

**Key Data Points:**

- Growth sluggish and labor markets remain weak.
- Global stock markets fall, signaling possibility of new recession.
- U.S. consumers struggle with high mortgage debt and falling wages.
- Stock market favorably valued based on earnings and dividends.
- Stock market selloff and heightened volatility add to investor cautiousness.

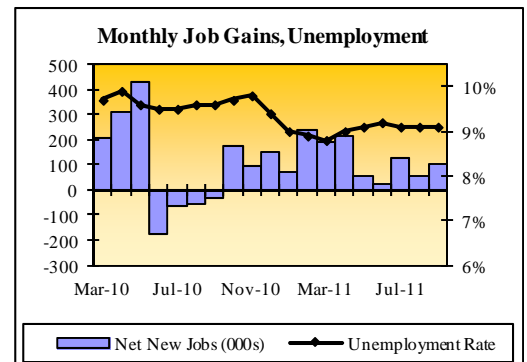
## Economic Recovery at Risk

Sluggish job creation and a sharp drop in global stock prices are warning signs that the United States, Europe and Japan may be heading back into recession.

Economic growth for 2011 has been largely disappointing. During the first half of the year, GDP grew at an annualized rate of less than 1%. Growth for the second half of 2011 is likely to look similar, but risks are to the downside.

Job growth—which has been lackluster compared to past economic recoveries—is now treading water at best. At the beginning of the year, monthly job

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## Stocks Looking More Attractive

Favorable valuations, attractive dividend yields, and heightened investor bearishness could lead to a profitable fourth quarter for stocks.

The U.S. stock market suffered through the worst quarter since 2008, with the S&P 500 Index dropping nearly 14 percent for the quarter. More than half of this drop occurred in September alone.

The third quarter's downturn hit international markets even harder than the U.S., with the EAFE International index, comprised mainly of European markets

and Japan, dropping 19%, while emerging markets lost almost 23%.

The selloff sent investors clamoring for the exits, withdrawing more than \$60 billion from U.S. stock funds during the quarter. Not surprisingly, investor sentiment has also collapsed, and now shows pervasive pessimism.

Amid this negativity, the question

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## Mortgage Debt, not Euro Debt, is the Root Problem

The U.S. economy will face stiff headwinds until housing prices stabilize and household balance sheets are restored.

It is no secret that American households continue to struggle. Real per-capita net worth in the U.S. has declined back to its 1999 level. The real per-capita value of housing equity has fallen to its 1978 level, and housing prices have yet to stabilize in many parts of the country.

In addition, real household income has been declining. During the Great

Recession—from December 2007 to June 2009—inflation-adjusted household income dropped by 3.2%. Since the recession ended, average real incomes have dropped by another 6.7%. This is not what one would expect to see coming out of a recession, nor does it bode well for consumer confidence or spending.

However, household debt has been falling and now stands at roughly 115%

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## ECONOMY...

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gains were averaging close to 200,000. But the August employment report showed total jobs created of only 57,000, and then in September, only 103,000 jobs were added to payrolls.

Employment gains are always welcome news, but for the economy to simply absorb new entrants into the workforce, it needs to create roughly 125,000 net new jobs each month. In other words, for the unemployment rate, which is currently at 9.1%, to simply stay constant, the economy needs to be adding 125,000 jobs per month. To return to somewhere near full-employment, the economy needs to consistently add jobs at more than twice that pace.

During 2008 and 2009, the U.S. economy shed more than 8 million jobs. Since the recession ended nearly two and a half years ago, the economy has added back less than 2 million jobs. With the economy now showing further signs of weakening, high unemployment is likely to remain for the foreseeable future.

Is the U.S. falling back into recession? At this point, we think the odds of a new recession have risen to about 40%. However, the difference between the current slow rate of growth, versus a new recession, may not be dramatically different. In fact, with unemployment still over 9%, many wonder if we are still in the Great Recession.

### WHERE'S THE REBOUND?

The Great Recession was more severe than first thought, and the economic recovery weaker than expected. During the downturn, corporations cut costs to regain profitability. Now many of these corporations have literally billions of dollars of cash (Apple \$76 billion, Microsoft \$52 billion, Hewlett-Packard, Intel & IBM all over \$12 billion), but most are still not hiring in earnest. Why haven't companies moved to hire workers and expand their businesses? Business surveys have repeatedly identified weak demand as the primary constraint on job creation. In other words, the reason companies are not hiring is because there is not enough demand for their products and services to justify hiring additional workers.

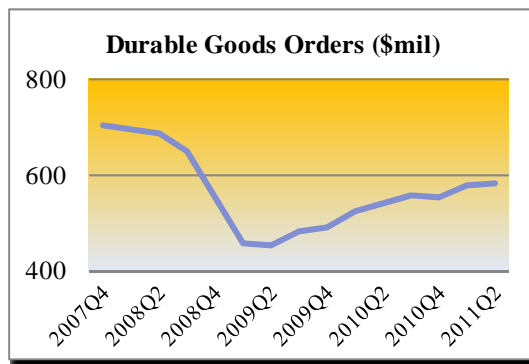
This raises the question: where has the demand gone? The breakdown in consumer demand—which is evident in durable goods orders (chart)—started in 2008 when the debt-financed housing boom ended. In hindsight, the boom had all the features of a crisis in the making—asset prices, especially home prices, inflated rapidly, consumer debt levels swelled as homeowners borrowed against their growing home equity. Credit was easy to obtain, and many took advantage of easy credit to finance ever more expensive

homes and live beyond their means. Unfortunately, real economic growth (i.e. growth not financed through debt) was actually slowing.

When the financial crisis of 2008 struck, demand collapsed due to the vast wealth destruction, the overhang of debt, and the loss of millions of jobs. Historically, this type of debt-induced financial crisis has led to deeper, more protracted downturns. And it appears the U.S. recovery is following this historical pattern. The economy is stalled in an anemic recovery in which many consumers continue to curtail their spending relative to their income, increase their savings, and reduce their debt even though interest rates are near zero. And, it is likely that this process of de-leveraging is only beginning.

### OUTLOOK

Severe economic downturns are often followed by robust recoveries. However, the recovery since the Great Recession has been weaker than many expected, mainly due to the enormous increase in personal debt leading up to the financial crisis of 2008.



The recent stock market drop punctuated the disconnect between previously sanguine expectations and the current economic reality, which is dominated by fears of a European sovereign debt contagion and the possibility of a double-dip recession.

While European debt problems pose a threat to the entire global economy, the current sluggishness of the U.S. economy is mainly the result of the ongoing private-sector

debt overhang. Simply put, consumers borrowed and spent too much, and now the pendulum has swung the other direction. High unemployment, and a move by consumers to save and pay down debt, has put a large dent in spending. As a result, business activity has suffered.

Going forward, economic growth is likely to remain below potential as long as consumers continue to rebuild their balance sheets. This de-leveraging process takes time, but this is not to say that the economy can't or won't grow.

During the first half of 2011, GDP grew at an annualized rate of 1%. Assuming we can avoid another recession, we expect growth will remain in the 1%-2% range this year, but accelerate to around 2.5% next year. Joblessness, on the other hand, is unlikely to fall significantly anytime soon. In fact, given our current growth assumptions, we expect the unemployment rate may stay above 9% until this time next year. And regardless of GDP growth, the economic recovery will not feel real to most Americans until the unemployment rate starts to fall in a meaningful way. ■

## STOCKS...

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arises: can markets now turn positive in the fourth quarter? The logical answer may appear to be no, but there are growing reasons for optimism. Chief among them are favorable valuations, attractive dividends, and extreme investor pessimism, which is typically a reliable contrary indicator.

### EQUITIES UNDERPRICED

One positive result of the selloff is that many equities now appear to be priced at attractive levels. Third quarter profits for the S&P 500 are expected to show an annualized earnings rate of roughly \$100 per share. Given the market's trading range over the last month, these earnings correspond to a forward-looking price-to-earnings (P/E) ratio somewhere between 10.8 and 12.2. This compares quite favorably to the market's historical median P/E of 16. And, consensus earnings estimates published by Bloomberg predict operating earnings for 2012 will reach \$110 for the S&P 500, further adding to the argument that stocks are favorably valued at current levels.

Should the U.S. economy fall into recession, it is true that earnings will likely drop. But the average recessionary earnings drop is only about 16%. Even factoring in such a drop in earnings, the market would still be favorably valued compared to historical averages. More importantly, corporate profits today appear to be less vulnerable than in past downturns because firms are already running quite lean in terms of inventory and payrolls. In addition, corporate balance sheets are strong with record amounts of cash.

### DIVIDENDS TRUMP BONDS

The current dividend yield for the S&P 500 is slightly higher than that of a 10-year Treasury; both hover around 2%. Except for a few months during the height of the financial crisis, Treasury yields have been consistently higher than stock yields over the last 40+ years. So today's yield inversion is somewhat unusual.

For investors, it means a "risk-free," 10-year investment in government bonds, held to maturity, will return 2% per year. Of course, this does not take into account inflation, which is likely to eat up most, if not all, of that 2% return.

Alternatively, the Dow Industrials offer a dividend yield of 2.5%, the S&P 500 yields slightly better than 2%,

and real estate investment trusts (REITs) yield nearly 3.5%. True, stock dividends do not come with a government guarantee, but stocks also have a history of going up over long periods of time. And, equities have done a good job historically of hedging inflation. High-quality bonds always have a place in a diversified portfolio, but when weighing the alternatives, the "safety" of government bonds may not seem so attractive now that yields have fallen so low.

### INVESTOR BEARISHNESS

Citigroup's Panic/Euphoria model, a proprietary combination of nine facets of investor beliefs and fund managers' actions, has been in "panic" territory since mid-August. Historically, overly bullish territory (Euphoria) generally signals a market correction is on the way, while a recovery arrives when sentiment is overly pessimistic (Panic).

The current panic level "generates a near 90 percent chance of higher equity prices in six months and a 97 percent probability of teen-like gains in the next 12 months," says Citigroup. But, it is worth noting that gauging investor sentiment isn't an exact science. Markets reached panic levels at the end

of June, but the subsequent rebound was relatively mild, and then gave way to much lower prices in August.

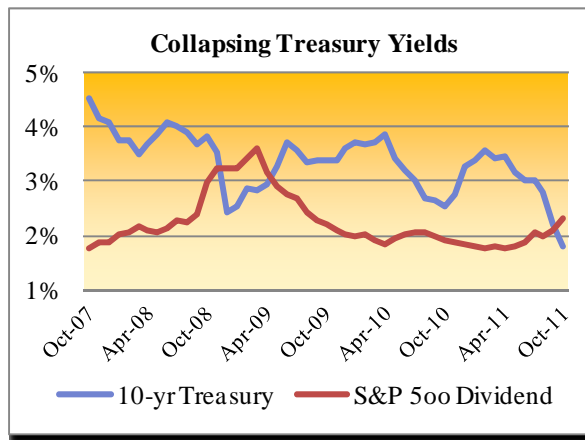
### EMERGING MARKETS

We have been bullish on emerging markets for many years, and this latest selloff does not change our view. Economically speaking, developing countries offer many advantages over the developed world. For instance, unlike the United States, Europe, and Japan, the developing countries benefit from

young populations, low debt burdens, and high rates of economic growth.

That said, the fly in the emerging market ointment is inflation. In 2010, China's economy grew at 10.3%, while Brazil's grew at 7.6%. Such rapid growth has led to higher inflation, as the growing demand for labor pushes wages, and ultimately prices, higher.

But this story may be about to change. Ironically, the global economic slowdown could help. Inflation, which tends to follow growth with a lag, is now likely to slow. Meanwhile, the sagging global economy has already translated into lower prices for agricultural commodities, energy and other raw materials. Slower growth and falling commodity prices may give emerging market central banks the breathing room necessary to stop raising rates, preventing an over-tightening scenario, which can lead to an abrupt economic slowdown, often called a hard landing. Should inflation moderate, we expect confidence to return to the equity markets. ■





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COLORADO CAPITAL MANAGEMENT, INC.

4430 Arapahoe Avenue  
Suite 120  
Boulder, Colorado 80303

Phone: 303.444.9300  
Fax: 303.444.2027  
Email: MAIL@COLORADOCAP.COM

[WWW.COLORADOCAP.COM](http://WWW.COLORADOCAP.COM)

of disposable income (largely resulting from foreclosures). This is 15 percentage points below the peak of 130% in 2007, but still significantly higher than its 1970-2000 average of 75%.

And, households are now saving more. The household savings rate hit a bottom of only 1.2% of disposable income in 2005, and since then the savings rate has risen to 5%, but this is still far short of the 8% average during the 1970-2000 period.

#### MORTGAGE OVERHANG

In the United States, mortgages account for most of the private-sector debt. And, it is estimated that 14 million homeowners now owe more on their home than it is worth. For underwater homeowners, the average amount of mortgage debt in excess of the home's value is nearly \$50,000. Under these circumstances, it would not take much, such as a major repair or a roof that needs replacing, for a homeowner to simply give up and walk away. Recent studies suggest that the share of strategic defaults—involving homeowners who are current on other debt obligations—has risen and now accounts for roughly a quarter of all defaults.

Defaults lead to foreclosures, which in turn lead to additional distressed sales. And distressed sales put further downward pressure on already weak home prices. Decisions to default depend critically on expectations about future house prices. In other words, if homeowners believe prices will rise, then they are more likely to hold on. If homeowners feel prices will fall further, they are more likely to give up.

Correcting the current imbalances will take time, but once households get back on a sustainable financial footing, the foundation will be in place for stronger economic growth and a brighter future. ■



*Hank Nicholson writes the Quarterly Market Update. He is a principal and portfolio manager for Colorado Capital Management and is a CERTIFIED FINANCIAL PLANNER®.*

## **We are pleased to announce that Kirsten Roeber has joined Colorado Capital Management.**

Kirsten will be providing operational and client service support for our office. Kirsten's background is in healthcare both in patient care and operations. She previously worked for the HealthONE Clinic Division as well as Rose Medical Center where she managed multiple physician practices and residency operations. Most recently, however, she served as a para-educator and long-term substitute teacher at Louisville Elementary School. Kirsten holds a Bachelor's of Science from the University of Colorado.

Kirsten has lived in Boulder and Louisville for many years. She is actively involved in the community and has served on several non-profit boards and committees. She loves the weather in Colorado, particularly in the fall, as it is perfect for playing tennis.

Please join us in welcoming Kirsten to Colorado Capital Management.

INTEGRITY



QUALITY



RESULTS