SAGE FINANCIAL GROUP
Investment and Wealth Management

SAGE INSIGHTS
MONTHLY ECONOMIC & MARKET ANALYSIS

April 2018

Equities Still Sorting through Policies and Politics

Overview

In March, major U.S. and foreign stock indices moved down. The stability that seemed to have reappeared at the end of February gave way to increased volatility after the Federal Reserve ended its meeting on March 21. Although the Fed's policy statement contained both dovish and hawkish elements, equity investors traded on the idea that the central bank would raise key interest rates more aggressively in the future. In addition, the Trump administration announced plans for a protectionist trading policy that rattled global markets because of fears that targeted tariffs could escalate into a full-blown trade war. Finally, the recently high-flying technology sector stumbled and brought down much of the broad market with it. These declines were prompted by revelations of data sharing by Facebook and the President's spirited Twitter attack on Amazon's business practices. The S&P 500 Index has now, as of 4/2/2018, declined by 10.1% from its most recent high, a drawdown range often referred to as a "correction." In this installment of *Insights*, we discuss our take on these three developments: uncertainty about future Federal Reserve monetary policy, the extent of protectionist U.S. trade policy and responses by other nations, and the changing fortunes of the tech sector. We continue to believe that the global economy is overall healthy and equity markets will eventually right themselves from this correction. In our view, global economic expansion should continue, if more moderately, despite the announced tariffs.

Performance

Core U.S. bond yields fell and their prices rose in March, but large U.S. stocks fell for a second straight month.

	March	2018 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	0.37	-1.11	2.73	4.40	US Muni Bonds
BarCap US Agg Bond TR USD	0.64	-1.46	1.82	3.63	US Taxable Bonds
BoAML US High Yield Master II TR USD	-0.62	-0.91	5.01	8.12	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	0.29	-1.74	4.69	7.04	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	1.02	4.44	-0.67	3.78	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	-0.69	1.17	3.12	0.03	Hybrid/Hedged Equity
DJ Industrial Average TR USD	-3.59	-1.96	13.32	9.86	US Equity -- Large
S&P 500 TR	-2.54	-0.76	13.31	9.49	US Equity -- Large
NASDAQ Composite TR USD	-2.79	2.59	18.07	13.23	US Equity -- Large
Russell 1000 TR USD	-2.27	-0.69	13.17	9.61	US Equity -- Large
Russell Mid Cap TR USD	0.06	-0.46	12.09	10.21	US Equity -- Mid-sized
Russell 2000 TR USD	1.29	-0.08	11.47	9.84	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	-1.76	-1.18	5.89	2.70	Int'l Equity -- Comprehensive
MSCI EM NR USD	-1.86	1.42	4.99	3.02	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	-0.62	-0.40	-8.32	-7.71	Commodities
HFRX Global Hedge Fund USD	-0.98	-1.02	1.29	-0.24	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 03/31/2018

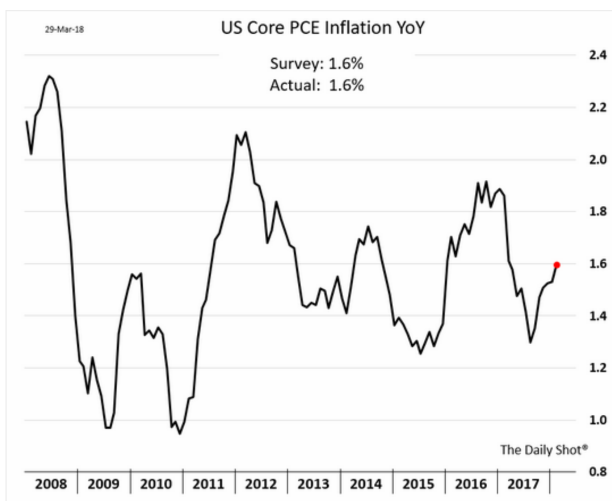
For the year through March, the S&P 500 Index is down 0.76%, and the U.S. Aggregate Bond Index is down 1.46%. Local currency emerging market bonds, however, continued to fare well despite the pressures on traditional developed market stocks and bonds. In part because the U.S. dollar has weakened this year, EM local bonds are up approximately 4.4% thus far this year, according to the JPMorgan GBI Emerging Market Diversified Index. Emerging market equities, despite a nearly 1.9% decline in March, remain up 1.4% for the year, as measured by the MSCI Emerging Market Index.

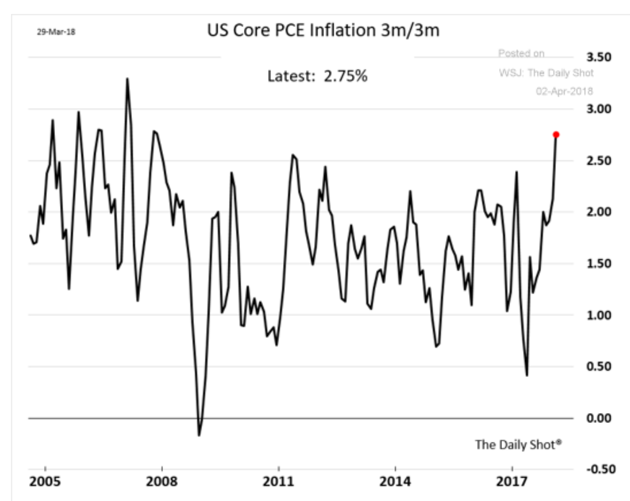
Outlook

Our base case outlook for a continued expansion remains intact, but the equity markets quaked at the end of March as questions arose in the minds of global investors. 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. This remains our prevailing outlook, despite renewed questions about future Federal Reserve monetary policy, the consequences of protectionist U.S. trade policy, and the shifting tech landscape. We think that these factors will most likely prove temporary and market conditions will come to recognize that, albeit not necessarily without the potential for some additional equity price volatility. Indeed, equity markets are still finding their new footing, and here is why.

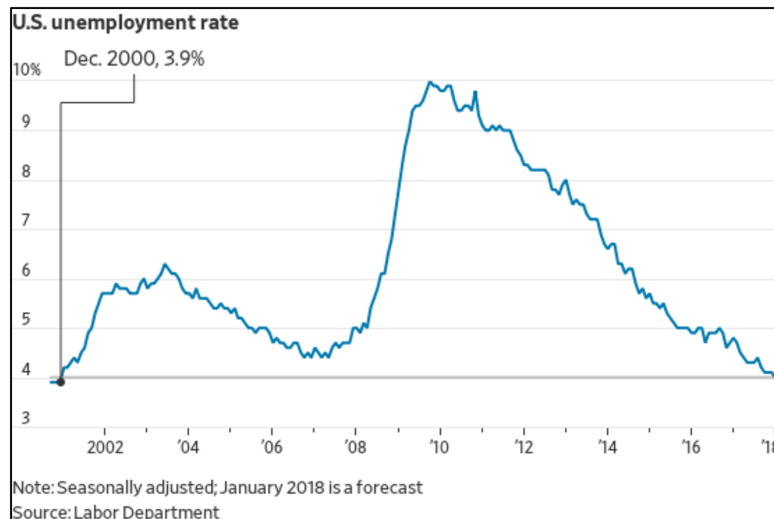
1. Inflation and Federal Reserve Policy

First, the Fed's statement last month had something for everyone, and the two graphs side-by-side below help to illustrate the point. The Fed's preferred gauge of inflation is the core personal consumption expenditures index (i.e., core PCE), which measures the price changes of consumer goods and services excluding volatile food and energy components. Dovish comments by the Fed are bolstered by the graph on the left, which shows that core PCE *year-over-year* is running at 1.6%. This is measurably below the Fed's 2.0% long-term average inflation target. The implication of this data point is for a disciplined, slower-acting Fed which raises interest rates only gradually. On the other hand, hawkish comments by the Fed are supported by the graph on the right, which shows that the core PCE for the last *quarter-over-quarter* is running at 2.75%, which is well above the Fed's 2.0% long-term average inflation target. One interpretation of this might be that the economy and inflation are running hot and need an aggressive Fed to raise interest rates more quickly and to a greater extent in order to keep the economy from overheating. The same core price index gives conflicting signals depending on which time period observation is used.

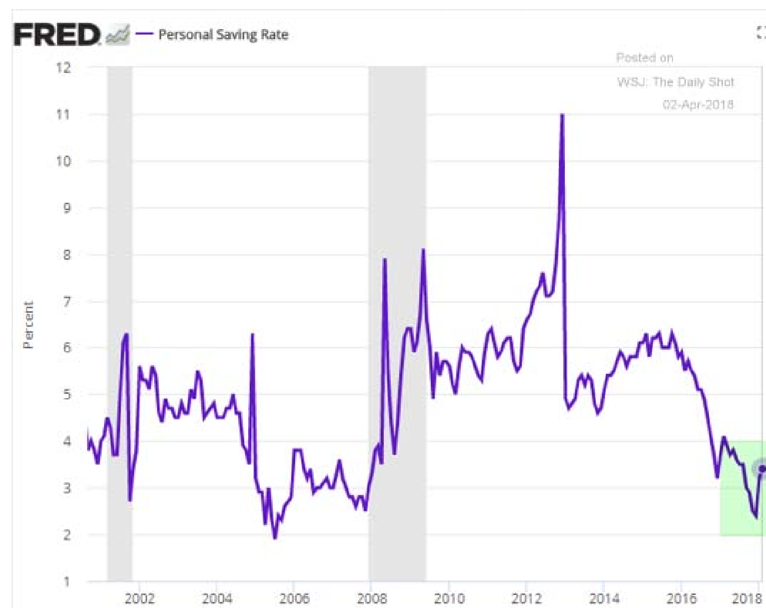




The chief concern that many investors have is that inflation may run too hot, and that bond yields might rise sharply and quickly in a way that chokes off economic activity through higher borrowing costs. For instance, although home mortgage rates remain very low by historical standards, they have increased of late. Higher borrowing costs can lead to decreased demand from buyers. Unemployment has steadily fallen since the height of the global financial crisis in 2009, and it has returned to its lowest level since 2000, as you can see from the graph below.



This has suggested to some that wage growth, which has not yet followed the gains in employment over the last decade, might start to pick up and contribute to the overall inflation picture. We think that wage growth may continue to increase modestly, but our emphasis is on "modestly." Moreover, additional assets that people have received either through wage increases or through reduced taxes from recent reform legislation have started to stay in people's pockets or bank accounts rather than circulate through the economy via spending. The personal savings rate has started to tick up in recent months, as you can see in the green shaded area in the chart below.

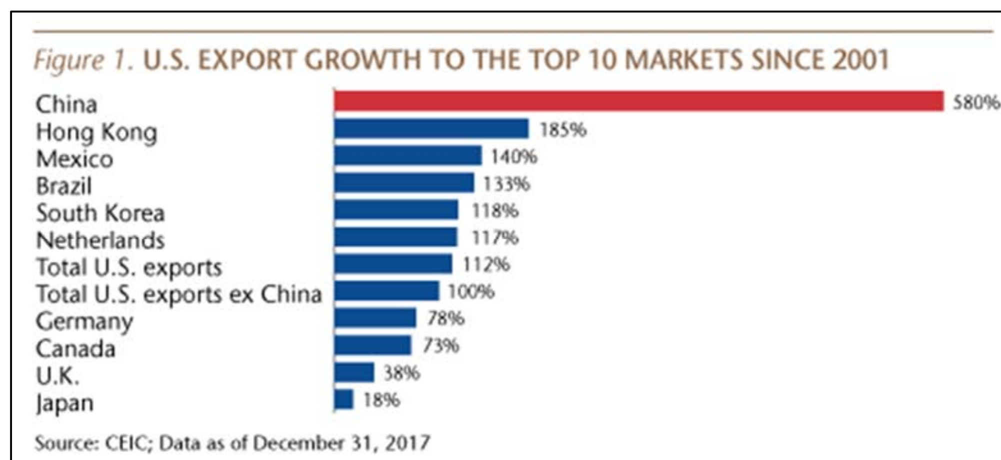


Equity markets are trying to sort out this data, conflicting inflation measurements and the realities of low unemployment with the potential for increased personal consumption, but so far mixed data on that front.

2. Protectionist U.S. Trade Policy

Second, investors are also still pondering the effect of protectionist U.S. trade policy and responses by other nations. Put simply, recent statements and actions by the Trump administration toward trade partners, on the one hand, and their responses, on the other, have risen the specter that the situation may spiral into a full-blown trade war, which would harm global growth for all. Our current view is that recent trade actions and retaliatory responses by nations such as China are unlikely to escalate into a full-scale trade war per se. A more precise description of what we think may occur is a series of low-stakes trade skirmishes. China does not want such a conflict, and it is not in the economic interests of anyone for the trading relationship to deteriorate into a full-scale trade war. Still, real risks to global trade exist if rhetoric and policy actions continue and intensify like a reciprocal vendetta.

Now, there are real trade imbalances to be addressed. There are policy terms in agreements like NAFTA that should be revisited and revised. There are also aspects of exploitation, patent infringement, and corporate espionage that must be faced squarely. At the same time, imbalances in imports/exports is not all bad. For instance, the U.S. imports more from China than it exports, to be sure, but, as you can see in Figure 1 below, U.S. export growth to China has expanded by 580% since 2001 when China joined the World Trade Organization (WTO). U.S. exports to the rest of the world were up only 100%. U.S. companies benefit from having Chinese markets open such as they are to U.S. goods and services. Boeing and General Motors sell more aircraft and autos, respectively, in China than in the U.S. American farmers export more produce to China than to any other foreign market.

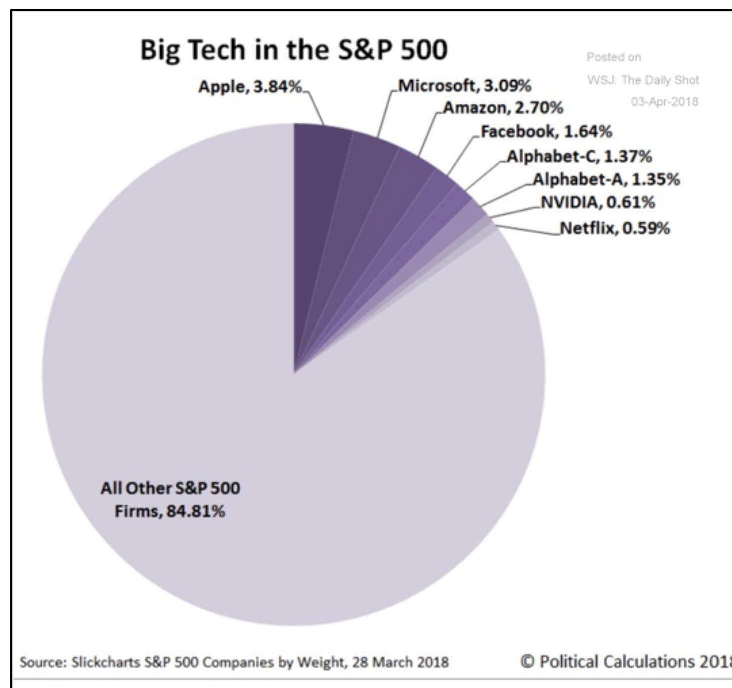


On the one hand, these are economic realities. We could have provided additional examples of sales growth and revenue for companies like Nike, Tesla, Nvidia, Dolby, and Apple. There are also political realities, such as the fact that some of the administration's constituent base works on the farms or in the factories for Boeing and GM that protectionist policies are ostensibly designed to help but that may, through secondary effects, actually hurt. If demand for soy beans or Buicks drops in conjunction with higher prices, then farmers and factory owners will likely adjust their workforce or wages accordingly. These considerations point toward a more moderate future policy now that the administration can point to the keeping of certain campaign promises.

On the other hand, it is not always clear that economic and political realities prevail when it comes to policy pronouncements or pursuits. If there are more extensive U.S. tariff impositions on trading partners, and if these partners retaliate in kind or, like a game of poker, raise the stakes, the cost of an ongoing trade war would be higher inflation, an increase in interest rates, and slower global economic growth, as well as likely lower asset prices and a weaker U.S. dollar. This extreme scenario really only applies if everyone everywhere were imposing tariffs with greater frequency and greater magnitude. That is not our base case, but it is possible, and so we mention it. We outline it also because this is something that global investors are also trying to weigh.

3. Re-valuation of the U.S. Technology Sector

Third, the changing fortunes of the tech sector have prompted a rapid re-evaluation – and revaluation – of the price of tech stocks. This is only natural because seven companies comprise more than 15% of the weight of the S&P 500 Index, as shown below. (Alphabet, the parent of Google, has two share classes.)



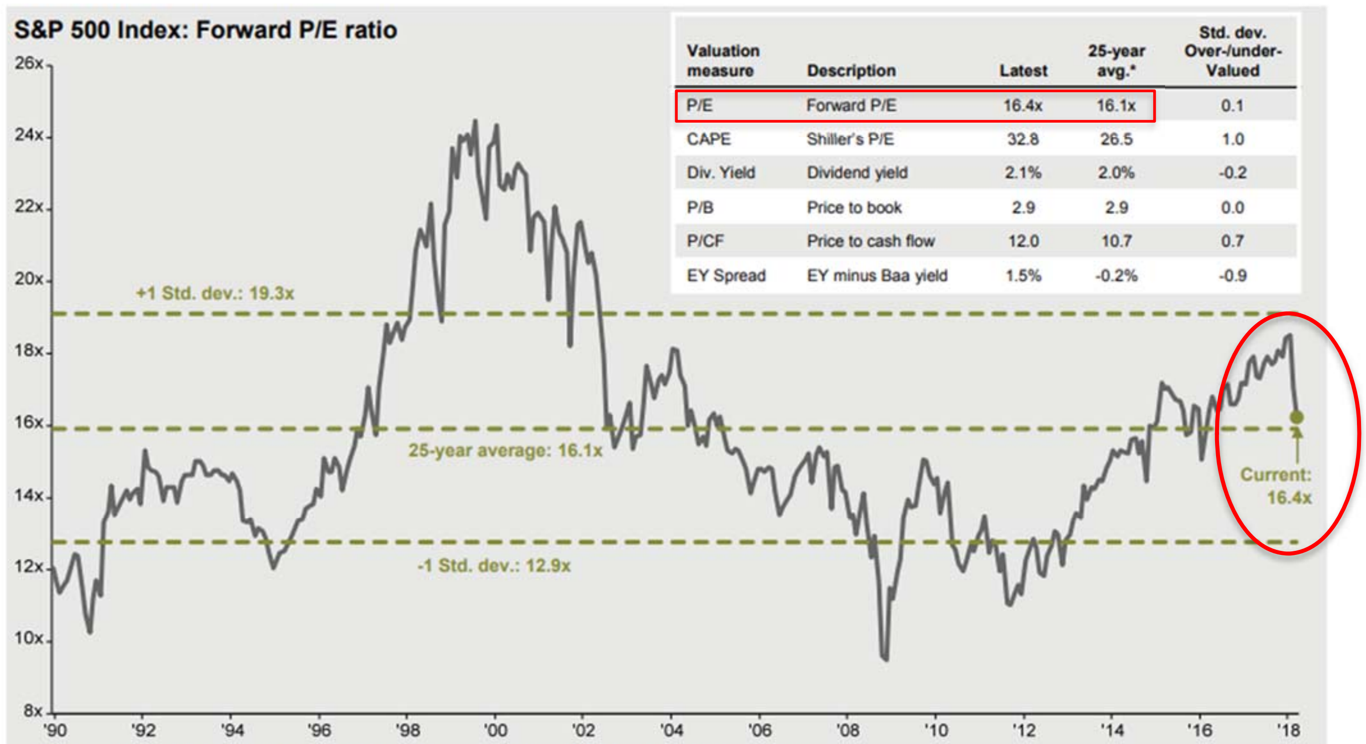
Facebook has tumbled recently because of fallout from revelations of its data sharing with a political consulting organization. That sharing may have been improperly disclosed, and the nitty gritty of the privacy policy was poorly understood by Facebook's millions of users. The incident has raised deeper questions of trust among social media users in general, not just those of Facebook. Moreover, Amazon has been the target of President Trump's tweeting ire concerning its shipping contracts with the U.S. Postal Service. It was also rumored the President may try to impose a sales tax on third-party sellers. The specific veracity of those shipping allegations aside, Amazon's stock price has plummeted in recent weeks. It had been one of the darlings and drivers of the equity rally of the previous few years, the equity tide that helped to lift other company stock price ships.

In our view, it seems that for the most part this is a healthy re-valuation. Prior to March of this year, the combined basket of Facebook, Amazon, Apple, Netflix, and Google (FAANG) had outperformed the S&P 500 by

35% since April 2017, and Amazon was ahead of the index by a remarkable 70%. Its reversal helped to lead the index quickly lower, but the collective price of big tech companies may have been unjustifiably lofty.

Unless the administration presses forward to wage a tech war in addition to or alongside a trade war, we think that the recent tech and tweeting storm will pass. We are reminded, however, of the power of the bully pulpit. As with the administration's trade policy announcements and actions, words have consequences, and other players must respond. Exactly how that verbal conflict between the administration and Amazon will unfold is unpredictable at present, just as it is uncertain how users' privacy concerns will affect any change in their social media behavior or associated advertising revenue for Facebook and other companies. But in one respect at least there is a silver lining to the recent correction of 10% in the S&P from its all-time high reached back in January.

The upside of the downward price action in the S&P 500 Index is not just a re-evaluation of the business models of various tech companies, but also the revaluation of the broad market stock index itself. As you can see in the table and chart below, the sharply lower movement in the S&P 500 over the last two months has brought the current valuation back in line with its longer-term average, as measured by the forward price-to-earnings ratio. As of the end of March, the S&P 500 Index was trading at 16.4 times its expected next-twelve-month earnings; the 25-year average is 16.1 times earnings.



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	16.4x	16.1x	0.1
CAPE	Shiller's P/E	32.8	26.5	1.0
Div. Yield	Dividend yield	2.1%	2.0%	-0.2
P/B	Price to book	2.9	2.9	0.0
P/CF	Price to cash flow	12.0	10.7	0.7
EY Spread	EY minus Baa yield	1.5%	-0.2%	-0.9

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

This is to say that recent stock market action has helped to make U.S. equities more fairly valued. Yes, there remain geo-political and economic risks; however, concerns about how richly U.S. stocks were trading should have somewhat abated.

Now, we still believe that investors would do well to temper their future portfolio return expectations given how much U.S. stocks in particular have performed above their long-term average and given other macroeconomic factors such as the path of monetary policy and the waning positive economic boost as time passes from tax reform. But those considerations do not change the fact that U.S. stock valuations are much more reasonable than just a few months ago, and corporate earnings still look as though they will grow more than nominal GDP growth over the next several quarters.

To recap, news about inflation and Fed policy, trade policy, and the popular and political challenges that tech companies face are likely to remain in the near-term central to much economic and political news. Worries related to each of these may induce collective concern or energized excitement, both in society and in global markets. Still, globally and in the U.S. many *leading* economic indicators (manufacturing/service activity indices, consumer/business confidence) and *lagging* indicators (GDP, wage growth) remain robust. In our view, this fact will likely contribute to additional economic expansion, although we recognize the potential for uncertainty from each of these three main areas -- U.S. inflation/monetary policy, U.S. trade policy, and the U.S. tech sector -- to be disruptive.

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. Federal Reserve Chairman Powell seems by and large to be continuing the informed, data-dependent approach of previous Chairwoman Yellen. Sorting out economic and market noise from substance remains a pressing task for investors, and we continue to appreciate the trust that our clients place in us to help them do just that.

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