

BWMInvestment
Guidance**Third Qtr 2010 Financial Markets Review**
Unexpected recovery of most 2nd Qtr losses**Key Points**

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| <ul style="list-style-type: none"> • 2010 Year to date Total Returns S&P 500 (1141) 3%; US 10Yr Bond (2.51%) 13%; NASDAQ (2368) 4%; Foreign (EAFE) Stocks -1% • U.S. GDP expected expansion = 2.7% • 2010 earnings expected increase = 40% • Stock market small upward bias • Jobless abnormal economic recovery |
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Executive Summary

Equity markets (EFA +17%, NASDAQ +12%, S&P 500 +11%) bounced back in the Third Qtr. with positive returns in the midst of a weak U.S. dollar (USD) and very good 2nd quarter earnings reports. Financial analyst 2010 earnings forecasts remain very strong with normal 2011 expected gains. The recovering euro (+10%) accounted for much of the foreign stock gains. During the 3rd Qtr. three of 4 top Obama Administration economic team members left or announced plans to leave office by year end. High unemployment 14 months after the recession officially ended remains both the top economic issue and political concern. A paradox exists between the large year to date rise (18%) in the price of gold and Federal Reserve Board Chairman Bernanke's highly publicized concern about a lower than desired inflation level. This quarterly review analyzes the relationship between U.S. stock and bond valuations to consider, if either is under or over valued based on available economic information. Particular economic sectors are reviewed to observe the relationship between current cash flows, expected earnings, and regulations. Thereafter, possible psychological and economic impacts of a Republican House of Representatives Majority after the November elections will be considered. (The October month end review will be published about Nov. 5 to provide analysis based on actual November election results.)

Themes

- **Are stocks and bonds under valued or over valued?**
- **What is the suggested impact of divided government: Republican House majority?**

Are stock and bonds currently under valued, fairly valued, or over valued?

Stocks appear to be under valued relative to bonds. Stocks are slightly under valued, on a historic basis, if financial analysts' 2010 and 2011 forecasts are within 5% of being accurate. The demand for bonds (gains) and resultant low yields are puzzling and appear unsustainable.

Market security valuations are primarily based on the delivery of expected cash flows. Bonds have specified maturities or the duration prior to payment of all contractual coupons and return of principle. Investment grade bond prices without factors like call or convertible options can be referenced to high grade U.S. Treasury securities rather simply. Non-investment grade bond prices include uncertainties and economic or specific risks similar to stocks, which have theoretical infinite corporate lives to return expected cash flows. Forecasts of future interest rates, inflation, and corporate earnings over the next 4 to 8 quarters are the main drivers of valuations.

Now appears to be an unusual time, when both recent past year (and 5 year) earnings, as well as forecasted 2 year earnings, usefully suggest future stock prices. In the past three months analysts' 2011 earnings forecasts have been reduced somewhat and look clear headed. In the world of bonds, prices appear extended in the midst of abnormal total bond demand by many (including the FRB) and increased U.S. Treasury bond supply to finance huge deficit spending.

The current consensus is between 2% and 3% U.S. 2010 and 2011 GDP forecasted growth. (Earnings data for the analysis is primarily from Zacks Research and differs from Standard & Poors, as well as other sources). *Would you be surprised if current late September 2010 consensus S&P 500 2010 company forecasted earnings (\$81.50) are 5% higher than they were in mid December 2009 (\$77.50)? **Don't be surprised. That is the current status!*** First and 2nd Qtr. S&P 500 earnings are reported and the consensus is that total 2010 earnings will exceed 2009 results by 40%. (Total current 2010 expected revenue growth (5%) is less than expectations (7%) last December.) Yet the bottom line for investors is that total S&P 500 2010 stock returns year to date are only up 3%. Blue chips are currently selling at a below normal 2010 Price/Earnings = 14.

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The primary reason for spectacular earnings growth is flooding of the U.S. and global economy with U.S. dollars by the FRB. In addition to controlling the short duration interest rates near zero, the FRB is manipulating the longer duration U.S. Treasury and related bonds by purchasing them through the tactic of quantitative easing. The 10 yr U.S. Treasury bond was yielding 3.85% in the beginning of the year and is now yielding 2.51%. Corporations are financing their operations at much reduced interest expenses. That explains the spectacular profit margins this year and likely in 2011. From a corporate financial stability perspective, S&P 500 corporate balance sheets show low risks. Cash and cash equivalents are at record levels of more than \$1.8T.

Why are hiring levels so weak? Uncertainty!

The economy has been shocked by massive regulations during the past 18 months through active regulatory agencies, the Patients Protection and Affordability Act (Healthcare Control), and Dodd-Frank Wall Street and Consumer Protection Act (Financial Control). Large companies are making primarily computer and technology capital expenditures to improve productivity, but they are hiring at a measured pace in the face of uncertain demand. (2011 S&P 500 corporate nominal sales growth is forecasted to be 5%.) The cost of newly hired (or currently employed) health care benefits and financial regulations can not be estimated until numerous rules by the health care and financial agencies are issued. That will take time and in the interim low financing costs mean high profit margins and earnings in a slow growth economy.

The more important issue is that very small companies, usually privately held, are overwhelmed by the regulations. They are the risk takers, who hire the majority of new employees. Here is an example which was learned during a conversation with small business owners. The Healthcare Control Act requires that small businesses file tax forms for every vendor that sells them more than \$600 in goods. According to an Associated Press story, more than 38M U.S. small businesses are effected by the IRS provision, which is meant to prevent vendors from underreporting income and bring the U.S. government more than \$19B over the next decade. The House was aware of the problem in July. Democrats could not agree with Republicans on taxes to be raised to replace lost expected revenue from cancelling this provision.

Low financing costs are resulting in interesting corporate balance sheet restructurings, which demonstrate the unusual relationship between stock and bond valuations. During September Microsoft registered over \$4.75B in bond offerings at various maturities at nearly U.S. Treasury yields, while it holds about \$35B in cash, to finance dividend payments. Microsoft, which currently sells at a Price/Earnings = 12, profit margin = 30%, and Dividend yield = 2.5%, certainly is worth researching in contrast to purchasing a 10 yr. Treasury bond at 2.5% yield.

It is worth looking at five economic sectors that represent more than 50% of the private economy to observe the impact of cheap financing, net profit margins (NPM : after-tax earnings/sales), global trade, entrepreneurial opportunities, and regulations. S&P 500 corporate 2010 NPMs (9.0%) are forecasted to increase in 2011 (9.8%). Selected sectors are Computers & Technology, Industrials, Consumer Discretionary, Oil & Gas, and Medical. *I suggest that stocks are under valued by 5 to 10% on average.* Yet that does not leave enough safety margins for the long term prudent investor. Some economic sectors, based on fundamental risks and market psychology, are relatively better opportunities than others.

Computers & Technology are forecasted to grow earnings at high NPMs in 2010 (39% at 15.5%) and 2011 (18% at 16.2%) with high cash flows and balance sheet cash assets. They benefit from a cheap USD policy and high export expansion. Apple, Intel, Oracle, and a host of mid sized companies continue to innovate and strategically acquire supporting operations. They are cautiously expanding in the midst of expanded U.S. regulations, but do not suffer from targeted economic sector controls. At P/E valuations in 2010 (15) and 2011 (13) based on current market prices, Techs are the growth sector of the economy and offer the moderately risk tolerant investor dividend growth stock opportunities.

The Industrial companies include machinery and durable goods suppliers. Their earnings growth rates are high, but at lower NPMs than Techs in 2010 (35% at 7%) and 2011 (23% at 8%). Cash flows are good and balance sheet cash assets are improving. The cheap USD policy supports their global sales growth. At P/E valuations in 2010 (17) and 2011 (14), dividend growth opportunities exist.

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Consumer Discretionary companies include a variety of retailers from McDonalds to Nordstrom's to Netflix's. Their business models and strategies vary widely. Yet in light of cautious consumption, the best companies are expanding global footprints that impact both the top and bottom line. Their forecasted earnings growth rates are high with higher NPMs than Industrials in 2010 (21% at 8.5%) and 2011 (18% at 9.5%). Expansion, especially into Asia, supports their outlook. Steady dividend growth opportunities can be found in this sector.

The Oil & Gas sector continues to be ridiculed by current U.S. government officials almost as much as the financial sector. It presents value opportunities, in contrast to the previous growth sectors. O & G production/transportation master limited partnerships with steady growing dividends and investor returns of capital greater than 5% appear to compare favorably to U.S. Treasury security purchases. O & G includes global production giants such as Exxon Mobil, as well as exploration and service companies. Their earnings growth rates are recovering from 2009 depressed levels with NPMs comparable to Industrials in 2010 (49% at 7.5%) and 2011 (14% at 7.5%). Cash flows and balance sheet cash assets are improving. The cheap USD policy supports their global sales growth. At P/E valuations in 2010 (12) and 2011 (10), downside risks appear modest.

The Medical sector is suffering from the uncertainties of new known and as yet undefined heavy regulations. Many parts of this group, particularly the insurers, pharmaceuticals, and nursing facilities are being transformed into government controlled health utilities. A once growth sector is now a possible value sector. When sellers cause valuations to drop enough, opportunities exist. Their overall expected earnings growth rates are modest, but at good NPMs in 2010 (7% at 9.5%) and 2011 (8% at 10%). At 2010 (12) and 2011 (11) P/Es, medical stocks, such as Johnson & Johnson, are relatively low risk steady dividend growth suggestions.

Above equity ideas appear to be good valuation alternatives to U.S. Treasury securities. When a non inflation protected bond is purchased at a 2% market yield and held for 5 years until maturity, a low risk 2% annual yield with return of face value principle is a certain cash flow stream. *Yet, is a certain 2% yield cash flow a good investment, if inflation rises to the 3.5%*

long term annual rate in 2 or 3 years? More specifically, a retiree or conservative investor focused on cash flows should be aware that unsustainable low inflation rates are implied by current market bond yields.

Does FRB Chairman Bernanke know something that markets don't know?

The Federal Open Market Committee statement at the conclusion of its September 21 meeting included 3 references to disinflation that appear to be more politically motivated than economically based. The underlying inflation (annual Consumer Price Index 1.1%, Core CPI 0.9%) is considered somewhat below long run levels to promote max employment and price stability, is likely to remain subdued, and the FRB is prepared to provide additional accommodations (more Treasury bond buying) to return inflation, over time, to levels consistent with its mandate. Recall that the FRB's stated mandate range for core inflation is 1% to 2%.

Critical questions for investors are: *What if FRB quantitative easing purchases do not result in higher employment levels and What are the risks if the FRB continues to buy Treasury securities in the midst of huge federal budget deficits?* Studies and data to date do not support the thesis that more than \$1T of FRB purchases of U.S. Treasury, Fannie Mae, and Freddie Mac securities promoted employment growth. Bank reserves have grown far above historical levels. Loan volume is lower than past levels and hence the flow (velocity) of money is relatively very low. Yet acquisitions are being financed and many corporations are issuing bonds directly as noted above in the Microsoft example. In fact, the lending quality standards are reported to have been relaxed somewhat in the past 2 quarters. Banks generally need to make good loans in order to earn profits. It is unclear if bank lending quality standards are tighter than FRB standards. If the FRB buys another \$1T of Treasury securities during the next 12 months, it is doubtful that employment will increase by 2.5 million or another acceptable level or that the 2011 GDP will grow at a 2.6% annual rate instead of 2.2%. A lively debate concerning the wisdom of the FRB is in process.

The price of gold and currency exchange rates implies that Chairman Bernanke's deflation fears are unsupported. The price of gold has increased more than 18% in this year to date. The Swiss currency has appreciated to near parity with the

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USD. Even the Brazilians are complaining about the appreciation of their real versus the USD. Price changes of the component goods and services that make up the CPI do not suggest that the U.S. core CPI will drop to perfect zero stability in the next 6 months, unless the reasonably reliable Conference Board Leading Economic Indicators and the ECRI Weekly Economic Indicators are wrong and a new recession starts in the 4th Qtr. 2010. (Third Qtr. 2010 economic data implies slow GDP growth.) The LEI increased more in August (0.3%) than in July (0.1%) with interest rate spreads and real money supply growth being the most positive contributors. The six month forecasted GDP growth rate is slow (0.5% to 1.5%), but positive.

An unstated FRB concern may be housing prices. With the equity of some home owners non existent (under water), the most recent Case Shiller Home Price survey estimates overall home prices in July are 3.2% higher than a year ago. That implies recent price stability due to record low mortgage rates (30 year fixed rates less than 4.35% prior to fees.) The FRB may be worried about a possible 5% retrace of home prices during the upcoming 4th and 1st Qtr. slow selling seasons, while banks still have a sizeable inventory of reclaimed houses due to non mortgage payments or foreclosures.

Regardless of the FRB reasoning, quantitative easing bloats the central bank's balance sheet and results in a risk that future normal U.S. GDP growth (3%) or depreciation of the USD versus foreign currencies will force higher FRB interest rates and inability to shrink its balance sheet to a stable level. *Economics is an interesting science!*

What is the suggested impact of divided government: Republican House majority?

Dissatisfaction with high unemployment, the increase in federal government controls, and spending are primarily inspiring non-affiliated (Independent) citizens to vote incumbents out of office. The mood currently gives Republicans better than even odds to be voted back to House of Representatives majority status, but less than even odds to be voted back to Senate majority status. The 1946 and 1994 were recent mid term elections when a Democratic President lost a large Democratic majority in the House of Representative. The post World War II focus on normal economic issues differed from the post tax increase and failed Universal Healthcare debates of 1994. In any case, the House of Representatives generally originates spending

legislation and negotiations with the Senate prior to sending bills to the President for approval and enactment into law. The House majority status is most important to Republicans. *How would a majority Republican leadership function?* The Republican *Pledge to America* document contains patriotic statements and many photos in 48 pages. The stated focus on jobs creation, smaller constitutional government, repeal and replacement of the unpopular health care mandate, and congressional reform refers to sound principles. Yet it is not a bold statement. For example, a declaration that the rules of Congress will not allow ear marks (pet projects) into legislation without full debate does not exist. In the larger scope of things, the leadership of 4 key committees, Budget, Appropriations, Ways & Means, and Oversight & Government Reform are most important. The ranking Republican members on 2 committees appear strong and those on the other 2 committees do not have consistent small government voting records.

The Budget Committee is often less important than the other 3; however, in the midst of huge federal spending increases, this committee headed by Paul Ryan should focus the debate on both discretionary and entitlement issues. Ryan is intelligent and articulate. The Appropriations Committee is always important because it authorizes specific spending bills that are voted on by the full House. Lobbyists contribute heavily to committee members in order to influence bills. Republican ranking member Jerry Lewis has an unpredictable voting record. The Ways & Means Committee is responsible for all revenue (taxes) bills. Republican ranking member Dave Camp has an unpredictable record with protectionist tendencies. Oversight & Government Reform Committee ranking Republican Darrell Issa seems to understand the U.S. Constitution and may be quite capable in exposing the overreach of many federal agencies.

President Obama is correct in labeling the Republican Congressional members as the *Party of No*. That is what an opposing party is supposed to do, when constitutional checks and balances are working properly. Careful review of the vast transformation of federal government control over the health care and consumer financing economic sectors is important by both Congress and the Justice system. Responsible regulations by a smaller federal government are a good goal.

Can divided government deliver that lofty goal?

What about impacts on stock market returns?

A sample of two post World War II potentially similar scenarios of divided government is too small to indicate potential 2011 U.S. stock returns. S&P 500 returns in 1947 (6%) were below normal and returns in 1995 (37%) were above normal. More certainties due to defined and reasonable regulations often increase investor psychological confidence. Other issues include taxes and interest rates. Extension of all current tax rates will likely avoid a reduced disposable income drag on the 2011 economy. A limited extension of current tax rates for single households earning less than \$200,000 adjusted gross income (AGI) and families earning less than \$250,000 AGI may be difficult to pass in a 25 day lame duck Congress after election day and prior to year end when all holidays are considered. In addition to wages; capital gains, dividends, deductions, and exemptions are all involved. If current tax rates are assumed for those below the noted AGI limits, then note that 2011 extensions for those above the AGI limits are estimated to mean between \$35B and \$50B of potentially lost IRS revenue. Compare that to a stimulus law that spent over \$350B in 2010 and it looks like an ideological issue, instead of an economic federal deficit issue. The 2011 U.S. GDP boost due to extending the upper income tax rates is estimated between 0.2% and 0.4%. Interest rates in 2011 are more important in my view in relationship to earnings and equity valuation than the upper income tax rates issue. If the weak USD policy or bond holder demands result in higher interest rates, then volatile markets are likely. A bond market decline, as interest rates increase, is most likely. However, reduced earnings forecasts, especially for firms with high debt structures would also reduce demand for stocks. We are not there now; yet beware of the dynamics involved with highly leveraged federal government financing.

Market psychology is slightly positively biases.

The volatility fear (S&P 500 VIX) index fell about 25% in September to its historical neutral level (23) from an elevated June level (30). The euro (10%), as well as most currencies, advanced vs. the USD to add to foreign denominated stock gains for U.S. investors. Market forecasters and small investors optimism is at normal levels. M2 money growth may be supporting intermediate term equity price advances. Weak consumer and business confidence, as well as no resolution of 2011 federal income tax rates, prior to the November elections, has not dampened investor

stock demand. Earnings trends remain positive. *Global stock prices are climbing the wall of worry at reasonable valuations.*

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	2.7	2.4	9.6
Japan	2.8	1.4	5.2
China	9.9	8.4	9.0
Great Britain	1.5	1.9	7.8
Euro Common Mkt	1.5	1.3	10.0
Russia	4.8	4.0	5.8
India	8.0	8.1	10.0
Brazil	7.8	4.5	6.9

The total 2010 global economy is expanding (3.3%) with Asia leading the way. In Table 2 the U.S. positive 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 has been 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	2.5
Japan	0.2	1.1
China	2.5	2.9
Great Britain	0.8	3.1
Euro Common Market	0.9	2.3
Russia	7.7	5.4
India	6.0	8.2
Brazil	10.7	6.2

Economic Sectors

Technical Overview relative strength shows U.S. stock prices advanced with euro currency strengthening. Compared to a 3rd Qtr. S&P 500 11% advance, Consumer Discretionary, Industrial, Technology, Material, Energy, and Utility sectors and EAFE foreign stocks (17%)

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outperformed, while Financial, Healthcare, and Consumer Staple sectors, Treasury Bonds (5%), and Gold (6%) under performed S&P 500 average stocks.

Suggestion: Hold normal portfolio asset weights, but shorten bond durations (maturities). Stock market psychology is positively biased. It is unclear how slow economic growth and tax policy will impact investor psychology through year end. If stock markets rise another 10% by mid November (possibly due to an elected divided government) reducing equity risks will be consider. The discussed issues will still exist in fully valued markets.

Alternative Investments – Diversification

The Real Estate Investment Trusts (REITs) index rose in the 3rd Qtr. 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) (18% YTD) is suggested.

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**

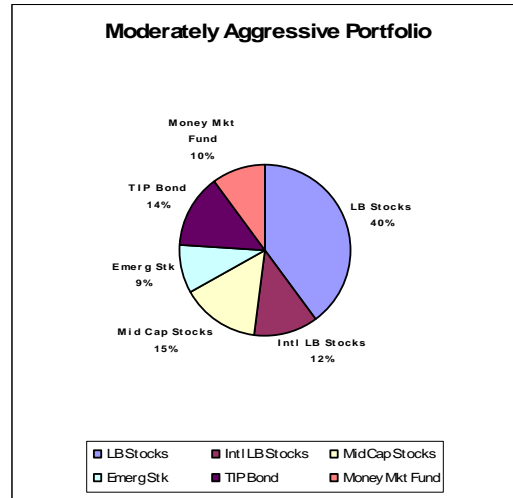
Sample Portfolio A - Moderately Aggressive

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 –

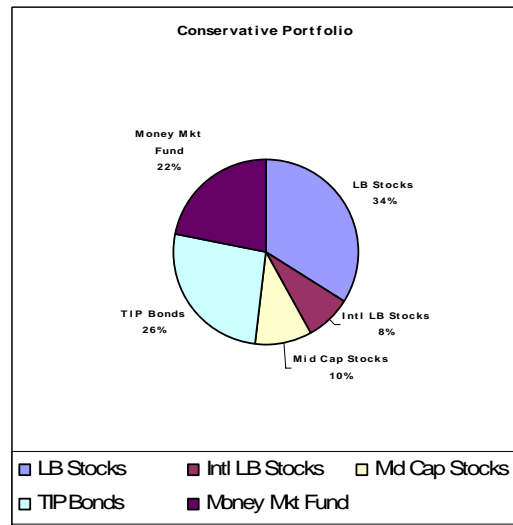


Sample Portfolio B - Conservative

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.