

BWM

Investment
Guidance

February 2009 Markets Review
Economic & Market Uncertainties Continue

Key Points

• Year to date Total Returns :	
S&P 500 (735)	-18% ;
US 10Yr Bond (3.04%)	-13% ;
NASDAQ (1378)	-12% ;
Foreign (EAFE) Stocks	-23%
• U.S. GDP expected contraction =	-1.2%
• 2009 earnings expected decline =	-12%
• Large year to date losses; 1 st Half 2009	partial recovery uncertain

Executive Overview

Year to date 2009 markets continued 2008 downtrends. S&P 500 index and foreign EAFE large February losses (11%) reflected uncertainty and very weak economic conditions. Nearly all asset classes suffered big losses. Investor fears and market volatility remain high. The CDS market handled a record number of Feb. defaults. Commodity and U.S. asset class relationships are unusual. The 10 yr. Treasury bond fell further, while gold gained a bit to indicate lower demand (higher supply) for quality bonds and decreased fear of deflation. The USD remained steady with an 8% year to date gain versus the Euro. Reduced oil price volatility may indicate future stable commodities demand. The economic indicators remain very weak across employment, revised 2008 Q4 GNP, and home sales reports. Q4 2008 S&P 500 (85% reported) earnings are dreadful and headed to 25% below Q4 2007 earnings. The corporate Q1 and full 2009 year guidance are highly uncertainty. In the midst of a deep recession, government policy decisions may be adding to market uncertainty and selling. Enacted laws, policy, and budget submittals matter and they are key themes. Domestic and international economy, earnings, and investment portfolio suggestions will be discussed in the midst of continued highly uncertain times.

Themes

Investment markets themes are: Obama administration policy initial analysis and general expectations, short term & intermediate term investment return impacts.

One party rule historically overreaches goals

President Obama was elected with a 53% popular vote and enjoys a large (258D/177R) majority in the House of Representatives. Pending the Minnesota election results, a near filibuster proof Senate (59 D/I 41R) majority is expected. As demonstrated with passage of American Recovery and Recovery (Stimulus) Act (\$787B + interest on debt), there is no need or true desire to enact bipartisan legislation. The President intends to dramatically increase government control to advance his goals as shown in his February 24 speech to Congress and Feb. 26 future budgets submittal. Top goals include a clean environment through carbon credit sales, universal health care, and economic wealth fairness through increased income and capital gains taxes on joint taxpayers earning more than \$250,000 (singles earning \$200,000+). That is an extraordinary set of multiple goals. Let's look at periods of one party rule over the past 40 years to form an objective view of expectations. Are the goals achievable? Will the majority of the American citizens vote for the other party during the next 3 biannual elections? Then a more specific view can be provided on this administration and its impact on short term and longer term investment impacts.

Three other periods of one party rule (President and both Houses of Congress) have occurred in the past 40 years. After the resignation of President Nixon and weak performance of President Ford, the Democratic Party swept to one party rule led by President Carter in both the 1977 and 1979 legislative sessions of Congress. Carter enjoyed a filibuster proof Senate (61D) and large House (291D/144R) majority. He enacted his big spending, tax, and ideological regulatory agenda (energy control) without opposition. Yet, high fiscal deficit spending and low interest rates (weak monetary policy) through Aug. 1979 resulted in a 30% fall (in 12 months) of the USD value. The terms stagflation (high inflation, weak economic growth) and the misery index were coined to note poor domestic policy. That and perceived foreign policy weakness in dealing with the Iran hostage situation provided Ronald Reagan the opportunity to be elected President for 8 years, although he never enjoyed a Republican majority in the House of Representatives.

President Clinton enjoyed one party rule upon election in 1992 with a large but not filibuster proof Senate (57D votes) and large House

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(271D/164R) majority. With the majority, his big tax increase passed by one vote in the Senate. His ideological complex public/private universal health care plan overreached and was not enacted. The Republicans focused a response and 2 years later gained Senate (54R) and House (230R/204D) majorities. President Clinton adjusted to reduced spending increases (“the age of big government is over”) and a capital gains (20%) tax cut during his next 6 years in office.

President Bush enjoyed one party rule barely in the 2nd session of his 1st term with Senate (51R) and House (229R/206D) majorities and in the 1st session of his 2nd term with Senate (55R) and House (231R/204D) majorities. After the September 11, 2001 terrorist attacks on NYC and Washington D.C., he became a war time president. His goal was to prevent another attack on American soil. Other than defense spending, government grew under his leadership. A half hearted attempt to reform the Social Security “pay as you go” system was ineffective. No clear ideology was shown. Due to poor execution of the Iraq War prior to General Petraeus’ strategy change and low Bush popularity, Democrats swept to power in the Senate (51D&I) and House (236D/199R) in 2007.

Are President Obama’s goals achievable?

Literally, the answer is no. The incentives and numbers don’t add up. Symbolically, anything is possible if the American people accept control of their society and lower living standards similar to European countries such as France and Italy.

As stated in President Obama’s enacted law or executive orders, and proposed budgets, the approach to a goal of a clean environment and an inferred conscientious energy policy is complex and unworkable. The proposed sale of carbon emission credits applies to all carbon emitters including utilities, farmers, and ranchers. All energy users will pay usage taxes through higher utility charges. In a dynamic society, no incentives to produce due to reduced potential profits will result in fewer goods and services sold. The disincentives to use oil and coal energy sources, the lack of interest in natural gas and nuclear energy, and the focus on alternative energy sources such as wind and solar is unworkable. Oil, oil shale, and coal are the most abundant, available energy resources. Increasing regulation to limit their use will force citizens to use higher priced, less effective resources. Note that after spending \$9B over 25 years for the

nuclear waste disposal site at Yucca Mountain, NV, the administration recently decided to discontinue it prior to completion. This is an indirect approach to limit a proven clean energy technology – nuclear power. Natural gas, with a few development issues and far fewer subsidies than wind and solar, is not being promoted. The carbon emissions and energy policy results in a relative tax on lower and middle income energy users and will not achieve its advertised goal.

The approach to universal health care is equally complex and unworkable. Health care providers appear to be forced to take lower medicare fees to control costs. Yet, they may receive partial reimbursement for electronic record keeping. Biotech patent law period reductions are being encouraged, while supplemental payments for middle class child health care are increased. With many conflicting initiatives there are numerous scenarios of unintended consequences. Hopefully, health care providers can keep up with all the controls. The net inefficiencies and societal costs can not be clearly calculated.

Will increased individual income tax rates on the highest wage earners result in more revenue for society (higher GDP) and the U.S. government? President Obama in his infamous 2008 Charles Gibson (ABC) interview stated reduced government revenues due to higher income and capital gains rates do not matter, because the ideological issue is fairness. If his argument is accepted, there is non sequitur logic. His new budget assumes that there will be higher revenues from higher tax rates. Historical data shows lower tax revenues are likely. Higher tax rates and increased controls will drag the U.S. economy down and President Obama’s tax revenue goals will not be achieved.

Americans and foreign people are uncertain due to a major global recession. Deleveraging or living with lower credit velocity reduces all standards of living. We live in an ironic time. President Obama enjoys overall high approval ratings (60+%), while a similar number feel the policies being enacted are taking the country in the wrong direction. The disconnected feelings may be emotionally due to his likeability, even though the probable impacts of following his policies are not understood. I expect that President Obama’s budget projects of real GDP growth in 2010 (3.2%), 2011 (4.0%), and 2012 (4.6%) will not occur. I further expect that the projected net government budget deficit in

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FY2012 (-\$582B), which exceeds the record FY2008 (-\$455B), will be larger. The multiple goals through government control of society and the budget numbers do not make sense.

An indicator of prosperity is productivity. According to the Bureau of Labor Statistics the 1973 to 1979 stagflation period productivity rose at a low 1.2% rate and the growth and trade expansion 1995 to 2008 period productivity rose at a high 2.5% rate. Standards of living relate directly to productivity and the 2009 to 2015 appears poised for lower productivity growth.

Investment returns and productivity happen together. Government policy decisions matter. Periodic positive investment returns are expected to occur from oversold market conditions, such as now. However, net long term periods of real equity (and home) appreciation are not expected if current and proposed policies are enacted.

What about housing?

The housing devaluation process to sustainable lower prices is painful, but continues. The Case/Shiller 20 city housing survey shows home prices declined 27% from the historical blow off peak in the 2nd Qtr. 2006. Nationwide home prices are back to 2003 levels. The consensus is that they may bottom 10% lower at 2002 levels later this year (35% below the peak). The new home inventory is at a 5½ yr low and the new home construction rate (309K) is very low. The market is adjusting. Government plans to bailout homeowners, whose home values are below mortgage levels through judicial cram downs of mortgage amounts or interest rates will be too late to impact the process. The ire of Americans (90% who are not treated fairly by mortgage bailouts) appears to be indicated by the record number of "you tube" hits on reporter Rick Santelli's passionate rant that enough is enough. The process continues to impact derivative residential mortgage backed securities, as well as other asset backed security write downs.

A better approach than the government use of uncompensated taxpayer money is articulated by John Hussman as a govt. coordination effort to restructure mortgage payments without giving away something for nothing. His idea to preclude mortgage foreclosures is to administer property appreciation rights (PARs) to a mortgagee in foreclosure that cuts the mortgage principal and creates a PAR equal to the cut amount. The mortgagee agrees to pay back the PAR based on

the property or a subsequent property sale price appreciation. The IRS may be the conduit and proportionately direct PAR pay backs to lenders.

The \$787B (+ interest) Stimuli Act will provide little stimulation

President Obama's National Economic Council Head (Larry Summers') criteria for the Stimulus Act were that it be "timely, temporary, and targeted". Timeliness should be the only goal. A temporary stimulus to avoid job losses primarily through government and pseudo govt. jobs is a hoax. Political pressures make low productivity govt. jobs permanent. A temporary stimulus through \$8 to \$12 weekly tax credits for unemployed, low income, and middle income earners will be less effective than the 2008 \$600 tax rebates. If the tax credits only exist for the enacted 2 years, then there will be a relative tax increase drag on the economy in Apr. 2011. A permanent across the board tax reduction, such as the timely post 9/11 tax cuts, is a better politically incorrect stimulus. Targeted stimulus is a word for social engineering. The recently enacted law adds much money to all government departments with much spending flexibility. Corrupt government naturally follows the power of money. As 19th century historian, John Acton, educated "Power tends to corrupt, and absolute power corrupts absolutely." A target, the \$8B high speed transportation down payment from fun city (Disneyland Anaheim, CA) to sin city (Las Vegas, NV) in deference to Senate majority leader Reid (NV), looks like history's largest earmark to high population area commuters along the East or West coast corridors. The deep recession will end, in spite of the government explosive expansion stimulus instead of due to it.

Banking and Auto Bailouts

Banking industry stability is the key to economic recovery. Conventional wisdom, that banks are not lending, is wrong. In Jan. 2009 commercial bank total loans exceeded Jan. 2008 total loans by 5.7%. Banks are lending with higher loan standards in the midst of a deep recession. The indirect banking conduits of hedge funds, private equity, and related sources are not lending. They are the risk takers that the Treasury Dept. and FRB are in regular communication with. As a group, they are uncertain about when toxic mortgage and other asset backed security derivatives will reach bottom levels. After the housing price decline rates slow down in about the 2nd Qtr., I expect the government money men will make the deals with the indirect bankers.

This is the same problem that previous Treasury Dept. leaders had in the 4th Qtr. last year. The indirect banking system is the catalyst for increased credit flow.

Breaking up the “too big to fail” banks and insurers, such as Citigroup and AIG will also help to quarantine the most complex toxic derivatives. Contrary to public statements, they are nationalized and a few other giant banks may be added to the group. That process is ongoing.

The auto bailout hopefully will be defined in the next 2 months. President Obama made a politically correct mistake by naming a committee to oversee the bailout. Committee head Geithner is touted as a consensus builder. In a crisis, leadership and prompt action should be valued over consensus building. After a tortured process, I expect more bailout money to be thrown at General Motors and a few Chrysler products to be merged into GM. The issue is global auto production overcapacity. A merger will address the issue. Ford and foreign U.S. manufacturers will be at a disadvantage. That is what happens, when governments satisfy political constituencies and subsidize losers.

The Economy – Deep Recession Continues

All economic indicators – employment, capital goods orders, factory utilization, manufacturing activity, and new home sales – continue to show a deep recession similar to 1973/74 and 1980/82 with no indication of recovery, yet. The heavily money supply and yield curve weighted February Leading Economics Indicator was positive for a 2nd month and the inventory of unsold new homes fell again. Yet the 4th Qtr. 2008 GDP contracted at a steep 6.2% rate. The consumer is saving and improving household balance sheets. The likely scenario is that the unemployment rate will be between 8.5% and 9% in 12 months as government jobs grow. That is about the level at the end of 1973/74 recession and less than the 10% level at the end of the 1980/82 recession. Unexpected foreign affairs or trade shocks could make a deep recession worse.

Profits and Expectations continue to fall

Based on 85% of the S&P 500 4th Qtr. 2008 financial reports, total S&P 500 companies earnings fell about 25% below the 4th Qtr. 2007 level. The S&P 500 companies decreased book values a startling 37% in 2008. In addition to the financial sector, others also wrote down asset values. Analysts cut 2009 forecasts for 1/3 of

companies more than 10% in the past month. Healthcare sector and aerospace industry forecasts were cut in the past week in response to Obama budget releases. Corporate 2009 guidance is uncertain and sober. Dividend cuts are increasing as banks and others conserve cash.

Financial Analyst forecasts are also falling.

The current analysts’ forecast revision ratio is about 5:1 downgrades/upgrades in 2009, which is a slight improvement. Analysts have reduced forecast earnings declines (-12%) in 2009 to \$55 for the weighted S&P 500 shares in the Zacks methodology and to \$35 in the strict Standard & Poors methodology. At this time, the S&P 500 trades at 13 to 21 times 2009 forecasted earnings based on your choice of forecasts. It is also useful to note that blue chip stocks are trading at about book value, in contrast to a normal 1.4 X book value. Investors are forward looking. However, they don’t see earnings stability yet.

Foreign Economies

Developed economy GDP declines are expected in 2009 after major 2008 4th Qtr. declines. Major exporters Japan and Germany are hard hit and uncertain about even 2010 GDP growth. The emerging markets 2009 economic forecasts have been reduced significantly again last month. Russia, a commodity economy, is impacted by the fall in oil prices. U.S., China, Britain, the European Union and various other countries have announced Keynesian demand stimulus plans to push their economies out of recession. Key forecasts according to the *Economist* follow.

Table 1. Economic Forecasts

Economic Market	2008 GDP	2009 GDP	2009 CPI
United States	0.0	-1.2	1.0
Japan	0.0	-1.4	0.5
China	9.0	6.0	5.0
Great Britain	-0.4	-1.7	1.5
Euro Common Mkt ECM	0.4	-1.7	2.0
Russia	7.0	1.0	12.0
India	6.0	5.2	5.0
Brazil	5.2	2.4	5.5

Developed economies continued 4th Qtr. deep recessions. Notice the decline in emerging market growth. The global economy may not show positive 2009 growth. In Table 2 the U.S. positively sloped yield curve continues to show stimulative monetary policy. Short term interest rates are being cut as economies slow.

Table 2. Current Global Yields

Economic Market	3 month	10 Year
United States	0.3	3.0
Japan	0.6	1.2
China	1.4	2.9
Great Britain	2.1	3.9
Euro Common Mkt ECM	2.1	3.2
Russia	13.0	10.9
India	4.6	6.7
Brazil	12.0	6.2



Investors are hurting as the July 2002 *US Today* cartoon noted the value of a 401K account was cut to \$201K. Stock markets generally first hit bottom in July 2002 and touched bottom again in October 2002 and March 2003. The same bottoming process may be occurring now as stock markets hit low points in October and November 2008 and currently at the end of February 2009. If uncertainty prevails, then the bottoming process will continue.

My cautious hold suggestion over the past 2 months was too optimistic and wrong. I failed to see that the FRB and Treasury would delay starting up the Troubled Asset Backed Securities Loan Facility (TAFL) for dealing with devalued derivative securities. Secondly, the underlying economy has not responded to the growth in money supply. The TALF and economy will in time respond assuming no added hurdles such as protectionist policies. After much terrible news, I am sticking with my near term suggestion.

Economic Sectors and Investment Outlooks

A Technical Overview (BPNYSE, etc) indicates low demand for U.S. and foreign stocks. The volatility fear factor rose in Feb. vs. Jan. All time high cash levels exist in brokerage accounts. Money supply growth is a potential demand indicator. **Suggestion: Hold current positions. Do not add to portfolio equity levels, until the economy slows its rate of decline.** A recovery

rally seems likely as volatility declines. Gold is stable, but all sectors are weak. Foreign developed markets also declined sharply in Feb.

Economic Sector Analysis and Outlook

Telecom sector stock demand is normal. Hold current positions. **Utility** Sector forecasted 2009 earnings are stable. Dividends are around 4%. Hold current positions is suggested. **Consumer Staples** sector 4th Qtr. earnings fell and the 2009 earnings growth outlook is cautious. Demand is weak, in spite of continued price increases. Hold current positions. The **Energy** sector faced extreme volatile price swings in 2008. Earnings declines are forecast in 2009. Fundamentals at oil replacement cost estimates are desirable. Hold current positions. The above sectors have dividend growth candidates for value investors. **Healthcare** sector 2009 growth looked stable until the Obama budget requests announced added controls. Sell some positions. **Technology** Sector opportunities are mixed. Apple, IBM, Oracle, and Google have large cash flows and beat expectations. A good argument can be made for selective buying. The cyclical **Materials** sector is performing with negative Relative Strength, while earnings are weak. A below normal portfolio weight is suggested. **Industrial** sector exports (and earnings) to developing countries are slowing and aerospace industry stocks dropped hard after the Obama budget requests were announced. Below normal portfolio weights are suggested in this sector. The **Consumer Discretionary** sector remains a cyclical area. The RS is neutral but there is much dispersion between companies. Selective buying of steady earnings companies is suggested. The **Financial Services** sector remains uncertain and very weak. Stay away. Dividend cuts remain negative. **Economic sector earnings are weak in total.** Stocks are priced at book value. There is liquidity to demand stock prices higher. **Summary:** hold most current positions; but wait prior to adding to equity positions.

International Markets Are Stable

Foreign stock markets fell again in February, while the USD (1.28 Euro) held steady. Hold fewer developed economy stocks is suggested. Emerging market stocks are volatile. Normal weights may be considered if you can withstand large declines (-50% in 2008.)

Fixed Income - Less Volatile

U.S. Treasury bond (overvalued) year to date returns (-13%) are hurt by increased supply to

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finance huge deficits. Investment grade corporate bonds are unchanged. Money is moving from stock to money market funds. A small portfolio weight in a TIPS fund is suggested. Muni bonds are also suggested for taxpayers in high tax states, who research good general obligations bonds. High single digit after-tax returns at modest risk are possible.

Alternative Investments – Diversification

The Real Estate Investment Trusts (REITs) index continues to fall due to financing concerns and anticipated retail vacancies during the recession. Wait for more information prior to buying REITs. Gold funds are diversifiers. Normal alternative asset 5% gold fund weights appear reasonable.

Portfolio Management

Funds have cash (5.5%) to boost stock or bond prices higher. The S&P 500 index is trading at or above normal P/E based on uncertain earnings forecasts. The question remains: Will the forecasted earnings occur? Holding a diversified assets portfolio is suggested.

Current portfolio themes are:

Normal Investment Weights

- All U.S. stock caps funds normal weight
- Foreign EAFE funds below normal weights; Emerging stock funds normal wts.
- Fixed income – TIPS and possibly Muni
- Gold
- Only hold stocks in suggested sectors

Disclosure: Personal holdings: 53% Domestic & International Large Cap stock funds, 41% Small/ Mid Cap funds, 6% cash (19% Total International funds)

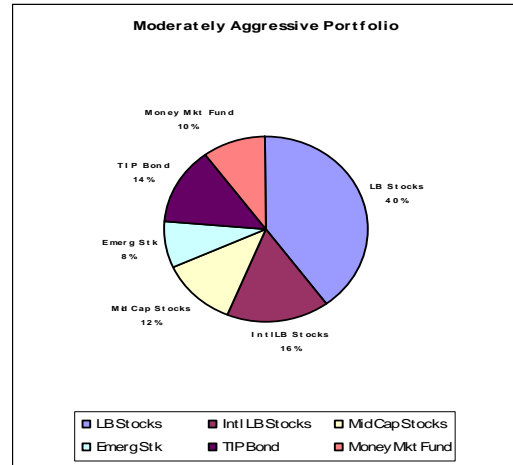
Sample Portfolios are models Not Client Recommendations

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

Normal Capital Accumulation –

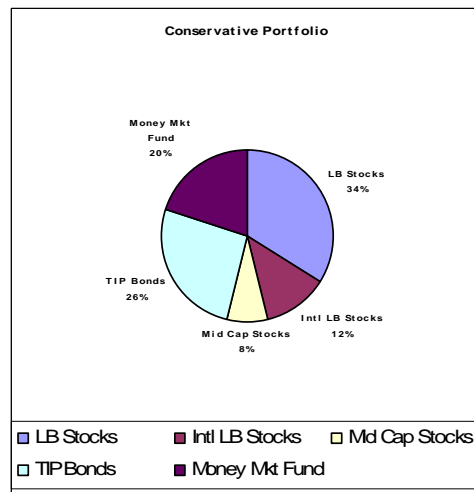


Sample Portfolio B - Conservative

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 –



Note client portfolios use available 401K plan funds and multiple funds in each category to reduce risk.

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