

BB Quarterly Update



In this edition of the newsletter, I will discuss investments that get little attention, but are probably more complicated than stocks. I'm speaking of bonds and the multitude of them in the market at any one time. The last few years have seen a dramatic decrease in bond yields, but with the recent increase in economic trends one would have expected rates to balloon over the last year. It is important to understand how and why bonds react to certain events and ignore others.

To begin with, it is important to understand what comprises the base to which all other bonds are compared—the 10 year US Treasury Bond—the safest bond in the entire World. In general, all other bonds in the US set their interest rates against the base of the current US Treasury plus an incremental increase called the spread. The riskier the bond, the higher the spread has to be to compensate for the risk. Bond analysts then grade bonds, just like your teacher graded you in school. In this case a passing grade is a BBB rating, and anything rated AAA, AA, A or BBB is called investment grade. A rating of BB and below is considered non-investment grade or junk. The lower the grade, the higher the spread when measured against the US Treasury, it's really that simple. The bond market itself is really very fluid; by that I mean for a bond to sell there must be an interested seller and more importantly an interested buyer. They will agree to a price on the bond and a rate of interest to be paid.

There are other things that can influence bond markets, most notably the Federal Reserve and its Chairman, Alan Greenspan. The Federal Reserve controls other influential rates, the overnight bank rate and the prime rate. This has an indirect affect on US Treasury rates which in turn affects all other bond rates.

How much Mr. Greenspan can influence all bond rates is debatable. He has recently warned of the

current trade deficit, the social security crisis and the budget deficit, but even so, these have done little to increase the 10 year US Treasury rate. Although the Federal Reserve has more than doubled the overnight rate over the year to its current yield of 2.25%, the 10 year Treasury has hovered around 4.25% about where it was at the beginning of 2004. So what influences the bond market more than the Federal Reserve?

Think of the bond market as a new car auto show. You may have the prettiest car on the floor, a beautiful model pointing at it and a wonderful exhibit—but eventually it will be up to a buyer and seller to negotiate a price. Analogously, Alan Greenspan is on the sidelines and wants to influence the market through increased rates and couched language in his speeches. For all that he can say and do, it is really up to the American People and the good old buyer and seller to decide whether they believe him or not through their market transactions. Right now the jury is out.

continued

Investment Management & Trust Services

Guiding you to a brighter financial future.

Advisors • Managers • Trustees • Founded 1869

Inside this Issue

Mark Kajita's Letter	page one
A Day in the Life	page three
2004 Stock Market Recap	page four

continued from page one

So what has been influencing the bond market? Remember how I said there is always a buyer and seller of a bond, and they have to agree on a price and interest rate? Well, in this case the buyer of the bond is an individual and the seller is a corporation selling its own bond (i.e. Boeing selling a Boeing Bond). The dilemma we currently face is US corporations like Boeing are flush with cash; they don't need to float any more of their own bonds, thus there is a lack of supply in the overall debt market.

To further illustrate, US Corporations have come off two years of very profitable earnings and high

productivity, and have accumulated an immense amount of cash, over \$600 billion in US banks and an estimated \$750 billion offshore. So the usual sellers of the bonds (US Corporations) really don't have a reason to sell, making the bonds currently in the market in short supply and more valuable. This in turn keeps the seller's rates low, and because there are so few bonds, the buyer will take what he can get. It really is a seller's market!

In addition, foreign corporations and governments like China have sold an enormous amount of goods to the US consumer over the years. Because of that, they were paid in US dollars that they now need to invest. They have a need to buy bonds for their investment portfolios. So on one hand you have buyers, (foreign corporations and governments) that are very anxious to buy and on the other, sellers (US Corporations) not interested in selling. Because of such demand interest rates remain extremely low. No matter what environment Mr. Greenspan foresees, as long as supply and demand are in their current state of flux, rates will not increase dramatically. As always, the question is when will we see a change in the interest rate dynamics?

We must pay close attention to the way corporations use their current cash hoard. US corporations can exercise some options with the cash they have on hand, and we may start to see these things take place. For example, they can pay out higher dividends, buy back their own stock or bonds, purchase another business, invest in machinery and equipment, or hire new employees.

If any of these actions take place, the effect would be to cause a drain in cash and increase the likelihood of corporate borrowing. This would drive up the supply of bonds in the market,

continued on page four



Savor the Moment

We're minding your investments so you don't have to. We listen to you and find solutions that fit your needs—now and in the years to come. Savor the moment and let us *guide you to a brighter financial future.*

BB Baker Boyer Bank
Guiding you to a brighter financial future.™



A Day in the Life of a Trust Officer

When I was asked to write this article for the newsletter, many thoughts began flowing through my head. The tremendous amount of variety I see as a trust officer has kept me interested for the last 27 years. While many estate plans have a lot of similarities, they are all just a little different too, if for no other reason than the people involved. And I would have to say it is also a rewarding career, as I help my clients through their financial problems.

My day usually begins with a review of the previous day's activities. Each trust officer is assigned the day-to-day responsibility for certain accounts. This daily review not only keeps me in the know about clients, but prompts me to take any necessary action with the help of an investment manager to see that funds are always invested properly and promptly. I can see who received income and from what source, any payments that were made to a beneficiary, and any bills that were paid for a client.

Depending on the day, part of it is spent every week in meetings with other trust officers and portfolio managers doing a thorough review of client accounts. The accounts are not only checked to verify that the investments match the account objectives, but also that any payments being made to beneficiaries are in accordance with the terms of the will, trust or foundation. Certain trust documents are intentionally not set up with specific instructions for distributions, but rather give us (the trustee) the discretion to decide whether or not to make payment to a beneficiary and if so, for how much. It is the responsibility of these committees to review such requests and determine if the request falls within the guidelines of a particular trust document. This is sometimes a tough call.

Institutional accounts are also a big part of what we do. Many charitable organizations have entrusted their investment management to us and part of my job is to facilitate their incoming donations and make sure they get the reports they need for their committees.

Sometimes, I must watch accounts transition to a different kind of trust, whether by death of a client or other circumstance. When you are a trust officer for someone for twenty-some years, you become a good friend. We help a client through their own advancing years with services such as payment of their bills, coordination of tax information, arrangement of in-home care, and uninterrupted investment of their assets. While it is difficult to lose a good friend we realize continuity is the primary reason many of these accounts were established in the first place. We assure our clients that their financial plan continues on after they are gone—for the benefit of their loved ones or favorite charity.

We assure our clients that their financial plan continues on after they are gone – for the benefit of their loved ones or favorite charity.

The remainder of my day is filled with many incoming and outgoing phone calls and drop-in visits. These range from me calling or visiting a client to check on them after they have had surgery

or to hear about their latest vacation, to a client calling me to get more information on a new stock or mutual fund they have heard about. ♦

Janice Palumbo
Vice President and Senior Trust Officer
palumboj@bakerboyer.com



2004 Stock Market Recap and Look Ahead to 2005

The year 2004 ended up being a decent year in the stock market. The S&P 500 ended the year with a 8.99% gain, the NASDAQ was up 8.59%, and the Dow Jones up 5.36%. For most of the year the markets were flat with the election, higher oil prices and a declining dollar grabbed the headlines. As the year progressed and oil prices came back down and the election had a clear winner the market had a nice year end rally. 2004 also saw a job market on the rebound, better retail sales than expected and record trade and budget deficits. The U.S. economy has had six straight quarters of above average growth in GDP, and corporate profits were up an average of 19% in 2004. Both of these factors and low interest rates have led to corporations having large cash positions. These cash positions have led to an increase in share repurchases, increased capital

spending, dividends, and mergers and acquisitions, which we expect to continue into 2005.

In 2005 we also expect the Federal Reserve to continue to increase rates, the dollar to continue to decline due to the record trade and budget deficits, and for GDP to slow from its recent 4% rate to around 3.5%. These factors should lead investors to companies with consistent earnings, strong balance sheets, low debt and healthy cash flow. Smaller company stocks have been the best performers for four straight years, but in 2005 we look for large company stocks to outperform. ♦

Ted W. Cohan CFP®
Vice President & Portfolio Manager
cohant@bakerboyer.com

continued from page two

making them less valuable. When bonds become less valuable, buyers are going to demand higher interest rates to entice them to buy.

We here at Baker Boyer are watching data very carefully to determine when we think this shift is happening. A dramatic decrease in unemployment, increase in machinery and equipment purchases, and stepped up mergers and acquisitions should be the first signs. When cash starts to be siphoned out of the economy, the pressure on bond prices should relax and yields should start to rise. This process may take us through all of 2005, thus we will remain defensive in our bond purchases with a view on shorter maturities. ♦

Mark H. Kajita, CPA
Vice President and Senior Portfolio Manager
kajitam@bakerboyer.com

Contact Us

Walla Walla Home Office
7 W. Main
P.O. Box 1796
Walla Walla, WA 99362
509-525-2000
1-800-234-7923

Tri-Cities Trust Office
7601 W. Clearwater
Suite 404
Kennewick, WA 99336
509-783-6800
1-800-234-7923

Yakima Trust Office
3703 River Road
Suite 3
Yakima, WA 98902
509-576-9000
1-866-525-2262