BB Quarterly Update

Summer 2004 clearly was assigned to that old sage and wise nymph, Mother Nature. "Why," you ask? Because it is Mother Nature who is now controlling the entire world's economy. To make my point, let's imagine what the world looked like 250 million years ago. The World as we know it was one large land mass called, "Pangea." The tectonic plates had not yet separated and all continents were closer to the equator where dinosaurs roamed. Why am I rambling on about ancient animals? Because those animals eventually died due to the ice age, decayed, and eventually became what is coveted by all economies —, OIL!

Oil is now priced at a high never before seen, which really begs the question, why now? There are many answers to this question and we will touch on those throughout this newsletter.

You may recall a movie that came out a few years ago called, *"The Perfect Storm,"* in which George Clooney plays a fishing boat captain who takes his crew to sea in an area where multiple hurricanes and storms collided to form the storm of the century. The analogy, unfortunately, is that we are in the middle of oil's Perfect Storm. Let's take a look back at some of the headlines that have transpired during these last few months. The first and foremost is the takeover of the Russian oil giant Yukos, by the Russian government, (namely President Putin). This was a bold move to stifle opposition in the Russian Federation. Unfortunately, this had a huge impact on the oil market. Yukos was still drilling but didn't have the capital to ship the oil to the open markets. Places like China and other industrialized countries were left without oil to stoke their factories.

Russia hasn't been thought of as a major oil producer in the past. The major oil producing countries like Saudi Arabia were believed to have the largest oil reserves in the world. Now, in fact, it is believed that Russia may hold the second largest oil reserves on the globe. Additionally, Russia is currently the second largest producer of oil in the world, second only to Saudi Arabia: so if there is a hiccup in its shipments of oil, the entire world feels a shudder. Fortunately, we here at the bank have believed that other oil companies shipping directly to China were safer investments and they have flourished since Yukos' oil shipments have suspended.

The Iraq War has also placed a lot of strain on oil prices. Although Iraq itself does not produce as much oil as everyone imagines, it is the thought that if insurgents can disrupt oil shipments from Iraq, they may be emboldened to disrupt oil shipments from Saudi Arabia, Kuwait or Yemen as well. Oil prices are based on future prices and the hedging of oil prices is rampant when uncertainty of a constant oil supply is present. So, although insurgents haven't brought the entire U.S. economy to its knees, (a feat to which they undoubtedly aspire), they have added to the chaos in the market.

I know everyone is tired of hearing me say it, but China is also a major player most industrialized countries have not adequately considered as they

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forecasted the world's demand for oil. China, as we all know, is going through a massive restructuring of its own economy, moving from the agrarian society favored by Mao Tse Tung to an industrialized economy. This means about 300 million people will be moving from rural to urban communities in the next decade. This requires massive oil and other raw material shipments to build the cities needed.

During the last oil crisis of the 1970's it was merely the embargo put in place by OPEC that limited the supply of oil and caused the price of oil to skyrocket. In the current crisis it is not only the disruption of the oil supply, but also an increase in oil consumption by China which has added to the turmoil.

Finally, Mother Nature played one last card that disrupted the oil supply. Her little children named, Charley, Frances, Ivan and Jean ravaged Florida and then have gone on to wreak havoc on the production of oil in the Gulf of Mexico. What was thought to have been slight damage to floating oil rigs, ended up being much more severe. You know that a storm is pretty violent when it can take an oil rig like the 9,400 ton Deepwater Nautilus and lose it in the Gulf of Mexico. The Nautilus was actually lost to the world until it was found the next day, 73 miles from where it was originally anchored.

So what does that mean for oil prices in the future? Unfortunately, I think it means we will see higher oil prices for a long period of time. Maybe not at the highs we are seeing today, but definitely above the $20 per barrel we became accustomed to in the past. The final chapter of this oil price increase has yet to be written. About now, oil refiners of the world are determining what to produce next. It is at these oil refineries where they take raw crude and make heating oil, gasoline, and other byproducts. At about this time they slow the refining of gasoline and increase the refining of heating oil for homes and businesses. It has been estimated that U.S. heating oil can increase in price by as much as 75% during this next winter.

How will this increase in heating oil effect consumers? It depends on what kind of winter the East Coast can expect. If it is a relatively mild winter there may be little effect on consumers' overall purchasing power. However, if it is a severe winter like it was last year, it could have a devastating effect on the ability of consumers to buy discretionary goods. Although we in the U.S. may be losing our status as the largest producer of goods in the World, the U.S. is still the largest purchaser of goods, which means a disruption of U.S. buying power has global ramifications.

Inflation has also been on the rise since oil prices have increased. If you think about it, anything that takes fuel to produce or ship to market will be affected by a doubling of oil prices. This will lead to an increase in raw material prices of all goods. Unlike the 1970's though, oil prices are increasing but at the same time labor costs are decreasing as more and more goods are being produced in lower cost production centers like China. This should help to stifle an enormous increase in inflation, but inflation will continue to rise as long as oil prices stay at these highs.

We have talked about the overall environment of oil, but what does that have to do with forecasts for the future? As long as oil prices continue to be high, I believe the economic expansion we are seeing will be slowed. I don't believe that it will cause a world-wide collapse because corporations are much more profitable than they have been in many years and unemployment continues to decrease. However, I do think it will be a slower recovery with fewer rapid upturns.

Bond markets may also take some warning shots as well. Overnight rates have increased from 1.0% at the beginning of summer to the present 1.75%,

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Value of Staying Invested and Not Market Timing

One of the most difficult decisions in investing is to not sell and to stay invested when the market is declining, because those who hold on usually perform substantially better than people who try market timing. An example of how market timing hurts your overall return is the realization that $1 invested in stocks twenty years ago would be worth $ 11.50 at the end of 2003. In addition, if a person market timed and missed the 17 best months of the 240 months in that 20 year period, their $1 would only be worth $ 2.71 at the end of the 20 year period. That is less than the $ 2.83 they would have had if they invested in treasuries for that same time period.

To emphasize the perils of market timing, in a year that the market goes up 12%, the average market timer will make 2-4% on their funds. They do substantially worse than the markets because they tend to buy when the market is up and get frightened and sell out when things are bad. It can be difficult not to sell in a declining market, but selling and missing out on a market rally can be much more costly.

People often market time because of their emotional attachment to their investments. It is human nature to panic in a decreasing market and to get overly excited in a rising one, but in investing you need to try to remove your emotions and stick to your asset allocation. The moral of this story is the best long term growth strategy is to stick with your asset allocation even during difficult times and your return will be higher than if you try and market time. This is the strategy Baker Boyer Bank Investment Management and Trust uses and it has proven successful over time.

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with expectations of a rise to 2.0% at the end of the year. So why is the 10 year treasury reporting at near 4.0% at the time I am writing this newsletter? If the 10 year doesn't change you will only receive 2.0% more to hold a Treasury note 3,364 days longer than the overnight rate is now paying. What is wrong with this picture? I think we should expect higher interest rates in long term bond rates, starting with the 10 year. This has led us to keep our bond portfolio relatively short so if the market does make a rapid change, we will hold our bonds only a few years until they mature.

What is our forecast for the future? Cautious optimism are still the words of the day. We believe consumers are still feeling relatively good about their future, as more of the U.S. consumer base is now employed, and consumer confidence (while lower in the past few months), is still relatively high. However, as higher oil prices start to affect consumers in the pocket book during this winter, we will have to wait by the sideline and hope the effects are relatively slight. It will be the first part of next year before we can actually judge the mood of U.S. consumers. By that time they will have been paying for their higher heating bills and holiday bills will just have hit their credit card statements. If consumer confidence can remain high at that time, I think we can breathe a sigh of relief.

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How many times have you wished for just a few more minutes? How about that week when you just can't fit everything in, but you cannot decide what projects to cut out? Then there is the time when the phone rings and you feel frustrated because you just do not have time to answer another call today?

Time is measured in many ways… Businesses frequently calculate the value of their employee's time. They include their salary, cost of benefits, and the cost of providing an office to determine the cost per hour for that employee. This exercise helps a manager determine if it is profitable to use a specific employee in the accomplishment of certain projects. It also helps to determine if it might be more effective in some cases to employ an assistant in the completion of those projects.

How you spend your time is more important than how you spend your money. Money mistakes can be corrected, but time is gone forever.

~David Norris

I recently found a calculator on the internet that determines if you have enough discretionary income to buy "more free time". The calculator computes the value of your time and compares it to tasks you may wish completed; e.g., painting your house yourself. The calculator can determine that it will take 200 hours of your weekend time and lets say that each of those hours is worth $20. This would tell you that you could pay a painter up to $4,000.00 to do the job instead of doing it yourself. Therefore buying more free time from the painter.

Thomas J. Stanley, Ph.D. and William D. Danko, Ph.D. tell us in their book *"The Millionaire Next Door,"* that people who are Unsuccessful Accumulators of Wealth spend far less time than people who are Successful Accumulators of Wealth consulting with professional investment managers, accountants, attorneys and investment counselors. The Unsuccessful Accumulators of Wealth worry more about financial issues, but they fail to leverage their time by proactively seeking the appropriate assistance that they need.

Seeking sound financial advice has many benefits. Only one of which could be that a good investment manager's experience can buy more free time for you now and in the future. Finding investment information today is easy. Understanding what information is worthy of your time is much more difficult. Allow our experience to relieve you of those hours of worry, concern and work.

Our commitment at Baker Boyer Bank of "Guiding you to a Brighter Financial Future" includes helping you conserve or find more of the precious time that you have for family and personal goals. It is our objective to evaluate and understand your needs so you worry less about financial issues, freeing you for other endeavors. It is our desire to assist you in taking proactive steps that will lead to the realization of a more balanced approach between your financial and personal goals.

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