

Key Data Points:

- **Growth slows as labor market remains sluggish.**
- **Fiscal debate heats up in Washington as debt ceiling limit approaches.**
- **U.S. debt-to-GDP ratio at 93% and climbing.**
- **GDP growth and hiring expected to reaccelerate later this year and into 2012.**
- **Global stock markets flat on disappointing economic news.**

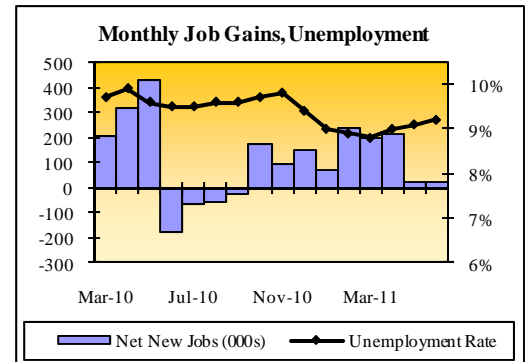
Hiring Slows to a Virtual Standstill

Uncertainty surrounding the economy and tax policy causes businesses to curtail hiring. However, job creation and economic growth are expected to rebound in the second half.

June's employment report proved a big disappointment. Not only did the unemployment rate inch up slightly to 9.2%, but the economy only generated a few thousand net new jobs. In other words, job growth has all but stalled, and with so many idle workers, wage gains are also at a standstill.

Weakness in the labor market, or the reluctance of companies to expand pay-

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Debt and Deficits take Center Stage

Aging populations in the United States and other developed countries will add additional financial stress to already heavily-indebted nations.

U.S. politicians are debating ways to trim the federal budget, which has reached a crisis point as the U.S. government approaches its statutory borrowing limit. For much of the last decade, the U.S. ran a substantial budget deficit, but one that appeared manageable.

However, this all changed in 2008 with the financial crisis and Great Recession. Even before the crisis, the Bush

tax cuts and ongoing wars in Iraq and Afghanistan, were resulting in large yearly deficits. But the fiscal situation went from bad to worse when the recession hit and millions of workers lost their jobs. No longer were these workers paying into the system through payroll taxes. Instead, many were collecting unemployment benefits.

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Stock Market Responds to Sluggish Economic News

U.S. stock prices drop 7% during May and June, but end the 2nd quarter nearly flat.

Global stock markets took on a decidedly wait-and-see attitude during the 2nd quarter. Most major markets saw declines of a few percentage points, but day-to-day market swings were considerably more volatile than the roughly flat quarterly results suggest.

The stock market's increased volatility can often be a hallmark of a turning point in the market's direction. However, in spite of the volatility and some-

what lower prices, we do not believe the market has entered a new period of declining stocks prices. Instead, we see global stock markets, and the global economy, experiencing reversions to more normal growth rates, but nothing worse.

Pessimism is running high, but pessimism is, more often than not, a contrary indicator. Until we see more foreboding signs of economic deterioration, such as

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ECONOMY...

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rolls, seems to be caused by a general lack of confidence by business leaders. With memories of the Great Recession still fresh, and lawmakers gridlocked over how to best deal with the nation's daunting fiscal challenges, firms seem to have adopted a wait-and-see approach when it comes to new hires.

The virtuous cycle of economic recovery cannot be sustained without meaningful and ongoing job creation. Today, total employment in the U.S. remains roughly 7 million jobs less than its peak in January 2008. With the economic recovery well into its second year, the time for job creation is now.

GROWTH TO REBOUND

Anemic job growth has done little to help the already tepid recovery. During the first half of 2011, GDP grew just below a 2% annualized rate. By the end of the year, however, we expect growth to accelerate to a nearly 4% annualized clip.

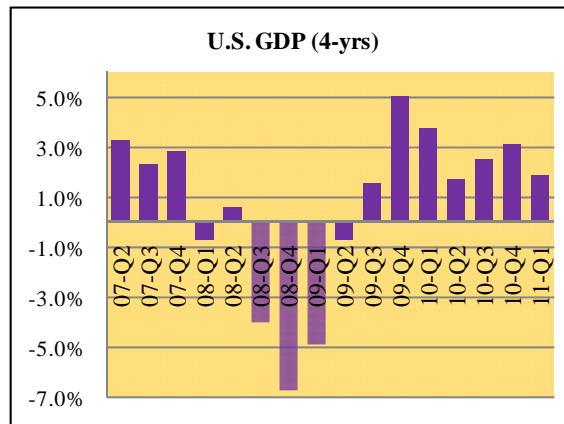
This forecast may seem optimistic, but outside of the poor jobs numbers, other indicators such as durable goods orders and chain store sales are strengthening. Even home prices appear to be stabilizing after years of devastating declines.

CONFIDENCE DOWN

True, consumer and business confidence has sagged. Last February, as the recovery was gaining strength, the Conference Board Consumer Confidence index stood at 72. As of mid-June, the index had fallen to 58. Much of this decline is attributable to rising gasoline prices and falling stock prices, both of which have seen recent improvement. However, we do not expect confidence to rebound in a meaningful way until the job market improves.

Falling confidence was just one of the headwinds facing the economy in the first half of 2011. Other setbacks included the Japanese earthquake and tsunami (which caused serious supply-chain disruptions around the world), a severe drought in the U.S. affecting much of the

agricultural south, reduced government spending at the federal, state and local levels, not to mention the ever-visible \$4 gasoline. However, in spite of these challenges, the economy still managed to grow, albeit at a slower than expected pace. Looking forward, we expect many of these economic headwinds will diminish in the second half, making stronger growth more likely.



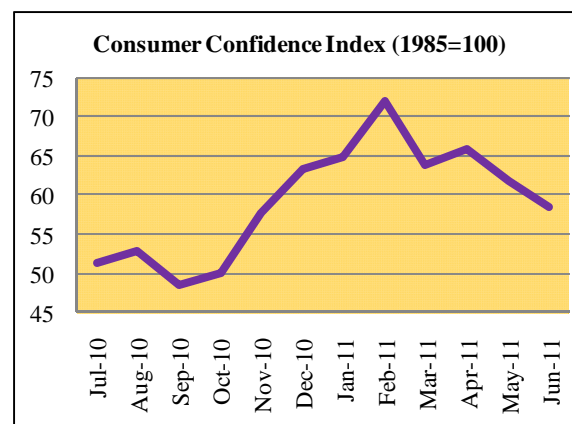
While difficult to see through the current gloom, the economy's fundamentals are improving. Corporate profitability and balance sheets are very strong. The question is not whether businesses can increase investment and hiring, but whether they are willing to do so. Household debt burdens are easing and credit quality is rapidly improving; delinquency rates among loans (other than first mortgages) are back to prerecession levels.

In addition, the financial system has been recapitalized and is generating significant profits again. As a result, the credit spigot seems to finally be opening again.

OUTLOOK

Notwithstanding the weak labor market, we expect economic growth to reaccelerate during the second half of 2011. And by 2012, we expect GDP in the U.S. will be expanding by nearly 4% annually. To put this in context, the economy's growth potential – the rate of growth sufficient to maintain a stable unemployment rate – is thought to be around 2.75%. When the economy can grow faster than 2.75%, new jobs will be created.

In 2010, payrolls grew by almost 1 million. This year, the economy is expected to add more than 1.5 million new jobs. During 2012, this number should grow to by an additional 2.5 million jobs. In spite of the job gains, the unemployment rate will remain stubbornly high. As of June, the unemployment rate stood at 9.2%. And, it will likely take until the end of 2012 before the unemployment rate approaches 8%. ■



DEBT & DEFICITS...

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At the same time, the government started aggressively spending on infrastructure and other public works projects aimed at stimulating the economy. And then there were the bailouts. Fannie Mae, Freddie Mac, AIG, and a number of large Wall Street institutions were deemed too big to fail and so the government stepped in to guarantee their obligations and prevent a potential financial system collapse.

THEN & NOW

According to the Congressional Budget Office (CBO), the U.S. last had a surplus during fiscal year (FY) 2001. Then, from FY2001 to FY2009, spending increased by 6.5% of GDP (from 18.2% of GDP to 24.7%) while taxes declined by 4.7% of GDP (from 19.5% of GDP to 14.8%). As of 2009, government spending was at the highest relative to GDP in 40 years, while the tax receipts were at the lowest relative to GDP in 40 years.

DEBT-TO-GDP

Running a budget deficit requires that a government borrow money to finance the shortfall. The accumulated government borrowing adds up to be the national debt. There are no rules or guidelines for how much a country can borrow, so typically a country's debt is compared against its GDP for relative comparison. The higher the debt-to-GDP ratio, the more indebted a country is relative to its economic output. Countries such as Greece and Italy, allowed their debt-to-GDP to climb well over 100%, meaning that these countries owed more in total public debt than a full year's worth of their economic output.

As of 2010, the United States' debt-to-GDP stood at 93%. This compares favorably to Greece (130%), Italy (118%), and Japan (226%), but not as well to a country like Germany (74%), which is considered the financial anchor of Europe.

DEFICITS DO MATTER

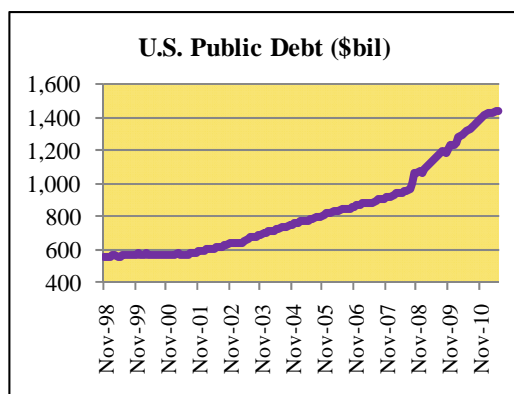
Deficit spending, by itself, is not a problem. Borrowing money today to invest for the future or smooth out a recession makes perfect sense. The danger occurs when chronic deficits compound into high debt-to-GDP ratios, raising concerns about credit worthiness in light of significant borrowing. At 93% and projected to go even higher, many consider the U.S. to already be a high-debt-

to-GDP country.

In addition, aging demographics, like that in the U.S. and other developed countries, are likely to grow public debt. Serious problems can arise when countries become so indebted that they are unable to raise additional debt. Currently, the U.S. has no problems borrowing money at favorable interest rates through issuing Treasury bonds. However, just as Greece and Italy have shown, even developed economies can allow budget deficits to balloon into overwhelming debt.

This is a legacy federal policymakers are working now to avoid. Generous retirement and Medicare benefits have already been promised to an outsized baby boom generation. Unfortunately, projections show there will not be enough taxpayers to fund these obligations in their current form.

How bad is the problem? By 2030, the number of people in the U.S. age 65 and over is expected to roughly double. At the same time, the number of workers supporting each retiree is expected to fall. In 1940, there were 42 workers per retiree. In 1950, the ratio was 16-to-1. Today, there are 3.3 workers per retiree, and within 40 years, it's projected that there will be just two workers per retiree. These numbers are untenable and reform of public entitlement programs will be required for the system to remain viable.



U.S. ADVANTAGE

The United States is not alone with its fiscal problems. In fact, much of Europe and Japan are in similar situations. However, among the many developed countries suffering from high debt levels and aging populations, the U.S. has a distinct advantage: young people from around the globe continue to immigrate to America in large numbers. Census data compiled by retired federal demographer Cam Gibson shows that in 2009, over 15% of the civilian labor force was foreign born. This compares to only 3.3% in 1970.

Mr. Gibson writes, "Immigration has a younging effect on the total population because immigration is concentrated in the young adult ages, which means that its age structure is conducive to a high overall birth rate." In other words, immigrants are usually young workers, and they often have children. This should result in additional workers entering the U.S. workforce at a time when they are greatly needed.

Of course, immigration alone will not solve the long-term problems of Social Security and Medicare, comprehensive reform will be needed. However, one of America's great strengths—its ability to assimilate immigrants—will again serve it well as it grapples with debt, deficits, and demographics. ■



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widespread reductions in profit estimates, we think stocks deserve the benefit of the doubt.

FAIR VALUATIONS

Corporate earnings can vary greatly from year to year. As a result, standard valuation measures such price-to-earnings (P/E) are considered by some to be too short-sighted. To capture a more normalized picture of earnings, many analysts will use median earnings over multiple years. Using this measure, stocks are very close to their historical averages. And with earnings of the S&P 500 expected to rise by some 16% over the next year, one could argue that stocks are actually slightly undervalued.

BOND YIELDS DROP

Treasury yields declined further in the 2nd quarter, with the 10-year note falling to 2.9%, and 30-year now yielding just 4.2%. This drop in yields gave a boost to bond prices, which finished the quarter ahead of stocks on a total-return basis. Our bond market proxy, The Barclays Capital Intermediate Gov't/Corp. index gained 2.1% during the quarter, while municipal bonds did even better.

Going forward, however, it is hard for us to imagine that intermediate and longer-term bond yields will fall much further. In other words, we expect returns on typical investment-grade bonds will be no higher than their yield for the foreseeable future. And, should interest rates begin to rise as many believe is likely, bond prices will fall, meaning typically cautious bond investors might be faced with negative portfolio returns. ■



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