

Key Data Points:

- GDP & job growth remain anemic, but are expected to accelerate in 2011.
- Housing prices may fall a bit further, but should begin to stabilize in 2011.
- Company profits continue to rebound. Firms holding record amounts of cash.
- Stock market strength signaling continued economic recovery.
- Long-term interest rates begin to rise.

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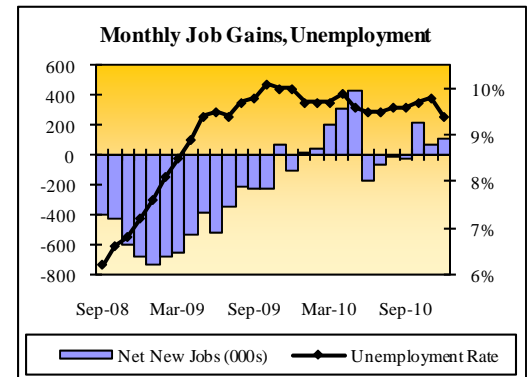
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Stronger Job Growth Likely To Come Soon

Strong cash positions and growing customer demand should force companies to start expanding payrolls.

The U.S. economy performed much better in 2010 than it did in 2009 and is set to advance further in 2011. Corporate balance sheets are strong and flush with cash. Consumers and businesses, which put off spending during the downturn, are cautiously beginning to spend again, pushing demand steadily higher. And, real estate prices are beginning to stabilize, adding to the generally held view that the worst of The Great Recession is now behind us.

We share this view and believe that real GDP growth could push as high as 4% this year. At this pace, the economy should begin adding sufficient numbers of new jobs to significantly shrink the jobless rate. Exactly when this will happen is unclear, but we are expecting hir-



ing to accelerate by summer and the jobless rate to fall to below 9% by the end of the year.

Surging corporate profits and strong balance sheets should persuade businesses to finally boost investment and hiring. During the downturn, firms dramatically

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Stocks Continue Rally, While Bonds Look Vulnerable

Stronger economic growth is fueling stock prices, but this same growth threatens to push long-term interest rates higher, hurting bond values.

The final four months of 2010 saw the stock market move steadily higher. During this time, the S&P 500 gained nearly 20%, and this rally has continued into the first few weeks of 2011, tacking on an additional 2% through the middle of January.

U.S. small-caps advanced over 16% in the 4th quarter.

For all of 2010, the market gained over 15%, with small and mid-sized company stocks doing even better.

Our outlook has not changed materially since our last newsletter three

months ago. At that time, we felt stocks were likely to rise, and bonds were at risk. Even though both of these markets have moved in the expected direction, we feel these trends may continue.

Stocks appear somewhat undervalued. Based on analysts' forecasts, the average expectation is for the S&P 500 to earn roughly \$96-per-share in 2011. This translates into a forward price-to-earnings (P/E) ratio of 13, versus a historical median P/E of 16. If earnings forecasts hold true, the market would

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lowered costs by laying off workers and postponing non-critical expenditures. Now that earnings have recovered from the recession – despite only modest sales gains – firms should start investing for the future.

WHEN IN DOUBT, WAIT

Business balance sheets are also about as healthy as they can be, with cash holdings at record levels. In fact, the proportion of corporate cash relative to short-term liabilities has never been higher.

The question is no longer whether businesses can expand their operations, but rather, are they willing to. If history is a guide, 2011 should see that willingness continue to grow. During past recoveries, profits have improved from six to 12 months before job growth picked up. The theory behind this is pretty straightforward – businesses realize they cannot boost profits forever merely by cutting costs. To sustain strong earnings growth (and support their stock prices), corporate leaders must seek to grow revenue. That means greater investment and more hiring.

However up until this point, business hiring has been anemic. Some of the sluggishness may be attributed to the tight credit conditions for small businesses, which are only now beginning to ease. But most of the constraints in hiring seem to be self imposed. Firms still appear somewhat shell-shocked from their experiences during the downturn, and appear unnerved by the uncertainty surrounding health-care, financial regulations, and the tax code.

However, the mood of business should slowly improve along with business conditions. With strong financial positions and growing customer demand, we think it is likely only a matter of time before hiring strengthens and the unemployment rate begins to fall.

HOUSING STARTS TO BOTTOM

Ground zero for the financial crisis and the Great Recession was the housing crash. Since the housing bubble peaked nearly five years ago, residential construction has fallen to pre-World War II levels, average national home prices have plunged more than 30%, and nearly 5 million households have lost homes through foreclosure or short sales.

Worse still, house prices may have a bit further to fall. More than 4 million first mortgage loans are in the foreclosure process or likely to default. It's likely that distressed properties will account for a larger proportion of total home sales. These sellers are often motivated, and willing to accept lower prices, putting additional pressure on prices. True, loan modification efforts will be helpful in reducing the number of distressed sales, but even so, the share of such sales will likely rise and house prices will likely fall in many markets.

That said, the degree of further house price declines should be relatively modest and gradual, averaging about

5% through next fall. With better job growth, near-record housing affordability, and ample credit from Fannie Mae, Freddie Mac and the FHA, housing demand is expected to slowly revive. In addition, investor demand for distressed properties should be sturdy as prices have fallen enough for investors to see opportunities in fixing and renting these houses.

TAX DEAL

The recently enacted compromise between the Obama administration and congressional Republicans on taxes and government spending adds significantly to growth prospects for the coming year. According to projections from Moody's Analytics, the deal will add approximately a percentage point to real GDP growth in 2011, double expected job growth from 1.3 million to 2.6 million, and will reduce unemployment by about a percentage point. Before, unemployment was expected to hover around 10% for the better part of 2011. Now, the unemployment rate is expected to fall to below 9% by this time next year.

However, in spite of the benefits, there are some downsides to the tax deal. Most importantly, it means Congress will make little progress towards deficit reduction this fiscal year. The deficit is likely to come in near \$1.3 trillion for fiscal 2011 – equal to 9% of GDP, and about the same as fiscal 2010. While the impact on long-term interest rates should be limited, there is a risk of backlash by global investors nervous about the U.S. fiscal outlook. Should this happen, interest rates, or borrowing costs, will rise for federal government, along with everyone else.

OUTLOOK

Even as the economy appears to be turning the corner, risks remain. For instance, house prices need to stabilize. Nothing works well in the economy when house prices are falling. Additional price declines will push more homeowners underwater, adding to the estimated 14.2 million already there and creating the fodder for more defaults, more distressed home sales, and thus more price declines. This is the same vicious cycle that plagued the economy during the recession and it could be reignited.

However, in spite of the downside risks associated with housing, not to mention the ongoing European debt crisis, there are still good reasons to be optimistic about 2011. Most importantly, corporate sales and profitability are on the rise. This, coupled with business's strong financial positions, should compel firms to begin hiring more aggressively in 2011. Finally, pent-up consumer demand is starting to translate into gains in consumer spending.

We expect economic growth to accelerate in 2011, with real GDP growth in the 3%-4% range. More importantly, we expect hiring to pick-up appreciably from its current doldrums. In the absence of external shocks, the unemployment rate should fall to less than 9% by the end of the year.



Summary of Tax Law Changes for 2011

Last month, new federal legislation was passed extending the Bush-era income tax cuts for another two years, and revising the amounts excluded from gift and estate taxes. Key provisions include:

- The maximum federal rate will remain at 35% for ordinary income, and 15% for qualifying dividends and long-term capital gains. Lower marginal income tax rates also remain constant, with the size of the brackets for each widening modestly.
- The lifetime gift tax exemption increases from \$1 million to \$5 million, although the annual gift exclusion (which doesn't count against the lifetime exemption) remains the same at \$13,000 per recipient.
- Similarly, the exemption from estate taxes also rises to \$5 million per person (\$10 million per couple), with excess amounts taxed at a 35% flat rate. The exemption is now portable, so that any unused portion can be passed to the surviving spouse. Any gifts made pursuant to the lifetime gift tax exemption effectively reduce the size of an individual's estate tax exemption.
- Individuals over age 70½ can continue tax free IRA payouts of up to \$100,000 to qualified charities. The gift counts against required minimum distribution amounts, and if done in January, can be retroactively applied to 2010.
- There is no cost of living adjustment to Social Security this year, meaning that benefits and the taxable wage base (\$106,800) remain unchanged. However, for 2011 only, employees only pay 4.2% of wages to social security, as opposed to the normal 6.2% level, a savings of up to \$2,136 per person. Employer contributions are unchanged.

At the beginning of 2013, income and estate tax rates and exemptions are scheduled to revert back to roughly year 2000 levels (which provide for much higher taxation), unless the law is further modified.

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need to rise another 20% before reaching the historical average P/E of 16. In other words, the market could rise further before reaching a level that would be considered overvalued in historical terms.

SMALL-CAPS, BIG RETURNS.

In terms of market segments, the outperformance of small caps has been dramatic of late. For well over a year now, we have been emphasizing small caps in client portfolios, but during this time, the difference in performance between small and large company stocks has been almost unnoticeable. However, this all changed during the second half of 2010. In the fourth quarter alone, the small-cap Russell 2000 index advanced an eye-popping 16.3%, compared to 10.8% for the large-cap S&P 500.

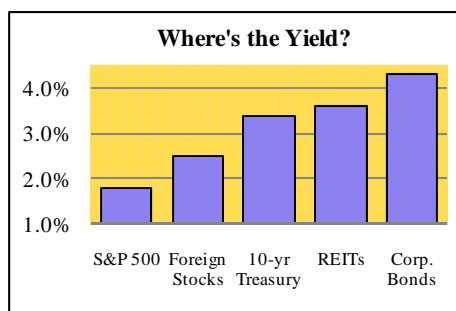
Historically, the recovery phase of the business cycle (which is where we believe the economy is currently), has favored small caps. This pattern held true following the recession of 2001, as well as most previous cycles. Currently, with attractive valuations relative to large-caps, and prospects for greater access to credit, we believe the pattern of small-cap outperformance may be in the early stages of repeating again. For that reason, we expect to maintain a higher-than-normal allocation to small-cap stocks throughout 2011.

EMERGING MARKETS

Another segment of the market we remain bullish on is emerging market stocks. Emerging markets have garnered much attention over the last several years, and have enjoyed steady inflows of new money. This is normally a cause for concern, as we are usually most comfortable investing in asset classes that aren't the darlings of Wall Street. However, in the case of emerging market stocks, we feel the macro-economic trends warrant the added attention and investment. These trends (low personal and public debt, young populations, and expanding middle classes) have propelled the emerging economies over the past decade, and these trends are still firmly in place.

We will grow more cautious on emerging market stocks should valuations become frothy. However at this time, the MSCI Emerging Markets Index trades at a lower P/E than the U.S. market – in spite of stronger earnings growth. The fly-in-the-ointment could prove to be Chinese inflation, which has recently accelerated to greater than 5% annually. The risk is that Chinese authorities may have to take steps to combat inflation, which is to say, slow the world's second largest economy, which is sure to ripple out to other parts of the globe.

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BONDS STUMBLE

As we have been expecting for some time, the bond market finally reversed course in the fourth quarter of 2010. During that time, the yield on the 30-year Treasury rose from 3.7% to 4.2%, and currently stands at 4.5%. As yields rise, bond prices fall. One commonly followed index of long term Treasuries (greater than 20 years) saw price declines approaching 15% since they peaked in August.

Once considered a safe haven like U.S. Treasuries, municipal bond prices have also dropped dramatically with the Barclays Capital Muni Bond index falling 4.2% in the fourth quarter alone. While this may not seem like a big decline, at a current yield of only 3.5%, the decline did wipe out (at least on paper) more than a year's worth of interest payments.

The correction in the bond market was long overdue. And now that bond prices have fallen some, the question becomes: are bonds now fairly valued, or do bond prices have further to fall. The answer to this question depends on the strength of the economic recovery, and whether this strength will ignite inflation. At this point, the economy remains sluggish, and inflation subdued, but this could change meaningfully over the course of the year. Given this, we continue to feel that longer-maturity bonds are at the most risk. To mitigate this risk, we are favoring shorter maturities, which we think have a good chance of being reinvested at higher rates in the future. ■



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The Trouble with Market Forecasts

A recent New York Times¹ article pointed out that at the beginning of 2008, the average Wall Street stock market analyst was projecting the market would gain 12% that year, and not a single strategist included in the survey projected a loss. The actual result for the year was a 38% decline, followed by further dramatic losses during the first ten weeks of 2009.

The inescapable conclusion of the article was that such forecasts need to be taken with more than a grain of salt. We would echo this advice. While we clearly believe in the importance of trying to understand economic developments and their impact on financial markets, we strongly oppose making decisions about getting in and out of the stock market based on this data. We don't believe that we, or anyone else, no matter their resources, can predict what is going to happen in the financial markets, particularly in the short term. This data overwhelmingly demonstrates the folly of attempting to time the stock market.

While its image was badly tarnished during the financial meltdown, the straight-forward buy and hold investing strategy that we endorse is once again proving its mettle. As Mark Twain once quipped, reports of its death have been greatly exaggerated.

¹ Your Money by Jeff Sommer, January 9, 2011, The New York Times.

INTEGRITY



QUALITY



RESULTS