

## INVESTMENT UPDATE

### Executive Summary

- The economy is beginning to stabilize as the aggressive actions by the Federal Reserve, U.S. Treasury and central banks around the world along with the natural healing powers of a capitalistic economy are starting to take hold. The economic recovery should start in the second half of 2009.
- We are increasingly optimistic that the worst of the bear market is behind us. Stock valuations are at historic lows and there is a record amount of cash ready to be invested. U.S. Treasury interest rates are at extremely low levels encouraging investors to invest in riskier assets.
- Investors should start to reduce cash positions, rebalance equity ratios back up, and add more corporate bonds to fixed income portfolios.

### Economy

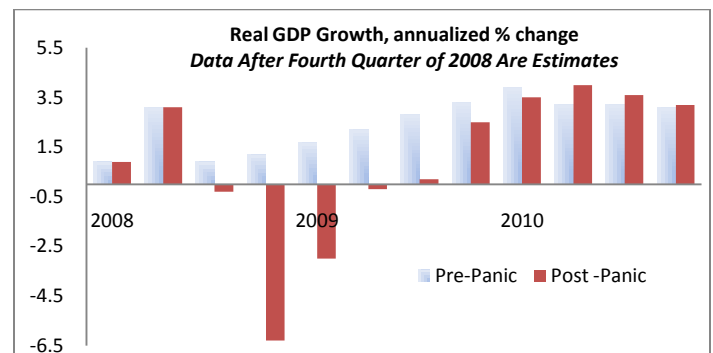
The economy continued to contract in the first quarter as the shock waves from the credit crisis and loss of confidence resulted in more job losses, lower corporate spending, and modestly lower consumer spending. Despite the continued weakness in economic growth, we are increasingly encouraged that the worst of the economic slowdown is behind us as there has been an increasing amount of economic data that is showing sequential improvement. Some of the key data points are:

- Retail sales have been very resilient with sales up +1.8% in January and only down -0.1% in February. This is a significant improvement from -3.1%, -2.1% and -3.4% retail sales growth in December, November, and October, respectively. Excluding autos, retail sales have been even stronger with sales up +1.6% in January and +0.7% in February.
- Real disposable income was up +2.2% in February yoy, in line with the last four year average annual growth of +2.3%. In the last three months, disposable after tax income is up at a +4.6% annualized rate.
- The savings rate has increased to 5% from 0% a year ago. The increase in savings is a result of higher disposable income and reduced spending. The fact that consumers have been able to improve their savings rate so quickly bodes well for a strong economic recovery once they regain greater confidence in the economy and their own financial situations.
- Both new and existing home sales are showing signs of bottoming with new home sales up +4.7% and existing sales

up +5.1% in February. A positive sign that housing prices are near a bottom is that the inventory of new homes for sale fell to 325,000 in February, down -43% from the peak in 2006 and the lowest level since 2002.

- The Philly Fed Index, the Richmond Fed Index, and the ISM Manufacturing Index (measures of manufacturing activity) have shown improvement. This was corroborated by the February durable goods orders which increased by +3.4%, the first increase in durable goods spending in seven months.
- The service sector as measured by the ISM Service Sector Index has improved significantly since December.
- The yield curve has steepened considerably which is helping banks improve profitability. This will set the stage for improved bank lending later in the year.
- Credit markets are slowly starting to thaw.
- Many commodity prices have rebounded indicating economic growth is stabilizing, if not regaining some positive growth. Oil and copper, in particular, are around the same levels as when the global economy first began to pick up in 2004. They are also well above the lows of 2001 and 2008, when the economy was previously going into a recession.
- Weekly unemployment claims have been relatively flat for the past 6 weeks.

**Chart 1: The Economy Finally Appears to Be Improving.**



Overall, the economy still faces a number of challenges with the economic slowdown moving to Europe, corporate and consumer confidence remaining very fragile, continued job losses, and reduced corporate profitability. Nonetheless, it appears that the aggressive moves by the Federal Reserve and the Treasury to stabilize credit markets and boost economic growth are starting to take hold. The natural adjustment process of the economy is also well underway setting the stage for economic growth to resume before year end.

## Federal Reserve Policy

The Federal Reserve continues to be extremely aggressive in its attempt to revive economic growth. Even though the Fed lowered the Federal Funds rate to an unprecedented and extremely stimulative range of 0.0%-0.25% in December, the longer Treasury rates and mortgage rates (determined by the market, not the Fed) didn't decline enough. In response, the Fed decided in March to try to reduce longer term interest rates and mortgages by increasing its purchases of agency bonds and initiating a program to purchase longer term Treasury bonds. The result has been lower long term interest rates and, more importantly, lower mortgage rates. The 30 year mortgage rate is currently at its lowest level in the last 40 years, spurring another mortgage refinancing boom and freeing up additional cash flow for consumers. Longer term, we are concerned that the Fed is being too aggressive in its efforts to stimulate the economy, which will eventually be reflected in higher inflation. Nonetheless, we applaud the Fed for aggressively addressing the economic weakness.

## Fiscal Policy

The Obama Administration has had a rough start with investors. We believe if it wasn't for so many policy mistakes by the Obama Administration and the Bush Administration before that, the economy would be further along the path to recovery and stock market would be considerably higher. The market was initially looking forward to a change as the Bush White House kept making mistake after mistake. Unfortunately, President Obama started following the same path as the Bush Administration away from the fiscal policies that created the longest and largest period of economic growth in U.S. history. Instead of incentivizing individuals to work harder, the Obama Administration is encouraging higher taxes, bigger government, threatening to start trade wars, trying to micromanage the auto and banking industries, and attacking the business community. President Obama's first budget proposal represents the largest increase in government spending since WWII and the largest budget deficits ever. Investors see right through the short term stimulus and are deeply concerned by the prospect of massive increases in the size of government and its attendant rise in tax burdens, both of which represent a significant drag on economic growth.

Fortunately, it appears that President Obama is learning quickly and better understanding the importance of businesses and investors to the economy. In recent weeks the Obama Administration has shown its ability to adapt quickly and has reversed course on a number of anti-business proposals and even has supported some investor friendly proposals such as bringing back the "uptick rule" to limit short selling and revising "mark-to-market accounting" to help the banking and insurance industries. Even the new Treasury Secretary Tim Geithner has regained some credibility with the unveiling of the Public Private Investment Plan to purchase toxic assets from the banking system.

## Bond Market

The yield on the 10-year U.S. Treasury Note at the end of the first quarter was 2.69%, up from 2.25% at the start of the year. The yield was over 3.0% in the quarter before the Fed announced its intentions to purchase Treasury securities. Shorter term interest rates remain at extremely low levels with the 1, 3, and 5 year Treasury Note yielding 0.54%, 1.12%, and 1.67%, respectively. The Salomon Broad Investment Grade Bond Index produced a total return of +0.2% in the first quarter while the investment grade bond index return decline by -5.0% and the 30-year Treasury Bond produced a -15.5% return in the quarter.

Interest rates are being influenced to stay at these extremely low levels by the Fed's desire to maintain the Fed Funds rate at 0.0-0.25% along with its significant purchase of longer term Treasury securities. Both actions are highly stimulative and potentially inflationary. Eventually, the Fed will need to stop manipulating interest rates lower and allow interest rates to rise. With rates at such low levels, even a small increase in rates can result in large losses in longer term bonds, such as the -15.5% return for the 30-year Treasury Note in the first quarter. As a result, we continue to recommend a shorter-than-average duration for bond portfolios.

## Stock Market

Despite rising by +8.5% in March, the best month since October 2002, the S&P 500 finished the first quarter down -10.9%. Both International and small stocks underperformed the S&P 500 in the quarter with the EAFE return at -13.9% and the Russell 2000 return at -15.0%. As investors begin to look beyond the current slowdown and toward the recovery in the second half of the year, the stock market will begin to respond positively. Especially considering that stock market valuations are at extremely low levels, the dividend yield on the S&P 500 exceeds the 10-year Treasury Note yield for the first time in fifty years, and there is more cash in interest bearing savings accounts and money market investments than the total value of the U.S. stock market. Therefore, we are suggesting a moderately more aggressive investment strategy that involves reducing cash positions, rebalancing equity ratios higher, and adding corporate bonds to fixed income portfolios.

**Chart 2: For the First Time in 50 Years the S&P 500 Dividend Yield Exceeds the 10-Year Treasury Note Yield**



*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 54952-8*

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