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QtrNotes

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Our New Look:

Welcome to the new look of QuarterNotes. This new look and the new logo are part of our image update undertaken this fall.

Our new brand visually combines the stability of a broad oak tree, symbolic of deep roots and growth. The path and rays of sunshine are emblematic of a well-planned journey towards a sustained and positive financial future.

Thanks to David Laidlaw at Laidlaw Creative, who designed and developed our new look. We have enjoyed working with Laidlaw and hope you enjoy the results. Our new web site will go live in the next few weeks.

Bailey Hallingby joins team:

P. Bailey Hallingby has joined our team. Bailey and his bride Abbey moved from New York, where he was on Wall Street in equity sales.

Anthony Poppe, CFA, CFP®

In addition to his CFA, Anthony has successfully passed his exam for CFP™ and is now a CFP® Certificant. Congratulations are in order.

A Better Year Than Expected: Outlook for Cautious Optimism

In 2010, hope overtook pessimism as the recovery began to take shape and businesses warily resumed normal operations. The recession of 2008 was technically over by June of 2009, but there was pervasive fear of a double dip, and the bear market had decimated investors' portfolios. With unemployment close to double digits and housing prices in shambles, many people had nothing left but hope. The markets ended with significant gains, but it is easy to forget how bumpy the year was. While on its way to the double-digit gains, the S&P 500 index fell 5%, then rose 15%, then fell 15%, and finally, since July, rose 23%. In the final tally, the S&P 500 finished the year 12.8% higher, but it was hardly smooth sailing.

Painful memories of the "Great Recession" caused investors to focus on any bad news and brace for impact. However, given time to unfold in 2010, events proved not to be so terrifying after all. The BP Oil Spill was a devastating event with long-term environmental consequences, but much of the immediate damage was quickly contained. The controversial General Motors bailout seems to have paid off for taxpayers with a successful IPO. Even the questionable TARP bailout is poised for a $16 billion gain—again, benefiting taxpayers. AIG is morphing into a more compact firm. It survives as it divests subsidiaries to raise cash. Its earnings are being used to pay back the government loans. The May 6th Flash-Crash came and went. Even real estate investments, such as REITs which were thought dead, have successfully recapitalized and produced a 27% return this year.

Elsewhere around the world, China seems to have resumed strong growth so quickly that the government is taking measures to prevent it from overheating. Emerging market countries continue their industrialization and formation of a middle class. Europe's debt woes started with Greece and continue with

Index	12/31/2010	% YTD
Dow Industrials	11,577.51	11.0%
S&P 500 Index	1257.64	12.8%
Nasdaq Composite	2652.87	16.9%
Russell 2000	783.65	25.3%
MSCI EAFE	1658.30	4.9%
10 Year Treasury	3.3%	

Ireland; Italy, Portugal and Spain have financial issues as well. Leaders in Germany and France, however, have voiced commitment to support the Euro and the European Union.

We start 2011 as a year of cautious optimism. Consumers are more confident, personal debt levels are much improved, and retail sales are up; all these developments make businesses more confident. Corporate profits are at an all-time high. Projected growth for GDP has been revised upward to 3.5%. Unemployment has stabilized and is improving, albeit slowly.

The year ahead is hardly without challenges. However, as we learned in 2010, not all bad news is as bad as it sounds at first.

Estate Taxes Settled for Next Two Years

We finally have clarity on estate taxes.The new legislation provides a temporary modification of estate, gift and generation-skipping transfer (GST) Taxes for 2010, 2011, and 2012. The bill reunifies gift and estate taxes, establishes a 35% top tax rate after a $5 million exemption for estate, gift and GST, and allows unused exemptions to be transferred to a spouse.

In addition to allowing most estates to transfer to heirs free from estate taxes, this change creates some interesting planning opportunities for wealthy individuals to transfer assets during their lifetimes. It is especially interesting to closely held businesses interested in passing down a portion of their ownership interest to the next generation.

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Other Notes

Municipal Bonds:

In a recent segment on CBS's 60 Minutes, market analyst Meredith Whitney highlighted risks to municipal bonds. She described finances for State and municipal governments as having been battered during the recession by plummeting revenues from income, sales, and property taxes. As revenues weakened, employee pension obligations continued to mount. While the recovering economy has helped some, many States still carry sizable debts and even greater unfunded pensions.

What does this mean for investors? First municipal bond default rates will likely be higher than normal but remain extremely low. Over the last 40 years, 0.03% of all municipal bonds defaulted. In 2010 this number increased to only 0.18%. Although States do not have their own currency and cannot print money, they do have several important weapons to reduce levels of default. Most States are required to balance their budgets. States also have the ability to increase taxes and lower expenses by cutting services and salaries.

The municipal bond market is not a single entity, and each issuer must be viewed in its own light. Interest from municipal bonds can be supported from a variety of sources. Some bonds are supported by State and local tax revenues; some are supported solely by revenue on services like highway tolls, stadiums, or water and electricity bills. Generally, bonds supported by State tax revenues are considered the strongest because States are financially stronger than smaller cities. Also, a bond supported by essential services like water and electricity is likely to be stronger than a bond supported by non-essential revenues. Each issue is unique, and bond managers must evaluate each on the strength of the revenues and the underlying issuing entity.

States like Illinois, Connecticut, and Kansas have severely underfunded pension obligations, whereas Florida, New York, Washington and Wisconsin pensions are currently fully funded.

Finally a Tax Bill for the Next Two Years

Congress finally passed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 on December 16th. As the title implies, there were several parts to this legislation. One is a two-year extension of the 2001 and 2003 Bush-era tax cuts for all taxpayers.

The debate preceding the bill's passage was contentious. Democrats wanted an extension of the tax cuts for all but the highest income-earners. They reasoned that those with incomes over $250,000 were least likely to spend their tax savings and thus would add to the federal deficit instead of aiding the recovery. Republicans believed that an extension for everybody was important, given the fragile state of the economy. They further argued that lower tax rates for all would increase economic growth, benefiting job creation and reducing the deficit in the long run. While credible arguments can be made for both points of view, the compromise was significant because it gave us some hope that Congress might actually be able to work in a bipartisan manner.

By all measures, extending the tax cuts and unemployment benefits is projected to increase the fiscal deficit, but if growth does accelerate, increased tax revenue is expected to offset some of the cost.

Equity investors should benefit from the 2010 Tax Relief Bill. Not only have GDP growth estimates been consistently revised higher, but corporate profits remain strong. Renewed faith in the legislative process has improved consumer sentiment. Also positive for the markets, taxes on both long-term capital gains and qualified dividends will remain at the maximum rate of 15%. Since corporations are sitting on substantial cash balances, increased dividend payouts, acquisitions, and stock buybacks may look like attractive options to increase their share price.

Having kicked the can down the road once again, Congress will have to confront tax policy prior to the next election cycle. By then, the economic recovery should be on firmer footing. In January, with the new House sworn in, deficit reduction will likely take center stage. Our representatives will have to decide whether tax cuts create sufficient growth to cut the deficit, or how to proceed with a combination of spending cuts and revenue enhancements.

Report of the President's Deficit Commission

With all the talk of deficits, the 18-member bipartisan National Commission on Fiscal Responsibility and Reform, co-chaired by former Wyoming Senator Alan Simpson and Clinton advisor Erskin Bowles, presented its recommendations under the title "The Moment of Truth".** Describing the looming fiscal crisis and the unsustainable debt, the commission recommends cutting government's 24% share of GDP down to 21%. The commission blames both parties with two wars and "a slew of fiscally irresponsible policies" along with the deep economic downturn. While the situation will improve with the recovery, spending is projected to continue to grow faster than revenues.

In order to meet its goal of bringing the budget into balance by 2015 (excluding interest costs), the commission made substantive recommendations. Everything was on the table, including cuts to defense spending. While the commission failed to reach the 14 votes required for adoption, the report is likely to set the framework for upcoming Congressional efforts to tackle the deficit. Principal recommendations include: cuting spending by $200 billion; restructuring and simplifying the tax code to capture more revenue; and limiting the growth of health care costs. The report concludes that cost cutting alone without revenue increases won't solve the long-term problem.

** For the complete Commission Report:
http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf