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summaries

SIGMA INVESTMENT COUNSELORS

the official newsletter of sigma investment counselors

December 2009

A Good Finish to a Difficult Start

As we usher in 2010, it hardly seems possible that we are already entering the second decade of the new millennium. It seems only a short time ago people were consumed with planning how they were going to celebrate the entry of the new millennium; how they were going to watch the calendar turn from 1-9-9-9 to 2-0-0-0; and whether all the programming, precautions and billions of dollars spent on Y2K would save the world from disaster. Similarly, it seems like just yesterday we were writing this newsletter with our summary of 2008, trying to put into perspective the market turmoil being experienced and more importantly, how to properly communicate to clients the need to hold true to their long term asset allocation strategies.

As with the decline in 2008, the 2009 rally has as one of its characteristics a high correlation across sectors, countries, asset classes and market capitalizations. While the first quarter of 2009 continued to create difficulties for investors, the rebound from the March lows has rewarded investors that maintained equity exposure. Bond investors also experienced significant gains as the risk premium priced into the bond markets a year ago have declined. Like all investors, we would like for this year to linger, "basking in the glow" of such strong market returns. However, our thoughts are now focused on the themes we expect will impact investors in 2010 as well as new themes that may emerge as the year unfolds.

The underpinnings of the market rally in both the equity and bond markets were supported by several factors. First, massive government stimulus actions across the globe helped the markets stabilize. Economic data was indicating the rate of economic decline was slowing; and a bottoming process began to appear in the aggregate statistics being reported. As evidence of economic stabilization materialized, cash that investors had built up in the preceding six months began to find its way back into the capital markets. In addition, investors became more comfortable accepting risk versus tolerating the near 0%, or negative, returns offered in short term treasury (cash equivalent) markets. Just as the stock market decline of 2007-2009 was violent and dramatic; the markets have since staged a dramatic reversal.

Interestingly, higher risk assets have provided the primary market fuel for the rally. For example, within the equity market, the higher beta (faster growing, less well capitalized) stocks, which were particularly hard hit during the downturn, have dramatically outperformed more stable stocks in this recovery. The sectors where these higher beta stocks are typically found include technology, basic materials, commodities (such as gold), consumer

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durables, financials, small cap stocks, emerging markets and those companies that carried a high level of debt.

The bond market reacted in a similar fashion to stocks. For example, over the past year, bond prices on intermediate and longer maturity bonds have risen dramatically as yields across the quality and maturity spectrum declined. The biggest move was seen in lower quality bonds, often referred to as "junk bonds." These bonds were trading at an extreme discount to par value, implying a high risk of default, during most of last year and early this year. As the economy showed signs of improvement, these discounts narrowed dramatically and in some cases, are now trading at a premium to par value. In short, after clinging to cash and treasury bonds at the end of 2008, both bond and stock investors began investing in riskier assets as stabilization occurred and uncertainty about the economy began to decrease.

As we begin to look at 2010, it is interesting to note the current slope of the yield curve. Focusing on the short-end of the curve, as mid-December 2009, the 3-month, 6-month and one year Treasury bills were yielding 0.02%, 0.15% and 0.31%, respectively. This is known as the "nominal" yield. The "real return" is simply the nominal yield less inflation. After factoring in an inflation rate, albeit low, it is clear that the real return for risk-free cash equivalents is actually negative in some cases.

While it may seem odd that the real return on cash equivalents may be close to zero or negative, we don't believe this will last much longer. While some investors have accepted such low returns as a reaction to last year's market rout, we would be hard pressed to see rates getting any lower. Instead, we believe that the real return will slowly go back to historical norms. The two catalysts we see for an upward move in interest rates on treasury securities are 1) an increase in investors' inflation expectations and/or 2) an increase in the rate required by investors to purchase treasury securities.

Despite the massive increase in liquidity by the Federal Reserve Bank we are only mildly concerned about inflation until later in 2010. The liquidity pumped into the banking system by the Federal Reserve and the U.S. Treasury has not been used to grow the economy the way one might expect. The money the government gave to the banks was not used to lend to companies and help them grow their businesses. Instead, banks used those funds to deleverage, repair their balance sheets and to buy treasury securities. This deleveraging process is also taking place across corporations and individuals alike. By its very nature deleveraging is a deflationary process. In addition, in a recession and particularly at its end, business activity is at its slowest, capacity utilization is low, unemployment is high and companies typically have little flexibility with regard to pricing power. It takes several quarters of improving economic activity to move the needle on these factors enough to create inflationary pressures.

As we move through 2010 it is our expectation that investors' appetite for additional treasury securities will wane unless real rates increase. The combined impact of rising real returns and (eventually) inflation should

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lead to higher nominal interest rates and downward pressure on bond prices, particularly longer dated bonds, all else being equal. Thus, not only are the large price increases witnessed in Treasuries, corporate and municipal bonds behind us, we believe there may be a partial give back in bond prices during the latter part of 2010 and/or in 2011.

For equities, the quick money may have been made as investors bought oversold stocks in early 2009 and enjoyed a dramatic recovery in price, particularly in those stocks that were the most depressed at the bottom. Looking forward, we believe the opportunity will come from companies that can demonstrate an ability to post positive revenue and earnings growth, particularly in an environment where economic activity remains sluggish and inflation remains subdued. Thus, winning companies are likely to be those that have pricing power, are able to increase unit sales, have a technological advantage that separates them from the competition, operate in a unique niche or have a scare resource. Investors will also be seeking stocks with attractive dividend yields given our low interest rate environment. That is why we are spending a great deal of time researching larger cap stocks involved in information and medical technology, basic materials, consumer durables and emerging markets as well as exchange traded funds with similar characteristics. We also believe that there will be less correlation between market segments, suggesting the importance of security selection (i.e. placing your bets carefully).

Finally, the activities of our government will remain vitally important. It will be critical to assess how Congress and the Administration move forward on initiatives such as "Cap and Trade," tax increases and the re-regulation of the financial sector. Overlaid on this will be the 2010 mid-term congressional elections. The elections will add a lot of "noise" as politicians resurrect issues that will get a lot of press but on which little will be done once the election is over. While we are concerned about how some of these issues may play out, in the case of healthcare reform we are more optimistic than we have been in awhile. The healthcare sector has been under a major cloud of uncertainty for several years. As any reform will likely be watered down from the initial proposal, health care stocks may get a boost as uncertainty is lifted. We also believe that any regulation may not be as onerous as once feared. While we can’t rule out a "head-fake," the recent strength in this sector would lead one to believe the market appears to be coming to a similar conclusion.

Yes, 2009 will be a difficult "act to follow" following the strong performance registered in equities and fixed income securities this year. However, we look forward to many new opportunities that we believe can be found in 2010.

In closing, we wish all of our clients and friends the happiest of holiday seasons and best wishes for a joyful, healthy and prosperous new year.

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Please watch for our discussion on Roth Conversions in next month’s issue of Sigma Summaries.

A Salute to our Troops, Including First Lieutenant Jeffrey Lehnert

President Obama recently spoke in Oslo, Norway, accepting his Nobel Peace Prize. "Evil does exist in the world," he said. "War is sometimes necessary."

For many, these quotes ring true, but exist only in the abstract. At the Bilkie household, a concrete reality has taken hold. Our daughter, Amanda, and her two children, Ava and Natalie, have moved back home to Northville while her husband, first dad/First Lieutenant Jeffrey Lehnert, serves out a 6 month Air Force deployment in Iraq beginning early in 2010.

While Shari and I relish the thought of having our grandchildren close by and with us, it is bittersweet as we are also understandably concerned that their father will be in harms way in a hostile, distant country. We do support our President though, and the leadership efforts of this great nation of ours to rid the world of tyranny and oppression, so we accept the role that we must play, however modest. We are also proud of Jeff, and the significant role he will play, and the sacrifice he is making for our country.

We do ask all of you for your prayers for not only Jeff's safe return home, but for that of all of our soldiers serving abroad.

God bless, and happy holidays.

Bob Bilkie

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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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