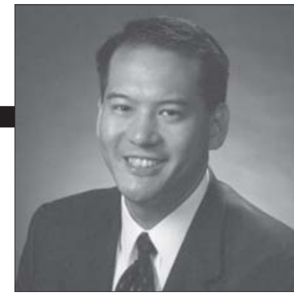
Quarterly Update



I am writing this newsletter on the last trading day of 2005. What a year and what a ride it has been! We have experienced the aftermath of a tsunami, a housing boom, hurricanes, Fed tightenings, oil crunches, cold winters, hot summers, and the list goes on and on. At year-end however, the Dow will basically have stayed steady and the Lehman Aggregate (the bond benchmark) will have gained just over 2.4%. Actually, this is quite a feat in the aftermath of Greenspan and those at the Federal Reserve more than quadrupling overnight rates from 1% 18 months ago to 4.25% as of the writing of this newsletter.

The question of the day is, "What will happen next year?" Since we have seen equities held stagnant and no growth in the total return of bonds during 2005, can we expect the same thing for 2006? I think not… for a number of reasons, all of which I will explore in this edition of the Baker Boyer Bank Investment Newsletter.

The first headline of the year that will change the outlook for the US Equity and Bond markets is that Greenspan will be stepping down as Chairman of the Federal Reserve and will be replaced by Bernanke. Bernanke, it is believed, will look to keep interest rates within a range. This differs from Greenspan's gut instinct in his determination of interest rates. Greenspan colloquies like "I don't know what a neutral rate should be but I will know it when I get there…" will fade into the past as it is believed that Bernanke's policies will be even more transparent and more easy to forecast than even the prior Federal Reserve's policies.

Going into 2006, it may seem counterintuitive to say that inflation is in check and at the same time see oil prices hovering at $60 per barrel; but there are good reasons for my hubris and belief that there is little current reason for the Fed to continue raising interest rates far into the future.

I know that everyone has been startled by the rise in energy prices. I know I have, especially when a friend told me that his heating costs for the month of December topped $500 for the month. Most people believe with increases in energy and oil prices that inflation should be rampant as it was in the early 70's and the oil embargo of 1973. Instead, we have seen relatively tame price increases in the consumer markets and for good reason. Productivity in developing nations, especially China, has been very high. This has translated into Chinese goods actually decreasing in price as more goods hit US shelves. So, although US retailers have been paying more for shipping costs, the actual goods they are buying for resale are either holding their price or actually coming down in price. Thus, US consumers haven't felt the energy price increases hit their domestic spending pocketbook.

This leads me to believe inflation will be contained and interest rates will probably be raised only two or three more times in 2006 and then halted as the Federal Reserve surveys the impact of their monetary policy.

By the way, one of the impacts of the Fed's monetary policy has been the inversion of the yield curve. I mentioned this many times both in the media and in this newsletter that sooner or later the Fed will invert the curve (meaning short term borrowing rates are actually higher than longer term rates… i.e. the two year rate is higher than the 5 or 10 year rate). Typically this inversion, at the very least, has meant that corporate profits decline and, at worst, it means that a recession is looming. Think of it in these terms, people are more scared of investing in the short term (1 – 2 years) than they are of investing in the long term (5 – 10 years): translation, investors think that in the short term a recession is looming and they want more interest paid to them to invest during a recession.

OK, that's typically what an inverted yield curve means. Why do I think that isn't what *this* inverted yield curve means? First of all, corporate profits are

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extremely high and corporate cash is at levels not seen in decades. $1.5 trillion dollars are still held by US corporations with more coming onshore as companies are retooling their factory floors and hiring more workers. In terms that everyone can picture, think of yourself as a young child in a tree and you are going to jump off a limb. Now you can jump off and hit the ground with all your might–THUD–or you can choose to jump off the limb and onto a trampoline. Which would you rather do? Jumping off the tree limb, represents the soft patch or slowing of the economy the US has seen in 2005. The US economy hit a soft patch when consumer demand fell after the hurricanes ravaged the Mississippi Delta and consumer purchases plummeted. American pocketbooks were also tightened due to the combined estimate of $5 billion sent for hurricane and tsunami relief, which doesn't include normal contributions to personal charities. If there were no other safety precautions you would typically go THUD, and a recession would occur.

However in this case, US corporations are retooling at the same time consumers are pulling back. Instead of hitting the ground, you hit a trampoline as you bounce back up into the air. I believe US corporate purchases of durable goods, computers, and other things to increase efficiencies will keep the US economy from truly faltering. In addition, US industrial goods aren't only being sold here in the US, but are being sold in China and other developing countries to build new factories and industries. This demand for US industrial goods will continue the US economy through this consumer soft patch, adding confidence into the economy and starting a second surge of purchases.

It is interesting that for many years the US and the World Economy has relied on the US consumer to hold it in a growth pattern. I don't say that lightly either. Without the US consumer purchasing goods over the last decade, surely the US economy, as well as that of Japan and Europe, would not have weathered through the storm created by the terrorist attacks of 2001. That one event was so devastating to the World, and its fragile economy after the dot-com companies had gone bankrupt in early 2000, that it was truly miraculous that the US consumer spent and kept the corporate sector profitable. In truth, China and the rest of the developing nations of the World also rely on the US consumer to continue growth for the next 20 years. That makes the US consumer the single most important factor in the World Economy for years to come, and why I watch any twitch and flutter that indicates a lack of consumer confidence.

We saw such a flutter and flat out plunge in consumer confidence after the hurricanes in 2005, but a surge in corporate demand for industrial goods kept the economy pumping even after 1 million people were displaced. This surge in industrial demand coincided with our prediction of just such a surge due to IRS tax breaks for corporations who hired new employees and invested in new plant and equipment. That September plunge in consumer confidence was then met by a huge increase in confidence for the last two months of 2005. With continued support and in-

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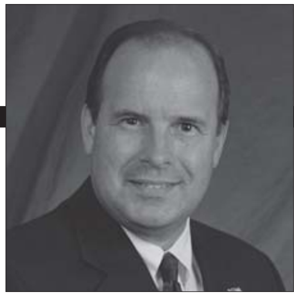

I am pleased to announce our recent move to the newly constructed Baker Boyer Bank building in west Yakima. Located on Triple Crown Way at the intersection of 40th Avenue and Castlevale Road, the official groundbreaking took place on June 30, 2005. The builder for this project was Tri Ply Construction in Yakima, Washington with consultation by Opp & Seibold General Construction in Walla Walla, Washington.

At the Yakima location we will offer a range of trust services, investment management expertise, qualified retirement plan administration and related plan investment consulting.

Baker Boyer's continued commitment to individuals, businesses, non-profit organizations and charitable foundations of the Yakima Valley is evidenced in the construction of this new building. The new building will greatly enhance our ability to nurture existing relationships and develop new ones while focusing on our clients' needs.

This permanent location will allow us to serve our clients and their professional advisors in comfortable, state-of-the-art surroundings. The interior of the building was designed to provide an ideal setting in which to conduct business with your Baker Boyer professional advisor. Unique features of our new building include focal walls highlighting local agriculture, the Yakima Valley and Baker Boyer's history, high ceilings with beautiful skylights and a palette of warm, welcoming colors. Our spacious client reception area with its comfortable seating arrangement and wide screen television will make you feel at home during your visit to our office. Our boardroom will also serve as a Community Room for Baker Boyer clients to reserve for after hours meetings.

As a 30 year resident of Yakima, I am very proud of the "bricks and mortar" commitment that Baker Boyer Bank has made to our community and our valley. I am equally proud to be the manager and trust officer charged with the responsibility of fulfilling our promise of providing personal, responsive and efficient service to guide you to a brighter financial future. I look forward to welcoming you to our new office.

Alan Dillman
Vice President and Trust Officer
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Groundbreaking – June 30, 2005
Jon Bren, Megan Clubb, Alan Dillman, Mark Kajita, Linda DeYoung

A lounge area complete with television awaits clients as they visit the Yakima office.

The doors to our new office were officially opened on January 9, 2006.

Baker Boyer Bank manages approximately 70,000 acres of farmland in the Northwest for trusts and individuals. A benefit that we receive from our professional farm management is the insight into the farm economy through working with various landlords, government agencies, farm suppliers, grain companies and farmers. While this insight does assist us in our planning and decisions, only hindsight is 20/20.

Who would have guessed that during this past year the cost of a gallon of diesel fuel would exceed the local price for a bushel of wheat, or that fertilizer prices would increase by 40%? Given the increase in production costs and the current local wheat price of $3.02, many farmers will be in non-profitable positions and the returns for landlords diminished. Farmers need to be optimists and farming tends to be cyclical, so let's all hope that the farm economy will show some improvement this year.

The demand for farmland continues and while we do not act as a real estate broker, we seem to get quite a few calls from individuals looking for property. Earlier this past year there was a surplus of investors looking to purchase farmland in the Walla Walla Valley. That demand seemed to dry up with the increase in fuel and fertilizer prices. However, during the past couple of months we have again been contacted by "outside investors" looking to sell their highly appreciated properties and purchase farmland.

While the reasons for owning farmland can be varied, most investors understand the concept of diversification and farmland can be a great diversification tool. Farmland has been considered a somewhat stable investment that has generated returns from land appreciation and direct agricultural production. Of course not all farms are created equal and we have seen substantial variations in the returns from individual farms.

If you own a farm or are considering farmland as an investment, we would be glad to talk with you about the expected returns and operating plans.

John Mathwich
Vice President and Trust Officer, Farm Manager
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fusion of much needed capital by the corporate sector, this little flutter should become a thing of the past and continued growth will be sustained once again by the US consumer.

How long will the US consumer have to bear the burden of leading the World Economy towards growth? At least through the rest of this decade I would guess, until the Japanese consumers and those of the developing nations can add their own support to the economy. At that time it will be the consumers of China and India that will push the World Economy toward growth.

I don't say this as an ominous harbinger of doom, but as a person who sees an opportunity to invest in the future. As the middle classes of China and India start to grow, it will only be natural for them to want the assets of an affluent society. As China and India have a combined population of 2.3 billion people, over 7.5 times the population of the US, it is only fitting that their middle classes will start to drive consumer demand in the future. Oh what a fascinating time we live in!

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