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summaries

SIGMA INVESTMENT COUNSELORS

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Mid-Year Market Review

As we approach mid-June, we reflect on the market activities of the second quarter. In doing so, we are again reminded how quickly both perceptions and realities change in the markets. March had been the worst month across all equity indices since the tumultuous markets of 1987. However, as we entered the second quarter, the equity markets began to rebound from their March lows on the back of the bail out of Bear Stearns. April was strong across the board with the majority of equity indices up 4-6%, followed by May, which was again quite strong with most indices up 2-5%.

The published accounts of the week leading up to the Federal Reserve/JP Morgan rescue of Bear Stearns highlight just how close the markets were to a potential "run on the banking system" the likes of which have never been seen. While reflection on that time period is an activity we prefer to do as infrequently as possible, the extreme actions by investors provide helpful insights into overall market behaviors. We will save much of that discussion for future Sigma Summaries. What is most striking however, is the manner in which the markets responded once there was a "floor" put on the value of asset backed credit securities and derivatives. Securities that had at one time been very liquid had become "priceless" in the days and weeks preceding the bail out. Unlike the MasterCard commercial, in this is situation "priceless" is an undesirable term: there was no price at which one could sell their securities. One of the keys to the Bear Stearns rescue was that the Federal Reserve, via JP Morgan, agreed to accept these complex securities with unknown underlying values and unknown counterparties, which provided a backstop for the credit markets. Once it was clear that the Fed had provided a floor, the credit markets began to unfreeze and the equity markets, as noted above, rallied strongly in both April and May.

Adding fuel to the equity markets were several factors as expectations were exceeded on many fronts, allowing the market bulls to take charge. First, it became clear that equity capital was available for major financial institutions. The capital came from sophisticated institutional investors who had an opportunity to interact directly with managements and in most cases review intimate details of the financial statements. Morgan Stanley estimates that thus far, financial institutions have raised $219 billion in total additional equity capital. As the financial sector began to show signs of healing, other sectors of the economy began to report earnings that held up well and in many cases exceeded expectations. Many management teams indicated that business outside the U.S. remained strong and that continued solid growth from international operations was expected. This offset, what was in many cases, nominal domestic growth. Government inflation data for May was the first month that began to reflect higher energy and food prices. However, overall inflation data seem tame, at least based upon government statistics. In addition, it is hoped that the stimulus checks will help to encourage the consumer and carry the economy until credit restraints are eased, allowing access to capital for consumers and businesses alike.

As we move into June, the equity markets have again become more tenuous with market perceptions swinging back towards the bear's case. Headline news of rising oil prices, commodity prices and food costs is in direct conflict with the government inflation numbers reported to date. This seems to be underscored by recent Federal Reserve Board Chair and Member comments as to concerns about inflation. At the time of this writing, the credit markets appear to be pricing in an expectation of interest rate hikes beginning this fall. While slower growth and a stronger dollar (a recent discussion point of both the US Treasury Secretary and the Bush administration) should in theory tame commodity prices, we have seen little indication of that to date. In addition, despite stimulus checks, continued increases in both oil and food have left consumers' discretionary spending squeezed. Consumers have little access to capital as lending conditions remain tight and housing prices remain depressed. For this reason, we expect the Fed, while speaking about inflation concerns, to remain accommodative longer than the markets are currently expecting in order to help maintain consumer spending. All of this leads to worries over reduced earnings visibility and more earnings risk as we head into the quarterly reporting season, which begins in earnest the second week of July. Our challenge is to discern as we go forward where the bull case will hold up and where the bear case is present.

We would be remiss if we did not mention in this missive our focus on the credit markets and fixed income investment philosophy over the past few months. Our focus has been on high quality securities within the fixed income markets. This served our clients very well during what has proven to be a chaotic time during which the credit markets experienced AAA rated asset backed securities "going down in flames" while several well-regarded, long established financial institutions saw their ratings downgraded and debt re-priced in the credit markets. We encourage clients to discuss their fixed income portfolios with their Portfolio Managers during portfolio reviews to better understand our approach and the process used in structuring fixed income portfolios over the long term.

One of the issues we have wrestled with is the municipal bond market. Over the years the number of actual defaults on general obligation bonds have been very few and far between. This is because a general obligation bond issued by a municipality draws on the very diversified revenue stream of all that town's residents and businesses. In addition many AAA rated municipal bonds have insurance backing the bonds. However, the insurance is only as good as the credit of the insurance company providing the guarantee. Over the past several months we have tightened our bond selection process for municipal bonds based on three themes we see unfolding. First, the credit quality of the insurers has come into question with the major insurers, MBIA and AMBAC, downgraded to AA from AAA by both Standard and Poor's (S&P) and Fitch. Moody's, the other major rating agency, has both insurers on credit watch (under review) with a negative outlook. Second, rating agencies themselves have lost credibility in the markets as it has become clear that the due diligence process was flawed. While this is more pertinent for the asset-backed sectors of the credit markets, we think this is an important consideration given the recent insurer downgrades. Finally, and perhaps most importantly, the foreclosure rates and declines in housing values span broadly across individual communities. Therefore, revenues based on those housing values are vulnerable to declines that have perhaps never been seen on such a broad scale before. In addition, as reported in the Wall Street Journal, many states are considering caps or a roll back of taxes on property values. These shrinking tax bases have the potential to play out in a negative fashion. Should this happen, we expect the rating agencies to be late to the party, as they have been on other recent issues of the day. This confluence of events makes us cautious on our municipal bond selection process at this point in time.

Concomitantly, we are now observing extensive discussion in Washington with regard to how best to restructure the regulatory environment as well as how the rating agencies should recalibrate their ratings models. The recent US Treasury Department proposal is the beginning of what we anticipate will be a long drawn out process to restructure the regulation of the financial system. We are hopeful that the benefits of a longer process will result in a full vetting of ideas, reforms and changes that will not be constructed to "fight the last war" but rather to provide investors with a more transparent, effective and efficient regulatory process, better suited for the age in which we operate. High stakes politics being what they are, we expect this to make "fodder" for the press along the way. We hope the legislators and regulators can see their way to focus productively on this issue.

We cannot end with out acknowledging the presidential election season at hand (which takes our minds off of ailing baseball teams this summer season). We anticipate markets will be more volatile this summer than otherwise might be the case, as investors react to the latest statements from either candidate on such topics as economic reform, taxes, health care spending, homeland security, the Iraq war and a whole host of other topics that may surface. In other words, investors and Tigers/Indians fans, might find themselves in a summer of discontent. In spite of that, the summer season in the Midwest is short but beautiful. With regard to both the weather and the markets, we must continue to take advantage of the opportunities as they are presented to us and hope all of our readers take the time to enjoy the long daylight of summer.

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Please remember to contact Sigma Investment Counselors if there are any changes in your financial situation or investment objectives.

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