June 14, 2006

Special Report from Baker Boyer Investment Management:

No doubt you have seen the news media covering the sharp drop in the equity markets that have taken place over the last 30 days. Although I have received a few phone calls from clients, I am guessing many more clients are sitting at their televisions wondering if the world is collapsing and what Baker Boyer is doing to stem the losses.

On this point, I wanted to take a few minutes of your time to review what is happening in the world in general. Right now, the markets are driven by two competing economic theories. One is the time tested (60 year) theory of US Centric economic performance. The other is the modern Global Strategy of investing. The US Centric view dictates that what happens in the US, whether it be good or bad, will quickly affect the entire world. If the US economy slows, then inevitably other countries supplying goods to the US will instantly have to cut production slowing economic growth everywhere and forcing a recession.

This view has been a dominant theory since the end of World War II, and with good reason, as the US accounted for well over ½ of the world's GDP after the last Great War. Since then, that percentage has decreased, but is still a respectable 28%.

The more modern view of Global Strategic investing is really looking at the microcosms of all the world's economies and determining if US production slows, will that cause a collapse in the rest of the world's economies; or is there enough demand worldwide, especially in the new BRIC nations, to offset any decrease in US demand? In addition, is there enough internal demand in places like India and China to dictate even greater exports of US heavy industry and goods to those markets? For various reasons Baker Boyer believes in the latter, more Global view on investing.

When looking at the US economy in addition to the Japanese, Indian and Chinese economies, our joint economies produce upwards of $20 trillion dollars or nearly 50% of the global dollar valued GDP. In terms of purchasing power parity, it is even a larger amount. With the US economy expecting 3 % growth, the Indian Economy producing over 9.5% growth, China producing greater than 10% growth and the Japanese market finally ramping up production and seeing 10.8% growth in manufacturing, I believe the Global economy can sustain a slowing of the US economy and still grow at a reasonable pace.

In other words, the global economy may slow, but shouldn't collapse as many people fear. In fact, the markets are being spooked more by day traders and hedge fund managers who are panicking, as opposed to seasoned investors whose decisions are based more on logic, financial statement analysis, and research capabilities with long term views on investing.

For sure there are some headwinds in the way of the US economy, the main one being the rate of inflation and what the Federal Reserve is prepared to do about it. Currently core inflation is again pegged at over 3.0% for the year, higher than what the Fed has in mind, but still not overwhelming. Their main course of action is to raise interest rates to slow down investment and consumer consumption. This has had mixed results, one of which is the inversion of the yield curve. In past newsletters we explained that an inverted yield curve is where it is more expensive to borrow money for a short period of time than it is to take out a long term loan, 10 years or longer. It usually indicates that people feel more uncertain about what will happen the very next day rather than what will happen in 10 years. It also is common for the curve to invert right before a recession.

Baker Boyer believes it is more likely that the US economy will slow in the next 9 months rather than go into recession. Consumer confidence has remained high, unemployment is at 4.6% (remember in the 80's when 8 – 10% unemployment was the norm), and long term interest rates have remained very low 5.0% for a 10 year US Treasury. Recession may be in the cards after 9 months, but for right now, it is unlikely.

As the global markets continue to grow, but at a slower rate, their own internal demand should help prop up the rest of the world economy and provide a soft landing from which the US economy will bounce back.

From a historical view, when the markets take a sharp decline the typical knee jerk reaction is to fall back to what you know best, and that has been the US Centric economic view. As Fed Board Members and others warn of inflation and of an inverted yield curve, people have panicked and believed the sky is falling, but Baker Boyer is watching the horizon, and currently we see a few clouds out there, but not a tsunami. The panic that has taken hold of the markets seems unfounded, and should be corrected. However, after that, a slower pace of US and international equity increases is expected as the entire world economy slows from the very rapid pace it has set over the last few years.

I wanted to write this letter to our clients to calm fears regarding where the market is and what is in the future. Although we can see the nice horizon, we can not predict a mob mentality, and the mob rules the markets. Fortunately, even a mob has to succumb to reason and logic, and parity will be found.

Baker Boyer has structured your specific investment portfolio to match your need for growth and stability with your tolerance for market adjustments. Our management style is to make optimum growth with as little financial uncertainty as possible, mixing our blend of US and international equities with fixed income and cash to lessen the volatility. As we go forward, Baker Boyer will be reviewing our asset allocations and change them if we believe the volatility is too large for the return we can expect.

Rest assured, we are watching the markets with GREAT care. If you would like to hear more of our views on the market, please join me by watching CNBC at 9:20 am on Friday June 16th, where I will be providing insight into our investment style.

Thank you for your interest. We appreciate your continuing support of Baker Boyer Bank.

Sincerely,

Mark H. Kajita

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