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summaries

SIGMA INVESTMENT COUNSELORS

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Take A Deep Breath...

At the time of this writing (mid March), the equity markets remain challenged as investors attempt to understand the ramifications of various government programs now being proposed and implemented in the early days of the new administration. For now, investors have chosen to vote with their feet, continuing to exit the equity markets.

We have no illusions about the difficulties we face. However, as we learn over and over again, the pendulum never swings in short strokes. Momentum carries it to extremes in both directions. The build up of debt over the last several years led to unsustainable spending and artificially high real estate prices. Purchases of discretionary items, from flat screen TVs, to designer jeans, to single family homes, shopping centers and office buildings was funded by debt that could not be repaid. The unwinding of that experience has led us to the other extreme. Consumption, conspicuous and otherwise, has disappeared. Consumers, uncertain about their futures, have opted to save - not consume, leading to the crushing of every data point one might use to measure economic growth.

For investors, capital preservation has become the overriding investment objective by a substantial margin. Thus, it is difficult for many to imagine that there will again be a time when investors demonstrate any appetite for capital appreciation, which involves risk, particularly with monies that are not already invested. However, this too will pass...we just don't know when.

What we do know is that the stock market tends to discount future events. Thus, if history repeats itself, the equity markets should show signs of a recovery in advance of the recovery in the economy. A rule of thumb suggests that the market leads the economy by as much as six to twelve months. Moreover, measured from its low point, the stock market oftentimes registers substantial and unpredictable gains, confounding those investors who seek to "time" the market.

While Sigma does not make market calls, we are beginning to see faint signs that liquidity pressures are easing and credit is flowing to high quality borrowers. With depressed stock prices and attractive interest rates for top quality borrowers, companies are raising debt and making acquisitions. Business Week reported high quality issuers have raised over $132 billion in the bond markets thus far in 2009, a 22% increase over 2008.

In fact, over the past two days, it is interesting to note that Merck has announced its intention in acquiring Schering-Plough, Roche is finalizing its takeover of Genentech and Dow Chemical has secured sufficient financing to complete its acquisition of Rohm & Haas. If this marks a return of mergers and acquisitions (M&A) activity, this would be welcomed relief from the doom and gloom attitude that is prevalent on Wall Street and Main Street.

We are also seeking signs that our banking system is beginning to stabilize and returning to the business of lending money to qualified borrowers. This is essential before the economy can show any signs of a sustained recovery. As an aside, Citigroup announced this week that the bank's first-quarter performance so far has been the banks best since the

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third quarter of 2007. It will be interesting to see if other banks begin to experience similar results.

Our attention is also focused on consumer spending and the unemployment rate. Even the slightest hint that these indicators are starting to turn positive may be a strong catalyst to change investor sentiment.

As these catalysts appear, investors will start to respond. It has been suggested that at present, cash in money market funds now exceeds 40% of the stock market's total equity capitalization. There is also anecdotal evidence that there are sizable cash balances "under mattresses" and in safety deposit boxes in lieu of one's checking and savings accounts. These cash balances are not included in the data above. Eventually, much of this cash will return to one's financial institutions, where it belongs. Thus, when investor sentiment changes, there is substantial liquidity that is available to bid stocks and bonds higher.

We cannot project the timing of this shift but we are convinced that a shift will take place. During the interim, we are fielding many calls from understandably concerned clients who are singularly focused on capital preservation. Unfortunately, we have no way of gauging where the bottom is or the timing of the eventual recovery. Given this uncertainty, some have chosen to temporarily exit the equity market, thereby minimizing further losses. The difficulty is that if this change in asset allocation is a temporary decision, an equally important decision on when to reinvest must also be made. Our experience, which is backed by empirical evidence, suggests that it is very difficult to get back into the market on a timely basis to participate in the early stages of the rally where a significant portion of the market's future returns may lie. Thus, once an appropriate asset allocation is identified, we are not inclined to sell stocks on a short term basis to avoid possible near term losses.

Yet, we also recognize the importance of identifying a suitable asset allocation strategy which includes a sufficient amount of cash and current income to support one's short and intermediate term liquidity needs. Thus, for clients with a long term time horizon and an ability to tolerate market volatility, we continue to have conviction in owning equities for the long term and feel that values are <u>particularly</u> compelling at current levels.

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