February 2016

Markets Experienced Heightened Volatility in January

Overview

January proved to be a bumpy start to the year. Stock prices declined across U.S. and international equity markets. The rise in volatility that began in the early fall picked up some speed during the month as headlines about plunging commodity prices and uncertain Chinese economic growth dominated the financial press. While volatility of any kind can be unsettling, it is important to remember that ups and downs are a normal part of the investing experience. One reason that the recent bout of volatility may feel unsettling is that sharp swings have been absent from financial markets for a few years now. The Fed has been incredibly supportive of financial markets and, as a result, volatility has been suppressed. Now that the Federal Reserve has begun to move away from an extremely accommodative interest rate policy, volatility may be here to stay. Fortunately, the economy is on firm footing.

Despite the swings in the market, both the U.S. and global economy both continue to grow at a modest, positive rate. U.S. employment data is showing a healthy job market at home. Although Q4 GDP in the U.S. increased at just a 0.7% annualized rate, consumer spending in 2015 accelerated at its fastest pace in 15 years. The Fed elected to keep rates steady at its January meeting, and the Federal Funds futures market currently anticipates that the committee may only raise rates once more this year, due to increasingly volatile investment markets.

Performance

Both U.S. and international equities were down during the month while core bond prices rose.

Index Name	January	2016 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	1.19	1.19	5.75	4.81	US Muni Bonds
BarCap US Agg Bond TR USD	1.38	1.38	3.51	4.66	US Taxable Bonds
BarCap US Corporate High Yield TR USD	-1.61	-1.61	4.24	6.62	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	-0.18	-0.18	5.45	6.70	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	0.35	0.35	-3.11	3.88	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	-4.50	-4.50	-2.23	-1.07	Hybrid/Hedged Equity
DJ Industrial Average TR USD	-5.39	-5.39	9.46	6.99	US Equity -- Large
S&P 500 TR	-4.96	-4.96	10.91	6.48	US Equity -- Large
NASDAQ Composite TR USD	-7.82	-7.82	12.65	8.27	US Equity -- Large
Russell 1000 TR USD	-5.38	-5.38	10.68	6.52	US Equity -- Large
Russell Mid Cap TR USD	-6.55	-6.55	9.48	6.73	US Equity -- Mid-sized
Russell 2000 TR USD	-8.79	-8.79	7.25	4.92	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	-6.80	-6.80	-0.55	1.51	Int'l Equity -- Comprehensive
MSCI EM NR USD	-6.49	-6.49	-5.56	1.84	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	-1.68	-1.68	-13.93	-6.76	Commodities
HFRX Global Hedge Fund USD	-2.76	-2.76	-1.39	-0.47	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 1/31/2016

The S&P 500 Index fell 4.96% in January while the Russell 2000 Index, a benchmark of small capitalization stocks, dropped 8.79%. Core bonds, as measured by the Barclays U.S. Aggregate Bond Index and the Barclays Municipal Index were up 1.19% and 1.38%, respectively. The BarCap U.S. Corporate High Yield Index fell 1.61% during the month as junk bonds weakened with the sell-off in equity markets. International equity markets fell by a slightly greater degree than U.S. large cap stocks, with the MSCI All Country World Ex USA Index declining 6.80%. The MSCI Emerging Market (EM) Index returned negative 6.49% for the month.

It was a weak start to the year, but not without precedent. Four out of the last seven calendar years have seen the S&P 500 decline in January, only to end the year with a positive return for the full twelve months.

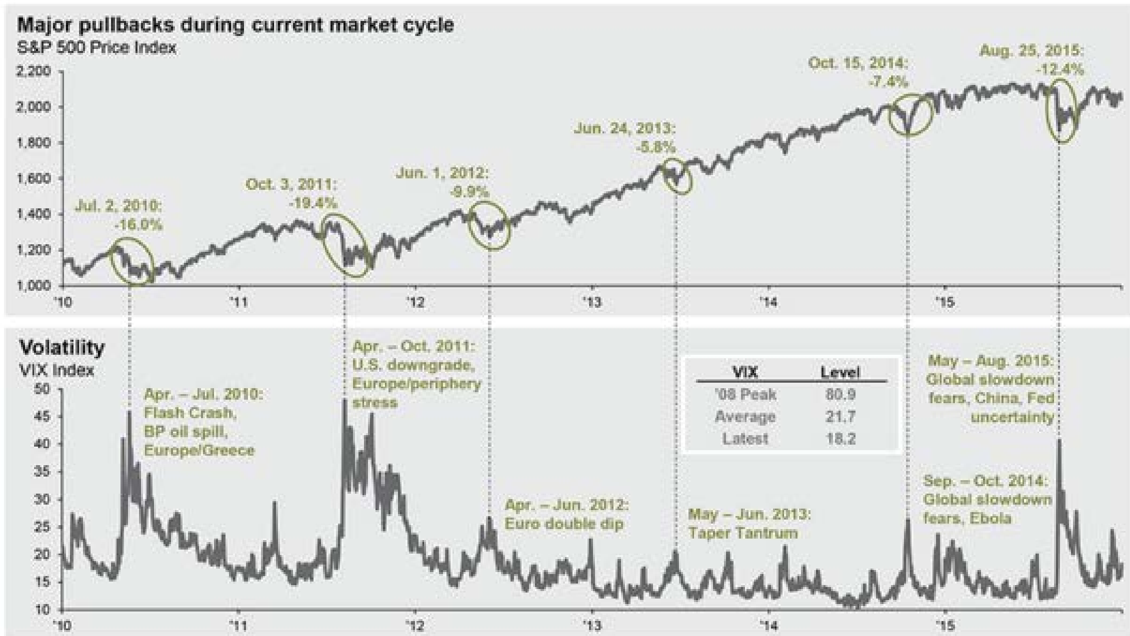
Outlook

When equity market volatility is as pronounced as it was in January, it is important to remember that sharp swings up and down are a normal feature of the stock market. Often times, both upside and downside swings in equity prices tend to be overreactions. While "healthy" may not seem like the best word to describe a *downturn* in stock market prices, it is an apt definition if one has a long-term return horizon and the fundamental outlook for the economy is positive. Having an opportunity to own stocks at cheaper levels than were previously available increases the odds of generating a higher future return. Fundamental data, while far more boring and less volatile than the markets, tends to be a better barometer for the health of the U.S. economy than the "Markets in Turmoil" headlines on CNBC would lead you to believe.

The recent volatility in equity markets reminds us of something Warren Buffett said in his Op-Ed in the *New York Times* in 2009, which we think applies well to today's environment. Speaking on volatility in the stock markets, he notes, ""I can't predict the short-term movements of the stock market. I haven't the faintest idea as to whether stocks will be up higher or lower a month – or a year – from now. What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up. … In short, bad news is an investor's best friend. It lets you buy a slice of America's future at a marked down price."

Buffett is suggesting that the short-term moves in the market are typically nothing more than noise. There are plenty of negative news items in any given week or quarter or year to spook an investor. Sometimes the market ignores them; sometimes the market obsesses over them. Right now, the obsession *du jour* is China and its deceleration in growth. That obsession, however, will likely subside, as it has with most every other instance over time.

The following graphic from JP Morgan highlights this concept well. In 2010, the flash crash, BP oil spill, and Greece drama dominated the market headlines. All seemed like worrisome events *at the time*. In 2011, the downgrade of U.S. debt, as well as fears over a wave of defaults in Europe captured investors' attention and sent the markets lower. However, markets eventually moved on from those concerns.



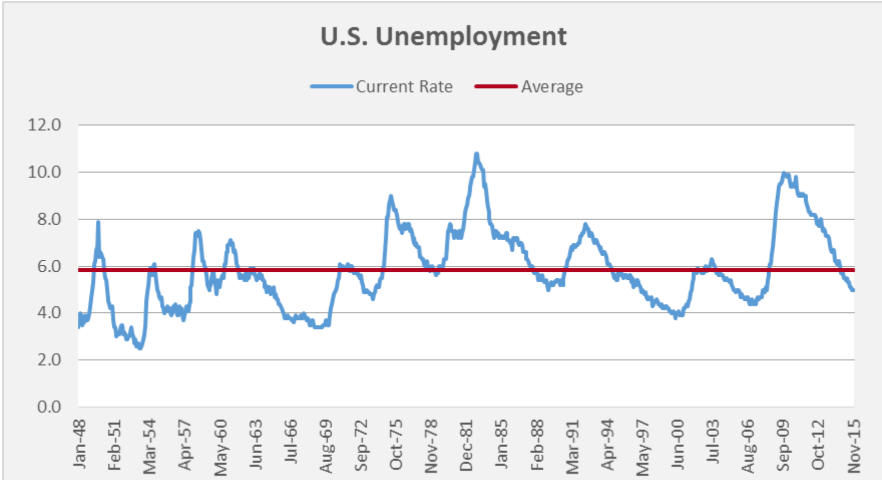
Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management; (Bottom) CBOE.
Guide to the Markets – U.S. Data are as of December 31, 2015.

Long-term trend positive and higher …

…despite short-term choppiness from headline concerns.

In nearly every calendar year, there was a notable negative event and a market pullback. Short-term-minded investors could have panicked and either gone to cash or gotten more conservative with their portfolios. However, the general trend in equities was higher, and those who bailed out also missed out on substantial returns.

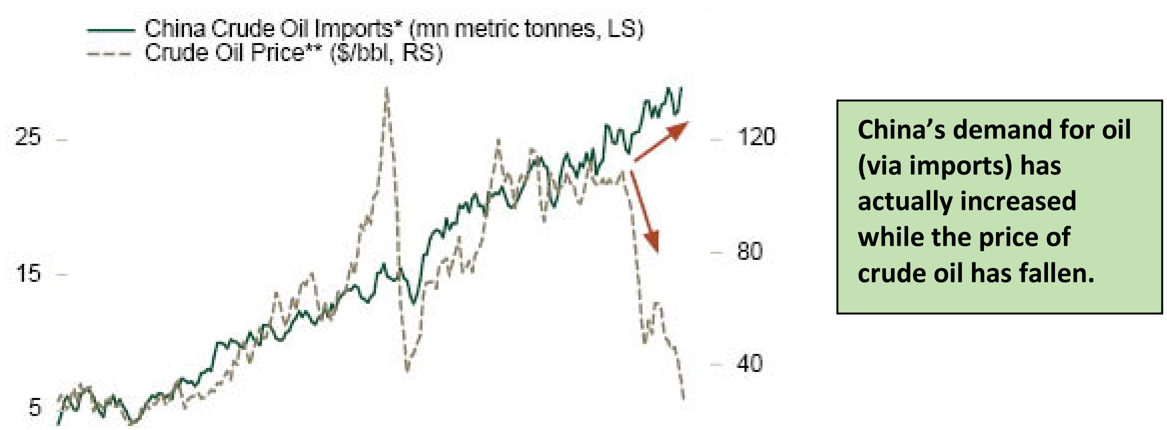
As we survey the economic landscape, we note that the labor market in the U.S. is stable and growing, that wages are improving, and that the U.S. consumer is spending money. In the chart below, we can see that the unemployment rate, with a current reading of 5.0%, is below its long-term average of 5.8%. The labor market has been steadily improving since the end of the financial crisis in 2009, and there have not been any signs of a deterioration in the job market despite the recent rise in equity volatility.



Source: Bureau of Labor Statistics, Sage Financial, as of Nov 2015

Labor market data is updated frequently and is a key barometer of economic health. Even though the stock market has been volatile, the jobs market has not reflected the tension felt in equities. A healthy job market also leads to a more confident consumer. Though fourth-quarter GDP in the U.S. grew at a meager 0.7%, annualized, the underlying data showed that consumer spending rose through all of 2015 at its fastest pace in a decade. In analysis of the fourth-quarter GDP report, Bloomberg News noted that, "while businesses are struggling, American households have plenty of ammunition to assist the economy. Last year, after-tax income adjusted for inflation climbed 3.5%, the most since 2006." On its most recent earnings call, Visa noted that "macroeconomic weakness is not evident in U.S. consumer spending."[1]

In the last year, many have focused on the downturn in commodity prices, specifically crude oil. The market's initial assessment of the downturn in oil prices was that it was due to an excess supply of the commodity. That is, energy companies were simply pumping too much oil. However, as prices have stayed depressed, some have begun to wonder whether the collapse in energy is also because demand has collapsed, which would be more troubling for the global economy. Despite this recent concern, we believe that global demand is not suffering. For instance, the following chart from MRB Partners shows that Chinese oil imports have continued apace. According to JP Morgan's fourth quarter Guide to the Markets, Chinese oil consumption has risen 9.7% since 2013.



Source: MRB Partners 1/25/2016

To be sure, the downturn in crude prices has brought about lower capital expenditures (capex) in both the energy sector and the U.S. manufacturing sector, which was a direct beneficiary of the build-out in new oil wells and projects. That decline in capex is being reflected in U.S. GDP's rising just 2.4% in 2015. Indeed, demand for commodities may even rise at a quicker pace than currently projected given how low prices have fallen. For instance, in 2015, automakers sold more cars and trucks in the U.S. than *any* year in the history of the industry. The drop in commodity prices has resulted in damage to certain sectors while simultaneously boosting other areas. In has also created opportunities within sectors such as master limited partnerships, to which Sage started allocating in the second half of last year due to the attractive yields and discounted valuations.

Looking abroad to emerging markets stocks, the asset class has suffered from underperformance relative to U.S. equities over the last five years. Yet the recent experience should not deter investors from sticking with emerging market allocations for the future. We have seen asset class rotation in the past with emerging market equities, and it has been a powerful force in smoothing out investors' overall portfolio returns.

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[1] "Economic Growth Cools as American Consumers Temper Spending," Bloomberg.com. Accessed 1/29/2016. "Visa's (V) CEO Charlie Scharf on Q12016 Results – Earnings Call Transcript," Nasdaq.com. Accessed 1/29/2016.

For instance, in the 1990s, the MSCI EM Index returned 8.77%, annualized. That was a solid return to be sure, but one that lagged the S&P 500's stunning 18.21%, annualized, return. It was tempting to chase U.S. equity returns then, as it is now, but patience paid off. In the 2000s, emerging markets returned to favor and rewarded investors who maintained discipline and stayed with their EM investments. While the U.S. experienced a lost decade when the S&P 500 lost 0.95%, annually, the MSCI EM Index returned *positive* 9.78%, annually, an outperformance of 10.73 percentage points, annually.

	Returns by Decade		
Investment	**1990s**	**2000s**	**2010s**
U.S. Equities	**18.21%**	-0.95%	**12.98%**
Emerging Market Equities	8.77%	**9.78%**	-1.21%

U.S. equities represented by S&P 500. Emerging Market equities represented by MSCI EM. 2010s from 1/1/2010 to 12/31/2015

Emerging market equity and currency valuations are at levels similar to where they were in the early 2000s, a point that preceded a period of very strong returns. Jason Zweig, author of the *Wall Street Journal*'s "Intelligent Investor" column recently wrote about emerging market equities. He noted, along these same lines, "A study of more than a century's worth of investment returns shows that emerging markets deliver their best results not when hopes are highest, but after they break investors' hearts." We encourage investors not to be heartbroken by recent, lagging returns within emerging markets but to remain committed to the asset class due to the low valuations and compelling future return opportunities.[2]

In summary, U.S. economic growth is modest, but areas such as the labor market and consumer spending have not reflected the volatility that has plagued equity markets during the first month of trading in 2016. The fundamental outlook for the U.S. economy is stable and areas such as the job market and consumer spending are in fine shape. While the volatility experienced has been unpleasant, investors would be well served to remember that sharp swings are a normal, healthy part of equity investing. We believe that U.S. equity returns will end on a positive note in 2016, but that volatility may persist as investors wrestle with uncertainty over how quickly the Fed will raise interest rates. In our view, this necessitates an allocation to international developed and emerging market equities, which are experiencing more favorable central bank policies and discounted valuations, respectively, than U.S. stocks, and should benefit a diversified portfolio in the event of asset class rotation.

[2] Jason Zweig, "Lessons From a Frontier Market: US." *Wall Street Journal* Print Edition, January 28, 2016.