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International diversification will be more important going forward than it was in the past.

The Fed may decide to stop raising rates earlier than anticipated

Investment Commentary

2004 in Review

Low lending rates set the stage for increased consumer and business spending and enhanced returns on financial investments in 2004. Federal deficit spending rose sharply to 4.5% of GDP. Although high, the deficit has been higher in six out of the last 25 years. The balance of payments continued to deteriorate, and private debt continued to increase. These trends contributed substantially to the U.S. dollar's decline relative to the euro and yen.

With the economy recovering from the post-bubble slowdown, the Fed began raising interest rates in June. Nonetheless, rates are still at historically low levels and are still at low levels relative to the lending rates in most of the rest of the world. The Fed has done a very good job of signaling increases. This predictability has helped maintain confidence and stability in the financial markets.

Consumer prices rose 3.5% in 2004, largely due to higher energy prices, compared with 2.3% in 2003 and 1.6% in 2002. Crude oil rose 34%, copper 44%, and steel scrap 37%. Higher commodity prices will be a drag on the economy in 2005, but low labor costs overseas will help constrain prices.

Low mortgage and lending rates led to increased borrowing. In particular, consumers used refinancing to reduce mortgage payments and take equity out of their homes. Consequently, consumer spending rose a sharp 3.5 - 4.0% after inflation.

The equity markets traded within a narrow range during the first ten months of 2004, as investors focused on the uncertainty of the presidential election, followed by a late-year rally to a full-year 9% gain. The S&P 500 index is now up 52% from its October 2002 low, though it is still down 21% from the peak reached four years ago in March 2000. The Nasdaq Composite is ahead 80% from its 2002 low, but is still 60% below its 2000 peak.

Renewed global investor confidence in U.S. equities overcame some substantial fundamental issues that could have derailed the strong investment returns. Foreign investment was 7 times higher in 2004 than the previous year. This inflow broadly enhanced returns. Large-cap stocks gained 9% (as measured by the S&P 500), the Nasdaq also rose 9%, and the Dow Jones Industrial Average rose just 3%.

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The four losing stocks in the Dow underscore the effects of international competition. GM is an example of a company that is drowning in the debt of health care and pension benefits. Foreign competitors have fewer such costs, allowing them to set lower prices or earn higher profits.

Stock prices increasingly moved independently from the market as a whole. Only 75% of the S&P 500 companies experienced rising stock prices last year as compared to 92% in 2003. The change reflects company-specific valuations. This trend will likely continue, and may be exploited by fundamental value-based security selection (as opposed to indexing).

The best-performing U.S. market sectors in 2004 were energy (+28%) and utilities (+20%). Strong stock price momentum during the last two months of the year drove valuations to high levels. However, given the still-low interest rates, these levels were not excessive. Fixed-income returns, with the exception of high-yield and international issues, underperformed stocks in 2004.

The IPO market came to life as the Google offering attracted broad public attention. Because private equity investments use the IPO market for eventual valuation and liquidity, the private equity market experienced rising valuations and new investor interest.

Thanks in part to the weaker dollar, international equities markets – particularly those in Latin America and Europe – outperformed U.S. equities.

Outlook for 2005

Our global investment outlook remains positive. Thoughtful diversification across sectors and asset classes remains a sound investment approach. International diversification will be more important going forward than it was in the past. Developing nations with low wages and taxes continue to gain access to capital and skilled labor enabling them to grow faster than their domestic competitors.

Gradual interest rate increases by the Federal Reserve will exert modest pressure on capital spending in 2005, although many companies are cash-rich. More importantly, with mortgage and lending rates rising, refinancing activity will slow. Consequently, consumer spending growth will likely diminish as the year progresses.

The Fed may decide to stop raising rates earlier than anticipated. The historically normal Fed funds rate of about 4.5% may be higher than the rate targeted by the Fed in this cycle. We anticipate that the measured language of the Fed will change before the rate reaches 3%, and that the rate will remain below 4% for the duration of the year.

As long as China's currency peg to the U.S. dollar remains in place, China's low-cost labor will exert a strong competitive advantage. That may kindle political pressure for a yuan revaluation in 2005.

There is always a risk of an equity market correction. In 2005, it could be triggered by an unexpectedly high inflation number, public perception of over-extended debt,

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an oil price spike, disappointing earnings, or commodity shortages. Mitigating the inflation risk, import prices will exert downward pressure on domestic prices.

However, the risk of a correction should not deter investment in equities. We expect rate increases to occur slowly and concurrently with a generally flattening yield curve. While rising rates will put some pressure on valuations, this effect is not likely to overwhelm profit growth.

Treasury bonds may decline slightly in price as interest rates (and inflation) rise. At the same time, credit spreads on corporate bonds may widen, driving up the cost of capital, particularly for the lower credits.

Corporate profits in the United States are likely to rise at a slower pace in 2005 as a result of tightening monetary policy and the rising costs of energy and commodities.

Meanwhile, many industries are evolving thanks to rapidly changing technology. The convergence of all media and communications toward a common internet protocol means that phone, cable, and radio companies will suffer falling prices in a new competitive landscape. Wider accessibility of broadband connections should also spur the growth of internet services.

Demand for commodities will continue to grow. Low cost labor in developing countries means that consumer price increases will be moderate even while demand increases substantially.

Longer Term

We are also optimistic about global economics and financial investments over the long term. Skilled labor is widely available, and international trade is increasingly cost-effective. These macro-trends set the stage for continuing growth of financial investments.

The tax and regulatory environment are also increasingly favorable to investors and the economy. Property rights are being strengthened worldwide. The financial markets are increasingly capable of efficiently allocating capital, distributing risks, sharing information, and creating resiliency against shocks like war and natural disaster. These trends point to higher asset values, lower downside risk, and higher after-tax returns on financial investments.

The oversupply of global labor is not likely to be fully utilized in this decade. Over four billion people have entered the global economy through economic reforms since the end of the cold war. Emerging economies, particularly China, India, and Russia will grow at a much faster rate than the global average after decades of under-performance. As global demand grows, energy and commodity demand will outpace supply. As a result, energy and commodity prices will rise, pointing to many attractive long-term investments.