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summaries

SIGMA INVESTMENT COUNSELORS

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Market Update

In a country of more than three hundred million people and a world of more than seven billion inhabitants, there will always be uncertainties, turmoil and shocks which affect markets. Some of these disturbances are purely economic in nature, while other disturbances may destroy life, and in some cases, even the fabric of cultures centuries old. Such tragedies are indeed heart breaking and seemingly incomprehensible for those not living in those geographical regions. As stewards of our clients' financial assets, we must take into account how economic, political and social forces across the globe, can impact the investment landscape and capital markets. Below are some key issues we believe are influencing today's global asset prices.

Interest Rates and Fixed Income:

U.S. investors appear fixated on when the Federal Reserve will increase the federal funds rate. For some time now, this rate has been set at 0.25%, with a target range of 0.00% – 0.25%. Symbolically, we would view an increase in the fed funds rate as a positive, as it would show a vote in confidence in the U.S. economy and a return to a normal monetary-policy environment. It is also our opinion that increases will be small and staggered over an extended time-period. As a result, we believe this period, and the resources used, are over-spent trying to second-guess the Fed and attempting to micro-manage the process. If the equity markets reacted decisively, negative on the news that rates were going higher, we would view this as a buying opportunity.

We believe that one's fixed-income portion of his and/or her portfolio serves as a source of liquidity, provides certainty of cash flows and is a way to offset volatility from the equity portion of the account. We also know that interest rates are near historic lows and will be migrating higher over time. Thus, we reiterate our posture – on average, our bond accounts should maintain short or intermediate-term durations.

However, one exception to this rule includes the use of Treasury Inflation Protected Securities (TIPs). Relative to other bonds, TIPs appear to be pricing a future inflation rate of 1.6%. This is low by historical standards, and is less than our longer-term forecast. If inflation rises above this 1.6%, we believe TIPs may act as a hedge in a fixed-income portfolio, capable of posting positive returns, while traditional bonds may suffer.

We have concluded municipal bonds may offer some compelling values. While there are many municipalities and state bonds remaining in poor financial condition, many other municipalities are showing improvement. As a result, we do find some compelling valuations in the municipal-bond market, on a selective basis.

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The Dollar and Developed International (Non North American) Markets

Last year, the S&P 500 Index experienced double-digit gains of 13.7%, while Developed International (Non-North American) Markets, MSCI EAFE Index lost 4.2%, a huge disparity. To date, we are seeing some signs of a possible reversal in this trend. As of March 16th, 2015, the S&P 500 Index has climbed 1.5%. Yet, even after the weakening of foreign currencies, relative to the dollar, the Developed Market MSCI EAFE Index has ascended 3.8%. Strength in foreign markets is due to a combination of oversold markets, which had compelling valuations as the year began, combined with investor sentiment that some of these economies have bottomed.

So why the strong dollar? In many developing and emerging markets overseas, interest rates on 10-year government-bonds are lower than what we find in the U.S. For example, the 10-year U.S. Treasury Bond yield is currently 2.1%, versus 0.3% on the 10-year German Bond, and 0.4% for the Japanese 10-year government bond. European and Japanese rates are so low because their economies are weak. They require the same type of monetary policy assistance/stimulation that the Fed provided to the U.S. economy, from the depths of the crisis, until just a few months ago. In other words, as low as U.S. Government Bonds' yields are, they remain attractive, relative to other sovereign debt. Combined with a strengthening U.S. economy, this has strengthened the dollar relative to most currencies. Also worth noting, even with our escalating debt and lack of a balanced budget, the U.S. currency and government bonds remain the safe-haven for the world in times of crisis.

There are pluses and minuses of a strong dollar depending on your perspective. A strong dollar is positive for American companies manufacturing in the U.S. and buying raw materials overseas. Similarly, if a company is an importer of finished goods, the cost of the goods has continued to decline, as it takes fewer dollars to buy the same amount of foreign goods, versus one year ago. It is also beneficial for consumers wanting to buy foreign goods -- think foreign cars manufactured overseas and Italian leather purses and shoes. If a trip to a country using the Euro is on your "bucket list", now would be a good time to seriously consider the opportunity. Clearly, these benefit the American consumer.

However, as foreign products become less expensive, U.S. products become more expensive and therefore less competitive against foreign imports -- domestic wines versus imported wines. Overseas, the effect is more pronounced, as U.S.-made products will require the consumer to pay more Euros, or Japanese Yen, for the same product, versus one year ago. In addition, for U.S. companies, which manufacture in the U.S., but sell products overseas, the profits on the same amount of the product sold overseas in March of 2014, will likely translate into less profits in U.S. dollars this March.

Make no mistake about it -- we think operating from a position of strength is always a benefit, and a strong currency is important. However, in an environment where other currencies are being artificially depressed, while the U.S. is no longer playing that game, can be tenuous. Continued dollar strength may result in the Fed holding off on rate increases longer than would otherwise be the case.

Emerging Markets

Exposure to emerging markets is important in a diversified portfolio. In aggregate, the valuations are compelling. In the past, population growth and economic shift in the populations of these markets often trumped the underlying economic drivers ~ oil, technology, infrastructure etc. However, as time has passed, there is significant deviation between the emerging economies and developed economies. They can no longer be viewed as a homogeneous group of fast-growing economies driven by demographics. The overlays of their lack of the same level of information flow and less liquidity versus developed markets make these markets less efficient. Active management better addresses the changing dynamics and we have repositioned portfolios accordingly.

Alternatives/Hedge Funds

Alternatives and hedge funds continue to be "all the rage". Recently, Bob Bilkie penned a blog providing much of our thoughts about alternatives. In a nutshell, we discourage the use of alternative investments and hedge funds, given high costs, lack of marketability, erratic track record and lack of transparency regarding their holdings and investment strategy. While often marketed as a method to reduce the risk in a portfolio, we believe they often do just the opposite.

Bob's blog, titled "Avoid Undue Complexity", posted on February 27, 2015, can be found on our website – www.sigmainvestments.com.

U.S. Economy

Overall, we are optimistic that the economy will continue to improve, but at a slow and sometimes erratic fashion. Moreover, there will be roadblocks along the way. For example, if interest rates rise too high and too fast, this may derail our economic expansion. Lower oil prices should benefit our economy but there are pockets which will also suffer as a result. Political gridlock and excessive regulation is also hurting our economy, with no end in sight.

Despite headwinds faced, U.S. companies worked hard to create solid balance sheets and are now flush with cash to spend. Consumers' balance sheets have improved as well. Lower interest rates have provided an opportunity for consumers to refinance mortgages at lower rates.

Oil prices, at least for the time being, have also put more money into the pockets of consumers. Even despite a lower labor participation rate, the employment rate has increased. Consumers represent 70% of the Gross Domestic Product (GDP), and continuing job growth, leading to more money in the consumers' pockets, should keep the U.S. economy in growth mode.

Summary

It is anyone's guess where the market or interest rates will be in a week, month, or year. No one knows. What we do know, is that our economy is showing a resiliency to overcome a myriad of obstacles and appears capable of grinding higher. We firmly expect interest rates to rise, but feel that it will be a slow and manageable increase. Equity valuations appear to be in the middle of the range, and therefore, capable of improving as the economy improves. Bonds may be under pressure as rates increase, so our advice is to keep maturities shorter-term, which is what we have done.

For long-term investors, our advice is to stay the course.

As always, all comments and questions are welcome.

Denise Farkas, CFA®
Chief Investment Officer

We are very pleased to announce that Christopher Frayne, CFA®, CFP®, has been made a partner and shareholder at Sigma Investment Counselors. Chris has served a variety of roles at Sigma during his nine year tenure at the firm. He has been instrumental in advancing the application of technology solutions for implementing investment decisions as well as for client reporting. In addition, he has proven adept at developing his own client base. We are very proud of him and all that he has accomplished.