



The world is experiencing, and working through, a most interesting time in history. Substituting challenging, disturbing, gut-wrenching and the like, for ‘interesting’ may better describe our collective feelings over the past twelve months. Whatever adjective one chooses, significant events, financial and otherwise, have transpired at speeds previously unimaginable. From our perspective, this environment mandates that investors, more than ever, maintain a clear focus on unfolding events, expect the unexpected, and prepare for the unintended consequences that will surely result from economic developments of the recent past. Maybe all of this goes without saying in a dramatically changed global setting, where foreign powers are now calling for the demise of the US dollar as the world’s reserve currency, and the state of California is now paying its debts with IOU’s.

The stock market rallied smartly in the second quarter of 2009 yet,

despite this advance since the March lows, the major US averages have only returned to roughly breakeven for the year. **This recent equity market bounce should come as no surprise, as stocks have always rallied by 30-50% at some point in the year following severe sell-offs.** Also not surprising was that the poorest quality companies (i.e. weak financial condition, high debt levels, low or no dividends, negative profit outlooks etc.) lead the way up, as generally these were the groups that were most eviscerated on the way down. In short, **the advance felt very much like a ‘relief rally’, as forecasts for financial Armageddon dissipated a bit.** Similarly, within the bond market, low quality trumped high quality, and in fact the prices for US Treasury securities experienced one of the worst quarterly declines in recent decades. In short, the ‘flight to quality’ that ensued as investors sought safety last year and earlier this year, was partially unwound over the past three months.

The market advance occurred in the face of mounting job losses, weak

corporate profits, and simply sour news. **A telling commentary on current business conditions is reflected in a Standard and Poor’s report that shows the number of companies that raised their dividends in the second quarter was a record low, and the number of companies that reduced their dividends was the largest in 50 years.** Only 4 of the 30 Dow Jones Industrial companies (Exxon, IBM, Johnson & Johnson and Procter & Gamble) increased their payouts, and the aggregate distribution by the 30 Dow companies fell 18% from the prior year. In short, few industries have been spared the pain since, with consumer spending representing 70% of economic activity, and households taking the brunt of this recession, the tentacles

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	June 30, 2009	June 30, 2008	Change
S&P 500 Index	919	1,280	-28%
MSCI World Index	964	1,402	-31%
Oil (per barrel)	70	140	-50%
Consumer Spending	-2%	+5%	-140%
Unemployment Rate	9.5%	5.6%	+70%
Federal Funds Rate	0.25%	2.00%	-88%

of the downturn have spread far and wide.

The above chart provides a basic perspective on the economic and market gyrations of the past twelve months. This ‘picture’ illustrates economic decline, financial pain, and the Federal Reserve’s efforts at resuscitation. More specifically, this period witnessed the collapse of some of the world’s largest and most successful companies, unprecedented government intervention, and the end of an era of easy borrowing and free spending.

There is no way to overstate the pain that broad swaths of the economy, and populace, are currently experiencing. However, **in certain respects the capitalist system is following a prototypical**

**pattern.** Savings rates are rising, household debt is declining, consumer spending is slowing, business inventories have fallen, weaker competitors are vanishing, and balance sheets are mending. These are time-honored responses to recessionary conditions, and should occur. **The problem, of course, is that the pendulum of economic excess had swung so far that getting back in line requires a massive shift rather than a modest adjustment.** Consequently, this recession will lumber on, inflicting additional trauma, very possibly into next year.

From an investment perspective, a key issue is whether the recent jump in stock prices is simply a bear market rally or the beginning of something better. **In light of the**

**pervasive uncertainty generally, the likelihood of a prolonged economic recovery, and the fact that equity valuations are not ‘cheap’, we strongly suspect that the stock market is not totally out of the woods.** On a brighter note, we continue to believe that the March low in stocks will prove to have been the bottom of this bear market, assuming the credit markets continue to mend, and if significant elements of government policy initiatives are not extreme (i.e. health care, energy/climate, taxes etc.).

Looking ahead, **one of the crucial issues for all of our consideration is the extent to which massive worldwide governmental stimulus actions (past and future) spawn inflation, deflation, or both.** Inflation is a scourge to

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investors and savers, and we are intensely attuned to this issue. Deflation is probably worse because there is nowhere to hide (see Japan since 1989). Indeed, the world's leading economists offer persuasive arguments for each scenario.


**On this front, we generally lean toward the ‘inflation risk’ camp,** and envision a scenario of mild deflation in the near term followed by the prospect of troubling inflation levels once the economy stabilizes. Consequently, bond investors should anticipate rising interest rates before too long, and should hold relatively short maturities. For equity investors, maintaining an emphasis on companies with superior financial strength is a must during episodes of deflation (weak economic conditions), or inflation (rising prices). The strongest businesses will survive this recession, and should be able to pass along rising costs to consumers, if and when inflation takes hold. Moreover, equities of such businesses often carry well covered dividends, which are particularly attractive in most any environment. In short, with regard to both stocks and bonds,

the uncertainty associated with future monetary conditions leads us to redouble the focus on high quality securities that can withstand significant changes (deflation to inflation) in business conditions.

Needless to say, investors have been challenged mightily over the past year and, indeed, for much of this decade. The stresses and strains caused by the current credit ‘crisis’ have been wrenching, as they always are following periods of extreme financial excess. We are now in a transition phase as the economy mends, deleveraging occurs, and the investment markets react to the gyrations of that process. As noted, this part of the economic cycle is natural in a capitalist system, and is necessary if business conditions are to emerge in a truly healthy state.

**We have suggested previously that ground zero for an economic and market recovery rests with the credit markets, and the significant progress in this arena has been heartening.** All is not perfect with borrowing and lending conditions, but they are vastly improved (thanks in part to government support) from just a few months ago.

The economic recovery will take time, and the ‘news’ will likely worsen before tangible positive developments are broadly apparent. Typically, the investment markets will anticipate these shifts long before the headlines turn positive. We intend to remain focused on the quality and liquidity of our client's investment positions, to err on the conservative side of security selection, and to be sensitive to the probability of inflationary challenges ahead.

Please call us with any thoughts or questions on this commentary, or if we may be of any service to you. 

## Managing Director Profile



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Kimberly A. Geary  
Managing Director

Kim has over 25 years of experience in the financial services industry, and has been with Lodestar since the firm's founding in 1989. She is a Managing Director, with complete oversight of the company's operating and finance departments. In addition, she serves as the firm's Chief Compliance Officer.

Over the years, Kim has also enjoyed having extensive contact with our clients with respect to their accounts at Lodestar.

Kim graduated cum laude from the University of Illinois with a Bachelor of Science degree in Business Administration.

In addition to enjoying time with her family and participating in community and charitable organizations, she is an avid outdoor enthusiast.

Kim may be reached at 312.630.9666 or at kim@ldstr.com.

## Market Snapshot - June 30, 2009

<u>Equity Indices</u>	<u>Quarter</u>	<u>YTD</u>	<u>Interest Rates</u>	<u>6/30/09</u>	<u>6/30/08</u>
S&P 500	15.92%	3.19%	5-Year Tax-Exempt AA	2.25%	3.47%
Dow Industrials	11.92%	(1.99)%	5-Year US Treasury Notes	2.41%	3.39%
NASDAQ	20.05%	16.36%			
Wilshire 5000 Index	16.21%	3.75%	<u>Commodities</u>		
			Gold	\$934.50	\$930.20
			Oil - WTI (\$/Barrel)	\$69.89	\$140.00

**“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. Flanzer  
William A. Goldstein  
John J. Sobel*