BWM

Investment
Guidance

January 2011 Month-end Markets Review
Earnings and the economy are growing as expected

Key Points

- ***2011 month to date total returns***
  S&P 500 (1286) 2%;
  US 10Yr Bond (3.37%) 0%;
  NASDAQ (2700) 2%;
  Foreign (EAFE) Stocks 2%
- U.S. GDP expected expansion = 3.4%
- 2011 expected earnings increase = 15%
- Stock market price advance - 5 months
- Modest jobless economic recovery

Executive Summary

Equity market returns in the 1st month of 2011 (S&P 500 2%, NASDAQ 2%, EAFE 2%) changed little as initial 4th Qtr. 2010 earnings reports are above forecasts and the U.S. economy is modestly expanding. Bond market (U.S. Treasury (UST)) returns were essentially flat. Small interest payments balanced small bond price losses. Egyptian tensions and uncertainty give equity markets a reason to correct overbought conditions. The euro currency recovered (2%) relative to the U.S dollar (USD). Federal Reserve Board (FRB) increased UST demand beginning in November (Quantitative Easing 2 (QE2)) was offset 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 related inflation. Soaring 2010 U.S. profits resulted from nearly free financing (0% short term rates) and high profit margins, while expansion was careful in response to new regulations and to be defined regulations from enacted health care and financial control laws. Consumption spending (4.4% 4th Qtr. estimated growth) steadily rose in 2010 recovery from a severe recession. Weak construction spending and high unemployment limited economic growth to date. Sources of new equity market demand may be pension funds, individuals selling bonds (primarily municipal securities) and purchasing blue chip stocks, mergers, acquisitions, and private equity firm related transactions. Commodity prices moved in crossing directions during January. Gold may have dropped in value (-5%) due to profit taking, while oil and other commodity prices bounced around without a clear direction.

Themes

- ***Supply/Demand Tug of War: Investor confidence in corporate financial reports vs. hedging for overbought equities***
- ***Where will President Obama's new focus on the U.S. economy and job creation lead to?***
- ***Research shows FRB fiscal policy stimulus policy is unstable and remains risky.***
- ***An insider argues against FRB dual policy mandate (price stability & full employment)***

Supply/Demand Tug of War: Investor confidence in corporate financial reports vs. hedging for overbought equities

The theme of extraordinary corporate net profit margins and increasing earnings over the past eight quarters may sound like a boring record. Using Standard & Poors data, since the banking group write down of impaired or illiquid financial assets resulted in about zero total S&P 500 corporate earnings in the 4th Qtr. 2008, the forecasted S&P 500 earnings in the 4th Qtr. 2010 (with 50% of financial statements reported) should rise to about $20.49 per total weighted shares price. Using S & P's methodology, blue chip stocks are valued by the market at 14 times annual earnings (about the long term average). *Why can't earnings continue to increase* for 3 times as many quarters or 24 quarters, such as the period from the 1st Qtr. 1992 ($4.93/share) through the 1st Qtr. 1998 ($10.92/share)? In fact total 2000 earnings ($56) exceeded 1999 earnings ($52). The answer is that no one knows the path of future earnings. But we do know the so called "reflation" of the U.S. credit environment by the FRB through interest rate controls far below the real cost of money (best estimated by the Treasury Inflation Protected Securities yield curve) is abnormal and unstable. Whether near free financing is sustained for 4 more quarters or more is simply a (perhaps educated) guess. Changing to Zacks data, we find that analysts forecast S&P 500 corporate earnings should increase from $82.60 (2010) to $95.54 (2011) or 15%. So investors are confident that above normal earnings growth will continue in 2011. A 10% total 2011 return including a 2% dividend or the S&P 500 index valued by the market at 1350 on Dec. 31 is an acceptable risk for many investors to hold stocks.

Market sentiments (emotions) have been extremely optimistic as measured by Investor Intelligence's survey of investment market letter writers, Mark Hulbert's surveys, and AAII small investor surveys. The December 2010 tax rate stimulus deal coupled with the FRB QE2 assured most people that extremely stimulative fiscal and monetary policies are set through mid 2011. The spread between bullish and bearish letter writers has exceeded an extremely optimistic +35% since the November elections. The very low recent bearish letter writer reading (19%) and 12 month low S&P 500 options VIX volatility (19) indicates relatively low investor fear. A retracement of equity prices in the 5% to 10% range in the current economic/emotional environment with Egyptian concerns is possible.

The equity markets flow of funds gives an idea of where the demand is coming from. Municipal bonds are effected by agency credit ratings and selling, which is driving down some bond prices, pushing up yields, and freeing up some money that is adding demand to buy stocks. In a broader sense, the direction of Treasury security prices is more important than corporate debt prices. Foreign interests hold over 35% of U.S. Treasury debt. Their decisions to hold U.S. debt for various reasons is a bigger issue than the bond vigilante speculators, who guess intermediate term price trends and try to take away profits from the market. U.S. Treasury and FRB policies in the midst of massive debt issuances will be a key future issue, although currently the trend of Treasury yields is a small factor in freeing money to demand stocks. Huge bank reserves and lending of money appears to be influencing stock demand in the areas of mergers, acquisitions, and private equity conversions of leveraged corporate assets into initial public offerings. Most of these transactions require financing and generally result in assets being bid up in price above comparable market assets. In a sense, momentum is adding demand for related assets.

A tug of war appeared during January between sectors of the equity markets. Large blue chip companies, especially technology and materials firms, but also value or defensive oriented firms in health care, utilities, and telecommunications sectors delivered stronger than expected financial reports and outlooks. Investors appeared to shift some funds from small growth to large value assets. Congressional hearings and their effects on limiting regulations may provide a positive bias to some health care and other highly regulated economic sector stocks.

Where will President Obama's new focus on the U.S. economy and job creation lead to?

President Obama's January 18 Wall Street Journal Opinion Article *Toward a 21st-Century Regulatory System*[1] and his January 25th *State of the Union* speech to the United States Congress should have provided a clear vision of the President's approach to improving economic growth and job creation.

The President's WSJ article did not recognize an extraordinary increase in federal regulations during the past 2 years and their resultant burdens on U.S. economic activities. A general call for a proper balance between regulations and the freedom of commerce referenced a vague executive order to ensure regulations protect safety, health and environment while promoting economic growth. Will the order reduce overlapping regulations and result in a transparent federal oversight process that reduces burdens on small and all other businesses? The President's article shows limited understanding of the economic constraints on growth and job creation that increased regulations have caused.

The *State of the Union* (SOTU) speech was more important because it is an enumerated presidential duty per Article 2 Sect. 3 of the U.S. Constitution. After a mid term election, where the U.S. citizens voted for a different approach to address weak economic growth, high unemployment, and extreme government debt increases, specific emphasis on these issues should have been President Obama's focus. Yet only 12 of 61 minutes specifically addressed the economy in contrast to 27 minutes during last year's SOTU speech according to *The Washington Post*. An analogy to a Sputnik moment appeared poorly selected to emphasize the President's points of a need to out educate, out innovate, and out build China and other global economic competitors. When Russia launched the first Sputnik satellite in 1957 many American school children were drilled monthly to go under their desks after sirens prepared them to respond to a Russian nuclear attack. There could have been a more relevant optimistic analogy to inspire 2011 U.S. economic productivity and job creation than the response of a nation over 50 years ago concerned with a potential Russian military threat. The emphasis on clean energy, high speed trains, and the internet repeated goals of the American Recovery & Reinvestment Act (Stimulus II) which did not result in promised private job creation (although public sector jobs were saved.)

The President's focus may lead nowhere, because many citizens and the majority in the House of Representatives don't support increased massive deficit spending for clean energy, fast trains, and other subsidized uneconomical investments. A majority backlash is possible if potential voters pressure Congress to rescind some regulations and the President decides to veto related acts that come to him for approval. His political calculations and resultant consequences may not work out as expected and the SOTU speech may be ignored. That would be good. The private economy should grow (4% in 2011) and employment increase without added federal investments.

Research shows FRB fiscal policy stimulus policy is unstable and risky.

John Hussman manages 2 conservative hedge funds. His weekly commentary letters show original thinking that is worth considering. A recent *Sixteen Cents: Pushing the Unstable Limits of Monetary Policy*[2] is summarized to give a thoughtful, well researched view of the instability of adjusting current FRB policy. The idea of a liquidity preference or demand for money is shown by a significant tight relationship between short term interest rates and the amount of non-interest bearing money that people are willing to hold directly as currency or indirectly as bank reserves. At lower interest rates, people respond by holding more cash per dollar of nominal GDP. The identity P (GDP price index) X Y (real GDP) = M (monetary base) X V (velocity of money flow during period) shows the nominal GDP (P X Y). The relationship is dynamic. All variables change as people make interest rate related liquidity preferences. Extremely high monetary bases, since the 2008 credit crisis and current QE2 purchases to further increase the monetary base, are very sensitive to velocity changes. Importantly, at the completion of QE2 the liquidity preference is required by the relationship to increase the monetary base to 16 cents per dollar of nominal GDP or an all time low implied 3 month Treasury bill yield of 0.05% to avoid intermediate term inflation. FRB members have stated that the interest rates that are paid on bank reserves can be manipulated to recognize the liquidity preference. Ultimately, there is trap between controlling various short term interest rates and liquidity preferences. Small errors in adjusting the monetary base, which the public is willing to hold, can have large consequences, where there is no single stabilizing adjustment toward equilibrium.

An insider argues against FRB dual policy mandate (price stability & full employment).

I pay attention to the FRB member speeches because they give an idea of the Federal Open Market Committee (FOMC) discussions. When policy is dovish or accommodating to future inflation, as now, there is added risk of unexpected consequences. Charles Plosser is the Philadelphia region Federal Reserve Bank President and a 2011 voting member of the FOMC. He voted with all other members in support of Chairman Bernanke's position at the January FOMC meeting. Yet his January 17 speech *The Scope and Responsibilities of Monetary Policy*[3] to the Central Bank of Chile showed a humble view of a central bank's ability to effect economic growth through monetary policy. He essentially laid out a view that the current FRB dual mandate of price stability and maximum employment is flawed. His conclusion follows.

Although it has been over 40 years since Milton Friedman cautioned against asking too much of monetary policy, his insights remain particularly relevant today. I too am concerned that we are in the process of assigning to monetary policy goals that it cannot hope to achieve. Monetary policy is not going to be able to speed up the adjustments in labor markets or prevent asset bubbles, and attempts to do so may create more instability, not less. Nor should monetary policy be asked to perform credit allocation in support of particular sectors or firms. Expecting too much of monetary policy will undermine its ability to achieve the one thing that it is well-designed to do: ensuring long-term price stability. It is by achieving this goal that monetary policy is best able to support full employment and sustainable growth over the longer term, which benefits all in society.

If a future law is passed to return to the pre 1977 single price stability goal, then the FRB will be out of the fiscal policy business. More stable long term economic growth and investment returns are then likely to occur, ceteris paribus.

Global Economies

Emerging countries (China, India, Brazil, and Russia) continue to grow at high speeds and developed countries (European Common Market (ECM), Great Britain, and Japan) grow at slow speeds. Economic growth does not directly translate into investment returns. China is struggling with FRB induced currency pressures and slowly reducing UST holdings. 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.

The potential returns merit some portfolio asset allocation weight through perhaps 2011 with awareness that volatility will remain high.

Table1. Economists Forecasts

Economic Market	2010 GDP	2011 GDP	2010 Unemployed
United States	2.9	3.5	9.4
Japan	3.6	1.4	5.1
China	10.2	8.9	9.6
Great Britain	1.7	1.9	7.9
Euro Common Mkt	1.7	1.5	10.1
Germany	3.5	2.4	7.5
Russia	4.0	4.0	6.7
India	8.8	8.6	10.0
Brazil	7.5	4.5	5.7

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	4.5	4.1
Great Britain	0.8	3.7
Euro Common Market	1.0	3.0
Russia	7.8	5.4
India	7.1	8.3
Brazil	10.7	6.2

Markets and Economic Sectors

Higher risk U.S. equity securities, such as small capitalization and growth stocks, and foreign equities are more volatile than others. During downturns they generally decline more in price and during upturns advance more than blue chip and value stocks and bonds. The current environment is speculative and price momentum driven. Global fears of over $100 per barrel oil related to Egyptian and possibly other oppressed nearby country riots are reasons for overbought equity corrective declines in the short term.

Yet, growth equity and commodity assets historically earn their highest returns in similar speculative periods with above expectation economic growth and overly confident investors. Currently consumer discretionary concept stocks such as Netflix and Priceline, as well as mid capitalization cyclical Technology stocks, appear more overpriced than high growth story stocks such as Apple and Google. Small and mid cap growth stocks advanced a great deal in 2010. It appears that 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 exceed those at the time of the July 2006 Israel Lebanon (Hezbollah) War. A similar 5% to 8% global markets decline with a spike up in oil prices would be a fundamental reason for equity prices to decline from overbought levels over a few months. This is an example of potential volatility that I suggested last month.

Yet, the underlying fundamentals appear solid. Leading and coincident indicators look stronger over the next 6 months as QE2 interest rate manipulation continues. Temporary continuation of the Bush tax cuts and new temporary Obama Social Security and Estate tax cuts, as well as full write off of capital investments will likely boost confidence, consumption, and intermediate term capital investments. The cross current of foreclosures and limited residential construction will likely not dampen the asset value reflation party (except housing) stimulated by monetary and fiscal policy.

U.S. Economic Sectors

Materials Sector 4th Qtr. earnings are higher to date than the overall S&P 500 Index, although price fell (-1%) in Jan. No suggestion. Energy Sector earnings are growing far above the S&P 500 index and price Relative Strength (RS) was 3% above the index. Consider dividend paying assets. Mideast tensions may boost oil prices about 15%. Financial Sector earnings and price RS was in line with the S&P 500 (2%) in the 4th Qtr. No Suggestion. Industrial Sector earnings, revenue growth and RS slightly beat the S&P 500 Index. Hold. Technology Sector earnings and earnings surprises, especially of large growth stocks (APPL, GOOG, ORCL) beat the S&P 500 Index and price RS (1%) slightly beat. Suggestion: Hold. The Consumer Staples earnings growth and RS lagged (-3%) 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 were in line with the S&P 500 Index and adjusting to new regulations. 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 negative RS (3%) vs. the S&P 500. No suggestion. Treasury Bonds (unchanged in Jan) will be influenced by FRB QE2 manipulation. Shorter maturities suggested. The price of Gold fell (-6%) in Jan. as some profit taking on hedge fund 2010 positions may have occurred. Hold. *Remember, 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.** 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 Jan. Energy MLPs may be effective ways to profit from income producing real assets. Gold funds are diversifiers. A 5% weight in a gold ETF (GLD) (-6% in Jan.) is suggested.

References

[1]President Barack Obama, *Toward a 21st-Century Regulatory System*, Wall Street Journal, Jan. 18, 2011

[2]Hussman, John, *Sixteen cents: Pushing the Unstable Limits of Monetary Policy*, Jan. 24, 2011

[3]Plosser, Charles, *The Scope and Responsibilities of Monetary Policy*, GIC 2011 Global Monetary Conference Series Santiago, Chile Jan. 17, 2011

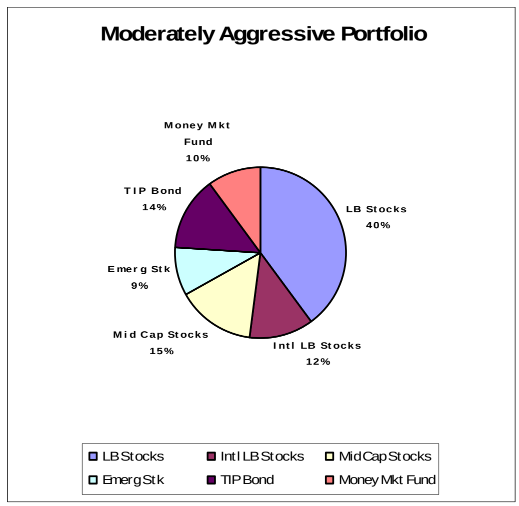
Current portfolio themes are:
Normal Investment Weights
- U.S. large stock funds normal weight
- U.S. small stock funds normal weight
- Foreign EAFE funds underweight; Emerging stock funds normal weight
- Fixed income – TIPS and short term notes
- Gold – Normal (5%) Positions

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

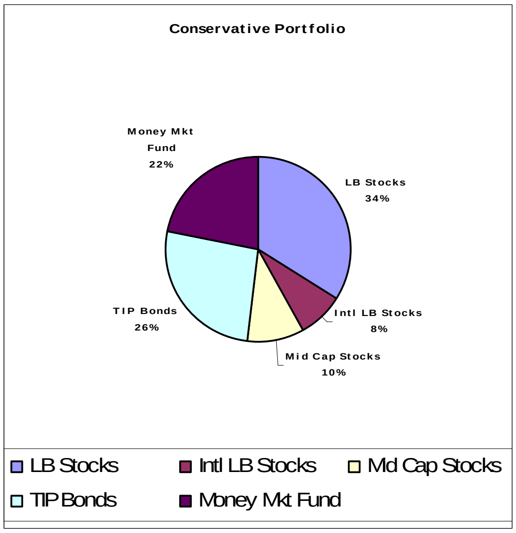
Sample Portfolio A - **Moderately Aggressive**
Example 45 year old college educated parents with 1 high school child and 1 college child.
- 40% Large Blend Stock Index Funds
- 12% Large Blend International Fund
- 15% Mid or Small Cap Stock Fund
- 9% Emerging Market Stock Fund
- 14% TIP Bonds
- 10% Money market cash

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

Normal Capital Preservation –



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