

Quarter Notes

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Market Summary

All the market indices ended the year near three year highs. After modest growth in the first quarter, the markets languished during the second and third quarters. The final quarter was the best in many.

International investments performed best, returning 17.6%. Returns were certainly helped by the dollar's fall. Small Caps, using the Russell 2000 as a benchmark, gained 17%.

Quote for the Quarter

"Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in corrections themselves"... Peter Lynch

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Year Closes on a Good Note Markets at Three Year Highs

2004 turned out to be a better year than we expected. The Dow Industrials, which includes Merck, Pfizer, GM and Coke (all of which suffered major losses), was up only 3%. But the S&P 500 had a better showing, gaining most all of its 9% in the last quarter. Small caps and intentional stocks gained 17%.

Bonds also surprised us. We expected the Fed's interest rate hikes, five in all, to have a more negative effect on bond prices. While the prices on short term bonds fell slightly as short term interest rates were increased, we saw little or no effect on longer term interest rates which have remained about where they were at the beginning of the year.

How will the Twin Deficits Affect Us?

We hear daily about the twin deficits which are significantly affecting our economy. What are they and how do they affect us?

The U.S. fiscal deficit is the result of our federal government spending more per year than it takes in. Currently this fiscal deficit is now 3.6% of our gross domestic product (GDP) – the amount of goods and services produced in this country. The Bush administration wants to make the tax cuts permanent, privatize a portion of social security, and pay for increased military spending, especially the War. Given these priorities, it is unlikely that we will see a reduction in deficit-spending anytime soon. Economic growth may help curb the shortfall, but a balance between revenues and spending will be required before we see a material change in the direction of the fiscal deficit.

The U.S. current account deficit is the record of all transactions with foreign countries that involve the exchange of goods and services. When we import more goods and services than we export, the U.S. current account reports a deficit. To pay for this imbalance, U.S. consumers, companies and our government are taking on increasing levels of debt.

Because the U.S. out-consumes the rest of the world, we have been running current account deficits for the last 30 years. These deficits continue to grow at record levels, now 6% of GDP or \$600 billion annually.

Index	Close on 12/31/2004	YTD % Change
DJ Industrial Average	10783.01	3.15%
S&P 500 Index	1211.92	8.99%
Nasdaq Composite	2175.44	8.59%
Russell 2000 Index	651.57	17.00%
MSCI EAFE	1515.48	17.59%
US Bonds*	7707.84	2.84%
*Intermediate Term		

Usually, trade deficits are corrected by a nation's currency dropping in value. As our dollar weakens against other currencies, our goods and services become less expensive for foreigners to buy – increasing U.S. exports. By the same token, foreign goods and services become more expensive for U.S. consumers, reducing demand for these goods and decreasing imports.

The dollar has weakened in relation to most major currencies, with the largest exception being the Chinese Yuan. This is because China has fixed the exchange rate between the Yuan and the dollar. The U.S. is China's largest customer and Beijing wants to keep its exports cheap for U.S. buyers. This fixed exchange rate has artificially prevented the dollar from falling against the Yuan.

Why is this bad? Because it doesn't make economic sense for China's economy to experience rapid growth, increasing foreign exchange reserves, and explosive foreign investment, yet maintain a depreciating currency because it is pegged to a falling dollar. The Yuan should be appreciating. Because it is not, the Chinese government is supporting excess demand from U.S. consumers.

The Bush administration is strongly suggesting that China allow the Yuan to trade freely against the U.S. dollar and let the global economy perform under natural market forces. If China's decision to decouple the Yuan and the dollar occurs gradually, it should be a relatively pain-free transition for the global economy. Because U.S. consumption drives the world economy, if the Yuan appreciates too rapidly and we dramatically reduce consumption, world-wide recession could result.



Do You Hold Old Savings Bonds?

There are over \$9 billion worth of savings bonds outstanding that have stopped earning interest.

Interest earned on matured savings bonds should be reported to the IRS even if the bonds were not redeemed. This could potentially expose the savings bond holder to interest and penalties from the IRS.

In addition, some states are trying to legally claim unredeemed and matured savings bonds held by residents. Other states will likely follow.

If you are holding any "forgotten" savings bonds, we can assist in analyzing which bonds are still accruing interest, and which need to be redeemed.

ADV Annual Offer

Each year the SEC requires that we notify clients when we are updating our ADV Part II. If you would like a copy of the updated form please call the office we will be happy to send one out to you.

Forecast for 2005 Continued Economic Growth or Maybe Not . . . Some Hurdles Ahead

Many analysts are forecasting continued economic growth projecting high single digit returns for 2005. We are skeptical. The main obstacles to the growth scenario are:

- 1) **Interest Rates:** Despite the Federal Reserve's small increases in short term interest rates, overall interest rates have remained lower than expected due to low inflation expectations. Lower interest rates keep current stock valuations attractive.
- 2) **Oil:** A retreat in oil prices to \$45 helped fuel the stock market rally. However, a new surge in prices well beyond \$50 could derail the markets.
- 3) **U.S. Dollar:** The falling US dollar helps US companies boost foreign sales and profits. However, it also pushes money away from U.S. stocks and bonds as domestic investors seek currency gains abroad and foreign investors avoid currency losses. A gradual fall in the dollar can use these conflicting effects as an offset, but if a rapid decline occurs, the stock markets could be hurt.
- 4) **War & Terrorism:** Cannot be forecast, but its relevance is undeniable as an impediment to economic growth.

Estate Planning

Nobody likes to think about death, but we all need to plan for it. Helping clients and their attorneys with estate planning is a critical function of our work. Since this is an area which is addressed infrequently by most people, here's a refresher on what some standard documents are designed to do:

Last Will and Testament – Your will controls who receives your personal property if the property does not pass by beneficiary designation. Accounts like IRAs, insurance policies, pensions and assets held as joint tenancy or trusts all pass by contract according to the beneficiary designations, not by your will.

The Executor – The person who handles the financial and legal issues and executes the instructions set out by the will. In Florida, this is called the Personal Representative.

A Trust – A separate entity which holds property. The trustee is the person named by the trust document who manages the property for the trust beneficiaries, while adhering to the terms of the trust.

Healthcare Power of Attorney – Allows you to appoint someone to make medical decisions on your behalf in the event you are unable to do so yourself.

Durable Power of Attorney – Lets someone else act on your behalf in all financial matters.

Living Trust – A trust established while you are alive to hold your assets. You may be the trustee and beneficiary of the trust and use the trust assets as your own. It allows you to make provisions in case you are unable to act on your own behalf. Also, the assets held in trust avoid the probate process upon death.

Probate – The probate process is a court proceeding which ensures that your will is properly executed.

Testamentary Trust – A trust established by your will, funded after you die.

Living Will – Spells out what measures should be taken to prolong your life in the event you are unable to communicate your wishes.

These are the basics. There are many more issues to consider when reviewing your estate plans. If it's been at least five years since you have reviewed your plans, it is time to review them again. The estate laws and tax issues are continuously changing. None of us wants to leave behind a mess for our loved ones, which could include an avoidable and unnecessarily large gift for your Uncle Sam.

