

Global Stocks Gain in July, But Some Headwinds Remain

Overview

In July, U.S. and international stocks rose, and domestic and foreign bonds were variously stable or positive. Economic data in the U.S. continued to be strong. It deteriorated further in Europe, but late in the month the Trump administration reached a conciliatory trade agreement with the European Union, which boosted sentiment. Protectionist rhetoric toward China, however, intensified. The Federal Reserve, as expected, kept its key benchmark rate steady on August 1; it remains within a target range of 1.75% and 2.00%. In this installment of *Insights*, we focus on three important areas: the current and likely future state of U.S. trade policy, structural and cyclical challenges facing Europe, and the continuing path of the U.S. economy and monetary policy. Overall, the global economy is still strong, but the escalation of protectionist rhetoric and policy through tariffs could be disruptive. Economic growth in the euro area in Q2 was just 0.3%, whereas U.S. GDP growth was 4.1%. Domestic strength is likely to keep the Fed on a rate hiking path for the foreseeable future; however, inflationary pressures are only modest, which combined with sluggish wage growth and European economic weakness could prompt the Fed to pause earlier than some expect. All told, we foresee continued global expansion that is consistent with a relatively low near-term risk of recession in the U.S. in view of the tailwind from tax reform, strong corporate earnings, solid manufacturing activity, and positive consumer sentiment.

Performance

U.S. equities gained in July, led by large companies. The S&P 500 advanced 3.72% on the month.

	July	2018 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	0.24	-0.01	3.76	4.41	US Muni Bonds
BarCap US Agg Bond TR USD	0.02	-1.59	2.25	3.73	US Taxable Bonds
BoAML US High Yield Master II TR USD	1.12	1.19	5.35	8.33	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	2.55	-2.81	5.43	6.91	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	1.90	-4.67	-0.92	2.15	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	0.72	0.97	2.67	0.00	Hybrid/Hedged Equity
DJ Industrial Average TR USD	4.83	4.07	13.11	11.25	US Equity -- Large
S&P 500 TR	3.72	6.47	13.12	10.67	US Equity -- Large
NASDAQ Composite TR USD	2.19	11.77	17.53	13.95	US Equity -- Large
Russell 1000 TR USD	3.45	6.40	12.96	10.70	US Equity -- Large
Russell Mid Cap TR USD	2.49	4.90	11.51	10.79	US Equity -- Mid-sized
Russell 2000 TR USD	1.74	9.54	11.33	10.39	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	2.39	-1.46	5.59	3.16	Int'l Equity -- Comprehensive
MSCI EM NR USD	2.20	-4.61	5.25	2.87	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	-2.13	-2.14	-7.06	-8.09	Commodities
HFRX Global Hedge Fund USD	-0.15	-1.00	1.08	-0.13	Multi-Asset Alternative Invmt

Source: Morningstar Direct. Data through 07/31/2018



Year-to-date through July, the S&P 500 Index is up approximately 6.5%. Small company domestic stocks in the Russell 2000 Index have fared even better, gaining 9.5% in 2018 through July. Foreign equities rebounded in July. EM equities rose 2.2% last month, as measured by the MSCI Emerging Market Index. The broad foreign benchmark, the MSCI ACWI Index Ex-USA was up a similar 2.4%.

The Bloomberg Barclays U.S. Aggregate Bond Index was basically flat for the month, inching up 0.02%. However, U.S. high yield and emerging market bonds (both dollar-denominated and local currency) gained. For EM bonds it was the first gain in several months because of investor worries about global trade, short-term currency fluctuations, and the rising U.S. interest rate trajectory. U.S. dollar-denominated debt (represented by the JPMorgan EMBI Emerging Market Diversified Index) gained 2.5%, and local currency EM bonds rose by 1.9%, according to the JPMorgan GBI Emerging Market Diversified Index.

Outlook

Data has continued to moderate in Europe and concerns around trade have escalated, but in our view the overall economic expansion remains on firm footing. We recognize that investors continue to be concerned about the length of the economic expansion, and growth is not as synchronous as it was in 2018; however, we think the outlook remains on balance largely positive. As we explain further below, despite trade concerns and some structural challenges in Europe, the global expansion is likely to continue with the United States as its growth engine.

Global Trade Policy

First, the White House has been focusing its trade policy on three main fronts: NAFTA (North American Free Trade Agreement), Europe, and China. The outlook for both NAFTA and Europe improved significantly in July. Various media outlets have suggested that the U.S. and Mexico are making progress on a compromise, and Trump and Jean-Claude Juncker, President of the European Commission, announced that they had come to an agreement not to escalate tariffs further.

Negotiations with Beijing have not been as smooth. In July there were seemingly daily headlines from both sides, primarily in the form of the U.S. announcing new tariffs and China matching them in a quid pro quo fashion. However, since the U.S. exports much less to China than it imports, the Trump administration announced tariffs on goods of more than \$200 billion, a number that China cannot match. The U.S. also announced it was considering raising the tariff to 25% rather than the 10% previously stated in order to combat China's devaluation of its currency, the yuan. In the midst of the escalation, however, it was announced that the two sides would resume talks.

In general, U.S. trading partners levy higher tariffs than the U.S. levies on them. The chart below on the left shows the average tariff applied by the U.S. on goods that it imports from trading partners (vertical-axis) and on goods exported by the U.S. to others (horizontal-axis). Data points to the right of the reciprocity line represent where tariffs applied by foreign countries to the U.S. are higher than by the U.S. on other countries. Additionally, other countries tend to rely more on exports as a percentage of GDP than does the U.S. The chart on the right

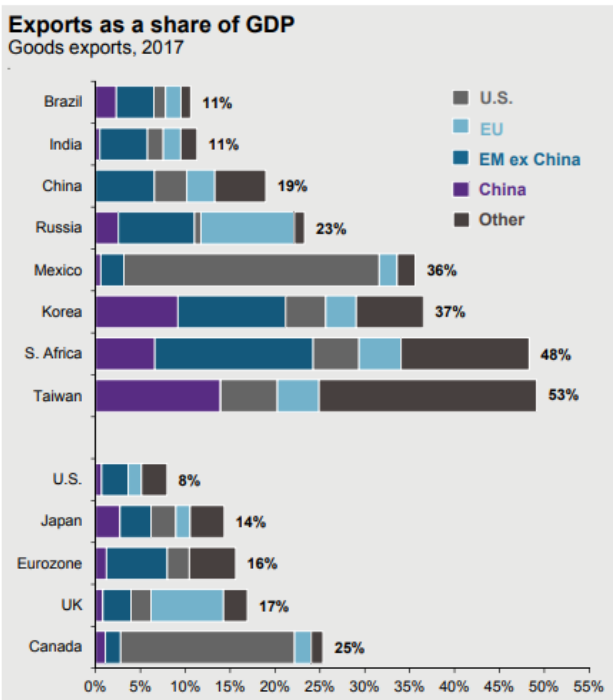
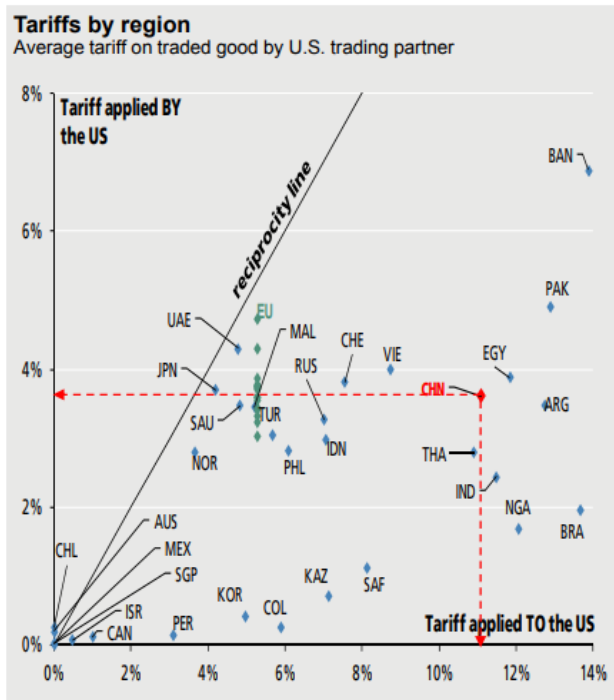
shows exports as a share of GDP by country, which may help to explain why the White House believes that it can strong-arm countries into new deals.

More countries tax at a higher rate what we export to them than the U.S. taxes what they export to us.

- China, on average, applies about an 11% tariff on imports from the U.S.
- The U.S. applies just under 4% of a tariff on goods that it imports from China.

All other major countries derive more of their GDP growth from exports than does the U.S.

- Economically, the U.S. stands to lose less from a proportional reduction in exports than other nations.
- China derives about 19% of its GDP from exports versus the U.S.'s 8%.



Source: FactSet, J.P. Morgan Asset Management; (Left) Eye on the Market, WTO, World Bank; (Right) IMF. Tariff data are as of December 31, 2015, or most recent available. Tariff is simple average of tariffs on traded goods. Data are as of July 31, 2018.

What does this all mean? It is still unclear if the Trump Administration will move forward with a 25% tariff. These developments raise the probability that tariffs of at least 10% will be imposed on a substantial portion of the \$200 billion in imports recently outlined. Although the political pressures of the approaching mid-term elections could invite a softening of protectionist rhetoric from one perspective, the situation could deteriorate from here. While the lines of communication are open, it does not sound like substantive talks are taking place yet. It is unclear what the path forward is from here, but there is still at least a glimmer of hope that there can be a deal struck in August. As mentioned in the July edition of *Insights*, the economic effect of a trade war is a small, but international trade is not an insignificant portion of global GDP growth. It remains the hot-button storyline in the markets and media today, but at this time we have not changed our investment positioning.

Structural and Cyclical Challenges Facing Europe

Second, economic data in foreign developed markets has lagged that of the U.S. This discrepancy has led to a stronger dollar. Europe in particular has seen various economic and political headwinds, including radical

populist backlash, a market environment with less dependence on its central bank, and escalating geopolitical tensions (e.g., Brexit).

From an economic perspective, data out of the eurozone and the U.K. weakened in the second quarter, and corporate earnings may have peaked. Populist backlashes have continued to gain momentum. The most recent case is in Italy, which remains a source of political uncertainty. These developments add to the troubles that the U.K. is having in trying to iron out a Brexit deal, and German Chancellor Angela Merkel facing difficulties in holding together her ruling coalition. The graph nearby on the right shows the clear divergence between a composite of leading indicators in the U.S. versus Europe.



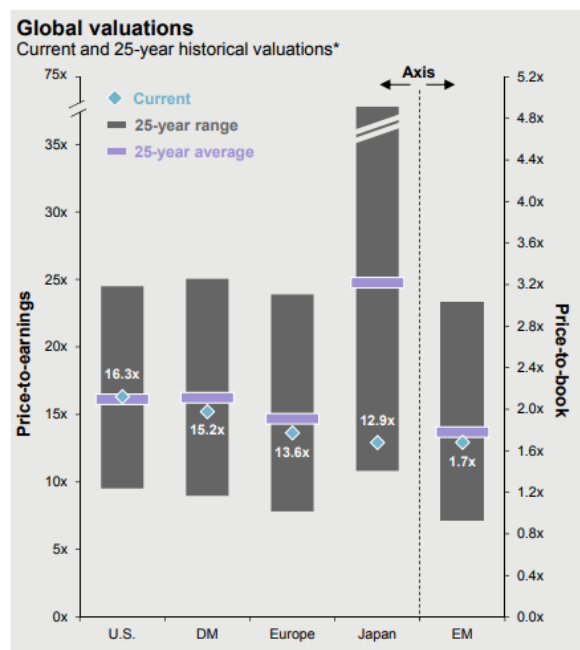
The graph nearby on the left shows the year-over-year change in Germany’s manufacturing orders, a leading indicator that went negative for the first time since early 2016. When the data began weakening earlier this year, it was our opinion (and the opinion of others) that the decline was weather-related, but more recently, now that the seasons have changed and more data has emerged, the weakness appears to be more of a structural problem.

Brexit negotiations have also been grinding along with very little to show for the effort. Two of the senior British negotiating leaders resigned the second week of July, and on July 22 Brussels rejected the UK's proposals on how to govern the City of

London's access to the European market after Brexit. Businesses are worried that the 1Q 2019 deadline is looming.

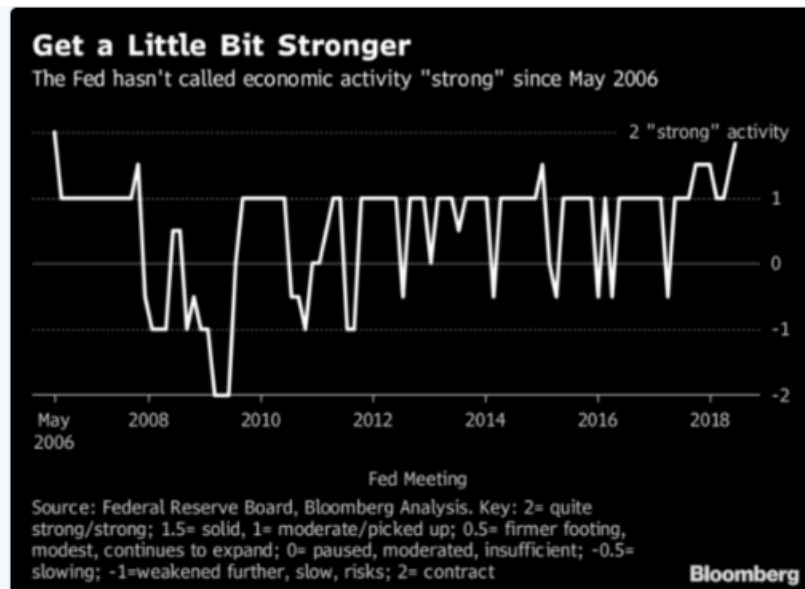
After the strong equity performance last year, valuations are in line with historical averages and appear generally fairly priced. The chart to the right shows the 25-year valuation ranges for each major global equity market (source: J.P. Morgan Asset Management). International developed market (DM) equities broadly are currently trading at 15.2x forward price-to-earnings, while Europe is trading at 13.6x and Japan at 12.9x. Aside from the exceptional case of Japan, all other markets are trading right around their 25-year average.

We are observing fair valuations and structural challenges in the way of political and economic uncertainty, both of which raise our level of caution somewhat about foreign developed markets moving forward.



Continuing Path of the U.S. Economy and Monetary Policy

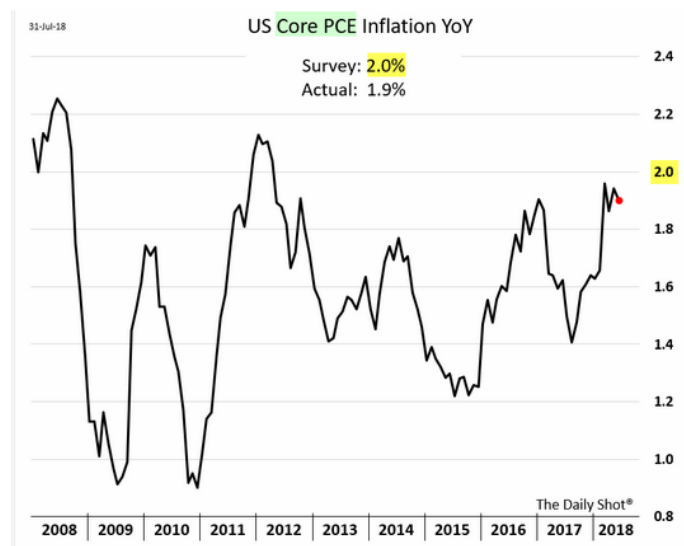
The Federal Reserve Open Market Committee (FOMC) met in July and decided, as expected, to keep the Federal Funds rate steady. It remains within a target range of 1.75% to 2.00%. Economic data in the U.S. remains broadly positive, a view echoed by the Federal Reserve's July statement and meeting minutes. The minutes cited that the economy is "strong," which is a view that the U.S. central bank has not expressed since May of 2006.



It is our current view that there will be two more rate hikes in 2018 (most likely in September and December) and two in the first half of 2019. If there are four hikes over the next 12 months and if inflation data remains subdued, then it is possible the FOMC will hold rates steady at least temporarily at that time to assess the economy and the effect of its tightening program.

The Federal Reserve's preferred inflation measure (core personal consumption and expenditures, or core PCE) has remained subdued below its 2% target (1.9% for the July reading). (The core measurement excludes the volatile food and energy components.) Headline inflation according to the PCE is currently 2.2%. Both measures are right around the Fed's long-term inflation target of 2.0%.

Although wage growth has been picking up in recent quarters, it currently lags headline inflation (via CPI, the Consumer Price Index) for the first time since 2013. This means that, after accounting for inflation, workers can purchase slightly less than they could have purchased one year earlier. Such lack of wage growth is surprising given the tightness in the labor market and the massive tax cuts that companies received at the end of 2017. As one analyst recently put it





sarcastically, “Kudos to companies for not giving raises.” However, the savings rate was recently revised upwards, reflecting the fact that the consumer likely has more discretionary income to spend than previously thought. Before this revision there was concern that consumers were spending beyond their means, but this trend seems to have been overstated. Sage expects that wage growth will pick up slightly during the second half of the year due to additional gains in employment within a context of full employment and further gains in corporate profits.

Overall, the U.S. economy remains on strong footing. The Federal Reserve is positioned to increase rates gradually, and against a backdrop of durable domestic economic growth, low inflation, and historically fair valuations, U.S. equities continue to be, in our view, more attractive than their developed foreign counterparts.

Summary and Conclusion

In summary and conclusion, we remain positive on the global economic outlook despite ongoing trade concerns. The Federal Reserve has stated that it believes the U.S. economy is strong, and Sage thinks that monetary policy will continue to tighten in the U.S. Political uncertainty in Europe has increased in recent months, and economic growth data has moderated. The risk of additional trade war rhetoric is real, but some progress has been made on the NAFTA and European fronts, and there seems to be an incipient negotiating path forward with China.

We continue to believe that investors should 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, despite the cloud of protectionism. We also believe that investors should remain balanced in their asset allocations and avoid overemphasis of one or two investments relative to others.



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