Sigma Investment Counselors

Sigma Summaries

Vol. 30, No. 1 January 2003

Outlook for 2003

History has shown that the U.S. equity markets have never experienced four consecutive negative annual returns since the Great Depression. If history is any guide, this may suggest that we are near a bottom and brighter days are just around the corner. At Sigma, we believe that this is too simplistic and instead, we prefer to consider structural elements that may influence equity valuations. A brief analysis of some of these follows:

<u>Iraq</u>

There is a strong indication that we will be going to war as George W. Bush appears resolute in forcing a change of regime in this Arab state and Saddam Hussein appears unlikely to step down without a fight. Theoretically, the U.S. will not initiate an attack without some evidence that Iraq is not complying with the U.N. resolution requiring it to give up all weapons of mass destruction. If we engage in conflict, many military strategists believe that a war with Iraq would be "decisive, swift and victorious." But perhaps the greater issue is how successful the U.S. and its allies will be in instituting a new government that can bring about constructive change in this Arab state.

<u>North Korea</u>

A small but growing minority of strategists believe that the tensions growing in North Korea present an equal or greater threat than the current developments in Iraq. By way of review, North Korea revealed in October that it had a secret uranium-based nuclear weapons program, in violation of a 1994 accord. As punishment, the U.S. and its allies halted oil supplies promised in the agreement. North Korea then announced it would reactivate its older plutonium-based nuclear program, saying it needs to restart a reactor to generate electricity. The U.S. believes that the plutonium-based facility could also be used to build nuclear weapons and, in fact, there is growing concern that North Korea may already have two nuclear weapons and could build several more in a relatively short period of time. Negotiations are currently underway for a peaceful resolution.

<u>Energy</u>

Oil and natural gas prices have been particularly strong in recent months due to a reduction in supply, strong natural gas demand, and concern over further supply disruptions if we go to war in the Middle East. While we believe these issues are temporary, energy prices are likely to remain both above average and volatile in 2003.

<u>Interest Rates and Inflation</u>

Interest rates remain near 40 year lows, the result of a benign inflationary environment as well as a monetary policy that is orchestrating lower rates. We believe inflation is likely to remain subdued for the foreseeable future with the CPI fluctuating in the 1.0 to 2.0 percent range, excluding any impact from energy prices.

We also expect that the Federal Reserve will tighten its monetary stance once the economy shows a sustainable sign of improvement. As this occurs, interest rates are likely to move directionally higher over time. However, the move is unlikely to be sudden and the rate of increase will likely be moderate. This scenario would generally be considered a positive for the equity markets.

<u>Fiscal Policy</u>

As this letter is being drafted, President Bush is finalizing a new economic stimulus package that will rely heavily on tax cuts to revive the economy. This follows the forced resignation of former Treasury Secretary Paul O'Neill and Lawrence Lindsey, a long-time White House economic policy advisor. While it is premature to handicap the impact of this more aggressive stance on fiscal policy, it will likely jump-start an economy that has been sputtering for some time.

<u>Economy</u>

By and large, the consumer has kept the U.S. economy alive. Despite the fear imposed by the war on terrorism, a loss in market value from investments, waning consumer confidence and an unstable job market, the consumer continues to spend, particularly on housing and autos. Of course, low mortgage rates and zero-based car loans have helped. Nevertheless, the consumer has surprised many economists over the past year although there are signs that consumer spending is starting to level off. For the equity market to stage any level of a sustained recovery, the consumer must stay in the game.

We must also see some signs of life from the business sector; both from increased capital spending and inventory replenishment. The recent decline in the U.S. dollar may offer some relief as our goods and services become more affordable overseas. But for our economy to regain its lost momentum, businesses must step up their expenditure plans after almost a two-year hiatus.

2003 Outlook

Forecasts are seldom accurate. However, it is important to entertain some conviction on where we are headed in order to guide us in our decision making process. For better or worse, here is where we are placing our bets for the new year.

- The economy is likely to muddle through another year, with GDP growth slightly positive but not particularly strong.
- Energy prices are likely to remain above normal for the immediate future but will likely trend lower as supply/demand imbalances correct themselves.
- Interest rates are likely to trend modestly higher but at a slow and meandering pace. We see no signs of significant inflation, except for energy prices.
- We believe the consumer will stay in the game but may find it difficult to increase the level of spending from last year. On the positive side, lower taxation due to a change in fiscal policy and the hoped for increase in consumer confidence may positively impact consumer spending. On the other hand, higher oil prices and health care costs, combined with a slowdown in mortgage refinancing are but a few of the forces that may take their toll on consumers' pocketbooks.
- Highly promotional rates will be relied upon in much of the retail environment.
- Businesses will grudgingly start to loosen their purse strings given the need to upgrade their infrastructure and replenish inventories. While the real impact may not be felt until 2004, any expectation of increased spending will be welcomed news by Wall Street.
- Wall Street will also look at any increase in activity regarding share repurchase programs, mergers and acquisitions, and IPOs as an indication that the market may have regained its footing. To date, such activity has been fairly quiet although many industry observers are cautiously optimistic that such activity in 2003 will be substantially improved over last year.
- Of course, it is impossible to handicap a number of wildcards that may impact investor psychology and the broad equity markets. With heightened tension between Israel and the Palestinians, the threat of war with Iraq and pending showdown with North Korea, combined with the fear of terrorism on our soil, it is not too surprising that the market has reacted as it has. Any constructive steps toward peace will be construed as positive whereas further conflict may be assessed as negative. It is unclear to what extent these uncertainties have been discounted in the market although it is probably safe to say some are incorporated already.
- It would be foolhardy to predict whether the market will be up or down in 2003. What we can offer is our unwavering conviction in the long-term merits of investing in equities and our belief that there are tremendous values at current prices.
- We also recognize that equities typically represent only a portion of one's financial portfolio and it is of paramount importance to understand how much exposure one should have in stocks versus alternative investments such as liquid reserves, fixed income securities and real estate.

In these uncertain times, Sigma has worked diligently in constructing a model portfolio that, by and large, is concentrated in companies that are industry leaders, well managed, and possessing strong or improving balance sheets. We have also recently included a number of companies that pay a healthy dividend. In this manner, we hope to fully participate in a variety of different market environments regardless of what happens to the economy or in the geo-political arena.

Written by:
Christopher J. Kress, CFA