

BWMInvestment
Guidance**1st Qtr. 2010 Mild Advance**
*Cautiously Enjoy Strong Earnings Impact***Key Points**

- | | |
|--|-----|
| • 2010 Year to date Returns | |
| S&P 500 (1168) | 5%; |
| US 10Yr Bond (3.83%) | 1%; |
| NASDAQ (2397) | 6%; |
| Foreign (EAFE) Stocks | 1% |
| • U.S. GDP expected expansion = 3% | |
| • 2010 earnings expected increase = 31% | |
| • 12 month stock market advance continues | |
| • Solid economic recovery | |

Executive Market Facts Snapshot

U.S. stock markets (S&P 500 5% and NASDAQ 6%) advanced in the 1st Qtr, while foreign markets (1%) advanced less. Smaller company stocks performed better (9%) than larger company stocks, as is normal in the third quarter of an economic recovery. Strong 4th Qtr. corporate earnings, with good profit margins and some sales expansion, is the key story. Industrial production and inventory restocking continue in the 1st Qtr. after a solid 4th Qtr. (5.6%) recovery. Economists expect a 3 to 4% 1st Qtr. GDP advance. Analysts continue to upgrade 2010 (31%) and 2011 (20%) earnings forecasts. Gold prices were up (2%) a little, while the U.S. dollar was up (6%) vs. the Euro (Greek fears) in the 1st Qtr. The U.S. 10 Yr Bond return was up 1% with little change in yield (3.83%). The U.S. Treasury securities upward sloping yield curve remains highly stimulative. Asset prices, including homes, continued to stabilize. Leading economic indicators forecast moderate 2nd half 2010 growth. The U.S. executive and legislative branches of government passed a divisive health care control entitlement. President Obama is focused with polarizing leadership. His party may need to answer for policy driven high unemployment, as well as a massive expansion in the size of government, deficits, and the national debt in the November elections.

Themes

- **Good economy, great earnings, fairly valued stocks**
- **How long will extremely stimulative monetary policy drive up stock prices?**

Economic story is as good as can be expected.

The 4th Qtr. 2009 GDP growth was a solid 5.6%. That is good, but in light of the 2nd quarter of an economic recovery, far below the 9.3% 2nd Qtr. recovery from the comparable 1980/82 double recession. Dirk van Dijk at Zacks analyzed the components of the 4th Qtr. recovery and outlook. Per Economics 101: GDP = Consumption + Investments + Net Exports + Government. Personal Consumption Expenditures (71% of the economy) contributed 1.2% to growth. Goods and services spending growth were equal (0.6% each). Gross Private Domestic Investments (12% of current economy) contributed 4.4% (78% of 4th Qtr. growth). Inventory restocking investments, instead of fixed structures (houses and factories), made all the gains, while equipment and software were positive contributors. Investments are the most volatile part of the U.S. economy and swing dramatically during the business cycle. Yet, at 12% of the current economy, they are significantly below their 15% normal level. Imports and exports both rose. Exports contributed very little net to 4th Qtr. growth. Government spending is a statistical anomaly. Increases in federal government spending were nearly equal to decreases in state and local spending. However, entitlements and other transfers, such as unemployment claims, are not counted clearly. Therefore, the big expansion of the federal government is not plainly stated in the statistics.

Generally, long term investments in plants and equipment support more valuable growth than inventory restocking. They drive longer term manufacturing productivity, which is critical in the high labor cost U.S. economy. Increases in software and equipment support shorter term productivity gains in the large economic service sector. Inventories fell so dramatically in the 4th Qtr. 2008 through 2nd Qtr. 2009 that the inventories to sales ratio remains very lean. Inventory restocking will contribute in both 1st and 2nd Qtr. economic growth. The immense fiscal economic stimulus is currently at its peak. The hiring of over half a million census takers in the 2nd and 3rd Qtr will add to short term GDP growth.

The current manufacturing resources utilization rate provided by the Federal Reserve Board (FRB) deserves attention to notice how this recovery is lagging the other great recession (1980/1982 double dip) and why more fixed structures are not currently needed. The current

4/1/2010

recession manufacturing utilization rate (72.7%) has risen 4% from its trough (68.7%) 6 months ago. The 1980/1982 rate rose 8% from its trough (69%) in 6 months. The Bureau of Labor Statistics unemployment rate peaked (10.8%) 4 months after the 1980/82 recession ended. This compares to a peak (10.1%) in October 2010 or 4 months after the probable end of the current recession. After the 1980/82 post recession unemployment rate peak (10.8%), it fell to 10.1% (6 months), 8.3% (12 months), and 7.2% (18 months).

What can we learn from economic recoveries and what do they mean for corporate earnings and stock prices?

Economic growth after a liquidation contraction, such as the recent recession, is more strongly impacted by monetary, than fiscal policy. Paul Volcker and Ronald Reagan had a different (near runaway inflation), but equally difficult challenge (banking industry illiquidity) from FRB Chairman Bernanke and President Obama. However, they took opposite approaches to deal with the problem. FRB Chairmen Volcker and Bernanke stabilized the monetary policy issues (inflation and illiquidity) effectively. Presidents Reagan and Obama addressed fiscal policy completely differently. President Reagan worked with the Democratic Congress to enact bipartisan tax cuts to incentivize small businesses especially to hire, invest, and earn take home profits. President Obama worked with a partisan Democratic Congressional majority to enact the largest scale government expansion (American Recovery & Reinvestment Act ARRA) in U.S. history, which will cost over \$800,000,000,000. Consider the annual interest on the ARRA will be \$36,000,000,000 with a normal future Treasury debt structure (4.5% weighted interest rate). If the standard for success is Economic Council Chairman Summer's Feb. 2009 goal of 8.0% peak unemployment, then the current government expansion has not worked. The policy, by extending unemployment aid to 99 weeks and increasing welfare programs, has incentivized dependency and condoned reduced job searches.

Yet, the economy is improving. New job growth will finally begin to increase for a number of reasons. The number of temporarily employed census workers according to the Dept. of Commerce is estimated to peak at about 650,000 in May, reduce unemployment by 0.3%, and increase 2nd Qtr. GDP by 0.2%. Inventory

restocking and normal demographic demand growth will likely result in greater than 3% 2010 GDP growth. All things considered, more than 200,000 monthly job growths can be expected for at least the next 12 months. The unemployment rate will decline slowly, but not to 1984 levels. A 1% drop in the unemployment rate to 8.7% over the next 12 months would please many economists. Yet corporate profits can still increase about 31%, as forecasted.

Scenario analysis is difficult, but worthwhile. Some economists are beginning to accumulate the data to ask the question: **What if there were only the Troubled Asset Relief Program (TARP)** financial institution bailout, including the automobile General Motors and Chrysler bailouts and no ARRA stimulus? Preliminary data implies that the 2nd Qtr. GDP 2009 decline (-0.7%) would have been worse (-2.7%) due to no stimulus checks to low wage workers and others and related spending. State and local government layoffs would have contributed to more unemployment. Third Qtr. 2009 GDP growth (2.2%) would likely have been flat (0%) and the 4th Qtr 2009 inventory restocking led recovery (5.6%) would have been similar. The unemployment rate would likely have peaked in January, 2010 at the 1981/82 recession level (10.8%). However, 2010 U.S. government deficit financing would have been far less. More data is needed to fully analyze the scenario and its impact on the rate of 2010 U.S. private sector employment growth. The non-political economic analysis will likely show significantly larger employment growth without the ARRA!

Be aware on March 2 the *Wall Street Journal* reported based on Treasury Dept. records that \$245 billion was invested in U.S. banks. \$170B has been paid back by 71 financial institutions, including all major banks, and \$15.3B in bank stock warrants, interests, and dividends has been paid to the U.S. Treasury. As Gerald Cassidy, an RBC Capital Markets analyst noted "Everybody loves to bash the banks, but that is not where the problem is". Total revised TARP costs have been dramatically reduced to \$117B and due to near exclusive estimated GM, GMAC, Chrysler, Chrysler Financial, and AIG losses. The TARP successfully bailed out the banks without taxpayer losses. Those are the facts.

How can profits increase without dramatic job growth? The answer is low borrowing costs, high free cash flow, tight working capital,

4/1/2010

and low budgeting for expansion in face of new government regulations and employment costs (Patients Protection and Affordable Care Act PPACA) can support intermediate term high profit margins and earnings. Less than normal capital spending is occurring because the rate of return on potential new capacity is less than the current cost of capital. Sales revenues are modestly expanding, but not booming. The engines of job growth, small private businesses, will likely be quiet for a while. They are most impacted by the new regulations, higher income and capital gains in 2011, and the PPACA new taxes on single or joint filing separately annual income earners over \$200,000. Their earnings do not show in the publicly traded corporate stocks, but they may make the difference between 2012 marginal GDP (1.5%) and normal growth (3%). Another way to look at things is that large corporation focus on efficiency. Their free cash flow is large enough to spur significant mergers and acquisitions in 2010. Yet, consolidations create few new jobs. Small businesses focus on entrepreneurial effectiveness. They take bigger risks in search of potential rewards. Contrary to President Obama's mantra, bank loans are not what worries the small business people that I talk with. They are worried about the expansion of government regulations, controls, and taxes.

What is an asset's earnings worth?

The price of stocks or their valuations depend on both the market buyer's desired price and earnings; that is P/E or specifically the outlook for P/E. When the outlook for earnings becomes clouded or psychological sentiment responds with reduced demand, then the P/E can drop as market prices drift, while current earnings increase. Reduced investor liquidity and higher interest rates eventually increase fear. Chairman Bernanke continues to state that interest rates will stay low for an extended time. Modest expected 2010 GDP growth (3.0%) is the basis for the conventional wisdom that low interest rates will remain unchanged this year. Forecasts of an additional 20% stock market rise (S&P 500 at 1400) in 12 months to match expected 2011 (20%) S&P 500 earnings growth appear too optimistic based on my expected normal (3½%) federal funds interest rate at about Sept. 2011.

How long will the 0% interest rates last?

That is the key question that everyone asks and no one knows with certainty. It depends on the economic scenario that actually plays out. We

know that the FRB has reduced flexibility due to the massive amount of debt that the Treasury Dept. is financing. The bond market leaders are giving speeches that show they are worried. They are also starting to vote with their money. Two weeks ago the interest rate on a short term (Berkshire Hathaway) corporate note sold at a lower yield than the comparable Treasury security. That may have been an anomaly due to technical supply and demand factors. Yet, bond market transactions never previously indicated that a corporate security had higher implied creditworthiness than a U.S. Treasury security. The Treasury has structured its debt to take advantage of low short term rates. The consequence is that it must go back to the market more often to refinance the debt. That makes the Treasury more susceptible to a liquidity accident. Corporations are acting responsibly by adding more cash to their balance sheets through borrowing and holding on to free cash flows. The credit spreads between Treasury debt and corporate debt have come down to relatively low levels. We now must look at things differently. It is no longer a question concerning the relative creditworthiness of corporate debt to the sound dollar (or any other fiat currency.) The question is: when will the creditworthiness of U.S. debt require a higher interest rate structure that effectively raises borrowing costs for consumers and businesses? The situation may or may not result in monetizing the debt through inflation. However, it will likely be a drag on the economy in late 2011 or 2012. The yield on the 2 year note, which is just outside of FRB direct control, is worth watching. If it reaches 1.5%, the FRB may be forced to begin increasing short term rates to address discontinuities in the Treasury security term structure. I am concerned that this may occur in late 2010, if the GDP grows at a 4% rate. Stock market investors may stop buying when that occurs. That does not guarantee a stock market decline; yet it does increase the probability.

A tangential, but relevant other issue

President Obama and Congress have stated that they plan to raise income taxes on higher earners to pay for increased government expansion. The populist talking point is "spread the wealth." The recently signed PPACA Health Control Law increases investment (interest and dividend) taxes dramatically (3.8%) on single or joint filing separately annual income earners at \$200,000 in 2013. The new tax is not indexed to inflation. Consider long term annual 3½% inflation results

in a 41% purchasing power decrease in 10 years. If wage earners hold purchasing power wages, a single or joint filing separately wage earner in 10 years will be impacted by the tax increase at the purchasing power of today's \$141,700. Very quickly, the tax becomes a middle class burden. That is what happened with the Alternative Minimum Tax. Additionally, there is an added PPACA 0.5% medicare tax on higher wage earners in 2013.

The key short term tax related stock return issue unfolds in the 2010 time frame. The Democratic House Ways & Means Committee initiates tax policy and must deal with the expiration of the 2003 Jobs & Growth Tax Relief Reconciliation Act tax cuts in December, 2010. Allowing full expiration would significantly slow the economy due to reduced after tax income. Congressional elections also occur in November. The Democratic Congress must figure out a way to posture for partial tax relief expiration. It would impact primarily high earners, be marketed as paying for the massive increase in spending, and result in enough public voter support to remain in power. Things are more complex than the uninformed observer notices. The tax cut expiration impacts capital gains taxes (15%) unadjusted for inflation and dividends (15%). Prior to 2003, capital gains taxes were 20% and dividends were taxed at the full income tax rate (top 39½%). What will the Democrats do about capital gains and dividend taxes? What will investors do, as soon as the House Ways & Means Committee shows its plans? Investors respond very directly to clear disincentives. The double impact of expected higher income taxes on top wage earners, as well as higher capital gains and dividend taxes, will result in some selling to take after tax gains. That will be a short term second half of 2010 issue. The longer term issue is the projects that never are started because the expected after tax returns do not pencil out. It is one thing to gleefully talk about spreading the wealth. It is another thing to actually reduce total future wealth (including future jobs) by reducing potential returns to entrepreneurs for taking risks. Be aware of the consequences of envying thriving entrepreneurs.

European and Japanese economic recoveries are relatively weak due primarily to high government debt load inflexibility

Notice in Table 1 that the European and Japanese recoveries are forecasted by *Economist* contributors to be weaker than the normal growth

U.S. recession recovery. That is barely noticeable growth in the first year after a major recession. European unemployment is forecasted to remain at approximately 10%. The European (including Great Britain) and Japanese economic policies are boxed in. Their federal debt levels are so high (all greater than 70% of GDP) that they do not have the choice to try the massive United States fiscal stimulus experiment. They must allow the recession to naturally end and accept slow growth thereafter.

Foreign Economies

Emerging countries China, India, and Brazil show good 2010 forecasted GDP growth. Russia is bringing its inflation problem under control and growing with oil selling at more than \$80 per barrel.

Table1. Economic Forecasts

Economic Market	2010 GDP	2011 GDP	2010 CPI
United States	3.0	2.9	2.0
Japan	1.7	1.6	-0.9
China	9.6	8.1	3.5
Euro Common Mkt ECM	1.2	1.4	1.2
Russia	3.5	4.3	7.9
India	7.7	8.0	10.7
Brazil	5.0	4.5	4.7

The total global economy is expanding (3.0%) with Asia leading the way. In Table 2 the U.S. extremely positive sloped yield curve continues to show the most stimulative monetary policy in the world. The U.S. FRB still forecasts extremely low (0 – ¼%) bank borrowing rates for an extended period. Most countries also have stimulative positively sloped yield curves.

Table 2. Current Global Yields

Economic Market	3 month	10 Year
United States	0.2	3.8
Japan	0.3	1.3
China	1.9	3.4
Euro Common Mkt ECM	0.7	3.2
Russia	8.5	6.6
India	3.9	8.3
Brazil	8.7	6.2

Economic Sectors and Investment Outlooks

A Technical Overview (BPNYSE, etc) indicates U.S. stock prices are trending slightly higher with lower volume and very little volatility. Money supply growth (M2) was normal (2.5%)

4/1/2010

over the past 6 months. Some speculation exists in IPO and smaller growth company stock price advances. **Suggestion: Hold normal portfolio asset weights; stock and bond markets are complacent. Although the S&P 500 earnings forecasts are strong, I don't expect more than another 7% advance (S&P 500 @ 1250) prior to a 2010 market top. Over the intermediate term (9 months), I sense more risk of a choppy market than simple upside rewards.**

Economic Sector Analysis and Outlook

Telecom sector stock demand is weak, as noted by negative sector price Relative Strength (RS). No Opinion. **Utility** Sector forecasted 2010 revenues and earnings increases are low (5%). Dividends are around 4%, but sector RS is weak. A 2011 change in dividend tax rates may worry investors. Avoid. **Consumer Staples** sector 2010 earnings growth is forecasted to be stable (13%) but below other sectors, while RS is in line. Consider selectively holding dividend paying stocks. **Energy** sector 2010 earnings growth (43%) is expected to recover from 2009 declines (-56%). RS is below the market. During the 1st Qtr. oil prices rose 5% to \$83 per barrel ahead of most commodities, while the USD strengthened. Research top quality oil services companies for possible purchases. Profit surprises with higher global demand are possible. The above sectors have dividend candidates for value investors. **Healthcare** sector 2010 earnings are forecasted to be solid (7%). After the healthcare sector control act (PPACA) was passed, little stock movement occurred. Investors accurately anticipated the situation. Stock P/E valuations are below normal and the lowest of any sector in 2010 (12) and 2011 (11). However, be aware that the sector is under government control, and many subsectors, such as medical products, will have new taxes imposed over the next 3 years. Do not assume that increased potential patients will result in increased profits in a government controlled sector. Hold only selective positions that are well understood. **Technology** Sector stocks have participated in the 1st Qtr. market advance and positive earnings surprises continue. This is the growth sector with good cash flows and solid 2010 forecasted earnings (33%) growth. 2010 P/E valuations (16) are 8% above the general S&P 500 market. Hold selective gainers. The **Consumer Discretionary** sector remains cyclical with opportunities for retailers, who have tight inventory controls and anticipate customer trends. No Opinion. The cyclical **Materials** sector RS is neutral, but volatile with

2010 good forecasted earnings growth (60%) after poor 2009 (-50%) earnings decline. They are sensitive to global GDP growth. No Opinion. **Industrial** sector exports (and earnings) to developing countries are positive, but sensitive to weak foreign currencies. The sector RS is neutral. No opinion. The **Financial Services** sector has generally been recapitalized after TARP and over a year of very cheap federal funds. No Opinion. The return of past bank dividend levels are not expected. **4th Qtr. 2009 earnings reports were outstanding and 1st Qtr. 2010 are forecasted to continue to be strong.**

Summary Suggestion: Cautiously hold normal selective stock and bond portfolio positions. The Tech sector is volatile, but with positive potential. The majority of the stock market recovery has occurred along with earnings surprises during the first 2 quarters after the end of the recession (through March, 2010).

International Markets Are Quiet

Foreign stock markets advanced little (1%) in the 1st Qtr, while the USD strengthened (6%) versus the Euro. Normal emerging market weights may be considered if you can withstand large declines and high volatility (-50% in 2008, 70% in 2009).

Fixed Income - Less Volatile but fully priced

The U.S. 10 year Treasury bond returned (1%) little. Investment grade corporate and GNMA bonds were a bit (2%) stronger, as risk adverse investors continued to purchase large quantities of bonds. A small TIPS portfolio weight is suggested. Muni bonds may be considered for taxpayers in high tax states, after due diligence reviews of credit ratings. Mid single digit after-tax returns at modest risk are possible.

Alternative Investments – Diversification

The Real Estate Investment Trusts (REITs) index advanced (10%) in the 1st Qtr, after an impressive 4th Qtr. (20%) recovery. Major REITs are working out vacancies and financing issues. Well informed partnerships may be an effective way to profit from income producing real assets. Gold funds are diversifiers. Only a 5% weight in a direct gold exchange traded fund (GLD) (+2% 1st Qtr.) is suggested.

Portfolio Management

Funds have little cash (3.4%) to boost stock prices higher. The S&P 500 index trades at a normal 2010 P/E (15). Be selective and remain

4/1/2010

diversified. Economic strength could cause the FRB to tighten monetary policy in the 4th Qtr.

Current portfolio themes are:

Normal Investment Weights

- U.S. large stock funds normal weight
- U.S. small stock funds normal weight
- Foreign EAFE funds below normal weight; Emerging stock funds normal weight
- Fixed income – TIPS and short term notes
- Gold – Entry Positions only

Disclosure: Personal holdings: Normal weights
39% Domestic & Intl Large Cap stock funds,
(15% Total International funds)
47% Small/ Mid Cap funds,
14% short term bonds and cash

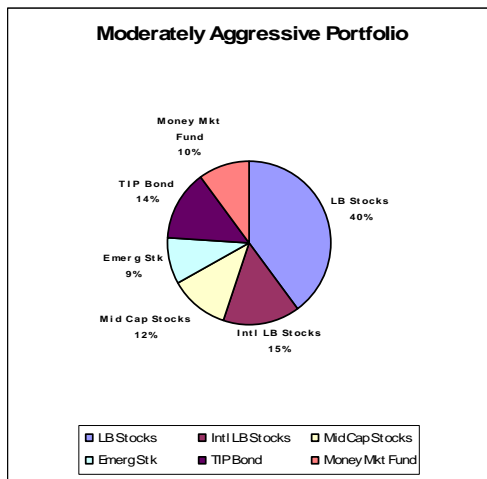
**Sample Portfolios are models
Not Client Recommendations**

Sample Portfolio A - **Moderately Aggressive**

Example 45 year old college educated parents with 1 high school child and 1 college child.

- 40% Large Blend Stock Index Funds
- 15% Large Blend International Fund
- 12% Mid or Small Cap Stock Fund
- 9% Emerging Market Stock Fund
- 14% TIP Bonds
- 10% Money market cash

Normal Capital Accumulation –

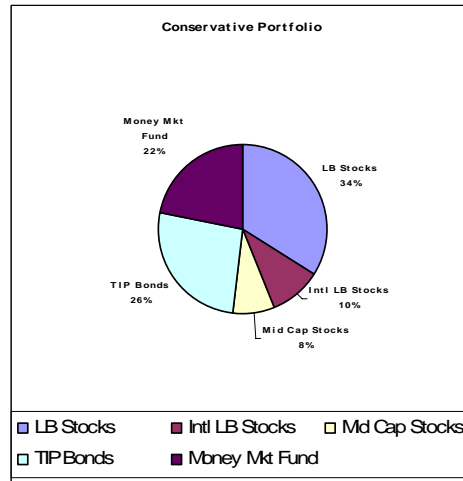


Sample Portfolio B - **Conservative**

Example 65 year old couple with Social Security Income (20% of spending needs) and Retirement 401K or Pension Plans converted to IRA's

- 34% Large Blend Stock Index Funds;
- 10% Large Blend International Fund;
- 8% Mid or Small Cap Stock Fund
- 26% TIPS Bonds
- 22% Money market cash

Normal Capital Preservation –



LEGAL DISCLAIMER – BWM Letters Information
The BWM letter is not in any sense a solicitation or offer of the purchase or sale of securities. The factual statements herein have been taken from sources I believe to be reliable but such statements are made without any representation as to accuracy or otherwise. Opinions expressed are my own unless otherwise stated.

Note client portfolios use available 401K plan funds and multiple funds in each category to reduce risk.

If I buy, hold, or sell securities discussed herein, then I will disclose my positions. Prices shown are approximate.
Joseph Banach, Chartered Financial Analyst.
www.BanachWealthManagement.com