

BWM

Investment
Guidance

April Markets Review

*Is the market's upturn real?**Will positive surprises continue?*

Key Points

- | | | |
|---|------|---|
| • 2009 year to date Total Returns | | |
| S&P 500 (872) | -2% | ; |
| US 10Yr Bond (3.12%) | -18% | ; |
| NASDAQ (1717) | +9% | ; |
| Foreign (EAFE) Stocks | -8% | |
| • U.S. GDP expected contraction = -2.6% | | |
| • 2009 earnings expected decline = -14% | | |
| • Markets may have hit bottom, but economy has not reached its low point | | |

Executive Overview

Equity markets may have hit bottom on March 9. Since that date, the S&P 500 index rose 30% through month end. It remained 44% below the Oct. 2007 stock market peak. During April the S&P 500 (9.4%), NASDAQ (12%), and EAFE (12%) advanced significantly. Investors rejoiced due to a number of positive surprises (less bad news than expected) from both the macro-economic and corporate earnings perspectives. The initial 1st Qtr GDP (-6.1%) report verified a deep recession, although seeds of a recovery were found. The price of gold was nearly unchanged, while the price of crude oil rose about 9% year to date (YTD). The U.S. dollar remained (5%) above the Euro YTD. Other asset classes, including homes, have not bottomed out in price yet. The 10 yr. Treasury bond (-18%) fell, as the yield rose above the 3.0% threshold. Leading Economic Indicators are falling less quickly, which lead some to see a recovery. Bank 1st Qtr. financial statements benefited from favorable non mark-to-market accounting judgment leniency. In the midst of a deep recession, numerous government controls continue to be directed. Domestic and international economy, earnings, and investment portfolio suggestions will be discussed.

Themes

Investment markets themes are:

- **Analyzing if the economic and corporate positive surprises can continue to support higher stock prices**
- **Pondering where the U.S. auto industry is going.**

Is the stock market upturn a bear market rally or the start of a bull market or what?

The 30% rise in the S&P 500 stock index since Mar. 9 through month end after a 57% fall from its Oct. 2007 peak, resulted in a net 44% decline.

What does that mean? It means that investors and speculators are betting that things are less bad than they appeared about 8 weeks ago. Markets are influenced by positive surprises, which have been more abundant and somewhat confirmed recently. The following analysis will make the case that the market advance is likely more than a Bear Market rally (implying that the S&P 500 will not fall below its 666 low point on Mar. 9), but less than a Bull Market confirmation (implying that the S&P 500 will not reach a new high above the 1550 Oct. 2007 high within 12 months.) A sideways moving market based with a slow 2010 economic recovery and less than 2007 total earnings appears the likely scenario.

Macro-economics – the top down view

The primary statistics that impact econometric forecast models are money growth and the interest rate yield curve (term structure of interest rates), which finance the economy and two high impacted factors, consumption and employment. The outlook for these items has guardedly improved in the eyes of market participants recently. The steep 6 month (4th and 1st Qtr. period) U.S. GDP decline that matched the 1958 recession period may be easing.

The **Federal Reserve Board** (FRB) has expanded its reach directly into numerous aspects of troubled financial securities as well as the traditional banking system. An extraordinary increase in the monetary base and money supply has attempted to compensate for the reduced velocity of financing ($GDP = M \times V$) as businesses and households try to stabilize (cut debt) their economic balance sheets. Velocity is measured indirectly. Only with time will it be clear, if the FRB has treaded the very precariously balanced needle between inflation and deflation. At this time the best case scenario of disinflation is occurring. Yet, the $M \times V$ equation is so delicately balanced and Chairman Bernanke fears both the bad deflation of the early 1930s and the acceptable deflation of the 1880s. Even his supporters are aware that 1970s style inflation is an intermediate term concern. The markets are aware that the flight to (demand for) the safety of Treasury bonds is slowing,

5/3/2009

while the supply of bonds is increasing. The 10 yr. Treasury bond has fallen 18% in 2009 while its interest rate has exceeded 3.0% during the past week. The FRB manipulated the interest rate lower through quantitative easing (printing money and buying T bonds) in Mar. Rising long term rates, which impact mortgage rates, may eventually be a negative issue. Yet, at this time the spread of over 200 basis points (2.00%) between 2 yr. notes and 10 yr. bonds indicates an extremely stimulative monetary policy, where banks are lending with large profit margins. With larger companies getting their financial balance sheets in order, the Hi Yield (junk) bond market has risen over 13% YTD. Markets are receiving net positive surprises from FRB related factors. A large negative issue relating the FRB, Treasury Dept. and Federal Deposit Insurance Corp. (FDIC) to banks and others remains. Those who have taken money from the Troubled Asset Relief Program (TARP) must do exactly as directed. Those large institutions, which have taken money and expressed desires to give it back, have not been allowed to get back their pre TARP status. It is interesting to watch the strong supporters (J.P. Morgan, Goldman Sachs, and Morgan Stanley CEOs) of the Obama Administration denied their requested freedom. Yet, the markets feel the FRB is engineering positive surprises with the economy.

Consumer spending rose 2.2% in the preliminary 1st Qtr. 2009 GDP report. Since consumer spending accounts for greater than 70% of the total GDP, markets considered the statistic as a positive surprise. The question is will this spending rate continue. The supporting data is that stimulus tax credit money of approximately \$8 to \$13 weekly through 2010 to non wage earners and wage earners below an income threshold increases consumption. The skeptic's data is that households are beginning to get their finances in order and the savings rate has exceeded 4% for 3 consecutive months. That has not occurred since 1999. More importantly, many households will find that they need to save at the closer to traditional 6% to 9% rates. Since households often make savings decisions as a capitulation to reality after initial resistance, it is reasonable to expect the savings rate will increase. High end discretionary spending would be susceptible to a generally value oriented consumer in 2010 and later. My vote is with the skeptics.

New Unemployment claims may be decreasing. Some economists look at the 4 week average of recent new weekly unemployment claims and try to call the high point prior to a fall back. They anticipate that if the current average of 637K continues to fall below 625K in the next few months that better times lie ahead. The St. Louis Federal Bank CEO Bullard recently forecasted that unemployment will peak at less than the 1982 10.8% rate in 2010. He may be correct. Growing economies require people to be working and spending to be stable. I consider the number of continuing unemployment claims, which recently rose for the 13th consecutive week and reached 6.27M to be more important. There is an unintended disincentive of recent federally enacted laws to increase unemployment compensation payments from 26 weeks to 46 weeks for those in some states and 59 weeks for those in high unemployment states. The similar 1974 recession laws gave the unemployed more resources to be selective in finding employment. It took longer for people to find work in 1975. Small business employers had a harder time finding workers as they wanted to expand at that time. Compassion for the unemployed must be balanced with incentives to selectively remain unemployed. The total number of unemployed will most likely gradually decline, beginning in 2010. Yet, all things considered, I am skeptical that the positive new unemployment expectations will help the overall economy significantly in the next 1½ years.

Specific macro economic surprises included regional purchasing agents' surveys, components of the preliminary 1st Qtr. GDP estimate, and Leading Economic Indicator (LEI) surveys. The Philadelphia, Empire (New York), and Chicago surveys were negative, but not as bad as forecast. The ISM manufacturing survey also indicated a less severe recession level. A large drawdown in inventories occurred during the 1st Qtr. and the consensus reasoning is that inventories must be restocked in the 2nd Qtr. All of these indicators are positive surprises. Yet, some of the inventory drawdown was at the retail discretionary consumption level in response to close out deep discount sales. Restocking may be modest at the surviving retailers. Commercial inventory drawdowns may simply reflect project completions in the midst of resource utilization levels less than 70% of capacity. The surprises and optimistic outlook must prove themselves. The LEI surveys have improved since Nov. Yet, the recession is easing due to excess money.

Corporate Earnings – the bottom up views

Thompson Reuters reported after 65% of S&P 500 companies submitted 1st Qtr. financial reports that the earnings crash has stabilized, although corporate earnings guidance remains cautious. In Jan. analysts forecasted a 12.5% earnings decline. Based on the submitted reports the earnings declined 35%. Yet the 1st Qtr. decline is considered a net positive 10% surprise over the recent analysts' forecasts, which have bounced around. It is little wonder that the S&P 500 stock index was in a continued fall for the first 10 weeks of 2009. Recently, volatility and forecasts have stabilized. Two thirds of reports exceeded analysts' forecasts and ¼ have failed to meet forecasts. The defensive sectors of health care, consumer staples, telecom, and utilities showed between +2% and -9% year over year earnings changes. The finance sector cut losses to about -47% after relaxed asset market accounting judgment rules allowed loan assets to be judged at expected operating cash flow levels, while debt liabilities are recorded at lower market values. The questionable standard was literally forced on the Financial Standards Board by the House Financial Services Committee led by Chairman Franks. A number of banks still hold very uncertain derivative assets and their earnings are not as good as reported. Standard & Poors expects S&P 500 2nd Qtr. earnings to fall 20% and 3rd Qtr. earnings to fall 4% on a year over year basis. Investors liked the fact that 1st Qtr. earnings surprises were positive and bought the stocks in Mar. and Apr. that were sold in Jan. and Feb.

Pondering where the auto industry is going.

The Obama Administration has taken unprecedented control of the automobile industry in quest of salvaging Chrysler and General Motors. The bankruptcy of Chrysler LLC after a 20 member non-TARP group, that holds \$1.0B in secured debt failed to agree to acceptable losses, is worth review. J. P. Morgan, Citigroup, Goldman Sachs, and Morgan Stanley, who are TARP recipients holding \$4.8B of secured debt, had already agreed with the government to take \$0.29 per \$1.00 for their holdings. The group of 20 includes pension funds and investment companies, as well as demonized hedge funds. They offered to take \$0.362 per \$1.00. The government directed J. P. Morgan to force the group to take \$0.326 per \$1.00 within 4 hours or bankruptcy would be initiated. The group of 20 said no. Their characterization by the president was misleading and dangerous in a free society.

I expect further investigation to show that some of the non-TARP pension funds had issues that could not be easily written off. The Justice Dept. assigned Bankruptcy Court Judge Gonzalez to administer a so called quick and surgical process of asset and liability resolutions.

The expected Fiat Chrysler merger, after the U.S. government adds \$8.0B more bailout funds, will be a case study in conflicts of interest. In total \$12.0B of taxpayers' money is being spent to save 54,000 jobs (i.e. \$22,000 per job). Fiat, a weaker company than former Chrysler owner, Daimler-Benz, will receive 20% of the Chrysler for no cash. The UAW union will have part of their stakes converted to equity and have seats on the Board of Directors. Protecting jobs in a competitive car market is not a good scenario for a future profitable company. In fact, the UAW union should consider if it is a good idea to own controlling equity interests that it does not know how to profitably manage.

The General Motors outlook is equally troubling. The government has taken over their new car warranties and defined a new merged Chrysler GMAC finance company. The recent GM proposal by the government appointed CEO offers the U.S. government to be majority (50%) owner of the company valued at \$15.4B, the UAW union to convert \$20B of claims to \$10B (39%) equity and \$10B, and the secured debt holders to convert \$27B of debt to (10%) equity and \$3B debt. The current 100% outstanding GM shares would be diluted to a 1% equity position. Again the debt holders may lose far more the UAW union. The debt holders made a counter proposal without government ownership. Time will tell what the controlling government accepts in the GM drama.

The U.S. is moving forward European style economic control, so it is useful to review the British government aiding the merger of weaker British Motor Holdings with stronger Leyland Motors Corp. in 1968. The BL Group became an effectively nationalized company with 40% of British auto sales. More than 1B GBP of taxpayers' money was poured into BL Group during the 1970s and its share of British auto sales fell to 16%. Another 1B GBP was given to the company in the 1980s prior to it being renamed MG Rover. In 2005 MG Rover went bankrupt. A Chinese group purchased MG and Indian TATA Motors purchased Jaguar and Land

Rover from British Ford. No production British car manufacturers currently in business.

In the next two quarters without bailout funds, Ford will likely sell more U.S. cars than GM and possibly more than Toyota. However, overcoming the unfair advantage of GM government resources may be difficult in 2010.

Profits and Expectations continue to fall

As previously discussed, currently reported S&P 500 company 1st Qtr. profits were 35% lower than in the 2008 1st Qtr. and surprisingly 10% better than the most recent analyst reports. In the 2nd Qtr. only the defensive Consumer Staples and Utilities are expected to show better profits than the comparable 2008 Qtr. The Technology and Consumer Discretionary Sectors had the best earnings surprises and they are the only sectors with positive 2009 forecasted earnings revisions.

Financial Analyst forecasts are still falling.

The current analysts' forecast revision ratio is less negative 2:1 downgrades/upgrades for 2009 than anytime in the past 6 months. Analysts have reduced forecast earnings declines 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 16 to 25 times 2009 earnings based on your choice of forecasts.

Foreign Economies

Developed economy GDP declines are expected in 2009 after extreme 2008 4th Qtr. and 2009 1st Qtr. declines. Major exporters Japan and Germany are hard hit and 2010 GDP growth is uncertain. Emerging countries China and India have the only 2009 forecasted positive growth. Inflation is still an issue in Russia. Key forecasts according to the *Economist* follow.

Table 1. Economic Forecasts

Economic Market	2009 GDP	2010 GDP	2009 CPI
United States	-2.7	1.4	0
Japan	-6.5	0.4	0
China	6.0	7.0	0
Great Britain	-3.5	0.3	1.2
Euro Common Mkt ECM	-3.4	0.2	0.4
Russia	-3.0	2.0	13.0
India	5.0	6.4	5.5
Brazil	-1.5	2.7	4.4

The total global economy is likely to show 2009 contraction. In Table 2 the U.S. positively sloped yield curve continues to be the most stimulative monetary policy. Yet, most countries are increasing their stimulative positive sloped yield curves.

Table 2. Current Global Yields

Economic Market	3 month	10 Year
United States	0.3	3.1
Japan	0.5	1.4
China	1.2	3.5
Great Britain	1.5	3.2
Euro Common Mkt ECM	1.4	3.1
Russia	13.0	10.9
India	4.0	7.5
Brazil	11.1	6.1

Economic Sectors and Investment Outlooks

A Technical Overview (BPNYSE, etc) indicates recent strong demand for US and foreign stocks. Money supply growth is supporting demand. However, be aware that only 4 times (1932, 1938, 1975, and 2002) near the end of recessions has the S&P 500 advanced more than the current 30%. The probability for a continued near term advance is low. **Suggestion: Review equity assets for possible sales that have significantly lagged the recent advance. They are most vulnerable to decline.**

Economic Sector Analysis and Outlook

Telecom sector stock demand is good. Hold current positions. **Utility** Sector forecasted 2009 earnings are stable. Dividends are around 4%. No opinion. **Consumer Staples** sector 2009 earnings growth is forecast to be flat (and above all other sectors), but there have been recent negative surprises. No opinion. A sizeable **Energy** sector earnings fall is forecast in 2009. Yet stock demand has been very strong as oil rose above \$50 per barrel. No opinion on the sector. The above sectors have dividend growth candidates for value investors. **Healthcare** sector 2009 earnings look stable. Yet stocks have lagged the recent general advance. No opinion on the sector. **Technology** Sector stocks have led the advance. Apple, IBM, Oracle, and Google have large cash flows. Selective buying is suggested. The **Consumer Discretionary** sector remains a cyclical area. Selective buying of steady earnings companies is suggested. While some firms are going bankrupt, some of the remaining stocks may be good opportunities. The cyclical **Materials** sector is performing in

5/3/2009

line with the market, while earnings are weak. No opinion. **Industrial** sector exports (and earnings) to developing countries are slowing. A reduced portfolio weight is suggested. The **Financial Services** sector remains very volatile. No opinion. **Earnings are weak in total.** Stocks are priced higher than 8 weeks ago.

Summary: sell weakest (declining) stocks.

International Markets Are Stable

Foreign stock markets rose in March, while the USD (1.32 Euro) held steady. Holding fewer developed economy stocks is suggested. Emerging market stocks rose in March (14%). Normal weights may be considered if you can withstand large declines (-50% in 2008.)

Fixed Income - Less Volatile

U.S. Treasury bond year to date returns (-18%) 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 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 are reasonable.

Portfolio Management

Funds have less cash (5.3%) to boost stock or bond prices higher. The S&P 500 index is trading above normal P/E based on uncertain earnings forecasts. Selling weak holdings after the recent stock market advance should be considered.

Disclosure: Personal holdings: **49%** Domestic & International Large Cap stock funds, **44%** Small/ Mid Cap funds, **7%** cash (**16%** Total International funds)

Changes are bold faced.

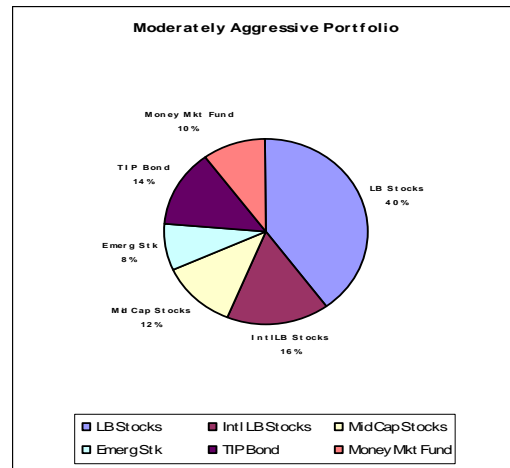
Some May sales are probable in personal and client accounts.

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

Normal Capital Accumulation –



Current portfolio themes are:

Normal Investment Weights

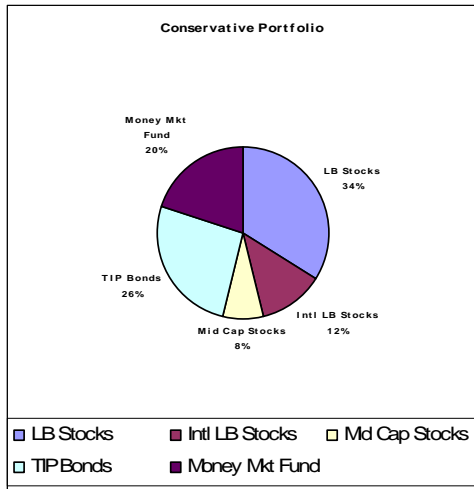
- U.S. large stock funds below normal weight
- U.S. small stock funds normal weight
- Foreign EAFE funds below normal weight; Emerging stock funds normal weight
- Fixed income – TIPS and possibly Muni
- Gold
- Only hold stocks in suggested sectors

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 –



LEGAL DISCLAIMER – BWM Letters Information
The BWM letter is not in any sense a solicitation or offer of the purchase or sale of securities. The factual statements herein have been taken from sources I believe to be reliable but such statements are made without any representation as to accuracy or otherwise. Opinions expressed are my own unless otherwise stated.

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. www.BanachWealthManagement.com