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For Clients and Friends of Financial Connections

Quarterly Newsletter, 2nd Quarter 2010
7/22/2010

Congratulations to the client survey participants whose names were randomly selected for a donation to their favorite charity. They are:

Celia Brezner
Thekla Hammond
Deborah Madison
Vicky Money
Bill Murphy

See the list of charities they picked inside the newsletter.

While most bond categories had positive returns for the first half of 2010, every segment in the equity market was down for the same period.

Volatility returned to the markets with a vengeance this quarter. The roller coaster for domestic stocks took them:

- Up early in 2010
- Down 5% in early February
- Up almost 10% by late April
- Down nearly 7% by the end of June
- Up almost 6% at the time of this writing

Challenges

In the coming years, the developed countries must walk a tightrope: They must reverse and reduce the level of debt without stopping economic growth.

Too much austerity can smother an economic recovery. We already endure high unemployment. New jobs won't be created if economic growth is choked off. Remember also that the slower the economic growth, the less tax revenue flows into government coffers.

Demographics

Another factor in this balancing act between reducing debt and stimulating the economy in all developed countries is their aging population. As more and more of us transition from working and saving to spending the funds we've saved, we also use more of the government programs (Social Security and Medicare).

In addition, as we earn less, we may pay less income tax—again reducing the revenue to the government.

Based on the demographics, Europe is facing this complex equation even sooner than the United States.

Continued on page 2...

Clients of Financial Connections

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In contrast, the developing countries are in much better shape. They have higher growth rates and younger populations. They make up the markets to which U.S., European, and Japanese corporations want to sell their goods and services.

Economic Forecasts

The term "double dip recession" has been in the news a lot lately but—as you can see from the insert—forecasting is notoriously unreliable.

Among the various economic forecasts we read, we like the International Monetary Fund's viewpoint. Its analysts seem to be more pragmatic and look at the world rather than one country or region exclusively. They forecast tepid growth over the next 18 months.

Second-quarter corporate profits are good, and Intel Corporation's forecast of a good second half is encouraging news. One economist actually cut his forecast of a double dip recession from 50% to 5% as a result of Intel's growth forecast!

Money Supply and Inflation

Based on past performance, a 5% increase in the money supply results in average inflation-adjusted economic growth of 3%. Unfortunately, the velocity of money (the rate which money travels through the economy) has stalled. So we don't have the money supply that usually supports a more aggressive growth rate. The silver lining of our current situation is that we don't have inflation right now either.

Getting Together

Enclosed are your reports for the first half of 2010. Please call us to discuss your investments, especially if your financial life has changed. Also, we do offer financial planning in a variety of areas and are always happy to help.

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CLIENT SURVEY RESULTS

Our survey response rate of 60% compares very favorably with an average rate of 39%. THANK YOU!

We are going through each individual survey's answers to identify some service you'd like offered, and we will try to comply. This will take us some time but don't be surprised if you get a call from us to discuss your situation!

Here are some results based on the total numbers.

♦ Overall satisfaction rating	99%
♦ I have a strong personal relationship with my advisor	93%
♦ I am confident with the level of risk in my portfolio	92%
♦ The range of services meets all of my financial needs	86%
♦ It adds value above and beyond investment performance	93%
♦ The written communications I receive are valuable	93%
♦ Desire access to an electronic vault to store my documents	56%
♦ Would like electronic access to retrieve quarterly reports	71%
♦ Desire educational workshops	56%

We are just starting to put together some education workshops. We are also negotiating with a company that will offer an electronic storage option and electronic access to quarterly reports.

Thank you again for your participation.

CHARITABLE CONTRIBUTIONS BENEFICIARIES

Celia Brezner—Heifer organization: Its mission *is to "work with communities to end hunger and poverty and to care for the earth."* www.heifer.org

Thekla Hammond—Kiva, a microlender: "*connects people through lending to alleviate poverty.*" www.kiva.org

Deborah Madison—Planned Parenthood: "*is the nation's leading sexual and reproductive health care provider and advocate.*" www.plannedparenthood.org

Vicky Money—Mercy Corps: "*exists to alleviate suffering, poverty and oppression by helping people build secure, productive and just communities.*" www.mercycorps.org

Bill Murphy—Brothers on the Rise: "*responsibility empowers male youth to achieve individual success, develop healthy relationships and contribute to a more just and equitable society.*" www.brothersontherise.org

NEW FINANCIAL LEGISLATION

At the time we were writing this newsletter, the Financial Legislation just past – all 2300 pages!

Detailed analysis of the legislation is still underway but we wanted to comment on some of the highlights.

The Federal Reserve

There was a lot of political pressure to take action to prevent government bailouts in future crisis. The new legislation allows the Congressional General Accounting Office to audit the Fed's actions. The Fed will be required to provide more disclosure and bars the Fed from bailing out individual companies.

Too Big To Fail

When companies are on the brink of bankruptcy, the government had only two options: 1) let them fail or 2) use taxpayer money to bail them out.

Now, regulators will be able to take control and break up the troubled financial firms if the collapse could jeopardize the economy. The FDIC would run the liquidation. The banking industry funds the liquidation.

Hedge Funds and Derivatives

Derivatives contributed to the financial system breakdown because of the lack of transparency to identify the risks. This was largely done by hedge funds and the "shadow financial system" we discussed in our 2008 newsletters.

The SEC and the Commodity Futures Trading Commission will regulate derivatives. Hedge funds and private-equity firms must register with the SEC. And those who sell such products must have some investment in these instruments so they assume some of the risk.

Banks

Banks had too much leverage when the credit market was in turmoil. Citigroup, for instance needed government support to survive.

The Fed will assume more responsibility over big financial firms. The "Volker Rule" will prevent banks from trading with their own capital.

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NEW FINANCIAL LEGISLATION
(Continued)

Consumer Finance

Much has been written about how consumers ended up with exotic mortgages only to default.

A new consumer protection agency will be created within the Federal Reserve. However, it will be independent to the extent that it will have its own budget and agency head appointment by the president. The agency will write rules for consumer finance including but not limited to mortgages and credit cards.

The Next Crisis

One of the major problems identified during the financial crisis was the regulatory system was old and fragmented.

The Financial Stability Council will be comprised of the major regulators. They will identify risks to the system and take action. The Treasury will have the Office of Financial Research to track potential problems.

Credit Ratings

One of the obvious problems from the crisis centered around the alleged high credit quality of these mortgages given by the credit rating agencies such as Standard & Poor and Moody's.

The Office of Credit Ratings, under the SEC, will "watch" the ratings. Investors will also be able to sue the rating companies.

2009 TAX BILLS LOWEST IN 59 YEARS

We all complain about taxes yet they are the lowest since Harry Truman's presidency. According to the Bureau of Economic Analysis (BEA) federal, state and local taxes consumed an average of 9.2% of personal income.

While personal income fell 2% last year, taxes paid dropped 23%. Social Security taxes are considered insurance payments by the BEA and are not part of the tax calculation.

Since 2007, the average tax rate paid by all Americans fell 27%. Translated into dollars, the average savings was $3,400 on average household income of $102,000.

One-third of the Federal Stimulus package resulted in tax cuts. "The idea that taxes are high right now is pretty much nuts," says Michael Ettinger, head of economic policy at the Center for American Progress.

Source: *USA Today,* May 19, 2010

ATTENTION: TAX CHANGE FOR REGISTERED DOMESTIC PARTNERS

In a Private Letter Ruling, the IRS stated that the concept of community income as used on the California State tax return for registered domestic partners (RDP) should also apply on their federal tax return. This change is retroactive to 2007.

<u>Example</u>

Partner 1: Gross income $100,000
Partner 2: Gross income $50,000

Filing jointly as RDP in California, each partner has a gross income of $75,000 ($100,000 + $50,000 = $150,000 divided by 2).

In previous years, the gross income on federal tax returns was $100,000 for partner 1; for partner 2, it was $50,000. Under the new ruling the income of each partner is now $75,000.

The Private Letter Ruling also permits couples to amend their tax returns as far back as 2007. Jill and Bonnie had their 2009 federal tax returns reviewed and can save a significant amount of money. Amending their federal returns back to 2007 may be worth the expense.

Please discuss this change with your tax professional. (If Brian prepares your taxes, this review has already occurred.)

Jill D. Hollander

Brian Pon

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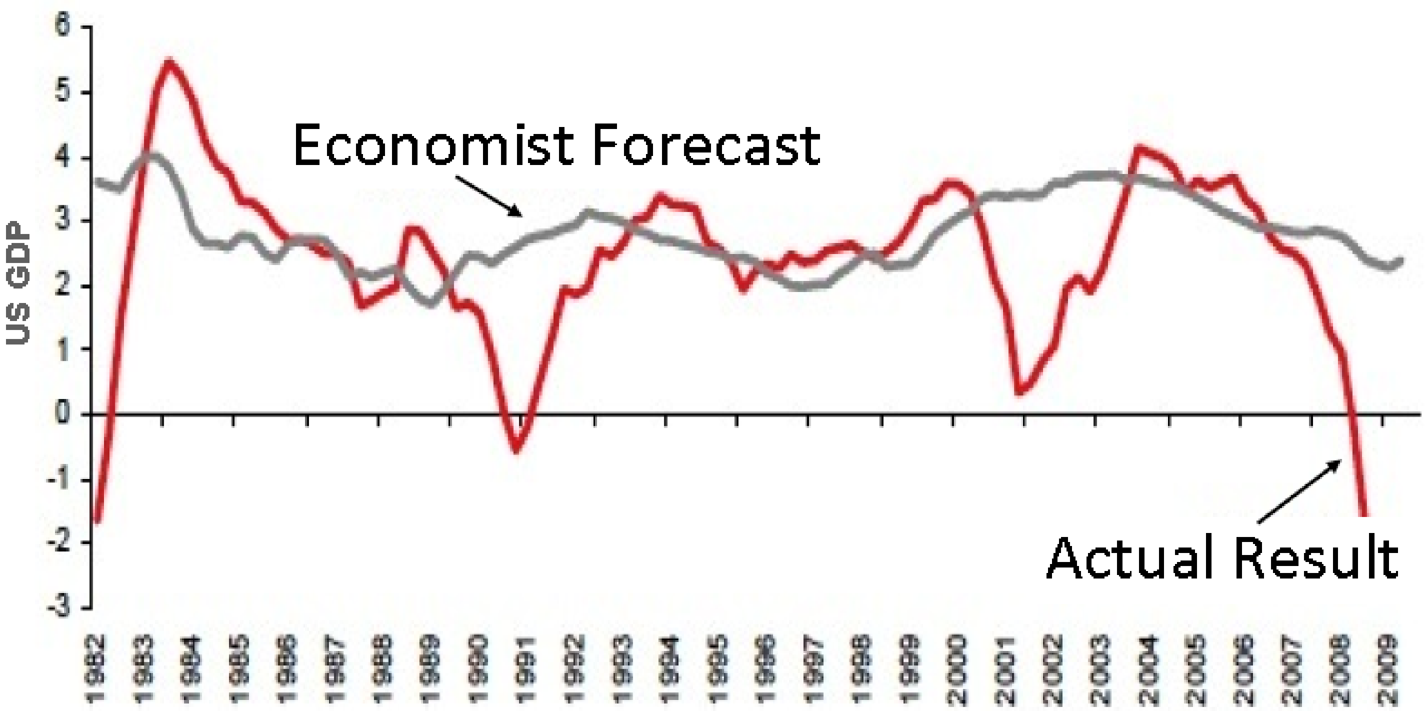
Economic Forecasting Is Practically Impossible

As we discussed in our July 2010 newsletter, economic forecasting is *notoriously unreliable*.

Forecasting the Economy: Below is a chart comparing the actual change in the United States Gross Domestic Product (GDP is a measure of economy activity) versus economists' forecasts. Notice how economists have been unable to predict changes in GDP.



Source: Davis Advisors and SG Global Strategy (Economists forecast United States GDP). Past performance is no guarantee of future results.

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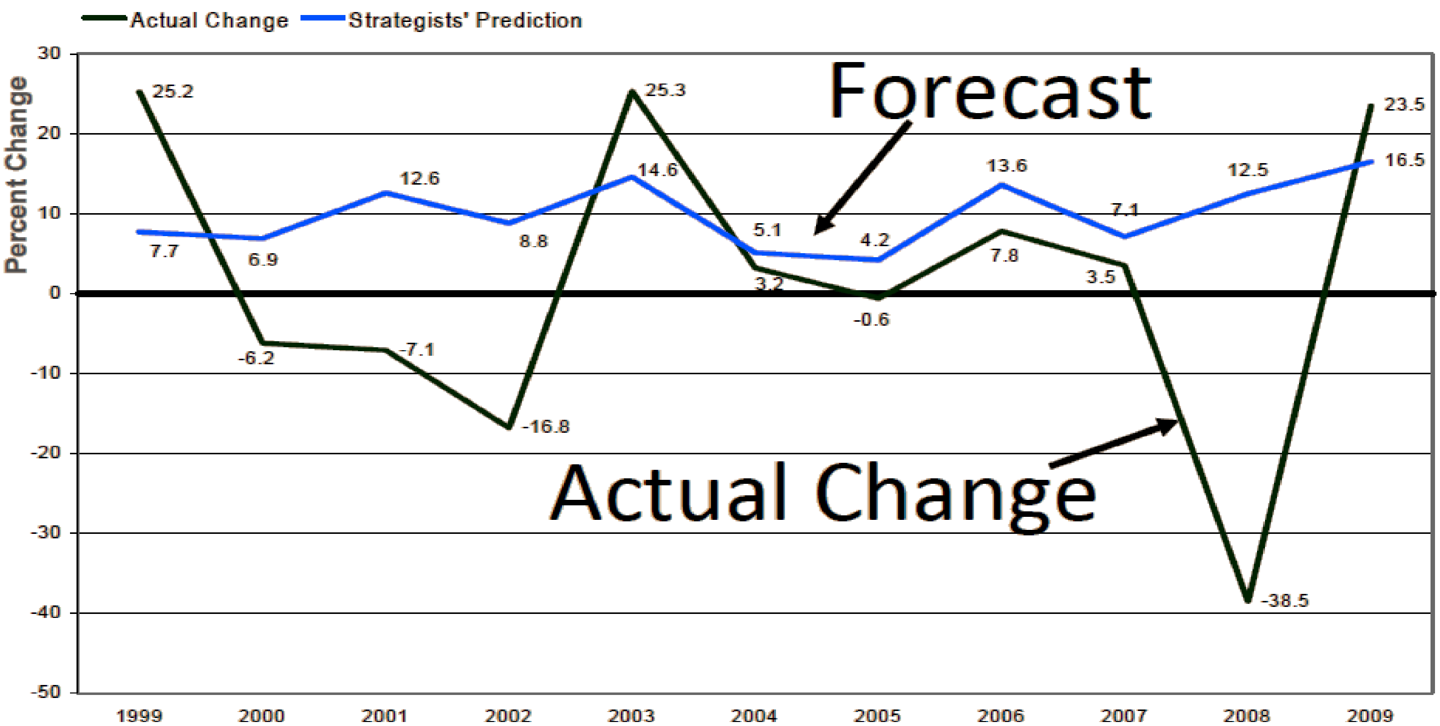
Economic Forecasting Is Practically Impossible (cont.)

Forecasting the Stock Market: Here is a chart comparing the actual change in U.S. stock prices versus the average forecasts of various stock strategists. Notice how strategists have been unable to predict market changes.



While it can be tempting to alter investment strategy based upon comments of economists and media pundits, it is important to realize that their opinions may not prove to be accurate forecasts!

Financial Connections does not "time the market" despite media messages. Please contact us so that we can review your current financial situation and discuss your investments.

Source: Davis Advisors and *Barron's* (from 1999 through 2005, numbers reflect Dow Jones Industrial Average forecasts; in 2006, Barron's began using the S&P500® Index exclusively). Past performance is no guarantee of future results.

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