



Baldwin Investment Management, LLC

FIRST THE REVIEW - THEN THE OUTLOOK

As we have in the past, the first order of business will be to review our predictions for this past year.

PREDICTIONS 2004

PREDICTIONS FOR 2004

COMMENTS

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| 1) The dollar will regain some of its former glory, trading closer to \$1.15/Euro | Wrong! |
| 2) President George W. Bush will be re-elected to office by a landslide | Landslide for the Republican Party; a very sound win for George W. |
| 3) Economic growth in the U.S. will top 4% year over year | Yes |
| 4) In spite of strong economic growth, inflation will remain quiescent | Yes |
| 5) Interest rates will stay low at least until the 4 th quarter and will rise | Wrong- rates lifted in a measured fashion but before Election Day |
| 6) Osama will be sold out and captured (we're sticking with this!) | Wrong! |
| 7) Progress will be made in North Korea with difficulty | Some progress |
| 8) There will be additional but fewer corporate scandals than during 2003 | Yes |
| 9) Commodity prices will be strong throughout 2004 | Yes |
| 10) The Japanese economy will improve, strengthening world economic growth | Yes |

As the reader will note, we were correct on 7 out of 10 predictions - with the 3 missteps being: the dollar, when interest rates would begin to rise and whether or not Osama would be captured. Happily, none of these incorrect predictions, even though revolving around important subjects, were terribly influential with the markets by year's end. The dollar's decline has been getting a lot of press, but to date the markets have taken the slide in stride. Interest rates started to rise earlier than expected, but their increase was from such a low level and at such a "measured" pace that again the markets were not rattled. Finally, the visage of Osama Bin Laden still pops up on television screens throughout the world reminding of super power frustration in not being able to capture the vagabond and also a reminder of potential terrorist calamity. Nevertheless, the lack of his capture also did not unnerve markets around the world.

Probably the defining prediction for 2004 was the electoral victory of George W. Bush on November 2nd. Since that victory, the U.S. markets have had quite a nice move upward enabling a 2004 finish in the plus column. It was as if a great cloud of uncertainty had been removed from the marketplace. Before the election so many things had been viewed as a "glass half empty". Post the election, that very same half empty glass was now "half full". Seemingly, it was the one uncertainty which ruled people's minds and as soon as the election was finished and the victor known, the markets moved ahead smartly.

Now let us begin to look forward. The heart and soul of the U.S. economy (i.e. the consumer) still seems to be quite happy. In fact, the most recent consumer confidence index rocketed to 102.3 in December - way above expectations. Across the board consumers were more positive about present and more importantly future conditions. Consumers are still buying and current expectations are that the Christmas retail season will be better than earlier expected. Why? From all that we gather, it is because of rising employment and household wealth. The nay sayers have been saying for almost forever that the consumer will "peter out". Yet, each year the American consumer continues to surprise.

U.S. corporations are expected to bring home in excess of \$300 billion in profits that they have squirreled away in their offshore subsidiaries for years. The reason that the cash was stashed abroad was because of some peculiarities in the U.S. tax code - which as we all know is one of the most simply crafted set of rules and regulations to be found anywhere in the world. During 2004, the Congress passed and the President signed a bill which will provide a window for many multinational corporations to repatriate foreign profits at the very low tax rate of approximately 5%. This window of opportunity will last until the end of this year. Many pundits see a "wall of cash" washing ashore in the U.S. and that money will be used for hiring new employees, buying new equipment, increasing dividends, paying down debt, etc. It is estimated that this could increase the growth rate for U.S. GDP in 2005 by some ½ of 1%.

There is some new pricing power in the U.S. economy. Certain commodities have become more expensive due to increased worldwide demand (especially from China). Also, some services have gone up in price. Nevertheless, a good bit of manufacturing capacity is still idle and there continues to be worldwide competition for many products and services. Consequently while some corporations have reacquired a bit of pricing power, that is not the case across the board. So again we are not fearful of inflation.

Mergers and acquisitions have become popular again. Johnson and Johnson is buying Guidant. Sprint and Nextel are merging. Oracle has finally been successful with its quest for Peoplesoft. When markets are moribund, mergers and acquisitions do not happen.

When the markets get lively, the investment bankers come to the fore. Generally M&A helps industries improve their health and this improved productivity ultimately drives up stock prices.

President Bush with his new “political capital” wants to push his “Ownership Society” agenda. On top of that list is the reformation of the Social Security System. No doubt it will be a tough sell in the corridors of Capitol Hill. Also, no doubt AARP will organize its constituents to fight against any perceived cut in social security funds for its members. Most worrisome to conservatives and liberals alike is the prospect of new debt in order to pay for the transition to the anticipated new “Ownership Society” system.

As part of the “Ownership Society” plan, Mr. Bush will push hard to make permanent the capital gains tax cut and the dividend tax cut. Both of these tax reductions have been very popular with the markets and with Mr. Bush in office it is expected that these reduced tax rates will not melt away in the sunset come 2010.

Mentioned earlier was a worry by quite a few about how the “Ownership Society” was to be paid for and that brings us to the whole topic of the U.S. deficit. President Bush has made clear in various venues that he is well aware of the deficit concerns held by not only liberals, but more importantly to Mr. Bush’s fellow conservatives. He has promised to reign in government spending and his administration plans to put forward a budget which allows for the smallest increase in spending that has been seen for years. There are many “doubting Thomases” in the marketplace. Mr. Bush’s “voodoo economics” do not seem to add up. He has made a commitment to reduce the deficit in half over the next few years. No doubt, the markets will hold him to that promise.

Finally, the currency which is at the top of all traders’ short list is the U.S. dollar. The once mighty greenback has been sliding inexorably and according to hedge fund managers, the dollar’s decline is a one-way trade. So sure are so many that the dollar will depreciate, that one has to begin to wonder about the wisdom of crowds and herd mentality. In the U.S., interest rates are going up which should make the U.S. dollar more attractive as an investment. Around the world, various central banks have stopped raising their interest rates and some in fact reduced interest rates. Why? Most probably because as other currencies have appreciated in value versus the U.S. dollar, the terms of trade between foreign countries and the U.S have worsened for the foreign countries. A depreciating dollar makes foreign goods more expensive to purchase and consequently the American consumer will begin to buy more domestic items. Further, quite a few foreign countries are not exhibiting robust economic growth. A way to stimulate their domestic economies would be to cut interest rates. Cutting interest rates would have the effect of making their currencies less attractive versus the U.S. dollar and possibly promote some depreciation of a particular foreign currency and thus appreciation of the dollar. Nothing goes in one direction forever. In 2004 we thought the dollar would re-achieve some sort of equilibrium around the Euro at \$1.15. That obviously did not happen in 2004 but we believe the present Euro/Dollar exchange rate is too high for the Euro.

To finish up this piece, we will now outline our predictions for 2005. To all of you we wish you a very happy and prosperous New Year.

PREDICTIONS FOR 2005

- 1) The dollar will rebound to \$ 1.15 per Euro as a result of interest rates elsewhere in the world declining
- 2) U.S. economic growth will slow to approximately 3.5% GDP
- 3) China and Indian demand will keep oil in the low \$40s to mid-\$30s in spite of increased supply
- 4) Japan will grow more quickly (~2% GDP growth) because of its China trade
- 5) President Bush will not be successful in radically overhauling the U.S. Tax Code or Social Security
- 6) Chinese economic growth will still support high (but not astronomical) commodity prices
- 7) The “Road Map” in the Middle East will be pursued again
- 8) The Iraqis will hold scheduled elections at the end of January but no resolution of the insurgents efforts will be realized
- 9) The U.S. stock markets will end higher, similar to the performance of 2004
- 10) Osama will be sold out and captured (we’re *still* sticking with this!)

A FINAL THOUGHT



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The reported numbers enclosed are derived from sources believed to be reliable, however, we cannot guarantee their accuracy. Past performance does not guarantee future results.

A list of our Proxy voting procedures is available upon request.

A current copy of our ADV Part II is available upon request or at www.baldwinim.com/disclosure.htm

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