Quarterly Update

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I often speak to people who go on cruises around the Caribbean. They tell me how fun the cruise was, but also how difficult it was to know how much to spend at each port. I was surprised to learn that people have a budget when they go on a cruise and they may hold off on spending at certain ports thinking that maybe, just maybe, there will be a better product or a better deal at the next port of call. So, this huge city on water moves from port to port and each port hopes they get more than their fair share of that purchasing power and the passengers hope they get a good deal. Sound familiar to anyone out there? Cruising somewhere in a warm climate sounds pretty tempting— especially now that the days are getting grayer and colder.

Unfortunately there weren't any fun cruises on the horizon in the financial markets this summer. There was a lot of volatility taking place in the markets and it has been hard for the average person to get their arms around why it's happening. In one word the volatility is due to "Liquidity."

I know, I know, you hear this all the time on television, that there is a liquidity shortage that is affecting the economy. But what does that mean? Liquidity, simply put, is the measure

of how much cash there is in the market to purchase assets. When there is high liquidity, cash is flowing extremely free and purchases of assets are quite heavy. When there is low liquidity or in other words a "Liquidity Crisis," or "Crunch," there is not enough cash in the financial system to purchase assets.

We are currently going through a liquidity crisis not only in the U.S. but globally. Why??? There are many reasons why, but ultimately it boils down to bigwigs on Wall Street not adequately taking into account the risk they were taking on certain investments. These investments were low quality for the most part and were not easily traded between buyer and seller. In other words they were 1) risky, and 2) hard to sell in declining markets.

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How can Baker Boyer Bank help you with your financial goals? Contact your Financial Advisor today - or call Janet Manuel at (509) 526-1282 or manuelj@bakerboyer.com.

Enter the slowdown in the US economy and housing. When that happened it prompted many of these risky investments to lose value and attractiveness to "sophisticated" investors who were the holders of those investments. At that point, there was a clamoring to sell out of the investments that were the riskiest and take the money and run. Well, like we learn in business 101 classes, we all know you must have a willing buyer to have a sale. The seller can attempt to sell anything he wants, but if no one wants to buy it, it will be a very slow day. In this case people were selling the riskier investments and no one was buying. The price on those risky investments plummeted and as bankers who lent to these "sophisticated" investors started seeing their collateral evaporate they started calling in loans.

This caused a wholesale rout in investments that led banks to reconsider every single loan they had on their books or were in the process of lending out, and reassess whether or not they wanted to lend out the money. It was a big pendulum swing when banks, which were giving out cash freely in a highly liquid environment, started to shun investors interested

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Year-End Planning Tips

The final months to consider gifting retirement dollars to a charity are upon us. The Pension Protection Act, passed in 2005, had a very significant provision in it that allowed retirees, age 70 ½ or older, to contribute tax free to a 501(c)3 charity of their choice, up to $100,000 from their individual retirement account until December 31, 2007. The provision offers welcome news to high net worth individuals that pay dearly each year on their required IRA distributions in income tax.

This particular gifting strategy can be a significant event and one that you should consider if you have a charitable intent in your estate plan, and you have deferred retirement dollars you feel you can contribute. One note of caution however, is that this is a gift, and once it is given, it cannot come back to you for future use. But with that aside, why wait to give excess assets to charity until death when there are many positive reasons to strongly consider such a transfer today. Some of the benefits include: Assuring continuation of the charity of choice and their good work; the fact that this gift will meet your minimum annual distribution required by the IRS; as the donor you will not have to pay income tax on the IRA transfer as you would if you received the distribution directly; if you have a taxable estate, both the gift amount and the appreciation that gift would have had within your estate will be gone and not subject to estate taxes currently up to 45%.

We hope you won't let this powerful estate planning tool pass you by. Contact a financial advisor at Baker Boyer Bank to learn more about this and other beneficial Wealth Management options.

Michael Pettyjohn
VP & Senior Financial Advisor
pettyjohnm@bakerboyer.com

in borrowing to finance their deal. So all lending, the Good, the Bad and the Ugly, got cut off.

This ultimately made liquidity in the market dry up. Cash was being hoarded by solvent investors and institutions for fear that any investing, even on a very good low risk investment, was tantamount to rolling dice at a seedy casino.

Later in the summer when the same liquidity crisis started to affect the European Union, the phenomenon went global. Enter the Foreign Central Banks and the Federal Reserve. They understood that liquidity was the primary concern, not the health of the economy. Remember, this problem was started by "sophisticated" investors on Wall Street not by the core economy which was stable, but not growing at a strong rate. The Federal Reserve and other Banks around the world felt that the liquidity crisis could be solved by dumping massive amounts of cash into the economic system. It was believed that if they pumped enough cash into the system they could add a sparkplug to get the economic engine going again. And their plan worked in part; we are probably in first gear instead of third, but it's a start.

In order to add even more liquidity, the Federal Reserve also made a huge about face as it pertains to its interest rate stance. In the past when they talked of the possible future liquidity crisis, the Fed was very direct in stating that they would not bail out investors by lowering rates if they were simply being greedy. When push came to shove, the Fed felt the economy might be jeopardized if they didn't help out during this liquidity crisis and thus, lowered both the discount rate and overnight rate by .50% in September.

What this should do is add cash into the markets to help liquidity flow into 2nd gear. The problem is that the underlying issue with risky investments didn't go away. Cash is flowing but it is flowing to different investments and avoiding the riskier ones... once burned twice shy.

Think of it like that cruise ship filled with buyers going from port to port, searching out the best deal. They are unhappy with the risky investments so they avoid that port of call. Yet, they want to buy something so they look toward the gleaming reflection on the waters of a port in the distance. This port sells oil, wheat, gold and all sorts of commodities. The long term need for these goods is high because the emerging markets are demanding more and more of these basic commodities. The passengers (investors) steam forward fast and furious to get to that port of call. When they get there they disembark and start buying like crazy. Prices start rising as people start speculating.

My story may seem trite, but I believe it portrays the reality of the moment. As people are less comfortable with investments that aren't tangible, they have drifted back to a barter style investment strategy, buying hard goods and shunning companies and risky loans. This has resulted in a dramatic price increase in

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commodity prices; everything from wheat to oil.

People also make the comment that Europe must be in a much better position than the US because the Euro is strengthening. In retrospect that may sound right, but not when a liquidity crisis of this magnitude is going on globally. What is really happening is that the Europeans are holding onto their Euros tighter than we are our Dollars.

Put another way, the Europeans are on another cruise ship and they aren't buying much of anything at any port. Because of this they are sitting tight on their Euros which makes their Euro worth more (e.g. the less an asset like the Euro is in circulation the more valuable it is when you find one). This doesn't mean their cruise ship is nicer or sturdier, it just means their passengers are not willing to buy.

So when will this liquidity crisis end? I may be going out on a limb, but it could be that this liquidity crisis may be here for another 18 months or so. It takes time for all of the sub-par investments to get marked down adequately and for stability to come back to the pricing system. In that time we will have spurts of volatility as liquidity continues to be an issue, similar to Old Faithful at Yellowstone.

Underlying all this however, the global economy seems to be handling this crisis quite well. The Central Banks, in general, acted quickly and decisively and added a semblance of stability to the markets and seem poised to again step in if another spurt of volatility takes control. Sooner or later everything that's heading down has to hit the ground. When that happens, it can only go up from there. We look forward to that day.

Mark H. Kajita, CPA
VP & Senior Portfolio Manager
kajitam@bakerboyer.com

Baker Boyer Bank
WEALTH MANAGEMENT

Contact Us

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

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

Yakima Trust Office
909 Triple Crown Way, Suite 101 • Yakima, WA 98908
509-576-9000 • 866-525-2262