SAGE FINANCIAL GROUP
Investment and Wealth Management

SAGE INSIGHTS
MONTHLY ECONOMIC & MARKET ANALYSIS

November 2018

Regrouping After a Difficult October

Overview

In October, all major asset classes posted negative performance, although economic data in the U.S. remained generally sound. There were several chief reasons for the across-the-board investment declines:

- Third-quarter corporate earnings were mixed, and stocks lacked support from company buybacks.
- Increased worries about geopolitical risk following Saudi Arabia's involvement in the killing of a journalist.
- Heightened concern about the trend in rising U.S. bond yields and the potential economic effect.
- A market repricing of global economic growth due to, among other things, concerns about a prolonged trade conflict between U.S. and China.

The first two of these are transient, and the second two are not new; however, they spooked many investors last month. In this installment of *Insights*, we focus on three topics of particular interest to investors: the outcome of the U.S. midterm elections, the U.S. economy and the likely policy path of the Federal Reserve, and the upcoming Brexit deadline. In the U.S. midterm elections, the Democrats regained control of the House, and Republicans held on to a slight majority in the Senate. We believe that the actual effect of these results on financial markets is likely to be modest, but the fact that the election is behind us is positive, since it has now brought certainty where there was speculation. The U.S. economy remains strong, with a Q3 growth rate of 3.5%. The Federal Reserve held rates steady the first week of November, but it is widely expected to raise its key benchmark rate again in December. The Brexit date is March 29, 2019, but a negotiated deal currently remains unreached, which has posed (and may continue to pose), economic uncertainty in the coming months, although we still think some late-hour compromise is likely.

Performance

October was not kind to all major asset classes, as you can see in the table below.

	Oct.	2018 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	-0.62	-1.01	3.25	4.80	US Muni Bonds
BarCap US Agg Bond TR USD	-0.79	-2.38	1.83	3.94	US Taxable Bonds
BoAML US High Yield Master II TR USD	-1.64	0.84	4.69	11.16	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	-2.16	-5.13	4.35	9.20	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	-1.96	-9.95	-2.59	4.07	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	-3.95	-4.81	1.19	1.46	Hybrid/Hedged Equity
DJ Industrial Average TR USD	-4.98	3.41	12.76	13.33	US Equity -- Large
S&P 500 TR	-6.84	3.01	11.34	13.24	US Equity -- Large
NASDAQ Composite TR USD	-9.16	6.71	14.58	16.87	US Equity -- Large
Russell 1000 TR USD	-7.08	2.67	11.05	13.42	US Equity -- Large
Russell Mid Cap TR USD	-8.31	-1.47	8.97	14.19	US Equity -- Mid-sized
Russell 2000 TR USD	-10.86	-0.60	8.01	12.44	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	-8.13	-10.97	1.63	6.92	Int'l Equity -- Comprehensive
MSCI EM NR USD	-8.71	-15.72	0.78	7.84	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	-2.16	-4.14	-7.31	-4.18	Commodities
HFRX Global Hedge Fund USD	-3.11	-4.30	0.14	1.37	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 10/31/2018

The S&P 500 fell 6.84% on the month, and the tech-heavy NASDAQ dropped 9.16%. The Russell 2000 Index of small companies declined 10.86%. The monthly declines for the NASDAQ and Russell 2000 were all worse than those of both the broad MSCI ACWI Index Ex-USA index (-8.13%) and the MSCI Emerging Market Index (-8.71%). Year-to-date through October, however, the S&P 500 remained positive at about a 3% gain, whereas both of those foreign stock indices are now down more than 10%.

The Bloomberg Barclays U.S. Aggregate Bond Index declined last month 0.79% as yields rose because of continued economic growth and higher inflation expectations in the U.S. For the year through October, that core taxable bond index has returned -2.38%. This is a fact that investors should keep in mind when they think about diversified portfolio returns, since there are times when both stocks and bonds are simultaneously weak.

Outlook

Economic data in the U.S. remains broadly solid. For instance, U.S. consumer confidence is still near its highest point in nearly 18 years, once again beating expectations. The unemployment rate remains below 4.0% and at a level consistent with full employment. China posted a Q3 GDP growth rate of 6.5%, in line with expectations. Its pace of continued economic growth remains largely stable but bears watching. Euro-area growth for Q3, quarter-over-quarter annualized growth rate was 0.8%, slowing from earlier in the year but still positive. Overall, the global economy is still strong, and we think that certain problems, such as Italy's budget dispute with the EU, will remain largely isolated. Trade policy worries still overshadow the financial picture, and Europe still faces certain structural challenges, including Brexit uncertainty. In our view, however, the broad investment outlook remains on balance largely positive. The global expansion is likely to continue over the near future with the United States and China, despite their trade squabbles and slight decelerating pace of expansion, as its growth engines. Although there remain a number of uncertainties, the outcome of the U.S. midterm elections is no longer one of them. It is to that subject that we now turn.

U.S. Midterm Elections

As November approached, the U.S. midterm elections drew increasing investor interest, and the uncertainty surrounding their outcome was likely one of the factors that contributed to October's heightened asset price volatility and negative returns. We now have an answer to the question of Congressional control. This may help us now to answer the related question on investors' minds, "How will the outcome of the midterm elections affect financial markets?"

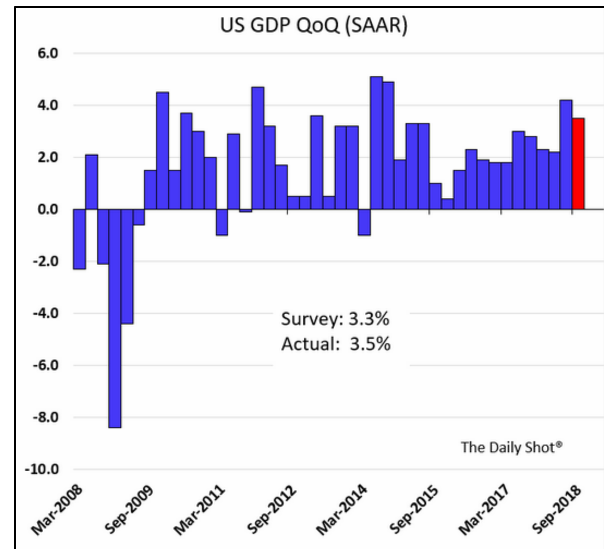
The table below outlines how the midterm election outcome may affect interest rates, the U.S. dollar, and the degree of difficulty in passing the increase to the debt-limit. Democrats have retaken control of the House and Republicans have maintained their majority in the Senate. Interest rates, according to this analysis, likely will decline slightly and very briefly post-election (see the "10-year" column), the yield curve will likely flatten further

("2-10 spread" column), the dollar will likely decline slightly ("USD" column), and there will likely be little opposition to raising the debt-ceiling ("Debt-limit passage" column).

House	Senate	Margin	Probability	10-year	2-10 spread	USD	Debt-limit passage
D	R	Slim	High	Decline <5 bps	Flatter	Modestly Bearish	Easiest

Source: BofA Merill Lynch Global Research

It is important, in our view, to separate feeling (i.e., one's preferred political views and election outcome) from thinking (i.e., what most likely will occur whether I like it or not given my policy views and my preferred election outcome) when making investment decisions. The economy continues to be strong. The most recent third quarter GDP figure of 3.5%, although slowing from the prior quarter, is the second-highest in four years. The effect of the new Congress on legislative policy over the next two years will likely be modest, and the effect of that legislative policy on a globally diversified portfolio will, in turn, also likely be slight.



Political gridlock often has a neutral to positive effect on financial markets, since policy uncertainty is reduced, and since the likelihood of the status quo is increased. The Democrat-controlled House will likely do what it can to frustrate the implementation of the Trump administration's agenda, but those powers from a single chamber of Congress are limited. Currently we do not expect much of a direct, lasting effect on investments from the midterms.

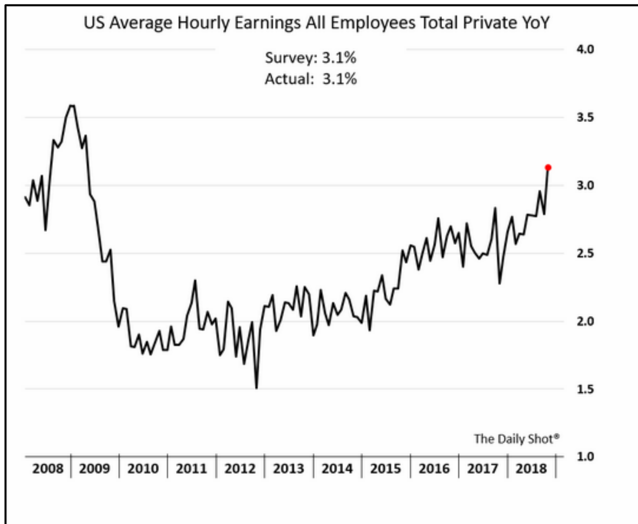
U.S. Economy and the Likely Policy Path of the Federal Reserve

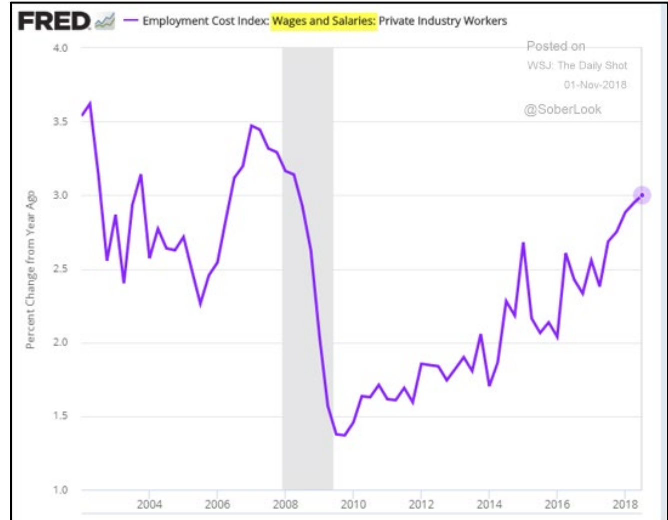
The Federal Reserve Open Market Committee met on November 6-7, and as expected it held interest rate policy steady within a target range of between 2.00% and 2.25%. The Fed is widely expected to increase the Fed Funds rate once more this year in December. The Fed's preferred metric of inflation, the Personal Consumption Expenditures (PCE), shows more modest increases than the frequently-cited Consumer Price Index (CPI). The core measure, as of September, is right at the Fed's long-term target of 2.0%. The Fed chooses to focus on the *core* inflation reading of the PCE, which excludes more volatile components like food and energy. The reason is that it wishes to base policy moves on more stable underlying inflationary pressures, not those that are ephemeral.

The strong U.S. economy has been good for corporations, workers, and consumers, but that strength and its related forces are starting to pose some policy challenges for the Fed. The Fed can properly respond to faster economic growth and inflation, after due consideration, with higher interest rates in order to achieve success with its dual mandate: low inflation and full employment. The particular challenge at present is how it should move forward when:

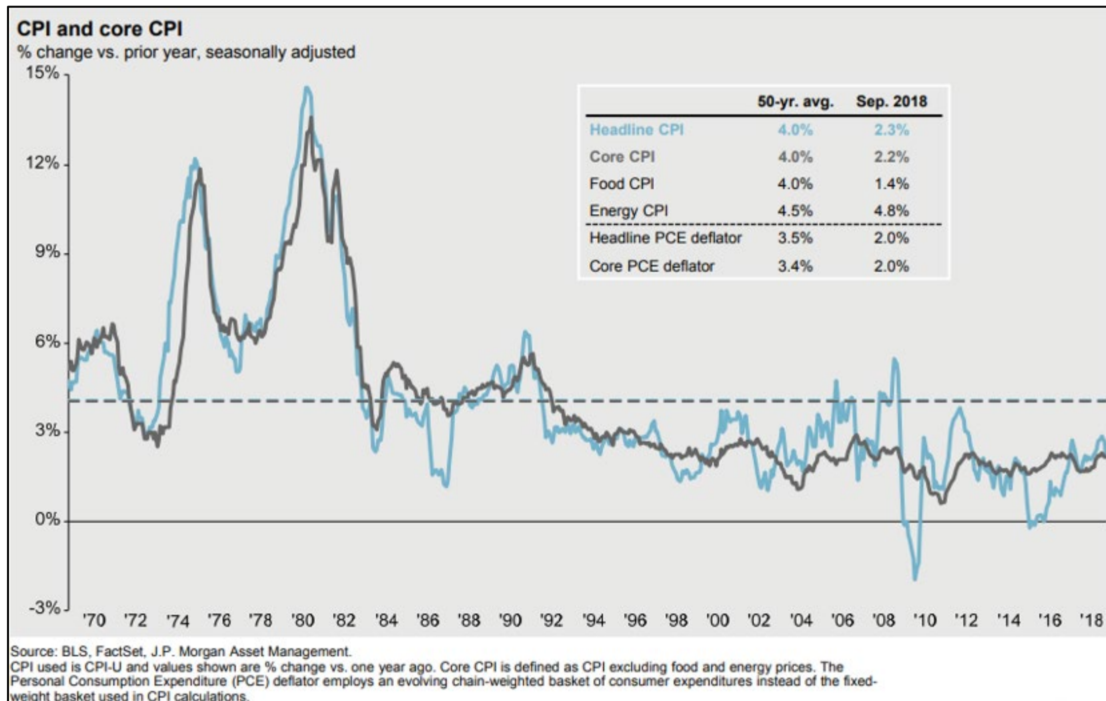
a) there is already full employment (the current 3.7% is below its estimated full employment rate),
b) economic growth is slowing from Q2 to Q3 as fiscal stimulus fades, yet remains robust at above 3%, and

c) core inflation is at its long-term target level, but wage pressures are rising (i.e., average hourly earnings have increased; see nearby charts) and price increases from trade tariffs are starting to be passed along to consumers but have not yet fully become manifest in the backward-looking data.





We agree with the current consensus that it seems most likely that there will be another increase in rates in December. Although some analysts believe that the Fed will raise rates 5 more times between now and the end of 2019 (i.e., once again in 2018 and 4 times in 2019), we continue to think it more probable that the Fed takes stock of its policy and the economy next year. If so, then it might only raise rates once more this year (in December) and twice in 2019 before pausing. This is not the consensus view, but it is worth considering given the likely fading economic effects from tax reform, already achieved full employment, and the effects of higher interest rates on lending and consumption patterns for things like auto and home purchases, as well as business investment.



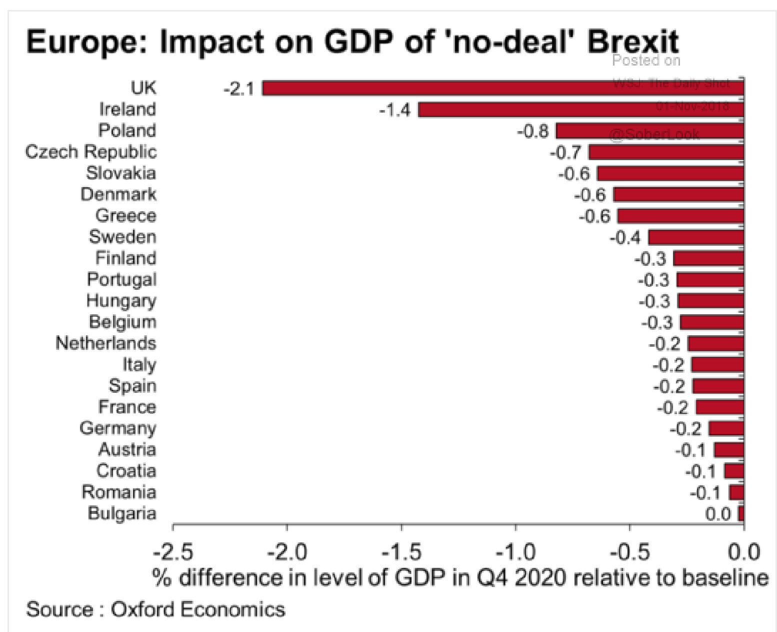
As for its view, communications from the Fed's Open Market Committee reveal that it currently anticipates that unemployment (currently 3.7%) will bottom around 3.5% in 2020. That prognostication, in turn, implies that the economy will likely continue to expand through this year and next and on into 2020. This already lengthy economic expansion seems to have the stamina to continue for the foreseeable future. Inflation remains contained and at the Fed's long-term target level. Wage growth has been ticking up slightly, but it has not yet translated into broadly higher consumer prices. So far tariffs on foreign goods have also not led to higher inflation. Both wage growth and pass-through price increases from tariffs, however, bear watching.

This is all another way of saying that inflation pressure in the U.S. is currently neither overly hot nor overly cold. The economy is expanding well, but it is not overheating. This is one reason that we believe that the near-term risk of recession is currently very low.

Brexit and Other Global Matters

The trade skirmish between the Trump administration and China continues. It is a positive development that President Trump and General Secretary Xi still plan to meet later this month at the G20 summit in Argentina. It remains unlikely, however, that a deal will be reached by the end of 2018. But such an agreement this year would be positive for trade, since before year-end the most recent tariffs imposed by the U.S. on an additional $200 billion's worth of goods will be just 10%. That duty is set to increase to 25% in 2019, as outlined in the summary graphic nearby. Nothing has really changed on this front. Although it grabs most of the headlines, the unfolding drama that is Brexit (i.e., Great Britain's exit from the European Union) is worth monitoring.

Brexit remains a potential geopolitical risk, specifically because there is currently still no transition deal on the books between the UK and the EU, including on the important matter of the Irish border. This lack of an agreement raises the level of uncertainty about what effect the exit will have on British and European companies, trade, immigration, worker status, and cooperation. If there is no deal by the end of March 2019 (Brexit is technically March 29, 2019), the U.K. will revert to operating under World Trade Organization rules. A no-deal Brexit is widely seen as an arrangement that would hurt British companies because of automatic tariffs that would be imposed on goods and services. It is also projected to impair the GDP of other European countries, as you can see in the nearby chart.



There is some urgency to negotiating a framework before year-end, because the British Parliament would need time to approve it before the end of March, and that passage is not guaranteed. Many Ministers of Parliament (MPs) in the Labour Party will likely vote against the deal both because they are in the opposition party to Prime Minister May's government and because they still wish to "remain" in the EU. Some Tory MPs are poised to vote against the current version of the negotiated deal because in their view it does not disentangle the UK sufficiently or contain their most

desired Brexit terms. Between these members of the Labour Party and the disaffected members of the Conservative Party, there may be enough votes to scuttle a negotiated exit and barrel the UK forward to a no-deal exit.

That has resurfaced recent speculation about another referendum that could potentially reverse the Brexit decision, but this would take 6 months to implement and would at this point need the Europeans to sign on to extend the March 29 deadline, which also is not guaranteed.

Even if the UK strikes a deal with Brussels (the home of the European Council) before year-end that is adopted by Parliament, there still will be a transition time, currently scheduled through 2020 but perhaps to be extended through 2021, during which the UK and the EU would fully formalize their future relationship and trade agreements. Even on the best-case scenario, there will be an extended formalization timetable.

In our view, we still believe that the most likely outcome is that some compromise deal will occur prior to the March 29 deadline; however, it may be a last-minute agreement with plenty of drama and brinksmanship along the way.

Summary and Conclusion

On the whole, domestic economic growth seems durable, inflation remains low, and employment remains high. We see the Fed's recent interest rate increase as a sign that the U.S. economy remains on strong footing. Some of October's weakness may have been from additional uncertainty related to the midterm elections that have just passed. Markets dislike uncertainty. With midterm elections out of the way and greater likelihood of policy gridlock now because of a split control of Congress (Democrats in the House, Republicans in the Senate), investors may rest more easily that no major policy upheaval is forthcoming.

The U.S. economy is likely to continue to grow but at a slower pace than it has recently, as fiscal stimulus slows and the cost of borrowing rises. There are some specific areas of the economy that are negatively affected by higher rates, such as housing and autos, and those industries have started to show some weakness. Consumer sentiment, however, remains at all-time highs, and consumer spending represents 67% of the U.S. economic output. We continue to foresee a relatively low near-term risk of recession in the U.S. in view of strong corporate earnings, solid manufacturing activity, and positive consumer sentiment.

We remain generally positive on the global economic outlook despite ongoing trade concerns and uncertainties in Europe, including the nature of Brexit and other forms of populism (e.g., the Italy/E.U. budget dispute, Spain's anti-E.U. sentiment). Although we do believe that in time China and the U.S. will strike a trade deal, we acknowledge that the path to that point remains murky and likely filled with ups and downs. The reaction by investors in foreign assets to some of these developments, particularly in emerging market stocks and bonds this year, is understandable but may be overdone. In our view, investors should remain balanced in their asset allocations and avoid overemphasis of one or two investments relative to others.

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