BWM

Investment
Guidance

2008 Financial Markets Review
Analyzing Awful Investment Results;
Yet 1st Half 2009 Potential Improvement

Key Points

- **2008 Total Returns** :
  S&P 500 (903) -37% ;
  US 10Yr Bond (2.22%) +28% ;
  NASDAQ (1577) -40% ;
  Foreign (EAFE) Stocks -43%
- U.S. GDP expected contraction = -0.4%
- 2008 earnings expected decline = -15.0%
- Huge 2008 investment losses; however, 1st Half 2009 partial recovery expected

Executive Overview

Nearly all asset classes suffered extraordinary 2008 losses. Leveraging (debt financing) of all assets decreased along with a dramatic decrease in risk taking. Equity markets illustrated by the S&P 500 index plunged an unmatched -50% from Jan. 2 through Nov. 20, prior to a restructured Citigroup bailout calming very nervous markets. Since its 1923 formation, the S&P 500 index, which represents about 75% of U.S. equity market capitalization, only had a worse lose in one year, 1931 (-43%). Foreign developed equity markets suffered worse 2008 losses (-43%) than U.S. markets. The CRB commodity index also posted a striking 2008 loss (-36%). Home prices fell 18% in the 12 month period ending Oct. 2008 according to the Case Shiller 20 city survey. Only an extreme 4th Qtr. flight to safety took Treasury securities to 50 year low yields and positive 2008 returns. Gold ended the year with a Dec. advance and a 2008 total 5% return. Diversification and most hedge fund strategies did not prevent big losses in a horrible year for almost all investors. The S&P 500 4th Qtr. losses (-22.3%) exceeded 3rd Qtr. losses (-7.5%). Nonetheless, volatility and trading volume fell noticeably and equity losses were trimmed a bit in December. Deleverage selling (debt value reduction), the recession, and poor earnings will continue. The new U.S. government's responses will be considered. Uncertainty and volatility will be explained, as I pick up the pieces of shattered plans, suggest lessons learned, and build a basis for recovery. Themes, the economy, and portfolio strategies will be discussed.

Themes

Investment markets themes are: what happened in 2008, investment lessons learned, elements for recovery, potential new government initiatives, and likely market responses.

What Happened in 2008?

A major bubble in global financing exploded as the trust between parties in a limited disclosure banking system broke down. Broad economic recessions can result, when the financial structures crack. Since World War II the 1973/74 recession occurred after ending price controls and a monetary policy in response to a greater than 4 fold increase in oil prices. The 1980/82 recession occurred after the Federal Reserve Board (FRB) slowed money supply growth to control runaway inflation. The entire economy was impacted by these financial system adjustments. On the other hand, the 1990/91 and 2000/01 mild recessions resulted when housing price and technology bubbles, that impacted a limited sector of the economy, were corrected. The current U.S. recession, which began in December, 2007 will last until at least the 2nd Half of 2009; that is the longest post World War II recession. The shadow banking system that is not fully disclosed to banking regulators broke down. As Charles Price, the former Citigroup CEO, infamously stated in July 2007 "As long as the music is playing, you've got to get up and dance". Major banks, hedge funds, government sponsored entities (Fannie Mae and Freddie Mac), and mortgage lenders were dancing like there was no tomorrow. Risk management systems were inadequate. Risk taking and leverage were unsustainably high and tomorrow came quickly, as the fragile banking system required massive government bank socialization to stay afloat.

The FRB, other central banks, and government Treasury Departments had to act creatively in the face of insufficient banking disclosures. Their actions resulted in a dramatic increase in money supply to compensate for the reduced flow (velocity) of higher risk adverse money. We will most likely avoid a 1930's type depression. However, their actions were inconsistent, did not promptly institute needed reform, and added to market uncertainties. Four key decisions by the FRB and U.S. Treasury were inadequate and let a bad situation grow into the largest economic contraction since World War II. After the municipal bond and derivative insurers, ACA, MBIA, and Ambac ran up losses in January, the FRB (Ben Bernanke and Timothy Geithner) and Treasury Dept. (Henry Paulson) should have immediately required a Credit Default Swap clearinghouse market to replace a non-standard contract over-the-counter mechanism. They did not have disclosed market risk information and needed it urgently. Sadly, the first clearinghouses were not approved until December. Secondly, the FRB should have made clear the ground rules for bailing out the Bear Stearns investment bank (IB) in March. The markets believed that the other four IB's, Merrill Lynch, Lehman Bros., Morgan Stanley, and Goldman Sachs would be bailed out if needed. In September, the Treasury Dept. reversed itself and let Lehman Bros. go bankrupt after Barclay's or Bank of America purchases failed, while bailing out mega insurer, American International Group (AIG). Global markets were stunned by uncertainty and risk premiums as measured by the relative cost of loans and quality spreads skyrocketed to stratospheric heights. On September 16, Wall Street's financial engineering problem became Main Street's basic financing problem. The 4th questionable Treasury Dept. decision was the changing use of the $700B Troubled Asset Relief Program (TARP). Fortunately, after initially focusing on buying up structured mortgage derivatives through an obtuse bidding process, the Treasury Dept. reversed itself and recapitalized the major banks. After a caustic critique of Mr. Paulson, I recognize that he was the best man for an impossible job. Former Treasury Secretary's Robert Rubin or John Snow may have made worse decisions. Yet, hopefully Timothy Geithner will do better.

Investment Lessons Learned

Market crashed like the 11 weeks through November 20 occur once in a lifetime. Historically, they occurred near the end of wars, when the situation of the ultimate loser changed for the worse. Reading books leaves a person poorly prepared to recognize the catalyst for a colossal collapse. I didn't recognize the impact of the Treasury Dept.'s allowance of the Lehman Bros. (LEH) bailout to falter and subsequent bankruptcy. However, the smart money saw that the Treasury Dept.'s bailout commitment was uncertain. High volatility soared even higher. Smaller counter parties to the giant LEH in exotic derivative swaps could become illiquid and fail. It is necessary to quickly take money off the table until the dust settled, when fundamental rules change and a market response is striking.

Elements of Recovery

There are two primary ways that modern governments react to economic contractions. Both approaches attempt to stimulate growth of commercial activities. However, philosophically they place their confidence in different value systems: either a government's ability to judge what is best for the people or its desire to support the people's capacity to judge for themselves. Governments, which feel that they know what is best, generally try to stimulate demand for favored social goals, such as alternative resources and infrastructure, universal home ownership or health care, and protected groups. They focus on John Keynes' *General Theory of Employment, Interest, and Money* comments concerning special project demand stimulation and budget deficits. Governments that focus on individual decisions to judge what is best generally favor limited controls and cut taxes to increase productivity and economic activity. Increased periods of government spending stimuli and tax cutting stimuli have occurred under both Democratic and Republican administrations and both stimuli have even occurred simultaneously. Interestingly, President elect Obama's selected Chair of Council of Economic Advisers, Christina Romer, presented a relevant study. It found since 1947, $1 of tax cuts resulted in $3 of GDP growth, while $1 of government spending resulted in $1.47 of GDP growth. Will Ms. Romer influence Mr. Obama's decisions? This is a critical question!

New Government Initiatives

Although Mr. Obama's limited Senate voting record and that of incoming Senate and House members favor expanded government at the highest level since 1976, many conflicting statements have been made. Clearly, big spending to stimulate demand for favored goals is expected. Less clear is tax policy. Tax policy to provide tax credits for lower income (middle class) groups and higher tax rates for high income groups would be bad because net incentives to produce, invest, and retain after tax returns would be reduced. Repealing the highest income tax rates prior to their Dec. 2010 expiration may extend the recession and be a poor policy. Regulatory policy to require full disclosure and open markets would be good, while regulations to force questionable bank lending policy, specified car features, or carbon credit mandates to trade potential emissions would be costly and unproductive. Trade policy may be the most subtle error by the Obama

Administration. Mr. Obama voted against the Central American FTA and has made statements that show impractical environmental and labor rights agendas. During recessions nations normally turn inward and increase barriers to trade. It is possible that agreements with unions will lead to more in-country product content laws and increased tariffs. Tit or tat global responses could quickly escalate without prominent laws, such as the infamous 1930 Smoot Hawley tariffs.

Likely Market Responses – Glass is half full

Markets respond to many factors. The short term votes of buyers and sellers are sometimes based on hopes and fears. The longer term weighing of asset values are more often based on steady earnings and the fundamental capacity to profitably employ capital for expansion projects. In the short term, the primary news communicators of television and newspapers have a bias and interest in the Obama administration looking hip and leading to better times ahead. Jobs saved and foreclosures avoided will be cheered. News stories should be expected to focus on the glass of confidence being half full. Since consumer confidence is at a very low level, relative improvements are quite likely. Investors also have increased their cash positions simply by selling assets during the past 4 months. Potential buyer fear has decreased, as measured by reduced volatility and a lower put (sell right) to call (buy right) trade ratio in the past 6 weeks. Relatively larger equity than debt loses in 2008 have skewed pension fund portfolio allocations to under weighted stock positions. Portfolio reallocations will likely increase 1st Qtr. 2009 stock demand. Less hedge fund activities and specifically lower leverage strategies will somewhat reduce trading volume and volatility. Since the economic earnings news will be terrible, the market is set to climb a wall of worry. The scenario could be overcome by foreign affairs. Vice president elect Biden may be correct in speculating the new administration will be tested in its first 6 months. However, the scenario would have to include a major impact new uncertainty that causes further unexpected business losses and extends the recession until 2010. Relax, but remain alert.

The Economy – Deep Recession

All monthly indicators – regional economic activity, capital goods orders, manufacturing activity, and employment – show that we are in the midst of a deep recession. The 4th Qtr. 2008 GDP appears to be contracting at a 5% rate and the full 2008 GDP contraction will be about 0.4%. The economic models seem to be calibrated and the situation looks to be stabilizing. The Bureau of Labor Statistics reported the Nov. 2008 unemployment rate increased to 6.7% reading. The most likely scenario is that the recession will end in the 2nd Half 2009 and 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.

General Price level deflation? - No

There is a general consensus that deflation is bad but that a little inflation is good. That is a poor excuse for general inflation in all currencies today. Price stability (0 +/- 1.0%) should be the goal of every central bank. Historically a conversion of money into a hard currency like gold provided the discipline to achieve price stability. 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%. I suggest not worrying that deflation will discourage demand for discretionary spending. Sometime in 2010, when the economy is growing, inflation will again be a real investor concern.

Profits and Expectations continue to fall

Banks must strengthen capital structures through deficient sales assets and new equity. Congressional complaints that banks are only making good quality loans after the bailout will not change the situation. Third Quarter 2008 S&P 500 profits fell (-17.4%) below 3rd Qtr. 2007 levels. Analysts now expect 4th Qtr. 2008 earnings to be -6.7% below last year and top down analysis implies even lower comparisons to the 4th Qtr. 2007. Consumer Staples, Healthcare, and Utilities sectors show positive expected comparisons. The technology and telecom sectors may not be as bad as forecast. The Financial Sector is difficult to judge due to likely asset devaluations. The 1st and 2nd Qtr. 2009 comparisons will likely also be negative.

Financial Analyst forecasts approach reality. The current analysts' forecast revision ratio is about 7:1 downgrades/upgrades in 2008 and about 12:1 in 2009. Analysts slashed forecasts in the past month. An incredible 22% of all S&P 500 firm 2009 earnings forecasts were cut more than 10% in the past month according to Zacks. Market prices imply the current reduced 11% total operating earnings growth in 2009 is still high. Zacks calculated that S&P 500 profits fell 13%, 16%, and 17% in the 1st Qtr. 2nd Qtr. and 3rd Qtr. 2008, respectively. At this time, the S&P 500 trades at 12 times 2008 earnings. If 2009 earnings equal 2008 earnings (instead of 11% growth), then the S&P 500 companies' index also trades at about 12 times 2009 earnings. Based on the no 2009 earnings growth, there appears to be the potential for a partial (25%) 2009 S&P 500 peak recovery (1150). As previously explained, the perception of an attractive new President may result in a 1st Half 2009 investor honeymoon. Thereafter, real earnings growth will be needed to hold the gains. Currently, profit margins are squeezed by weak consumer demand in many industries.

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. The FRB policy decision to either promote growth or control potential 2010 inflation will be the key to 2nd Half 2009 earnings.

Foreign Economies
Developed economies are set for no growth in 2008. Major 4th Qtr. declines are occurring in all developed economies similar to the U.S. Developed economy GDP declines are expected in the calendar year 2009. The British economy is expected to be weaker than the U.S. or any other developed nation economy. The emerging markets 2009 economic forecasts have been significantly 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	2008 CPI
United States	-0.4	-1.0	1.1
Japan	0.0	-0.9	0.9
China	9.6	5.5	5.0
Great Britain	-0.4	-1.4	2.7
Euro Common Mkt ECM	0.3	-0.9	2.3
Russia	6.5	2.0	11.0
India	7.6	5.0	6.0
Brazil	5.3	2.0	5.0

All developed economies slipped into 3rd Qtr. initial recessions. Deep recessions are in process. A global developed economies 2009 recession and total world economy 2% growth is forecast by the IMF.

In Table 2 the U.S. positively sloped yield curve continues to be the most stimulative monetary policy. However, 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	0.2	2.2
Japan	0.5	1.4
China	2.5	3.0
Great Britain	2.5	3.7
Euro Common Mkt ECM	3.0	3.1
Russia	11.0	9.0
India	5.5	6.5
Brazil	11.0	6.0

Economic Sectors and Investment Outlooks
A Technical Overview (BPNYSE, etc) indicates market demand and supply of U.S. stocks is uncertain with low volume demand. The volatility fear factor continued to fall during December. Hedge fund, mutual fund, and private fund redemption outflows were historically high in 2008. Total mutual fund assets ($9.6T) are down 24% since Dec. 2007. Investment cash on the sideline (5.0% estimated mutual fund cash) steadily increased in 2008. Key developed country stock indices fell more than the S&P 500 in 2008 (Japanese Nikkei 225 -42%, French CACI -42%, German DAX -40%). Money supply growth is a potential demand indicator. **Suggestion: Hold current positions and bring portfolio equity levels back to normal.** A recovery rally is likely during the 1st Half 2009 as volatility declines and portfolios are rebalanced with increased equity weights.

Sector price relative strength (RS) shows sector demand only in the consistent earnings Consumer Staples and Healthcare sectors. Stock demand is balanced between value vs. growth styles and small vs. large companies. Foreign equity securities denominated in the USD are also performing similar to US equities.

Economic Sector Analysis and Outlook

The **Consumer Staples** sector 3rd Qtr. earnings growth and 2009 earnings growth outlook remains stable with positive RS. Demand for this defensive sector remains solid and price increases continue as people continue to eat and buy basic goods in a recession. A portfolio over weight position is suggested. **Healthcare** sector 3rd Qtr. 2008 earnings are in the single digit range and 2009 growth looks stable. Biotech and medical products industry earnings are causing an overall positive RS. 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 is suggested. **Technology** Sector 3rd Qtr. reports were mixed. The highest P/E tech stocks were sold during the nervous markets. On the other hand, IBM, Hewlett Packard, Microsoft, Cisco, Oracle, Google, and Intel have large cash flows and enviable cash positions. For long term growth investors, a good argument can be made for these stocks. They will likely lead acquisition activities of smaller specific niche companies in the 2nd Half of 2009. The **Energy** sector delivered good earnings growth with oil above $140 per barrel. As oil prices plunged to below $40 their RS naturally turned negative. By the way, oil fell more than 75% from peaks in 1980 and 1990. Energy sector fundamentals at replacement cost estimates are desirable. The oil sector is trading at an attractive 2009 P/E = 8.5. Hold energy equities. 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. Write downs of bank debt securities continue and caution is prudent. Low interest rates and numerous FRB bailout asset transfer facilities will increase profit margins for banks and other financial industries. However, dividend cuts remain a negative factor. Financial Sector portfolio regional banks which avoided the toxic higher yield mortgage securities are attractive. Yet be prepared for continued volatility. **Economic sector earnings are weak in total. Diversified portfolios are now suggested.** Stocks are much less expensive than 3 months ago. There is liquidity to demand stock prices higher. **Summary**: hold current positions; if you were smart enough to be holding cash, buy in the suggested sectors with money not needed for consumption in the next 5 years.

International Markets Are Stable

Foreign stock markets rose 6% in December, while the USD (1.40 Euro) exchange rate fell. Holding 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 reduce flight to safety may reduce 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 total 2008 returns (28%) benefited from an extreme Nov. and Dec. flight to quality and reduced inflation expectation. Investment grade corporate bonds (-9%) still suffer from uncertainty. Money is flooding out of stock funds to money market funds. A small portfolio weight in a TIPS fund is suggested, although the reduced inflation expectation resulted in recent negative returns.

Alternative Investments – Diversification

The Real Estate Investment Trusts (REITs) index hemorrhaged 25% in the 4th Qtr. 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 a positive (5%) 2008 return and will likely perform well, when inflation heats up after this recession ends.

Portfolio Management

Funds have (5.0%) cash to boost stock or bond prices higher. The S&P 500 index is trading at about a 12 times trailing 2008 PE ratio. Normally, a reciprocal 8.3% earnings yield is favorable to the current 6.8% corporate "A" rated bond yield. Holding a fully invested portfolio is suggested.

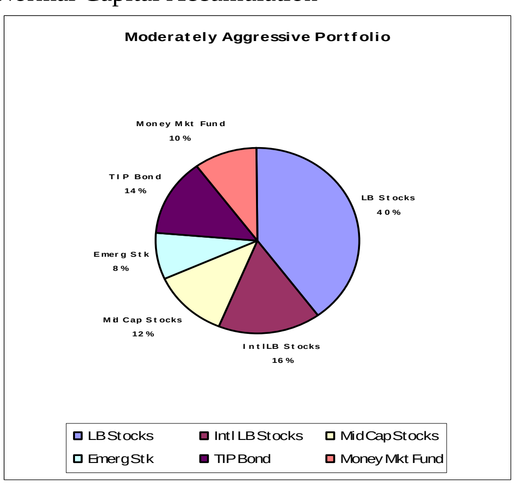
Current portfolio themes are:
Normal Investment Weights
- All U.S. stock caps funds normal weight
- Foreign EAFE funds normal weights; Emerging stock funds normal wts.
- Fixed income – TIPS preferred
- Hold stocks in suggested sectors

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

Sample Portfolios are models
Not Client Recommendations

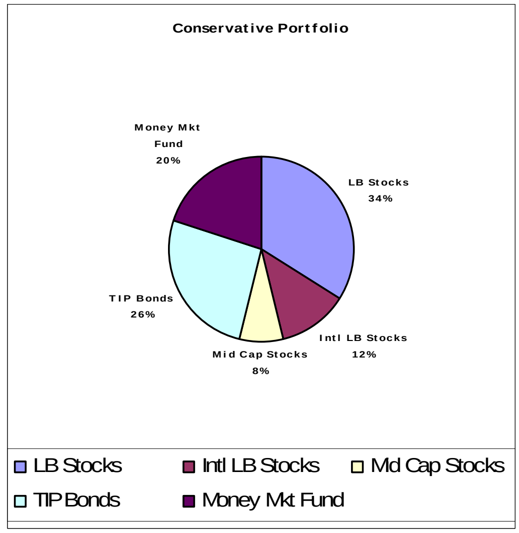
Sample Portfolio A - **Moderately Aggressive**
Example 45 year old college educated parents with 1 high school child and 1 college child.
- 40% Large Blend Stock Index Funds
- 16% Large Blend International Fund
- 12% Mid or Small Cap Stock Fund
- 8% Emerging Market Stock Fund
- **14%** TIP Bonds
- **10%** Money market cash

Normal Capital Accumulation –



Sample Portfolio B - **Conservative**
Example 65 year old couple <u>with Social Security Income (20% of spending needs)</u> 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

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.