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summaries

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Market Outlook

As investment advisors and portfolio managers, asset allocation and proper portfolio diversification always remain top of mind. Our client interactions and system designs are all focused on monitoring this as well. With equity markets continuing their upward march and bond yields remaining stubbornly low, we are finding that an increasing number of conversations and questions from clients are about asset allocation and portfolio positioning.

At Sigma we are fortunate to have our Investment Committee composed of ten well qualified very independent thinkers. Between the ten of us, we have an average tenure in the investment industry and employment at Sigma of 24 years and over 11 years respectively. The added value our experience brings to clients is embodied in the varied perspectives we have developed as practitioners. Each of us has a unique body of experiences which, collectively, results in discussions about asset allocations and diversification being approached from a variety of directions and diverse perspectives. How the asset allocation and portfolio positioning outlined in the Investment Policy Statement for each client gets implemented is a direct result of our Investment Committee dialogue and our outlook for each asset class. It is a dynamic and fluid process. Trades in a client portfolio are a synthesis of our investment committee perspective combined with the unique needs, circumstances, and asset allocation outlined in each client's Investment Policy Statement.

During a recent meeting of Sigma's Investment Committee, we began a discussion of asset allocation and diversification issues with the unanticipated behavior of the bond market this year and the continuance of sub 3% interest rates on the 10-year U.S. Treasury bond. Back in January, the 10-year treasury yield was at a multi-year high of 3.05%. At the time the "consensus" view from market commentators was that rates would continue to rise in 2014. We too expected rates would have an "upward bias". Driving this outlook was the Federal Reserve Bank's (the Fed's) tapering program announced late in 2013. This led us to continue to invest in shorter term bond maturities because the risk of holding longer dated bonds (7-10 years+) far outweighed the additional income and capital appreciation that would be gained if we were wrong.

Our predictions for interest rates have been less than accurate. Thus far in 2014, 3.05 % has been the high for the yield on the 10 year Treasury. Late in 2013, the Fed felt there had been enough artificial economic stimulation and announced it would begin tapering their bond buying program (known as QE or Quantitative Easing). Tapering is a reduction in how many bonds the Fed is buying in the open market. In this case they have gone from $85 Billion a month (that's billion with a "B"!) to $45 Billion per month, not an insignificant sum of money. As the Fed began to taper (wean the economy off an artificial stimulant) the expectation was the reduction in demand would

result in lower bond prices. Since bond prices and rates move in opposite directions, we expected a drop in demand would result in a drop in price and so yields would rise. Despite the reduction in demand for bonds, prices moved higher and rates moved lower. Rates bottomed at 2.3% on August 15th. Now, in early September (the time of this writing) the yield on the 10-year treasury sits at 2.6%. A range of 3% down to 2.3% may not seem like much. However, in this low interest rate environment, a 75 basis point change in rates means yields on the 10-year treasury dropped 25%! If rates were to rise from their August lows back up to 3%, that's a 33% increase in the yield! In other words, the moves have been fairly significant. The 10-year Treasury bond has not been able to sustain a yield above 2.8% for any period of time let alone breach the 3.05% yield. Our committee discussion focused on the reasons for divergence between expectations and the reality. Why/What gives? And, what should we expect looking forward?

As to "what gives?" hindsight, (as always), provides several explanations. First, offsetting the tapering activities was weak economic activity. During the first quarter, in part due to the unusually cold weather, the U.S. economy struggled to say the least. The result was negative GDP growth during the quarter of -2.9%. In addition, hiring was anemic and wage growth remained elusive. This does not create the economic backdrop for a rising rate environment. Hence, despite the Fed tapering during the first quarter, the economy was not generating the activities that would foster a rising rate environment.

As the year progressed, so did the economy. Economic activity has increased and the job market has improved. While still high by historical standards, the August unemployment rate of 6.1% is down from 6.6% in January, 7.2% a year ago and a cyclical peak of 10% in October of 2009. Often it is argued this number is not accurate because there are a significant number of people who have chosen to stop looking for work and so are no longer technically considered unemployed by the Bureau of Labor statistics. While that may be true, the trend is important when looking at economic activity.

Second, despite all its woes, the United States remains the world's safe haven. We need not remind readers of the details, but below is a partial list of issues facing the globe and global markets just in the past few months: The Russian incursion into the Ukraine and how that affects our NATO allies; the war in Israel and Gaza; questions about the longer term strategy in Japan and economic weakness in Europe and how much further the authorities in both regions might move to stimulate their economies by lowering rates; China's increasingly aggressive nature over territory in the China Seas; the continued lack of a cohesive structure in Afghanistan; whether Scotland will secede from Great Britain; and, of course, the now complex issues of the Islamic State of Iraq and the Levant (ISIL) and the long term uncertainty of how that affects the geopolitical global stage. Just hitting these highlights it is no wonder there would be a flight to safety. In a flight to safety, investors are most concerned about preservation of capital as opposed to returns on that capital. To date, US Treasury securities have provided what investors perceive to be the safest alternative to preserving capital, which creates increased demand and hence price increases/lower rates for U.S. Treasury bonds.

Third, there remains significant liquidity on the sidelines both in cash and short term bonds used as a "holding place" until a higher rate environment emerges. We believe these cash hordes represent significant pent up demand and will be moved quickly into bonds as rates approach 3% making the case for a significant rate increase beyond 3% difficult for some time.

Finally, we would note the municipal (muni) bond market has also been behaving a bit differently this summer. Given the bankruptcy of Detroit and concerns about Puerto Rico, Illinois, etc. one might expect muni demand to be weak. In fact, the opposite has been happening; demand for muni bonds has actually risen. We think the primary driver to the more expensive nature of muni bonds in general has been the increase in income tax rates. As tax rates increase, including the new Affordable Care Act tax, an increased appetite for municipal bonds is created. A small increase in one's tax rate can make a larger difference in one's appetite for muni bonds.

While we think all of these issues combined create a strong case for a continued low interest rate environment, some of the items that could derail this would include wage inflation, a more robust corporate lending environment, or higher inflation in general.
A continued moderate interest rate environment provides a solid underpinning for continued upward trend in the equity markets. With the low interest rate environment the equity market does not look over valued or "stretched". Certainly, there are pockets of over valuation such as small company stocks for example. However, the large company universe is made up of many corporations with healthy balance sheets, strong cash flows, and growing revenues. Earnings announcements for the second quarter were overall better than expected and in the past few months more analysts have been raising estimates than reducing them on large domestic companies. In short, the outlook for these companies continues to improve.

The one wild card we see between now and the end of the year for equity markets is the November election. An unexpected outcome could create an uncertainty for the markets that could make them stall or retreat. I do not wish to speculate on what that might be as the scenarios are endless. Suffice it to say that the fear mongering on both sides before Election Day could spook the markets as could a number of potential outcomes not in the "mainstream" today. We think any investor concerns will be short-lived but there could be increased nervousness by investors as we approach the November election.

Our note would not be complete without a comment on the recent "inversion" trend we have seen. In this case an inversion is when a US company buys a non-US company and then proceeds to move the corporate headquarters to the new company's location outside the US. The primary reasons companies are opting to relocate their headquarters outside the US are: 1) the US already has the highest corporate tax rate in the developed world. 2) Corporations which have made money abroad have kept it abroad so as not to pay the additional taxes that would be due were they to bring the money back to the US. Therefore, instead corporations are electing to expand their business abroad by purchasing a company with headquarters outside the US. Then, in some cases, they choose to move their headquarters to that foreign country in

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order to strategically reduce taxes over the long term. As fiduciaries to their shareholders, Boards of Directors have to look at ways to reduce all expenses, including taxes. This is human behavior; the majority of us do not like paying taxes. That said, as an American, this is frustrating and disappointing to watch. However, to me, inversion is little different from those corporations or individuals who are domiciled in one state and choose to leave that state for a state which has a lower tax rate or, no state tax. The inversion solution being discussed in Washington is to penalize companies for the inversion behavior. This approach is not a way to job creation and economic growth in the US. It is my hope (may be a dream) that the better solution: ***tax reform*** will somehow find its way into Congress's lexicon. In the end, it is tax reform that will have the intended effect. The elimination of tax loopholes and favors to special interests in the tax code while lowering the rate will have the intended effect of having American companies stay headquartered in America, higher collection of corporate taxes, and fueling economic and labor growth in the US instead of abroad. Anything else is just optics. ~Hope springs eternal.

All comments and questions are welcome.

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