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summaries

SIGMA INVESTMENT COUNSELORS

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Quarterly Update

The last few months have provided investors with many issues to consider. At the forefront of those issues is the concept of the Federal Reserve "tapering". Tapering is the term that has been coined for an eventual reduction in Federal bond purchases and extraordinarily loose monetary policy. These bond purchases have commonly been referred to as quantitative easing, or QE. Tapering, in its simplest form, is simply the anticipated end of QE.

Our market commentary written in early June alluded to the idea of the fed tapering and what that might mean for interest rates and bond investors. The first real effects of a possible tapering came in June, as Fed Chairman Ben Bernanke indicated that the Fed may reduce the pace of bond purchases in late 2013 and halt them altogether by mid-2014. Prior comments by Mr. Bernanke indicated that Fed bond purchases would slow as the unemployment rate approached 6.5% and inflation remained below 2.5%. Therefore, Bernanke's comments in June citing a reduction in bond purchases according to a certain timeframe, as opposed to a fundamentally driven decision according to unemployment and inflation numbers, caught markets off guard.

Part of the theory behind the Federal Reserve's actions over the last four years is that easy monetary policy, broadly, and the purchase of bonds in the form of QE, specifically, puts downward pressure on interest rates. Lower interest rates have a way of forcing savers into higher-risk assets (equities, real estate etc.). In theory, the intent is to create a wealth effect from rising asset prices, which leaves consumers feeling more confident. That confidence leads to increased spending, which propels economic growth. Most importantly, this economic growth should ultimately lead to job growth.

To date, some of these theoretical assumptions have not played out according to the textbooks. The economic recovery, as measured by gross domestic product (GDP), has been weak, at best, despite the massive amounts of liquidity that the Fed has pumped into the markets. In fact, GDP growth has yet to stay above 3% for two consecutive quarters since the Fed began their bond buying efforts in late 2008.

The truth of the matter is that 2-3% GDP growth is not capable of producing the level of job growth that the United States needs to approach full employment levels. Therefore, despite the theory behind quantitative easing, the reality is that GDP numbers remain weak, job growth remains elusive, and unemployment remains stubbornly high. The most recently reported unemployment figure for August came in at 7.3%. While unemployment is down considerably from the 10% level in the depth of

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the recession, much of the drop has been driven by a decline in the labor force participation rate. This rate has declined to 63.2% from pre-recession levels of 66.5%, indicating that a large portion of the working-age population has simply given up on looking for work. Once someone stops looking for a job the government no longer considers them unemployed and this can skew the unemployment figures materially. In June I read a piece of commentary that outlined this concept well. It stated that if an additional three million people were to become discouraged and drop out of the labor force, we would hit the Fed's 6.5% target unemployment rate without creating a single new job. With the August employment data having been subsequently released, that number now stands at a mere two million people. No tricks here; just simple math.

While the Fed has yet to reduce their bond purchases, we believe that a significant shift in the bond market has already started to take place. The June tapering comments resulted in an eye-popping 100 basis point increase in the 10-year treasury yield, from roughly 1.6% to just over 2.6%. That is a 60% move in a matter of weeks! From June up until the time of this writing, the yield on the 10-year treasury has continued its upward climb to 2.9%, representing an 85% increase in just over 90 days. While many bond investors knew that rates were bound to increase, the speed and magnitude of these moves over such a short period of time has caught many people off guard. It is commonly understood that when interest rates rise, bond prices fall. However, a sharp 90 day move was drastic enough to rattle a lot of long-term bond investors. At Sigma, we think the days of declining interest rates and perpetually rising bond prices are over.

As we also have noted in past commentaries, the good news in a rising interest rate environment is the opportunity for reinvestment of cash at more attractive yields. We anticipate the rise in rates will continue, but likely at a more measured pace. As rates have risen, where appropriate, we have taken advantage of opportunities in client portfolios to reinvest proceeds from maturing bonds and the sale of short-term bond funds into intermediate-term bond positions with more attractive yields.

Of course, equity markets are affected by interest rate moves as well. If interest rates are higher due to an improved economy, then company earnings should grow and equity prices will reflect those higher earnings. However, the Fed's June tapering comments and subsequent jump in interest rates resulted in an intermittent equity market decline out of fear that the economy would be unable to stand on its own with the Fed's support.

There are several other issues percolating as US Budget concerns are beginning to come back into focus with upcoming debt-ceiling discussions. In addition, the question of who the next Federal Reserve Chair will be continues weigh on the minds of investors. All of this combined with the issues surrounding Syria and the Middle East and now the dance with Russian President Putin have created potential pressure points for equity markets. Issues regarding the European and emerging market economies, most notably China, have continued to weigh on international markets. It so follows that year-to-date returns for international equities have significantly underperformed their US counterparts.

Given all of these concerns, we think the primary focus for US equity markets going forward will be how the economy actually adapts to the Fed's tapering process. The Fed's quantitative easing programs have created artificially low rates, but more importantly they have provided a crutch for the economy. The specter of less support from the Fed means that we will begin to find out the true strength, or lack thereof, of the underlying US economy. We are cautiously optimistic that enough underlying momentum exists to sustain slow but steady economic growth. To that end, we remain positive on the US equity markets. With regard to individual equities we continue to look for companies with solid balance sheets, revenue growth in excess of GDP growth and management teams that have demonstrated an ability to be good stewards of company assets.

While we have not yet increased our international weightings, we are starting to see some encouraging signs in Europe. Emerging market indices are also starting to show signs of life after dramatically underperforming the US indices year-to-date. While we are encouraged by the progress that has been made, we are maintaining our bias for the domestic equity markets with a focus on diversification across both company size and market sectors.

Once again, we find it amazing how quickly the year is flying by. Our next market update will be during the holiday season. Until then enjoy the wonderful gifts of fall: the beauty of Mother Nature's fall color, baseball playoffs and college football!

As always, please do not hesitate to contact me or your portfolio manager directly with any questions or comments you may have.

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!

The Interrogation Room

In late November 2007, I received an email from Shari Bilkie inviting me to interview at Sigma. I had only been job searching for a few weeks and I didn't remember specifically applying to Sigma. I hadn't heard of the company so after a quick review of the website, I responded and was scheduled for an interview four days later. My first interview with Bob was rather typical and what you might expect from any first interview.

My second interview, well that's a different story.

Upon arriving, I was escorted into a conference room and simultaneously interviewed by six members of the management team (five in the room and one on the conference phone). As you can imagine, having six people fire questions at you for 30-45 minutes was quite an intense experience. I walked away from the interview without an impression as to how things went from the perspective of my interviewers. It was all a blur, I couldn't remember the questions or my answers, I just hoped that I had made a good impression.

By virtue of this story, I'm sure you guessed that I got the job ☺. Almost six years later, here I am. I can honestly say, there has not been a dull moment for me at Sigma since that first day I walked through those doors. It has been nice to be in a position that has allowed me to grow professionally and be challenged in so many ways. In the course of my day to day activities, my direct contact with clients is very limited. So one of the things I have enjoyed most during my time here is helping to plan the Ladies Luncheon and Client Appreciation Events. It's at these events that I've had the opportunity to meet and interact with many of our clients. It's always nice to put a name to a face and I look forward to seeing existing clients and meeting newer ones at the luncheons. Being a part of the Sigma organization has been an awesome experience and I'm truly happy to have been selected to be a member of such a great team.

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