NORTH ★ STAR
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As we look ahead to 2006 there are a number of factors that will determine the tenor of the markets going forward. Here we will address some of what we consider to be most salient. After much movement up and down the S&P 500 index ended the year with a 4.9% gain including dividends. The Dow Jones Industrial Average ended the year with a loss of .61%.

Equity Markets

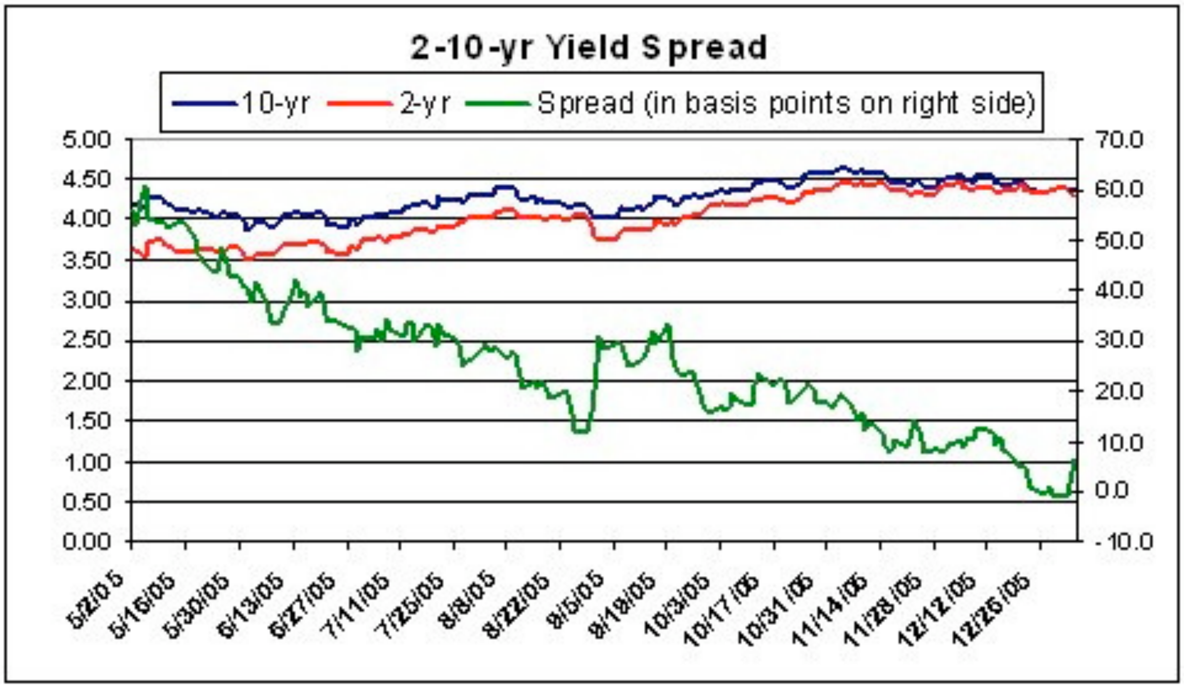
While we learned long ago to not try to forecast where the markets will be a year from now, our work does offer some clues as to the kind of year that we may have. Technically speaking, the current market uptrend is getting a bit long in the tooth. Historically, bull markets tend to last an average of 36-39 months. This is important to remember since as of this month we are entering our 40^{th} month since the last major bottom was made in October of ’02.

Minutes from the latest Federal Reserve meeting indicate that they are close to reaching a neutral credit stance and will need clues from the economy about the need for further increases. We are mindful that while the economy is strong and profit growth is strong, both are likely to slow down somewhat in 2006. Indications are that the consumer is beginning to flag, thanks in part to a somewhat cooler real estate market. For now, the stock market appears to be fixated on the likelihood that the Fed will end hikes sooner rather than later. This scenario is contingent on benign inflation since they are not likely to stop hiking rates if inflation worries are high.

Ironically, the strongest S&P industry sectors are those that benefit from higher inflation. Indeed, as we start the year, energy, materials and certain large-cap technology issues dominate the plus column as we enjoy a remarkable early January rally. We expect commodity prices to remain strong, led by energy and basic materials. Consistent with conditions found during early or mild economic contractions, we will be watching with particular interest shares of consumer staples, select health care, and Information technology companies.

Interest Rates

For nearly all of 2005, the yield on the ten-year stayed within a fairly narrow range of 4.00%-4.50%. The longer end of the yield curve seemed to be immune from the effects of the **eight** interest rate increases the Federal Reserve instituted during the year in their ongoing campaign to remove monetary stimulus and return monetary policy to a more neutral stance. The shorter end of the yield curve was not as lucky as those rates basically moved up in tandem with each increase by the Fed. The disparate performance of the shorter end of the yield curve versus the longer end has resulted in a yield curve that is very flat and in some cases **inverted.** The yield spread that has garnered the lion’s share of attention is the difference in yield between the ten-year note and the two-year note. This spread has been narrowing for quite some time and recently became slightly inverted with the two-year yielding more than the ten-year.



The reason this is noteworthy is that an inverted yield curve has in the past been a fairly reliable predictor of economic weakness. Is it different this time? There is substantive evidence to suggest that in fact it may be different this time. First of all, the level of nominal interest rates is still low when compared to historical averages. The yield on the ten-year note has averaged 6% over the last fifteen years and 5.3% over the last ten years. One would be hard pressed to characterize the current level of interest rates as restrictive to economic growth. Secondly, in trying to explain the relatively low longer-term interest rates domestically, Alan Greenspan refers to something called "globalization". The Federal Reserve's own study indicated that the yield on our ten-year Treasury note is likely a full 150 basis points (1½%) lower than it would be otherwise based solely upon foreign demand for our government bonds. There has been a significant build up of liquidity worldwide and our government bond market seems to be the market of choice. There has also been an increase in demand for longer term fixed income investments from the large pension funds. Both of these factors have placed downward pressure on the longer end of the yield curve.

Finally, the key measure of the predictive value of an inverted yield curve appears to be the level of **real** interest rates. Real interest rates equal nominal rates minus inflation. The current fed funds target rate is 4¼% and is likely headed to 4½% later this month when the Fed meets. The year over year increase in the core inflation rate is essentially 2%. Therefore, the real rate is 2¼%-2½%. The average real interest rate during the last nine yield curve inversions was a much more restrictive 4.88%. The last two times yield curve inversions gave false warnings of economic weakness the real rate was 2.74% and 3.68%.
We do expect economic growth to slow somewhat this year to the 3¼%-3½% range from the recent 4%+ rate. However, in spite of the recent slight yield curve inversion, we do not expect the economy to stumble into a recession.

PENSION PLAN ACCOUNTING IS IN THE NEWS AGAIN

Several years ago, defined benefit pension plans were in the news because of the accounting woes that were brought on by negative stock market returns. Today pensions are in the news again, but for different reasons. In a new and disturbing twist, the recent bankruptcies of United Airlines and others were structured to allow the companies to shift their pension obligations to the federal Pension Benefit Guaranty Corporation (PBGC). The situation that we are faced with today is being addressed by proposed legislative reforms that may cause more problems than they solve.

The PBGC is an employer-financed, government-backed program of pension insurance. Dating back to the early 1960s, this safety net for pensioners was loosely modeled on the Federal Deposit Insurance Corporation (FDIC) which provides insurance for customers against bank failures. According to Forbes magazine, the PBGC currently faces a $23.3 billion gap between its assets and its liabilities. If other airlines and large corporations seek to shed their pension obligations, its deficit will mushroom. Eventually U.S. taxpayers are going to have to pay for the shortfall. In all likelihood, a PBGC bailout would be more expensive than the savings and loan rescue of the 1980s. If there is a bailout, the winners will be the corporations that created the crisis.

Defined benefit pension plans are designed to provide employees with a fixed benefit when they retire. Employers are required to contribute to and maintain the funds necessary to provide those benefits in the future. Pension fund obligations represent the amount that an employer would need to invest today, based on a rate that discounts the present value of future obligations to employees. Pension accounting has little effect on cash flow until a company's plan becomes insufficiently funded to satisfy requirements established by ERISA, the regulatory body that oversees pension funds. The funding calculations are complex, but when assets in the plan fall below 80% of funding obligations, the company has to start adding cash from its own balance sheet to the plan.

Pension plan liabilities have always represented a two-edged sword to corporate earnings. As company assets, positive returns on pension investments can enhance corporate earnings. In addition, investment performance in excess of anticipated returns can be used to offset expenses earmarked for future contributions. This virtuous circle has occasionally reversed with a vengeance as returns have turned negative and companies must make up for lost value from cash reserves. Real concerns begin when companies are hit with sequential years of flat to down market performance coupled with layoffs or even bankruptcy.

Many employers have terminated their defined-benefit plans or converted them to defined-contribution plans, such as 401(k)s, in which the employee (rather than the firm) bears all the risk of stock market fluctuations and investment choice. Furthermore, most defined-contribution plans require employees to decide whether and how much of their salary to set aside. Younger employees rarely foresee their retirement needs, and low-wage employees usually don't have the extra cash to divert into savings. Thus without the forced pension savings of a defined-benefit plan, many individuals are unlikely to set aside the money they will need in their later years. Even if they do, few lack the skill or discipline required to generate above-average returns year in and year out. This year the first members of the so-called baby boom generation are turning 60. The implications of this milestone are significant as this large demographic group will be experiencing the success or failure of self directed retirement investing.

Timothy J. Waymire, CFA   Richard P. Kopp, CFA   Moses Taylor
Frederick B. Taylor   Bob Van Wetter

Cynthia Sack   Gina Spencer

Northstar Investment Advisors, LLC
700 17th Street
Suite 2350
Denver, CO. 80202
303-832-2300
800-204-6199
www.northstarinvest.com

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.

Richard P. Kopp, CFA   Moses Taylor   Frederick B. Taylor

Bob Van Wetter   Charlie Farrell, J.D. LL.M.   Timothy J. Waymire, CFA

Cynthia Sack   Gina Spencer

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