

Market Commentary

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Gloom Gives Way to Optimism

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Investors owe thanks to governments and central banks around the world for their continuing efforts to stimulate the global economy. Whenever major stock or bond markets registered heightened concern, policy makers responded aggressively with measures that restored confidence, at least temporarily, and asset prices recovered.

At some point, when it becomes apparent that their economies and markets can grow without intervention, governments will have to change their accommodative stance; but for now it appears that government support will continue for awhile longer. Talk of “exit strategies” is limited to emerging markets, where some central banks (e.g., China and South Korea) have starting to tighten.

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Quarterly Performance Benchmarks

Passive Benchmarks*	Q4-2010	Y-T-D	1 Year	3 Year†	5 Year†
S&P 500 Index	10.4	14.7	14.7	-3.0	2.2
MSCI KLD 400 Social Index	10.0	11.9	11.9	-1.4	2.4
DJIA (reinvested dividends)	8.0	14.1	14.1	-1.6	4.3
S&P MidCap 400	13.5	26.6	26.6	3.5	5.7
Russell 2000 (Small Cap)	16.3	26.9	26.9	2.2	4.4
MSCI EAFE (Europe, Australasia, Far East)	6.6	7.8	7.8	-7.0	2.5
MSCI Emerging Markets	7.4	19.2	19.2	-0.0	13.1
Barclays Capital Aggregate Bond	-1.3	6.5	6.5	5.9	5.8
Lipper Mutual Fund Benchmarks*					
Average US Diversified Equity	11.4	17.1	17.1	-1.8	2.7
Large Cap Growth	11.4	14.8	14.8	-2.8	2.5
Large Cap Value	10.6	13.0	13.0	-4.5	0.9
Mid Cap Growth	14.2	25.9	25.9	-0.6	4.7
Mid Cap Value	12.8	22.4	22.4	1.2	3.9
Small Cap Core	15.6	25.2	25.2	1.8	4.1
International Equity	7.4	10.7	10.7	-6.4	2.9
Real Estate	7.0	27.6	27.6	-0.0	1.9
Intermediate-term Bond	-0.9	7.7	7.7	5.1	5.2

Performance data quoted represent past performance and are not guarantees of future results. Investing involves risk, including loss of principal. Passive benchmarks are unmanaged groups of stocks and are not directly available for investment. Lipper Mutual Fund Benchmarks are compiled by Lipper, Inc., a Thomson Reuters company. Information has been obtained from sources considered to be reliable; however, neither First Affirmative nor its agents guarantee the accuracy of the numbers reported.

* Sources: *The Wall Street Journal*, *The Financial Times*, and MSCI.

† The 3-Year and 5-Year returns are average annual returns for that benchmark.

Rough Quarter for Bonds

Bonds were having a great year until the fourth quarter, which turned out to be one of the worst quarters in decades. But the worst may be over. A slow economic recovery and the Fed's bond-buying program should support bond prices for awhile. If and when the recovery gathers momentum, bond prices may falter, but that does not appear imminent.

Factors that will be working in bond investors' favor this year:

- The calendar: When the Fed announced "QE2" many bond investors sold. Most sellers haven't yet come back into the market.
- Inflationary pressures, the biggest long-term threat to bonds, are not an immediate concern.
- Many pension funds and life insurance companies' bond portfolios have shorter asset duration than their liabilities. There is a lot of pent-up demand to take advantage of any significant rate rise.
- Until the sovereign-debt problems in Europe

subside, U.S. Treasuries are an attractive alternative for global institutions.

Corporate Bonds

Fundamentals in corporate credits are sound, which bodes well for investors. Default rates are expected to remain in a 2% to 3% range. Many companies have improved balance sheets and are generating healthy cash flows. Look for GDP growth between 2.5% to 3% this year. The technical underpinnings of the market also look relatively stable.

If and when economic growth accelerates and inflation again becomes a concern, high quality bond yields will have to go up. But that may be a slower process than investors expect.

Municipal Bonds

The typically staid municipal-bond market was roiled in the final months of 2010. Yields reached their highest

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2010: A Financial Markets Chronology

The financial story of the year was government support of financial markets. In the first quarter, stocks rose on robust earnings reports. The S&P 500 index topped 1,200 in April for the first time since September 2008.

Early May saw the European debt crisis. Riots in Greece sowed fear that other euro-zone countries and European banks would be under threat as well. Turmoil in the sovereign bond markets led European governments to create a massive rescue fund.

Such efforts provided relief to global financial markets for a time, but by July, the S&P 500 had fallen 15%. Disappointing data on jobs and housing caused confidence in the economic recovery to plummet. But the Federal Reserve was prepared.

In late August, Fed Chairman Ben Bernanke gave a speech in which he hinted that a second round of quantitative easing ("QE2") might be forthcoming. In retrospect, this "hint" was the turning point of the year as investors

started buying stocks again with renewed confidence. In September, the Fed announced its plan to buy \$600 billion of U.S. Treasury obligations.

By purchasing Treasuries in such large amounts over time, the Fed depresses yields. This is important to the economic recovery, but it also encourages investors to seek out higher-yielding, riskier investments (such as stocks or corporate bonds).

Another round of government stimulus in December boosted stocks yet again. Investors had been hoping that negotiations between the White House and Republicans would result in an extension of Bush-era tax cuts. The surprise: a 2% reduction in Social Security payroll taxes for 2011, in addition to two more years of the Bush cuts.

Deficit hawks warn that there is no free lunch and that the bill will eventually come due. They may be right; but for now, investors should not fight the stimulus trend.

Stocks Finish Strong

As 2010 came to a close, stocks finished with a head of steam. December saw the S&P 500 Index gain an impressive 6.7%, reflecting an improving outlook for the global economy. The S&P Small Cap Index had an even stronger finish, with a December advance of 7.7%. The performance of small cap stocks is widely believed to reflect the outlook for the U.S. economy, since smaller companies are not as globally diversified as their larger cousins.

Optimism has been spreading as the economic data suggest that the U.S. economy continues to gain strength. In those areas where additional stimulus is needed, government is providing it. A good example is the \$858 billion tax and spending bill President Obama signed into law last month, which includes the stimulus of extended unemployment benefits.

Developed vs. Emerging Markets

No longer are the U.S., Europe, and Japan such economic powerhouses—the engines that can be counted

on to consistently drive global economic growth. Emerging markets are poised to contribute more to the global economy in 2011 than developed markets. Whether this trend continues beyond this year will depend on domestic demand. Governments want to reduce the role that exports play in their economies, and to increase their populations' willingness and ability to buy goods and services. If they are successful—if domestic demand replaces exports as the main driver of these economies—emerging markets will continue to lead global economic expansion.

How well emerging-market governments and central bankers perform the task of tapping the brakes in some regions and, at the same time, pressing the gas pedal on others, remains to be seen. And if commodities-fueled inflation picks up, emerging markets officials might have to apply the brakes even harder, which could have unintended consequences in other markets. But so far, the ability of governments to collaborate for the greater global economic good has been impressive.

How to Cope with Market Volatility

The road to double-digit percentage returns from stocks last year was not a smooth ride. Last spring and summer was especially choppy. Initially, the rally that began on September 1st looked like so many other short-lived rallies—who could have known that it would continue through the end of the year!

As far as stocks are concerned, price volatility comes with the territory. Of course, no one minds upward price volatility. So, isn't "volatility" simply a euphemism for falling stock prices and losing money?

If only we could know...

- How much volatility there will be?
- If that last drop was the bottom?
- If this rally is nearing a top (or did it already reach a top?)
- If this next decade will be better than the last for the stock market?

The investment industry is full of people who would like you to believe that they can answer these and similar questions. The truth is, they cannot.

Investors are left, ultimately, with having to choose among competing uncertainties. The good news is that you don't have to choose to invest in any one "thing." You can diversify by holding many different things and many different kinds of things. Diversification helps—a lot—but it does not eliminate all risk.

Here are a few ideas that might help investors cope with risk and market volatility:

1. Do not pursue the impossible: don't accept the idea that you can achieve better returns without risk.
2. Don't be naïve as to the risk involved. If you don't know what the risks are, find out.
3. If you don't have to take a particular risk, why take it? It's not that investors shouldn't take any risk;

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How to Cope with Market Volatility

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rather, know why you are choosing to take the risk.

4. Know yourself. Know what types and what levels of risk you can accept.
5. Turn off the media's "noise." If you are investing for the long-term, who cares what the market did yesterday? If you do listen to pundits, remind yourself that no one has a crystal ball.
6. Remind yourself that the overall global trend, despite periodic setbacks, is toward more open, more free, more fair capital markets, which favors

long term ownership of diverse businesses.

7. Remember, when things appear most uncertain or gloomy, those points are often viewed in retrospect as having been very good times to invest.
8. Control what you can, and let go of the rest.

Care to add to this list? Submit whatever suggestions have worked for you, and we will try to publish them in a future issue.

Rough Quarter for Bonds

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levels since early 2009 as investors fled mutual funds invested in municipal bonds. The muni market was a victim of three phenomena—a surge in supply, rising Treasury rates, and worries about defaults.

Sudden Supply

For months, the fate of the Build America Bonds (BABs) program was in doubt. (Build America Bonds was a program whereby state and local governments issued federally subsidized taxable bonds as part of the administration's efforts to stimulate the economy.) The diminishing likelihood of Congress voting for an extension beyond December 31st motivated local governments eager to lock in the federal subsidy. Thus, billions of dollars of BABs came to market in the final months of the year.

Treasurys Sneeze, Munis Catch Cold

The Fed's "Quantitative Easing" was intended to drive down interest rates on Treasurys, but yields actually rose (and prices fell) when investors dumped bonds in favor of stocks. Unnerved by what was happening in Treasurys—which long-term municipal bonds tend to track—individual investors in muni-bond mutual funds rushed to the exits, which sent prices tumbling.

Doom for a Few, But Not Widespread Gloom

Finally, concerns about the solvency of some muni issuers gained national exposure via the CBS program "60 Minutes." Meredith Whitney, a banking industry ana-

lyst who recently turned her attention to state and local finances, said the U.S. could see "50 to 100 sizable defaults" this year, amounting to "hundreds of billions of dollars worth of defaults." Municipal bond analysts dismissed Ms. Whitney's comments, saying that although defaults might increase due to the fiscal stress that many local governments are facing, it is more likely there will be a small number of defaults, not the widespread scenario Whitney predicts.

The outlook for municipals this year is mixed because of the BABs issuance overhang from last quarter. Expect January and February to be calm, amid seasonally low borrowing by local governments.



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