



Economic Review and Outlook

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Economic Review and Outlook

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As we say farewell to 2004 and welcome in 2005, the prevailing view seems to be that 2004 was a so-so year and that we should be cautious, maybe even pessimistic in 2005. Of course, we had many reasons to feel that 2004 was not so great: terrorism fears, the war in Iraq, instability in North Korea, election angst, rising oil prices, a falling dollar, a weak job market and rising consumer debt dominated the headlines. Public sentiment followed suit. And if that was not enough, the Federal Reserve began raising interest rates for the first time in four years. Thus, to many, the stock market seemed to struggle for much of the year.

Though the glass appeared half

empty, a closer look reveals that it was actually quite full. Real GDP growth in 2004 was the best in 20 years (see chart below). The equity markets had positive returns, with some categories delivering stellar performance. For example, international large cap value and international small cap both delivered returns of around 30% for the year, and even large U.S. company stocks were up about 10%. So statistically, it was a good year, even though it still felt bad. Why? Let's evaluate some of the important economic factors from last year to answer that question. Specifically, let's look at the weak dollar, the trade deficit, fiscal policy, jobs, corporate profitability, interest rates and

inflation as they affected investment performance in 2004 and as they may impact 2005.

Looking Back at 2004

The Dollar and Trade Deficit

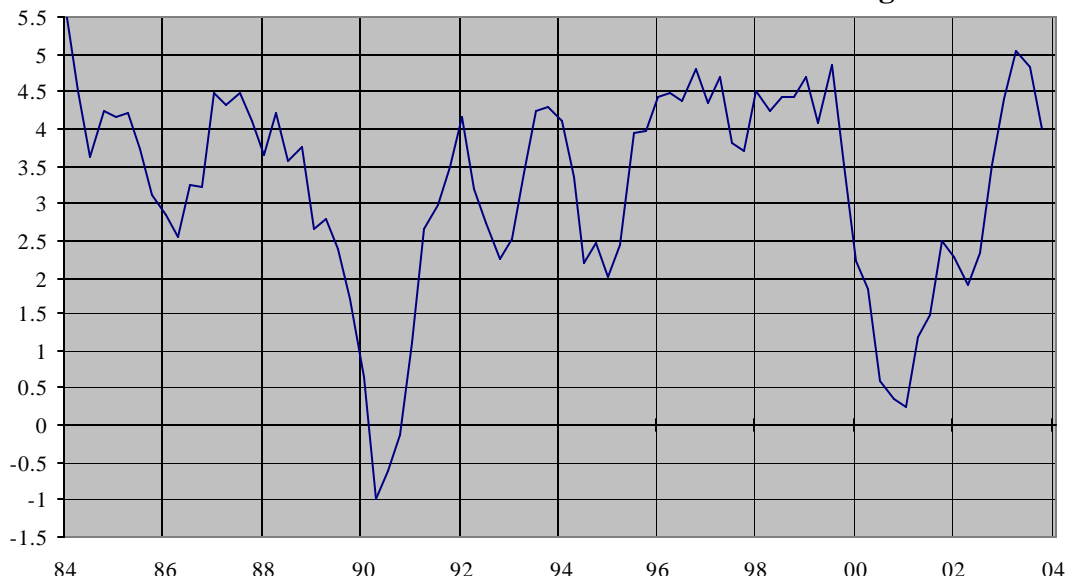
The weak dollar and soaring trade deficit received a lot of attention last year. The dollar has actually been falling for three years, but it seemed to draw a lot of attention in 2004 due to all the talk of a trade deficit. Politically it is unwise to allow the dollar to weaken. In fact, some think it's un-American not to prop up the dollar. However, a weak dollar can be good for the

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"Humans must breathe, but corporations must make money"

-Alice Embree

Gross Domestic Product: Real Year To Year % Change



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economy, acting as a demand stimulant for U.S. goods and services because it serves to lower the prices foreigners pay for U.S. goods. At the same time though, U.S. consumers must pay higher prices for foreign produced goods.

However, if that's the case and if the dollar was weakening, why did the US trade deficit continue to grow? I suspect three reasons for this apparent paradox: First, prior to the downward trend of the previous three years, the dollar had increased in value for ten years, an increase that was much greater than its recent weakness (see chart below). Second, trade improvement historically lags change in the price of the currency by two to three years. Finally, though the dollar had been weak against

slow growing economies such as Europe and Canada, it had been relatively stable against the growth economies in Asia. As a result, the lower prices of U.S. goods and services have not yet induced foreign buyers to buy those goods and services. Will the weak dollar start to increase economic activity for 2005? We think it might.

Fiscal Policy

Much like the dollar, fiscal policy can be a strong stimulant to the economy. For example, Congress recent tax cuts and continued high level of spending acted as a stimulus to the U.S. economy in 2004.

Jobs

Last year we worried about jobs going overseas and the lack of job growth at home.

But in fact, the U.S. economy created 1.6 million new jobs in 2004, and the unemployment rate now stands at 5.4%, low by historical standards, and is improving gradually. The bad news is that U.S. workers still have to compete with very low labor costs in many parts of the world, making job growth slower than we would like. In addition, U.S. Corporations were slow to hire in 2004. The good news is, that in order to compete, the U.S. work force has become increasingly productive, meaning that we are able to produce more efficiently. The hope is that the higher productivity of the U.S. work force will help U.S. workers compete with less productive, but lower cost foreign workers.

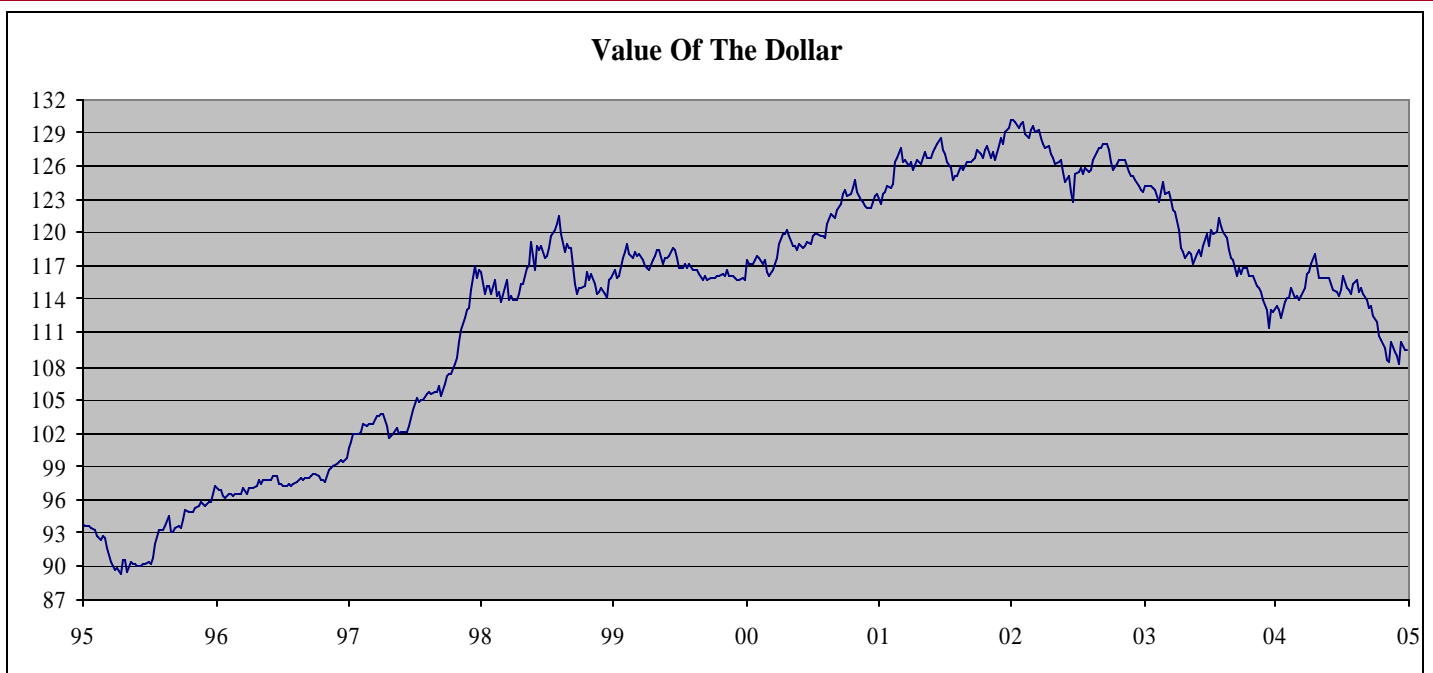
Improvement in the U.S. trade deficit will likely come

from technically advanced goods and services such as engineering services, airplanes, software, and other technology. For instance, today as I write this article, Boeing reported that Chinese Airlines just purchased 60 of the new 787 airplanes. The total purchase price was in excess of \$7.3 billion dollars. If history is any guide, Boeing will hire higher paid, more technically skilled U.S. employees to build those planes. In addition, such technically advanced goods are more profitable than commodity type products; thus, increased profitability should lead to a growing demand for U.S. workers.

Corporate Profitability

Partly as a result of an increasingly productive workforce, U.S. corporations

Value Of The Dollar



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experienced strong profitability in 2004. Final numbers are not yet complete, but 2004 should prove to have been a strong year for corporate America. In fact, corporate profits for 2004 should show an increase of 15% over 2003 and exceed expectations from a year ago.

Interest Rates and Inflation

Finally, but just as importantly, interest rates and inflation also contributed to a good year (see chart below). After reducing rates for three years, the Federal Reserve started to raise rates in 2004. Even so, current rates are close to the lowest rates we have seen in 30 years.

The Federal Reserve uses short-term interest rates to achieve its stated goal of price stability, in other

words, to keep inflation low. The current low interest rate environment suggests that they have achieved that goal. Likewise, rates on bonds are historically low. The current yield on a thirty year treasury bond is at a forty year low of 4.6%. If investors were concerned about higher inflation rates, they simply would not invest in long-term bonds at such low rates. In contrast, when we were most concerned about inflation in the early 1980's, the yield on a thirty-year treasury bond reached a high yield just under 16%. Today low rates across all maturities suggest we are not concerned about inflation. In fact, the inflation rate is low with the CPI likely to come in under 3.5% for 2004. If we take out the volatile food and energy sectors, the CPI could come in under 2% for the year.

Putting it all together, though we had many things to be

concerned about in 2004, the economic conditions were as good as we have had in a long time. Consequently, even though the year did not feel very good, it turned out better than many expected.

Looking Forward to 2005

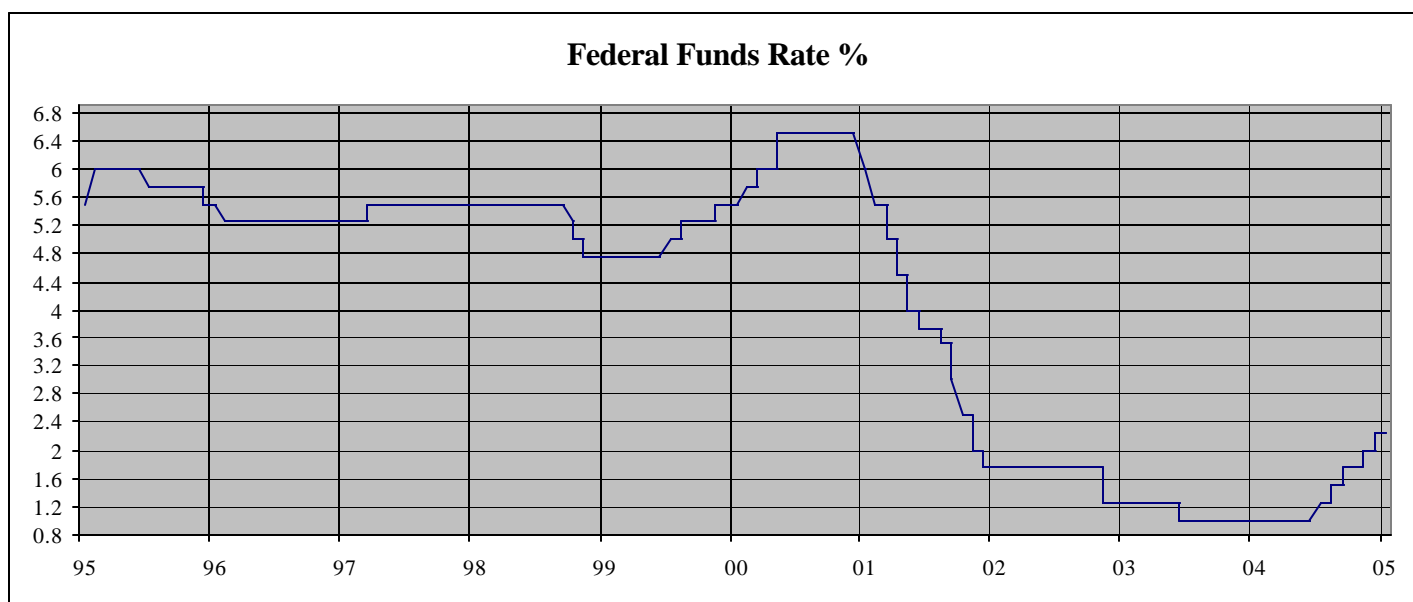
Many who are familiar with our approach to investment management know that we are cautious about making forecasts or making investment decisions based on forecasts. The litter bins are filled with the advice of investment professionals who made a great call that was followed by disaster. That's because forecasts are prone to capture the current mood or bias and project that bias forward. Additionally, markets tend to lead the economic news, so even if we guessed right, the market may have already reflected the economic news in the prices

of securities before we bought them. Therefore, we do not base our investment decisions on forecasts.

However, we do believe it is important to think about the world we live in and about the future, partly to help manage client emotions. Investment decision making that follows an extreme view and exaggerates the prevailing sentiment, whether positive or negative, can be dangerous to your wealth and emotions. If you doubt, remember the Dow 35,000 forecast of the late 1990s. Today, the Dow stands at around 10,000, lower than it was four years ago and far short of that lofty forecast. If you had invested in anticipation of a sharp increase in the Dow, you'd be a poorer—and much sadder investor today.

We like to avoid such extreme views—and consequences—and encourage our clients to be

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cautiously optimistic in their approach to investment management. Cautious, because any market we invest in can lose money; optimistic, because over a long-time period, it has paid to be invested in the markets.

As we evaluate an upcoming year we like to look at the current consensus view of what the professionals think and ask what could go wrong with that view. Additionally, we like to assess the mood in the current economic environment and ask whether any of the markets we invest are at an extreme. If the consensus thinking is overly pessimistic or optimistic, the markets could represent an opportunity or a danger. In the end, this approach supports the discipline we

encourage of trimming our clients' best performing asset classes and adding to their underperforming classes, what we call rebalancing.

That said, we believe the current mood seems to be moderate and subdued, but not negative. To illustrate, the *Wall Street Journal's* economist survey consensus expects GDP to grow by 3.5% in 2005 and inflation to average 2.5% versus about 4% GDP growth for 2004 and 3.5% for inflation. The growth forecast is nicely positive, but lower than last year's pace. Inflation is also under control.

The risk of the consensus view is that the economy may actually grow faster than expected, and inflation may sneak into the system. The logic works like this. We have had stimulation because of reduced taxes and

increased spending in the last year. Add to that the fact that the Federal Reserve has been stimulating the economy for the last three years through both strong monetary growth and low interest rates. Finally, after three years lag, the weak dollar should accelerate demand by foreign buyers. At the same time, the *Economist* magazine reports world GDP growth for 2004 will be the fastest in 30 years. Will these three levers working together create increased demand and accelerate economic growth in the U.S.? If that happens, it would not take a lot of demand growth in the U.S. for corporations to start hiring. Finally inflation would become more of a concern and lead interest rates higher. This would be a cyclical response to a stronger economy rather than long-term trend of higher interest rates and inflation.

There are plenty of reasons why growth might not accelerate above the consensus: high consumer debt level, high energy prices, problems with global terrorism, etc. But if economic growth should be stronger than expected; inflation would likely begin to creep up. If economic growth outpaces expectations; equity markets would deliver positive returns, though long-maturity bonds and preferred stocks could suffer price declines. We do not invest in either and would caution against doing so in most markets.

To conclude, we see plenty of opportunity for good portfolio growth during the coming year as we stay well diversified and maintain our discipline.



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