

*BWM Letter****Global and U.S. equity markets decline amid uncertainty. Are markets pricing a recession?*****Key Points**

- **August, 2011 YTD Total Returns**
- S&P 500 (1218)      -2%;
- US 10Yr Bond (2.23%)    10%;
- NASDAQ (2579)        -3%;
- Foreign (EAFE) Stocks   -8%
- U.S. GDP expected expansion = 1.8%
- 2011 expected earnings increase = 16%
- Stock market – negative correction
- Questionable economic recovery

***Executive Summary***

Volatility and large stock market losses occurred (S&P 500 -6%, NASDAQ -6½%, EAFE -9%) in August. Bond market (U.S. Treasury (UST)) returns soared (4%) as yields fell in the midst of double dip recession worries. The 10 yr. UST bond touched a 50 yr. low of 1.97%. The Germans and French talked but did little about weak nation sovereign debt issues; yet the Euro currency was unchanged vs. the U.S. dollar (USD). Federal Reserve Board (FRB) Chairman Bernanke wisely stated nothing new at the Jackson Hole, WY summer monetary forum after pushing through an extended low interest rate period (to mid 2013) statement over the objection of 3 regional Fed presidents at the August FOMC meeting. The 2<sup>nd</sup> Qtr revised economic GDP growth estimate (1.0%) was weak. In summary, with 1<sup>st</sup> Qtr (0.4%) 2011 GDP, the U.S. economy grew less than 1% in the 1<sup>st</sup> Half 2011. Many regional Fed Bank reports were weak and caused revised downward GDP growth forecasts for the next 6 quarters. High initial unemployment claims continued. The counter positive point is the resilience of large corporation (S&P 500) 1<sup>st</sup> and 2<sup>nd</sup> Qtr. earnings and revenue reports. Large company expenses appear unusually under control as companies adjust to added regulations with some price increases and maintain high net profit margins. Cash flows remain high. Small businesses are adjusting to the new regulations without added workers. The expected somewhat higher 2<sup>nd</sup> Half 2011 GDP (1% to 2%) growth may support large and medium size corporate profits through year end, but the employment outlook is unclear. U.S. fiscal and monetary policies have used many political and tactical resources. The downside risks of euro related problems, natural disasters (earthquakes and hurricanes), or global unrest could push a fragile US economy into at minimum a shallow 1978 type recession.

***Themes***

- ***Have equity markets adjusted for a near term economic recession?***
- ***Are constructive political responses likely?***

***Have equity markets adjusted for a near term economic recession? Yes - a shallow recession***

The abrupt decline (more than 18% from April 2011 highs) by mid August of U.S. and global equity indices qualified as a correction. If equity markets decline further to more in total than 20% some observers consider that a bear market. (Note a 20% decline requires a subsequent 25% advance to return to a net unchanged position.) The broader NYSE composite 21% decline met the bear market definition. Bear equity markets have predicted (usually by 6 months) or occurred simultaneously with past economic recessions about 60% of the time. Another perspective is predictive pattern of the economy itself. Economic (GDP) growth less than 1% for two quarters preceded over 80% (9 of 11) post World War II recessions. The total 2011 1<sup>st</sup> and 2<sup>nd</sup> Qtr. U.S. GDP grew at about a 0.8% annual rate. Thus, equity markets and economic data forecast at least a 50% probability of a shallow recession.

Some people comment that the negotiations between divided chambers of Congress and the President with different philosophies of the size of government spending and total debt resulted in a U.S. federal debt ceiling agreement that caused investor fears. The subsequent Standard & Poors downgrade of the U.S. Treasury debt securities from AAA to AA+ added to investor fears. Yet observe that all global equity markets declined during July and August. Various federal debt levels and downgrades of U.S., European, and Japanese sovereign debt were factors weighing on investor psychology. Additionally many U.S. and global reports showed weakening economic growth. Some argued that the regional Aug. 18 Philadelphia Business Conditions -30.7 reading alone indicates a high probability of a new recession. (The Chicago ISM Index positive reading (56.5) is a counter point.) The fear of an imminent recession and little that the federal government can do to avoid it is a key factor causing investors to adjust their equity holdings.

*What does a recession feel like?* That depends on your perspective. Psychology affects markets. Normally to most households a recession means that one or more members are unemployed or underemployed. By that definition, the recession that began in the 4<sup>th</sup> Qtr of 2007 has not ended.

To the federal government worker population that has grown throughout the period, there was no recession. To investors, who are partly living from investment returns, volatile equity prices and net negative 4 yr. returns have been more harmful than actual changes in the gross national product. Home equity losses have been especially severe. Extremely low interest rates leave bank certificate of deposits and general bond returns at real negative rates relative to consumer price inflation above 3%. Most long term investors feel along with the unemployed or underemployed households that volatile negative total returns since the 4<sup>th</sup> Qtr of 2007 feel the full past 3½ yrs have been a recession. The economic condition is a prolonged global debt reduction and credit restructuring cycle and not a post World War II business cycle corrective recession. The U.S. runaway inflation correction 1980 and 1982 recessions were similar in problem significance; yet the government in contrast used effective monetary and fiscal policies to address the business condition.

Market psychology determines how much will be paid for either asset earnings or asset financial book value. The past 100 years of equity market data shows that investors normally pay about 15% for long term (5 year) annual recent earnings (earnings/price return 6.7%) and about 14% for recent (1 year) earnings (E/P = 7.1%). Next year's E/P yield is expected to be the same as the past period results. S&P 500 2011 earnings after 2 quarters of actual earnings are expected to be \$96 with the S&P 500 Index currently trading at 1218. That is an E/P yield of 7.9% or P/E = 12.68 or *10% undervalued*. Past equity returns grew nominally 10% in a 3% inflation normal environment. Assets are also priced by the market relative to the financial or accounting book values. The analysis process is more subjective because accounting rules generally are flexible in subtracting goodwill or depreciation from asset purchase prices. Certain economic sector companies show market value (MV) / book value (BV) ratios much different from others. Equity markets generally value assets with BV/MV ratios of about 2.0. Related future earnings net profit margins are expected to remain the same. The recent S&P 500 equity index correction brought the ratio to about 1.8. Based on the key assumption that earnings and margins will remain unchanged equity markets appear *about 10% undervalued*. That is not extremely out of the normal range when compared to 2000 dot com ratios 100%

overvalued or 1982 recession ending 25% undervalued MV/BV ratios. Yet, assuming a shallow recession, global stocks are pricing unchanged 2012 versus 2011 earnings. At this time, individual S&P 500 company analysts' 2012 forecasts sum up to 14% earnings growth.

Market cash flows can sometimes indicate if there is an abnormal potential demand waiting to purchase equities or other asset classes. The demand for UST securities has forced yields along the term structure (years to maturity) to 50 year lows. Although global yields are generally falling, the UST is leading the low yield path. Bond cash flows are abnormal, but again may continue. The 2011 meteoric rise of the price of gold (28%) and Treasury Inflation Protected Securities (TIPS) returns (9%) indicate a long term inflation concern. Transferring cash flows from debt to equity securities will likely require higher CPI inflation (5+%) coupled with real earnings (after inflation) remaining flat. The cash flows indicate rational fear, but high uncertainty about the size of a possible recession and impact on S&P 500 type company earnings.

Market movements, some economic reports, investor feelings, market psychological pricing, and cash flows have been considered. In summary, a shallow recession with unchanged S&P 500 2012 earnings is most likely reflected in market prices, *ceteris paribus*.

*What about potential external factors that may cause a more serious 1936 type double dip recession instead of a 1978 recession?*

Other factors will certainly change the outlined scenario. The most obvious external factors are a major failure of the European Union (EU) euro currency system. The EU political system may be less effective than the much maligned U.S. Congressional and Administrative wrangling about the size of government, level of debt, and function of the administrative agencies. Germany is the most stable euro based economy and must decide whether it will effectively accept added risks as a sovereign entity and for its bankers to provide more debt to bail out less fiscally responsible nations, Portugal, Ireland, Italy, Greece, and Spain. The outcome is unclear. However, even if weak countries, such as Greece and Portugal, exit the euro currency system and offer their own currencies, minor trade problems will likely develop for Spain and France. Germany, the export engine, would suffer somewhat. U.S. trade with Europe might be

reduced 10%. Some banks may experience defaults on sovereign debt bonds. That appears to be a plausible scenario that reduces U.S. 2012 GDP about 1%. Current S&P 500 companies forecasted earnings do not reflect this relatively benign scenario. The more severe dissolution of the euro system would hit Germany, France, and other former euro system sovereign nations hard. In fact, large trading nations, such as Great Britain (35% of GDP) would experience a major recession in that scenario. The U.S. 2012 GDP in my view would be reduced at least 2% in that severe scenario. Iranian mischief is another global scenario that would affect the U.S. economy and others, if the U.S. military departs from Iraq as planned at the end of 2011. Iran could try to topple Iraq and cause problems for Saudi Arabia. Large spikes in oil prices contributed to global recessions in the 1970s. The real U.S. GDP could be reduced about 2% if the price of oil doubled during 2012 and the FRB allowed inflation to rise significantly. The world is risky with external factors that could cause a significant 2012 U.S. recession that reduces S&P 500 corporate earnings 10% to 15% with equity prices falling 10+% below August 2011 lows. However, I am an optimist. The next theme explores what near term federal government policies could avoid a potential shallow recession.

***Are constructive political responses likely? No -Yet they are possible.***

Many people feel a stalemate between those who want to keep the entitlement security net essentially unchanged and those who want to reduce the size of the federal administrative state government and restructure the security net without raising net taxes can not be resolved. The select Congressional Debt Limit Committee was formed to either actively present a restructure future federal spending and revenues plan by Oct. 23 or passively enact \$1.5T of deficit cuts over 10 yrs. That is a big challenge. The Debt Ceiling Agreement issue must be resolved by the end of 2011. Democrats have chosen committee members who have been vocal about raising tax revenues in order to limit future spending constraints. Republicans have selected a former Office of Budget Management and a former private Club for Growth President. The group is more diverse in philosophies than the so-called Senate Gang of Six or Simpson/Bowles Commissions, which could not conclude with the required agreed to final report. The key will be to agree to tax loophole

reductions that are not harmful to economic growth and more importantly promote growth. Income tax rates on the hedge fund performance fees instead of capital gains rates, eliminating ethanol, wind, and solar credits, and limiting home mortgage deductions would likely not cause major economic disincentives if long-term capital gains, dividend, and income tax rates were made low. A trade between lowering the corporate tax bracket and a specific period foreign subsidiary profits repatriation tax reduction for elimination of tax credits and deductions is possible. Of course, lobbyists would plead their cases and no tax reform is likely by the end of 2011. The added tax revenue crowd is sponsoring a European or Japanese value added tax (VAT). It is a questionable way to raise revenues for the following reasons. By adding a tax at each level of production, domestic suppliers lose export competitiveness. The tax is not a simple national sales tax. Because consumption is most impacted, subsidies are usually given to low income households to make the tax progressive. Finally, politicians can easily raise a VAT tax for any future desired revenue need. A focus on regulation reform is a more fertile area for productive employment supportive agreements.

No debt cut agreement may result in automatic federal spending cuts over 10 years and equity markets may be fearful of further gridlock. Less federal spending (printing money) will reduce the federal government part of the 2012 GDP if no stimuli (added deficit) programs are agreed to in 2012, relative to 2009 to 2011 stimulus. That may be as much as 2% less government spending, although it is difficult to forecast \$0.30T of lost potential GDP growth in a \$15T economy. The more important issue is how the 65% non-total government private economy will grow over the intermediate term (5 years).

The President is likely to get part of his requested stimulus spending for another year of 2% reduced social security taxes. That does not make the Social Security system more solvent or create jobs. It simply increases consumption spending with borrowed money. Yet the key debate will concern a 2 year (99 week) extended unemployment payment program for a 4<sup>th</sup> year. No thorough analysis shows that the program reduces unemployment. At the margin, extended unemployment payments are disincentives that discourage the unemployed from considering less desirable employment opportunities or

starting their own businesses. Eliminating the extended unemployment program may reduce consumer spending and the GDP 0.4%. If regulation growth is slowed, unemployment may actually fall 0.4%. Then politicians can take credit for reduced unemployment (even though they do not recognize the incentive to work at less desirable jobs when a safety net is less easy.)

It is hard to imagine that the President's proposal for more shovel ready infrastructures to be enacted into a stimulus law after he joked about its ineffectiveness. In summary, the President is likely to get a small amount of added stimulus, which alone will have little economic impact.

Regulation reform is getting more attention. Anything that reduces uncertainty and inspires businesspersons to take more hiring risks will be a near term gift. The value of reduced uncertainty is cumulative and more people are beginning to see it. When the regulation czar, Cass Sunstein, talks to the Wall Street Journal and other publications about making regulations more efficient and saving \$10B over 5 years, a reasonable analysis must ask, "*Is that the best you can do?*" Many non-political people do not want an efficient federal administrative government. They want an effective transparent regulatory system. During 2009 through 2011, annual regulatory agency budgets grew 16% or \$54B according to a George Washington University and Washington University of St. Louis study<sup>1</sup>. Federal Agency employment in the past 28 months has increased 13% to 281,000 while private employment has shrunk by 5.6%. The Health & Human Services and Labor Departments, Environmental Protection Agency, and National Labor Relations Board are issuing the most controversial decrees. At last count, 4,200 new rules and regulations were in process excluding more Dodd Frank Financial Reform and Consumer Protection Act and the Patients Protection and Affordable Care Act future rules.

Senator John Barrasso is leading the counter movement<sup>2</sup>. He has noted new regulations with estimated impacts of \$100B that are ignoring President Obama's Executive Order for formal cost-benefit analyses. His proposed Regulations From Executive In Need of Scrutiny (REINS) Act would require Congressional Approval for Regulations with greater than \$100B impact. The current Senate political majority will not let the bill see the light of day. Yet it may have a good chance of enactment if the political landscape

changes after the 2012 election. In the interim, Congressional debates concerning unaccountable regulators may slow down the harm they are currently doing to job creation. House Speaker Boehner required President Obama to list the seven new 2011 regulations estimated to cost more than \$1B and those estimated to cost more than \$100M each. An EPA tighter smog standard alone is estimated to cost the economy between \$19B and \$90B. The \$100M to \$1B category identified 219 in process 2011 regulations. House Majority Leader Cantor plans to submit ten bills to delay or change specific regulations. These Senate and House plans will focus on specific regulations. The Senate majority and President are unlikely to work to enact most regulation limits into law. Yet the process may reduce uncertainty and increase potential risk adjusted new project returns. These are small constructive step to bring a little optimism to the frustrated, non political independent grumpy businesspersons.

#### ***Global Economies***

Emerging countries (China (9%), India (7.8%), Brazil (4%), and Russia (4.3%)) continue to grow faster, while developed countries (United States (2.1%), European Common Market (ECM 1.8%), Great Britain (1.3%), and Japan (-0.6%)) grow slowly or stagnant in 2011. Germany (3.3%) falls in between. Both emerging and developed nations are now forecasting slower 2012 growth than the prior month forecasts.

As previously discussed, the European Union euro currency sovereign debt problems are major. The best case scenario is austerity will bring the 2012 GDP level to about the same as 2011. The worst case scenario of defaulted debt countries leaving the euro currency or the euro system breakup are more serious with uncertainty discussed in the initial theme.

Higher interest rates in China, India, and Brazil should slow down inflation in the 2<sup>nd</sup> Half 2011. Yet negative investment returns (-8% in 2011) may continue. Earnings growth and generally responsible fiscal and monetary policies should set the stage for acceptable (10% to 15%) risk adjusted returns in 2012. Most foreign developed countries have debt and deficit problems that will make less government spending (austerity) the only viable choice. The scenario will limit GDP growth and earnings. Diversification in emerging is suggested, while being aware that a disruptive default of a euro based sovereign debt could

cause volatility near term and ECM as well as Emerging Market stock and bond losses.

**Table 1. The Economist Forecasts**

Economic Market	2011 GDP	2012 GDP	2011 Unemployed
United States	2.1	2.5	9.1
Japan	-0.6	2.6	4.6
China	9.0	8.7	6.1
Great Britain	1.3	1.9	7.9
Euro Common Mkt	1.8	1.5	9.9
Germany	3.3	2.1	7.0
Russia	4.3	4.5	6.5
India	7.8	8.4	10.8
Brazil	4.0	4.1	6.2

The total 2011 global economy is expected to continue to expand at a reduced rate (3.3%) with Asia leading the way. Table 2 shows a U.S. positively sloped yield curve and a highly stimulative monetary policy that Chairman Bernanke plans to continue for at least 2 more years. Global long term interest rates have declined in 2011 with Emerging Market high short term rates to calm down inflation.

**Table 2. Current Global Yields**

Economic Market	3 month	10 Year
United States	0.1	2.2
Japan	0.2	1.0
China	5.4	4.0
Great Britain	0.9	2.7
Euro Common Market	1.5	2.2
Russia	4.7	4.7
India	8.4	8.3
Brazil	12.4	6.2

#### **Personal Goal an, Portfolio Management**

Personal goals generally focus on spending or distributing accumulated wealth for retirement expenses, family gifts, or charitable donations. Near term spending (next 5 years) is a virtually certain liability, which should be matched by low risk asset (bond or annuity) portfolio cash flows.

August showed abnormally volatile stock and bond movements. A proxy for fear is the S&P 500 options related VIX index, which began around 24, hit above 45 (May 2010 flash crash level), and ended August at an above normal 32. The nervousness may subside to a more normal range of 15 to 20 if economic results improve, the U.S. political divide becomes less ideological and external factors do not surface. Yet, it is prudent to be cautious. Risky assets, such as

equities, appear to be undervalued as previously discussed. Anxiety may still keep a lid on price levels. The demand for less risky sovereign debt (UST and others) is difficult to understand. Treasury Inflation Protected Securities (TIPS) 9% and USD referenced gold price 28% returns in 2011 also show large bets on future inflation. Nervous investors are causing absolute values and relative asset relationship to be misaligned. Portfolio adjustments should be considered.

A risk budgeting portfolio management approach discussed in last month's BWM markets review is worth further comment due to the relationship between UST debt and S&P 500 stock dividends. The UST 10 yr. bond yields 2.23% today and 45% (225) S&P 500 stocks yield more than that. Dividend increases are much more likely than dividend cuts. UST bonds do not increase (or decrease) periodic coupon payments. Of the S&P 500 stocks 77% (386) paid dividends and 1/3 of dividend paying stocks raised dividends more than 10% on average over the past 5 years. S&P 500 companies hold more than \$1B cash for potential projects, acquisition, and share repurchases, or increased dividends. Overall, UST securities are over priced, unless a severe recession with deflation causes them to become more overvalued. Dividend paying stocks can fall in price during a stock market decline. However, recent August declines showed the S&P 500 dividend growth index fell 3% less than the S&P 500 index. Suggestion: rebalance investment portfolio with 5% fewer UST bonds and 5% S&P 500 dividend growth stocks. Also consider reduce fewer risky small and medium stock holdings. The relative risks are tilting the probability of future returns.

#### **Markets and Economic Sectors**

Higher risk U.S. securities, such as small capitalization stocks, appreciated more than large cap stocks in the first 5 months of 2011, but gave back more than their return lead in the past 3 months. Small cap stock 2011 losses (-6%) exceed S&P 500 stock losses (-2%). Growth company stocks have a remaining lead (1%) over value type stocks. Commodity prices have been volatile in 2011 with the total CRB Index near 3%. The more interesting observation is that the price of oil (-2%) declined about the same as S&P 500 stocks, but gold continues to advance (28%). Commodities are speculative and tricky with short term momentum changes.

**Technical Analysis**

The U.S. stock market volatility settled at month end, but as discussed it remains above normal. Future bursts of volatility and stock declines remain likely during the next 6 months and even longer. S&P 500 stocks fell below longer term (40 week moving average = 1290) thresholds. Investors seemed to use put options to hedge, while their newsletter advisors did not become as negative as normal during a stock market corrective decline. The S&P 500 index hit its 2011 high (1353) in April and various technical factors lead to an educated guess that near 1300 is a likely 2011 year end target for a few % total return. As usual, limit risks per your risk tolerances and cash flow needs.

**U.S. Economic Sectors**

Materials Sector 2<sup>nd</sup> Qtr. earnings were higher than other sectors, but August market price changes (-8%) lagged behind the S&P 500 Index (-5%) for a negative Relative Strength (RS). The Material commodity sector includes Gold (+28%). No suggestion. Energy Sector 2<sup>nd</sup> Qtr. earnings grew more than the S&P 500 index, but July and August oil prices declined 6%. The August RS (-6%) lagged the market. Oil price changes (+/-15%) would impact future Energy Sector earnings. Consider steady dividend paying assets. Financial Sector earnings and price RS continued to lag the S&P 500. Avoid. Industrial Sector earnings slightly beat the S&P 500 Index and RS was neutral. No Suggestion. Technology Sector earnings and earnings surprises slightly beat the S&P 500 Index during August with neutral RS. Suggestion: Hold. The Consumer Staples earnings growth lagged, but RS beat the S&P 500 during August. Suggestion: Hold dividend paying stocks. Utility Sector Stocks earnings lagged, but price RS led the S&P 500 Index during August. No suggestion. Healthcare Stocks earnings lagged, but RS beat the S&P 500 Index. Suggestion: Hold. Consumer Staples, Utility, and Healthcare stocks showed classic defensive, stable earnings attributes during the August market correction. Consumer Discretionary stock earnings varied with overall similar RS to the S&P 500. Hold selectively. Treasury Bonds (+4%) again led the S&P 500 during August. They are acting like the safest assets in a risky world and appear overpriced. The price of gold rose in Aug (14%) and YTD (28%). Suggestion: Hold.

**Portfolio Suggestion: Hold above normal dividend paying stocks and below normal small cap weights. Stock market psychology is cautious.** Reduce small cap stock and other risky assets if stock prices rise. Volatility is likely to increase.

*Primarily focus on your goals.*

**Alternative Investments – Diversification**

The Real Estate Investment Trusts (REITs) index advanced more than the S&P 500 Index in the 1<sup>st</sup> Half 2011 and declined less than the market in August. Well informed partnerships and energy MLPs may be effective ways to profit from income producing real assets. Gold is a diversifier. A 5% weight in a gold exchange traded fund (GLD) is suggested.

Current portfolio themes are:

Normal Investment Weights

- U.S. large dividend stock funds overweight
- U.S. small stock funds under normal weight
- Foreign EAFE funds underweight; Emerging stock funds normal weight
- Fixed income – TIPS and short term notes
- Gold – Normal (5%) Positions

Disclosure: Personal holdings: Normal weights  
**39%** Domestic & Intl Large Cap stock funds,  
 (13% Total International stock funds)  
 48% Small/ Mid Cap funds,  
**8%** short term U.S. & Intl. bonds and cash  
 Changes in **bold**

**References**

<sup>1</sup>Higgins, Sean, *Regulatory Reforms Don't Actually Kill Many Regulations*, Investors Business Daily, August 24, 2011

<sup>2</sup>Barrasso, John, *Regulatory overreach smothering economy*, Washington Times, August 22, 2011

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