Quarterly Newsletter,
4th Quarter 2010
1/21/2011

Enclosed are your reports for 2010 including the Realized Gains/Loss Report on yellow paper that should go to your tax professional (unless we prepare your tax returns).

For Clients and Friends of Financial Connection

We end 2010 with a strong rally in the fourth quarter. And in this same quarter—the first in a long time—bonds lost money and equities did not.

Sometimes investors think that healthy market returns mean a healthy economy. Yet a glance at some of the issues below makes the market's positive tone a surprise. Of course, the market looks ahead. You might think we had a robust recovery under way rather than an anemic one.

The Good, the Bad, and the Ugly of the Economy

For every one step forward, we seem to take two steps back. The global economy is better than it was, but that doesn't mean it is good. With the fiscal stimulus receding, the economy has to grow on its own. But will it? In 2010, the stock market seemed to think so.

<u>The Good</u>

- ♦ The consumer has less debt
- ♦ Emerging market countries have healthy balance sheets (large cash hoard)
- ♦ Emerging markets' middle class is spending (see insert)
- ♦ Third-quarter corporate profits in 2010 are up an estimated 27.8% over profits the same quarter a year earlier
- ♦ Near the end of 2009, pre-tax corporate profit margins were approximately 9.4% compared to 13% on September 30, 2010
- ♦ More companies are issuing dividends
- ♦ Consumer spending increased modestly (about 2%)

The Bad

- The labor market is still weak
- Although household debt declined at the fastest rate on record, much of the decline is due to defaults
- Overall household debt remains excessive in relation to disposable income
- The housing market continues its slump
- U.S. government debt is growing
- The finances of state and municipal governments are in poor shape
- The European sovereign debt crisis continues
- Potential inflation looms
- Commodity prices are rising

The Ugly

- Jobs lost during the recession total: 8.4 million
- Average number of *monthly* new jobs created since the bottom (12/2009): 86,500
- New monthly jobs needed to keep pace with growth in the labor market: 100,000
- Average ratio of job seekers to jobs is 4:2 (down from 6:2)
- Among the unemployed, 42% have been out of work for at least 27 weeks
- As of September 30, 2010 (according to CoreLogic), 23% of all homes have negative equity

We do not try to gaze into a crystal ball, as you know. The goal of our diversification efforts is to lose less when the market declines and participate when the market increases.

Please call us if you would like to get together to review your financial situation. This is especially important if any changes would require adjusting your investment strategy.

TO SAVE YOUR IMPORTANT DOCUMENTS SECURELY

One of the questions on our client survey last year was "Would you like to receive your reports electronically?" A whopping 76% said yes! The survey company said this was a larger percentage than seen by other survey results from similar companies.

Because of your willingness to embrace electronic reports, Financial Connections hired a company to help us create a "Client Vault."

How it works

You, the client, set up a user name and password on the secure server. Financial Connections will place reports in your personal vault. You receive an e-mail message letting you know reports are available. You click on the link, sign in, and there are your reports, ready for viewing.

No information is distributed through email.

Bonus

Not only can we place reports in your vault, we can upload forms whenever we require your signature. And you have the option of placing important documents on the site securely. Here are documents you might want to store:

- Trusts
- Advance Health Directives
- Durable Power of Attorney
- Vital documents (birth certificate, marriage/divorce papers, etc.)
- A list of your accounts with user name and passwords
- Letters to your beneficiaries
- Photos

To access your personal vault, you will sign in to our Web site www.FinancialConnections.com. Scroll down the page and click on the Clients Only link.

When

We are going to roll out this service during the next few months. Please let us know if you are anxious to get established now.

DO ECONOMISTS KNOW HOW TO FORECAST?

James Montier of GMO (a global investment company) said in a recent newsletter,

Economists are probably the one group who make astrologers look like professionals when it comes to telling the future. They have missed every recession in the last four decades! They have had no better luck with inflation, bond yields, and pretty much everything else.

Below are some statements from names you may recognize.

Jeremy Siegel, professor of finance at Wharton School and author of *Stocks for the Long Run*, predicted that the U.S. would avoid a recession in 2008 and that financial stocks would outperform the S&P 500. Actually, financial stocks underperformed all market sectors, and the recession brought back memories of the Great Depression.

Nouriel Roubini, professor of economics, New York University, told investors to avoid the stock markets in 2009, warning of a further loss of 50% of their wealth. Investors who followed this advice missed the 24% rise in the S&P 500.

Jim Cramer, (*Mad Money*, CNBC), predicted that Goldman Sachs would finish 2008 at $300 a share and Google's share price would reach $1,000. Goldman Sachs finished 2008 at $84, and Google ended the year at $307.

Byron Wien, a legendary Wall Street strategies and Blackstone economist, forecast that the U.S. economy would grow at an inflation-adjusted 5% in 2010. Further, that unemployment would fall below 9%; the Fed would hike short-term interest rates above 2%; the 10-year treasury would yield 5.5% by year's end; and the S&P 500 would have zero gains in 2010. These forecasts were wrong.

Everyone is entitled to an opinion, and it seems the "experts" are no better at predicting than you or we are.

SHOULD YOU WORRY ABOUT MUNICIPAL BONDS?

Meredith Whitney, a municipal bond financial analyst, caused a stir when she said on *60 Minutes,* "You could see…50 to 100 sizeable defaults. This will amount to hundreds of billions of dollars."

As a result of such bad press and the publicity surrounding state and local government financial difficulties, the municipal bond market, usually considered a safe and low-volatility investment, has investors running for the exits. Mutual funds have found it necessary to sell their holdings to meet redemptions, fueling the impression of a selloff.

Is the situation that dire? We do not think so.

Looking deeper, we can attribute losses in the muni bond market to such circumstances as these:

- Muni interest rates are tied to the U.S. Treasury interest rate; the recent selloff coincides with the Treasury selloff several days after the Fed announced the bond buyback (when bond prices decline, yields—interest rates—rise).
- In advance of the year's end, the market was saturated with new issues of taxable bonds in the Build America Bond (BAB) program, which provided a subsidy to local governments for issuing them. Congress decided not to renew the BAB after December 31.
- Muni bonds are exempt from federal tax (and often from state tax); with the extension of the Bush era tax cuts, municipal bonds are less attractive than at higher tax rates.

State and local tax revenues are actually up 5.2% from a year ago. Actual municipal bond defaults were 0.095% in 2010. Defaults in 2009 were higher.

Because municipal bonds have a tax advantage, their interest rate is usually lower than the same duration Treasury bond (no tax advantage to a treasury security). Munis have historically carried yields that average 82% of a comparable Treasury. On January 11, a 10-year muni yielded 3.4% versus 3.3% for a 10-year Treasury.

Not all bonds are created equal. There are different types of municipal bonds; depending on the source used to repay the loan. So it is still important to be selective. However, many investors consider the current muni environment a buying opportunity. With yields on CDs and money markets almost zero, a 3+% return on a tax-advantaged bond with such a low default rate can be very attractive.