BWM

Investment
Guidance

August Month End 2008 Markets Review
Market Churns; Long Shallow Recession

Key Points

- **Year To Date 2008 Total Returns** :
  S&P 500 (1282) -11% ;
  US 10Yr Bond (3.85%) +3% ;
  NASDAQ (2367) -11% ;
  Foreign (EAFE) Stocks -19%
- 2008 US GDP expected growth = 1%
- No 2008 earnings growth expected
- Negative 2008 portfolio returns likely

Executive Overview

Equity markets gyrated during light August trading with foreign markets continuing to decline. The S&P 500 Index drifted up 1.0% and the NASDAQ Index gained about 1.4%. I feel the Bear Stock Market will continue, even though some professionals feel that the mid July low was the bottom of the downturn beginning in October 2007. Bonds gained nearly 1.5% in August. All asset classes remain volatile. Oil retreated to $113 per barrel prior to ending the month at $116 after Russia invaded and annexed 2 separatist Georgia provinces and Hurricane Gustav bore down on the Gulf Coast. Gold drifted down to $817 per ounce and the U.S. dollar (USD) exchange rate loss to the Euro and most major currencies improved significantly to approach no change in 2008. Economic data continues to indicate a stalled U.S. economy with high inflation. The on going credit bubble contraction and expected consequences on the banking industry, housing market, consumer, and corporate profits are analyzed. Federal Reserve Board (FRB) policy and stagflation (low economic growth and high inflation) remain key issues. Zacks calculated S&P 500 companies 2nd Qtr. 2008 total reported net earnings fell 21% after falling 15% in the 1st Qtr. Earnings have disappointed investors for the past 3 quarters and are further analyzed relative to inflation headwinds. Market themes, the economy, and market sectors are discussed to suggest portfolio strategies to contain potential losses during the high inflation, nervous investment markets.

Themes

Current investment markets themes are: unwinding credit bubble leverage and a long period of below normal U.S. economic growth.

Credit Bubble Slow Contraction

The Federal Reserve Board (FRB) of Governors and guests had their annual retreat in Jackson Hole, WY during the 3 days ending August 22. Chairman Bernanke defended the FRB bailouts and highly stimulative monetary policy over the past 12 months, as he reviewed monetary easing, collateral (transferring of bank debt to the FRB accounts) lending programs, and various requested regulations. No discussion of possible consequences of an alternative investment bank (Bear Stearns) or a government sponsored entity (Fannie Mae or Freddie Mac) failure was provided. The speech by Willem Buiter, a former Bank of England officer, was more interesting. He challenged the FRB policy of being too close to and bailing out Wall Street without proving that the moral hazard (leveraged bankers feeling they will be saved by big government) was good for society. The FRB governors circled the wagon, questioned his character, and considered his questions improper. The net effect may be that the FRB and Treasury Secretary Paulson get the message that thoughtful people feel the FRB broke its trust with U.S. taxpayers by unnecessary bailouts.

Over the past 6 months, I questioned the wisdom of reducing the fed funds rate (FFR) to 2%. Rate reductions are appropriate during weak economic conditions. Yet extra high inflation was the consequence of reducing the FFR to 2% instead of a more reasonable 3%. The USD fell more and oil price rose more than necessary due to the inflationary weak dollar policy in 2008. Now be aware of pass through price hikes and high core inflation over about the next 9 months. Central banks of the European Union, Japan, and England controlled inflation better. The net effect of global monetary actions and economic responses is an expected U.S. consumer inflation 2008 peak of 5% and then return to a more tolerable 3½% rate in the second half of 2009. If responsible fiscal (no new stimulus acts) and monetary policy (FFR at 3% by June, 2009) follows, stagflation may be broken at that time.

The **contraction of the massive credit bubble** is the **primary issue**. At this time, banks have written down $505B of loan asset values. As mortgage, auto, and credit card loan valuations fall during slow economic conditions over the next 10 months, more bank asset values will be written down while loan reserves are added to the financial balance sheets. Bank lending practices have become stricter. The wide spreads between their cost of money (FFR) and loans originated allow banks to earn large net profits on reduced new business. It also lets them dump foreclosed properties on the market and take losses on the related mortgages. Remember that national home prices rose to over 60% of the long term trend by early 2007 and have only returned 20% of the inflated prices. The rate of price declines may be starting to slow. Banks are not out of the woods. The Federal Deposit Insurance Corp. (FDIC) noted that 2nd Qtr. 2008 bank profits dropped 86% year over year (yoy) from $36B to $5B. The FDIC 2nd Qtr. 2008 assets also increased from $26B to $78B yoy, while the number of problem banks increased to 117. This is a largest number in the past 5 years, but far less than during the 1991 S&L bailout. The situation is very complex. The problem bank issue is conceptually simple. Bank common stock market values (equity) have declined to reflect asset (mortgage security) value declines. Banks have few options to restore the capital base. New equity offerings will dilute the value of existing shares. Preferred stock or bond debt must be offered at economically unacceptable high yields. Yet, business trends indicate further mortgage asset value write downs. Very Messy!

The mortgage derivative assets of regular banks, investment banks, insurance companies, and other players are just as messy. They are generally considered off balance sheet assets, which are not fully disclosed to regulators. The marketplace discovers true valuations, when an investment banker, such as Merrill Lynch or Lehman Bros., sells a package of derivative securities. The transaction establishes a comparable real price. Even though recent transactions have been below analyst estimates, market transaction prices give a tangible relief.

The big question in financial markets during the past month has been if or when Fannie Mae and Freddie Mac, the two largest Government Sponsored Entities (GSEs) will be bailed out. Briefly, let's look at Fannie Mae's 2nd Qtr. 2008 financial statements. It had $41B total equity including $20B common stock and $845B total debt; i.e. over $2000B liabilities when all guarantees are included. Its leverage of all liabilities to common stock is about 100:1! It raised $36B in debt and $7B in equity sales during the 2nd quarter. The market in August continued to buy new Fannie Mae debt offerings at high yield spreads over Treasury securities. Fannie Mae's stock is a highly speculative, since it only has $9.4B excess core capital. If its asset mortgage values decrease more than 5% by year end, Fannie Mae's cash flow from operations and financing may be inadequate. **Translation**: the U.S. Treasury will likely bailout and take over Fannie Mae by injecting new cash starting with about $25B. Another lower probability scenario is that home values and related Fannie Mae and Freddie Mac mortgage securities more gradually decline about 3% per quarter through the end of 2009, Fannie and Freddie reduce their rate of new mortgage security offerings and thus conserve capital, the market place does not panic, and they survive as functional market entities. If the U.S. Treasury socializes these GSEs through a take over, the impact on the economy is expected to be similar to the 1991 Resolution Trust Corp. bailout of the S&Ls. Effective mortgage rates may be a little higher, overall liquidity will be somewhat lower, and the GDP may be 0.5% lower in 2009 than otherwise.

The Shape of the Economy

Some people describe a recession by using a letter shape; e.g. U, V, or W. The 2001 recession is referred to as W shaped with 2 negative GDP quarters interrupted by 1 up quarter prior to 9/11. The 1981 recession is referred to as V shaped with a sharp drop to choke off runaway inflation. The 1991 recession is referred to as U shaped or more gradually down the 1981 recession. The current downturn may be officially labeled a recession beginning in the 1st Qtr. 2008 by the National Association of Business Economics based on their criteria; GDP, sales, employment, income, and production. The NABE review continues. The impact of the Economic Stimulus Act of (Feb.) 2008 complicated their review. Employment and non rebate real income fell, but sales and GDP increased in the 2nd Qtr. **What letter will describe economic conditions** if the 3rd Qtr. GDP grows marginally after the 2nd Qtr. GDP grew normally? It may be **None of the Above**, based on the following 4th Qtr. 2008 and 2009. A letter W type recession assumes that a single declining 4th Qtr. 2008 GDP occurs. I expect conditions to result in a second GDP dip in the 4th Qtr. 2008 through the 2nd Qtr. 2009, which lasts longer than the January through April 2008 dip. The **key investor issue** will be **earnings**; not a letter describing the economy.

Below Normal Future GDP Growth
Consumption drives the U.S. economy. Consumer net worth is falling, as home equity continues to slide and other investment equity asset values decline. Real purchasing power is declining due to inflation and unemployment is rising. A retrace to $100 per barrel oil similar to the January 2008 level and related gasoline and natural gas price retraces will help consumer purchasing power. Yet, I expect higher unemployment to result in slightly negative real consumption from the fall through the spring. Business durable goods spending, supported by the Stimulus Act accelerated depreciation provision remains positive. A key component of the hardy 3.3% 2nd Qtr. revised GDP growth estimate was a 13.2% net export change. Many factors impact exports and imports; but, I don't expect them to be a major future GDP booster.

Mortgage refinancing, foreclosures, stricter loan requirements, and bank asset deleveraging should continue to limit available financing and generally reduce home prices another 5% to 10% by the middle of next year. Home building should remain at its current low level, until new home inventories decline from the 10 month current supply to a 6 month supply next year.

Current U.S. Economy and Corporate Profits
The 2nd Qtr. 2008 U.S. 3.3% revised growth report was much better than 1st Qtr. growth. Consumers spent or reduced debt with the tax refund stimulus checks. Bank solvency (not liquidity) is a key concern, although a number of chartered and investment banks must still strengthen their capital structure through sales of derivative assets. Non financial sector corporate cash flows continue to be better than in past economic slow periods. The 4th Qtr. 2008 GDP will give an idea of what to expect in the 1st Half 2009. The FRB and Congress will likely hold off 4th Qtr. actions, while politicians campaign. I expect the 4th Qtr. 2008 and 1st Qtr. 2009 to be similarly weak. Thereafter fiscal policy by the new Congress and President may impact the 2nd Qtr. 2009 (similar to the 2nd Qtr. 2001.)

Financial Analyst forecasts are too optimistic.
The current analysts' forecast revision ratio is about 1:1 downgrades:upgrades in 2008 and 5:4 in 2009. Analysts, who expect 26% total earnings growth in 2009, are too optimistic. The 1st Qtr. 2008 S&P 500 companies' total earnings fell (16%) after falling (22%) in the 4th Qtr. and Zacks calculated that 2nd Qtr. earnings fell 21%. Profit margins continue to be squeezed between increased material costs and weak consumer demand in various industries.

During past recessions earnings fell for about 3 consecutive quarters. This time export profits partially offset banking losses and the total earnings declines have been more gradual for 3 quarters. The 3rd Qtr. S&P 500 earnings may or may not marginally decline. Yet, the 4th Qtr. earnings expectations are critical for the forward looking stock markets. Analysts expected easy comparative 4th Qtr. gains for the Financial Sector after very large 4th Qtr. 2007 losses. But the rest of the economy may show earnings declines due to weak consumer spending. I expect declining S&P 500 total earnings to continue through the 1st Qtr. of 2009 (6 total quarters). That would be in line with the end of the credit squeeze. The length of the economic slowdown and a change in FRB policy to control inflation will be the key factor to 2009 earnings. Total S&P 500 2008 earnings growth forecasts are now a bit negative. The visibility for a 2009 earnings recovery is not clear. Inflation distorts financial statements. The S&P 500 stock index is currently trading at a 2008 P/E ratio of 15 and 19 according to Zacks and the more cautious Standard & Poors service. The market valuations are not attractive in a stagflation economy.

Foreign Economies
Developed economies are poised for below long term growth in 2008 and 2009, while emerging economies show growth with inflation issues worse than the U.S. according to the *Economist*.

Table 1. Economic Forecasts

Economic Market	2008 GDP	2009 GDP	2008 CPI
United States	1.5	1.2	4.9
Japan	1.4	1.2	1.6
China	9.8	9.0	6.6
Great Britain	1.6	1.2	3.6
Euro Common Mkt ECM	1.6	1.2	3.6
Russia	7.5	6.8	13.9
India	7.7	7.1	7.1
Brazil	4.6	3.4	6.1

All developed economy GDP growth forecasts are below 2.0%. Changes since last month forecast slightly lower 2009 GDP growth and inflation. Most developed economies continue to grow below long term rates and to experience global credit contraction with Great Britain, Germany, and Japan slowing noticeably.

Some foreign government debt yield term curves are negatively sloped with short term interest rates higher than long term rates in order to slow inflation, as shown in Table 2. The U.S. positively sloped yield curve continues to be the most stimulative monetary policy. The aggregate global monetary policy will likely slow GDP growth in 2008 and 2009.

Table 2. Current Global Yields

Economic Market	3 month	10 Year
United States	2.1	3.8
Japan	0.8	1.5
China	4.3	4.9
Great Britain	5.8	4.6
Euro Common Mkt ECM	5.0	4.2
Russia	11.0	7.0
India	9.2	9.7
Brazil	12.9	6.2

Economic Sectors and Investment Outlooks

A Technical Overview (BPNYSE, etc) indicates market demand remains slightly above supply for U.S. stocks. Ten months after the Oct. 2007 peak, market indices are 18% lower. Short interest positions are at record high levels. Recent money supply growth, net mutual fund cash positions (4.4%), and even bullish/bearish sentiment indicators are potential demand indicators. Alternatively, September and October often bring out tax loss harvesting supply when year to date losses exceed 10%. The uncertainty of a close election also limits demand. **Suggestion: Be cautious in nervous markets.** Normal bear markets can last 18 months based on economic conditions and earnings. Sector price relative strength (RS) shows no particular sector demand. Growth and value style stock, as well as small and large stock demand is about equal. U.S. based foreign equity securities due to a relatively stronger dollar are losing value.

Economic Sector Analysis and Outlook

Utility and Telecom Sectors are reporting steady revenue, slow earnings growth as costs are passed through, and neutral market price RS. Demand for the defensive dividend paying **Utility and Telecom** sector stocks is normal in a slow growth economy and a normal portfolio allocation is suggested. The **Consumer Staples** sector 2nd Qtr. earnings growth is slow, the 2008 earnings growth outlook is stable, and RS is neutral. Demand for this defensive sector is normal and normal portfolio weights are suggested. **Healthcare** sector 2nd Qtr. 2008 earnings are in the single digit range, but biotech and medical products industry earnings are causing an overall normal RS. They are vulnerable to investor uncertainties concerning added regulations. Yet, I hold a slight overweight in this sector. **Technology** Sector 2nd Qtr. reports were good, although some big name companies issued negative surprises. The relatively high P/E tech stocks are vulnerable in nervous markets. I hold a slight overweight in this sector. The **Energy** sector delivered good earnings growth with oil above $140 per barrel, but RS has turned negative when oil fell below $120. Below market neutral portfolio allocation is suggested for this commodity sector. Energy sector fundamentals remain good. The cyclical **Materials** sector is performing with neutral RS, while earnings are normal. Caution and a below normal portfolio weight is suggested. **Industrial** sector exports to developing countries are strong, but earnings growth is slowing. Below normal portfolio weights are suggested in this sector. The **Consumer Discretionary** sector remains a cyclical area. Even though RS is good Consumer Discretionary sector stock portfolio under weighing is suggested. The Financial Services sector was the worst performing area of the U.S. stock market in 2008. Write downs of bank debt securities continue and caution is prudent. Low interest rates will increase profit margins for banks and other financial industries late in 2008, yet Financial Sector portfolio under weighting continues to be suggested. **Economic sector earnings and portfolio suggestions are cautious.** First and 2nd Qtr. 2008 earnings growth was below normal under stagflation conditions. There is liquidity to demand stocks and squeeze an overly short positioned market higher, but there are counter arguments for selling. **Summary**: all things considered, hold current positions if you have the capacity to take an additional 10% decline to a normal bear market low between now and March, 2009. Be aware of and expect continued market volatility.

International Markets Are Vulnerable

Net foreign stock markets fell more than 7% during August, while USD (1.47 Euro) exchange rates improved about 6%. Developed economy stock under weighting is suggested. If foreign banks raise interest rates, the USD should recover more and act as a headwind for foreign stock returns. Emerging economy stocks are volatile. Normal weights are reasonable, if you have the capacity to withstand a sizable decline.

Fixed Income - Less Volatile
U.S. Treasury bond total 2008 returns (3.0%) and overall investment bond returns improved in August. Money is flowing from stock funds to bond funds in 2008. A small portfolio weight in a TIPS fund is suggested with the expectation that returns will match inflation (4+ %) for 2008.

Alternative Investments – Diversification
The Real Estate Investment Trusts (REITs) index is flat year to date. Healthcare related REITs may be considered. Gold funds are diversifiers but flat as 2008 inflation and USD hedges. Normal alternative asset 5% gold fund weights appear reasonable. At the moment they are volatile.

Portfolio Management
Funds have some (4.4%) cash to boost stock or bond prices higher. The S&P 500 index is trading at about a 14 times trailing 2007 PE ratio and a 15 times forward 2008 PE ratio. Normally, a reciprocal 6.7% earnings yield is favorable to the current 6.1% corporate "A" rated bond yield. Holding an 84% invested portfolio is suggested. If nervous, an 80% invested position is sensible.

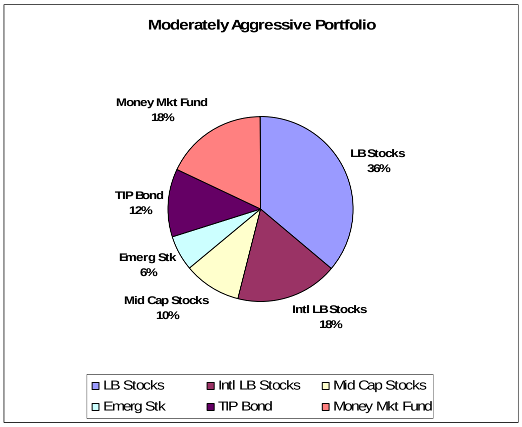
Current portfolio themes are:
Capital Preservation
- All U.S. size stock funds normal weight
- Foreign developed funds below normal weights; Emerging stock funds normal wts.
- Fixed income – TIPS preferred
- Reduce large cap stocks in suggested under weighted sectors, if you can not tolerate near term volatility

Disclosure: Personal holdings: **52**% Domestic & International Large Cap stock funds,
32% Small/ Mid Cap funds, **16**% cash
(**22%** Total International funds)
Changed weights in **bold**

Sample Portfolios are models
Not Client Recommendations

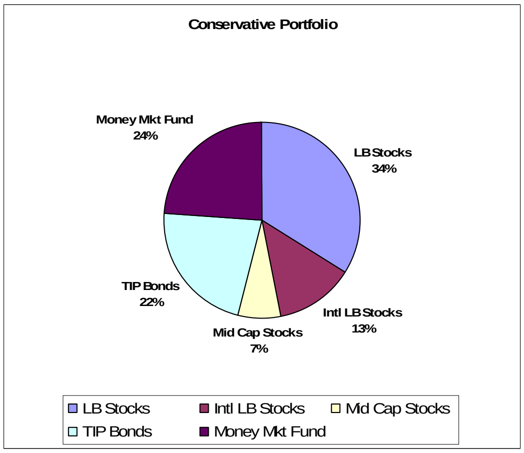
Sample Portfolio A - **Moderately Aggressive**
Example 45 year old college educated parents with 1 high school child and 1 college child.
- 36% Large Blend Stock Index Funds
- 18% Large Blend International Fund
- 10% Mid or Small Cap Stock Fund
- 6% Emerging Market Stock Fund
- 12% TIP Bonds
- 18% Money market cash

Cautious Capital Preservation –



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;
- 13% Large Blend International Fund;
- 7% Mid or Small Cap Stock Fund
- 22% TIPS Bonds
- 24% Money market cash

Cautious Capital Preservation -



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

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