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summaries

SIGMA INVESTMENT COUNSELORS

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Market Outlook

By any reasonable measure, investors in the US equity markets should be quite pleased with year-to-date returns and even more pleased about performance over the past 12 months. Year-to-date through May 31st the S&P 500 is up 15.4%. The S&P 400 MidCap and S&P SmallCap 600 indices are up slightly stronger. Similarly, over the past 12-month period the S&P 500 is up 27.3%; with the mid and small cap indices both up approximately 30.0%. This data compares quite favorably to the long-term (1926-2012) S&P 500 average annualized return of 9.8%. In short, those who had the discipline to remain invested in equities benefitted greatly, experiencing the equivalent of three years worth of stock market returns in just twelve months. Wow! So, where does this leave us? Activity thus far in June would perhaps indicate a "summer swoon" is upon us. Should one follow the old adage "Sell in May and go away"? We think not.

Looking deeper into historical returns, the recent strong equity performance has led us just above levels that we have visited twice before. After hitting a high of 1669 on May 21st, the S&P 500 index has pulled back slightly. The last time the index traded near these levels was October 2007 when it peaked at 1565 and before that it hit 1527 back in March of 2000. Both of these peaks proved to be ominous times for the economy and the markets.

Going forward the question becomes why should this time be different? Is the environment now constructive enough to sustain and propel the domestic markets to higher levels? After all, the US economy and the equity market have been supported by a very accommodative Federal Reserve Policy, but now the Fed may begin to "taper" or unwind their asset purchase programs, better known as quantitative easing (QE). Such a tapering means there will be one less bond buyer in the market place (a BIG buyer), demand will be less, bond prices will fall, and hence interest rates will begin to rise. This perception of the US economy possibly being weaned away from the Federal Reserve safety net has created concern in the equity markets. Particularly hard hit have been higher yielding stocks, which have been viewed as an income alternative to bonds. In addition, the US continues to struggle to reduce the unemployment level or the national debt in any meaningful way. We also are steaming towards the implementation of the Affordable Care Act (Obamacare), yet the apparatus for implementation of this massive program is not nearly ready. Given the immense impact the Act will have on everyone in America, the uncertainty is unsettling to both individuals and the markets. On top of these issues, world events are dicey. Ongoing troubles and social unrest continue in Europe. Japan is implementing a massive financial restructuring that will affect our economy and markets. And the Chinese appear to have several structural issues to deal with in an economy where growth is slowing. And those are just some of the recent headlines.

Despite the issues, our outlook remains positive; we continue to see the glass as half full. The US government balance sheet remains challenged. However, the economy continues to grow. Corporate balance sheets, which make up the investment pool for equity markets, are in much stronger shape relative to the last two market peaks. And, consumer balance sheets while still "wobbly" continue to improve, albeit slowly. In addition, the economy continues to plod along and is making forward progress on problems that surfaced in 2008. One of the most notable is the housing market, which was seemingly an endless abyss by early 2009 but has picked up significantly over the last year. While not completely out of the woods, the tone of the housing industry is clearly one of solid improvement. Overall domestic growth remains positive, pretty consistently in a range around 2%. While not robust, 2% economic growth produces a lot of opportunities for investment.

Absent tax reform, our expectation is that the drag from a fiscally weak government (at the national level as well as many state and local levels) will challenge the ability of the US economy to grow beyond the 1 ½ -2 ½ % level for any sustained period of time. At these levels of growth, unemployment will remain stubbornly high. In short, while the road will remain bumpy we will continue to stay on a path of improvement. The problem is in a slow-growth environment the ride never feels "comfortable". The data is never convincing enough to provide investors solid conviction. Yet, we expect positive data points will continue to outweigh the negative. As investors take the time to look in the rearview mirror they will see progress has been made. One only needs to look back to late 2008 or early 2009 to determine if they feel better about their own prospects and those of the overall economy. We expect the current US economic environment will continue to support higher equity prices. Any improvement in Europe or parts of Asia will be gravy.

As a final comment about prospects for the equity markets, the long-term annualized return for the S&P 500 is 9.8%. By comparison, for the trailing thirteen-year period ending 5/31/13 (start date is approximately the time of the March 2000 market peak) is a paltry 3.01%. The five- and ten-year returns through 5/31/13 are better at 5.4% and 7.6% respectively but still far from the historical average of 9.8%. While we do not believe an investment strategy should on based soley upon a reversion to historical averages, the data suggests that despite recent strength, further market upside is not an outlandish expectation.

In our view, fixed income markets continue to be a less compelling investment. Bonds are a necessary part of a diversified investment portfolio. Given our concerns about rising interest rates, our bond portfolios remain heavily weighted to short and intermediate duration (maturity) investments. As rates rise prices on bonds already issued will decline. The good news is that in a rising-rate environment, as bonds mature the funds will be reinvested at higher rates. Here, again, a historic perspective can be instructive. In 1981-'82 rates on the 30-year US Treasury Bond peaked at nearly 16%! In the thirty-two years since 1981, rates have been declining, creating a bull market in bonds that provided investors an annualized return of 8.68% versus a long-term (1926-2012) annual return of 5.1%. Such outsized returns are nothing short of eye-popping given the conservative risk profile of US government bonds. This thirty-two year anomaly created a risk reward tradeoff which is out of sync with longer-term reality, providing bond investors a false sense of security. With the 30-year Treasury Bond yield recently bottoming at 2.46% and now hovering a bit higher at roughly 3%, the bull market ride is over. Investors, like all human beings, rely most heavily on their most recent experiences to predict the future. Understandably so, given the recent history in bonds versus stocks there are many investors who continue to prefer the bond market. As stated above, bonds are a necessary investment for most individuals. They provide certainty and stability to the overall portfolio. However, going forward, bond investors expecting a bond market with the low risk and high returns provided by the past thirty-two years will be sorely disappointed.

As always we look forward to your comments and questions. Enjoy the warmth and sunshine of summer!

Denise M. Farkas, CFA

As a reminder, 2013 is Sigma's 40th Anniversary year. In honor of this, each month our employees are sharing personal "Sigma Stories" with you. We hope you enjoy!

My First Day on the Job

As I recently thought through all of my memories of Sigma in an effort to come up with one worth sharing for the firm's 40th anniversary, I decided to write about the first day that I showed up at the office for work.

I was a 19 year old freshman engineering student and Bob Bilkie needed some temporary help. This was shortly after all of the old paper reports and client documents that were previously stored at the office had been scanned one by one and archived electronically. I was lucky enough to have not gotten that job, as Bob's daughters had spent the entire previous summer, 40 hours every week, in the copy room with endless stacks of paper. Because Sigma no longer needed to store paper records and because the lease was coming up for renewal, Bob was able to reduce the overall size of the office by about 500 square feet and reduce the rent as a result. These were all good things, except for the fact that several offices and work stations needed to be moved, along with a lot of furniture that was being stored or replaced. Apparently I was just the guy for the job.

In need of funds and knowing that lunch would be provided as well, I gladly accepted the job and decided to drag my brother along for an extra set of hands.

Perhaps the best perk of the job was the dandy of a 1980, no air conditioning, 50 mph top speed U-Haul that we got to cruise around in for the day. For those of you who know Bob, you can imagine how excited he was to drive the truck, sing to the radio and honk the horn, which sounded almost exactly like the Road Runner's "meep meep".

After 12 hours of tearing down, moving and reassembling furniture in addition to 4 trips with a full U-Haul to the storage unit, I was spent. Even though Bob was willing to pay us what seemed like a windfall for a couple of college kids, that day of hard labor convinced me that for my own sake, any future work that I was going to do for Sigma would probably have to be with my brain.

I went on to finish my engineering degree, but was lucky enough before my senior year to be offered an internship at Sigma to see what the business was truly about. One summer with everyone at the firm and seeing Bob's leadership was enough to convince me that this would probably be a pretty good place to start a career.

Today, more than nine years after that first unofficial day of work and six years into my full-time job with Sigma, I'm truly thankful for the opportunities that the company and more importantly Bob and Shari Bilkie have provided me with. While my tenure has been short compared to the average of my Sigma co-workers at more than 15 years, I'm proud to be part of such a dedicated team of individuals that have been serving clients for 40 years.

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