

## INVESTMENT UPDATE

### Executive Summary

- Recent investor reactions based on fear not fundamentals.
- European debt crisis is worrisome but is creating a significant shift towards fiscal austerity which is extremely positive for stocks in the long run.
- Real GDP growth of +2-3% is expected over the next 12 months.
- Interest rates should move higher as economic growth continues and the fear mentality eases. Stay relatively short.

### Stock Market – Fear Mentality, Not Fundamentals Drove Stocks Lower. Stay the Course

Fear is back in vogue. After a year in which the market was primarily focused on the core fundamentals of an improving economy, strong growth in corporate profitability, and very attractive stock prices, the market has once again been distracted by a number of fears. Some of the fears have merit while most appear to be overblown. We believe the market has once again over-reacted to the negative news and is presenting long-term investors with another opportunity to purchase stocks at very reasonable prices.

The main fear in the market is over the large debt burdens and budget deficits of many of the European countries with Greece being the weakest. The fear is that Greece will default on its debt and trigger a credit crisis in Europe that would spread to the rest of the world and lead the Western nations (including the US) into another recession. We agree that Greece and most European governments (and the U.S.) have overspent and created huge budget deficits and debt levels that need to be reduced. However, we disagree with the conclusion that the fiscal austerity measures underway in Europe (and in many states and local municipalities) are an overwhelming headwind for worldwide economic growth and stock prices.

After years in hibernation, the bond vigilantes have returned and are forcing nations into more fiscally responsible behaviors. They started with Greece by boycotting the purchase of their bonds, thereby forcing interest rates on its sovereign debt to levels that it couldn't afford. The threat of higher interest rates has been a wakeup call to investors and politicians in other highly indebted countries. Fortunately, the European Union (led by Germany) and the European Central Bank (ECB) came to the rescue of Greece and the other highly indebted European nations such as Portugal and Spain, with a €750 billion (approximately \$925 billion) fund intended to give the countries the time (approximately 2 years) needed to get their financial situations fixed. Many are concerned that the rescue plan only pushes the

problem into the future as Greece and the other highly indebted nations may not have the political will to follow through on the austerity measures needed to make a difference. The fear is that the fall of Greece will start a domino effect in which Spain, Portugal, Italy, etc., end up defaulting on their debt, sending all of Europe into recession. On the other hand, we have been encouraged that European nations are attempting to address their own fiscal weaknesses. For instance, Greece has already cut its fiscal budget deficit by 38% in the first five months of this year, far faster than anyone thought possible. Spain, England, France, Italy and Germany have all announced fiscal austerity programs to reduce government spending and even the G-20 nations have agreed for the need to reduce government spending as a percent of their economy.

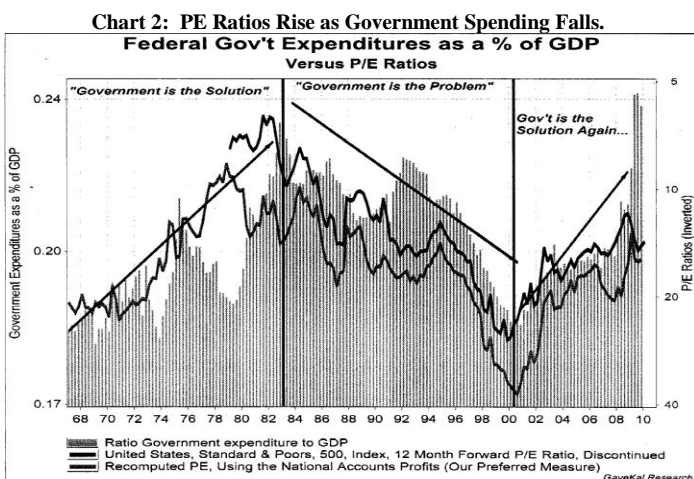
Amid all this worry about the European debt issues, investors are missing a very critical positive development. For the first time in over a decade, the Western nations are starting to believe that increased government spending is part of the problem and not part of the solution. The investment community appears to be very concerned that the reduction in fiscal spending will slow economic growth and potentially force Europe back into a recession. We strongly disagree with this assertion. First, if government spending was directly tied to GDP growth, then the countries with the largest increase in spending should have grown the fastest or have the strongest economies. The opposite is true. Economic growth tends to be fastest when government debt relative to the size of the government is smaller not larger (see Chart 1). The reason is government spending crowds out private spending as government spending misallocates capital. Taxpayers and businesses also understand that increased government spending results in higher taxes at some point in the future and adjust current level of spending downward to adjust for the future higher level of taxes.

**Chart 1: Less Government Spending Leads to Faster Economic Growth  
Real GDP Growth as the Level of  
Government Debt Varies**  
(Selected Advanced Countries,  
Average Annual Percent Change)

Country	Period	Federal Government Debt/GDP			
		Below 30%	30% to 60%	60% to 90%	90% & Above
United States	1790-2009	4.0	3.4	3.3	-1.8
Canada	1925-2009	2.0	4.5	3.0	2.2
France	1880-2009	4.9	2.7	2.8	2.3
Germany	1880-2009	3.6	0.9	N/A	N/A
Italy	1880-2009	5.4	4.9	1.9	0.7
Japan	1885-2009	4.9	3.7	3.9	0.7
United Kingdom	1830-2009	2.5	3.4	2.1	1.8
20 Country Average		3.7	3.0	3.4	1.7
20 Country Median		3.9	3.1	2.8	1.9

Source: Reinhart, Carmen M., and Kenneth S. Rogoff. "Growth in a Time of Debt," IMF, OECD, World Bank

In addition to faster economic growth, stock market valuations (PE ratios) tend to improve as government spending is reduced (see Chart 2). There are several reasons for this. First, increased government spending (bars within Chart 2) is usually accompanied by increased government regulations, increased taxes on businesses, and slower economic growth. All of these tend to depress investor confidence and PE ratios (line graph in Chart 2 inverted). Second, as government spending declines, economic growth improves, corporation profit growth rates increases, and investor confidence returns, resulting in higher PE ratios for stocks. While we are still early in the process, for the first time in over a decade, it is becoming politically acceptable, if not preferable, to promote a reduction in government spending. The process is already underway in Europe and should begin in the U.S. next year. The political environment is set for a massive upheaval of both political parties in the U.S. towards the more fiscally conservative members of each party (Reagan Republicans and JFK/Clinton Democrats). This change should be well received by the stock market.



Although this apparent change in trend towards smaller government is very positive over the longer term, both the stock and bond markets are currently fixated on negative current events such as the BP oil spill, the potential slowing of growth in China, the European debt crisis, and the potential for a double dip recession. As a result, investor psychology has turned quite negative resulting in global stock market losses in the 2<sup>nd</sup> quarter, erasing sizeable gains in the first part of the year. The S&P 500 declined by -11.4% in the quarter while the Russell 2000 and international stocks (EAFE) fell by -9.9% and -14.0%, respectively. For the year, the major indices are negative with the S&P 500 down -6.7%, EAFE declining by -13.2%, and the Russell 2000 falling by -2.0%. Investors have fled stocks and other “risky” assets in favor of “safe” assets such as government bonds and money market investments. Despite the setback in the second quarter, the stock market, as measured by the S&P 500, has produced an incredible +60% gain from the March 9, 2009 intraday low of 666.

Even with the potential slowdown in economic growth in the second half of the year due to the contagion of the European

debt issues, the stock market remains extremely undervalued and attractive for long-term investors. There are many positive fundamentals, including an extremely easy monetary policy, a gradually improving economy (we expect moderate +2-3% growth in the second half of the year) that is beginning to create new jobs, low interest rates, growing corporate earnings, and near record levels of corporate and investor cash that are being ignored. We continue to believe the positive factors outweigh the concerns and anticipate the S&P 500 approaching 1,400 over the next 12-18 months. We are using the current weakness in the stock market as a buying opportunity and recommend maintaining our stock allocation towards the upper half of one’s targeted range.

An important aspect of this economic recovery is the rebalancing from a consumption-led economy to a production-led economy. Over the last decade, the U.S. has helped develop the emerging markets with its large current account deficit (excess consumption). As the emerging countries have developed and grown, their economies have grown in size so that they are now becoming the engine of global consumption growth. In fact, the combined consumption of the emerging countries (China, Brazil, India, etc.) now exceeds consumption in the U.S. and is growing at a much faster rate. The increase in emerging market consumption along with the relatively weak U.S. dollar versus the emerging markets will enable the U.S. to rebalance its economy with production and savings growing faster than consumption and debt over the next several years. Although this transition will result in a stronger and more balanced economy, it will also likely be accompanied by fears about the relatively slow recovery of U.S. consumer purchases.

### Bond Market – Stay Relatively Short

Bond investors have been the beneficiaries of the increased fear as investors flocked to the safety of U.S. Treasury obligations. Interest rates declined substantially in the 2<sup>nd</sup> quarter with the yield on the 10-year U.S. Treasury Note falling to 2.95% from 3.83% and the 1-year U.S. Treasury Note yield decreasing modestly from 0.38% to 0.33%. The Salomon Broad Investment Grade Bond Index produced a total return of +3.7% in the 2<sup>nd</sup> quarter and +5.3% for the first half of 2010. A short-term positive of the European debt crisis is that the Fed will have more flexibility to keep short-term interest rates at the current level for the remainder of the year. This has also contributed to the decline in interest rates along the yield curve. Any expectations of increasing short-term interest rates in the next six to nine months have been removed. Nonetheless, with the economy gradually recovering, inflation close to 2.0%, and monetary and fiscal policies still extremely stimulative, we continue to recommend a shorter-than-average duration for bond portfolios as positive economic news and a reduction of the fear mentality will likely result in higher interest rates.

*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*