INVESTMENT STRATEGY UPDATE

December 29, 2004

2005 – THE YEAR AHEAD

"Prediction is very difficult, especially about the future." So said the late Nobel prize winning physicist Niels Bohr. His proclamation seems particularly relevant to us now as, in a financial sense, there are a number of unresolved issues. The good ol' U.S.A has developed some serious economic imbalances. There is the trade deficit and the very large federal-budget deficit. In addition, as a nation of consumers, we save far too little. To compensate, we import great amounts of capital from overseas, resulting in a huge current-account deficit. Yet these are matters of longer-term concern, which do not necessarily have to be resolved quickly. In fact, we think the current imbalances could persist for years. Furthermore, it is entirely possible that one or more of the afore-mentioned deficits may actually turn out to be self correcting. Remember that we had a record budget deficit in 1992, followed by huge budget surpluses just a few years later, only to be followed once again by very large deficits.

As we look to the new year, there are more immediate issues to be considered as well, such as the falling dollar, an overly-indebted consumer, and continuing threats of terrorism. But at the same time, there are numerous reasons to remain constructive. The global economy is strong, inflation remains contained, interest rates are still very low, and the Federal Reserve Board continues in an accommodative stance. Furthermore, Corporate America is awash in cash, and even after two good years in a row for equity investors, stock market valuations are still generally reasonable.

So how will these factors all come together? We are reminded of the classic question: Is the glass half empty, or is it, instead, half full? Such is the focus of this, our annual forecast issue. But as we predict the future, we are inclined to cite Niels Bohr's proclamation as a strong disclaimer. Our continued investment success will depend much more on our ability to interpret and adjust to trends and events as new information becomes available. With that in mind, what follows is our outlook for 2005 – the year ahead.

The Economy

There have been ten economic expansions since World War II, not counting the current one. The median duration was 42 months, although the two most recent growth cycles were considerably longer. According to the National Bureau of Economic Research, the

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current upturn dates back to November 2001, or about 37 months ago. So if this expansion turns out to be average, a new recession might begin sometime this year. But that is not our expectation.

Typically, as an expansion ages, the spare productive and labor capacity left over from the preceding recession becomes increasingly utilized. With higher capacity utilization comes improved corporate pricing power, and less available labor leads to rising wages. So inflation and inflationary expectations begin to rise. Interest rates move higher as well. And eventually, in an effort to restrain the growing inflationary pressures, the Federal Reserve Board tightens monetary policy, thereby sowing the seeds for the next economic slowdown.

To date, the current economic recovery has been far different than those in the past. The previous recession was shallow and mostly contained within the corporate sector. And because the recession was shallow, the recovery has been relatively constrained as well. As a result, productive and labor force capacity remain abundant. So wages have been rising very slowly, corporate pricing power is only now beginning to improve, and at least for now, inflation has been kept at bay. With few excesses and not much inflation, we see little reason for any of the restrictive policies or factors that would typically lead to a recessionary slowdown.

No doubt, there are potential problems. With the consumer so heavily indebted, consumer spending would seem to be at risk. On the other hand, business spending has been lagging historic norms, and we are hopeful that a liquidity-rich Corporate America will soon step up to the plate. But in our opinion, the real key to America's continued economic health lies in the hands of the Federal Reserve Board. Thus far, Alan Greenspan and crew have done a masterful job of providing sufficient stimulation to both offset the post-bubble deflationary pressures and grow the economy. But going forward, the Fed must navigate a much more narrow path, raising short-term interest rates enough to offset emerging inflationary pressures, but not so much as to impede the economic uptrend. It is a delicate balance and, unfortunately, the question of how much tightening is too much will only be known after the fact.

As mentioned, the U.S. economy has a number of longer-term issues of note. Eventually our structural imbalances must be resolved. But so long as the global economy remains healthy, we see little reason that the U.S. economy can't continue to produce an acceptable rate of growth. We anticipate a reasonable economic environment in 2005, with an 8 to 10% rise in corporate earnings.

Inflation, Interest Rates, and the Bond Market

Inflation is a mixed bag at present. On the one hand, there is little question that inflationary pressures are beginning to build. We can all see it in our ongoing daily expenditures, be they on food, fuel, or tickets to the movies. Yet inflation has been very slow to show up in the official data. To some extent, that's a result of how the government tallies the data, such as imputed rent and quality improvements (i.e., although the cost of purchasing an automobile may rise, the extent to which the price increase reflects quality improvements such as the inclusion of airbags or seatbelts, it is not counted as inflation).

On the other hand, it appears likely that there will be less inflationary pressure on the energy front this year. Furthermore, as was so well stated by San Francisco Federal Reserve Board President Janet Yellen during a late October speech, "There are some fundamental factors tending to push inflation down, including the remaining slack in the labor and product markets and continued rapid growth in productivity." And we would add the very competitive current global-business environment. In order to remain competitive in this environment, companies must continually strive to be among the lowest-cost producers. And that objective entails constantly seeking to enhance productivity and, all too often, relocating manufacturing facilities to lower-cost locations.

We expect only a modest rise in inflation this year, but enough to encourage the Federal Reserve Board to continue on the path of raising short-term interest rates toward a more neutral stance. And for the Federal Funds Target Rate, we think that neutral is more than a full percentage point higher than the current level.

Insofar as longer-term interest rates are concerned, bond market yields are still very low, historically. Over the last fifty years or so, the median yield on the ten-year U.S. Treasury note was 6.6%. Currently, that note yields 4.2%. Yet the remaining post-bubble deflationary pressures are dissipating, and higher interest rates seem a very likely by-product of our huge budget and current-account deficits. In our opinion, it is not a question of whether interest rates will rise. Rather, it is a question of when.

With rising interest rates will come lower bond prices. There will be a time to lengthen fixed-income maturities, but that time is not yet. For now, our fixed income posture remains short term and defensive.

The Stock Market

The last several years have been anything but dull. We have witnessed a huge stock market bubble, the secular bear market which followed, and a significant rise off the bottom. So what comes next?

In keeping with a theme of our recent *Investment Strategy Updates*, we think the second half of the 1970s provides investors with a useful guide to what is likely to lie ahead. There was a stock market bubble in the early 1970s, followed by a very nasty bear market. Then, after a rather substantial rise off the 1974 low, there followed a several-year period of alternating, cyclical bull and bear markets, with a modest upward tilt. At the time, each bull phase seemed filled with the promise of still further gains ahead, while each cyclical bear that followed warned of continued deterioration. But each time investor convictions became sufficiently strong that the existing trend was destined to persist, the stock market turned and went the other way. And so the uptrends brought increasing risk, and the downtrends, opportunity. In retrospect, however, the 1970s provided a very good environment for opportunistic investors. The keys were keeping one's emotions under control and utilizing, rather than getting caught up in, the swings. And so we think it will be, going forward.

It wouldn't surprise us to see the first of the expected cyclical swings begin sometime during the first half of 2005, although the catalyst may be something totally unanticipated. No doubt the downturn will seem scary as it occurs, but it is important to remember that the secular bear market is behind us. The decline investors experienced during the first three years of the millennium was devastating. But historically, such an event happens only two or three times a century. The next decline should have a limited downside and therefore be looked upon as providing an opportunity to invest at more favorable prices.

So how should one approach the coming months? Our plan is to build some buying power by moderately reducing our clients' equity exposure. It is not an all-or-nothing proposition. For one thing, neither we nor anyone else can consistently identify tops and bottoms as they occur. For another, while stock market valuations are elevated, they are not all that unreasonable given the current environment of little inflation and low interest rates. (See BTR's September 30, 2004 *Investment Strategy Update*.) Furthermore, our clients' portfolios contain a number of core equity positions which we will choose to ride through any normal stock market corrections.

The coming years will be an important time for active sector selection and for broadening our geographical exposure. The world is changing, and there are quality companies and investment opportunities in many countries. In some nations, the economies are growing more rapidly than here, while their stock markets are valued less expensively.

Our plan is to approach the next downturn as an opportunity. Depending on the timing, it is entirely possible that the stock market will end 2005 higher than it begins, yielding reasonable returns overall. Also, it is interesting to note that since 1935, every year ending in the number five has been an up year for the market. But we know that is just coincidence.

We look forward to the years ahead. They are unlikely to produce the outsized gains of the 1980s and 1990s, and they will almost certainly require more patience and skill than before. But when all is said and done, stock market returns should stack up quite well, both relative to the rate of inflation and, we think, as compared to most of the alternatives.

Conclusion

The global economy is evolving. The U.S. and Europe are mature and growing more slowly than in the past. Our manufacturing base continues to erode. But at the same time, other nations are emerging as world-class manufacturing powers. And their economies are growing rapidly. The workforces of China and emerging Asia are increasingly skilled and well educated, and they are moving up the curve of technological sophistication. This evolution is a natural process, although it is certainly disruptive for those whose livelihoods are affected. Such transitions used to span centuries. But in this era of enhanced technology and communication, the pace of change seems much more rapid.

Yet for investors, this is a world filled with opportunities. The global economy is increasingly open, and a growing world requires all kinds of goods and services – banking, insurance, raw materials, food, clean water, distribution, transportation, health care, and entertainment to name but a few. Entrepreneurs and innovative companies find unique niches to provide goods and services that they can manufacture and provide better, cheaper, and more efficiently than before, no matter where they are headquartered. There are globally-based companies which benefit from these trends, as well as U.S. companies which are doing business globally. In fact, it might surprise investors to learn just how many U.S. companies derive the majority of their profits from overseas.

A changing world provides both challenge and opportunity. As investors, we have a choice of where and when to invest – in what companies, in what sectors, and in what parts of the world. The glass we see is global, and it is certainly more than half full. Our expectations are high.

As always, we wish all of our friends and clients peace, joy, and a happy, healthy, and prosperous New Year.

BTR Capital Management is very pleased to announce that Steven M. Vannelli has joined our firm as a principal, portfolio manager, and key member of our research and investment strategy team. Steven, a long-time friend, has been a member of the San Francisco Bay Area investment community for more than twenty-five years, engaging in both research and portfolio management. During the 1990s he was a managing director and senior portfolio manager with Kingsley, Jennison, McNulty, & Morse of San Francisco, as well as with its successor firm Stein Roe Investment Counsel. He holds a bachelor's degree from University of California (Berkeley) and an MBA from Syracuse University.
