

Key Data Points:

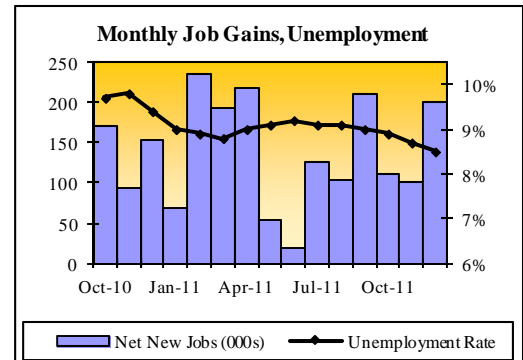
- **Economic growth accelerated in the 4th quarter. Real GDP should expand by 2.5%-3.0% in 2012.**
- **At 8.5%, unemployment rate nearing a 3-yr low.**
- **U.S. business expected to remain cautious in 2012.**
- **Stock market favorably valued based on earnings and dividends.**
- **The growing federal debt needs to be addressed, but is still manageable at this point.**

Economic Recovery Expected to Creep Ahead in 2012

Job growth is rebounding, but the unemployment rate is likely to remain above 8%.

The U.S. economy appears to be gaining momentum coming out of a disappointing 2011. Real GDP is expected to show a better than 3% annualized growth rate in the fourth quarter, which is up from roughly 2% in the third quarter, and considerably stronger than the first half of 2011 when growth was closer to 1%. Additionally, growth estimates for 2012 are starting to be revised upward, and are now in the 2.5%-3.0% range. Reflecting the

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Stocks Climbing a Wall of Worry

Investor pessimism, along with attractive valuations, should support stock prices in 2012.

U.S. stocks rose nearly 12% in the fourth quarter of 2011, but you would not know that based on investor sentiment. Generally speaking, investors are not an optimistic bunch. To prove this point, one needs to look no further than mutual fund redemptions, which recorded the second-worst year on record in 2011.

It is easy to understand why investors are unnerved. Between April and October of last year, U.S. stocks dropped over 19%, the worst decline since 2008. At the same time, daily volatility intensified. During

the third quarter, the S&P 500 moved 2.4% on average between its intraday low and high. The Dow Jones Industrial Average alternated between gains and losses exceeding 400 points on four straight days in August—the longest streak ever. With such dramatic swings, investors seemed to lose confidence that stocks were trading based on any fundamental measures or valuations. As a result, many opted for the relative safety of cash and bonds.

Similar to individual investors, hedge

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How Dangerous is the Ballooning National Debt?

More than two years after the end of the Great Recession, the global economy cannot seem to shake its effects. Economies in the developed world are struggling to grow. Unemployment in the U.S. and Europe remains near double digits, while Japan is stuck in a 20-year slump.

One impediment to stronger growth is the debt burden the U.S. and other developed countries find themselves under. As annual budget deficits reach record

amounts, overall government debt is piling up quickly.

The current fiscal predicament is not the making of the Great Recession alone. However, it did quickly bring long-simmering fiscal pressures to a boil. The U.S., like Japan and many developed economies in Europe, suffers from an aging population and rapidly rising health-care costs. This situation has long been

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ECONOMY...

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stronger economy, job growth is also starting to revive. In December, private payrolls grew by more than 200,000, and the unemployment rate has dropped for the fourth consecutive month, falling to 8.5%. For the year, companies added 1.6 million employees, the best year of job gains since 2006. One surprising area of strength is manufacturing, which has been steadily adding jobs for the last two years. Before the gains of the last two years, manufacturing sector payrolls shrank in every year going back to 1997.

Lest we sound too optimistic, economic problems still abound. At this point, aggregate demand is still too weak to justify a strong resurgence of hiring. While it is likely that job growth will strengthen in the first half of 2012, the improvement will be gradual as uncertainties continue to undermine business confidence. Put another way, we expect firms will typically continue to hire only on an as-needed basis, and not make bold hiring moves in an attempt to spur company growth. As a result, the unemployment rate is expected to remain stubbornly above 8% through 2012.

EURO DEBT CRISIS

Europe has now been pushed into recession by a lingering debt crisis. However, U.S. stock prices, in spite of dramatic volatility, are little changed since Europe's problems surfaced nearly two years ago. It is easy to construct dark scenarios in which Europe loses the political will to hold the Euro zone together in its current form, and its economy enters a deep recession with significant spillover effects on the U.S. and other global economies. But this seems like a less likely outcome as Europe's leaders are showing greater determination to work through the current issues.

In addition, the U.S. Federal Reserve and other global central banks have teamed together with the European Central Bank to provide funds to the stressed banking system. To the relief of financial markets, these powerful central banks seem to be signaling that they will not allow a major bank to fail from a lack of liquidity.

If policymakers successfully stabilize financial markets, Europe's downturn is expected to be relatively mild, lasting only through the middle of 2012, with real GDP in the euro zone falling no more than 2%.

PAYROLL TAX CUT

In late December, lawmakers passed a two-month extension of the payroll tax cut while continuing to negotiate a

yearlong extension. Though both sides appear to agree on a yearlong cut in principal, reaching a final agreement was again bogged down in partisan wrangling.

Reaching an agreement to extend the 2-percentage point payroll tax rate reduction enacted for 2011, and the emergency unemployment insurance program, will have a meaningful impact on 2012 economic performance. Together they will be worth close to 0.9 percentage point on 2012 GDP, but would also cost taxpayers nearly \$175 billion.

Given the lackluster economic recovery, it seems likely that policymakers will come to some agreement, because not extending the payroll tax reduction will prove to be even more costly if the economy slips back into recession.

With the heightened political and economic uncertainty, it is hard to see businesses expanding operations more aggressively through increasing investment or hiring anytime soon. Still, businesses have the financial wherewithal to do so—profits are strong and balance sheets are sturdy—but caution is still being practiced in the wake of the Great Recession, and events in Washington and Europe do little to bolster confidence.

Historically, economic recoveries have evolved into self-sustaining economic expansions when businesses decided to take a leap of faith and expand without knowing for sure whether demand justified the additional production.

The current business cycle appeared to be following a similar pattern early in 2011, as firms began to increase investment and hiring. But this was apparently short-circuited by a surge in commodity prices, the Japanese disaster, the spectacle in Washington over the debt ceiling, and the European debt crisis. How long it will take to get the business cycle back into gear isn't yet apparent, but it is possible that business investment and hiring will remain sluggish until after the 2012 election.

CONCLUSION

With businesses expected to remain cautious, 2012 is unlikely to be a breakout year for the U.S. economy. That said, real GDP is expected to post respectable growth in the range of 2.5%-3.0%, while creating as many as two million new jobs. However, the unemployment rate is likely to remain above 8%.

With modest growth and stubbornly high unemployment, inflation and interest rates are expected to remain low. Core consumer price inflation will stay well below the Federal Reserve's implicit 2% target, which should allow the Fed to easily continue its zero-interest rate policy. ■

STOCKS...

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funds have also grown weary of stocks. As a group, hedge fund stock exposure is now only slightly greater than it was during the March 2009 low. In the spring of 2009, hedge funds were caught leaning the wrong way as the market bottomed, then quickly moved higher. We suspect late 2011 and 2012 could follow a similar pattern.

STOCKS LOOK CHEAP

In terms of earnings and other valuation measures, stocks look very favorably valued. The S&P 500 currently trades at 13.5 times reported earnings, which is much less than the average P/E ratio of 16.4 since 1954. Overall, earnings for companies in the S&P 500 are expected to be up 7.5% in the final three months of 2011 versus the same period in 2010. And even if fourth quarter earnings (which are

starting to be released now) prove disappointing, earnings for 2011 will still be more than 10% above 2010 earnings.

More importantly, based on consensus estimates, earnings are expected to rise again in 2012, reaching more than \$105-per-share for the S&P 500. At current stock prices, this would mean a P/E ratio of only twelve. The last time stocks were that cheap on an earnings basis was in the mid-1980s. At that time, more than 25 years ago, 10-year Treasury yields were between 7%-9%. This compares to yields of less than 2% today. In other words, in the mid-1980s, Treasury bonds yielding in the high single digits were a very attractive, risk-free alternative to stocks. But today, stock earnings are being valued no more favorably than in the mid-1980s, even though the risk-free alternative to stocks today is yielding less than 2%.

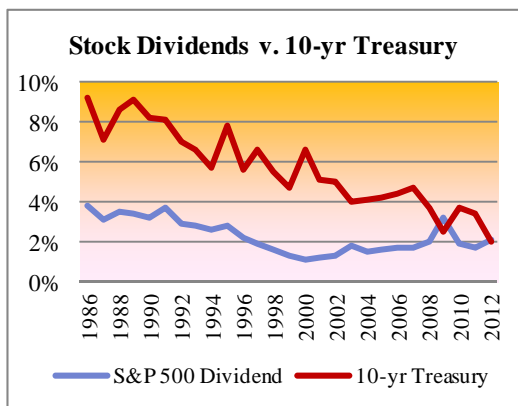
In addition to earnings, other valuation measures paint a similarly favorable picture. For instance, the ratio of debt to assets, which measures the financial strength of companies, reached its best level since 2002. And, stock dividends continue to rise, with the yield on the S&P 500 now greater than 2%, which is also higher than the yield on the 10-year Treasury. It has been more than 50 years since the dividend yield on stocks has been above 10-year Treasury yields.

LOOKING FOR YIELD

Today's low-yield environment has investors wondering where to turn for attractive yields. Of course, higher yields come at the price of higher risk, but one higher-risk area which offers an attractive reward trade-off is high-yield bonds. Our preferred high yield bond investments currently offer yields

better than 7.5%, which is net of any defaults within the portfolio, and much higher than other bond classes.

Considering that inflation in the U.S. is below 2%, and that the U.S. economy is expected to keep growing, we believe high-yield bonds continue to offer attractive yields for long-term investors interested in income. In addition, due to their modest correlation with stocks (about 50%), high yield bonds can add meaningful diversification to portfolios, as well as potentially attractive returns.



OUTLOOK 2012

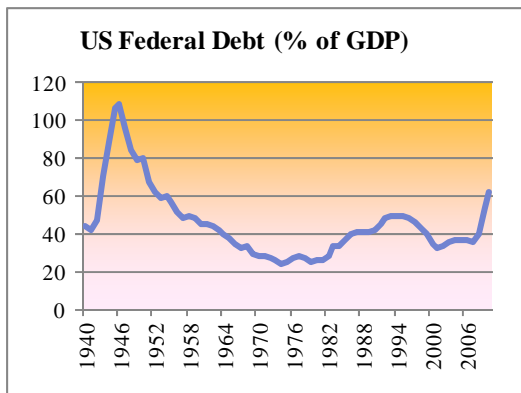
Low expectations and attractive stock valuations, coupled with under-invested individuals and institutions, have created an environment in which the market could easily move higher. While we are not expecting a breakout year in terms of economic growth, we are expecting growth, and feel like the market still has some catching up to do from last year's selloff. Furthermore, we expect 2012 will see lower volatility, making it easier for investors to return to stocks. ■

NATIONAL DEBT...

(Continued from page 1)

anticipated, but the financial crisis and economic contraction of the last several years accelerated the day of reckoning, as governments were forced to borrow and spend heavily to avoid even worse outcomes.

In the U.S., the federal government's debt-to-GDP ratio has surged by some 30 percentage points in just the past four years. The current ratio of publicly traded debt to GDP is close to 65%, the highest since World War II and well above the approximate 40% average of the postwar period. This reflects the downward pressure the recession has had on tax revenues, due to higher unemployment and lower payroll tax collection, as well as increased government spending



on unemployment insurance claims and other social-safety-net programs, and also the government's multifaceted response to the financial crisis. Put another way, demands on the federal

budget were soaring at the same time receipts were tumbling.

The total budgetary cost of the Great Recession is expected to ultimately top \$2.35 trillion, equal to more than 15% of GDP. The cost to taxpayers was substantial but would have arguably been greater without the government's aggressive policy response, as the economy would have almost surely suffered a depression.

With fiscal deficits projected for years, the question becomes: how much can the U.S. borrow before reaching a tipping point at which the size of the national debt becomes so

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large it undermines the economy?

POINT OF NO RETURN

The concept of fiscal space can be used to determine how close a government is to this point of no return. Fiscal space, a concept introduced by the International Monetary Fund (IMF), is defined as the difference between a nation's sovereign debt-to-GDP ratio and the limit beyond which the nation will default unless policymakers take fiscal steps that are outside of anything they have done historically.

The amount of fiscal space, or the capacity to add additional debt, is affected by a country's economic growth rate and the interest rate it pays on its sovereign debt. Not surprisingly, nations, like the U.S., that enjoy stronger GDP growth and lower interest rates have higher limits and more fiscal space than those that do not.

ROOM TO MANEUVER

Analysis conducted by Moody's Analytics suggests that U.S. still has some room to maneuver. In fact, Moody's estimates that U.S. debt could increase by roughly 70% and 10-year Treasury yields could rise to nearly 9% (currently 2%) before incurring a serious fiscal problem. This is not to say that U.S. policymakers can be complacent. Given a budget deficit equal to 8.5% of GDP in fiscal 2011 and large deficits likely for a number of years even under the most optimistic assumptions, the borrowing capacity of the U.S. will shrink quickly. At the same time, it is neither necessary nor desirable to do too much too quickly. After all, nothing will push the U.S. to its debt limit faster than another recession. ■



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