

**BWM**Investment  
Guidance**January\* 2010 Markets Review****Watch Market Volatility****Shaky Start to New Year**

\*written prior to last trading day (Jan. 29) of month

**Key Points**

- |  |      |
|--|------|
| • <b>2010 Year to date Returns</b>         |      |
| S&P 500 (1084)                             | -3%; |
| US 10Yr Bond (3.65%)                       | +2%; |
| NASDAQ (2179)                              | -4%; |
| Foreign (EAFE) Stocks                      | -4%  |
| • U.S. GDP expected expansion = 2.9%       |      |
| • 2010 earnings expected increase = 31%    |      |
| • Stock markets advanced for 10 months     |      |
| • Economic upturn strength approaches peak |      |

**Executive Overview**

The U.S. (S&P 500 -3% and NASDAQ -4%) and foreign (-4%) January stock markets returned losses with troubling volatile prices. The total 65% advance from the 2008/09 bear market March low to year end may require a correction to get expectations (-10%?) in line with reality. Macro-economic news of expanding industrial production, export gains, and significant inventory restocking supports a very good 4<sup>th</sup> Qtr. U.S. GDP growth (4 to 6%) forecast. With nearly ¼ of the S&P 500 company 4<sup>th</sup> quarter reports released, earnings lead forecasts by a sizably margin. Analysts continue to upgrade forecasts for 2010 and 2011. Gold prices are about unchanged, while the U.S. dollar (USD) is up (2.5%) versus the Euro year to date. The U.S. 10 Yr Bond yield fell from 3.85% to 3.65% for a positive return (2%). The U.S. Treasury securities upward sloping yield curve remains highly stimulative. Other asset prices, including homes, continued to stabilize. Leading economic indicators forecast very good GDP growth in the 1<sup>st</sup> half of 2010 based primarily on favorable yield spreads and liquidity. The U.S. executive and legislative branches of government are repackaging their agenda after the surprise victory of Scott Brown in the Massachusetts U.S. senatorial election. President Obama has shown partisan polarizing leadership. His party will need to answer for high unemployment, as well as a massive increase in the size of government, deficits, and the national debt during the November elections.

**Themes**

- **Watch market volatility – it indicates fear or complacency**
- **Financial analysts appear too optimistic – transition assumptions are complex**
- **European and Japanese economic recoveries show the inflexibility of large government economies**

**Market volatility spikes may indicate earnings forecasts are approaching unachievable levels**

Every investor and speculator wants to know the direction of market asset prices. If only a crystal ball showed how to take some profits away from markets. Only a few markets are controlled by a dominant participant, such as a government Treasury or central bank. Even correctly guessing the direct or indirect impact of their decisions on asset prices and speculating profitably is difficult.

Most asset prices in liquid markets are influenced by the emotions of many potential buyers and sellers. In the short term, as the godfather of financial analysts (Benjamin Graham) stated, markets are voting machines. Prices may move far over or under accurate operational asset valuations. Even if an asset price accurately reflects an operational value, conditions change and market prices reflect actual and perceived changes. The idea of an efficient market for asset pricing is an ideal based on more assumptions than most people consider. That is why measures of market emotions can be useful at times.

The VIX is a measure of implied U.S. stock market fear or complacency based on its rate of change and level. Specifically, it is the Chicago Board Options Exchange volatility index built on the implied S&P 500 index options expectation for the next 30 days. Options prices are divided by the square root of the number of monthly options used to calculate the expected change in the S&P 500 stock index over the next 30 days. The VIX can be useful because it generally rises (fear increases) when stock prices fall and conversely falls (complacency increases) when stock prices rise smoothly. The VIX rose to new high levels during the fall of 2008, when uncertainty was rampant after the effective nationalization of the mortgage industry (Fannie Mae & Freddie Mac under U.S. government receivership) and bankruptcy of Lehman Bros.

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The VIX spiked again to a very high level in March 2009, when the fate of Citigroup bank was uncertain and stock markets around the world hit bottom. During the past 10 months, the VIX gradually fell to the level of the market uncertainty in the summer of 2007. The complacency was interrupted briefly in June and October, 2009 as the VIX spiked up and key stock markets fell back about 5% in price.

What is the VIX telling us now? The VIX spiked in January to nearly the late October, 2009 level. The news of the day was uncertainty over the response of the Obama administration to the election of Massachusetts Republican Senator Scott Brown, the President's initiative to split away the high risk parts of commercial banks from their traditional loan function (Volcker Rule), and the Senate re-election of Ben Bernanke to another term as FRB chairman. There may be a simpler market fear that stock prices reflect unrealistic hope that the economy will recover smoothly to GDP, earnings, and employment growth similar to past post U.S. recessions. Primary reasons for fear may not be clear initially. However, fear is an emotion that builds on itself. It often starts with intermittent market declines. Speculators (traders) are the first ones to notice a change in market emotions and stop placing bids near current market prices. Spread between bids and asking prices increase and fear builds. Ultimately, the selling reaches a climax and exhausts itself. But, who knows when that occurs? For now, the suggestion is to be more cautious than in the summer and fall of 2009. If the VIX rises above the 30 level, review your portfolio of assets. Consider selling part of the weakest holdings, if you are not comfortable with an additional 10% decline in a normal market correction. Stock markets are overdue for a correction after a 10 month advance and a sense of analyst complacency that S&P 500 earnings will increase 31% in 2010.

**Financial analysts appear too optimistic – transition assumptions are complex**

Financial analysts are currently forecasting an increase in S&P 500 total corporate earnings from \$58.15 (2009) to \$76.47 (2010), and \$92.27 (2011) according to Zacks Research. The 31% (2010) and 20% (2011) expected earnings increases would put 2011 S&P 500 earnings at the 2006 level after a 5 year inflation adjustment.

The forecasts are based on implicit assumptions about a smooth transition from currently

excessive over leveraged fiscal (extreme deficits and added debt) and monetary policies to sustainable levels.

The size of the FRB balance sheet with low quality assets after effectively nationalizing the home mortgage market (through Fannie Mae and Freddie Mac) is too large to smoothly sell back quickly into the normal market. If the FRB simply stops buying new low quality mortgage debt, then mortgage rates will likely rise between ¼% and ¾%. Either FRB selling back or not buying new mortgage debt will have a negative impact on the housing prices. Lower home prices reduce household net worth and require compensating savings, instead of consumption, to remain stable. Low consumption increases generally translate to low GDP growth.

Contrary to some concerns, inflation (3%+ level) will not be an issue, if overall industrial capacity remains below 76% in 2010 and the unemployment rate (10%) does not fall much, as is likely. Yet, that implies that the U.S. 2010 GDP growth will not meet the 2.9% forecast. Most importantly, revenue (sales) growth is needed to boost earnings 31%. A combination of employment growth and productivity growth will not result in a 31% earning growth without at least 10% sales growth. The forecasted S&P 500 revenue growth in 2010 is less than 5%. From a top down macroeconomic perspective, the 2010 earnings outlook is based on low corporate interest rates, significant hiring, and continued extraordinary (recession type) productivity gains along with the smooth transition to a reduced monetary stimulus.

Unexpected accidents, such as bombings of commercial airliners or required responses to Middle East issues, are not factored into intermediate term hopeful positive change scenarios. President Obama's promise in his State of the Union address to allow the so called Bush tax rates on couples earning more than \$250,000 to expire do not appear to be factored into 2011 economic forecasts. It is best to temper 2010 and 2011 earnings expectations. If you are comfortable paying 16 times (P/E) S&P 500 earnings based on 20% earnings growth in 2010, then hold stocks with expected above average market volatility and less than a 5% return. An expected 2010 smooth stock 10% return seems unreasonable due to unrealistic expectations of smooth monetary transitions.

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**European and Japanese economic recoveries show the inflexibility of expansive governments and related debt loads**

After painting a somber picture of a recovering U.S. economy, notice that European economies are in worse shape than the U.S. economy. As noted in Table 1 below, the European and Japanese economies are forecasted to grow less than 1.5% in 2010. That is barely noticeable growth in the first year after a major recession. European unemployment is forecasted to remain at approximately 10%. The European (including Great Britain) and Japanese economic policies are boxed in. Their federal debt levels are so high (all greater than 70% of GDP) that they can not try the massive government fiscal stimulus of the United States and add more to government debts. A look at the credit default swap market shows the cost of insurance against government debt credit rating reductions is rising. Most other developed countries have such high debt levels that they must simply allow the recession to naturally end and accept slow growth thereafter.

The predicament of other developed countries is a clear lesson for the United States. There will not be an opportunity for massive government expansion and added deficit spending in 5 years to respond to a recession, if federal debt levels are 80% to 100% of GDP, as forecasted. The interest costs on the federal debt will limit fiscal policy responses and standards of living will likely decline. Most people do not understand the impacts of a lower level of national security and a lower standard of living due to poor government policy decisions.

**2010 Good (Not Great) Economic Outlook**

The intermediate term time frame (1<sup>st</sup> Half of 2010) outlook remains good. The Conference Board Leading Economic Indicators (LEI) rose 1.1% in December. The LEI rose faster in the past 6 months (5.2%) than in any other period since the deep 1982 recession and is at its highest level (106.4) in its current form (100 score in 2004). Stimulative monetary factors, lower new unemployment claims, and stock price advances head the positive factors. The LEI indicates there will be an average of at least 2 or 3 quarters of 3.5% growth. The FRB 2010 forecasts have a central tendency of 3.0% GDP growth and 9.5% unemployment rate. Be aware that there is no precedent for FRB unwinding its massive buying spree and the likely effect on money supply and yield spreads. The LEI may be too optimistic.

The 4<sup>th</sup> Qtr. 2009 earnings reporting season has started well. With ¼ of the S&P 500 companies reported to date, the ratio of earnings positive to negative surprises relative to forecasts is a healthy 3.8 and the median surprise is 6% relative to a normal 3%. Bellwether semiconductor giant Intel, technology whiz Apple, securities trader par excel lance Goldman Sachs, and mega bank J.P. Morgan have all exceeded expectations. Yet stock markets appear to want better forward earnings guidance in general. There has been an unusual amount of selling after good reports in the second half of January in contrast to price rises in the beginning of the month. This is a reflection of the previously discussed volatility theme.

Analysts continue to revise their forecasts up versus down (1.64 ratio) for 2010 and (1.74) for 2011. Earnings recovery in the finance, material, and energy sectors is the prevailing outlook. If they are correct, the current S&P 500 P/E of 14.6 for 2010 is near long term fair value and a 10% price increase would result in a somewhat over valued P/E ratio of 16 at year end. Lower than expected sales growth is the factor that would upset forecasts. The S&P 500 companies count on a large portion of international sales. Exports to China, which is reining in a monetary easy money stimulus policy, and to the slow growing developed countries, may be less than forecast. Even a stronger USD versus the Euro and Yen, could limit net international sales.

Significant policy changes cause uncertainty as the effected parties figure out how to respond in their best interests. The banking reform proposed by President Obama and dubbed the “Volcker Rule” is a reasonable top level response in my view to the recent “too big to fail” financial industry bailout. The idea is to split the traditional lower risk commercial bank loan functions from the riskier private equity, derivative, and trading functions. Commercial banks receive FDIC guaranteed deposits from retail savers and must operate within FRB and FDIC guidelines. The FDIC has a process to shutdown small and medium size banks, which can be adjusted for large commercial only banks. Bank holding companies, which own banks as well as insurers, brokers, and others, are more complex entities. The Volcker rule would affect their leverage based on their liability risks, as well as the mega banks, that also include the higher risk activities. Details are critical in determining if Volcker’s approach will lead to a

sounder banking system. The caution is to error on the side of simplicity, transparency, and to avoid being punitive on the most successful operators. The unintended consequences may be Goldman Sachs reverting to a private entity as prior to 1999, as well as reduced commercial banking leverage resulting in effectively higher interest rates and slower money flow (velocity). Complex laws result in high uncertainty and reduced business activity, which hurts the overall economy. That is an issue to ponder with the ideological Obama administration and Congress.

### Foreign Economies

Developed economy 2009 GDP declines stabilized, but 2010 GDP forecasted advances are relatively weak. Emerging countries China, India, and Brazil show good 2010 forecasted GDP growth. Note China is slowing loan growth. Japan, the ECM, and Britain will lag behind the U.S. Key forecasts according to the *Economist* follow.

**Table1. Economic Forecasts**

Economic Market	2009 GDP	2010 GDP	2009 CPI
United States	-2.0	2.9	2.7
Japan	-5.3	1.5	-1.3
China	8.2	8.6	0
Great Britain	-4.7	1.5	2.1
Euro Common Mkt ECM	-3.9	1.4	0.4
Russia	-7.0	2.5	12.2
India	5.5	6.3	9.8
Brazil	0	3.8	4.9

The total global economy is likely to show a 2010 expansion (3.0%) with Asia leading the way. In Table 2 the U.S. extremely positive sloped yield curve continues to show the most stimulative monetary policy. The January U.S. FOMC meeting showed no change in monetary policy. Most countries also have stimulative positively sloped yield curves.

**Table 2. Current Global Yields**

Economic Market	3 month	10 Year
United States	0.2	3.6
Japan	0.3	1.3
China	1.8	3.7
Great Britain	0.7	3.8
Euro Common Mkt ECM	0.7	4.2
Russia	8.0	8.1
India	3.7	7.7
Brazil	8.6	6.2

### Economic Sectors and Investment Outlooks

**A Technical Overview** (BPNYSE, etc) indicates U.S. and foreign stocks are trendless, the number of advancing stocks is narrowing, and volatility is increasing. Money supply growth (M2) is normal (3.1%) over the past 3 months and below normal (2.2%) over the past 6 months. **Suggestion: Hold normal portfolio asset weights, note a 10% correction is overdue, and don't expect more than a 7% return (S&P 500 @ 1200) prior to a 2010 market top.**

### Economic Sector Analysis and Outlook

**Telecom** sector stock demand is weak, as noted by negative sector price Relative Strength (RS). No Opinion. **Utility** Sector forecasted 2010 revenues and earnings are stable. Dividends are around 4%, and sector RS is neutral. No opinion. **Consumer Staples** sector 2010 earnings growth is forecasted to be stable (10%) but below other sectors, while RS is in line. Consider selectively holding dividend paying stocks. **Energy** sector 2010 earnings growth (47%) is expected to recover from 2009 declines (-56%). Stock demand has been in line with the market. Oil prices near the \$80 per barrel level and a stable USD are assumed. OPEC is holding output at current levels. No Opinion. The above sectors have dividend candidates for value investors. **Healthcare** sector 2009 earnings were solid and earnings growth (9%) is forecasted in 2010 with healthcare controls uncertain. Stock P/E's are below normal. Hold selective positions. **Technology** Sector stocks led (60%) the 2009 market advance with 4<sup>th</sup> Qtr. positive earnings surprises (APPL, GOOG, and AMZN) from major leaders. This is the growth sector with good cash flows and solid 2010 forecasted earnings (22%). Hold selective gainers. The **Consumer Discretionary** sector remains cyclical. No Opinion. The cyclical **Materials** sector RS is neutral, but volatile with 2010 good forecasted earnings growth (99%) after poor 2009 (-62%) earnings decline. Sensitive to below forecasted global GDP growth. No Opinion. **Industrial** sector exports (and earnings) to developing countries are positive and the sector RS is neutral. No opinion. The **Financial Services** sector remains very volatile. No opinion. **Initial 4<sup>th</sup> Qtr. 2009 earnings reports are improving more than forecasted.**

**Summary Suggestion:** Cautiously hold normal selective stock and bond portfolio positions. The Tech sector is volatile, but with positive potential. Stock markets usually advance in price

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along with earnings during the first 2 quarters after the end of a recession (through March, 2010).

### International Markets Are Pulling Back

Foreign stock markets fell slightly more (4%) than U.S. markets, while the USD strengthened (2.5%) versus the Euro. Emerging market stocks fell about 7% in January. Normal weights may be considered if you can withstand large declines and high volatility (-50% in 2008, 70% in 2009).

### Fixed Income - Less Volatile but fully priced

The U.S. 10 year Treasury bond returns (2%) were positive in January. Investment grade corporate and GNMA bonds provided good 2009 returns, as risk adverse investors purchased record levels of bonds. A small TIPS portfolio weight is suggested. Muni bonds may be considered for taxpayers in high tax states, after due diligence reviews of credit ratings. Mid single digit after-tax returns at modest risk are possible.

### Alternative Investments – Diversification

The Real Estate Investment Trusts (REITs) index declined (-6%) in January, after an impressive 4<sup>th</sup> Qtr. (20%) recovery. Commercial and retail vacancies and financing are issues. Well informed partnerships may be an effective way to profit from income producing real assets. Gold funds are diversifiers. Only a 5% weight in a direct gold exchange traded fund (GLD) (unchanged in January) is suggested. The 2009 return (24%) was good in a noninflationary environment concerned with fiat money credit rating risks.

### Portfolio Management

Funds have little cash (3.7%) to boost stock prices higher. The S&P 500 index trades at a normal P/E. Be selective and remain diversified. Economic surprises may cause FRB monetary policy changes.

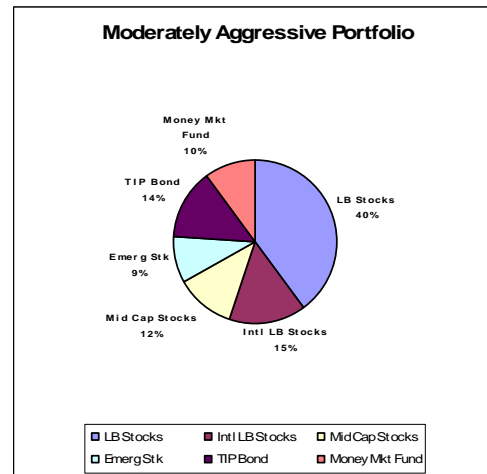
Disclosure: Personal holdings: Normal weights  
39% Domestic & Intl Large Cap stock funds,  
(15% Total International funds)  
47% Small/ Mid Cap funds,  
14% short term bonds and cash

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

Normal Capital Accumulation –



Current portfolio themes are:

Normal Investment Weights

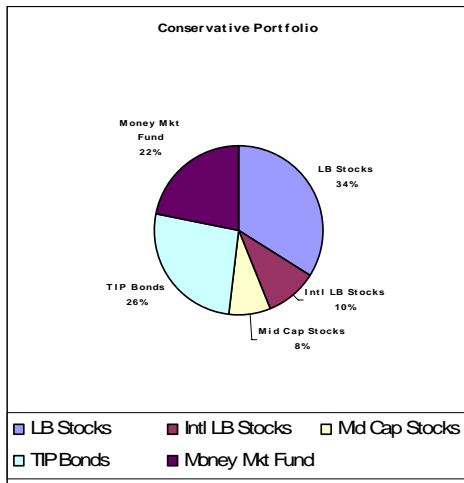
- U.S. large stock funds normal weight
- U.S. small stock funds normal weight
- Foreign EAFE funds below normal weight;  
Emerging stock funds normal weight
- Fixed income – TIPS and short term notes
- Gold – Entry Positions only

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

Normal Capital Preservation –



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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, Chartered Financial Analyst.

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