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summaries

SIGMA INVESTMENT COUNSELORS

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Not much happened in the third quarter, right?

If one were to have viewed the equity market indices on June 30th and promptly left for a three month vacation, a first impression upon returning and checking those same market averages would be that not much had changed; it was probably a quiet, uneventful summer in the markets. As we are all well aware, nothing could be further from the truth. At times it seemed that every day a major event occurred, ultimately resulting in sustained levels of high volatility. Yet as we reflect on the past summer, we do so somewhat comfortably as portfolio values have increased and the equity markets, at the time of this writing, are trading at or near record levels.

We wrote in August about market conditions, and we see no reason to again relive the pain suffered in the sub- prime markets and the spread of credit concerns into the overall fixed income and equity markets. That said, some observations are worthy of mention. Earlier in the year we discussed our uneasiness about investor complacency over the risk profile of different investments. The significant shift in the yield curve during the third quarter indicates fixed income investors now recognize that all debt is not created equal.

A second observation is the inability of technical models to truly capture the activity that occurs in unexpected events. Typically, financial models are driven by assumptions over a range of probabilities. As occurred with the dislocations in the fixed income markets in the late 1990's that brought down the venerable hedge fund, Long-Term Capital, assumptions and relationships that work under normal conditions do not hold up in the low probability scenarios (abnormal conditions), particularly when the assets are leveraged. The lesson is that models are only as good as the judgments used to build them. Their predictions should be continually challenged and tested, not taken at face value.

Our third observation is that while world markets are developing rapidly, the impact of activities in the U.S. markets still has a dominant effect around the globe. In addition, while we are all aware of the globalization of markets, we remain struck by the broad ownership in portfolios around the world of investments and derivatives tied to sub-prime loans made in the U.S.

Our final observation is that even in a globalized market with more participants than ever, including more behemoths than ever, Central Banks still provide the backbone of support and have not been subverted by large market players. The Federal Reserve's behavior and ability to calm the markets remains important. Its entry into the markets with liquidity and a subsequent cut in interest rates provided the support to steady the markets and calm investor fears.

The equity markets continue to tell a story of the "haves versus the have-nots." In the third quarter the financial sector struggled as investors were unable to determine the underlying values of sub-prime loans and the derivative products associated with them. Consumer stocks also underperformed as the housing market, with its falling home prices and rising default rates, continued to fuel investor concerns about consumer spending. After a brief flight to quality in mid-summer, investors refocused on growth. Sigma portfolios benefited from positions in technology and over-weighted industrial sectors as continued business spending, exposure to international markets, and the falling dollar drove performance. Direct investments in international markets also recorded strong performance, particularly for U.S. investors who benefited from both the strong price movement as well as foreign currency appreciation.

While it is important to review where we have been, it is only so that we can apply our best judgment going forward. We continue to believe the markets' underpinnings will bode well for investors. The recent rate cuts by the Federal Reserve Board have alleviated some of the recession fears that were creeping into investor sentiment. As the dollar declines, commodities such as gold and oil continue to reach new highs. Higher energy costs, falling home prices and ongoing reports about consumer credit, default rates and the weak housing markets, will continue to weigh on consumer spending. The fallout in the housing market is not over and will keep the possibility of a recession an ongoing issue for investors. All that said, we remain in a relatively benign interest rate environment with long-term Treasury bond yields below 5%. We anticipate these aforementioned issues will concern the Federal Reserve Board members too and result in additional interest rate cuts. The effect will likely be a subtle. The yield curve should continue to steepen as short-term rates are reduced, but inflation fears continue to apply upward pressure on longer-term bonds.

In addition to continued strength in corporate capital spending, the somewhat surprising strength of both the job market and recent consumer spending have provided support for the equity markets. However, we believe the real power behind the move in the equity markets is the weaker dollar as investors anticipate better than expected earnings from companies with growing exports and overseas profits. A test of this thesis comes now as the third quarter earnings season begins.

In sum, the housing market troubles are likely to keep a lid on long-term interest rates. A low interest rate environment and healthy earnings reports driven by a weaker dollar will bode well for "the haves" sectors of the market such as commodities, multi-national companies, some financial sector companies, capital goods, and technology as well as international investments. While political issues, such as higher taxes (a topic for another day) could temper our optimism, we remain positive on both the economy and the equity markets for as far as the eye can see which is, for us, merely the balance of 2007 and into early 2008.

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