

**BWM**Investment  
Guidance**January 2009 Markets Review**  
*Economic & Market Uncertainties;*  
*New US Govt Administration starts awkwardly***Key Points**

• <b>January 2009 Total Returns :</b>	
S&P 500 (826)	-8% ;
US 10Yr Bond (2.86%)	-13% ;
NASDAQ (1476)	-6% ;
Foreign (EAFE) Stocks	-14%
• U.S. GDP expected contraction =	-1.2%
• 2009 earnings expected decline =	-6%
• Large January 2009 losses;	
1 <sup>st</sup> Half 2009 partial recovery uncertain	

**Executive Overview**

January 2009 markets generally continued 2008 trends. Nearly all asset classes suffered losses, yet inflation concerns altered the “flight to safety” theme. The expected demand from pension funds rebalancing to specified equity weights and employee bonus check investing in equities did not happen. Increased risk aversion after large 2008 losses led to record money market levels. High investor fear levels and volatility continue. Conversely, 3 mo. U.S. dollar LIBOR rates eased to 1.18%, which indicates a thaw in near frozen short term loans. Commodity and U.S. asset class relationships were unusual. The 10 yr. Treasury bond fell 13%, while gold gained 6% to indicate a lower demand for quality and increased fear of inflation. In contrast, the USD gained 8% versus the Euro and oil prices fell 6%, which points to relative USD strength and disinflation. The economic indicators remained weak across employment, FRB Beige Book, preliminary 2008 Q4 GNP, and new home sales reports. Q4 2008 S&P 500 (33% reported) earnings are dreadful and appear headed to 29% below Q4 2007. The corporate Q1 and full 2009 year guidance shows high uncertainty. In the midst of a large recession, government policy decisions impact market demand and economic outlooks. Initial awkward policy statements and potential laws will be analyzed to understand implications. The primary investment themes, domestic and international economy, earnings, and investment portfolio suggestions will be presented in the midst of continued highly uncertain times.

**Themes**

Investment markets themes are: big banks’ sickness, awkward new government policy actions and statements, consumers’ views, and capital spending.

**Banks remain sick; No painless cures**

The largest financial exchange traded fund (XLF) includes the major money center banks and related key financial companies. It fell over 26% in January and touched November 2008 all time lows. Investors did not like earnings reports below expectations, asset write-downs, increased bad loan reserves, large dividend cuts, and negative comments by the new administration and Congress. The Treasury Dept. and Federal Reserve Board (FRB) continue to operate with limited derivative security data. Full security disclosures from the mortgage servicers are needed to narrow the spread between fundamental economic values and security market prices. The valuation task is difficult, because the securities are complex combinations of mortgages and hedging products. However, it is necessary to quote the spreads at least monthly in order to make smart decisions.

The Treasury Dept. and FRB are using 3 basic bank survival tools. They are bank capital injections by purchasing preferred or other bank equity securities, trading good Treasury securities for bad bank securities, and guaranteeing bad bank securities. The Troubled Asset Relief Program (TARP) capital injections stabilized bank prices and avoided October 2008 major bank bankruptcies. However, further Citigroup and Bank of America bad security purchases and loan guarantees indicated additional derivative security devaluations. The Geithner Treasury is struggling with the same issues as the Paulson Treasury. That is: whether to completely nationalize selected banks that are judged too big to fail, wipe out remaining bank equity and bond holders, and let Congress run the banks based on social agendas. Current remaining TARP funds are not large enough to cover the greater than \$1.0T bad debts. The politics to appropriate more TARP funds may be difficult, since most taxpayers oppose bank bailouts. The Treasury and FRB have floated ideas of a bad bank to purchase the devalued bank assets. Yet, there is limited basis to set prices that will not harm either the taxpayer by overpaying or the bank security holder by underpaying. Another FRB and FDIC idea, to bail out the mortgage holders, will also be complex and unfair. Be aware that about 1/3 of defaulted mortgages are owned by speculators, who do not personally live in the properties. Responsible mortgage payers will protest mortgage restructuring programs that bailout the speculators. Home prices will stabilize, defaults and foreclosures will fall, and added bank loss reserves will no longer be needed at about the end of 2009. The big government plans to short cut the process based on limited data will likely be too late to make an impact that is fair to the taxpayer.

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### **Obama Government & Congress Awkward Start**

President Obama and his followers won overwhelming victories in November 2008 elections. Democrats can easily pass desired legislation into law without Republican support. The temptation is great to over reach for their goals, while complaining that the other side is not cooperating in a bi-partisan spirit. (I am not affiliated with either party and simply analyze issues logically.) The over reaching for big government programs will harm the U.S. economy in the intermediate term and eventually give the Republicans the opportunity to return to leadership. That is the nature of American politics.

The Treasury Dept. has the biggest challenge: Stabilize the banking system. As discussed above, there are no easy solutions. Using the remaining \$350B of appropriated taxpayer TARP funds wisely is crucial. Spreading the money around for mortgage restructuring, buying devalued derivative assets, and purchasing capital (preferred stock) from banks teetering near bankruptcy is a slow, unpredictable process. There are not enough appropriated funds to effect a magical “shock and awe” to stabilize the banking system. Home prices and other credit asset prices must stabilize first, so that related derivative asset values stop deteriorating. The banking system ship must settle in a solid port at low tide. Plugging the ship holes in turbulent seas prior to low tide will simply put the government further in debt and limit future after-tax earnings of U.S. citizens.

The HR1 American Recovery & Reinvestment Act of 2009, which was passed on Jan. 28 **will not stimulate** the U.S. economy in my humble opinion. I read through the 647 page document. It can be referred to as pork barrel spending due to its primary effective purpose to benefit particular political constituents – namely, each department of government, which gets a share of the \$816B net authorized costs. It is worth noting the origin of the term pork barrel. Generally, a pork barrel holds less perishable pork salt that was used as a larding component by 19<sup>th</sup> century families and was a measure of financial well being. Prior to the U.S. Civil War, Congress began referring to pork barrel bills as rewards to constituents, who would have to nominally compete for their share of the hand outs. HR1 greatly expands funding and the size of every department of government. It could better be referred to as the Government Expansion Act

(GEA); pronounced Gee Ah? As in: How will taxpayers pay for it? In the 2008 year end BWM letter, I noted a study by President Obama’s Chair of Economic Advisers, Christina Romer. It showed that \$1 of tax cuts resulted in \$3 of GDP growth and \$1 of added government spending resulted in only \$1.47 of GDP growth. The study did not influence the President and HR1. More than 80% of the act authorizes spending, less than 20% authorizes tax cuts. The Senate has yet to make changes. HR1 will not reduce the length of this deep recession, but may reduce peak 2010 unemployment from 9.5% to 8.5%.

Subtle protectionist under currents in HR1 and statements by Treasury Secretary Geithner should be carefully observed. HR1 includes a “Buy American” provision for steel and iron. (President Bush implemented a similar provision by Executive Order for a period during his time in office.) In the midst of a global recession and significant cut backs in international trade, the “Buy American” provision could cause sharp retaliatory responses from other trading partners and even impact the NAFTA. Protectionism contributed to the 1930’s depression. Treasury Secretary Geithner’s Jan. 22 testimony before the Senate Finance Committee that China may be manipulating its currency to stimulate exports was another protectionist mistake. He is a very smart technocrat, but has already heard a message of mistrust by the 34 Senators, who voted against his confirmation after disclosures of tax filing problems. Mr. Geithner’s statements were carefully made and certainly approved by President Obama. They will encourage Senators Schumer (D) and Graham (R) to reintroduce their bill to put a 26% tariff on Chinese imports due to alleged currency manipulations. China is watching and has a culture that does not like to be disrespected. Protectionism starts trade wars quickly!

### **Consumers’ Pocket Books Will Recover Slowly**

Households experienced large declines in net worth during 2008. All asset classes were volatile and most, including home equity, dropped significantly. I expect 1<sup>st</sup> Qtr. 2009 net worth data will show declines approaching 20% relative to 4<sup>th</sup> Qtr. 2007 peaks. That means belt tightening, i.e. savings, to stabilize household finances. A home owner’s best source of cash flow may be refinancing a mortgage at a lower rate and monthly payment. But the reduced mortgage expenses will not be used for vacations

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and fancy cars. I expect savings to increase, voluntary retirements to be delayed, and very selective purchases of good value products and services. Zero rate financing may be used to trade in a Chevy Malibu with 200,000 driven miles for a new Malibu, but I don't expect it to be used to buy a flashy red Corvette. People can't afford conspicuous consumption. HR1 will not kick the US GDP into long term growth rates until consumers balance their books. Endless deficit spending is not a U.S. consumer's option.

#### **What about Capital Spending?**

H.R.1 includes a surprisingly small amount for so called infrastructure spending. New highways and electricity grids will not be built with the seed money provided. The bill lacks regulatory changes to simply encourage the private sector to do capital spending; such as building efficient nuclear plants to replace vilified less efficient coal energy power plants. There will be less demand for new Las Vegas casinos, Manhattan Island building renovations, and new suburban malls. Capital spending in 2009 will focus on stable computer and communication industry product demand. Residential construction capital spending will remain at very low levels, while the inventory of new homes is sold off.

#### **The Economy – Deep Recession**

All economic indicators – employment, FRB Beige Book, capital goods orders, manufacturing activity, and new home sales – continue to show that we are in the midst of a deep recession with no indication of recovery. The only hopeful signs are that the heavily money supply weighted January Leading Economics Indicator turned positive and the inventory of unsold new homes fell notably. The preliminary 4<sup>th</sup> Qtr. 2008 GDP contracted at a 3.8% rate. (The 50 yr. low nominal 4.1% GDP contraction implies weak profits.) An inventory increase prevented a larger 4<sup>th</sup> Qtr. fall, but implied reduced 1<sup>st</sup> Qtr. production while inventory is sold. The BLS reported the Dec. 2008 unemployment rate increased to 7.2%. Many large companies announced layoffs in the past 4 weeks. The most likely scenario is that the unemployment rate will be between 8% and 9% in 12 months. That is about the level at the end of 1973/74 recession and less than the 10% level at the end of the 1980/82 recession. Unexpected foreign affairs or trade shocks could make a deep recession worse. However, if we define an economic depression as the 15% average unemployment in the 1930's, this economic contraction is not a depression.

#### **Disinflation? Yes: Deflation? – Probably No**

The U.S. 2008 CPI was 0.1%; the lowest in 45 yrs. Core inflation (1.8%) was within the FRB goal range of 1% to 2%. All central banks are flooding the globe with paper money today. Even if home prices fall another 5 to 10% prior to stabilizing sometime in 2009, the general price levels of all goods and services as measured by the 12 month core CPI gauge will likely not deflate to less than -2.0%. The sharp Jan. 2009 increase in Treasury 10 year bond yields should be observed as a possible future inflation indicator. When the economy grows again, inflation will be a real investor concern.

#### **Profits and Expectations continue to fall**

Based on 1/3 of the S&P 500 4<sup>th</sup> Qtr. 2008 financial reports, total S&P 500 company earnings are forecasted to fall 29% below the 4<sup>th</sup> Qtr. 2007 level. According to Zacks, excluding the Financial Sector, total earnings will fall 13%. Although the 4<sup>th</sup> Qtr. 2007 saw huge Financial Sector losses, the 4<sup>th</sup> Qtr. 2008 losses were 7 times worse! Analyst forecasts of just last month were far too optimistic on 4<sup>th</sup> Qtr. 2008 earnings. Healthcare and Utilities sectors showed the only positive comparisons. Corporate 2009 guidance is uncertain and sober. The 1<sup>st</sup> and 2<sup>nd</sup> Qtr. 2009 comparisons will likely also be negative.

#### **Financial Analyst forecasts approach reality.**

The current analysts' forecast revision ratio is about 6:1 downgrades/upgrades in 2009, which is an improvement from last month's 12:1 ratio. One quarter of S&P 500 firms saw consensus 2009 earnings forecasts fall more than 10%. Analysts have finally forecast earnings declines (-5.5%) in 2009 to \$69 for the weighted S&P 500 shares and that may drop more. At this time, the S&P 500 trades at 12.5 times 2009 forecasted earnings. In a no inflation no earnings growth environment that is near fair value.

During past recessions earnings fell for an average of 3 consecutive quarters. They will fall for a longer period during this recession; i.e. 6 to 7 quarters likely. Consumer spending is the issue. Consumer balance sheets and spending will recover more slowly than financial institution balance sheets.

#### **Foreign Economies**

Developed economies are set for no growth in 2008. Major 4<sup>th</sup> Qtr. declines occurred in all developed economies similar to the U.S. Developed economy GDP declines are expected

in the calendar year 2009. The emerging markets 2009 economic forecasts have been reduced throughout the year. Russia, a commodity focused economy, is especially hard hit by the fall in oil prices. U.S., China, Britain, the European Union and various other countries have announced Keynesian demand stimulus plans to push their economies out of recession. Key forecasts according to the *Economist* follow.

**Table 1. Economic Forecasts**

Economic Market	2008 GDP	2009 GDP	2009 CPI
United States	0.0	-1.2	1.2
Japan	0.0	-1.4	0.5
China	9.0	6.0	5.0
Great Britain	-0.4	-1.7	2.0
Euro Common Mkt ECM	0.4	-1.7	2.3
Russia	7.0	3.7	13.0
India	6.2	6.0	7.0
Brazil	5.3	2.4	5.5

All developed economies continued 4<sup>th</sup> Qtr. deep recessions. A global developed economies 2009 recession and total world economy 2% growth is forecast by the IMF. Japan and Britain are in the midst of severe recessions.

In Table 2 the U.S. positively sloped yield curve continues to be the most stimulative monetary policy. All countries are dramatically cutting short term interest rates as economies slow and inflation fears subside.

**Table 2. Current Global Yields**

Economic Market	3 month	10 Year
United States	0.3	2.9
Japan	0.6	1.2
China	1.4	3.0
Great Britain	2.1	3.7
Euro Common Mkt ECM	2.3	3.0
Russia	13.0	11.3
India	4.6	6.7
Brazil	12.0	6.2

### Economic Sectors and Investment Outlooks

**A Technical Overview** (BPNYSE, etc) indicates low market demand for U.S. and foreign stocks. The volatility fear factor rose a bit in Jan. vs. Dec. Investment cash on the sideline (5.0% estimated mutual fund cash) steadily increased. All time high cash levels exist in brokerage accounts. Money supply growth is a potential

demand indicator. **Suggestion: Hold current positions, but do not add to portfolio equity levels, until economic indicators slow their rates of decline.** A recovery rally is likely during the 1<sup>st</sup> Half 2009 as volatility declines; however, continued January declines were worse than expected. Sector price relative strength (RS) shows sector demand only in the consistent earnings Utility and Healthcare sectors. Large growth stock demand is **slightly less bad** than other style subsets. Foreign equity securities denominated in the USD declined significantly due to the relative USD strength.

### Economic Sector Analysis and Outlook

**Healthcare** sector 4<sup>th</sup> Qtr. 2008 earnings are in the high single digit range and 2009 growth looks stable. Biotech and medical products industry earnings are causing an overall positive RS. Hold them. But they are vulnerable to uncertainties concerning added regulations. The **Utility** Sector reported single digit 2008 earnings growth and stable forecasted 2009 earnings. The RS is better than the general market and dividends are around 4% (over Treasury bond rates.) Normal portfolio asset allocation weights are suggested. Demand for dividend paying **Telecom** sector stocks is below normal in a recessionary economy. Hold current positions. The **Consumer Staples** sector 4<sup>th</sup> Qtr. earnings fell slightly and the 2009 earnings growth outlook is cautious even for powerful Proctor & Gamble. Demand for this defensive sector is surprising weak, in spite of continued price increases. Hold normal portfolio weights. The **Energy** sector experienced extreme volatile price swings in 2008 and total year earnings grew 18%. Large earnings declines are forecast in 2009. Energy sector fundamentals at oil replacement cost estimates are desirable. The oil sector is trading at a 2009 P/E = 9.1. Hold energy equities. The above 5 sectors have interesting dividend growth candidates for the value investor. **Technology** Sector 4<sup>th</sup> Qtr. reports were mixed. Apple, IBM, Oracle, and Google have large cash flows and beat expectations. For long term growth investors, a good argument can be made for these stocks. On the other hand, be aware that the Tech Sector trades at the highest 2009 sector P/E (19). The cyclical **Materials** sector is performing with negative RS, while earnings are weak. A below normal portfolio weight is suggested. **Industrial** sector exports (and earnings) to developing countries are slowing. Below normal portfolio weights are suggested in this sector. The **Consumer**

**Discretionary** sector remains a cyclical area. The RS is neutral but there is much dispersion between companies. Below normal portfolio weights in trendy retailers are suggested. The Financial Services sector remains uncertain and very weak. Write downs of bank debt securities and numerous FRB bailout asset transfer facilities will continue. Dividend cuts remain a negative factor. **Economic sector earnings are weak in total.** Stocks are much less expensive than 5 months ago. There is liquidity to demand stock prices higher. **Summary:** hold current positions; but wait prior to adding to equity positions.

**International Markets Are Stable**

Foreign stock markets fell 14% in January, while the USD (1.28 Euro) exchange rate rose 8%. Holding fewer developed economy stocks is suggested. As foreign banks continue to cut interest rates, the USD may recover more and act as a headwind for foreign stock returns. Alternatively, a reduced flight to safety may cut USD exchange rates. Emerging market stocks are very volatile. Normal weights may be considered only if you have the capacity to withstand a very large decline (-50% in 2008.)

**Fixed Income - Less Volatile**

U.S. Treasury bond January 2009 returns (-13%) were hurt by reduced demand (possibly from China). Investment grade corporate bonds were unchanged, while high yield (junk) bonds curiously gained in Jan. Money is flooding out of stock funds to money market funds. A small portfolio weight in a TIPS fund is suggested. Note reduced inflation expectation may result in recent negative TIPS returns. Muni bonds are also suggested for taxpayers in high tax states, who research good general obligations bonds. High single digit after-tax returns at modest risk are possible.

**Alternative Investments – Diversification**

The Real Estate Investment Trusts (REITs) index hemorrhaged 18% more in Jan. due to financing concerns and anticipated retail vacancies during the recession. Wait for more information prior to buying REITs. Gold funds are diversifiers. Normal alternative asset 5% gold fund weights appear reasonable. Gold did have positive Jan. returns (6%) and will likely continue to perform well, when inflation inevitably heats up after this recession ends.

**Portfolio Management**

Funds have cash (5.0%) to boost stock or bond prices higher. The S&P 500 index is trading at about a forecasted 2009 PE = 12. Normally, a reciprocal 8.3% earnings yield is favorable to the current 6.8% corporate “A” rated bond yield. The question remains: Will the forecasted earnings occur? Holding a diversified assets portfolio is suggested.

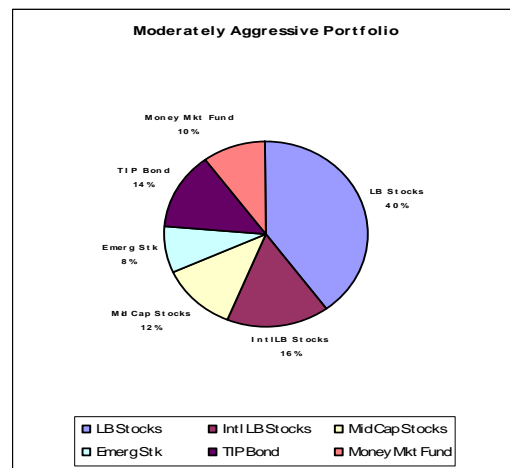
- Current portfolio themes are:  
 Normal Investment Weights
- All U.S. stock caps funds normal weight
  - Foreign EAFE funds below normal weights; Emerging stock funds normal wts.
  - Fixed income – TIPS and possibly Muni
  - Gold
  - Hold stocks in suggested sectors

Disclosure: Personal holdings: 53% Domestic & International Large Cap stock funds, 41% Small/ Mid Cap funds, 6% cash (19% Total International funds)

**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

Normal Capital Accumulation –

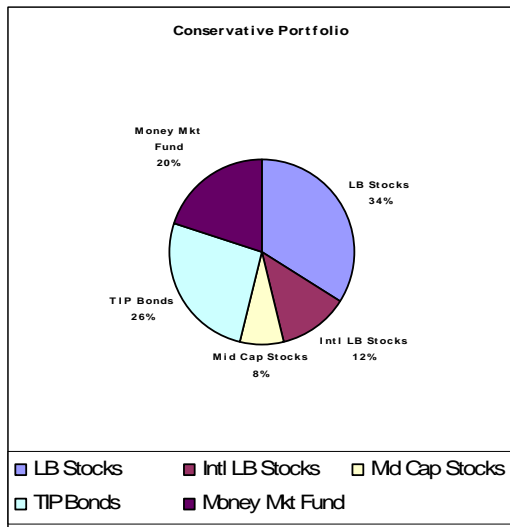


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**Sample Portfolio B - Conservative**  
Example 65 year old couple with Social Security Income (20% of spending needs) and Retirement 401K or Pension Plans converted to IRA's

- 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 –



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](http://www.BanachWealthManagement.com)

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