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summaries

SIGMA INVESTMENT COUNSELORS

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The Winds of Change

At the time of this writing it is the second week of September and we are reflecting, as we do each year at this time, on how another summer has gone by so quickly! The summer brought with it winds of change for the markets, some for the better and some for which it is too early to judge. While we are sad to see the long summer days disappear we cannot say that we lament, from a market perspective, the summer quarter of 2008 nearing an end.

A review of the quarter to date includes many noteworthy events. Commodity prices continued upward into early July. Most notably, oil reached a new record level intraday high of over $147 per barrel versus prices in the mid-$70's one year ago. A fundamental case for higher prices due to demand growth in developing countries was often cited as the reason for skyrocketing prices. However, many felt that supply and demand imbalances were being exacerbated by a combination of actions promoted by speculators and oil companies. The swift and volatile price rise led to talk of government intervention as Congressional Investigative Hearings were opened on the reasons for the rapid increase and murmurings about windfall profit taxes began to appear. The dramatic price decline since mid-July dampened much of this activity near term. However, the volatility in price does lend credence to the "speculation" about speculators. We expect this to be a continued concern with Congress and the regulators.

The peak in oil prices were accompanied by the market lows observed thus far for this cycle. After reaching highs on July 11, oil prices began to decline and oil's grip on the markets began to loosen as equity markets rallied. Each month as part of our analytic process, we review the performance of several market based "themes" or sectors which can be inferred from subsets of the Standard & Poor's 500 Stock Index (S&P500). Interestingly, for the month of July, of thirty three "themes" reviewed, thirty out-performed the overall S&P 500 Stock Index. In other words, as energy prices declined, monies that would have flowed into the energy companies were redirected into other opportunities, and as a result, almost every other sector of the economy "won". We continue to be cautious about the long-term supply/demand outlook for oil. However, we believe that the price of oil had gotten ahead of itself and that the current, more moderate oil price environment will persist over the near term.

In an effort to stabilize the markets and increase liquidity, winds of government intervention by the Federal Reserve, Treasury Department and the Security and Exchange Commission (SEC) picked up force during the quarter. To provide needed liquidity, the Federal Reserve implemented a secured lending program to provide funds directly to investment banks. For this privilege investment banks will be under increased regulatory supervision. To help stabilize markets the SEC enacted an emergency temporary short selling rule requiring short sellers to specifically pre-borrow stocks of Fannie Mae and Freddie Mac as well as seventeen other financial firms. This activity helped curtail possible manipulation of stock prices (an illegal activity) and stabilized financial institutions. At the time of this writing, the Treasury Department just announced the conservatorship of Fannie Mae and Freddie Mac. While we had been hopeful that this step would not be needed it appears that investors remained unsatisfied with the implied government guarantee and the uncertainty which that created. In assessing the factors surrounding this move, it appears several of our foreign friends may have provided the final push to the Treasury. As large owners of our debt other sovereign nations indicated their unwillingness to continue purchasing the debt instruments of Freddie and Fannie without an explicit guarantee, and strongly encouraged U.S. government officials to intervene. The certainty of the intervention action has drawn favorable reviews from most market participants. It will be some time before we can truly access the impact of each of these government actions on the markets or on monetary or fiscal policy. In the near term, however, we can look for signposts of increased liquidity and lower volatility as indications of how these activities have impacted investor sentiment and the markets.

Fixed income markets remain stratified as the flight to quality remained, leaving treasury bonds at low yields while the spread between corporate and treasuries remains at the upper end of their normal ranges. In the municipal bond market, yields on maturities beyond ten years are above treasury yields, an anomaly. The combination of investors' flight to quality and tight municipal bond supply has lead to the current situation. Overlaid on this are credit concerns. While the rating agencies have developed new rating scales, the performance of the rating agencies through this credit crisis has left investors more skeptical about the creditability of ratings. These factors have all culminated in the wider yield curve spreads relative to the treasury market. In our bond portfolios we continue to focus on high quality credits and take advantage of opportunities as they arise along the yield curves.

A new "wind" this quarter is the strength of the US dollar. Despite the economic concerns investors have about the U.S. it now appears that the slowdown our economy has experienced is now spreading to other

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countries. As foreign economies begin to experience weakness there has been a significant decline in several foreign equity markets. EFA, the Exchange Trade Fund (ETF) proxy for the developed foreign markets of Europe, Australia and the Far East, as well as EEM, the ETF proxy for the emerging markets, have declined 13% and 19% respectively thus far in the quarter. Part of this decline is attributable to a strengthening dollar because on a relative basis, the U.S. economy appears to be in better shape (further through the downturn) than various other countries. For long-term investors, the value of the dollar should not impact the long-term commitment to international investing. That said, in the shorter term currency fluctuations can have a significant impact on the portfolio in any given time frame. In the current environment the upward bias of the U.S. dollar will continue to pressure returns on international investments.

Our client portfolios typically have a direct international investment in the range of 15-25% (versus the 57% that foreign stocks represent in the global marketplace according to the Dow Jones Wilshire Total Global Market Index). Our valuation models indicate that the weightings in international stocks should currently be at the high end of the range. However, offsetting this is our expectation of a continued upward bias for the dollar over the near term so we have positioned most portfolios towards the middle of the range, a more neutral position.

We note that this under-performance of international common stocks occurs as advisors in general continue to recommend to clients that they increase their exposure to foreign markets (although we are not yet in that camp). Unlike fifteen to twenty years ago when the U.S. markets made up 67% of the investable global public markets, the U.S. now makes up approximately 43% of the global market capitalization of publically traded common stock (again, according to the Dow Jones Wilshire Total Global Market Index). Years ago, U.S. investors acting in mass to invest in the markets abroad would be tantamount to an elephant stepping in a puddle. Most markets were small, illiquid, undeveloped and unregulated. Today, developed foreign markets are liquid and fluid with much more robust regulatory bodies. Emerging markets are less liquid and not as well developed but significantly larger than twenty years ago. Not investing a portion of the portfolio abroad ignores significant opportunities for investors. At Sigma, we continue to have an active debate as to the appropriate level of foreign investments for clients and the appropriate benchmark to be used for performance comparison purposes. We expect to address the issue of appropriate benchmarking in an upcoming issue.

As to the foreign exposure issue, the crux of our debate focuses on the question of what is the most appropriate approach to serve the best interest of our clients, primarily U.S. investors with future liabilities (such as mortgages, college tuition and future living expenses) that are also denominated in U.S. dollars. On the one hand, it is important to expose a portion of the portfolio permanently to international markets. Foreign markets provide diversification and overall offer higher growth opportunities than what exists domestically. On the other hand, if future liabilities and living expenses (also liabilities) are denominated in dollars, how much foreign currency risk should be introduced into the asset base (investment portfolios) that supports those liabilities? To support an increase in the weighting of foreign stocks one must believe the incremental opportunities for growth out-weigh the risk of additional currency exposure.

Changing gears, and looking nearer term, we expect the upcoming earnings season to provide helpful insights into 2009. The investment banks report earnings in late September. This information will provide a sense of how quickly or slowly the management teams at these enterprises see the credit crisis moving through the economy and how readily the markets are seeing improved liquidity. This will be further fleshed out when the banks and housing related companies report in October. Along the way, casualties at the corporate and individual level will continue and we do not take these problems lightly. We believe, however, that as we move forward investors will begin a period of "marking time" as opposed to engaging in the waves of panicked selling that has so characterized the markets over the past twelve months. This should allow some of the volatility we have experienced to dissipate. Finally we expect third quarter earnings reports of companies will give us a sense of the health of the consumer, health of foreign economies, and health of business spending going into 2009. Overall as we look forward we anticipate that oil prices will have stabilized and credit issues will continue to see resolution. As this happens, we expect the environment will be one in which credit becomes available again to creditworthy borrowers, enabling consumers to resume spending patterns, albeit from a new lower plateau, resulting in a more robust pattern of activity in the economy. With this, we would expect both equity and fixed income markets to behave in a more constructive manner.

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