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If you are reading this on your smartphone, iPad or PC, it is the first week of February. If you are reading it with a much older technology *(recycled tree - invented 105 AD, Han Dynasty)* the date could be early March – depending upon the efficiency of the bankrupt United States Postal Service. No matter your method, let me be *the very last* to wish you a Happy New Year! And may 2012 bring you all the gloom, catastrophe, paranoia, anxiety and despair that NBC, CNN and Geraldo Rivera can muster.

I've developed a habit of waiting until mid-January to begin work on this annual correspondence. I enjoy reading the Top-10 list of the year just ended and the prognostications for the year to come. Say what you will about the media, but they are consistent. It seems that the top end-of-year story is an end-of-the-world prediction by something called the Mayan Calendar.

The January 29, 2012 Sunday Newark Star Ledger sits on my desk. After a glance at the front page, then the comics, my attention turns to the BOOKS page. Wouldn't you know the day I plan to write my annual message, the BOOKS page runs a piece entitled *Chasing the market: Five selections that follow the money.* Oh lucky me. I share with you the titles of three of the five books reviewed:

Capitalism at Risk: Rethinking the Role of Business
The Great Crash Ahead: Strategies for a World Turned Upside Down
Survivors: A novel of the Coming Collapse

Selected passages from the reviewers:

"...has penned another significant book concerning the plagued, if not doomed, American economy"

"In this America of unimaginable economic hardship, the dollar becomes worthless, banks have collapsed and the stock market has crashed."

"The consequences of red ink venture beyond the stigma of debt; they can mean a depression for a nation or an eviction for a family"

"...he is predicting another crash before the economy stabilizes"

And my favorite: *"If you are interested in escaping today's economic unease to enter the prospect of total calamity...has a new novel for you."*

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Half-way through the book reviews my mind wanders off the written page to an image of McCartney and Lennon in full Sgt. Pepper regalia. Sir Paul happily singing, "It's getting better all the time..." and John in his catastrophically dour best retorting, "It can't get no worse." And once again, an entire Bodnar Financial White Paper summarized with a single sentence from a Beatles song: *"It's getting better all the time"* ***vs.*** *"it can't get no worse"*

Corporate earnings have exceeded the peak level of earnings in 2007, which is pre-Great Recession. American corporations have done a phenomenal job of running their businesses in the most anemic of environments. Most companies are reporting record profits. Imagine what it will look like when the economy improves!

Interest rates are at the lowest levels in a lifetime. Households across America continue to pay down credit cards and other consumer debt. We are in a mid-cycle phase, not a peaking period, thus no inventory backlog. What does that mean? Probably even more growth to come.

Yet, in the 3rd quarter of 2011, investors redeemed more dollars from equity mutual funds than they did following the Lehman Brothers collapse in 2007. Think about that statistic for one moment. Investors were so on edge that they spooked themselves out of owning some of the greatest companies in the world- even more so than when a true financial catastrophe occurred 3 years prior. When the great unwashed should have been climbing over each other to buy stocks, the only bull market I witnessed was in pessimism.

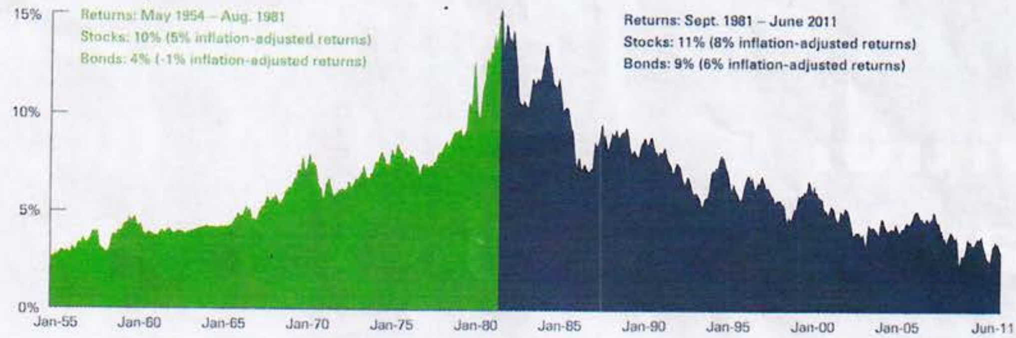
How could that be? I call it crisis-fatigue. Investors are simply exhausted. The drumbeat of negative opinion has literally blinded them to the facts of life on our planet.

So where did all the money that came out of equity mutual funds go? Why into bonds, of course. When the Mayans (aka. the mainstream media) are predicting the end of civilization as we know it because a country has been legally in default 51% of its history (Greece), or a 75-year old leader paints his hair with shoe polish, chases around teenage girls and abruptly resigns (Italy), any sane individual would use that news as a signal to sell the largest energy producer or microprocessor manufacturer or pharmaceutical company in the world.

Yet, those same great companies were announcing all-time-high profits. So were those people crazy? In retrospect, absolutely. But at the time, we were all stunned into silence when the tag along the bottom of the screen said <u>IMPORTANT DEVELOPMENT IN THE EUROPEAN DEBT CRISIS: Greek bus drivers to strike if retirement age increased to 57!</u>

INTEREST RATES MAY PRESENT A NEW INVESTMENT PARADIGM

10-year U.S. Treasury Yield



Portfolio assumptions established during the prolonged period of declining interest rates and expanding P/E growth between 1982 and 2008 may need to be reconsidered as we look at long-term prospects for stagnant growth and rising rates.

For illustrative purposes only. The information is not intended to be a recommendation to purchase or sell a security. Past performance is no guarantee of future results. Returns reflect reinvestment of capital gains and dividends, if any. Indices are unmanaged and do not incur fees. It is not possible to invest in an index. Stocks are represented by the S&P 500 Index. Bonds are represented by the Ibbotson Associates U.S. Intermediate Term Government Index. Inflation-adjusted returns are based on the average Consumer Price Index (CPI) through the referenced period (5% from 1954 to 1981 and 3% from 1981 to June 2011).

Source: St. Louis Federal Reserve Bank, Morningstar

The chart above depicts the yield of the 10-year U.S. Treasury over a time frame approximating my life (May 1954 - June 2011). The apex of the chart, August 1981, is when I entered the financial services industry. Although there have been moments since 1981 when interest rates increased, the increases proved temporary. It is improbable that any of us will live long enough to witness such a spectacular decline in interest rates ever again. This chart is simply jaw-dropping!

What is the take-away? That in spite of the best efforts of central bankers and politicians, interest rates simply cannot go any lower, and in fact will probably cycle in the other direction. The great risk for investors over the next 5-10 years is not another 9/11, the crumbling of the Euro Zone or Iran getting The Bomb. What the chart illustrates with bold simplicity is that the real risk to investors is the permanent loss of capital when interest rates increase.

> *FACT: when yields go up, bond prices go down. The huge premiums investors have paid for the safety of US Treasury bonds will disappear - permanently. How can I be so sure? Look at that chart again. I ask you: where will the line go next? Will it continue lower, or will it cycle back upward?*

Investors acting badly...making the classic BIG MISTAKE. Are they selling the stuff priced at record high prices and buying the bargains? Of course not. They are selling the out-of-favor under-valued asset class (stocks) and putting those dollars into the most over-valued asset class on the planet (US Treasury bonds).

The topic of rising interest rates and what it means to you and your personal financial planning will be discussed at every annual review for the next few years. Remember, successful investing is usually counter-intuitive. Oftentimes, the highest use of my time is to get clients to do the exact opposite of what their instincts tell them to do. As humans, we are wired to avoid danger (stocks) and to seek safe shelter (bonds).

Last year I ended my commentary this way: *"Since stocks have had such an incredible short-term positive explosion – and everyone 'knows' that equities are going up, they will probably struggle this year. Since everybody 'knows' interest rates are going up, interest rates will probably not go up much, if at all, and bonds will probably return more than most expect this year."*

I remind you of this, not because of how prescient that statement turned out to be, but how I came to that conclusion.* I came to that conclusion because almost everything we read 12 months ago was predicting the exact opposite. Such mass group-think makes me very uncomfortable.

So what's ahead for 2012?

- It's not as bad as it sounds. But the really incredible good news is still 3-5 years off
- Globalization continues and disseminates everything – not just goods but ideas, people, drugs, services, revolution, disease, emotions
- The U.S. is misgoverned and misinformed, but economically resilient
- Only the beginning of the beginning in the Middle East
- Pakistan & Afghanistan – not on our planet
- China – more instability, slower growth, stuck in middle income
- The Eurozone, as we know it, is doomed
- Major transformations are in the works – booming developing economies and technological marvels. "Tight Oil" and "Shale Gas" generates a boom and an era of cheaper electricity for U.S. manufacturing
- It will be very difficult (if not downright impossible) for US Treasury bonds to match the returns of 2011 – simply because interest rates cannot go below zero

"It's getting better all the time..."

John Bodnar, CFP®, CIMA®
2/3/2012

*OK – maybe I am doing it to show off, but just a little.