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summaries

SIGMA INVESTMENT COUNSELORS

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Ceiling the Deal

Given the importance that one must attach to the present budget deficit/debt ceiling discussions going on in Washington DC, we felt it fitting to devote this missive to our thoughts on the implications of these deliberations for the financial markets and by extension, our investing clients (and deviate from our typical Market/Economic Outlook format).

Discussions in DC are ongoing and intensive. This creates a risk that the analysis can quickly become outdated, or may just prove wrong, based upon subsequent developments. Nonetheless, we feel that this is a useful exercise. It is important that our clients understand why we are positioning their portfolios as we are.

Although not always the case, government policy is probably the single most significant factor today impacting financial asset prices. The nature and size of government spending, the impact of taxation on various enterprises and investment instruments, and perhaps most importantly, the incentives (or lack thereof) that are created by policy actions will affect long term economic growth. In that regard, it is widely believed that most jobs (and wealth) created in the US come from small companies (often, but not always becoming larger enterprises) and start up companies. However, small and newer companies are typically least able to financially adapt to policy actions. (Note the hue and cry from members of the National Federation of Independent Business to the Affordable Care Act.) They are also least able to influence policy actions through lobbying as they simply lack the means. Larger companies can impact deliberations, but a favorable action for one entity could prove harmful to yet another. Needless to say, it is important that investors closely follow developments in the political arena.

As the rancor has ratcheted up in Washington DC, it appears to us that, broadly speaking, the discussions are coalescing around two related fault lines which ultimately rest upon the ideological proclivity of the majority of voters in the US. Principally, the argument is; how much government is desired as measured by the financial percentage involvement that the government sector represents compared to the overall economy (GDP), and how much are voters willing to pay for the size that they want? Deficits and debt have become problems because the elected class has expanded the government sector, but did not levy sufficient taxes to pay for it. Barring some agreement, the US Government will have more commitments than they have cash to pay come August 2, 2011 because the borrowing limit by the US Government will be reached on that date.

In several news conferences in mid-July, President Obama staked out one prevailing position. He believes that the American people want greater security from unforeseen and unexpected threats. While he recognizes the danger from unchecked and unfunded federal spending, he now believes that higher taxes, coupled with spending reductions, are necessary to fund the size of government being

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demanded. Eric Cantor, Republican from the House of Representatives, has articulated the countervailing position. The government is either unwilling or unable to control spending. Therefore, the proper course of action related to the budget deficit is to impose a discipline which requires elected officials to commit to spending within specific parameters. These parameters are defined as that percentage of GDP which has generally prevailed for the last 30 years or so. This results in a reduction in federal expenditures and no tax rate increases.

That brings us to the present, pondering the following questions: Without compromise, what are the choices and the most likely outcome? With compromise, what is the most likely settlement and what is the probability of said settlement? In short, what is most likely to happen?

First, if republicans and democrats are unable to come to agreement, on August 2 the US Treasury will have to make some difficult choices. There will be insufficient revenue to pay all of the bills and no tax revenue increase would have been legislated. The impact would be a cut in government expenditures. One choice would be for the government to reduce or eliminate the spending that causes the greatest harm to voters so as to extract sufficient pain and teach lessons for future votes. An example of this is the outcome, President Obama suggests, might occur wherein social security recipients are cut off. Of course, it is hard to decipher who or whom voters would most likely blame for this. As a result, that course of action seems politically risky and therefore unlikely. Instead, it would appear that if no agreement were reached, government recipients with little clout would suffer the most (public broadcasters?). In this type of outcome, the government would be forced to make fairly draconian cuts, but the priorities would be clearly established and as minimal amount of damage to any one group or individual as practical would result. The aggregate affect on the economy however, would be materially negative and dramatic, as a huge prop to the economy would suddenly be removed.

In terms of compromise, one might foresee either a long-term budget deficit/debt cure-all focused entirely on tax increases and no cuts in spending (unlikely, but this is the original budget framework that President Obama offered in February); another alternative is some revenue increases but greater expenditure cuts (possible, but not likely either since this was the scenario that attracted most participation in DC but to no avail); or no increased taxes, but enough spending cuts that in return, a modest bump up in the debt ceiling limit is approved enabling the government to finance its operations for another year or so. This last scenario, we believe, is the most likely outcome.

From an investment standpoint, a brief synopsis of the implications from the various scenarios is warranted:

- No agreement; draconian but targeted spending cuts. Bond and equity markets would sell off in the short term, potentially violently.

- An all tax increase/no spending cut framework would soothe the bond markets but would prove unpalatable to equity markets with some downside pressure.

- Modest tax increases and coincident spending cuts would similarly placate bond markets, but in the short run, equity prices would suffer as more private (productive) capital flowed out of private hands and in to public coffers.

- No tax increases, coupled with moderate spending cuts and a raise in the debt ceiling to facilitate another year of funding would cause bond markets to suffer somewhat and equity markets to experience a moderate relief rally. Within a matter of months, though, financial markets would begin to discount the likelihood of uncertainty on the next needed raise in the debt ceiling limit (year 2012), and markets would become more volatile. **Our investment portfolios are structured with a strong bias towards this outcome.**

In keeping with this scenario, we believe that the 2012 presidential elections will prove a referendum on the "fault lines" described above. One candidate will petition for a more caring, benevolent government consistent with the social safety nets of Europe, and the other will suggest a return to the entrepreneurialism that defined America for most of its existence and enabled it to economically outpace Europe for the past several decades. In this regard, we think it would make sense to pay attention to the "Tea-Party" as their strength of conviction seems in excess of either republicans or democrats and they may prove the spoiler on the presidential race and tip the scales regarding ideology.

Before closing, we have been asked by some clients if we should have a contingency plan for the least likely, but potentially short term harmful scenario. That would be the situation of no negotiated settlement, no tax increases and no spending cuts. If this unfolded, our expectation is that equity price movements would be quick, violent, and swiftly reversed and more harm could result for investors who try to "time" such actions versus simply riding out the storm. For those clients whose circumstances do not enable them to shoulder the risks of short term weakness, we are already positioned in such a way that the volatility is mitigated through asset allocation.

We welcome all thoughts and comments.

Robert M. Bilkie, Jr., CFA

Summer Favorites

To celebrate the summer season, we at Sigma, wanted to share some of our personal favorite recipes with you. Whether it is during family gatherings, friendly get-togethers, or neighborhood barbecues, we hope you sample one (or many) of our summer suggestions. Who knows, your next favorite could be listed below!

Halibut Filet and Salsa

Ingredients:

-One halibut filet, about 1.5 pounds
-Two ears corn
-One tablespoon butter
-Half cup red onion, finely chopped
-One can black beans, drained and rinsed
-Salt and pepper
-Two roma tomatoes, diced
-Juice from half of a lemon or lime
-Eight ounce can crushed pineapple
-One-fourth teaspoon cayenne pepper (optional)

1.) Remove kernels from corn and sauté in butter for three minutes.
2.) Add remaining ingredients, except fish, and heat through.
3.) Sautee halibut for four-five minutes per side over medium heat.

Peach, Basil & Red Onion Salad

Ingredients:

-Three peaches sliced into one-half inch thick slices
-Three-fourth cup of red onion, sliced very thin
-One-third cup fresh basil
-Juice from half of a lemon
-Half teaspoon coarse salt
-Fresh ground pepper
-One tablespoon of extra virgin olive oil

1.) Toss all the ingredients listed above, except the extra virgin olive oil
2.) Top the salad with the extra virgin olive oil

Beer Bread

Ingredients:

-Three and ½ cups all purpose flour
-Three tablespoons sugar
-One tablespoon baking powder
-Twelve ounces of beer
-Half teaspoon of salt
-One Beaten egg
-Egg wash

1.) Adjust the oven rack to the lower-middle position of the oven and pre-heat to 375 degrees.
2.) First, mix the dry ingredients in a large bowl and then add beer and stir with a fork until just combined.
3.) On a floured surface, knead dough quickly to form a ball.
4.) Place dough on a baking sheet and firmly slit an 'X' on top with a serrated or very sharp knife. Brush loaf with egg wash.
5.) Bake until golden brown, usually about 45 minutes and transfer to a wire rack to cool.

Angel Delight

Ingredients:

-One 20 ounce can crushed pineapple, not drained
-One package Jell-O Vanilla Instant Pudding
-One cup thawed Cool Whip Whipped topping
-One angel food cake
-Mixed berries of choice

1.) Mix pineapple and dry pudding mix in medium bowl.
2.) Stir in whipped topping, this creates the filling.
3.) Cut angel food cake horizontally into three layers. Fill the layers with the filling.
4.) Top with layer of filling and mixed berries.
5.) Chill for at least one hour and ready to serve!

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