



Baldwin Investment Management, LLC

THINGS TO PONDER

'Tis' the season for prognostications and seers throughout the world gather up their thoughts, try to get them organized and outline a prediction for the ensuing year in "the marketplace". Before we delve too deeply into the future, let's first see what we said at the end of 2004 and how we did.

PREDICTIONS FOR 2005

COMMENTS

- | | |
|---|---|
| 1. The dollar will rebound to \$1.15 per Euro as a result of interest rates elsewhere in the world declining | Yes, \$ is stronger due to higher U.S. interest rates & strong U.S. economy |
| 2. U.S. economic growth will slow to approximately 3.5% | Yes, But a bit stronger than expected |
| 3. Chinese and Indian demand will keep oil in the low 40s to mid-30s in spite of increased supply | No, Oil around \$60/barrel - speculation rampant |
| 4. Japan will grow more quickly (~2% GDP growth) because of its China trade | Yes |
| 5. President Bush will not be successful in radically overhauling the U.S. Tax Code or Social Security | Yes, Iraq situation overshadows all else |
| 6. Chinese economic growth will still support high (but not astronomical) commodity prices | Split decision, Energy & Metals up - Livestock & Agriculture down |
| 7. The "Road Map" in the Middle East will be pursued again | Yes, Gaza has been left by Israel; the beginning of a Palestinian state |
| 8. The Iraqis will hold scheduled elections at the end of January but no resolution of the insurgents efforts will be had | Yes, sadly |
| 9. The U.S. stock markets will end up higher similar to the performance of 2004 | No, despite better than expected corporate earnings, low inflation & increased dividends - Go figure! |
| 10. Osama will be sold out and captured (we're <i>still</i> sticking with this!) | Not Yet!!! |

Correct	6/10
Incorrect	3/10
Split Decision	1/10

Early in the new year, Ben Bernanke, will become the Chairman of the Federal Reserve, succeeding Alan Greenspan who retires after a storied career. Mr. Bernanke is a former Fed member (now Chief of President Bush's Council on Economic Advisors), who was very influential on Fed thinking during his tenure. He is a staunch advocate of clarity with regard to Federal Reserve policy and inflation targeting. It is supposed by most that Mr. Bernanke will largely follow the policies of Chairman Greenspan and the markets have been quite happy with his selection as the new Fed chairman. Next year will be a political year as the House of Representatives is up for re-election and a good chunk of the Senate will be running races. The Republican Party is probably not where it wants to be with regard to electoral popularity primarily because of the war in Iraq. No doubt there will be a great deal of posturing in the run up to the elections so that the Democrats can try to steal seats and the Republicans can try to maintain their advantage. At this juncture there are no odds on who will be the winner - but we are going to give the edge to the Republican Party as the United States has become more conservative in its politics and we think that the "Iraq situation", post the election of December 2005, will be less nettlesome.

Is the American consumer dead (for the 18th time)? We believe the answer is no. The American consumer is a very resilient creature. Supporting this strength is that household net worth reached a record high of \$51.1 trillion dollars at the end of the 3rd quarter of 2005. This net worth is likely to support continued consumer spending and keep the American economy strong. The demise of the American consumer has been predicted prematurely far too many times.

House prices may well flatten - with increases in certain locales and decreases in others. Quite a few pundits have pointed to a "housing bubble" and have predicted its bursting "any day now". Certainly, there are some areas in Southern California, in Southern Florida and in New York City where speculation in residential real estate is evident. But we do not believe that housing prices in general are "out of sight" in relation to income and cost to carry a residence. Consequently, we do not believe that there is a "bubble" nationally and thus there is not a bubble to burst.

Companies are "cashed up". In other words, corporate cash flows have been extremely strong. Debt has been paid down and company profits have been growing more quickly than companies that have been spending the money on various capital expenditure projects. Hiring intentions for the first quarter of 2006 also look strong according to a recent ManPower, Inc. survey. The U.S. economy can look not only to the American consumer for its resilience but also to American corporations. Productivity is also quite strong which further encourages corporations to hire new workers. In fact, the strength of labor productivity has been very surprising for quite a few years exceeding numerous analysts' expectations. This has been the primary factor in keeping inflation in check, which has led some experts to predict that interest rates may finally be near their peak. This speculation was only enhanced by minutes of the most recent Federal Reserve Board meeting as the Fed changed its language, removing the word "accommodative" to describe its monetary policy. To quite a few, this was a clear signal that the Fed is nearly finished increasing interest rates. Obviously, this would bode well for common equities and fixed income in the U.S. markets.

Internationally, the Iraqis have just completed a nationwide election for their government. It is supposed by some that this election will reduce the insurgency as people will exchange bullets for ballots. Soon it is hoped that the Iraqi people will unite and chase out foreign interlopers who seek to disrupt Iraq. When the Iraqis begin to take more responsibility for their politics, it is presumed that American forces will begin to be drawn down in the relatively near future. If this happens, it would be a big boost for Republican politicians running for office in 2006.

OPEC keeps producing at its present very high level and in fact inventories of crude oil in the U.S. are well above average. Major new exploration projects are commencing in the Middle East, in the Caucuses, in offshore Africa, in the South China Sea, in Libya and possibly in the Arctic National Wildlife Reserve. Within a couple of years it is expected that increased production will provide a further inventory cushion over expected demand. OPEC is scheduled to increase its production and at the same time work to defend a crude oil price of approximately \$50 per

barrel for West Texas Intermediate. In the short run, the price of oil will still be uncomfortably high. But in the intermediate term, we believe that the price of oil will decline to below \$50 a barrel as new production comes on stream. With increased investment in various oil horizons around the world there is also increased capital spending in countries such as: China, India, Slovenia, the Czech Republic, Poland etc.

Thomas Friedman of the *New York Times* has pointed out the world is getting flatter and capital will flow to locales where it is most productive, as economic systems have continued to morph into capitalistic ones. The natural advantages of lower labor costs, an educated workforce, convenient locations to markets, etc. have pushed companies to invest in many new lands around the globe. We believe that this is a trend which will continue for many years. In China, over the last number of years, there has been a huge investment in plant and equipment. The demand for the Chinese currency, the renminbi, has been staggering. For years the Chinese government managed the currency for domestic economic and political reasons. In 2005, the Chinese government allowed a modest revaluation upward of the renminbi, in the face of international political pressure and domestic economic forces to do so. We believe that the Chinese currency will continue to appreciate throughout 2006.

Finally, we should mention the avian flu and the possible repercussions from a pandemic. Throughout the history of man, there have been few pandemics and thus we are unaccustomed on how to deal with them. If a pandemic does develop, no doubt it will be severe in its consequences. Many will die and world commerce will be interrupted. People will be scared, investors will be scared. Risk will not be tolerated; safety will be prized. A pandemic is an outlier in statistician's prose. However, the possibility of an avian flue pandemic is being written about in the daily press and discussed at the highest levels of government. Consequently, it cannot be ignored and should be included in one's thinking about the immediate future. Authorities around the world are coordinating efforts to avoid a widespread outbreak. We have no particular words of wisdom and only hope for the best.

As per usual, our predictions for 2006 are listed below. We hope that your holidays have been happy and that the New Year is filled with opportunity.

PREDICTIONS FOR 2006

1. The dollar will continue to be strong (\$1.15-\$1.20/E)
2. The Fed will stop raising interest rates in Q1 2006
3. Republicans will lose seats but maintain control of Congress and the State House
4. Troops will be drawn down in Iraq by 20%
5. Japan's economy will continue to gather steam
6. Exchange Traded Funds (ETF's) will boom as an investment vehicle
7. More U.S. money will flow to international markets
8. Corporations will continue to hike dividends
9. The U.S. Stock Market will do better than in 2005
10. Politics in Europe will remain confusing; a negative for equity markets there
11. Osama will be sold out and captured (we're *still* sticking with this!)

A FINAL THOUGHT



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

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