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summaries

SIGMA INVESTMENT COUNSELORS

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Market Perspective

The economy showed signs of progress in the 2nd quarter after a slow start to the year. Economic activity improved, wage growth showed signs of life and the housing market demonstrated strong volume and rising prices. The strength of the U.S. dollar kept import prices low for U.S. consumers, but caused headwinds for domestic companies that sell goods abroad.

The employment picture continued to improve with the unemployment rate now standing at a 7 year low of 5.3%. This is good news! However, the percentage of the working age population that is either working or looking for work, also known as the labor force participation rate, stands at a 38 year low of 62.6%. All in, despite some negatives, the continued low-growth/low-inflation environment should provide support for U.S. equities.

The bull market is showing signs of slowing. This should be expected as the level of returns seen in the past several years cannot be sustained indefinitely. Annual U.S. equity market returns over the past 5 years have been in the high teens. The long-term average annualized returns for U.S. large cap stocks have been 9-10% while U.S. small cap returns have been slightly higher at 11-12%. A reversion to the long term averages should be expected. Thus, our expectation is U.S. equities will post annual returns in the mid to upper single digits over the next several years. Company managements that continue to grow their businesses profitably and demonstrate superior stewardship of the assets entrusted to them will likely also experience superior returns.

After several years of strong performance the bond market "took it on the chin" as signals from the Federal Reserve indicated the much anticipated interest rate hike may be close at hand. Bonds remain an integral part of many client portfolios. That being said, bonds remain expensive. At the end of 2014, the 10-year Treasury yielded 2.17%. After briefly trading as low as 1.67% in February of this year, the 10-year Treasury ended the second quarter at 2.35%. In a more normalized environment, it would not be surprising to find the 10-year Treasury trading closer to 4.0%, or higher. An increase in the yield curve by this magnitude would materially reduce bond prices. Yet, it is unlikely that the Treasury yield curve will move dramatically higher when government bonds of other major countries are stubbornly low. For example, the comparable 10-year government bond yield for Germany and Japan as of June 30th stood at 0.76% and 0.46% respectively.

Since late last year we have believed there would be no rate increases before September. Even that date might prove to be too early given all of the debt crises and central bank activities around the world. However, we do not think the Fed has the luxury of waiting too much longer. Investors are increasingly looking to a rate increase as a test of whether our economy and equity markets can still function well and grow without depending on stimulus from the Fed. Thus the Federal Reserve is in a quandary. One the one hand, they are anxious to return interest rates to more normalized levels. Yet, there are downside risks to our economy and abroad if our rates rise too quickly while other developed countries' rates remain low. What we do know is that the current yield curve is artificially low and is likely to trend higher in an erratic fashion over the next several years. As a result, the bond market is likely to post erratic performance and will likely underperform its longer term averages. This is why we have embraced a strategy of favoring short to intermediate-term fixed bonds, seeking to minimize portfolio volatility during this period of transition and uncertainty.

Both developed and emerging international markets dramatically underperformed U.S. markets over the past 5 years. After struggling for years, many of the international economies appear to be in better shape and market valuations appear attractive. While down for the quarter, year-to date-returns for international markets remain ahead of the S&P 500. We continue to view equites as the asset of choice with international equites providing a more compelling valuation than any time in the past few years.

From a macro perspective, both developed and emerging economies continue to find their way out of a prolonged economic downturn. Going forward an ankle weight on global economic growth contributing to investor uncertainty is the abundance of sovereign debt. Greece, Puerto Rico, Argentina and China are all current examples. With regard to Greece the real issue is not Greece itself but rather what lessons the other debtor nations (i.e. Spain and Italy) and creditor nations (specifically Germany) will learn from this experience and how it will affect their respective behaviors going forward. It is unclear how Greece or any other of these situations will ultimately play out. Regardless, in each instance it is in everyone's best interest to seek pragmatic solutions which will likely involve restructuring and concessions on the outstanding debt as well as mechanisms to tap the capital markets in order to maintain sufficient liquidity for the public. These issues are not isolated instances. Government debt, be it sovereign nations or local governments, has created the underpinnings for a drag on global economic growth that will take several years to fully run its course. That said, while some investors may wish to stay completely on the sideline until these issues are fully resolved, the opportunity loss by not having a presence in international equities is great. At current valuation levels the upside opportunities reflect the current level of uncertainty.

As always, all comments and questions are welcome.

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Please remember to contact Sigma Investment Counselors if there are any changes in your financial situation or investment objectives

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