

**BWM**Investment  
Guidance**February 2011 Month-end Markets Review  
Rare Secular Bull or Late Stage  
Normal Cyclical Bull Stock Market?****Key Points**

- **2011 year to date total returns**

S&P 500 (1327)	6%;
US 10Yr Bond (3.42%)	0%;
NASDAQ (2782)	5%;
Foreign (EAFE) Stocks	6%
- U.S. GDP expected expansion = 3.4%
- 2011 expected earnings increase = 15%
- Stock market price advance: 6 months
- Modest jobless economic recovery

**Executive Summary**

Equity market returns in the 2<sup>nd</sup> month of 2011 (S&P 500 3%, NASDAQ 3%, EAFE 3%) were positive. Yet North African and Middle East unrest pushed oil prices (\$97 per barrel) up 6% and added uncertainty (volatility) to markets. Fourth Qtr. 2010 earnings reports continued above forecasts and the U.S. economy is modestly expanding. Bond market (U.S. Treasury (UST)) returns were essentially flat. Interest payments balanced small bond price losses. As suggested last month, Egyptian, Libyan, and other country tensions gave overbought equity markets something to worry about. The euro currency recovered a bit more (2%) relative to the U.S. dollar (USD). Federal Reserve Board (FRB) increased UST demand beginning in November (Quantitative Easing 2 (QE2)) continued to be matched internationally by slightly reduced demand. Foreign sovereign reserves held in UST securities are impacted by a weak USD, as the primary global currency, that links to their home currency inflation, as well as commodity price related inflation. Soaring 2010 U.S. profits resulted from nearly free financing (0% short term rates), high profit margins, and little incentive for the risk of expansion. Consumption spending (4.2% 4<sup>th</sup> Qtr growth) steadily rose in the 2010 recovery from a severe recession. Weak construction spending and high unemployment limited economic growth to date. Sources of new equity market demand are blue chip stock buying, mergers, acquisitions, and private equity firm related transactions. Some agricultural and industrial commodity price increases will likely get passed on in consumer price inflation.

**Single Theme**

- **A Question to think about: Are we in the initial stage of a rare Secular (10 years average) Bull or late stage of a normal Cyclical (2 to 2½ years) Bull Market?**

The question is important to households and institutional investors in order to execute strategies and tactics in wealth management and investment policy decision making. The last inning of a baseball game calls for different risk management tactics than the early innings.

Understanding sometimes irrational, emotional markets requires effort to gain and maintain confidence in a dynamic world economy. When the probability of equity and debt market asset valuation uncertainties appears to be above normal, it is wise to review risk taking budgets, consider scenarios, and apply appropriate tactics. Reducing risks by selling assets, transferring from generally high risk to lower risk assets, or implementing other defensive tactics to protect principle should be considered. In contrast, when the probabilities for higher market asset valuations appear favorable, riskier assets may be considered to achieve financial goals within defined constraints. The following analysis will study underlying corporate earnings and outlooks (bottoms up), macro-economic fundamentals (top down), sentiments (emotional measures), and present the arguments for both cyclical and secular bull markets in financial assets. Let's lay out the relevant facts for the different points of view.

**Starting from the bottom and going up: Earnings**

The S&P 500 corporations that account for about 75% of U.S. public company revenues had an extraordinary 2010 profit recovery. Earnings increased nearly 44% with over 85% of 4<sup>th</sup> Qtr. financial reports tabulated in the Zacks data base. The S&P 500 look to have earned \$785B (2010) versus \$544B (2009). Long term profits annually increase about an average 10% and (including 3% inflation) total returns average about 10%. Analysts are further forecasting 2011 earnings increases of 15% to exceed the 2007 peak and thus be labeled as an earnings expansion. Early 2012 forecasts sum to an additional earnings increase of 10%. In a nutshell, nearly 0% financing costs, cost controls, and below normal capital expenditures for expansion boosted after-tax S&P 500 profit margins to 8.6% in 2010. Excluding the difficult to analyze financial sector, net profit margins (NPMs) were nearly 8.2%. That is far above normal 5% to 6% NPMs. S&P 500 capitalization weighted

2/28/2011

shares earned about \$82.75 and ended the month at 1327 for a trailing 12 months (TTM) earnings based Price Earning Ratio (P/E) of 16.04. Current and forward looking valuations with P/E ratios will be further reviewed. The primary economic sectors will finally be considered as a rationale for suggested stock holdings.

***And coming from the top: Macro economic views***

The U.S. economy (GDP) grew modestly (2.8%) in the 4<sup>th</sup> Qtr, as well as for all of 2010 (2.8%); thus recovering from a recession ending 2009 (-2.6%). The 2010 current (nominal) GDP was \$14.86T including 1.3% inflation according to the U.S. Dept. of Commerce Bureau of Economic Analysis. Personal consumption, which accounts for 70% of the economy and was propped up by the American Recovery and Reinvestment Act (Stimulus) transfer payments, increased 4.2% in the 4<sup>th</sup> Qtr. Many economists note a deceleration in inventory growth (\$7B) in the 4<sup>th</sup> Qtr. after \$121B growth in the 3<sup>rd</sup> Qtr. and expect an inventory restocking boost in 1<sup>st</sup> Qtr. 2011 GDP. Non residential fixed investments increased (5.3%) in the 4<sup>th</sup> Qtr. compared with (10.0%) the 3<sup>rd</sup> Qtr. The 4<sup>th</sup> Qtr. savings rate was 4.1%.

The Conference Board and ECRI calculate data as ***Leading Economic Indicators*** (LEI) monthly and Weekly Leading Indicators (WLI), respectively. They have reasonably good records of forecasting intermediate term (6 month) economic levels of activities. The LEI expects continued economic expansion over at least 6 months based primarily on the highly stimulative term structure of interest rates and recent stock market gains. That is in spite of now stable M2 money supply expansion (4%) and no increase in manufacturing hours worked. The WLI, which correctly noted the 3<sup>rd</sup> Qtr 2010 economic uncertainty, has returned to its 2<sup>nd</sup> Qtr forecast of moderate minimum 6 mo. expansion. The weekly initial unemployment claims trend implies an expansion of jobs to average over 125,000 new monthly net U.S. jobs and no increase in the unemployment rate by year end. A 2011 GDP growth rate of 3.4% and more than 12% 2011 S&P 500 earnings growth look justified from the top macroeconomic view looking down to corporate earnings.

The ***employment level*** (unemployment rate) is the economic statistic, which people feel directly. If you, a family member, friend, or neighbor is not employed, that is more clearly understood than if the S&P 500 company earnings increased 44% or the index return was 15% last year. The past

recession was unusual. Manufacturing employment cuts were small in comparison to many service sectors. Due to productivity gains, the level of U.S. manufacturing, except for domestic automobile output, is at a record level. The government sector, including federal, state, and municipal employment level to date, has contracted little. It is larger than 10 years ago. The private sector service industry took the largest employment losses. More automated call centers and professional service automation occurred as the service sector battled to increase productivity. Fewer consultant opportunities exist, as the value of their services is carefully scrutinized. Salaries and service compensations are increasing at about the level of inflation and must be justified more carefully than anytime in recent decades.

***Is the current stock valuation sentiment level reasonable?***

As previously stated, the current S&P 500 TTM P/E is 16.04. The forecasted 2011 earnings are \$95.29 per share to calculate a forward P/E of 13.93. Since the valuation process is forward looking and economic life includes many uncertainties, one year forward looking earnings naturally have a higher probability of estimation accuracy than two year forward looking earnings. And there are other ways to value stocks with more past data, such as 5 or 10 yr. average or normalized earnings. They may also be operating or total earning based on the analyst's focus. After the great recession, 5 yr. avg. P/E valuations are higher than 20 and above the long term average. Does that imply that they are over valued? A counter view point is that 2011 S&P 500 E/P yield is currently in the 7.25% range in comparison to the lower risk 10 yr. Treasury bond yield in the 3.50% range. Does that mean that there are enough buffers to conclude that stocks are relatively better values than bonds?

Financial analysts are the *professional forecasters* of corporate and macro economic expectations. They use SEC filings and as much other accurate data to infer a forecast with models and judgment. As a group they appear to be marching in step toward ***overly optimistic 2012 forecasts***. Expected NPMs are a good check to measure professional optimism. The forecasted 2011 and 2012 total S&P 500 NPMs are currently 9.5% and 10.1%, respectively. Excluding the unique leveraged financial sector, NPMs remain at 8.9% and 9.3%. That is far above normal and implies a very favorable scenario or more specifically, the basis for the secular bull market.

2/28/2011

Market timer letter writers, traders, institutional money managers, and small investors are surveyed and their behaviors indicate the market sentiments. When they are over confident, fear indicators are generally low, momentum strategies are working, short trades are squeezed, some new money is supporting demand, and stock investors are fully invested. *Market procrastinators are now aligned with the professional analysts.* They have been looking for a pull back, since the Bernanke QE2 announcement stock advance started in early September, 2010. In stead an orderly advance has continued for 6 months. They are generally bullish, but praying for a 10% correction to make purchases at a lower risk level. Their prayers have not been answered yet. Fourth Quarter, 2010 S&P 500 year over year earnings grew 30%, instead of an expected 20% growth rate. The corporate TTM fundamental earnings were very good. Macro economic uncertainties are pushing up oil prices and some people worry about possible current year U.S. federal spending cuts. ***At this time confidence remains unshaken.*** Demand for value vs. growth or for large vs. small stocks for the first 2 months of 2011 appears nearly equal. Overall emerging stock market declines of about 4% are an indication of caution as China, India, and Brazil are controlling their currencies against commodity and trade related inflation. Technically, the stock market remains in an overbought intermediate term position and is dependent on continued nearly 0% financing to push up earnings and keep the P/E valuations near normal levels.

#### ***The Cyclical Bull Market Argument***

Ned Davis Research charts and tables form the basis for the normal cyclical bull market argument. Most stock markets advance for about 26 months after they hit bottom at or near the end of a recession. Their total trough to peak advance is about 85%. Some cyclical market peaks occur as much as 30 months after the bottom; however, subsequent stock market movements don't usually reach higher peaks prior to a correction (-15%) or finally a bear market (-25% from peak). The average down turn lasts about half as long as the upturn. Since the March, 2009 S&P 500 intraday low of 668, the S&P 500 index advanced recently to 1343 or 101% in 23 months. Remember, the S&P 500 declined 57% over the prior 17 months. The S&P 500 remains 14% below its peak and has made a slightly larger than average recovery from a far larger than normal decline in less than a normal time period. If the S&P 500 peaked within the next 3 to 6 months at about 5% above the current level it would qualify as cyclical bull market.

#### ***The bottoms up and macro scenarios for a cyclical bull market***

The cyclical bull market view implies the professional forecasters (analysts) are wrong about 2012 continued normal earnings expansion. If analysts are wrong about NPM expansion, it would likely be due to higher financing costs, higher energy costs, or unexpected government controls. Some economic sectors, such as consumer staples and consumer discretionary items (airline tickets), have pricing power to pass product costs (inflation) on to consumers. Yet there is manufacturing utilization slack in other sectors, such as industrials and other consumer discretionary items (automobiles) that must absorb higher cost of goods that reduce NPMs and limit profits.

*Chairman Bernanke* may be *constrained* in accepting higher inflation to attempt to push the employment level higher. China raised interest rates recently to contain inflation at 4% and the ECB is focused on not allowing inflation to exceed 3%. There may be foreign Treasury security holder sales and Congressional pressure if \$4.50 per gallon gasoline and a TTM CPI rate of 4% are reached in 12 months. High federal debt and new deficits must be financed at prevailing interest rates. Increasing short term interest rates up to the current real cost of money (about 2.5%) or sales of various FRB debt assets and increasing long term rates (flatten the yield curve) would increase the cost of corporate financing, *decrease NPMs*, and reduce bottom line earnings growth. An *emotional* valuation driver may be market *sentiment*, which has been so focused on 0% interest rates for 2½ years that some investors may sell stocks quickly, take profits, and move on to assets with lower relative valuations (rental housing?) in response to any short term interest rate increases.

Less probable *business cycle issues* could be real *factory utilization* that may be higher than measured, so that supply limits begin at 78% instead of normal 80% readings near December, 2011 and cause pricing pressures. During the recent recovery, capital expenditures were mostly replacements of worn out plants and equipment, instead of expansion of new plants and equipment.

An unexpected foreign issue due to trading partner currency stresses (Spain?) or attacks on allies (Israel?) can be a catalyst to slow down global business growth after markets are valued above normal. Unknowns are unpredictable but have a way of happening when the majority of investors are overconfident.

### ***The Secular Bull Market Argument***

Laszlo Birinyi is a 40 year veteran money manager, who appeared regularly as one of Louis Rukeyser's PBS *Wall Street Week* guests in the 1970's and 1980's. He focuses on technical analysis money flows and the momentum of the recent past to forecast the future for stocks. He has been talking quite a bit recently about the S&P 500 advancing an additional 31% in his worst case scenario and 100% in his best case scenario over the next 2½ years (by September, 2013). His best case scenario would qualify as a 4½ year total 200% U.S. large capitalization stock advance, a secular bull market, and very likely an asset valuation bubble.

Technically, the 4 most recognized secular bull markets in the past 110 years have lasted at least 7 years to gain more than 200% (16% annual return) in generally low average annual inflation (<3%) periods. Secular Bull Markets occurred in 1900-1907, 1922-1929, 1950-1966, and 1982-2000. A Secular Bull Market scenario is possible; yet, very favorable new developments are necessary. During the first period large industrial consolidations were orchestrated by New York bankers and more specifically under the watchful reins of John Pierpont (J. P.) Morgan. Macro-economic growth was significant and traders used insurance products to speculate and push valuations higher. Economies of scale in the steel and other industrial industries were special factors supporting economic growth. During the Coolidge Administration roaring 20's the Harding political scandal was quickly cleaned up, the U.S. had no foreign issues to use up economic resources, tax rates were lowered, the World War I debt was paid, and both key inventions like refrigeration and manufacturing advances to churn out Model T Fords occurred in a very favorable era for economic growth. Speculators used stock margins as high as 90% and boosted stock valuations to extreme levels by the August, 1929. The post World War II period after non-rationing inflation and regulation issues settled down until the beginning of the Vietnam War was a third Secular Bull Market. Inflation was about 2%, the U.S. had limited foreign security resource drains with an effective Korean War stalemate, the Kennedy tax cuts boosted household take home pay, the quest for a moon landing supported optimistic U.S. confidence, and the costs of Johnson's Great Society entitlements or the divisive nature of the Vietnam War were yet to come. There were few new financial speculative products during the period, although in 1966 some so called go-go growth style mutual funds sported 100% gains to capture speculators' imagination.

The last Secular Bull Market ran an unprecedented 18 years with only a minor 1990 recession through the end of the 20<sup>th</sup> century. Again many favorable factors occurred to make it possible. After Chairman Volcker effectively killed the inflation dragon and President Reagan reduced taxes and limited regulation growth, employment and economic growth strengthened, the stock market crash of 1987 was quickly forgotten, the collapse of Cold War foe U.S.S.R paid a peace dividend of limited defense spending for a decade, Iraq War I was quickly won, a minor recession and S&L industry debacle were contained, and a divided 1990's President/Congress limited government and deficits growth. Low inflation occurred during the period and the Technology, Telecom, and Media stock extremely high valuations ended the last of 4 Secular Bull Markets in the past 110 years.

In order for Birinyi's best case scenario to occur, extremely favorable conditions must occur during the next 2½ years. Most importantly, a fiscal policy entitlement spending and deficit ceiling agreement could encourage investor confidence. A business friendly environment could emerge that result in higher private (primarily small business) employment growth expectations. For small businesses, exceptions or a moratorium from newly enacted regulations could be enacted. Treaties with Columbia and Panama, in addition to the recently renegotiated South Korean Trade Agreement, could be presented to Congress for passage to show that the U.S. government supports trade. A corporate tax law concerning differential foreign tax credits could be enacted to give corporate foreign subsidiaries an incentive to pay U.S. taxes and bring cash back to the U.S. for expansion and added employment. Permanent low U.S. tax rates could be the incentives for economic expansion. A favorable environment would be called a goldilocks scenario of continued low interest rates, reduced government deficit spending, continued inflation less than 3%, increased productivity, and economic growth between 3% and 4%. No foreign crises would be assumed. In that environment, the financial analysts 2012 corporate profit scenarios are possible.

### ***Which scenario do you expect?***

Normal Statement of Fact: No one can predict the future. Yet, the favorable business conditions scenario seems improbable at this time. The key issue should be encouraging businesses, who deal with real economic constraints, to invest, expand, and create new job opportunities. A quiet period of no new regulations would give small businesses

especially a chance to understand and deal with recent regulations. With existing conditions, likely interest rate increases within the next 12 months appear destined to end a cyclical bull market run short of the autumn 2007 S&P 500 price peak of 1560. I update my opinion as the facts change.

### ***Global Economies***

Emerging countries (China, India, Brazil, and Russia) continue to grow at high speeds with currency related inflation issues. Developed countries, European Common Market (ECM) (except Germany), Great Britain, and Japan grow at slow speeds. An unexpected slow down in 2011 Chinese GDP growth rate (to 7%) could impact neighbors like South Korea or Australia. Most emerging countries and markets appear to show continued steady growth with responsible government policies. Their stock markets look fairly valued, but moving lower with monetary controls. Potential returns merit some portfolio asset allocation weight through perhaps 2011 with awareness that volatility may remain high.

***Table1. Economist Forecasts***

Economic Market	2010 GDP	2011 GDP	Jan. 2011 Unemployed
United States	2.8	3.4	9.0
Japan	4.2	1.5	4.9
China	10.3	9.0	9.6
Great Britain	1.6	1.8	7.9
Euro Common Mkt	1.7	1.5	10.0
Germany	3.5	2.6	7.4
Russia	3.7	4.3	7.2
India	9.1	9.0	10.8
Brazil	7.7	4.3	5.3

The total 2011 global economy is expected to expand at a similar rate to 2010 (3.6%) with Asia leading the way. In Table 2 the U.S. positively sloped yield curve showed a continued very stimulative monetary policy. During the 4<sup>th</sup> Qtr all country 10 year bond rates rose. Developed country 2011 bond yield rates imply continued GDP growth.

***Table 2. Economist Current Global Yields***

Economic Market	3 month	10 Year
United States	0.2	3.4
Japan	0.2	1.3
China	4.8	4.1
Great Britain	0.8	3.9
Euro Common Market	1.1	3.3
Russia	7.8	5.2
India	7.1	8.3
Brazil	11.2	6.2

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

The current environment is speculative and price momentum driven. Global fears of higher oil prices related to Libyan and other country riots are reasons for overbought equity corrective declines in the short to intermediate term.

Growth equity and commodity assets historically earn their highest returns in similar speculative periods with above expectation economic growth and overly confident investors. Currently some consumer discretionary concept stocks appear more overpriced than high growth story stocks such as Apple and Google or low price high NPM blue chips with short term issues like Hewlett Packard and Johnson & Johnson. Small and mid cap growth stocks advanced a great deal in 2010. Large caps, especially dividend paying stocks such as IBM and Intel, may attract more demand sometime during 2011.

### ***Technical Analysis***

The US stock market was technically overbought until the implication of higher oil prices related to Middle East unrest caught the attention of markets. At this time it is unclear if tensions and potential global economic impacts will be a catalyst for a 10% decline.

The underlying fundamentals appear solid. QE2 interest rate manipulation continues. Temporary continuation of the Bush tax cuts, new temporary Obama Social Security and Estate tax cuts, and full write off of capital investments seemed to boost confidence, consumption, and intermediate term capital investments. The cross current of foreclosures and limited residential construction will likely not dampen the asset value deflation scenario (except housing for maybe 6 months) stimulated by monetary and fiscal policy.

### ***U.S. Economic Sectors***

Materials Sector 2010 earnings growth exceeded the S&P 500 Index, healthy earnings and revenue growth are forecasted in 2011 and being revised up; prices rose (2%) less than the S&P 500 year to date (YTD). No suggestion. Energy Sector earnings and revenues grew more than the S&P 500 index and price Relative Strength (RS) was far (11%) above the index YTD. Consider dividend paying assets. Mideast tensions have boosted oil prices about 9%, as you can see at the gas pump. Financial Sector 2010 earnings recovered outstandingly, the 2011 earnings outlook is good, but no 2011 revenue growth is forecast. The price RS was in line with the S&P

2/28/2011

500 (5%) YTD. No Suggestion. Industrial Sector 2010 earnings and revenue growth beat the S&P 500 Index, 2011 earnings forecasts are being revised up, and RS was in line with the S&P 500 Index. Hold. Technology Sector 2010 earnings (46%) and revenue growth (17%) was strong. 2011 NPMs (10%) and earnings look strong. RS slightly lagged the market. Suggestion: Hold. The Consumer Staples earnings growth and RS lagged (-4%) the S&P 500. Hold dividend paying stocks with pricing power. Utility Sector Stocks earnings and price RS lagged behind the S&P 500 Index. No suggestion. Healthcare stock earnings growth and price RS lagged behind the S&P 500 Index, but P/Es are low. Hold selectively. Consumer Staples, Utility, and Healthcare stocks are normally defensive, stable earnings stocks, which are less volatile and lag other equity assets during similar speculative periods. Consumer Discretionary stock earnings varied with overall in-line RS vs. the S&P 500 YTD. No suggestion. Treasury Bonds (unchanged YTD) are influenced by FRB QE2 manipulation. Shorter maturities suggested. The price of Gold is about unchanged YTD. Hold. *These suggestions are not recommendations. Portfolio management is specific to client goals, objectives and risk tolerance.*

**Suggestion: Hold normal portfolio asset weights. Shorten bond durations (maturities).** Stock market psychology is positively biased; market prices are extended; volatility can cause a quick decline in prices. Markets appear fairly and fully valued.

*Think about your risk tolerance.*

#### Alternative Investments – Diversification

The Real Estate Investment Trusts (REITs) index performed in-line with the S&P 500 Index YTD. Energy MLPs are effective ways to profit from income producing real assets. Gold funds are diversifiers. A 5% weight in a gold ETF (GLD) is suggested.

Current portfolio themes are:

Normal Investment Weights

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

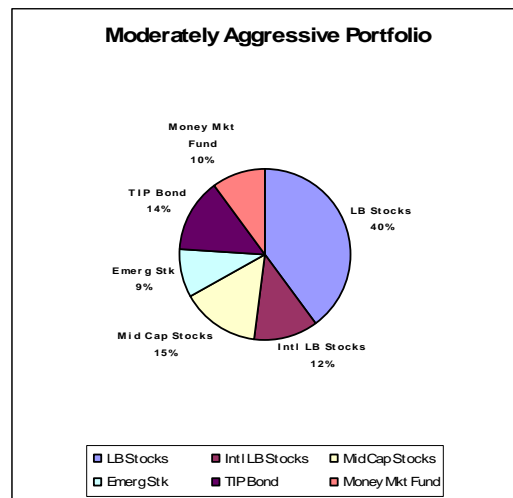
Disclosure: Personal holdings: Normal weights  
39% Domestic & Intl Large Cap stock funds,  
(13% Total International stock funds)  
48% Small/ Mid Cap funds,  
13% short term U.S. & Intl. bonds and cash

#### Sample Portfolios are models Not Client Recommendations

Sample Portfolio A - **Moderately Aggressive**  
Example 45 year old college educated parents with 1 high school child and 1 college child.

- 40% Large Blend Stock Index Funds
- 12% Large Blend International Fund
- 15% Mid or Small Cap Stock Fund
- 9% Emerging Market Stock Fund
- 14% TIP Bonds
- 10% Money market cash

Normal Capital Accumulation –



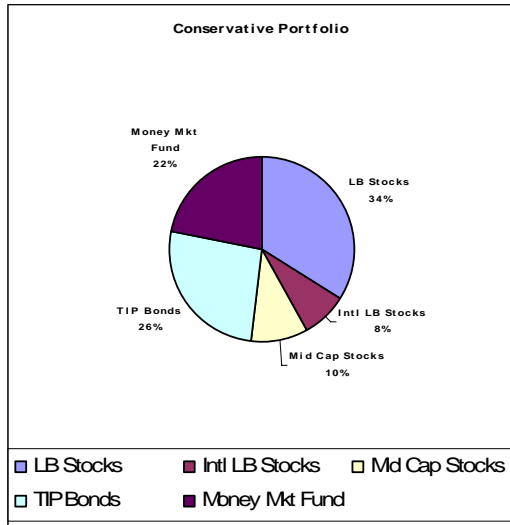
#### Sample Portfolio B - **Conservative**

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

- 34% Large Blend Stock Index Funds;
- 8% Large Blend International Fund;
- 10% Mid or Small Cap Stock Fund
- 26% TIPS Bonds
- 22% Money market cash

2/28/2011

Normal Capital Preservation



**LEGAL DISCLAIMER – BWM Letters Information**  
The BWM letter is not in any sense a solicitation or offer of the purchase or sale of securities. The factual statements herein have been taken from sources I believe to be reliable but such statements are made without any representation as to accuracy or otherwise. Opinions expressed are my own unless otherwise stated.

If I buy, hold, or sell securities discussed herein, then I will disclose my positions. Prices shown are approximate. Joseph Banach, Chartered Financial Analyst, Certificiant in Investment Performance Measurement  
[www.BanachWealthManagement.com](http://www.BanachWealthManagement.com)

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