

Key Data Points:

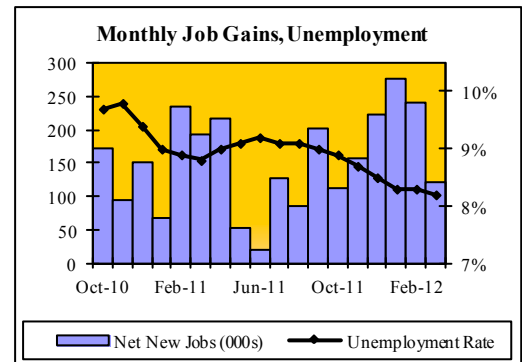
- **GDP is growing at annual 2.5% pace.**
- **Businesses now hiring more. Unemployment rate falls to 8.2%.**
- **More households are now buying homes signaling possible housing recovery.**
- **Rising gasoline prices pose biggest economic threat.**
- **Bond yields rising, but still near historic lows.**
- **Dividend paying stocks now offer yields similar to bonds.**

U.S. Economy Gaining Strength

Job creation is averaging around 175,000 net new jobs per month, which should push the unemployment rate below 8% by year end. But rising energy prices are a threat.

The U.S. economy appears to be on a more solid footing than at any time since the end of the Great Recession. GDP is growing at an annual rate near 2.5%, which is hardly a boom pace, but should be strong enough to expand employment and reduce joblessness in coming months. The unemployment rate has now fallen to 8.2% and should fall below 8% by the end of the year. Consumer confidence has also been rising rapidly over the last five months, in spite of high and rising gasoline prices.

Higher energy costs pose the biggest obstacle to continued economic expansion, but assuming the conflict with Iran



does not boil over, fuel prices may well moderate later this year.

In addition, the European debt situation

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Bonds: A Different Type of Risk

Low volatility make bonds an attractive alternative to stocks, but current yields may not keep pace with inflation.

There is risk in every type of investment. Stocks, of course, can lose value. We speak of this type of risk in terms of volatility, or fluctuation in value. On the other end of the spectrum, cash has no volatility, but it does have risk because cash will also lose value gradually over time as inflation erodes the purchasing power of each dollar. Bonds are somewhere in the middle. Bonds have lower volatility than stocks, but interest payments must exceed the rate of inflation, or bonds, like cash, will lose value over time in real terms.

Bond values will suffer if interest rates begin to rise.

Consider this, since 1965, the U.S. dollar has lost 86% of its purchasing power. It takes seven dollars today to buy what one dollar purchased in 1965. To simply keep up with this inflation, a bond investment would have needed to earn, after taxes, roughly 4¼%. For someone paying tax at the 25% rate, this would mean a required yield of about 5.7%, just to pay taxes and keep up with inflation.

Fast forward to today and we see bond investors in a similar predicament. Inflation is running at a modest 2% annually. But at the same time, bond yields—especially government bond yields—are historically low. The 10-year

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ECONOMY...

is still a threat, as are the mounting home foreclosures in the United States. However, both of these threats seem to be diminishing, though resolution will not come quickly, or without additional economic stress.

But the economy's prospects should continue to brighten—possibly substantially toward the middle of the decade. The household debt load that has been weighing heavily on U.S. growth is lifting as the process of deleveraging advances. This should translate into stronger consumer spending as household balance sheets continue to strengthen.

The economy is expected to return to full employment—a jobless rate closer to 6%—by 2016. And recent data show good progress toward this outcome. Real GDP grew at a 3% annualized rate during the last two quarters. Consumers—the biggest economic driver—are starting to spend a bit more freely. Retail sales are growing at a respectable mid-single-digit pace and vehicle sales in February topped an annualized rate of 15 million units, the fastest pace since before the recession.

Businesses appear to be responding to better growth by hiring more. While the pace of job additions is still modest, when combined with the low rate of layoffs, the net number of jobs is rising at a sturdy pace, near an average of 175,000 per month. And because the labor force itself is not increasing much, job growth at this pace should be enough to bring down unemployment.

In addition, revisions to 2011 data show that households earned more in 2011 than previously estimated, and that the personal savings rate did not decline as much as initially believed. Future revisions will likely show the savings rate has been stable at close to 5% over the past year. And with stock prices more buoyant, wealthier households are likely to soon be spending more.

A HOUSING BOTTOM

The boom and bust cycle in residential real estate has driven the U.S. economic cycle over the past decade. Since the bust, sluggishness in home prices coupled with excessive mortgage debt has resulted in a sluggish economic recovery. Now however, there are emerging signs that suggest these conditions may be improving. For example, more households are now buying homes. New

and existing home sales have firmed and inventories of homes for sale continue to decline. In fact, the inventory of available new houses has never been lower.

Prices, however, are still weak. And it will be nearly impossible for the economy to experience a truly robust recovery as long as house prices continue to erode. However, upon closer inspection, weakness in prices appears to reflect the rising share of sales that involve foreclosures and short sales. At the end of 2011, distressed sales accounted for more than 35% of all home transactions. But prices in non-distressed transactions are actually holding firm.

The residential real estate market is being supported by lower unemployment and favorable mortgage rates—which hover near historic lows, making home ownership more affordable. In the fourth quarter of 2011, The National Association of Home Builders/Wells Fargo Housing Opportunity Index, which tracks home affordability, recorded the highest level of affordability ever in its 20-year history. Prospective home buyers are being constrained by tighter credit standards and a soft economy, but not by prices and mortgage rates.

Real estate investors are also buying properties and contributing to a healthier housing market. As prices

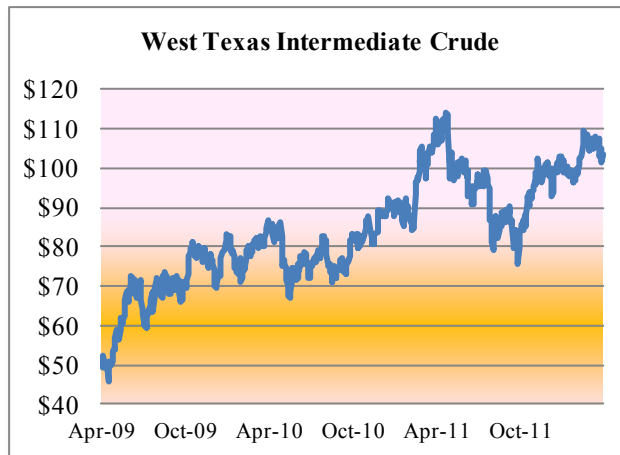
have fallen, rents have risen to the point where investors can turn a profit converting houses to rental property. These real estate investments are long-term and reflect a growing confidence that a bottom in real estate prices is finally beginning to form.

RIISING OIL PRICES

The most immediate threat facing the U.S. economy is the rising price of crude oil and gasoline. West Texas Intermediate crude has risen roughly \$20 per barrel since the fall (chart) and gasoline is up nearly 50 cents per gallon. Even if oil prices stabilize at current levels, gasoline prices are likely to continue higher.

With the higher price of gasoline, households will spend roughly \$75 billion more on fuel than they would have if prices remained at last fall's levels, which is equal to half a percentage point of GDP. While certainly meaningful, this alone will not derail the recovery. However, if oil prices continue higher—due possibly to a renewed

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BONDS...

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Treasury bond currently yields around 2.3%, the 30-year Treasury offers 3.4%, and intermediate-term, high-quality corporate bonds yield between 4%-4.5%. In this environment, inflation will need to remain subdued in order for many bond investments to deliver positive real returns.

In addition to yields that might not keep pace with inflation, bond investors face another risk. If the economy continues to strengthen as expected, interest rates are likely to rise, which will push the value of bonds lower. In other words, an improving economy may actually hurt a bond portfolio.

Forecasting the direction of interest rates can be just as difficult as predicting where the stock market is heading, but so far this year, longer-term interest rates have been rising. Since the beginning of the year, the yield on the 30-year Treasury has risen from 2.9% to 3.4%. While this might not seem like a dramatic move it does have a material impact on bond prices. The iShares 20+ Year Treasury Bond ETF (ticker: TLT), which holds a basket of long-term Treasuries, had a net loss (including dividends) of nearly 7% in the first quarter.

WHY OWN BONDS?

With bond yields so low, and interest rates likely to rise in the future (which will hurt bond values), one could question the wisdom of owning bonds. Warren Buffett recently quipped in his annual Berkshire Hathaway letter to investors, "Right now bonds should come with a warning label."

True, investors should not expect bond returns to match that of recent history, but bonds do still have an important role within a typical portfolio. Most importantly, bonds are rarely as volatile as stocks, so overall portfolio values will fluctuate less than the stock market. This is especially important for those investors making regular withdrawals. Having to sell assets that have gone down in value, and thus locking in losses to accommodate portfolio withdrawals, is not an ideal scenario.

In addition, bonds provide meaningful diversification in that bond prices will often move counter to stock prices—especially during times of market distress. In other words, when the sky is falling and stock prices are plummeting, high quality bond prices are usually

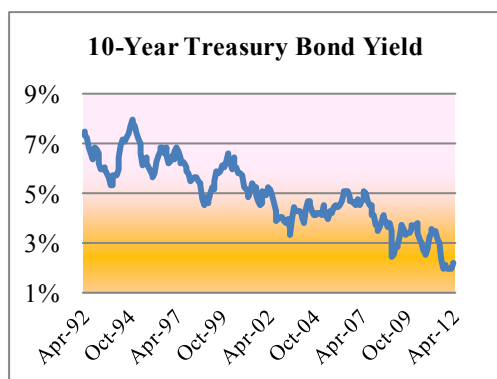
rising in value. Finally, bonds provide a reliable stream of income.

INCOME STRATEGIES

The current low-yield environment has resulted in meaningful changes to the targeted characteristics of our bond holdings. First, we keep average bond maturities relatively short. When interest rates shift, bonds with longer maturities fluctuate more in value than do shorter-maturity bonds. Should we enter a period of rising interest rates, which we feel is likely, longer-maturity bonds will suffer the largest price declines.

Secondly, to increase yield, our bond portfolios now include sizable allocations to corporate debt. This includes bonds from high-credit-quality, blue chip companies, as well as smaller allocations to broadly diversified baskets of lower-credit-quality, but higher yielding bonds.

As a result of the financial crisis of 2008, the difference in yield between government bonds and corporate bonds grew dramatically as investors fled the uncertainty of corporate issues in favor of the relative safety of government bonds. Although this spread has narrowed over the last few years, corporate bonds still offer a meaningful yield advantage over government bonds. For instance, a 5-year Treasury bond currently yields roughly 1.6%, whereas a 5-year, high-quality corporate bond yields over 4%. High yield corporate bonds offer even more attractive yields, but also come with greater volatility. Should the economy continue to grow as expected, the credit risk of corporate bonds should remain stable, or even improve, making them an attractive alternative to government bonds.



DIVIDEND STOCKS

For bond investors willing to take on some additional risk, a potential alternative to bonds is dividend-paying stocks. Typically, companies paying meaningful dividends are established blue chip companies with substantial cash flows. Dividend yields for these companies can exceed that of government bonds and even approach corporate bond yields. For example, the iShares Dow Jones Select Dividend Index Fund (DVY) offers a yield of 3.4%.

However, even though dividend stocks are typically less volatile than the market as a whole, they do have the same risk as other stock market investments. That said, they also have the potential for appreciation, which is something bonds are highly unlikely to deliver given that interest rates can scarcely go any lower than they are now.



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outbreak of hostility surrounding Iran's nuclear program—serious economic damage could be done. If oil prices were to surge to around \$150 per barrel, and gasoline prices topped \$5 per gallon for more than a couple months, a new recession would likely follow.

OUTLOOK

Assuming such a dark scenario does not occur, the U.S. economic expansion should hold its own in coming months and gain traction after the election. U.S. policymakers still face difficult decisions regarding taxes and spending, but the election will help determine how those decisions are made.

The economy should also receive a lift as households and firms finish repairing their balance sheets. U.S. companies have arguably never been in better financial shape and the banking system overall is well capitalized and profitable. More foreclosures are still coming, but most households have made significant progress in lightening their debt loads. Credit is already flowing more normally, and the spigot should be fully open to qualified borrowers in 2013.

Real GDP growth is expected to accelerate from 2.5% this year to 3% in 2013 and closer to 4% in 2014 and 2015. By 2016, the economy has the potential to return to full employment. This is a long way off and much could go wrong, but there are more reasons for optimism than pessimism about the economy's prospects. ■



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