

BWM

Investment
Guidance

First Qtr. 2011 Financial Markets Review
Extremely Stimulative Monetary
continues to boost earnings in
moderately growing economy

Key Points

- **2011 1st Qtr Total Returns**

S&P 500 (1328)	6%;
US 10Yr Bond (3.46%)	0%;
NASDAQ (2777)	5%;
Foreign (EAFE) Stocks	3%
- U.S. GDP expected expansion = 3.3%
- 2011 expected earnings increase = 14%
- Stock market – trend remains positive
- Modest economic recovery

Executive Summary

Equity market returns rose in the 1st Qtr. of 2011 (S&P 500 6%, NASDAQ 5%, EAFE 3%). Bond market (U.S. Treasury (UST)) returns (0%) were flat as interest returns matched price declines. The weak southern countries (Greece, Portugal, and Spain) and Ireland continued to be a drag on the euro currency and limited growth in the European Common Market (ECM). Yet, the highly stimulated US dollar (USD) depreciated (6%) versus the euro. Federal Reserve Board (FRB) increased UST demand beginning in November (Quantitative Easing 2 (QE2)) was offset by reduced demands from other buyers. In the midst of \$300B of added FRB demand during the 1st Qtr, bond yields and related 30 yr. fixed mortgage rates increased ¼%. The U.S. economy ran modestly on most of its cylinders. Profits continued to grow. Consumer spending (2.6% real growth) rose in a modest recovery. Yet Middle East and North African uncertainty pushed oil prices (17%) higher. Gas pump prices are very visible at \$4.00 per gallon. About ½% of potential growth may have been cut in the 1st Qtr. Some industrial supply chain problems developed due to the Japanese huge (9.0) earthquake related manufacturing and distribution dislocations. Sizeable new U.S. jobs were finally created in the 1st Qtr. and the economy is near escape velocity from the perceived need for excess FRB financing stimulus. Huge (greater than 6% federal deficits) remain a big issue. With global energy and other uncertainties, stock buyers remained satisfied, confident, and pushed prices higher in the 1st Qtr.

Themes

- **Extraordinary monetary stimulus is finally making an economic impact.**
- **Will corporate net profit margins continue to rise?**
- **When does market confidence become perilous complacency?**

Extraordinary monetary stimulus is finally making an economic impact.

The FRB engaged in exceptional monetary expansion, creative lending mechanisms, and essentially zero interest rates to encourage bank liquidity and money flows. The exercise, which began in the 3rd Qtr. 2008, is yielding positive lending and jobs growth after 2½ years. Various financial tools or facilities were innovated to encourage short term financing, when counter party (lender) distrust peaked in the 4th Qtr. 2008 and 1st Qtr. 2009. An increase in corporate spending for mergers, acquisitions, and public offerings, increased dividend payouts, and added capital expenditures indicate positive results.

The AT&T initiated acquisition of T Mobile wireless from Deutsche Telekom is significant. *When elephants dance, the collateral impact is large.* AT&T is currently offering \$39B, in terms of \$25B cash and \$14B AT&T stock (or an 8% AT&T interest). An estimated 34M subscribers would be added to give AT&T about a 38% part of the U.S. wireless phone market versus about a 31% portion for Verizon. J.P. Morgan is the sole financier providing \$20B cash for 19 months. AT&T included a \$3B breakup fee to Deutsche Telekom if the deal is not completed. There are a number of points to take away from the proposed transaction. AT&T is confident enough that it will work its way through the maze of U.S. and global regulators to include a \$3B breakup fee in the offer. J.P. Morgan is confident in the economy and willing to loan \$20B cash without spreading the deal and risk to other banks. Major suppliers of AT&T, T Mobile, Verizon, and Sprint will reassess their markets and likely merge to maintain competitive positions. As financing funds are flowing in a steadily improving economy, other sectors of the economy, including healthcare, will likely reassess risks and use their substantial cash accounts to acquire strategic corporate assets. During the 1st Qtr. 2011 U.S. corporations spent \$257B for M&A, which was the most since the 2nd Qtr. 2008. They will likely to spend more in the upcoming quarters.

4/1/2011

Public offerings are also increasing and require financing. They come in a few varieties. Private equity companies are selling companies that they bought from the public market prior to the 2008/2009 Great Recession as Initial Public Offerings. They are also buying assets considered to be undervalued in the public market for many reasons. The number and total dollar amount of private offerings increased in the 1st Qtr. 2011 and is likely to increase for the next few quarters, as private equity firms are willing to take risks and able to get funding from various sources. Floating rate short term mutual funds sponsored by pseudo banks are stepping in to provide reasonable financing rates.

A steady increase in capital expenditures, primarily for software and equipment lasting less than 3 years, is shown in the 4th Qtr. 2010 GDP 8% year over year increase. This differs from past recoveries, when building construction and major equipment added to a higher rate of capital expenditures. Yet, the process is positive and corporate cash is being used.

Corporations are also spending their cash for stock repurchases. Smaller numbers of shares outstanding naturally increase the reported earnings per share. In the 1st Qtr. 2011 share buybacks increased 38% over the 1st Qtr. 2010.

The trend of dividend payout increases is positive. Optimists calculate that dividends will reach \$31 per S&P 500 index value or a 20% rise in 2½ years. Liquidity is high. Corporations are spending significant cash flows as their risk appetites increase. FRB stimulative easy money is the basis for the cash spending that is lifting the economy to steady moderate growth. Monetary intervention should now be reduced to limit the major risk - future inflation.

Macroeconomic Liquidity Logic

Federal Reserve published data analysis provides another approach to judge if the FRB has been effective to date in achieving its conflicting dual objective of price stability and full employment.

Price stability is elusive. Historically, price stability meant a representative set of goods and services would not vary in price more than about 2% from zero price change. Gold or silver was usually used to back the currency medium of exchange. Deflation and inflation occurred historically, but over decades, in nations such as the United States during the 19th century, price

stability existed with no long term inflation or deflation. Balance of trade payments between sovereign nations often caused dislocations that resulted in short term inflation or deflation during periods of recessions or depressions.

Since President Nixon severed the last link for foreign trade payments convertible to gold in 1971 and Congress changed the FRB single objective of price stability to the dual objective of price stability and full employment in 1977, the FRB definition of price stability changed. It now means either core consumer (goods and services) price inflation (CPI) less food and energy in the range of 1% to 2% annually or the personal consumption expenditures index referenced inflation less than 2%.

Chairman Bernanke has stated that some inflation (currency devaluation) is good based on the expectation that a long term inflated asset class, housing, will reach stable prices at the risk of other asset price inflation bubbles developing. The primary analysis should focus on when the FRB determines that inflation is unacceptable and starts the process of selling its portfolio of U.S. Treasury (higher bond/mortgage rates) and other securities bought during the weak economic period, adjusting reserve requirements, and raising short term interest rates to their real economic level (currently in a 2% to 4% range.) If the FRB focuses on the core CPI, we can make an educated guess that it will exceed 2½% at the end of 2011. There have been 3 recent months of 0.2% core CPI and there are commodity price indications that it will continue to rise at the 0.2% through year end. The compounded CPI core rate will likely reach 2½% by year end. Another factor is that the core rate includes a major housing equivalent rent factor. Since little new housing is being built and vacant housing for possible occupancy is hard to analyze, a modestly growing economy may result in a net national rent factor increase to further boost core CPI by yearend.

St. Louis FRB regional bank monetary data and analysis provide useful information. Historical graphs show key monetary factors, MZM and M2, and related velocity ratios, GDP/MZM. MZM is *money at zero maturity* and made up of currency cash, checking accounts, savings accounts, and money market funds. It is similar to M2 with a certificate of deposits adjustment. The trend of MZM has been steady at a 5.2% annual growth rate, while the velocity factor,

4/1/2011

GDP/MZM, increased from about 1.49 to 1.55 during the past 12 months. While the ratio remains depressed from the past 10 yr. average of 1.80, a great deal of money is being printed during QE2 in order to get to the 1.55 level. I expect the velocity factor to reach no higher than 1.62 prior to the CPI (4¼%), core CPI (2½%), and USD currency depreciation (-5%) becoming politically unacceptable at about yearend. The FRB may be forced to become less stimulative and observe that the economy has reached a self-sustaining 3% GDP growth rate escape velocity. Then a change to a neutral monetary policy and historically adequate liquidity will be executed.

Will corporate net profit margins continue to rise?

The current record high net profit margin (total S&P 500 index 8.6% and ex-financial sector 8.3% in 2010 using Zacks data) is causing head scratching by value oriented analysts and investors. *How much higher can NPMs be reasonably expected to go?* Analysts expect 2011 and 2012 NPMs to continue to rise in total (9.6% and 10.3%) and ex financials (8.8% and 9.4%) to higher record levels. They are increasing 2011 and 2012 earnings forecasts in the midst of a 17% oil price rise during the 1st Qtr. 2011. Some economic sectors are minor users (consumer discretionary and health care) of energy. Others (consumer staples) have dominant pricing power and can pass higher energy costs to customers. And another sector, naturally supplies the commodity (energy) at a likely higher NPM. Yet the majority of economic sectors (industrials, technology, and utilities) will likely see energy costs increase and NPMs decrease. In total, an increase in NPMs, while energy costs increase about 15% in 2011 and further in 2012 is not intuitively clear. Financing costs are another factor likely to impact NPMs in 2012. The financial sector NPMs will be squeezed and their customer economic sectors will also be limited if financing charges increase 1% or more.

Economic sector level NPM analysis also questions the expectation of rising values. In 2011 the main expected driver for an increase in total S&P 500 NPM from 8.6% to 9.6% is a leap in Financial Sector NPM from 10.7% to 15.7%. The NPM jump looks unsustainable and due to reverse impaired asset valuations or usage of remaining tax credit carryovers. These non-operational factors will run their course and NPMs will fall. The S&P 500 ex financial

Sector NPM jump from 8.3% to 8.8% in 2011 is also puzzling. The most profitable Technology Sector NPM is forecast to rise from a sky high 15.3% to 16.3% in 2011. The economic sector is subject to unexpected product demand changes, just in time material shortages, and the previously mentioned energy impacts. The Consumer Staples Sector NPM is also forecasted to jump from 9.9% to 11.8%. Possibly large inflation costs can be passed to customers to artificially inflate the NPM. Yet, in the final analysis favorable NPM related factors appear more like extrapolations of current favorable conditions than clearly identified new items.

When does market confidence become perilous complacency?

Emotional sentiment or behavior indicators are fickle. Statistical inferences generally signal secondary signals, when assets are mispriced far from fundamental values. A catalyst for change must also be correctly spotted within a relatively tight opportunity time frame. That is difficult. Assets can remain mispriced for long periods such as the 12 months of 1999. *The markets are confident that the Bernanke QE2 will continue to add liquidity and demand for higher asset prices.*

The 1st Qtr 17% increase in oil prices and visible \$4 per gallon gasoline prices based on North African and Middle East supply uncertainties did not affect investors. Potential global supply shortages for the 2nd and even 3rd Qtr due to the tragic Japanese massive earthquake have not affected global investors. Sentiment indicators are positive and somewhat mixed, while the February and March employment reports, averaging slightly more than 200,000 average net new jobs created, are encouraging. The market letter writers (Investors Intelligence) remained net positive (bullish) through out the 1st Qtr. They are often a contrarian indicator, but were right recently. Small investor (AAII survey) sentiment is sometimes a contrarian indicator; yet, it was somewhat neutral during the period.

The excess liquidity is lifting nearly all asset classes. The total CRB commodity index rose 8% during the 1st Qtr. The price of Silver rose 25%, while Gold gained a modest 1% after a significant 2010 gain. Volatility (S&P 500 VIX) spiked once to 30 (highest fear level in 8 months) in mid March at the peak of the Japanese earthquake and oil supply uncertainties, but returned to the low fear level of 17 within a week and finished the 1st Qtr at that level.

Investors are relying on the primary factor that QE2 ending in June will leave enough liquidity and demand in markets to avoid a rise in 10 yr. Treasury bond yields to 4.0%, a rise in 30 yr. mortgage rates above 5¼%, slower earnings growth, and a fall in stock prices. Confidence and complacency may be the correct sentiment in the intermediate term 2nd Qtr; yet the inflation factor and USD depreciation factors are likely to create problems for stock markets by the 4th Qtr. *Invest prudently in potentially perilous waters.*

Global Economies

Emerging country (China, India, and Brazil) banks tapped on the brakes with higher interest rates during the 1st Qtr to slow down their currency inflation, which is partially caused by a weak and highly liquid USD. Their forecasted GDP growth shown in Table 1 (*Economist* data) exceeds developed nations in 2011 and 2012. Table 2 shows related emerging country higher short term rates than long term interest rates. Notice that in spite of its euro currency issues that the European Common Market (ECM) is forecasted to grow at about the same rate as Great Britain and Japan. The U.S. fiscal policy with higher deficit spending and very stimulative monetary policy is taking more future price stability (inflation) risk than all developed and major emerging countries.

Table1. Economists Forecasts

Economic Market	2011 GDP	2012 GDP	Current 2011 Unemployed
United States	3.3	3.2	9.8
Japan	1.7	2.0	4.9
China	9.0	8.7	9.6
Great Britain	1.6	2.0	8.0
Euro Common Mkt	1.6	1.7	9.9
Germany	2.6	2.0	7.3
Russia	4.3	4.5	7.4
India	9.0	8.7	10.8
Brazil	4.3	4.5	6.1

Table 2. Current Global Yields

Economic Market	3 month	10 Year
United States	0.2	3.4
Japan	0.2	1.2
China	4.3	3.9
Great Britain	0.8	3.5
Euro Common Market	1.2	3.2
Russia	8.0	4.8
India	7.3	8.2
Brazil	11.7	6.2

Personal Goals and Portfolio Management

Investment market commentaries usually focus on asset valuations, risks, and expected returns in the context of rational decision making. Yet at least quarterly, personal goals and uncertainties should be pondered by normal emotional people, who are not consistently cognitive or rational.

Now is a good time to consider risk taking and personal goals. If goals were met in the 1st Qtr, and a wealth spending surplus buffer developed, transferring a small portion of risky equity assets to generally less risky balanced equity/bond funds may be considered. As discussed, U.S. investors have a confident 2011 outlook and their confidence has been profitable for three consecutive quarters. At minimum, a scenario of higher volatility after the scheduled end of QE2 in June should be pondered. Nine quarters of above average (8%) balanced portfolio (55% stocks, 35% bonds, and 10% cash) returns are possible. Yet the average period of post recession bull markets, prior to a correction of 15% is 26 months. Remember the uncertainties of March 2000 to March 2003 and November 2007 to March 2009. It is normal to become emotional and irrational during those times and take greater risks, when wealth plan deficits grow. As suggested at the end of 2010, watch for asset valuation bubbles (e.g. Google and Apple stocks trading for more than 25 times past 12 month earnings) and consider transfers to less risky dividend paying or stable cash flow investments gradually if bubbles develop during 2011. In wealth management, that is moderately conservative value investing focused on personal long term spending goals.

Markets and Economic Sectors

Asset returns except housing (and some bond classes, which were about unchanged) were positive during the 1st Qtr 2011. Higher risk U.S. securities, such as small capitalization stocks (8%) appreciated more than large cap stocks (6%). Growth company stocks appreciated slightly more than value type stocks. All commodities (8%), particularly Silver (25%) and Oil (17%) participated in the increased valuations. The environment is speculative and price momentum driven by monetary liquidity.

Growth equity and commodity assets historically have earned their highest returns in similar speculative periods with above expectation economic growth and overly confident investors,

4/1/2011

as discussed in the 2010 year end BWM Letter. That is simply what happened in the 1st Qtr 2011.

Technical Analysis

The U.S. stock market is technically advancing with a narrower breadth of issues than in the 4th Qtr 2010. The VIX (S&P 500 options) continues to trade at a fearless level (17), and investors are confident (yet not at most extreme levels). Stock markets are more risky than in 2010 because they are supported by an unsustainable stimulative monetary policy and assets are priced at fair value. More volatility is probable in the future.

U.S. Economic Sectors

Materials Sector 1st Qtr. earnings are expected to lead the market as noted by recent upside earnings forecasts revisions. Returns matched the S&P 500 Index (6%) in the period. 2011 earnings and sales growth is forecast to lead the index. No suggestion. Energy Sector earnings grew similar to the S&P 500 index. Yet returns about matched the 17% rise in the price of oil. Recent earnings forecast revisions are accounting for the steep rise in oil prices. Consider dividend paying assets. Financial Sector earnings and price Relative Strength (RS) lagged the S&P 500 in the 1st Qtr. No Suggestion. Industrial Sector earnings and RS slightly beat the S&P 500 Index. Earnings forecast revisions are positive. 2011 sales are forecast (10%) to lead the S&P 500 Index ex-financials (6½%). Hold. Technology Sector earnings and earnings surprises slightly beat the S&P 500 Index, but price RS slightly lagged. Tech stocks are priced based on extremely high NPMs. Suggestion: Hold or take partial capital gains profits. The Consumer Staples earnings growth and RS lagged the S&P 500 and 2011 forecasts are also lagging. Hold only dividend paying stocks. Utility Sector Stocks earnings and price RS lagged behind the S&P 500 Index and 2011 forecasts are also lagging. No suggestion. *Healthcare stock earnings growth lagged, but price RS led the S&P 500 Index. No suggestion; yet based on low valuations research these stocks.* Consumer Staples, Utility, and Healthcare stocks are normally defensive, stable earnings stocks, which lag other equity assets during speculative periods, such as the current condition. Consumer Discretionary stock earnings varied with market average returns vs. the S&P 500. Hold selectively. Treasury Bonds (0%) under performed stocks in the 1st Qtr and are influenced by FRB QE2 manipulation. They

still appear overpriced; shorter maturities suggested. Corporate bonds yielded about 1%. The price of Gold (1%) lagged behind the S&P 500 Index stocks (6%) in the 1st Qtr. Hold.

Suggestion: Hold normal portfolio asset weights; but consider selling weak holdings that are lagging the related markets. Shorten bond durations (maturities). Stock market psychology is positively biased; market prices are extended. Liquidity is cheap. Markets are fairly and fully valued. *Think about your risk tolerance.*

Alternative Investments – Diversification

The Real Estate Investment Trusts (REITs) index performed in line with the S&P 500 Index in the 1st Qtr. Well researched partnerships and energy MLPs may be effective ways to profit from income producing real assets. Gold funds are diversifiers. A 5% weight in a gold exchange traded fund (GLD) (1% in 1st Qtr 2011) is suggested.

Current portfolio themes are:

Normal Investment Weights

- U.S. large stock funds normal weight
- U.S. small stock funds normal weight
- Foreign EAFE funds underweight; Emerging stock funds normal weight
- *Sell part of underperforming asset positions*
- Fixed income – TIPS and short term notes
- Gold – Normal (5%) Positions

Disclosure: Personal holdings: Below normal weights
39% Domestic & Intl Large Cap stock funds,
(17% Total International stock funds)
44% Small/ Mid Cap funds,
17% short term U.S. & Intl. bonds and cash
Large Stock decrease; cash increase changes - **bold**

**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.

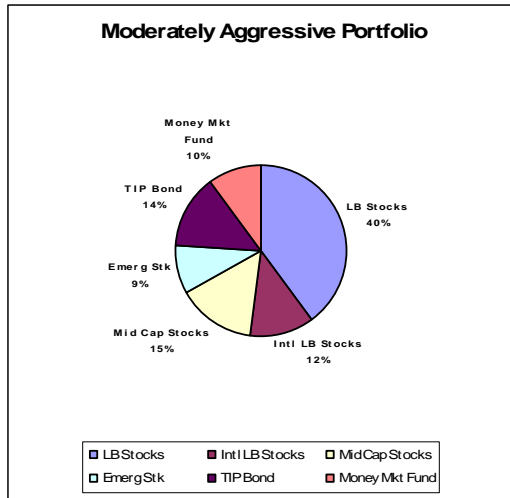
- 40% Large Blend Stock Index Funds
- 12% Large Blend International Fund
- 15% Mid or Small Cap Stock Fund
- 9% Emerging Market Stock Fund
- 14% TIP Bonds
- 10% Money market cash

Sample Portfolio B - Conservative

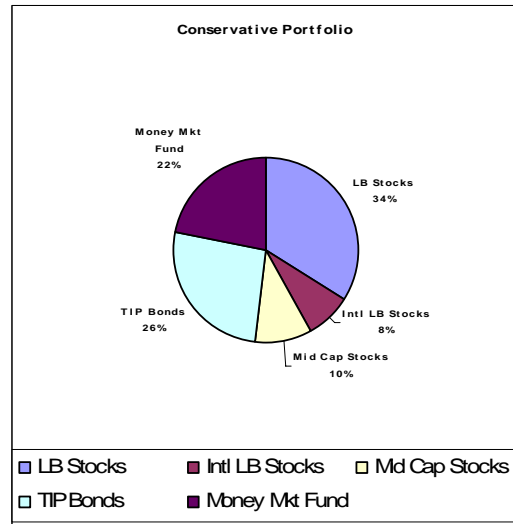
Example 65 year old couple with Social Security Income (20% of spending needs) and Retirement 401K or Pension Plans converted to IRA's

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

Normal Capital Accumulation –



Normal Capital Preservation –



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