



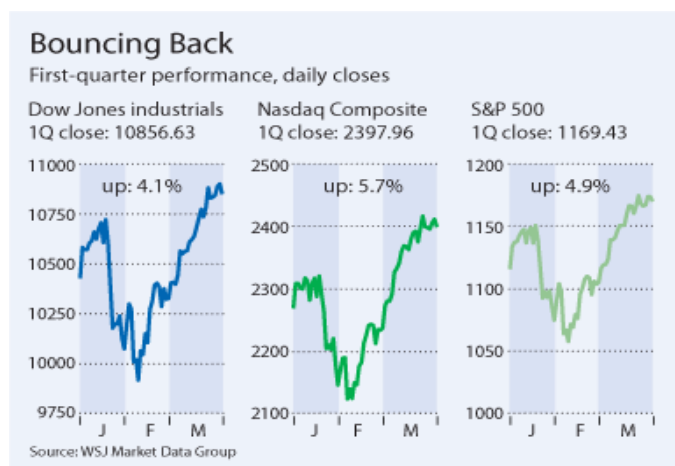
Financial *focus*

Second Quarter, 2010

FIRST QUARTER IN REVIEW

Wow—another roller coaster quarter! As you can see from the charts below, the Dow Jones Industrial Average (Dow) experienced a significant drop in January and then rebounded, ending up with another impressive quarter with a total return of 4.1%. This marks the Dow's fourth consecutive quarterly gain and its best first-quarter performance since 1999. The S&P 500 index rose 4.9%, and the NASDAQ Composite index also had an impressive quarter, up 5.7%. (Source: WSJ, April 1, 2010)

The stock market extended its rally, while many of the trends that helped the stock market stage a remarkable recovery in 2009 continued to provide a favorable environment for many U.S. stocks. For example, corporate earnings again came in stronger than expected for many companies as the battered U.S. economy continued to improve.

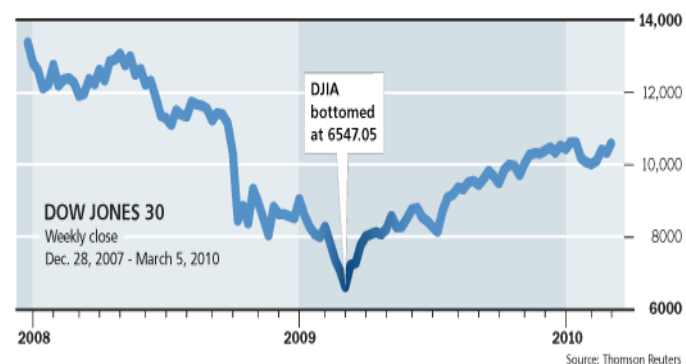


The Dow Jones closed above 11,000 on Monday, April 12, something it hasn't achieved since the financial system started deteriorating 19 months ago. This rise was caused by optimism about corporate profits, a recovering economy and the latest debt release plan for Greece. (Source: WSJ, April 13, 2010)

We just passed a major anniversary for the U.S. stock market. Just over a year ago, the Dow hit bottom and has since rallied more than 70%. A big question is how much of the market's rebound was driven by improving economic fundamentals and how much of the stock market increase was due to government stimulus.

The Comeback Kid

The DJIA has rallied 61% since its March 2009 low, to 10,566. Even so, the average remains 25% below its all-time high of 14,164, established on Oct. 9, 2007. Although unemployment has stayed stubbornly high, corporate America is in far better shape today than a year ago, which bodes well for investors.



Unfortunately, as you can see from the chart, this rebound was not in the form of a straight line. The Dow endured various corrections during this period, including its pullback in January of this year. Although market corrections are scary, investors must accept that pullbacks are normal occurrences during every advance.

Fountains at Roseville | 1013 Galleria Blvd., Suite 205 | Roseville, CA 95678
Tel (916) 797-1888 | Fax (916) 797-4986 | info@deboerfg.com | www.deboerfg.com

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Most sector, stock or investment styles are not immune to such events and it is simply one of the costs of business to anyone who owns stocks.

There are many typical patterns related to economic cycles and recovering economies. This revival of our economy continues to play out very similar to past recoveries, with consumer spending leading the way, followed by industrial production and, much later, employment and capital spending. Consumer spending and industrial production have already begun their upward rise, while employment and capital spending should begin, according to many economists, to grow again sometime during mid-2010. Usually, without some type of significant outside force, recovery very often begins to feed itself. This momentum is usually as hard to break on the upside as it is on the downside. The virtuous cycle starts with more spending that leads to more production... that leads to more factory hours worked and more employment... that results in increasing consumer income...that leads to increased spending, and so forth, as the cycle begins anew.

Although both the Dow and the S&P are up about 5% so far this year, the market still looks poised to gain more ground in 2010. The S&P 500 is trading at about 15 times the estimated 2010 profits. However, that is not expensive given today's low bond yields.

While the U.S. economy faces serious long-term headwinds, a cyclical recovery is underway and corporate profits are on the upswing, meaning dividends may start to make a comeback. (Source: Kiplinger's Personal Finance, March 24, 2010)

The yield on the S&P 500 is only 2.1% at the moment, but that figure is likely to grow as payout rates rise. Please note that over the 1925 to 2009 period, reinvested dividends accounted for 43% of the total return in stocks. (Source: Forbes, March 29, 2010)

One of the major providers of support for stocks is the solid state of many corporate balance sheets. Jason Desena, Chief Investment Strategist at Strategas Research Partners, insists that by several measures, there never has been more cash in corporate coffers. In the fourth quarter, undistributed corporate profits (essentially, the flow of cash that companies generate but don't disperse) hit an all-time high of \$527 billion. In addition, the non-financial companies in the S&P 500 have a record \$830 billion of cash on their books, according to Strategas. There is evidence that some companies may start doling out some of that cash to shareholders through higher dividends, which is a positive trend for stocks. (Source: WSJ, April 1, 2010)

GLOBAL OVERVIEW

The global recovery has been driven by growth in China. Huge government stimulus funds taken at the height of the crisis have had a sizeable impact on China's economic growth. China has also passed Germany as the #1 exporter in the world and is now the largest automobile maker, bypassing the United States at the end of 2009. (Source: American Funds)

Chinese revitalization of Asian capitalism remains one of the most important positive events in the world in the last 30 years. Not only did it release a billion people from oppression, but it transformed a communist enemy of the United States into an indispensable capitalist partner. Unfortunately, instead of treating China like a crucial economic partner, the U.S. treats China as an adversary because it defies us on global warming, dollar devaluation and internet policy.

In 2009, the U.S. economy shrank by 2.4% to \$14.5 trillion in size, while China's economy grew by 8.7% to \$4.9 trillion in size. Some experts say it is a bubble and others believe that it will continue to grow at the same pace or better. (Source: Commerce Department)

If we take a look at 2010, the U.S. economy is predicted to grow 2.7% and China's economy is predicted to grow 10%. (Source: International Monetary Fund)

EMERGING MARKETS

It has become an investing truism lately: If you want stocks with high-octane potential, you are wise to invest in the fast-growing economies of the emerging markets. The result has been frenzied demand for such stocks and skyrocketing valuations. The MSCI Emerging Markets index has risen 76% in the last year and China's main stock index now trades at a price/earnings ratio of 31, more than 50% higher than that of the S&P 500. Many investors find themselves in a quandary. Yes, new economies have a rich potential, but at these prices! Some international stock managers have found an answer—buying shares of companies in established economies that have significant exposure to emerging markets. Many larger companies are experiencing their fastest growth from places like China, Brazil, and India.

Emerging markets could suffer reversals in coming months, but their long-term outlook is robust, according to many economists. Many emerging markets are exiting the global recession on stronger footing than many developed markets. If the global economy continues to recover, emerging market stocks and bonds could be top performers again.

At the end of World War II, the United States emerged as an economic superpower, with widespread growth and consumption. More recently, many countries around the world have been undergoing a similar shift, with a growing middle class and rising standards of living. While the world economy and markets still face significant challenges, these trends suggest that there is significant opportunity in global markets for patient, long-term investors.

For example, consider the following:

- In 2009, for the first time, China passed the U.S. as the world's largest carmaker. First time buyers were responsible for at least 70% of car purchases in China (as of 2008).
- Only 10 years ago, one out of 100 Russians had a cell phone account. Although not everyone has a cell phone account, since many people have more than one, Russia now boasts more cell phone accounts than people.
- From 2003 to 2008, toothpaste usage in India increased roughly 40% per person. With more than 1 billion people in India, the total amount of toothpaste used in a year would fill 43 Olympic-size swimming pools!
- Over the next decade, nearly 450 million newcomers are expected to join the middle class in China and India alone, according to the McKinsey Global Institute. (Source: American Funds)

The story of long-term economic growth is not limited to countries outside the U.S. In fact, despite recent economic challenges, there are many reasons to believe that America's future could be potentially bright:

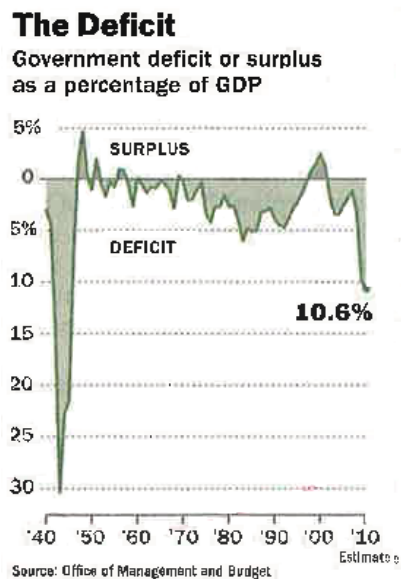
- The U.S. remains the world's largest single-country economy, with a Gross Domestic Product (GDP) in 2008 of about \$14 trillion a year: roughly 24% of the world's total output.
- 15 of the 20 largest public companies in the world are based in the U.S. (as of October 31, 2009). (Source: American Funds)
- The U.S. has 4% of the world's population, 24% of the GDP and about 35% of its net worth. (Source: Forbes, April 26, 2010)

International investing involves special risks including greater economic and political instability, as well as currency fluctuation risks, which may be even greater in emerging markets.

U.S. BUDGET DEFICIT

This report is not meant to be political, and although some of President Obama's proposals and ideas might appear to be on the extreme side, it is important to also remember that much of the deficit is a natural result of a deep recession that was inherited. Please note that a new commission has just been launched to deal with the federal deficit and both parties are participating.

The budget is the main arena in which the nation as a whole decides on the allocation of resources. What we spend money on – and what we don't – reflects what we value as a nation. Making the best choice isn't all that simple. It is in the federal budget that the breakdown of consensus is most vivid and most dangerous. One side of the political divide wants to cut taxes and shrink existing public services and the other side often wants to increase public spending on social and economic means – even as it remains unclear on how to fund the outlays. There is no absolute rule on when the deficits of public debts are too high relative to an economy's size. As the economy grows, deficits fall and debts become more sustainable, lightening the deficit burden and reassuring investors.



According to the latest projections by the Administration in presenting the budget for fiscal year 2011 (the 12-month period from October 1, 2010 to September 30, 2011) the U.S. debt has reached record highs for peacetime. The deficit is now expected to reach \$1.6 trillion, an outstanding 10.6% of GDP. (This is double the 5% incurred during Franklin Roosevelt's New Deal from 1933-1936.)

Some of that reflects the downturn in the business cycle, which cuts into tax revenue while boosting unemployment compensation, bank bailouts and other spending. Yet there is nothing temporary about the enormous deficit. The Obama budget office projects mega deficits for years to come – as high as \$752 billion, roughly 4% of GDP, in 2015 – despite some rosy economic and budgetary assumptions.

Meanwhile, as the Treasury hurries to fill in the gap between revenue and outlays, the government debt is soaring. In fiscal year 2010, the Obama budget office projects the public debt will increase by \$1.75 trillion. That amounts to roughly \$15,000 per household. For 2015, the cumulative rise in the debt is projected to exceed \$6 trillion. Remember – this doesn't even include the budget problems facing most states, such as California, New York and New Jersey, which face multi-billion dollar deficits. (Source: Time Magazine, February 15, 2010)

Shortly after he took office, the President signed into law a two-year stimulus package worth about \$787 billion, which the Administration estimated would save or create about 3.5 million jobs. With the stimulus, the White House predicted that unemployment would peak at about 8%. Instead, unemployment rose to 10% in 2009. Although it has dropped slightly to 9.7%, it will stay at about this number for most of 2010, according to the Administration's forecast.

This unexpected bad performance has placed the President in an uncomfortable spot. Just when he ought to start switching his attention towards deficit reduction, he faces a labor market far weaker than was forecasted last January. Meanwhile economic weakness has further damaged the country's fiscal position. (Source: The Economist, February 6, 2010)

Another worry is that federal borrowing may crowd out private borrowing and drive interest rates significantly higher for mortgages, car loans, etc. Finally, many investors are concerned that the increased federal spending might ignite inflation and in turn drive interest rates higher, which would lower our standard of living.

Federal Reserve Chairman Ben Bernanke gave a speech in Dallas on Wednesday, April 7 and warned about the concerns he has about the deficit. Mr. Bernanke bluntly stated that two giant fiscal waves were headed for the federal government, one on top of the other. First comes the big deficit caused by the economic downturn, which will be followed immediately by the ballooning costs of baby-boomer retirees drawing Social Security and Medicare funds. He is worried that the huge U.S. budget deficit threatens the Nation's long-term economic health and should be addressed soon. "To avoid large and unsustainable budget deficits, the nation will ultimately have to choose among higher taxes, modifications to entitlement programs such as Social Security and Medicare, less spending on everything else from education to defense, or some combination of the above," Mr. Bernanke said.

To sum up Mr. Bernanke's statement as simply as possible: There are two ways to reduce the deficit—cut

spending or increase taxes. Many political battles during the next few years will pit taxpayers against the beneficiaries of public spending. Generations may also be pitted against each other, as our nation's biggest medium-term budget busters are pensions and healthcare for retirees. These battles are also intertwined—taxpayers who do not work for the government finance public employee pensions which are, by and large, more generous and predictable than in the private sector. (Source: The Economist, March 6, 2010)

To understand how hard it is to cut Federal spending, consider this: about three-fifths of our public spending (57.3%) goes out in direct payments to individual Americans or is spent on their personal behalf (for example, by healthcare and housing providers).

The biggest area of discretionary spending is on military operations and hardware. At 19.6% of next year's budget, defense is the third-largest federal expenditure by function after healthcare and pensions. Obama and Congress are eyeing major cuts in armament programs, but defense contractors will remind the voters of how many manufacturing jobs they support in most of the 50 states. In fact, getting rid of all defense spending would eliminate less than half of this year's \$1.6 trillion deficit. (Source: USA Today, March 17, 2010)

What is left of discretionary spending is about every other function of the government: transportation, education, homeland security, law enforcement and disaster relief, just to name a few. The problem is that all of these together account for only about 16% of federal spending. In fact, not one of these functions gets even 3% of the budget and many are well under 1%. (Source: Kiplinger's Personal Finance, April 20, 2010)

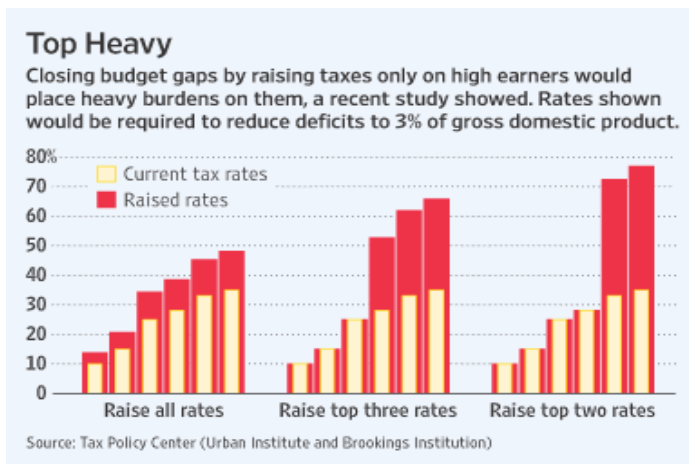
Our tax revenues are adequate to cover just four budget items: military spending, health spending, Social Security, and interest on the national debt. Every other program has to be covered with borrowed funds. This includes unemployment compensation, homeland security, support for state and local governments – the list goes on and on.

President Obama has proposed a number of different tax increases in order to help reduce this deficit. We will discuss different tax issues later in this report. Unfortunately, the projections for the tax increases in order to balance the budget are not easy to swallow.

A January study by the non-partisan Tax Policy Center provides the worst-case scenario. It found that to reduce the federal budget deficit to a sustainable 3% of GDP, the government would have to find an average of about half a trillion dollars each year in new revenue (or spending caps). That is roughly how much the federal

government spends now on the giant Medicare program. To cover that amount through tax increases on the top two brackets – roughly families with more than \$209,000 in taxable income – top rates would have to go from the current 33% and 35% to 72.4% and 76.8%, according to this study!

Please see the chart below that illustrates how the factors would change depending on if it's a rate across the board or just only to the top two tax rates, as the current proposal is today. (Source: WSJ, April 12, 2010)



It appears as though some investors are not too concerned about these deficits. One theory is that these numbers are so high and the subject so complicated that it is difficult, if not impossible, for many investors to truly relate to what these numbers really mean! (Source: By the Numbers, February 1, 2010)

Let's take a look at how many zeros there are in a trillion dollars: \$1,000,000,000,000.

When we hear the word “trillion” almost daily from the media—oh, a trillion here, a trillion there—it can make us immune to the actual importance and seriousness of this amount of money. Apply it to your personal life and you'll come to the same conclusion everybody should, which is:

A trillion dollars is a lot of MONEY!

Let's put this in perspective – the U.S. government paid \$1 billion of interest expenses on its Treasury debt every 40 hours during the month of February 2010! (Source: Treasury Department)

NATIONAL HEALTH PLAN

On March 23, 2010, President Obama signed the Patient Protection and Affordable Care Act and H.R. 3590. The bill is massive – nearly \$1 trillion in spending and \$400 billion in new taxes over the next decade, not to mention coming in at over 2,000 pages! This is the biggest change in America's welfare state since the 1960s and a

major attempt to bring healthcare coverage to the country's uninsured. This new law will extend coverage to 32 million uninsured by expanding Medicaid rules, establishing new health-insurance changes to provide more competitive rates, and providing subsidies for middle class families to buy into private plans.

The cost of these health reforms - \$940 billion over the next 10 years – paid for by measures that include reducing Medicare spending, levying a new tax on high-end “Cadillac” health plans and raising taxes on the wealthy. The Congressional Budget Office (CBO) projects that the savings for all these changes will reduce the federal deficit by \$130 billion by 2019. Republicans, who unanimously opposed the legislation, say that these predictions are woefully optimistic and will end up adding hundreds of billions of dollars in deficit spending.

Unfortunately, most taxpayers do not realize that within this voluminous document is a special provision adding a “surtax” to high-income taxpayers. There were a number of different changes in these new tax laws that affect about everyone one way or another. Some of the new law's provisions will take effect soon while other elements will phase in slowly, over the next few years. Health care reform is but one aspect of a larger trend: the government is becoming more involved in the economy and is exerting greater influence on our investment decisions.

The tax implications of this healthcare legislation raise critical questions for investors looking to preserve their assets. A significant portion of the revenue raised by the act comes in the form of an additional Medicare tax hike that will affect higher-income taxpayers. For example, starting in 2013, there will be an additional 0.9% Medicare Health Tax (from the current 1.45% to 2.35%) on earned income above \$200,000 for individuals and \$250,000 for joint filers. The bill also imposes a Medicare tax of 3.8% on investment income, such as dividends and interest, for individuals with Adjusted Gross Income (AGI) above \$200,000 and joint filers with AGI \$250,000 starting in 2013. Distribution from pensions, IRAs, 401(k)s, and other qualified retirement plans will be exempt.

The President also hopes to raise \$354 billion over 10 years from the same taxpayers by raising the top two tax rates to 36% and 39.6%, plus another \$105 billion with the higher tax on dividends and capital gains, plus another \$500 billion by capping and phasing out exemptions and deductions. Add it all up and the government is counting on squeezing an extra \$1.2 trillion over 10 years from a small number of taxpayers who already pay more than half of all individual taxes.

TAX PLANNING STRATEGIES

Let's look at a tiny sliver of taxpayers for a minute—the top 1% of taxpayers. In 1980, they paid 19.1% of all federal income tax while the bottom 50% of taxpayers paid 7.1%. In 2007, they paid 40.4% of all federal income tax while the bottom 50% of taxpayers paid only 2.9%. Thus, since 1980 the top 1% of taxpayers has gone from paying nearly three times the federal income tax of the bottom 50% of taxpayers to nearly fourteen times as much! (Source: Tax Foundation)

Projections from the Urban-Brookings Tax Policy Center show that 38% of Americans were expected to have zero or negative federal individual income tax liability in 2009 before the stimulus package was enacted. After the stimulus and other tax changes, this proportion will increase to nearly 46%! Today, according to the Tax Foundation, 50% of Americans consume more in government services than they pay in taxes. (Source: WSJ, April 14, 2010)

The tax law change from this health care plan is one of many different tax increases that will affect many taxpayers. For example, taxpayers at all income levels could be affected by new limits on medical flexible spending accounts and medical deductions. The 3.8% investment tax, combined with the expected expiration of the Bush tax cuts for high-income taxpayers on January 1, 2011, would produce a top federal income tax rate of 23.8% on long-term capital gains from the sale of investments in 2013, up from 15% today. The top income tax rate on interest and other types of “passive” income would increase to 43.4% from 35% today.

Dividend income is expected to be affected the most, and if Congress doesn't act, the top income tax rate on dividends will zoom from 15% in 2010 up to 44.6% in 2013!

There are too many tax law changes included in this national health plan to be included in this quarterly economic report. In addition, there is talk about additional taxes, including the possibility of a national sales tax, also known as a value-added tax, to help pay for any additional shortfalls. We will attempt to cover these details soon, along with tax reduction strategies, in a supplementary report for our clients.

SOCIAL SECURITY CHANGES

With all the baby boomers retiring, a major concern for many taxpayers was how long it would take before Social Security would start paying out more to retirees than the money it took in from working employees. Well – you don't have to wait any longer – it just happened! The Congressional Budget Office (CBO) did

not expect this to happen until at least 2016. Unfortunately, payments have risen more than expected during the economic downturn because many jobs have disappeared and many people applied for benefits sooner than they had originally planned. In addition, its revenue fell sharply because of the high unemployment and fewer people working. The CBO stated that this would have no affect on benefits paid in 2010 and retirees would keep receiving their checks as usual.

At least a bit of good news – according to their latest projections, the program will not exhaust its funds until about 2037. Let's hope these projections are more accurate than the one above. (Source: NYT, March 24, 2010)

INFLATION VS. DEFLATION

The Consumer Price Index rose 2.7% in 2009, compared with only 0.1% in 2008. Gasoline prices, up more than 50% over 2009, drove the index higher. (Source: CNN/Money) At this time, the Federal Reserve believes the substantial slack in the economy makes inflation a distant prospect. Even if prices do rise, the Fed believes it can control this problem. Instead, they are worried about the opposite: that the already-low rate of inflation is slowing further. At the same time, at its last meeting on March 16, the Federal Reserve left its short-term rate target between 0% and 0.25% for the tenth consecutive time, and, given “subdued inflation trends,” said it probably would leave it there for an “extended period.”

Despite a surge in the cost of gasoline and other energy products, consumer prices rose just 0.2% in January. Perhaps more important, core consumer prices – which exclude volatile food and energy costs and which are considered indicative of underlying inflation trends – actually fell 0.1% during the month of January. This news excited investors and relieved some of the financial market's fears that the Federal Reserve would be forced to raise interest rates soon to keep inflation in check. However, investors should curb their enthusiasm. Some analysts are now beginning to whisper the D-word – deflation. Deflation is a concern because of the unusual amount of unused labor and production yields pricing power and the ability to command higher wages.

Deflation, according to some economists, is an even bigger potential problem than inflation. If widespread price declines were to take hold, they could be particularly debilitating for the economy. Faced with the prospect of depressed prices for products, many companies would be unlikely to expand operations or add workers. Falling prices also already give shell-shocked consumers yet another reason to hold on to their cash. Why buy something today that will cost less tomorrow? (Source: Bloomberg Business Week, March 8, 2010)

UNEMPLOYMENT

Unemployment today doesn't look like any unemployment in the recent American experience. We have the astonishing new reality that the "long-term jobless" – people out of work more than six months – was about 44% of all people unemployed in February. A year ago, that number was only 24.6%. Please see the chart below. (Source: WSJ, April 8, 2010)

The Long Wait for Work

Percentage of the unemployed who are out of work for 27 weeks or more



Source: Bureau of Labor Statistics

This means that nearly one of every two Americans who has lost his job is waiting at least a half a year to get a new one. The damage in lost skills and human capital is enormous and can do life-long damage.

Unfortunately, there has not been a significant increase in new jobs during the current administration. The U.S. did add 150,000 jobs in March, the most in three years, but some of that was due to hiring temporary workers for the 2010 Census.

Congress is extending jobless benefits, and in the first week of April, President Obama proposed a new subsidy for the jobless in the form of mortgage payment reductions if you are out of work. Even with this news, there remains huge ground to make up.

REAL ESTATE

Another key concern is that accommodation of an expiring housing credit, higher interest rates and more restrictions on FHA loans could stop the housing recovery. Some real estate experts are saying prices have now stabilized and are even, in some cases, rising from their lows of the recession. (Source: Morningstar Stock Investor, February 2010). It is difficult to determine the true course of where real estate is going and this varies depending on the specific geographic location and of course the unemployment rate, especially in our particular area.

INTEREST RATES

The biggest variables in the coming months are how and when the U.S. Government will wean markets from the financial support it injected in the economy over the past year, and when the Federal Reserve might begin to push interest rates higher. The potential for interest rates to rise significantly is perhaps the biggest worry for holders of medium and longer-term bonds, because rising rates hurt the value of existing bonds. However, Ben Bernanke, chairman of the Federal Reserve Board, has stated that he intends to keep rates low for "an extended period."

There is now more than \$9 trillion sitting on the sidelines in various low-yielding bank instruments. The average interest rate was less than 0.1% on Treasury Bills, as of April 9, 2010. (Source: Investment News, February 6, 2010) It isn't logical that barely yielding bank accounts and certificates of deposit should continue to hold such overwhelming appeal. It is amazing how many people are willing to earn zero interest to protect their capital.

THE BOND MARKET

Just like stocks, the bond market is also affected by the state of the economy. The interest rates on bonds are affected by the demand for lendable funds. In an economic expansion, the demand for funds often causes interest rates to rise, increasing the cost of borrowing. During economic contractions, or a recession, the demand for loans is usually low and interest rates tend to decline.

Interest rates can't stay at historical lows forever and will eventually start getting higher. Some investors think it has already started; others feel that it will be between now and the end of the year; and still others believe it won't be until 2011 until interest rates start increasing.

Whenever interest rates do go up, what can investors expect? Although the bond market has historically been less volatile than the stock market, bonds also fluctuate in price, some significantly.

When yields for new bonds fall, existing bonds with higher yields become more valuable and can demand a higher price. When yields for new bonds rise, the prices of existing bonds fall to compete with the increased demand for new bonds. If history serves as a guide (which is no guarantee), bond investors will suffer when interest rates start to move upward.

Bond yields, especially long-term bond yields, are sensitive to inflation expectations because inflation can rule the value of a bond over a period of time.

If inflation expectations are high, lenders require higher interest rates to lend funds for more than the short-term. If inflation expectations remain high, long-term interest rates may take longer to drop, even when the Fed is cutting rates. (Source: Morningstar)

Unfortunately, if the inflation rate increases even slightly, it will probably be an interest rate shock that would affect most bonds, particularly when you realize that short-term interest rates are starting from zero. Such an increase would likely be in response to a stronger economy, rising bond yields and higher commodity prices.

Americans usually say they are seeking safety and income. However, in the real world, sometimes what they crave is the illusion of safety, and all the income they can get their hands on! Historically, more money has been lost in the mindless quest for high yields than in all the stock market crashes since the dawn of time. (Source: Nick Murray Interactive, April 2010)

Since the financial crisis began in 2007, investors have bought up government bonds as protection against the crumbling economy. Please remember that the historical average for the benchmark 10-year Treasury note yield is 7.31%, way above the current yield just shy of 3.90%. According to Michael Pentto, chief economist at Delta Global Advisors, there is a tremendous amount of latent inflation built into the pipeline. There is no reason that interest rates should be half their historical value. “Everybody now believes that the economic crisis has ended. Inflation has to be headed higher all the time. I have been swamped by a tsunami of treasury auctions. Where are all the buyers going to come from?” (Source: Yahoo Finance)

While interest-rate risk worries many investors, other factors also affect bond performance:

- Rising inflation erodes the value of a Bond’s principal and interest payments, influencing investor demand.
- Credit risk affects the chance that a company might not make principal or interest payments on its debt.

The Federal Reserve increased the so-called “discount rate,” the rate that the Fed charges member banks to borrow from the Fed itself, rather than from other member banks, from 0.5% to 0.75% during February 2010.

Although the Fed did not signal a near-term increase in short-term interest rates, it appears that the Federal Reserve was laying the groundwork for interest rate hikes – maybe even later this year.

The sudden drop-off in investor demand for U.S. Treasury notes during the week of March 26 is raising questions about whether interest rates will finally start increasing which would impact the government’s borrowing costs, spelling trouble for the fragile housing market. In fact, during the last week of March, mortgage rates have also picked up. The average 30-year mortgage rate rose to 5.13%. (Source: WSJ, March 26, 2010)

IS IT GOOD NEWS OR BAD NEWS?

One of the hardest, most useful lessons every investor must learn is that there is no such thing as “good” or “bad” news. A significant amount of economic data comes out each week and often the information can be interpreted in either a positive or a negative way. The same piece of news can be good for a stock one week and prompt a major sell-off the next. This doesn’t mean that news is useless; rather, what is really important is how the market reacts to news. Please refer to the table below which lists a few recent important announcements and how this information could be interpreted as positive or negative; talk about some differences!

Data Item/Report	Positive View	Negative View
FOMC Committee holds short-term rates unchanged at 0.00% to 0.25%	Keeping rates low helps to strengthen the banking system, stimulate overall economic activity, and stabilize the housing sector	Low rates are a recognition that economic growth is weak and unemployment is high; risk-averse savers are earning next to nothing on money-market investments
Consumer Price Index (CPI) is unchanged in February; low for past year	Inflation isn’t a worry – benefiting consumers and the bond market	Low inflation is due to high unemployment, weak consumer spending, and low energy prices
New housing starts dropped to an annual rate of 575,000 in February from 611,000 in January	Almost all of the decline was in multifamily homes; single family homes were almost equal to last month	Housing starts were up over where they were in February of 2009; the decline was more a function of bad weather conditions in many areas
The nation’s trade deficit increased by +12.9% for 4Q 2009	Global trade is recovering from the Great Recession; consumers are starting to spend more, including more foreign goods	Our indebtedness to foreigners is increasing while our manufacturing continues to wither away

Source: Bob LeClair’s Finance & Markets Newsletter

It is difficult to predict accurately what is going to happen next, but it appears that many investors are nervous about not only the current state of our economy, but where we are headed in the near future as well. This added nervousness and an investor's mood at any particular time might affect their reactions to new information. Therefore, it is important to remember a couple of the general rules of investing:

- Psychological reasons usually outweigh economic reasons!
- The dominant determinant of real-life, long-term investment outcomes is not *investment performance*; it is *investor behavior*.

There have been countless articles recently that suggest the stock market is ready for a major upturn and now is the time to invest, while many others predict that the Dow is headed back to the 6,000 range and now is the time to get out! Who is right? No one knows for sure—the markets seem jittery and susceptible to change for about any reason.

There are no easy solutions to the long-standing issues and problems within our economy. Don't expect the markets to ignore these problems. They won't. Until the markets get a real sense that we are making progress on many of these fronts, investment returns are likely to be volatile and unpredictable.

So what should you do? Remember the next three rules of investing, which are:

- Diversify
- Diversify
- Diversify

Your portfolio should be invested within different asset classes and asset allocation strategies, that are based upon your particular goals, needs and objectives. Please remember – there is no guarantee that a diversified portfolio will outperform a non-diversified portfolio in any given market environment.

PREVENTING THE NEXT FINANCIAL CRISIS

Note: The information in this section was compiled from a number of different books that are listed in the sources at the end of this report.

Policymakers want to do whatever is necessary to ensure that something like this never happens again. Unfortunately, many people make the same mistakes because they do not identify the real cause of a particular problem.

It is important that we properly assess the real reasons behind the Great Recession. Therefore, I would like give a brief summary of this fiasco.

It appears that the Great Recession was the byproduct of three government-created “debacles.”

The first was our monetary policy. The housing bubble would not have reached its immense size without the Federal Reserve's low-interest-rate, “easy money” policy of the early 2000s. This affected not only housing, but the entire economy.

The second debacle: Government-created mortgage giants Freddie Mac and Fannie Mae helped inflate the real estate balloon even further. Fannie and Freddie dominated the sub-prime market. By 2008, Freddie and Fannie boxed, packaged and guaranteed more than \$1 trillion worth of less-than-prime Mortgage Brokerage Securities (MBSs), selling these securities to investors. The securities were rated AAA by rating agencies, even though the investments were sub-prime!

The third government disaster was a succession of regulatory failures. The worst by far was the new “mark-to-market” or “fair value” accounting rules, which became effective during the third quarter of 2007 and destroyed the net worth of many banks and insurance companies overnight. Mark-to-market accounting required financial companies to write down the value of their investments to what they would command on the open market, with the losses appearing on the companies' profit-and-loss statements.

One fundamental problem is that not all assets on a balance sheet are necessarily saleable at any given moment. For example, if you estimated the value of your home based on what you could get if you had to sell it today, the amount might be very low—well below the amount you might get if you listed it with a realtor. Similarly, when the sub-prime mortgages began defaulting in 2008, the market for MBSs dried up. Yet, rigid mark-to-market accounting rules forced the drastic reduction in the value of MBSs, even when investors were both willing and able to hold them until the market improved or until they matured.

Even the prices of bonds that were still paying in full and on time fell by 60% or 70%, and those losses were reflected on the income statement. This in turn wiped out regulatory capital, caused bankruptcies and created a vicious downward spiral in the economy. Of the \$600 billion the financial institutions wrote off between the summer of 2007 and the fall of 2008, almost all were book losses and not actual cash losses.

In retrospect, it is clear that this new mark-to-market accounting rule was a major force behind the panic of 2008. (Source: First Trust Economic Commentary, March 31, 2010)

When the financial companies drastically wrote down the value of their mortgage portfolios, many of these banks and insurance companies had to raise more capital, sending distress signals to the market that forced down their stock prices even further. Unfortunately, many hedge funds saw this scenario and started shorting financial stocks. The frenzy of short selling sent many financial stocks into a spiral. Many companies had their credit downgraded by agencies almost overnight.

The significant increase in short selling was due to repeal of the “uptick rule” in July 2007. The uptick rule was enacted back in 1938 to stop the practice that devastated many companies in the 1920s and 1930s. Someone would pick a stock, spread rumors that it was in trouble, then sell it short relentlessly, hoping to create panic. Initially they would force the price into a downward spiral, and then they would buy the stock back at a considerably lower price and make a profit.

The uptick rule allowed a short sale only after a stock went up from its previous price, thereby preventing or at least slowing these market manipulators. Without the uptick rule, market volatility increased, deepening the atmosphere of anxiety and uncertainty; the VIX index, which is a key measure of volatility, quadrupled. (Source: Forbes, October 19, 2009)

On February 23, 2009, the SEC passed a new rule similar to the uptick rule regarding the ability to sell short. This new rule applies to stocks that decline at least 10% in a single day. For such stocks, the SEC will allow short selling only if the price of the sale is above the highest bid price nationally. In other words, the short seller is blocked from dumping the shares at a cut-rate price. (Source: WSJ, February 25, 2010)

Ben Bernanke made a comment on February 24, 2010, acknowledging the issues with mark-to-market accounting: “...commercial real estate loans should not be marked down because the collateral value has declined. It depends on the income from the property, not the collateral value.” It would have been much better for the economy if Mr. Bernanke had been this clear about mark-to-market accounting back in 2008. If he had been, the U.S. might have avoided the panic of 2008. (Source: First Trust Economic Commentary, March 31, 2010)

When the mark-to-market rule was repealed on March 8, 2009, the equity markets, led by financial companies, kicked off like rockets from their lows. One day later, on March 9, the S&P 500 hit its low point, marking the end of the Bear market. (Source: Forbes, October 19, 2009)

Wow – what a comedy of errors! This seems a bit unusual to have some new laws go into effect that ended up being disastrous and then having to make a complete reversal back to the old rules and wonder how this could have happened in the first place. I am not sure if anyone will ever know that answer.

The bottom line is that I think the following statement is accurate:

One of the major causes for this Great Recession was a change in the accounting rules—“mark-to-market”—and how to calculate the value of an investment for a financial services company.

These reasons are not the only causes of our recent financial crisis, but they were major contributors.

However, the subject of “mark-to-market” is rarely referenced by the media as a major cause of the Great Recession.

Even former Federal Reserve Chairman Alan Greenspan was interviewed recently about how his actions or inactions while he was in office caused this Great Recession and he replied that the crisis was inevitable for various reasons, but made no reference to mark-to-market accounting.

Unless these facts are fully disclosed to the public, there is a good likelihood that many investors will never know how a change in accounting rules could cause such economic turmoil worldwide.

We must now face the challenge of redesigning the regulatory overlay of the global financial system in order to make it more robust without destroying its ability to innovate and spur economic growth.

CONCLUSION

The severe global sell-off that erupted in 2008 coincided with the global recession that affected developed and developing markets alike.

One year later, the outlook is much different. Most stock markets have recorded extraordinary gains, boosted by government and Central Bank interventions. Stronger-than-expected corporate profits are a sign of stability and recovery in economies throughout the world.

Despite the strong rebound in global stock markets, financial and economic difficulties persist in many countries, particularly the United States. However, remember that the problems facing equity markets today (inflation, unemployment, regulatory uncertainty) have been experienced—and conquered—before.

As many of you know, the media often takes information and blows it out of proportion, making it appear much better or worse than it actually is. Remember, the ultimate goal of financial journalism isn't to help you become financially confident and independent; it's to get you to buy more financial journalism! In our opinion, journalism's goal is to keep your focus as short-term as possible (ideally minute to minute) so you won't dare turn off that television.

Our goal is to help you think, plan, and invest for the long term, through good times and bad.



Jeffrey W. DeBoer
President

P.S. The government bailout of various financial companies is starting to look less expensive than once feared and is shrinking to just a fraction of previous estimates. Treasury Department officials said that the total expenses would be approximately \$89 billion, which includes the Troubled Assets Relief Program, capital injections into Fannie Mae and Freddie Mac, and various other courses of action it has taken over the last couple of years. Just a year ago, the government estimated that the overall bailout would cost more than \$250 billion. (Source: WSJ, April 12, 2010)

P.P.S. This new health care plan is very lengthy – over 2,000 pages – and as you know, longer documents do not necessarily mean it's a better document. For example, let's put this into a little perspective:

- The Lord's Prayer: 66 words
- The Ten Commandments: 179 words
- The Gettysburg Address: 286 words
- The Declaration of Independence: 1,300 words
- U.S. governmental regulations on the sale of cabbage: 26,911 words (Source: 'Game Over' by Stephen Leeb)
- U.S. tax code, tax regulations, IRS ruling: 71,684 words (more than four times the 16,500 words that this data consisted of in 1969 (Source: CATO Institute))

I am not sure how many words there are in the over 2,000 pages of the health care plan, but I am sure that no matter how you want to describe it, simplification is needed in government contracts and regulations!

Notes: Presented by Jeffrey W. DeBoer. The views stated in this letter are not necessarily the opinion of Commonwealth Financial Network, Inc., and should not be construed, directly or indirectly, as an offer to buy or sell any securities mentioned herein. Investors should be aware that there are risks inherent in all investments, such as fluctuations in investment principal. With any investment vehicle, past performance is not a guarantee of future results. Material discussed herewith is meant for general illustration and/or informational purposes only; please note that individual situations can vary. Therefore, the information should be relied upon when coordinated with individual professional advice.

Due to volatility within the markets mentioned, opinions are subject to change without notice. Information is based on sources believed to be reliable; however, their accuracy or completeness cannot be guaranteed.

Indexes cannot be invested in directly, are unmanaged and do not incur management fees, costs or expenses. No investment strategy, such as asset allocation, can guarantee a profit or protect against loss in periods of declining values. International investing involves special risks not present with U.S. investments due to factors such as increased volatility, currency fluctuation, and differences in auditing and other financial standards. These risks can be accentuated in emerging markets.

There is no guarantee that a diversified portfolio will outperform a non-diversified portfolio in any given market environment. Rebalancing investments may cause investors to incur transaction costs and, when rebalancing a non-retirement account, taxable events will be created that may increase your tax liability.

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, an investor may lose money, and there is no guarantee that securities will appreciate.

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.

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 (2/25/10, 3/26/10, 4/1/10, 4/3/10, 4/8/10, 4/12/10, 4/13/10, 4/14/10), Business Week, New York Times (3/24/10), By The Numbers (2/1/10, 2/15/10, 4/12/10), Barron's (3/8/10, 4/12/10), Times Magazine (2/15/10, 2/25/10), Kiplinger's Personal Finance (2/10/10, 3/24/10, 4/20/10), Morningstar Stock Investor (1st quarter 2010), The Economist (3/6/10, 3/20/10), Bob LeClair's Finance Newsletter (2/20/10), Forbes (10/19/09, 3/29/10, 4/26/10), USA Today (3/27/10), Nick Murray Interactive (2/10/10). Mark-To-Market book sources: Fool's Gold, by Gillian Tett; Financial Shock, by Mark Zandi; How Capitalism Will Save Us, by Steve Forbes. © MDP, Inc.



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DeBoer Financial Group

Retirement and Estate Specialists

Fountains at Roseville

1013 Galleria Blvd., Suite 205

Roseville, CA 95678

Tel (916) 797-1888 | Fax (916) 797-4986

info@deboerfg.com | www.deboerfg.com

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1013 Galleria Blvd., Suite 205

Roseville, CA 95678

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