

Key Data Points:

- GDP & job growth begin to accelerate.
- Unemployment rate falls to 8.8%.
- Unrest in the Middle East sends oil prices higher.
- Gasoline nears \$4/gal threatening pace of economic expansion.
- Stock market showing continued strength as bull market turns 2-years-old.
- Debt and demographics favoring emerging economies.

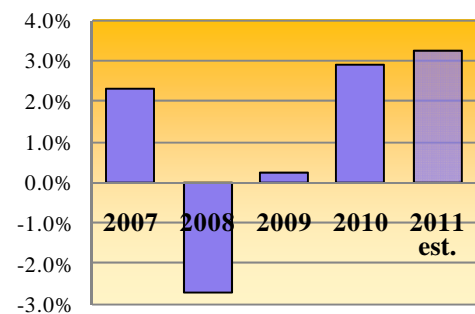
Economic Growth Expected to Continue

High and rising oil prices will slow expansion, but should not derail the recovery.

Just as the U.S. economy appeared poised to create a meaningful number of new jobs, war and unrest in the Middle East has sent oil prices sharply higher, and growth forecasts lower. As recently as January, we expected GDP growth would approach 4% in 2011. It now appears GDP growth will still exceed 3%, possibly reaching 3.5%, but rising commodity prices, and the looming battle over the federal debt ceiling are adding uncertainty and risk to an economic climate already clouded by the disaster in Japan, Europe's debt crisis, and turmoil in the Middle East.

In spite of these difficulties, GDP growth should still be enough to create

U.S. Gross Domestic Product



sufficient jobs to keep the unemployment rate trending lower. The March employ-

(Continued on page 2, *Economy...*)

Inside this issue:

- Unemployment continues to fall 1
- Stock market shakes bad news 1
- Unemployment claims falling 2
- Oil prices exceed \$110-per-barrel 2
- The Investment Answer 3
- Emerging market advantages 3
- Kate Whitney joins CCM team *Back*

Stock Market Proving Resilient

Following a rash of negative news, and a nearly 6% correction, U.S. markets manage to end the quarter with gains.

In spite of rising oil prices, the Japanese disaster, the ongoing European debt crisis, and a looming showdown in Washington over raising the debt-ceiling limit, U.S. markets posted strong results during the first quarter of 2011. Large company stocks (as represented by the S&P 500) advanced 5.9%, while the small-cap Russell 2000 surged almost 8%. International stocks also gained value during the quarter, but to a lesser degree than the U.S. market.

The S&P 500 has gained roughly 25% over the last seven months.

TWO-YEAR-OLD BULL

March marked the two-year anniver-

sary of the current bull market in stocks. In March of 2009, the Dow Industrial Average fell below 6,600. Today, the same average stands at over 12,000, which is to say, the stock market has roughly doubled in value since those dark days in early 2009.

In spite of the market's recent rise, the S&P 500 today is at the same level it was twelve years ago. But although it was a "lost decade" for stock investment returns, it was not in terms of broad economic performance. For example, during the last twelve years, U.S. GDP has grown by 27%, global industrial production has expanded by 61%, and profits on the S&P 500 index grew by almost 80%.

(Continued on page 3, *Stocks...*)

ECONOMY...

ment report showed more than 200,000 net new jobs created during the month. The private sector (not government) added the most jobs with professional/business services, education/healthcare and leisure/hospitality sectors experiencing the strongest gains.

Unemployment insurance claims continue to trend lower, while job gains are accelerating and broadening across economic sectors. Looking forward, conditions for even stronger job growth are already largely in place. For instance, many, if not most, larger companies are enjoying rising sales and profits, and have little in the way of debt. In other words, businesses are in a good financial position, and with sales expected to rise further, business leaders will have little choice but to start hiring more aggressively.

HIGHER OIL

Few things are harder on the U.S. economy than rising oil prices, which essentially act like a tax increase, making most everything more expensive and leaving fewer dollars available for other goods and services. In fact, given the current known threats to the recovery, none are looming larger than rising energy prices.

The core of the problem is that there is no good policy response to fight higher energy prices – if the Federal Reserve raises interest rates, the economy heads into recession. If the Fed does nothing, inflation will spread through the broader economy, likely resulting in a stagflation scenario.

Since unrest flared in the Middle East a number of weeks ago, oil prices have risen from around \$90-per-barrel to more than \$110. If oil prices remain at current levels, U.S. consumers will be forced to spend almost \$100 billion more to fill their tanks this year compared to last year.

However, the good news is that the American economy is better equipped to handle higher oil prices than in previous decades. Thanks to greater energy efficiency and a shift towards less energy-intensive industries, the number of BTUs needed to produce a dollar of GDP today is roughly half what it was a quarter century ago. As a result, today's high oil prices should not push the econ-

omy into recession, but higher oil can certainly make things uncomfortable.

Moody's Analytics estimates that if oil rises to \$125-per-barrel this year – the equivalent of roughly \$4-per-gallon gasoline – economic growth will slow to a crawl and unemployment will reverse course and start rising again. And, even darker scenarios are possible. Iran and Saudi Arabia are the two largest oil producers in the Middle East. Should the region's current unrest spread to either or both of these countries, oil prices could easily spike to \$150-per-barrel, causing gasoline prices to soar to near \$5-per-gallon. Recession would be all but unavoidable with energy prices that high.

While it is impossible to predict what might happen in the oil-rich Middle East, supply disruptions do not seem likely at this time. However, oil prices are likely to remain elevated until the situation in the Middle East begins to stabilize.

OUTLOOK

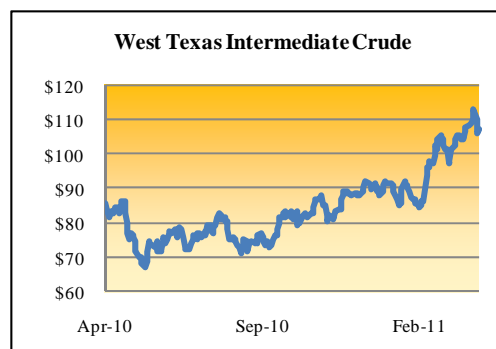
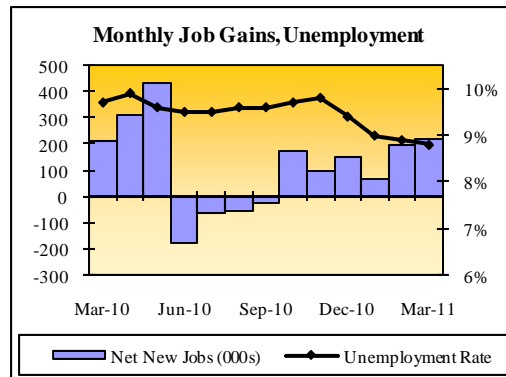
A self-sustaining economic expansion has finally taken hold, but the threat of higher energy prices clouds an otherwise sunny outlook. Real GDP is expected to advance 3.0% – 3.5% this year, compared to 2.8% in 2010. Total job gains this year will likely reach near 2.5 million, double that of 2010, and the unemployment rate is expected to continue lower, but still above 8% through the end of the year.

This sanguine outlook is dependent on a few critical factors. For one, oil prices must stabilize and even begin to turn lower. At \$100-per-barrel (\$10 below the current price), the current economic expansion strengthens. However, if oil prices rise to the \$125-per-barrel range, growth virtually stops.

Other risks include a potential government shutdown, which will occur unless the debt ceiling limit is

increased before the middle of May, and the ongoing European debt crisis, with Portugal recently added as the latest country needing a bailout.

At this point, the strength of the U.S. economic recovery appears adequate to overcome these obstacles, but this could always change. ■



The Investment Answer

By Gordon Murray and Dan Goldie, 2011, Hachette Book Group

We love this book! *The Investment Answer* was originally self-published for limited distribution, but after receiving prominent coverage by the New York Times and National Public Radio, a hardback edition was released in January that quickly became a best seller. The book is enthusiastically endorsed by former senator Bill Bradley, Nobel laureate Harry Markowitz, renowned academicians and investment experts, Eugene Fama and Kenneth French, and many others.

The reason we like it so much is because it concisely, powerfully and simply argues for the same investment approach that we employ with our clients. The book has received extraordinary attention, not just for its content, but also for the unusual circumstances of coauthor Gordon Murray, a former high-level Wall Street investment banker dying of a brain tumor.

Murray, now deceased, clearly wanted to leave a legacy that he could be proud of, and he succeeds beautifully. He and his friend, independent investment advisor Dan Goldie, advocate a very non-Wall-Street approach. They advise investors to avoid the hype, the conflicts of interest, and the excessive fees that characterize many brokerage firms, money managers and others.

The book is organized around five decisions—the key issues that you, as an individual investor, must address. These include:

- 1. Should I invest on my own or seek help from an investment professional? And if so, which type of advisor is the best?**
- 2. How should I allocate my investments among stocks, bonds and cash?**
- 3. Which specific asset classes within these broad categories should I included in my portfolio and in what proportions?**
- 4. Should I take an actively managed approach to investing that seeks to outsmart the market, or follow a passive alternative that delivers market type returns?**
- 5. When should I sell certain assets in my portfolio and when should I buy more?**

We plan to tackle these questions in a series of short articles in future issues of our *Quarterly Market Update*. In the meantime, if you are on our mailing list and would like a complimentary copy of *The Investment Answer*, just let us know and we would be happy to send one your way.

(Continued from page 1, Stocks...)

In other words, the economy has been performing far better than the stock market over the last number of years. And as a result, equity valuations are much more attractive than they were a decade ago. Currently, the S&P 500 trades at a price-to-earnings (P/E) ratio of 16 on a trailing basis (i.e. the last year of reported earnings). While this matches the median P/E of the stock market over the last 80 years, the market still appears attractively valued because earnings growth is expected to continue expanding nicely as the economy continues to recover and more people find employment. Additionally, the strong profits and rising dividends of equities compare favorably against the current backdrop of low cash and bond yields.

Based on current forecasts, the S&P 500 is expected to earn nearly \$98 in 2011, which would be a 15% jump over 2010 earnings. Assuming these forecasts are accurate, the S&P 500 would also need to climb 15% over the next year to maintain its current, and historically average, P/E ratio.

EMERGING MARKETS

In spite of its recent underperformance versus U.S. equities, we remain bullish on the long-term opportunities of investing in the emerging economies. This view is guided by two important factors which broadly distinguish the developed economies from the developing ones: debt and demographics. As a whole, the developed world has an aging population and lots of debt – both public and private.

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(Continued from page 3)

The emerging economies, on the other hand, are characterized by young populations and low debt levels. Given the choice between the two, it is hard to argue against the long-term prospects of the emerging market economies.

	Price / Earnings	Price / Book	Price / Sales
	P/E	P/B	P/S
MSCI Emerging Mkts Idx	14.2	2.2	1.5
S&P 500	16.1	2.3	1.4

In addition, emerging market stocks offer compelling valuations over U.S. stocks (see table), while at the same time, offering higher overall economic growth rates.

OUTLOOK

The outlook for the U.S. and global stock markets remains quite favorable given the attractive valuations and strong growth prospects. That said, the S&P 500 has gained roughly 25% over the last seven months, and this type of rapid price appreciation is often followed by a period of consolidation in which stock prices either decline, or move sideways before resuming the upward trend.

While we remain very bullish over the long term, shorter-term, we must acknowledge that the prospect of higher oil prices is a threat to stock prices. Already, rising oil and gasoline prices are expected to take a substantial bite out economic growth (see previous article). Should oil prices rise further; the stock market will likely stumble. ■



Hank Nicholson writes the Quarterly Market Update. He is a principal and portfolio manager for Colorado Capital Management and is a CERTIFIED FINANCIAL PLANNER®.



Kate Whitney

We are pleased to announce a new addition to our staff. Kate Whitney joins us as a client account specialist and will be providing operational and client service support for our office. Kate has experience in the financial services industry, which includes working as a commercial credit analyst for a local bank and in policy services for Aviva USA. Kate holds a bachelor's degree in sociology and business administration from Western State College of Colorado.

Kate is passionate about empowering individuals and communities in developing countries through enterprise. Kate is deeply involved with international partnerships and the college ministry at Flatirons Community Church. She recently moved to Boulder and is excited to be close to such great rock climbing!

Please join us in welcoming Kate to the Colorado Capital Management team.

INTEGRITY



QUALITY



RESULTS