

BWM

2011 First Half Financial Markets Review

**Earnings Growth continues to lead
Employment Growth;**

**Federal Debt Ceiling and Deficit Agreements
Are Critical for Future U.S. Prosperity**

Key Points

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| • 2011 First Half Total Returns | |
| S&P 500 (1320) | 6%; |
| US 10Yr Bond (3.16%) | 2%; |
| NASDAQ (2773) | 5%; |
| Foreign (EAFE) Stocks | 3% |
| • U.S. GDP expected expansion = 2.6% | |
| • 2011 expected earnings increase = 16% | |
| • Stock market prices - trendless | |
| • Jobless abnormal economic recovery | |

Executive Summary

Equity market 2nd Qtr. 2011 returns were flat (NASDAQ 0%, S&P 500 0%, EAFE 0%). Bond market (U.S. Treasury (UST)) prices in the 2nd Qtr. gained (2%) as yields fell in the midst of less expansive U.S. GDP growth than expected six months ago. The Greek soft default (rollover/term extension) of Greek sovereign debt surprisingly coincided with a Euro currency gain (3%) versus the weak U.S. dollar (USD). Federal Reserve Board (FRB) increased UST demand (Quantitative Easing 2 (QE2)) boosted some risk asset classes (stocks not housing) as planned. What's next? The U.S. economic GDP growth slowed in the 1st Qtr. (1.9%) in response to a 1st Qtr. jump in gasoline prices (\$4 per gal.), supply impacts due to the Japanese earthquake, and U.S. weather issues. Lackluster 2nd Qtr. (2.7%) growth is expected. Profits expanded in the 1st Qtr. above forecast and adjusted 2nd Qtr. forecasts are modestly expanding. In Dec. 2010 S&P 500 2011 corporate profits were forecasted to expand 10%. 2011 profits are now forecasted to expand 16% with nearly 6 months of added real data. That is positive. The primary economic issues are slowing employment growth and unsustainable growth in U.S. government debt. U.S. fiscal and monetary policy has used all its political and printing press resources to try to spend the economy back to prosperity. In the midst of extreme government over leveraging and household deleveraging (slowly returning to normal debt/income levels) more time (nearly 3 years under ideal austerity conditions) is needed to stabilize the U.S. economy for steady future growth. The 2011 2nd Half Investment landscape is tricky to analyze in a world of cross currents.

Themes

- **Uncertainty in poor economic conditions is worse than uncertainty in normal times.**
- **Current US economic conditions may hurt 2nd Half employment prospects more than profits**
- **Will U.S. political debt agreements affect 2nd Half 2011 or 2012 investments more?**

Uncertainty during poor economic conditions is worse than uncertainty during normal times.

There is much talk about economic uncertainty. Recent U.S. monetary and fiscal policy did not achieve promised results as measured by the facts. Yet an unconventional thinker, such as Clifford Asness, founding principal of the AQR Capital Management Hedge Funds, is needed to restate the problem. Cliff is to market arbitrage, what Andy Kessler is to startup technology company venture capital. They are very smart risk takers. Asness points out in *Uncertainty Is Not the Problem*¹ that it is not the federal government policies that we don't know about that are retarding the economy. It is the bad policies we know and have that are increasing the cost of taking risks to expand business, increasing the required returns to overcome expected risks, and decreasing normal risk taking at this stage of economic recovery.

The uncertainty of new projects is part of the problem; yet, the cost of taking certain risks has gone up significantly in the past 2 years as the Executive Branch of the U.S. government and its directly reporting agencies have transformed the U.S. way of life. During 2 years and 4 months, since Jan 20, 2009, the Environmental Protection Agency has released a record 928 rules in a 28 month period and 703 rules are in the proposal review stage. The Dodd Frank Reform Act Law proposed 243 rules administered by 11 agencies. The Patients Protection & Affordable Care Law (Obamacare) Law has a larger number of proposed rules administered by a larger number of agencies with the art of lobbying taken to new heights for favored groups, who are able to get exemptions.

The picture is clear. The certain costs of doing business in the transformed U.S. society have increased. Those most overwhelmed by the new rules of the game are the small business men and women, who generally produce more jobs (net employment) than big corporations and lobbyists. The liquidity of the banking system is not the problem. All banks, not only the big international U.S. commercial and investment banks, are operating under new rules that are increasing the costs of new loans. Under current

conditions, Asness provides a few scenarios to demonstrate why normal economic recovery growth and employment are not occurring and should not be expected to occur.

The certain regulatory costs of doing business in the U.S. have gone up. Normal economic growth is more likely to occur if the added regulatory costs cease and desist. A divided government, including a House of Representatives that appears to have a different philosophy than the Senate and President, can only slow regulators from their tasks. It can not cause the regulators to cease and desist.

Current US economic conditions may hurt 2nd Half employment prospects more than profits

Life includes many paradoxes. A common question is: *Why are big businesses earning relatively very good profits, while employment growth is lagging?* Facts that I analyze show the prior theme answers part of the question. The hurdles for new projects increased during recent years. The required revenues to overcome added regulatory costs have increased. Large corporations can scale up their support departments to comply with or get exemptions from new rules. Small businesses are overwhelmed by the new rules. Monthly polls of small business sentiment by the National Federation of Independent Businesses have consistently documented these facts. They are not happy campers.

Yet the large companies are earnings relatively large profit margins. This is primarily because their cost of financing is lower than the costs of complying with or getting exemptions from new regulations. Large companies are not taking on significant large projects with unpredictable pay offs. They are simply focused on operating productivity with significant capital expenditures for information technology, processing software, and related equipment. They are also using large cash flows to acquire competitors under the radar of anti-trust regulators. Relatively large cash flows and high profit margins can continue as long as financing costs are near zero and regulatory exemptions are granted. The situation is historically unusual and will not last. Near zero financing costs can not continue indefinitely because eventual inflation requires regulated interest rates to approach the real cost of money. Generally speaking with 2% economic growth, the real cost of money at zero inflation is 3% and the cost to prime borrowers is 5%. With current core inflation of 2%, the bank (federal funds) cost of money should be much more than ¼% in

a stable economy currently operating at a steady 76.7% manufacturing capacity utilization. Small companies are experiencing relative much higher regulatory costs than large companies.

The relative number of small to large businesses must increase for the U.S. to maintain its standard of living. Small businesses are more dynamic, take more risks, and create more jobs. Based on the U.S. culture there is reason to hope for a change back to prior U.S. smaller business/smaller government relationships. A friend recently pointed to the seeming miracle of higher German GDP growth, a lower unemployment rate, and a lower ratio of sovereign debt/GDP than the U.S. Note that 78.5% of the German workforce is employed by companies with fewer than 500 employees and they create more than 53% of the German GDP. That is a far different situation than in the U.S. where the federal government currently accounts for 25% of the GDP and large businesses account for more than 55% of the GDP.

Forecasts for U.S. GDP growth in the 2nd Half of 2011 are between 3% and 4%. 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.

Will U.S. political debt agreements affect 2nd Half 2011 or 2012 investment returns more?

That is a question that is not being analyzed thoroughly. During the 4 year U.S. presidential election cycle, certain rules of politics apply. The economy is generally stimulated by monetary and fiscal policy in the 3rd year of the cycle; corporate and investment profits rise. During the 4th year of presidential campaigning employment generally rises, corporate profit growth slows and the incumbent is likely to be reelected. Each cycle has a specific scenario; yet 1996 and 2004 are reasonable examples of how the system works.

In 2011 the massive federal government budget deficit (8.5% of GDP) and required increase in

the statutory debt limit after a weak recovery from a deep credit liquidity type recession create a relatively unique scenario. The debt limit can not simply be increased (clean bill) without addressing the debt/GDP, ongoing forecasted annual federal deficits/GDP, and the primary entitlement programs (Social Security, Medicare, and Medicaid) or negative economic consequences will follow. After the general public recognized the situation shown in polling data, the politicians recognized the need to somehow address the debt and deficits as part of the debt limit increase agreement. *Will the agreement be to raise taxes and to reduce federal spending or will it be to reduce spending equally to the amount of the debt limit increase?* Those are the positions that must be resolved. President Obama, as leader of the Executive Branch of government and effective leader of the Senate, is now involved in the process, which is necessary to make an agreement. His political position for millionaires to pay higher taxes to increase revenues is predictable, as noted in his June 29 press conference. Yet, tax reform negotiations are complex and the legislative process will not result in changes prior to the statutory debt limit (\$14.29T) being reached in early August. More importantly, data that I analyze shows that the federal government is less productive in using added tax revenues than taxpayers, who consume, save, and create enterprises with wealth otherwise paid to a smaller U.S. government.

It is most likely that the President will approve an agreement prior to the statutory debt limit being reached that includes added tax revenues, some near and longer term federal spending cuts, and is large enough to fund deficit spending through the November, 2012 presidential election. Some corporate tax accounting rule adjustments, such as requiring First In First Out Inventory accounting, instead of allowing the choice of First In First Out or Last In First Out accounting have been mentioned. The details are somewhat complex to fully discuss, but the expectation is that higher corporate taxes will be paid. Naturally, reducing the depletion allowance for extracted assets (oil company tax loopholes) and deductions for corporate jet expenses have been discussed. Limits on personal itemized deductions, such as mortgage interest rates, may also be considered.

Since the president agreed to extending current tax rates and deductions in December, 2010 for the years 2011 and 2012, it will be interesting to note how both a currently planned 2013 tax

increase and an added new revenue tax increase will be agreed to. The potential areas of either discretionary or entitlement spending cuts are too numerous to mention. The issue is timing the spending cuts to either reduce the forecasted deficit in 2012 or at some future date.

I expect the best agreement for House Speaker Boehner (in a naturally weaker political position than the President) would be large spending cuts in 2012 and increased tax revenues limited to corporate and individual tax deductions matched by cuts in the President's favored sector (investment) tax credits. That type of agreement would be referred to as austerity.

The initial 2011 equity markets response to an agreement that increases the statutory debt limit is likely to be positive, because nightly news stories of a reduction in aid to government spending beneficiaries would be avoided.

Yet, timing and details of the agreement will impact 2012 government spending, consumption by federal aid recipients, inflation, interest rates, possibly regulatory agency budgets, and potentially job creation rates. Near term government spending limits would be positive in the long run because they would begin the process of deleveraging the massive federal debt and budget deficits. Note a government spending cut will reduce overall economic consumption. In a U.S. economy based 70% on consumption, an unexpected lackluster 2012 GDP growth (2% or less) may follow and related profits would likely be less than the expected. Economic data, including employment reports, in the 4th Qtr. 2011 will indicate if longer term investors should grow cautious and reduce equity markets exposure. Currently I am considering reduced portfolio equity weights, if a statutory debt limit increase includes a real cut (>\$200B) in 2012 federal government spending and equity markets advance 5% to 10% after an agreement. Forecasted 2012 S&P 500 earnings would likely not occur and equity prices would likely adjust as needed in early 2012.

Global Economies

Emerging countries (China (9%), India (8.6%), Brazil (4.0%), and Russia (4.2%)) are growing at high speeds and developed countries (United States (2.6%), European Common Market (ECM 1.9%), Great Britain (1.6%), and Japan (-0.2%)) are growing at slow speeds or stagnant in 2011. Germany (3.2%) falls in between.

Euro currency economies addressed Greek, Portuguese, and Irish sovereign debt insolvency

issues with short term political compromises and bailouts. Strained Spanish and Italian sovereign debt payments also exist. Ultimately, the benefits of a common currency were outweighed by cultural differences that resulted in countries expanding government sectors and welfare entitlements more than their private sectors and citizen taxpayers would pay for. 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 more disciplined German culture and their banks may accept defaults on PIIGS sovereign debts and later end the experiment of a common European currency. There is a lesson for Japan and the United States that large governments with large welfare entitlements eventually leave a lower standard of living for their children in stagnant no growth economies. A second lesson is that a national currency and willingness to accept the austerity of reducing the size and control of the federal government, like the current British scenario, is worth watching. A successful rejection of the ideas of British John Maynard Keynes would be quite an irony.

Economic growth does not directly translate into investment returns. During the 1st Half 2011 USD investors in the mainland China A stock market suffered a 2% loss, in India a 10% loss, and in Brazil an 8% loss. More generally, the Barclay iShares Emerging Market Index EEM Fund declined 1%. Alternatively, the Barclay iShares Developed Europe Asia and Far East Market Index EFA Fund advanced 3%.

The global factors influencing potential returns in the 2nd Half 2011 will change. Higher interest rates in China, India, and Brazil to slow down inflation in the 1st Half 2011 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, deficit, or inflation 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 for USD investors, if the U.S. continues to generally devalue its currency. Sound currency, slow steady growth country stock markets, such as Switzerland, often offer good risk adjusted returns. In summary, 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 and short term ECM stock and bond losses.

Table 1. Economists Forecasts

Economic Market	2011 GDP	2012 GDP	2011 Unemployed
United States	2.6	3.0	9.1
Japan	-0.2	2.6	4.7
China	9.0	8.7	6.1
Great Britain	1.6	2.0	7.7
Euro Common Mkt	1.9	1.7	9.0
Germany	3.2	2.2	7.0
Russia	4.2	4.5	7.2
India	8.6	8.9	10.0
Brazil	4.0	4.3	6.4

The total 2011 global economy is expected to continue to expand at a steady rate (3.6%) with Asia leading the way. In Table 2 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 the 1st Half 2011 as Emerging Market high short term rates to calm down inflation are acceptable to most bond and stock investors.

Table 2. Current Global Yields

Economic Market	3 month	10 Year
United States	0.2	3.0
Japan	0.2	1.1
China	6.1	4.1
Great Britain	0.8	3.1
Euro Common Market	1.5	3.0
Russia	8.3	4.7
India	8.2	8.4
Brazil	12.2	6.2

Personal Goals and Portfolio Management

Investment market commentaries usually focus on asset valuations, risks, and expected returns in the context of rational decision making. Yet at this mid year point let's consider personal goals and uncertainties for normal emotional investors.

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 cash flows. Pension funds refer to the process as asset liability matching. Asset valuations have risen over the past 9 quarters since March 2009 above the long term normal

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annual 10% stock returns and 5% bond returns. About 90% of the losses for most balanced and stock weighted portfolios have been recovered since the 4th Qtr. 2007 peak.

Now consider your risk taking view and personal goals. If goals can be met, while reducing longer term risks, a recently earned wealth spending surplus buffer can be made more stable by selecting more low risk assets. I believe we are in the speculative phase or late innings of this stock and bond market recovery game. At minimum, that is a scenario for more volatile markets. Another 3 to 12 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. This stock market advance has stretches past the normal (26 month) period. Note recovery corporate profit growth usually lasts for 13 quarters. 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 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 very excited. In wealth management for most people, focusing on values and personal long term spending goals is suggested, especially now.

Markets and Economic Sectors

Asset prices except housing generally increased since March, 2009. Higher risk U.S. securities, such as small capitalization stocks appreciated more than large cap stocks. Growth company stocks appreciated more than value type stocks. Commodity prices were volatile in the 1st Half 2011 with the total CRB Index advancing marginally (2%) and key components gold (7%) and oil (4%) advancing about the same as stocks and bonds. The environment is speculative but tricky with short term momentum changes. Hedge funds on average were unable to make gains in 2011 above just holding most assets.

It is unclear whether the IPO speculators will get their chance in the next 12 months to walk away with 1999 type returns. They may be cut short by possible limited fiscal government spending or monetary policy related financing constraints.

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 near average with the S&P 500 and NASDAQ Indices currently trading above their 200 day (40 week) moving average. The trend is less important in the short term to technicians than if the moving average acts as a floor or support level for the broader stock market. If prices fall below the moving average, then more selling in July is probable. External negative events like a euro related unexpected default or positive events like a quicker than expected U.S. debt ceiling agreement are likely to be the consensus reason for equity market movements. Yet, there is now no clear trend in my view.

U.S. Economic Sectors

Materials Sector 2nd Qtr. market price changes were about the same as the S&P 500 Index (-1%) after lagging behind (negative Relative Strength (RS)) in the 1st Qtr. No suggestion. Energy Sector earnings likely grew slower than the S&P 500 index as oil prices pulled back during the 2nd Qtr. The 2nd Qtr. RS was -6% after a +9% RS in the 1st Qtr. For the year to date (YTD) Energy stocks earned a 10% return relative to an S&P 500 Index 6% return. Oil price changes (+/-15%) would impact future Energy Sector earnings. Consider dividend paying assets. Financial Sector earnings and price RS lagged the S&P 500 in both the 1st and 2nd Qtrs. Avoid. Industrial Sector earnings and RS slightly beat the S&P 500 Index during the YTD. Suggestion: Hold. Technology Sector earnings and earnings surprises slightly beat the S&P 500 Index, but price RS slightly lagged during the YTD. Suggestion: Hold. The Consumer Staples earnings growth lagged, but RS led the S&P 500 during the YTD. Suggestion: Hold dividend paying stocks. Utility Sector Stocks earnings lagged, but price RS led the S&P 500 Index during the YTD. No suggestion. Healthcare stock price RS significantly led the S&P 500 Index. Suggestion: Hold. Consumer Staples, Utility, and Healthcare stocks are normally defensive, stable earnings stocks, which lag other equity assets during speculative periods, such as the current condition. However, all 3 sectors led the S&P 500 Index during the 2nd Qtr. *Cross currents!* Consumer Discretionary stock earnings varied with overall positive RS vs. the S&P 500. Hold selectively. Treasury Bonds (2%) lagged behind the S&P 500 during the YTD. They are influenced by FRB manipulation and appear overpriced; shorter maturities suggested. Gold's price rose (7%) YTD. Suggestion: Hold.

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Portfolio Suggestion: Hold normal portfolio asset weights. Shorten bond durations (maturities). Stock market psychology is speculative. Reduce risky assets if stock prices rise. 2nd Half 2011 volatility is likely to increase. Liquidity is cheap. Markets appear fairly and fully valued. **Think about your risk tolerance.**

Alternative Investments – Diversification

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

References

¹ Asness, Clifford, *Uncertainty Is Not the Problem*, Wall Street Journal, June 14, 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

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