

### Key Data Points:

- Job losses during this recession will approach 8 million. Job gains are expected to resume early this year.
- Leading indicators, including the stock market, point to continued growth. Double-dip recession unlikely.
- Stock market climbs 60% off early March lows.
- Foreclosure crisis continues with roughly 1 in 5 homeowners underwater.
- Homes most affordable since 1971.

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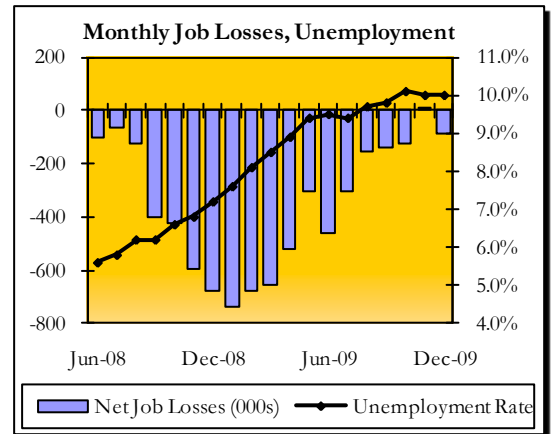
## U.S. Economy Moving from Recession to Recovery

The foreclosure crisis continues to weigh on growth, but the economy should start creating jobs during the first half of the year.

The U.S. economy is slowly but steadily recovering. Real GDP is likely to have grown by a respectable rate of more than 4% during the fourth quarter of 2009. And, even more important to most Americans and for the nascent recovery, the labor market is finally stabilizing after two years of massive job losses.

The December employment report showed a net loss of 85,000 jobs during the month. This was higher than expected and follows a small gain in November. Even though the economy is not consistently adding jobs at this point, the trend is certainly positive. (chart)

Leading indicators continue to gain strength, pointing to stronger growth in the future. This growth is expected to translate into job gains by early 2010, but the unemployment rate will likely remain



stubbornly close to 10% for much of the year.

Federal policymakers seem willing to aggressively combat the serious threats to the recovery. Lawmakers are likely to enact

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## Stock Market Climbing a Wall of Worry

In spite of economic headwinds and investor mistrust, global equity markets continue to march higher.

The late British economist Arthur Pigou once said: “The error of optimism dies in the crisis, but in dying it gives birth to an era of pessimism. This new era is born not an infant, but a giant.”

After suffering through the last (lost) decade, it is easy to understand why many investors remain pessimistic about the stock market, even after its nearly 60% rally off the lows of last March. Ten years ago, the S&P 500 traded around 1,400. Today, the widely-

*During the last decade, the S&P 500 had an average annual return, including dividends, of -1%.*

followed stock index is nearly 20% below that level. During the decade that just ended, the S&P 500 had an average annual return, including dividends, of -1%.

The last decade began with the euphoria surrounding the dot-com boom and the “new” economy. The opposite bookend to the decade was the financial crisis and *Great Recession* that led to the worst bear market in stocks since the 1930s.

Will this next decade be better? There are never any guarantees, but chances are high that market returns over the next ten years will be well above the negative re-

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## ECONOMY...

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even more temporary tax cuts and spending increases to support the job market, and the administration is continually adjusting its mortgage modification program in an attempt to make it more effective at forestalling foreclosures. In addition, the Federal Reserve has signaled it is unlikely to raise interest rates until unemployment has definitively moved lower. This fiscal and monetary stimulus should provide support to the fledgling recovery until it becomes self-sustaining, which is likely by year end.

How quickly the recovery becomes self-sustaining will depend upon how quickly firms resume hiring. Job losses are ebbing, but judging from the high number of people receiving continuing, extended, and emergency unemployment benefits, hiring is basically at a standstill.

### FORCLOSURES

Housing markets are starting off 2010 on shaky ground, and the worst housing correction since the Great Depression may still have more to play out. Home sales, residential construction, house prices and foreclosures had all improved or stabilized by the end of 2009, but double-digit unemployment, combined with an estimated 15.6 million homeowners (one in five) now underwater, are pushing mortgage delinquencies and defaults ever higher. Housing prices have little hope of rising so long as foreclosures continue to mount and lenders attempt to mitigate loan losses by liquidating properties at depressed prices.

Adding to the woes in housing are the pending expiration of government programs designed to support prices. These programs include the first-time homebuyer tax credit and the Fed's successful credit-easing program — aimed at getting mortgage rates below 5%. Should mortgage rates begin to climb, affordability will fall, adding additional downward pressure on home prices.

With close to 10 million homeowners more than 20% underwater, strategic defaults are also on the rise. Strategic defaulters are those with the financial resources to make their mortgage payments, but who have concluded that it makes little sense to continue to do so, considering they could rent a similar home for less than their mortgage payment.

Nevertheless, the healing job market and policy measures that have supported sales and prices and slowed foreclosures should be enough to help the housing market fully shake off its correction in the second half of this year. By the end of 2010, the stage will be set for a stronger rebound in 2011 and 2012.

### HOUSING REBOUND

The biggest reason to be optimistic about a positive turn in housing prices is rising affordability. The National Association of Realtors' affordability index remains near a record high, thanks to the sharp decline in house prices and very low mortgage interest rates. Moreover, homes are much more affordable than before this cycle. Homes are now calculated to be 13% more affordable than they were at the previous affordability peak in 1971. Furthermore, the cost of owning relative to renting is improving.

Affordability is likely to remain high this year, as house prices will likely remain depressed. Mortgage interest rates, which have been held down in large part by Fed policy actions, will reverse course, but remain low by historical standards. Renting will remain a cost-effective alternative to buying a house, particularly given the large supply of owner-occupied homes converted to rentals.

While homes may be affordable, credit remains scarce to all but the best credit risks. On this front, 2010 should bring some relief. A stabilizing housing market will encourage

lenders to loosen standards slightly. At the end of 2009, several lenders, including Genworth Financial and Wells Fargo, had reduced down payment requirements.

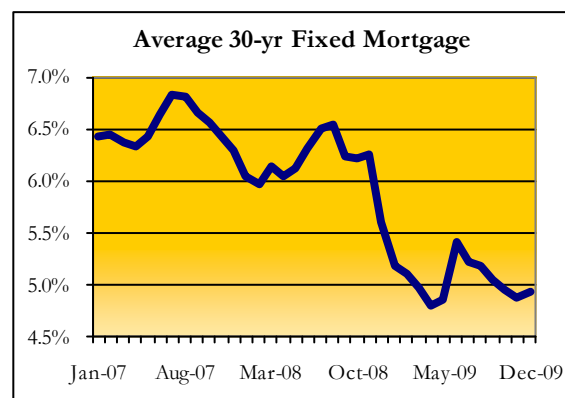
Negative homeowner equity will remain a major constraint on housing demand. The trade-up market will suffer as underwater homeowners — those who owe more on their mortgages than their houses are now worth — are unable to sell their homes without

a loss. About 21% of all homeowners are underwater.

The Treasury Department's pledge in December to give Fannie Mae and Freddie Mac unlimited assistance for the next three years offers hope that these Government-Sponsored Entities (GSEs) can continue to help lenders provide credit by purchasing mortgages. This support will be crucial once the Federal Reserve ends its purchases of mortgage-backed securities in March.

The key driver of housing demand is abating job losses. Although the economy's job-creating engine will probably not kick into gear until the second half of the year and although job growth may be weak, some of the newly employed will buy homes. By the second half of 2010, brighter job prospects and a sense that the housing market is nearing a bottom will improve confidence all around and generate more sales.

Finally, the extension and expansion of the first-time homebuyer tax credit — which expires June 30 — should result in 300,000 to 400,000 additional sales in the first half of this year.



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## INVESTING...

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turns of the last ten years. Historically speaking, the decades following those of significant market underperformance have brought solid returns. Following the 1930s, the S&P 500 enjoyed average annual returns of 8.7% during the 1940s, and 19.2% during the 1950s. In fact, every subsequent decade since the 1930s experienced average annual returns greater than 5%, except the last decade, which was the worst decade for the stock market since the decade of the 1820s.

That said, there are good reasons for being cautious because there are always impediments to growth coming out of recession. This recovery faces high unemployment, a foreclosure crisis, skyrocketing Federal debt, and an impaired credit market. It is easy to point to these and other negatives that threaten the economy's recovery. However, statistics fail to capture the capacity of markets, economies and individuals to reinvent themselves and adapt to the new realities of a changing economy. We suspect there is a high level of this type of reinvention occurring now.

Given the obvious economic headwinds, the financial media continues to paint a dour picture – in spite of the surging stock market. Market strategist Lazlo Birinyi quipped in his 2010 outlook report: “For whatever reason, the press refuses to call this duck a duck – even with all the quacking going on.”

We are also optimistic about the market, but without blinders on to the problems ailing the economy, or to the fact that the market is overdue for a correction. And in spite of the bumps we know are ahead, we remain strong believers in the long-term proven success of strategic asset allocation, diversification and consistent rebalancing.

### GOVERNMENT DEBT

The biggest obstacle to near-term growth is the lack of job creation. However longer-term, the biggest obstacle may turn out to be the soaring government debt. Although private sector debt is being paid down rapidly, the public sector is on a spending spree to help support the sagging economy.

U.S. agencies and the Federal Reserve have lent, spent or guaranteed over \$8 trillion in emergency funds to bring the economy back from the brink. U.S. public debt has surged to \$7.7 trillion, up from an average of \$5 trillion in 2007. This figure is sure to worsen with Federal budget

deficits projected as far as the eye can see. The risk is that rising public debt will further weaken the dollar, lead to higher taxes, and possibly lead to higher interest rates should the world decide to stop financing U.S. government expenditures through Treasury purchases.

### EMERGING OPPORTUNITIES

While the U.S., as well as most of the developed world, carry large debt burdens, many countries in the developing world, and especially China, run large surpluses and have amassed significant foreign reserves. This trend doesn't seem to be reversing as growth in the developing world continues to outpace overall global growth. The International Monetary Fund is forecasting global growth of 2.5% in 2010. At the same time, the IMF expects growth in India will be 6.4%, Brazil 3.5%, and real GDP growth in China is projected to top 9%.

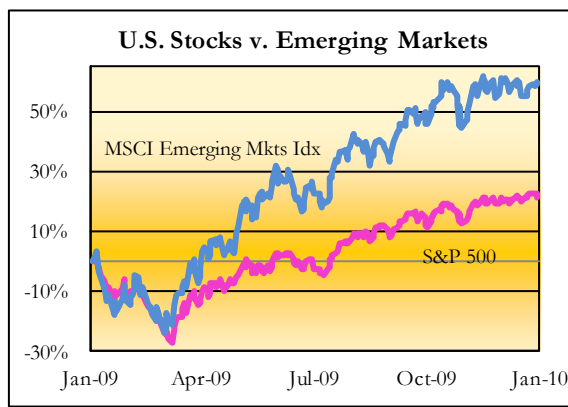
Meanwhile, many emerging economies have healthier banks, natural resource wealth, market-oriented reforms and rising discretionary incomes resulting in growing middle-class consumer populations. In addition, many emerging economies benefit from favorable demographics. According to the Research Affiliates chairman Rob Arnott, in 2002, the U.S. was adding 10 new working-age people for every new senior citizen. By 2023, he estimates that will flip to 10 new retirement-aged people for each new working-age person. The emerging world, on the other hand, has younger populations poised to fuel growth into future generations.

Finally, investing internationally offers a hedge against further declines in the dollar. This is true for investments in the emerging and developed foreign markets, as well as commodity-based investments.

### CONCLUSION

The global economy is rebounding from the worst recession in decades. While the recovery may be choppy, we believe that a double-dip recession is unlikely. A stronger economy should lead to higher corporate profits, and presumably higher stock prices. A great deal of attention will be on the Fed in 2010 as it starts to unwind the stimulus pumped into the financial system. Although we think eventual rate hikes by the Federal Reserve are a necessary signal that the recovery has become self-sustaining, volatility is likely to result.

We continue to see the greatest opportunities in the developing world. That said, the prosperity of emerging economies is no secret and the possibility of a bubble forming in these markets is a risk that we will watch carefully. ■





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## ECONOMY...

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### OUTLOOK

Real GDP is expected to weaken from its annualized pace of more than 3% during the second half of 2009 to closer to 2% during the first half of 2010. This growth will be fast enough to end net job losses by early in 2010; however, this rate of growth will not be enough to keep unemployment from rising, at least not right away. The jobless rate is expected to peak near 10.6% in the third quarter of 2010.

The Federal Reserve and fiscal policymakers are likely to provide just enough additional support to ensure that the recovery does not back-track into recession early in the year and becomes self-sustaining by this time next year. Real GDP is expected to accelerate to 2.5% during the second half of 2010.

Even stronger growth of almost 4% is expected in 2011. By the end of 2011, the unemployment rate is expected to have fallen to around 9%.

There are some obvious reasons to be cautious about the economy's prospects longer run. Most notably, it will be years before the more than 8 million jobs lost in the past two years are regained and the economy returns to full employment. However, the economy is performing measurably better today than it did a year ago, and it should be doing better still a year from now. ■



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