

QUARTERLY REPORT

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HAPPY DAYS ARE HERE AGAIN... MAYBE

The rains in California have subsided and we are returning to our more typical blue skies. The mood on Wall Street seems to be brightening as well with reported earnings for a number of companies surprising on the upside. We are anticipating another good year for the stock market in 2005 and a relatively benign environment for bonds. You will find more specifics about our market expectations for the coming year in the article below.

We continue to find the global arena fascinating and have included a brief geography “quiz” to highlight interesting but perhaps little known facts. We hope you find it both entertaining and enlightening.

On a personal note, I am grateful for the privilege of working with a strong team including Dave Niebuhr who heads up our research efforts, the welcome addition of Alice Wong who brings additional analytical focus, Warren Wimmer who provides our macro outlook on economics and Karin Dreyer who offers experienced and personable service as we interface with our various constituencies. Most of all, I am pleased that our clients continue to value our services and utilize our counsel in myriad ways.

Cordially,
Kathy Wimmer, CFA
President



OUTLOOK FOR 2005

The New Year saw Wall Street celebrating its second consecutive annual gain as the S&P 500 Index rose a healthy 9%. Yet, the S&P 500 Index remains 26% below its all-time high set in March of 2000. The Dow Jones Industrial Average (Dow) logged a 3.2% increase in 2004 as the Dow's blue chip companies were weighted down by a loss of confidence in the drug sector, most notably with Pfizer and Merck. Both companies suffered from conflicting studies on the class of painkillers known as COX-II inhibitors, namely, Celebrex

and Vioxx. We remain concerned with Merck's potential liability with Vioxx claims but are more sanguine with Pfizer's possible exposure to Celebrex claims.

The Nasdaq Composite Index (Nasdaq) is a strong barometer of the high-tech industry, as well as younger, high-growth companies. The Nasdaq logged an admirable 8.6% increase in 2004 after the whopping 50% increase in 2003. Nevertheless, the Nasdaq remains at less than half its all-time high set in March of 2000.

Please turn to page 2

KEY FACTS FOR 2005

- Annual gift exclusion \$11,000
- Estate tax exemption
\$1.5 million in 2005
\$2.0 million in 2006-2008
- Highest marginal estate tax rate
47% in 2005, 46% in 2006
- IRA contribution limits
\$4,000, plus another
\$500 for those over fifty
- 401(k) contribution limits
\$14,000, plus another
\$4,000 for those over fifty
- SEP IRA contribution limits
25% of compensation or
maximum of \$42,000
- Top Federal tax rate is 35%
on income over \$326,450.
Highest combined effective
tax rate for California
residents is 41%

INSIDE THIS ISSUE:

OUTLOOK FOR 2005 1

A LITTLE 3
GEOGRAPHY QUIZ

OUTLOOK FOR 2005

Continued from previous page:

In 2004, we continued to see the United States serve as the locomotive for worldwide economic recovery. Low interest rates and rising equity values in homes stoked the appetite for increased consumer spending in the U.S. despite the Federal Reserve ratcheting short term interest rates (Fed Funds) to 2.25%, a



“The New Year saw Wall Street celebrating its second consecutive annual gain as the S&P 500 Index rose a healthy 9%.”



three-year high. The Federal Reserve’s “measured” approach to rate hikes helped keep longer rates from climbing as investors maintained confidence in the Fed’s ability to rein in inflation over time. Indeed, the 10-year Treasury note declined slightly to 4.22% in 2004 from 4.26% in 2003.

Two major themes in 2004 were the continued, phenomenal economic growth of China and the rise in the cost of oil, from \$32.52 per barrel at the start of the year to \$43.45 per barrel at year end. China’s GDP grew nearly 10% in 2004 compared to less than 2% for Europe and 4.5% for the United States. Indeed, Chinese industrial production grew some 14% in 2004, which fueled a worldwide surge in demand for oil and industrial commodities. Since 1978, China has quadrupled its GDP, an unprecedented accomplishment. Asian demand for energy accounted for over half of the annual 2.6 million barrel increase in oil usage in 2004. We continue to see increased demand for oil and commodity consumption in 2005, even as China slows its GDP growth rate down to a still-high

8-9% per annum. China’s growth will remain a boon to its Asian neighbors, as well as the United States, as we continue to benefit from low-cost Chinese goods serving as a brake against inflation.

We anticipate another year of solid U.S. economic growth in 2005, although less than the 4.5%+ rise of 2004. The slowing U.S. economy will see higher

short and long-term interest rates as the Fed steps up its campaign against nascent inflation. Rising U.S. interest rates should moderate the decline in the dollar versus other major currencies as higher U.S. interest rates

attract overseas investors into U.S. denominated debt. Tighter fiscal policy will also act as a brake on the economy as the large U.S. federal budget deficit rules out any additional tax cuts. The deficit will continue to be under pressure from increased pharmaceutical benefits for Medicare recipients and the Iraq war effort.



The housing market will also continue to cool as rising rates make home purchases more expensive. The refinancing boom of the

past five years has provided a “wealth effect” which has served as a stimulant for increased consumption and higher corporate revenues. We remain concerned about prospects for the U.S. housing market but believe that any decline would be gradual and moderate. We expect to see the S&P 500 index rise in a 6% to 8% annual range and believe that both short and long-term notes will become more attractive to bond investors in the second half of the year.



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A LITTLE GEOGRAPHY QUIZ BY DAVE NIEBUHR, CFA



Given the increasing roles of China and India in the world economy, we thought a geography quiz to start the year was in order. Some of the answers are surprising!

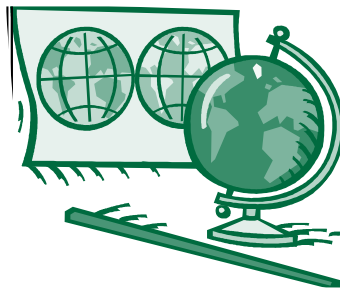
- 1) Of the six countries pictured on the left, which country has the largest land area?
- 2) Rank the same countries by population.
- 3) Rank them by literacy.
- 4) Rank them by GDP (Gross Domestic Product).

Extra Credit) Which country has the most oil reserves?

1) Russia wins the area contest hands down with almost double the area of the two runners-up, the U.S. and China, which are roughly the same size. Canada is close behind. Brazil is not much smaller than Canada without its waterways but India is only one-third our size. In terms of arable land, the U.S. is the clear winner, although if global warming is indeed on its way, both Canada and Russia could be ahead by the turn of the next century.

2) China leads the world in population at 1.3 billion people with India close behind and gaining at 1.1 billion. India's population is much younger – nearly 32% are under 15 years old (an even higher percentage than Brazil's 27%) compared to 22% in China, very close to our own 21%. We are a distant third in population at 293 million, Brazil is fourth at 184 million while Russia is a shadow of its former Union with only 144 million people (not many more than Japan's 127 million) and the fewest, about 15%, under 15 years old. Canada is by far the least populated with only 32 million inhabitants.

3) If you can believe the CIA (from whom we got most of this data), Russia has the highest literacy rate at 99% followed closely by a three way tie at 97% for the U.S., Canada and China (maybe it's easier to decipher those characters than we think.) Brazil lags at 86 % while India is far behind at 60% (70% for men; 48% for women)



4) It should come as no surprise that the U.S. economy is the most productive, with GDP in 2004 of about \$11 trillion. China, however, isn't too far behind at \$6.4 trillion and India is third at \$3 trillion (Japan's GDP is about \$3.6 trillion.) Brazil, Russia and Canada, in descending order, bring up the rear at a little over a trillion dollars each. On a per capita basis, this works out to \$37,800 in the U.S., \$29,800 in Canada, \$8,900 in Russia (about the

same as Mexico), \$7,600 in Brazil, \$5,000 in China and \$2,900 in India.

Extra Credit) Comparing energy reserves is challenging. 'Proven' reserves, the standard measure, are a tradeoff among geologic estimates of what's physically there, the estimated cost of getting the oil out of the ground and current market prices. Russia has tremendous reserves of both oil and natural gas but getting them out of the ground and across Siberia, barring significant global warming, is going to be an expensive process. In terms of proven (not actual) oil reserves, Russia's 51.2 billion barrels (per the CIA) are about twice those of the U.S. or China, at about 24 billion each, and way ahead of those in Canada, Brazil and India. However, all five countries added together don't come near the 262 billion barrel reserves of Saudi Arabia. On the other hand, in terms of natural gas, Russia dominates with over seven times the reserves of Saudi Arabia or the U.S., which are about the same.

Please turn to page 4

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We strive to optimize our clients' financial well being by coordinating investment decisions with other professionals in the fields of taxation and estate planning.

A LITTLE GEOGRAPHY QUIZ

Continued from page 3

Observations:

The world has experienced significant changes since the Berlin Wall came down fifteen years ago. Russia has gone from being the undisputed number two world power to a country beset by internal woes and conflicts and a declining population. China's GDP has almost tripled in the same time frame, turning that country into the second largest economy in the world. Combined with moderate population



growth, the Chinese have enjoyed a significant rise in both personal incomes and wealth. Today, the U.S. and China, despite huge differences in culture, history, government and language, are very similar in many demographic measures (such as age and relative income distribution) and

in the problems they are likely to face over the next few decades. Both see the specter of dwindling energy reserves, aging baby boomers and increasing public indebtedness. Competition between the two countries for natural resources is likely to grow, although we are hopeful that the use of western technology along with Chinese capital will be mutually beneficial.



Disclosure: "Be careful about reading health books, you may die of a misprint." Mark Twain Keep that in mind as you read these articles. We obtain data from sources we believe are reliable but they should not be relied upon for making life-changing decisions.