

Key Data Points:

- **GDP & job growth remain anemic. Unemployment rate at 9.6%.**
- **Economic growth expected to accelerate over next 12 months, possibly reaching 5% real GDP growth by 2012.**
- **Company profits continue to rebound. Firms holding record amounts of cash.**
- **Consumer balance sheets strengthening, as households pay down debt.**

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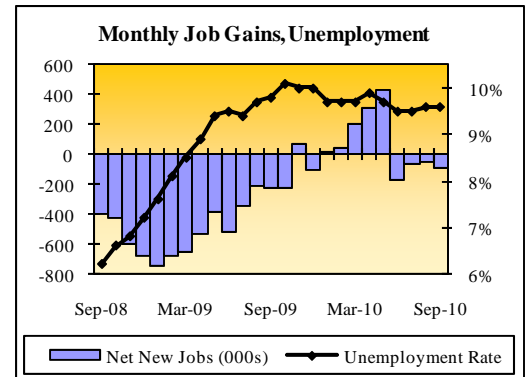
U.S. Economy Tries to Turn the Corner

Unemployment remains high, but conditions for more robust growth start to emerge.

Economic recovery in the U.S. lost significant momentum over the summer. We estimate that real GDP growth slowed to a paltry 1.5% annualized rate during the 3rd quarter, which is roughly half the overall rate experienced since the recession ended more than a year ago.

For many, joblessness is becoming chronic, while home foreclosures continue to mount. According to the NBER (National Bureau of Economic Research), the recession ended in 2009, but for millions of people, there is little difference between recession and recovery.

Going forward, we do expect the economic hue to brighten somewhat, with GDP growth averaging roughly 2.5% over the next twelve months. As we approach 2012, however, we expect growth



might accelerate considerably – possibly reaching 4%-5% in 2012 and 2013. This may seem wildly optimistic, but we feel conditions, such as growing corporate profits and strengthening consumer balance sheets, are pointing to stronger economic growth in the future.

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Global Stock Markets Surge in September

U.S. and emerging market stocks remain attractively valued, but prices on “safe” investments, such as U.S. Treasuries, appear lofty.

The U.S. stock market reached its high for the year last April. Since that time, worries over a double-dip recession, have kept markets stuck in a trading range with the S&P 500 fluctuating mainly between 1,050 and 1,200. However, even

The S&P 500 gained over 11% in the 3rd quarter.

though the market kept within this trading range, dramatic swings, both up and down, have also been the norm. In each of the months from May through September, the stock market swung more

than 7% between its peak and trough. This type of volatility keeps many investors on the sidelines, but we suspect that it might now be a reasonable time for the under-invested to get in the game.

The choppy and corrective phase of the last two quarters now appears to be giving way to a more sustainable advance. Statistically speaking, stocks have tended to perform relatively well in the fourth quarter, and that is especially true in the fourth quarter of a mid-term election.

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ECONOMY...

ECONOMY NEEDS JOBS

At present, the biggest impediment to growth remains lackluster job creation. Last month's disappointing labor report showed the economy shed jobs for the fourth month in a row. (see front page chart) True, much of these losses were the result of temporary census workers being laid off, but the private sector only generated 64,000 jobs in September, which was not enough to fill the gap. For the unemployment rate to begin to fall from its current 9.6% level, monthly private sector job creation will need to double from its current pace – at a minimum.

With confidence low and the economy sluggish, a near-term surge in hiring seems unlikely. Consequently, the unemployment rate is expected to worsen, moving back towards 10% in the coming months. The economy appears to be caught in a negative cycle: high unemployment and onerous debt burdens cripple consumer spending and damage confidence. Low confidence and weak demand give companies little reason to hire more workers. Unemployment stays high, and the cycle continues.

What will break the cycle? The simple answer is time. Although economic activity remains weak, it has stabilized, and even improved, over the last year. During the financial crisis of 2008-2009, job losses mounted at a truly alarming pace. For the five months starting in November 2008, the average number of jobs lost was over 730,000-per-month. For the Great Recession as a whole, over 6.2 million total jobs were eliminated. To put that in context, that is roughly equivalent to the population of Dallas/Ft Worth, the 4th largest metropolitan area in the United States. Needless to say, losing this many jobs was a terrific blow, and not one that consumers, or the greater econ-

omy, bounce back from quickly or easily.

Luckily, a number of important factors are falling into place that will likely pave the way to stronger growth in the future. For one, company profits have rebounded. Earnings for the S&P 500 (a proxy for large, U.S. companies) are projected to approach pre-recession levels next year. Meanwhile, these same companies are sitting on record levels of cash. Costs have already been cut to the bone, so to keep profits growing, business leaders will soon be forced to invest to grow their businesses. This should translate into higher capital expenditures and expanding payrolls.

On the consumer front, households are paying off – or walking away from – debt at a rapid pace. According to Equifax, outstanding consumer debt has fallen by more than \$800 billion since peaking in October 2008 – that is an average of over \$30 billion per month. As a result, the borrowing excesses that contributed to the financial crisis are being quickly corrected. As personal balance sheets strengthen, consumers should be more willing, and able, to spend.

OUTLOOK

Frustration, pessimism, and even despair, are understandably permeating our media and public discourse as Americans struggle to adapt to a new austerity – a new normal. We expect another twelve months of subdued economic performance. Should the economy manage to muddle through this period without being sideswiped by unforeseen shocks, we feel much stronger growth and job creation will emerge as we approach 2012. This outlook may sound optimistic, but we feel the conditions for a stronger economy are beginning to fall into place. ■

(Stock Market... continued from page 1)

Meanwhile, many market participants are emboldened by recent Federal Reserve statements. In effect, The Fed has stated that it will implement another round of quantitative easing should the economy begin to falter again. Quantitative easing refers to the process by which The Fed prints new money, and then spends this money buying bonds and other assets on the open market, thus injecting new money into the system. For stocks, the benefit is thought to be twofold: one, The Fed pushes bond yields lower, making stocks more attractive on a relative basis; and two, some of the newly created money is redeployed into stocks.

Of course, this second round of quantitative easing, or QE2 as it is being called, may not be necessary if the economy accelerates out of the current mid-cycle slowdown. And this is the hope. But either through an improving economy, or intervention by The Fed, the perception is that the stock market stands to benefit.

LOOKING FORWARD

Based on the thousands of analyst forecasts tracked by Bloomberg, the S&P 500 is estimated to earn nearly \$96 in 2011. This estimate is sure to change as we move through earnings season, a time when companies report current profits and losses, but more importantly, companies offer guidance on business conditions going forward. But using this current estimate, the S&P 500 now trades at 12x forward earnings – well below its historical median P/E of around 16. Our baseline expectation is for a slow, but gradual, economic recovery, that gives way to stronger growth in 2012 and beyond. Given this, we feel the stock market is attractively valued at its current level.

True to historical patterns, small company stocks have outperformed large company stocks since the market bottomed in March of 2009. This outperformance was most pronounced during the first 13 months of the market's recovery – a period that saw the small-cap Russell 2000 in-

dex more than double from its early 2009 low. However, since the U.S. market peaked in April of this year, the performance of small, medium, and large company stocks have been nearly perfectly correlated.

If the stock market resumes its upward trend (which we expect it will), we believe small-cap stocks are likely to outperform once again. However, a number of factors might disrupt this otherwise sanguine outlook. For one, the global economy is fragile at best. A double-dip recession, or even slower growth, will hurt small-caps disproportionately. In addition, low interest rates and falling credit spreads (the difference between risk-free U.S. Treasury bonds and other debt instruments that have default risk) tend to benefit small-caps, but any shock to the financial system, or spike in interest rates, will likely push investors away from riskier small-caps.

On the growth-versus-value continuum, we continue to reside in the middle, as there are compelling reasons to own both styles. Growth stocks, such as those in the technology and consumer discretionary sectors, should do well once the economy can get back on a growth trajectory, which might come sooner than many expect (see previous article). As business leaders and consumers gain confidence, spending in these sectors will likely rise.

Value stocks, like those in the financial and manufacturing sectors, offer investors attractive dividend yields and lower volatility, both attractive qualities in today's uncertain environment. The current yield on the Russell 1000 Value index stands at 2.2%. For comparison sake, the current yield on the 10-year Treasury bond is only 2.4%.

EMERGING MARKETS

Among the asset classes we invest in, emerging market stocks were again the top performer – sprinting ahead an eye-popping 18% during the 3rd quarter. We think recent gains in global stock markets reflect positive expectations for global economic growth. However, the spoils of this growth will not be shared equally – structural forces still favor the developing world.

The developed economies of the U.S. and Europe are characterized by high structural unemployment, high national and household debt levels, and retrenching consumers focused more on paying down debt than purchasing new goods and services. And, these structural impediments are likely to take years to correct. In the

meantime, emerging economies enjoy low consumer and public debt, a growing middle class with rising incomes, and generally faster economic growth. Framed in this light, the emerging economies appear to be at a distinct advantage.

Caution however, is always warranted. In the case of emerging market investments, we will continue to focus on valuations and investor expectations. We believe asset bubbles, like technology stocks during the late 1990s, and more recently, housing prices, have two common elements: one, valuations become grossly elevated, and two, investor optimism reigns supreme.

At this point, emerging market stocks, as measured by the MSCI Emerging Markets Index, appear normally valued. In fact, using the three most watched valuation ratios, price-to-earnings (P/E), price-to-book (P/B), and price-to-sales (P/S), emerging markets stocks have nearly identical valuations relative to U.S. stocks. The MSCI Emerging Markets Index and the S&P 500 both currently trade at P/E

ratio of 14.8, have a P/B ratio of 2.1, and P/S ratios of 1.3 and 1.2, respectively.

On the investor sentiment front, money continues to flow disproportionately into emerging market stocks. Since late 2008, the monthly average flow into 68 emerging market funds has trended to a new high of \$2.3 billion, while the monthly average flow into developed market funds has been flat to slightly lower. These outsized fund flows may represent the seeds

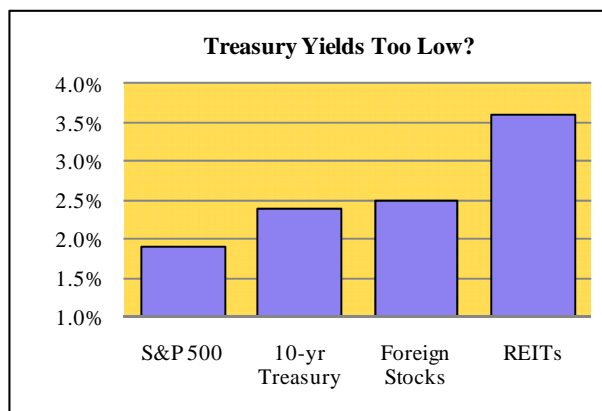
of investor exuberance, but until we see more ominous signs, such as a greater expansion of emerging market fund offerings, or a substantially higher market capitalization, we will continue to favor this asset class.

SAFETY IS EXPENSIVE

The price of safety continues to rise. Or, put in a less provocative way, yields on U.S. Treasury bonds continue to fall, pushing prices on the “risk-free” securities ever higher. As previously mentioned, the 10-year Treasury is now yielding roughly 2.4%. This is down from a yearly high of 4.0% reached in April. Remarkably, Treasury yields are only slightly higher now than they were during the height of the financial crisis, when flight-to-quality buying pushed the 10-year yield to a low of 2.1%.

Describing the U.S. Treasury market as a bubble would be overstating the case. After all, investors do not seem overly optimistic about expected returns – especially as they lock in a meager 2.4% for ten years. However, Treasuries

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do appear overvalued and we are cautious about investing new money at this time.

We are, however, finding attractive risk/reward tradeoffs in bonds with higher credit risk, such as corporate bonds and even high-yield (junk) bonds. The difference in yield, or the spread, between investment-grade corporate bonds and Treasuries remains elevated by historical standards – reflecting investors’ risk aversion. However, as the economy improves, we feel the credit-worthiness of companies will improve as well, giving a natural tailwind to corporate bond prices. Current yields on intermediate-term, investment-grade bonds range between 4.5%-5.0% and high-yield corporate bonds are in the 8%-9% range. We recommend purchasing such bonds through a well-diversified fund to reduce the impact of default by any one company.

OUTLOOK

Through the first half of October, the S&P 500 has tacked on an additional 4% to the 3rd quarter’s 11% gain. However, it is important to remember that October can historically be a vexing month for the market. Any number of developments, from renewed sovereign debt concerns, to a trade war with China, to uncertainty around the mid-term elections, could spark a selloff. At this point, with the economy improving and The Fed prepared to take aggressive action should the economy stumble, we feel any correction in the market will likely give way to a resumed uptrend that could carry the market higher through the end of the year and possibly into next. ■



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A lot of grey hair for only ten-years-old !

2010 marks the ten-year anniversary of Colorado Capital Management. What a decade it has been! From the euphoric highs of the internet bubble, to the depths of the financial crisis, it was quite a ride.

We have always appreciated the incredible loyalty of our clients, but it is even more meaningful given the volatile markets of the last ten years. Our business has grown and continues to grow because of your support, your referrals, and the trust you have placed in us. We can’t think of a greater compliment. Thank you.

INTEGRITY



QUALITY



RESULTS