

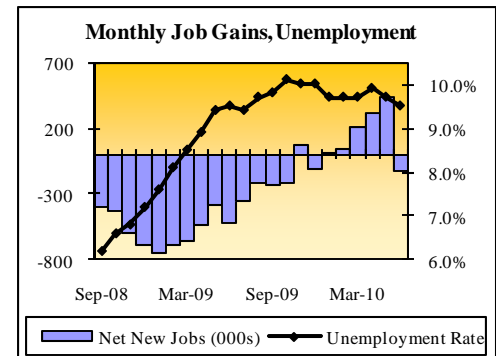
**Key Data Points:**

- Growth slows as labor market remains sluggish.
- Unemployment expected to top 10% by year end.
- U.S. stocks correct 15%, as fear re-enters markets. Stocks appear favorably valued.
- GDP growth expected to remain weak this year, but accelerate in 2011-2012.
- Financial reform legislation heads to Senate.

## U.S. Economic Recovery Slows

Chances of a double dip recession are on the rise, but U.S. economy likely to withstand the current soft patch and strengthen in 2011 and 2012.

The economic recovery is losing momentum. Retailing, housing, manufacturing, and most importantly the job market have weakened in recent weeks. Real GDP, which grew 4% annualized during the second half of 2009, has slowed to nearly 3% during the first half of this year and is expected to approach 2.5% during the second half. Given the lack-



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## Economic Uncertainty Sends Stocks Reeling

Pessimism is running high, but valuations tell a much more upbeat story.

Following more than a year of rising stock prices, the market finally corrected during the second quarter, sending U.S. equity prices (as measured by the S&P 500) tumbling more than 15% over the two months ending June 30th. Other markets around the globe performed in a similar fashion with MSCI EAFE International Index, with nearly two-thirds of its portfolio invested in European stocks, declining more than 20%.

The crowd sentiment indicator by Ned Davis Research, which measures investor confidence, went to extreme optimism in March. And with the benefit of hindsight, it is clear that three months ago things were not as well as they appeared. Fast forward to the present, and we find the same crowd sentiment indicator has fallen into the range of

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## Financial Reform Legislation May Not Go Far Enough

The near-collapse of the world financial system in late 2008, and the global credit crisis that followed, led to calls to overhaul the financial regulatory system.

On June 25<sup>th</sup>, members of the House and Senate conference committee announced they had worked out a compromise version of reform legislation, which included weaker versions of the two most contentious parts of the financial regulatory overhaul concerning derivatives and the so-called Volcker rule. These

changes could force banks to spin off the lucrative non-bank parts of their business.

The bill has been widely described as the most comprehensive reorganization of financial regulation since the Great Depression. President Obama claims it will reduce the chance of system-wide failures and would protect borrowers by the creation of a consumer protection agency.

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## ECONOMY...

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luster growth, unemployment is expected to drift back up into the double digits. With unemployment so high and policymakers increasingly perplexed over how to respond, the risks to the recovery are rising again. We believe the odds of a double dip recession are likely around 1-in-4, but the risks are growing and the economy remains vulnerable to external shocks such as a spike in energy prices, terrorist attack, or the debt crisis in Europe.

### STIMULUS FADES

Fiscal policy-makers have provided an enormous stimulus throughout the Great Recession and current recovery. From the tax rebate checks that were mailed in the spring of 2008 to the early 2009 Recovery Act to the current job tax credit, almost \$1 trillion has been provided. This sum equals nearly 7% of GDP, well more than double that provided during the severe downturn of the early 1980s.

The stimulus was instrumental in ending the recession and jump-starting the recovery, but its boost is waning, as stimulus spending is scheduled to start declining this quarter and largely wind down by this time next summer.

### POLITICAL REALITY

Congress and the Obama administration are also running out of options. As election year politicking gears up, they are even having difficulty agreeing to extend expired emergency unemployment benefits and provide more aid to state and local governments, which would be the two clearest steps to support the economy in the next few months.

Concerns that some unemployed workers are taking advantage of the generous benefits and that states and municipalities need to become more efficient may not be without basis, but they are likely overstated. There are more than four unemployed workers for each open position – compared with closer to one-for-one in a well-functioning economy – which suggests that there simply aren't enough jobs for those competing to find work.

Furthermore, worries that any additional stimulus measures that are not offset by spending cuts or tax increases will add to the nation's daunting fiscal challenges

are logical. However, restraint should begin not this year or next, but rather after the economy has recovered and is able to withstand austerity measures. Given the immediate risks to the recovery – not to mention the fiscal havoc that another recession would wreak – a pay-as-you-go stimulus policy probably isn't advisable at this point. As unsavory as a bloated national debt may be, deficit spending until the economy can fully recover may be a necessary evil.

### EURO DEBT

The European debt crisis has become an unanticipated drag on the U.S. economy. European policymakers are making progress stemming the crisis, but financial markets remain unsettled, and significant damage has already

been done. The euro zone economy is expected to slump by early next year as credit constraints and fiscal restraint intensify. The U.S. economy will feel the ill effects from weaker exports to Europe, but the biggest impact may be from lower stock prices.

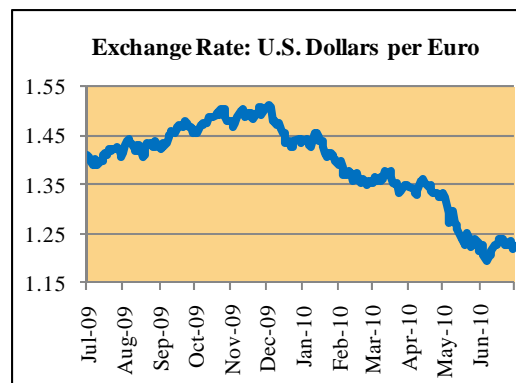
### OUTLOOK

Federal Reserve Bank of Richmond President Jeffrey Lacker summarized the current economy this way, "The economy

is still growing. The risks of slower-than-average growth for a couple of quarter may be notched up a bit, [but] it's important to remember recoveries are choppy and uneven in the early stages."

"Choppy and uneven," might be putting a euphemistic spin on the current slowdown, but much of the recent slowing had already been anticipated, so the 2010 outlook for real GDP, jobs and unemployment has not appreciably changed. Real GDP is expected to advance nearly 3% this year, monthly payroll employment gains are expected to average close to 125,000, and the unemployment rate is expected to end the year back over 10%.

Prospects for 2011-2012 remain much more upbeat. Real GDP is expected to advance almost 4% in 2011 and 5% in 2012 amid stronger employment growth. This forecast is predicated on a range of developments: a more or less successful resolution of the European debt crisis this summer, more stable financial markets as a result, stabilizing home prices, and continued solid growth in emerging economies. ■



## STOCK MARKET...

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extreme pessimism. Similar to the exuberance of three months ago, it now appears sentiment has swung to the other extreme. And just as things were not as rosy as they appeared a few months ago, we also think it is likely that economic and business conditions will not prove to be as bad as they seem now.

### PERCEPTION & REALITY

Though the market's price momentum (the voting machine) is quite negative, valuations (the weighing machine) are actually quite compelling. Assuming the current slowdown does not worsen, we think it is likely that companies will continue to successfully navigate this environment of relatively slow growth by increasing productivity and keeping a tight lid on expenses.

In spite of negative press, we continue to believe the S&P 500 will likely earn around \$90-per-share in 2011, which translates to a price-to-earnings (P/E) ratio of only 11.5 at current prices. This compares favorably to its multi-decade average of 15.3 and very favorably to comparable periods of low inflation and interest rates, when the market traded closer to 17 times earnings. Put another way, the stock market seems to have already priced in disappointing economic news. Should the current recovery stick, stocks will likely benefit handsomely as growth estimates are revised higher.

Including dividends, and adjusting for inflation, the S&P 500 has fallen at an annualized rate of 3% a year over the past 10 years. During the same period of time, long-term Treasury bonds show a gain of 5% after inflation. Gold is up 10% a year and real estate investment trusts (REITs) 8% a year. The S&P 500 index itself, without adjusting for inflation and dividends, is today at a level it first reached 12 years ago, meaning it has gone nowhere in more than a decade.

Depending on your point of view, this may or may not be encouraging news. For younger investors and others with long time horizons, the fact that the market has underperformed by so much, for so long, statistically suggests better-than-average returns are likely in the future. However, the market's recent correction has reminded us that in the short run, many current headwinds, such as high unemployment and a potential debt

crisis in Europe could prove strong enough to push markets lower still.

### "SMART" MONEY

Hedge-fund managers, Wall Street's best compensated and supposedly smartest investors, don't seem to have any better sense of where the markets are heading than anyone else. After finishing the worst second-quarter performance in a decade, hedge funds have scaled back trading as they struggle to figure out where markets are headed.

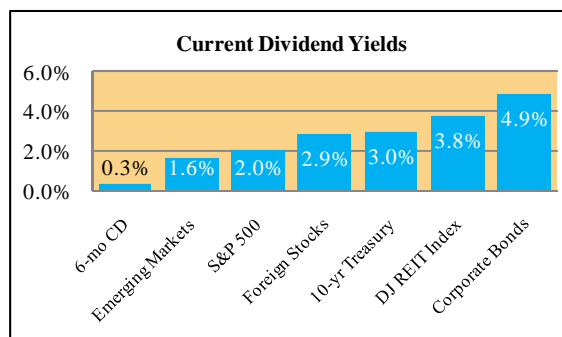
Well-known hedge fund manager Barton Biggs, whose purchase of stocks in March 2009 gave his Traxis Partners LLC a 38 percent gain last year, said last week he sold about half his stock investments because of concern governments around the world are curtailing stimulus measures too soon. Meanwhile, equally famous hedge fund manager John Paulson, who made \$15 billion wagering against home mortgages during the financial crisis, is now betting on a U.S. economic recovery. Furthermore, Paulson, who runs the \$33 billion Paulson & Co., has not changed his bullish views even in the face of recently disappointing economic news and a steep market correction.

Market timing is always a risky proposition, but given that

some of the world's best market timers hold conflicting views, the proverbial crystal ball has never seemed cloudier.

### LOOKING FOR YIELD

The short-term direction of stock prices is largely unpredictable, but current yields of stocks and fixed income investments are known, and more importantly, can make up a significant part of investors total return. The chart above shows the current yield on various investment classes. True, it is hard to get excited about yields in the low single digits, however, one must always keep inflation in mind when evaluating yield. The core consumer price index was up only 1% for the year ending this May, its slowest rate in several decades. And, inflation should remain low through 2010 as the economy recovers. In other words, today's yields may be low, but so is inflation, so the *real* yield to investors is actually better than the yield alone would suggest. In fact, with the exception of cash deposits, all of the asset classes listed in the chart have a dividend yield higher than the rate of inflation. ■





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To reduce the odds of a future crisis, the Democratic plans would take three basic steps. First, regulators would receive more authority to monitor everything from mortgages to complex securities. This is meant to keep future financial time bombs, like the rampant no-documentation loans, risky insurance products, and collateralized debt obligations of the past decade, from becoming rife.

Second, financial firms would be forced to reduce the debt they take on and to hold more capital in reserve. This is the equivalent of requiring home buyers to make larger down payments: more capital will give firms a bigger cushion when investments go bad. Finally, if that cushion proves insufficient, the government would be allowed to seize a collapsing financial firm, much as it can already do with a traditional bank. Regulators would then keep the firm operating long enough to prevent a panic and slowly sell off its pieces.

In addition, the House-passed version of reform legislation would impose regulations on derivatives. Most derivative trading would be required to take place through open marketplaces and banks would have to segregate or spin off their derivative-trading wings, although some exceptions were created in the final round of deal-making during the conference committee.

The final measure also included a somewhat watered down version of the Volcker rule. The rule, named for Paul Volcker, the former Federal Reserve chairman who proposed the measure in early 2010, restricts the ability of banks, whose deposits are federally insured, from trading for their own benefit. Eliminating the heads-I-win, tails-you-lose conflict – where big banks kept profits in the good years, only to shoulder taxpayers with the losses suffered during the financial crisis – will likely reduce bank profitability, but it also serves to protect taxpayers and the financial system. Some however, including Paul Volker himself, feel the final version of the bill gives banks too much wiggle room to repeat the behavior that threw the nation into crisis in the first place.

The Senate will take up the bill after the Fourth of July recess. ■



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