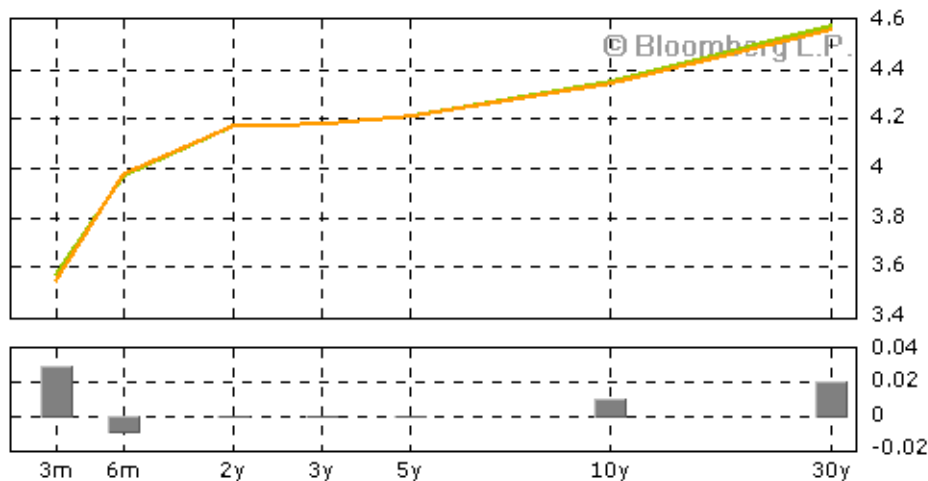


## THIRD QUARTER 2005

The markets were buffeted by a number of headwinds during the third quarter, both literally and figuratively. As if rising interest rates, the return of inflation and high energy prices weren't enough to spook the markets, along come not just Hurricane Katrina but Rita as well. Yet through it all, the markets have managed to hang in there, primarily because of strong corporate earnings. At the end of the quarter, the S&P index was up 3.6% including dividends. The Ten year Treasury bond began the quarter with a yield of 3.96% and ended with a yield of 4.32%. In this report we analyze how developments in several areas of the economy and business will likely impact our lives in the months ahead.

### SHAPE OF YIELD CURVE PREDICTS THE FUTURE OF THE ECONOMY



To most people, movements in interest rates and the bond market make about as much sense as quantum physics. Nevertheless, understanding the predictive qualities of bond prices can provide some valuable perspective to the overall economy. Based on the reasonable theory that an aggregate decision by many individuals is smarter than one made by a handful of educated institutional investors, prices in any market reflect perceived conditions in the future. While bond prices react to all sorts of economic stimulus on a short term basis, the relationship between the yields of short maturity bonds and longer maturity bonds can speak volumes about how investors feel about the future.

This relationship is known generically as the yield curve because the yields represented by various bond maturities along a time line describe a curve. Depending on where those points fall as you go out in time, this curve can be described as steep, flat, or inverted. Normally the yield curve shows some steepness as shorter maturity bonds yield less than longer maturities. The shape and degree of the yield curve is indicative of various economic factors. Changes in the shape of the curve are often predictive of future conditions. Here are some examples:

- Cyclical factors: at the end of a recession, the Fed will have already been cutting the Fed funds rate to stimulate borrowing. The curve will be rather steep at that point in the business cycle and, not coincidentally, this is when an expansion is most likely to occur.
- Liquidity: a steep yield curve is stimulative because low short-term rates encourage businesses to invest cash elsewhere for higher returns. Creating liquidity is the main goal of Fed policy during such periods. The Fed Funds rate is the rate at which banks borrow. Banks will loan money aggressively to individuals and businesses because it is repaid at higher, longer-term rates.
- An aging economic expansion: The yield curve flattens after several rounds of tightening by the Fed in an effort to slow the pace of growth that a steep curve encourages.

Right now the yield curve is nearly flat. In an effort to avert inflation, the Fed began raising short-term rates in mid-2004. Strong investor demand for longer bonds has pushed those yields lower than might otherwise be the case. Many analysts are anticipating an inverted yield curve as a result. Inverted yield curve describes a situation in which short term bonds yield a higher return than that found in longer-dated bonds. This situation is anathema to the nature of bond investing which dictates that the farther out you go in time, the more you should be paid for taking that risk. An inverted yield curve is a fairly rare occurrence but is typically a harbinger of economic recession. For borrowers, the chance to take out cheap long-term loans is attractive. But for lenders, an inverted curve means they lose money on long-term loans. This tightening of liquidity discourages investment by businesses. Regardless of what factors contribute to the yield curve inverting, it demonstrates a collective expectation by the Bond Market that even lower rates are imminent. At such times investors will buy bonds in anticipation of a slower economy as bonds offer risk-free return in favor of other, more speculative investments.

If energy prices remain high and result in higher rates of inflation, the Fed may have no choice but to keep raising short term rates in response. Current thinking is that if the Fed tightens short-term rates too much there is a considerable risk that economic growth will be choked off, resulting in recession. The last time the yield curve inverted was in January of 2000. Fresh in many investors' minds is undoubtedly the unheeded message that the yield curve sent in January 2000 when it inverted. The NASDAQ, market index peaked two months later.

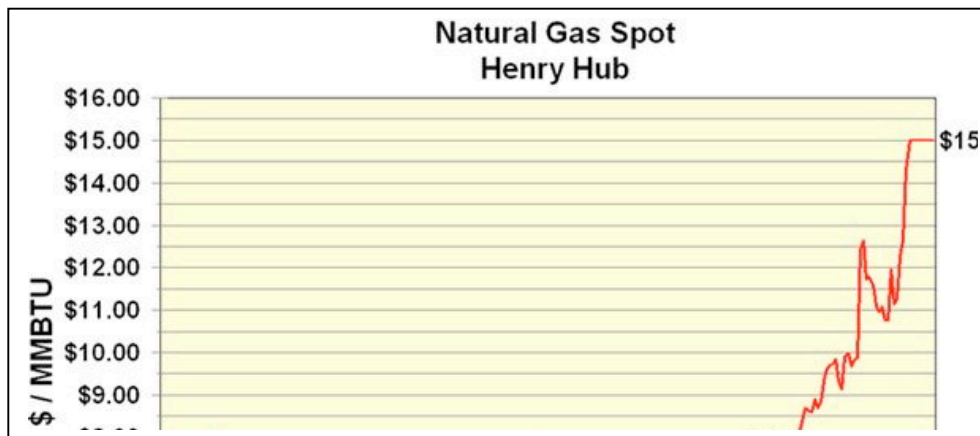
The current situation certainly bears watching, especially as the unbelievable devastation in the Gulf Coast ripples through the economy and causes the federal deficit to grow. Some believe that persistently high energy prices will apply a sufficient tax on the economy to cause the Fed to end the current tightening cycle. To be sure, the Fed faces an unusually difficult time as it tries to navigate monetary policy to offset the inflationary, against the contractionary effects of high energy prices. Only time will tell. Meanwhile, keep your eyes on the shape of the yield curve.

## **NATURAL GAS PRICES PUSH HIGHER**

Media attention, after the two severe hurricanes, has been heavily focused on the oil side of our energy problems, especially with the very visible price of gasoline at the pump and its effect on consumer budgets. Less attention has been directed to another

facet of the energy complex—natural gas. Currently, natural gas is priced in excess of \$14 per MMBtu. This represents an increase much greater than that seen in most other forms of energy. The primary users are ultimately consumers (home heating, cooking, AC, etc.) and industrial/commercial. As we approach the winter heating season, consumer budgets will likely take another hit, especially if we experience severe cold weather.

With the natural gas storage injection season coming to an end, gas in storage is in decent shape, although below last year. We probably will not catch up due to the damage to production facilities in the Gulf of Mexico and to onshore processing plants, some of which will not be fully restored until next year. Unlike oil, we have limited ability to import foreign gas because of a lack of LNG (liquefied natural gas) terminals and Canadian production constraints limit a significant increase from the north. These current problems are superimposed on an ongoing decline in domestic production despite a dramatic increase in drilling. All of this points to higher prices to users of natural gas, a dampening effect on our economy and a need to conserve. Let's hope for a warm winter!!



## **HURRICANES AND THE INSURANCE INDUSTRY**

One of the most significant news events during the third quarter was the potentially negative economic impact on the US economy from hurricanes Katrina and Rita and specifically the cost to the insurance industry.

Although estimates vary, Katrina may have caused as much as \$60 billion in uninsured losses and Rita could be as high as \$6 billion. For homeowners and corporations in the

surrounding areas this could mean huge increases in premiums or result in insurance companies providing less coverage in the future.

Price increases are common after major disasters - insurance rates for many corporations doubled after the September 11, 2001 terrorist attacks. This time around however, the rise in premiums may not be quite as severe because many insurance companies are in better shape financially than four years ago thanks to price increases after September 11. Also, corporate buyers may pursue other alternatives to conventional insurance or make greater use of self-insurance vehicles. Homeowners may not be so lucky; they may have fewer insurance carriers to choose from or if coverage is too costly, such as in the case of flood or earthquake insurance, they will elect to forego extra coverage.

An insurance stock that we follow and own for some of our clients is Allstate. Allstate dropped 15% when Katrina hit but we think it will recover due to adequate reinsurance coverage and a \$23 billion surplus to cover any losses. Its PE ratio of 10 compares favorably to the average PE for the insurance industry of 18.

In the long run these types of natural disasters usually mean higher premiums for homeowners and corporations which, in turn, translate into better earnings for insurance companies in the future.

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to save for your retirement years, won't be paying FICA tax, and the kids should be out of the house.

Here are the Savings to Income Ratios

Age	Savings to Income Ratio
30	0.1
35	0.9
40	1.7
45	3.0
50	4.5
55	6.5
60	8.8
65	12

To use the chart, take your current income and then multiply it by the Savings to Income Ratio that corresponds with your age. For instance, if your income is \$150,000 and you are 50 years old, your Savings to Income Ratio should be 4.5. Thus, you should have approximately \$675,000 in investable assets (\$150,000 X 4.5).

If you would like to explore these concepts in greater detail as they may relate to your personal finances, please feel free to call your portfolio manager. Charlie's ratios were originally published in an article he wrote for the Journal of Financial Planning in January 2006, and have also appeared numerous times in the Wall Street Journal.

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