SAGE FINANCIAL GROUP
Investment and Wealth Management

SAGE INSIGHTS
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August 2019

U.S. Stocks and Bonds Rise in July on Fed Hopes, but New Trade Tensions Stoke Worry

Overview

In July domestic stocks and bonds rose again, primarily in continued anticipation that the Federal Reserve would lower interest rates at its meeting on July 31 and that the action would support U.S. economic growth. The monthly return for the S&P 500, for instance, was 1.44%. In contrast, non-U.S. stocks in the MSCI ACWI ex-USA fell 1.21%, largely because of jitters around slowing European growth and renewed uncertainty involving Brexit.

In this issue of *Insights*, we share our updated view on the shift in global central bank policy, particularly by the U.S. Federal Reserve and the European Central Bank (ECB), toward lower rates and greater accommodation. Low inflation, declining GDP growth, and persistent uncertainty about the direction of global trade have prompted central banks to respond with greater dovishness in an attempt either to cushion global economies from additional deterioration or to stimulate them from weak positions. There is a clear divergence within the global economy between weaker manufacturing activity, exports, and business spending, on the one side, and relatively strong consumption and business services sectors of the economy, on the other. We believe that the concurrent central bank policy shifts toward more accommodation, slower growth, subdued inflation, and historically low global government bond yields will continue to be key investment themes for the remainder of 2019.

Performance

Domestic and foreign bonds and U.S. stocks all gained in July, although foreign stocks and commodities declined (see table below).

	July	2019 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	0.81	5.94	3.77	4.63	US Muni Bonds
BarCap US Agg Bond TR USD	0.22	6.35	3.05	3.75	US Taxable Bonds
BoAML US High Yield Master II TR USD	0.51	10.72	5.08	8.62	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	1.21	12.66	5.47	7.58	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	0.93	9.73	-0.06	3.04	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	1.07	7.10	1.19	1.34	Hybrid/Hedged Equity
DJ Industrial Average TR USD	1.12	16.69	12.87	14.19	US Equity -- Large
S&P 500 TR	1.44	20.24	11.34	14.03	US Equity -- Large
NASDAQ Composite TR USD	2.15	23.94	14.65	16.55	US Equity -- Large
Russell 1000 TR USD	1.55	20.69	11.15	14.10	US Equity -- Large
Russell Mid Cap TR USD	1.43	23.08	9.59	14.35	US Equity -- Mid-sized
Russell 2000 TR USD	0.58	17.66	8.53	12.47	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	-1.21	12.22	2.12	5.42	Int'l Equity -- Comprehensive
MSCI EM NR USD	-1.22	9.23	1.84	4.56	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	-0.67	4.35	-8.34	-4.11	Commodities
HFRX Global Hedge Fund USD	0.77	5.02	0.22	1.33	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 7/31/2019

The S&P 500 gained 1.44% on the month, nearly identical with the Russell 1000 Index of large companies (up 1.55%). The Russell 2000 Index of small companies was also positive but to a much smaller degree (up 0.58%). With these gains, large-cap and small-cap Russell indices have advanced 20.69% and 17.66%, respectively, for the year through July. The MSCI ACWI Index Ex-USA Index, a measure of all stocks outside the U.S., fell 1.21% in July, but it remains up 12.22% YTD through July. The MSCI Emerging Market Index fell a nearly identical 1.22% for the month but has risen 9.23% YTD through July.

Once again, largely in anticipation of increased dovish policy by the Federal Reserve, the prices on core U.S. bonds rose. The Bloomberg Barclays U.S. Aggregate Bond Index gained 0.22% in July. Emerging market bonds gained for yet another consecutive month. U.S. dollar-denominated emerging market bonds in the JPMorgan EMBI Global Diversified Index rose 1.21% in June and have risen 12.66% YTD through July. The local currency EM bond index, the JPMorgan GBI EM Global Diversified, also climbed 0.93% in July. A 50/50 blend of the two EM bond indices has a YTD gain through July of approximately 11.20%.

Outlook

We continue to believe that the U.S. economy remains generally sound, in fact, Q2 GDP growth was 2.1%. But growth is slowing for several reasons, including fading effects from earlier tax reform, declining business sentiment and spending, and ongoing uncertainty about global trade policy. The uncertainty surrounding trade policy not only pertains to the tensions between the U.S. and its major trade partners, including China, but also between other players, such as Japan and South Korea. In addition, within Europe, the election of Boris Johnson to succeed Theresa May as UK Prime Minister has reignited worries about a hard, no-deal Brexit.

A positive for the U.S. economy continues to be the consumer. Consumer spending comprises approximately 70% of GDP, and consumer expectations remain near cycle-highs, largely due to the strong employment situation (e.g., 3.7% unemployment, positive real wage growth). In recent months both consumer confidence and expectations rebounded from lows earlier in the year (see charts below). When consumers feel good about job prospects and wage growth, they are more likely to buy a new house, car, and other items.

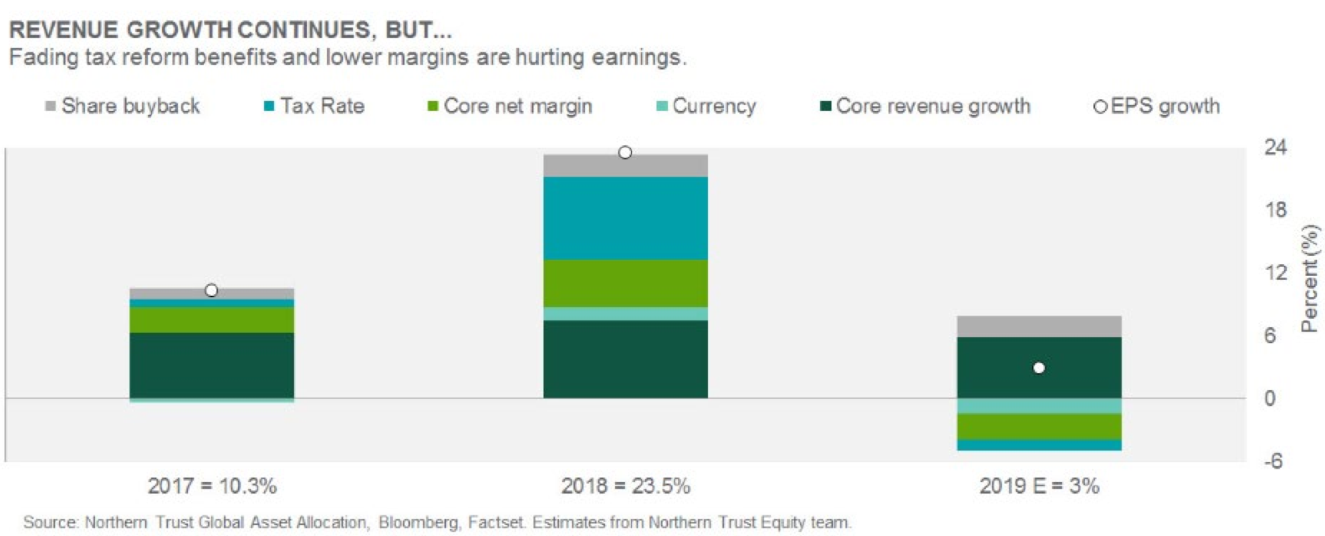
On the trade front, although the U.S. and China agreed to a trade truce at the G20 Summit in Japan in late June, their renewed negotiations have largely stalled. These trade talks did not provide businesses and consumers with any clarity about when a deal could be completed. The Trump administration has begun to suggest that a deal may not be reached prior to the U.S. presidential election in 2020. In fact, policy tensions have re-escalated in recent weeks.

On August 1, President Trump announced a 10% tariff on an additional $300 billion worth of goods, which means that, if implemented, all goods exported from China to the U.S. will have a tariff. The new tariffs do not take effect until September 1, which may allow for a change in announced policy. But given China's response to the Trump administration's announcement of additional tariffs, it seems likely that they will go into effect. On August 5 China halted imports of U.S. agricultural products and allowed its currency to weaken beyond 7 yuan to a single dollar, a record low for the yuan, making Chinese goods cheaper to global (esp. U.S.) buyers.

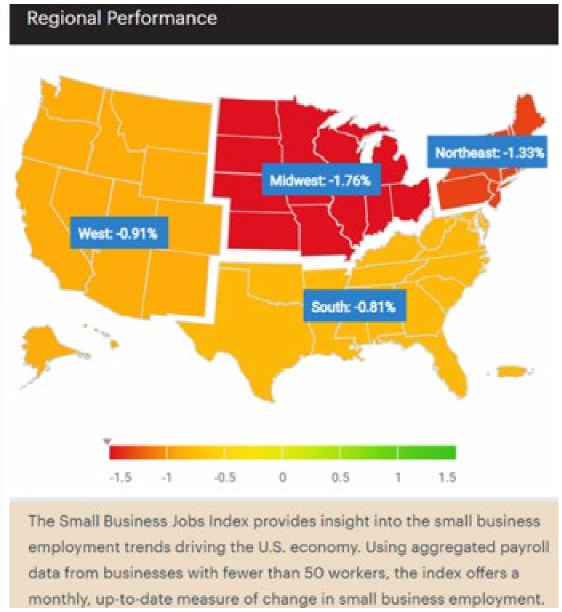
Both measures by the U.S. and China were generally unexpected by the other party, and they show how tit-for-tat retaliatory measures can get as each side angles for leverage. The escalation and continued uncertainty surrounding negotiations have led businesses to pull back on capital expenditures and to build their inventories this year.

The nearby chart shows a high correlation between the shipping index (red line, which has a 3-month lead), a leading indicator, and a basket of Federal Reserve bank manufacturing economic surveys, both of which are trending downward and are at or in contractionary territory. All of these factors continue to threaten the direction and pace of global growth.

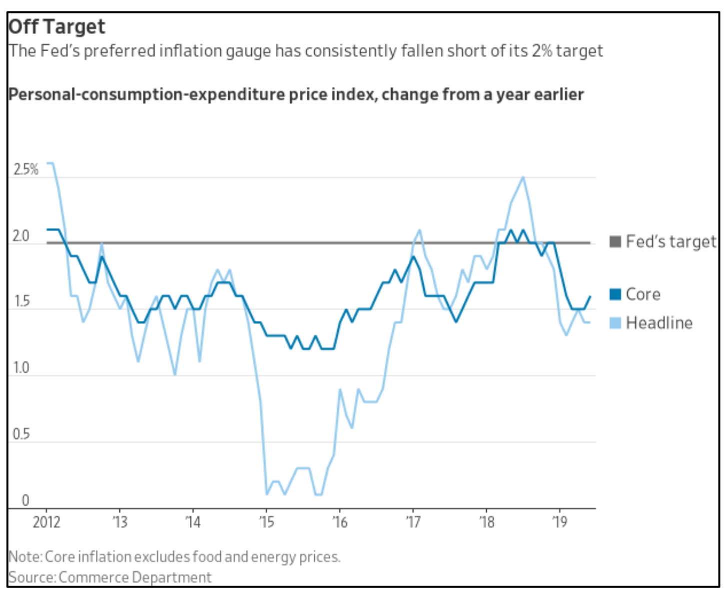
Despite the economic slowdown in the U.S. and abroad, U.S. corporate earnings have been positive; however, as you can see from the graphic below, lower margins and fading fiscal effects are hampering earnings growth.



The U.S. economy has added jobs for 106 consecutive months, and the official unemployment rate is at a very low 3.7%. Small business hiring, however, has been contracting in light of the less certain economic prospects (see the charts below). Jobs growth is expected to slow in coming quarters due to the tight employment situation, but the July figures were right in line with broad expectations. In tight labor markets, it becomes more difficult for employers to find the right people to help them expand because qualified applicants are already employed. As a result, GDP growth slows.

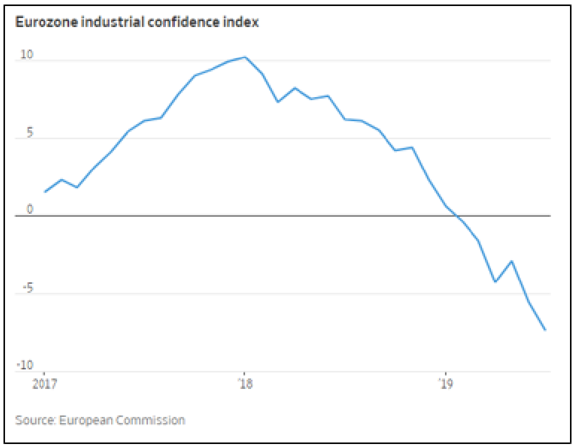


Bond yields have continued to fall in response to concerns about future growth, including in the United States, where the yield curve has been persistently inverted since mid-May. A bond yield curve is said to be inverted when the yield on short-term bonds is higher than the yield on long-term bonds. Through early August, the difference (i.e., spread) between the 10-year Treasury Note and the 3-month Treasury Bill had widened to as much as -0.25%. In our view, this inversion, which has lasted at present for approximately 3 months and has been of noteworthy magnitude, deserves to be heeded. The U.S. bond market is signaling by the inversion that the future economic and investment outlook is increasingly cloudy.



That increasingly cloudy economic outlook is a main reason that the Federal Reserve lowered its benchmark policy rate at the end of July by 0.25% to a range of between 2.00% and 2.25%. Another justification for the move is that inflation in the U.S. and abroad remains well-contained and even by some measures low. The Fed's preferred inflation metric, the Personal Consumption Expenditures, shows more modest increases in its measure of U.S. goods and services: 1.35% for headline and 1.6% for core in June. The *core* figure of 1.6% is shown nearby. Both PCE measures are below the Fed's long-term target of 2.0% and have decreased since December.

Germany's inflation, too, has been running very cool. The most recent reading came in at 1.1%, slightly below expectations and the lowest level since 2017. The same was the case for broader Euro-area headline inflation in June (1.06%), while core inflation was lower at 0.88%. More broadly, in the second quarter, Euro area GDP growth, compared with the same quarter of 2018, expanded at a +1.1% year-over-year rate. This was in line with expectations but slower than the pace of growth in Q1. Economic growth in Europe is likely to continue to be challenged for several reasons: broad trade uncertainty, renewed risk of a no-deal Brexit, and a decline in manufacturing activity given weaker global demand. As you can see from the graph below on the left, industrial confidence in the Eurozone has been steadily trending down for more than a year, and it is now at its lowest level in the last few years. The graph below on the right shows how manufacturing activity in the Eurozone is contracting (i.e., below 50). This is a notable development because more than 45% of Eurozone GDP growth comes from exports, according to the World Bank, whereas exports of goods and services account for only about 12% of U.S. GDP.

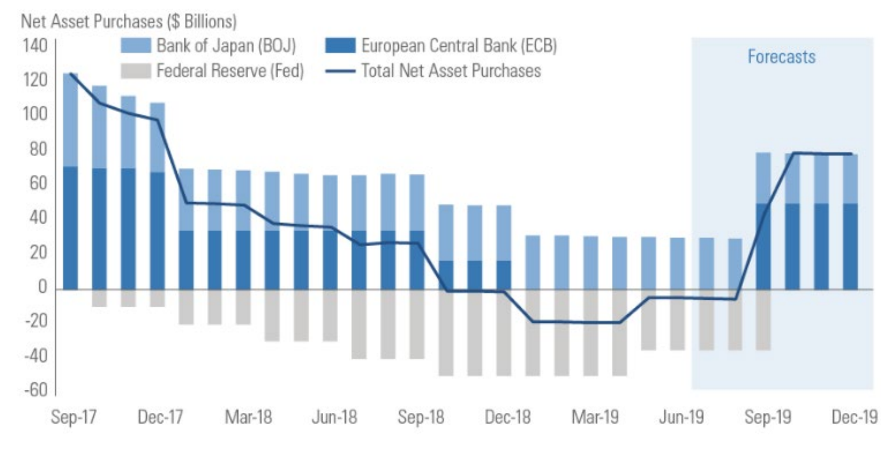


It may be that the Eurozone broadly will avoid recession, despite the ongoing risks, just as the U.S. economy has remained strong enough in certain areas such as consumer spending and consumer confidence for growth to remain positive for the remainder of the year, even if a bit lower than in previous quarters. Risks of a recession in the U.S., e.g., within the next 12 months have risen, but a recession is not absolutely certain. One investment implication is that risks from global trade tensions, lower growth, extremely subdued pricing pressures, and political unknowns are making economic growth around the globe susceptible to adverse organic developments and sudden shocks.

Another main observation that we believe investors should take to heart at present is this: low inflation, declining GDP growth, and persistent uncertainty about the direction of global trade have prompted central banks to respond with greater dovishness in an attempt either to cushion global economies from additional deterioration or to stimulate them from weak positions.

The Fed has lowered rates so far by a quarter-percentage point, and it is closely watching economic data (including inflation and GDP figures), as well as trade spillover effects, as it determines its next move. The European Central Bank (ECB) is likely to lower its deposit rate in September and take additional measures as well, including potentially the resumption of certain asset purchases. The Bank of Japan continues to ponder ways to jumpstart its low inflation/deflation challenges. The People's Bank of China may also be prompted by the trade tiff with the U.S. to lower reserve requirements as a means of boosting economic activity, in addition to further currency moves.

The forecast, in other words, calls for increased central bank activity in the coming quarters, as you can see from the graphic below. Bond and stock investors will need to factor this into their portfolio positioning.



Source: Fed, ECB, BOJ, Bloomberg, and GSAM. As of July 25, 2019.

Bond yields may remain low for some time still while investors add perceived safe-haven assets such as government bonds, and if central banks begin again or expand their asset purchase programs. Many bond investors wonder about adding to core bonds after yields have fallen as much as they have already this year in response to growth worries and trade friction. The 10-year U.S. Treasury Note in early August touched a 1.73% yield after China initially devalued its currency. How much lower can the government bond yield go? That is an open question, but even if yields do not go much lower from here, yields may stay low for some time. Given weak inflation and weakening global growth, and in view of increasingly dovish central banks, interest rate risk may not be a huge concern in the U.S.

This year both core bonds and global stocks are sharply positive, which is not often the case to this degree. The U.S. yield curve remains inverted, based on the 10-Year minus 3-Month spread. Bond investors are discounting future slow growth and low inflation, and they are anticipating a generally weaker economic environment. Despite this and trade war worries, U.S. stock markets have reached new all-time highs multiple times. There are signs that the U.S. consumer remains strong and that the economy itself remains on solid ground. Despite some market hiccups, investors have been anticipating a generally stronger or stable economic environment. As we have written before, it is often the case in U.S. history that stocks continue to climb higher during and despite a yield curve inversion. So there may be more stock gains to come.

We have also noted before that the yield curve inversion is uncannily consistent in preceding economic downturns. The investing takeaway may be that market activity and economic developments do not always walk in lockstep. Investors can be tempted to confirm their biases. Risk-averse investors might see the inverted yield curve and bond market gains as confirmation of their own view of what economic development is likely to come to pass, and they might believe that more of the same bond market returns will continue. Risk-welcoming investors might focus on certain strong fundamentals in the U.S. economy and on corporate earnings as confirmation of their own views of continued economic expansion, and they might believe that more of the same equity market returns will continue. The truth is that all investors should be aware of their own biases, and no investor should discount relevant economic and market data simply because it is inconvenient.

Conclusion

We think that a combination of factors -- especially low inflation, declining GDP growth, and persistent uncertainty about the direction of global trade -- is likely to (a) keep bond yields low in coming months and (b) prompt increased central bank activity to bolster or stimulate their economies. On the positive side, the U.S. consumer does remain strong and has been providing an anchor for growth.

Moreover, the recent resumption of *quid pro quo* escalations in trade restrictions is a negative development that threatens to delay any resolution to the disagreements that exist between the U.S. and China. The path to an accord will likely not be smooth or predictable. Heightened tensions and intensified retaliations will likely stoke market volatility, as well as investor and business jitters.

Central banks are keenly aware of all of these factors. In our view, then, policy shifts by the Federal Reserve and other global central banks toward more accommodation will continue to be a key investment theme for the remainder of 2019. Temporarily this could be positive for both stock and bond investors: for bond investors, it may mean increased demand for high-quality bonds and lower yields; for stock investors, it may mean support for economic growth and the corporate earnings that stem from it.

Currently, the U.S. Treasury yield curve is inverted, and yet domestic economic growth currently seems ongoing, inflation remains low, employment remains high, and the Fed has indicated a willingness to support additional economic expansion. The U.S. economy is likely to continue to grow this year but at a slower pace than it did in the first quarter and perhaps somewhat slower than the 2.1% annualized rate of the second quarter. Corporate earnings growth is positive but lower than a year ago, and investors may take note. Abroad, economic growth in key economies such as Europe and China also seems to be decelerating.

We see reasons why stock and bond markets may continue to respond in the near term to this mixed picture in similarly positive ways, as they have year-to-date through July. At some point, however, we do believe that the different futures that stock and bond markets anticipate will result in a divergence in market returns. We may not be at that point yet, but we are closer than we were a month ago. Bond investors have pushed down yields on secure, government debt in anticipation of a less rosy future, yet stock investors have pushed equity prices in the U.S. to new all-time highs in expectation of a rosier future. The fact that both cannot be right in the same sense indefinitely is itself a signal to use some caution and additional prudence when making asset allocation decisions.

The uncertain horizon makes now a difficult time to invest because, depending on the time frame, there is a wide range of potential outcomes. Sometimes the best move for an investor to make is to acknowledge the difficulties that characterize the moment. We believe that well-diversified portfolios like those we have constructed can withstand not only moments like this one, but also durably help to advance clients toward their longer-term goals. And we are privileged to navigate the current path with you.

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