

INVESTMENT UPDATE

Executive Summary

- The U.S. economy is approaching the second full year of recovery with real growth of +3-3.5% expected in 2011.
- Corporate earnings and free cash flows are at record levels and are anticipated to grow another +10-15% in 2011.
- The political winds have shifted with federal, state and European governments slowly moving towards more conservative and market friendly fiscal policies.
- The stock market still offers meaningful upside given reasonable valuations, high investor skepticism, record corporate profits and low interest rates.
- Our bond strategy remains defensive in anticipation of rising interest rates in 2011.

Markets Overcome Global Turmoil

The stock market has nearly doubled from the S&P 500 intraday low of 666 on March 6th of 2009 (see Chart 1) despite numerous challenges over the last two years including fear of a double dip recession, high unemployment, the BP oil spill, financial crises in Europe and the election of 2010. While these events have brought significant volatility, the strong underlying trends have not changed. In fact, these fundamentals continue to improve with corporate earnings and cash flow at record levels, balance sheets the healthiest they've been in a decade, and economic growth gaining strength and becoming self-sustaining.

Chart 1: S&P 500 Index

Figure 1: Doubling of the S&P 500 from its intraday low of 666 on March 6 2009



Source: Bloomberg

The underlying strength of the economy was evident in the first quarter. Despite the increased unrest in the Middle East driving oil prices higher, followed by the earthquake in Japan causing fears of radiation and potential disruptions in the global supply chain, the economy and corporate earnings continued to grow, allowing the markets to overcome these events and finish in positive territory. For the first quarter of 2011, the S&P 500 total return was +5.9%, while the Russell 2000 (small companies) total return finished at +7.9%. International stocks, as represented by the Morgan Stanley EAFE Index, generated a total return of +3.2% for the quarter.

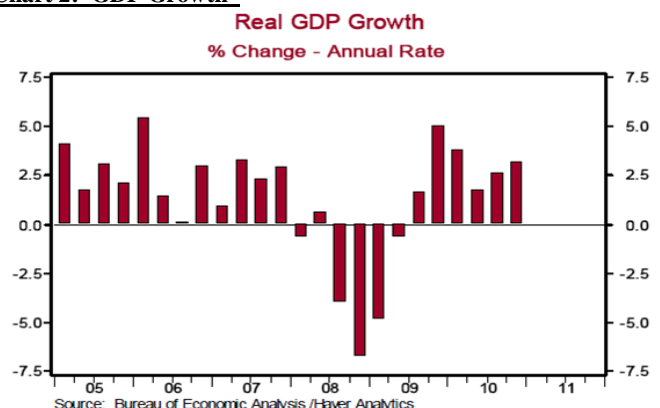
Although the events in Japan are devastating, it is important to keep perspective on the potential economic impact. While current estimates of the cost of rebuilding range from \$200-\$300 billion (approximately 5% of Japan's annual GDP), the global economy, at nearly \$50 trillion, will be able to absorb this shock without a severe impact. It appears that the damaged reactors are being brought under control and that the Japanese will weather this tragedy. The disaster in Japan could actually result in an economic boost in the second half of 2011 as Japan rebuilds its damaged infrastructure.

The increasing civil unrest in the Middle East represents a wild card that could prove positive or negative. While the overthrow of dictatorial regimes is certainly justified, what is left in its wake is uncertainty as to whether democracy or more tyranny will prevail. As the uprising of citizens spread from Egypt to Libya, oil prices rose from \$90 a barrel in late January to as high as \$106 in early March. Libya is the world's 18th largest producer of oil and, therefore, does not threaten the global supply of oil in a meaningful enough way to disrupt global growth. However, the fear over this unrest spreading to the Persian Gulf will continue to put upward pressure on oil prices as regional stability remains uncertain. Nonetheless, at this point, the strong fundamentals supporting global economic growth outweigh higher oil prices.

Economy in Self-Sustaining Growth Mode

The U.S. Economy is one quarter from finishing the second year of recovery (see Chart 2). Growth of +3.0-3.5% is expected in 2011, aided by strong global trade and business expenditures along with moderate consumer spending. As the recovery continues, growth becomes more self-sustaining with the strength in corporate profits resulting in increased employment and wages which drive higher demand and higher profits.

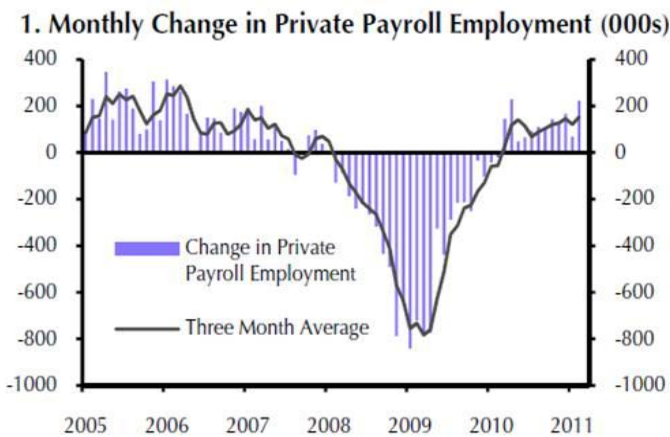
Chart 2: GDP Growth



Source: Bureau of Economic Analysis /Haver Analytics

Typical of most recoveries in their early stages, the missing ingredient in this recovery was the lack of employment growth. This is changing as net private sector job growth has been improving throughout the last two years (see Chart 3). Employment growth averaged +100,000 per month throughout 2010 and will likely average over +150,000 in 2011. As a result, the unemployment rate should continue to gradually head lower this year. The lower unemployment rate along with +4% wage increases in the last 12 months give consumers the ability and confidence to increase spending (+3% real increase in consumption) while also saving more (+6% savings rate) and reducing debt.

Chart 3: Employment Growth



Federal Debt

The “debt and deficit” culture of the past represents the largest challenge to future prosperity. A transition towards balanced budgets will need to take place for growth to continue. The political winds have shifted with federal, state and European governments slowly moving towards more conservative and market friendly fiscal policies. A good example of this is the tax legislation signed into law by President Obama last December which maintains previous tax rates and provides a further boost to economic growth. However, major cuts in spending will be necessary to produce meaningful improvements in the deficit.

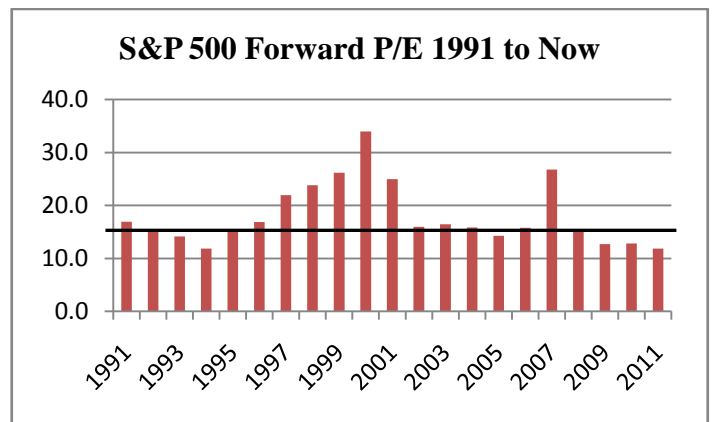
Stocks Remain Undervalued

Even with the impressive recovery since the stock market bottomed in March of 2009, equity prices have not kept pace with the V-shaped rebound in earnings, resulting in forward P/E ratios near their lowest levels since the mid 1990’s(see Chart 4). Despite the strong rebound in the stock market, investor skepticism and cash reserves remain high as investors tend to look backward, not forward. However, it appears that investors are starting to regain confidence in the market as stock mutual

funds recently had net inflows for the first time in over two years.

We believe the stock market is undervalued due to the strong growth in corporate earnings and cash flow. The S&P 500 earnings per share (EPS) are expected to increase by +13.3% in 2011 after increasing by +44.2% in 2010. In addition, strong corporate balance sheets have resulted in a pick-up in mergers and acquisitions, share repurchases and dividend increases. Applying a relatively modest P/E of 14x to 2012 S&P 500 EPS of \$110 results in a price level of 1,540. This represents an attractive potential return of +15-20% over the next 12 months. Our strategy is to maintain above-average equity ratios as stocks remain undervalued.

Chart 4: S&P 500 Forward Earnings



Source – NSAM

Note – Forward P/E based on our estimates of \$98 for 2011 and \$110 for 2012

Bond Market – Continue to Stay Relatively Short

After rising from 2.50% to 3.35% during the fourth quarter of 2010, the yield on the 10-year Treasury Note climbed to a high of 3.70% before falling to 3.50% at the end of March as investors sought a safe haven from the events unfolding in the Middle East and Japan. Interest rates are likely to rise this year as the Fed ends quantitative easing (QE) in June and its zero interest rate policy (ZIRP) later in the year. Continued economic growth, growing inflation concerns, government debt expansion and the reversal of the strong flow of investor dollars into bond funds should also contribute to higher rates. As a result, we continue to recommend a defensive bond strategy with short durations. Should rates rise as we expect, we will likely revisit our strategy and potentially lengthen durations to take advantage of the more attractive yields.

In accordance with SEC Rule 204-3(b), our Form ADV Part II is available upon request. Please call or write to Susan C. Beaver, North Star Asset Management, Inc., P.O. Box 8012, Menasha, Wisconsin 54952-8012