

BWMInvestment
Guidance**July 2009 Month End Markets Review**
*Economic Recession near End***Key Points**

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|--|-------|---|
| • 2009 Year to Date Total Returns | | |
| S&P 500 (987) | 10.5% | ; |
| US 10Yr Bond (3.50%) | -21% | ; |
| NASDAQ (1978) | 25% | ; |
| Foreign (EAFE) Stocks | 11% | |
| • U.S. GDP expected contraction = -2.4% | | |
| • 2009 earnings expected decline = -13% | | |
| • Stock markets hit bottom in March, as the economic recession nears an end | | |

Executive Overview

The U.S. (S&P 500 +7%, NASDAQ 8%) and foreign (EAFE +9%) stock markets unexpectedly rose in July during a seasonally low volume, quiet period. The macroeconomic perspective noted gradual less negative industrial production and GDP surprises. The bottom up corporate view saw better than expected corporate 2nd Qtr. earnings based on cost cutting instead of revenue growth. Significant investor cash on the side lines, mild economic fundamental positive surprises, and possibly a bit of a short squeeze on speculators betting on normal pullback after the 2nd Qtr. stock market rise generally explain the July market advance. The price of gold rose in July (3%) and is up about 8% for the year to date (YTD), indicating limited current U.S. currency inflation concerns. The U.S. dollar (USD) remained about flat YTD. The U.S. 10 Yr Bond yield was unchanged in July, but the YTD return remains -21% as shown above. The new supply of debt to finance the massive U.S. deficit, including Federal Reserve Board (FRB) quantitative demand, is holding the Treasury securities yield curve up. The global economic bottoming process appears to be setting a demand floor for oil in the mid \$60 per barrel range. Other asset price declines, including homes, are leveling out in most of the country. Leading economic indicators continue to forecast GDP growth in the 2nd Half of 2009. The executive and legislative branches of the U.S. government are working feverish to enact healthcare, energy, and other controls. Yet, markets appear to currently be focused on the post recession cost cutting based earnings.

Themes

Investment markets themes are:

- **Recession Near End; Follow the Money**
- **U.S. government controls**
- **Stagnant future economic cycle**

Recession near End; Follow the Money

The U.S. and foreign economies are working their way through recession bottoms. Credit crises based on massive expansions in leverage were severe in the U.S. and many European countries. The correction process, which included bursting extreme housing and derivative debt asset inflation bubbles in many countries, resulted in a 2008/2009 recession. At this point it is similar to the major recessions since World War II; i.e. 1957/58, 1973/74, and the W shaped 1980/1982 recessions in terms of either GDP or employment declines. Governments attempt to ease the economic correction process by monetary and fiscal policy. That is monetary policy interest/credit rate easing and fiscal policy stimuli; either Keynesian government project deficit spending or Monetarist tax cut deficit spending.

Monetary policy generally impacts the economy more quickly than fiscal policy. Therefore, the monetarists expected and are not surprised that the current recession appears to have bottomed out at the end of the 2nd Qtr in terms of GDP and the production of goods and services. They correctly observed that the massive 2009 American Recovery & Reinvestment Act (\$787B Stimulus) fiscal stimuli designed by National Economic Council Director Lawrence Summers would not meet its stated objective of being “timely, targeted, and temporary” and would not result in an unemployment rate that does not exceed 8%. Less than 25% of the stimulus money is spent and the unemployment rate is currently 9.5%. The monetarists, including Brian Wesbury, were wrong in not predicting the 2008/09 recession. On the other hand, the Keynesians Paul Krugman and Nouriel Roubini, appear to have overstayed their negative forecasts by continuing to forecast that a 2nd Half 2009 initial stage recovery is unlikely and that unemployment will rise to 11%.

The FRB bought massive amounts of short term and longer term debt from various financial institutions, in addition to cutting the bank lending rates to between 0% and .25%, to jump start the flow of credit. The extraordinary purchases of about \$1.5T debt assets resulted in

(printed) money growth to compensate for a slower flow (velocity) of funds in the economy. At some point in time (2011?) the economy will expand at a fast enough rate that assets will need to be sold for USDs in order to contain short term asset (goods and services) inflation. Longer term asset (housing) price stability (inflation or deflation) is not always correlated with short term asset prices. FRB Chairman Bernanke and his governors accomplished the first half of their mission: prevent a credit driven asset deflation and depression (greater than 20% unemployed). Unwinding the massive FRB balance sheet asset purchases without causing 1970s inflation (greater than 6%) will show if they achieve the final part of their mission related to currency price stability. Good timing in the social science of economic engineering is very difficult.

Savings, Factory Rates, & Unemployment

Regardless of political biases, three factors are generally agreed to: households will consume less and save more, factory utilization rates (64.6% low since 1948 record keeping) will rise slowly to a normal (80%) level, and the unemployment rate will stay above a normal 5% rate more than a year after the end of the recession.

Consumers bought far more goods (stuff) financed by debt and credit during the past 10 years than in the early 1980s. According to a report by Tyler Durden¹, car ownership per licensed driver increased an absolute 15% during the past 30 years to 1.2 cars per driver. The rate of annual housing starts (1.8M) compared to household formations (1.2M) during the 2001 to 2007 period far exceeded the more balanced annual housing starts (1.4M) compared to household formations (1.3M) in the 1980 to 2000 period. To revert to sustainable past levels fewer cars and fewer new houses will likely be purchased during the next 4 years. As shown in Figure 1 Twin Pillars of Wealth from Tony and Rob Boeckh's *Great Reflation Experiment of 2009*² essay, based on reduced housing and equity wealth, the U.S. household is at about its 2003 level. The liability side of the household balance sheet must shrink as savings pays off debt to match reduced asset values. The 2nd Qtr estimated 5.2% savings rate is likely to approach a stable 10% level, such as during the stressed 1970s through early 1980s. (It was 4.0% in the 1st Qtr 2009 and 5% in all of the 1995 period.) A higher stable savings rate may also continue for 4 or more years.

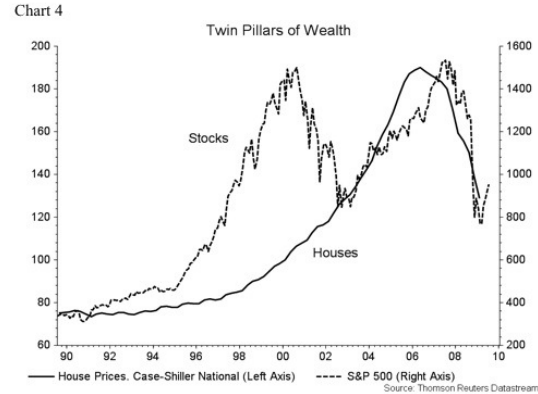


Figure 1. Twin Pillars of Wealth

Factory utilization rates will increase more slowly during the recession recovery as fewer automobiles (11M/year?) and other consumer goods are produced. Related to factory utilization is retail commercial real estate, which will not need to expand for the retailer sector.

The unemployment rate was 9.5% in June and the FRB estimate of a 9.8% to 10.1% peak after the recession ends (Q1 2009?) appears to be a reasonable guess. In 1982 the unemployment rate peaked at 10.8%. Emergency unemployment and extended benefits are being compassionately provided. Unfortunately, the extended benefits and recently increased minimum wage rate (for the 37 states that do not exceed the federal rate) slow the process of reducing unemployment. The 2009 stimuli act was heavily weighed on state and local govt. spending (18%) and federal expansion of all federal departments (45%). All things considered, the promised 8% peak unemployment rate in response to massive stimuli spending will likely not be seen until it falls back to that level in 2011.

Stock Markets – Climbing the Wall of Worry

Investment money is flowing into the U.S. and foreign stock markets, in spite of a weak global economy. With the economic conditions discussed, are investors acting rationally? There appears to be an implicit feeling that the economy will expand during the next 12 months with increased earnings and cash flows. Investors are aware of the eventual balancing act that must be done to unwind the unstable FRB balance sheet prior to letting the 1970s inflation genie out of the bottle. They also are getting anxious about holding large cash accounts in very low interest paying certificates of deposits, money market

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funds, and treasury securities. At this time broadly based stock buying appears to be occurring. There is limited sector leadership, which will be discussed in a future section, taking place. Momentum trading that drives growth stocks ahead of the rest of stock markets is not occurring yet. These observations are normal after large stock market declines, such as during 1975 and 1983 stock market recoveries.

An unexpected external (exogenous) event could upset and terminate the stock market rise. September 11, 2001 occurred after the mild technology bust recession appeared to end. Consumer confidence and stock prices fell as P/E ratios drifted back significantly during 2002 from the extreme 2000 peak levels.

More Government Controls?

Stock market investors are handling the energy and health care uncertainties related to legislation working through Congress calmly.

H.R. 2454, the American Energy and Security Act, which passed on June 25 with the help of Executive Branch pressure is an extreme 1428 page government industrial power control grab. It makes President Carter's 1978 government control of oil and gas resources look benign. In nominal USD terms \$846B of carbon auction receipts are expected to offset \$821B of benefit rebates during about a 20 year period. This forced use of politically favored energy resources and payoff of big lobbyists and corporation to play non-productive games is not good for society. The Senate is a more deliberate moving body with a number of senators, who have some business acumen. Even though the President's party has a filibuster proof majority to pass his desired policies, it is unclear how the energy controls legislation, which is sometimes derisively referred to as Cap and Tax, will proceed through the Senate.

The Obama Administration in 2009 with slightly larger congressional majorities is farther along than the Clinton Administration in 1993 in enacting a universal health care extreme reform of the U.S. health care economic sector. The Clinton team failed to get bills voted out of committee, whereas it appears the Obama team will be able to enact some type of health care legislation, such as universal health insurance coverage (and mandated payments) by the end of the year. More health care regulations will make the U.S. healthcare system less productive.

Added health care regulations will change the decision making (rationing) process from the individual/insurer/provider to the government/insurer/provider.

HR3200, the American's Affordably Health Choices Act of 2009, worked its way through three House of Representatives committees. The Ways & Means (finance), Budget, and Energy, Commerce, Oversight, and Government Reform Committees have passed out legislation. After listening to voters back home during the August recess, the full House will vote in September or later in the fall on some form of mandatory health insurance and possibly a government run insurance provider option.

Senate bill (# TBD), the Affordable Healthcare Choices Act has been passed out of the Health, Education, Labor, and Pension Committee and is currently being debated in Chairman Baucus' Finance Committee. Due to Senate budgeting rules it is desired to get some Republican support. Otherwise, a straight party line vote for the combined Senate bill may not pass with a filibuster proof 60 votes. The alternative of a simple majority passage may result in a sunset provision similar to the Jobs & Growth Relief Reconciliation Act of 2003 (Bush Tax Cuts), which expire in December, 2010. After the August recess, the full Senate will vote on the bill in September or later in the fall prior to reconciliation with the House. The health insurers have the most apparent risk of increased regulations and lower earnings at this time. The Generation X & Y relatively healthy individuals, who often don't need or purchase general health insurance, may be forced to buy it. It is time for the American voters to clearly state their wishes concerning government controls to their elected representative.

New stagnant future U.S. economy

The future 3 to 5 year U.S. economy was discussed from the macroeconomic perspective of governments attempting to stabilize one problem, private sector debt over leveraging, with government sector over leveraging last month. As governments dramatically increase deficit spending and the level of debt to be financed annually, they create a stifling burden on their productive tax paying citizens. Japan was provided as an example of an economically stagnant society for the past 20 years.

The perspective of the citizen, who works in private sector endeavors and pays increasing taxes, should be carefully considered by big government supporters. As mentioned previously the U.S. household spent far above its means in the past 2 decades and took on unsustainable debt levels. More income, more savings, and less borrowing to pay for desired goods and services are expected. Larger government agencies, more regulators, auditors, guidance counselors, and taxes will stimulate or inspire few citizens to achieve more. People will retire at older ages during at least the next 5 years. Government social security, medicare, and other benefits are not sufficient to compensate for the bursting of household wealth (Fig. 1 housing and investments) asset valuations. Proposed direct higher taxes on high income earners and indirect added consumption taxes through higher energy and other controlled item costs on middle and lower level income buyers will discourage wealth growth and consumption. The vision of government should be to inspire families to work productively, achieve better living standards, and give their children and selected charities opportunities for a more fulfilling life than they enjoy. More controls will be counter productive.

Secular growth in the health care sector will continue to provide employment opportunities as the senior population increases during future decades. Government health care programs may distort relationships, but demand for physician services with related supporting equipment and medicines will continue to grow. The tech sector and various service industries that support increased productivity will likely grow normally during a stagnant economy. Many other sectors will grow slower. In absolute terms the U.S. real GDP may grow 1 to 2% less than the long term 3% average through the middle of the next decade, if price stability (<3% inflation) is maintained. The political choice the FRB must make is to maintain the stability, instead of boosting the economy to average long term GDP growth through 1970 style inflation. Cleaning up subsequent inflation at a later date will likely cause a future 1982 type severe recession.

Profits continue to fall; but cost cutting helps

S&P 500 company 2nd Qtr. profits with 67% of reports published were 29% lower than in the 2008 2nd Qtr. Yet they are 7% better than recent analyst expectations (-36%). Seventy five per cent of firms topped earnings forecasts, but only 50% beat revenue forecasts. In the 2nd Qtr. the

Consumer Staples and Healthcare sectors are showing slightly better profits than the comparable 2008 Qtr. The Technology and Consumer Discretionary Sectors had the best recent earnings surprises. Total profits are currently expected to fall 23% in the 3rd Qtr and rise with the GDP in the 4th Qtr. In the bigger view, S&P 500 company profits fell 18% in 2008, and are forecasted to fall 13% this year, prior to rising 24% in 2010. Note that S&P 500 earnings are expected to be lower in 2010 than in 2007.

According to Zacks, bottoms up analyst S&P 500 total operating earnings forecasts are currently stable at about \$60 in 2009 and \$74.50 in 2010. On the other hand, macroeconomic top down total earnings forecasts are about \$56.50 in 2009 and \$67.75 in 2010. The differences may imply macroeconomic forecasts picking up extraordinary (non-operating) expenses or they are missing cost cutting efficiencies, which may continue to help profit margins and overall profitability.

Financial Analyst forecasts are stable

The current analysts' forecast revision ratio are nearly normal 6:5 upgrades/downgrades for 2009 and 11:10 for 2010. At this time, the S&P 500 trades at 16 to 26 times 2009 and 13 to 21 times 2010 earnings based on your choice of Zacks or the more conservative Standard & Poors forecasts.

Foreign Economies

Developed economy forecasted 2009 GDP declines have continued to stabilize after extreme 2008 4th Qtr. and 2009 1st Qtr. declines. 2010 forecasts have improved slightly. Emerging countries China and India have recently improved 2009 forecasted GDP growth. Emerging markets show the only inflation issues. Key forecasts according to the *Economist* follow.

Table 1. Economic Forecasts

Economic Market	2009 GDP	2010 GDP	2009 CPI
United States	-2.4	2.6	-0.3
Japan	-6.1	1.0	-1.1
China	7.2	7.6	-0.5
Great Britain	-3.7	1.1	1.7
Euro Common Mkt ECM	-4.4	0.6	0.4
Russia	-5.0	2.0	12.1
India	5.5	6.4	5.2
Brazil	-1.5	2.7	4.7

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The total global economy is likely to show a 2009 (-2.4%) contraction and 2010 (2.0%) expansion. In Table 2 the U.S. positive sloped yield curve continues to show the most stimulative monetary policy. Most countries also have stimulative positively sloped yield curves.

Table 2. Current Global Yields

Economic Market	3 month	10 Year
United States	0.25	3.5
Japan	0.4	1.3
China	1.4	3.6
Great Britain	1.1	3.8
Euro Common Mkt ECM	1.0	3.3
Russia	11.0	11.1
India	3.2	7.5
Brazil	9.2	6.2

Economic Sectors and Investment Outlooks

A Technical Overview (BPNYSE, etc) indicates recent broad based U.S. and foreign stock demand. Money supply growth continues above normal, although a slower recent M2 annual growth rate (1.7% past 3 months) implies savings deposit money market funds are possibly being used to purchase other assets (stocks & bonds?). **Suggestion: Hold normal portfolio asset weights.**

Economic Sector Analysis and Outlook

Telecom sector stock demand is neutral, although sector price Relative Strength (RS) is lagging. Hold current positions. **Utility** Sector forecasted 2009 earnings are stable. Dividends are around 4%, and sector RS is lagging. No opinion. **Consumer Staples** sector 2009 earnings growth is forecast to be above all other sectors, while RS is in line. Hold positions. A sizeable **Energy** sector earnings fall is in process. Yet stock demand has been in line as oil held around \$68 per barrel. OPEC is holding output at current levels. No Opinion. The above sectors have dividend growth candidates for value investors. **Healthcare** sector 2009 earnings look stable. Stocks are performing in line with the market. Hold positions. Be aware of potential legislation uncertainties. **Technology** Sector stocks continue to participate in the advance. Positive earnings surprises continue. Selective buying is suggested. The **Consumer Discretionary** sector remains a cyclical area. Earnings surprises are positive. Selective buying of value retailers may be considered, as stronger firms are buying bankrupt assets. The cyclical **Materials** sector RS is better than the market.

No opinion. **Industrial** sector exports (and earnings) to developing countries are slowing, and the sector RS is lagging. No opinion. The **Financial Services** sector remains very volatile. No opinion. **Earnings are currently weak, improving, and the market may be anticipating 4th Qtr better earnings.**

Summary Suggestion: Cautiously hold normal stock and bond portfolio positions. The technology sector is showing the only clear RS price momentum leadership. Market demand appears to be in line with stable earnings trends, in spite of the generally poor consumption and employment outlook. Stock markets usually advance in price along with earnings during the first 2 quarters after the end of a recession, although 2002 was an exception.

International Markets Are Advancing

Foreign stock markets rose along with U.S. markets, while the USD (1.42 Euro) was stable during July. Holding developed economy stocks is a reasonable plan. Emerging market stocks rose nearly 55% since the March bottom. Normal weights may be considered if you can withstand large declines (-50% in 2008) and high volatility.

Fixed Income - Less Volatile

U.S. Treasury bond year to date returns (-21%) may not improve as increased supply to finance huge deficits is only partly offset by FRB buying. Investment grade corporate and GNMA bonds should provide single digit 2009 returns. A small portfolio weight in a TIPS fund is suggested. Muni bonds are suggested for taxpayers in high tax states, who research good quality general obligations bonds. Mid single digit after-tax returns at modest risk are possible.

Alternative Investments – Diversification

The Real Estate Investment Trusts (REITs) index has improved after plunging in the 1st Qtr. 2009 based on financing concerns. Commercial and retail vacancies remain problems. Private equity or knowledgeable partnerships may be a more effective way to profit from income producing real assets. Gold funds are diversifiers. Only a 5% weight in a less volatile direct gold exchange traded fund (GLD) is suggested.

Portfolio Management

Funds have less cash (4.6%) to boost stock prices higher. The S&P 500 index is trading at slightly above a normal P/E with uncertain earnings forecasts. Be open to possible positive

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economic surprises, which may support intermediate term slightly higher stock demand and prices through year end.

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
- Fixed income – TIPS and possibly Muni
- Gold – Entry Positions only

Disclosure: Personal holdings: Normal weights
42% Domestic & Intl Large Cap stock funds,
 (16% Total International funds)
48% Small/ Mid Cap funds,
10% short term bonds and cash
Changes are bold faced.

**Sample Portfolios are models
 Not Client Recommendations**

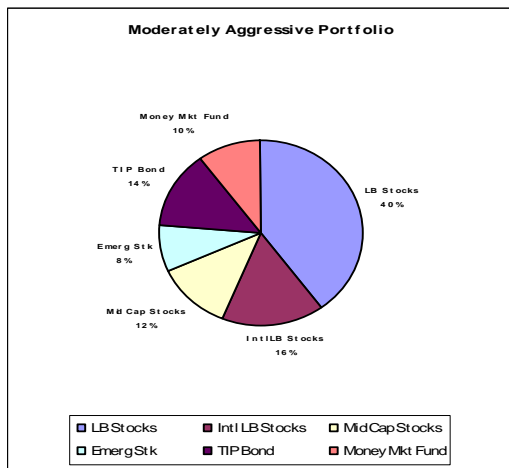
Sample Portfolio A - **Moderately Aggressive**

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

- 40% Large Blend Stock Index Funds
- 16% Large Blend International Fund
- 12% Mid or Small Cap Stock Fund
- 8% Emerging Market Stock Fund
- 14% TIP Bonds
- 10% Money market cash

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

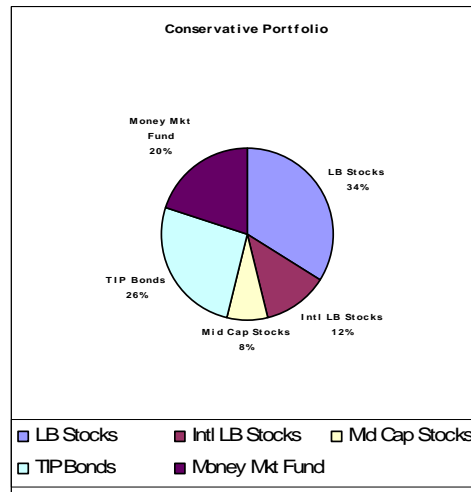
Normal Capital Accumulation –



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;
- 12% Large Blend International Fund;
- 8% Mid or Small Cap Stock Fund
- 26% TIPS Bonds
- 20% Money market cash

Normal Capital Preservation –



References

¹Durden, Tyler, *The End of the End of the Recession*, July, 2009

²Mauldin, John, Weekly e-Letter, Boeckh, Tony and Rob, *The Great Reflation Experiment of 2009*, July 31, 2009

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