LFM&P

Your Personal Financial Advisor

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Outlook & Trends

Stocks and bonds took a breather last quarter. Real estate remains strong, despite concerns in some quarters about a "bubble". To stay on the course to your financial goals, it is helpful to maintain an accurate perspective of where we are in the continuous flow of economic events, as well as having a sound investment strategy and a financial plan as a guide. Hopefully this letter will help you with the perspective.

Economy

All economic systems are "go". Leading indicators suggest the pace may pick up again after softening a bit last year. The economy grew by 6.6% during 2004, faster than 2003, and ended the year growing at a 6.2% rate in the fourth quarter. Likewise, investment analysts are expecting corporate earnings to increase by 9.4% during 2005. The Federal Reserve continues to raise short-term interest rates, but still believes that their rate policy is "accommodative", meaning that the rate increases are not expected to slow down economic growth, but are proceeding toward a neutral stance. Why are these numbers important to investors? They are important because earnings growth and interest rates are primary determinants of overall investment return, which translates into dollars in investors' accounts.

The other major economic trend has been the fall in the value of the dollar, which has continued uninterrupted, except by small rallies, since 2002. This decrease tends to make our domestically produced goods less expensive abroad, and help US producers and local job creation. It is good for the employee in us. The other side of the same coin is that foreign goods become more expensive for us to buy, which is felt by the consumer in us as increasing inflation. Not only are foreign goods more expensive, but prices of commodities that are used extensively by the rest of the world, such as oil, are higher as well.

Financial Markets

If the employee and consumer in us are affected differently by economic forces, what about our investor side? Real estate appreciated rapidly with sustained low interest rates. Foreign governments bought US bonds to support the dollar (and thereby slow down the US price increase of their own goods), which also helped keep our interest rates low. Foreign stock investments have been profit leaders. Their prices have increased for us, just like the prices of imported goods or a trip to Paris. Holders of energy stocks have been the other beneficiaries of this global economic trend, as oil prices have risen to new highs.

In general though, stock investments have followed the domestic economy, with their values influenced by expectations of earnings growth and interest rates. A good stock rally occurred from last summer through the end of the year, but cooled off during the last quarter and finished lower under the pressure of rising interest rates. Rising rates, which go hand in hand with an economic expansion, will also reduce bond prices. Higher rates may also affect real estate sales eventually, by reducing home affordability, if wages do not keep pace.

Stock prices are also affected by the calendar. We are about to enter a period during both the calendar year and the 4-year presidential cycle that has been historically less favorable. There will be less political motivation to pump up the economy than there was during the last several years, but if growth continues at a reasonable pace, and interest rates do not rise too much, the general growth trend in equities is likely to persist.

<u>Social Security Planning Commentary</u>

The hot discussion in Washington is the repair of Social Security. A voice above the politics, Alan Greenspan, Chairman of the Federal Reserve, suggests that the method of financing Social Security benefits (personal accounts, etc.) is a secondary issue. According to Greenspan, the real problem is an economic one. How do we build an economy that continues to generate enough wealth to support the baby-boom retirees? Merely printing Social Security benefit checks will not do it. If the underlying economy, with a smaller percentage of productive workers, does not support the retired citizens, then those benefit checks will just get eaten up by inflation. From this perspective, the political financing debate is the economic equivalent of "rearranging the deck chairs on the Titanic". The solution, for both individuals and the nation as a whole, to meet the coming retirement challenge is to save, invest, and increase productivity, so fewer workers are able to produce more goods.

Regardless of how the current debate turns out, it is clear that the Social Security program will not have the same form, generosity, or both, for future retirees. The younger the worker, the truer this will be. This development follows a similar trend that has seen corporations transferring retirement risk to employees by changing from defined benefit pension plans to 401(k) plans.

The underlying message in the Social Security discussion should be a wake-up call for people to seriously commit to providing as much of their retirement income as they can, and begin as early as they can, by saving in a manner that provides sufficient return at a reasonable level of risk. While it possible to think of countless reasons not to do so, including the necessity to juggle other expenses, the longer retirement saving is delayed, the harder it becomes to recover.

Financial planning can help you see how to balance today's requirements while building an effective approach to provide for your own future. Investment management can help you achieve securities market returns while managing risk.

If you would like help planning to reach your financial goals or managing your investments, please give us a call or send an e-mail.

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