

BWMInvestment
Guidance**April 2010 Financial Markets Review**
*Sell in May or Stay?***Key Points**

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|---|-----|
| 2010 Year to date Returns | |
| S&P 500 (1186) | 7%; |
| US 10Yr Bond (3.66%) | 3%; |
| NASDAQ (2461) | 9%; |
| Foreign (EAFE) Stocks | -1% |
| • U.S. GDP expected expansion = 3+% | |
| • 2010 earnings expected increase = 35% | |
| • 14 month stock market advance continues | |
| • Solid economic recovery in process | |

Executive Market Snapshot

This review analyzes the mantra “Sell in May and Go Away” in the midst of an extraordinary earnings recovery during the past 2 quarters. U.S. stock markets (S&P 500 +2% and NASDAQ +3%) made small April advances, while foreign markets fell (-2%). Smaller and medium size company stocks continued to perform better (5%) than larger company stocks. Strong 1st Qtr. corporate earnings reports, with high profit margins and sales expansion, are the story. Industrial production, tech and business service investments, consumer spending and inventory restocking continued in the 1st Qtr. GDP (3.2% est.) after a 4th Qtr. (5.6%) advance. Analysts raised earnings forecasts, 2010 (+35%) and 2011 (+19%). Gold prices rose (4%), while the U.S. dollar climbed (2%) vs. the Euro (Greek, Portuguese, & Spanish debt downgrades) in April. The U.S. 10 Yr. Bond return improved with a 2% drop in yield. Leading economic indicators continue to forecast solid 2nd half 2010 growth. The U.S. executive and legislative government branches are in the midst of financial reform control efforts after passing a very partisan health care control law. President Obama is focused on polarizing politics. Many Democrats will need to respond to distrusting voters for high unemployment and a massive expansion of government controls, deficits, and the national debt in the November elections.

Themes

- **How strong are corporate earnings? Will they continue?**
- **How may an investor view long term asset values in light of uncertainties?**

Earning growth story is simply great.

The 1st Qtr. 2010 earnings, with nearly 50% of S&P 500 companies reporting, are extremely robust. Recalling your initial calculus course, the first derivative or rate of change of earnings in the 1st Qtr. 2010 versus the 1st Qtr. 2009 is very high. The combination of near zero short term interest rate expenses, cautious outlays, limited hiring, and near 2007 record high profit margins are boosting up bottom line earnings.

The data of Dirk van Dijk at Zacks Research¹ is the primary S&P 500 earnings and revenue information. Positive earnings surprises are leading negative surprises by an unusually high 5.7:1 ratio and the midpoint (median) surprise is +7.2% (versus a normal +3%). Total earnings for the S&P 500 companies are now forecasted to expand 35% in 2010 and a further 19% in 2011.

Sales growth is also noteworthy with a sound positive 2.5:1 sales surprise ratio and a median +1.43% surprise. Recall that the 1st Qtr. 2009 was the depth of the recession and 2009 S&P 500 sales fell 6.8%. A 2010 3.6% rise in sales is forecasted to result in an S&P 500 35% earnings recovery, from 2008 (-27.3%) and 2009 (-7.4%) earnings declines. A 2011 7.0% S&P 500 sales rise is forecasted to result in an added 2011 19% earnings recovery. To put the forecasts into perspective, 2011 S&P 500 earnings are forecasted to reach a level 8.3% above the 2007 record level. Thus the stock market optimists (bulls) recommend holding stocks in anticipation of an S&P 500 price level in 2011 of at least 1350. (The S&P 500 index peaked at a price of 1565 in October, 2007.)

Economists and analysts forecast earnings from the macroeconomic top down, as well as from a summary of individual company microeconomic bottoms up. The bottom up view usually results in a better attribution of component factors and understanding of which economic sectors are driving sales and earnings expansion. The bottom up method shows double digit sales recoveries for industrial, auto, materials, energy, and consumer discretionary retailers and related earnings recoveries. Financial companies, which borrow short term money in various forms at nearly free rates (0 to 0.5%), and either lend or leverage their own trading or derivative businesses, are generally showing significant earnings recoveries. Their reduced loss reserves for depressed assets (mortgages and derivatives) also boost earnings. The computer and related

technology sector continues to show revenue and earnings forecast growth. The top down and bottoms up approaches seem to converge on technology sector growth. In the macroeconomic view, business capital expenditures for computers, software, and related investments are the basis for productivity gains. Business services from IBM and others are closely related to the technology sector, and showing stable high quality earnings growth. Although residential and other construction spending is slowly improving from depressed levels, it does not appear to have the sustainable growth potential of the technology sector. The so called defensive economic sectors, consumer staples, utilities, and health care, are lagging behind with stable earnings forecasts. Health care and utilities have special uncertainties after various controls have been enacted, that add risk to their earnings forecasts.

Cash is King

A study by Standard & Poors Research, prior to 1st Qtr. 2010 financial reports, calculated that the S&P 500 companies, other than financial bank related firms, held a record \$834B in cash and cash equivalents. In addition to record operating cash flows, they borrowed through bond offerings at relatively low interest rates during the past year. The high cash levels give them flexibility. Choices include previously discussed capital expenditures, acquisitions, stock repurchases, and dividends. S&P 500 company dividend yields of 2.0% are expected in 2010. Yet they remain 16% below 2008 peak levels, due primarily to bank dividend cuts. That leaves stock repurchases and acquisitions, as the primary uses of cash. Stock repurchases simply reduce shares outstanding and boost earnings per share. With cautious hiring and record low interest rates, S&P 500 firms show exceptionally high liquidity. In fact, an eventual rise of the federal fund interest rate to a normal nominal 4% level (assuming 2% inflation) and real 2% interest rate in 2011 does not appear to impact most earnings forecasts.

Corporations remain lean, highly productive, and at this point cautious to increase hiring in the midst of numerous new government regulations, higher health care benefit costs, and uncertain new taxes. The consensus is that very high profit margins will decline, as significant hiring rates develop. The consensus may be wrong. High profit margins, guarded hiring, and steady earnings gains have a good chance of continuing.

As usual, we consider the question “What is an asset worth?”

The Zacks bottom up S&P 500 2010 (\$77.48) and 2011 (\$92.26) and top down 2010 (\$79.75) and 2011 (\$92.92) earnings estimates have risen more than 10% in 4 months. The professional analysts have followed corporate executives and increased forecasts significantly. As previously noted, if the 2011 forecast is achieved, then it will exceed the 2007 record. A scenario of the S&P 500 Index at a 1350 level translates to a forward Price/Earning valuation of 14.5 or the long term average P/E ratio. The reciprocal earnings yield is 6.9%. An alternative less risky bond yield is 5.75% (Vanguard Investment Grade Bond Fund). Thus, *if inflation remains in the 2% to 3% range, there is a 1% risky asset premium for owning stocks over bonds. Stocks appear to be fairly valued to gain 10% by the end of 2011.* Extremely stimulative monetary policy appears to support higher investment returns, while extremely stimulative fiscal policy does not appear to be able to meet its goal of an 8.0% unemployment rate in the next 12 months. (The longer term problem of massive Obama Administration government expansion will occur later, if not stopped. Don't confuse intermediate term investment circumstances with longer term more important losses of liberty.)

What is the investor's view?

There are two distinct types of investors; institutional investors, who manage assets for pension funds, endowments, and high net worth entities, and retail investors, who get most of their information from the nightly news, brokers, and planners. Generally, institutional investors work to approved Investment Policy Statements with very rational goals, constraints, and reviews. Retail investors and speculators at times work with planners and have Investment Advisor Agreements, but in many cases change plans under elevated stress (Sept. 2008 to Feb. 2009). Human risk tolerances change under emotional stress. Retail investors are normal, but more often irrational than institutional investors.

During the past 14 months, institutions have reevaluated investment conditions faster than retail investors. The institutions have been net buyers of equities during the stock market recovery, while retail investors have been net buyers of bonds. The retail investor has begun to accept equities, as investments during the past 2 months, as witnessed by demand for small company stocks and related mutual funds.

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The money market fund levels of retail investors are near normal levels after recent year bond purchases. The retail investor appears to have some money market fund resources to buy more stocks. With the relative strength of corporations, it appears that their bond credit ratings may improve relative to U.S. and other government bonds. All things considered, short term bond rates may increase more than long term rates (flatter yield curve), so that few bond fund redemptions may flow into stock purchases. The net effect appears to me to be modest retail investor potential demand for stocks.

A Slight, but Noticeable Difference of Views

Investor emotions are often measured by weekly polls of small investors (150,000 Amer. Assoc. of Individual Investors (AAII)) and Investment Intelligence's newsletter writers' bullish and bearish sentiment. Poll results do not always agree and they tend to have a better record as contrarian indicators at market lows than at market price highs. Thus, it is worthwhile to note that the recent AAI survey of median 60 year old investors shows normal investment portfolio asset allocation (Stocks 54%, Bonds 22%, and Cash 19%) and near normal expectations (41% bullish, 30% neutral, and 29% bearish). The newsletter writers, in contrasts show excess optimistic sentiments (54% bullish, 18% bearish and 28% undecided). The 36% bull/bear spread can stay frothy for a while, yet the view should indicate to be cautious. Market corrections (10%) are normal during positive economic conditions such as now, when prices get ahead of values.

Should You Sell in May and Go Away?

Let's look at some analysis^{2,3} by Sven Bouman and Joseph Meth to see if the mantra is good advice. The saying is sometimes called the Halloween indicator, which is based on the belief that the period from November to April inclusive has stronger equities average growth than the other months (May to October). (British historians may also recognize the original saying "Sell in May and go away, stay away till St. Leger Day" (the last day of the British horse racing season.)) Bouman's study showed the effect occurred in 36 out of 37 countries, goes back to 17th century Britain, and is strongest in Europe. There is a loose relationship to past seasonal interest rate cycles (lower interest rates/higher stock returns). However, in a 22 years period beginning in 1982 with exclusion of the volatile 1987 and 1998 markets, there appeared to be no exploitable anomaly.

Meth took a simple approach to check if there is an exploitable trend, by reviewing 71 years of S&P 500 monthly closing prices beginning in 1939. He found that 47 of 71 May to October (bearish periods) or 66% had positive returns, while 50 of 71 November to April (bullish periods) or 70% had positive returns. Also relevant is that in 44 of 70 years or 62% of the periods, the market performed positively or negatively in the May to October period after a similar November to April period performance. That implies momentum or the 3rd factor in Fama and French's famous size, valuation, momentum three factor stock returns model. Maybe "The Trend is Your Friend", is a better mantra, than "Sell in May and Go Away"? Simple short cut tactics are interesting, but they are rarely exploitable for investment strategies, if the general market is aware of them.

Another usual question to ponder is "How long will extremely stimulative 0% FRB short term interest rates last?"

No one knows the answer to the question based on possible economic scenarios and the U.S. central bank's response. Yet we have two kernels of information that allow us to make an educated guess. The short answer is extremely stimulative near 0% rates will most likely be extended until after the November elections. First, the 25 page April 7 testimony of former FRB Chairman Greenspan to the Financial Crisis (2008 meltdown) Inquiry Commission not only focused on the surge in questionable loans by major U.S. government sponsored enterprises (GSEs) Fannie Mae and Freddie Mac. It also discussed the political situation that the chairman felt locked into. Chairman Greenspan essentially stated that he did his best to warn about the housing bubble. Yet the political situation due to Congressional and Dept. of Housing & Urban Development pressure was too unbearable to raise then 1% FRB rates in 2004 and thus reduce cheap money liquidity to feed the bubble. Second, President Obama announced the appointment of 3 new members, Janet Yellen, Sarah Bloom Raskin, and Peter Diamond, to the 7 member FRB board on April 29. Janet Yellen's appointment as FRB Vice Chairman concerns me the most. I have read and listened to the former FRB Bank of San Francisco governor. She is an easy (soft) money advocate that will most likely continue to argue for low interest rates long after they are appropriate. The desperation of the Obama Administration to reduce the unemployment rate at any long term

cost will result in too much pressure against the Federal Open Market Committee to increase interest rates prior to the November elections. There will likely be 2 consequences. A normal growth (3 to 4%) economy requires real (above inflation) rates to properly allocate money, but speculative low interest rate trading bubbles may develop instead. A look at the Bank of Canada and Bank of Australia interest rates also indicate that there should be some movement toward normal interest rates now. Other than with the Euro, which has serious internal problems, the U.S. currency exchange rate may be impacted by artificially low rates in the 3rd Qtr. But, I am humble enough to know that FRB members are smart, have more information than I do, and their approach may be better than my suggestions.

European and Japanese economic recoveries remain weak due the Greek bailout and high government debt load rigidity, respectively

Notice in Table 1 that the European and Japanese recoveries are forecasted by *Economist* contributors to be weaker than the more normal U.S. recession recovery. They expect 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. The resistance of Greek public workers to reduce their lavish benefits may result in a larger issue: German departure and the end of the Euro.

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	3.1	3.0	2.0
Japan	1.7	1.6	-0.9
China	9.5	8.1	3.5
Euro Common Mkt ECM	1.0	1.2	1.2
Russia	3.6	4.5	7.9
India	7.7	8.0	10.7
Brazil	5.0	4.8	4.7

The total 2010 global economy is expanding (3.2%) with Asia leading the way. In Table 2 the U.S. positive sloped yield curve remains the most stimulative monetary policy in the world. The U.S. FRB still forecasts low (0 – ¼%) bank borrowing rates for an extended period. Most countries have stimulative positively sloped yield curve monetary policies.

Table 2. Current Global Yields

Economic Market	3 month	10 Year
United States	0.2	3.7
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

In next month's review, when the Financial Sector Controls Law is nearer to passage, potential impacts will be analyzed

Economic Sectors and Investment Outlooks

A Technical Overview (BPNYSE, etc) indicates U.S. stock prices are trending higher with some Euro currency related volatility. Money supply growth (M2) was normal (2%) over the past 6 months, but velocity remains subdued. Smaller growth company stocks, primarily in the broad technology sector and some narrower industries, continue to lead price advances. **Suggestion: Hold normal portfolio asset weights. The S&P 500 earnings forecasts are very strong. Market prices are extended. Yet continued low interest rates will likely add to speculative intermediate term demand. Last month's comment of an S&P 500 top @ 1250 in 2010 may be too conservative in the context of continued easy money. The market is risky, but I am now agnostic about suggesting a 2010 S&P 500 top price.**

Economic Sector Analysis and Outlook

Telecom sector stock demand is weak, as noted by negative sector price Relative Strength (RS) with respect to the advancing total stock market. Avoid. **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 weak and sales may decline. Consider selectively holding

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long term dividend growth stocks. **Energy** sector 2010 earnings growth (43%) is expected to recover from 2009 declines (-56%). RS is in line with the general market. During April oil prices rose 3% to \$86 per barrel ahead of most commodities, while the USD strengthened. Research top quality oil services companies for possible purchases. There may be undervalued stocks in this sector that politicians love to hate. The above sectors include dividend candidates for value investors. **Healthcare** sector 2010 earnings are forecasted to be solid (+8%). After the healthcare sector control act (PPACA) was passed, little stock movement occurred, but in the recent month the sector lagged behind the market. Stock P/E valuations are below normal and the lowest of any sector in 2010 (12) and 2011 (11). Hold selective positions that are well understood. **Technology** Sector stocks have participated in the 1st Qtr. market advance and positive surprises continue. This is the growth sector with good cash flows, high forecasted 2010 sales (13%) and earnings (38%) growth. 2010 P/E valuations (16) are 8% above the general S&P 500 market. RS is in line with the market. Hold selective gainers. The **Consumer Discretionary** sector remains cyclical with opportunities for retailers, who have tight inventory controls and anticipate customer trends. Sector RS leads the market. Hold leaders as discretionary spending increases. 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 the weak Euro. The sector RS is neutral. Hold. The **Financial Services** sector benefits most from very cheap federal funds. Hold. **First Qtr. 2010 earnings reports are outstanding with half of the S&P 500 firms reported.**

Summary Suggestion: Hold normal stock and bond portfolio positions. The Tech sector is volatile, but with positive sector potential. Small company earnings and price advances lead large company earnings and price advances. 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). However, it appears worth while for long term investors to hold for normal forward quarter returns, in spite of a potential 10% correction at any time.

International Markets Are Quiet

Foreign stock market returns have been flat year to date, while the USD strengthened (8%) 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 US 10 year Treasury bond returned 3% YTD. Investment grade corporate and GNMA bond returns (2.7%) were similar, 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 (6%) in April, after an impressive 1st Qtr. (10%) 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. A 5% weight in a direct gold exchange traded fund (GLD) (6% year to date) is suggested.

Portfolio Management

Funds have little cash (3.3%) to boost stock prices higher. The S&P 500 index trades at a normal 2010 P/E (15). Be selective and remain diversified. Economic strength will likely cause the FRB to tighten monetary policy after the November 2010 elections.

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 (5%) 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**

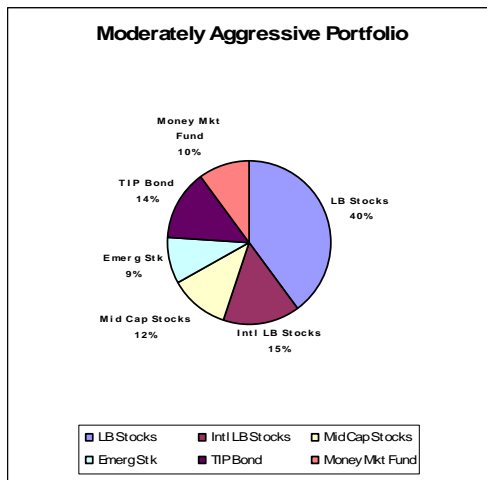
Sample Portfolio A - Moderately Aggressive
Example 45 year old college educated parents with 1 high school child and 1 college child.

- 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

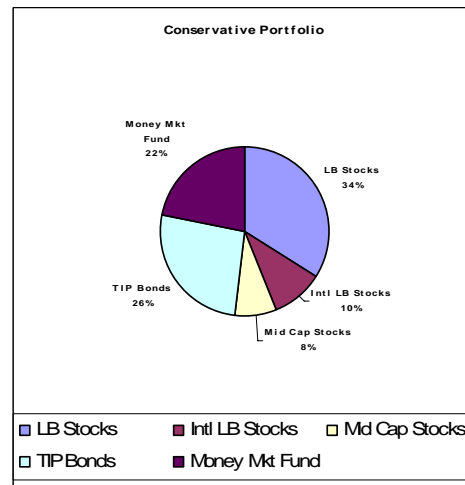
Sample Portfolio B - Conservative
Example 65 year old couple with Social Security Income (20% of spending needs) and Retirement 401K or Pension Plans converted to IRA's

- 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 Accumulation –



Normal Capital Preservation –



Footnotes

¹www.Zacks.com

²Meth, Joseph *Sell in May And Go Away – Again?* www.dailymarkets.com, April 26, 2010

³Bouman, Sven; Jacobsen, Ben *The Halloween Indicator, Sell in May and Go Away: Another Puzzle*, American Economic Review, 2002

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