NORTH ★ STAR
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THIRD QUARTER 2004

Greetings. We are thrilled to be in our new offices in downtown Denver at 700 17th Street, Suite 2350. When you are in the neighborhood, please stop by. 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.

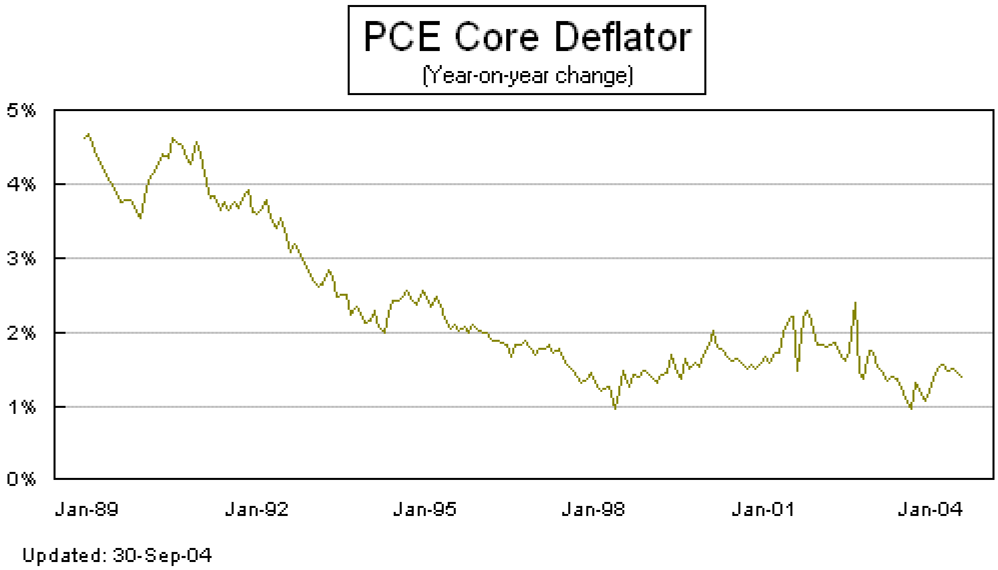
Observations for the quarter: The approaching election is shaping up to be quite contentious and very close if you believe the polls. The economic outlook and the fate of the markets for the remainder of the year will be determined by developments in the direction of interest rates, energy prices, and corporate profits.

Interest Rates

In a reversal of the trend witnessed in the second quarter, interest rates declined steadily throughout the third quarter with the yield on the ten-year U.S. Treasury note settling at 4.12% after starting the period at 4.60% and briefly dipping below 4% in late September. In last quarter's commentary we attributed the *rise* in rates in that period to the market's anticipation of the commencement of a less accommodative monetary policy from the Federal Reserve. As anticipated, the Fed did in fact begin to remove monetary stimulus with a 0.25% increase in the federal funds target rate on June 30, 2004. This was followed up with two more 0.25% increases in August and September, leaving the current fed funds target rate at 1.75%. Judging by the *decline* in longer-term rates this quarter, concurrent with a Fed that is becoming less accommodative, the anticipation must have been worse than reality.

As oftentimes happens, the bond market does its best to confound the greatest number of people. Actually, there were at least two factors worth commenting on that likely had some bearing on the direction of the market during the quarter. The first is something the Fed described as a “soft patch”. This is the description the Fed used to characterize a slowing in economic activity this summer. The real gross domestic product did in fact slow to 3.3% growth in the second quarter from 4.5% in the first quarter. A major reason for the deceleration was the pullback in consumer spending as evidenced by the lackluster retail sales. The consumer, who has been doing the lions share of the heavy lifting in sustaining economic growth, apparently succumbed to the headwinds of higher energy prices and the lapping of the stimulus provided by last years tax relief. While 3.3% growth does represent a slowing from the first quarter, it is still above the average growth of 3.2% for the last ten years. Fortunately, business investment spending has begun to pick up the slack and for this reason the economy appears to be in a sustainable growth trend.

The other factor influencing the bond market this quarter is something called the personal consumption expenditures core deflator. This happens to be Chairman Alan Greenspan's favorite measure of inflationary pressure. A current chart of this index is found on the next page. In spite of the very visible increase in energy prices, inflationary pressures have actually eased in the last few months. This is one of the main reasons the Fed is comfortable raising rates and likely will continue to do so until they perceive monetary policy to be neutral.



Energy Prices

Energy prices have continued their relentless increase during 2004 for numerous reasons. Political turmoil and terrorist actions in the Middle East are obvious. Nigerian oil workers have been in and out of strike mode for several weeks. Nigeria is a significant exporter to the United States. Hurricane Ivan has caused shut-in status for many Gulf of Mexico fields. This potential production is not lost, but deliverability has been disrupted, probably for the rest of the year. Demand for petroleum products around the world exceeds supply as economic recovery continues. This problem is exacerbated, as hoarding exists in many countries in the form of increasing amounts of product being placed in strategic storage. Speculation in the futures markets is also creating upward pressure.

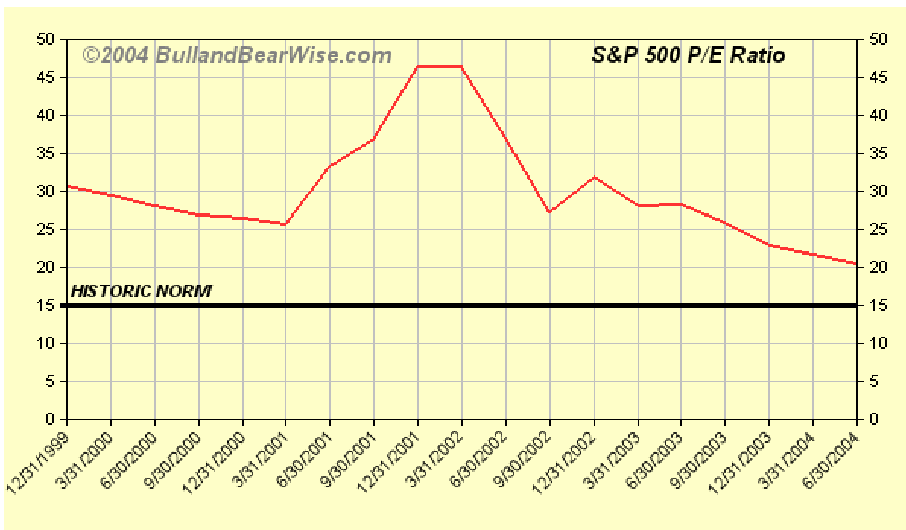
All of this has an effect on the United States as we end the summer with crude oil inventories at low levels. Demand for heating oil and natural gas this coming winter is an unknown based on weather. Natural gas storage facilities are near full, but storage capacity has not increased meaningfully in several years, while demand has steadily risen. Nobody really knows how these factors will be resolved, but it seems likely that energy costs will remain high for some time. For our economy, this will have a mitigating effect on growth. Some estimates indicate that the year's energy cost increases will have a negative effect of some 2% on retail sales. These sales are still growing at about 7% annually so the end result will not be disastrous, but it will lower economic expectations, especially in some industries.

Corporate Profits

Any stock market investor worth his or her gray hair knows that the two main variables that drive stock prices are the earnings produced by a company and the amount that investors are willing to pay for them. When investors turn cautious and the markets enter a trading range, attention is directed to earnings to complete the picture. Having posted four consecutive quarters of twenty percent growth, the earnings picture has shown impressive improvement in the face of considerable political and economic uncertainty.

The consternation caused by the war in Iraq, the outcome of the election and the rising price of energy to name a few, has translated into an essentially flat market as measured by the S&P 500 for most of this year. Stock prices anticipate conditions down the road a bit and the view has not been all that rosy for some time. Meanwhile, earnings from a broad array of businesses have surged for most of the past year. This combination of events has actually caused the widely watched price/earnings ratio for the S&P 500 to drop to below 20 for the first time since the mid 1990's. Just two years ago, the P/E was 36.

There has been a lot of negative news for stocks lately. Economic growth has moderated since last spring. Stubbornly high energy prices will hurt consumers and businesses alike. The Federal Reserve is removing stimulus by raising short-rates. Geopolitical risks are causing everyone to worry. In spite of all of this, the impressive surge in earnings has already lowered the P/E on the S&P 500 to a low enough level to provide support for stocks.



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