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summaries

SIGMA INVESTMENT COUNSELORS

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The Economic and Market Environment

To clients of Sigma Investment Counselors, Inc.:

We recognize that the current crisis environment enveloping the capital markets has been at best, unsettling. The extreme price action requires our constant re-examination of underlying fundamentals to ensure that our investment strategies adequately capture new market phenomena and dynamics. New developments are occurring daily, with each potentially having the power to materially change the investment landscape and cause us to modify our current strategies. However, at the time of this writing, we are satisfied with the strategies and positioning of our portfolios to navigate the current market turbulence, while continuing to keep our sights set on the long-term objectives for each client portfolio. Below, we provide you with our analysis of what is taking place in the global economy and capital markets and how this impacts your portfolio. We are presenting in our normal format but expanding the discussion substantially versus what you find typically in our monthly newsletter.

In Sum: Investors abhor uncertainty, the greater the uncertainty the greater the market turmoil. In the past month capital markets have been in a state of perpetual turmoil as uncertainty in the sub prime credit markets spread broadly to markets overall. Dramatic changes in common stock prices and the deteriorating US residential mortgage market for sub-prime, or less creditworthy borrowers, has dominated headlines. Notwithstanding the extreme stress in capital markets, most central banks have left interest rates unchanged. Investors, however, have now begun to recognize risk and have demanded higher interest rates from lower quality issuers. Left out of recent headlines is the continued strength in global economic growth that has fueled increasing corporate profitability. Low unemployment around the globe, coupled with strong corporate profits, continues to fill government coffers.

In response to client inquiries, we do not believe these events foreshadow the beginning of a major market correction or economic recession. We know that some are questioning whether this current market environment is a repeat of what we experienced following the end of the dot-com craze of 2000. We do not think this is the case at this time. Rather, we believe that "risk" is being appropriately reintroduced into the capital markets. In the long run, this is a good thing. We also recognize that investors tend to be emotional, and sometimes irrational, during times like these. We believe these storm clouds will pass sooner than later and a more stable and constructive market environment will re-emerge.

Monetary: At the epicenter of the storm clouds in the financial markets has been the US residential mortgage market. Borrowers with less than stellar credit have been defaulting on their loan payments at a rate well in excess of the expectations of certain investors (read, aggressive hedge funds). As investors recognized the deteriorating fundamentals, few (at times, none) were willing to commit any of their financial resources to buying mortgage backed investments at any price – meaning market "liquidity" quickly dried up across the globe. In addition to the individual securities, the multitude of derivative products developed using these securities as the underlying collateral were all affected. The lack of purchases and sales meant that "prices" for these securities could not be established. Without the ability to price or sell their investments to raise cash, several hedge funds collapsed, essentially losing all of their investors' money. These losses fanned more fears of collapses, and panic behavior overcame rational thinking. Even the ability of institutions to price quality investments became difficult and apprehension quickly spilled over into the equity markets. Financial institutions that serve these specialized investors have experienced added duress, and this has unnerved still other market participants. In the face of this frenetic environment, the Federal Reserve elected to leave interest rates unchanged. However, as investor fears created an environment that became even more irrational, unable to distinguish quality investments from risky

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investments, the Federal Reserve and other Central Banks around the globe began pumping liquidity into the system, (i.e., lending money into the banking system to provide the banks the flexibility and needed liquidity to provide loans to worthy borrowers). All told, the Federal Reserve is working to ensure that the financial crisis does not evolve into an economic crisis, and at the time of this writing, markets appear to be stabilizing. While the Federal Reserve does not appear compelled to lower interest rates at the moment, the situation could change quickly depending upon how the economy responds to these financial developments. Continued close monitoring is of paramount importance.

Geo-political: US consumer mortgage default concerns have so overshadowed other events in the news media that they have given the impression that the status quo is prevailing. Iraqi death tolls continue to rise with daily pronouncements of insurgent terrorist activity. North Korea finally appears to be cooperating with the agreement reached earlier in the year to begin dismantling their nuclear material production capacity. Conversely, Iran seems intent on maintaining its nuclear efforts, although popular discontent in that country over poor economic conditions may foment enough pressure for a change in government leadership.

Economic: Economic growth in the US slowed for the second quarter of 2007, as GDP clocked an increase of 1.8%. This was about the slowest rate of growth for any economy the world over for that same time period. Indeed, stronger growth abroad may well keep the US (and the rest of the world) out of recession, and enable companies with profitable foreign sales to continue to advance. That said, we note that a continued slowing of GDP growth would on its own create a scenario in which the Federal Reserve would lower rates, which we had recognized as possible scenario for late in 2007. However, recent market activity has created a scenario in which the Fed may ease sooner than we had originally anticipated.

Fiscal Policy: Record tax receipts continue to spill into the US Treasury. As a result, the budget deficit has improved dramatically. Spending appears poised to jump, however, with a host of social programs being proposed by the US Congress, and no signs of any cuts in defense spending. Without a corresponding plan to increase tax revenues even further, a return to widening deficits could be in order.

Equity Markets: Global equity market volatility in July and thus far in August increased dramatically versus the past several months. This volatility is a result of the spillover from the credit markets where residential mortgage defaults have been increasing, as described above. Common stock prices respond inversely to changes in risk, and the credit default risk increase has lead to an overall adjustment in the prices of most common stocks. Emotional selling often leads to opportunities as investors, in their haste, fail to adequately assess the true long-term risk involved. Investors who have emphasized large company shares in their portfolios, as in most Sigma managed accounts, have fared relatively better during this period of volatility.

Fixed Income Markets: In the July Sigma Summaries, Chief Investment Officer Denise Farkas focused on "risk" and noted that investors did not seem to be rationally differentiating between higher and lower risk investments. This irrational anomaly in the fixed income markets is in the process of correcting. Interest rates on bonds issued by entities with less than stellar credit records should be substantially higher than those on their better quality counterparts. Indeed, spreads between such issuers have been widening since mid July as investors demand higher returns to compensate for higher risk. Treasury securities have generally moved higher in price across the maturity spectrum as demand has spiked in a "flight to quality."

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