



Thanks to a hearty Santa Claus rally, and despite the continued existence of significant headwinds, US stocks achieved solid gains in 2010. Overseas, the returns were mixed, with some smaller markets showing strong gains, and others, particularly the European PIIGS (Portugal, Italy, Ireland, Greece and Spain) and China, posting significant declines. **In retrospect, the year was anything but stable, with the market swooning at the outset, and then staging an impressive recovery beginning in late summer.** As we all know, this pattern of volatility has become the ‘norm’ in recent years. In the ‘fun fact’ department, roughly three-quarters of the entire year’s market gain took place over 5 days, each of which was the first trading day of a month. In all, 94% of the gain occurred on ‘first days’.

In light of the generally low yields available from high quality securities, we were particularly pleased to see stock dividend payments return with a vengeance, as 1,729 US companies increased payouts in 2010, providing almost \$29 billion of additional income to investors. Yet, despite the better news on this front, it may not be until 2013 before total dividend payments return to the level of 2007.

Bond returns were modestly positive in 2010. **Interest rates declined through**

most of the year as investors focused on the weak economy. This trend shifted in the fall, mainly due to concern with the Federal Reserve’s announcement of a second major monetary stimulus program, and to anticipation of improving economic conditions. Since October, the 10-year Treasury note yield has jumped from 2.4% to 3.4%. Corporate debt has fared better than municipal issues due primarily to concern over credit quality. Some investors have become uneasy with the municipal market, resulting in somewhat higher tax-exempt bond yields, and increased financing costs for certain state and local governments. These concerns are justified as state and local officials grapple with a growing list of challenges related to pension obligations, Medicaid mandates, and economic stress. Fortunately, most municipalities have options to maintain their creditworthiness (higher fees, expense reductions, operating efficiencies), and state governments are generally required to balance their budgets. While doom and gloom stories dominate the airwaves, we have always considered credit selection to be a top priority, and the current weakness in the muni market is providing opportunities as, in many cases, the baby has been thrown out with the bath water.

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compared with the 2008-2009 period.

The credit crisis faded, US elections provided divided government, existing tax rates were extended, and the economy appears poised to improve. However, prior to September, when most of the better ‘news’ started to develop, investors fretted about the fractious political climate, the anti-business regulations promulgated by the administration, Europe’s economic and debt woes, and worries over a possible double dip recession. Continued weakness in the US housing environment, and mountainous debt and deficits also cast a pall. In surveying these worries, one might ask what has changed, since none have been resolved. What did change was the Federal Reserve’s decision in October to implement a second round of quantitative easing (QE2), and a rally cry of “don’t fight the Fed” has since propelled the market higher.

As with many significant policy decisions, additional and unintended consequences of the

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Fed’s money printing actions are evident far and wide, including sharply higher prices for commodities, and interest rate increases by central bankers the world over. Prices for copper, corn, coffee, and cotton all surged in 2010, and gold finished higher for the tenth consecutive year, as increasing numbers of investors are concerned about the value of paper-based currencies. Indeed, the Fed’s easy money policies have rippled throughout the world. The Chinese central bank estimates that of every new US dollar printed, 40 cents ends up in China. These dollars are finding homes abroad for good reasons: higher interest rates, better growth opportunities, and less risk of devaluation. **Unfortunately, with all this liquidity sloshing about, global inflation is beginning to rise.** In reaction, China, India and Russia have raised interest rates, and Brazil recently signaled its intention to do the same. Additional repercussions are likely in 2011, and we expect US inflation and interest rate levels to rise as well.

Outlook

Recent data, foretold by the stock market, portends an improving economy. Business conditions, as measured by indicators such as industrial production, retail sales, personal income, and initial jobless claims, suggest that US and global growth is gaining traction. With fewer near-term uncertainties, including taxes and anti-business legislation, confidence has improved and there seems to be enough momentum to support

reasonable GDP growth this year. It should be noted however, that while incremental healing of the economy has occurred, this recovery is relatively weak from a historical perspective.

With regard to equities, in the very short run, a correction of modest magnitude should not be a surprise.

In each of the last two quarters the major stock indices have achieved double digit returns - quarterly gains of this magnitude have occurred only 16 times over the past 30 years. Moreover, after gaining almost 25% in such a short period, sentiment indicators have reached levels that often signal a coming retrenchment. **For the year as a whole, the outcome is harder to predict, as compelling evidence exists to support both moderately bullish and bearish views.** Due to the building economic momentum, and abundant liquidity, it is hard to argue against a favorable overall result. Moreover, stock valuations are not unreasonable, with the S&P 500 currently priced at 14 times this year’s expected earnings, which is below the historic norm. Anecdotal evidence also supports a positive bias - malls are packed again, airplane seats are full, and restaurant reservations have become more difficult to procure. Lastly, 2011 represents the third year of the Presidential election cycle, almost always a positive year for stocks. The most glaring problem with a favorable outlook is that it mirrors the consensus view. Beyond just investor sentiment being heavily tilted toward the optimist camp, Wall Street strategists almost universally see 10-15% market gains, and analysts are of one mind about the

positive outlook for earnings prospects. At least in the near-term, a healthy dose of skepticism is probably warranted.

Once we reach the latter half of 2011, a major question for market participants will be the action, or inaction of the Federal Reserve. Will QE2 be the last liquidity injection for this economic cycle? Will the Fed raise short term interest rates? Conversely, will the economy, banks and financial markets require additional stimulus to remain stable? The answers to these questions will be instrumental in determining the direction of most investment markets.

It’s All About The Debt

There are always big picture issues to be concerned with, and numerous ‘flash points’ that can upset the markets. Usually, those most difficult come out of the blue. However, there are also those that are deep-rooted and stubbornly difficult to solve. Today’s seemingly intractable problems, to name a few, include the fiscal problems facing many Western nations, Iran’s nuclear ambitions, rapidly rising food prices, international trade protectionism, and increased US government interference in the economy.

However, the issue of debt makes all others pale in comparison. We have focused on this time bomb for some time, and it is not an exaggeration to say that positive economic and financial market trends cannot be sustained until the extreme risks associated with US debts and obligations are brought under

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control. **Over the past several decades, economies around the globe have underwritten their lifestyles largely through the assumption of enormous amounts of leverage.** The borrowers include national and municipal governments, businesses and individuals. The debt has taken the form of overt borrowing as well as future commitments, including retirement related promises. **The totality of these obligations now weighs heavily on global economies, is unsustainable, and needs to be addressed. How this overarching and ubiquitous challenge is tackled will influence investments for years to come.**


The facts are startling: US Federal debt hit the \$14 trillion mark early in 2011, with almost \$5 trillion of the total having been borrowed in the last two years alone. During this time, when individuals and corporations were tightening their belts, government discretionary spending (non-defense) rose by 41%. The record on this front is clear: the more debt added, the slower an economy grows. The co-chairs of the President's debt and deficit commission, one Republican and one Democrat, recently offered an ominous assessment of our nation's fiscal future, saying that current trends “will destroy the country from within” unless tough decisions are made. Pretty strong stuff, but 100% accurate in our view.

The extreme volatility of recent years can be tied directly to this debt issue. **The ‘systemic shocks’ that have upended the markets, including the**

US financial meltdown and the more recent European debt crisis, resulted mainly from the fact that excessive leverage is now the ‘tail wagging the dog’. Until the risks associated with this mountain of debt are under control, investors should expect further market disruptions. Most objective analysts agree that we cannot grow or tax our way out of this problem, and that spending must be drastically reduced. The debt crises faced by a number of European countries has provided governments there with sufficient cover to enact necessary austerity measures. The US will likely be forced to do the same, or risk major fallout for the economy, dollar, and financial markets. There is one piece of good news on this front. **The new political balance in Washington will result in proposed spending reductions, and we should know some time in 2011 if the administration and Congress are serious about making the difficult decisions that are necessary. If they do, we strongly believe that the long-term outlook for economic growth and investment returns will be substantially improved.** If meaningful debt reduction can be accomplished, and a credible deficit plan is put in place to truly address the nation's fiscal challenges, the next period of prosperity in America may arrive sooner than most expect. If not, we would expect the consequences to be severe, including much higher interest rates and unemployment, and turbulent and poorly performing investments.

Conclusion

The year ahead will no doubt include some ‘excitement’, but, in general, certain major underlying trends provide reason for near-term optimism. There will be several key areas related to the economy and government policy making that require our attention. In short, **we are hoping that the underlying long-term fundamentals of the world's major economies will be put on paths toward firmer footing. While progress may be slow and incremental, the benefits of such trends would be positive and enduring.**

‘Fear and Greed’ and ‘Risk and Reward’ have always been tightly entwined concepts that heavily influence investment returns. Over the past decade, an insatiable appetite for risky assets led to the technology and real estate bubbles, ultimately giving way to the extreme fear and collapse of late 2008 and early 2009, and the roughly 90% market advance over the past 21 months. In hindsight, the good markets were not as firmly rooted as many believed and the bad markets were not as dire as many pundits and publications espoused. Investors who kept their equilibrium despite the convulsive advances and declines, and remained committed to a sensible investment approach, survived. The importance of adhering to a logical investment plan through varying market conditions, proved to be, and remains, critical to achieving investment success. 

Managing Director Profile



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John J. Sobel
Managing Director

John has over 19 years of experience in the investment industry. He joined Lodestar in 2000 after holding the position of Portfolio Manager with Salomon Smith Barney in Seattle, Washington.

John earned his undergraduate degree (BA) from the University of California at Los Angeles, and received a Master's in Business Administration degree from the University of Washington in Finance and Marketing.

He enjoys spending time with his family, and is involved in community affairs.

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Market Snapshot - December 31, 2010

| <u>Equity Indices</u> | <u>Quarter</u> | <u>YTD</u> | <u>Interest Rates</u> | <u>12/31/10</u> | <u>12/31/09</u> |
|-----------------------|----------------|------------|--------------------------|-----------------|-----------------|
| S&P 500 | 10.76% | 15.09% | 5-Year Tax-Exempt AA | 1.80% | 1.70% |
| Dow Industrials | 8.03% | 14.06% | 5-Year US Treasury Notes | 2.05% | 2.71% |
| NASDAQ | 12.00% | 16.91% | | | |
| Wilshire 5000 Index | 11.14% | 15.69% | <u>Commodities</u> | | |
| | | | Gold | \$1,405.50 | \$1,100.00 |
| | | | Oil - WTI (\$/Barrel) | \$91.38 | \$79.36 |

“Lodestar”: 1 *A guiding principle, interest, or ambition.* 2. *A star, especially Polaris, that is used as a point of reference.*

Lodestar Investment Counsel was formed in 1989, as an independent registered investment advisor, with the above definitions firmly in mind. All of our principals have extensive experience working with high net worth individuals, families, corporate and individual retirement plans, and charitable organizations, like those who make up our client base today.

We recognize and respect the need to grow and preserve our clients' core

assets. Our services are designed to provide a risk-averse approach to long-term capital appreciation, that is tailored to the unique financial circumstances and needs of each specific investor. We provide discretionary account management for taxable, tax-exempt, balanced and fixed-income portfolios.

To assure that all our clients receive a high level of personal service, our minimum account is \$1 million in investable assets. In all aspects of our

business, we strive to adhere to the guiding principles of focus, consistency and service.

We would welcome the opportunity to meet with you, or others you know who might benefit from our services.

*Robert H. Dearborn
Peter W. Flanzger
Mark Ganchiff
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