Trusted Advisor

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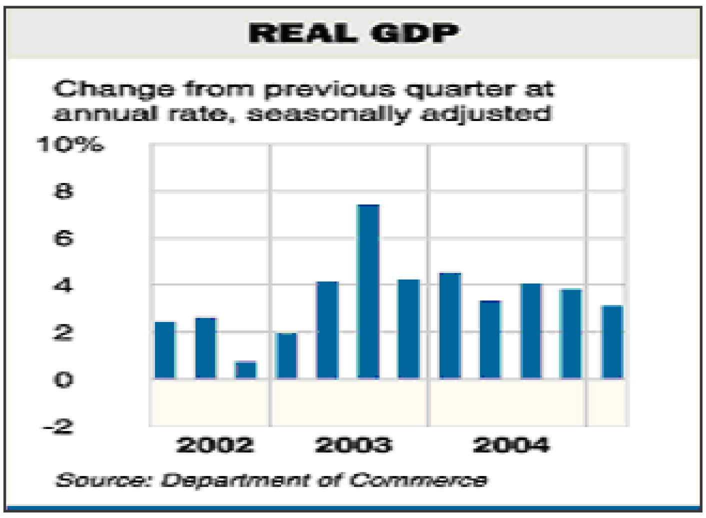
Worrisome Trends



Source: Department of Commerce

Guessing overall market direction is not the primary driver of our investment selections for client portfolios, but we do watch trends for significant signs of a change in direction that may affect your holdings and the timing of new purchases or sales. Two recent pieces of information, preliminary Gross Domestic Product and inflation in the first three months of 2005, have given us reason to worry. The U.S. economy grew at a 3.1% seasonally adjusted annual rate in the first quarter of 2005, the slowest growth in two years, based on a Commerce Dept report released at the end of April. Economists surveyed by Reuters MarketWatch had been expecting Gross Domestic Product to increase 3.6%. I suspect growth has not slowed to the degree indicated by today's report, but retailing companies have generally reported slowing sales in their first quarter filings with the SEC. Additional data will come in later, leading to revisions that could be sharp. The revised first-quarter GDP estimate is due out May 26. Inflation also heated up in the March quarter. Core consumer prices increased at a 2.2% rate, putting the year-over-year increase at 1.6% -- near the top of the Federal Reserve's comfort zone. With energy as a huge contributor, the actual inflation increase was 3.3%, the fastest since an identical jump in the first quarter of 2001. It was inevitable that we would feel the effects of imported price inflation due to high-energy prices, and now the evidence is upon us. These combined figures remind me of a word not used to describe the U.S. economy in about thirty years: "Stagflation." This is a condition wherein the cost of things gets higher, corporate earnings increase nominally, but after adjusting for inflation, the economy is hardly growing at all. We are a long way from this questionable condition but may be headed in that direction. Why? High-energy prices hurt our balance of trade and force consumers to make choices: Fill the gas tank or eat out on Friday night? Take the family on a long summer vacation or a shorter one close to home? Of course, energy is not the only thing threatening America's economic growth. In the belief that free trade is ultimately good for all, bi-partisan majorities in Congress have passed bills to promote free trade; perhaps the most egregious mistake in this well-intentioned approach was granting "Most Favored Nation" status to Red China in 1997. Despite China's continual suppression of the right to free speech, free press, emigration and decent working conditions, Congress and successive Presidents continue to allow our markets to be flooded with cheap Chinese goods, putting thousands of American businesses and their employees out of work. Meanwhile, exports to China, largely intellectual property like software and entertainment, are there widely

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pirated, while Chinese authorities look the other way. China has artificially pegged its currency at a low value relative to the U.S. dollar to maintain its dominant pricing advantage. With the Chinese among the largest buyers of Federal Treasury debt issues, there appears to be little stomach for challenging this ruinous state of affairs in Congress, despite recently reported posturing on the issue. General Motors' and Ford's bonds were lowered to "junk" status during the first week of May, and China is preparing to launch its offerings of automobiles into our markets within two year's time. The Chinese word "Kow Tow" comes to mind when thinking of our trading policy with China. Does this rant about the gutting of U.S. industry amount to a belief in an imminent bear market? Not necessarily, but the long-term trend is worrisome, which is why we demand a sizable margin of safety for any stock we acquire.

Fortunately, the companies in our clients' portfolios have universally announced healthy quarterly earnings this season. In a more sanguine market environment, their stocks might be soaring. But after five unimpressive years for equities, the mass of investors is skittish, having lost confidence in their ability to judge stocks. Take Wal-Mart (WMT), for example: with margins improving yearly on the back of those cheap Chinese imports, and with an impressive performance by virtually all metrics for a business, Wal-Mart's stock price trades below its level of five years ago. Now, Wal-Mart probably would have been considered a conservative purchase during the peak of the Tech Bubble in early 2000; yet despite its reputation as the retailing juggernaut, the stock has oscillated in a trading range with no discernible trend upward. Discounted Cash Flow analysis, something we rely upon, would have indicated that the stock was over priced for most of the past five years. It was a stock we avoided, not because the business was a bad one, but because the shares were simply too expensive. Without benefit of this type of analysis, a do-it-yourself Wal-Mart investor has tied up funds unnecessarily for years. All of our stock and equity mutual fund selections are run through this type of analysis, adding value for our clients who have stayed with us through five long, not particularly easy, years for the markets.

Vanguard Closes its Healthcare Fund

We picked up this five-star-rated mutual fund for appropriate client accounts in early November, 2004 when healthcare stocks were being buffeted by bad news, especially with regard to the supposedly lethal effects of popular pain killer prescriptions. The fund recently achieved an all time high price and closed its doors to new investment, but current holders can add to positions, and we will handle this for you if judged opportune.

Real Estate as an Investment Class

REITs, virtually ignored when they paid dividends near 10% in 1999, have become much beloved in the eyes of buy-side analysts (retail brokerages) now that yields for many have fallen under 5%. We began trimming our exposure to this sector last year after enjoying handsome cash flow and price appreciation. However, I love liquid securities backed by real estate for their ability to dampen portfolio volatility and provide true portfolio diversification. An opportunity to again increase the commitment of client portfolios to REITs presented itself, this time through a mutual fund focused abroad. Securitized real estate, as an investment class of its own, is increasingly acceptable to conservative investors outside of the United States, particularly in Asia. Like the United States, the developed countries of Asia have an aging population, most of whom are conservative investors seeking income. Yields on bonds in Japan, for example, are below our own, so investors are turning to real estate-related securities to receive higher income. It appears this trend is gaining traction. Potential demand seems similar to where U.S. investors stood with regard to REITs in the United States 3-4 years ago before the explosive rise of share prices for these domestic securities.

Marriage Savings

As an analytical financial type male, I must admit to being unimpressed with brides who insist that their families spend vast sums of money for that perfect one-day party -- a wedding. Better to keep it modest and instead ask the folks to help with the down payment on a new home, an excellent long-term investment. But since few brides-to-be will abide such humbug, a middle road to a glorious, but affordable wedding was offered in a Wall Street Journal article on May 6: instead of asking for crystal or a set of formal dinner plates, consider asking guests to instead pledge toward defraying the cost of the wedding extravaganza. To view the article, you can go to the "Useful Links" portion of our web site: www.trustedfinancial.com .

College Costs Continue to Soar: How to Afford College

A single year of schooling in a private college now averages about $27,000. There are many tools to make college affordable. Some are more appropriate when the child is young; others can make the best of an expensive situation, even if your high schooler is going to matriculate this fall. Through a combination of tax credits, tax write-offs, and overlooked sources of inexpensive borrowing, a higher education should be affordable for every worthy student. The best approach is to begin socking away money in tax-deferred accounts such as Coverdale Education accounts and Qualified Tuition plans while the child is young. These are excellent vehicles through which grandparents, as well as parents can make a meaningful improvement in the lives of their progeny. For help in understanding the many options and how they may interact, give us a call!

Gary E. Miller, Certified Financial Planner ™
will be teaching classes during the remainder of 2005 as follows:

Class Title	Location	Date/Time	To register call or visit...
Financial Independence for Women	Irvine Valley College	Thursday evenings, July 14 & May 21 6 PM - 9 PM	www.123getsmart.com 949-451-5555
How to Find High Income in a Low Income World	Saddleback Community College	Saturday October 1 9:00 AM-Noon	www.saddleback-ce.com 949-582-4646
Retirement Plans for the Self Employed	Saddleback Community College	Saturday, November 5 9 AM - Noon	www.saddleback-ce.com 949-582-4646

(Footnotes)

[1] Still, inflation gauges in the report were mixed. The chain-weighted GDP price index, a measure of economy-wide inflation, increased at a 3.3% rate -- after rising 2.3% in the fourth quarter. The price index for personal consumption rose at a 2.1% rate after climbing 2.7% in the fourth quarter.

[2]"China hopes to make major inroads in U.S. car market" - USA Today. April 26, 2005

[3] Perhaps they should change their name to "The Great Wal-Mart of China"

[4] We've also added quite a few, thanks to client referrals!

[5] This statement may seem to contradict the earlier one suggesting that the dividends from foreign real estate securities are low compared to domestic REITs. Recall, however, that a yield of 2-3% is high to a Japanese investor where government bonds yield less than 1.36%. Mabico.com, 3-31-05.

[6] Lot's of other useful financial information available here as well. Note: These are sites we believe to contain valuable information, but cannot vouch for the accuracy of third party providers. - Finaid.com, May 2005