BWM

Investment
Guidance

April 2011 Markets Review
Extremely Stimulative Monetary Policy continues to boost earnings and speculation

Key Points

- ***2011 Year to Date Total Returns***
  S&P 500 (1363) 9%;
  US 10Yr Bond (3.30%) 1%;
  NASDAQ (2873) 8%;
  Foreign (EAFE) Stocks 9%
- U.S. GDP expected expansion = 2.9%
- 2011 expected earnings increase = 16%
- Stock market – trend remains positive
- Modest economic recovery

Executive Summary

Equity market returns rose again (S&P 500 2%, NASDAQ 3%, EAFE 6%) in April. Bond market U.S. Treasury (UST)) returns (1%) rose due to small price increases. The weak southern countries (Greece and Portugal) continued to drag the euro currency down and limit growth in the European Common Market (ECM). Yet, the U.S. dollar (USD) was devalued much more versus the euro (5%) and all currencies, due to the Federal Reserve Board (FRB) increased UST securities purchases in the Quantitative Easing 2 (QE2) program that is 90% complete. U.S. GDP growth (1.8%) slowed in the 1st Qtr. per the preliminary estimate. A 20% rise in gasoline prices over the past two months was a key factor. Oil closing at $113/barrel rose 6½% in April, as commodities surged. Profits grew above forecast with 65% of S&P 500 company financial reports released. Some industrial supply problems due to the Japanese huge (9.0) earthquake reduced industrial and technology sector revenues. Sizeable new U.S. jobs were created in the 1st Qtr. and are expected to continue, although initial weekly unemployment benefit claims increased over 400,000 during each of the past two weeks. The economy may be near escape velocity from the perceived need for excess FRB financing stimulus. Huge continuing (>6%) annual U.S. federal deficits and debt (>$14T) issues will be discussed. In spite of energy and other uncertainties, commodity and stock buyers are satisfied, confident, and are pushing up prices with the excess USD supply and liquidity.

Themes

- ***Very good earnings and tolerable inflation appear acceptable for investors.***
- ***Likely QE2 completion impact on financial market?***
- ***Changed political debate about federal government spending – constructive?***

Very good earnings and tolerable inflation appear acceptable to investors.

Initial 1st Qtr. corporate financial reports are very good – earnings higher, revenue gains, and net profit margins are better than forecasted. These conditions may sound like a broken recording after 6 consecutive quarters. Yet, earnings growth and expectations give equity assets value and boost prices over the long term. As of April 29, 65% of S&P 500 companies, representing nearly 80% of S&P 500 total earnings, released 1st Qtr. financial reports. Year over year quarterly growth (17% total, 20% without the financial sector) resulted in a median earnings surprise of 5% (3% normal) according to Zacks research data. The median revenue surprise (>1%) above expectation is also strong. About 73% of reports showed positive earnings surprises (62% normal) and over 50% showed positive revenue surprises. Estimates of full 2011 revenue, net profit margins, and earnings are now being made considering monetary policy, higher energy costs, and other factors. The earnings revision ratio (positive/negative) remain positive for 2011 (1.54) and 2012 (1.91). (Std. & Poors estimates higher quarterly earnings (26%) and sales growth (13%) in their format.)

The expected 2011 S&P 500 index earnings ($96.28) per cap weighted total shares at the current S&P 500 price (1363) result in the Price/Earnings (14.2) that is below the long term current one year average (14.7). (There are other P/E calculations based on historic 5 and 10 year periods that suggest the U.S. stock market is 20% or more overvalued.) Yet, the earnings yield (E/P = 7%) is an attractive risk adjusted return for many investors in comparison to U.S. Treasury 10 year maturity Bond yields (3.3%).

How do you select the equity (stock security) risk that you want to take? Are you focused on value or future growth? There are a number of factors used to measure value and growth potential. In either focus, noting the profitability of an enterprise over several periods as defined by the net profit margin (NPM = net income/revenues) is a sound approach to judge if a business is a good value. Table 1 shows 2011 S&P 500 sector forecasts of earnings, revenues, NPM, and P/E for your review of economic sector stock values.

Table 1 2011 Economic Sector Forecasted
Net Income and Revenue Growth
(NPM descending order) and P/E

Sector	Net Inc (%)	Revenue (%)	NPM (%)	P/E
Tech	18.1	11.1	16.2	14.2
Finance	14.5	-16.8	14.9	12.6
Healthcare	4.4	4.2	13.5	12.0
Consumer Staples	8.7	-8.5	11.8	14.1
Consumer Discretion	25.6	10.4	9.5	16.5
Industrial	30.3	14.2	8.5	16.5
Energy	34.2	20.6	8.5	12.2
Materials	35.6	13.0	8.5	13.8
Utilities	3.5	3.8	7.8	16.5
S&P 500	15.8	4.3	9.53	14.2

The S&P 500 total factors are cap weighted. They are not simple totals divided by the sum of the sector factors. Without Financial Sector odd revenues, 9% total revenue growth is expected. The NPM values, as discussed in the past, are worth pondering because by historical reference they appear unsustainable. Table 1 is referenced in the economic sector review. In any case, liquidity and speculation that are supporting a bubble in asset valuations are discussed next.

Likely QE2 completion impact on financial markets?

The FRB QE2 is scheduled to be completed as planned in June, per the April 27 Federal Open Market Committee's (FOMC) statement and Chairman Bernanke's historic first press conference. FRB data shows that 85% ($548B) of $638B planned Treasury securities (1½ yr. notes through 30 yr. bonds) buying is complete and expands FRB balance sheet assets to $2.69T. The purchased U.S. Treasury securities nearly equaled U.S. government deficit spending financing over the past 7 months. The QE2 goal was to support a fragile U.S. economic recovery beginning in the 4th Qtr. 2010. When QE2 was announced in August, 2010 some feared slowing GDP growth and little private employment growth in response to the massive American Reinvestment & Recovery Act fiscal stimulus required an additional monetary demand shock (Keynesian hypothesis) stimulus. Well informed economists argued that QE2 was successful, unsuccessful, and too early to judge based on beliefs and factors measured.

Supporters argue QE2 boosted 4th Qtr. 2010 and 1st Qtr. 2011 growth and employment levels above baseline expectations. Critics argue the USD relative trade weighted value vs. the reference group of dominant currencies hit a record low during the past week. Be aware that the euro is working its way through Greek and Portuguese debt crises, the British pound is coping with a deep UK recession, and the yen is responding to an earthquake related slowdown. In addition to currencies, commodities, such as oil, industrial metals, agricultural staples, gold, and silver, and U.S. stocks surged in dollar referenced prices more than 25% since August, 2010. Critics also observe foreign buyers of U.S. Treasury securities are purchasing about 20% less than their previous 40% of offerings. They worry that the FRB has leveraged up its asset purchases to nearly 50:1 of its effective capital. With a small capital base, the FRB is limited in responding to exogenous (uncontrolled external) events that may occur at the time that it decides to bring the USD monetary currency base and interest rates back to real market driven rates.

Chairman Bernanke with the support of the monetary doves, Vice Chairman Yellen and Fed Bank of New York President Dudley, will guide FRB policy as he judges best without challenge. During his press conference Chairman Bernanke stated that the FRB will use maturing security proceeds after QE2 is completed to purchase more Treasury securities as a transition prior to allowing the monetary base to fall to a less leveraged level. Eventually (December 2011?) the federal fund interest rates will be raised to external market rates.

The FRB looks at wages in addition to core inflation (normal goal less than 2%), with less focus on food and energy costs in the Consumer Price Index (CPI) and Personal Consumption Expenditures (PCE) Index, to judge if inflation is too high and must be countered with higher interest rates. The recent 20% rise in gasoline prices during the past 2 months is considered transitory partly because manufacturing capacity utilization is currently 77.4%; that is 3% below the recorded 38 year average 80.4% rate. Chairman Bernanke and his team do not feel that wages will start rising until the cap utilization rate reaches 80%. FRB reasoning is not understood by the majority of people paying much higher gasoline prices recently!

What are the FRB tools to control inflation? The FRB pays interest (now 0.25%) on money reserves held by member banks and sets interest rates (now avg. 0.1%) for interbank borrowing at the federal funds rate. The Bank of England and European Central Bank use similar systems. (Capital reserve requirement changes are other more powerful tools.) In ideal situations, banks are encouraged to lend if inflation is acceptable by lowering the rate paid on reserves and discouraged from lending by raising the rate paid. If there are no external (exogenous) factors, the range between the lending window rate and reserve holding rate can be manipulated to control borrowing and inflation. Yet, with such a tight range external shocks may alter the liquidity preferences of holders of cash and require the FRB to sell Treasury securities to soak up or take money out of circulation. Depending on the mix and amount of securities sold, the FRB can cause many odd Treasury interest rates along the maturity curve. The feared situation is referred to as the liquidity trap of a highly leveraged entity. The FRB is responsible to steer clear of that trap.

If we assume no external events causing liquidity preference dilemmas, an educated guess is that the U.S. 2011 GDP will grow between 2.5% and 3.2% (FRB forecast 3.1% to 3.3%) and that either foreign trading partner frustration with a devalued USD or U.S. consumer frustration with inflated goods prices will cause the FRB to start raising the federal funds rates at the end of 2011. The FRB will signal its intentions through its post FOMC meeting statements and Chairman Bernanke's quarterly press conferences.

Changed political debate about federal government spending – Hopefully constructive? At this point, Themes 1 & 2 established companies are currently profitable, earnings are very good, investors are now not concerned about inflation, and the FRB feels that it can reign in its massive monetary liquidity in the intermediate (next 9 months) term. Now consider the time frame past the intermediate term. The U.S. federal government spending and debt debate changed last month. *Did you notice?* More relevantly, the size of the federal government is being discussed by more than the tea party folks. A simple graph of the forecasted U.S. government spending as a % of GDP through 2021 by Economist John Taylor in his recent *Wall Street Journal* article, Obama's Permanent Spending Binge[1], illustrates how the debate changed. The graph showed that the February 14 President's 2012 Budget I request to Congress stated the U.S. government should remain at its current 24% of GDP through 2021. It also showed the April 5 House of Representatives' passed 2012 (Ryan Plan) budget would bring the U.S. federal government size back to 20% of GDP; that is the average size of the federal government for 60 years prior to 2008. Finally, the graph shows the April 13 Obama Administration's 2012 Budget II narrows the size of the federal government in 2021 to 22½% of total GDP. If the President, Senate, and House focus on similar terms, progress can be made. The 2012 Budget II is a set of political talking points and not as detailed as the House passed budget. In the background is the Dec. 2010 President's National Commission on Fiscal Responsibility and Reform Report concerning deficits and debt, which was not referenced in either proposed Budget I or Budget II. Finally, a group of 6 senators has yet to make its early May proposed government spending and tax revenue changes to address the size and the sustainability of the federal government. Markets ignored the potential shutdown of the federal government over fiscal 2011 spending appropriations. The 2012 budget debate is more important because House Republicans will require some spending limitations from the Democratic President and Senate prior to raising the debt ceiling or statutory absolute cap of U.S. Treasury borrowing ($14,290,000,000,000), when it is expected to be reached between mid May and mid July (after adjustments.)

The related debate will be how to finance government spending. The conventional wisdom is that U.S. voters want to keep the size and their benefits from government, but don't care how they are paid for. The so called wisdom may not be true, if the consequences of a large government are realistically discussed and explained. Initial polling on the House passed 2012 budget shows the public is near evenly split over changing to a citizen controlled payment and voucher Medicare system for those currently age 55 and younger. Since Medicare is the most costly entitlement spending category, that is a hopeful sign. It is noteworthy because many polls still show that the majority of the public does not favor the Obamacare Patients Protection and Affordable Care Act of 2010.

Financing the private economy and public government are related. Let's explore macroeconomic financing from the perspective of an article, Does Unreal GDP Drive Our Policy Choices?, written by an innovative thinker and investment manager, Rob Arnott[2], in his April, 2011 monthly *Fundamental Index Newsletter*. Arnott asks the question: *Does our country confuse prosperity with debt fueled spending*? GDP measures spending, but doesn't distinguish debt financed spending from asset or working income based spending. More importantly, consumption at a household level financed by credit cards or at a federal government level financed by printed fiat money is not a good measure of prosperity. GDP growth financed by additional debt (deficit spending) is not prosperity and can lead to insolvency. Lack of measured government productivity is the main reason for misunderstanding its economic value. Arnott defines structural GDP per capita as GDP after excluding net new debt obligations per person. Using 2010 dollars, structural per capita GDP after subtracting public debt actually declined 5% over the past decade. Government (federal and state) per capita outlays over the period grew 50%. Focusing on total GDP alone promotes debt financed private and government consumption. It discourages spending cuts and ridicules countries such as the U.K. that rely more on spending cuts than on U.S. deficit spending. Yet there is a limit to the patience of debt holders with illiquid and eventually insolvent creditors, as Greece found out.

Are there enough millionaires and billionaires to tax more to significantly reduce forecasted federal deficits? President Obama has a visceral instinct to raise taxes on the high income earners and expects them to statically pay higher taxes without changing their work efforts. His advisors should inform and convince him that bright people with higher incomes change their habits by working less or somehow shelter more income to avoid being punished for earning high incomes. Most people do not share the president's view of a social compact. There are too few millionaires and billionaires, let alone those earning more than $200,000 per year, to bear enough added taxes to significantly reduce the forecasted deficits at anywhere near the current level of federal spending. Analyzing tax receipts over the past 30 years shows the top 5% paid far higher portions of total income taxes in 2008 at current tax rates than in 1980 when tax rates were much higher. Higher tax rates are a simplistic approach that will not encourage top income earners to pay more taxes and likely will not result in higher total tax receipts. Tax code change focused on simplification, fewer credits and deductions, savings instead of consumption, and added total work to grow the GDP in a stable manner is a wiser approach. In any case, let the deficit, debt debates continue. Longer term prosperity and investment returns depend on the size and financing of government selected.

Global Economies

Emerging country (China, India, and Brazil) main banks tapped on the brakes with higher interest rates during 2011 to slow down their currency inflation, which is caused by a devalued highly liquid USD. Their forecasted GDP growth shown in Table 2 (*Economist* data*)* exceeds developed nations in 2011 and 2012. Table 3 shows related emerging country higher short term rates than long term interest rates. Notice that in spite of its euro currency issues that the ECM is forecasted to grow at about the same rate as Great Britain. The U.S. fiscal policy with high deficit spending and very stimulative monetary policy is taking much more future price stability (inflation) risk than all developed and major emerging countries.

Table 2. *Economist* Forecasts

Economic Market	2011 GDP	2012 GDP	Current 2011 Unemployed
United States	2.9	3.1	8.8
Japan	0.7	2.3	4.6
China	9.0	8.7	7.6
Great Britain	1.6	1.9	7.8
Euro Common Mkt	1.7	1.7	9.9
Germany	2.7	2.1	7.1
Russia	4.5	4.5	7.4
India	8.9	8.7	10.4
Brazil	4.0	4.3	6.5

Table 3. *Economist* 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	3.6
Euro Common Market	1.3	3.3
Russia	8.0	4.7
India	7.2	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. Personal goals and uncertainties should be pondered by normal partly rational and partly emotional investors (i.e. you and I). If you have set and reached 2011 investment return goals, then consider further potential 2011 investment gains as a surplus to adjust for possible future year deficits below expected returns. (Also recognize you are losing purchasing power because the USD is being devalued). You may reduce some commodity holdings, such as silver, or transfer some small stock assets to less volatile larger dividend paying stocks. The point is to recognize that the commodities and stock markets are currently driven by speculation based on loose FRB monetary policy and the traders may all try to nail down profits (in terms of a devalued USD) at the same time sometime in the second half of 2011. Many growth stocks such as Apple and Google appear to be fairly priced at P/E ratios of about 17. Other growth stocks such as Netflix and Priceline seem over priced. The demand between small/mid size and large companies is now skewed to small/mid size companies which normally are impacted more by increases in future financing expenses. That is why larger dividend paying stocks are suggested.

Markets and Economic Sectors

Asset returns except housing continued to rise in an orderly way during each month of 2011 and are now extended. Higher risk U.S. securities, such as small cap stocks appreciated (10%) more than large cap stocks (9%). Growth company stocks appreciated slightly more than value type stocks. All commodities (12%), particularly Silver (35%) and Oil (23%), participated in the increased valuations per the devalued USD. The environment is speculative and price momentum driven by excess monetary liquidity.

Growth equity and commodity assets historically have earned their highest returns in similar speculative periods with economic growth and overly confident investors, as discussed in the 2010 year end BWM Letter. That is what happened so far in 2011 and may continue for a few more months. Some people may be tempted to follow the adage: Sell in May and go away, don't come back until after Halloween day. That is a safe tactic at this time. Yet I suggest monitoring the speculation and becoming more cautious (i.e. selling part of a held asset), when trading gets disorderly (e.g. the recent sharp price rise in silver). *Enjoy the party in a rational, thoughtful way. It will end when the FRB takes away the proverbial punch bowl.*

Technical Analysis

The U.S. stock market is technically advancing and the breadth of advancing stocks expanded recently. The VIX (S&P 500 options) continues to trade at a fearless level (14.6 – lowest level since before the fall, 2008 meltdown). Both investment newsletter writers (Investors Intelligence survey) and small investors (AAII survey) are confident. Stock markets are more risky than in 2010. They are supported by an unsustainable stimulative monetary policy. Equity assets are priced at fair value. *Monitor volatility for a stock market mood change.*

U.S. Economic Sectors

Materials Sector 1st Qtr. earnings are leading the total market as noted in recent financial statements. 2011 earnings and revenue forecasts have been revised above the general market. 2011 returns (6%) have lagged behind the S&P 500 Index (9%), so that material sector Relative Strength (RS) is negative. Material sector NPMs are cyclical and generally below the market average. **No suggestion.**

Energy Sector earnings and revenues are growing above the S&P 500 index as oil is priced in the devalued USD. 2011 returns (16%) exceeded the S&P 500, but lagged the 22% rise in the price of oil. **No suggestion.**

Financial Sector earnings and RS lagged behind the S&P 500 index. Revenues and NPMs are affected by debt asset revaluations. **Avoid**.

First Qtr. **Industrial** Sector earnings and RS beat the S&P 500 Index. Earnings forecast revisions are positive based on increased 2011 forecasted sales (14%), primarily in exports priced in the USD. **Hold**.

Technology Sector earnings and revenue surprises slightly beat the S&P 500 Index and RS matched the Index. Tech stocks are priced at the market with high NPMs. Suggestion: **Hold** or take partial capital gains profits.

Consumer Staples earnings growth and RS lagged the S&P 500 and 2011 forecasts are also lagging. Some large companies (Kimberly Clark and Proctor & Gamble) are not able to pass through all 1st Qtr. commodity cost increases to consumers.) **No Suggestion.**

Utility Sector Stocks earnings and price RS lagged behind the S&P 500 Index and 2011 forecasts are also lagging. **Avoid**.

Healthcare stock earnings growth lagged, but price RS led the S&P 500 Index. Less fear of regulations and recent acquisition prices may be adding investor demand. **No suggestion**.

Consumer Staples, Utility, and Healthcare stocks are normally defensive, stable earnings stocks, which lag other equity assets during speculative periods. Yet consider them separately now.
Consumer Discretionary stock earnings varied vs. the S&P 500. **Hold selectively**.
Treasury Bonds (1%) underperformed stocks so far in 2011 and are influenced by FRB QE2 manipulation. They still offer relatively too little return for the risk; **shorter maturities** suggested. Corporate bonds yielded about 2%. The return for holding **Gold** (10%) about matched the S&P 500 Index in 2011. **Hold**

Suggestion**: Hold normal portfolio asset weights; but be aware of the environment. Shorten bond durations (maturities).** Stock market psychology is positively biased; 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 so far in 2011. 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) is suggested.

References
[1]Taylor, John, Obama's Permanent Spending Binge, *Wall Street Journal* April 22, 2011
[2]Arnott, Rob, Does Unreal GDP Drive Our Policy Choices?, *Fundamental Index Newsletter*, April, 2011

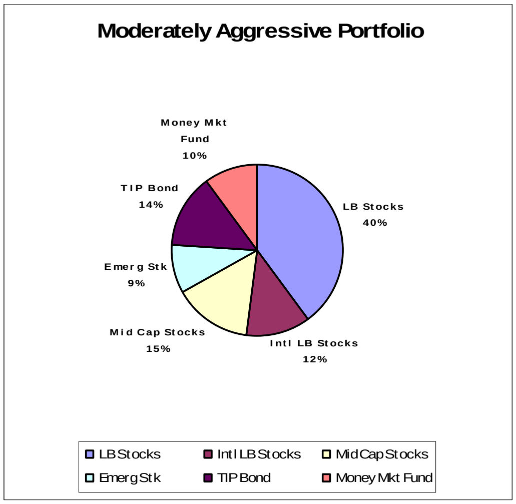
Current portfolio themes are:
Normal Investment Weights
- U.S. large stock funds normal weight
- U.S. small stock funds normal weight
- Foreign EAFE funds normal weight; Emerging stock funds normal weight
- *Sell part of underperforming asset positions*
- Fixed income – TIPS and short term notes
- Gold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

Disclosure: Personal holdings
40% Domestic & Intl Large Cap stock funds, (18% Total International stock funds)
49% Small/Mid Cap funds,
11% short term U.S. & Intl. bonds and cash
Large Stock increase; cash decrease 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

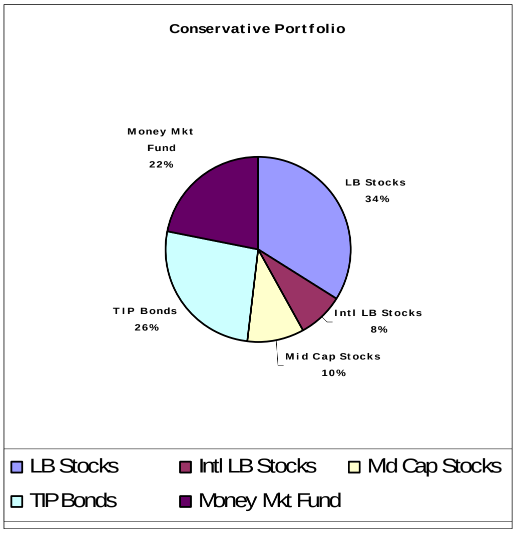
Normal Capital Accumulation –



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;
- 8% Large Blend International Fund;
- 10% 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.

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

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