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Investment Outlook First Quarter 2005

The widely expected fourth quarter stock market rally turned a mediocre year into a respectable year for investors, especially on top of the strong gains achieved in 2003. Once market participants began to anticipate a Bush victory in the hotly contested Presidential race, a celebratory rally took the major stock market indices to their highest levels in over 3 years. The market averages advanced between 10% and 14% from their levels two weeks prior to the election until year-end. For the entire year, the DJIA gained 3.1% the Nasdaq 8.6% and the S&P 500 9.0%. The bond market exceeded most projections for the year as core inflation expectations remained modest and the economy expanded at a moderate pace. Consumer spending was strong and capital spending accelerated from prior years. Employment gains for the full year, though lumpy, averaged approximately 185,000 net new jobs created per month in 2004 and the unemployment rate edged lower to 5.4%. Housing market activity remained robust last year, buoyed by mortgage rates only modestly above their recent low levels. The US international trade deficit widened to record levels, primarily due to a surge in imports and a slowdown in most of the major foreign industrial country's economic activity. While the US federal budget deficit reached a record level of over $400 billion in 2004, it was actually almost $100 billion less than original projections due to stronger than expected tax receipts. Oil prices surged to record levels during the year and remained stubbornly high as traders fretted over rising demand and potential supply disruptions. And the US Dollar weakened further against most major foreign currencies, largely related to our faster growing economy and our low short-term interest rates.

As we embark on a new year, there a mixed signals for both the economy and the financial markets. Optimists point to continued healthy economic expansion in the range of 3.5-4%, low inflation expectations of around 2.0% and corporate profit growth close to 10%. Pessimists are concerned that US GDP growth will be slower than expected, in the range of 2-2.5%, energy prices will stay high, corporate profit growth will slow as demand wanes and profit margins get squeezed and the Fed will continue raising short-term interest rates throughout much of the year. Our own view is that economic activity will remain solid early in the year and inflation will continue to be tame in the 2-2.5% range, but corporate profit growth will indeed slow down to high single digit growth and the Fed will persist in raising the Fed Funds target to a range of 3.5%-4% by year-end 2005. In this environment, the yield curve is likely to flatten further with 2 year US Treasury rates rising toward 4.50% and ten-year rates rising to the 4.75-5.25% range. Persistent Fed tightening is likely to cause the dollar to stabilize vs. the Euro and the Yen, but may well reduce overall US economic growth later this year.

In addition, fiscal stimulus will be lacking in 2005 as the government seeks to contain discretionary spending and additional tax reform is unlikely this year. The US federal budget deficit is projected to contract to $313 billion in 2005 as healthy GDP growth continues to increase tax receipts while budgetary constraint slows spending growth. With global economic activity estimated to slow, energy demand should subside modestly. However, oil prices have become unpredictable given global security threats and the potential for supply disruptions. We therefore expect prices to remain volatile within a wide range of $35-$55 throughout the year. Should oil prices move outside this range for any length of time, it will create either a stimulus (lower prices) or a drag (higher prices) on global economic activity. Employment trends are likely to continue last year's modest recovery with net new jobs averaging roughly 200,000 per month and the unemployment rate ticking down toward 5% by year-end.

The recent release of the Federal Open Market Committee minutes from the December 14 meeting makes abundantly clear the Fed's intention to further increase short-term interest rates. They specifically cited that even with the latest fed funds rate increase to 2.25% - "the current level of the real funds rate target remained below the level it most likely would need to reach to keep inflation stable and output at its potential. With the economic expansion more firmly entrenched, cost and price pressures were likely to become a clearer intermediate-term risk to sustained good economic performance absent further reduction of accommodation."

The combination of rising interest rates and slowing profit growth is clearly not the best formula for stock price appreciation. We are therefore somewhat cautious on the stock market's prospects until it becomes clear that the Fed's tightening intentions are near an end. In response to this cautious stance, we believe it appropriate to tilt the equity exposure in client accounts toward higher quality sectors and securities. In addition, we intend to raise a modest amount of cash by selling some of the stocks that tend to perform poorly a Fed tightening phase. Overall, we expect to increase our exposure to Consumer Staples, Healthcare and Energy while further reducing our commitments to the Consumer Discretionary and Technology sectors. With short-term interest rates having risen throughout the past six months, we have begun to invest temporary investments in short-term government and corporate fixed income instruments. If intermediate interest rates rise as expected, we will once again begin investing in high-grade 3-10 year term securities.

We also reiterate our comments from our fourth quarter 2004 outlook when we indicated it is hard to build a case for a long sustained bull market given current conditions. While valuation levels are reasonable presently, we are concerned that as both inflationary expectations and interest rates continue to trend higher, price/earnings ratios are likely to contract. We repeat our apprehension concerning the prospects for stock prices in the multi-year timeframe. Once again, history suggests it takes a good decade or longer after a financial bubble bursts before markets are able to normalize. With the bursting of the internet and telecom bubble in 2000, that would suggest that stock market gains may continue to be sub-par through the end of the current decade.

In a low-return environment, our analytical focus has shifted to identifying asset classes and securities that may offer somewhat higher returns while reducing risk through greater diversification. Depending upon each client's individual objectives, it may be worthwhile to discuss the appropriateness of alternative investment vehicles such as inflation-linked securities, principal protected securities and international investments. We look forward to having these discussions and wish each of you a happy and healthy New Year.