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Dear Money Management Client:

One year ago at this time we wrote that "the lows had been set for **long term** interest rates, but the odds of a rapid and sustained move higher from here is not likely because the consequences would be devastating to the economy and financial assets. An extended period of ranging and consolidation for interest rates is our outlook." That outlook proved accurate and enabled us to invest accordingly, achieving excellent returns in 2004.

Our confidence last year resulted from believing the Federal Reserve would do everything in its power to support economic growth. The Fed and other central banks around the world have maintained an accommodative monetary policy even as concerns over inflation mounted. **Short term** interest rates have risen, but no where near enough to bring monetary policy back to neutral. The reason is simple, authorities would rather err on the side of inflation than faltering economic growth caused by rising crude oil prices.

Now that signs of inflation are abundant, the Fed's loose money policy is increasingly less likely. Since the beginning of this year, the Federal Reserve has raised short term rates twice and assured us more rate hikes are coming. At what level higher short term interest rates succeed in dampening economic activity is a question of timing. And if it's only a matter of time before economic activity slows, don't expect to see long term rates moving much higher. Which is why bonds are making a lot more sense right now.

Currently the vast majority of economists are expecting higher domestic inflation, but it's not really the kind of inflation our Central Bank should be worried about. Sure the prices of raw commodities like oil and steel and cooper have risen, but all as a result of demand from Asia. What's not happening in the United States is a rise in prices as a result of consumers chasing goods, and that's the kind of inflation that's destabilizing. Higher commodity prices and rising short term rates are sewing the seeds for our next slowdown because they act as a drain on consumer descretionary spending. Without wage growth in this country, consumers just don't have the means to compete for goods and drive prices higher.

Massive U.S. trade and budget deficits and a falling dollar, (yes the dollar will eventually move lower) are all reasons to expect long term interest rates to increase. But that's only going to happen when China and Japan stop buying our bonds because they no longer need to re-cycle dollars received from selling us their goods. Yesterday's pledge between India and China to double their bilateral trade over 5 years could be just the thing which ultimately upsets the trade balance apple cart.

Weaving through these macro forces is an exercising adventure. The Fed's policy initiatives are increasing near term risk to equities, but bonds are likely to benefit. Longer term projections remain particularly susceptible to crude oil prices and demands emanating from Asia, but as always we remain confident that a well managed and diversified portfolio will weather all storms.

Very truly yours,

Clay Campbell