

BWMInvestment
Guidance**October 2008 Markets Review**
Large Losses across All Markets
Panic Volatility & Selling**Key Points**

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|--|------|---|
| • Year To Date 2008 Total Returns : | | |
| S&P 500 (969) | -33% | ; |
| US 10Yr Bond (3.96%) | +0% | ; |
| NASDAQ (1721) | -35% | ; |
| Foreign (EAFE) Stocks | -43% | |
| • 2008 US GDP expected growth = 0.6% | | |
| • 2008 earnings decline expected = -8.5% | | |
| • Negative 2008 portfolio returns | | |

Executive Overview

Equity markets imploded (S&P 500 -17%) in October. All markets suffered a lack of confidence. Volatility exploded and risk premiums increased in every asset class. Even the so called smartest guys on Wall Street, hedge funds, lost money in the 3rd Qtr. and client redemptions forced selling of all asset classes in October. Last month, I incorrectly suggested the Bear Stock Market may be near an intermediate term bottom due to massive financial system bailouts and related improved liquidity. The impact of deleverage selling (reduced liquidity) was far greater than expected. All asset class volatilities increased from high to unprecedented levels. Oil tanked 39% from \$101 to \$62 per barrel before recovering to \$68 at month end. Gold prices dropped from \$851 to \$713 per ounce. The U.S. dollar (USD) exchange rate with the Euro and most major currencies picked up 11%. What is going on? Deleveraging, I will explain. The preliminary 3rd Qtr. GDP estimate showed -0.3% contraction with elevated 4.1% inflation. The global financial bailouts will be discussed. Real consumption and profits continue to fall. Zacks calculates S&P 500 firm's 3rd Qtr. 2008 total earnings (60% reported) fell 11%. Earnings continued to disappoint investors for the past 3 quarters. The corporate guidance and analyst forecasts are moving down to reality. Market themes, the economy, and market sectors are discussed to suggest portfolio strategies to survive this bear market.

Themes

Current investment markets themes are: unprecedented fear across all asset classes;

historic global body liquidity reduction; government financial rescues; and economic conditions and outlook.

Extreme Fear – Volatility – All Asset Classes

The challenge in investing is responding to asset valuation changes. Risk tolerance was significantly stressed in October. All asset classes lost extraordinary value in a 6 week period. The magnitude of the drop in valuations is unprecedented in recorded stock, bond, commodity, and currency market data. During the 6 weeks through Oct. 27, the S&P 500, which is the biggest global market, lived through 2 of its biggest 5 up days and 3 of its largest 5 percentage down days ever. The S&P 500 October drop (-17%) was exceeded only once - during the brief October 1987 crash (-22%). Table 1 records the past 6 weeks' most negative volatility (downturn) and year to date losses for 11 available asset classes.

Table 1. Asset Class Volatility and Year to Date Returns

Asset Class	Past 6 Weeks (%)	Year to Date (%)
Treasury Bond	-5	0
All U.S. Bonds	-5	-6
Muni Bonds	-12	-6
S&P 500 Stock	-28	-33
Ru2K Sm Stks	-36	-28
EAFE Stocks	-33	-43
EmergMkt Stk	-40	-49
CommodityIdx	-33	-25*
Oil	-31	-29*
Gold	-20	-14
Euro Currency	-12	-12*

*Commodities had big positive 2008 returns in July

No asset class has year to date positive returns. This is a first-time occurrence. Cash was the only effective wealth preservation strategy. The average hedge fund and Real Estate Investment Trust show year to date -19% and -38% losses, respectively. The average home lost 15% value year to date. There was no place to hide. Financing was yanked from all assets. U.S. household wealth peaked in October 2007 at \$56T. It fell to \$52T by mid September 2008 and another \$5T in the past 6 weeks to \$47T. That is a 16% cut in U.S. household net worth.

Global Body Circulation Reduced – Big Time

The global body of asset valuations, which lives on transaction liquidity flows, was reduced in an

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historic manner. Money flow; dollars, euros, yens, and all the credits denominated in a currency; is the life blood on the global economy. That flow suffered a massive censure in the past 6 weeks due to numerous factors. The cold hard facts of asset bubbles; U.S., British, and Spanish home prices; emerging market debt financing, and derivative deals; could not be sustained. Lack of transparency and complex speculation put the global body circulation on steroids while risk premiums were driven to unreasonably low levels. The falling domino situations in the U.S. financing system – Fannie Mae, Freddie Mac, sub prime loans, credit default swaps, etc. – were discussed in last month's review. The global body found very quickly during early October that other parts of the world had their own falling domino situations – emerging market loans, commodity based economic contractions, and the stresses of different European economies within the defective Euro Currency System. The high expense, expected steady return hedge funds and private speculators could not meet their client promises. When clients redeemed shares, leveraged (some at 10 times clients' investments) asset positions had to be quickly sold. Volatility reigned. The stresses are being patched up by numerous Federal Reserve Board guarantees and transfer facilities to buy short and long term debt securities from around the world, as well as similar structures through the European Central Bank, Bank of England, Bank of Japan, Bank of China, and others. There is a high bureaucratic cost to pay for capital injections to partially nationalize banks; that is controls and social engineering directives. Risk premiums will be higher than in simply regulated free societies, productivity will be lower and fewer profits will be earned by risk takers in the next few years. The circulation velocity of financing (life blood of the global body) has slower considerably.

I'm the Federal Government and am here to help!

The Federal Reserve Board added more transfer facilities to exchange liquid U.S. Treasury securities for less liquid non-collateralized loans, asset backed securities, and foreign currencies from various bank and non-bank entities within and outside the U.S. The balance sheet of the U.S. FRB has been degraded. The U.S. Treasury Bond AAA rating vulnerability can be seen in the infamous credit default swap market. The default insurance (CDS) rate for a U.S. Treasury security held for 10 years has risen to 3.9% of face value. That is more than the 3.8% 10 year

German bund rate. "Sound as the dollar" is starting to lose its 1950's ring, even though other currencies are relatively weaker. The FRB coordinated interest rate cuts with numerous developed countries and China during the month. At its Oct. 29 meeting, the Federal Open Market Committee cut the federal funds interbank rate to 1.00% (FRB to bank discount rate cut to 1.25%). The FRB has used its low interest rate stimulants. The 2001 recession cycle rate low was 1.00% and before that (in a more structured era) the 1954 recession interest rate was 1.00%. Most money market funds have at least 0.50% operating expenses. Banks and money market funds must pay more than 0.20% to their depositors or they will leave the money in checking accounts. A comparison to the Bank of Japan's 0.30% federal funds rate to justify lower FRB rates seems specious. The FRB has done a good job. It expanded the money supply with creative transfer facilities and very low interest rates to compensate for low money velocity. The FRB nearly doubled the Treasury securities or USD currency in circulation in the past 9 months. (Money X Velocity = GDP). Inflation remains in the health, education, and food part of consumer's budgets. I hope the FRB now lets the recession occur during the 4th Qtr. and 1st Qtr. and that the chairman stops approving Congressional deficit spending stimuli schemes. The FRB has a difficult monetary challenge. Fiscal policy comments are not part of its job.

Treasury Secretary Paulson got the Emergency Economic Stabilization Act of 2008 to bailout the financial industry passed on October 3 after the Senate increased its price tag to \$850B by adding \$150B for unrelated items. The act was needed to deal with the undercapitalized banks and their declining loan asset values. Time will tell if the \$700B bailout act achieves its objective without unnecessarily burdening the taxpayer.

Secretary Paulson changed direction from buying up illiquid (hard to price and purchase) mortgage derivative securities to partially nationalizing the banking industry through mandatory government purchases of large bank preferred stock and warrants. The idea is to increase large bank balance sheet equity capital and encourage them to either make more loans or buy weaker banks. Congress will no doubt continue their social engineering and make it more costly to create new mortgages and deal with defaulted mortgagees. An Oct. 17 interview of Secretary Paulson by business show host Larry Kudlow

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gave a bothersome idea of the thinking of an investment banker. Mr. Paulson did not clearly explain why government purchases of bank stocks are not nationalization, why Bear Stearns was bailed out, and why the Lehman Bros. bankruptcy (which disrupted the opaque CDS private transactions market) was condoned.

SEC Chairman Cox's testimony to the House Financial Services Committee last week was the weakest presentation by the 3 top administration financial officials. He complained about the situation, instead of proposing his plan to standardize credit default swap contracts and trade them on clearinghouse exchanges. The FRB and ECB are holding meetings to form U.S. and international exchanges. Plans are to be submitted in the next 2 weeks and a selection is to be made thereafter. It is important to openly trade a standardized CDS on a controlled exchange to reduce counter party risk ASAP, regardless of SEC or other government agency jurisdiction. The chairman also failed to discuss the extreme securities market volatility, which is scaring investors away from markets.

Fixing the Flawed Regulatory System

The new Administration and Congress will have a major test of their competence next year, when they consider and hopefully enact improvements to the financial regulatory system. During the past 95 years, including formation of the Federal Reserve Central Banking System and the Securities & Exchange Commission, the President and Congress have enacted good and bad laws. Open, transparent, and streamlined regulations are needed. Simple operating objectives and oversight are desirable. Less volatile market operations are needed. Fannie Mae and Freddie Mac social engineering of the home mortgage industry remains a big problem. Next month's markets review will analyze the challenges based on the new president's cabinet selections and statements by powerful congressional leaders.

The Economy and the Consumer

The U.S. and global economy coped with housing asset price declines and highly leveraged financial problems marginally well for the first 8½ months of 2008. Very stimulative FRB monetary policies, the \$29B Bear Stearns Corp (BSC) bailout, the \$168B Economic Stimulus Act with tax rebates to middle and poor income tax return filers, and the \$300B Housing & Recovery Act with Fannie Mae and Freddie Mac

bailout provisions were shouldered by taxpayers. The process kept the commodity bubble inflated and U.S. GDP expanding until mid September. Gustav and Ike were the 4th and 3rd costliest hurricanes in U.S. history, but preparations were acceptable and the natural disasters were handled well. Unemployment rose and investors took 10% to 15% overall stock loses, in line with three quarters of declining earnings.

Secretary Paulson's decision to let the Barclay and Bank of America negotiations to purchase Lehman Brothers fail in mid September without government involvement appears to have been the straw that broke the financial market's back. No one knows, if another event would have caused the break. But clearly, Wall Street's problems bled into Main Street. Interest rate and credit default spreads spiked up, money market stable principal funds were stressed, and the short term commercial paper rates rose. Main Street small and large business financing was impacted. Demand fell for various discretionary items. Loan screening tightened and costs rose. Consumer spending makes up nearly 70% of the economy. It fell in the 3rd Qtr. **Caution and fear are on people's minds.** Personal savings rose from 0.8% in August to 1.3% in September. Home Equity Loans dropped from \$100B in the 3rd Qtr. 2007 to an estimated \$0 in the 3rd Qtr. 2008. Non-cash portfolio 3rd Qtr. 401K statements showed sizeable losses. Layoff plans increased. All corporate financial statement guidance is cautious. The 4th Qtr. 2008 GDP decline will likely be more than 2.5%.

Is there any good economic news?

It is too soon to make an informed guess. Next month, in addition to considering the new administration and congress' regulatory plan, potential fiscal policies will be discussed. The 3 month London Interbank loan rate (LIBOR) did fall in the last 2 weeks from 4.8% to 3.0%. That implies that banks are making more loans to each other. Based on the U.S. 1.00% fed funds rate and other global factors, a LIBOR of less than 2.0% will imply that short term financing is priced consistent with the stimulative monetary policy. Yet, central banks do not control long term bond and mortgage interest rates. The debt supply, demand, and inflation most impact long rates. The 30 year fixed mortgage rates above 6.2% are expensive. Rates will need to come down or more government bailout financing will be done to increase regular home sales and other types of long term financing.

Corporate Profits Continue to Slow

The major bank partial nationalization bailout increased bank capital and solvency. Stronger banks are encouraged to purchase weak banks (e.g. Wells Fargo purchasing Wachovia). Banks must still strengthen their capital structure through sales of deficient assets and new equity. Non financial sector corporate cash flows have been stressed by high commercial paper (CP) rates until the FRB started buying CP. The 3rd Qtr. profits are calculated to be below (-11%) 3rd Qtr. 2007 levels. I expect the 4th Qtr. 2008 to 4th Qtr. 2007 non financial S&P 500 earnings comps to be slightly negative, although the huge 4th Qtr. 2007 bank write downs will cause total earnings including the financial sector to look positive. Thereafter fiscal policy by the new Congress and President will impact the 2nd Qtr. 2009 (similar to the 2nd Qtr. 2001) consumer consumption, corporate outlooks, and profits.

Financial Analyst forecasts are still high.

The current analysts' forecast revision ratio is about 5:1 downgrades/upgrades in 2008 and about 8:1 in 2009. Analysts are scampering to reflect corporate cautious guidance. The expected 20+% total operating earnings growth in 2009 is still optimistic. Zacks calculated that S&P 500 profits fell 13%, 17%, and 11% in the 1st Qtr., 2nd Qtr., and 3rd Qtr. 2008, respectively. Currently, the S&P 500 trades at 13 times 2008 earnings. If 2009 earnings equal 2008 earnings, then the S&P 500 companies' index now trades at about 13 times 2009 earnings. Based on the conservative earnings expectation, there is a limited (optimistically 25%) 2009 S&P 500 peak recovery (1200) potential. Profit margins continue to be squeezed by finance expenses and weak consumer demand in various industries.

During past recessions earnings fell for about 3 consecutive quarters. This time they will fall for a longer period; perhaps 5 or 6 quarters. The economy will show earnings declines due to weak consumer spending. The credit crisis (financial industry instability) may end in the spring. However, consumer balance sheets and spending will recover slowly. The FRB policy to promote growth or control late 2009 inflation will be the key to 2009 earnings.

Foreign Economies

Developed economies are poised for no growth in 2008 and 2009, while emerging economies show less than past expected growth according to the *Economist*.

Table 2. Economic Forecasts

Economic Market	2008 GDP	2009 GDP	2008 CPI
United States	0.9	0.2	4.2
Japan	1.0	0.4	1.8
China	9.7	8.0	6.4
Great Britain	1.0	-0.1	3.7
Euro Common Mkt ECM	1.1	0.3	3.5
Russia	7.3	6.0	14.0
India	7.4	6.8	7.5
Brazil	4.5	3.2	6.0

All developed economy GDP growth forecasts are below 1.0% in 2009 after big recent changes. Most developed economies slipped into a 3rd Qtr. initial recession period. A global developed economies 1st Half 2009 recession is probable.

In Table 3 the U.S. positively sloped yield curve continues to be the most stimulative monetary policy. The aggregate global monetary policy will likely slow GDP growth in 2009.

Table 3. Current Global Yields

Economic Market	3 month	10 Year
United States	1.4	3.96
Japan	0.8	1.4
China	4.1	3.3
Great Britain	5.5	4.3
Euro Common Mkt ECM	5.0	3.9
Russia	10.5	7.9
India	8.5	8.5
Brazil	12.9	6.1

Economic Sectors and Investment Outlooks

A Technical Overview (BPNYSE, etc) indicates market demand is above supply for U.S. stocks. Hedge funds (\$50B), mutual funds (\$50B), and private funds were redeemed in both September and October. That left investment cash on the sideline (5.0% estimated mutual fund cash held). Alternatively, the extreme volatility will likely keep much cash parked out of the line of fire. Key developed country stock indices are about 50% below the Oct. 2007 peaks. Money supply growth and very bearish sentiment indicators are potential demand indicators. **Suggestion: Cautiously hold current positions in a nervous market.** Bear markets are currently in place. Yet, the intermediate path of least market dynamic resistance appears up. Sector price relative strength (RS) shows no particular sector demand. Stock demand favors the value style. Also foreign equity securities denominated in the USD are very weak due to the combination of

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their weak currencies and poor earnings outlooks.

Economic Sector Analysis and Outlook

The **Utility** Sector reported weak earnings in the 3rd Qtr.; however, problems may have been due to recent short term financing issues. The RS is better than the general market and dividends are around 4% (at Treasury bond rates.) Late customer payments may become an issue. All things considered, normal portfolio asset allocation weights are suggested. Demand for dividend paying **Telecom** sector stocks is below normal in a recessionary economy. Hold current positions, but no new buys, is suggested. The **Consumer Staples** sector 3rd Qtr. earnings growth and 2008 earnings growth outlook is stable with positive RS. Demand for this defensive sector is normal and price increases continue as people keep on eating and buying cosmetics in a recession. A portfolio over weight position is suggested. **Healthcare** sector 3rd Qtr. 2008 earnings are in the single digit range, but biotech and medical products industry earnings are causing an overall positive RS. They are vulnerable to investor uncertainties concerning added regulations after the election. Yet, I anxiously hold a slight overweight in this sector. **Technology** Sector 3rd Qtr. reports are mixed with any growth company negative surprise being treated to a trip to the woodshed (major selling). The relatively high P/E tech stocks are vulnerable in nervous markets. The **Energy** sector delivered good earnings growth with oil above \$140 per barrel, but RS has turned very negative when oil fell to \$62 recently. Below market neutral portfolio allocation is suggested for this commodity sector, although Energy sector fundamentals will be good if the price of oil settles at \$85 per barrel in the spring. The cyclical **Materials** sector is performing with negative RS, while earnings are a bit below normal. A below normal portfolio weight is suggested. **Industrial** sector export (and earnings) to developing countries is slowing. 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. Below normal portfolio weights are suggested, unless you have specific company insights. The Financial Services sector was the worst performing area of the U.S. stock market in 2007 and 2008. Write downs of bank debt securities continue and caution is prudent. The insurance companies suffered losses due to their own

portfolio valuations. But, low interest rates and numerous FRB bailout asset transfer facilities will increase profit margins for banks and other financial industries. **Financial Sector portfolio equal weights are now suggested**, especially regional banks which avoided eating the toxic higher yield mortgage security fruits. Yet be prepared for continued volatility. **Economic sector earnings are weak in total and portfolio suggestions are cautious.** Conversely stocks are about 20% less expensive than last month. Warren Buffett is probably correct to suggest buying now, when there is blood in the vicinity of Wall and Broad Street. There is liquidity to demand stock prices higher. **Summary:** hold current positions; if you were smart enough to be holding cash, buy in the suggested sectors with money not needed for consumption in the next 5 years. Be aware of and expect market volatility.

International Markets Are Very Vulnerable

Foreign stock markets fell 20% in October, while the USD (1.27 Euro) exchange rates improved about 10%. New developed economy stock buys are not suggested. If foreign banks cut interest rates, the USD may recover more and act as a headwind for foreign stock returns. Emerging market stocks are very volatile. Normal weights may be considered only if you have the capacity to withstand a very large decline (-23% in Oct.)

Fixed Income - Less Volatile

U.S. Treasury bond total 2008 returns (0%) and overall investment bond returns were marginally weak in October. Money is flooding out of stock funds to money market funds in 2008. A small portfolio weight in a TIPS fund is suggested with the expectation that total returns will not lose value in 2008.

Alternative Investments – Diversification

The Real Estate Investment Trusts (REITs) index hemorrhaged 30% in October due to short term financing concerns and a large company solvency problem. Wait for more information prior to buying REITs. Gold funds are diversifiers, but declining 2008 inflation and financing issues are pressuring the price of gold lower. Normal alternative asset 5% gold fund weights appear reasonable, but no new buys are currently suggested. At the moment they are as volatile, as every other asset class.

Portfolio Management

Funds have some (5.0%) cash to boost stock or bond prices higher. The S&P 500 index is trading at about a 13 times trailing 2008 PE ratio. Normally, a reciprocal 7.7% earnings yield is favorable to the current 6.8% corporate “A” rated bond yield. Holding an 88% invested portfolio is suggested.

Current portfolio themes are:

Neutral – Underweight foreign developed stocks

- All U.S. stock caps funds normal weight
- Foreign EAFE funds below normal weights; Emerging stock funds below normal wts.
- Fixed income – TIPS preferred
- Hold stocks in suggested sectors

Disclosure: Personal holdings: **52%** Domestic & International Large Cap stock funds, **39%** Small/ Mid Cap funds, **9%** cash (19% Total International funds)
 Changed weights in **bold**

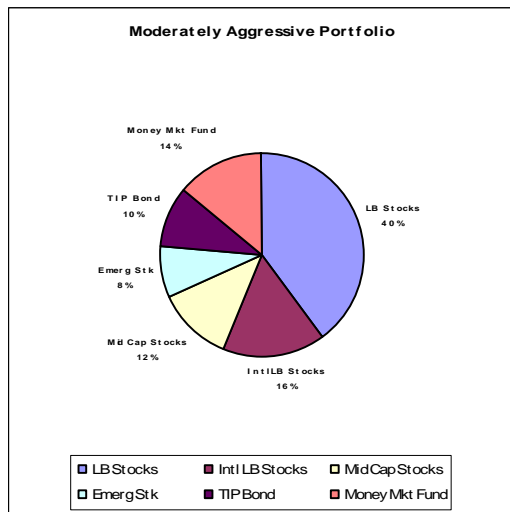
**Sample Portfolios are models
 Not Client Recommendations**

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
- 16% Large Blend International Fund
- 12% Mid or Small Cap Stock Fund
- 8% Emerging Market Stock Fund
- 10% TIP Bonds
- 14% Money market cash

Neutral Capital Allocation –

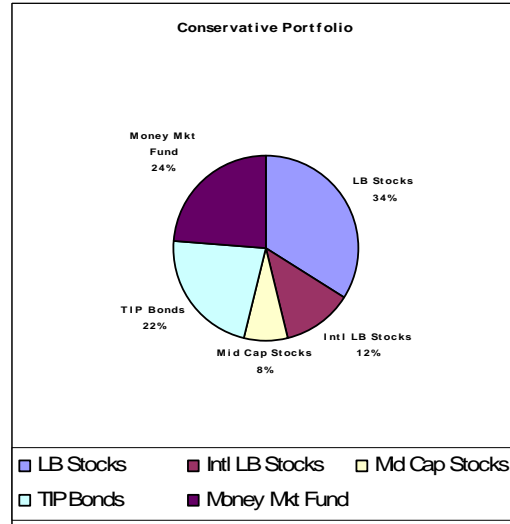


Sample Portfolio B - Conservative

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
- 22% TIPS Bonds
- 24% Money market cash

Capital Preservation –



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

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