

BWM

U.S. government debt limit uncertainties dominated July financial markets while generally good Q2 earnings were reported;

Key Points

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| <ul style="list-style-type: none"> • July, 2011 YTD Total Returns | |
| S&P 500 (1292) | 4%; |
| US 10Yr Bond (2.82%) | 5%; |
| NASDAQ (2756) | 4%; |
| Foreign (EAFE) Stocks | 1% |
| <ul style="list-style-type: none"> • U.S. GDP expected expansion = 2.5% • 2011 expected earnings increase = 16% • Stock market prices – cautious decline • Jobless abnormal economic recovery | |

Executive Summary

Small negative equity market returns occurred (NASDAQ -1%, S&P 500 -2%, EAFE -2%) in July. Bond market (U.S. Treasury (UST)) returns during the month gained (3%) as yields fell in the midst of weak 2nd Qtr. estimated U.S. GDP growth (1.3%) and U.S. federal borrowing limit uncertainties. The Greek limited default (rollover / term extension / reduced new debt principal) of sovereign debt surprisingly coincided with no Euro currency change versus the weak U.S. dollar (USD). Federal Reserve Board (FRB) post Quantitative Easing 2 (QE2) manipulations of US Treasury security prices in the middle of the U.S. debt default concern appeared limited. The 2nd Qtr. initial economic GDP growth estimate (1.3%) was weak. The revised 1st Qtr. (0.4%) 2011 GDP was worse. A key issue is 13 weeks of high (>400,000) weekly initial unemployment insurance claims prior to last week's 398,000 claims. High unemployment claims coincided with increased unemployment over the past 3 months. The counter surprise is the resilience of large corporation (S&P 500) 1st and 2nd Qtr. earnings and revenue reports. Large companies are adjusting to higher energy costs and added regulations with some price increases, several regulation waivers, and stable high net profit margins. Cash flows remain high, mainly among prominent growth (Apple and Google) and blue chip value (Intel and Microsoft) companies. Yet small businesses are suffering. The expected higher 2nd Half 2011 GDP (3%) should support large and medium size corporate profits through year end, but the employment outlook is unclear. U.S. fiscal and monetary policies have used all their political and printing press resources. There appear to be some near term small upside GDP opportunities, but big downside risks. The 2011 2nd Half and 2012 Investment landscape is full of complex risks.

Themes

- *What are debt markets telling us about federal government debt ratings?*
- *Are S&P 500 Q2 earnings more critical than a threat of a U.S. government debt default?*
- *Regulations are starting to hurt larger companies in addition to the smaller ones.*

What are debt markets telling us about federal government debt ratings?

Daily news consistently informs us that the U.S. Congress and President are acting pathetically in maneuvering to set some spending controls while agreeing to increase the government debt (U.S. Treasury) limit. The emphasized point is that the U.S. government credit rating will fall below the cherished top AAA rating, if an agreement is not signed into law prior to the Treasury Secretary's quoted date of August 2 with dire consequences. Well, there is a more thoughtful larger analysis of the story.

The U.S. sovereign debt has already lost its cherished AAA rating based on market debt related prices. More importantly, the process that resulted in the downgrade, if unchanged, will result in further downgrades and eventual (but not yet due to relatively worse euro issues) higher interest rates on future U.S. Treasury securities and other debt referenced to U.S. debt (corporate debt, home mortgages, etc.)

A lesser known debt rating group than Moody's, Fitch, and Standard and Poors, is Credit Market Analysts, Ltd. (CMA), which has a more quantitative methodology and in my view better forecasting record than its peers. Its ratings better align with current and future market expectations. CMA relies significantly on 5 year Credit Default Swap (CDS) default insurance pricing. CDS prices are used to estimate the probability of default in the next 5 years and inversely rate sovereign debt from the top *aaa* rating to lower ratings as appropriate. The primary factors for credit ratings are the overall total country debt/annual GDP (ability to pay the interest, as well as principal at maturity) and annual budget deficits between revenues (taxes, tariffs, etc.) and spending that add to total debt.

Table 1 below shows the sovereign debt ratings of 5 developed nations (Japan, United States, France, United Kingdom, and Germany) at the 1st Qtr. 2010¹ and 2nd Qtr. 2011² based on CMA data. It also shows the 2010 Debt/GDP from the *IMF World Economic Outlook*³ and 2011 forecasted budget deficits from *The Economist*⁴ for each nation (country).

Table 1. Sovereign Debt Analysis

Nation	Rating Q1 2010	CDS Q1 2010 (bps)	Rating Q2 2011	CDS Q2 2011 (bps)	%Debt GDP Q4 2010	% Budget Deficit 2011
JPN	aa+	67.3	a+	90.9	225	-8.4
USA	aaa	41.1	aa+	50.5	92.7	-9.1
FRN	aaa	47.1	a+	79.8	84.2	-5.8
UK	aa	77	aa	61.4	76.7	-9.1
GER	aaa	31.6	aaa	40.9	75.3	-1.7

A person listening to Treasury Secretary Geithner focus on the U.S. sovereign debt rating during interviews should be aware that the U.S. sovereign debt already lost its top rating. *I didn't hear the Treasury secretary talking about the U.S. sovereign debt being downgraded last year. Did you?* Further notice, that all developed nations in Table 1 are paying more for debt insurance now than they did 5 quarters ago. For example, on July 1, 2011 an investor paid \$505 to insure a new \$10,000 U.S. 5 year Treasury note against default. The German % Debt/GDP and budget deficits are lower than its peers. Germany also has a positive trade surplus, which supports its top credit rating. The UK has a stable, but worrisome credit rating and a high budget deficit, but its debt duration (13 years) is longer than others. Time will tell if a relatively strict austerity program (reference article⁵ notes UK effects; US may be similar if and when it selects reduced spending), an independent currency, and a high trade level gives it flexibility to stabilize its government finances. France is caught in the euro currency constraints with a much weaker economy than Germany. France's government finances are really worse than the UK. The USA % Debt/GDP figure may not be familiar to some readers. For comparisons to other nations, the total federal debt is shown. (The quoted external market securities U.S. % Debt/GDP does not include internal supplemental debt used to fund wars and inter agency borrowing. When the U.S. % Debt/GDP is quoted as 60%, about \$5T of supplemental debt is not counted.)

The Japanese governmental finances are in a unique position among developed countries. Their demographics, lack of natural resources, uniform society, limited cultural entrepreneurial attributes, and extraordinary current debt burden will very likely reduce their future standard of living. A last macroeconomic factor, % federal spending/GDP is not shown in Table 1, although all 5 developed have passed the 25% threshold of a modern social welfare state, which crowds out the private sector's ability to grow sufficiently.

Overall each developed country has chosen to significantly add unsustainable federal government spending, budget deficits, and with the exception of Germany has suffered a reduced credit rating. The U.S. government President/Senate vs. House of Representatives basic *philosophical difference concerning the size and control of government is the key debt ceiling issue*. The path of lower credit ratings, limited economic growth, higher debt interest payments, and lower standards of living for Japan and France are fairly certain. The German welfare state will remain economically stable, similar to its smaller neighbors, Sweden and Switzerland, due mostly to cultural discipline. The U.K. selection of some austerity measures shows U.S. citizens and their elected politicians an attempt to limit the growth of the government welfare state.

U.S. credit rating downgrades are clear economic signals that debt interest rates are most likely to rise and standards of living are most likely to fall to European and Japanese levels, if growth of federal spending is not reduced and private economic growth does not return to normal 3+% annual rates. To put an exclamation point (!) on added economic stress, related to both raising the U.S. debt ceiling and European Central Bank bailing out or accepting euro debt restructuring defaults, near July month end the Figure 1 CDS related insurance rates rose to U.S. (63 bps), France (114 bps), and Germany (62 bps). The market place is losing confidence in all developed country sovereign debt securities even though weak economic growth is keeping interest rates abnormally low.

Are S&P 500 Q2 earnings more critical than the threat of a U.S. government debt default?

About 66% of S&P 500 companies have reported 2nd Quarter financial statements. The results are a bit better than forecasted based on Bloomberg and Zacks data. Considering the weaker than forecasted (in May 2011) 2nd Qtr. U.S. and developed countries' GDP growth; U.S. large corporations' earnings, revenue, cash flow, and net profit margin growth are good. In the midst of the U.S. government debt nearing its statutory limit and extreme political posturing, investors appear to be currently cautiously watching corporate earnings and holding their stocks, as well as bonds. To an extent, hedging insurance is occurring in the CDS and options markets and large funds are holding added cash.

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The positive earnings surprise ratio at 72% is better than normal (68%) with year over year earnings growth of about 17% in the eighth quarter since the great recession ended. Also recall the solid 1st Qtr. earnings growth (16%), while the GDP grew an anemic 0.4%. The earnings, revenue growth in some economic sectors (Materials (47%, 18%), Energy (35%, 32%), and Technology (23%, 13%)) are very good. The Industrial earnings and revenue growth (19%, 9%) also exceeds the total current 2nd Qtr. S&P 500 reports to date (10%*, 7%). The sectors with significant Asian businesses are prospering in weak dollar based exports. The economic sectors directly exposed to consumer retail spending (consumer staples and discretionary items) are meeting forecasts, but may be exposed to material price increases and moderate pricing power. Analysts' forecasts are sanguine (positive 2011 upside revision ratio (1.32); yet corporations are more cautious. The S&P 500 2011 forecasted P/E = 13.6 with 1st Qtr. and most 2nd Qtr. reports released. That is about a 7.3% earning yield in comparison to a less risky 2.9% Treasury 10 yr. bond yield. The S&P 500 companies are valued fairly, if the U.S. economy does not stall out in the 2nd Half 2011 at GDP growth less than 2%. So far investors are holding equities cautiously as the threat of U.S. debt default and yield increases on August 2nd exists at the time of this writing.

* total earnings growth does not include the financial sector -29% earning decline due primarily to Bank of America's \$8B Countrywide mortgage settlements charge).

Regulations are starting to hurt larger companies in addition to the smaller ones.

The complaints of small businesses, as noted through their representative organization, the National Federation of Independent Businesses, have been loud and consistent over the past 2½ years. Yet, the complaints of larger businesses about the Obama Administration and related agency increased regulations have been more politically guarded. The big guys often contribute to campaigns of the party in power and hence the conflicted distasteful big government / big business relationship exists. It is unusual for Jamie Dimon, J.P. Morgan Bank CEO, to challenge Federal Reserve Board Chairman Bernanke in direct public questions. The FRB essentially controls all key factors of banking.

However, the level of big business frustration with federal government regulations reached a higher level with the July 18, 2011 Wynn 2nd Qtr. financial report conference call. In passing through Las Vegas, most people notice the neat signature *Wynn* across the top of one of the newer nice hotels on the strip. Steve Wynn, CEO, knows the politics of Las Vegas and is a substantial contributor to Nevada Senator Reid and President Obama. Yet his statement "And I'm saying it bluntly, this administration is the greatest wet blanket to business, and progress and job creation in my lifetime" surprised every one from Senator Reid to the general media. The statement was not isolated and continued with numerous supporting facts. If a CEO in union controlled Las Vegas no longer feels a need to hold back his frustrations with the onslaught of new federal regulations, similar emotional comments from business leaders may be heard in the future.

A rational analysis of the impact of regulations by Ashby Foote in the Clarion Ledger, *U.S. jobs all tied up*⁶, for the calendar year 2008 prior to the increased flow of regulations, estimated the cost of federal regulations at \$1.75T for the year. At near a \$14T U.S. GDP, regulations were estimated to cost 12.5%. Is that a reasonable charge for the value provided? Is the real cost higher in terms of human capital that simply gave up and stopped making the effort to produce one thing or another? Some regulation costs may be considered reasonable, if they included all the related consequential costs. For example, in 2008 the IRS Tax Compliance administration costs were \$160B in the process of collecting \$1,500B from taxpayers. Is 10.7% a reasonable cost to control tax under reporting to a 15% level? Would a simpler tax code that required less preparation costs, less IRS agents, and most likely fewer reported errors result in a better, more productive society for all? The Federal Environmental Oversight and OSHA / Homeland Security regulatory costs were about \$160B and \$75B in 2010, respectively. Be aware the regulation costs do not include the actual citizen compliance costs. The new Patients Protection and Affordable Care Act (PPACA Obamacare) and Dodd Frank Financial Reform Act will create added regulatory costs. Maybe, Steve Wynn is addressing a real government transformation problem that is hurting many.

A few politicians have noticed the regulation impact on the economy and are trying to do

something to lessen the burden. Freshman Senator Ron Johnson spoke with the *Wall Street Journal*⁷ and noted as a former mid size company CEO that the costs of regulations are huge. In each of the Obama administration years a record new 84 regulations per year have been enacted with an estimated cost greater than \$100M annually. He introduced a bill titled the Regulations Moratorium & Job Preservation Act that would not allow any new regulation estimated at greater than \$100M until the unemployment rate falls below the 7.7% rate when President Obama entered office. There are too many special interests for such a bill to pass. Yet, for the optimist looking for a few years of 4% GDP growth there is a hopeful approach!

Forecasts for U.S. GDP growth in the 2nd Half of 2011 are near 3%. If the weather and Japanese earthquake 1st Half related supply bottlenecks are cleared, then the cost of energy and certain lesser impact commodities may be key factors in GDP and profit growth. Near zero financing costs are expected to continue through at least year end even if core inflation rises to 3% (far above the FRB target 2% high end range.) That is a scenario for continued profit growth approaching current 2011 S&P 500 forecasts of 16%. Yet, the scenario does not imply monthly employment growth of 200,000 net new jobs and less than an 8.5% unemployment rate at yearend. Government jobs are easier to create or save than private sector jobs, as shown in the past 2 years.

Global Economies

Emerging countries (China (9%), India (7.8%), Brazil (4%), and Russia (4%)) continue to grow at high speeds; developed countries (United States (2.3%), European Common Market (ECM) 1.7%), Great Britain (1.5%), and Japan (-0.6%)) are growing at slow speeds or stagnant in 2011. Germany (3.2%) falls in between.

Euro currency economies addressed Greek sovereign debt insolvency issues with a short term debt restructure/bailout. Portugal & Ireland are next. Strained Spanish & Italian sovereign debt payments also exist. Germany is the effective head of continental Europe. Eventually, some bailed out countries like Greece will probably find it easier to outright default on their debt obligations, return to a devalued national currency, and accept a lower standard of living. The disciplined German culture and their banks may accept PIIGS sovereign debt defaults and later end the common currency experiment.

Economic growth does not directly translate into investment returns. During 2011 USD investors in the Barclay iShares Emerging Market Index EEM Fund had no (0%) returns. The Barclay iShares Developed Europe Asia and Far East Market Index EFA Fund earned 1%.

I continue to expect higher interest rates in China, India, and Brazil to slow down inflation in the 2nd Half 2011 and may continue to impact investment returns. Yet corporate earnings growth and generally responsible fiscal and monetary policies should set the stage for acceptable (10% to 15%) risk adjusted returns in 2012. Most foreign developed countries have debt and deficit problems that will make less government spending (austerity) the selected choice. The scenario will most often result in 1% to 2% GDP growth through 2012, but possible acceptable equity returns (holding purchasing power) for USD investors, if the U.S. continues to generally devalue its currency. Sound currency, slow GDP (2%) growth country stock markets, such as Switzerland, may offer good risk adjusted returns. Limited diversification in emerging and developed markets is suggested, while being aware that a disruptive default of a euro based sovereign debt could cause volatility near term and ECM stock and bond losses.

Table 2. The Economist Forecasts

Economic Market	2011 GDP	2012 GDP	2011 Unemployed
United States	2.3	2.9	9.2
Japan	-0.6	2.8	4.5
China	9.0	8.7	6.1
Great Britain	1.5	2.0	7.7
Euro Common Mkt	1.9	1.7	9.0
Germany	3.2	2.2	7.0
Russia	4.3	4.6	6.1
India	7.8	8.6	10.0
Brazil	4.0	4.1	6.2

The total 2011 global economy is expected to continue to expand at a steady rate (3.5%) with Asia leading the way. In Table 3 the U.S. positively sloped yield curve continues to show an excessive stimulative monetary policy for a 3rd year. Global long term interest rates have declined in 2011 as Emerging Market high short term rates to calm down inflation are acceptable to most bond and stock investors.

Table 3. Current Global Yields

Economic Market	3 month	10 Year
United States	0.2	2.9
Japan	0.2	1.1
China	6.1	4.1
Great Britain	0.8	3.0
Euro Common Market	1.6	2.9
Russia	8.3	4.7
India	8.1	8.5
Brazil	12.2	6.2

Personal Goals, Portfolio Management, & KISS

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 portfolio cash flows. The *Keep It Simple Stupid* (KISS) approach applies to personal finances, as well as most things in life.

Asset valuations have risen over the past 9 quarters since March 2009 above the long term normal annual 10% stock returns and 5% bond returns. The probability of slower or slightly declining government spending to address out of control deficits and debts may impact future GDP growth. The sequence of recessions in 1980 and 1982 is worth studying. The key problem then was extreme inflation (8 – 11%) and a short recession was followed by a longer one. There is now a greater than 25% probability in my view that a long 2008/2009 credit liquidity recession may be followed by a short shallow 2012 recession to bring the out of control 2009 and 2011 government spending to acceptable lower budget deficits. Be vigilant.

Consider the simple concept of risk budgets for your portfolio investments to earn personal goals. If goals can be met, while lowering your total (expected volatility) and components risk budget, a recently earned wealth spending surplus buffer can be made more stable by selecting more low risk assets. The approach is also called periodic rebalancing. Another 3 to 6 months of above average (8%) balanced portfolio (55% stocks, 35% bonds, and 10% cash) returns are possible. However, 3 years of high profits have only occurred 5% of the time in the past 100 years. In viewing time period risk, caution is good. Most S&P 500 stocks appear fairly valued on a base of cheap financing and related very high profit margins. Current talk of Initial Public Offerings (IPOs) for social media darling stocks like Facebook and Twitter in early 2012 is highly speculative. The recent successful

offering of related Linked-In has got many people excited. Even dull concept Dunkin Donuts IPO gained over 50% in its first week of trade. In wealth management for most people, focusing on values, personal long term spending goals, and KISS are suggested, especially now.

Markets and Economic Sectors

Higher risk U.S. securities, such as small capitalization stocks, appreciated more than large cap stocks in the first 5 months of 2011, but gave back their relative return lead in the past 2 months. At this time large and small cap stocks year to date have similar (4%) returns. Growth company stocks have a remaining lead (3%) over value type stocks (primarily due to financial stocks). Commodity prices have been volatile in 2011 with the total CRB Index advancing marginally (3%) and oil (4%) advancing about the same as stocks and bonds. The big story is the continued advance (14%) in gold prices which directly mirrors the reduced purchasing power of the USD. The environment is speculative but tricky with short term momentum changes. Hedge funds on average were unable to make gains in 2011 above holding most assets.

There are about 100 (20%) of S&P 500 stocks paying dividends above 10 yr. Treasury bond yields. Considering portfolio changes toward dividend paying stocks is suggested.

Technical Analysis

The U.S. stock market volatility is slightly above average with the S&P 500 and NASDAQ Indices currently trading near their 200 day (40 week) moving average. Some shorting related to the U.S. debt ceiling uncertainty possibly caused net selling in the last week of July. Yet, comments that the U.S. stock market will fall 6% on Aug. 2 if President Obama does not sign an increased statutory debt ceiling law by then seem unlikely. In the main economy banks, businesses, and even the U.S. Treasury have had a month to adjust their cash flows for a delayed increased statutory debt ceiling law enactment for a short period after Aug. 2. In contrast, the Lehman bankruptcy was a surprise because another U.S. government bailout somewhat similar to Bear Stearns, Merrill Lynch, and Fannie Mae was expected and no one understood the real counter party risks. A few more days of political games may occur after Aug. 2 or the issue may be resolved by the time you get to this part of the BWM Letter. *Remember the U.S. already lost its AAA rating based on the real market trading.*

The bigger economic concern is possibly continued weak economic growth and lower future earnings growth for the Russell 2000 smaller cap stocks. Equity markets appear cautious and technical short covering seems just as likely to boost net buying if a statutory debt ceiling law is enacted on Aug. 2. Based on valuations, I generally suggest staying with your general portfolio plan at this time.

U.S. Economic Sectors

Materials Sector 2nd Qtr. earnings were very good and July market price changes were about the same as the S&P 500 Index (-2%) after lagging behind (negative Relative Strength (RS)) in the 1st Half. No suggestion. Energy Sector earnings grew a bit more than the S&P 500 index even as oil prices were unchanged in July. The July RS was 3% after a +5% RS in the 1st Half. For the year to date (YTD) Energy stocks earned a 12% return relative to an S&P 500 Index 4% return. Oil price changes (+/-15%) would impact future Energy Sector earnings. Consider dividend paying assets. Financial Sector earnings and price RS continued to lag the S&P 500. Avoid. Industrial Sector earnings slightly beat the S&P 500 Index, but RS lagged during the month. Suggestion: Hold. Technology Sector earnings, earnings surprises, and RS slightly beat the S&P 500 Index during July. Suggestion: Hold. The Consumer Staples earnings growth lagged, but RS met the S&P 500 during July. Suggestion: Hold dividend paying stocks. Utility Sector Stocks earnings lagged, but price RS led the S&P 500 Index during July. No suggestion. Healthcare Stocks earnings and RS lagged the S&P 500 Index. Suggestion: Hold. Consumer Staples, Utility, and Healthcare stocks are normally defensive, stable earnings stocks that are less volatile than others. Consumer Discretionary stock earnings varied with overall similar RS to the S&P 500. Hold selectively. Treasury Bonds (+3%) led the S&P 500 during July. They are influenced by FRB manipulation and appear overpriced; yet no sign of potential default on July 29. The price of gold rose in July (9%) and YTD (14%). Suggestion: Hold.

Portfolio Suggestion: Hold normal portfolio asset weights. Stock market psychology shows crossing caution and speculation. Reduce risky assets if stock prices rise. Volatility is likely to increase. Liquidity is cheap. Markets appear fairly and fully valued.

Primarily focus on your goals.

Alternative Investments – Diversification

The Real Estate Investment Trusts (REITs) index advanced more than the S&P 500 Index in the 1st Half 2011 and in July. Well informed partnerships and energy MLPs may be effective ways to profit from income producing real assets. Gold is a diversifier. A 5% weight in a gold exchange traded fund (GLD) is suggested.

Current portfolio themes are:

Normal Investment Weights

- U.S. large stock funds normal weight
- U.S. small stock funds normal weight
- Foreign EAFE funds 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

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