



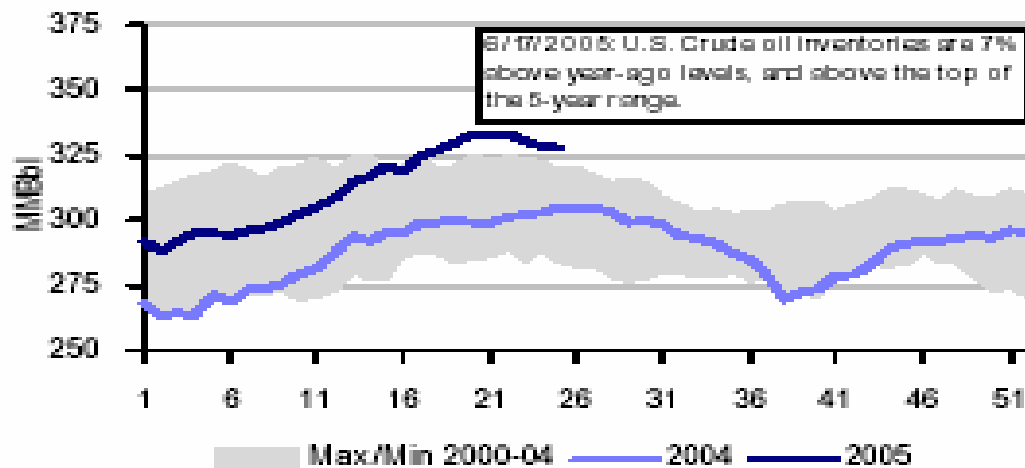
Baldwin Investment Management, LLC

SLIPPERY SLOPE

For quite some time there has been only one number to capture the market's attention and that is the price of a barrel of oil. Throughout the second quarter, crude oil rose in price and year-to-date the price has become significantly more expensive. At each \$5 and \$10 interval, the market has become anxious and then has acclimated. When a new, higher level is breached, the market worries about resulting economic effects - i.e. slower growth and /or inflation. So far, the deleterious effects of higher oil prices have not been demonstrated, so the U.S. and World economies have "mushed" through. Various pundits have opined that inevitably higher prices will do the U.S. and World economics no good - but to date they have been wrong for there appears to have been no immediate effects.

Historically, higher oil prices have always had negative ramifications. Why is it different this time? Past spikes in the price of oil were generated by supply shocks. In other words, it was because of embargos from the Middle East or disruptions in the Middle East (the world's primary source of crude oil supply) that crude prices increased dramatically. This time, however, the increase in price has been generated by strong demand - especially out of China and India, newly developing and rapidly growing economies. Consequently, there are sound economic reasons to explain why the price of oil has increased as opposed to political reasons for a spike.

Overlaying the demand part of the equation is some sense of fear that there is no "supply cushion" in the world crude oil trading system and that there could be supply problems. We disagree. Following, the reader will see a chart which quite clearly demonstrates that inventories of crude are ample and have been for quite some time.



Source: Department of Energy

From a supply/demand perspective, there should be no particular worry based on inventory statistics. There is a perception in the futures market that there “should be a worry” - but in fact, there is no reasonable rationale for that position. Further, the “positive effect” of higher oil prices are already at work in the marketplace. Drilling has increased rather dramatically. In Canada, there is increased activity in Canada refining oil from the huge tar sands deposits which was uneconomic at lower prices. New LNG (liquid natural gas) tankers are being built and new LNG regasification facilities are being developed. Several major oil companies have announced deals to turn dry natural gas into diesel through new technology. Again, this was uneconomic at lower prices. All of this bodes well for future supplies of hydrocarbons, even in the face of increased demand. In fact, Cambridge Energy Research Associates, a consulting firm, has written that it looks forward to a glut of hydrocarbons in the marketplace in the relatively near future. This is certainly a radical position during days when some analysts are looking for a “super spike” in the price of oil to \$105 a barrel. Lee Raymond, the highly respected chairman and CEO of Exxon Mobil has warned people not to forget that the oil business is indeed a cyclical business and that he does not believe in the “price deck” of today’s marketplace. This is a pretty powerful message from a man who has had a long and distinguished career in the oil business.

Mr. Greenspan and his colleagues are about to meet and it is widely expected that they will increase interest rates another time. There has been a fair amount of speculation that the Fed is close to the end of its interest rate increasing spree. One Fed Governor recently was so bold as to say that the Fed was in the 8th inning of a 9 inning interest rate increasing game. The markets would obviously enjoy such an indication.

The dollar has found some new strength as interest rate differentials have widened between it and the Euro. The Euro has also suffered some political damage as the European Union has not been able to muster essential votes to move forward on ratifying a new constitution. Unfortunately, for Europeans, once interest rate props melt away, analysts have only to focus on economic fundamentals and consequently have pushed the Euro down versus the Dollar.

Earnings are still expected to be strong for the second quarter of 2005. Year-to-date, companies have surprised analysts on the upside. There have been few warnings about earnings for the second quarter - so we would anticipate that the earnings season will not disappoint. The earnings pictures continue to be a very strong support for stock market valuations. If the Fed were to signal that they are near the end of increasing interest rates; if the price of oil were to decline as people realize there is no supply problem in the system; and if investor psychology moves from one of "wringing hands" to appreciating the strength of the U.S. economy, the dollar and corporate America - then the stock market should have a nice advance.

PREDICTIONS FOR 2005

COMMENTS

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|--------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------|
| 1. The dollar will rebound to \$1.15 per Euro as a result of interest rates elsewhere in the world declining | \$ is stronger, Euro trading at \$1.21 v. \$1.37 |
| 2. U.S. economic growth will slow to approximately 3.5% | Looking Good |
| 3. Chinese and Indian demand will keep oil in the low 40s to mid-30s in spite of increased supply | Oil still much higher |
| 4. Japan will grow more quickly (~2% GDP growth) because of its China trade | A Little Shaky! Recent figures not helpful across the board |
| 5. President Bush will not be successful in radically overhauling the U.S. Tax Code or Social Security | Still feel this way. Compromise on the way |
| 6. Chinese economic growth will still support high (but not astronomical) commodity prices | So far - Prices down |
| 7. The "Road Map" in the Middle East will be pursued again | Yes |
| 8. The Iraqis will hold scheduled elections at the end of January but no resolution of the insurgents efforts will be lessened | Yes |
| 9. The U.S. stock markets will end up higher similar to the performance of 2004 | So far, incorrect but the year is young |
| 10. Osama will be sold out and captured (we're <i>still</i> sticking with this!) | Not Yet!!! |

A FINAL THOUGHT



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