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SIGMA INVESTMENT COUNSELORS

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The Million Dollar Question:

Why is it worth knowing what a dollar is worth?

In a conversation with a client several weeks ago, the question was asked, "Why is the value of the dollar important?" His question was prompted by the many references to the dollar made in the media concerning its value, the impact on economic and financial markets, and perhaps most curiously, why the supermodel Gisele Bündchen was reportedly refusing to accept payment in dollars, instead insisting upon Euros.

By way of review, the dollar, like any other currency, is simply a medium of exchange for goods and services. Currency is generally issued by a sovereign government and is designed to be used to facilitate transactions (barter is a fairly ineffective process). Currency has been utilized by most advanced societies for centuries. By and large, for a currency to be accepted as a medium of exchange, it has to have the confidence of most, if not all, participants operating in the economic system.

With the advent of international mercantilism, markets for the exchange of currencies sprang to life. If you have dollars, and the item you are attempting to buy is priced in British pounds, then you must exchange your dollars for pounds in order to pay your trading partner. Post World War II, however, many non-US merchants began accepting US dollars in lieu of their local currency for payment, effectively establishing the dollar as the de facto global reserve currency. While this is a brief and admittedly crude discussion, it frames why currencies in general are of interest to consumers, policy makers and investors.

Over the course of the past five years, the trade weighted US dollar index has fallen to near unprecedented and multi-decade low levels against other major currencies. This has garnered most pundits' attention of late. Beyond the purely statistical fascination, there are indeed practical considerations which make this declining pattern worth monitoring.

First, keep in mind an elementary facet of any type of market: relative supply and demand determine price. Hence, if the demand for butter were to rise, or the supply to fall, the price would rise. Therefore, if the dollar is falling, this must mean that either the supply of dollars is increasing, or the demand for dollars is falling, or both.

Dollars are generally demanded for one of three reasons: to pay for the purchase of a good or service, to undertake a US dollar based investment, or simply to use as a store of value when a local currency is under assault.

In the first instance, clearly trade is the dominant force. Much has been written in the past several years about the US trade deficit, the net difference between the value of US exports versus imports. A trade deficit means US consumers have been buying more imported goods and services than foreign consumers are buying US produced goods and services. (continued)

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This is due, in large part, to the lower cost structure that exists in other countries, primarily lower wages and benefits. This means it costs the foreign companies significantly less to produce the same products which can then be sold in the US at a cheaper price.

The second source of dollar demand is investment in US dollar-based assets and securities. There has historically been interest on the part of foreign investors in acquiring US assets simply because of the expected investment gain. Finally, a third component of demand has been the desire to hold dollars because the US is perceived as the most stable financial and political system in the world.

Given the dynamics and complexity of currency markets, it would be beyond the scope of this letter to ascertain the specific reasons why the value of the dollar has dropped or to make a forecast of when the slide might abate. Suffice to say that in most market systems, free function establishes clearing prices, meaning a level at which further changes seem less likely. A good example today would be gasoline prices. As the price has risen, substitution and conservation efforts have increased, leading to lessened demand and a stabilizing price.

The focus of the remainder of this discussion will concentrate on some expected outcomes of the weaker dollar – both positive and negative – and why these outcomes are important. Before beginning the discussion, it is worthwhile to note that for most domestic consumers and investors, spending and investing patterns seem relatively un-impacted in the short run to changes in the value of the dollar. A flash Florida freeze or a gasoline supply disruption would have an immediate and notable impact on orange juice and gasoline prices respectively. Changes to the value of the dollar are less dramatic, and, in most cases, the impact takes longer to work through the system, so changes do not immediately impact consumers. Nonetheless, it is worth knowing the short and long term impact from both the consumption and investment standpoint.

As to outcomes, perhaps the most obvious is that US exporters of goods and services will benefit by virtue of the weakened dollar having made their prices more competitive in global markets. At Sigma, client portfolios have been invested in certain companies specifically because of the expectation that these companies would directly benefit from the advantageous cost position. Other winners would include foreign consumers of US goods, foreign buyers of US assets and US borrowers who obtained their borrowed funds from lenders abroad and can repay the debt in depreciating dollars.

Those disadvantaged by a weakened dollar include US consumers who are subject to rising prices (inflation) as many goods and services are imported and the weaker dollar makes these prices more expensive. This is an area that impacts individuals and their budgets and concerns Sigma's investment counselors. When attempting to develop investment strategy and advise clients on proper spending rates, we understand that inflation rates have a tremendous impact on expected future consumption, and, hence, the required level of present savings to meet that future spending need.

US consumers traveling abroad are also subject to materially higher prices and are disadvantaged by the weaker dollar. Foreign producers who accept US dollars for payment (such as oil producers) will stand to lose as will those companies operating in nations that peg their currencies to the dollar. As the dollar declines, the companies are being paid back in dollars that have less value than before.

In sum, changes in the value of the dollar versus other currencies will have short and long term effects both from a spending as well as an investment perspective. It is important to consider these effects when determining broad investment strategy as well as specific investment selections. Of course, this must be pondered in concert with the myriad other factors impacting the investing environment including the rate of global economic growth, geo-political events, monetary policy, and fiscal policy, to name but a few. Indeed, this is central to the manner in which Sigma approaches the investment process.

Robert M. Bilkie, Jr., CFA
President

The Economic and Market Environment

In Sum: The geo-political environment appears to have improved somewhat within the past several weeks. Global economic cross currents are proving a difficult challenge for central bankers as sovereign interests collide with concerns over currency exchange rates. The US government recently approved an economic stimulus package in an effort to prevent further economic weakness from unfolding. Common stock prices across the globe have improved from the low levels reached in mid-January.

Geo-political: New developments: Kosovo declared independence from Serbia in mid-February, and the US and Russia are polarized over the issue. Relations with the former/re-emerging superpower have thus continued to deteriorate. Other areas of continuing concern and a brief update on the status of conditions include: Iraq – better; Iran – better; Venezuela – better; Cuba – better; North Korea – no change; Pakistan – worse; Israel/Gaza – worse; Kenya – worse. On balance, and weighted by degree of strategic importance, the geo-political environment appears to have improved modestly.

Economic: The US economy continues to be teetering between a lower growth environment and a recession. Weakness in residential construction appears to be spreading to the auto and other industries – including services. In contrast, many other global economies are faring well. Commodity prices (agricultural products such as corn, wheat, and soybeans, as well as industrial commodities including non-precious metals and energy) have spiked of late, confounding most economists. Concerns about a recurrence of the insidious malady of the 1980's, slowing economic growth and rising inflation – stagflation – have mounted. The very large and well capitalized debt markets have steered interest rates lower across the globe, though, and this stands as perhaps the most significant non-confirmation that stagflation is reappearing.

Monetary: In response to concerns over the weakening US economy, the US Federal Reserve Board reduced the federal funds interest rate twice in January – once following an emergency meeting on January 21 and then again at the regularly scheduled meeting on January 30. In contrast, the European Central Bank opted to keep rates unchanged according to its press release of February 7, 2008. The Bank of England and the Bank of Japan also determined rates should be left unchanged. Such monetary policy contrasts could spell additional volatility in currency exchange rates, with expectations that the US dollar could decline yet further (see related discussion).

Fiscal Policy: The Bush administration and the US Congress recently formulated and signed into law the Economic Stimulus Act of 2008. It is unclear what impact this piece of legislation will have on the economy. Similar measures have been attempted in the past, with varying levels of success.

Equity Markets: Global equity prices rebounded somewhat from the lows reached in mid-January, but significant volatility has persisted. From the standpoint of valuation, and particularly compared to fixed income investments and certain real estate, common stock prices appear relatively attractive.

Fixed Income Markets: The fixed income segment from the January Economic and Market Environment article remains relevant today. Interest rates on US Treasury securities are at unusually low levels based upon the stimulating tilt of actions at the Federal Reserve relating to monetary policy and as investors continue to flock to fixed income securities as a source of refuge.

Robert M. Bilkie, Jr., CFA
President
February 19, 2008

Heaven on Earth!

Our first, and only, darling grandchild, Ava Grace Lehnert, will be turning 18 months old soon. What an incredible 18 months it has been. With all of the gyrations in the securities markets these past several months, I have been reluctant to write about the family lest I cast dispersions about the real character of this crisis, but I have been receiving inquiries from many asking about the grand-parenting "business" generally, and Ava specifically, so I determined that I should, and could, indulge my passion for her and beg forgiveness from those who may not be interested.

The well–worn, humorous T-shirt phrase, "Had I known how much fun grandchildren were, I would have had them first!" certainly applies to Shari and me. Ava is a typical, precocious, curious, energetic 18 month-old. Her beauty makes my heart melt, and she has the most stunning eyes (judge for yourself – picture attached!). These eyes have enraptured me and frankly, turned me into putty. Ava has spent all of her brief lifetime in San Angelo, Texas as her father, an Air Force officer, completed his Intelligence training there. They have been told that they have to report to Denver, Colorado this March, so a new chapter for them begins shortly.

Shari and I have made many trips to Texas the past several months, and Mandy, Jeff and Ava have likewise visited us often in Michigan. So, while we do not get to see them as frequently as we would like, when we do, we are pressed together in a fashion that allows us to really "bond."

This past Christmas was incomparable. Christmas is a favorite Bilkie family holiday, and, again the kids were able to stay with us for 10 days. We had the Christmas tree set up with the old Lionel 027 gage Erie diesel train encircling the base of the tree. Ava was awestruck from the moment she first laid eyes on them. She waddled over to the tree in her footie pajamas, plopped herself down next to the controls, and stared in wonder at the Freighter with all of the cars being tugged behind as they made their perpetual endless journey. She was fascinated, but content to just watch them. Amazingly, not once did she attempt to impede the trains, touch the cars, or otherwise disturb the village of houses and characters. The photographs we have are precious – imagine her sitting next to the glimmering tree with the bulbs reflected in her eyes, just fixated at the splendor before her. That visual is just burned into my memory!

Incredibly, the excitement and joy at seeing her at the airport each time she or we arrive never wears thin. As we coo and coddle, she warms up after a brief, indecisive interlude, and then resumes her spitfire demeanor, and we pick up where we left off from the last visit. Indeed, by the time this goes to print, we will have traversed the continent once again to Texas for the last time, and will have retrieved Ava to come live with us for a short spell while her mama and daddy set up her new household in Denver. I have already planned out Ava's calendar – Saturday morning breakfasts with Papa and his friends at the chiropractor's office; Sunday morning church and then breakfast at Lucas Restaurant with grandma and Aunt Ashley; Wednesday dinners with Papa, great uncle Ken, and great-grandpa Bilkie; sled rides down the hill next to Papa's house and 4-wheeler rides on the not too cold days, and – a big bowl of rice cereal and then a rocking chair ride with a nice warm milk bottle. Trust me – it's Heaven on Earth!

Robert M. Bilkie, Jr., CFA

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

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