CYPRESS FINANCIAL REVIEW

Quarterly news for Cypress clients and partners ▪ www.cypressplanning.com ▪ (856) 534-6431

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Cypress Financial Planning, LLC

Editor's Note
Welcome to the second issue of the *Cypress Financial Review*. In an effort to reach out to clients and partners, we are happy to provide news and insights on the financial landscape, and wish you a healthy and prosperous New Year!

2009 Review

2009 will go down in the history books as a year of reconstruction for the global economy. Dual housing and credit bubbles growing since the beginning of the decade finally popped in 2008, leaving policymakers, businesses, consumers and investors scrambling to recover and rebuild. Unprecedented governmental intervention in the US and abroad attempted to restore credit and stimulate the economy. Businesses appear to be nearing the end of a significant period of cost and headcount reduction, looking forward to driving profit growth through increased revenue. Consumers were given a rude awakening that they cannot use their home equity as an ATM and instead have started saving money. Investors are breathing a sigh of relief as they begin to see healthy gains in their quarterly statements.

United States Governmental Economic Policy Response

A multi-faceted approach by federal lawmakers as well as the Federal Reserve helped to stem the freefall of the US economy.

Bank stress tests were conducted to determine the financial strength of 19 of the nation's largest banks and thrifts. This has been compared to Franklin D. Roosevelt's action during the Great Depression, in which he ordered to close all banks early on a Friday and as he put it, "Open all of 'em except a couple hundred," on Monday. He explained, "It really doesn't matter [which banks you open], because the ones you open, everyone will think are safe." The 2009 stress tests helped to restore confidence in our banking institutions.

Attempts were made to shore up the two weakest parts of the economy, the housing and automobile market. The first-time homebuyer tax credit to stabilize housing values, the loan modification plan to help homeowners facing foreclosure, and efforts to provide mortgage credit to the residential mortgage market were critical to stabilizing the housing market. The Car Allowance Rebate System ("Cash for Clunkers"), was a $3 billion program intended to provide incentives to U.S. residents to purchase new, more fuel efficient vehicles. This program provided a much needed shot in the arm to failing, cash-strapped automakers, facilitating almost 700,000 new vehicle sales and increasing passenger car sales

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17.4% from the previous year. Gross Domestic Product increased at an annual rate of 2.8% from the second to third quarter of 2009, officially ending the Great Recession.

The passage of the American Recovery and Reinvestment Act of 2009 in February was hailed as a lifeline to stabilize the economy and create jobs. This $787 billion package intended to provide tax credits, invest in national energy efficiency, improve our transportation and communication infrastructure, and assist individuals in obtaining jobs through education. The official program website recovery.gov states that the number of jobs saved totals over 640,000, almost entirely focused on public sector jobs, with roughly half being teachers whose positions would have been eliminated. Critics argue this number is too low given the size of the stimulus and demand to see a larger focus in decreasing the unemployment rate. The unemployment rate peaked at 10.2% in October and finally edged down to 10% in November, making the 4.6% rate in the fall of 2007 seem like a distant memory.

Equity Markets

Since the March lows, the Standard and Poor's 500 index has rallied 63%, led by the financial sector. However, the index still remains down 28% from its October 2007 high. Investors are fleeing from safer investments, such as cash, US Treasuries and Money Markets due to their rock-bottom yields and moving into riskier investments.

Unlike most years, investors received virtually no diversification benefits from International Developed markets in 2009 as they moved in lock-step with the US markets. The MSCI EAFE Index, an equity benchmark for international stock performance, appreciated by 23%. Weakness in some European countries has been detrimental to returns – Greece, for example, has been significantly downgraded by ratings agencies as its budget deficit rose to 12.7% of GDP compared to the European Union's 3% limit. International ratings agency Fitch warned Britain, France and Spain of credit downgrades from their 'AAA' rating if they do not have more credible plans to reduce state debt risk.

2009 has seen several emerging market countries begin to mature and gain market share, with strong performances in India (+75%), China (+83%) and Brazil (+65%). With large and growing agricultural, mining, manufacturing and service sectors, the Brazilian economy ranks highest among all the South American countries while also acquiring a strong position in global economy. Unlike the US banks who appear to remain very tight in terms of small business lending, Chinese state-owned banks are doing all they can to fan the flame of business expansion. In 2009, lending increased 30% from the previous year and the government still targets a 20% increase for 2010.

Bonds, CDs and Savings Accounts

The US government has auctioned Treasury bills and notes to finance public debt at a record pace. The market has shown signs of concern over budget deficits and the corresponding supply of treasury bills. Although this was the best performing asset class of 2008 (+24.1%), 2009 was less glamorous. The Barclays Long Term Treasury Index was down almost 13% this year. Corporate credit displayed strong 2009 returns (+18.6%) alongside a rebound in the equity markets.

Municipal bonds showed respectable gains this year as well (+12.9%) despite credit rating downgrades for the State of California and a near default from Jefferson County, Alabama earlier in the year.

With the government committed to keeping interest rates low for an extended period, diligent savers are being punished with rock bottom interest rates on conservative investments. In fact, the average money market interest rate is currently 0.07%. Investors who do a little digging can find short-term CDs and savings accounts yielding between 1% and 1.5%. It is important to recognize, however, that during most years, inflation has eroded a significant portion of the yield in these safe investments. With inflation virtually nonexistent last year, the small interest you have received is still below average, but a respectable real return compared with historical years.

Currencies, Commodities and Inflation Fears

The US Dollar is losing favor partially because of the drastic fiscal stimulus, which causes an oversupply and devaluing of the currency. Gold is viewed as a protection against inflation and a safe investment in uncertain times. Foreign banks have purchased gold for reserves in place of US dollars which have declined in value so significantly. Since November 2008 it has rallied over 50%.

Crude oil has rallied from its lows just above $30 per barrel at the end of 2008 to over $80 per barrel in November on speculation of global economic growth. Since then, oil has been on a downtrend as investors focus on the fundamental story (supply and demand) behind the commodity.

Converting a Traditional IRA to a Roth IRA in 2010

For many years, only a select group of investors have been able to take advantage of tax-free retirement income by converting a Traditional IRA into a Roth IRA. Starting in 2010, the laws will be modified to allow anyone to utilize this strategy. Depending on your unique circumstances, this conversion may ultimately be very helpful or very harmful, impacting your lifetime tax bill by thousands of dollars.

What is a Roth IRA Conversion?

Traditional IRAs provide for an immediate tax deduction on contributions and tax free growth, but any distributions are fully taxable. In contrast, Roth IRAs do not have an immediate tax benefit, but any future earnings and retirement distributions are completely tax free. When an investor converts his or her Traditional IRA to a Roth IRA, taxes will be due on any amount that had not previously been taxed. However, because the funds are now in a Roth, there will be no future tax liability on retirement distributions as there would have been in the Traditional. You are paying the tax now to avoid the tax later.

The Change in Tax Law

The Tax Increase Prevention and Reconciliation Act of 2005 states that in 2010, the existing $100,000 income limit for converting a traditional IRA to a Roth IRA no longer apply. As an additional benefit, an investor converting in 2010 will be allowed to defer half of the taxes due to 2011 and the other half to 2012, effectively paying the tax in 2012 and 2013. After 2010, taxes must be paid in full the following year. Separately, wage earners of $110,000 or more ($160,000 for married joint filers) are now able to make new contributions to a Roth IRA.

Should I convert my Traditional IRA?

The sections that follow provide examples of the key factors that influence the overall benefit of the conversion.

At Cypress Financial Planning, we build comprehensive financial models of future cash flows and tax liabilities under both scenarios to ensure the most optimal decision are being made for clients.

When it May be Optimal to Convert to a Roth IRA

1. The tax bracket in which you expect to be while taking distributions is higher than your current bracket. You will be taxed less if you pay the taxes on conversion while you are in a lower tax bracket, compared to paying the taxes upon distribution of the traditional IRA.

2. You have significant assets in a Traditional IRA that had already been taxed as a result of non-deductible contributions. There is no current tax due on this type of conversion, and earnings will be able to grow tax free.

3. You do not anticipate needing the IRA money within your lifetime. You will avoid the annual mandatory distributions required from a traditional IRA when you reach the age of 70½ because that rule does not apply to a Roth.

When it May not be Optimal to Convert to a Roth IRA

1. You must use part of the traditional IRA assets to pay the income taxes due as a result of the conversion. This would reduce the amount remaining in the Roth IRA for compounding. If you are under the age of 59½, you will be subject to an additional 10% early withdrawal penalty.

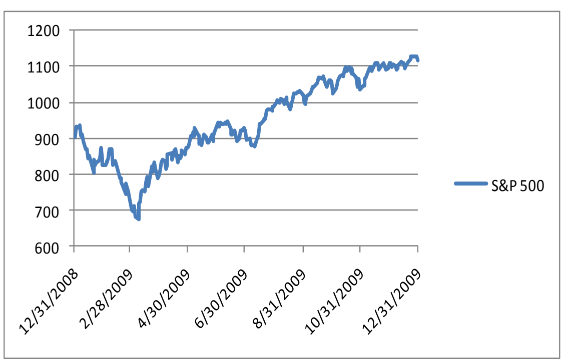
2. If the added current income caused by the conversion affects items on your income tax return that are tied to adjusted gross income (AGI), this would likely cause higher taxes overall.

3. The tax bracket in which you expect to be while taking distributions is lower than your current bracket. You will be taxed more if you pay the taxes on conversion while you are in a higher tax bracket, compared to paying the taxes upon distribution of the traditional IRA.

2010 Outlook

Economic Recovery?

Debate over whether the economy will grow, sustain its current level, or dip again in 2010 and beyond has been strong as the we enter the new year. Government stimulus has been beneficial to many sectors of the economy. However, many question what will happen once 'the training wheels come off,' when the government is no longer there to support these failing entities.



Fortunately, policymakers recognize that turning off the stimulus too abruptly could drive the country back into a deep recession and are erring on the side of caution in that regard. Federal Reserve Chairman Ben Bernanke released his final statement of the year in which he reiterated the desire to keep the Federal Funds Target Rate, from which most savings and lending rates are derived, at historical lows for an extended period, meaning at least until mid-2010. Meanwhile, President Obama is refocusing the disbursement of federal stimulus funding towards job creation, specifically into projects that build roads, lay high speed rail, install broadband in rural areas and fund research at health institutions.

Despite signs that the unemployment rate may be bottoming, some fierce headwinds remain in the face of a quick recovery. Small businesses, historically the main driver of job creation, have been deprived of financing as banks are still hesitant to lend.

Source: Yahoo Finance

Businesses, especially retailers, will need consumers to return before they start experiencing significant top-line growth to expand their workforces.

Inflation Concerns

Many economists project an increase in inflation as the printing presses of money in the US continue to work overtime, interest rates remain at zero, and the consumer begins to recover. If you agree with this view, there are several ways for investors to hedge against inflation, including buying gold or Treasury Inflation-Protected Securities. However, at Cypress, we believe that inflation will be contained due to the significant slack in the economy. As business resources, including factories, materials and labor remain underutilized, they are very unlikely to increase the prices for their goods. Another important component in inflation, the cost of housing, is not expected to rise significantly with the glut of foreclosed homes continuing to keep prices in check.

2010 Areas of Focus

The US health care reform circulating through Congress will undoubtedly be one of the most pivotal issues of the coming year. The main goals of the reform are to broaden insurance coverage for Americans and cut costs from the system. Unfortunately, these are inherently conflicting goals, as people with health insurance tend to use more medical services than those without. In addition, it will be very difficult for the House and Senate to merge their unique bills, as they are growing significantly apart. The House's version includes a provision restricting payments for abortion services and also includes a public option, a government-run insurance plan similar to Medicare. The Senate's version allows for young adults to remain on their parents' insurance policies until age 26 and also addresses the gap in Medicare prescription drug benefits which currently cover annual costs less than $2,700 and greater than $6,154, but not in between. Both bills are strongly opposed by Republicans who argue passage will result in Medicare cutbacks, higher insurance premiums, higher taxes and, in the long run, higher deficits.

The housing market is expected to continue its current recovery into 2010. With the newly extended and expanded homebuyer tax credit, homebuilders are applying for more construction permits, mirroring the expectation of stronger sales to come in the first half of the year. The biggest headwind for the housing market remains the lack of credit being supplied by banks in the form of mortgages to homebuyers and construction loans to builders.

Equity Markets Forecast

After rallying over 60% from the March lows, many investors believe the market may be due for consolidation. Looking at past market performance, this situation could be comparable to 2004, after the crash from 2000 to 2002 and the rally in 2003. 2004 saw sideways movement for most of the year, followed by a small rally to finish the year positive. The S&P is trading at a P/E of 20.1, compared to its historical average of 21.1, suggesting there may be more room to extend '09 gains.

Outside of the US, the European markets will have their own significant issues to navigate in order to continue their broad 2009 rally. Unflatteringly nicknamed the PIIGS, Portugal, Italy, Ireland, Greece and Spain are under intense scrutiny to mend their overextended budgets. The European Central Bank, the Euroland's equivalent to our Fed, has vowed not to bail out debt-stricken member states and risk the health of the stronger countries.

Emerging markets were a great story in 2009 and it appears they may continue to mature in 2010 and beyond. Despite rallying 108% from their lows, the Chinese market remains relatively cheap. The iShares FTSE/Xinhua China 25 Index Fund currently trades at a price/earnings ratio comparable to developed economies, helping to allay fears of a bubble.

Outlook for Bonds, CDs and Savings Accounts

While it may be tempting to invest in CDs and bonds that have longer-dated maturities to reach for extra yield, Cypress advises to proceed with much caution. When the Fed does decide to raise rates, the market values of these investments will decrease sharply, as the market becomes flooded with new securities that have significantly higher yields than those you are now stuck with. Your options will then be limited to holding these investments until maturity and collecting their relatively modest income, or selling at a loss to reinvest in the new, higher-yielding securities.

In the corporate bond world, yields currently stand at 4.52%. As you would expect with low overall interest rates, this is significantly less that their historical average of 8.48%. Up until the credit crisis, corporate bonds typically yielded approximately 0.90% greater than risk-free treasuries but the spread is currently 2.06%, indicating some remaining fear in the market. On the tax-free side, municipal bond yields currently stand at 3.59% compared to their historical average of 6.02%.

Key Takeaways for Investing in 2010

- Keep your safe cash liquid and your bonds short-dated, then gradually purchase longer-term investments once interest rates begin to rise again.
- If you are in a high tax-bracket, municipal bonds offer attractive yields compared to other debt alternatives.
- Stick to your long-term allocation of US equities for the first part of the year and consider paring back once the effects of the government stimulus wear off.
- For your international investments, pay close attention to the movement of the US dollar and the more fragile countries in the European Union. When our Fed starts to raise rates, the dollar will strengthen and impair international stock returns. Additionally, a major crisis is potentially looming for the fate of the PIIGS.
- Consider an allocation to Chinese stocks, but pay attention to their valuation. Like tech stocks in the late 90s, this is a very popular investment that has the potential to become inflated well beyond their inherent value.