

June 2018

U.S. Stocks Gain in May, But Foreign Assets Decline Amid Political Uncertainty Abroad

Overview

In May, U.S. stocks rose but foreign stock indices declined. Economic data in the U.S. continued to be strong, but political uncertainty in Europe and idiosyncratic developments in a few emerging market countries rattled investors. The Federal Reserve left its key benchmark rate unchanged, as expected, at its meeting on May 2, but meeting minutes released subsequently suggest that the central bank will raise rates after its next meeting on June 13. This would reflect an assessment of overall U.S. economic strength. In this installment of *Insights*, we revisit economic strength in three key global regions: the U.S., Europe, and emerging markets (EM). Overall, we anticipate continued global expansion that is consistent with a relatively low near-term risk of recession in the U.S. In our view, risks such as trade policy disputes and monetary policy tightening in the U.S. are real, but they will likely not derail further global economic expansion.

Performance

Core U.S. bond yields fell and their prices rose in May, as the yield on the 10-year Treasury Note declined due to investor risk aversion near the end of the month. Year-to-date through May, the Bloomberg Barclays U.S. Aggregate Bond Index has declined 1.50%. U.S. large, mid, and small-sized stocks gained, turning year-to-date performance positive for large- and mid-caps. The S&P 500 Index now has risen 2.02% YTD through May. The Russell 2000 Index of small-cap stocks is now up 6.90% YTD through the last month.

	May	2018 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	1.15	-0.33	2.92	4.30	US Muni Bonds
BarCap US Agg Bond TR USD	0.71	-1.50	1.98	3.72	US Taxable Bonds
BoAML US High Yield Master II TR USD	-0.02	-0.27	4.87	7.70	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	-0.94	-4.08	4.34	6.67	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	-4.98	-3.69	-1.66	2.74	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	0.30	0.92	2.78	-0.46	Hybrid/Hedged Equity
DJ Industrial Average TR USD	1.41	-0.24	12.78	9.67	US Equity -- Large
S&P 500 TR	2.41	2.02	12.98	9.14	US Equity -- Large
NASDAQ Composite TR USD	5.50	8.31	17.97	12.68	US Equity -- Large
Russell 1000 TR USD	2.55	2.19	12.91	9.18	US Equity -- Large
Russell Mid Cap TR USD	2.27	1.64	11.79	9.24	US Equity -- Mid-sized
Russell 2000 TR USD	6.07	6.90	12.18	9.64	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	-2.31	-1.92	5.46	1.86	Int'l Equity -- Comprehensive
MSCI EM NR USD	-3.54	-2.61	4.52	1.62	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	1.42	3.62	-6.64	-7.92	Commodities
HFRX Global Hedge Fund USD	0.26	-0.66	1.08	-0.46	Multi-Asset Alternative Invmt

Source: Morningstar Direct. Data through 05/31/2018



In May, EM bonds declined for several reasons, including worry about global trade, short-term currency fluctuations, the rising U.S. interest rate trajectory, and idiosyncratic developments in certain places like Venezuela, Argentina, and Turkey. U.S. dollar-denominated debt (represented by the JPMorgan EMBI Emerging Market Diversified Index) fell nearly 1%, but they are now down for the year through May by just over 4%. In contrast, local currency EM bonds dropped sharply by 4.98%, but they have performed better than the USD-denominated debt this year, down now approximately 3.7% for the year, according to the JPMorgan GBI Emerging Market Diversified Index. EM equities also fell 3.54% in May, as measured by the MSCI Emerging Market Index.

Outlook

Our base case outlook for further global economic expansion remains intact, although economic data in Europe and Japan has moderated over the last several weeks. We continue to anticipate a moderate rate of inflation in the U.S., a largely measured and telegraphed U.S. Federal Reserve policy, and supportive economic growth in emerging markets. This seems the most likely scenario, in our view, despite some risks in three areas in particular: (a) the pace of growth in Europe (we think it will continue to slow from its rate last year); (b) trade policy (we believe that protectionism will continue to stoke market worries and exert a slight economic drag), and (c) central bank policy (we think current policy paths in the U.S. and Europe will contribute to currency volatility and other market movements).

In the U.S., economic conditions remain solid, and there are many signs of health. Consumer confidence remains near its recent high. Wage growth is picking up slightly. Manufacturing activity for non-defense goods is increasing, and new orders reached a recent high. GDP growth in the first quarter came in at 2.2%, which was above the consensus expectation of 2.0%. Fiscal stimulus from tax reform seems to have started to help corporate earnings, and it may help to explain why smaller-cap stocks have outperformed larger domestic stocks this year: on the one hand, lower corporate taxes may be more immediately realized by small companies; on the other hand, smaller companies typically have a smaller global footprint and so are less susceptible to worries about global trade protectionism.

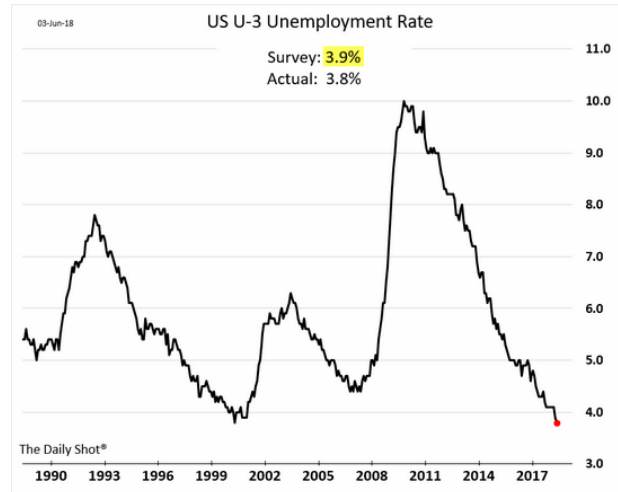
Although it is impossible to predict the exact outcome of ongoing trade negotiations, particularly those between the U.S. and China, on the one hand, and the three NAFTA countries, on the other hand, we currently think that the end result of these talks will be largely benign to the global economy. We acknowledge that announcements in recent weeks by the Trump administration have heightened risks; however, our present view remains that recent trade actions and retaliatory responses by nations such as China are unlikely to escalate into a full-scale trade war.

Prices have continued to move gradually toward the Fed's target levels. Headline inflation (via CPI) rose at a 2.5%, year-over-year, rate in April. Core CPI (without volatile food and energy items) held steady at 2.1%, year-over-year. This core measure, which is similar to the Fed's preferred metric, is right around the long-term target of 2.0%. We remain of the opinion that the Fed will increase its policy rate three more times in 2018, which would take the target range from the current 1.50-1.75% to 2.25-2.50%. As we see it, the next increase will likely be announced on June 13.

Two other factors reflect the strong state of the current U.S. economy, but they also pose a slight risk down the line: wage growth and low unemployment in the context of fiscal stimulus through tax reform. The risk is that a condition of full employment should spark additional increases in pay and inflation, and fiscal stimulus through lower taxes may prompt a slight acceleration in economic growth; however, this could lead to near-term

economic overheating. When the effect of tax reform fades after, say, 2019, conditions could be ripe for cyclical economic slowdown.

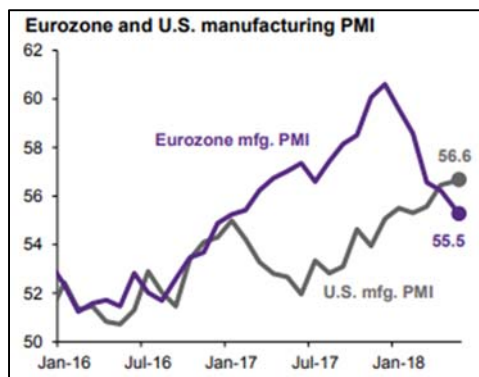
First, wage growth has begun to increase, but not in a massive way. The graph of hourly earnings below on the left is a bit noisy and the most current reading is slightly below its recent high, but the trajectory continues to be upward. Second, unemployment has steadily declined since the end of the global financial crisis and now stands at 3.8%, a level last seen in 2001 (see chart below on right).



Near-term, these are both positive aspects of the U.S. economy. They bear monitoring over the next year or so, because there is the potential at least for inflationary pressures related to full employment and rising wages to prompt the Fed to use higher interest rates to choke off economic growth.

In Europe, economic data has weakened somewhat, and political uncertainty has risen, especially in Italy and Spain. GDP continues to expand at a moderate rate. Unemployment has fallen. Corporate earnings are good but may have peaked. The European Central Bank (ECB) has reduced its quantitative easing program to 30 billion euros per month and removed its bias toward easing. The ECB has signaled that it will end bond purchases in September, but, depending on economic data, the central bank may extend them beyond that point.

As you can see in the graph below, manufacturing activity has risen in the U.S. over the last 18 months, but it has



Source: JPMorgan, data as of 5/15/2018

declined in Europe since the tail end of last year. Some of this may be due to the anticipation of the end of quantitative easing in Europe if businesses are decreasing output because they expect that financial conditions will tighten and demand will taper off. Some of it may be due to recent euro strength, which has tempered some demand from foreign trading partners. Whatever the reasons, manufacturing activity continues to expand (a reading above 50 indicates expansion), but at a slower pace.

This is not entirely to be unexpected. Last year the eurozone economy broke out from the disinflationary malaise that had bedeviled it for some time, and the ECB's quantitative easing program showed signs of

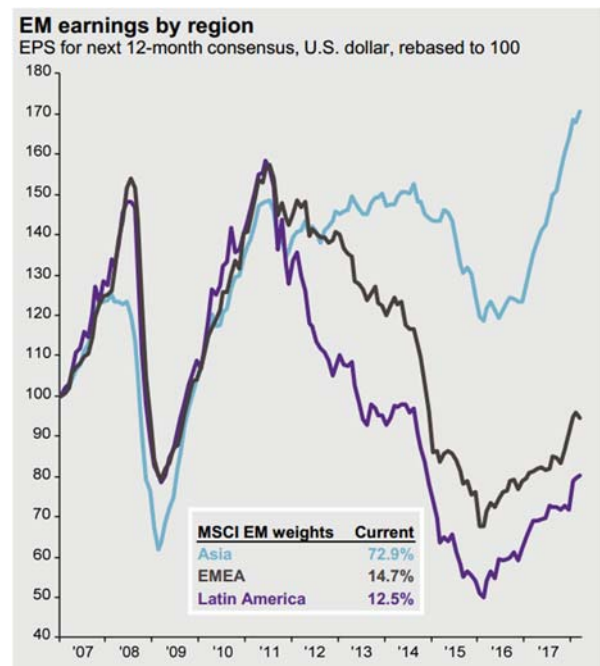
success. Moderation from that feverish recovery pace is normal. The Euro has given up some of its gains from earlier in the year, and a slightly weaker euro may help to stabilize demand for exports. Political disruptions, particularly in Italy and Spain in recent weeks, as well as trade skirmishes with the U.S., have not helped. Although we note the deceleration of growth and certain activity, we expect economic growth to remain stable.

Although recent economic GDP data out of the eurozone has weakened, the story is different in emerging markets. China continues to expand at, by U.S., Japanese, and European standards, an enviable clip. It reported that its economy grew at a 6.8% annualized rate in the first quarter of 2018, which beat expectations. China has been looking to shift to a service-based economy, similar to the U.S. Measures of both manufacturing and service sector activity are expanding in China. As we have said before, in many ways as goes China, so go emerging markets generally.

Emerging market economies are, broadly, in an earlier stage of economic expansion than the U.S. Earnings-per-share growth across the EM world is expected to be positive over the next 12 months, particularly in Asia, as you can see in the nearby graphic. Asian equities represent the vast majority of market capitalization within the MSCI EM Index (approximately 73%). Investors who have broadly diversified EM equity exposure along these lines may then benefit from simultaneous global growth, an upswing in commodity prices, an expanding middle class with greater means to purchase goods and services, and technological efficiency that helps corporate profitability.

All told, then, we observe and anticipate greater economic strength over the near term from the U.S. and emerging markets. We think that European growth will remain largely stable, but it is likely moderating downward from a recent peak. Political uncertainty may linger and pose somewhat of a drag as well. We believe that risk of a recession in the U.S. in the near term remains low. At some point the monetary policy tightening by the Fed via higher interest rates could potentially curtail economic growth, but inflation and wage growth data suggest movement in those areas to healthy levels. This is especially the case with core inflation, which is hovering around the longer-term Fed target.

Core bond prices remain vulnerable to rising rates in the U.S. High yield U.S. bonds and loans are attractive debt options relative to U.S. government bonds because of their lower interest-rate sensitivity and correlation to economic strength. The risks posed by U.S. central bank monetary policy (i.e., rising rates by the Fed) and uncertainty surrounding global trade pacts and policies due to protectionist rhetoric and retaliation are real and should not be discounted. In our view, however, these may add to periodic bouts of volatility for various asset classes but not derail the ongoing global economic expansion. Geopolitical risks, monetary policy risks, and trade rhetoric do increase the likelihood that 2018 will continue to see pockets of volatility that have so far characterized this year but were abnormally absent in 2017. But we believe that investors would do well to be encouraged by the underlying economic strength globally, especially in the U.S. and emerging markets. These remain bright spots with a number of investment opportunities.



Source: JPMorgan, as of 3/31/2018. (EMEA = Europe, Middle East, and Africa.)



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