65	12.31	US Equity -- Mid-sized
Russell 2000 TR USD	-2.41	11.51	11.07	11.11	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	0.46	-3.09	4.12	5.18	Int'l Equity -- Comprehensive
MSCI EM NR USD	-0.53	-7.68	3.61	5.40	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	1.92	-2.03	-7.18	-6.24	Commodities
HFRX Global Hedge Fund USD	-0.69	-1.23	1.02	0.70	Multi-Asset Alternative Invm't

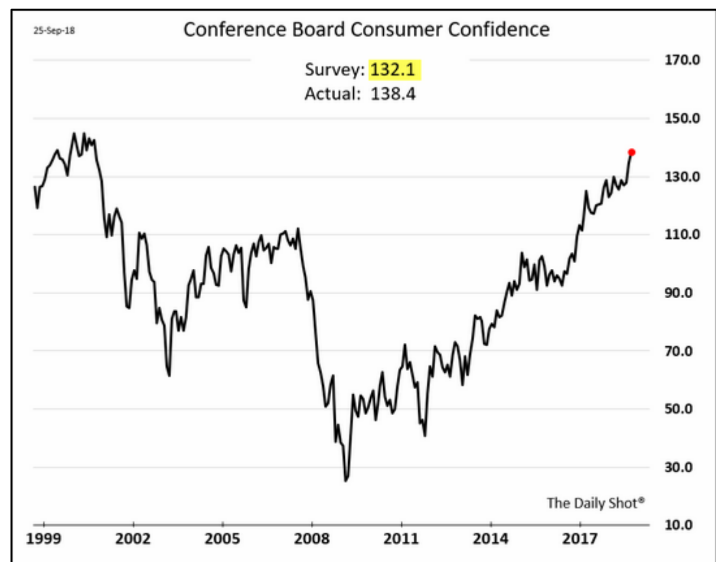
Source: Morningstar Direct. Data through 09/30/2018

The S&P 500 rose 0.57% on the month, but the Russell 2000 Index of small companies declined 2.41%. Year-to-date through September, the S&P 500 Index is up approximately 10.5%. Small company domestic stocks in the Russell 2000 Index have fared slightly better, gaining nearly 11.5% in 2018 through September. Foreign equities as a whole edged up 0.46% last month, as measured by the broad MSCI ACWI Index Ex-USA, but EM equities, as gauged by the MSCI Emerging Market Index, declined 0.53% in September primarily on currency effects and some increased trade worries. The comprehensive MSCI ACWI Index Ex-USA Index is now down just about 3% so far this year.

The Bloomberg Barclays U.S. Aggregate Bond Index declined last month 0.64% as yields rose because of continued economic growth and higher inflation expectations in the U.S. U.S. high yield bonds, however, gained, as did emerging market bonds (both dollar-denominated and local currency) due to positive policy developments in Turkey and Argentina, which reduced investor worry about contagion.

Outlook

Economic data in the U.S. remained broadly solid. For instance, U.S. consumer confidence reached the highest point in nearly 18 years, beating expectations. The unemployment rate remains below 4.0% and at a level consistent with full employment. Some of the idiosyncratic pockets of turbulence abroad that rattled markets in August have seen constructive policy responses (e.g., Turkey's central bank raised interest rates to support its currency, and the IMF increased the size of its credit package to Argentina). Overall, the global economy is still strong, and we think that problems will remain largely isolated. Trade policy worries still overshadow the financial picture, and Europe still faces certain structural challenges, including Brexit uncertainty. In our view, however, the broad investment outlook remains on balance largely positive. The global expansion is likely to continue over the near future with the United States and China, despite their trade squabbles and slight decelerating pace of expansion, as its growth engines.

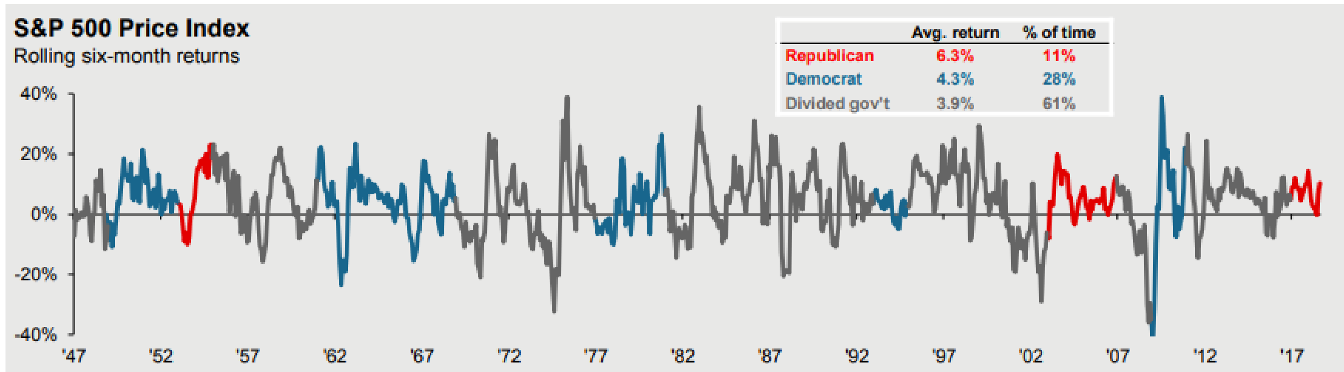


U.S. Midterm Elections

As November nears, the upcoming U.S. midterm elections are drawing increasing investor interest. Specifically, the question is often asked, "How could elections affect financial markets?"

Because the pendulum tends to swing between political parties over time, the party of the incumbent President typically, more often than not, loses seats in midterm elections. With such slim majorities by Republicans in the House of Representatives and the Senate, a salient question is whether Democrats will take back seats in Congress from Republicans and, if they do, whether they might take back control of one or more houses of Congress. Although politics and the potential for divided government (i.e., "gridlock") make for great headlines, the investment implications of elections are usually minimal. In fact, looking back to 1947, the government has

been divided 61% of the time, while Democrats and Republicans controlled both the executive and legislative branches 28% and 11% of the time, respectively. The important point to note: Stocks via the S&P 500 Index have experienced positive rolling six-month price returns across all three different scenarios of political control.



Source: FactSet, Office of the President, J.P. Morgan Asset Management; as of September 30, 2018.

U.S. GDP growth is projected to be above 3% in the third quarter. Unemployment is at a 20-year low. Inflation is low and stable. And central banks are not being overly restrictive. In times of strong economic growth, the minority party tends historically not to win in a landslide against the incumbent party, even if it does gain seats. It is not clear if that tendency will repeat this year.

The table below outlines how the various midterm election outcomes may affect interest rates, the U.S. dollar, and the degree of difficulty in passing the increase to the debt-limit. For example, the highest probability outcome is that Democrats take the House and that Republicans maintain their majority in the Senate. Interest rates, according to this analysis, would decline slightly (see the "10-year" column), the yield curve would flatten further ("2-10 spread" column), the dollar would decline slightly ("USD" column), and there would be little opposition to raising the debt-ceiling ("Debt-limit passage" column).

House	Senate	Margin	Probability	10-year	2-10 spread	USD	Debt-limit passage
D	R	Slim	High	Decline <5 bps	Flatter	Modestly Bearish	Easiest
R	D	Slim	Low	Decline 5-10 bps	Flatter	Modestly Bearish	Hardest
D	D	Slim	Medium	Decline ~10 bps	Flatter	Bearish	Very challenging
		Landslide	Low	Decline 10-20 bps			
R	R	Slim	Medium	Increase 5-10 bps	Steeper	Bullish	Challenging
		Landslide	Low	Increase 10-20 bps			

Source: BofA Merill Lynch Global Research

Our current view is that a divided Congress with Democrats' regaining the House is the most likely midterm election outcome. From an investment perspective, the outcomes with the most implications would be a landslide in either direction, which seems unlikely at this time.

It is important, in our view, to separate feeling (i.e., one's preferred political views) from thinking (i.e., what most likely will occur whether I like it or not) when making investment decisions. The economy continues to be strong. Whatever the outcome of the midterms, in our view the effect of the new Congress on legislative policy

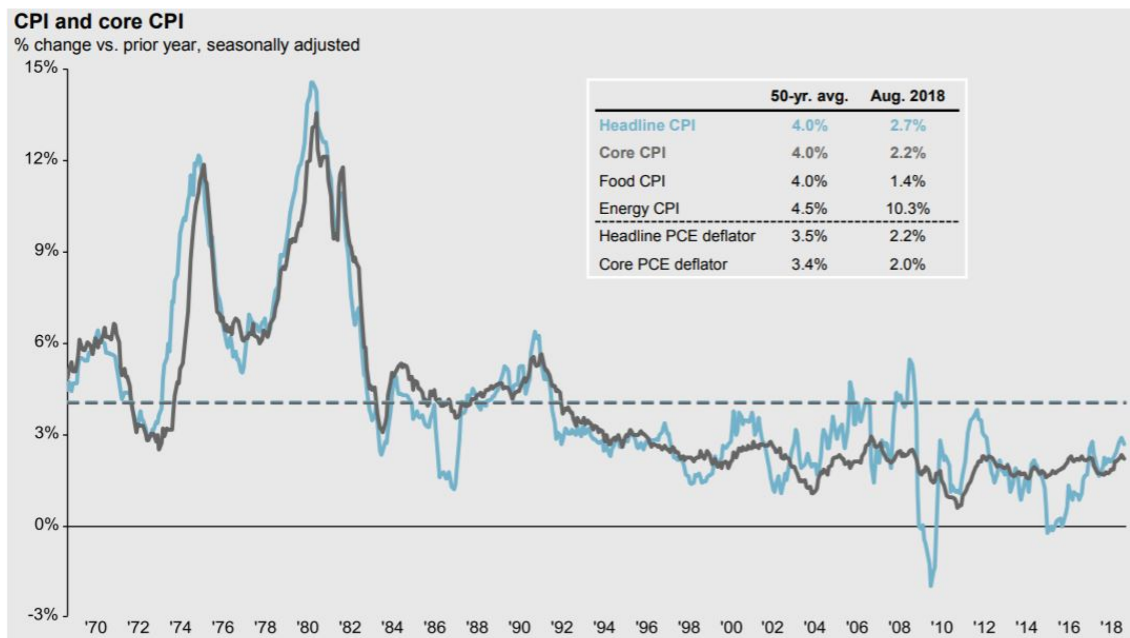
over the next two years will likely be modest, and the effect of that legislative policy on a globally diversified portfolio will in turn also likely be slight.

Since tax reform was passed last year, it seems unlikely that the Republican-controlled Congress will tackle entitlement reform or immigration policy in any meaningful way anytime soon. A split in Congress or a Democrat-controlled Congress with a Republican president's veto power is not likely to change that lack of anticipated legislative progress. Political gridlock often has a neutral to positive effect on financial markets, since policy uncertainty is reduced, and since the likelihood of the status quo is increased. Currently we do not expect much of a direct, lasting effect on investments from the midterms, however they turn out.

Federal Reserve Policy and Economic Forecast

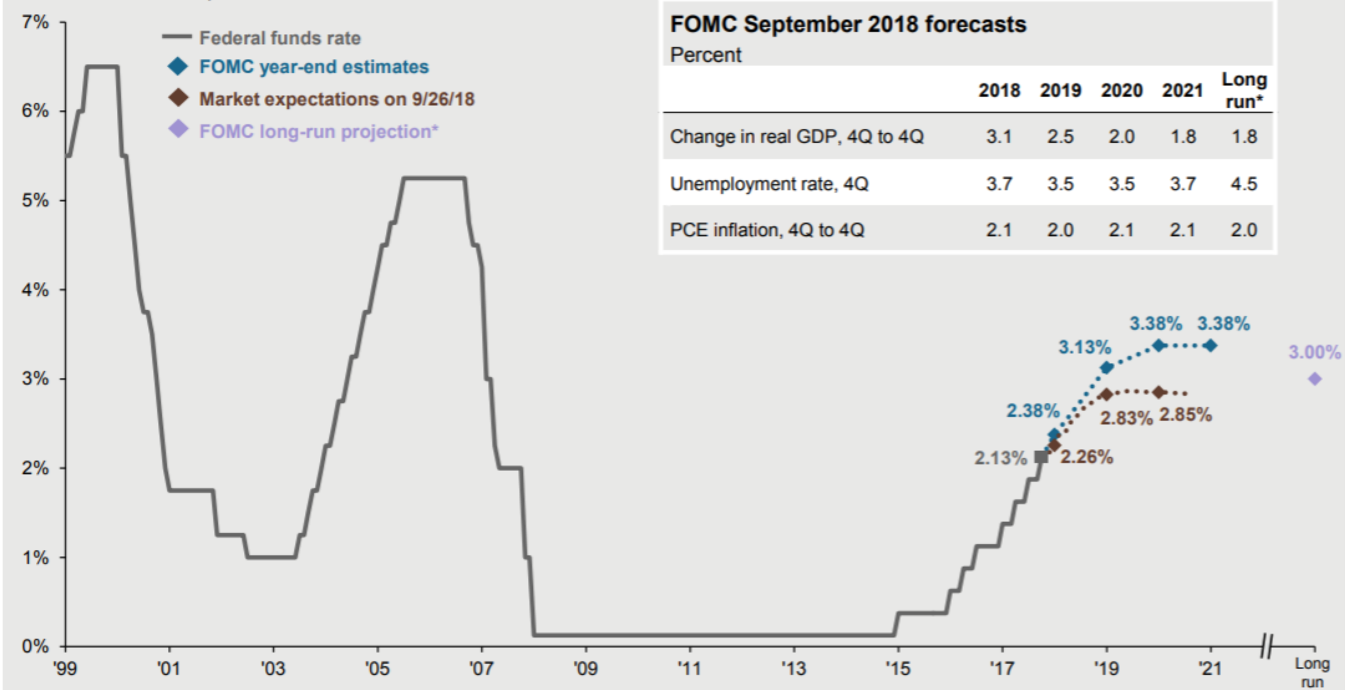
When the Federal Reserve Open Market Committee met on September 25-26, it raised its benchmark Fed Funds rate one-quarter percentage point. The Fed's preferred measure of inflation, the Personal Consumption Expenditures (PCE) deflator, has risen to the Fed's target level right at 2.0%. It can be helpful to keep in mind that the Fed uses a different metric for its policy decisions than the widely cited Consumer Price Index (CPI). It also helpful to remember that the Fed chooses to look at the *core* inflation reading of the PCE, which excludes more volatile components like food and energy. The reason is that it wishes to base policy moves on more stable underlying inflationary pressures, not those that are ephemeral.

Two key signals emerged from the recent two-day meeting by the Fed to market participants about its outlook and likely future policy measures. One was that it removed for the first time in years from its statement the clause "the stance of monetary policy remains accommodative" as a description of its overall policy. The change in wording suggests that the committee wishes to advance interest rate policy beyond the exceptionally low (and at times near-zero) interest rate policy that has prevailed since the onset of the global financial crisis a decade ago. The economic recovery has matured, and so must the monetary policy.



Source: BLS, FactSet, J.P. Morgan Asset Management.
CPI used is CPI-U and values shown are % change vs. one year ago. Core CPI is defined as CPI excluding food and energy prices. The Personal Consumption Expenditure (PCE) deflator employs an evolving chain-weighted basket of consumer expenditures instead of the fixed-weight basket used in CPI calculations.

A second signal was the so-called "dot plot," which depicts where Fed members expect interest rates to go over the next few years. It is important because it implies what economic and financial conditions the Fed Committee members believe will prevail in either response to which or in anticipation to which Fed policy will be enacted. Currently, it seems most likely that there will be another increase in rates in December. It also seems as though, at present, there will be another three hikes in 2019 and one more in 2020, with rates possibly on hold in 2021. Although some analysts believe that the Fed will raise rates 5 more times between now and the end of 2019, we continue to think it possible that the Fed takes stock of its policy and the economy next year more than many expect. If so, then it might only raise rates once more this year (in December) and twice in 2019. This is not the consensus view, but it is worth considering given the likely fading economic effects from tax reform and the effects of higher interest rates on lending and consumption patterns for things like auto and home purchases, as well as business investment.



	2018	2019	2020	2021	Long run*
Change in real GDP, 4Q to 4Q	3.1	2.5	2.0	1.8	1.8
Unemployment rate, 4Q	3.7	3.5	3.5	3.7	4.5
PCE inflation, 4Q to 4Q	2.1	2.0	2.1	2.1	2.0

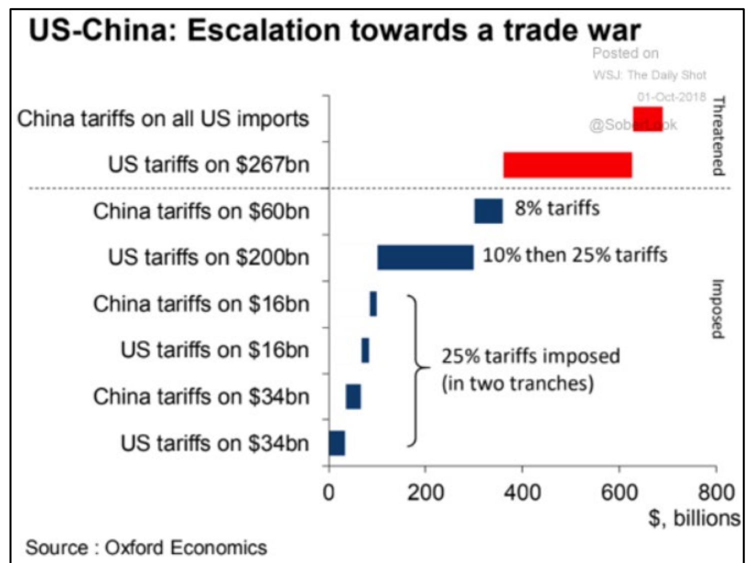
Source: Bloomberg, FactSet, Federal Reserve, J.P. Morgan Asset Management.
Market expectations are the federal funds rates priced into the fed futures market as of the date of the September 2018 FOMC meeting and are through September 2021. *Long-run projections are the rates of growth, unemployment and inflation to which a policymaker expects the economy to converge over the next five to six years in absence of further shocks and under appropriate monetary policy.

We should emphasize that the dot plot views are subject to change; they do not guarantee Fed policy in the future. Still, they reveal an outlook for economic conditions that are critical to both economists and investors. For instance, the Committee currently anticipates that unemployment will bottom around 3.5% in 2020. That prognostication, in turn, implies that the economy will likely continue to expand through this year and next and on into 2020. This already lengthy economic expansion seems to have the stamina to continue for the foreseeable future. Inflation remains contained and at the Fed's long-term target level. Wage growth has been ticking up slightly, and it has not translated into broadly higher consumer prices. So far tariffs on foreign goods have also not led to higher inflation.

This is all another way of saying that inflation pressure in the U.S. is currently neither overly hot nor overly cold. The economy is expanding well, but it is not overheating. This is one reason that we believe that the near-term risk of recession is currently very low.

Trade Policy and Other Global Matters

Now that the Trump administration has negotiated trade pacts with the European Union and Canada/Mexico, we are encouraged that in theory the U.S. may be able to focus more than it has up to this point on similarly ending uncertainty and inking a trade deal with China. When the two countries will achieve such success remains unknown.



We do not expect any agreement before the U.S. midterm elections. It is not inconceivable, however, that a deal could be reached by the end of 2018. That would be a sound strategic goal, since until that point recent tariffs imposed by the U.S. on an additional $200 billion's worth of goods will be just 10%. That duty is set to increase to 25% in 2019, as outlined in the summary graphic nearby.

Some planned global appearances by high-level administration officials could open doors to a deal. Vice President Pence will participate in November at the East Asia summit in Singapore and the Asia Pacific Economic Cooperation forum in Papua New Guinea. President Trump will have an opportunity to meet with Chinese President Xi several weeks later at the G20 forum. At this point, resolution before late fall seems unlikely, and financial markets may remain vulnerable to trade-related volatility events in the meantime.

Although we do believe that in time China and the U.S. will strike a trade deal, we acknowledge that the path to that point remains murky and likely filled with ups and downs. In this connection, it is worthwhile to mention some of the risk factors that we are watching.

Perhaps the most significant if it were to occur is the risk that China's economic growth decelerates at a sharper pace than currently expected. Such potential slower growth could ensue because of a larger effect from its trade dispute with the United States. GDP growth in China over the next year is likely to range between 5.5% to 6.5%, but where it actually falls will depend on a number of currently unpredictable factors.

The ongoing uncertainty until such a trade deal is reached between the U.S. and China also remains a risk factor for global market sentiment generally. The potential for escalating trade frictions combined with an increasingly hawkish Fed and a still strong dollar that might draw additional inflow from emerging market assets is the largest hurdle for foreign assets in general.

Brexit remains a potential geopolitical risk, specifically because there is currently still no transition deal on the books between the U.K. and the E.U. This lack of an agreement raises the level of uncertainty about what effect

the exit will have on British and European companies, trade, immigration, worker status, and cooperation. If there is no deal by the end of March 2019, the U.K. will revert to operating under World Trade Organization rules. This is widely seen as an arrangement that would hurt British companies because of automatic tariffs that would be imposed on goods and services.

On the flip side, we believe that we could be nearing a peak in country-specific risks like those that have garnered attention in Turkey and Argentina. And so we do not think that they are somehow indicative of broader problems in the emerging economic world.

Summary and Conclusion

On the whole, we see the Fed's recent interest rate increase as a sign that the U.S. economy remains on strong footing. Domestic economic growth seems durable, inflation remains low, and employment remains high. We remain positive on the global economic outlook despite ongoing trade concerns. It is encouraging that the U.S. has negotiated trade agreements in recent months with both the European Union and North American neighbors Mexico and Canada. Such progress may clear the way for the Trump administration to make similar constructive headway with China, although much about that path forward remains unclear. Political uncertainty in Europe has increased in recent months with both Britain's exit next year from the EU and in places like Italy, where populist reforms raise additional geopolitical questions. The reaction by investors in foreign assets to some of these developments, particularly in emerging market stocks and bonds this year, may be overdone. In our view, investors should remain balanced in their asset allocations and avoid overemphasis of one or two investments relative to others. Whatever the outcome of the U.S. midterm elections, we foresee a relatively low near-term risk of recession in the U.S. in view of strong corporate earnings, solid manufacturing activity, and positive consumer sentiment.

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