

# NORTH ★ STAR

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*Serving Clients Since 1995*

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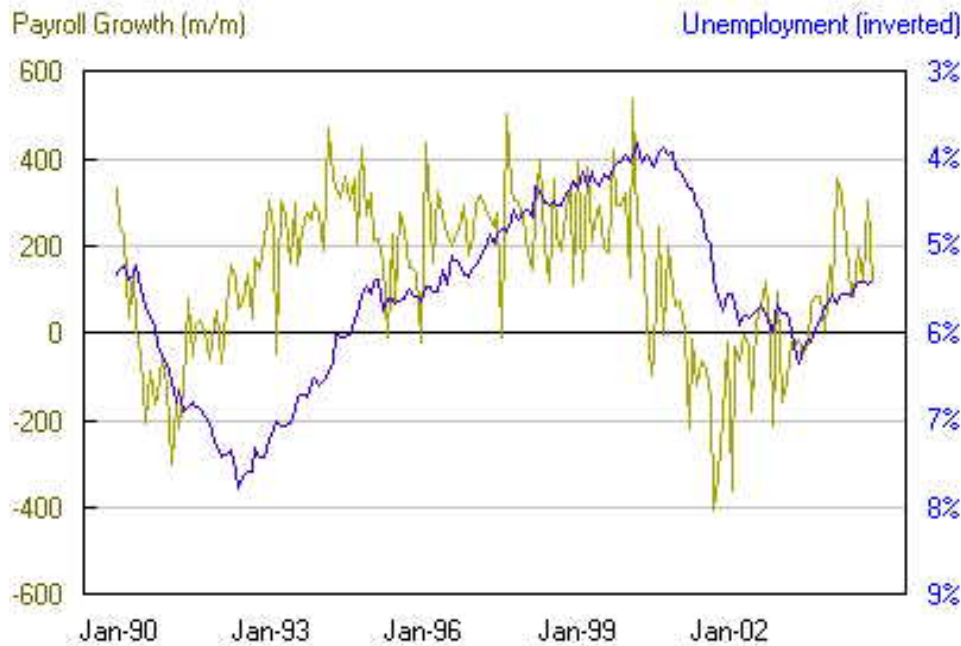
## YEAR END 2004

The stock market, having been held back for most of the year due primarily to election uncertainty, reacted to the clear and undisputed results with exuberant relief during the fourth quarter. The declining value of the dollar and a significant easing in oil prices added some potent fuel to the fire. Having added 9.23% during the fourth quarter alone, the S&P 500 finished 2004 with a gain of 10.9%, including dividends.

## INTEREST RATES

In what may be characterized as one of the bigger surprises in the investment landscape in 2004, longer-term interest rates actually declined over the course of the year. The ten-year U.S. Treasury Note began the year at a yield of 4.25% and closed the year at 4.22%. Likewise, the thirty year U.S. Treasury Bond started out at 5.07% and ended the year at 4.82%. While these slight declines understate the overall range of rates during the year, it is still somewhat remarkable given the economic and monetary conditions experienced during the period. More specifically, the economy grew at an above average inflation adjusted rate of 4% and the Federal Reserve commenced removing monetary stimulus by nudging rates 1.25% higher in five ¼ point moves. The shorter end of the yield curve responded in a more predictable fashion with those rates rising to the highest levels in three years. This disparity of return between the different maturity sectors resulted in a flatter yield curve.

Among the factors contributing to the relative out performance of longer-term bonds was the continued robust demand for our government bonds by foreign investors. Also, for **most** of last year there was little evidence of broad, rising inflationary pressures. The muted employment situation also likely kept longer rates in check. The graph below illustrates the nonfarm payroll growth since 1990 compared to the unemployment rate (inverted).



This particular economic barometer is worth singling out as the bond market often experiences outsized moves based upon the perceived strength or weakness in the payroll numbers. We have previously discussed the potential faults with the payroll survey, i.e. not accounting for small businesses and the self-employed. Notwithstanding those concerns, it is apparent from the chart that the current expansion is experiencing slower growth in job creation than past cycles. For this reason the bond market has maintained a healthy dose of skepticism regarding the sustainability of this expansion and this has kept rates on a short leash. However, there are signs of a pick-up in inflation that are certain to catch the eye of the Federal Reserve. In January of 2004, the year-over-year increase in the core-CPI was 1.1%. At present that rate has doubled to 2.2%. More recently, the past three months have risen at a 2.8% annual rate. The Fed has stated its intention of removing monetary stimulus in a measured pace that so far has equaled ¼ point installments. The current fed funds target rate is 2.25%. The Fed is likely to continue to raise rates until they reach what they consider a “neutral” rate, which is thought to be between 3%-3 ½%.

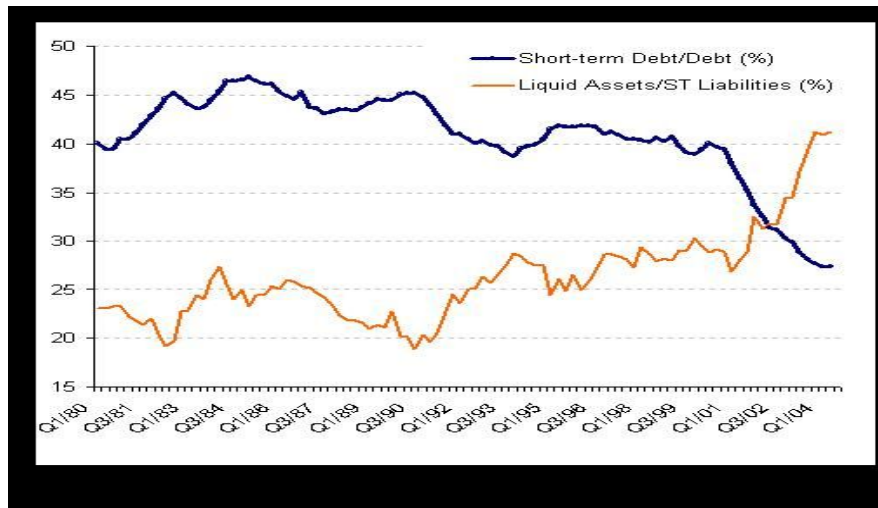
## A RETURN TO LARGE-CAP?

Looking ahead, we are seeing conditions improve with regard to the outlook for large-cap stocks. Large-cap companies, those distinguished by market capitalization values greater than \$5 billion, have trailed smaller stocks since early 2000. A confluence of factors, including valuation, dividends and strong balance sheets are lining up to favor these often unexciting but powerful companies.

The Price-Earnings ratio of the top 25 names in the market-cap or dollar weighted S&P 500 is at a 20-year low at 16.8 times 2004 earnings. The remaining 95% of the stocks in the S&P 500 now trade at around 18 times 2004 earnings. The largest names in the S&P typically trade with higher Price-Earnings ratios than the rest.

The dividend yield of the largest 25 companies in the S&P now stands at 2.2%. This compares to a 1.8% yield on the rest of the index. This represents the widest gap in almost 20 years.

Massive deleveraging of balance sheets over the past two years has resulted in high levels of corporate liquidity. Corporate scandals and tough competition from abroad has forced management to sell off marginal businesses and cut costs. Look for large companies to use this freed up cash to boost shareholder value through stock buybacks and dividend increases. Rising interest rates will increasingly hinder leveraged firms while helping those that carry less debt.



Another indication that we have entered a big company era is merger activity. Mergers dropped off starting in 2001 - a victim of recession, corporate scandals, and a sluggish stock market. A robust economy and soaring corporate profits have boosted stock prices and cash on hand. Consequently, M&A activity in 2004 increased 41% over 2003. Big companies are eager to buy market share. Other factors are at play as well. The weak dollar makes U.S. assets more inviting to foreign investors. Stricter governance standards are forcing poorly performing CEOs and boards to entertain offers. And in a repeat of the 1990s, deals are spawning more deals as companies scramble to keep up in consolidating industries.

We appreciate your interest in Northstar. Referrals are our best source of new business. If you know anyone who would benefit from our services, please pass our name along.

Wishing you a healthy, happy, and prosperous New Year.

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