

Rochester Financial Services

Fee-Only® Financial Management Services

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Dow Jones	S&P 500	NASDAQ	Russell 2000	10 yr Treas	Earnings Yield (S&P)	Crude Oil	Gold
11,382	1,225	2,591	756	3.02%	6.94	\$89.44	\$1,416

Principal



Investment Strategy Report

Has Day of Reckoning Arrived For Bonds? December Brings Stock Rally Despite Weak Jobs Report

The stock market essentially took November off, with the major averages down about 0.5% for the month. Following an initial surge during election week, the Dow had to fight to just barely hold on to the key 11,000 level by month's end. Instead, most of the action occurred in the fixed income markets. November saw the long awaited "turn of the screw", the time when interest rates stopped falling and the inevitable upturn began.

Since December of 2008, bonds (and therefore the bond funds we use) have enjoyed tremendous success. Following the near collapse of the financial markets in the fall of 2008, when the danger of the credit markets freezing up was all too real, corporate bond prices bottomed that December. Then, as confidence in the financial markets was restored, bond prices began to rise (as the interest rates of corporate bonds fell). During this almost 2 year period, bonds have appreciated in value anywhere from 20% for conservative bonds to 50% and up for more aggressive (less credit-worthy) bonds. For most of this time, AAA rated Treasuries have not feared as well as investors have fled the safety of Treasuries for lower rated corporate bonds. However, since an interest rate peak was reached back in April of this year, interest rates for *all* fixed income investments have been plummeting. For example, back in April, the yield of a 10 year Treasury peaked at 3.99% and that of a 5 year Treasury peaked at 2.74%. On November 4th, these rates bottomed at 2.48% and 1.03% respectively! This dramatic drop in rates was initially the result of fears of a double dip recession that developed back in the Spring. But the second leg down in rates has been attributed to the Federal Reserve, which has initiated QE2 or its second round of quantitative easing. This is a stimulus program in which the Fed has pledged to buy an additional \$600 billion in Treasuries over the next 8 months. This large demand for Treasuries drove down interest rates (and drove up the prices).

Despite the downward pressure on interest rates exerted by the Fed, at some point you have to ask yourself, "Who would buy a 5 year Treasury yielding 1.03%?". Everyone knew that this was only a temporary phenomenon and that at some point, interest rates would have to rise. The only question was when. Since November 4th, we have seen rates jump to 1.62% for the 5 year and 3.02% for the 10 year Treasuries. This backup in interest rates has caused a fall in bond prices and therefore in the value of bond funds. We knew that this time would come. Back in my September 3rd letter, I first alerted you to the negative effect that rising rates would have on bond funds and my plan to use a fund that will benefit from rising rates (the Yieldquest fund). During the past 4 weeks, traditional bond funds like PIMCO Total Return have lost about 2.5% in value. Some of our less traditional funds have lost only 1-2% in value. The Yieldquest fund has actually gained about 8.5% during that time, in many cases more than offsetting the losses in the other funds. There is no guarantee that rates will continue to rise but it does look like this can be the beginning of a longer term trend. I have made many rebalancing moves in the past few weeks and will continue to do as the situation warrants.

Equities - The S&P 500 ended on Friday almost exactly at its high for the year, which it initially reached back in April. This move capped a 3 day advance which saw US markets gain 3.7% for the first 3 days of December. Friday's move came despite a very disappointing jobs report which saw the unemployment rate rise to 9.8%. Up until this disappointing news, the general consensus was that while Europe was mired in a financial crisis which has seen country after country facing default and requiring bailouts, the US was returning to its position of global leader as the recovery of our economy has begun to pick up steam. So let's call this yet another turning point for the markets. Can we shrug off continuing bad employment news and dire news from Europe? On Friday, it seemed that the markets were saying that we have seen enough favorable economic news here to outweigh the negative news to keep the uptrend intact, at least for now.

Another Year has come and gone and I'd like to thank you for your continued trust in me. While 2010 has for the most part been a profitable year for our investments, it would be an understatement to say that there are still tremendous challenges that remain. As we continue to walk that fine line going forward, here's to a Healthy, Happy, and Prosperous New Year. *Jeff Feldman*

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