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summaries

SIGMA INVESTMENT COUNSELORS

the official newsletter of sigma investment counselors June 2009

Recovery or Relapse?

When we wrote our last detailed market update in early March, it was in the midst of the lows we have seen thus far in the market cycle. The factors that caused investors to drive the market lower, particularly this year, included rising unemployment, factory orders at a standstill and consumer confidence at record lows. In addition, there were concerns about the health of our domestic auto industry and how bankruptcies in this sector of the market could profoundly cripple our economy and lead us into an extended recession or even depression. The instability of our financial industry also cast a pall over the equity markets.

How quickly perceptions change. Now, only three months later, the haze appears to be clearing. Housing and leading economic indicators are showing signs of bottoming and/or recovery, the banking industry has dramatically improved its capital structures, credit spreads are narrowing dramatically and lenders are ever so slowly starting to lend again.

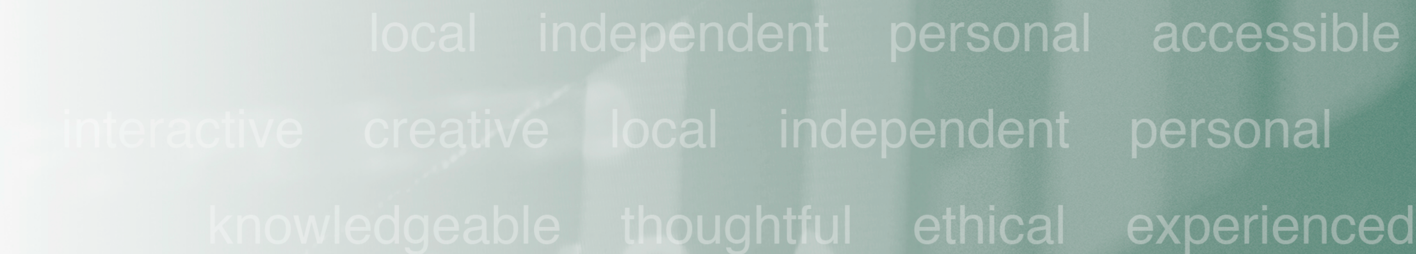
Second, the stimulus packages and alphabet soup of government programs that have been enacted (TARP, P-PIP, TALF etc.) are also supporting this recovery. Finally, and perhaps most importantly, first quarter earnings reports were better than expected and management comments, while tepid, were generally indicative of a more normalized operating environment.

Taken together these factors address many of the uncertainties investors have been wrestling with for the past year. Thus, having registered a low in the broad market averages in the first half of March 2009, the equity markets have staged a spectacular recovery, with some indices up more than 40% from depressed levels.

In our March 2009 Sigma Summary, we discussed the fact that the equity markets could stage a significant recovery from recent lows and we counseled many of our clients to resist the urge to sell their securities into this weakness. For example, we wrote in March, "if history repeats itself, the equity markets should show signs of recovery in advance of the recovery in the economy, ...moreover, measured from its low point, the stock market oftentimes registers substantial and unpredictable gains, confounding those investors who seek to time the market." Thus, only with the benefit of 20/20 hindsight (and a 40% move in the equity markets), this underscores the difficulty and dangers of trying to time the markets.

Despite the powerful nature of the recent equity market rally, we think there are several issues that linger for investors. First is the legitimacy and sustainability of both the rally and the economic recovery. With hindsight, it is clear that the behavior of the consumer and corporations in the fourth quarter of ’08 and the first quarter of ’09 resulted in the liquidation of inventories to an unsustainable level. When these inventories need to be replenished, this will serve as a potentially powerful economic stimulus.

However, household debt remains at unsustainable levels. As reported in the 6/9/09 Wall Street Journal: *On Borrowed Time --Consumer-Led Recovery*: "Despite recent frugality the consumers have barely dented their debt load." The article cited the following statistics: "Household debt remained at 130% of disposable income at year end ’08, down only slightly.....from 133% in Q1’08. The first time this number crossed the 100% line was in the 2001 recession as debt fueled consumer spending." The article goes on to report that with the reduction in net worth



due to the combination of declines in housing and stocks, credit standards much tighter and the focus on debt reduction and savings (the rising unemployment rate is not even mentioned), a consumer-led recovery will be more difficult to materialize. The question for investors becomes: Are the signs of the economic recovery we are seeing sustainable?

A second set of issues for investors is the likelihood of inflation versus deflation. With commodity prices climbing, the US government "printing money" and bond yields beginning to climb, inflation fears are increasing. This is a dramatic turnaround from just a few short months ago when investors feared that debt levels, bursting asset bubbles in housing and equity markets, rising unemployment, excess capacity and extremely low levels of business spending and wage deflation in many industries (hordes of companies applied across-the-board pay and benefit cuts instead of, or in concert with, layoffs) would lead to deflation and the onset of the next depression.

Finally, the government's active role in the economy has investors concerned as the government has never proven to be an efficient allocator of capital. The overriding US business culture is one of capitalism and while it has its faults, over time, it is the system that has proven best suited to allocate capital. Thus, a more socialistic form of government leaves investors in an uncertain world.

For example, as a country we are about to embark on an important discussion with regard to health care reform in the United States and whether socialized medicine is the better choice for our citizens. It is impossible to predict the outcome of these discussions. However as the market sensed the move from a capitalistic approach to one of socialism for healthcare, the stocks in that sector have dramatically under-performed the broad market averages. As further discussions and negotiations take place this summer in Washington, the stocks in the health care sector will serve as a proxy for investor sentiment and may hold implications for other sectors wherein the government has become more "involved."

As we weigh the competing signals and examine the landscape before us, we are cautiously optimistic that we are on the road for a return to economic growth, albeit a very treacherous road from a much lower plateau. Just as the economy will have setbacks along the way, it would be logical to expect the equity markets to show erratic price performance as well. Yet, we feel that we have indeed seen the low point in equities in early March and that from that point forward, they have begun a long and arduous recovery.

As always we look forward to discussions about these issues as well as other market and portfolio issues that may be of interest.

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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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