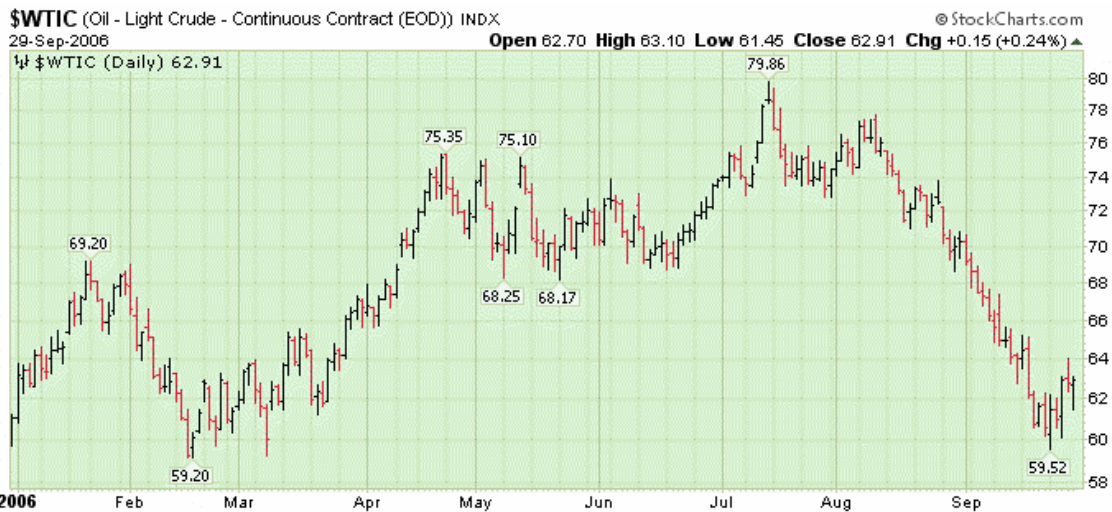


THIRD QUARTER 2006

The equity markets defied historical expectations by posting some impressive gains in the 3rd quarter. Indeed, the 5.2% gain in the S&P 500 is the best seen during that period in nine years. This, followed by the much-heralded achievement of an all-time high by the Dow Jones Industrial Average, has brightened everyone's outlook for the fourth quarter. A review of some of the factors that have contributed to the seasonal performance of the markets will help us form our expectations for the rest of the year and beyond.



Having started the 3rd quarter at nearly \$80 per barrel, the approximately 25% drop in energy prices since mid-July has contributed significantly to this impressive rally. While the economic implications of cheaper oil are very positive, it is unlikely that still lower energy prices will benefit the equity markets going forward. Indeed, the energy sector is more oversold relative to the rest of the market than it has been in at least 9 years – including 1998 when prices briefly touched \$10 per barrel.

Oil and commodity prices may in fact stay depressed for some time as forecasts for global growth moderate, but this is not necessarily a good thing in relation to normal business cycles. Historical performance studies of major industry groups during various stages of the economic cycle reveal that energy and commodities typically show their best performance during the latter stages of the cycle, and then turn lower in anticipation of a slowing economy.

From the perspective of the Federal Reserve, by looking at historical lags between monetary policy and the impact on GDP, it is clear that the economy has not yet fully felt the impact of all the tightening already in the economic pipeline. In addition to energy prices, signs of economic softness have been seen in those areas that usually feel it first – housing and autos.

The bond market enjoyed a robust rally during the third quarter with the aid of falling energy prices and a Federal Reserve that hit the pause button after two plus years of hiking interest rates. The yield on the ten-year Treasury note made a high of 5.25% in late June just prior to the Federal Reserve's meeting on June 28-29th. While the Fed did in fact raise rates at that meeting by ¼%, the market began to rally based upon the press release from the Fed that seemed to open the door for a pause in the rate increases. This perception became reality on August 8th when the Fed refrained from raising rates and kept their target for Fed Funds at 5 ¼%. The FOMC meeting on September 20th had the same outcome. The ten-year yield dropped to a low of 4.53% in late September before closing the quarter at 4.63%.



As mentioned in prior commentaries, the Fed is attempting to achieve that delicate balance of restraining inflationary pressures without causing significant economic slowing. The market calls this a “soft landing”, and thus far, everything appears to be going according to Hoyle. The economy grew 5.6% in the first quarter of the year and slowed to 2.6% growth in the second quarter. The housing market is in the midst of a well documented slowdown after several years of unprecedented strength. The manufacturing sector is slowing as evidenced by the most recent readings on durable goods and the Institute of Supply Management (ISM) index. Durable goods orders have posted back to back declines for the first time since early 2004 and the ISM index has made a series of lower highs/lower lows over the past year and at the most recent reading of 52.9% is much closer to the 50% level that divides growth from contraction. However, in the words of the Federal Reserve, “the Committee judges that some inflation risks remain”. Wage and salary growth has been at an 8% year over year pace, while the core Personal Consumption Expenditures (PCE) index is rising at a 2.5% pace over the last twelve months. The Fed would

like to see this last indicator somewhere between 1 ½-2%. The magnitude of the strength in the bond market this quarter would indicate that bond market participants believe the next move by the Federal Reserve will be to lower rates, and perhaps soon. That perception may take longer to become reality than is currently factored in to current interest rate levels.

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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