



NCM Client Notification

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To our clients:

Beware of the dominos...

We can best characterize the concerns of our Investment Committee in the context of a game of dominos at the most simplistic level. Set them up as a child would, one after the other in a row, tip the first over and watch the dominos fall, each knocking over the next.

In our investment analogy a bad game with a bad outcome takes place when the first domino represents the PIIGS (Portugal, Italy, Ireland, Greece and Spain) sovereign debt crisis and the final domino the unsustainable US debt load.

A good game with a good outcome plays out if the dominos were not properly aligned. While the first domino continues to represent the PIIGS sovereign debt crisis and the final domino the unsustainable US debt load, somewhere in the middle exists a misaligned domino representing the EU/IMF rescue package. This misaligned domino remains standing, leaving the remainder of the row standing, most likely to fall another day.

What type of a game are we in?

The Final Domino.....

For some time we have expressed concerns about the sustainability of US debt. We are not unique in this regard and such warnings are easily ignored because they have been brought to the fore so many times.

However, alarm bells are sounding as we witness a rapid escalation in both the accumulation and velocity of debt.

Accumulation: The most recent Government Accountability Office (GAO) report states "Our long-term simulations show that absent policy changes the federal government faces an unsustainable growth in debt."

Velocity: The same GAO report goes on to say "debt held by the public as a share of GDP could exceed the historical high reached in the aftermath of World War II by 2020 - 10 years sooner than our simulation showed just 2 years ago."

For our Investment Committee it is not a matter of whether the US will experience an adverse credit event (i.e. default) but instead when. It is a surreal discussion, but represents reality. Denial will extract a heavy price.

The First Domino????

The ultimate outcome of the Euro zone sovereign debt situation remains murky. There are questions about whether the solution can be implemented, what impact imposition of strict austerity measures will have on consumption and trade and most importantly will the Euro survive.

Through April 2010 \$341 of \$519 billion in stimulus has been spent. Of the remainder, the vast majority is committed to states in the form of Medicare and education funding. The sole large remaining category is \$25 billion to be spent on federal infrastructure projects.

If the economy softens, it seems to us the government has very few tools at its disposal. We fear with elections close at hand, more stimulus may be considered. More stimulus results in more debt.

The news is not all bad.

The US recovery remains fragile but intact. Current economic indicators point to a continued gradual recovery in the US economy. Corporate profits are growing.

Market reaction to the employment report last week was somewhat overdone. New private sector jobs were created, but in vastly fewer numbers than anticipated. Additionally, wages, weekly hours worked and productivity all grew.

So we return to our domino game. No one domino represents a disaster. The question is whether events will cascade in such a way to hasten movement towards the final and largest domino.

We are compelled to proactively deal with the current circumstances judiciously understanding we run the risk of an unaligned domino halting the game. Under that scenario stock losses would be short lived and a resumption of the ascent of the market likely.

Our current plan is to continue to liquidate stocks and accumulate cash until we have a better sense of the game's outcome. If conditions deteriorate further, this will be a domino game we prefer to sit out.

Please inform us if you do not wish to adopt a more conservative posture.

Northern Capital Management, Inc.
Investment Committee

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