SAGE FINANCIAL GROUP
Investment and Wealth Management

SAGE INSIGHTS
MONTHLY ECONOMIC & MARKET ANALYSIS

July 2019

Hope for Accommodating Fed and Renewed Trade Talks Ignite Broad Gains in June

Overview

In June domestic and foreign stocks and bonds rose sharply, primarily in response to signals from the Federal Reserve that it may soon cut interest rates and hopes for renewed trade policy negotiations between China and the U.S. The monthly return for the S&P 500, for instance, was markedly positive, up 7.05%, and non-U.S. stocks in the MSCI ACWI ex-USA climbed 6.02%. U.S. bond prices rose and yields fell as investors anticipated that the central bank would ease interest rates. For instance, the Bloomberg Barclays U.S. Aggregate Bond Index rose 1.26%. In this issue of *Insights*, we share our updated view on (1) a potentially more dovish Federal Reserve and (2) the U.S./China negotiations on trade. On both fronts, we are cautiously optimistic.

In response to some deterioration in U.S. economic data and other pressures, it now appears even more likely that the Federal Reserve may cut interest rates in 2019, perhaps as soon as at the end of July. This could help market sentiment and the economy in the near term, although some benefits may be priced into equity markets already, and there could be questions about how long the effects will last. As for trade negotiations, in our view, the agreement to stop *quid pro quo* escalations in trade restrictions is a positive development. Overall, advances toward a realistic trade agreement between the U.S. and China will economically benefit both parties and the global economy in general. We have learned, however, that trade-related risks are ever-present and may likely continue to cause volatility in the markets throughout the year.

Performance

Stocks, bonds, and commodities all rose in June (see table below).

	June	2019 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	0.37	5.09	3.64	4.72	US Muni Bonds
BarCap US Agg Bond TR USD	1.26	6.11	2.95	3.90	US Taxable Bonds
BoAML US High Yield Master II TR USD	2.45	10.16	4.70	9.22	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	3.40	11.31	5.30	7.78	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	5.51	8.72	-0.45	3.41	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	1.39	5.97	0.66	1.39	Hybrid/Hedged Equity
DJ Industrial Average TR USD	7.31	15.40	12.29	15.03	US Equity -- Large
S&P 500 TR	7.05	18.54	10.71	14.70	US Equity -- Large
NASDAQ Composite TR USD	7.51	21.33	13.97	17.19	US Equity -- Large
Russell 1000 TR USD	7.02	18.84	10.45	14.77	US Equity -- Large
Russell Mid Cap TR USD	6.87	21.35	8.63	15.16	US Equity -- Mid-sized
Russell 2000 TR USD	7.07	16.98	7.06	13.45	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	6.02	13.60	2.16	6.54	Int'l Equity -- Comprehensive
MSCI EM NR USD	6.24	10.58	2.49	5.81	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	2.69	5.06	-9.15	-3.74	Commodities
HFRX Global Hedge Fund USD	1.61	4.22	-0.11	1.42	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 6/30/2019

The S&P 500 gained 7.05% on the month, nearly identical with the Russell 1000 Index of large companies (up 7.02%) and the Russell 2000 Index of small companies (up 7.07%). With these gains, both large-cap and small-cap Russell indices have advanced 18.84% and 16.98%, respectively, for the year through June. The MSCI ACWI Index Ex-USA Index, a measure of all stocks outside the U.S., rose more than 6% in June and is up 13.60% YTD through June. The MSCI Emerging Market Index also gained more than 6% for the month and has risen 10.58% YTD through June.

Largely because of increasingly dovish signals from the Federal Reserve, yields fell, and the prices on core U.S. bonds rose. The yield on the 10-year Treasury Note fell 0.1 % in June to close the month at 2.00%, its lowest level since November 2016. The Bloomberg Barclays U.S. Aggregate Bond Index gained 1.26% in June, and emerging market bonds gained yet again. U.S. dollar-denominated emerging market bonds in the JPMorgan EMBI Global Diversified Index rose 3.40% in June and have risen 11.31% YTD through June. The local currency EM bond index, the JPMorgan GBI EM Global Diversified, also climbed 5.51% in June. A 50/50 blend of the two EM bond indices has a YTD gain through June of approximately 10.02%.

Outlook

At present we believe that the U.S. economy remains generally sound (Q1 GDP growth was 3.1%), but growth is slowing as the effects of the tax cut fade and business spending deteriorates. GDP for the second quarter is expected to be lower than in Q1 and closer to between 1.5% and 2%. Tensions between the U.S. and its major trade partners continue to threaten the direction and pace of global growth. Although the U.S. and China agreed to a trade truce at the G20 Summit in Japan in late June, the renewed commitment to negotiations did not provide businesses and consumers any clarity about when a deal could be completed or if tensions may escalate yet again. Such uncertainty has led businesses to pull back on capital expenditures and to build their inventories this year.

Bond yields have continued to fall in response to concerns about future growth, including in the United States, where the yield curve has been persistently inverted since mid-May. A bond yield curve is said to be inverted when the yield on short-term bonds is higher than the yield on long-term bonds. Through early July, the difference (i.e., spread) between the 10-year Treasury Note and the 3-month Treasury Bill was consistently around -0.18%, although narrowed late in the second week of the month. In our view, this inversion, which has lasted at present for approximately 2 months and has been of noteworthy magnitude, deserves to be heeded. The U.S. bond market is signaling by the inversion that the future economic and investment outlook is increasingly cloudy.

If investment assets responded positively to the anticipation of progress on U.S./China trade negotiations and the Fed's signals in June that it is ready to become more accommodative in policy, what then is our outlook on these two fronts?

1) Federal Reserve Policy

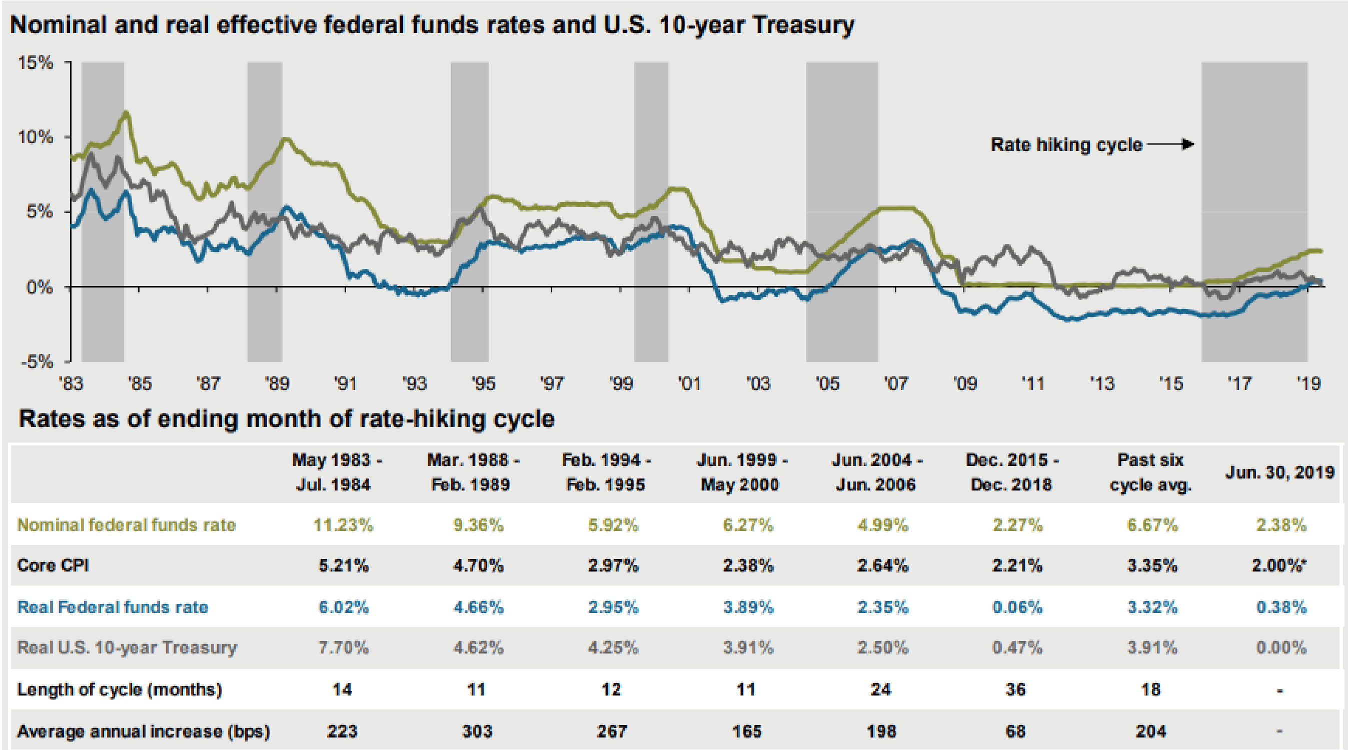
Chairman Powell and the Federal Reserve have a very difficult job ahead of them. Investors are widely expecting two or more 25 bps (0.25%) rate cuts by the end of the year. At this point, central banks and economists around the globe observe that the world economy is slowing, and lowering interest rates is a prudent measure to try to stimulate growth. These cuts, therefore, if they materialize, are being viewed as preventative measures that

could help to orchestrate a soft landing (i.e., slowing growth but no recession). Given this optimism, U.S. equity markets are at all-time highs, despite the fact that the Treasury yield curve is inverted.

To its credit, the Fed's stated policy outlook has successfully walked the fine line between supportive and concerned (tilting more toward concerned as of late), but more accommodative monetary policy still needs to translate into corporate profits for equity markets to maintain gains. U.S./China trade news has tilted back to favorable territory following the G20 summit, but global economic data (e.g., business spending and wage growth, among others) has worsened on the margins.

Why might the Fed cut interest rates if the U.S. economy is generally solid and the June jobs report showed expanded hiring? Macroeconomic data in more than one sector has been weaker than expected earlier this year, and Chairman Powell has repeatedly mentioned that extending the current economic/business cycle is a top priority for the Federal Reserve. The Fed seems intent on trying to prevent any more significant deterioration. Two quotes from recent Fed commentary that stuck out to us were, "An ounce of prevention is worth a pound of cure," and, "Certain groups have just begun to benefit from the current expansion." Basically, the Fed's main intention at present is to elongate the business cycle.

In past cycles the Fed raised interest rates for one of two reasons: either to fight inflation or to fight an excessive rise in asset prices. In contrast to the early 2000s (tech valuations) or 2005-2007 (housing prices), we do not see any clear financial imbalances at present. In the current cycle, the Fed previously raised interest rates in an attempt to normalize rate policy, and thus because inflation was not a worry and asset prices were recovering from a deep downturn in 2008-09, it could be less aggressive. As shown in the table below, the path of rate hikes has been much less pronounced than in prior cycles, averaging only 68 bps per annum in the current cycle as opposed to the past 6 cycles, which averaged 204 bps of hikes each year.



Rates as of ending month of rate-hiking cycle

	May 1983 - Jul. 1984	Mar. 1988 - Feb. 1989	Feb. 1994 - Feb. 1995	Jun. 1999 - May 2000	Jun. 2004 - Jun. 2006	Dec. 2015 - Dec. 2018	Past six cycle avg.	Jun. 30, 2019
Nominal federal funds rate	11.23%	9.36%	5.92%	6.27%	4.99%	2.27%	6.67%	2.38%
Core CPI	5.21%	4.70%	2.97%	2.38%	2.64%	2.21%	3.35%	2.00%*
Real Federal funds rate	6.02%	4.66%	2.95%	3.89%	2.35%	0.06%	3.32%	0.38%
Real U.S. 10-year Treasury	7.70%	4.62%	4.25%	3.91%	2.50%	0.47%	3.91%	0.00%
Length of cycle (months)	14	11	12	11	24	36	18	-
Average annual increase (bps)	223	303	267	165	198	68	204	-

Source: Bureau of Labor Statistics, FactSet, Federal Reserve, J.P. Morgan Asset Management. The real effective federal funds rate and the real 10-year Treasury are calculated as the nominal yields less core CPI. Between 1979 and 1982, the FOMC changed its approach to monetary policy,

As shown in the table below, the yield curve is currently pricing in a 100% probability of a cut in July and 74.3% probability that another cut will be needed in September.

Current Implied Probabilities

Dates: Meeting / Calculation — Calculated 07/05/2019

Meeting	Hike Prob	Cut Prob	1.75-2	2-2.25	Fwd Rate
07/31/2019	0.0%	100.0%	1.5%	98.5%	2.13
09/18/2019	0.0%	100.0%	74.3%	24.6%	1.94
10/30/2019	0.0%	100.0%	59.9%	17.5%	1.87
12/11/2019	0.0%	100.0%	42.1%	10.2%	1.77

Source: Bloomberg, as of 7/5/2019.

As we have written in previous editions of *Insights,* it is difficult to know exactly how these cuts will be perceived by investors or the media. Business and consumer sentiment will be key to how the cycle and markets proceed.

In a positive scenario, an interest rate cut could be perceived as ammunition to address slowing growth in a conventional way. In this scenario, markets could be reassured that the world's most influential central bank is eyeing the total effect of global economic conditions and commercial relations between nations. The U.S. Treasury yield curve could normalize from its current inverted state to something that looks more healthy. As opposed to the last two economic cycles in which the Fed's hand was (or was felt to be) forced into continuing

to hike rakes to control financial imbalances, a dovish Fed may lead to a soft landing (i.e., no, or a very shallow, economic recession).

However, an interest rate cut may be negative if it proves to be a self-fulfilling prophecy of economic weakness and impending recession. That is, a rate cut designed to forestall economic downturn might, by heightening broader market, consumer, and business anxiety, indirectly "cause" that downturn to materialize. An inverted yield curve can be taken to be a self-fulfilling prophecy in its own right for at least two reasons. First, companies can see the inverted curve as a sign that the economy is going to grow more slowly in the years to come and delay hiring, research and development, etc. Second, banks may tighten lending standards in part due to pressured profitability from shrinking net interest margins. (Banks make consumer loans at long-term rates and pay deposits at short-term rates.) In this less positive scenario, the U.S. and global economy would likely slip into a mild recession, and the Fed may need to cut further to stem the tide.

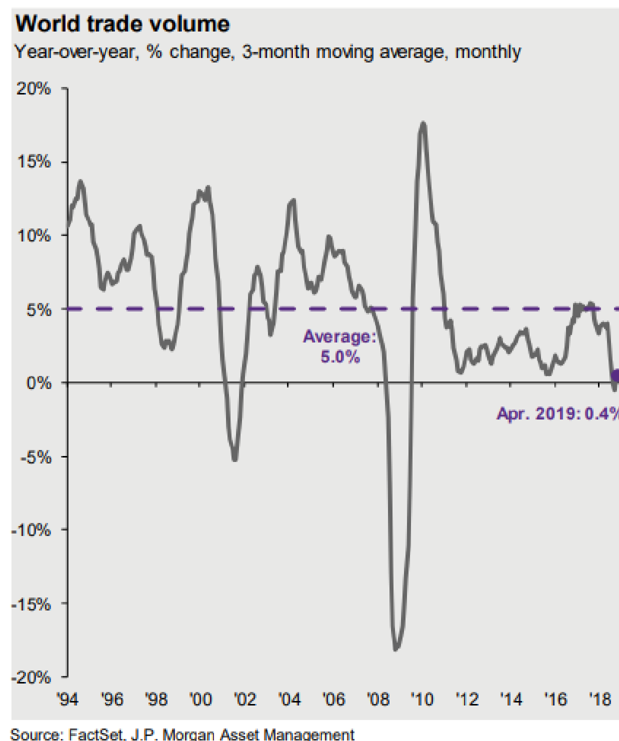
Overall, it now appears more likely than it did previously that the Federal Reserve may cut interest rates in 2019. We do not think that a Fed cut means a recession is immediately imminent. As opposed to previous cycles, the Federal Reserve is much more cognizant of how equity prices and global economic conditions affect the U.S. economy, and there is little need now to fight inflation or excessive asset prices. A cut in interest rates because of geopolitical instability (e.g., trade) could be viewed as positive by market participants and stimulate the economy, although that response is not guaranteed.

2) U.S./China Disagreement on Trade

President Trump and China's President Xi met on June 28 to discuss ongoing trade tensions between the world's largest two economies. The best hope for an outcome between them at the G20 Summit did occur, which was their agreement to renew trade negotiations and to cease any escalation measures in the interim. The one unexpected positive development was Trump's good faith gesture to potentially reduce restrictions against China's 5G powerhouse, Huawei, which is considered a global leader in 5G technology and one of China's most important companies. Trump granted concessions that Huawei can buy certain products from U.S. companies if "the parts do not affect national security." Markets opened slightly higher on the Monday immediately following the G20 Summit based on the news of reengagement between the two countries, but some of the initial market optimism faded and U.S. stocks retreated from new all-time highs as investors digested the truce further. Still, this development on the trade front was largely anticipated, and its coming to pass has been viewed positively.

As recently as April, many market participants expected a trade deal to be inked at this summit, but expectations proved to be unrealistically high after China walked back key points it had agreed to previously. Following those setbacks, expectations retraced to fairer levels. As we have outlined in previous editions of *Insights*, an agreement between the two sides may take longer than many expect, but we are cautiously optimistic that the two sides will reach an agreement later this year.

While these are positive negotiating developments, there is still no guarantee that a deal can be reached or that a deal would completely address the differences that have driven investor anxieties. These anxieties include enforcement of any deal reached, along with questions about what level of access U.S. firms could have to Chinese markets. World trade volume growth has declined significantly since trade tensions began, and trade uncertainty has been cited by many large companies (e.g., Apple, FedEx, J.P. Morgan, etc.) as a headwind to corporate earnings.



Source: FactSet, J.P. Morgan Asset Management

In our view, the agreement to stop *quid pro quo* escalations in trade restrictions is a positive development, as is Trump's unexpected relenting on punitive measures directed against Huawei. Negotiations will continue between representatives within the Trump and Xi administrations. China stepped back from previous concessions that the U.S. views as sticking points (Intellectual Property (IP) rights, forced technology transfers, etc.), and these will need to be addressed when talks resume. Overall, advances toward a realistic trade agreement between the U.S. and China will be economically beneficial for both parties and for the global economy in general. We have learned, however, that the path to an accord may not be smooth or predictable, and any setbacks may reintroduce investor anxiety and equity market volatility.

Conclusion

On the heels of sharply positive performance in June by U.S. and foreign stocks, for the year through last month, the S&P 500 Index had posted an 18.54% return, and foreign stocks in the MSCI ACWI ex-US index had gained 13.60%. Investors ought not to lose sight of these gains. They also should not lose sight of the fact that the yield curve has remained persistently inverted since May, which is historically a sign of slowing growth and a cloudy economic outlook. In response to deteriorating U.S. economic data, the Fed has signaled that it is poised to lower interest rates if conditions warrant. The U.S. and China are moving toward renewed negotiations about a trade agreement, but the path to an accord is neither certain nor likely to be smooth. We continue to think that, in time, China and the U.S. will strike a trade deal, but the precise path or timeline to reach any eventual deal may still be filled with ups and downs.

Now that the curve has inverted again -- and done so more steeply and for a period of weeks -- we believe that risk of a recession within the next 12 months has risen, especially since the steeper and protracted inversion

comes against the backdrop of slowing global growth and heightened global trade tensions. Still, the historical record provides ample precedent for equity price appreciation, sometimes for extended periods, after a yield curve inversion and before the next bear market and/or recession. The challenge for investors is that it is very difficult to reap all the market gains and none of the losses associated with a recession because it is next to impossible to predict precisely when it will come. It is, in other words, implausible to think that one can exit at the exact top and reenter when equity markets hit their exact bottom.

At present, domestic economic growth currently seems ongoing, inflation remains low, and employment remains high. The U.S. economy is likely to continue to grow this year but 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. Abroad, economic growth in key economies such as Europe and China also seems to be decelerating.

The present environment is one in which investors may be particularly inclined to act overly aggressively or overly defensively. Given the wide range of potential economic and market outcomes, we believe that both responses represent investing pitfalls to avoid. We believe that investors of both temperaments should take this opportunity to discuss with their wealth manager whether their portfolio remains appropriately positioned, consistent with their long-term risk tolerance and goals, both to capture gains and withstand declines.

The outlook then, as we see it, is mixed. Global growth continues but is decelerating. Bond investors have pushed down yields on secure, government debt in anticipation of a less rosy future, yet stock investors have pushed equity prices in the U.S. to new all-time highs in expectation of a rosier future. The fact that both cannot be right in the same sense is itself a signal for some caution and additional prudence in making asset allocation decisions.

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