BRIAN D. LOWDER, INC.

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FINANCIAL MARKET OVERVIEW

The relatively modest stock returns during the first two quarters of this year were nearly completely offset by the declines during the third quarter. Some categories performed noticeably better than others such as small-company value, international and mid-cap value, but in general, the average diversified stock fund fell nearly 3% during the third quarter and is up less than 1% through September 30, 2004.

The surprise category was bonds. Even though Alan Greenspan raised the short-term federal funds rate three times, long-term bonds initially dropped in value but have rallied since then to post 3% gains for the quarter. Below are sample returns of various asset classes during the third quarter of 2004:

Year-To-Date	**3rd Qtr.**	
- 2.5%	- 2.9%	Dow Jones Industrial Average
+1.7%	- 1.9%	S&P 500 Index
+2.4%	- 1.9%	Wilshire 5000 (broad market)
- 2.4%	- 4.6%	Large Cap Growth
+2.8%	- 0.4%	Large Cap Value
- 0.5%	- 4.9%	Mid Cap Growth
+6.0%	- 1.0%	Mid Cap Value
- 3.0%	- 6.2%	Small Cap Growth
+7.1%	- 0.8%	Small Cap Value
+19.5%	- 0.2%	International Stocks

FORECAST

Inflationary pressures will remain low and **corporate earnings** are likely to grow at a moderate rate with gradual improvement over the next five years. Only a few corporations have the ability to raise prices as their costs increase. Oil companies are the best example. They can raise prices overnight at the slightest hint of increased costs, reduced or impaired supply or simply fears of disruption. Most corporations cannot raise prices without the risk of losing customers and this phenomenon will persist for many years. Yet, low inflation and the inability to raise prices will not adversely impact corporate earnings growth throughout the remainder of this decade. The two primary reasons are solid consumer spending (baby-boom generation) and the U.S. productivity rate. The productivity rate (essentially the ability to produce the same or a better product or service in less time and at a lower cost) in the U.S. has more than offset the inability to raise prices.

The current **interest rate** level, the future direction, and the speed of change in interest rates all have an enormous impact on our economy and the investment performance of many asset classes. Except for retirees living on the income generated from their investments, nearly all consumers and businesses benefit by, and would rather have, lower interest rates. Therefore, most consumers and businesses are wishful and hopeful for continued low rates. Since April 1, 2004, short-term interest rates have moved higher (up ¾%), and we expect they will continue to do so over the next few years.

The Federal Reserve Board has raised the federal funds rate three consecutive times at each meeting

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since April 2004. After each meeting, short-term rates were increased by ¼% and the federal funds rate now stands at 1.75%. Three interest rate increases over a six-month period certainly appears to be negative news. The direction of the interest rate change(s) is up and the speed of change does appear rather swift. However, the current level, or nominal federal funds rate, is only 1.75%. Without proper perspective, the recent interest rate increases may cause some individuals to formulate a negative outlook for the future direction of our economy.

Over a three-year period beginning with the Sept 11th tragedy in New York through the end of 2003, Alan Greenspan lowered the federal funds rate 11 times to an astonishingly low 1% rate. Since April 1, 2004, the federal funds rate has increased three times and now stands at 1.75%. Three short-term interest rate increases following a three-year period of falling interest rates is not cause for celebration, but the change is not going to turn our world upside down either.

In general, rising interest rates adversely impact the value of bonds and most other fixed-income investments. As interest rates rise, bond values fall and the magnitude of change is greater for bonds with longer maturities than bonds with short maturities. After three consecutive interest rate increases since April 1, 2004, investors would normally assume that the price or value of long-term bonds would fall. Not so! An odd and short-term reaction to rising interest rates has occurred over the past six months.

Short-term *bond* rates have increased modestly over the past six months, but have not increased as much as the ¾% increase in the federal funds rate. Curiously, one would expect long-term *bond* rates (and *home mortgage* rates) to increase by ¾% as well, right? Wrong! Initially, when the federal funds rate was increased by ¼% in June, 2004, long-term bond rates and home mortgage rates had already jumped ¾%. Four months later and after two more federal funds rate increases, long-term bond and home mortgage rates are right back where they were before rates began rising. What's going on here? How can interest rates stay nearly flat after Greenspan raised the federal funds rate by ¾%?

It's difficult and challenging to predict the timing of interest rate changes over the short-term and equally difficult to determine when the financial markets will react. In the recent case, the initial reaction to the Greenspan rate increase was an immediate jump in interest rates that was three times as large as the actual ¼% federal funds rate increase. Now, we are back to April 2004 levels even though the federal funds rate has increased two more times. The reasons why long-term bond and home mortgage rates have not increased <u>over the short-term</u> (or more accurately why rates have retreated back to their April 2004 level) are: the perception that the economy may be growing too slowly; the war in Iraq is a negative cloud hanging over consumer confidence; the Presidential election is undecided and filled with negative accusations; oil prices have jumped to nearly $50 per barrel; and a general feeling that the long-term outlook is unclear. The end result is the financial markets (all investors combined) don't believe or see an improving economy and therefore this is no need or justification for higher interest rates.

The most likely interest rate scenario over the next six to eighteen months is that short term rates will continue to increase and long-term interest rates will not move up much at all. This scenario is often referred to as a flat yield curve – short and long-term interest rates are not significantly different. As the economy grows, the U.S. involvement in Iraq subsides and the negative presidential election campaign is over, our forecast calls for moderately higher interest rates throughout the balance of this decade.

In summary, the five-year outlook looks attractive. Corporate earnings growth is solid and will

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continue to move along at a reasonable to above-average pace. Inflation will remain low and while interest rates will continue moving up, the rate of change and the nominal level is still relatively low. Lastly, one of the most significant factors supporting a positive economic environment in the years ahead is the age and income demographics of the baby-boom generation. We will discuss the economic power of this segment of the population and their impact on economic growth and specific asset classes below.

REAL ESTATE

The demand for new homes and the volume of real estate transactions has started to slow and will continue to weaken over the rest of this decade. This statement will be very difficult for homeowners, mortgage brokers and real estate investors to accept. Similarly, investors refused to believe stocks were overvalued in the late 1990's and would rather believe the past trend will continue indefinitely. If our readers will carefully review the support and rationale for this position and leave their emotions and rear-view mirror perspective behind, they too will be able to understand why real estate has performed so well over the past seven years and why real property values will likely hold steady at best and gradually weaken in the years ahead.

First, the stage was set for a recovery in real estate prices beginning in 1997. Real property values were depressed and declining from 1991 through 1996. Second, the stock market was performing very well in the late 1990's which led to greater wealth creation and consumer confidence. The technology sector in particular was booming and the wealth effect was spreading throughout the economy. Together, a build-up in demand from depressed levels and an increase in wealth were the catalyst for a recovery and surge in real property values.

Third, low interest rates provided additional incentive and desire for first-time homebuyers to enter the market and it allowed many families to finance a trade-up to larger homes without additional cost. Thirty-year fixed-rate home mortgages were nearly cut in half from a range of 7.5% to 8.5% down to the 5% range. Families could purchase a larger home, increase their mortgage, and still pay approximately the same monthly financing cost. Refinancing a mortgage was as common as changing the oil in your automobile. In addition, lenders were gladly offering lower variable-rate mortgages below the 5% fixed rates and lenders were happy to qualify borrowers at the lower variable rate. Today, real estate buyers can easily find lenders willing to offer 100% financing or no qualifying process at all when buyers are willing to make a down payment of at least 25% of the purchase price.

To summarize thus far, we began with depressed real estate values, followed by a significant increase in family wealth fueled by the overall growth in the economy, a bull market in stock prices and finally, interest rates declined to their lowest levels in forty years.

The most compelling and final piece of the puzzle that helps explain the surge in real estate prices is demographics. As people and households age and they enter their most productive income-earning years, they spend more on housing (up to a point). The U.S. Bureau of Labor Statistics has recently published the *Consumer Expenditure Survey, 2000*, which covers the ten year period ending in 2000. This report contains detailed information regarding our spending choices, patterns, income levels etc.

This survey offers valuable insight into the demographics of home buying and the enormous impact the baby-boom generation has on our economy. The greatest home-buying years fall between age 26 (when the average person marries and is transitioning out of the rental cycle) and age 42. A starter-home surge begins at age 28-31 and the highest volume of house buying occurs during the trade-up surge into age 37, but begins to slow

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markedly after age 42. ***The peak baby-boomers born in 1961 would have hit the primary peak in home buying in 1998 and the secondary peak at age 42 in 2003***. This data does not mean that the total market for real estate transactions has peaked, but it does coincide with the fact that momentum has clearly begun to slow and will continue to do so. The data also indicates that the peak *purchase prices* paid for a home (as opposed to peak volume of sales) occurs around ages 50-55. Usually, these transactions are described as "dream house" where the family is making the last purchase of a home that has everything they wanted. Lastly, the data also shows that the affluent class (top 20% of incomes) of home buyers makes their peak volume purchases at age 37. For the affluent section of baby-boom generation, that age 37 peak corresponds to the 1998 calendar year.

The peak-buying years of the baby-boom generation are behind us and their peak purchasing years occurred simultaneously with the lowest interest rate environment in over 40 years. The combination of the largest numbers of buyers, the lowest interest rates in forty years, and pent up demand for housing resulted in an explosive real estate market over the past seven years. Amazingly, the doubling of real estate prices occurred during a time when annual inflation rates (the driver of all past real estate booms) was less than 2% annually. Look around your circle of family, friends and co-workers and ask: Of those families who *wanted to buy or trade-up*, who hasn't made the move yet over the past five years?

Where is the audience of new buyers to support a continuation of housing demand – particularly after prices have already doubled? The next meaningful group of potential buyers is 15 years away from the beginning of their surge in real estate purchasing power. Better yet, what do you suppose will happen to the over-supply of four-bedroom plus baby-boomer homes as that generation moves into retirement (trade-down) phase beginning in about 2010? Baby-boomers will begin retiring, trading down, and the economy will be slowing at the same time (2010). Also, the number of new 20-year-olds entering the market will be down as well.

In our view, the near-term prospects for personal residence values are flat or very modest increases over the next few years with a gradual decline beginning later in this decade. Although rising interest rates will signal the end to repetitive home mortgage refinancing, the rate increases will be moderate and will not result in a precipitous decline in home values.

How significant are local circumstances regarding the future of real estate? Local conditions do matter and can certainly accentuate the decline or boom times. However, the most common "special" local conditions cited, such as: a) less open land space available for big development; and b) the growth in county population are certainly helpful and do impact real estate prices. But these arguments are not big enough to hold back macro-economic and demographic changes nor large enough to defend against the impact of rising interest rate changes on the real estate market. In addition, California's population is not growing as fast as planners once thought. Last week, the new estimate was reduced by 8 million residents over the next thirty-five years or about 200,000 fewer people annually than originally predicted. The drop is being attributed to a decrease in births (demographics).

Beyond 2010, apartments may perform better than homes when the downturn begins as people feel less confident about buying a home. Large upscale homes will likely be hit hard after 2010 and won't recover for many years. Office and industrial properties may be hit the hardest as baby-boomers retire, the economy slows and the number of new twenty-year olds entering the market will be down significantly. You have several years to make your plans and adjustments.

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If you have not purchased the home of your dreams and are awaiting lower interest rates, the time to act has come and gone. If you have an existing mortgage that does not match your long-term or short-term plans for your home (such as a variable rate loan and a long-term horizon or a fixed rate loan with a short-term horizon), or if you need to consolidate loans, we are recommending that our clients meet with their mortgage broker before year-end. Most of our clients have refinanced several times over the past five years and work closely with one or more mortgage brokers. If you do not have a mortgage broker relationship, or if you are not satisfied with your current mortgage solution adviser, we can refer you to one of several in which we have confidence. Below is one such adviser that our firm and clients have had a successful relationship with for several years.

Darin Laird Chase Home Finance
12780 High Bluff Drive, Suite 200
San Diego, CA 92130
(858) 794-6003

U.S. STOCKS

Stocks should perform relatively well throughout the remainder of this decade. Over the short-term, the Presidential election, the conflict in Iraq, rising short-term interest rates, the rising price of petroleum and the uncertainty in the public's perception of our economic future will mask the underlying direction of our economy. The baby-boomer's spending power will continue to be strong over the next five years.

The financial press has such a negative way of reporting the facts. For example, if you were told that corporate earnings are expected to grow 15% over the next twelve months, wouldn't you assume that a 15% growth rate is reasonably positive news? The financial press would rather convey this estimate in a negative manner. During the 2003 calendar year, corporate earnings were up nearly 30% over the dismal 2002 calendar year (the worst year for U.S. stocks in over a decade). Here is how the financial press presents these figures for 2004: The rate of growth in corporate earnings is expected to be 50% below the previous year's growth (a drop from 30% growth rate to 15%). The truth is our economy is moving forward at a sustainable pace. We believe large-company stocks offer the best risk-adjusted return opportunities.

Inflation will remain low, interest rates will be slightly higher and corporate profits will likely grow at a sustainable rate. Yes, there are disturbing exogenous events hanging over our heads, but wars do not last forever, and neither will the price of oil stay at current levels for a sustained period of time. We can argue how long it may take to resolve the above issues, but our present circumstances will improve.

INTERNATIONAL STOCKS

Perhaps the biggest opportunity and the best growth trend is the international market, especially those countries that are developing political and economic infrastructures to support an industrialized middle-class economy. The competitive global economy clearly favors moving many low, semi, and some high-skilled manufacturing jobs overseas to be produced at much lower costs than in the U.S. In particular, Southeast Asia, India and China have the best opportunities. We expect to continue increasing our portfolio allocations to international stocks over the next few years.

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ANNUAL RANKING OF WEALTH MANAGERS

We are pleased and honored to be recognized in Bloomberg Wealth Manager's fourth annual ranking of the top 450 leading independent financial-advisory firms. We have worked hard and diligently to maintain our level of personalized service and will continue with this endeavor in the future. Likewise, we appreciate your referrals and will continue to work hard to maintain that level of trust and confidence in the future.

ANNOUNCEMENTS

We are very happy to announce a new arrival. Our Office Manager, Remette Martinson is a new Grandmother. Sonja Jean Louise was born Sept. 26, 2004 and Remette is looking forward to her new role as "Grandma." We are also pleased to announce that Mike Kinnear, CFP, and his lovely wife Bernadette are expecting their first child, a baby girl, to arrive the day before Christmas. This will be an exciting holiday season with our two new babies!

Best regards

Brian Lowder | Clinton Winey | Michael Kinnear | Remette Martinson | Pam Priest