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summaries

SIGMA INVESTMENT COUNSELORS

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Market Update

At the time of this writing domestic equity markets are trading near five-year highs and bond yields are at, or near, all-time lows. This seems quizzical given the state of uncertainty in which we seem to find ourselves. For example, the European debt crisis and the viability of various banks and governments in the EU (to say nothing of the Euro currency itself) seem to move between crisis mode and Band-Aid mode. China, a significant driver of global growth, appears to be experiencing a dramatic slowdown in economic growth. In the Middle East, various conflicts continue. Within countries such as Syria, the "Arab Spring" has morphed into civil war and is resulting in daily violence and tragic loss of life. And all across North Africa and the Middle East, the US is being vilified.

There is global concern as Iranian's "uranium enrichment" program continues with the widespread belief that it is not for nuclear power but rather for a nuclear bomb. Middle Eastern countries worry about how the balance of power in the "neighborhood" will change were Iran to have a nuclear arsenal. Israel, which has always articulated grave concerns about Iran's program, has recently heightened its conversations and concerns since the further Iran's progress continues to be unchecked, stopping its program becomes increasingly difficult.

And then we have our own domestic issues led by reported unemployment in the US remaining stubbornly above 8% (and, in reality, it is much higher if one takes in to consideration those individuals that have stopped looking for jobs all together). Prices at the pump are on the rise and food costs are increasing as the drought takes its toll on crops this season. US government debt, growing at an out of control pace, has already been downgraded by Standard & Poor's and now the rating is also under review at Moody's. Deteriorating employment has led to QE 3, or "quantitative easing" - which really means flushing new dollars into the system in an attempt to get the economy moving. In this latest round, the Fed has proposed to buy mortgage-backed securities from the banks. The new, open-ended plan is to buy (spend) $40 billion per month (1/2 trillion per year) in perpetuity, for as long as is necessary to bring down unemployment. The fiscal cliff is fast approaching and, oh yes - very partisan election rhetoric fills the airways with each party's list of the dark days our

nation will suffer should the opposing side win the election.

So what gives? Why in a world of such high stakes uncertainties are markets seemingly ignoring the economic landscape set before them? Despite all the above listed concerns the US equity markets are trading near multi-year highs and interest rates, which should reflect risk, remain near all-time lows. At Sigma, we spend a great deal of time examining such issues since the way we think about the world impacts the decisions made in portfolios.

One answer may be that the issues listed above have been pretty well "baked in" to the markets and that there is not all that much "new news" that would change investor sentiment or put additional pressures on the equity markets. In effect, people, including people that run companies, both large and small, are waiting for the election results to determine their next move. For companies, the cost of delaying an action, such as hiring a new employee or investing in new equipment, today is outweighed by the potential costs associated with having made the wrong bet on the election outcome and having to undo that move a few months later. Taking action now is not worth the potential risk.

In the meantime, while some companies may be experiencing slowdowns, the overall tenor of the corporate environment is still quite solid. Corporate America continues to demonstrate its ability to operate profitably with solid returns on investment. In addition, unlike the mid-80's and early 90's, when corporations were struggling with overleveraged balance sheets, most large corporations have low debt levels and are flush with cash. In short, Corporate America is offering quality investments, good value, and opportunity for growth at what are overall reasonable prices.

The ideas behind the QE 3 monetary stimulus strategy are primarily two-fold. First, by selling the Fed their less attractive assets (mortgage-backed securities) that have been difficult to sell in the open markets, banks will receive cash which they can then lend out, in particular for real estate loans. This will create demand for homes and get the housing market moving, which is what many believe is the fuel that will finally get the economy moving again. Given the low-rate environment we have been in for some time, it is hard to believe that there are many credit-worthy borrowers left that need a loan. That said, recent data suggests the housing market may actually have bottomed in most markets and has turned the corner to more stable/rising prices. Therefore, the timing of this latest round of stimulus may prove to be a particularly effective tool. As housing prices rise those who have unable to move since their houses were "under water" (home is worth less than their

mortgage) may begin to emerge to suck up this new liquidity.

A second theme behind this easing is that the time frame is open-ended. The Fed will do whatever it takes for as long as it takes to create jobs. This clearly pushes out the time horizon for the current low-rate environment. At the beginning of the year, reading the tea leaves from the Fed, most experts expected a low interest rate environment through 2013. Now, barring an unexpected quick and dramatic pick-up in job growth, the Fed has signaled it will maintain the program into 2015 and possibly 2016 (or as long as needed). In plain English what this means for bond investors is that they will have to contend with very low yields for a very long time. Come hell or high water "Big Ben" (the Fed's Chairman Ben Bernanke) is going to force people into riskier assets. The concept here is that in such an extended low-rate environment investors will eventually have to turn to riskier assets to get the investment returns necessary to achieve their long-term goals. As people invest in these assets the prices will go up, people will feel better about their situation, become more confident and will spend more, creating more economic activity, which will ultimately create more jobs.

In addition to the equity markets, this move by the Fed makes commodities more appealing for similar reasons. And at some point, all of this quantitative easing will create inflation to which commodities and real estate provide a hedge. Many of the emerging market economies are heavily tied to the price of commodities. Hence, they also become more attractive investments.

At Sigma, we have been favorably inclined to the equity markets for quite some time. As we have written on several occasions, we expect investors will continue to seek out better returns than the fixed income markets offer. Over the next several years we believe there will be a significant shift of funds from cash and fixed income into the equity markets. This latest move by the Fed reinforces our conviction in this thesis.

The asset that will experience downward pressure due to the quantitative easing is the dollar. The more dollars being printed, the less valuable they become. However, other countries trying to stimulate their economies through exports may in turn be inclined to devalue their currencies so that on a relative basis their products remain competitively priced. Such activities could therefore moderately offset this latest devaluation by the Fed. That being said, we anticipate the equity markets to remain volatile. In the current environment we view cash as the "least bad" asset to hold as a defense to the volatility.

As a final note, we expect the elections to create an additional layer of volatility in the equity markets over

the next few weeks. We are in no better position than anyone else to predict the outcome of what appears, at this point, to be a very close race. My wise colleague and friend, Bob Bilkie, recently quoted one of his former colleagues about leadership: "We elect leaders who have a vision and they surround themselves with people who believe in that vision and work to implement it." Given the divergence of visions between Obama and Romney we believe the markets are focused on the ramifications of each of these leaders' visions. Hopefully the electorate is equally as focused as they prepare to go to the polls to vote.

As always we look forward to your comments and feedback.

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