



All Star Quarterly

Second Quarter 2006

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2nd Quarter Review & Preview

Market confronts a triple threat – **Inflation, Slower Growth, Profit Pressures**

Overview

The second quarter proved to be a time when most news of a positive nature was quickly balanced out by areas of growing concern for investors. The **biggest issues** were signs of a **slowing economy, moderating corporate profits and continued inflation threats**. The Federal Reserve did its part as well, **raising interest rates** during the past quarter for the **16th and 17th** time in the **last 24 months**. The last hike came on June 29, when it bumped the Fed Funds rate to 5.25% from a low of 1.0% two years ago.

The Fed was not alone. **Central Banks in Europe and Japan** also tightened monetary policy, leading to a sell-off in both equity and bond markets overseas.

Corporate profit growth during the period continued to exceed expectations, but there are **clear signs of a slowdown** in the rate of earnings increases, adding to investor concerns. Leading economic indicators and statistical releases indicate that the economy is not as robust as it appeared at the beginning of 2006. On top of that, energy prices remain stubbornly high, contributing to inflation fears.

The biggest question investors appear to be grappling with at mid-year is which battle the Fed will

fight - inflation (by continuing to raise interest rates) or **slowing economic growth** (by halting rate hikes or even lowering rates)?

Economy

The 2nd Quarter

Is this as good as it gets for this economic cycle? In the 1st quarter, the economy grew at a robust 5.6% rate, achieving nearly full employment. Manufacturing hit a peak with over 80% capacity utilization. These are all positive signs, but also appear to be the high water mark for this cycle.

Still, **the economy has held up rather well in the 2nd quarter**, particularly given the continued impact of higher energy prices. Most companies seemed willing to hold the line on prices and avoid “passing through” higher gas costs over the past year-and-a-half, but there are signs that this is changing. Consumer prices rose by an annualized rate of 4.2% in May. The positive note related to prices is that the “core inflation” rate (excluding the more volatile food and energy sectors) was a more modest 2.4%.

Corporate profits rose a healthy 12% in the 1st quarter and business spending was up 10%, a sign that companies remain positive about prospects for the economy.

Consumer spending also remains solid, but it is **showing signs of fatigue**. The **housing boom** may officially be **ending**, as this sector slowed and new construction and residential real estate prices have declined substantially in recent months.

Looking Ahead

Although it seems likely that the rate of economic growth will slow in the months to come, **the general trend remains positive**. The biggest concern is that the Fed will **overdo its “inflation-fighting”** stance and cause a more serious slowdown.

BOB’S CORNER

“Sell in May and Go Away”

Is it true that the six months starting in May and ending in October of every year is a poor time in the market? Great question and the answer is YES. Since 1945, the average return for those six months is 1.5%, while the return for the six months from November to April has averaged 7.1%. There are many reasons for this but for the most part it is summer vacations, and the political uncertainty leading up to November. There has been 22 years over this 60-year time period; however, when the May to October time period has out-performed. What that tells me is you can not time the market and need to be in the market (albeit a little less exposure). Remember “It’s not timing the market, it’s time in the market!”

ASF Contact Info:

Phone: 952-896-3820
Fax: 952-896-3819
Toll Free: 888-809-7901
E-mail: asf@allstarfinancial.com
Website: www.allstarfinancial.com
Bob Klefsaas, President: 952-896-3816
Maren Aipperspach, Vice President: 952-896-3817
Bruce Bonner, Research Analyst: 952-896-3818
Paul Sommerstad, Account Executive: 952-896-3835
Nick Hohn, Account Executive: 952-896-3823
Trent Klatt, Account Executive: 952-896-3826

The mid-year *Wall Street Journal* survey of economists showed that this group expects the rate of **economic growth to slide to less than 3% in 2007**. At the same time, the economists anticipate **inflation will dip below 3%** with an easing of oil prices, and the **unemployment rate will remain under 5%** well into the future. The struggling **dollar** is expected to **continue to weaken** against other currencies.

Corporate profits are expected to rise 14% on average for 2006, but some analysts anticipate the **growth rate could fall below 10% in 2007**, creating another concern for investors.

The long-awaited **move away from small-cap stocks** finally came to fruition in the quarter. The **Russell 2000** (small-cap) Index **declined 5.02%** during the period, while **mid-cap stocks lost 2.58%** as a group.

Hardest hit were **small-cap growth** and micro-cap stocks, both **declining** approximately **7%** for the quarter. It should be noted that we sold all of our positions in the small-cap arena in mid-May, **right at the top of the market**.

Funds that position themselves for market declines, such as **bear market** and **long-short funds**, **gained 4.8% and 2.1%**, respectively, in the 2nd quarter. These are relatively new fund categories and may grow increasingly attractive as the current bull market continues to show its age.

Looking Ahead

The silver lining of the market's woes in the 2nd quarter is that **stock valuations are attractive again**, especially given the corporate earnings outlook and current dividend yields. We won't know about **2nd quarter profits** for a few weeks, but there is every reason to expect **mostly good news**. If this occurs, the **bull market** may be **revived** in the **2nd half of 2006**.

Still, this is a **bull market** that is **long in the tooth**. **Profit growth**, while still solid, appears to be **slowing**. **Interest rates** have **moved higher**, making **lower-risk assets** like short-term **bonds more competitive**. The lower valuations and higher dividend yields of many large-cap stocks will provide some cushion for long-term investors.

Stock Market

The 2nd Quarter

Any chance the stock market had at **gaining momentum** during the 2nd quarter quickly **evaporated** as most of the **emotion** and hype during the period centered on **rising interest rates** and **growing inflation threats**. **Large-cap value** stocks were the **only equity market style to show gains** during the period, but even that was a **meager 0.59%**. Investors clearly showed a **preference for large**, blue chip stocks that can generate **reliable dividends**. Value stocks, in general, were the safe haven during the quarter, **rising 0.28%** across the **Russell 3000 Value Index**. At the same time, growth stocks (measured by the **Russell 3000 Growth Index**) **lost 4.22%**.

Investors focused on defensive sectors in the 2nd quarter. **Utility** stocks **led the market**, gaining **3.8%**, while **natural resource funds returned 3.4%**. Higher gold, silver and platinum prices boosted mining stocks and oil sector stocks benefited from heavy merger and acquisition activity. Not surprisingly, **traditional growth sectors** such as **technology** and **health care** stocks **suffered** the biggest declines.

Performance Update

Annualized Returns

Market Index	2nd Qtr	1-Year	2-Year	3-Year
DJ Ind. Average	.87	11.11	5.87	9.99
S&P 500	-1.46	8.62	7.43	11.18
Russell 2000	-5.29	13.29	10.68	17.34
S&P Mid-Cap 400	-3.14	12.98	13.50	18.12
Russell 3000	-1.98	9.56	8.80	12.55
MSCI EAFE	-.26	23.63	17.01	20.85
NASDAQ Comp.	-7.17	5.60	2.99	10.20
Lehman High-Yield	.25	4.80	7.79	8.62
Lehman Agg. Bond	-.08	-.81	2.93	2.05
Lehman Credit Idx.	-.39	-2.06	2.91	1.96
Lehman Gov. Bond	.02	-1.16	2.67	1.31

Bond Markets

Bonds endured their own struggles during the 2nd quarter as interest rates continued to creep higher. The **Lehman Aggregate Bond Index declined 0.08%** during the three-month period.

High-quality global and world bonds gained 1.5%, aided by a recovery in the euro and yen and a weaker dollar. Shorter maturity debt securities benefited from the environment, with ultra-short bonds, short-government and short-corporate bonds generating positive returns. Inflation-protected **TIPS bonds were up 0.30%** on rising inflation expectations.

There was **no reward for higher-risk bonds** during the quarter. **Emerging market bonds declined 2.5%** as some investors began to see these issues as overvalued. Long-term government bonds lost 2% for the period, and high-yield corporate bonds declined approximately 1%.

Looking Ahead

There is a great deal of **uncertainty** about whether **the Federal Reserve will continue to boost short-term interest rates**, which is disconcerting to the bond markets. Still, as investors begin to take a more risk-averse approach, bonds could benefit. **Bond managers** are indicating that they are **willing to lengthen the average maturity** of their portfolios, **anticipating** that interest rates may be **nearing a peak** for this cycle.

Although the higher risk segments of the market, such as high-yield and emerging market bonds, struggled recently, it may have created more attractive valuation for these sectors. But investors need to be realistic, and **not expect double-digit returns from these bond market segments as in the recent past**. If the dollar continues to **decline** in value versus other major currencies, **global bonds will benefit** in the months to come.

Foreign Markets

Consistent with the theme of risk-averse investing, investors pulled back from previously popular emerging market investments. Worries that a slowing U.S. economy could harm demand for output and products from developing countries, **emerging market stocks declined 4.97%** for the quarter. That downturn occurred despite a sudden 6.5% rebound in value during the final week of June.

Japanese stocks suffered as well, **declining 6.8%** as many export-related companies dependent on U.S. consumers saw significant drops. **Pacific Asia and Latin American stocks also declined 6.8%** during the quarter. By contrast, **European stocks** held up relatively well, with a generally **flat performance** for the period. A large number of European companies have good balance sheets and pay dividends, therefore fitting the value style which is in vogue at the moment. France, the United Kingdom, Sweden and Italy all gained more than 5% in the quarter.

Looking Ahead

Central banks in Europe and Japan are expected to **continue boosting short-term interest rates** in the months ahead, a factor that is **likely to slow growth** overseas. Yet we remain optimistic about prospects for foreign stocks relative to domestic markets. European stocks look to be attractively priced, particularly given the fact that many pay high dividends. Growth rates in Canada and Japan mirror those in the U.S., with more attractive currencies. The big players among developing markets, such as **China and India, continue to expand their economies at a 6% to 9% rate annually**. Combine these positive factors with the recent sell-off, and **global stocks appear to offer real opportunity**.

As is usually the case, **overseas markets** also carry **some risks**, heightened these days by **geopolitical tensions**. **Mexico's recent Presidential**

election could be disputed and leave an aura of uncertainty. The situation in Iraq is not stabilizing and **Afghanistan** seems to be **more tenuous** than before.

The **conflict between Israel and Palestine** has heated up in recent weeks, and **North Korea** is now actively **testing missiles**, adding further fear to the markets. **So global opportunities do exist, but with an eye on issues that could create a negative environment**.

Summary

Stock market analysts use terms like "correction," "pullback," "consolidation" or "pausing" to describe the kind of environment we experienced in the 2nd quarter. No matter what you call it, it isn't the kind of situation any investor wants to deal with for long.

In reality, the setback that occurred over the last three months was **minor** in relation to all the **gains realized** in a **three-year bull market**. In fact, the recent high level of day-to-day price volatility seems like a return to normalcy after seven months of fairly stable market performance.

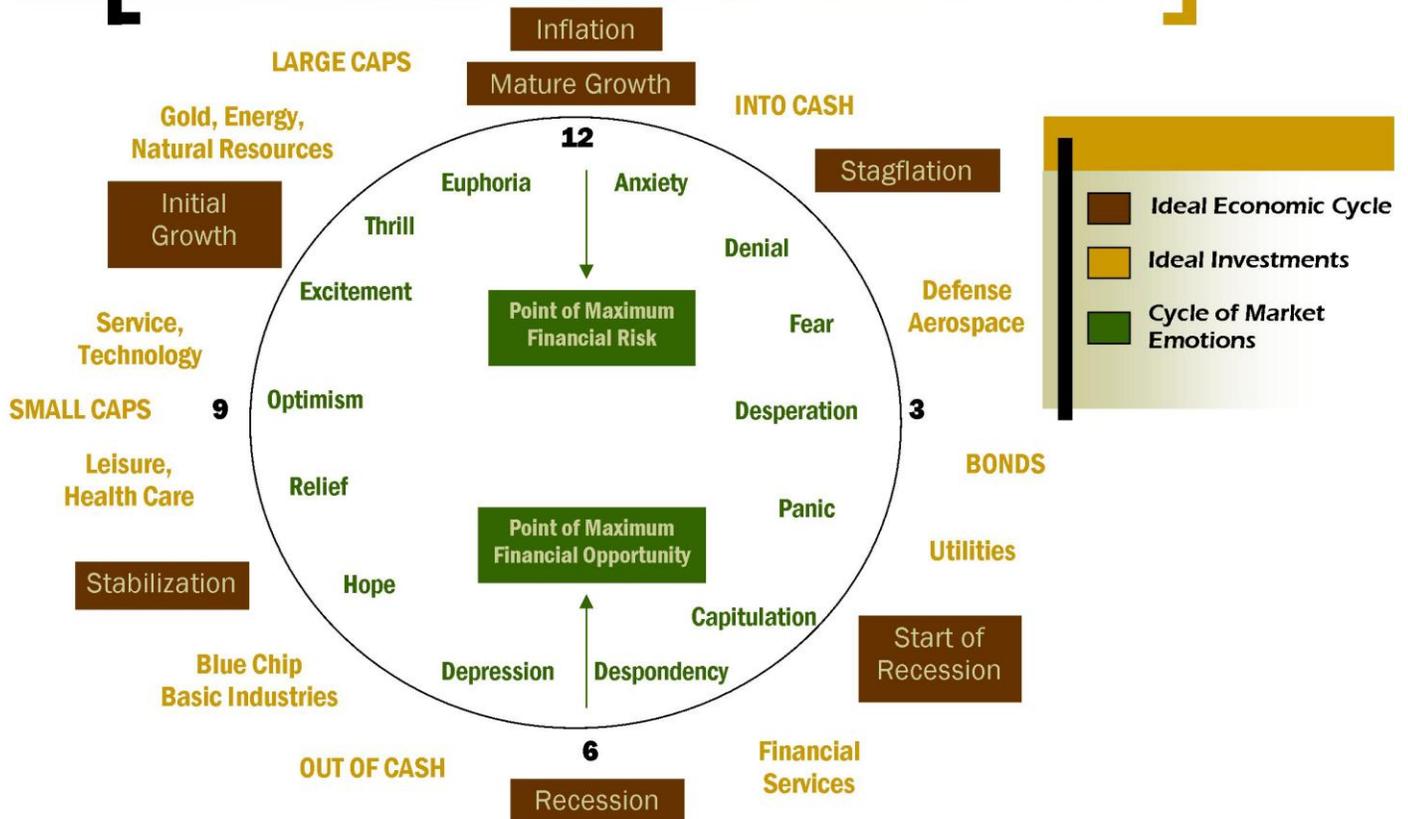
Now is the time to ask yourself if you are a **long-term investor**. If the answer is **yes**, today's equity markets offer solid, **long-term opportunities**. Corporate profits are breaking records and stock valuations, by most measures, are quite attractive. If you **are not a long-term investor**, this may be the time to **consider shifting** to a **more conservative allocation** and take advantage of higher yields from bonds and/or dividend-paying stocks.

The reality all investors must accept is that more price fluctuations are ahead. The bull market is aging and as we near the end of the current business cycle declining growth rates are likely to keep returns in a modest range. **Adjust your expectations accordingly**. Remember, too, that since World War II, the average bull market has lasted 5 to 7 years, so by that standard, there may continue to be opportunity for investors in the current market.



All Star Quarterly

ECONOMIC, MARKET, AND EMOTIONAL CYCLES



IS THIS AS GOOD AS IT GETS?

At All Star Financial, we believe the answer to this question is, yes, we are very close to the top of the market. As we have explained in the past, we manage your assets with a disciplined, economically-based value-driven methodology. This unemotional process has proven to be very successful for us over the full economic, market, and emotional cycles.

We are approaching 12 o'clock on the economic cycle, which means the average investor is starting to come down from their euphoria and starting to experience some anxiety. Looking ahead in anticipation of the next part of the cycle, we have been reducing your domestic equity exposure since the first of the year, selling approximately 14-16% of your domestic stock allocation, and adding 6-8% into the international markets and the remaining 8% into cash. We believe the international markets are at 10 o'clock, on the economic clock, with room to grow. I can promise you that you will go through a variety of tough emotions over the next 12-18 months. The key is to stay unemotional and let us minimize the downside risk by playing defense for awhile. Remember our motto is "It's not how much you make, it's how much you keep!" We are going into a *keeping mode*, where PATIENCE is going to be the key. Are you okay with losing 5% when the market goes down 10%? If not, you should probably be in a more conservative portfolio at this time.