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Third-Quarter 2011 Market Review ~ Interest Rates on Sale

October 2011 - The third quarter was not lacking from news that whipsawed stocks and bonds: the ongoing U.S. budget-deficit debate and debt-ceiling stalemate, European sovereign-debt crisis, and broad economic slowdown spurred financial markets volatility. It was the worst quarter for stocks since the fourth-quarter fall 2008 financial crisis, with across-the-board double-digit losses for market indices. The bellwether Standard & Poor's 500-stock index has posted five consecutive monthly declines, while flight-to-safety buying and Federal Reserve actions sent Treasury bond yields to record lows.

In July and the beginning of August the focus was on the political gridlock in Washington and the risk of default if lawmakers were unable to reach a deal on the nation's borrowing limit. Although an early-August resolution was reached, it was followed by a Standard & Poor's downgrade of the U.S. credit rating to AA+ from AAA. Stocks then seesawed for the next four days, with alternating down-and-up daily moves of 400-plus-points in the Dow Jones Industrial Average. Meanwhile, despite S&P's downgrade, Treasury securities rallied as investors sought a safe haven for their funds.

Treasury yields were also pushed lower during the volatile week when the Federal Reserve announced that it would maintain its near-zero target for short-term interest rates for two more years. Noting that economic growth in 2011 has been slower than expected and threats to the economy had risen, it was the first time the Fed set a firm date for maintaining its short-term interest rate policy. Previous statements said that rates would remain low for an “extended period," widely assumed to be a few months.

Midway through the final month of the quarter, stocks rallied and broad indexes neared break-even for the year. However, on September 21, the Federal Reserve announced that, in response to "significant downside risks" in economic outlook, it would undertake a "maturity extension program" to further drive down long-term interest rates and stimulate the economy. Dubbed "Operation Twist," through June 2012 the Fed will "twist the yield curve" by selling $400 billion of securities in its portfolio with a maturity of less than three years and use the funds to purchase securities with maturities ranging from six to 30 years.

At the same time, the Fed said that it would reinvest proceeds from maturing portfolio securities in mortgage-backed securities in an attempt to lower mortgage rates and encourage home buying and refinancing. These pronouncements lead the yield on the 10-year Treasury Note to sink to a record-low 1.70%, while five-year and 30-year Treasuries slid to below 1.0% and 3.0%, respectively. Investors saw the Fed's moves as a negative signal for the economy and corporate profits, leading stocks to post their worst week and quarter since the fall 2008 financial crisis.

At quarter end, the yield on the 10-year Treasury note was 1.91%, down 125 and 138 basis points for the quarter and year-to-date, respectively (the yield as of October 12th was 2.21%).

Below are rates of return for selected market indices for the third quarter of 2011, year-to-date 2011, and the three, five, and 10-year compound annual returns as of December 31, 2010.

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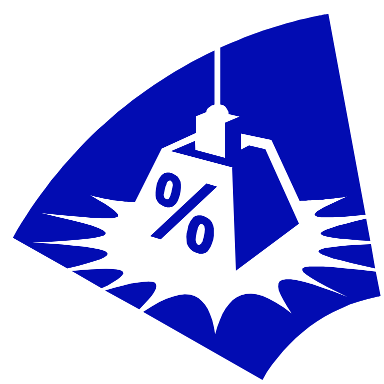
	3Q:2011	YTD-2011	3-Year	5-Year	10-Year
Equity (Stock) Indices					
Domestic Large Cap					
Russell 1000 - Growth	-13.14%	-7.20%	-0.47%	3.75%	0.02%
Russell 1000 - Value	-16.20%	-11.24%	-4.42%	1.28%	3.26%
Russell 1000 - Blend	-14.68%	-9.25%	-2.37%	2.59%	1.83%
Domestic Small Cap					
Russell 2000 - Growth	-22.25%	-15.57%	2.18%	5.30%	3.78%
Russell 2000 - Value	-21.47%	-18.51%	2.19%	3.52%	8.42%
Russell 2000 - Blend	-21.87%	-17.02%	2.22%	4.47%	6.33%
Real Estate (FTSE EPRA/NAREIT Global)	-17.72%	-13.94%	-4.67%	3.49%	NA
International					
MSCI EAFE Developed Large Cap	-18.95%	-14.62%	-6.55%	2.94%	3.94%
MSCI EAFE Developed Small Cap	-18.55%	-15.22%	-1.37%	3.17%	9.87%
MSCI Emerging Markets	-22.46%	-21.66%	-0.03%	13.11%	16.23%
Fixed-Income (Bond) Indices					
Barclays Capital					
Global Aggregate	0.98%	5.40%	5.85%	6.72%	6.76%
U.S. Aggregate	3.83%	6.65%	5.90%	5.80%	5.84%
U.S. Treasury TIPs	4.52%	10.59%	4.97%	5.33%	6.90%
U.S. Corporate High Yield	-6.06%	-1.39%	10.38%	8.91%	8.88%
Municipal	3.81%	8.40%	4.08%	4.09%	4.83%
International Emerging Markets	-2.91%	1.94%	8.89%	8.36%	10.49%

Source: russell.com, reit.com, msci.com, barcap.com

Interest Rates on Sale



A weak economy and Federal Reserve actions have driven home mortgage interest rates to their lowest levels since records have been maintained. On October 6th, Freddie Mac reported average rates of 3.94% and 3.26% for 30-year and 15-year fixed-rate mortgages, respectively.

If you can qualify for a mortgage, it is an incredible opportunity to lock in low, long-term borrowing costs for a home purchase or refinance. Even if you have refinanced within the past couple of years, if your mortgage has an interest rate in the high 4%-range or higher, it may make sense to consider going through the money-saving process again.

The main factors to consider in your decision whether to refinance are how long you intend to keep the property, cost to refinance, and monthly savings. The first issue may be the hardest to determine. Comparing the costs of refinancing with the monthly savings is relatively easy.

An estimate of the costs for a mortgage can be obtained online or from a lender. The three main cost categories include:

1. Lender fees to originate, underwrite, and process the loan.
2. Title fees for title search, title insurance, and closing.
3. Government fees to record the transaction in the land records.

The monthly savings is simply the difference between the monthly payment before and after the refinance.

With this information, you can calculate the "payback period," which is how long it takes for the monthly savings to “payback” the cost of refinancing. You will have to wait until end of the payback period before realizing any savings. For example, with a cost to refinance of $3,000 and a monthly savings of $100, the payback period is 30 months (divide the cost of refinancing by monthly savings). If you plan to keep the property for more than 30 months, refinancing may be good idea.

Beyond monthly savings and the payback period, you should consider the total interest you would pay over the life of the new mortgage versus what you would pay on your old mortgage.

As with any financing, the lender will consider the three "Cs" of underwriting a mortgage in its decision about whether the risks are acceptable:

1. Collateral – with an appraisal, the lender will compare the market value of the property with the amount to be borrowed.
2. Creditworthiness - the lender will use the borrower's credit report to review credit score, history, and record of paying on time.
3. Capacity - based on income, the lender will consider the borrower's ability to make the payments. Generally, the lender will not want the borrower's total monthly debt (housing expense and all other obligations) to exceed 45 to 50 percent of gross income.

Many homeowners may be shut out of refinancing if their mortgage is under water (owe more than the house is worth). However, if you have a mortgage that was originated prior to June 2009 and is now owned by Fannie Mae or Freddie Mac, you may be eligible to refinance under the Home Affordable Refinancing Program. Under HARP, borrowers must be current on their mortgage payments, and the mortgage must not exceed 125 percent of the value of the home.

Another factor to consider when making a refinancing decision includes the impact on equity build up or principal payments. Extending the maturity of a mortgage usually lowers the amount of the monthly payment paid towards principal because more goes toward interest at the beginning of the mortgage. If you can afford it, you might want to consider a shorter loan period (e.g., 15 or 20 years). This may also be the best option if you have paid down 10 to 15 years of a 30-year mortgage.

In addition, don't forget the tax implications. Although you may be saving money every month with lower interest payments, your savings may be less if your tax liability increases.

If you are fortunate enough to obtain a record-low interest rate, another important decision will be what to do with the savings. Perhaps this would provide the perfect opportunity to establish or increase your retirement savings?

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There are many variables to consider in the refinancing decision. Please contact Kalorama Wealth Strategies if you would like to discuss which option might be best for you. For more information on our investment advisory and financial planning services, please see our web site at www.kaloramawealth.com.

Thank you for your continued business and referrals. Please feel free to forward this newsletter to friends and colleagues who can benefit from information about investing and financial planning. If I can be of any assistance to you or anyone you know, please do not hesitate to contact me.

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