

BWMInvestment
Guidance**October 2009 Month End Markets Review**
*Normal Market Correction in process***Key Points**

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|--|------|---|
| • 2009 Year to Date Total Returns | | |
| S&P 500 (1036) | 17% | ; |
| US 10Yr Bond (3.38%) | -18% | ; |
| NASDAQ (2045) | 29% | ; |
| Foreign (EAFE) Stocks | 19% | |
| • U.S. GDP expected contraction = -2.3% | | |
| • 2009 earnings expected decline = - 7.1% | | |
| • Stock markets hit bottom in March | | |
| • Economic recovery in process | | |

Executive Overview

The U.S. (S&P 500 -2½%, NASDAQ -4½%) and foreign (EAFE -3%) stock markets declined during October after 2nd and 3rd Qtr. recoveries from the brutal 57% decline 2008/09 bear market. Macroeconomic news in terms of positive industrial production, modest exports improvement, and regional growth supports a modest 2nd Half U.S. GDP growth (3%) forecast. The bottom-up view notes better than normal positive corporate 3rd Qtr. earnings surprises with over ½ of the S&P 500 financial reports released. Analysts are upgrading forecasts for the remainder of 2009 and 2010. After a straight up 7 month reflex recovery, stock markets paused in October for some profit taking and institutional investors waiting for political uncertainties to be resolved. The price of gold rose (5%) during the month and is up about 19% for the year to date (YTD), indicating current U.S. currency concerns. The U.S. dollar (USD) remained down about 5% YTD. The U.S. 10 Yr Bond yield fell 1% and adjusted the YTD return to -18%. The U.S. Treasury securities upward sloping (stimulative) yield curve held stable. Other asset prices, including homes, continued to slowly improve in many parts of the country. Leading economic indicators have forecasted GDP growth in the 2nd Half of 2009 for the past 5 months. They appear to be correct. The executive and legislative branches of the U.S. government are working feverishly to enact universal healthcare and global warming controls. Legislative uncertainties may be adding to the recent increase in market volatility and the market pull back.

Themes

- **Government debts and the Grand Assets/Liabilities Balance Sheet**
- **Ideological fever and citizen uncertainty**

Economic General Scenarios

The current U.S. government expansion and deficit spending forecasts are unsustainable. There will be significant changes from the current path within 8 years or overall standards of living will decline. The simple spectrum extreme scenarios follow.

Scenario 1 - Government spending declines and private economic growth is positive but less than post World War II annual rates, while all financial leverage is reduced. Lower annual growth is likely in U.S. standard of living than in the past 65 years for about a decade. Best Case.

Scenario 2 – Government spending, controls, and individual taxes increase, private economic growth stagnates (near zero), while financial leverage is reduced. U.S. standard of living may decline to that of the social democracies of France, Japan, and Italy in 8 and 15 years.

Scenario 2 is in process. Yet historically, the self reliant American spirit is incompatible with being an unexceptional member of the developed nations club. The 2012 U.S. Presidential Election will better indicate the current American spirit. If a large controlling government is reelected in 2012, then a smaller government advocate candidate will likely emerge in 2016 to capture the historic spirit of the American voter. Recall the U.S. Constitutional 22nd Amendment was proposed on March 24, 1947, after President Franklin Roosevelt was elected to 4 terms and implemented the first phase of controlling U.S. government. It was ratified to limit any future president to two terms on February 27, 1951. Only one amendment, the 18th Amendment prohibiting alcoholic beverage sales in 1917, was repealed as the 21st Amendment in 1933. It would be surprising if the current president's supporters persuaded ¾ of the state legislatures to the repeal the 22nd Amendment and allow him to fully institutionalize a European or Japanese controlled society in the United States.

Accounting View – The Grand Balance Sheet

A grand accounting balance sheet including all assets on the left side and all liability plus equity positions on the right side is worth considering. Tangible and intangible (potential) economic

value assets may be owned by private citizens or controlled by public governments. Intangible assets include human capital; i.e. the potential economic value of individual efforts. The left side assets have right side equity owners and/or liability claims (financing, etc.) Table 1 depicts the grand balance sheet.

Table 1. The Grand Balance Sheet

Assets	Liabilities & Equity
Government Capital	Government Debts
Individuals' Economic Capital	Individuals' Debts
Individuals' Human Capital	Government Equity
	Individuals' Net Worth

A simple example of an individual asset, liability, and equity relates to a home. It is usually financed by a liability mortgage loan after an equity down payment. The home is collateral to be returned to the mortgage loan lender, if agreed upon liability interest and principal payments are not made. Otherwise, the liability is paid in full and the claim is terminated. The asset may be made more valuable to the owner by improvements. However, it's appraised or market equity value is based on the sale of similar homes in a similar location at a specific time. The homeowner equity value may increase if the appraised or market asset value increases or the loan principal is paid down. Alternatively, it may decrease if the appraised or asset value declines or the loan principal value increases.

Individuals and governments consider the grand balance sheet differently. Individuals usually focus on the equity related to an individual asset or net worth of all their assets. Equity shows what they actually own and can spend. It is the adjustment variable related to asset values. Equity usually changes more than liabilities or debt values. Asset values must be measured to find if an individual has the equity to be self reliant and support him/her self. Governments in contrast often focus on the financing increased liabilities. Government capital or assets are resources to provide security against external threats and maintain peaceful internal law and order. Key government assets are its national defense resources, its legal and judicial systems, and commercial support systems for individuals, whose economic outputs are taxed to pay for the other assets. Yet governments only indirectly measure the value of these assets through the economic productivity of individual citizens. The Gross Domestic Product, per capita after tax income, and currency exchange rate indicate the

general value of a functioning government. Since individual citizens do not require their governments to measure assets, there is no subsequent measure of return on government capital (assets). For example, no incentive exists for the U.S. government to sell Amtrak or other assets that waste its tax payer receipts. This differs from the incentive of an individual or household to sell a car or other asset that costs more to upkeep than the value provided.

The U.S. and other federal governments have a unique tool, the fiat money printing press that distorts the Grand Balance Sheet. When money is printed to pay for government assets, government debts are created. Real individual asset and debt values are eventually impacted through debt interest rates and the purchasing power of money. Yet, the process is complex because the product of the money supply (printed money) times the velocity (speed of money flow) impacts asset prices. If deleveraging or the use of debt by individuals and corporations declines faster than government debt leveraging increases, then the increased money supply will temporarily not cause inflation. Currently, the federal government is increasing its leverage through added debts, while private households and corporations are decreasing their leverage through paying off debts. The transition from net private deleveraging to net government leveraging will determine when inflation becomes a problem, such as in the late 1970's.

A Severe Recession Changes the Grand Balance Sheet

During the most recent recession, the total U.S. citizens' net worth declined about 20% or more than \$10 trillion. The related losses in individual economic capital on the asset side of the ledger were split about evenly between real estate and various equity security and non public business values. The deleveraging of corporations was also significant. Government capital and human capital can not be easily measured. If government policy is restrictive it can be argued that the government capital value is unchanged, but less productive. It can not be demonstrably measured that government capital increases, because for instance the size of the Department of Education increases. The prime exception of government capital value is the Armed Forces. After World War II and the Cold War, Western Europe and Central/Eastern Europe, respectively, increased their economic relationships with the U.S. Both sides of the balance sheet increased.

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The most important asset is human capital. Restrictive government policies reduce the incentives for future individual economic efforts. The restrictive policies include regulations, protectionist trade strategies, and increased taxes. If the risks of working or operating a business increase and the expected net returns decrease, human capital will naturally produce less and be worth relatively less. Atlas will shrug.

This can only be seen over a series of sequential (annual) balance sheets. The net worth of individuals is an important indicator. If that equity category is not steadily increasing, then human capital is not being converted into financial earnings and ultimately into retained earning or increased net worth.

A symptom of reduced human capital value and reduced individual economic net worth can be seen on the grand balance sheet. That is increasing government debt and effectively a dysfunctional balance sheet. The government debt to government capital relationship becomes artificial. Creative imagination is needed to argue that increased debt to finance government bureaucracy results in a stable grand balance sheet. A positive bureaucracy multiplier effect is not measurable on any economic level.

Moving from the Grand Balance Sheet to the U.S. Government Income Statement

Government policy effects human capital in a primary ways. Extraordinary multi-year U.S. federal deficits (nearly 10% of GDP) have never been experienced previously except during war periods. The current experiment in increased government size, control, and debt must be financed. As the deficit increases faster than the GDP, the increased debt will put upward pressure on interest rates. This will likely occur even if the GDP is only growing at a subpar 2% in 2011. That means that the current 2011 and beyond interest payments on the debt are unrealistically low forecasts. Human capital value is reduced because income taxes, especially on the successful higher income entrepreneurs, will be increased to try and reduce larger than forecasted federal deficits. Entrepreneur profits will be impacted by the increased costs of controls.

The entrepreneurs' net income will be lower and their risk adjusted future returns will be lower. Therefore, they are less likely to expand. In addition to the entrepreneurs, the under utilized

(or unemployed) potential employees will not be hired. The human capital of both the entrepreneur and the potential employee are both reduced. Increased tax rates do not give small or big businesses incentives to take risks, expand businesses with new employees, and pay more taxes.

The Democratic FRB Chairman Volcker and Republican President Reagan had a different but equally challenging near runaway inflation problem in 1982. Yet they took a different approach of higher interest rates and lower taxes than the current Republican FRB Chairman Bernanke and the Democratic President Obama in 2009. It is hard to imagine that the later results will be as successful as the former.

Ideological Fever is adding uncertainty

Congress is in the midst of debating three major U.S. government control themes: financial markets reform, universal healthcare, and global warming controls. Uncertainty is very high. Citizen stakeholders will be affected by any legislation that is signed into law by President Obama. Different sides of the issues will try to convince voters in the upcoming elections of benefits or detriments of the added controls.

The financial markets reforms should be the most straightforward. The simple approach: Listen to The President's Recovery Advisory Board Head, Paul Volcker. Separate commercial banking from investment (and various toxic derivative trading schemes) banking and require full transparency of all trades. That requires all derivative vehicles, such as credit default swaps, to be standardized and trade through a clearinghouse. Counterparty risk would be made visible. The "too big to fail" moral hazards of the Troubled Assets Relief Program (TARP) would be directly addressed. Commercial banks, which have direct access to the FRB money window, could be directed through FRB and FDIC bankruptcy processes, if needed. Treasury Secretary Geithner and Economic Council czar, Dr. Summers, have more nuanced proposals to Congress. Remember Summers and Geithner were Treasury officials that encouraged the termination of the 1933 Glass Steagall bank reforms act with the 1999 Gramm Leach Biley act that allowed merging of commercial banking and investment banking operations. Their Wall Street supporters, such as Citigroup and J.P. Morgan, are not interested in a potentially lower profitability (lower risk) regulatory environment.

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Other reforms under consideration to protect consumers, etc. and executive pay limits are relatively minor issues. Reducing the moral hazard of “too big to fail” institution bailouts (including car and insurance companies) is most important to preclude future financial meltdowns. Time will tell what financial regulations will be enacted.

The universal government controlled health care reform is the key legislative issue. Speaker Pelosi has introduced the 1990 page healthcare reform bill that is scheduled to begin review in the House of Representatives next week. A quick check with a word processor notes that the word “shall” is used over 3,000 times in the document. That should give you something to ponder. Majority Leader Reid has announced key points of the Senate healthcare reform, but has not issued a bill for review at the time of this writing. Yet the process of debate and enactment is taking shape. The key issues (addressed slightly differently in each bill) are: who provides health care (public option), what are the taxes for not participating (employer and individual mandates), and what is the added tax on others (pharmaceutical and medical products taxes and surcharge on individuals with annual adjusted gross incomes above TBD levels). Sixty votes are needed in the Senate to begin debate without filibuster, which many expect to occur. Sixty votes are also need to pass the bill. The Senate has a legislative process called reconciliation that was invented by Senator Byrd, adopted in 1985, and amended in 1990 to allow a simple majority (51) to pass specific budget bills. The Senate anticipated the possible challenge of enacting healthcare reform in April and included a budget resolution related to it with an Oct. 15 deadline. At this time, fancy foot work will be needed to extend reconciliation for a healthcare bill, which many knowledgeable people consider to be outside the bounds of the budget related process. The process may be messy with the partisan divide growing larger than ever. Keep informed. This debate, which should have small impacts on near term company cash flows, will likely cause market uncertainties, primarily in the health care sector.

The Global Warming (Climate Control) legislation is meant to curb green house gas emission across the U.S. economy. A bill has passed in the House of Representative. However, the review in Chairman Boxer’s Environmental & Public Works Committee requires completion

of climate impact models related to her bill to receive Republican support to proceed. Based on priorities of all the Obama Administration initiatives in Congressional processes, the Energy control legislation may wait until after year end. President Obama currently plans to speak at the United Nations Climate Change Conference in Copenhagen on about Dec. 17 after receiving his Nobel Peace Prize in Oslo on Dec. 10. He may only have his climate control executive orders concerning U.S. government agency and department assets that he controls to present at the UN Climate Change Conference.

In summary, all these government control initiatives are causing uncertainty and concern with many U.S. citizens.

Stock Markets – Near Term Pauses

The S&P 500 blue chip stock index fell from a 1560 Oct., 2007 intraday high to a 666 Mar., 2009 intraday low (more than a 57% decline). It subsequently rose to near 1092 (30% below the Oct. 2007 high) early this month prior to the October retreat. Is the volatile stock market index over valued now? The answer as usual depends on time frames, earnings, and market dynamics.

The intermediate term time frame, where the macroeconomic outlook matters, is relevant. The Conference Board Leading Economic Indicators (LEI) rose 1.0% in September. The LEI rose faster in the past 6 months than in any other period since the deep 1982 recession. Although I have characterized the current process as a small “v” recession recovery, the LEI indicates there will likely be at least 2 or 3 more quarters of 3+% growths. The BEA Advanced 3rd Qtr. 2009 GDP Estimate of 3.5% showed higher consumer consumption and lower inventory restocking than expected.

That leads next to a review of earnings. Inventory restocking, exports, technology, and health related earnings growth should overcome modest consumer spending with high unemployment during the next 2 quarters. Over half of the S&P 500 companies have reported 3rd Qtr. earnings. The earnings are coming in with a 7% positive surprise. That is quite a bit more than a normal 3% average. In absolute terms 2009 3rd Qtr. earnings are projected to be 18.5% (forecasted 24.7%) below 2008 3rd Qtr. earnings.

Market dynamics or investor sentiment is hardest to judge. A short term correction appears to be in process with the S&P 500 (-5%) and NASDAQ (-6%) below recent highs. Trends and moving averages have turned negative and volatility has increased. A normal correction is defined as a 10% decline in stock market prices. All things considered, the odds imply that we are about ½ ways through a normal correction process.

Financial analyst forecasts have continued to improve recently to extraordinary 2.4:1 and 2.1:1 upgrades/downgrades ratios for 2009 and 2010 (Zacks methodology). The analysts are responding to 6:1 earnings up/down surprise and 1.5:1 sales up/down surprise ratios. The S&P 500 index is trading at 17 to 23 times 2009 expected earnings and 13.5 to 19 times 2010 forecasted earnings based on Zacks bottom up, top down, or Standard & Poors forecasts. Stocks are priced slightly below normal if 2010 earnings materialize as forecasted. Yet there is less upside future year returns potential than the blue chip stock returns of either of the past 2 quarters.

The secondary market dynamics or psychology implies that certain areas of stock market growth and small company sectors of the market got overvalued recently. The intermediate market trends have turned negative. The overbought stock market condition is being corrected quickly as large institutions are distributing stocks (taking profits). This is a normal process after a 7 consecutive month stock market recovery.

Small stock prices advanced more and caught up to larger stock 2009 returns during the 2nd Qtr. That was a normal stock market rotation and they (risky assets) are currently retreating faster. The speculative growth buying theme appeared in Sept. as the anticipated market correction was delayed until Oct. The moderately aggressive risk tolerant investor should consider continuing to hold small stock biased portfolios at this time with an expectation of a further market correctly through Nov. The moderately conservative risk tolerant investor may consider transferring a small part of riskier equity holdings to less risky dividend paying equities. The downside (low) probability may be a 10% 4th Qtr. decline if a 1st Half 2010 GDP slowdown is implied in the future by weak monthly macroeconomic data. Currently, the LEI and supporting reports imply 3% GDP growth in the 4th, 1st, and 2nd quarters.

Foreign Economies

Developed economy forecasted 2009 GDP declines stabilized after extreme 2008 4th Qtr. and 2009 1st Qtr. declines. 2010 GDP forecasts continue to improve. Germany's export focused economy expanded in the 2nd Qtr. Emerging countries China, India, and Brazil improved 2009 forecasted GDP growth. Emerging markets show some inflation issues. Key forecasts according to the *Economist* follow.

Table 2. Economic Forecasts

Economic Market	2009 GDP	2010 GDP	2009 CPI
United States	-2.4	2.5	-0.4
Japan	-5.5	1.4	-1.2
China	8.2	8.6	-0.8
Great Britain	-4.4	1.4	2.0
Euro Common Mkt ECM	-3.8	1.2	0.4
Russia	-7.0	2.5	12.1
India	5.5	6.3	9.2
Brazil	0	3.8	4.9

The total global economy is likely to show a 2009 contraction (-2.2%) and 2010 expansion (3.0%) with Asia leading the way. In Table 3 the U.S. positive sloped yield curve continues to show the most stimulative monetary policy. Most countries also have stimulative positively sloped yield curves.

Table 3. Current Global Yields

Economic Market	3 month	10 Year
United States	0.18	3.4
Japan	0.4	1.3
China	1.8	3.8
Great Britain	0.7	3.6
Euro Common Mkt ECM	0.7	3.2
Russia	10.0	9.2
India	3.2	7.6
Brazil	8.6	6.2

Economic Sectors and Investment Outlooks

A Technical Overview (BPNYSE, etc) indicates U.S. and foreign stock overbought supply and a negative trend in process. Money supply growth has slowed below normal to an M2 annual growth rate of 0.2% in the past 6 months. **Suggestion: Hold normal portfolio asset weights.**

Economic Sector Analysis and Outlook

Telecom sector stock demand is neutral, as noted by neutral sector price Relative Strength (RS). No Opinion. **Utility** Sector forecasted 2009 earnings are stable. Dividends are around 4%,

and sector RS is negative. No opinion. **Consumer Staples** sector 2009 earnings growth is forecast to be above all other sectors, while RS is in line. Consider selectively adding positions. A sizeable **Energy** sector earnings decline is in process. Yet stock demand has been in line with \$77 per barrel oil. OPEC is holding output at current levels. No Opinion. The above sectors have dividend candidates for value investors. **Healthcare** sector 2009 earnings look solid. Stocks are performing in line with the market. Hold positions. Potential legislative uncertainty is limiting demand. **Technology** Sector stocks are participating in the advance with extraordinary positive earnings surprises (APPL, GOOG, and AMZN). This is the growth sector. Hold gainers. The **Consumer Discretionary** sector remains cyclical. Earnings surprises are positive. The cyclical **Materials** sector RS is near the market RS. No opinion. **Industrial** sector exports (and earnings) to developing countries are positive and the sector RS is neutral. No opinion. The **Financial Services** sector remains very volatile. No opinion. **Earnings improved more than forecast in the 3rd Qtr and the market is anticipating 4th Qtr better earnings.** Cost controls and efficiency projects may continue to boost earnings without employee hiring in the 4th Qtr.

Summary Suggestion: Cautiously hold normal stock and bond portfolio positions. Note high yield bonds are much overvalued. The Tech sector is volatile, but with positive potential. Market demand is weak while earnings trends are positive. Stock markets usually advance in price along with earnings during the first 2 quarters after the end of a recession, although a correction may be currently in process.

International Markets Are Advancing

Foreign stock markets rose along with U.S. markets, while the USD (0.68 Euro) was stable in Oct. Holding developed economy stocks is a reasonable plan. Emerging market stocks rose nearly 60% since the March bottom. Normal weights may be considered if you can withstand large declines and high volatility (-50% in 2008).

Fixed Income - Less Volatile

U.S. Treasury bond year to date returns (-18%) may not improve much as increased supply to finance huge deficits is partly offset by FRB buying. Investment grade corporate and GNMA bonds have shown very good 2009 returns, as risk adverse investors purchased record levels of

bonds. A small portfolio weight in a TIPS fund is suggested. Muni bonds may be considered for taxpayers in high tax states, although they are now priced richly. Mid single digit after-tax returns at modest risk are possible.

Alternative Investments – Diversification

The Real Estate Investment Trusts (REITs) index improved impressively in the 3rd Qtr. (35%), but was flat in Oct. after plunging in the 1st Qtr. 2009 based on financing concerns. Commercial and retail vacancies remain problems. Private equity or knowledgeable partnerships may be an effective way to profit from income producing real assets. Gold funds are diversifiers. Only a 5% weight in a less volatile direct gold exchange traded fund (GLD) is suggested. The 2009 YTD return (19%) is very good in the current noninflationary environment.

Portfolio Management

Funds have less cash (3.0%) than at any month in the past 2 years to boost stock prices higher. The S&P 500 index is trading at a normal P/E after higher recent earnings reports and forecasts. Be flexible and remain diversified. Positive economic surprises weighted against political uncertainty may result in volatile stock demand and prices through year end.

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 – Entry Positions only

Disclosure: Personal holdings: Normal weights
42% Domestic & Intl Large Cap stock funds,
(16% Total International funds)
48% Small/ Mid Cap funds,
10% short term bonds and cash

No Changes

**Sample Portfolios are models
Not Client Recommendations**

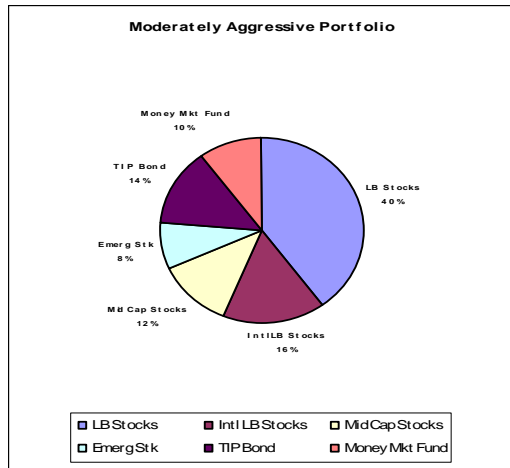
Sample Portfolio A - **Moderately Aggressive**
Example 45 year old college educated parents with 1 high school child and 1 college child.

- 40% Large Blend Stock Index Funds
- 16% Large Blend International Fund
- 12% Mid or Small Cap Stock Fund
- 8% Emerging Market Stock Fund
- 14% TIP Bonds
- 10% Money market cash

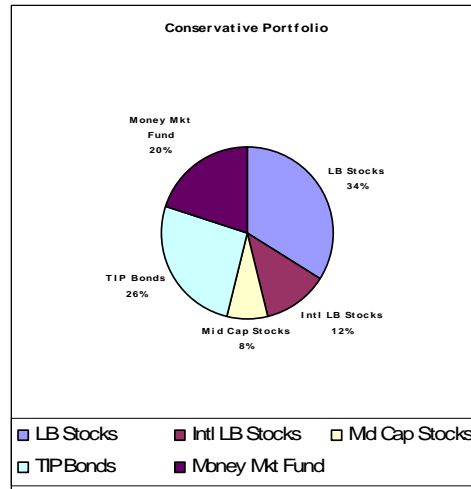
Sample Portfolio B - **Conservative**
Example 65 year old couple with Social Security Income (20% of spending needs) and Retirement 401K or Pension Plans converted to IRA's

- 34% Large Blend Stock Index Funds;
- 12% Large Blend International Fund;
- 8% Mid or Small Cap Stock Fund
- 26% TIPS Bonds
- 20% Money market cash

Normal Capital Accumulation –



Normal Capital Preservation –



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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.
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