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We are a nation at war. Enemies largely unknown and without uniform are targeting our economy. They are loosely organized, present in many areas of the World, and principally united by religious beliefs that we, as a country fail to understand. Since early in 2002, the dollar has fallen 37% against the Euro and 22% against the yen. In the same time the value of gold and oil has risen dramatically. As a nation, our debt and our balance of payment deficits have risen to levels considered by some to be quite dangerous. Our dollar is just not buying what it used to buy and is being challenged in the role where it has been recognized since at least 1979: as the standard for measuring world currencies.

Still.... We are supporting troops on every continent and waging a war against a largely unknown enemy. We have undertaken enormous responsibilities at a time when the world sees an absence of the rule of law. The authority of the United Nations as an arbiter of world conflict has fallen into disrespect. Judges viewed as corrupt in their own small nations have assumed the bench of the World Court and the Court of International Justice. Some would provide them with the authority to adjudicate for the world.

In such a market environment it is indeed gratifying that our stock market rose in 2004. Some analysts are suggesting this will continue into the New Year.

For the year past, the Dow rose 3.15%, the NASDAQ 8.59%, the S&P 500 9.00%. A number of analysts, pointing to increased corporate expenditures, an improving job market, significant reductions in the price of oil, suggest that momentum will continue. But will it?

I see one of the most difficult new years ever for market prognostication. Are we winning or losing the war? Will other countries continue to support our capital needs by buying our bonds and supporting our markets? Will the intelligence network of some 100 nations including several significant Arab nations assembled to restrain Al Qaeda continue to work effectively or will the Terrorists gain authority and respect at the same time fragmenting that network?

A milestone should Al Qaeda progress to respectability within the Arab world will come on January 30<sup>th</sup>. Should the rebels be successful in making ineffective the Iraqi election, it will be seen within the Arab world as another instance where the extremist have thwarted the will of the Americans. They may even find success in moving their base from the wastelands of Afghanistan to a real country. Fellow travelers will not be quite so willing to provide assistance to the Americans. The result will reverberate in our markets.

For a more detailed analysis of what I have been discussing read America's Secret War by George Friedman published by Doubleday in November 2004. This is certainly not a commendation of George Bush but shows the tragic mistakes made by each of the Presidents for the past twenty-five years, mistakes that have given rise to our present nasty international environment. Its insight and holistic appraisal has been a revelation to me.

That environment has been significant in helping to shape where the US Government and its citizens have spent their money over the past three years. There is significant correlation between those expenditures and the industries that have led the American market. Terrorism has scared our people leading them to

spend on themselves. Little wonder that leading market sectors have included the home, home furnishings, leisure and entertainment. Meanwhile, the government has sought to protect its people from the ravages of terrorism's attack. Leading industries have included defense technology and communications, defense, steel. Armor manufacturers and manufacturers of bio immunology have done quite well. So haven't oil and gas and gold mining stocks.

With the unpleasant international environment and our people terrified by terrorism, business spent little on its infrastructure from 2000 until this year. What was particularly satisfying for the market domestically in 2004 and particularly toward the end of 2004 was to see our industry again begin to spend on CAPEX. There had been a hiatus for such as expenditures for technology equipment unrelated to defense took a sabbatical just prior to the millennium. What was also satisfying for our industry, the markets, and our balance of payments as a nation was to see the decline in oil prices that came just after the American elections and has continued to the present. These factors showed their impact on the job market, the stock market, our domestic output as a nation, the value of the dollar.

But an appropriate forecast of market activity for 2005 cannot limit itself to international events. An extraordinary array of domestic issues are scheduled that will impact the domestic market. Their individual focus can be anticipated to be addressed in the President's Inaugural Address and in his State of the Union Speech. They include tax reform, social security initiatives, class action tort claims, Sarbanes-Oxley, and fraud in the marketplace.

Facing so many issues all anticipated to come together in the headlines for January 2005 a market commentator can legitimately do little more than to fall back on that old market adage that it is not a stock market but a market of stocks. Further, the wise man has to reserve any broad market statement until after January 30<sup>th</sup> when the State of the Union Speech, the Inaugural Address, the initial commentary of the new American Congress and the Iraqi election are all history.

For January we anticipate volatile markets, encourage defensive flexibility, and recommend: diversify, diversify, diversify.

*The foregoing letter was written early in January while this is coming January 31. Although the market has been down in January, a significant event occurred yesterday that should strengthen national unity behind the President. His program for the New Year is comprehensive and he will need the added political capital just earned. The result of the Iraqi election will have its impact on our markets and may reverse the market trend that for January has been down..*

Warm Regards,

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