

BWMInvestment
Guidance**1st Half 2010 Weak Financial Markets Review**
Expect 2nd Half Trading Range**Key Points**

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| <ul style="list-style-type: none"> • 2010 Year to date Total Returns S&P 500 (1030) -7%; US 10Yr Bond (2.94%) 8%; NASDAQ (2109) -7%; Foreign (EAFE) Stocks -16% • U.S. GDP expected expansion = 3% • 2010 earnings expected increase = 34% • Stock market correction after 14 mo advance • Economic recovery in process |
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Executive Summary

U.S. equity markets fell 12% in 2nd Qtr primarily in reaction to foreign sovereign liquidity (debt) and market psychological concerns about the jobless recovery. The 2nd Qtr. correction (17% decline from peak) far exceeded 1st Qtr. 2010 gains. Financial analyst reduced forecasts, especially for 2011, during June. The weak euro may impact exports and persistent unemployment may reduce expected increased consumption spending/GDP growth. European and other countries are ending stimulus programs, while the Obama administration pushes its Keynesian ideology. There are abnormal divergence in the economy, earnings, and investor psychology forecasts. Economic models (Keynesian, Monetarist, and Rational Expectations) are producing diverse predictions in a world of huge U.S. government (federal and state leveraging) debt increases noted by Robert Samuelson¹, as well as gradual private household debt reduction (deleveraging). In this situation, the issues will be weighed and a case for a trading range (+15%/-10%) through year end will be made. There are a few increasing value markets despite net deleveraging. Gold (13%), U.S. corporate and treasury bonds (5 to 8%), and all currencies versus the euro are 1st half leaders.

Themes

- **Poor U.S. fiscal policy limits recovery from a deep recession.**
- **The impact of a vastly expanded U.S. government can now be estimated. How will the citizens respond?**
- **Market valuation factors are currently especially difficult to conjecture; my reasoning follows for your consideration.**

Poor U.S. economic policy limits recovery from a deep recession.

The Obama administration inherited a deep recession. It had to decide to focus on a private sector recovery or government expansion. It decided with control of Congress on a huge government expansion. The Feb. 2009 American Recovery and Reinvestment (ARRA) Act (\$862B before interest) is actually Stimulus II, as noted in a recent *WSJ* editorial². The Feb. 2008 Bush administration Economic Stimulus (I) Act (\$168B) was primarily an ineffective tax rebate that boosted the economy for one quarter. The ARRA is focused on three goals: avoid state government employee layoffs, a tax rebate, and expand federal government agencies, while providing grants for so called "shovel ready" projects. Stimulus II is more than 5 times larger than Stimulus I and arguably more ineffective, based on the overall initial economic recovery, the unemployment rate, and the federal debt as measures of effectiveness. Transfers of funds to state governments did not work as planned. The credit ratings of Illinois, California, and New York debt continue to sink as their municipal bond interest rates soar. These states will need to address their state employee salaries, retirement dates, and pension benefits, which are far in excess of comparable private industry wages and benefits. The tax rebates and various welfare aid programs are boosting consumption less than expected. Households are paying down their debts to balance their net assets, such as home equity, which have declined in value. The so called spending multiplier appears to be less than 1.0. While federal government employment expanded during the past 17 months, private sector employment did not and private sector voters are not happy. They are saying "Enough Already; Stop the Spending". The federal deficit cost of an added Stimulus III is not acceptable.

The current recession recovery has completed 3 quarters with modest GDP growth rates (2.2%, 5.6%, and 2.7%) and May 9.7% unemployment. A Monetarist income tax cut stimuli was implemented in response to the 1980/82 double dip deep recession with the following 3 quarters of recovery GDP growth rates (0.3%, 5.1%, and 9.3%). The subsequent 4 quarters each showed growth rates greater than 7%. It is no surprise that the unemployment rate fell from 10.8% in Nov. 1982 to 7.2% in Nov. 1984. That is how private sector focused fiscal policies work. Do not expect the next 4 quarters to generate GDP growth rates greater than 7%.

The impact of a vastly expanded U.S. government can be estimated – Uncertainty!

Health care control and financial related institutions controls have been primary focuses of the Obama Administration and large like minded majorities in the Senate and House of Representatives. Now that the laws are enacted, (final Financial Reform vote is near) affected parties (and Congress itself) are learning about the impacts. A restructuring of vast sections of an economy results in uncertainty, while stake holders figure out how new laws affect them and what they will do to minimize negative impacts.

The health care control act is the most dangerous law. No one, healthy or unhealthy, can avoid it. Health insurance must be purchased by all. Added taxes must be paid by high income earners and indirect higher health care cost taxes must be paid by all. Yet more than 100 bureaucratic committees will arbitrarily set rules. The current uncertainty is significant and the impact can not be estimated with any confidence. The economic issue is how health care services are rationed. In the relative free U.S. society prior to World War II, patients (health care users) demanded services and physicians (with their assistants) supplied it. During World War II, in order to control overall wages the U.S. government encouraged company benefits (health insurance) in lieu of added wages. A reasonable question is whether health care users really need anything other than catastrophic or high cost accident recovery insurance. The catastrophic concept is similar to home fire insurance or car accident insurance.

The Social Security Act of 1965 implemented government single payer health care for those over age 65. Subsequent Medicaid and State Children's Health Insurance Programs set the stage for the Obama Administration and like minded members of Congress to enact the Patients Protection and Affordable Care Act (PPACA) and subsequent 2010 Healthcare and Education Reconciliation Act to bypass Senate super majority rules. President Obama's and supporters' ultimate goal is a government single payer health care system for all. That changes the economic rationing relationship from the doctor supplying the health care to patients to the doctor supplying the health care to government determined patient demand. A government bureaucracy must be paid during the process.

Health care costs rise and health care services are limited to keep the scheme working. Ultimately, every other socialized democracy, who tried a

government single payer experiment, needed an outlet to survive. The U.S. will not escape the reality that a second tier outlet for privately paid healthcare, either legally or in an illegal black market, will be needed to supplement poor quality government controlled health care.

For those entertaining the idea of repealing the PPACA, the task will be great and unlikely to succeed. However, a combined strategy of limiting the funding for aspects of the PPACA and encouraging Health Savings Accounts (HSA) may provide real world data to compare rationing between the government and health care providers versus the patient and health care providers. The latest surveys estimate that 8,000,000 people use an HSA. (Disclosure: I use an HSA.) Although the PPACA limited aspects of the HSA program, it did not destroy it. If future limited government legislatures and presidents enact favorable laws and the HSA program expands in size to cover more than 15% of the population within 10 years, it will be hard for the government to ignore a superior concept.

Financial controls are easier for an investor to analyze. The financial related institutions control act was reviewed in the May 2010 BWM Letter. Recent House/Senate negotiations proceeded as discussed. A new Consumer Protection Agency will tightly regulate mortgages and credit cards, but to no one's surprise Government Motors got an exemption for car dealers. A new Council of Federal Regulators will monitor the entire financial industry to presumably identify "too big to fail" institutions and somehow bring them down to safe sizes. The horse trading went on between Chairmen Dodd, Frank, and money center bank lobbyists. The Volcker proposal to separate commercial banking from investment/derivative banking was given "a wink" with 3% limits related to capital and subsidiary reporting. Flexibility was provided to keep the mega bank risk taking profitable operations in business.

The primary causes of the financial crisis, Fannie Mae and Freddie Mac, were left unchanged. The financial controls will increase the cost of credit to consumers and small businesses. Financial leverage of both the providers (banks) and users (consumers/businesses) will be reduced. The deleveraging will likely constrain the velocity (movement) of money and the economy (GDP.) Big government and the big banking business will continue incestuous conflicts of interest. Data is needed for macroeconomic models to determine if 1% or more annual GDP growth is reduced by the financial controls act.

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The Obama Administration drive to control the energy economic sector through so called cap and trade legislation appears to be possible in a less ambitious Senate form than in the passed House of Representative bill. Utility stock valuations are very modest with uncertainties about whether added taxes will be enacted. The window of opportunity with a near filibuster proof Senate, prior to the Labor Day start of full fledged campaigning, may run out before added energy controls are enacted on Americans.

A final fiscal policy issue must be considered: Higher Individual Income Taxes. It seemed politically suicidal for the Obama Administration to allow House of Representatives Majority Leader Hoyer to recommend higher taxes for middle income earners as well as higher income earners four months prior to Congressional Elections. Republicans can advertise a break from President Obama's multiple pledges of "not one added dime of new income, capital gain, or dividend taxes for households earning less than \$250,000" similar to Democrats advertisements of President George H. Bush's pledge to "read my lips, no new taxes". What were the Democrats thinking? That is a favorable political mistake for tax payers. It will likely be politically harder for Democrats to silently allow the Jobs and Growth Relief Reconciliation Act of 2003 (Bush Tax Cuts) to expire in 2010 and push many tax payers into higher tax payments. It will also be economically foolish in a high unemployment, moderate growth environment. I do not expect the Democrats to be foolish.

There is room for optimism. The key voters in the U.S. democratic republic are non-affiliated independents. (Disclosure, I have always been non-affiliated and don't intend to change.) The term "tea party" was coined on Feb.19, 2009 from the floor of the Chicago Mercantile Exchange by Rick Santelli, a CNBC market commentator in frustration over massive Stimuli II ARRA spending. Since that time it became obvious to the majority of Americans that not only did it waste future taxpayers' money, but that the following government controls over their lives have gone far past a comfortable level. "Throw out the incumbents" appears to be a stronger sentiment now than at any time during the past 50 years. Republican and Democratic incumbents are losing primary elections. It is unclear if divided government (House of Representatives – Republican Majority) will occur in November. Yet, there is a healthy effort

by tea party members and independents to learn more about the U.S. Constitution and follow its principles. **It will take decades to see if the oldest constitutional republic can move back to its limited government checks and balances roots.** During the 3rd Qtr. Markets Commentary, the political landscape will be reviewed again. Be aware that markets weigh factors daily. If they sense a more constrained divided federal government, they will anticipate a more favorable business climate and tend to bid equity prices higher, *ceteris paribus*.

Over promising and poor crisis leadership are not helping President Obama. The federal government is not equipped or motivated to respond to and solve unpredictable emergencies. The U.S. government was unprepared and responded poorly to both the Hurricane Katrina and the BP Oil Spill. Let's be honest. What should be expected from the U.S. government? The 1990 Federal Oil Pollution Act in response to the Exxon Valdez oil spill decreed faster and more aggressive government cleanup operations after oil spills. A faster cleanup did not occur 20 years later. There were no skimmers or other government contracted ships to collect and burn off the leaking oil for weeks. Foreign vessels were not exempted from the 1920 Maritime Law (Jones Act) to allow offered support for months. The President or his Interior Secretary stirred up non-cooperative business adversarial sentiment with comments like "Looking to kick ass" or "putting a boot on BP". That is not the way to solve problems. President George H. Bush did not suspend all U.S. single hull oil tanker usage after the Exxon Valdez accident. President Obama ordered suspension of all oil drilling at 33 Gulf of Mexico exploratory wells for 6 months. Federal Judge Feldman responded by lifting the order based on lack of justification and large economic impact on the Gulf Region. President Obama should have looked to his hero Franklin Roosevelt in 1940 prior to the U.S. involvement in World War II. FDR quietly shed his anti-business posture, appointed competent Cabinet secretaries, and prepared to unleash the full resources of American private businesses should they be needed to develop and manufacture the tools to fight a war. Then he should have told Louisiana Governor Jindal and Florida Governor Crist that they will lead their coastal cleanup efforts with all federal resources at their requests. Local leaders have more incentives to solve local problems! President Obama received poor leadership grades for his

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response to BP oil spill similar to those for President George W. Bush's response to Hurricane Katrina. A decline of President Obama's popularity may moderate his bias toward an authoritarian controlling temperament.

Notice lesser indicators that the progressive push toward an expanding federal debt may be losing momentum. During recent G-8 and G-20 government meetings, the other countries told President Obama and Secretary Geithner that the era of massive government deficit spending must end now. They can not and will not follow the Obama approach any longer.

The Senate gave the same message to President Obama and Leader Reid in response to a Stimulus III bill that will add \$35B to the federal deficit. The Democrats fell short of a filibuster proof majority needed to extend weekly unemployment benefits twice in June, although they will get needed NE Republican votes in July. The June Republican response bill to continue to extend benefits paid for with unallocated Stimulus II funds was rejected by the Democrats. In an intuitive economic way the ending of unemployment benefits after 99, 78, and finally 26 weeks would be an incentive for the unemployed to try harder to earn an income either by working for less than desired wages or offering services at more competitive rates. If an estimated 1,000,000 people stop receiving extended unemployment checks, it is reasonable to expect the unemployment rate to likely decline in the fall and winter. We all adapt to survive.

Market valuation factors are currently especially difficult to conjecture

The U.S. equity valuation uncertainty caused by the large increasing U.S. government deficits, debts, and controls make forecasting macro-economic factors and individual corporate earnings, efficiencies, liquidity, and solvency more difficult than normal.

Global issues include sovereign debt levels, liquidity, and currency exchange rates. The Greek debt crisis and bailout focused European Union countries and Great Britain on welfare state financing limits. Federal worker retirement ages, pension levels, and the level of government employment must be reduced to try to match reduced tax revenues. Reduced federal employee compensations naturally impact consumption spending and each country's GDP. Devaluing a common currency (euro) only helps the most competitive exporter (Germany).

Greece and the other Mediterranean weak euro based economies must pay higher long term interest rates to adjust for poor creditworthiness. Their best alternative is to reduce regulations, increase entrepreneurial competition, and let the price of goods and services fall (deflation). Employment level change paths are debatable. Forecasted reduced European exports by U.S. producers due to relatively lower euro priced goods and overall reduced consumption spending is the key issue of U.S. macroeconomic models. The possibility of a sovereign debt default is causing some odd model outputs. U.S. state (IL, CA, NY) debt crises are also difficult to model. The primary causes (declining home values, high regulations, and related unemployment levels) differ. Thus, estimated business revenues are uncertain. Macro economists are estimating unemployment levels differently and making diverse forecasts of consumption and savings (deleveraging) rates.

The corporate level financial analysts have more specific inputs from direct monthly retail sales data. Inventory levels and primary producer sales must then be indirectly estimated. Forecasts are usually accurate until quarterly corporate analyst conference calls surface a significant supplier issue, product recall, or major litigation. In the past month, some weak 2011 forecasts by dominant corporations have slowed the general euphoria of analysts after extraordinarily good 1st Qtr. 2010 financial statements. The 2011 individual corporation revenue and earnings forecast ranges are widening. 2011 S&P 500 earnings downgrades are now greater than upgrades. If the trend accelerates, then the professional analysts as a group will no longer expect 2011 S&P 500 total average earnings to increase 19% over 2010 levels. Market values will then be impacted by fundamental analyses.

The market psychology is negative. The stock market downtrend and volatility were significant in the 2nd Qtr. No market uptrend after a current correction (17% decline) has started. Market forecasters show less than normal bullishness, but not capitulation. Lower trade volumes are normal in the summer. I see no solid sentiment clues toward an intermediate term equity price recovery trend. Technical indicators broke major bear market resistance points on June 29 and 30.
Note High Psychology Based Risk.

Market Valuations Remain Slightly Favorable

S&P 500 earnings expectations according to Zacks Research declined in June to \$77.50 (2010) and \$93.00 (2011). The upgrades/downgrades ratio fell to negative (less than 1.0) 0.9 (2010) and 0.8 (2011). The 2011 trend is a concern, but at the current S&P 500 price level (1030), \$93.00 earnings (if they occur!) translate to an 11.1 forward 2011 Price/Earnings Ratio (E/P = 9.0%). In a 2% inflation environment and 10 year Treasury bond 3.0% yield, the bond yield risk premium is a normal 1.0% and the blue chip stock risk premium is a relatively high 7.0%. Many dominant blue chips pay higher dividends than Treasury bond yields. The record level of corporate cash is a margin of safety to support dividends and liquidity. In summary, there are multiple uncertainties and U.S. fiscal policy has been poor. Yet my analysis suggests a trading range with profit growth and without many new jobs, worth the risk of participation for U.S. stocks prior to the November elections.

Foreign Economies

Good emerging countries China, India, and Brazil 2010 forecasted GDP growth continues in the *Economist* Table 1. The European Common Market will suffer slower forecasted growth in response to bailouts, reduced financial leverage, and government spending growth limits. Yet a double dip recession is not clear at this time.

Table1. Economic Forecasts

Economic Market	2010 GDP	2011 GDP	2010 CPI
United States	3.0	3.0	2.0
Japan	2.7	1.7	-1.0
China	9.6	8.2	3.3
Euro Common Mkt ECM	1.1	1.3	1.4
Russia	4.8	4.0	6.4
India	7.8	8.0	12.0
Brazil	7.0	4.5	5.5

The total 2010 global economy is expanding (3.3%) with Asia leading the way. In Table 2 the U.S. positive sloped yield curve shows a stimulative monetary policy similar to India. The U.S. FRB plans low (0 – ¼%) bank borrowing rates for an extended period in a modest GDP growth, high unemployment scenario. Most countries are continuing stimulative positively sloped yield curve monetary policies. Stimulative U.S. monetary policy appears to have been more positively effective than U.S. fiscal policy during the past 2 years.

The relationship between a lower U.S. 10 yr. rate (flatter yield curve), tame inflation, and higher gold prices puzzles most macro economists.

Table 2. Current Global Yields

Economic Market	3 month	10 Year
United States	0.3	3.1
Japan	0.2	1.2
China	1.9	3.4
Euro Common Mkt ECM	0.7	2.6
Russia	7.8	5.8
India	5.2	8.0
Brazil	9.4	6.2

Economic Sectors and Investment Outlooks

A Technical Overview (BPNYSE, etc) shows U.S. stock prices trended lower during the 2nd Qtr. with Euro currency related volatility. Declining stock trends led advancers. The 2nd quarter showed equities falling together. Healthcare and Financial stocks declined more than the general market, while real estate and utilities declined less. Gold rose 11%.

Suggestion: Hold normal portfolio asset weights, if you can tolerate an added 10% decline. Or trim equity positions to your comfort level. Stock markets are declining and risky. It is unclear how a slow growth rate will affect earnings and future valuations.

Economic Sector Analysis and Outlook

Telecom sector stock demand is less weak than the total stock market, as noted by positive sector price Relative Strength (RS) with respect to the declining total stock market. Hold. **Utility** Sector forecasted 2010 revenues and earnings increases are low (3%). Dividends are about 4%. Sector RS is less weak than market. Regulations and a 2011 dividend tax rates change may worry investors. Avoid. **Consumer Staples** sector 2010 earnings growth is forecasted to be stable (10%) but below other sectors, while RS is stable. Selectively hold long term dividend growth stocks. **Energy** sector 2010 earnings growth (33%) is expected to recover some of 2009 declines (-56%). RS is in line with market. Research top quality undervalued oil services companies for possible purchases. The above sectors include dividend candidates for lower volatility value investments. **Healthcare** sector 2010 earnings are forecasted to be less (+6%) than most sectors. After the healthcare control act (PPACA) was passed, uncertainties caused the sector to lag behind the market. Stock P/E

valuations are below normal and the lowest of any sector in 2010 (11) and 2011 (10). Hold selective understood positions. **Technology** Sector stocks have slightly better RS, as positive surprises continue. This is the growth sector with good cash flows, good forecasted 2010 sales (13%) and high earnings (30%) growth. 2010 P/E valuations (15) are slightly (7%) above the general S&P 500 market. Hold selective gainers. The **Consumer Discretionary** sector remains cyclical with opportunities for retailers, who have tight inventory controls and anticipate customer trends. Sector RS slightly leads the market. Hold leaders. Watch consumer spending. The cyclical **Materials** sector RS is neutral, but volatile with 2010 good forecasted earnings growth (46%) after poor 2009 earnings decline. They are sensitive to global GDP. No Opinion. **Industrial** sector exports (and earnings) to developing and developed countries are positive, but sensitive to the weak Euro. Avoid. **Financial Services** sector benefits from very cheap federal funds. Hold cautiously. **Stock selections are important in this trading range market.**

International Markets Are Quiet

Foreign stock market returns have been negative year to date, while the Euro (-15%) weakened versus the U.S. Dollar. Normal emerging market weights may be considered if you can withstand large declines and high volatility (-50% in 2008, 70% in 2009). Avoid developed market equities. Their currencies, especially the euro, continue to weaken relative to your home currency (USD.)

Fixed Income - Less Volatile but fully priced

The US 10 year Treasury bond returned 8% YTD. Investment grade corporate and GNMA bond returns (5%) were also good as risk adverse investors continued to purchase large quantities of safe 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 fell slightly in the 2nd Qtr. yet remains positive YTD. Major REITs are working out vacancies and financing issues. Well informed partnerships may be an effective way to profit from income producing real assets. Gold funds are diversifiers. A 5% weight in a direct gold exchange traded fund (GLD) (15% YTD as all fiat currencies are distrusted) is suggested.

Portfolio Management

Funds have little cash (3.4%) to boost stock prices higher. **Remain diversified and selective.** Economic strength will likely cause the FRB to tighten monetary policy after the November 2010 elections and limit stock valuations (lower prices) at that time.

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 – 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

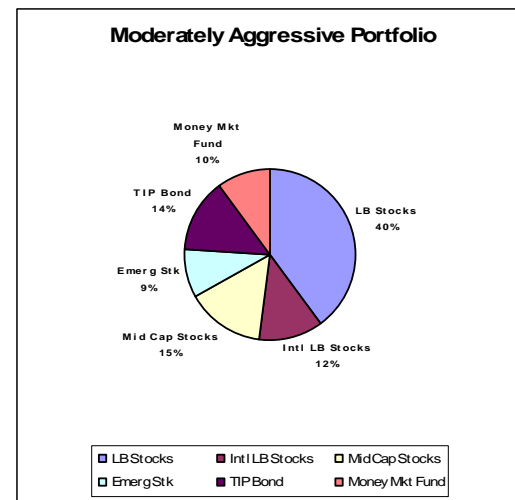
**Sample Portfolios are models
 Not Client Recommendations**

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

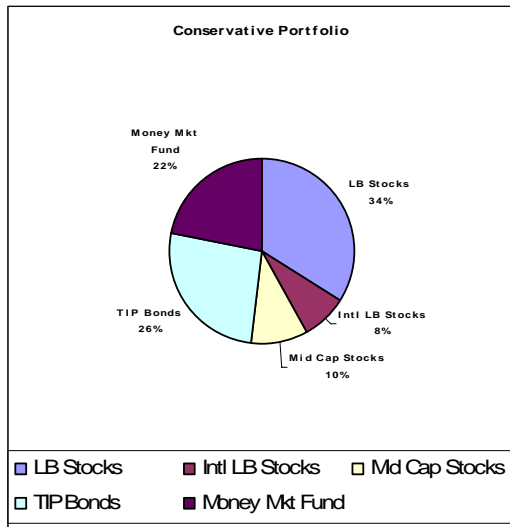
Normal Capital Accumulation –



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 –



Footnotes

¹Samuelson, Robert *Economics Unhinged*, Washington Post, June 28, 2010

²Editorial, *The Keynesian Dead*, Wall Street Journal, June 26, 2010

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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.
www.BanachWealthManagement.com