

# CYPRESS FINANCIAL REVIEW

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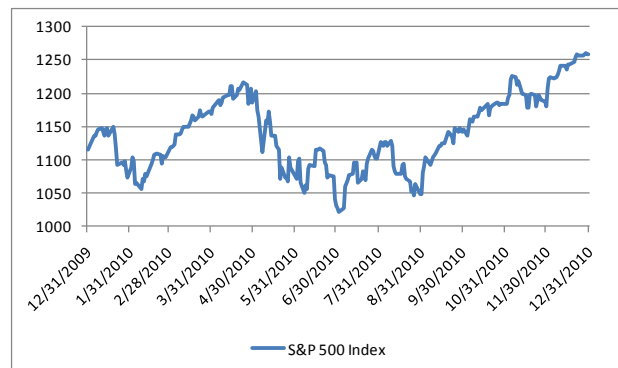
## Aboard the Rollercoaster: A Look Back at 2010 and a Peek at What Lies Ahead

2010 was a strong year for investment performance, though it was a year marked with high volatility. The Dow Jones Industrial Average gained nearly 11%, and the Nasdaq did better still. Nevertheless, stock growth faced a bumpy ride to the top, best exemplified by the flash crash of May 6, at which time the stock market lost nearly 1,000 points. Fortunately, this last quarter, during which the US Congress extended existing and created new tax breaks, gave US stocks a final boost to the finish line.

### Equity Market Performance

After such a stellar stock performance in 2009, many investors were skeptical if the bull market could continue into 2010. Fortunately, fears of a double-dip recession subsided as corporate profits surged. The S&P 500 posted a total return of 12.8% to finish at 1257.62, though it is important to note the huge variations in global stock performance. As investors bought into riskier assets towards the end of the summer, U.S. small-capitalization stocks began to surge. The Russell 2000 index of small-cap stocks finished the year up 25.3 percent, an apparent show of optimism towards the U.S. economy.

Affecting stock markets globally was Europe's sovereign debt crisis. Fears that countries such as Greece, Ireland and Portugal would default sent US markets down over 16% in the spring. Although our market eventually recovered in the second half of the year, those at the center of the crisis did not fare as well—Greece plummeted 35.6% and even Euro-zone heavy-weight Spain slumped 17.4% in 2010. China's continuing economic strength helped drive growth across Asia, but surprisingly could not lift its own stock market. While small Asian markets such as Indonesia and Thailand rose over 40%, the Chinese market actually fell 14.3% as the Chinese government took steps to rein in inflation. In aggregate, international stocks underperformed the US, with the MSCI index of non-US stocks returning 8.4%. Those brave enough to invest in the battered commercial real estate market were rewarded with a stellar 21.4% return as that market continued its path back to health.



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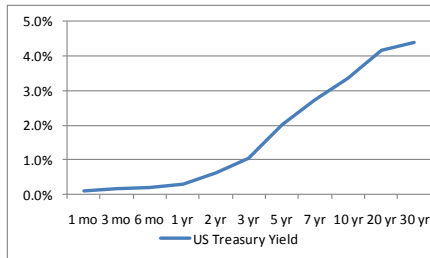
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**Bond Market Performance**




As the economy slowly recovered, the US Treasury implemented policies to lower interest rates in an attempt to encourage borrowing and growth. One such policy was their controversial bond buying program to lower yields of longer maturity treasuries. The yield on the 10-year Treasury note is now at a historically low 3.3 percent. Borrowers of all shapes and sizes, from homeowners to large corporations, can take advantage of rock-bottom borrowing costs as national lending rates are tied to the 10-yr Treasury. A major trend of last year was for retail investors to shift assets away from low-yielding money market and savings accounts into riskier strategies such as corporate bonds. This trend drove the prices of these bonds up throughout the year, and an investor who had beat the rush and been invested in corporate bonds for the entire year was rewarded with a 9.0% total return.



The municipal bond market had a weak end to the year; tax-exempt municipals did not benefit from Washington's tax-cut compromise, and the possibility of expiration of the Build America Bond program—which offers states and local governments subsidies when selling taxable debt—increased anxieties about municipal bond issuance for the next year. Municipals in aggregate managed to putter to a modest return of 2.4% which is fairly respectable when compared to after-tax yields of investments with similar risk.

**Major Economic Headlines in 2010**

	<p><b>BP Oil Spill</b> — On April 20, 2010, aboard the drilling rig Deepwater Horizon while working on a well for oil company BP, an explosion caused the largest oil spill in history. 185 million gallons of oil leaked from the well, requiring more than \$2.2 billion be paid to some 150,000 individuals and businesses from the \$20 billion BP claims fund.</p>
	<p><b>Greek Debt Crisis</b> — During the past decade, a strong euro and low interest rates encouraged Greece to drive up borrowing, surmounting \$500 billion in debt. In December of 2009, Prime Minister George Papandreou admitted that his predecessor had disguised the growing debt, and in early 2010, fears of a potential default turned into a full-fledged panic.</p>
	<p><b>Flash Crash</b> — On May 6, 2010, a computer glitch caused the stock market to drop almost 1,000 points. One official commented that an unexplained surge in selling in Chicago around 2:45pm set off trading, leading to the unexpected drop in prices. After the stock exchange temporarily halted and traders realized there was no systemic reason for the drop, prices returned to normal.</p>
	<p><b>Chinese Fiscal Tightening</b> — China's central bank has been raising interest rates to suppress inflation as many Chinese consumers express discontent at rising prices. The government must walk a fine line between aiding its citizens through price controls and preventing the economy from falling into a recession.</p>
	<p><b>Homebuyer Tax Credit</b> — In 2010, a tax credit was initiated for home purchases, qualifying home buyers for an \$8,000 tax break during the purchase of their first home, and \$6,500 for those moving to a new residence. This tax credit expired this past spring, with the last deals closing June 30.</p>
	<p><b>Federal Reserve Quantitative Easing</b> — Through quantitative easing, the Federal Reserve purchased U.S. Treasury securities to lower interest rates across debt markets that are closely tied to US Treasury rates. Lower rates are meant to help some homeowners refinance and help businesses access cheaper credit.</p>

	<p><b>General Motors Initial Public Offering</b> — GM sold more than \$23 billion worth of shares in its December initial public offering. The US Treasury reduced its stake in the company to about 33% from 61% and may actually turn a profit from the controversial bailout.</p>
	<p><b>Ireland Debt Crisis</b> — A low corporate tax rate and low interest rates, among other factors, encouraged the expansion of the Irish economy during the last decade, dubbed the Celtic Tiger years. A property bubble burst in 2007, putting Irish banks under severe pressure, pressure which was only exacerbated by the global financial crisis.</p>
	<p><b>Federal Tax Changes</b> — The tax plan approved December 15 extends the Bush-era tax cuts at all income levels for two years as part of a package that continues benefits to the long-term unemployed and cuts payroll taxes for all workers for a year. In addition, it sets new estate tax parameters, including an exemption of \$5 million per person or \$10 million per couple, and a maximum rate of 35%. The tax cuts will ultimately cost \$801 billion and the extended unemployment benefits will cost \$57 billion.</p>

**State of the Economy**

The Great Recession officially ended in 2009, yet the US economy is still far away from the peak levels of output and health reached in the boom years of 2006-2007. The following is a summary of the major measures that indicate the overall health of our country:

- **Gross Domestic Product** — After two years of experiencing zero or negative GDP growth, Moody’s Analytics estimated a 2.9% real GDP growth in 2010, with an expectation that it will rise in the new year. Although this growth is short of the 4 or 5% needed for a full recovery, the US economy is slowly improving.
- **Unemployment Rate** — The monthly unemployment rate has lingered above 9% for 19 straight months, the longest stretch on record since the government started tracking unemployment in 1949. Despite a weak report in November—only 39,000 jobs were added—analysts expect the economy to add about 150,000 jobs a month on average in 2011, compared to 90,000 a month in 2010. The average number of initial jobless claims, at 422,750, is down more than 20,000 from a month ago. Purchasing managers report continued employment in the manufacturing and service sectors, and business executives are growing more confident about the economy, signaling higher employment.
- **Inflation** — Throughout 2010 the consumer price index increased 1.1%, led by gasoline and energy costs. Despite inflation pressures at the producer level and for commodities, inflation for consumer goods is still quite subdued.
- **ISM Manufacturing** — The Institute for Supply Management surveys more than 300 manufacturing firms to understand industry trends. According to the ISM report for November, manufacturing continues to grow at a solid rate, posting increases in employment and strong activity in the supply chain.
- **Retail Sales** — Retail sales in November came in stronger than expected, led by -sporting goods and hobby up 2.3%, clothing up 2.7%, and general merchandise up 1.3%. The weakest sales were in electronics and appliance stores, down 0.6%.
- **Housing Starts** — Housing starts are registered at the onset of construction of new buildings intended for residential use. In November, housing starts posted a weak comeback, led by increases in the Midwest. Unfortunately, there is still a glut of foreclosures on the market that is continuing to prevent a meaningful rebound.

## Outlook for 2011

According to the latest Wall Street Journal forecasting survey, economists are optimistic about US growth in the next year. The 55 respondents predict GDP growth of 3% for the year and have reduced the odds of a double-dip recession to 15%, down from a forecast of 22% in September. While there is optimism resulting from the tax-cut compromise in Washington, there remains fear due to lingering unemployment, instability in Europe's economy, and, most significantly, the weak housing market. Many economists predict the housing market will not see any improvement. They expect home prices to drop by an additional 15% to 30% due to an excess of inventory. Despite these concerns, a forecast of 11 strategists at Wall Street's biggest banks predict the S&P 500 index to end 2011 at 1,374 – up more than 9% for the year.

## Searching for Yield: Where to put your Safe Money

These days, investors still need to be cautious about where they put their money, but it seems as if the returns offered by safe funds are lower than ever. To stimulate a struggling economy, the Federal Reserve employs various tools to lower the Federal Funds Rate, the rate that banks lend to each other. This is done to help drive down the rate of various loans so that businesses and individuals will be more incentivized to take on debt and utilize it to grow the economy. One major downside of this effort is that the rates on virtually every savings instrument fall in tandem with the Federal Funds Rate. At Cypress Financial Planning, clients often wonder where they can find a higher yield than their current bank account without taking on much risk. There are various vehicles available, each with their own unique characteristics. Below, some worthwhile options are examined and compared, as well as the benefits and risks:

### Savings Accounts

A typical savings account is a deposit account held at a bank that provides principal security and a modest interest rate. Depending on the type of account, the owner may not be able to write checks without incurring extra fees, and the account usually has a limited number of free transactions. US regulations actually limit the number of transfers into and out of a savings account to six per month. In contrast to a checking account, a savings account is typically used for money that isn't intended for daily expenses.

Savings accounts offer FDIC insurance up to \$250,000 per account. This means that even if you place your money in a troubled bank that becomes insolvent, the federal government will guarantee that you are repaid your principal, adding an additional layer of safety.

In recent years, new banks have been formed outside of the traditional brick-and-mortar realm. Operating solely through the internet, these institutions have significantly less overhead and can offer relatively higher yields to individuals comfortable transferring money electronically.

An unfavorable characteristic of savings accounts is that they offer low yields in comparison to other investment instruments, usually around just 1%. Additionally, this rate can change depending on the fluctuation of market rates and the Federal Funds Target rate. An example of a relatively high savings rate offered by an internet-only bank is 1.25% at Discover Bank ([www.discoverbank.com](http://www.discoverbank.com)).

### CDs

A Certificate of Deposit is a savings certificate that entitles the bearer to receive interest that is typically at a higher interest rate than a savings account. They are available in term periods of three months to five years, with higher interest rates offered for longer lock-up periods. By purchasing a CD, one invests a fixed sum of money for a fixed period of time. In exchange, the bank pays interest, usually at regular intervals. When the CD reaches its maturity date, the money you originally invested is returned as well as any accrued interest. If the CD is redeemed before it matures, however, one pays an "early withdrawal" penalty or forfeits a portion of the interest earned. CDs are generally issued by commercial banks and, like savings accounts, are also insured by the FDIC up to \$250,000.

Examples of relatively high CD rates include 1.41% for a 1-year CD at Bank of the Internet USA ([www.bankofinternet.com](http://www.bankofinternet.com)) and 2.55% for a 5-year CD at EverBank ([www.everbank.com](http://www.everbank.com)).

### **Money Market Accounts**

A money market product is a conservative savings vehicle offered by a bank or a brokerage institution. Money in these vehicles is used to purchase high quality, short term bond securities such as U.S. Treasuries. Many people do not realize that there are actually two forms of money markets with varying degrees of risk: Money Market Deposit Accounts and Money Market Mutual Funds.

Money Market Deposit Accounts (MMDAs) are available at many banks and offer FDIC insurance. In addition, MMDAs frequently have a tiered interest rate schedule, rewarding savers who deposit great amounts of money with the bank. Money Market Mutual Funds, however, are generally offered by brokerage institutions such as Fidelity and do not have FDIC insurance. Even though the money market is typically seen as a safe place to put money due to the highly liquid nature of the securities and short maturities, there are risks involved if the underlying securities default. Money market mutual funds generally have a share price that stays constant at \$1 per share, though this share price is not guaranteed. In fact, in the fall of 2008, the value of one money market mutual fund fell below the \$1 dollar per share threshold (also known as "breaking the buck").

Examples of relatively high money markets include a 1.25% Money Market Deposit Account at Cornerstone Bank ([www.cornerstonebank.net](http://www.cornerstonebank.net)) and 0.12% for the PayPal Money Market Mutual Fund ([www.paypal.com](http://www.paypal.com))

### **Fixed Deferred Annuities**

A fixed deferred annuity is the insurance industry's version of a savings account. The insurance company guarantees both earnings and principal. A fixed annuity is very similar to a CD in that the principal is generally locked for a set period of time. A major benefit over CDs is that all interest earned is tax deferred until the annuity is cashed out, and if the annuity is rolled, the tax deferral can continue. Although insurance contracts are not covered by the FDIC, every state has an Insurance Guaranty Association that will intervene if an insurance company becomes insolvent. For example, in New Jersey, the New Jersey Life & Health Insurance Guaranty Association will cover the present value of an annuity benefit up to \$500,000.

Like CDs, rates on fixed annuities will increase as the term of the annuity increases. Principal offers a 3-year fixed annuity yielding 1.00% and John Hancock offers a 6-year fixed annuity yielding 2.25%.

### **Short Term Bond Mutual Funds**

Short-term bond portfolios invest primarily in corporate and other investment-grade U.S. fixed-income issues and have durations of 1 to 3.5 years. These portfolios are less sensitive to interest rates than portfolios with longer durations. However, they are still subject to the risks of the bonds themselves; the value of the bond fund will rise and fall as the value of the bonds in which the fund invests rises and falls. These risks depend primarily on the terms and quality of the obligations in its portfolio, as well as on bond market conditions. When interest rates rise bond prices fall, and when interest rates fall, bond prices go up. For example, the Lord Abbett Short Duration Income Fund invests in short duration investment-grade mortgage, corporate, government and asset-backed securities and currently offers a yield of 2.39%.

### **Conclusion**

In conclusion, it is wise to think about goals for money management and look at less-familiar options for fulfilling those goals. Always remember that there is no free lunch in the investing world and any higher yield that is being offered is due to higher levels of risk or more unfavorable characteristics such as lock-up periods. It is not guaranteed that the bank offering the highest savings yield at the moment will still be the highest a few months from now. It would require an enormous amount of effort to open accounts and transfer assets if you always chase the highest yielding account or product. A useful website called [www.bankrate.com](http://www.bankrate.com) can help you find the most attractive rates, though research is still required to find safe and high-yielding funds. Cypress Financial Planning helps clients to identify their goals and craft a comprehensive strategy utilizing many of these conservative vehicles.

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