

SECOND QUARTER 2006

In a fit of volatility worthy of late 1999, the markets spent the end of the 2nd quarter gyrating between the rock of economic growth and the hard place of rising inflation. The equity markets ended the quarter with a slight loss with the S&P 500 down 1.4% including dividends. Year to date the S&P 500 is up 2.7%.

Over the past two years the Federal Reserve Board has resolutely raised short term interest rates from 1% to 5 ¼% in an effort to put a check on inflation before things get out of hand. History shows that the Fed is often too successful in their quest to cool things off. Meanwhile, investors the world over have been driving up prices of virtually all asset classes. Foreign and domestic stocks, bonds, real estate, timber, collectibles and gold have benefited as cash looking for higher returns has found its way around the world. Much, but not all of this cash is dollar denominated. Speculators, in the form of hedge funds and private equity managers, have been borrowing Euros and Yen at low rates. Japan was stuck in an intractable deflationary recession for many years until recently. To help turn things around, the Bank of Japan lowered rates and added loads of cash to bank reserves in the hopes that it would be lent in a way that would stimulate the Japanese economy. This strategy finally found success – Japan is doing much better. Just recently, Japan and other Asian countries have begun raising rates to remove some of the heat from their own economies.

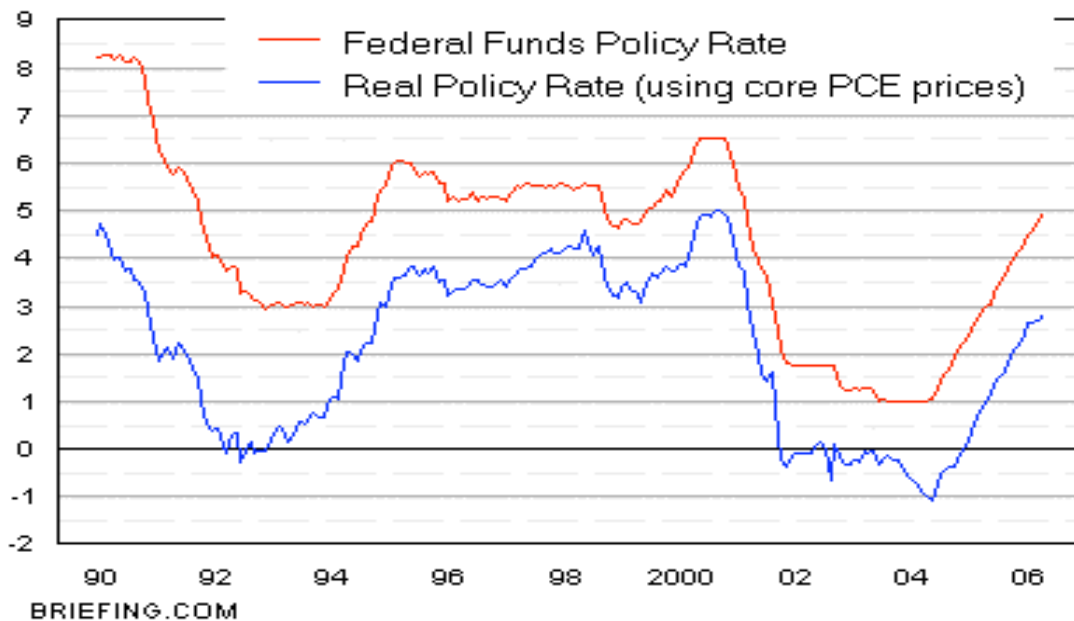
The above illustration helps to describe the global economy in which we all participate. Just as low-cost (interest-wise) US Dollars were invested both locally and internationally over the last few years, cheap Japanese Yen were invested in India, Indonesia and elsewhere. The global mechanism that takes advantage of low rates in one nation to earn a better return elsewhere is far from perfect but it is well-oiled. When that flow works in reverse as it did in early June, the fallout can be unsettling. For most of the month of June, few markets – foreign or domestic - were happy places to be.

Many market pundits and the media in general have cited fears of inflation as the reason for the recent correction. Markets have been increasingly volatile around monthly price data, and a bit confused by the pronouncements of the new Federal Reserve chairman, Ben Bernanke. If the markets fear inflation, why would stocks that gain the most from rising prices fare the worst during the selloff? Gold fell from over \$700 an ounce in mid May to just over \$600 while bond prices gained ground – activity hardly indicative of rising inflation. Meanwhile, we have seen Consumer Staples, Utilities and Healthcare – defensive stocks - outperform the rest of the market over the same period. This behavior would indicate that the market may be anticipating an economic slowdown rather than the opposite. If this turns out to be the case, the Fed will have accomplished its goal by deliberately removing liquidity over the last two years.

How does the Federal Reserve know what to do?

The stock and bond markets both enjoyed meaningful rallies in the closing days of the second quarter. This strength was attributed to the markets' interpretation of the latest statement from the Federal Reserve. As expected, the Fed raised their target rate for federal funds $\frac{1}{4}\%$ to $5\frac{1}{4}\%$. This represented the 17th consecutive $\frac{1}{4}$ point increase dating back to June of 2004. That the Fed raised rates again was not a surprise, however, the spark that appeared to ignite the markets was contained in the statement released by the Federal Reserve discussing their decision. More accurately, it was what was *missing* in the wording of the statement that got the markets excited. While most of the statement was identical to the May statement, the phrase "further policy firming may be needed" was left out of the most recent statement. The markets took this less hawkish statement to mean the Fed has more room to pause or even cease raising rates at the next meeting in August.

The difficult task facing the Federal Reserve is to know when rates are high enough to restrain inflationary pressures without causing significant economic slowing. This task is rendered all the more difficult because the policy tool being utilized has a significant lag effect. In other words, the effects from the various rate hikes are felt six to nine months later. It is a little like trying to drive a car by looking in the rearview mirror. However, the chart below may provide some clues as to how much room the Fed has before becoming too restrictive.



In order to determine how restrictive current monetary policy really is, one has to consider the current level of "real" interest rates. This chart displays one version of real interest rates. In this case, the personal consumption expenditures deflator is utilized as the proxy for inflation. The current level of the PCE for the

first quarter of this year is 2.0%. The proxy for nominal interest rates in this case is the federal funds policy rate, currently at 5¼%. Therefore, the current level of real interest rates is 3¼%. In the past, economic growth has been stunted when real rates have reached the 4% level or higher. Because the PCE is one of the Fed's favored measures of inflation, continued attention to this indicator should yield clues as to the Fed's intentions.

The return of volatility to the financial markets – for whatever length of time - reminds us of the importance of diversification in all portfolios. A sensible approach to investing includes exposure to all kinds of equities by market capitalization and industry groupings. Investing in emerging markets and different geographic regions is usually appropriate as well. Additionally, commitments to fixed income and cash may also play a strategic role in reaching long-term financial objectives. We appreciate the trust that you have placed in Northstar. As we celebrate eleven years in business, we are grateful to our many clients, friends and associates.

Thank you for your interest in Northstar, we look forward to having an opportunity to serve you.

Note: Regulations limit our ability to share specific recommendations in this forum. For more information please contact Northstar Investment Advisors.

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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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