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summaries

SIGMA INVESTMENT COUNSELORS

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Market Outlook

We have just marked the 2nd anniversary of the bottom of the bear market in common stocks in 2009. The events of the last few years have provided each of us new and different perspectives on the world in which we live. While not a "brave new world"; significant changes have taken place both here and abroad leaving virtually no one on earth untouched by the changes. As investment advisers we continually monitor these changes to determine from an investment perspective, where new opportunities exist as well as where new land mines may lie.

As the smoke began to clear in the spring of 2009, we started the process of assessing the damage done to each of the sectors in the economy as well as individual companies within those sectors. At about the same time a combination of pent up demand and slightly increased job security by those who were employed led to a pickup in consumer purchases and the economy began to "limp" along to recovery. For the United States, the government stimulus plan and actions by the Federal Reserve helped to provide a foundation from which the economy could begin to build. Much has been made of these government actions and whether without them we would still be mired in a domestic, or possibly global, recession. While we can't truly know the answer to that theoretical question, those activities did provide the crutch needed to restart the economy and enabled the seeds to be planted for the current economic recovery. Albeit from a lower plateau, factory utilization levels have improved dramatically, GDP data continues to demonstrate growth, consumer demand remains strong and measurements of consumer confidence have returned to high levels. In addition, growth in developing markets has further increased demand for U.S. goods and services. At Sigma, we track other key metrics for U.S. companies including cash flow return on investment (CFROI), revised analyst earnings upgrades versus downgrades, and year over year revenue growth. All are up significantly from their recession lows. To the extent these trends remain intact we would expect continued economic expansion and growth both domestically as well as globally.

While the trends cited above are all quite positive, the economic ecosystem in which we live remains fragile. Several uncertainties and concerns remain creating significant risks to the recovery. One set of these uncertainties pertains to changes in government regulations. Leading up to the crisis there was a lack of attention to risk parameters combined with a lack of regulator or "adult supervision" in financial companies. This led to significant changes in regulations regarding market operations, banking industry regulations, and requirements on publically traded companies. Good legislative work has been done but there has been much bureaucracy created in the process. Some of the

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legislative actions appear to have their sites aimed at firing where the rabbit was as opposed to anticipating its next moves. Of concern is whether or not the new legislation and the bureaucracy created will serve to avert another economic disaster. Will the benefits justify the additional cost burden that will ultimately be paid by the consumer? Only time will tell.

Uncertainty about tax rates have been tabled for the time being allowing employers to make decisions regarding investment in their businesses. Removing this tax uncertainty (for now) is a benefit to employers as they look to make spending decisions both on employment and reinvestment in their businesses. While there has been some resolution on taxes, the outlook for healthcare costs remains cloudy. The cost of healthcare as a percentage of employee compensation and the rapid rate at which the premiums continue to rise is a continued drag on employers' willingness to hire new employees. With the courts now involved, the uncertainties surrounding healthcare remain a significant impediment to businesses' hiring decisions. This is disconcerting as the unemployment rate, while declining slightly, remains at levels which do not bode well for a transition from economic recovery to economic prosperity. A structural unemployment rate of 9-10% is not a sign of a healthy economy.

The municipal bond market had always proven to be a safe haven for investors. However, as the consumer retrenched, tax collections from local businesses declined. As housing prices declined, local tax collections were further reduced. Severe declines in revenues for cities and states have forced these entities to reassess their budgets and spending plans as well as the current and future benefits promised to employees. The fiscal health of many cities, counties, and state governments (to say nothing of the United States government) remains of concern. Elected officials at all levels of government are faced with very difficult choices. The idea of business as usual, (continuing programs without the funds to pay for them in the hopes that somehow they will get paid for down the road) is no longer an option. Government officials can no longer ignore the problems. The time has come to address the gaps between commitments made and the ability to pay them, be they healthcare packages, pension plans or entitlement programs. We have seen various reactions and solutions. In Illinois the decision was to raise the state tax rate. In Wisconsin, Ohio, and several other states, energized electorates on both sides of the debate argue over decisions about cutting public employee benefits and determining how those benefits are established in the future and whether collective bargaining will be part of that process.

This upheaval has led to warranted concerns in the municipal bond market as the ability to make interest payments and payoff principal at maturity is threatened by the significant reductions in revenues. In addition, the financial health for many communities has long been obfuscated by several items, not the least of which was the lack of a requirement until recently, to display future pension obligations on the balance sheet. As we have mentioned in the past, at Sigma we have been concerned about these issues long before they were fashionable. For the past three plus years we have focused our municipal bond purchases primarily on high quality, general obligation bonds. In addition, for local community bonds we have targeted those cities where we have some ability to monitor the activities more closely. The battles described above are taking place across the country; the financial issues are being addressed head on. While we would expect to see a rise in the municipal market default rate we do not anticipate the decimation of this market that some market analysts have called for.

The prospect of inflation is more relevant than a year or two ago. The growth in developing countries has increased demand on many raw materials resulting in a rise in many commodity prices. Weather related issues affecting crops in some high producing regions has led to increased crop prices. Commodities are priced in US dollars regardless of the exchange on which they are traded. A decline in the dollar has added further pricing pressures to commodities. Added to the pricing pressures is the reality that at some point the consequences of the policies of the Federal Reserve and its printing press will take its toll becoming a significant factor in the inflation equation.

For this reason we remain sanguine about the fixed income markets at this time. Since 1981 bond holders have experienced outsized returns as interest rates declined, pushing up bond prices. Bonds have an important role in asset allocations and portfolios. However, current yields are not compelling. As inflation rises, it will pressure bond prices. Bond prices will continue to decrease as interest rates rise. For those who hold their bonds until maturity this will be less of a factor.

Finally we would be remiss not to address the unrest now consuming the Arab countries of the Middle East and North Africa. Living in a democracy, one cannot help but cheer for the uprisings of people who have long been oppressed by their dictators. The true power of the internet has been displayed by the magnitude and speed at which these activities spread across the region. Concerns about the oil fields will add volatility to the markets for the near and perhaps intermediate term. As gas prices at the pump rise it will, at the margin, lower the consumer's ability to make other purchases. If sustained long enough, higher gas prices could take us back to the summer of '08 when smaller cars were more in demand than the big gas guzzlers. Our view on oil prices is not unique. We expect that as long as the Saudi Arabian oil fields are not threatened, oil prices will remain in the current trading range. If the situation changes, we would expect a significant rise in the price of oil. Suffice it to say, such a shock to the system would not bode well for equity markets. Such a shock would likely create a flight to quality, causing regret for those who have chosen to short the treasury market.

More important to us is the long term implications of the uprisings. The peoples of these countries have never really experienced a true democracy. Will there be a shift toward a government that will allow and help them to raise their standards of living or will new undesirable regimes simply replace the old? While either case brings uncertainty to a volatile region, we certainly hope for the former. However, the latter remains of concern.

For all the reasons listed above we recognize that our recovery remains fragile and that it would not take much to throw the financial ecosystem off balance. We

face economic issues both domestically and abroad. Yet, barring a shock to the system, we believe the trends underlying this recovery are strong and continue to gain momentum. While the equity markets have had a strong move it is not without underlying fundamental support. Our best assessment is that, while no market goes up in a straight line, the equity markets continue to offer many opportunities.

As always we look forward to the opportunity to discussing our market outlook with you as well as any other financial matters you may wish to discuss with us.

Denise Farkas, CFA
Chief Investment Officer

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Note: At the time of this writing, Japan has just experienced one of the worst natural disasters the world has ever seen, with devastation that is almost unfathomable to the human mind. There will be plenty of time to think about and discuss the financial and economic impact at a later date. However, for now, we keep the Japanese nation in our thoughts and pray that they do not experience additional devastation in the days to come.

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

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