Sigma Investment Counselors

Sigma Summaries

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What Has Changed? What Has Not?

Shock, anger, fear, depression, anguish, despair, and rage are just a few of the emotions many of us have felt over the last few weeks. It is with heavy hearts that we attempt to carry on our normal activities, and it is with certainty that we know the definition of normal has forever changed. In the face of such horrific tragedy, it seems almost callous to discuss the investment implications of the events that have transpired. However, life must continue. If we become paralyzed with fear, the terrorists win. We cannot imagine that those who have lost their lives or their loved ones would want this. Instead, we must move forward as a country and as individuals. Our lives can be a tribute to the terrorists' victims if we embody the ideals and values of our country: freedom, opportunity, respect for diversity, and unity.

In this spirit, we now begin to assess the ramifications of the events of the last few weeks. In our opinion, the terrorist attack of September 11, 2001 will go down in history as a watershed event and the end of an era of security and calm for the U.S. The disintegration of the Soviet Union was the turning event that brought us the peace that we have enjoyed for more than a decade. In this regard, our fortunes have reversed. It will take time to effectively address these new external dangers. In the interim, nearly everything is different now in some way, even if the foundation of our country remains intact. The challenges, behaviors and alliances of the governments of all the free nations will change. Consumption patterns will differ from the past. Some businesses will prosper, while others may suffer permanent impairment, and all will prepare differently for the future.

Prior to the terrorist attacks, there was evidence that the economic slowdown was worsening. Many sectors were dealing with traditional problems of cyclical troughs – excess inventories, too much capacity, and weak demand. Unemployment was starting to rise and there was concern that consumer confidence, which had thus far allowed the economy to avoid a full-fledged recession, was beginning to dwindle. Further, the weak economic outlook was spreading to other nations.

This cycle's downturn, and its magnitude, caught investors by surprise for various reasons. Near perfect market conditions over most of the '90s had lulled investors into believing that the stock market could rise indefinitely. Stock prices had grown at an unprecedented 20% annual rate during the last five years of this period. Inflation was contained and employment statistics were healthy. The cold war was over and peace became the norm. The risk premium of stocks fell to almost zero versus bonds meaning that the markets were pricing stocks as if they were as safe as bonds. The extended period of extremely favorable market conditions obscured the fact that we were not only in the upside of a normal business cycle, but a couple of major sectors (particularly telecommunications) were in a period of excess demand and over-expansion. When demand slowed, like an extended rubber band, the turn down in those sectors and their ripple effect on the rest of the economy and markets were swift and painful. The cumulative effect of all this was to put US markets at, or near, new recent lows. The effect overseas was also being felt, with Japan's Nikkei at a 17-year low and European markets dropping in tandem with the US.

What Has Changed?

We believe the terrorist attacks will result in many changes. On a near term basis, the attacks have accelerated the deterioration in the economy and corporate profits as a result of the immediate business interruption. They may also lead to a more protracted downturn if consumer confidence, which plunged right after the attacks, does not rebound. Lower oil prices and huge home equity refinancing at attractive interest rate levels may restore some lost consumer confidence, but higher unemployment levels will clearly be an offsetting factor.

On a longer-term basis we must assess the implications of the U.S. and, indeed, all of free civilization being at war. Wartime economies are different from peacetime economies. The President, as we have already witnessed, is likely to enjoy the kind of bi-partisan support that is common in times of national crisis. This may allow for the pushing through of a pro-business political agenda even in matters unrelated to the crisis. Fiscal spending is likely to be aggressive, serving to grease the wheels of a sustained economic recovery, perhaps sometime next year. Further monetary stimulus, beyond the Fed's announced rate cut before the market reopened after the terrorist attacks, should also revive economic growth. This longer-term prognosis assumes no future terrorist attacks. Additional disastrous attacks would, no doubt, severely undermine consumer confidence.

It is expected that the public sector's role in the economy will increase after falling from over 20% of gross domestic product (GDP) in 1990 to 17% in 2000. It is safe to assume that government spending on defense will be adjusted to a higher level for the foreseeable future. It had fallen to 3% of GDP from 5% over the last decade.

It is likely that we will battle Afghanistan. It is possible we will also attack Iraq. These kinds of confrontations will require spending on tanks, planes, and missiles. However, the war itself will be against an organization that does not belong to a nation-state. To fight this war, we must also increase spending on intelligence.

The real effect of this spending will be determined by how it is financed. Most likely, the surplus we were counting on will disappear. Social Security will be harder to fund, so it is possible the retirement age may increase or the benefits decrease. Another possibility is that some government spending may be cut to finance the increase in military spending. It is possible that the arsenal needed for this type of war will cost less than more conventional wars. Still, history suggests that more spending (and/or more tax breaks) is more probable than fiscal restraint.

As the pendulum swings back to the public sector, there will be economic consequences. On the margin, investment in security will take place at the expense of productivity enhancing investments. This ultimately will result in a reduction of long-term economic growth. In fact, the emphasis on security of all kinds (of people, property, and information) and the costs associated with lost time and other dislocations also will result in reduced productivity and slower economic growth.

This has implications for the equity markets. The valuations placed on securities are a function of the level of inflation (lower inflation leads to higher valuations), the rate of growth of corporate earnings, and the risk premium over bonds. Valuations have been at the high end of their historical norm for the last few years. Slower growth would imply lower valuations. So would higher inflation if it results from the increased monetary and fiscal stimulus. More risk-averse investors in the future also would imply lower valuations.

We believe that economic growth is likely to be much slower than the torrid pace of the late 90s, once it rebounds from its current deterioration. Longer- term, the innovation that evolves from our current malaise due to the resiliency and ingenuity of the American people may amaze us. Fortunately, our monetary leaders are cognizant of the inflationary implications of a guns and butter economy and most likely would act to prevent inflation from reaccelerating. Whether investors become more risk-averse for a sustained period is very difficult to determine. Most likely, this will be a function of how confident investors are that safety has been restored and terrorism is being defeated. It is important to emphasize, however, that even in a period of uncertainty, there will be many specific investment opportunities. Reassessing the landscape for those companies that can perform well in the changed environment should be the key focus of investors. That's what we are committed to doing at Sigma.

What Has Not Changed?

We will resume our day-to-day lives. We will continue to send our children to school. We will continue to buy the basics such as food and fuel, but we will also buy computers and wireless phones, go to football games and go on vacations.

More importantly, America continues to be the strongest nation in the world. Our leadership position in many industries including ethical drugs, medical equipment, technology, defense, among many others, has not changed. The freedom and entrepreneurship to create innovative new companies remains solidly intact. We have courageous and patriotic citizens that respond selflessly, heroically, and tirelessly in time of need. And we have an indomitable spirit that will help us heal, allow us to stand up to the enemy and assure that our way of life endures.

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