

BWMInvestment
Guidance**October 2010 Financial Markets Review**
U.S. citizens vote for political change again!**Key Points**

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| • 2010 Year to date Total Returns | |
| S&P 500 (1183) | 7½%; |
| US 10Yr Bond (2.61%) | 12%; |
| NASDAQ (2507) | 10½%; |
| Foreign (EAFE) Stocks | 4% |
| • U.S. GDP expected expansion = 2.6% | |
| • 2010 earnings expected increase = 42% | |
| • Stock market small upward bias | |
| • Jobless abnormal economic recovery | |

Executive Summary

Equity markets (NASDAQ +6%, S&P 500 +4%, EFA +5%) October returns continued the positive trend in the midst of very good 3rd Qtr. earnings reports and weak estimated U.S. GDP (2%) growth. Financial analysts' 2010 earnings forecasts grew stronger (42%) with 2011 normal expected gains (10%). The Federal Reserve Board preparation for more Quantitative Easing (QE2 printing money and buying U.S. Treasury securities) and U.S. citizens voting to return to split government (Republican House of Representatives and more Republican Senators to balance the Democratic President Obama Administration) influenced investor demand. They were the primary issues in October. There are a number of constructive proposals that the new 112th Congress can make regarding federal spending, regulations, taxes, and trade policy.

A paradox continues between the large year to date rise (24%) in the price of gold and FRB Chairman Bernanke's publicized concern about a lower than desired rate of inflation. This monthly review considers the relationship between fairly valued U.S. stocks, richly valued bonds, and the possibility of somewhat better than expected 2011 U.S. GDP growth (2.4% per *Economist*) within the scenario of QE2 and the Republican *Pledge to America*.

Themes

- **Good earnings reports; fairly valued stocks**
- **Expected impact of Quantitative Easing**
- **Will greater Republican Congressional Influence support an improved economy?**

Good earnings reports; fairly valued stocks

Approximately 70% of S&P 500 large U.S. corporations released 3rd Qtr. financial reports to date. An analysis of data provided by Zacks Research shows median earnings about 5% above forecasts and about a 9:2 positive surprise ratio versus normal median earnings 3% above forecasts and a 3:1 positive ratio. After two quarters of above forecast earnings, a third sequential quarter of strong earnings has boosted the total forecasted 2010 earnings forecast to 42% above 2009. The large company earnings growth is extraordinary considering estimated sub-normal 3rd Qtr. (2.0%) and total 2010 (2.6%) forecasted U.S. GDP growth. Corporations are cautiously weighing the cost and impact of the Patients Protection and Affordable Care Act (PPACA Healthcare Reform/Control) and Dodd Frank Wall Street Reform and Consumer Protection Act. Employee total benefit costs remain uncertain until federal agencies define and implement the reform laws. Capital expenditures are for computer, communication, and software productivity enhancement products. Factory capacity utilization remains at 74.7%; that is 6% below the long term average. There is limited need for industrial or commercial construction. Yet, the cost of financing is extremely low. Profit margins are high and may go higher in the midst of a monetary policy focused on expanding the liquidity bubble and devaluing the U.S. currency.

S&P 500 blue chip company sales growth and profit margins provide an insight into high earnings growth rates. The expected 2010 blue chip 5% nominal sales growth is in a 1.1% inflation environment with federal government growth, small business stagnation, and slight state/local government shrinkage. The expected 2011 S&P 500 corporation sales growth is 6%. Net profit margins are expected to increase from 6.4% (2009) to 8.7% (2010) and 9.0% (2011.) Normal NPMs are between 5% and 6%. If the NPMs are achieved, the forecasted 2011 additional 10% earnings growth is possible. Yet remain aware that a liquidity bubble of nearly free financing administered by the FRB is making this scenario possible. There will come a time; possibly within 6 to 12 months when bond owners will anticipate inflation even more so than gold (priced in USD) owners anticipate it. The interest rate on U.S. Treasury debt will rise and all other finance costs will follow. Cautiously enjoy the asset inflation party, while it lasts.

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Net profit margins and P/E ratios

Net profit margins and related Price/Earnings ratios are a good way to consider if equities are valued fairly in the intermediate and long term. (Euphoria and panic is always possible in the short term, which makes investing interesting in the midst of opportunities and risks.) Computers and Technology show the highest NPMs at 15.7% (2010) and 15.4% (2011) according to the Zacks database. Finance is the 2nd highest NPM sector, although its business is based primarily on the spread between its borrowing and lending rates. Thus, many people consider the Financial Sector to be a separate, unpredictable area to analyze. Business Services NPMs 12.0% (2010) and 12.3% (2011) and Consumer Staples 10.4% (2010) and 11.1% (2011) are generally thought of as highly profitable sectors. The Construction sub-sector 1.8% (2010) and 3.0% (2011) NPMs show the least profitable sector during this low commercial and residential building period.

As expected Tech P/E ratios of 16.5 (2010) and 14.7 (2011) are higher than others with Business Services at 18.0 (2010) and 14.5 (2011) and Consumer Staples at 15.7 (2010) and 14.0 (2011) closely following. The total S&P 500 P/E ratios of 14.4 (2010) and 13.1 (2011) are essentially at their long term current year average of 14.7. Total S&P 500 NPMs are far above average, while financing costs are far below average. ***The conclusion is that U.S. equities are fairly priced.*** Yet, when financing charges increase in the midst of inflation above the 3% to 4% range, it will be prudent to sell some equities. NPMs will likely fall and earnings will stop increasing. That may be at about 10% higher U.S. stock market prices in six months. Time will tell. However, it is wise not to greedily expect 25% higher U.S. stock market prices in 12 months.

Expected impact of Quantitative Easing (QE2)

The FRB led by Chairman Bernanke has been lecturing about an anticipated move to print money and purchase large quantities of U.S. Treasury securities (QE2). The idea is to flood the market place with more liquidity, effectively set a floor under housing asset prices, and spur the economy to higher job creation. The initiative is based on an understanding of the FRB's dual goal to control a stable currency (price stability) and promote full employment. Chairman Bernanke's view is that the full employment goal supports a mission of fiscal policy initiatives. The issue is that QE1 did not spur corporations to draw down their cash

positions in an uncertain climate and there is little assurance that QE2 will do any more. Members of the FRB, such as Kansas City FRB Governor Hoenig and others are questioning the FRB's ability to improve conditions with QE2 and similarly its ability to remove QE2 in a manner that does not harm the economy. The FRB decided at its Nov. 3rd Federal Open Market Committee meeting to print dollars and purchase \$600B longer term Treasury securities by the end of the 2nd Qtr. 2011 at a monthly rate of about \$75B, unless the new QE2 program is adjusted.

QE2 is a different type of initiative than TARP. The Troubled Asset Relief Program was initiated in the heat of a financial upheaval after Fannie Mae and Freddie Mac were moved into receivership (in effect bankrupt), AIG was technically bankrupt, and Lehman Brothers was formally bankrupt. Chairman Bernanke, Treasury Secretary Paulson, and FRB New York Governor Geithner were in uncharted waters and didn't know whether recapitalization by purchasing bank equity positions or purchasing their junk toxic assets was the best approach. Many political games were played with TARP funds. Yet at that time of a massive financial breakdown it was necessary in my view. QE1 was initiated in conjunction with TARP. The flow of money supported bank balance sheets and made financing cheap for everything from mortgages to corporate debt extremely cheap. It is not clear based on thorough analysis that QE1 provided real support to the general economy.

Some former FRB governors have suggested that Congress should change the FRB goals to keep it out of fiscal policy making. A change of goals from price stability and full employment to price stability and avoidance of asset price bubbles has been offered as an improvement that would have significantly reduced the risk of tech stock price bubbles in the 2nd Half 1999 and housing price bubbles in the 1st Half 2005. Since the FRB has no data to support the virtue of QE2, we can only hope that it does no more harm than devaluing the U.S. currency relative to gold and other government fiat money and currency.

Will greater Republican Congressional Influence support an improved economy?

The turn of popularity of President Obama's vision and performance in 2 years was reflected in mid-term Congressional elections. He concentrated on achieving an ideologically divisive PPACA Healthcare Reform with

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questionable tactics and a near super majority Democratic support over unanimous Republican opposition during a tortuous 10 month period. American voters, most importantly the independent citizens, noticed the uncertainty caused by the reform. The President also did not recognize that there is a difference between focused fiscal stimulus on private sector employment, when an economy is emerging from a financial near meltdown, and spreading nearly \$800B around to political supporters. The T³ talking points of timely, targeted, and temporary described a program of temporary lower and some middle class tax rebates, state/local government aid, and so called shovel ready projects. There has been only one limited study, *How the Great Recession Was Brought to an End*¹, by Democratic advisor, Alan Blinder, and both McCain and Obama political advisor, Mark Zandi, that I am aware of. It justifies both the TARP and the American Recovery and Reinvestment Act, but did not consider a simple private sector focused permanent corporate or individual tax cut stimulus. The study has been criticized by various scholars. Voters felt that the current 9.6% official unemployment (17% under-employment) resulted from poor economic policy. An analysis of the response of countries around the world is also sobering. Germany and other countries did not implement any fiscal stimulus in response to the great recession. Their unemployment rates are lower and GDP growth rates are higher than the U.S. rates. The added uncertainty caused by President Obama in conjunction with Congress was to postpone any votes on extending all or part of the Jobs & Growth Tax Relief Reconciliation Act of 2003 (Bush Tax Cuts) until after the November election. The economy (high unemployment) and over reaching by President Obama to achieve his reform/control goals were primary issues for citizen voters.

Will the Republican House of Representatives legislate in a civil, disciplined manner? We do not know yet how the Republicans will organize themselves. President Obama holds the veto pen. The deliberate pace of a smaller majority Democrat vs. Republican split Senate will mean that only smaller bipartisan bills will be sent to the President for his approval into law.

As mentioned last month, Darrell Issa, House Oversight and Government Reform Committee chairman, will have the subpoena power to call hearings on questionable government agency

actions. If he maintains focus on reining in agency actions that appear to exceed laws, the vast increase in regulations over the past few years may be slowed to a more measured pace. Curbing politically motivated regulations would reduce uncertainty; especially for overwhelmed small businesses, who take the majority of risks while hiring new employees.

Good-natured Paul Ryan will be Chairman of the Budget Committee. The committee will be especially important in the current period of runaway government spending. He may not address all the entitlement issues discussed in his *A Roadmap for America's Future*. Yet, he is willing to discuss his views openly.

In last month's review, I commented that Jerry Lewis is the likely chairman of the powerful Appropriation Committee. Republicans must waive their term limit rules in order for Lewis to head that committee. Harold Rogers, another earmark spender, is the next senior candidate to possibly lead the committee.

There are areas, where Republicans can help the President out of his ideological constraints and aid the economy. Energy, trade, tax policy, and spending are areas of possible agreement. (Changes to the President's main triumph, Healthcare Reform, may require a veto override.) Nuclear energy plants require simplified reviews, financing, and a place to store recycled fuel. The President's rhetoric to stimulate the industry can be encouraged to action by Republicans.

Trade agreements with South Korean, Columbian, and Panamanian that have sat at the President's desk for two years should be actively supported. Trade treaties increase U.S. jobs and economic growth in the long run. There is conceptual merit in Secretary Geithner's numerical trade-balance limit proposal. There is also large risk that the rigid U. S. rhetoric about Chinese currency exchange rates may encourage retaliation of protectionist trade wars.

Tax policy will be a difficult area to work with the President. Ideologically, he is focused on spreading wealth and raising taxes on those, who he considers have enough. The President wants higher tax rates for high income earners (\$200,000) and households (\$250,000) in 2011. Suggested compromises are creating a new \$1,000,000 tax bracket at the top Clinton era tax rate with extension of Bush era tax rates or extending Bush era tax rates for everyone, but limit the top income rates to a 2 year period. The

President would likely prefer the first suggestion because it makes millionaires pay more and would avoid a tax rates issue in a 2012 election year. That may be the best negotiation that Republicans can achieve with President Obama. However, it should also include a freeze on federal employee hiring, salaries and overall discretionary spending as part of the agreement.

Tax policy can be addressed on the deductions and credits side, as well as the tax rate side. Simplifying tax policy with fewer deductions would benefit the government with added revenue, as well as give income earners an incentive to produce more and increase hiring as demonstrated by the Tax Reform Act of 1986.

What is the stock market telling us?

U.S. and foreign stock markets advanced more than 15% in the seasonally weak past 2 month period. They correctly anticipated mid-term election results and the FRB QE2 decision in an environment of a slowly improving economy. Market average volatility (VIX – fear factor) declined from August (24) to September (22) to October (20). A small upward stock market bias on Election Day and FRB QE2 announcement day indicates investors are comfortable with earnings, economic, monetary policy and expected fiscal policy results. A technical intermediate term positive indicator, Dow Jones Industrial Average close above the late April 11,205 high closing price confirmed by a similar DJ Transportation Index advance, occurred after the FRB meeting. Historically, conditions are good for equity market advances in the 3rd year of a presidential term. There are no guarantees. More specifically, markets are due for some selling, as capital gains are normally taken in the last 2 months of the year.

What is the economy telling us?

A so called double dip recession appears unlikely after a month of generally positive economic indicators. The Institute for Supply Management Manufacturing (56.9) and Service (54.3%) reports recently indicated steady expansion for October above forecasts. Employment indicators are slowly improving, but price indices are high (>65). The Conference Board September Leading Economic Index expanded 0.3% due primarily to financial stimulus, M2, interest spreads, and stock price advances. The Coincident Economic Index is stable. Housing starts and sales are slightly improving. If the Friday (Nov. 5) employment report confirms the

positive ADP October (43,000) private sector net new jobs report, slight employment improvement would be indicated. The Thomson Reuters/Pay Net Small Business Lending Index rose 16% in September to its highest level in 2 years. Since small businesses hire more quickly than larger corporations, small business lending is encouraging. The U. S. economy appears poised for improved employment reports and a slightly better 4th Qtr. GDP than the 3rd Qtr. GDP. My limited government biases lead me to think that the U.S. economy can recover to a higher than a forecasted 2011 GDP (2.4%) and lower than expected unemployment rate (9.5%), if the U.S. Congress holds current tax rates and limits new regulations, and the FRB forgets its QE2 plans. Freezing discretionary spending would be helpful, but business simply needs confidence that government rules are set and stable, so that they can take the risks of expansion and hiring.

Foreign Economies

Slow developed world economic growth with high unemployment and good corporate earnings growth continues. Strong emerging countries China, India, and Brazil 2010 forecasted GDP growth continues in the *Economist* based Table 1. The European Common Market, especially Germany, is reducing budget deficits and increasing exports more the U.S.

India has the largest inflation problem.

Table 1. Economic Forecasts

Economic Market	2010 GDP	2011 GDP	2010 Unemployed
United States	2.6	2.4	9.6
Japan	2.9	1.4	5.1
China	9.9	8.6	9.6
Great Britain	1.5	1.8	7.7
Euro Common Mkt	1.5	1.3	10.0
Germany	3.3	1.9	7.5
Russia	4.2	4.0	6.6
India	8.4	8.6	10.0
Brazil	7.5	4.5	6.7

The total 2010 global economy is expanding (4.0%) with Asia leading the way. In Table 2 the U.S. positively sloped yield curve shows a more stimulative monetary policy than other central banks. The U.S. FRB plans low (0 – ¼%) bank borrowing rates for an extended period in a very modest GDP growth, high unemployment scenario. U.S. monetary policy, primarily TARP, was more effective than U.S. fiscal stimulus policy during the past 2 years.

Table 2. Current Global Yields

Economic Market	3 month	10 Year
United States	0.2	2.6
Japan	0.2	0.9
China	2.7	3.0
Great Britain	0.8	3.1
Euro Common Market	1.0	2.4
Russia	7.6	5.3
India	6.5	8.2
Brazil	10.7	6.2

Economic Sectors

Technical relative strength shows U.S. and foreign stock prices advanced with a stable USD/euro exchange rate in October. Materials Sector 3rd Qtr. earnings grew similar to the S&P 500 Index with positive relative strength (RS) compared to the 4% October S&P 500 advance. No suggestion. Energy Sector earnings lagged the S&P 500, although there were more positive earnings surprises and the RS was positive. Consider dividend paying assets. Financial Sector earnings exceeded the S&P 500, but positive earnings surprises and RS lagged. Avoid Financials. Industrial Sector earnings and positive surprises beat the S&P 500 and RS matched the S&P 500. Hold. Technology Sector earnings, earnings surprises, and RS exceeded the S&P 500. They are extended in price. Suggested Hold or take partial capital gains profits. The Consumer Staples earnings, positive earnings surprises, and RS lagged the S&P 500. Hold dividend paying stocks. Utility Sector Stocks earnings lagged behind the S&P 500 and the RS was weak. No suggestion. Healthcare stock earnings lagged the S&P 500 and RS was weak. No suggestion. Consumer Discretionary stock earnings varied with overall positive RS vs. the S&P 500. Hold selectively. Treasury Bonds (-1%) under performed stocks in October and will be controlled by FRB QE2 manipulation. They appear overpriced. Gold (5%) outperformed S&P 500 average stocks slightly in October. Hold.

Suggestion: Hold normal portfolio asset weights, but shorten bond durations (maturities). Stock market psychology is positively biased, but prices are extended. A November tax rate extension deal is possible. Although stocks have technical support and liquidity is cheap, capital gains selling may be appropriate for portfolio allocation to less risky assets. Markets appear fairly and fully valued.

Alternative Investments – Diversification

The Real Estate Investment Trusts (REITs) index rose in October similar to the S&P 500. Well informed partnerships and energy MLPs may be effective ways to profit from income producing real assets. Gold funds are diversifiers. A 5% weight in a direct gold exchange traded fund (GLD) (24% YTD) is suggested.

Reference

¹Blinder, Alan and Zandi, Mark *How the Great Recession Was Brought to an End*, July 27, 2010

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
- Fixed income – TIPS and short term notes
- Gold – Normal (5%) Positions

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

**Sample Portfolios are models
Not Client Recommendations**

Sample Portfolio A - **Moderately Aggressive**

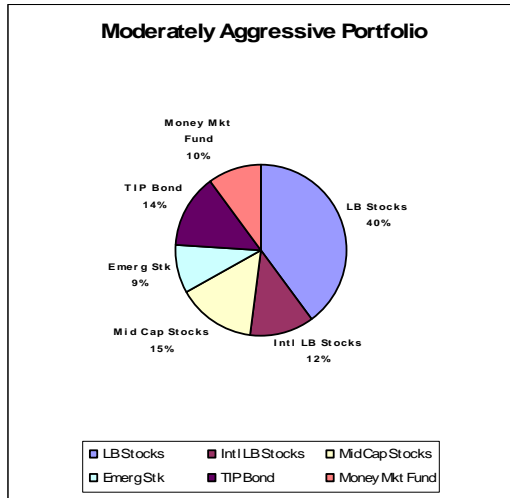
Example 45 year old college educated parents with 1 high school child and 1 college child.

- 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

If I buy, hold, or sell securities discussed herein, then I will disclose my positions. Prices shown are approximate.
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Normal Capital Accumulation –

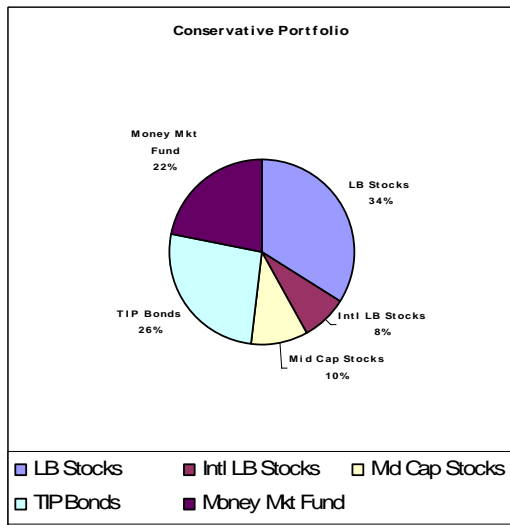


Sample Portfolio B - Conservative

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 –



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