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summaries

SIGMA INVESTMENT COUNSELORS

the official newsletter of sigma investment counselors December 2014

Quarterly Market Outlook

At a recent meeting the head of my daughter's school talked about the challenges of educating girls in a VUCA world. VUCA, I learned, is a military term used to define the world in which the military operates. It is an acronym for Volatility, Uncertainty, Complexity and Ambiguity. While the intensity could not begin to compare to that of a military battle field, VUCA is an apropos way to describe the tumultuous financial market environment in which we steward our clients' assets on a daily basis. The vast amount of information provided and the rapid pace at which events and circumstances change in today's world only serve to amplify the "VUCAness" of the financial market environment.

The year 2014 has not lacked for events that one could reasonably expect to create a market environment that is full of VUCA. However, despite episodes that in the past would have wreaked havoc in financial markets, this year's markets (at least in the US) were relatively tame. Examples of the events investors have dealt with include: Russia/ Putin's aggressive behavior in the Ukraine and disturbing rhetoric about its future plans; the emergence of ISIS and its desire to create a nation state in the Middle East; the end of the Federal Reserve's Quantitative Easing (QE) program; massive decline in oil prices; slowing growth in China; and, mid term elections (just to name a few). Yet we have not seen a correction of 10% or more in the S&P 500 Stock Index (the most widely used definition of a correction is a decline of 10% or more and, for a bear market, 20%.) While mid- October gave us a scare, through the end of November US large cap stocks continued to lead the way, up 13.9%. This compares with US Midcap and US Small Cap, up 8.8% and 2.8% respectively. Internationally, Developed Markets were down 4.9% while Emerging markets were up 2.3%. The overall strong S&P 500 performance is due to a few factors. First, our economy, while not robust, is growing at a low single digit rate. It doesn't feel all that great but we are on the right track. In addition in times of uncertainty capital flies to safe havens. Right now, despite its problems and issues, the United States remains the world's safe haven.

That said, the equity markets in December are off to a rocky start. At the time of this writing, turmoil in the oil markets has created the worst weekly performance for the S&P 500 (-3.50%) since 2011. While it is anyone's guess as to the price of oil going forward, it is clear that the industry will be experiencing an environment of VUCA in 2015. The energy stocks at this point reflect much of that difficulty. In addition, as we approach year end, the combination of tax loss selling combined with "window dressing" by fund managers may be providing a little extra selling pressure on energy stocks. For those who are unfamiliar with the term "window dressing", fund mangers must report their holdings at year end. Many managers sell the worst performers so that they do not have to display them in year end portfolios. We find this a silly practice. The stocks do not show up in the portfolio at year end. However, the performance during the time the stocks were held will still be reflected in the fund's overall performance numbers.

Our outlook for interest rates remains tempered. Rates remain range bound. The recent decline in oil prices has reduced inflation expectations, a key factor in determining interest rates. Trying to accurately predict interest rates is a fool's game. Our best judgment is that rates may creep up slightly over the next year but will remain at relatively low levels. With the recent drop in the price of oil, it is likely rates will begin the year at what might ultimately prove to be the lowest levels of the year. Given that no one has the ability to consistently predict interest rates our approach to credit markets is the best defense is a good offence. This means while we make relative valuation judgments within the various fixed income sectors, overall our fixed income portfolios are well diversified across both maturity ranges and credit quality. The one area we have chosen to avoid is the long end of the curve (10+ years) where we have minimal exposure. That said, long term bonds - both government and corporate - have been among the best performing asset classes in 2014. Through November long term government bonds were up 21.2% and long term corporate bonds gained 15.1%. Our perspective remains that outsized returns do not come without outsized risks. In this case, the credit risk may be acceptable but the interest rate risk is great. We continue to believe the upside opportunity given up by not holding long dated bonds is more than offset by the downside risk created by the possibility ofa rise in rates. We do not view the risk/return tradeoff as appropriate for fixed income portfolios where clients seek stability, preservation of principal and certainty of cash flows.

In November, I attended a conference where several Midwest company managements from small and mid size public companies presented to institutional investors. Overall, the presentations were upbeat and encouraging. (Note: Early in my career I realized that if managements did not have a good story they will not bother with investor presentations at conferences.) The luncheon speaker was a Bloomberg economist. He opened his speech by asking how many attendees anticipated that the US economy would experience a recession (two consecutive quarters of negative GDP growth) in 2015. In spite of the fact we are in one of the longest economic expansions on record, in a room of 110+ institutional investors, NOT ONE hand went up. This made my heart sink. In my mind, the fact that no one was expecting a recession increased the odds of a recession at some point in 2015.

Our economic outlook for 2015 incorporates an economy that does continue to move forward. We do not anticipate a "shoot the lights out" economy. Rather, we believe the past four to five years have been spent building an economic foundation which is solid. Corporations continue to experience high returns on projects that generate strong cash flows. They are flush with cash but have held back on spending due to a combination of lessons learned in the great recession, an increasing regulatory burden and a more litigious operating environment. Yet over the past year we have seen some "loosening of the purse strings" with a marked increase in merger and acquisition activity. In addition, management teams recognize that they are not being paid to sit on cash that earns nothing. It does not endear them to shareholders and leaves them vulnerable to shareholder activist groups. We have seen companies begin to increase spending and reinvestment in their businesses. Job growth has been encouraging and in the latest employment report the average hourly wage which has not budged showed some very early signs of life. All of this, combined with continued strong consumer confidence numbers and the "pay raise" people are experiencing from the falling price of crude oil/gasoline, provides encouragement for consumer spending as we roll into 2015.

So what could knock economic growth off its current track? Just a few months ago the prevailing view was that many of the opportunities for job growth in the US existed in our growing domestic energy industry. As the price of oil has declined (down approximately 45% from its peak of $107/barrel in June) there has been much written about the lower prices at the gas pump providing opportunities for consumers' dollars to be spent elsewhere in the economy. What has not received much press is the offset. Energy companies are slashing spending as they shut down wells and cease new drilling opportunities. In a recent Barron's article, the Barclay's Bank head of U.S. Equity Strategy, Johnathan Glionna, commented that energy sector spending represents 30% of S&P 500 capital expenditures. He estimates the decline in oil prices could impact budgets by as much as $40 billion in the energy and materials industry. Even if those dollar estimates are a bit high, the impact can be dramatic as the ripple effects are felt elsewhere throughout the economy.

Other areas where the economy may be skating on thin ice include the housing market which remains tepid. Even the low rate environment has been unable to spur the first time home buyer into action. Government agencies Fannie Mae and Freddie Mac buy most of the mortgage loans from the initial lenders. In October, the agencies announced a loosening of credit standards for first time buyers, reducing down payments (with some stipulations) to 3%. We all know how badly that story ended just a few short years ago. Even major banks such as Bank of America have announced they are not going along with the program. Regardless, it is clear the new construction housing market remains anemic.

There are many other scenarios we could mention but we think the ones listed above are the most likely to disrupt the economy. (Of course often it is the unseen "Black Swan" that ruins the day.) One area where we hold hope for a possible upside surprise is foreign markets which have continued to underperform. At the conference mentioned earlier, management teams were positive on the outlook for their businesses in Europe and most for Asia as well. A bad turn for either of these regions would certainly be detrimental for the US economy.

Since we are closing in on year end, it is appropriate to provide a brief comment about our attention and management of taxable gains in portfolios. A recent article in Barron's highlighted how mutual fund investors with taxable accounts can be surprised by the level of realized capital gains and income taxes created in 2014. Fund managers compete solely on performance and hence have no concern for tax liabilities they may create for their taxable investor base. Managing taxes in a portfolio are a significant part of the services we provide our clients with taxable portfolios. We have ongoing discussions with clients to understand their tax situation and how realized gains and losses will affect their overall financial situation. In addition, we take advantage of down markets or temporary declines to harvest losses that can be used to offset future gains. These are some of the techniques we employ to effectively manage taxable portfolios to minimize taxes and actually enhance after-tax returns. This is a facet of management not available to investors involved in the active mutual fund arena.

As clients review their overall portfolio performance at year end, most will find equity portfolios have outperformed the broader MSCI global index but have lagged the S&P 500. Each market sector has its "day in the sun". Right now it is the US market, and large cap stocks in particular which continue to shine. We have yet to find the investor who has the prescient crystal ball enabling sufficient visibility to consistently time markets or predict which sectors of the markets will be the best and worst performers in any given year. The best long term strategy for client portfolios remains diversification between the different asset classes (equities, bonds, gold, real estate etc.) as well

as with in the various asset classes. In the equity market this means large, mid, and small cap as well as developed and emerging international exposure. For fixed income this means different maturities and credit quality ratings. We make judgments and overweight and underweight sectors accordingly. However, a consistently applied diversification strategy is what allows for long term investment success. Hence we will continue to maintain this approach (until we find the crystal ball).

Finally, as always when I write the December update, I am once again amazed how another year has gone by so quickly. This year is no different. A year ago key financial headlines included: How the implementation of the Affordable Care Act would happen; Whether and when the Federal Reserve would begin to taper; How all the new fields and discoveries in the energy industry would create American jobs; How long before Bitcoin would be used in everyday transactions; Whether the long term structural issues in the budget deficit and national debt would be addressed; Will Europe show signs of any growth or head into recession? Today some of the issues seem as if they are far back in our rear view mirror, while the latter two issues remind us that the more things change the more things stay the same.

As always, we thank you, our clients for the friendships and continued trust and confidence. It is truly our privilege to be your advisor. There is no better compliment from a client than when we have earned your confidence and you choose to share your experience with a friend or family.

On behalf of all of my colleagues at Sigma we wish you a very Happy Holiday Season and a wonderful, healthy and prosperous 2015.

Denise Farkas, CFA
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