SAGE FINANCIAL GROUP
Investment and Wealth Management

SAGE INSIGHTS
MONTHLY ECONOMIC & MARKET ANALYSIS

February 2018

After Strong Stock Returns in 2017 and January 2018, Stocks Reset

Overview

In January, U.S. and foreign equity prices moved sharply higher through the first three weeks of the year before retreating somewhat yet closing the month with still notable gains. On the month, the S&P 500 Index rose 5.73%, while the MSCI All Country World ex-US Index was up a similar 5.57%. The MSCI Emerging Market Index climbed still higher, up 8.33%. Global economic activity generally continued to expand and remains on firm footing. U.S. GDP for Q4 advanced at a 2.6% annualized rate after rising 3.1% in the third quarter. In this installment of *Insights*, we discuss our take on recent economic and investment developments. We focus especially on the rise in U.S. bond yields and Federal Reserve policy, on the one hand, and the rapid rise in equity prices to start the year and the recent week's pullback, on the other. The global economy, and that of the U.S. in particular, is very healthy and continues to experience synchronous growth. In our view the volatility that emerged in the month's final week should not have been unexpected given valuation levels, but the pullback is likely part of a period of consolidation and digestion rather than the start of a sustained downturn.

Performance

U.S. and foreign equity performance was once again markedly positive in January, especially emerging market stocks. The U.S. dollar weakened, which helped to boost foreign stock and local currency emerging market bond returns. Bond yields rose, however, and the prices of core bonds, which move inversely to yields, dropped.

Index Name	Jan./ 2018 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	-1.18	2.69	4.20	US Muni Bonds
BarCap US Agg Bond TR USD	-1.15	2.01	3.71	US Taxable Bonds
BoAML US High Yield Master II TR USD	0.64	5.65	8.10	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	-0.04	4.85	7.20	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	4.48	-0.83	3.86	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	3.41	4.07	0.10	Hybrid/Hedged Equity
DJ Industrial Average TR USD	5.88	16.36	10.41	US Equity -- Large
S&P 500 TR	5.73	15.91	9.78	US Equity -- Large
NASDAQ Composite TR USD	7.40	20.16	13.23	US Equity -- Large
Russell 1000 TR USD	5.49	15.72	9.85	US Equity -- Large
Russell Mid Cap TR USD	3.76	14.29	10.26	US Equity -- Mid-sized
Russell 2000 TR USD	2.61	13.33	9.76	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	5.57	7.11	3.44	Int'l Equity -- Comprehensive
MSCI EM NR USD	8.33	5.74	3.88	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	1.99	-8.52	-7.03	Commodities
HFRX Global Hedge Fund USD	2.45	2.22	0.03	Multi-Asset Alternative Invm't

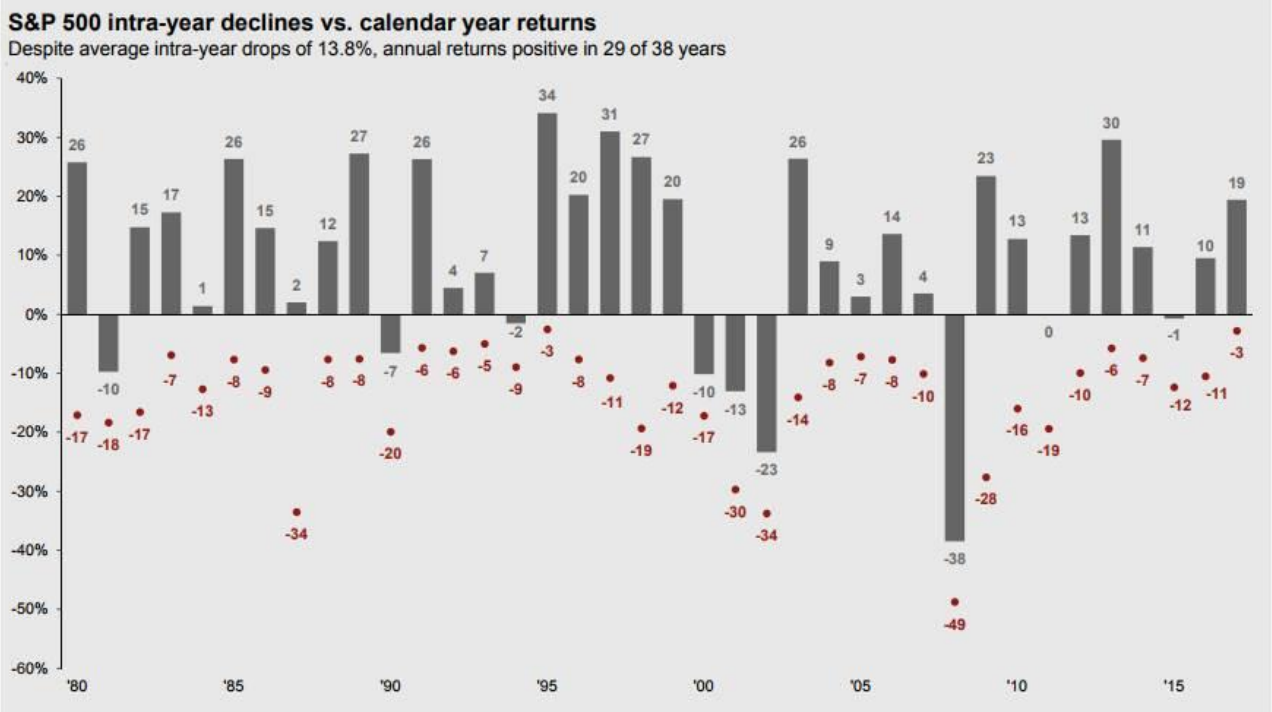
Source: Morningstar Direct. Data through 01/31/2018

Outlook

As we have noted in recent installments of *Insights*, we continue to anticipate consistent economic growth, a moderate rate of inflation, and a largely measured and telegraphed U.S. Federal Reserve policy, with supportive global growth in Europe and emerging markets. All of these factors may contribute to largely stable market conditions albeit with the potential for an additional equity correction given still somewhat elevated valuations and low current levels of volatility.

In the final week of January, U.S. and foreign stock markets declined, with broad U.S. equity indices down 4+% for the week. 2017 was an abnormally smooth year for U.S. equities. That can make the drawdown that began in January's final week feel different or unfamiliar. But declines in stock market indices occur periodically and can be healthy for the market, especially after a period of unusually low volatility.

As shown in the chart below, very few years go by without the market's correcting by at least 5%. In fact, in only two years in the past 38 have experienced market corrections less than 5% (2017 and 1995).



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.

In fact, as noted in a *New York Times* article, "The S.&P. 500 did not decline by more than 2 percent on a single trading day in all of 2017, which helps explain why Friday's 2.1 percent drop seemed so startling. … There were five such days in 2016, six in 2015 and four in 2014. In 2011, there were 21 trading days in which the S.&P. fell by more than 2 percent, nearly two per month." In other words, the low volatility and lack of a notable drawdown in 2017 was an anomaly. It was, in a sense, overdue.

The following table on the next page, provided by the Capital Group, helpfully groups the average frequency and duration of downturns in the Dow Jones Industrial Average. Part of the significance of the illustrative data is that (a) downturns happen regularly but (b) they do not persist indefinitely.

Market Downturns Happened Frequently and They Didn't Last Forever

Dow Jones Industrial Average 1900–2015

	-5% or more	-10% or more	-15% or more	-20% or more
AVERAGE FREQUENCY[1]	About 3 times a year	About once a year	About once every 2 years	About once every 3.5 years
AVERAGE LENGTH[2]	46 days	115 days	216 days	338 days

[1]Assumes 50% recovery of lost value
[2]Measures market high to market low
The Dow Jones Industrial Average is an unmanaged, price-weighted average of 30 actively traded industrial and service-oriented blue chip stocks. Past results are not predictive of results in future periods.

Source: The Capital Group

How, then, might we assess the downturn that has occurred over the last week from the end of January to the first week of February? The *New York Times* article noted above provides what we think is a good perspective to maintain: "The 7.8 percent drop in the Standard & Poor's 500 over the last six trading days is similar in scale and speed to drops in January 2016 and August 2015, neither of which left lasting scars."

One of the major catalysts for the sell-off on Friday, February 2, was the continued move upward in bond yields. Higher bond yields and interest rates reflect a strong economy, and their rise was prompted by reports of higher wage growth and solid employment data. That Friday was also the last day of Janet Yellen's term as Chair of the Federal Reserve before Jerome Powell took over on Monday, and the transition may have prompted heightened uncertainty about Fed policy in light of this data.

Bond yields are rising, but our clients' fixed income portfolios in particular are, and have been, positioned for this through exposure to short duration and unconstrained strategies. These approaches help to diversify not only the overall portfolio but also the U.S. portion of the fixed income allocation by lowering its sensitivity to moves in interest rates.

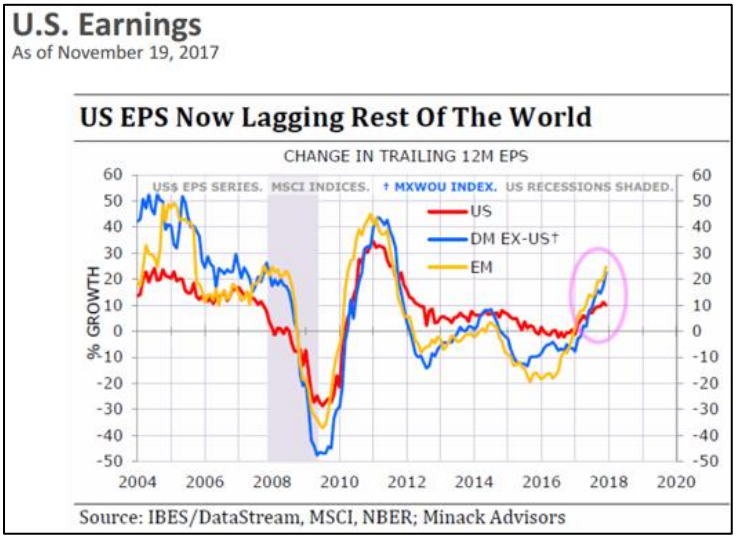
Historically, higher interest rates have been associated with a decline in asset prices, but the turning point is typically not seen until the yield on the U.S. 10-year Treasury reaches 5%. The pivotal yield point may be lower than that 5% average in this economic cycle, given that Janet Yellen and other former and current central bankers believe that the neutral interest rate in this post-global financial crisis era will be structurally lower than in the past. The current 10-year Treasury yield is still below 3% and so still has room to rise as growth continues.

Indeed, both *leading* economic indicators globally and in the U.S. in particular (Manufacturing/Service PMI, Consumer/Business confidence) and *lagging* indicators (GDP, wage growth) remain robust. In our view this fact will likely contribute to additional economic expansion.

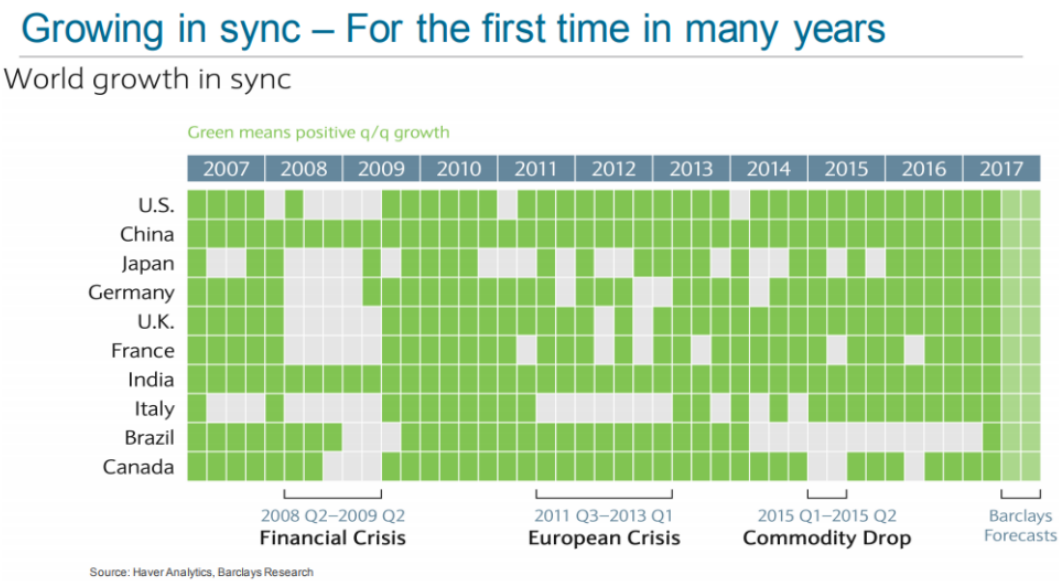
Second, fiscal stimulus in the U.S., in the way of tax cuts and legislative reform, also may provide a modest economic boost and help to extend one of the longest expansions in U.S. history, which we do not see ending this year.

Third, earnings season has been very good so far. About half of companies have reported fourth quarter 2017, and through Friday, February 2, 81% of S&P 500 companies have beat estimates, which is the highest in 7 years. A record 75% of U.S. companies have raised 2018 earnings guidance. Businesses are feeling good, spending more, and announcing more spending in the U.S. in part due to tax reform.

What is more, as good as U.S. earnings have recently been, earnings per share growth in the U.S. is now lagging that in the rest of the world, as you can see in the nearby chart.



In Europe, annual GDP growth in 2017 was +2.5%. More than half of global economies are experiencing accelerating growth, according to data announced by the IMF. The graphic below from Barclays and Haver Analytics illustrates in the far right columns the synchronous growth that is expected to be reported as the official Q3 and Q4 data is released and revised. There is no gray square among the major countries, and the chart would be similar if more emerging market countries were added.



Another way to visualize our main point – that economic growth indictors remain robust – is to view the U.S. Weekly Leading Indicator Index, which has continued to move upwards, which you can see in the chart on the following page. This upward trend line suggests that economic conditions may support additional corporate earnings and, as a result, potentially stock market gains. As such, this provides additional support for the view that recent declines in equities are part of a normal market correction during an economic expansion rather than some portent of future economic recession.

Short term fluctuations in asset prices are typically a distraction from the big picture. Yes, the fact that bond yields and interest rates are moving upwards increases uncertainty, but they are also a sign of an improving economy. In recent years, market observers complained that wage growth was non-existent or sluggish at best. Recent employment reports confirm that an economy with essentially full employment, and now an increase in wages is starting to materialize. That has both encouraged and somewhat unnerved some market participants, who fear that inflationary pressures may prompt more aggressive tightening policy at the Fed under the leadership of a new chairman, Jerome Powell. The larger worry that markets seem to be discounting through recent declines is whether the Fed will enact policy changes that will choke economic growth and prematurely end this economic expansion.

In our view, new Chair Powell will by and large continue the measured, informed, and data-dependent approach of previous Chair Yellen. To the extent that recent market declines owe to concerns about Fed policy tinkering, we believe those concerns are premature or misplaced.

Moreover, we are coming off of a year in which the majority of asset classes had very positive returns (e.g., the S&P 500 Index gained nearly 22%, and the MSCI Emerging Markets Index climbed more than 37%). Pullbacks after such strong performance is often natural and can be healthy. In fact, until last week's pullback, many asset classes had put in year-like returns within a month. Those markets may have gotten a little ahead of themselves. In our communications at the end of 2017 and in our 2018 outlook, we noted that clients should be prepared for increased market volatility. The S&P 500 Index has not had a negative monthly return for 15 consecutive months, a record and a streak that we believe is bound to change. And that may be part of a normal market correction (understood as a decline of 10% or more from the most recent high).

We recognize that political uncertainty looms, particularly later in February when the government faces another potential temporary shutdown as lawmakers and the executive branch debate the nation's budget. In January, the government shut down for 3 days, and the U.S. stock market was indifferent. Looking back over the previous 18 shutdowns, the S&P 500 Index returned an average of 14.2% during the calendar year of a shutdown. We do not necessarily forecast that average to be realized this year. Our point is that headlines about another shutdown are not necessarily ominous for U.S. stocks. If short-term patches become serialized, markets could begin to take notice.

As always, the larger context is key to interpreting particular developments and potential occurrences. The larger context at present is that economic momentum is positive globally. Inflation in the U.S. and major foreign

nations remains contained and healthy. The U.S. Federal Reserve is widely expected to raise rates again at its next meeting in March and potentially a total of four times in 2018. The pace of rate increases could be faster or slower than this, and a faster increase would pose a potential risk to both fixed income and equities, a point of which we believe Chair Powell and the other Fed governors are mindful.

To recap, then, we do not believe that recent market declines signal a near-term end to economic expansion. We do believe that the pullback in equities is part of a consolidating process that occurs regularly during bull markets but that has not happened as typically might be expected during the last 18-24 months of strong stock market gains. In this sense, a correction has been overdue. Portfolio performance was strong in January, and in some ways it may have been too much too fast. But with growth and other indicators as positive as they are, we do not anticipate a recession this year. Economically, we believe that growth will continue, and, after a period of settling, investors will recognize that and return to stocks.

So we encourage clients and friends to enjoy the Eagles' Super Bowl victory, and to view any declines and market fluctuations in the positive global economic context that we have detailed above.

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