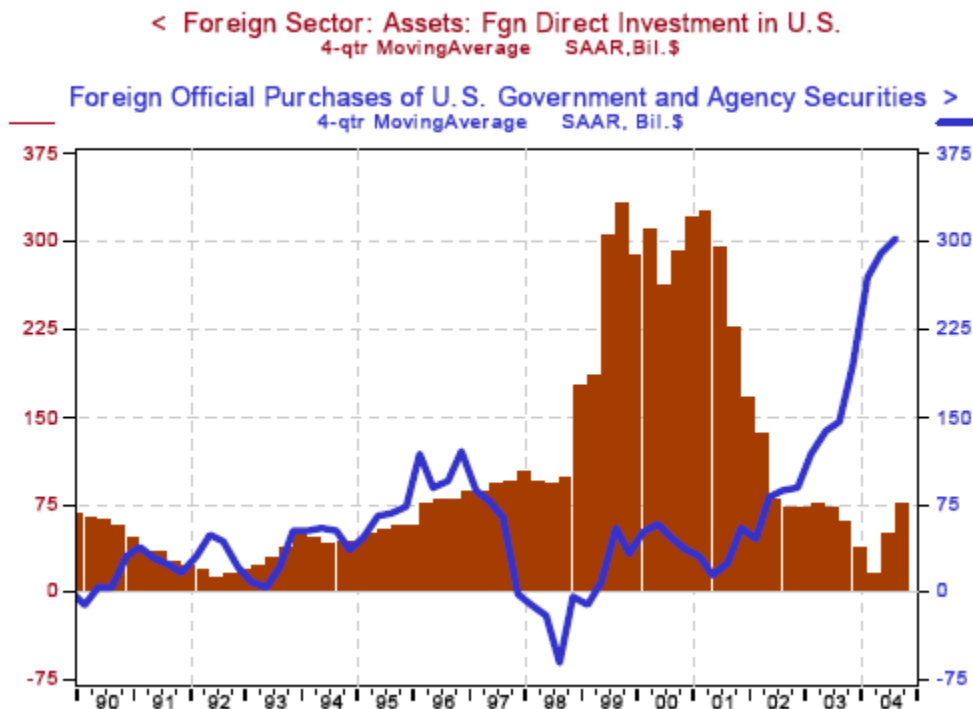


The Sidelines Remain Attractive

January 24, 2005

Over the last three years or so, market analysts have worried investors to death about the possibility of foreigners not buying our government bonds. Why? Because of the twin deficits of a negative balance of payments account and the federal budget. We have not analyzed it in detail, but it's our opinion that most of the accounts that we have lost over these same three years have been for this reason. Our argument has been and is (1) If China and Japan want to sell us goods, they must buy our treasury assets and (2) At some point in time, it will become apparent that common stocks lack total return characteristics and there will be a move into bonds.

How have our arguments worked out to date? As far as the purchase of our government securities is concerned, it remains as strong as ever. There has been a switch in that foreign private money no longer flows this way, but the slack has been taken up by foreign central banks. Please note the chart below.



Source: Northern Trust Positive Economic Commentary: December 17, 2004

What about the switch to bonds and out of stocks? So far in 2005, money has been flowing out of stocks and into bonds. Does this mean that the investing public is beginning to see the light, or is there something else at work? Frankly we don't know. Our guess is that the major and rather long lasting move is yet to come. The desperate need for income may be the driving force behind the purchase of bonds. Stocks on balance yield less than 2% and 10-year and longer bonds yield twice that amount. If it is yield alone that is causing bonds to advance in price, then it will not last. Reaching for yields has always been a mistake. All

markets, it seems to us are presently overvalued and what we are seeing is a subtle first shift to bonds, which will be corrected before long. The real reallocation (stocks to bonds) will come when a move to safety becomes paramount in one's thinking. What will cause this? The next recession, which will result, in our opinion, in massive debt defaults on the part of the consumer. In the meantime, when all markets are overvalued, the best idea is to keep from losing money and exercising patience.