SAGE FINANCIAL GROUP
Investment and Wealth Management

SAGE INSIGHTS
MONTHLY ECONOMIC & MARKET ANALYSIS

May 2019

S&P 500 Notches New All-Time High Amid Patient Fed and Strong Economic Growth

Overview

In April, domestic and foreign stocks and bonds climbed yet again. The monthly return for the S&P 500, for instance, was a sharply higher 4.05%, and non-U.S. stocks in the MSCI ACWI ex-USA gained 2.64%. U.S. bond prices were largely flat on modest yield movement so that, for instance, the Bloomberg Barclays U.S. Aggregate Bond Index returned an almost unchanged 0.03%. The specter of Brexit was delayed until the fall. Negotiations between the U.S. and China seemed to be going well through the end of April, although we continue to think that trade-related risks may be a source of volatility for markets throughout the year. The Federal Reserve reaffirmed its more dovish, wait-and-see approach to any future rate increases or decreases. These were key elements of the benign backdrop against which the S&P 500 hit a few all-time highs near the end of the month. In this issue of *Insights*, we share our view on (1) the current state of the U.S. economy, (2) the market and economic developments in Europe, and (3) the potential implications of the latest all-time highs reached by the S&P 500.

In our estimation, the underlying fundamentals of the U.S. economy continue to minimize the risk of recession in 2019, and the Fed's most recent comments and policy announcements strengthen this assessment. Europe remains a mixed bag in markets, politics, and economics, but, in our view, it poses minimal systemic risk to overall global growth despite its own struggles. When an index like the S&P 500 reaches an all-time high, this prompts various investor behavioral responses (especially fear of pullback or greed for more gains). We examine the history of all-time highs to provide some potential guidance to investors.

Performance

April was another positive month for most U.S. and foreign stocks, as well as certain bonds (see table below).

	April	2019 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	0.38	3.28	3.56	4.55	US Muni Bonds
BarCap US Agg Bond TR USD	0.03	2.97	2.57	3.72	US Taxable Bonds
BoAML US High Yield Master II TR USD	1.40	8.90	4.84	10.19	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	0.24	7.21	5.23	7.96	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	-0.18	2.74	-0.97	3.52	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	0.67	6.67	1.09	1.79	Hybrid/Hedged Equity
DJ Industrial Average TR USD	2.66	14.79	12.60	15.43	US Equity -- Large
S&P 500 TR	4.05	18.25	11.63	15.32	US Equity -- Large
NASDAQ Composite TR USD	4.77	22.38	15.82	18.10	US Equity -- Large
Russell 1000 TR USD	4.04	18.60	11.41	15.39	US Equity -- Large
Russell Mid Cap TR USD	3.81	20.97	9.75	15.65	US Equity -- Mid-sized
Russell 2000 TR USD	3.40	18.48	8.63	14.10	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	2.64	13.22	2.83	7.75	Int'l Equity -- Comprehensive
MSCI EM NR USD	2.11	12.23	4.04	7.50	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	-0.42	5.88	-9.43	-2.67	Commodities
HFRX Global Hedge Fund USD	0.66	3.28	-0.02	1.64	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 4/30/2019

The S&P 500 rose 4.05% on the month, in line with the Russell 1000 Index of large companies (up 4.04%). The Russell 2000 Index of small companies also gained 3.40% in April, and both large-cap and small-cap Russell indices have advanced approximately 18.5% for the year through April. The MSCI ACWI Index Ex-USA Index, which is a measure of all stocks outside the U.S., is now up approximately 13.25% YTD. The MSCI Emerging Market Index gained more than 2% for the month and is up nearly 12.25% YTD through April.

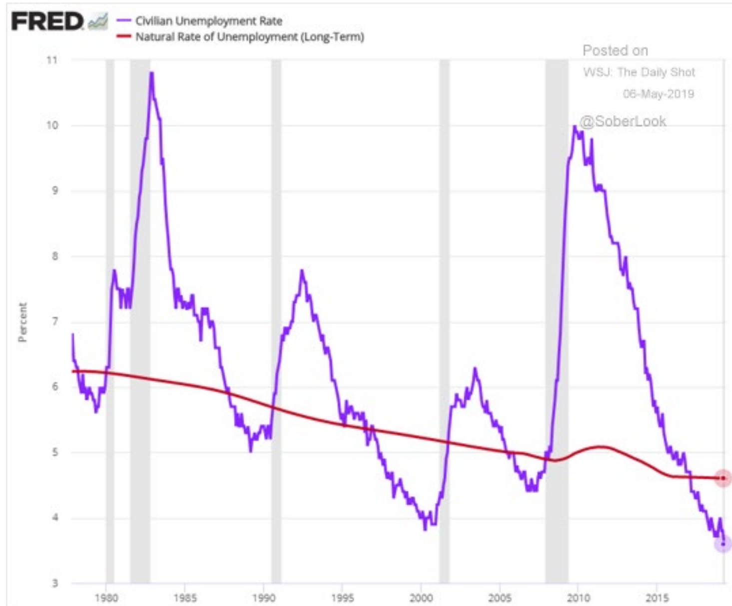
The Bloomberg Barclays U.S. Aggregate Bond Index was essentially flat in April (inching up 0.03%). The yield of the 10-year Treasury Note rose about 10 basis points on solid GDP and earnings news. With additional indications of steady economic growth and patient interest rate policy from the Federal Reserve, high yield bonds gained 1.40% last month. Foreign, U.S. dollar-denominated emerging market bonds in the JPMorgan EMBI Global Diversified Index gained 0.24% in April and have risen 7.21% YTD through April. The local currency EM bond index, the JPMorgan GBI EM Global Diversified, nudged down 0.18% in April largely because of U.S. dollar strength. A 50/50 blend of the two EM bond indices continues to have a YTD gain, through April, of approximately 4.97%.

Outlook

The Fed has confirmed its wait-and-see approach, and fears that gripped markets in the fall that monetary policy error by the Fed might tip the country into recession have subsided. The pace of equity market gains this year through April has been rapid, and we caution that the magnitude of this appreciation is unlikely to be replicated at the same pace through the remaining eight months of the year. At the same time, we caution investors not to view recent all-time highs reached by the S&P 500 Index in too pessimistic a light. Valuations in U.S. equities have broadly become more elevated after the S&P 500 has reached new all-time highs, but, as we explain below, in and of itself a new all-time high does not portend an imminent, sharp decline in stock market prices. Economic weakness and political uncertainty may continue in Europe, but Europe has many economic ties to China, which has been buoyed by stimulus measures, and a strengthening Chinese economy has the potential to lift European economic prospects. Trade negotiations between the U.S. and China are ongoing and seem to have been largely constructive; however, signs have emerged in the first week of May that there remain some lingering challenges to the conclusion of a landmark trade accord between the two economic giants. We remain optimistic that such a deal will be reached this year.

U.S. Economy and Equity Markets

Economic growth in the U.S. remains sound. First-quarter U.S. GDP growth beat expectations with a quarter-over-quarter annualized growth rate of 3.2%. The growth rate had in recent quarters been broadly decelerating, amid mixed data reports. Economic growth for Q1 GDP was expected by many observers surveyed by Dow Jones to be 2.5%. As we discussed last month, although the U.S. yield curve inverted for 6 days beginning at the end of March, we continue to think that the near-term (i.e., in 2019) risk of recession is low. Global economic growth (i.e., in the U.S. and elsewhere) is slowing from prior rates of economic expansion, but the U.S. remains a bright spot. The fading effects of fiscal stimulus via tax reform may lead to a recurrence of slowing growth in the U.S. as the year progresses. After the protracted government shutdown at the beginning of the year, the stronger-than-expected GDP number is welcome, although we think it unlikely that full-year 2019 growth will be above 3%.



One result of the extended period of economic growth since the last recession has been the steep and steady drop in the unemployment rate. The nearby chart shows this decline with the purple line. As of the end of April, the unemployment rate hit a 50-year low of 3.6%. The red line shows the long-term average rate of assumed full employment, which is determined by the Federal Reserve. The fact that the endpoint on the red line is above the endpoint on the purple line means that the labor market is currently characterized by extremely positive conditions and that it may be difficult for employers to find skilled workers without increasing wages to attract them. Hourly wage increases have been growing at an annualized rate above 3% in recent months, which is well above the overall inflation rate. Productivity gains, partly through increased automation, have helped to blunt the effect on corporate earnings, but wage inflation remains something to watch.

Despite these incipient wage gains, inflation is well contained in the U.S. Headline inflation (via the Consumer Price Index, or CPI) rose at a 1.9% year-over-year rate in March. Core CPI (without volatile food and energy items) was 2.0% year-over-year at the end of March. The Fed's preferred metric, Personal Consumption Expenditures, shows more modest increases: 1.5% for headline and 1.6% for core in March (the latest data). Weak inflation had prompted some to think that the Fed might cut interest rates at some point in the next several quarters to boost an economy that until recently had seemed to be decelerating. The stronger-than-expected growth rate for Q1 seems to have poured water on that idea. The dip back down from the low-2% range to the mid- to upper-1% range for various inflation gauges also seems to lessen the likelihood that the Fed will resume its program of raising interest rates again to curtail growth. The economic data, in other words, simply reinforces what the Fed has been at pains to insist and explain since late December, namely, that it is on hold and that it remains both extremely patient and data-dependent.

Abroad, China has continued to stimulate its economy, and there are signs that it has recently begun to have some positive effects, as we will discuss below. But economic data out of Europe is less positive, which is more in line with U.S. indicators.

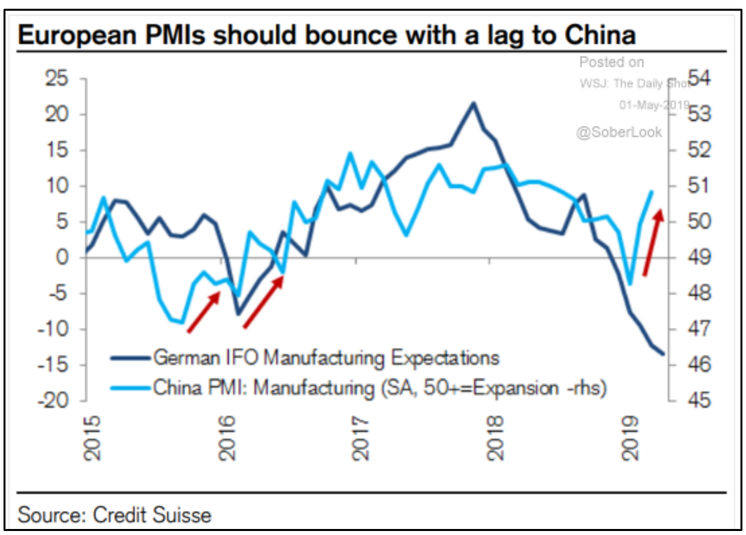
Although our economic outlook does not foresee the occurrence of a U.S. recession in 2019, our current investment outlook is less certain because of a wide range of potential outcomes. Stocks, in particular, have run up very quickly this year off of the lows reached in late December. We do not think that these gains are unjustified given the sharpness of the 4Q 2018 sell-off, but we do wonder to what extent such gains may continue in view of, among other things, the possibility that markets have already priced in a coming conclusion to the trade tensions between China and the U.S. As of this writing, the yield curve is no longer inverted, and even if it were to invert again briefly, it would be difficult to base near-term investment decisions on it.

An Update on Europe

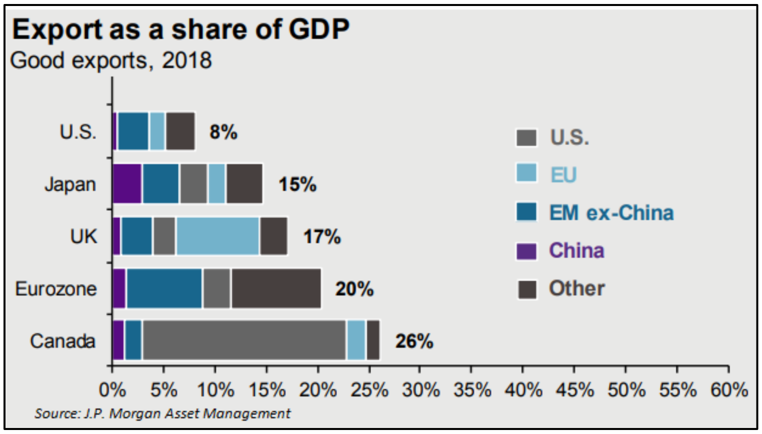
From an economic perspective, data out of the eurozone and the U.K. weakened throughout 2018 and into 2019. Italy entered its first technical recession (i.e., two consecutive quarters of negative growth) since 2014, and Germany just narrowly avoided one. The chart nearby shows how Euro-area GDP generally, and Germany GDP specifically, slowed significantly last year in Q3-Q4. Economists on average expect GDP to accelerate through the rest of 2019.

The positive projections are largely tied to a rebound in Chinese economic activity, which tends to affect Europe positively by boosting its exports to China.

Through the first four months of 2019, the trade situation became less gloomy, the Brexit deadline was extended, and, most importantly, China's economic activity picked up meaningfully thanks to government stimulus in the world's most populous country. Europe stands to benefit from China's improved backdrop, which could boost European exports and thus its manufacturing numbers. As shown below, the relationship between European exports and China's activity tends to operate on a 6-month lag but is not perfect.



However, the outlook remains mixed. Europe's economy tends to be more cyclical than that of the U.S., largely because of Europe's heavier dependence on cyclical, goods-producing industries (e.g., automobiles, aerospace, etc.). In terms of GDP, the U.S. counts on exports for only 8% of its GDP, whereas selling goods to other countries accounts for 20% of the Eurozone's GDP. The U.S. relies much more heavily than does Europe on service industries (e.g., technology, health care, financial services), which tend to be steadier in nature than cyclical industries.



Overall, we think economic weakness could continue in Europe, but China's rebound could well be the catalyst for an improved European growth picture.

Reflections on S&P 500 Index at All-Time Highs

While it can be a natural tendency for investors to want to sell at an equity index's all-time high, the decision to remain invested tends to be the better move based on the historical record.

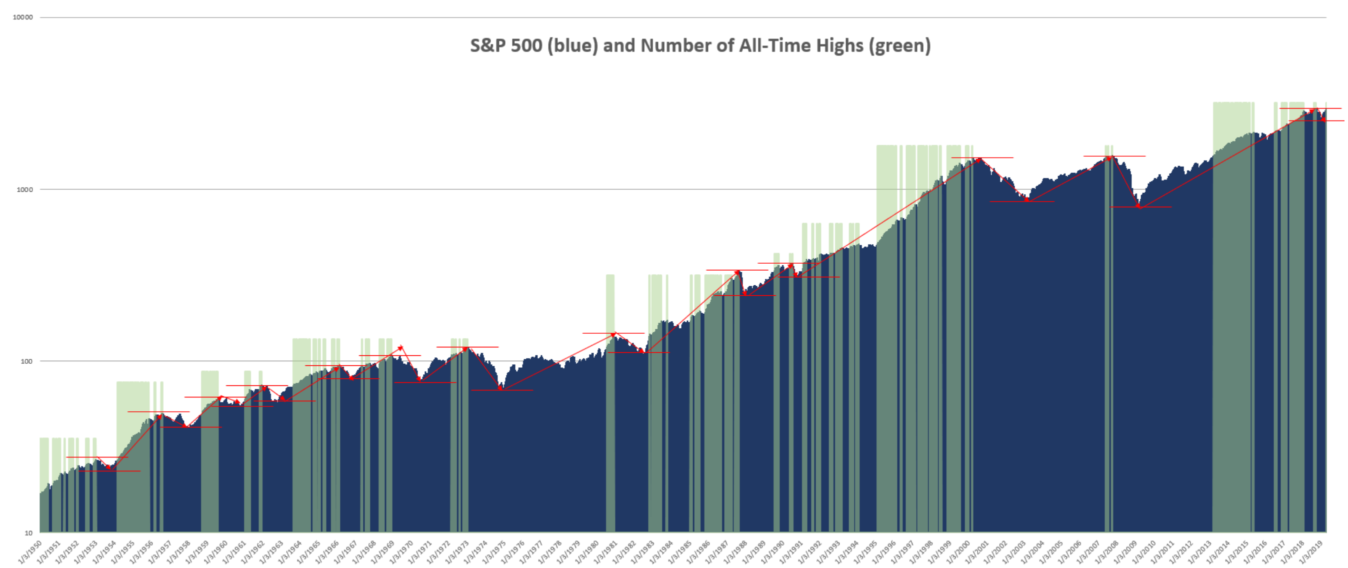
Between the tech bubble and the market peak in 2007, which immediately preceded the bear market that began in 2008, only 8 all-time highs occurred. As you can see from this historical survey in the table and graphic below, this low number was not exactly unprecedented, but it was still unusual. The longer historical pattern suggests that it is more likely than not that, barring a financial crisis or other similar external shock, the S&P 500 will achieve a number of additional all-time highs before the next bear market begins.

- Just because an all-time high may look like a new market peak has been reached, the all-time high often precedes a period of new all-time highs. The period of these all-time highs can be short (as in 2007) or extended (as from 1991-2001).
- As shown in the table below, between 2009 and 2018, the S&P 500 hit all-time highs 207 times. This was similar to the 1990-2000 period when the S&P reached new heights 307 times.
- Since 1950 through 2018, bull markets have averaged 95 all-time highs per cycle, drawn down an average of 29.8%, and rallied 139.3%.
- At the end of 2018, the S&P 500 fell 19.8%, while the technology-heavy Nasdaq and small-cap Russell 2000 dropped by over 23%.

Peak Date	Trough Date	Related Recession or Market Event	Bull Market Name	Years from Peak to Trough	Related Market Sell-Off	Years from Trough to Peak	Recovery Following Market Event (%)	Number of All Time Highs During Bull Run (Daily Close)
1/5/1953	9/14/1953	Q2 1953 - Q2 1954	1953 to 1956	0.7	-15%	2.88	1.19	136
8/2/1956	10/22/1957	Q3 1957 - Q2 1958	1957 to 1959	1.2	-22%	1.78	56%	49
8/3/1959	10/25/1960	Q2 1960 - Q1 1961	1960 to 1961	1.2	-14%	1.13	39%	39
12/12/1961	6/26/1962	N/A - 1962 flash crash	1962 to 1968	0.5	-28%	6.43	107%	170
11/29/1968	5/26/1970	4Q 1969 - 4Q 1970	1970 to 1973	1.5	-36%	2.63	74%	34
1/11/1973	10/3/1974	Q4 1973 - Q1 1975	1974 to 1980	1.7	-48%	5.37	90%	-
2/13/1980	3/27/1980	Q1 1980 - Q3 1980	1980 to 1980	0.1	-17%	0.67	43%	23
11/28/1980	8/12/1982	Q3 1981 - Q4 1982	1982 to 1987	1.7	-27%	5.04	229%	152
8/25/1987	12/4/1987	N/A - 1987 flash crash	1987 to 1990	0.3	-34%	2.62	65%	18
7/16/1990	10/11/1990	Q3 1990 - Q1 1991	1990 to 2000	0.2	-20%	9.46	417%	307
3/24/2000	10/9/2002	Q1 2001 - Q4 2001	2002 to 2007	2.5	-49%	5.00	101%	8
10/9/2007	3/9/2009	Q4 2007 - Q2 2009	2009 to 2018	1.4	-57%	9.58	332%	207
10/3/2018	12/24/2018	N/A - Recession Fears		0.2	-20%		TBD	

Source: Sage Financial Group; Standard and Poor's. Green shading indicates a bear market that occurred without a recession.

The graph below represents visually the same data, which supports the idea that there are often periods of new market highs and not typically a simple one-and-done occurrence of a new market high.



Source: Sage Financial Group, Standard and Poors. S&P 500 Price Index from 1/1/1950 to 4/30/2019.

Bottom line: All-time highs must come before new all-time highs. Both highs and lows get higher over time because equity markets tend to expand with the global economy. This advance does not come without periodic drawdowns, but neither does an all-time high signal an imminent stock market decline, based on historical precedent.

Put differently, from a behavioral investment perspective, at present we caution against both the fear of an impending bull market decline (there may well be a sequence of new all-time highs) and the overconfidence that equity markets will unrelentingly march higher (there may well be a correction before the next recession).

Conclusion

Investment assets, especially equities, have risen strongly, through the first four months of 2019. Positive returns are always exciting, and we are very pleased with this development. But we do not think that the rate of gains realized in the first four months is likely to continue at the same pace or with the same magnitude throughout the remainder of the year. Domestic economic growth seems durable, inflation remains low, and employment remains high. The U.S. economy is likely to continue to grow, but it may expand at a slower pace than it did in the first quarter. Corporate earnings growth is lower than a year ago, and investors may take note. Major risks to economic and market stability may have their source in geopolitical surprises more than any fundamental financial imbalance or investor exuberance.

We remain generally constructive on the global economic outlook despite the unfinished trade agreement and ongoing uncertainties in Europe, including the growth slowdown there. We continue to think that, in time, China and the U.S. will strike a trade deal, but the precise path to the goal line may still be filled with ups and downs.

We explained last month that the recent temporary and shallow inversion of the Treasury yield curve should not be seen as overly alarming but also should not be ignored. Similarly, our thoughts this month convey our belief that the recent all-time highs that the S&P 500 has notched should neither be seen as signaling a market peak that is necessarily past nor a stock market decline that is imminent. With regard to both yield curve inversions and the attainment of all-time highs, the historical record has frequent and recurrent evidence of additional equity price appreciation, sometimes for extended periods, before the next bear market and/or recession.

Stock price appreciation, when it occurs, does not occur in a straight line upward. There are fits and starts, ups and downs. Currently, the U.S. economy does not show significant evidence of the type of imbalances that typically prompt or coincide with recessions, and we remain of the view that an economic recession is unlikely in 2019. At the same time, given how much equity markets have run up so far in 2019 through April and given the unpredictable nature of geopolitical or policy surprises, we remain of the opinion that, rather than skewing allocations toward one type of investment or another, a balanced approach to portfolio asset allocations is warranted.

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