

BWMInvestment
Guidance**2010 Financial Markets Year End Review***It was a good year**From euro adjustments to tax rate extensions**Profits flowed and investors cheered**It was a good year**-to paraphrase Frank Sinatra***Key Points**

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|--------------------------------------|----------|
| • 2010 Total Returns | |
| S&P 500 (1257) | 15%; |
| US 10Yr Bond (3.29%) | 6%; |
| NASDAQ (2652) | 17%; |
| Foreign (EAFE) Stocks | 5% |
| • U.S. GDP expected expansion = | 2.6% |
| • 2010 expected earnings increase = | 43% |
| • Stock market price advance - | 3 months |
| • Jobless abnormal economic recovery | |

Executive Summary

Equity market returns rose in the 4th Qtr. of 2010 (NASDAQ 12%, S&P 500 11%, EAFE 4%). Bond market (U.S. Treasury (UST)) prices retreated (6%) as yields rose significantly. The Irish debt crisis dragged down the Euro currency (-5%) relative to the U.S. dollar (USD). Federal Reserve Board (FRB) increased UST demand beginning in November (Quantitative Easing 2 (QE2)) was offset by reduced demands from other buyers. In the midst of \$300B of added FRB demand during the 4th Qtr, bond yields and related 30 yr. fixed mortgage rates unexpectedly increased ½%. The U.S. economy ran on about 75% of its cylinders during 2010. Profits soared. Consumption spending steadily rose in a subnormal (2.6% real growth) recovery from a severe recession. Weak construction spending and high unemployment held back economic growth. Major healthcare, financial, EPA, FCC, FDA, and other regulatory agency expansions increased economic uncertainty, the cost of labor, and new projects required returns. As will be analyzed, the U.S. economy was surprisingly productive in the midst of extraordinary uncertainty. At the 11th hour after his party lost control of the House of Representatives and a filibuster proof Senate, President Obama sent his trusted Vice President Biden to make the best tax rate/stimulus deal possible from his perspective with Senate Minority Leader McConnell during a so-called lame duck Congress session. Stock buyers were satisfied, confident, and pushed prices ahead of current values in my view.

Themes

- *Why were 2010 earnings far above expectations? Will they continue in 2011?*
- *What is more critical in 2011: Monetary or Fiscal Government Policy?*
- *Will investor optimistic emotions settle down to cautious rational questioning?*
- *Who is politically at more risk: Chairman Bernanke or President Obama?*

Why were 2010 earnings far above expectations?

The cost of financing has been very, very low since Federal Reserve Board (FRB) Chairman Bernanke and Federal Open Market Committee members expanded credit in the midst of a major 2nd Half 2008 illiquid credit dislocation (Fannie Mae and Freddie Mac conservatorship through AIG bailout, Lehman Brothers bankruptcy, and GM bailout). The total cost of financing is below the real cost of money (Treasury Inflation Protected Security) rates and inflation (1%). Profit margins increased to record levels and earnings increases followed. A further key element is cautious business decision making in the midst of high uncertainty. According to Columbia University Historian Alan Brinkley, in terms of laws passed, the 111th Congress was the most productive in at least 50 years. Unfortunately, many laws are non-specific, burdensome, and contradictory. The total cost of the Patient Protection and Affordable (Health Control) Care Act and Dodd Frank Wall Street Reform and Consumer Protection Act are yet to be set by newly created federal sub-agencies. Corporations are controlling large cash flows to cope with increased regulatory expenses. This was the unusual 2010 economic environment in which profits soared, while unemployment stagnated at levels above 9.5%.

Will profits continue to soar in 2011?

Profits likely will continue to increase (11%) if consumer demand increases modestly, the weak U.S. dollar (USD) policy boosts export demand, the cost of overall financing does not increase more than 1½%, and the cost of energy does not increase more than 15%. Let's consider those 4 conditions. 2010 prime holiday season consumer spending (30% of annual consumer spending) increased about 5%, which was significantly above 2008 and 2009 levels. Household savings rates have been a stable 5% throughout 2010, as people work toward balancing extended check books. It is conceivable that consumer spending will modestly increase (3%) in 2011 as the Obama Social Security (SSA) tax cuts take effect

1/2/2011

and unemployment declines to possibly 8.9%. The USD may remain stable against a market basket of other currencies in 2011. Relevant factors are: FRB stimulative QE2 Treasury Securities purchases and fiscal tax cut stimulus. If the 2011 U.S. GDP growth approaches 4%, as I suggest, then both exports and imports should rise modestly. Presidential submittal of the Columbia and Panama free trade agreements (FTA), in addition to the South Korean FTA, to Congress for approval would support trade and offset counter protectionist US WTO complaints. The cost of financing after 3 years of extremely low interest rates will be both a rational and a psychological issue. If QE2 financing results in foreign buyers of U.S. debt reducing demand and consequently increasing interest rates, the FRB will have a dilemma to address. Either it must increase interest rates to slow core inflation rising above its 2% guideline or change the guideline and state that price stability is less important than stimulating economic growth and employment. Corporate profits will not be initially reduced because of the momentum of huge cash flows. However, expectations will change, bond prices may fall, and the valuation of earnings (psychological P/E ratio) may also fall. The cost of energy is a factor because prices at the gas pump are very visible to consumers. If oil rises above \$110 per barrel in a growing global economy, then U.S. gas pump prices will likely hit \$4.00 per gallon. There will be political pressure, which the FRB will likely be forced to respond to with less aggressive QE2 and other policies. In summary, there is a reasonable probability that S&P 500 earnings will increase about 11% in 2011 and match their peak of the 2nd Qtr. 2007. The S&P 500 stock index may be valued at about 10% above current levels sometime in 2011. However, in my view unstable monetary and fiscal policies will likely create asset price bubbles that must be reduced through higher interest rates before the 2012 presidential election.

What is more critical in 2011: Monetary or Fiscal Government Policy?

Monetary policy is most critical currently to both asset (stock, home, etc.) valuations and economic activity. Chairman Bernanke rang the clearest bell possible on November 4 in his *Washington Post*¹ article that he is determined to inflate asset prices. In conjunction with The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation (\$801B) Act of 2010 signed by President Obama on December 17 equity

investors and speculators got the message that the U.S. economy received a double dose of added stimulus (III) and asset (demand) prices will rise. Very low interest rates and QE2 will likely be the primary boost for significant (4%) 2011 U.S. GDP growth. After the 2nd Half 2008 illiquid credit dislocation, the FRB had more impact with liquid cheap credit to pull the economy out of a tailspin than the American Recovery and Reinvestment (Stimulus II) Act. *The nature of money, as a medium of value exchange at a price (interest rate), simply has a dominant impact on economic transactions.* Yet there will be a point in the future before the 2012 election that the intoxicating punch bowl of cheap money must be drained to reduce the ill effects of asset price (inflation) bubbles.

Fiscal Government Policy is important both directly and indirectly. The Obama Tax Relief and Job Creation Act extended the Bush Jobs & Growth Tax Relief Reconciliation Act tax rates for 2 years, set the estate tax at death of individuals at 35% beginning at \$5,000,000 for two years, and reduced individual SSA taxes by 2% for one year. An added \$1,000 of disposal income for an individual earning \$50,000 annually will be significant to 2011 consumption spending. U.S. employment payroll gains of 200,000 per month next year appear likely. That may translate to an 8.9% rate in December, 2011, as I suggested last month. In a sense short term SSA tax reductions are like other tax cuts by Kennedy, Reagan and Bush. Yet, the unemployment reinsurance authorization part of the Obama Act to reduce economic hardships of the longer term unemployed will dampen the potential job creation impact of lower tax rates.

Regulations are the indirect, difficult to quantify factors of fiscal government policy, which must be considered. The federal administrative state is controlling the economy with numerous rules and constraints according to large and small business persons. These factors will continue to dampen the impact of stimulative tax rates on job creation. In summary both monetary and fiscal policy will be highly stimulative in 2011, but monetary policy impacts are greater.

Important related questions are:

Will the federal government reduce spending? & Will the economic growth increase tax revenues? in order to reduce the out-of-control federal deficits, government expansion, and increased debt to be financed by the U.S. Treasury.

1/2/2011

Will investor optimistic emotions settle down to cautious rational questioning?

When Chairman Bernanke suggested QE2 in September, rang the bell in November, and President Obama did the deal in December, investors and speculators heard the news clearly. The U.S. government is doing everything possible to re-inflate asset valuations and investors are going to play along. Yet, there is always a rational valuation that runs in parallel with emotional optimism. I will make a case for the current unbridled optimism, as well as a suggestion to consider methodically reducing asset ownership exposure during 2011.

The Optimistic Case

S&P 500 operating earnings are approaching the 2007 2nd Qtr peak level of \$21.88 per share and using Zacks' methodology the annual 2011 earnings are forecasted to be about \$91 per share. At the end of that 2007 2nd Qtr, the S&P 500 index traded at 1503 or 17.2 times earnings. In fact, the S&P 500 index peaked at about 1560 in October, 2007 at somewhat lower 3rd Qtr earnings. The optimists believe that at a long term normal P/E ratio of 14.7 the S&P 500 can trade at 1340. The earnings forecasts are based on a macro-economic environment of a steady consumption annual spending increase of 3% and business capital investment expanding due the Obama Tax Cut Act allowing businesses to deduct 100% of capital investment (full write-off expense) in 2011, instead of the current 50% write off rate. Exports and imports are forecasted to grow without an increase in the still sizeable trade deficits. Finally, interest rates are forecasted to stay low for short term borrowing and increase manageably (¾%) for long term (10 to 30 year) bonds and mortgages. The 3rd year presidential cycle trend of above average stock returns supports the optimistic case. That is a result of similar macro-economic conditions that occurred historically. The optimistic case notes that mutual fund investors became very cautious in 2009 and 2010, after the S&P 500 stock index lost more than half of its value through March, 2009. Then, they bought far more bond funds than stock funds during the past 2 years. Recently, it appears that U.S. Treasury debt prices from 1 year notes through 30 year bonds may have peaked and have given back some of their gains. It would be a normal emotion for performance chasing individuals, as well as institutional investors, to transfer some bond assets to stocks in 2011, if bond returns are falling and stock returns are rising.

The More Cautious Case

Given that the U.S. economy will be operating on stimulus steroids in 2011 and earnings will likely increase, what could spoil the investor party? The federal deficits and debt financing are real issues that will remain. In the past 3 months, based on TIPS pricing, the real cost of money has increase ½% to about 2%. In normal U.S. economic conditions since World War II, the real cost of money has been between 2½% and 3%. That is before inflation and Chairman Bernanke is encouraging inflation to rise. The federal deficit is currently being financed with more short term (3 yr.) notes than normal (6 yr.) notes to determine the average Treasury debt structure. Thus, more debt must be rolled over with new issuances to the market place, which includes more than 35% foreign investors. One trillion (\$1,000,000,000,000) dollar U.S. federal deficits can not be sustained for more than perhaps 1 to 2 years. If the marketplace demands higher U.S. interest rates to buy U.S. government debt, then the FRB Chairmen and his subordinates on the Federal Open Market Committee may be forced to act. I think the issue is more about over reliance of investors on very low interest rates, than a potential weak USD, that will catch the attention of speculators and investors. Finally, market emotions should not be ignored. Extreme confidence is apparent in the high bullishness of small investors (AAII survey), high bullishness and net bullish/bearish market timer levels of investment letter writers (Investors Intelligence survey), the high number of stocks trading in up trends, and the low level of fear demonstrated by low stock price volatility (S&P 500 VIX options). Overconfidence is often interrupted by market corrections, even in a generally up trending stock market. Currently, markets are very confident in the bullish story.

Who is politically at more risk: Chairman Bernanke or President Obama?

Politics are an issue in the currently highly U.S. stimulated economy both at 20th St. & Constitution Ave and 1600 Pennsylvania Ave.

Chairman Bernanke selected a political presence to justify QE2 use to a skeptical global financial community and incoming U.S. Congress with a December 5 *60 Minutes* interview. This was his second *60 Minutes* interview in 2 years. It was a political decision that challenged the other elected branches of government and ultimately will reduce the independence of the FRB. That is why Chairmen McChesney Martin (1950s –

1/2/2011

1960s), Volcker (1980s), and Greenspan (1980s – 2000s) did not do *60 Minutes* interviews. Chairman Bernanke exposed himself to added Congressional questioning of decisions that he does not have data to support. A response in the *60 Minutes* interview to Mr. Pelley's question: *Can you act quickly enough to prevent inflation from getting out of control?* is noteworthy.

Chairman Bernanke: *We could raise interest rates in 15 minutes if we have to. So there is really no problem with raising rates, slowing the economy, reducing inflation at the appropriate time.* If he believes that in practical terms, then the Chairman will have many long testimonies to House Financial Services Committee Chairman Baucus and House Financial Services Domestic Monetary Policy Subcommittee Chairman Paul. Chairman Bernanke does not have the historical data to demonstrate with a reasonable probability that the FRB can sell trillions of debt securities into the market without disrupting prices and the economy. In gentlemen's terms that is called *bursting asset bubbles*.

Chairman Bernanke may have internal FOMC issues also. Each year certain regional bank voting members rotate on and off the FOMC. In 2010, Kansas Fed Bank President Thomas Hoenig consistently opposed and voted against FRB Chairman Bernanke's low interest rate and QE2 policies. In 2011, Mr. Hoenig will not be a voting member, but Dallas Fed Bank President Richard Fisher and Philadelphia Fed Bank President Charles Plosser, who have views similar to Mr. Hoenig, will be voting members. Based on other appointed FRB voting governors, Chairman Bernanke will still have enough votes to set policy. However, his confidence and influence may be reduced. The biggest political issue which naturally reduces FRB independence is the dual mandate of price stability and full employment, which Congress defined in 1977. The mandate itself is normally in conflict and can not avoid political problems. Chairman Bernanke's risk will be evident, when interest rates must eventually be raised.

President Obama's position is naturally political. When his party lost control of the House of Representatives, he pivoted and got the best tax cut deal from his perspective in the lame duck Congress. Breaking his higher tax rates promise for individuals earning income more than \$200,000 annually, had limited consequences. There is little risk that natural progressive allies will seek a Democratic challenger to the political

left of the President. It is also unlikely that a third party candidate would pull votes in the 2012 elections from the President similar to Ross Perot in 1992. The President and the House of Representatives appear to me to be on a politically level field with very different views concerning the U.S. Constitution, the role of government, and individual liberties. They both have incentives to work toward revenue neutral simpler tax policies and reduced federal spending deficits prior to the 2012 elections. The President also has an incentive to work more closely with people in his own Executive Branch and in the private sector that have business experience to increase economic revenues and encourage higher U.S. employment prior to the 2012 election. He has power, influence, and mildly favorable ratings to get re-elected, even if he continues to criticize political foes similar to the past two years. His political risks are less than those of President Clinton's in 1994, due to a supportive Senate majority.

Global Economies

Emerging countries (China, India, Brazil, and Russia) grew at high speeds and developed countries (European Common Market (ECM), Great Britain, United States, and Japan) grew at slow speeds in 2010. Considering euro currency issues related to Greek and Irish bailouts, ECM economies handled their issues with normal political compromises. Yet, economic growth does not directly translate into investment returns. The mainland China A stock market offered USD investors a 1% loss, while the Hong Kong Hang Seng market offered a 20% gain in 2010. The British FTSE 100 market offered USD investors a 5% gain, while the French CAC 40 market offered a 6% loss. More generally, diversified Emerging Markets (MSCI) offered USD investors a 17% gain in 2010, which was similar to the S&P 500, and diversified Developed non-US markets offered a 5% gain.

The global factors influencing potential returns in 2011 will change. The highly stimulative Bernanke QE2/Obama Tax Cut policy will boost U.S. GDP growth and support corporate earnings more than forecasted 3 months ago. Higher U.S. interest rates are less likely to be negative factors than possible volatility in the USD exchange rate with other countries. The ECM, Britain, and Japan will deal with specific issues and less stimulative economic policies. Most emerging countries and markets appear to show continued steady growth with responsible government

policies. Their stock markets appear fairly valued. Yet the potential returns merit some portfolio asset allocation with awareness that volatility will remain high.

Table 1. Economists Forecasts

Economic Market	2010 GDP	2011 GDP	2010 Unemployed
United States	2.8	3.5	9.8
Japan	3.2	1.3	5.1
China	10.2	8.9	9.6
Great Britain	1.7	1.9	7.9
Euro Common Mkt	1.7	1.4	10.1
Germany	3.4	2.2	7.5
Russia	3.5	4.3	6.8
India	8.8	8.6	10.0
Brazil	5.5	5.1	6.1

The total 2011 global economy is expected to expand at a similar rate to 2010 (4.0%) with Asia leading the way. In Table 2 the U.S. positively sloped yield curve showed a more stimulative monetary policy than any other central banks throughout 2010. During the 4th Qtr the global real cost of money increased. All country 10 year bond rates rose. Investors are implying that global economic growth will increase in 2011 based on developed country bond yield rates.

Table 2. Current Global Yields

Economic Market	3 month	10 Year
United States	0.2	3.4
Japan	0.2	1.2
China	3.8	3.8
Great Britain	0.8	3.7
Euro Common Market	1.0	3.0
Russia	7.8	5.8
India	7.2	8.3
Brazil	10.7	6.2

Personal Goals and Portfolio Management

Investment market commentaries usually focus on asset valuations, risks, and expected returns in the context of rational decision making. Yet at least annually personal goals and uncertainties should be pondered by normal emotional people.

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 cash flows. Pension funds refer to the process as asset liability matching. When asset valuations rise as during 2009 and 2010 for most assets (except housing) a surplus or deficit reduction in long term wealth plans occurs.

Now is a good time to consider risk taking and personal goals. If goals can be met, while reducing longer term risks, a planned wealth spending surplus buffer can be made more stable and offer greater peace of mind. As discussed, U.S. investors have a confident 2011 outlook. At minimum, that is a scenario for more volatile markets. Three years of above average (8%) balanced portfolio (55% stocks, 35% bonds, and 10% cash) returns are possible. However, they have only occurred about 5% of the time in the past 100 years. The late 1990s were the most recent extended period of abnormally good returns. Remember the uncertainties of 2000 to 2002. It is normal to become emotional and irrational during those times and take greater risks, when wealth plan deficits grow. I suggest watching for asset valuation bubbles (e.g. Google and Apple stocks trading for more than 25 times past 12 month earnings) and moving to less risky dividend paying or stable cash flow investments gradually if bubbles expand during 2011. In a game of poker, that is folding the cards and walking away from the table with money in your pocket. In wealth management, that is conservative value investing focused on personal long term spending goals.

Markets and Economic Sectors

Most asset prices except housing and some municipal bonds increased in value during 2010. Higher risk U.S. securities, such as small capitalization stocks appreciated more than large cap stocks. Growth company stocks appreciated more than value type stocks. Combining the two factors, small cap growth stock returns (27%) exceeded large value stock returns (14%). All commodities (17%), particularly precious metals like gold (29%) and silver, as well as oil (15%) and copper participated in the increased valuations. The environment is speculative and price momentum driven. Most bonds earned reasonable (5% to 10%) returns as interest rates dipped to very low levels prior to finishing the year on average ½% above their lows.

Growth equity and commodity assets historically have earned their highest returns in similar speculative periods with above expectation economic growth and overly confident investors. In the late 1960s and early 1970s it was called the period of the Nifty Fifty Stocks like Polaroid, Xerox, and Eastman Kodak. In the late 1990s it was called the TMT (Technology, Media, and Telecommunications) period of Microsoft, Amazon, and Yahoo. The *Optimistic Scenario*

1/2/2011

looks more compelling for the 1st Half of 2010 than the *More Cautious Scenario*. Yet don't forget your poker playing skills.

Technical Analysis

The U.S. stock market is technically overbought with over 75% of stocks trading in up trends, the VIX (S&P 500 options) trading at the fearless 2007 level (18), and small investors (AAII small investors survey) overly bullish. The market is technically risky; yet can remain in that state for an extended period prior to sellers causing corrections down in price. Simply stated, stock markets are more risky than in 2010. More volatility is probable in 2011 than in 2010.

U.S. Economic Sectors

Materials Sector 3rd Qtr. earnings and market price changes were higher than the S&P 500 Index in the 4th Qtr. No suggestion. Energy Sector earnings grew similar to the S&P 500 index and price Relative Strength (RS) was 5% above it. Consider dividend paying assets. Potential surprises may boost oil prices more than 20%. Financial Sector earnings and price RS lagged the S&P 500 in the 4th Qtr. No Suggestion. Industrial Sector earnings and RS slightly beat the S&P 500 Index. Hold. Technology Sector earnings and earnings surprises slightly beat the S&P 500 Index, but price RS slightly lagged. Tech stocks are extended in price. Suggestion: Hold or take partial capital gains profits. The Consumer Staples earnings growth and RS lagged the S&P 500. Hold dividend paying stocks. Utility Sector Stocks earnings and price RS lagged behind the S&P 500 Index. No suggestion. Healthcare stock earnings growth and price RS lagged the S&P 500 Index. No suggestion. Consumer Staples, Utility, and Healthcare stocks are normally defensive, stable earnings stocks, which lag other equity assets during speculative periods, such as the current condition. Consumer Discretionary stock earnings varied with overall positive RS vs. the S&P 500. Hold selectively. Treasury Bonds (-3%) under performed stocks in the 4th Qtr and will be influenced by FRB QE2 manipulation. They still appear overpriced; shorter maturities suggested. The price of Gold rose in line with S&P 500 Index stocks in the 4th Qtr. Hold.

Suggestion: Hold normal portfolio asset weights. Shorten bond durations (maturities). Stock market psychology is positively biased; market prices are extended. First Quarter volatility (up or down) is likely. Liquidity is cheap. 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 in the 4th Qtr. Well informed partnerships and energy MLPs may be effective ways to profit from income producing real assets. Gold funds are diversifiers. A 5% weight in a gold exchange traded fund (GLD) (29% in 2010) is suggested.

References

¹ Bernanke, Ben *What the Fed did & why: supporting the recovery and sustaining price stability*, Washington Post, Nov. 4, 2010

Current portfolio themes are:

Normal Investment Weights

- U.S. large stock funds normal weight
- U.S. small stock funds 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,
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.

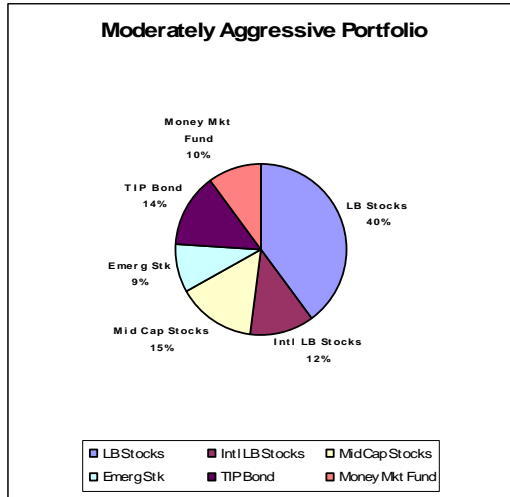
- 40% Large Blend Stock Index Funds
- 12% Large Blend International Fund
- 15% Mid or Small Cap Stock Fund
- 9% Emerging Market Stock Fund
- 14% TIP Bonds
- 10% Money market cash

Sample Portfolio B - Conservative

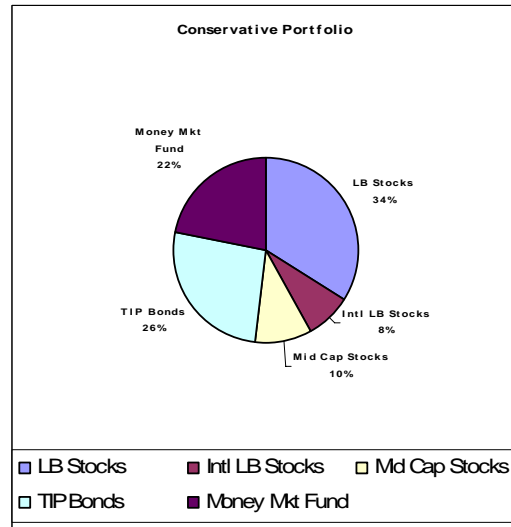
Example 65 year old couple with Social Security Income (20% of spending needs) and Retirement 401K or Pension Plans converted to IRA's

- 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

Normal Capital Accumulation –



Normal Capital Preservation –



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