Sigma Summaries

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The Five E's

In recent weeks, five variables have plagued the U.S. stock market. Discussed internally as the "Five E's", they include rising energy prices, the steady weakening of the euro, earnings warnings, slowing economic growth both here and abroad, and the upcoming national elections. These variables have served to reverse the stock market's upward trajectory in August and to wipe out the stock market's march toward recovery this summer. Indeed, as we begin the last quarter of the first year of the new millennium, the major stock market indices are now in the red for the year. The Nasdaq suffered a significant setback recently, falling 12.7% in September alone and is now down 9.7% year-to-date through the end of the quarter. In similar fashion, the S & P 500 has weakened recently, although less so, but also has ended the quarter with negative year-to-date returns of 2.2%.

The divergent directions of oil prices and the euro are not the kinds of trends that inspire rallies in the market. Stocks also have been battered in recent weeks amid broad concerns about how corporate profits will fare in the slowing U.S. economy. This has been compounded by the weak euro, which is expected to hurt results of U.S. companies who are heavily dependent on exports to Europe or have significant revenues in Europe. Multinationals with large European exposure and unhedged portfolios are particularly at risk. Indeed, the stocks of McDonald's, DuPont, and Gillette, among others, have been punished lately after each cautioned that slow overseas sales would reduce their earnings prospects.

The rising price of oil also has contributed to the market's jitters. Rising energy costs act as a tax on consumers and business. For consumers, this curbs demand of alternative products as energy related purchases require a greater percentage of personal disposable income. For business, revenues may slow because of weaker consumer demand. Moreover, unless companies are able to raise prices, margins are squeezed by higher energy related costs.

As far as corporate profits are concerned, the U.S. economy has become less sensitive to changing energy prices as a consequence of the shift toward the service sectors. In fact, energy costs are now a relatively small portion of total business costs. Certain sectors, of course, are less immune to higher energy prices than others. The transportation, consumer cyclical, and industrial sectors are impacted the most either by lower demand for their products or higher raw material costs.

There is no question that these very real shocks of rising oil and currency costs and slowing demand for some products and services are damaging profits for many companies. Keep in mind, however, that we are in the "confessional" season for corporate earnings reports. Companies who expect disappointing earnings generally preannounce such results before the end of the quarter. Once we get through this seasonally difficult period, a strong, albeit slowing economy, should lead to reasonably strong overall corporate profits. Consumer confidence remains high, productivity gains are still sizable, inflation is still tepid and interest rates could drift lower as job growth slows and business inventories continue to build.

We do expect, however, that the higher energy prices may be problematic for some time to come. The higher prices likely will put into motion forces that will bring about their own reversal. The rise

in oil prices will stimulate conservation, increased oil and gas exploration, and moves to alternative energy sources. However, given the low level of exploration over the last 15 years, the tightness of worldwide demand vs. supply, and the current shortage of refining capacity, it may take a number of years to reduce energy prices to significantly lower levels.

The euro crisis, however, may have a silver lining that could cause its reversal faster than energy prices. While European governments have made significant progress in loosening the rules that have held their economies back, the low euro may cause politicians to realize the need for faster change. European politicians need to finish their long promised reforms. Indications that this is happening could include currency intervention in unison by the European leaders, more tax cuts, deregulation of labor markets, and more efforts to introduce private pensions to reduce huge social security deficits.

Only time will tell whether rising oil prices, weak foreign currencies, and current earnings warnings may have derailed the bull market. We continue to focus our attention on the appropriate asset allocation for clients, given individual income and liquidity needs and tolerance for risk. In addition, risk is controlled by maintaining a highly diversified equity portfolio. Further, as we walk through the process of stock selection, we continue to focus our attention on those securities with the best sustainable long-term growth outlooks with attractive valuation characteristics. We also reduce or eliminate positions where fundamentals deteriorate or valuations become extreme. These tactics should protect our clients in the interim if the bull decides to take a breather from a 10-year up trend.

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