

NORTH ★ STAR

Investment Advisors, LLC

— Building Portfolios to Last a Lifetime —

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TAX TRIVIA

In keeping with the spirit of tax time, here are a few tax trivia tidbits:

- The first tax e-file was in 1986.
- The first income tax ever was in 1404 in England.
- The IRS employs 114,000 people; that's twice as many as the CIA and five times more than the FBI.
- The Gettysburg address is 269 words, the Declaration of Independence is 1,337 words, and the Holy Bible is only 773,000 words. However, the tax law has grown from 11,400 words in 1913, to over 7 million words today.

First Quarter 2011

Every day, good and bad things happen that fall outside of our range of expectations. The first part of 2011 has seen some remarkable twists and turns - some good, some bad and some unspeakably tragic - all have challenged our perceptions of normal and altered our expectations for the future. The unfolding tragedy that struck Japan in early March –a huge earthquake followed by a tsunami followed by a dangerous nuclear event - will have significant consequences that go far beyond the immediate devastation and human suffering. Indeed, the future of the nuclear industry and global supply chain management are sure to be affected.

In classic contradictory fashion, the markets have responded to the drama and heartbreak of this New Year with what amounts to a big yawn. From the unscheduled removal of dictators in Tunisia and Egypt to the violent conflicts in Libya and other parts of Africa, and amid signs of a continuation of the European debt crisis, the markets have not registered the same fear that accompanied the financial crisis of 2008. The reason for this is that the financial crisis of 2008 represented a systemic threat, and was therefore very scary for the markets in a way that natural disasters and even wars, are not.

As proof, the S&P 500 experienced its best quarter since 1998, finishing up 5.89%. The bond markets ended mostly flat, having gyrated between flight-to-safety buying and end-of-QE2 selling. At the end of the quarter the yield on the 10 year US Treasury was 3.45%.

Unexpected events are a given on our busy, changing planet. While the risk of one-time incidents can't be eliminated, through diversification, effective asset allocation and risk management we can limit the damage when negative events do occur.

Referrals are an important source of new business for us. If you know of anyone that would benefit from our services please have them give us a call.

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Bond Market Commentary

As one can see from the chart below, the interest rate on the benchmark ten year U.S. Treasury Note fluctuated between roughly 3 ¼% and 3 ¾% and ended the quarter in the middle at 3.45%. This represented a slight increase in rates from the 3.32% at the start of the period. As always, there were a number of countervailing forces impacting the bond market during this period. Interest rates began to move higher in early February as the economic news became more encouraging. Also weighing on bond prices was the knowledge that the Federal Reserve's active buying of Treasury securities would be winding down by midyear. The Fed has been buying an estimated \$80 billion in U.S. Treasury securities per month since last November in order to "promote a stronger pace of economic recovery and to help ensure that inflation, over time, is at levels consistent with its mandate..."* Interest rates reached their high for the quarter in mid February at 3.74%.

However, rates then began to move lower as the political unrest in the Middle East and North Africa regions unfolded along with the possibility of economic fallout as a result of this turmoil. U.S. Treasury securities proved once again, despite our rather large budget deficit, they are the "go to" flight to quality investment. Continuing the flight to quality theme, rates moved to the lows for the quarter in mid March in response to the tragic events in Japan.

From a sector standpoint, corporate bonds outperformed government agency bonds which outperformed U.S. Treasury obligations. Municipal bonds, to the surprise of some, turned in a significantly better performance than the fourth quarter shellacking and actually improved relative to treasuries. Within corporates, the intermediate term maturities performed best and the returns improve as you

move down the quality scale. In fact, high yield (junk) bonds had the best performance of any fixed income sector during the quarter. As Bob Van Wetter mentioned in his comments, unexpected events are going to happen. The challenge is to construct portfolios, including equities and fixed income securities, which will weather these events sufficiently in order to provide some stability of assets and produce meaningful income.

*Federal Open Market Committee minutes from the 3-15-11 meeting



The Debt Ceiling

Last week Congress debated a spending bill for the rest of fiscal year 2011, which ends in September. This debate is part of the bigger umbrella issue of our national debt.

The deal Congress debated last week only covers what the government will spend for the next 6 months. It didn't address where the government will get the money it wants to spend. Getting the money is what creates the problem with our national debt.

As you may know, the US government has a self-imposed legal limit on the amount of debt it can issue. That limit is called the "debt ceiling," and it currently stands at \$14.3 trillion. The US government is rapidly approaching its debt ceiling as our borrowing is at about \$14 trillion right now. Thus, within a month or two, we will reach the legal limit on the amount of money the US government can borrow.

Because we'll soon reach the debt ceiling, the US government will not have enough revenue to fund the spending package Congress just agreed upon, unless they raise the debt ceiling.

Now the debate over the debt ceiling carries lots of long term implications, and people feel differently about how much debt the US should incur. But what we want to focus on is the reality of the numbers that Congress must deal with and what we think

is most likely to happen in this debate.

The first thing to understand is that for every \$1 Congress spends, it only collects 60 cents in taxes. That means it must borrow the other 40 cents, and those borrowings become part of our annual budget deficit and get added to our total national debt.

In the aggregate, Congress spends about \$3.7 trillion per year, and only collects taxes of about \$2.2 trillion. That's why we incurred a \$1.5 trillion deficit this year. We had to borrow that extra \$1.5 trillion to fill the gap.

Now, if the US debt ceiling isn't raised, that means the US government cannot issue any more debt and must live on only the tax revenues it collects. So the government would continue to operate but could only spend \$2.2 trillion next year, as opposed to the \$3.7 trillion that it has been spending.

This may sound like a good "tough love" approach to the deficit, but it would be disastrous to make that type of change in one year. Essentially, the government would need to cut 40% of all of its spending. Economically, it's just not feasible.

For better or worse, the US government is involved in many aspects of our daily lives, from highway and bridge construction

to doctor and hospital payments and the support of our military. Moreover, just about every major industry sector generates substantial revenues from government contracts. That means private companies in areas such as technology, consumer staples, industrial manufacturing, health care, energy, banking and defense all provide the government with significant goods and services. If the US government were to cease its business with these entities, it would have major negative implications for those firms and the overall economy.

Structurally, we're stuck with the current debt situation because we can't change it all at once. What we need is a long-term plan to reduce the annual deficits and bring down the growth of our national debt.

The debate that will rage in Congress over the debt ceiling isn't really about whether we will raise the debt ceiling. We have to raise it. The math dictates that. The debate will be over how much we raise it, and what sort of spending cuts and revenue changes we'll implement for future budgets.

The debt ceiling issue is something we'll be living with for many years, and markets and investors will have to get used to it.

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The Debt Ceiling (continued)

The only way you don't add to our national debt each year is to run a balanced budget. And we're far from running a balanced budget in the US. Thus, we'll continue to run some level of deficits in the years to come, and we'll continue to bump up against whatever new debt ceiling we set.

On a positive note, the fact that we have a debt ceiling forces us to confront the financial hole that we're digging for our country. So while the debate may be ugly, it is necessary; and in the end, will most likely lead to a more secure financial foundation for the US economy.

Best wishes to you, from all of us at Northstar!



From left to right: Charlie Farrell, Fred Taylor, Gina Spencer, Melissa Rosenberg, Bob Van Wetter, Tim Waymire, Dick Kopp, and Cindy Sack.

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