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BWM

Investment
Guidance

Third Quarter 2008 Markets Review *Chaotic Credit Markets September to Remember*

Key Points

Executive Overview

Equity markets cratered notably (S&P 500 -8.8%) on the last Monday of the 3rd Qtr. after the surprising House defeat of a massive financial system bad debt bailout bill. During the 3rd Qtr. the S&P 500, NASDAQ, and foreign (EAFE) equity markets fell 7.5%, 8.2%, and 15.2%, each. The Bear Stock Market may be near an intermediate term bottom due to massive financial system bailouts and related improved liquidity. All asset classes remain volatile. Oil retreated 30% from \$143 to \$101 per barrel in spite of Hurricane Gustav and Ike disruptions in the Gulf Coast and uncertainties caused by the Russian invasion of Georgia and annexation of its South Ossetia and Abkhazia provinces. Gold prices jumped around and settled down at \$851 per ounce. The U.S. dollar (USD) exchange rate with the Euro and most major currencies improved 8% during the 3rd Qtr. to no change in 2008. Economic data indicates the 3rd Qtr. GDP weakened with above normal inflation. The near normal 2nd Qtr. (2.8%) GDP was due to a tax rebate stimulus act. The Fannie Mae and Freddie Mac bailouts and the dramatic reshaping of the investment banking industry will be reviewed at length. Real consumption and corporate profits continue to fall. Zacks calculated S&P 500 companies 2nd Qtr. 2008 total reported net earnings fell 17% after falling 14% in the 1st Qtr. Earnings have disappointed investors for the past 3 quarters and are further analyzed. Market themes, the economy, and market sectors are discussed to suggest portfolio strategies to remain alert during the nervous recession period bear market.

Themes

Current investment markets themes are: chaotic credit market deleveraging and a long period of below normal U.S. economic and profit growth.

It's About Trust, Stupid!

To paraphrase advisor James Carville's winning slogan for President Clinton's 1992 election campaign, the focus is now on trust more so than simply the economy. Borrowers and lenders are cautiously assessing transaction risks and holding extraordinary reserves. The lack of trust means higher financing costs along the term structure line from the short term Treasury to Euro (TED) spreads and commercial paper rates to various longer term inferior debt securities. Everyone using credit financing is affected.

The banking system predicament is reviewed prior to discussing expectations. It is a fragile, leveraged structure and when the dominoes start falling, the system can quickly go into uncharted waters. Events during the past year set the stage for the past chaotic month. The September events exposed many losers and a few possible winners. The future financial industry will be less leveraged. Details such as the credit default swap (CDS) market, the accounting asset mark to market accounting rule, and shorting, are discussed to complete the picture. Finally the Treasury Dept., Federal Reserve Board, and Securities & Exchange Commission performance are appraised, and expectations are discussed.

The banking system by its nature faces systemic risk because it doesn't simply hold customer deposits, which can be called back on demand at the ATM. It lends out the deposits, as well as a lot of borrowed debt. The FRB sets the total capital to shareholder's equity ratio (currently about 12:1) that a bank can leverage (fractional reserves requirement). At about 11 parts debt and 1 part equity capital structure, a bank can not afford to make many bad loans (assets). When mortgage and other loan asset values are written down on the left side of the balance sheet, equity must be written down on the right side. When equity is written down, the capital ratio increases until more equity is sold to get back within requirements. A significant distrustful customer run to demand deposits can quickly cause the bank to be judged insolvent by the regulator.

That is what happened to Washington Mutual on Sept. 25. More specifically, the WaMu credit rating was downgraded on Sept. 15. During the

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following 10 days customers withdrew \$16.7B and the Office of Thrift Supervision determined it was insolvent. The OTS put WaMu under Federal Deposit Insurance Corp receivership. On June 30 WaMu assets were listed as \$307B. Most of WaMu assets and liabilities were sold to J. P. Morgan Chase on Sept. 25 evening for \$1.9B. That is the primary way the OTS and FDIC handle large bank failures, while insuring that deposits up to \$100,000 are fully covered.

In addition to the leverage issue, the other banking systemic risk is the mismatch between borrowing short term and loaning long term funds. Banks earn a profit on the spread between borrowed and lent funds. When they make too many bad (late payment or foreclosed subprime, Alt-A, etc.) loans, the leveraging risk turns into a solvency problem. In contrast, a properly operating insurance or fully funded pension plan does not have this problem. It matches the outflow obligations each year with the assets, expected returns, and a contingency reserve for poor asset returns. Other industries do not normally have banking leverage and mismatch risks. The special problem of insurer American International Group (AIG) will be explained.

The tip of the credit crisis iceberg popped up in August 2007 after a pair of Bear Stearns hedge funds failed and the FRB cut the bank lending rate by ½ point. In late October, various banks and brokers reported huge losses and asset write downs as equity markets hit peak levels. In January the largest monoline insurers (MBIA and Ambac), which guarantee municipal bonds against defaults, were downgraded due to problems in the questionable counterparty CDS market. The FRB bailed out investment bank Bear Stearns in March by guaranteeing bad assets and engineering the sale of BSC to J. P. Morgan Chase. The key issue involved the CDS over-the-counter private market (nonstandard contracts without a clearinghouse). The key July event was legislation permitting the Treasury Dept. to use taxpayer money to bailout government sponsored enterprises, Fannie Mae and Freddie Mac. Treasury Secretary Paulson's infamous quote on July 15 to the Senate Banking Committee "If you have a bazooka in your hand and people know it, you probably won't have to use it" will be remembered by many taxpayer. Less than 2 months later on Sept. 7 the bazooka was used. Fannie and Freddie were effectively bankrupt and bailed out under the Federal Housing Finance Agency conservatorship.

Beginning in August, 2007 the FRB slashed interest rates from 5¼% to 2% within 10 months. It also provided various creative vehicles to inject money into both the regulated banks and unregulated investment banks, as well as transfer (purchase) debt and equity securities from banks to the FRB. By some calculations the FRB has made \$1.4T creative loans in the past 14 months.

The reshaping of the Investment Banking industry, bailout of Fannie and Freddie, bailout of insurer AIG, money market fund insurance, and enormous failed agreement at a \$700B bailout of the remaining bank bad debt through the Treasury Dept. took place in a *September To Remember!* At the beginning of 2008, five major investment banks (IB's) (Goldman Sachs, Morgan Stanley, Merrill Lynch, Bear Stearns, and Lehman Brothers) existed. The IB's had the opportunity for higher leverage than normal banks, because they didn't directly access the FRB money machine and were less regulated. In fact, regulators effectively allowed them to increase leverage to about 30:1 in 2004. A number of short term security vehicles allowed IB's to raise money at rates near the FRB rates.

BSC was bailed out by the FRB and purchased by JPM in March. The remaining 4 IB's attempted to sell equity blocks globally to increase capital and return to capital leverage requirements. John Thane led Merrill Lynch for 8 months and effectively saved the franchise by methodically raising capital to try to return the 40:1 capital ratio back into requirements and promptly sold the company to Bank of America on Sept. 15. Richard Fuld in contrast tried unsuccessfully to sell Lehman Bros. equity to a South Korean group. He could not close the deal and was at the mercy of Secretary Paulson. There may have been personal issues between Paulson, the former Goldman Sachs CEO, and Fuld. In any case, Lehman Bros. was the only major IB allowed to fail and file for Chapter 11 bankruptcy on Sept. 15. The markets assessed the impact of marking down short term LEH debt and a major money market (stable principal) fund (Reserve Prime) asset share value briefly broke below \$1.00. Putnam followed by closing 2 money market funds to escape short term debt solvency risk. A federal money market insurance plan was initiated. Two IB's, the famed Goldman Sachs and Morgan Stanley carefully made equity sales and the FRB granted them a change from lightly regulated IB's to fully regulated holding company banks. Direct

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lines of credit at the low FRB rates were accessed in trade for the added FRB regulations, lower capital ratios, and likely lower future profits. The Oracle of Omaha, Warren Buffet, purchased a preferred equity and options stake (a vote of confidence) in Goldman Sachs. Within 6 months the highly leveraged, very profitable IB business model vanished.

Outside of the direct banking industry, the huge insurer, AIG, over extended itself in writing credit default swaps that could not be covered after Lehman Bros. failed and default swap values rose. The potential collateral damage of its failure was considered too complex and unknown by the Treasury Dept. Secretary Paulson charged a high interest rate for an \$85B bridge loan, the installation of a former Goldman Sachs executive as AIG CEO, and an 80% equity share of AIG. The taxpayer will likely not lose money on that bailout, as AIG sells businesses, the CDS market shrinks, and AIG emerges from Treasury Dept. oversight in about 4 to 6 months.

The failure of the House of Representative to pass the \$700B banking system bailout (rescue) Emergency Economic Stabilization Act of 2008 on Sept. 29 was a big surprise to leadership and markets. Partisan issues between the House Speaker and Minority Leader may have resulted in only 205 votes for the bill with 228 against. Neither party brought enough votes to the table in an atmosphere of record low ratings for the President and Congress. I read the 110 page draft document and concluded that it lacked proper accounting (a balance sheet) to clearly show cash flows and profits or losses of purchased and sold assets on a quarterly basis. The bill called for \$700,000,000 of taxpayer funds and increased the debt ceiling by \$1,300,000,000. Neither the bill nor its justification were fully explained by the Treasury Secretary or other involved parties involved. I expect a similar bill to pass within a week or so. Main Street has no trust in the government, but the major Sept. 29 market drop will likely get the legislature and president to enact the rescue plan.

A few related issues are worth review. Short term markets are seriously strained. Large corporations issue commercial paper (credit) for financing. The most creditable companies are currently paying between 2.0% and 3.0% above the federal funds rate, instead of the normal 0.5%. More important, smaller less creditworthy businesses are not able to get expansion credit.

The CDS market is shrinking while the cost for credit default insurance is rising. The lack of visibility or transparency is an area where trust is lacking. An accounting concept referred to as "mark to market" is objected to as part of the problem for banks trying to hold required capital. Financial Accounting Standard 157 requires securities that are planned to be held less than 1 year to be valued at an estimated market price on quarterly statements. Securities that are planned to be held more than one year may be listed at historic prices less applicable depreciation. FAS 157 reflects good accounting principles. The defeated bailout bill Section 133 calls on the SEC to study the impact of doing away with the concept. This is the dangerous idea, if it does not set rules for non-market valuations. If assets held for short term trading are listed at historical prices, the balance sheet does not accurately reflect market value for their intended purpose.

Performance Ratings: C, C, C

In the jargon of sports the FRB, Treasury, and SEC have played defense for the past year and deserve a C for effort. The FRB led credit related activities with monetary policy federal fund rate decreases (3.25%), creative transfer facilities, and various auctions to transfer higher quality Treasury assets into the economy. However, it effectively supported a weak dollar policy and added risk to the FRB balance sheet by reducing its asset holdings from 90% high quality Treasury holding in Aug. 2007 to 42% Treasury holdings currently. Future long term inflation or so called crowding out of the bond market and slow economic growth similar to the 1970's will be the result of these policies. The Treasury Dept. addressed crises promptly as discussed previously. However, plans have not been communicated well and bailouts versus market failure decisions have appeared arbitrary. Secretary Paulson did a poor job of explaining the \$700B banking industry bailout to the American taxpayer and did not work both sides of the political spectrum in trying to get the legislation passed. The SEC has also been completely on defense. Instituting directives to not short financial stocks after canceling the "no short on uptick rule" for trading in July 2007 was inconsistent. Shorting is acceptable in my view to encourage liquid market prices based on institutions playing with the same settlement rules as retail customers. However, shorting stocks on sales (down ticks) adds unnecessary volatility.

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To earn A, A, A Performance Ratings from my assessment, the players must have clear policies and go on offense to implement them before all hell breaks loose. (It did break loose!)

The FRB must implement a strong dollar policy. Specifically, understand the long term inflation impact of recently pumping massive liquidity into the economy. There will be pressure at the October FRB meeting to cut the bank lending rate from 2.00% to 1.50%. With inflation above 4% and a very stimulative lending term structure, more rate cuts or fiscal spending by the new President will not get the economy back to stable long term growth in 2009. However, lowering interest rates will tempt the FRB to leave interest too low for too long in the 2nd Half of 2009.

The Treasury Dept. led by Henry Paulson understands the economic problems. However, it does not communicate well with the taxpayers and Congress. Fannie Mae and Freddie Mac liquidity problems should have been strongly stated to Congress and pro active approaches to reduce debt expansion, instead of bailouts are appropriate. A clear legally sound bailout policy should be followed and close work with the SEC for security related economic issues is needed.

A positive offensive SEC would address the opaque CDS market; clearly justify accounting standards, and implement sound market liquidity principles. The Treasury and SEC knew the non standard CDS contracts and over the counter private market were problems with the January bond issuer rating down grades. Since the private counter parties did not self regulate, the SEC had a duty to work with Treasury and the Congress to promptly require standard clearly written credit default swap contracts that are traded on an enacted regulated clearinghouse exchange as soon as possible. A CDS exchange by March 2008 may have reduced the “don’t know the contingent damage” arguments for bailing out Bear Stearns and AIG on one hand and allowing Lehman Bros. to go bankrupt on the other hand. As previously stated, I consider the FSA 157 mark to market rule to be acceptable. Yet, the SEC should clearly communicate to the regular citizen why it is appropriate. Finally, sound market liquidity appears to argue for a return to the “short on uptick” rule and end arbitrary rules concerning not shorting specific financial or other securities.

Below Normal Future GDP Growth

Consumer net worth is falling, as home equity and other investment equity asset values decline. Real purchasing power is declining due to inflation. Unemployment is rising. A retrace to \$100 per barrel oil occurred faster than expected. Related gasoline and natural gas price retraces will help consumer purchasing power. I continue to expect higher unemployment to result in slightly negative real consumption from the fall through the spring. Deleveraging will continue as banks and other financial institutions weigh their debt valuation write downs against retained earnings on new business and new capital on their balance sheets. The relatively higher finance charges reflect risk premiums. Key components of the normal 2.8% 2nd Qtr. GDP growth were a large export increase and the tax rebate stimuli. The USD value returned to yearend 2008 levels and the tax rebates are spent. Exports and consumer spending will not boost the 3rd Qtr. and future GDP. I expect the 3rd Qtr. GDP growth to be in the sluggish 1% range and a few future declining GDP Qtrs. (recession).

Stricter loan requirements will continue to limit available financing. Yet, the various bailout acts will put a floor under home prices nationally at no more than 5% below current levels. Home building should remain at its current low level, but it is encouraging that the supply of unsold new homes is dropping.

Current U.S. Corporate Profits Slowing

Bank solvency (not liquidity) is a key concern. A number of banks must still strengthen their capital structure through sales of deficient assets and new equity. Non financial sector corporate cash flows remain better than in past economic recessions. Yet, 3rd Qtr. profits are expected to again be below (-6%) comparable 3rd Qtr. 2007 levels. I expect the 4th Qtr. 2008 to be similarly weak, although the huge 4th Qtr. 2007 bank write downs will cause a flawed comparison. Thereafter fiscal policy by the Congress and new President may impact the 2nd Qtr. 2009 (similar to the 2nd Qtr. 2001) profits.

Financial Analyst forecasts are too optimistic.

The current analysts’ forecast revision ratio is about 5:2 downgrades:upgrades in 2008 and also 5:2 in 2009. They appear to be making good near term earnings forecasts. But expected 24% total earnings growth in 2009 is too optimistic. Zacks calculated that S&P 500 profits fell 22%, 14%, and 17% in the 4th Qtr. 2007, 1st Qtr. 2008, and

2nd Qtr. 2008, respectively. The 4th Qtr. 2007 bank write offs make the 4th Qtr. 2008 35% expected profit growth comparison suspect. Profit margins continue to be squeezed by increased material and finance expenses, and weak consumer demand in various industries.

During past recessions earnings fell for about 3 consecutive quarters. This time they may fall for a longer period. The 3rd Qtr. S&P 500 earnings will likely decline. Yet, the 4th Qtr. earnings expectations are hard to judge due to Energy, Material, and Consumer Staples growth estimates. The buy outs or bankruptcies of financial corporations may also make comparisons meaningless. The economy may show earnings declines due to weak consumer spending. I expect declining S&P 500 total earnings to continue through the 1st Qtr. of 2009 (6 total quarters). That may be in line with the end of the credit crisis. The length of the economic slowdown and FRB policy to control inflation or promote growth will be the key to 2009 earnings. Total S&P 500 2008 earnings reduction forecasts are now -6%. The S&P 500 stock index is currently trading at a 2008 P/E ratio of 14 according to Zacks. The market valuations are neutral in a stagflation economy.

Foreign Economies

Developed economies are poised for below long term growth in 2008 and 2009, while emerging economies show growth with inflation issues worse than the U.S. according to the *Economist*.

Table 1. Economic Forecasts

Economic Market	2008 GDP	2009 GDP	2008 CPI
United States	1.5	1.2	4.4
Japan	1.0	0.9	1.6
China	9.8	8.5	6.7
Great Britain	1.2	0.6	3.7
Euro Common Mkt ECM	1.3	0.9	3.6
Russia	7.5	6.8	14.0
India	7.7	7.1	7.1
Brazil	4.6	3.4	6.0

All developed economy GDP growth forecasts are below 2.0%. Changes since last month forecast lower 2009 GDP growth. Most developed economies continue to grow below long term rates and to experience global credit contraction with Great Britain, Germany, and Japan slowing noticeably. A global developed economies 1st Half 2009 recession is conceivable

Some foreign government debt yield term curves are negatively sloped with short term interest rates higher than long term rates in order to slow inflation, as shown in Table 2. 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 the 4th Qtr. 2008 and 2009.

Table 2. Current Global Yields

Economic Market	3 month	10 Year
United States	1.4	3.8
Japan	0.8	1.5
China	4.3	4.3
Great Britain	5.7	4.5
Euro Common Mkt ECM	5.0	4.0
Russia	11.0	8.0
India	9.0	9.1
Brazil	12.9	6.2

Economic Sectors and Investment Outlooks

A Technical Overview (BPNYSE, etc) indicates market demand may equal supply for U.S. stocks after a possible Sept. 29 near term bottom. Key developed country stock indices touched 30% below the Oct. 2007 peak recently. Short interest positions are below August high levels (after SEC short restrictions). Money supply growth, net mutual fund cash positions (4.5%), and bearish sentiment indicators are potential demand indicators. **Suggestion: Be cautious in nervous markets.** Normal bear markets can last 18 months based on economic conditions and earnings. Sector price relative strength (RS) shows no particular sector demand. Stock demand recently favored the value style. U.S. based foreign equity securities due to a relatively less weak dollar are losing value.

Economic Sector Analysis and Outlook

Utility and Telecom Sectors are reporting slightly weak revenue, slow earnings growth as costs are passed through, and slightly weak market price RS. Demand for the defensive dividend paying **Utility and Telecom** sector stocks is below normal in a slowing economy. A normal portfolio allocation 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 a portfolio over weight is suggested. **Healthcare** sector 3rd Qtr. 2008 earnings should be in the single digit range, but biotech and medical products industry earnings are causing an overall positive RS.

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They are vulnerable to investor uncertainties concerning added regulations. Yet, I hold a slight overweight in this sector. **Technology** Sector 3rd Qtr. reports may be weak, with some big name companies issuing recent negative surprises. 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 negative when oil fell to \$101. Below market neutral portfolio allocation is suggested for this commodity sector. Energy sector fundamentals remain good. The cyclical **Materials** sector is performing with negative RS, while earnings are normal. Caution and a below normal portfolio weight is suggested. **Industrial** sector exports to developing countries may be weak and earnings growth is slowing. Below normal portfolio weights are suggested in this sector. The **Consumer Discretionary** sector remains a cyclical area. Even though RS is good Consumer Discretionary sector stock portfolio equal weighing is suggested. 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. Low interest rates will increase profit margins for banks and other financial industries late in 2008. **Financial Sector portfolio equal weights are now suggested.** Yet be prepared for continued volatility. **Economic sector earnings are weak in total and portfolio suggestions are cautious.** There is liquidity to demand stock prices higher, but negative earning surprises are also likely. **Summary:** all things considered, hold current positions. Be aware of and expect continued market volatility prior to future stock market lows around the Sept. 29 level during the next 6 months.

International Markets Are Vulnerable

Net foreign stock markets fell 16% during the 2nd Qtr., while USD (1.41 Euro) exchange rates improved about 8%. Developed economy stock under weighting is still suggested. If foreign banks raise interest rates, the USD should recover more and act as a headwind for foreign stock returns. Otherwise, if the FRB lowers U.S. interest rates, then a weak dollar policy will support foreign stock returns. Emerging economy stocks are volatile. Normal weights are reasonable, if you have the capacity to withstand a sizable decline (20% in 2nd Qtr.)

Fixed Income - Less Volatile

U.S. Treasury bond total 2008 returns (2.0%) and overall investment bond returns improved in the 2nd Qtr. Money is flowing from stock funds to bond and money market funds in 2008. A small portfolio weight in a TIPS fund is suggested with the expectation that returns will match inflation (4+ %) for 2008.

Alternative Investments – Diversification

The Real Estate Investment Trusts (REITs) index is flat year to date. Healthcare related REITs may be considered. Gold funds are diversifiers but flat as 2008 inflation and USD hedges. Normal alternative asset 5% gold fund weights appear reasonable. At the moment they are volatile.

Portfolio Management

Funds have some (4.5%) cash to boost stock or bond prices higher. The S&P 500 index is trading at about a 14 times trailing 2007 PE ratio and a 14 times forward 2008 PE ratio. Normally, a reciprocal 7.1% earnings yield is favorable to the current 6.1% 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 developed funds below normal weights; Emerging stock funds normal wts.
- Fixed income – TIPS preferred
- Hold stocks in suggested sectors

Disclosure: Personal holdings: **50%** Domestic & International Large Cap stock funds, **39%** Small/ Mid Cap funds, **11%** 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.

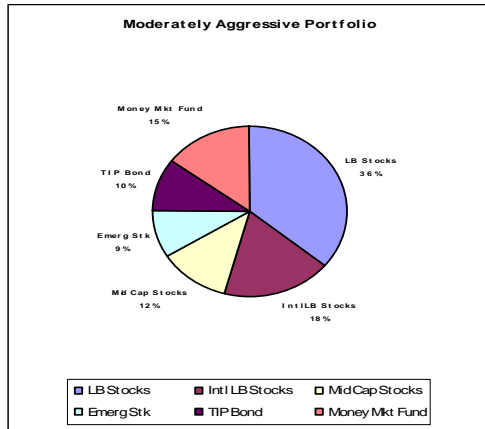
- 36% Large Blend Stock Index Funds
- 18% Large Blend International Fund
- 12% Mid or Small Cap Stock Fund
- 9% Emerging Market Stock Fund
- 10% TIP Bonds
- 15% Money market cash

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

If I buy, hold, or sell securities discussed herein, then I will disclose my positions. Prices shown are approximate. Joseph Banach. www.BanachWealthManagement.com

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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;
- 13% Large Blend International Fund;
- 7% Mid or Small Cap Stock Fund
- 22% TIPS Bonds
- 24% Money market cash

Capital Preservation -

