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summaries

SIGMA INVESTMENT COUNSELORS

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A Healthy Dose of Caution

Oftentimes, investors will embrace a particular investment strategy because it is "working" or going up in value. For example, in years past, equity investors clamored to buy anything that was tied to the Internet. This caused valuations to skyrocket and, in retrospect, reach levels that could not be justified using traditional economic valuations. A more recent example of this "herd mentality" can be seen in the real estate market in downtown Miami. At one time, speculators could "flip" a condominium even before the unit was built and occupied and pocket a tidy profit. This instant wealth acted as a magnet, and developers from around the globe wanted a piece of the action. At the peak of the market, it was estimated that nearly 60,000 condos were under construction or in the planning stages of development, with many of these units being priced over $1 million. Now that the bubble has burst, many of these condos will never be built. There is a massive oversupply in the market that will take years to absorb. Units that were once priced at $1 million cannot even be sold despite significant discounting in price.

In today's equity market, we can't help but wonder if other "bubbles" are developing right before our eyes. For example, is $100 oil sustainable? Our gut instinct is that it is not. Our understanding is that the marginal cost to produce a barrel of oil, outside the Middle East, is perhaps $20, plus or minus. For more unconventional reserves, where the cost to produce a barrel of oil is much higher, such as the oil sands in Canada, our understanding is that one can turn a profit at $40 a barrel, plus or minus. As oil can be easily transported, conventional economic theory would suggest the price of oil should be influenced by the marginal cost of the last barrel brought into the system. In this simplistic scenario, that would be $40 a barrel. While we are not suggesting that oil will soon trade at $40 a barrel, we are suggesting at $100 per barrel there will be a lot of exploration by wildcatters and multinationals alike to find, produce and bring to market more crude. As the supply of crude increases, the price of oil should ease.

We are also intrigued by the dramatic rise in valuation for many of the stock markets within the emerging markets arena. Based on information provided by iShares, by way of review, China, South Korea and Brazil represent 43% of the country exposure of the MSCI Emerging Markets Index. Other countries with over a 5% weight include Taiwan, Russia, South Africa, India and Mexico.

Clearly, these are some of the hottest markets in which to invest, but we wonder if the appropriate amount of risk has been factored into their share prices? By limiting ourselves to just the top three countries represented in the MSCI Emerging Market Index, it is interesting to note that, according to iShares, the FTSE/Xinhua China 25 Index is up 39% for the third quarter of 2007 and has appreciated by 122% for the past year, using September 30th as a cutoff date. The MSCI Korea Index and the MSCI Brazil Index are up 14% and 21%, respectively, for the quarter and up 45% and 97%, respectively, for the year. This explains why the Emerging Markets Index is up 14% for the quarter and 58% for the past year.

With these extraordinary returns, it is quite clear why US investors can't get enough of these shares, particularly given all of the economic issues that we face at home. Sigma does not dispute the logic or importance of maintaining a healthy exposure of international exposure in a well-diversified portfolio, and, in fact, we widely own three separate international exchange traded funds (ETFs), including the Emerging Markets Fund for such exposure.

Perhaps where we differ from others is our concern that valuations are beginning to look frothy to us despite strong economic fundamentals. We want to remain mindful that there are significant geo-political risks associated in these funds, risks that may not be fully discounted in their current share prices. Our strategy is not to exit our investment in the emerging markets but to reduce our exposure on the margin for those clients who have a greater exposure than what we believe is warranted given their risk profile.

We are also mindful that a high percentage of companies that are represented in the S&P 500 have significant exposure to the overseas markets, including the emerging markets. As global economies become increasingly interdependent on one another, investors are finding that they have a growing and vested interest in the international arena by default.

We invite our clients to discuss with us our use of exchange traded index funds to provide discreet exposure to the overseas markets and why we prefer the use of these funds versus individual securities at this time.

Christopher J. Kress, CFA

The Economic and Market Environment

In Sum: Dollar weakness is now stealing the business headlines, relegating sub prime credit woes to a still significant, but secondary, issue for global investors. Economic growth the world over continued in the second and third quarters of 2007, but inflation concerns are increasing due to higher energy costs. The conduct of monetary policy has become increasingly complicated due to the aforementioned dollar weakness, inflation concerns, and troubles in certain key sectors of the US economy. The US federal deficit has ceased to be an issue, but tax and spend policies in the US will take on greater visibility as the presidential election campaign season heats up in 2008. The average global common stock index, such as the Standard & Poor's 500 or the Hang Seng Index (see related article by Chris Kress, CFA on China investing), has provided positive investment returns so far in 2007 although the gains have moderated of late. Bond markets are flashing conflicting signals about economic growth and inflation.

Geo-political: The value of the US dollar has been falling precipitously of late, accelerating in early November. While the sharp contractions in global financial markets during the summer were related primarily to sub prime credit woes, dollar weakness has been cited as the chief cause of the latest spate of volatility. A coordinated action by the major central bankers to manipulate currencies, a´ la the 1980's, has not been considered a remedy to date. However, other developed nations' treasury officials are beginning to voice their displeasure over the impact that a weakening dollar will have on their exports and, hence, their economic prospects. The credibility of the dollar as the global reserve currency is being threatened. The implications could prove challenging particularly if more global investors gravitate to the Euro as a reserve currency.

Economic: Economic growth in the US accelerated in the third quarter of 2007, but recent indicators point to a weakening in the current quarter. Manufacturing and construction appear to be the industries showing the most softness. On a bright note, US labor productivity surged in the third quarter of 2007, gaining 4.9% and the best showing in several quarters. This offers a ray of hope for containing domestic labor costs. Global growth continued unabated, based upon Bloomberg's Global Economic Matrix, which published gross domestic product data for the second and third quarters of 2007. Expansion ranged from 0.6% in the second quarter 2007 for Denmark to 11.5% in the third quarter 2007 in China. The faster growing economies are seeing higher rates of inflation on average, and this complicates central bankers' policy actions.

Monetary: As indicated in the preceding paragraph, monetary policy is now fraught with some degree of peril because of the prospective ills that could impact global economies. In the US, a severe contraction in residential home construction and plummeting home prices portends potentially serious deterioration in consumer sentiment and, likely, consumer spending. Consumer spending accounts for 67% of US Gross Domestic Product. More sustained and balanced growth abroad combined with rapidly accelerating energy prices hint at rising inflation. The cure for the former is an easing of interest rates. In contrast, for inflation containment, higher interest rates are in order. A lack of coordination by central bankers could have more serious consequences for the value of the dollar versus other major currencies. A declining dollar, all other things being equal, improves US economic growth prospects at the risk of greater price increases, but harms trading partners' economies. Deft and creative policy measures will be required to sustain non-inflationary global growth.

Fiscal Policy: As has been the case for most of this fiscal year in the US, the federal budget deficit has declined. A great majority of other industrialized nations are in a similar budgetary environment. US tax and spending policies will receive much greater attention in the coming months as the forthcoming presidential election will highlight candidates' spending priorities and plans.

Equity Markets: Global equity market volatility returned in November. Most benchmarks still show gains for the year, but these gains have been trimmed. With the dollar weakening, large US based multi-national companies should fare reasonably well with expected profit gains. Companies located outside of the US that cannot respond to the benefits created by a weaker dollar or that do not have an ability to leverage into rapidly growing economies may suffer. In a similar fashion, smaller US companies might struggle with the softening domestic economy.

Fixed Income Markets: The anomaly in the bond markets in the waning stages of 2007 has been a decline in interest rates on US Treasury securities across the maturity spectrum, notwithstanding concerns over inflation. Collectively, bond market participants appear to be "telegraphing" that risk is being reassessed. Put differently, there appears to be a renewed "flight to quality." Alternatively, they may be indicating that inflation concerns are overblown and economic growth may be the greater threat. This situation bears close scrutiny over the coming months.

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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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