

**BWM**Investment  
Guidance**August 2009 Month End Markets Review**  
*Coming out of an Economic Recession***Key Points**

- |                                          |       |   |
|------------------------------------------|-------|---|
| • <b>2009 Year to Date Total Returns</b> |       |   |
| S&P 500 (1020)                           | 15%   | ; |
| US 10Yr Bond (3.40%)                     | -19%  | ; |
| NASDAQ (2009)                            | 27%   | ; |
| Foreign (EAFE) Stocks                    | 16%   |   |
| • U.S. GDP expected contraction =        | -2.4% |   |
| • 2009 earnings expected decline =       | -12%  |   |
| • Stock markets hit bottom in March      |       |   |
| • Recession at statistical end           |       |   |

**Executive Overview**

The U.S. (S&P 500 +3%, NASDAQ 2%) and foreign (EAFE +5%) stock markets drifted higher during August to a more overbought condition. The macroeconomic perspective noted gradual positive industrial production, home sale, and GDP surprises. The bottom-up corporate view noted better than expected corporate 2<sup>nd</sup> Qtr. earnings due to cost cutting, instead of revenue growth. Investor cash on the side lines and mild economic fundamental positive surprises after a four month stock market rise from its nadir kept the advance going for a fifth successive month. The price of gold rose in August (1%) and is up about 9% for the year to date (YTD), indicating limited current U.S. currency inflation concerns. The U.S. dollar (USD) remained down about 2% YTD. The U.S. 10 Yr Bond yield drifted lower in August and slightly changed the YTD return to -19% as shown above. The new supply of debt to finance the massive deficit, including Federal Reserve Board (FRB) quantitative demand, is holding the U.S. Treasury securities upward sloping (stimulative) yield curve in place. The global economic bottoming process appears to be setting a demand floor for oil in the mid \$60 per barrel range. Other asset prices, including homes, are leveling out in most of the country. Leading economic indicators continue to forecast GDP growth in the 2<sup>nd</sup> Half of 2009. The executive and legislative branches of the U.S. government are working to enact healthcare, energy, and other economic controls. Yet, markets appear to currently be focused on the post recession cost cutting based earnings.

**Themes**

Investment market themes are:

- **Recession at End; NBER process**
- **Stagnant future economic cycle**
- **What do the citizens want?**

**Recession at End; the NBER will speak**

The global economy is complex and the U.S. is a significant part of it. Many people have opinions about economic expansion and contraction. Yet the official arbitrator of business cycle dating is the National Bureau of Economic Research (NBER). It is worth considering what the NBER looks at and what they mean by an economic expansion (good times) and a recession or depression (bad times.) Many of the Federal Reserve Banks release a monthly national economic activity index that includes more than 80 indicators which are separated into four broad economic categories: production, employment, consumption, and sales. The NBER tracks four of the broad indicators to judge (many months thereafter) whether the economy is expanding or contracting. Various private economists maintain economic models to forecast specific conditions for their clients.

The four NBER indicators<sup>1</sup> are nonfarm payrolls, industrial production, incomes excluding transfer payments, and business sales. The nonfarm payrolls are still shrinking with July job losses of 247,000 and an unemployment rate of 9.4%. The August job losses and unemployment rate are expected to change slightly. The weekly new unemployment claims at a current 4 week average of 566,000 are about 50,000 below their spring peak. Be aware that demographics indicate that about 150,000 new jobs must be created monthly to keep the U.S. GDP at a stagnant 0% no contraction rate. The Federal Reserve Board and consensus economists expect a 10% peak unemployment rate in mid 2010. The recession may be declared statistically ended prior to the lagging peak unemployment rate. The industrial production readings have turned positive recently with July industrial production +0.8% and durable goods orders up a solid 4.9%. Inventories fell to very low levels during the uncertain 1<sup>st</sup> and 2<sup>nd</sup> Qtrs. The post automobile bankruptcy adjustments and 'cash for clunkers' buyer incentives aftermath are boosting 3<sup>rd</sup> production. Regional surveys point to expanding production indicators. The August ISM Manufacturing Index expanded with a 52.9 reading. Incomes excluding transfer payments are slowly growing with July income slightly

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above 0% after July income was -0.8%. The indicator provides a mixed message related to spending and savings. If spending (consumption) grows between 0% and 0.5% in the 3<sup>rd</sup> and 4<sup>th</sup> Qtr. then it will support a GDP expansion. Yet a 4% savings rate will support marginal household balance sheet improvements. Business sales include both domestic and global sales. If U.S. goods are competitively priced, primarily due to productivity gains and the currency exchange rate, then net exports may be a catalyst to support an expanding U.S. GDP. Special limited time incentives of cash for clunkers and first time home buyer incentives also are supporting current quarter GDP growth. All things considered the consensus among economists for greater than 3% 3<sup>rd</sup> Qtr. GDP expansion and near 3% 4<sup>th</sup> Qtr. GDP growth is probably correct. The NBER may declare the recession, which started in Dec. 2007, ended about Aug. 2009. A 21 month recession would be the longest post 1930s recession. Yet the unemployment rate will likely peak far below 1930s levels and below the 1982 recession 10.8% peak. This is due primarily to the FRB responding creatively to an extraordinary break down in credit market transaction trust through many lending facilities and more than doubling the monetary base.

#### **Stagnant future economic cycle**

Historically fiscal policy expansion or growth of government to boost an economy, which is contracting, has caused long term problems. The issue boils down to the lack of measurements and audits of the benefit of government goods and services provided for the cost. Government administrators, auditors, and bureaucrats are not measured by a productivity or profit standard as their peers in the private sector. Their lack of competition results in political decisions to condone wasting taxpayer resources, whether the issue is U.S. Post Office first class mail business losses (and annual bailouts) or a host of other examples. Government monopoly activities have no natural constituencies to monitor them and shut down poor performers.

President Obama approved extreme increases in the size of government departments and agencies through the American Reinvestment and Recovery Act of February, 2009. The \$787B Stimulus Act, which included \$288B in tax credits and \$499B in various department and agency spending programs over more than 2 years, is unprecedented in scope, lack of focus, and wastefulness. A few weeks later the

Omnibus Spending Act of 2009 approved by the President, which included \$410B for emergency and congressional earmark projects, was \$32B greater than President Bush's initial bloated request. The problem with government fiscal spending programs since President Hoover and to a larger extent President Franklin Roosevelt is the permanent inflexible bureaucratic monopoly set up to administer them. I have not read any thorough analyses that show \$1 of government project spending stimulates more than \$1 of private sector new permanent annual revenues.

Even temporary tax rebates or tax credits result in temporary taxpayer consumption (or savings.) The \$152B Economic Stimulus Act of 2008, which included tax rebates, business investment incentives, and expanded Fannie Mae and Freddie Mac mortgage loan limits, approved by President Bush is an example of a one time 2<sup>nd</sup> Qtr. 2008 GDP boost, which dissipated after the tax rebates were spent.

The Executive (Presidential) Office of Management & Budget (OMB) August 25, 2009 Mid Session Economic Forecast presented an unsustainable economic situation to Congress (and the American people.) Projected trillion dollar (\$1,000,000,000,000) peace time U.S. government deficits in 2009, 2010, and 2011 have never occurred before. The 2011 projected deficit is based on expiration of the Bush 33% (single over \$171,550 and married over \$208,850 annual taxable income) and 35% (single and married over \$372,950 annual taxable income) inflation adjusted tax (cut) brackets. History shows that higher tax rates do not increase government taxable income. It is likely that the 2011 deficit will be larger, unless government spending is dramatically cut.

The OMB is adjusting referenced blue chip economic forecasts to imply an achievable forecast. The weak link in the forecast is the forecasted 2011 and 2012 real GDP growth rates, 3.8% and 4.3%, respectively. Lower GDP revenues will result in lower than forecasted government tax receipts and higher than the forecasted interest paid on the debt of \$288,000,000,000 and \$388,000,000,000 in the respective years, in my view.

The sheer size of government will control and impede growth in the remaining economy, unless government spending is cut. This does not necessarily mean 1970s type inflation. Yet,

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politically there is an incentive to make the increased debt worth less on a real basis and fool voters into accepting inflation as uncontrollable. The more strategic issue may be the strength of the USD relative to other currencies such as China and India. It is much more difficult to influence global security with a declining U.S. economy.

#### **What do the U.S. citizens want?**

The August health care debate and townhall meetings appear to show many worried citizens. The HR3200 America's Affordable Health Choices Act of 2009 is a 1,017 page government health care control prescription. (A good aspect about modern technology is that any interested citizen can download the 1.8MB .pdf document from the internet and read it. Decide for yourself what it means.) Enough people are concerned about the vague wording and implications that the President and his allies are having trouble controlling the rationing message. In the political world, what counts are the unaffiliated independent voters. They may be losing trust in the President's leadership.

The tone of rhetoric shows more than health care is involved. Incoherent statements are being made on all sides of the discourse. Many people are uncomfortable with the speed of the changes. It was one thing to vote for change. Yet it is another thing to start feeling what it may mean in terms of a loss of both freedom and responsibility for one's well being. If polls of citizen sentiments are indications of the voter's mood, it may be wise for President Obama to look to President Clinton, instead of President Roosevelt, for guidance. That is to back off the complete health care and energy control legislation and salvage a healthy Democratic majority in the House and Senate in the 2010 elections. The President and Congress have the votes to do what they want now. However, one party U.S. rule is fragile. Congressional elections occur every 2 years. Talk radio and the blogosphere may align the voters very quickly for another change, if the controlling legislation is enacted.

Citizens are also concerned about economics; that is jobs. The OMB projects 2009, 2010, and 2011 unemployment rates of 9.3%, 9.8%, and 8.6%, respectively. The federal government is increasing its own size, but not helping the main engine of jobs, small businesses, with a good environment for expansion and startups.

The U.S. citizens appear to want what they have normally wanted. They are looking for a secure environment, where they can experiment and find out what they can do to make a good life for themselves. An independent spirit is still part of their culture and core beliefs. They do not want someone, who cares less about their well being than they do, telling them how to live.

#### **Stock Markets – Anxious, but holding on**

Investment money continued to flow into the U.S. and foreign stock markets during August. The economic news has been steadily better than forecasted, as discussed in the Recession at End section. Investor sentiment fell at the end of the month after the stock market reached much overbought short term trend (large breadth of advancing shares) levels. September has historically been the only major (-1%) declining month of the year. As I write, U.S. and European markets are down on the first trading day of September in high volatility. Short seller may be experimenting in an attempt to draw out nervous sellers. After more than a 50% advance since the March low, a declining correction of more than 10% is to be expected, but not a certainty.

Many sentiment indicators are mixed. Investment newsletter writers are strongly bullish, while small investors are nervously neutral. Small stock prices are advancing more than larger stock prices. Yet, speculative growth theme buying is not prevalent. There has been an absence of sellers up to this point. After Labor Day politicians and traders will be back at their offices and trading desks. That will provide added noise and trading volume to assess whether the scale tips to an oversupply of stocks and further downside concerns.

#### **Cost cutting continues to help the bottom line**

S&P 500 company 2<sup>nd</sup> Qtr. profits with all reports published were 31% lower than in the 2008 2<sup>nd</sup> Qtr. Yet they are 5% better than recent analyst expectations (-36%). Thirty one per cent of firms showed better earnings in the 2<sup>nd</sup> Qtr. 2008, but only 24% showed quarterly year over year revenue growth. In the 2<sup>nd</sup> Qtr. the Consumer Staples and Healthcare sectors are showing better profits than the comparable 2008 Qtr. Material and Consumer Discretionary sectors are showing the most positive surprises and the Tech, Health Care, and Energy sectors are also doing better than expected. Total profits are currently expected to fall 27% in the 3<sup>rd</sup> Qtr.

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and rise with the GDP in the 4<sup>th</sup> Qtr. In the bigger view, S&P 500 company profits fell 20% in 2008, and are forecasted to fall 12% this year, prior to rising 23% in 2010. Note that S&P 500 earnings are expected to be lower in 2010 than in 2007.

According to Zacks, bottoms up analyst S&P 500 total operating earnings forecasts are currently stable at about \$60.60 in 2009 and \$74.90 in 2010. Yet, macroeconomic top down total earnings forecasts are drifting lower at \$53.84 in 2009 and \$67.44 in 2010. The macroeconomic forecasts may be picking up extraordinary (non-operating) expenses or they are missing cost cutting efficiencies, which may continue to help profit margins and overall profitability.

**Financial Analyst forecasts are stable**

The current analysts' forecast revision ratio has swung to positive 5:3 upgrades/downgrades for 2009 and 4:3 for 2010. At this time, the S&P 500 trades at 16 to 26 times 2009 and 13 to 21 times 2010 earnings based on your choice of Zacks or the Standard & Poors forecasts.

**Foreign Economies**

Developed economy forecasted 2009 GDP declines have continued to stabilize after extreme 2008 4<sup>th</sup> Qtr. and 2009 1<sup>st</sup> Qtr. declines. 2010 forecasts are stable. German and Japanese export focused economies expanded in the 2<sup>nd</sup> Qtr. Emerging countries China and India have recently improved 2009 forecasted GDP growth. Emerging markets show the only inflation issues. Key forecasts according to the *Economist* follow.

**Table 1. Economic Forecasts**

Economic Market	2009 GDP	2010 GDP	2009 CPI
United States	-2.4	2.0	-0.3
Japan	-6.4	1.1	-1.1
China	8.0	8.0	-0.6
Great Britain	-4.2	1.1	1.8
Euro Common Mkt ECM	-4.4	0.6	0.5
Russia	-7.0	2.5	12.2
India	5.5	6.3	6.0
Brazil	-1.0	2.7	4.9

The total global economy is likely to show a 2009 (-2.4%) contraction and 2010 (2.0%) expansion. In Table 2 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 2. Current Global Yields**

Economic Market	3 month	10 Year
United States	0.26	3.4
Japan	0.4	1.3
China	1.7	3.7
Great Britain	0.9	4.0
Euro Common Mkt ECM	0.9	3.3
Russia	11.0	11.3
India	3.2	7.6
Brazil	8.7	6.2

**Economic Sectors and Investment Outlooks**

**A Technical Overview** (BPNYSE, etc) indicates continued broad based U.S. and foreign stock demand. Money supply growth continues about normal with an M2 annual growth rate of 3.2% in the past 6 months. **Suggestion: Hold normal portfolio asset weights through an expected volatile September.**

**Economic Sector Analysis and Outlook**

**Telecom** sector stock demand is neutral, as noted by neutral sector price Relative Strength (RS). Hold current positions. **Utility** Sector forecasted 2009 earnings are stable. Dividends are around 4%, and sector RS is neutral. No opinion. **Consumer Staples** sector 2009 earnings growth is forecast to be above all other sectors, while RS is in line. Hold positions. A sizeable **Energy** sector earnings fall is in process. Yet stock demand has been in line as oil held around \$68 per barrel. OPEC is holding output at current levels. No Opinion. The above sectors have dividend growth candidates for value investors. **Healthcare** sector 2009 earnings look solid. Stocks are performing in line with the market. Hold positions. Be aware of potential legislative uncertainties. **Technology** Sector stocks continue to participate in the advance. Positive earnings surprises continue, especially among the huge industry leaders. Watch for lower purchase prices. The **Consumer Discretionary** sector remains a cyclical area. Earnings surprises are positive. Watch value retailers, as stronger firms buy bankrupt assets. The cyclical **Materials** sector RS is better than the market. No opinion. **Industrial** sector exports (and earnings) to developing countries are flat and the sector RS is neutral. No opinion. The **Financial Services** sector remains very volatile. No opinion. **Earnings are currently weak, improving somewhat, and the market is anticipating 4<sup>th</sup> Qtr better earnings.** Cost controls may continue to boost earnings without revenue gains or employee hiring in the 4<sup>th</sup> Qtr.

**Summary Suggestion:** Cautiously hold normal stock and bond portfolio positions. No sector is showing clear RS price momentum leadership. Market demand appears to be in line with stable earnings trends, in spite of the generally poor consumption and employment outlook. Stock markets usually advance in price along with earnings during the first 2 quarters after the end of a recession, although 2002 was an exception. September is normally a volatile month. New buying is not suggested.

**International Markets Are Advancing**

Foreign stock markets rose along with U.S. markets, while the USD (1.43 Euro) was stable during Aug. Holding developed economy stocks is a reasonable plan. Emerging market stocks rose nearly 50% 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 (-19%) may not improve as increased supply to finance huge deficits is only partly offset by FRB buying. Investment grade corporate and GNMA bonds should provide single digit 2009 returns. A small portfolio weight in a TIPS fund is suggested. Muni bonds are suggested for taxpayers in high tax states, who research good quality general obligations bonds. Mid single digit after-tax returns at modest risk are possible.

**Alternative Investments – Diversification**

The Real Estate Investment Trusts (REITs) index has improved after plunging in the 1<sup>st</sup> Qtr. 2009 based on financing concerns. Commercial and retail vacancies remain problems. Private equity or knowledgeable partnerships may be a more 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.

**Portfolio Management**

Funds have less cash (4.4%) to boost stock prices higher. The S&P 500 index is trading at above a normal P/E with uncertain earnings forecasts. Be flexible and remain diversified. Possible positive economic surprises may support intermediate term slightly higher 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 possibly Muni
- 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**

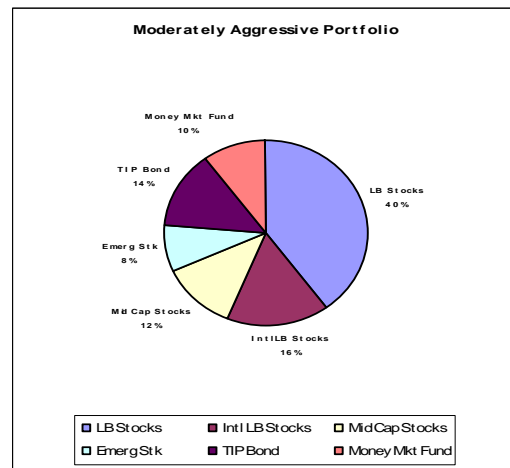
**Sample Portfolio A - Moderately Aggressive**

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

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

**Normal Capital Accumulation –**

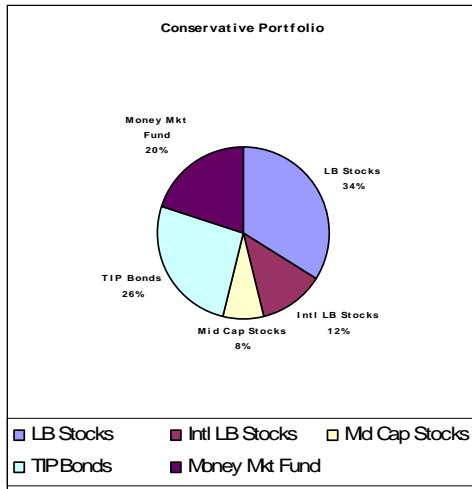


**Sample Portfolio B - Conservative**

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

Normal Capital Preservation –



**References**

<sup>1</sup>Nutting, Rex, *Economy was still in recession in July*, MarketWatch, August 24, 2009

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