

BWM

Investment
Guidance

May 2010 Financial Markets Review
Economic & Political Events
fuel panic selling

Key Points

- **2010 Year to date Total Returns**

S&P 500 (1089)	-1%;
US 10Yr Bond (3.30%)	5%;
NASDAQ (2257)	-1%;
Foreign (EAFE) Stocks	-14%
- U.S. GDP expected expansion = 3+%
- 2010 earnings expected increase = 35%
- Stock market correction after 14 mo advance
- Solid economic recovery in process

Executive Summary

Equity & many other markets plunged during May in response to foreign sovereign liquidity (debt) and psychological events. Last month's review mentioned the possibility of an equity market correction (10% decline) after a huge recovery advance from deep economic recession and market nadirs. Yet, the analysis did not anticipate the actual fearful response to European government policy decisions. This month key short and long term economic factors are considered, market responses are analyzed, and an intermediate term likely scenario is suggested.

U.S. stock markets (S&P 500 (-9%) and NASDAQ (-9%)) plunged in May, while foreign markets nose dived (-13%). Many commodity prices tumbled (Oil -14%). Strong 1st Qtr. corporate earnings reports, with high profit margins and sales expansion, continued. Industrial production, tech and business service investments, consumer spending and inventory restocking continued in the 1st Qtr. GDP (3.0%) after a 4th Qtr. (5.6%) advance. May economic data indicates a modest 2nd Half U.S. GDP (3%) growth rate. Leading economic indicators tempered their forecast of 2nd half 2010 growth. Analysts raised S&P 500 earnings forecasts, 2010 (+35%) and 2011 (+20%). Gold prices rose (4%), while the U.S. dollar climbed (8%) vs. the Euro (Greek, Portuguese, & Spanish sovereign debt strains). The U.S. 10 Yr. Bond year-to-date return improved (2%) due to a global search for principal safety. U.S. economic conditions are stable, in spite of questionable government policy decisions, which will be evaluated herein.

Themes

- **What will be the impact of Euro sovereign debt problems on U.S. and other economies and markets?**
- **Will expected U.S. financial controls help or hinder economic stability and growth?**
- **What can we learn from the recent fearful response to economic uncertainties?**

Euro Currency governing framework is poorly structured to address welfare state debt issues – recurring problems inevitable!

The euro is the common currency for 22 European nations. Eleven nations have a GDP greater than Greece and 10 nations have a GDP less than Greece. The United Kingdom, Sweden, and Denmark belong to the European Union (EU) economic group, but use their own currencies. Andorra, Kosovo, Montenegro, Monaco, San Marino, and Vatican City use the euro as their official currency, but do not belong to the 27 member EU. Switzerland uses its own currency and does not belong to the EU. The European Central Bank (ECB) is responsible for a single objective of euro price stability; that is keeping inflation below a 2% annual rate. In contrast, the U.S. Federal Reserve Bank (FRB) has conflicting objectives (price stability and full employment). If the facts sound confusing, you see the outline of a political puzzle that can not effectively solve problems of economically and culturally diverse nations. Let's examine the sovereign nation and economic issues.

There are two stable euro currency countries, Germany and Norway. Germany, with its efficient manufacturing society is the third largest global exporter. Norway, with large oil and gas production, is the sixth largest global exporter. Although they are welfare states with high taxes and large entitlements, governmental checks and balances or oil/gas production flexibility make Germany and Norway the lynch pins of the euro based region. The German 2010 budget deficit (4%) exceeds the Euro country maximum rule of 3%, but the level is much less than the high budget deficit, high debt weak euro countries; Portugal, Ireland, Italy, Greece, and Spain (the so called PIIGS). Germany and the ECB are the key players to try to bail out the weak euro country liquidity (paying sovereign debt obligations when due) problems without incurring their own future solvency (no lenders for future debt to bankrupt countries) problems.

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The macroeconomic issues from my perspective are: total national sovereign debt/GDP, national GDP growth, fiscal budget deficits, trade balances, and governmental spending/GDP. National sovereign debt is measured in slightly different ways to account for national and regional debts and pseudo debts. Nevertheless, the accepted standard measurement shows debt/GDP ratios above 60% reduced national GDP growth from above 3.5% to below 2.5% during the post World War II period according to Harvard economist, Ken Rogoff¹. All EU countries, which use the euro, have government debt/GDP ratios far above 60%. The Greek ratio exceeds 100%. (Non European developed nations such as Japan also exceed 100%, and the United States Obama Administration plans for the U.S. government debt/GDP by 2020 to reach 100 %.) As noted by Dr. Rogoff, large debt nations have future sub normal national GDP growth.

Recall that sovereign debt must be financed with interest payments. Larger sovereign debts must be financed with more interest payments. The problem is dynamic. Creditworthiness decreases and interest rates increase as debt levels increase. That brings us to fiscal budget deficits. The EU rule mentioned above is: member countries shall not exceed 3% budget deficits. The rule is problematic because it assumes economic growth of greater than 3% and increased tax revenues to avoid long term insolvency (bankruptcy or in non-government lingo “a Ponzi scheme”). Yet 3% annual European GDP growth has not occurred during the past 20 years and is extremely unlikely in the foreseeable future. Most importantly, the EU nations consistently fail to meet their 3% budget deficit rule. In 2010 all the troubled PIIGS nations far exceed the 3% deficit rule. In fact, the somewhat less unstable French government will incur an 8% fiscal budget deficit (United States 10%) in 2010. Fiscal budget deficits incurred to “grow economies out of recessions” historically have not worked. France currently plans large fiscal deficits in 2011 (6%) and 2012 (4.6%). Fiscal deficits add to sovereign debt, dynamically higher interest rates, and total interest payments.

Trade deficits add to problems because they must be paid to foreign nations. In other words, nations that consume beyond their means, owe payments to foreign parties, who are hesitant to forgive or restructure debts, when times are tough (now). Let’s begin with the less critical

euro currency nation. France has an average \$45B annual trade deficit with a \$2,900B GDP or about a 1.5% trade deficit. While Germany has an average \$185B trade surplus with a \$3,300B GDP or about a 5.5% trade surplus. Even with a common currency, European articles consistently show friction between the Germans and French. Each of the PIIGS nations has a little different trade deficit problem. Yet they add to difficulties primarily with Germany and especially German banks, which are reluctant to use resources to bailout less disciplined nations.

The final key macro-economic issue impacting EU countries is their government spending/GDP. An historic rule is that a sovereign government that spends above approximately 20% to 25% of its GDP is a welfare state. That is entitlements, such as universal pensions, health care, and other cultural specifics controlled by monopoly governments, provide adequate but inferior welfare services to all their citizens. All European governments have spending/GDP ratios above 45% by commonly used government spending calculations. That includes all the problematic PIIGS nations. Germany and France have over 50% ratios. The factor is important, because national productivity is reduced by less efficient government bureaucracies in competition with and control of private sector goods and services producers. With both low productivities and poor demographics (shrinking populations), historically welfare states (nations) do not produce economic growth sufficient to work through liquidity problems to become stable (solvent). Standards of living stagnate and social unrest is normal. Although the euro currency problem and liquidity is the current urgent issue, it helpful to be aware that the so-called emerging nations China (21% ratio), India (20%), Brazil (17%), and certain Eastern European countries do not have welfare state burdens. The U.S. government spending ratio was stable at about 20% since World War II. The Obama Administration has submitted budgets to expand it to 25% by 2020. By objective standards that is an economic definition of a welfare state. For completeness, Japan (31% ratio) is a welfare state.

Kicking the can!

The EU is kicking the proverbial can down the road in time. The euro currency arrangement does not appear likely to be disbanded within the next 5 years. Politically, there is much to lose if

either Greece or other weak nations default on their sovereign debts. Trust would be lost and Greece (or others) would pay dearly for new debt arrangements. Public union riots, lower future economic growth and standards of living are a smaller price for Greece to pay than more serious dislocations from fully defaulting on their debt. Germany, as the stronger nation, also would lose by abruptly ending the euro as its currency. German banks own a significant amount of European sovereign debt denominated in euros. They would take large losses on those debts through sovereign debt restructuring. Germany also reaps the advantage with significant exports through a weak euro currency and becomes relatively stronger than other European countries (although 1% GDP growth remains unstable.) The best case scenario is for European nations to gradually accept lower standards of living in exchange for their weak welfare states.

The ECB, Europeans, and other countries (including the U.S through the International Monetary Fund) provided a political approach to solving the Greek liquidity problem through loans, guarantees, and other facilities. However, it will likely be inadequate, since countries normally cheat on their austerity discipline promises. As in many centuries of history, sovereign debt issues will likely be restructured in the future and banks or other holders will take hair cut losses on bond principal. Nobody will like it, but they will tolerate it as better than the uncertainty of defaults, insolvency, and the Lehman Bros. straight bankruptcy alternative.

A Lesson for the United States

The bailout of Greece and potential other euro currency weak sisters, is a current lesson for the Obama administration and supportive Congress. There are consequences to turning the United States into a welfare state. The macro-economic factors discussed above apply to the US, as well as other countries. The U.S. advantage of an entrepreneurial small business class can be lost through more regulations, higher health care costs, and promised higher income taxes. If people do not have incentives to start businesses and employ people or “earn an acceptable return on investment” in business terms, they will be as cautious as the government bureaucrats watching over them. The issue is an intermediate term, not short term problem. At this time, interest rates near 0% (essentially free money) are expected to result in a normal 3% U.S. GDP growth rate with some employment growth over the next year.

What about the cost of global security?

The United States must consider another macro economic factor that the European countries have the luxury to ignore. Regardless of political biases, the U.S. is the defensive power that has kept global peace (often awkwardly) since World War II. Yet government defense spending must be financed. A factor to observe over the next 6½ years of presumably a two term Obama presidency is the ratio of government debt interest payments to defense spending. When the ratio exceeds 1.0, a tipping point will likely be reached; that is the U.S. will likely not enjoy global hegemony. A reversion back to the Monroe Doctrine and influence over only North and South America is a scenario to ponder. That would be a world different from the U.S. 1980 to 2000 Peace through Strength era.

Will expected U.S. financial controls help or hinder economic stability and growth?

President Obama stated the goals of his Financial Services Industry Control Plan in an April 22 speech at Cooper Union College in Manhattan, symbolically near the corner of Wall & Broad Streets. The four goals will be stated, an assessment of their merit will be given, the expected House/Senate bills reconciliation to be enacted will be judged, and a grade will be assigned based on its impact on United States economic liquidity and commerce.

Financial services control goals were stated as:

1. shutdown “too big to fail” banks without future taxpayer bailouts, including enactment of the Volcker Rule, which places limits on banks’ size and risks that banking institutions can take,
2. standardize financial derivatives and trade them on clearinghouse exchanges,
3. enact a consumer protection agency to control home mortgages, credit card, and auto loans, and
4. empower the SEC to give company shareholders more say over executive pay.

The Volcker Rule, as described by Mr. Obama, differed significantly from speeches by former FRB Chairman Volcker, which I read. Mr. Volcker’s idea is to separate the investment banking and derivative trading operations of banks from their commercial loan making operations. That is close to banking laws prior to the Financial Service Modernization Act of 1999. It would force Citigroup, Bank of America, and J.P. Morgan to sell off their investment banking and derivative trading operations over a suggested 5 year period.

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Taxpayer backed Federal Reserve Bank and Federal Deposit Insurance Corporation safeguards would only apply to traditional deposit commercial banks. System wide financial leverage and total loans outstanding would be sizably reduced. The approach would reduce financial leverage. Mr. Obama's nuanced version of the Volcker Rule instills political boards into the process to arbitrarily decide when a bank is too big and what derivatives should be standardized. In other words, bank lobbyists would have continued incentives to contribute to politicians' campaigns and uncertainty over politically motivated boards would deleverage the financial system. The Obama goal will reduce financial leverage and risk, but the political implementation will be poor and economic cost higher than the Volcker approach.

The standardized financial derivatives goal is good as has been advocated in these reviews over the past 1½ years.

Enactment of a new Consumer Protection Agency is a federal government control grab. Think about the documentation that you signed in quest of obtaining home mortgage, car or credit card loans during the past decade. What protection can reasonably be gained by having a Washington D.C. bureaucrat pass judgment on the institutions, who provide loans, and those who receive the loans? Government political administrators in my experience do not add to transparency. Yet, they add to the cost of loans and reduce prudent business practices.

Empowering the SEC to give shareholder more say in board meetings is generally good. Yet the goal must be transparency and not arbitrary limit executive incentives because Mr. Obama feels that executives are "earning enough" (whatever his statement means.) If shareholder rules are not done carefully, then hedge fund and buyout firm activities may harm honorable companies. Prudent rules are needed.

The House/Senate bills reconciliation committee is expected to spend its efforts primarily on the goal of deciding which derivatives to standardize and how to limit bank cash flows to their derivative trading operations. The House Financial Services Committee chairman (Barney Frank) and Senate Banking Committee chairman (Chris Dodd) will have their meetings with lobbyists to determine the political solution.

Financial Controls Act missed Opportunities

The Financial Controls Act does not address the primary cause of the recent financial meltdown: the extraordinary amount of sub-prime and Alt-A loans financed or securitized by Fannie Mae and Freddie Mac. To date, Fannie and Freddie (Government Sponsored Entities) have received \$145B of bailout funds while being in government controlled bankruptcy. That is more than the estimated net bailout funds to the banks, car companies, and AIG. The Congressional Budget Office current estimate is \$380B in total Fannie and Freddie bailout funds. Democrats enjoyed a large enough majority to defeat Republican amendments to attempt to restructure these GSEs. The matter should have been addressed. Another defeated amendment deserves attention. The risk retention amendment would have directed federal regulators to establish minimum loan underwriting standards, including a 5% minimum down payment and fully documented income, including credit history and employment history. Considering that average U.S. home prices have fallen more than 30% in the past 4 years, it is extremely irresponsible for Congress to enact financial reforms without requiring at least 5% mortgage down payments. Finally, investment banks, such as Goldman Sachs and Morgan Stanley, should have lost their access the FRB borrowing privilege, which was provided during the autumn 2008 credit crisis. The financial controls should have returned them to their former status.

Considering events of the past 2 years, the Financial Controls (Reform) Act planned to be signed into law prior to the July Congressional summer recess deserves a D grade. The partial addressing of non standard derivative and possibly more open corporate shareholder meetings are the positive elements of the legislation. There is a consequential cost for these financial controls. The law will reduce the number and increase the costs of future loans, in following the new regulations. The flow or velocity of money and GDP growth will slow down. Sometimes punishing banks for their perceived greed hurts their customers more.

What can we learn from the recent fearful response to economic uncertainties?

Fear and greed are opposite, usually asymmetric, emotions. That is fear or panic occurs relatively quicker than greed. Hence, the capitulation or "throwing in the towel" last phase of a bear market usually takes asset values below rational

operational valuations more quickly than the preceding bull market price advance above operational (rational) valuations. The capitulation after 8 to 10 months of a stressful drifting decline is usually remembered and keeps many investors cautiously in cash for a year or more. A bearish stock market is often defined as a market (e.g. S&P 500 index) decline more than 25% below a recent peak. At times, a stock market index declines (corrects) 10% to 20% very quickly to bring over-valued stock market price levels back down to simple earnings related valuations. Fear is also involved in market correction selling, but it is more quickly forgotten after perhaps a 2 to 3 month decline and subsequent 3 to 5 month return to the recent peak. In both cases macro economic and market actions concurrently occur, that trigger speculator and investor fears. A scenario for the current market correction (not bear market) with characteristics similar to the October 19, 1987 bear market crash will be developed.

The U.S. stock market (S&P 500) advanced more than 80% between its early March, 2009 low point and April 23, 2010 high (1219). New daily stock price highs were increasing to extreme levels (over 1,000) and most (80%) stock price trends were positive at the peak. Yet the final two month market advance was limited (9%). Retail investors continued to purchase more bonds than stocks. Many investors were confident in steady U.S. economic growth and superb earnings without noticing the lack of additional stock demand. The Greek sovereign debt liquidity crisis and the May 6 so called "flash crash" were the catalysts that got professional money managers' attention. More than 70% of trading volume today is controlled by funds of one type or another and professionals are as emotional as individual securities market participants. They generally sold especially European stocks and the euro, while seeking safety in U.S. Treasury bonds.

A lecture² by Richard Bookstaber, SEC Policy Advisor, concerning *Risk Management and Market Crises* provides a useful model to examine abrupt market declines. Mr. Bookstaber notes 5 factors of abrupt market declines or crises. A stock market must be fragile or nervous about a macro economic event. An irrational or uneconomic market mechanism must exist. A shock must occur to cause a market malfunction. Liquidity must quickly dry up. Finally, the shock must propagate to other markets to cause a

global shock. The crisis causes risky asset markets to decline, increased trading, yield spreads between risky and safe debt to increase, market maker liquidity to decline, and sellers to take big losses to raise needed liquidity.

In autumn, 1987 the U.S. stock market had experienced more than a 200% blue chip (300% small capitalization) stock advance over 5 years. Foreign exchange discontinuities were occurring due to a U.S. trade deficit and weak dollar. Put options were being sold as insurance without adequate margin to back the option derivatives. Options were an easy source of extra income as they expired worthless during the smooth 1987 stock market advance. The market decline on Friday, Oct. 16 caught the attention of a few professionals, who saw the potential impact of the large number of put options outstanding. On Monday, Oct. 19, stock markets around the world fell with the S&P 500 suffering a record 20% single day loss. Put option writers could not back their contracts, when holders exercised their rights to put stocks back to them at the strike prices. There were limited breakers to halt trading at the time and market floor specialists were unable to provide liquidity as sell orders overwhelmed buy orders. Stock market declines were correlated around the world. The U.S. market bounced back on Oct. 20 to recover half of its loss. However, the true market bottom occurred on Dec. 4. Technically, a 3½ month bear market between the Aug 26 peak and Dec. 4 trough is very short and the U.S. stock markets actually finished slightly positive for the year, 1987. Market circuit breakers to halt trading and broker put option rules were implemented to try to prevent a future market crash.

By April 26, 2010 as previously noted the U.S. and global stock markets had advanced significantly from the March, 2009 low point. The Greek sovereign debt liquidity crisis and the poorly coordinated response of debt holders and the ECB caused concern around the world. The May 6 U.S. stock markets (S&P 500, DJI, NASDAQ) 9% intra-day decline and 4% closing price decline on the 5th heaviest trading day on record caught the attention of global markets. The irrational prices of some stocks during the quick sell-off showed there were effectively no market makers to provide liquidity for a brief period. The lack of liquidity was different than the 1987 put option writer inability to honor naked contracts. In 2010, high speed ETF program trading and small private exchanges

appeared to overwhelm market makers within the circuit breaker boundaries. The lack of the pre July, 2007 “short on uptick rule” may have also allowed faster price falls and contagion between so called “short ETFs”, derivative options and futures contracts. In any case, liquidity dried up, and contagion between global markets occurred. The SEC has implemented a few market circuit breakers. However, there may be more actions taken to slow down wild market price swings.

Your simple question may be: Is the current S&P 500 and NASDAQ (13%) correction over? Nobody knows the answer with certainty. A new macro economic development (wars, PIIGS nation debt default, etc.) may not be priced into markets. Historically since 1926 records were available, after an 80% recovery from a bear stock market, corrections have averaged 21% with a median of 19%. By that reference, the correction may persist until at least some time in June with a lower price bottom. A two handed analyst may respond “on the other hand”, that the May 6 intra-day bottom was tested on May 26 and short term fear factors (VIX May 7 (41), May 21 (47), and May 26 (35)) may be starting a downward trend. The more convincing optimistic analyst view is that stock price valuations (price/earnings ratios) and forecasted earnings are attractive, even though market correction lows may not have been made yet.

Foreign Economies

Emerging countries China, India, and Brazil continue to show good 2010 forecasted GDP growth in the *Economist* Table 1. The European Common Market may suffer slower than forecasted growth in response to bailouts, reduced financial leverage, and some government spending growth limits.

Table1. Economic Forecasts

Economic Market	2010 GDP	2011 GDP	2010 CPI
United States	3.1	3.1	2.2
Japan	2.1	1.7	-0.9
China	9.9	8.1	3.5
Euro Common Mkt ECM	1.0	1.2	1.4
Russia	4.5	4.2	6.1
India	7.7	8.0	10.7
Brazil	5.5	4.5	5.2

The total 2010 global economy is expanding (3.5%) with Asia leading the way. In Table 2 the

U.S. positive sloped yield curve remains the most stimulative monetary policy in the world. The U.S. FRB plans low (0 – ¼%) bank borrowing rates for an extended period. Most countries are continuing stimulative positively sloped yield curve monetary policies.

Table 2. Current Global Yields

Economic Market	3 month	10 Year
United States	0.2	3.5
Japan	0.3	1.3
China	1.9	3.4
Euro Common Mkt ECM	0.7	3.2
Russia	8.5	6.6
India	3.9	8.3
Brazil	8.7	6.2

Economic Sectors and Investment Outlooks

A Technical Overview (BPNYSE, etc) indicates U.S. stock prices trended lower during May with Euro currency related volatility. The change from bullish to bearish outlooks over the past four weeks was among the most abrupt in recent times (a contrarian positive psychological factor). Smaller growth company stocks, consumer discretionary, and technology sector stocks are relatively stronger than other areas of equity markets.

An Operational Company Valuation Review

My data source, Zacks Research, showed outstanding 1st Qtr. 2010 S&P 500 total earnings. The bottom line earnings surprise ratio (beating/lagging forecasts) was an impressive 4.9 with the median (midpoint) surprise of +6.8%. Stated differently, 75% of S&P 500 companies reported better than forecasted results and total net income was 47% above the 1st Qtr. 2009 recession ending level. The top line revenue surprise ratio (2.2) with a median surprise of +1.4% was also good in a low inflation environment. Total 2010 and 2011 S&P 500 company earnings forecasts of \$78.22 and \$94.00 are 35% and 20%, respective growth rates. If achieved, 2011 earnings will be 10% above peak 2007 S&P 500 earnings. The expected 2010 and 2011 revenue growth of 5.0% and 7.3%, respectively, is supportive. Imagine if massive fiscal policy spending was focused on increasing private sector employment, instead of increasing public sector employment. The good 2010/11 (during high unemployment) earnings growth may have resembled even stronger profit growth during the faster post recession employment recovery of 1983/84.

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U.S. Equities appear to be undervalued

The current 2010 S&P 500 Price/Earnings ratio (with the 1st Qtr. recorded) is 14.0 and the forecasted 2011 P/E = 11.7. The long term S&P 500 P/E in a similar moderately low inflation environment is 14.7. Therefore, if forecasts are achieved stocks are currently undervalued by 5% and a case can be made for a 15% stock market advance from current levels by the end of 2011 with some margin of safety. As previously discussed, an emotional correction may cause stock markets to bottom out at a lower level. An individual needs to be a smart market timer with more information than I have to figure that out.

Suggestion: Hold normal portfolio asset weights. The S&P 500 earnings forecasts are strong. Stock markets are working through a correction. Continued monetary stimulus will likely cause intermediate term demand. Stock markets are always risky and usually volatile.

Economic Sector Analysis and Outlook

Telecom sector stock demand is weak, as noted by negative sector price Relative Strength (RS) with respect to the declining total stock market. Avoid. **Utility** Sector forecasted 2010 revenues and earnings increases are low (5%). Dividends are about 4%. Sector RS is weak. Regulations and a 2011 dividend tax rates change may worry investors. Avoid. **Consumer Staples** sector 2010 earnings growth is forecasted to be stable (13%) but below other sectors, while RS is stable. Selectively hold long term dividend growth stocks. **Energy** sector 2010 earnings growth (43%) is expected to recover from 2009 declines (-56%). RS is weak after oil spill. During April oil prices fell 14% to \$74 per barrel in line with most commodities, while the USD strengthened. Research top quality undervalued oil services companies for possible purchases. The above sectors include dividend candidates for low volatility value investments. **Healthcare** sector 2010 earnings are forecasted to be solid (+7%). 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 weak RS, as positive surprises continue. This is the growth sector with good cash flows, high forecasted 2010 sales (20%) and earnings (30%) growth. 2010 P/E valuations (15) are 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 leads the market. Hold leaders and watch discretionary spending. The cyclical **Materials** sector RS is neutral, but volatile with 2010 good forecasted earnings growth (66%) after poor 2009 (-50%) earnings decline. They are sensitive to global GDP growth. No Opinion. **Industrial** sector exports (and earnings) to developing and developed countries are positive, but European exports are sensitive to the weak Euro. The sector RS is very weak. Avoid. **Financial Services** sector benefits from very cheap federal funds. Hold cautiously.

International Markets Are Quiet

Foreign stock market returns have been negative year to date, while the Euro (-8%) 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 5% YTD. Investment grade corporate and GNMA bond returns (3%) were similar, 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 retreated (9%) in May, 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) (10% year to date) is suggested.

Portfolio Management

Funds have little cash (3.3%) to boost stock prices higher. **Remain diversified and be selective.** Economic strength will likely cause the FRB to tighten monetary policy after the November 2010 elections and cause stock revaluations (lower prices) later this year.

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 – Entry (5%) Positions only

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

Allocation changes in bold

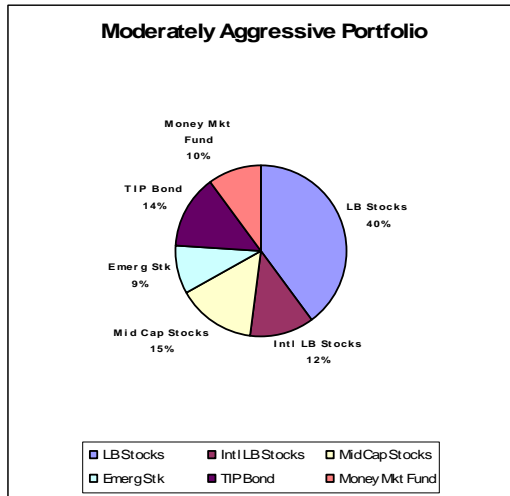
**Sample Portfolios are models
 Not Client Recommendations**

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 –

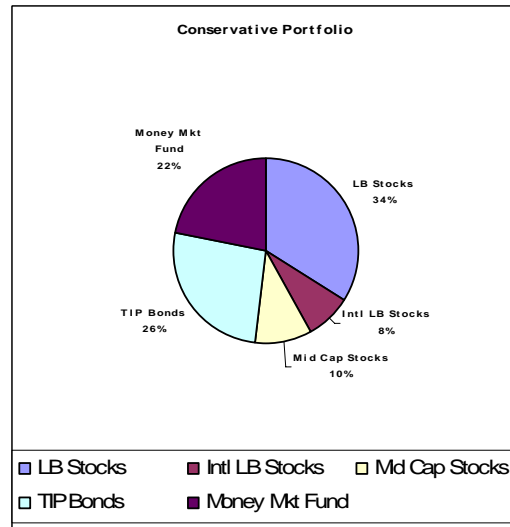


Sample Portfolio B - **Conservative**

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

¹Rogoff, Kenneth, *Understanding Financial Crises*, CFA Conference, May 17, 2010

²Bookstaber, Richard, *Risk Management, Market Crises*, CFA Conference, May 17, 2010

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

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