



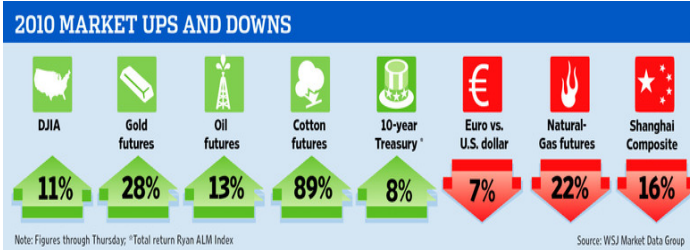
Quarterly Economic Update

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2010 Year in Review

Amid stumbles and scares (including the Flash Crash on May 6 when the Dow dropped almost 1000 points before recovering most of the loss), the U.S. stock market finally ended with a second straight year of gains, in which the Dow reached levels not seen since the fall of Lehman Brothers in September 2008. The Dow Jones Industrial Average gained almost 11.0%, the Standard and Poor's 500 Index gained 12.8%, and the NASDAQ earned 16.9%. The S&P 500 and the Dow Jones Industrial Average are both up about 14% for the year, including dividends, as a result of solid corporate earnings. The second half of the year was responsible for almost all of the 2010 stock gains. Since hitting a low on July 2nd, the Dow has advanced 19.4%. (Source: WSJ, December 31, 2010)

3. The stock market increased by 20% in the past 4 months, partly due to growth elsewhere: American companies make a third of the profits *outside* of the United States. (Source: *The Economist*, January 1, 2011, pg 11)
4. Corporate profit growth has been strong since early 2009 as businesses learned to produce more with fewer workers. As economic growth continues, businesses will probably have to increase their payrolls.
5. Rock-bottom interest rates heighten the relative appeal of stocks.
6. Stocks do not appear to be excessively valued, with the market's price-earnings or P/E ratio at 13 times projected 2011 earnings.
7. Some big U.S. banks are starting to increase their lending to businesses. Businesses will likely use such loans to expand their operations, which could lead to new jobs and eventually to increased borrowing and spending by hired workers.
8. Many corporations that have been sitting on large amounts of cash are now looking to expand.
9. Hopeful news at the end of 2010 included a drop in initial claims for unemployment (to the lowest level in over two years) and a rise in the index of pending home sales of 3.5% for November. (Source: WSJ, December 31, 2010)
10. The continuation of the Bush tax cuts has made many people more confident about 2011.
11. Holiday sales were up more than 5.5% from last year, according to MasterCard Advisors' SpendingPulse Report. They are now at an all-time high, nearly \$10 billion more than before the recession. (Source: *Time Magazine*, pg 24, January 10, 2011)



Bull Market or Bear Market for 2011?

The debate still rages as to whether stocks are overpriced or underpriced given the tense economic climate of the past two years and the uncertainties that lie ahead. Let's look at a few of the arguments for each side.

Bull Market Indicators

1. The economy grew slightly faster than the government previously estimated, fueled by more consumer spending and fewer layoffs. It is nearing a peak it reached before the crisis.
2. The nation's Gross Domestic Product (GDP) shows a growth trend, rising 1.7% in the second quarter and 2.6% in the 3rd quarter. Goldman Sachs raised its 2011 U.S. economic forecast from 2.5% to 3.4%.

Bear Market Indicators

1. The economic growth rate is below the long-term average.
2. Job growth is not strong enough to keep pace with the natural growth of the labor force, much less reduce

the number unemployed and underemployed, and some economists believe that wage growth is likely to remain low, and perhaps even negative, because of the large number of people looking for jobs.

3. Risks to consumer spending include the possibility of higher-than-expected layoffs by state and local governments, and the possibility that energy prices continue to rise (the average price for a gallon of gas in January topped \$3 for the first time in two years).
4. Yearly Social Security surpluses may turn to deficits in a couple of years, raising concerns about higher taxes and/or lower benefits.
5. The Medicare program, which is already facing yearly deficits, will now have the added burden of an additional 10,000 people per day reaching age 65 and qualifying for benefits.
6. Many state and local pension programs are vastly underfunded and will put increasing pressure on local budgets, which may result in higher taxes and reduced payouts.
7. The lack of political compromise in Washington doesn't bode well for the future.
8. Any fresh shocks to confidence on any of these topics may prompt consumers to start saving more and spending less. The public tends to focus on the "fear factor" while ignoring fundamental signs of strength in the equity markets (thanks to a daily diet of journalistic pessimism has made many Americans feel like we are experiencing a catastrophe). (*Source: Mike Harvey*)
9. Contradictory signals from an expanding economy might keep volatility high.
10. Federal Reserve Chairman Ben Bernanke is concerned about an "unusually uncertain" environment again—he thinks inflation is too low and clearly wants to engineer higher price increases through a second round of Quantitative Easing (QE2). Because this strategy has been untested, there is a risk that inflation might increase more than he would like.

Questions That Remain...

- Can corporate profits resume their high growth mode, or will they continue to weaken as they have for the past two quarters? The recently passed tax bill should add to corporate profitability, but will it be enough to push gains toward the double-digit range?

- Many economists believe that the U.S. economy will have stronger growth in the first half of 2011, but will this growth be sustainable?
- What will the U.S. consumers do? Are they ready to shoulder the hefty 70% share of the economy they typically bear?

Quantitative Easing, Round 2 (QE2)

In the U.S., sustaining the economic momentum is the priority for now, even at the risk of causing inflation. (*Source: Bloomberg Business Week, January 3-9, 2011*) It is not yet clear if the effects of the new stimulus will be enough to generate sustainable economic activity. This is the main reason that the Federal Reserve has announced its second round of so-called Quantitative Easing (QE2) with a plan to buy \$600 billion of long-term Treasury Securities through June of 2011. QE2 is designed to make credit more available, help our economic recovery, and try to keep interest rates low. If QE2 is successful in spurring economic growth, it would cause the demand for bonds to go down, which in turn would cause interest rates to go down. Many investors are optimistic about Ben Bernanke's results.

Thus far, the Fed's plan has had unintended consequences for the bond market—interest rates went up and bond prices fell significantly during the 4th quarter. The Fed's somewhat controversial actions show that it is willing and able to implement programs designed to spur the economy. However, the Fed has stated that monetary policy alone may not be sufficient to improve the pace of the economic recovery.

China

For almost 30 years, the Chinese economy has been the fastest growing major economy in the world. No country has ever grown so fast for such an extended period of time, and it is likely to continue over the next decade, if not longer. However, keep in mind that rapid economic growth does not always create generous investment returns. (*Source: WSJ, December 14, 2010*)

2010 marked the first time that China's overseas investments were heavier in hard assets like iron, oil and copper (\$31 billion) than in U.S. Government bonds (\$23 billion), most likely to feed its rapidly expanding industrial base. This preference for hard assets over Treasuries is sure to put upward pressure on

U.S. interest rates and make U.S. economic growth somewhat more difficult. China must maintain a balance between investing wisely and making sure the U.S. remains economically healthy enough to buy Chinese exports. Lately, however, any “China Effect” has been replaced by Treasury purchases by the Federal Reserve to its QE2 program.

China’s inflation reached above 5% in November, its highest point in two years. Policy aimed at controlling inflation has impacted Chinese stocks, sending the Shanghai Composite to its lowest point since early November.

International Equities

International equities had a wide variety of investment performance in 2010, especially when you compare the developed market international equities, which posted a twelve-month return of 3.3%, to the emerging markets, which managed to achieve very strong equity returns of 20.2%. Although a global growth recovery appeared to be gaining further traction, there were signs that this might have some problems in the near future. For example, several countries (e.g., China, India and Australia) took steps to temper inflationary pressures by reining in strong economic growth, while others, particularly in the European Union, grappled with massive government deficits and deteriorating economic growth prospects. (*Source: Market Environment, International Equities*)

Job Growth

Job growth will continue to be a front-page issue going forward. Despite the best efforts of industry and government, unemployment has remained above 9% since May of 2009—the longest stretch above that threshold since the Great Depression. It is anyone’s guess on how long it will take to reabsorb the 7 million jobless workers we have now, and for unemployment to fall to about 6% of the workforce.

Companies in the private sector added 297,000 jobs in December, according to payroll processor Automatic Data Processing Inc. and consulting firm Macro Economic Advisors, LLC. The gain was the largest in the report’s 10-year history, and nearly tripled many economists’ forecasts. This report, along with recent declines in new claims for unemployment benefits, fueled optimism that economic growth is picking up.

But a key question still remains: Will job creation finally pick up? Employers have added only about a million jobs to their payrolls in the past year, a fraction of the 8.4 million jobs lost in the two years before that.

Housing

A lasting general recovery is unlikely without a recovery in the housing market. The Case-Shiller report showed that house values are still declining at a double-digit annual rate across the country. The best we can hope for is some degree of stability, without much increase in real value. If fresh declines bring more buyers into the market, that would be good for housing, even if price declines prove painful.

The Obama Administration is expected by the end of January to put together a housing plan expected to deal with housing giants Fannie Mae and Freddy Mac. It is still unknown how much of a government backstop for mortgages the government may propose. (*Source, WSJ December 29, 2010*)

The sudden jump in Treasury yields has driven 30-year mortgage rates above 5%, keeping pressure on the struggling housing market and countering the Federal Reserve’s efforts to help the economy. Even with rates hovering at historically low levels, any rise is likely to weaken housing demand, putting more pressure on sellers to cut their asking prices.

Tax Law Changes

The battle to extend the Bush-era tax cuts was politically divisive, and the process agonizingly prolonged. Yet the decision to continue the cuts, and throw in a few others, is producing something the U.S. economy needs: optimism. Here are some important changes for 2011:

- Income taxes. This year’s low tax rates are carried over from last year and expire at the end of 2012.
- Tax rates on long-term capital gains and stock dividends. These tax rates will continue at historic lows—for taxpayers in the 15% income tax bracket and below, the rate is zero; for taxpayers in the 25% bracket and above, the maximum rate is 15%. This expires at the end of 2012.
- Estate and gift taxes. The top rate is now 35% and the exemption has been increased to \$5 million for individual state and gift taxes. This also expires at the end of 2012.

- Payroll taxes. Last year's big surprise was a temporary 2-percentage point cut in the employee's share of Social Security tax, saving a maximum of \$2,136 per worker.

Bonds

Some financial advisors say bond investment may pose a bigger risk to investors in 2011 than stocks. Investor optimism can lead to inflation and higher interest rates, which are inversely related to bond prices. So what should the prudent investor do? Bonds are an essential part of a conservative portfolio: they provide income and are usually more stable than stocks. If you are retired and relying on investment income to pay the bills, in most cases, it's not appropriate to invest only in equities. Unfortunately, while Treasury bonds are less volatile than stocks and have features that stocks don't, bonds are far riskier than some investors appreciate. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

Interest rates are at their lowest levels since the 1950s. Investors who grasp for that last percentage point of yield and buy long-term bonds are making a gigantic bet that rates will fall even further or at least hold even. However, with rates this low, the question isn't if they will rise, but when. If inflation rears its ugly head and interest rates rise, depending on the bond, an investor could most likely get their investment back if they hold their bonds until maturity, but not in real terms, of course.

The municipal bond market is suffering one of its periodic selloffs. While the Federal government continues to provide assistance to state governments, direct aid is declining. Without additional federal aid, states will have to balance their budgets by cutting spending and off-loading costs to local governments. Pension liabilities are major concerns for state and local governments given their declining asset values and funding pressures. The median state pension plan had enough money to pay just 76% of its obligations as of August 20th according to a report compiled by Bloomberg. Ben Bernanke earlier this month said, "The states should not expect loans from the Fed."

Stock Dividends

One strategy is to invest more money into companies that pay large dividends. Stock dividends are taxed at a lower rate than interest generated from bonds or savings accounts. The current dividend yield on the S&P 500 is 1.9%. This doesn't look too good until you compare it to interest rates on bonds. And if inflation does take off, dividends would probably rise, whereas government bonds would look horribly overpriced. Remember, the payment of dividends is not guaranteed because those tax dividends may be reduced or eliminated at any given time.

Inflation vs. Deflation

Will it be inflation or deflation? Either could be damaging to businesses. Inflation allows rising costs to eat into the bottom line. In contrast, deflation causes consumers to cut back on purchases as they wait for prices to drop further, often leading to more layoffs, less demand and a spiral of sliding prices.

Our high deficit level leads many economists to believe that inflation will soon be much higher, even though the current inflation level remains extremely low. (*Source: Financial Planning Magazine, September 2010*) However, others believe that there is so much unused capacity in the United States it won't happen for at least a couple of years.

Gold

Since 2002, gold climbed from \$275 an ounce to over \$1,400 at end of 2010, and many investors are questioning its future price direction. Have the price gains in the last decade (which beat out stocks, bonds, and many other asset classes) peaked? There is a good likelihood that gold is in a bubble right now. Therefore, it might be best to wait on the sidelines for the price to drop a bit before putting any serious money in gold. Speaking of that, due to the volatility and lack of liquidity, we do not recommend more than 1-3% of your total portfolio invested in gold or a similar precious metal, and then only if you can stomach the turbulence. Gold is extremely volatile and the market swings can be greater than many investors can take. It is important to speak with us first about your individual situation prior to considering making any changes to your portfolio.

Conclusion

There are major indicators that the economy is recovering, but many concerns remain. We're still missing three important economic engines that drove our economy in the good times: a booming stock market, surging home values, and rapidly growing personal debt. This means that most people will not be able to borrow their way out of financial difficulty, or get a "bailout" from capital gains or increased home equity. Most of us can still reach our financial goals with careful planning, but it will take more work, discipline and time.

Many people have asked me, "Why can't I just sit on the side and watch until the problems go away?" We

cannot predict when the next painful market experience is going to take place, or the next serious upswing. You can't sit out the bad without missing out on much of the good. You also don't want to sell your stocks when they're low.

Maintain ample cash reserves. This will help bring you more confidence during turbulent times, which is what we want for all our clients. If you have any questions or concerns about your own plan, please do not hesitate to contact us.

P.S. Boom, Baby Boom! A recent report from the PEW Research Center indicates that, beginning in 2011, about 10,000 people a day will reach 65, and that this rate will continue for the next 19 years.

About David N. Gordon:

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This optimism about the future does not minimize the fact that we have gone through one of the worst economic periods in market history. Remember that equity markets are volatile and an investor may lose money and there is no guarantee that securities will appreciate. This material contains forward looking statements and projections. There are no guarantees that these results will be achieved.

The price of commodities is subject to substantial price fluctuations of short periods of time and may be affected by unpredictable international monetary and political policies. The market for commodities is widely unregulated and concentrated investing may lead to higher price volatility.

In general, the bond market is volatile, bond prices rise when interest rates fall and vice versa. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss. The investor should note that investments in lower-rated debt securities (commonly referred to as junk bonds) involve additional risks because of the lower credit quality of the securities in the portfolio. The investor should be aware of the possible higher level of volatility, and increased risk of default.

Municipal bond offerings are subject to availability and changes in price. If sold prior to maturity, municipal bonds may be subject to market and interest risk. An issuer may default on payment of the principal or interest of a bond. Bond values will decline as interest rates rise. Depending upon the municipal bond offered, alternative minimum tax and state/local taxes could apply.

Investments in real estate have various risks including possible lack of liquidity and devaluation based on adverse economic and regulatory changes.

Sources: Wall Street Journal (10/25/10, 11/4/10, 11/13-14/10, 11/16/10, 11/20-21/10, 11/18/10, 11/29/10, 12/10/10, 12/14/10, 12/17/10, 12/23/10, 12/29/10, 12/30/10, 12/31/10, 1/3/11, 1/6/11, 1/7/11, 1/8-9/11, 1/10/11, 1/13/11), Barron's (11/8/10, 1/3/11), Money Magazine (Jan/Feb 2011), Bloomberg Business Week (10/18-24/10, 11/18-14/10, 1/3-9/11, 1/10-16/11), Kiplinger's Personal Finance (1/2011), By The Numbers (1/8/10), Fortune Magazine (12/27/10), Investment News (11/10, 11/15/10), The Economist (9/4/10, 10/30/10, 12/18/10, 1/1/11), Forbes (12/20/10), Nick Murray Interactive (January 2011), Financial Planning Magazine (September 2010, January 2011), Time Magazine (1/10/11)

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