

**BWM**Investment  
Guidance**May 2011 Markets Review****Short Term Risky Trades Taken Off  
Added Government Policy Uncertainties****Key Points**

- |  |    |
|--|----|
| • <b>2011 Year to Date Total Returns</b> |    |
| S&P 500 (1345)                           | 8% |
| US 10Yr Bond (3.05%)                     | 3% |
| NASDAQ (2835)                            | 7% |
| Foreign (EAFE) Stocks                    | 6% |
| • U.S. GDP expected expansion = 2.8%     |    |
| • 2011 expected earnings increase = 14%  |    |
| • Stock market – trending lower          |    |
| • Modest economic recovery               |    |

**Executive Summary**

Equity market returns fell (S&P 500 -1.5%, NASDAQ -1.5%, EAFE -3%) in May. Bond market U.S. Treasury (UST) returns (2%) rose due to a flight to safety. The weak PIG (Portugal, Ireland, & Greece) countries euro currency solvency issues expanded to include the remaining PIIGS (Italy and Spain) with austere government spending and limited potential European Common Market growth as the only alternative. Some type of Greek and other bond defaults by an acceptable name appears inevitable. The U.S. dollar (USD) benefited (+3%) versus the euro, but less (+1%) versus the British pound, and most other currencies. The Federal Reserve Board (FRB) increased UST securities purchases in the Quantitative Easing 2 (QE2) program that is 95% complete. It is scheduled to change to a non-expansion mode in July. U.S. GDP growth (1.8%) slowed in the 1<sup>st</sup> Qtr. The commodities risk trades were truncated with higher silver margin requirements that affected other commodities, as will be explained. Oil closed down 10% to \$102/barrel in May, as silver led a number of commodities down in price. Profits grew above forecast in the 1<sup>st</sup> Qtr. with all S&P 500 companies financial reports released. Sizeable new U.S. jobs were created in the 1<sup>st</sup> four months of the year and are expected to continue, although initial weekly unemployment benefit claims increased over 400,000 in each of the past 7 weeks. Huge continuing (>6%) annual U.S. federal deficits and debt (>\$14T) issues will be discussed. Investors became defensive in May, as the outlook for economic growth moderated. A CFA conference in Edinburgh provided me different views of the U.S. fiscal and economic outlook.

**Themes**

- **Risky Trades taken off in the Short Term**
- **U.S. Government Policy Issue Impasse**
- **British example, etc. provide advise**
- **Are Czar Sunstein's Regulations Productive?**

**Risky Trades taken off in the Short Term**

Risk taking speculative strategies decreased in May. They coincided with the Wall Street bromide *Go Away in May* ... which was mentioned in last month's markets review. Historically May begins a season where fundamental economic factors and reduced buyer demand are primary issues in summer & autumn doldrums. Money flows tend to fall off in the 2<sup>nd</sup> Qtr. People think about vacations as Northern Hemisphere weather warms up and schools close. Non seasonal uncertainty issues like wars and government decisions that reduce risk taking liquidity can occur at any time. Commodity markets experienced the cut off of risk taking in the highly speculative silver contracts by multiple increases in margin requirements and the silver spot price fell (-20%) in May. The rules of the speculation game were changed and reduced liquidity forced sales and reduced prices.

Government decisions with nearly insolvent PIG countries that use the common euro currency showed how serious high government debt/GDP and deficit issues are. Debt holders are concerned if their contractual interest and principle will be paid back. Debtor countries must cut spending to immediately reduce further added debts (budget deficits) and support added total economic growth to earn government tax revenues. An obvious response: sell government assets, such as infrastructure enterprises, and reduce regulations on productive work; is too hard for most countries. An alternative approach is for debt holders to accept a so-called hair cut – reduced debt principle or extended debt maturity. A 10% haircut is different than a 50% haircut even in the mild summer weather. In the midst of these May issues, the euro fell 3% vs. the British pound and 4% versus the USD.

An important energy commodity, Oil, spot price pulled back (-10%). Many different observers noted the increased volume of speculative trades (70%) vs. commodity user and producer trades (30%). Five years ago the relationship was reversed. The fear that exchanges will increase margin requirements or require direct limitation of speculative trading may have been enough to encourage some traders to reduce their risk by

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selling large oil long positions. Interestingly demand for gold was little changed (-1%) during May. The overall commodity index fell 5%. The euro weakness and commodity trade liquidation created the ideal conditions for a flight to the safety of UST securities. The 10 yr. UST bond gained 2% in price, as its yield fell to less than 3.1%.

Equity markets saw reduced risk taking as speculative domestic sectors Energy (-3%), Materials (-5.5%), Industrials (-2.5%), and Technology (-3%) fell in price. Less cyclical defensive domestic sectors Healthcare (+2.5%), Consumer Staples (+2%), and Utilities (+2%) rose. Emerging market equities (-3%) and developed country equities (-3%) fell. U.S. speculative small capitalization stocks (-1.5%) fell the same as large S&P 500 stocks (-1.5%).

As risk taking trades were generally taken off by speculators, trading could be characterized as rational, but not fearful. The VIX volatility indicator rose nearly 30% at its peak during May. In contrast it rose nearly 100% in March. Recall the May 6, 2010 *Flash Crash* or *Flash Crash of 2:45*, when the Dow Jones Industrial Index dropped 6% between 2:42 PM EST and 2:47 PM. The VIX rose 200% on that day and on May 25. That is fearful emotional trading by all market participants. In May, 2011 risk taking was taken off in a more orderly way.

The fundamental U.S. economy experienced headwinds. U.S. regional and national output data showed a continuing moderation of manufacturing and services growth at the beginning of the 2<sup>nd</sup> Qtr. after the lackluster 1<sup>st</sup> Qtr. U.S. GDP growth (1.8%). Consumer spending (0.4%), income (0.4%), and savings rates (4.9%) continued very gradual growth in April. Adjusted for inflation, consumer spending increased a miniscule (0.1%) amount. Higher energy costs (gasoline up 26% year to date) are the primary factor that is reducing expected 2011 U.S. GDP growth from 3.3% expected in January to 2.8% expected currently. At this time layoffs are limited and large corporations have announced hiring plans that contributed to new net private sector employment gains in the first 4 months of the year. Yet remember that small companies are the primary risk takers, who dominate swings in employment. They do not appear to be hiring significantly. That is the key U.S. economic headwind.

### ***U.S. Government Policy Impasse***

In last month's market review the changed U.S. federal government spending and debt debate was noted. Unfortunately, there was no real progress in May. Treasury Secretary Geithner made statements that a total federal debt ceiling increase was needed without restrictions and that extraordinary measures would be needed if the ceiling was not authorized in early May. Mr. Geithner lost more of his limited credibility in the process. By month end it was clear that the statutory absolute cap of U.S. Treasury borrowing (\$14,290,000,000,000) would not be reached in mid May or even mid July as initially stated. The new date for reaching the cap on Treasury borrowing is early August.

President Obama appointed Vice President Biden to chair a panel of six Congressional leaders to determine the conditions for increasing the absolute cap on U.S. Treasury borrowing. No agreements have been announced to date and based on participant schedule priorities it is unclear how often they will meet. The scope of any spending and tax agreements and their relationship to a new cap on U.S. Treasury borrowing is unstated.

The logical sequence of events would be to pass a 2012 Senate budget and proceed to reconcile differences with the House passed budget, prior to passing a new statutory absolute limit on U.S. Treasury borrowing. The Senate voted on President Obama's initial budget submittal and it was defeated 97 to 0. It also voted on the 2012 House passed budget and it was defeated 56 to 40, which led one commentator, Kimberley Strassel, to observe Ryan (40) vs. Obama (0). In reality things are more complex and Mr. Ryan's challenge is to convince a majority of Americans (politicians watch polls) that having control of their future Medicare choices through a more limited federal government support system would provide them a better value. He is working hard explaining his vision in numerous venues, but must overcome the *MediScare* labeling of his opponents, to convince a majority of voters that his plan is best for the country.

Markets correctly ignored the process to enact a law to authorize the remainder of 2011 federal government spending. They concluded that the spending law would be legislated and enacted. Markets are not focused on a possible partial shutdown of the federal government in August, if the debt ceiling is not increased.

A group referred as the Gang of 6 Senators appears to have run into a standoff concerning Medicare entitlements, while trying to build a small consensus for a Senate 2012 Budget Plan. That caused Republican group member Tom Coburn to walk away from the discussion in mid May. His related *Bloomberg* news article indicated that additional revenue sources to the Patients Protection and Affordable Care (Obamacare) Act taxes would be part of an agreement. His focus is to reduce taxable deductions, cut tax rates, and end up with net higher tax revenues in addition to lower than currently forecasted future spending.

*So; what is the likely 2012 debt ceiling outcome, what about a 2012 budget, and do the financial markets care?*

It is doubtful that the U.S. Treasury cap on borrowing will be resolved until before or slightly after its line of credit with the American people is maxed out. Mr. Biden's panel is unlikely to produce a new debt ceiling related spending agreement regardless of his comments that \$1,000,000,000,000 projected deficit reductions over an unspecified period are nearly agreed to. The senate gang is unlikely to reach a consensus agreement, just like group failures during the Obamacare preliminary negotiations. If President Obama's popularity has declined after the boost related to killing Osama bin Laden, then he may be forced to get involved in the process during the heat of late July after the July 4<sup>th</sup> congressional recess. Mid May Gallup polling shows 19% of Americans favor raising the debt ceiling, 47% don't want the debt ceiling raised, and 34% don't have an opinion. Most important for a President looking toward reelection; of Independent voters, 15% favor raising the debt ceiling, 46% don't want the debt ceiling raised, and 39% don't have an opinion. The President may be forced to specify tax revenue increases that he favors. Any meaningful tax increases will include voters earning less than \$200,000 in taxable income. If the debt ceiling is reached in August, I think it will coincide with other factors that add uncertainty to stock and other markets. Slower than expected earnings or employment growth, are just as important in my view to stock markets as the federal government reprioritizing or limiting spending after the U.S. Treasury reaches its statutory absolute borrowing cap (\$14,290,000,000,000.) U.S. Treasury security prices and yields may be more impacted by a euro related flight to safety than a possible 2012

downgrade of U.S. Treasury security credit worthiness, if the debt limit is reached and not changed. There are other factors for investors to worry about in managing portfolios in addition to the U.S. government maxing out its line of credit. In any case, there appears to be a reasonable chance that a 2012 Senate budget will be agreed to after the statutory absolute increased borrowing cap is enacted. 2012 spending authorization bills would likely follow.

***British example, etc. provide advise to U.S.***

The CFA, Chartered Financial Analysts', Annual Conference in Edinburgh, Scotland was a good opportunity to listen to thought leaders present their views of the current condition of the global economy. There is no consensus that the Keynesian supported expansion of federal governments to reduce the impact of a severe recession was both successful and that monetary expansion will be withdrawn in a smooth, price stable manner. All presenters felt that central bank monetary expansion stabilized a severe reduction of liquidity as counterparty trust between banks and clients decayed and some lending markets nearly froze. Yet, Keynesian government fiscal policy expansion is questioned. Some countries, such as the United Kingdom have largely addressed the recession through austerity or limited added deficit spending. Have they been more successful than the U.S. huge increase in government stimuli and expansion relative to the private economy? A measure, which most people relate to, is the change in country employment between the start of the recession (Q1 2008) and the latest comparable data (Q4 2010). During that period the total U.K. employment has dropped 0.7%, while total U.S. employment has dropped 3.7%. That translates to millions of jobs and factually speaking a failed U.S. policy of government expansion. For completeness, note that U.K. GDP recession was more severe, initial recovery was less robust, and federal employment did not increase as in the U.S. The current U.K. inflation (4%) is also higher than the U.S. (3%). The U.K. economy has not fully recovered, although it seems to be more fiscally stable than that of the U.S.

Keynesian supporters of monetary expansion have an important issue to ponder. How will central banks, such as the U.S. FRB, reduce their monetary expansion to a sustainable level? As I listened to both sides of the presentations, trying to judge things in an Aristotelian manner, it

appears that the big government supporters have lost some of their confidence. They are not sure how Chairman Bernanke will return to a stable sustainable monetary policy. The Chairman and the President have some critical decisions to make prior to reappointment and election days.

The most obvious observation is that the U.K. does not have a dominant global currency, had a larger relative debt, and did not expand the regulatory agencies (Obamacare, EPA, etc., etc.) the way that the U.S. did. The U.K. leaders did not have the latitude to get distracted with reform, instead of guiding the private economy back to stable economic growth.

The International Monetary Fund estimates by 2020 the U.S. needs more (7%) added fiscal cuts (as a % of GDP) than the U.K. (1%). What else should the U.S. government do to stabilize its economy? In broad terms, regulations should be streamlined and assets should be reviewed for possible sale. In the political world, those are considered harsh suggestions.

What about the U.S. Postal Service? The U.K. Royal Mail is in the process of privatization<sup>1</sup>. The process of paying off pension deficits is causing expected bureaucratic delays, but it looks like it will happen and provide a tangible sale price for an operating asset. How much of a deficit is the U.S. Postal Service incurring? A complete analysis<sup>2</sup> shows the problem is huge. Follow the research and decide for yourself.

Another large potentially valuable asset that the U.S. government owns is land. A number of scholars have noted the amount of non-National Park, non-Bureau of Land Management land that the U.S. government owns. Much of the land is in the western states and is suitable for ranching, mining, and drilling. A resurgence of gas and oil drilling is occurring on private land in the past 3 years after new horizontal drilling and fracking techniques have been developed. Another 10% increase in continental oil and gas output is conceivable if desirable federal land was sold or drilling right agreements were negotiated. More U.S. jobs and less foreign oil purchases is an attractive consideration to the status quo.

#### ***Are Czar Sunstein's Regulations Productive?***

The biggest issue among small business people that I know over the past 2 years has been the increase in federal (and other) regulations. Cass Sunstein is the Czar of the Information &

Regulatory Affairs. He previously wrote a book, *Nudge*, with noted financial analyst, Richard Thaler. The book promoted an oxymoronic concept "paternal libertarianism" where normal individuals would be nudged by an elite government to do what is good for them. This naturally catches the attention of self reliant decision makers. Czar Sunstein wrote a recent article<sup>3</sup> updating progress on federal government reforms. He claims that 30 agencies will be reviewed to streamline and coordinate reforms. Read the article and decide if it is more important to streamline old regulations or eliminating them. Be aware that the number of pages in the federal government list of new regulations increased 18% in the 18 months between mid 2009 and the end of 2010. That is a record increase. Forty three major regulations costing businesses an estimated \$26B have been enacted. Obamacare and Dodd Frank Financial Reform legislation has not been turned into regulations yet by more than a dozen agencies involved. For completeness, a quote from a counter point article<sup>4</sup> by writer and scholar, Mark Steyn, puts the harmfulness of the onslaught of federal regulations in context.

"The hyper-regulatory state is unrepugnant. It strikes at one of the most basic pillars of free society: equality before the law. When you replace "law" with "regulation", equality before it is one of the first casualties. In such a world there is no law, only a hierarchy of priorities. And yet Americans put up with it. The small business administration estimates the cost to the economy of government regulations is \$1.5T. You and your fellow citizens pay for that – and it is about twice as much as you pay in income tax"

Will Sunstein or Steyn's view result in a more good and productive society? The attached satire put to hip hop music concerning policy decisions promoted by Lord Keynes and Fredrick Hayek, representing the free or Austrian economists, may be worth the fun of 20 minutes of your time. <http://pipesandtheories.blogspot.com/2011/04/keynes-v-hayek-rap-battle-part-ii.html>

#### ***U.S. Economic fundamentals and valuations: Moderating Economic Growth, Acceptable P/E***

Reported earnings/revenues and the outlook for S&P 500 earnings by financial analysts have not changed in the past month. Net profit margins (9.3%) remain far above normal in 2011 and 2012 margins (10.1%) are expected to go higher. Trailing year based Price/Earnings valuations are

historically reasonable. I expect something to change in the low wage growth, low financing cost, modest consumption and investment demand scenario. The dominant intermediate term (6 mo. forward) economic factors are the availability of money (M2) and term structure of Treasury security yields. In the 3<sup>rd</sup> year of a 4 year political cycle, the dominant factors remain favorable. Uncertainties caused by wars and significant increases in price of important commodities, such as an additional 35% in the cost of oil, can overwhelm normal dominant factors and upset the consensus outlook and demand for equities at any time.

### **Global Economies**

Emerging country (China, India, and Brazil) main banks tapped on the brakes with higher interest rates during 2011 to slow their currency inflation caused by a devalued liquid USD. Their forecasted GDP growth shown in Table 1 (*Economist* data) exceeds developed nations in 2011 and 2012. Table 2 shows all developed nation long term interest rates fell. Notice that in spite of its euro currency issues that the ECM is forecasted to grow at about the same rate as Great Britain. The U.S. fiscal policy of high deficit spending and stimulative monetary policy is taking more price stability (inflation) risk than all developed and major emerging countries.

**Table 1. Economist Forecasts**

Economic Market	2011 GDP	2012 GDP	Current 2011 Unemployed
United States	2.8	3.2	9.0
Japan	0.2	2.4	4.6
China	9.0	8.7	6.1
Great Britain	1.6	2.0	7.7
Euro Common Mkt	1.6	1.7	9.9
Germany	2.8	2.1	7.1
Russia	4.5	4.5	7.1
India	8.9	8.8	10.8
Brazil	4.0	4.3	6.5

**Table 2. Economist Current Global Yields**

Economic Market	3 month	10 Year
United States	0.1	3.1
Japan	0.2	1.1
China	4.6	4.1
Great Britain	0.8	3.3
Euro Common Market	1.4	3.0
Russia	8.3	4.7
India	8.1	8.5
Brazil	11.9	6.2

### **Personal Goals and Portfolio Management**

Investment market commentaries often discuss asset valuations, risks, and expected returns in the context of rational decision making. Personal goals and uncertainties should be considered by normal partly rational and partly emotional investors (i.e. you and I). If you are anxious about modest May equity losses and some commodity losses, then review last month's suggestion - *You may reduce some commodity holdings, such as silver, or transfer some small stock assets to less volatile larger dividend paying stocks.* The point is to recognize that the commodities and stock markets are currently driven by speculation based on loose FRB monetary policy and the traders may all try to nail down profits (in terms of a devalued USD) at the same time sometime later in 2011. The demand between small/mid size and large companies is now neutral and small/mid size companies are normally impacted more by increases in future financing expenses. That is why larger dividend paying stocks are suggested.

### **Markets and Economic Sectors**

Asset returns except housing continued to rise in an orderly way through April and fell in May. Small investors, investment letter writers, and speculators became more cautious in May. The environment remains speculative, as the Initial Public Offering of the social network stock *Linked In* showed. Excessive monetary liquidity is supporting a profits and valuation bubble.

Growth equity and commodity assets historically have earned their highest returns in similar speculative periods with economic growth and confident investors. That is the 2011 story and may continue for a few more months. I suggest monitoring speculation and becoming more observant after the fall in the silver prices.

*Enjoy the situation in a rational, thoughtful way.*

*It will end when the FRB takes away the proverbial punch bowl.*

### **Technical Analysis**

The U.S. stock market is technically in a mild decline and the breadth of declining stocks expanded recently. The VIX (S&P 500 options) trades at a confident level (16). Both investment newsletter writers (Investors Intelligence survey) and small investors (AAII survey) show normal optimism. Stock markets are more risky than in 2010. They are supported by an unsustainable stimulative monetary policy. Equity assets are

priced at fair value. *Monitor volatility for an indication of a further correction in stock prices.*

**U.S. Economic Sectors**

**Industrial** Sector 1<sup>st</sup> Qtr. earnings and revenue growth led the S&P 500 Index sectors. 2011 earnings and revenue forecasts are also positive. Price Relative Strength (RS) is in line with the S&P 500 Index. Exports are strong. **Hold**

**Consumer Staples** earnings and revenue growth lagged the S&P 500 and 2011 forecasts are also lagging. Net Profit Margins (NPM) are good, although commodity prices may squeeze them down. RS is positive. Defensive Sector **Hold**

**Utility** Sector Stocks earnings and revenue lagged behind the S&P 500 Index and 2011 forecasts are lagging. RS is positive. Defense Sector **Avoid**

**Healthcare** stock earnings and revenue growth lagged, but price RS led the S&P 500 Index. NPMs are positive. Defensive Sector **Hold**

**Technology** Sector earnings, revenue, and NPM beat the S&P 500 Index, but RS lagged. **No suggestion.**

**Materials** Sector 1<sup>st</sup> Qtr. earnings and revenue growth and 2011 forecasts are positive. 2011 returns (8%) are near the S&P 500 market, but RS lags. Material sector NPMs are cyclical. **No suggestion.**

**Energy** Sector earnings and revenues are growing above the S&P 500 index as oil is priced in the devalued USD. 2011 returns (12%) exceeded the S&P 500, but RS is negative based on pull back in Oil prices. **No suggestion.**

**Financial** Sector earnings and RS lagged behind the S&P 500 index. Revenues and NPMs are affected by debt asset revaluations. **Avoid.**

**Consumer Discretionary** stock earnings and revenues varied vs. the S&P 500. **No suggestion.**

**Treasury** 10 Yr. Bonds (2%) outperformed stocks in May and are influenced by FRB QE2 manipulation. They still offer relatively too little return for the risk; **Avoid.**

**Corporate bonds** offer similar returns. They appear overpriced. **Hold selectively.**

**Gold** returns (7%) about matched the S&P 500 Index in 2011 year to date (YTD). **Hold**

**Suggestion: Hold normal portfolio asset weights, except Treasury bonds. Be aware of the environment.** Stock market psychology is slightly negative biased; prices are extended. Liquidity is cheap. Markets are fairly and fully valued. *Remember your risk tolerance.*

**Alternative Investments – Diversification**

The Real Estate Investment Trusts (REITs) index performed better (11%) than the S&P 500 Index (8%) in 2011 YTD. Well researched partnerships and energy MLPs may be effective ways to profit from income producing real assets. Gold funds are capital preservers. A 5% weight in a gold exchange traded fund (GLD) is suggested.

References

<sup>1</sup>Groom, Brian, *Ministers poised to pump 1B GBP into Royal Bank to drive sell-off*, Financial Times, May 20, 2011

<sup>2</sup>Leonard, Devin, *The U.S. Postal Service Nears Collapse*, Business Week, May 26, 2011

<sup>3</sup>Sunstein, Cass, *21<sup>st</sup> Century Regulations: An Update on the President's Reforms*, Wall Street Journal, May 25, 2011

<sup>4</sup>Steyn, Mark *Our Unrepublican Hyper Regulatory State*, Orange County Register, May 28, 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 normal weight; Emerging stock funds normal weight
- *Sell part of underperforming asset positions*
- Fixed income – TIPS and corporate bonds
- Gold – Normal (5%) Positions

**Disclosure: Personal holdings**

40% Domestic & Intl Large Cap stock funds, (18% Total International stock funds)

49% Small/Mid Cap funds,

11% short term U.S. & Intl. bonds and cash

**Sample Portfolios are models**

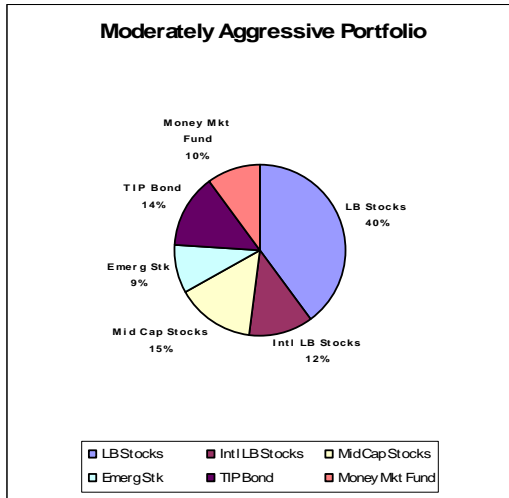
**Not Client Recommendations**

Sample Portfolio A - **Moderately Aggressive**

Example 45 year old college educated parents with 1 high school child and 1 college child.

- 40% Large Blend Stock Index Funds
- 12% Large Blend International Fund
- 15% Mid or Small Cap Stock Fund
- 9% Emerging Market Stock Fund
- 14% TIP Bonds
- 10% Money market cash

Normal Capital Accumulation –



If I buy, hold, or sell securities discussed herein, then I will disclose my positions. Prices shown are approximate. Joseph Banach, Chartered Financial Analyst, Certificant in Investment Performance Measurement [www.BanachWealthManagement.com](http://www.BanachWealthManagement.com)

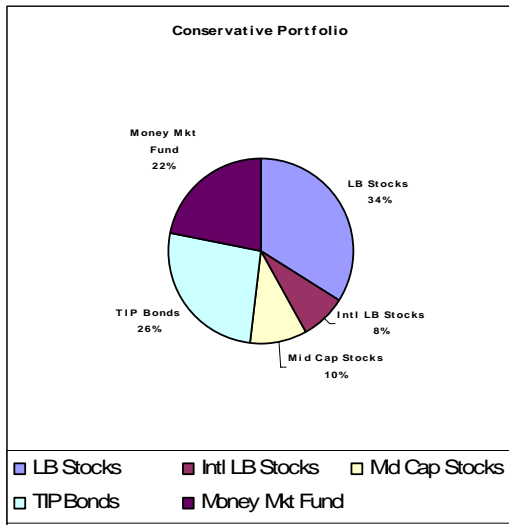
Note client portfolios use available 401K plan funds and multiple funds in each category to reduce risk.

**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 –



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