

BWM

Investment
Guidance

1st Half 2009 Markets Review
Credit (Financial) Depression Averted
Economic Recession Easing

Key Points

• 1 st Half 2009	Total	Returns	
S&P 500 (919)		3%	;
US 10Yr Bond (3.52%)	-20%		;
NASDAQ (1835)	17%		;
Foreign (EAFE) Stocks	2%		
• U.S. GDP expected contraction = -2.6%			
• 2009 earnings expected decline = -14%			
• Stock markets likely hit bottom in March, as the economic recession eases			

Executive Overview

The 1st Half 2009 saw a credit (finance triggered) depression averted. Yet, it took until March to show that a “too big to fail” money center bank (i.e. Citigroup) would not pull the global economy into the abyss. From a macroeconomic, as well as individual large company perspective, the trajectory of the recession diminished considerably during the 2nd Qtr. As will be analyzed, the new stagnant economy for the remainder of this political administration will be problematic. First, the good news is that in the 2nd Qtr. the S&P 500 (15%), NASDAQ (20%), and the foreign EAFE (24%) stock indices rose to produce the Key Points 1st Half 2009 returns. Remain aware of the far larger -37% to -43% stock index losses in 2008. Positive (less bad) macroeconomic and corporate earnings surprises during the 2nd Qtr. caused investors to begin seeing the proverbial glass half full with several leaks, instead of cracked and spilling mistrust all over the globe. The price of gold remained nearly flat during the 2nd Qtr. and up about 5% during the year to date. That indicates a limited current U.S. currency inflation concern. The U.S. dollar (USD) fell in value versus the Euro in the 2nd Qtr. about as much as it rose in the 1st Qtr. The U.S. 10 Yr Bond yield rose about the same in both the 1st and 2nd Qtr. and caused the net return to fall 20% as shown above. Reduced foreign demand (and new supply of debt to finance the massive U.S. deficit) effectively eliminated the flight to safety status of the USD. The 1st Half 57% recovery of oil to about \$70 per barrel prior to the end of the recession shows that pre 2005 Hurricane Katrina \$2.20 per gallon gasoline will be rare or not exist in the future.

Other asset price declines, including homes, are leveling out in most of the country. Economic indicators at the end of the 2nd Qtr. showed fewer positive surprises than in April and May. The consensus continues to expect about a 3% GDP decline in the 2nd Qtr. and a slight GDP increase in the 3rd Qtr. The new administration controls expanded dramatically. Their longer term impacts on U.S. household wealth under a primary scenario will be analyzed.

Themes

Investment markets themes are:

- **U.S. government controls policy analysis.**
- **Last innings of the recession**
- **New stagnant future economy**
- **General wealth preservation strategies**

Rational expectations in a control society

After 5 months in power, enough enacted U.S. laws, executive orders, and policy statements have occurred to form a good idea of what the next 3½ years of fiscal policy will look like. Life means change and divided government between the executive and legislative branches is possible after the 2010 elections. While 1994 election change is feasible, 1978 continued one party rule is likely. The minority party lacks leadership, so this observer will primarily analyze the scenario of a large Congressional majority enacting many of President Obama’s planned policies. They differ from the founding principles and late 20th century direction of his party.

The earth belongs to each generation, during its course and fully in its own right. The 2nd generation receives it clear of debts and encumbrances of the 1st. ... Then no generation can contract debts greater than can be paid during the course of its own existence.

- Thomas Jefferson “Earth Belongs to the Living” Letter to James Madison Sept. 6, 1789 prior to founding the Democratic Republican Party, which partially evolved into the Democratic Party in 1824, argued strongly against runaway deficit spending.

As times change, so Government must change. We need a new Government for a new century, humble enough not to try to solve all our problems for us but strong enough to give us the tools to solve our problems for ourselves, a government that is smaller, lives within its means, and does more with less.

- Bill Clinton Jan. 20, 1997 “Age of Big Government is Over” Inaugural Address.

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President Obama has a liberal vision, while President Jefferson had a conservative vision and President Clinton had a centrist vision in his 2nd term. Society will change under the President's vision to control the Energy, Financial, and Healthcare sectors, which make up 12%, 14%, and 16% of the U.S. economy, respectively. The investment strategies for a less productive economic outlook will focus on wealth preservation, instead of wealth accumulation.

In an ideal country, global warming issues would be debated formally between different points of view on a medium, such as C-SPAN. Responses and counter arguments to questions would be limited to 3 minutes and either 2 graphs or 3 equations would be permitted per answer. Anyone with a science or engineering (thermodynamics and physics) education should be able to follow the details. Probabilities would be assigned to natural and man-made undesirable factors and consequences. No reasonable cost estimates of global warming controls can be made currently. Administration leaders don't have a specific plan to accomplish specific results. New regulations cause uncertainties and require adjustments. There are critical reduced productivity issues, besides added taxes on unfavored carbon emitters. It is reasonable to expect that if a global warming (climate control) act becomes law that it will take a long time to understand and execute with much confusion.

The healthcare control plan is more easily grasped. The President's plan to initiate a government insurance alternative to make health insurance available universally stretches the logic of a thinking person. The simple analogy is having a baseball umpire assign a new team to the league, because all the other teams are making errors. Yet, when the new government team makes errors, all the other teams will have to give it their players. I expect over time, if enacted as proposed, productivity will fall, while costs and politically motivated healthcare resource rationing will rise.

Financial controls could be the least harmful to society, if there are strong debates among the FDIC, Federal Reserve Board, Securities & Exchange Commission, and Treasury Dept. as each tries to protect its interests. The FDIC is arguing for non political "too big to fail" limits on all financial institutions. That would mean that Citigroup must sell off its derivative divisions, just as AIG is currently doing. The

FDIC would oversee all bank restructures per standard methods. This would reduce the political games between the FRB and Treasury Dept in deciding, who will survive and who will fail. The SEC is arguing that it should standardize, securitize, and monitor trading of most credit derivative swap and derivative products per existing methods. Transparency and market transactions are good ideas. Other FRB and Treasury initiatives to control systematic financial risk are problematic because the terms of control are unclear. Will the finance operation of an industrial company be politically protected by the Treasury, such as GM and Chrysler finance subsidiaries have been? More specifically, will established bankruptcy laws be subverted by a political Treasury Dept.? There is not enough information to speculate if new financial controls will prevent a future financial crisis. Yet, they will likely slow credit flow velocity and productivity of the banking sector and U.S. economic system.

The expected controls scenario (impacting 2010 & later) is hopefully incorrect. The Dems and GOP positions are fairly clear. It will be the Independents, who decide over the next three bi-annual elections, the extent of controls that will be implemented. If they link economic impacts to the already incomprehensible deficit spending, the controls train may be slowed down.

The recession is in the 8th inning – Near End.

The current recession has been deep. If it ends per the consensus view, in July or August, then earnings of many economic sectors will likely be positive in the 4th Qtr. on a year over year basis. However, this has not been a shallow 1991 or 2001 type recession. It has been similar to a 1994 or 1982 deeper recession, due to credit or unstable currency factors. During April and May a number of positive (less bad) employment, consumption, and production readings indicated significant improvements. Yet, June indicators are returning closer to expectations. That means the recovery trajectory may be flattening out.

The three factors, which are especially important now, are the number of unemployed citizens, the factory utilization rate, and the household savings rate.

The headline May, 2009 unemployment rate is 9.4% and may peak over 10%. More importantly the total continuing unemployment claims currently stand at 6.74M and the number of

partly or under employed is significant. Those issues will only improve slowly because of the nature of fiscal policy selected. Government make-work jobs to maintain federal, state, and local government jobs and build discretionary bike paths and visitors centers are relatively unproductive. In economic terms there is no well documented economic multiplier effect. President Kennedy after the double 1958, 1962 slow periods and President Reagan after the double 1980, 1982 recessions selected tax cut stimulus policies. They resulted in direct economic multiplier effects and employment based on their incentive responses to a recession. The current condition will likely result in state and local govt. job under employment based on effectively 4½ day work weeks, as these entities try to get spending budgets back in order. Private sector job growth, based on recent surveys, is not yet in sight.

The May, 2009 factory utilization rate is 68.3%. Based on the FRB methodology since 1967, this is lower than the prior 1982 (70.9%) low and 10% below the long term average. Over all recorded methods, the utilization rate is about at the 1958 recession level. Manufactured goods in our service based economy make up about 21% of GDP, in contrast to 40% in 1958. However, surveys show that manufacturers see little future demand to cause them to initiate capital spending for new plants & equipment. The trade picture is a concern. President Obama approved "Buy American" provisions in the recent stimulus act and automobile bailout orders, which are causing retaliation from Mexico and Canada. All countries are following with similar approaches in their stimulus acts. Now that protectionism has started in indirect ways, it will be harder to increase manufactured export good sales.

The household savings rate improved to 6.9% in May, 2009. From the perspective economic stability and balanced trade, that is a welcomed development. Since biblical times, a 10% savings rate and 10% charitable giving rate has been encouraged. As recently as the last major (1982) recession, the savings rate was at about the 10% level. The issue is that a 70% consumption economy relies on spending (not savings). I expect the savings rate to continue toward the 10% level because national household net worth (primarily home value) is about 20% lower than 3 years ago, net total employment income is not rising, and people are uncertain about current fiscal policies.

New stagnant U.S. economy expected

The unemployment rate is expected to continue to be above the past 27 year normal 5% rate for at least the next few years. The U.S. GDP is forecast to grow at a 1.6% rate in 2010. Runaway U.S. deficit spending will not result in anywhere near a normal 3% real annual GDP growth rate and 5% unemployment rate during the next 3 years. Deficits must be financed with Treasury debt. Currently the relevant ratio (publically held U.S. debt/annual U.S. GDP) is 48% according to the Congressional Budget Office. It was 46% at the depths of the Great Depression. Other countries (e.g. Japan (170%), Italy (104%), and Germany (65%)) now have worse ratios. They are inflexible to add more deficit spending and are 20% to 30% less productive than the U.S. Our standard of living will fall toward these other countries within 10 years, if proposed spending levels are authorized.

Thirty years ago, President Reagan began campaigning based on the concept of a misery index that added the unemployment rate to the inflation rate. The idea resonated with voters, when inflation was over 10%. There is not enough data to conclude if inflation will be an issue in 2012. In any case, the FRB has an extremely delicate balancing act to sell back the trillions (\$2,000,000,000,000) of USD securities to the markets that it purchased to avert a financial depression. If the USD weakens sharply in 2011 as it did in 1979, global factors may force the FRB to protect the USD after inflation exceeds the uncomfortable 5% level. Time will tell if the so called misery index reaches the teens and is an issue in 2012.

An offsetting expectation is improved 4th Qtr 2009 and total 2010 U.S. corporate earnings. The economic sectors will earn profits unevenly. Stock price advances of another 10% are conceivable if expectations are met, S&P 500 total 2010 earnings return to \$75, and they hold that level in a non inflationary environment. Rosy beliefs prop up the green shoots outlook.

General Wealth Preservation Strategies

Wealth strategies should focus on needs (primarily cash flows), objectives, and the available intermediate and longer term asset risk adjusted returns. In the current unstable fiscal policy period, a tilt toward wealth preservation for retirees, instead of wealth accumulation, is suggested.

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For most households, risk free cash flows are suggested, if the flows achieve the objectives of expected life span retirement spending, charitable gifts, and intergenerational family wealth transfers. Only take necessary risks.

The simplest need (objective) is life time retirement spending. A pension from a financially sound institution, where a husband and wife worked for most of their careers, may provide 100% of planned retirement spending with a max inflation annual adjustment of 3%. They may also receive social security payments (e.g. 20% above planned spending). For this steady working household, there is no financial risk. Their pension providers own the risk of providing needed spending checks. Social security payments are a buffer in case high inflation reduces their pension checks' purchasing power or unplanned health issues cause their spending needs to increase.

Most households do not receive pension checks that cover all retirement spending needs. Some, however, accumulate enough wealth prior to retirement and may purchase a life time fixed payment annuity with an annual max inflation adjustment of 3 or 4%. If the annuity payments (added to social security payments) equal retirement spending needs, then they transferred all risks to the providers. Most people do not purchase fixed annuity contracts, because decisions are irrevocable. The normal feeling is that potential estate gifts at death will be lost to the insurer, if the annuitants die prematurely. Households may otherwise build a series of cash payments through a portfolio of bonds or bond like securities, such as U.S. Treasury Inflation Protected Securities (TIPS) or bank Certificates of Deposits (CD's). They are both guaranteed by the U.S. government, although CD's payments are not adjusted for inflation. Bonds may be phased or laddered so that they mature and payout retirement spending flows monthly or quarterly over a period of 5 or more years.

The majority of households within 5 years of retirement should focus on saving as much as possible within tax deferred accounts and consider working longer. Wealth preservation strategies should emphasize **returns of capital**, instead of **returns on capital** during the near future. Similar to the last paragraph, the first 5 years of retirement spending cash flows should be as risk free as possible with bond type securities such as TIPS and CDs. The next five

years of retirement cash flows may use dividend paying equities, like high quality utility and telecom companies or steady dividend growing blue chip companies. Blue chip Real Estate Investment Trusts (REITs) or certain commodity production related dividend paying securities should be considered. That is value investing! Growth at a reasonable price investing may also be considered for quality technology companies.

Household with a time horizon of greater than 15 years until retirement may broadly diversify wealth portfolios across asset classes, such as small U.S. and foreign company funds, as well as fully researched alternative asset classes. Their time horizons usually merit a wealth accumulation strategy over weighted in equity assets, as an economy emerges from a recession. The overweight tactic is not currently suggested, because equity markets appear to be within 10% of their potential prices, based on the expected impact of current government policies on corporate earnings. Simple baseline wealth accumulation strategies for households with long working time horizons are generally suggested.

Profits continue to fall; but better expectations

Total S&P 500 company 1st Qtr. profits were 27% lower than in the 2008 1st Qtr. but 14% better than recent analyst reports. In the 2nd Qtr. the Consumer Staples and Utilities are expected to show better profits than the comparable 2008 Qtr, while total profits are expected to fall 36%. The Technology, Healthcare, and Consumer Discretionary Sectors had the best recent earnings surprises. Total profits are currently expected to fall 23% in the 3rd Qtr and rise slightly with the GDP in the 4th Qtr. In the bigger view, S&P 500 company profits fell 18% in 2008, and are forecasted to fall 14% this year, prior to rising 24% in 2010. Note that S&P 500 earnings are expected to be lower in 2010 than 2007 and only 7% higher than the 2008 level.

Financial Analyst forecasts continue to improve

The current analysts' forecast revision ratio continued to improve to an above normal 4:3 upgrades/downgrades for 2009 and 2010. Analysts 2009 forecast earnings have remained steady at \$57 for the weighted S&P 500 shares in the Zacks methodology and lower in S&P research approach during the past month. At this time, the S&P 500 trades at 17 to 26 times 2009 and 13 to 21 times 2010 earnings based on your choice of forecasts. Full prices for uncertainties!

Foreign Economies

Developed economy forecasted 2009 GDP declines have steadied recently after extreme 2008 4th Qtr. and 2009 1st Qtr. declines. 2010 forecasts have improved slightly. Emerging countries China and India have recently improved 2009 forecasted GDP growth. Key forecasts according to the *Economist* follow.

Table 1. Economic Forecasts

Economic Market	2009 GDP	2010 GDP	2009 CPI
United States	-2.6	1.6	-0.2
Japan	-6.7	0.8	-1.0
China	7.3	8.9	0.5
Great Britain	-3.7	0.6	1.5
Euro Common Mkt ECM	-4.1	0.5	0.4
Russia	-5.0	2.0	11.5
India	5.0	6.4	5.0
Brazil	-1.5	2.7	4.7

The total global economy is likely to show a small 2009 (-2.9%) contraction and small 2010 (2.0%) expansion. In Table 2 the U.S. highly positive sloped yield curve continues to be the most stimulative monetary policy. Most countries also have stimulative positively sloped yield curves.

Table 2. Current Global Yields

Economic Market	3 month	10 Year
United States	0.4	3.5
Japan	0.4	1.5
China	1.2	3.4
Great Britain	1.2	3.8
Euro Common Mkt ECM	1.3	3.5
Russia	11.5	10.6
India	3.4	7.3
Brazil	9.2	6.2

Economic Sectors and Investment Outlooks

A Technical Overview (BPNYSE, etc) indicates recent balanced U.S. and foreign stock supply and demand. Money supply growth continues above normal. **Suggestion: Hold normal portfolio asset weights.**

Economic Sector Analysis and Outlook

Telecom sector stock demand is positive. Hold current positions. **Utility** Sector forecasted 2009 earnings are stable. Dividends are around 4%, and sector Relative Strength (RS) is in line. No opinion. **Consumer Staples** sector 2009 earnings growth is forecast to be above all other sectors, while RS is in line. No opinion. A

sizeable **Energy** sector earnings fall is forecast in 2009. Yet stock demand has been very strong as oil surged to \$70 per barrel. OPEC is holding output at current levels. Hold energy stocks. The above sectors have dividend growth candidates for value investors. **Healthcare** sector 2009 earnings look stable. Stocks are performing in line with the market. Hold positions. Be aware of potential legislation uncertainties. **Technology** Sector stocks continue to participate in the advance. Positive earnings surprises continue. Selective buying is suggested. The **Consumer Discretionary** sector remains a cyclical area. Selective buying of value retailers may be considered. The cyclical **Materials** sector is performing in line with the market. No opinion. **Industrial** sector exports (and earnings) to developing countries are slowing, but a weak USD may support increased sales to emerging markets (China & India). No opinion. The **Financial Services** sector remains very volatile. No opinion. **Earnings are currently weak, but the market may anticipate 4th Qtr better earnings.** **Summary Considerations:** cautiously purchase stock sectors with stable earnings and technically tight trading ranges after recent advances. Trim (sell thoughtfully) weak outlook sectors or asset classes.

International Markets Are Advancing

Foreign stock markets rose more dramatically than U.S. markets, while the USD (1.40 Euro) weakened during the 2nd Qtr. Holding developed economy stocks is a reasonable plan. Emerging market stocks rose nearly 50% since the March bottom. Normal weights may be considered if you can withstand large declines (-50% in 2008) and high volatility.

Fixed Income - Less Volatile

U.S. Treasury bond year to date returns (-20%) may not improve as increased supply to finance huge deficits is partly offset by FRB buying. Investment grade corporate and GNMA bonds should provide single digit 2009 returns. A small portfolio weight in a TIPS fund is suggested. Muni bonds are suggested for taxpayers in high tax states, who research good quality general obligations bonds. Mid single digit after-tax returns at modest risk are possible.

Alternative Investments – Diversification

The Real Estate Investment Trusts (REITs) index has improved after plunging in the 1st Qtr. 2009 based on financing concerns. Commercial and retail vacancies remain problems. Private equity

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or knowledgeable partnerships may be a more effective way to profit from income producing real assets. Gold funds are diversifiers. A 5% to 10% weight in a less volatile direct gold exchange traded fund (GLD) is suggested, instead of the gold mining companies.

Portfolio Management

Funds have less cash (4.9%) to boost stock prices higher. The S&P 500 index is trading above a normal P/E with uncertain earnings forecasts. Be open to possible positive economic surprises, which may boost short term asset class demand and prices.

Current portfolio themes are:

Normal Investment Weights

- U.S. large stock funds normal weight
- U.S. small stock funds normal weight
- Foreign EAFE funds normal weight;
- Emerging stock funds normal weight
- Fixed income – TIPS and possibly Muni
- Gold – Entry Positions
- Only hold stocks in suggested sectors

Disclosure: Personal holdings:

- 35%** Domestic & Intl Large Cap stock funds, (15% Total International funds)
 - 45%** Small/ Mid Cap funds,
 - 20%** short term bonds and cash
- Changes are bold faced.**

Some July changes are possible in personal account and in client accounts.

**Sample Portfolios are models
Not Client Recommendations**

Sample Portfolio A - Moderately Aggressive

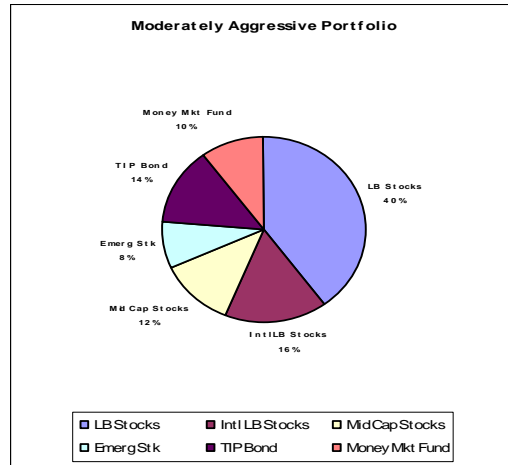
Example 45 year old college educated parents with 1 high school child and 1 college child.

- 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

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. www.BanachWealthManagement.com

Normal Capital Accumulation –

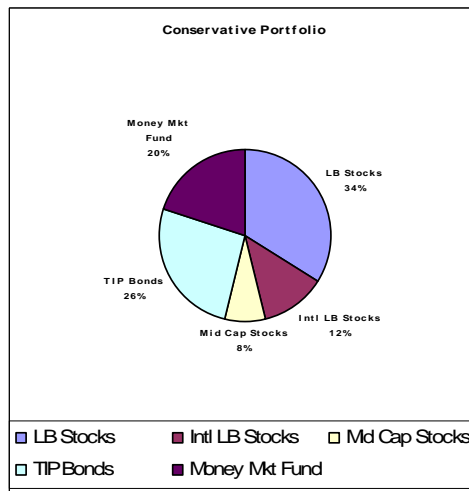


Sample Portfolio B - Conservative

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;
- 12% Large Blend International Fund;
- 8% Mid or Small Cap Stock Fund
- 26% TIPS Bonds
- 20% Money market cash

Normal Capital Preservation –



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