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SIGMA INVESTMENT COUNSELORS

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Is This Time Different?

Given the equity market moves since the lows of last October, most major US equity market indices are now at or approaching price levels not seen in quite some time. This might cause one to ponder, is this time really any different? From an economic perspective the answer is a resounding yes! At Sigma's recent investment strategy meeting, attended by all Sigma investment professionals, we discussed the differences between the foundations for equity market valuations of 2008 versus the underpinnings of today's equity market valuations. We then focused on the opportunities those differences create for investor portfolios over the next several years.

One very significant difference between today versus 2008, is the debt levels that were in play throughout the financial system and the overall economy back then. Growth in complex financial products was flourishing. Most new products were based off of poorly structured mortgage backed securities overlaid with layers of financial strategies (often termed synthetic products since they were made up of derivatives and had no "tangible" assets) designed to hedge against the mortgage bond investments. These products created a smorgasbord of opportunities for institutional investors seeking ways to enhance portfolio returns to meet their long term obligations. In short, in 2008 the institutional investor base was primed and ready to invest in these products.

These convoluted financial products provided the pools of dollars that funded unworthy borrowers with mortgages and credit cards. Easy access to credit cards and mortgages allowed consumers to spend way above their means. Businesses had no way of knowing they were selling to people who didn't really have the ability to pay. With this false sense of demand for their products and services, businesses hired more people and invested capital in their businesses. A vicious circle was created as consumers continued to run up credit card bills on each new credit card offer that was presented to them. The result was businesses continued to take comfort in a false sense of demand. Though unsustainable, this activity was reflected in the economic data being reported at the time.

A similar scenario was taking place in the housing markets. Easy access to mortgage credit allowed for home purchases by borrowers that could not pay. However, the housing prices continued to rise and new homes continued to be built due to what appeared to be strong demand. In short, there was an artificial foundation on which the economy was operating. The level of demand created was unsustainable. As we all know, the house of cards fell in late 2008. Economic activity came to a screeching halt. By late 2008/early 2009, economic activity was operating at the lowest level that 300 million people could possibly generate.

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Today the world is much different. In 2008, there was too much money chasing too few credit-worthy borrowers. Today it is the opposite. Investors remain cautious and cash levels remain high despite the fact that return on cash is nil. Interest in investing in exotic financial products is not there. Credit is no longer free flowing or readily available. On the contrary, often businesses with long track records are having trouble getting banks to renew their credit lines and if the credit lines are renewed it is often for lower amounts than before. Certainly consumer lending has changed dramatically. It is much more difficult to qualify for a mortgage in today's environment. And credit card lending is defined by a much more stringent set of parameters.

It is impossible to have a sustained recovery if the banking system is not stable. Banks that survived the crisis continue to rebuild their balance sheets and regulations have increased the minimum equity capital banks must maintain. This means banks are increasing the amount of equity capital (net worth) on their balance sheets. The combination of sustainable economic activity and a stronger banking system provide necessary underpinnings for the economic growth to remain positive.

While quite painful, the dramatic fall in economic activity back in 2008 allowed the economy to rebuild itself from a solid sustainable base. Business spending today is based on demand with a solid foundation. Companies that survived are in much better financial shape and have been able to take market share as weak competitors went out of business or declared bankruptcy. Economic data over the past several months shows evidence of a continuing, albeit slow growth recovery. All of this has provided markets comfort that the economy is operating from a sustainable level and earnings of public companies are not artificially inflated.

These reasons provide some of the important answers as to why this time is different. The economy and the markets are in a much different place versus 2008. While we may see an economic pull back sometime in the next 12-15 months, it should be mild as the slow steady growth has not created the excesses that would cause a dramatic decline in the markets.

So how does this affect client portfolios? In this slow growth economic environment, revenue growth becomes a scarce resource. Our individual security selection continues to focus on companies that demonstrate both improving returns on capital invested as well as solid revenue and earnings growth. In addition, we continue to focus on situations where we perceive the mispricing of an asset class, allowing us to be opportunistic through the purchase of an ETF that represents that specific asset class. While we remain optimistic about the US economy, the markets seem to reflect much of the good news. We have begun to trim equity positions given the strong run the markets have had over the past six months.

We also note that fixed income markets are much different from 2008. At that time, even bond investors had a huge appetite for risk. Complex financial instruments became all the rage. There was little price (yield) differentiation between investment grade corporate bonds and junk bonds. Today we operate in a much more austere environment. Many bond investors remain scarred by their experiences in 2008/2009 and thus remain invested in US treasury securities. In our view, the strong demands for treasuries combined with the Federal Reserve's printing press have kept rates artificially low. Whenever we see what we perceive to be an artificial (unsustainable) structure in the markets we become concerned. Today the yield on a ten year treasury bond is approximately 2%. If inflation exceeds 2% over that time period (we think that is a likely scenario given the Federal Reserve printing press) then the real return on bonds will be negative. Translation: A ten year treasury bond bought today will not grow enough over the coming ten year period to allow you to buy the same basket of goods and services that you can buy with that money today. Your purchasing power is reduced. That reduction runs contrary to the purpose of investing. In short, at today's prices we think the bond market presents risk to long term purchasing power. The treasury market and long term bonds in particular are overpriced. To that end, we continue to keep bond allocations at the low end of client asset allocation ranges and reinvest bond proceeds in shorter term, non-US treasury fixed income securities. This will serve portfolios well by muting the effect of a rising rate/inflation environment as well as the negative impact that a rise in rates will have on longer term bond returns. While we are encouraged by the economic environment in the United States, we expect Europe will continue to be a drag on economic activity for the foreseeable future. Greek debt concerns appear to be addressed (for the time being). Unfortunately, it means that Europe and the markets will now likely have to move on to the next country of concern. At our strategy meeting we could not agree on what the path for a European recovery may look like. However, we had a general consensus that the responsibilities and authority of the fiscal and monetary bodies in Europe will look much different in five years time. There is a good probability that the membership of the Euro currency countries will be different as well.

With regard to Asia and emerging markets; Asian economies and China in particular may be slowing. However, the growth is still large in absolute terms. This will continue to provide opportunities for Asian equities as well as corporations that sell into the Asian markets. Emerging market countries are typically not burdened with government debt and have attractive growth profiles as they continue to develop their middle class. Given the drubbing emerging markets took last year (down 18+ %), we find the valuations attractive.

At our strategy session we also discussed the issues that we expect to most likely affect the economy and market movements in the coming months. The "usual" suspects remain at the top of our list. With regard to the economy, higher gasoline prices are the most imminent threat to derailing our economic progress. The reasons for sustained higher gasoline prices would likely be a disruption to oil supplies in the Middle East. Needless to say, an outbreak of war between Israel and Iran would, at least initially, wreak havoc on the markets, oil and otherwise.

Uncertainty created by the November election will also impact investor sentiment and the markets. Short of an obvious and clear winner early in the season (not likely), the ebb and flow of the campaign season will heighten market volatility. The intensity of the impact will increase as we approach Election Day. Also of importance is tax policy. As it stands now, there are significant tax cuts that will expire on January 1, 2013, the same time taxes are increased to pay for ObamaCare. As we move closer to the end of the year, this will have a significant impact on investor behavior if it appears that nothing will change this course of action.

Sadly this list would not be complete without the mention of the threat of a terror attack, be it a bomb, cyber hack or something we cannot yet imagine. It is not wise to invest based on those concerns. Rather we continue to work with clients to make sure that their cash positions and asset allocations are positioned properly to see them through an unforeseen circumstance.

Overall we came away from our strategy day with a positive perspective of the investment horizon. It will not be smooth sailing. It never is. However, operating on what we believe to be a solid economic foundation provides us with an optimistic outlook as we work with clients and make investments on their behalf. To us, the glass remains half full.

As always, we welcome your questions and invite you to contact us to discuss these issues further should you wish to discuss your portfolio in this environment or have other additional questions.

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