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US CURRENT ACCOUNT DEFICIT—END OF THE FREE WORLD?

There is much discussion about the role of the US current account deficit and the subsequent effect on the pricing of financial assets and currencies. Some believe that the dollar will crash from today's levels as speculators sell dollars and foreigners liquidate their holdings in US financial assets because they do not want to bankroll the consumption of imported goods by the US consumer.

We agree that the US current account deficit needs to be reduced but we are skeptical about the hype as to how this will occur.

Some Basic Facts

- The current account deficit along with the capital account surplus are released on a quarterly basis by the Bureau of Economic Analysis (BEA), a division of the Department of Commerce.

- The current account and the capital account have to sum to zero. If a country has a negative current account it has a positive capital account for the same amount.

- The US current account, which is currently in deficit, is the sum of our net trade position (goods and services), returns paid out from investments (such as interest payments) and other components such as government transfers.

- The US trade deficit represents about 90% of the current account deficit.

- The US capital account, which is currently at a surplus, represents the net investment flow between the US and foreigners and consists of both publicly traded securities (stocks and bonds) as well as direct investments (factories and companies).

Both the current account deficit and the capital account surplus are approaching 6% of GDP. A level that most consider too high and unsustainable.

Context

It seems that the whole world has now turned bearish on the US dollar.

The laundry list of US dollar woes is long but currency markets have already moved considerably. This is particularly true with the euro which is up 47% since the end of 2001. Other major trading partners' currencies are the Canadian dollar (up 34%) and the Japanese yen (up 27%).

As a contrast to the Japanese yen and the euro, the Chinese yuan, the value of which is controlled by China's central bank remains fixed versus the US dollar. Through the third quarter of 2004, 25.7% of our total trade deficit is now with China.

The most recent data show China and Japan holding a combined $1.25 trillion in foreign currency reserves. Many suggest that this is very dangerous as these two central banks may dump their US dollars which represent a large percentage of their reserves. It is important to note that the currency markets clear over $1.8 trillion a day which puts some perspective on the relative sizes.

So what are the reasons behind the trade imbalance? The United States is growing faster than most of the developed economies and has been for some time. In addition, the US has a younger population than both Europe and Japan which has resulted in a lower savings rate, higher consumption and the subsequent trade deficit.

What drives the other side of the coin? Remember the capital account surplus which mirrors current account deficit can be driven by investors' willingness to invest into the US market to take advantage of perceived higher returns. This was particularly true in 1999 and 2000 when the US dollar was strong and the current account was widening.

More recently, the central banks of China and Japan have been re-circulating their trade surpluses into US Treasury bills and notes to

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CURRENT TOPICS

- *Current Account Deficit: We are not as bearish on the dollar as consensus*
- *Treasury Inflation Protected Securities: Not the right choice for a bear market in bonds*
- *Expected Returns for Global Asset Classes: US Equities move to slightly overvalued*
- *Stairway Update: We are effective with the SEC and open for business*

Stairway Partners, LLC

"The most significant risk for TIPS is that real rates go higher from a very low level"

Treasury Inflation Protected Securities—a Perspective

TIPS have been touted as a way to ride out the imminent bear market in bonds that will result from higher interest rates. Before accepting this notion, we would first like to provide perspective by examining the components of TIPS to understand what is currently discounted in prices.

In the example of 10 year TIPS, the current quoted yield or real rate is 1.75%. The real rate represents the rate that an investor is willing to accept for 10 years net of inflation.

The differences between the yield on 10 year TIPS (real rate) and the yield on regular 10 year Treasury notes (nominal rate), are commonly referred to as inflation expectations. Inflation expectations, as measured by this yield differential, reflect the market's view on the average inflation rate for the full 10 year time period of the bonds.

As seen in the chart below, inflation expectations for 10 years have been moving higher and now reside at 2.61%. The idea of inflation growing at 2.61% for the next 10 years is probably fair given the uncertainty in forecasting inflation for such a long time period. As a result, the good news from inflation expectations moving higher is already priced into 10 year TIPS .

In contrast, the 1.75% real rate (quoted yield on TIPS) for the same 10 years is not attractively priced to the investor in TIPS. The chart also reveals that the real rate or quoted yield for 10 year TIPS has moved significantly lower over time and is currently well under our estimation of fair value.

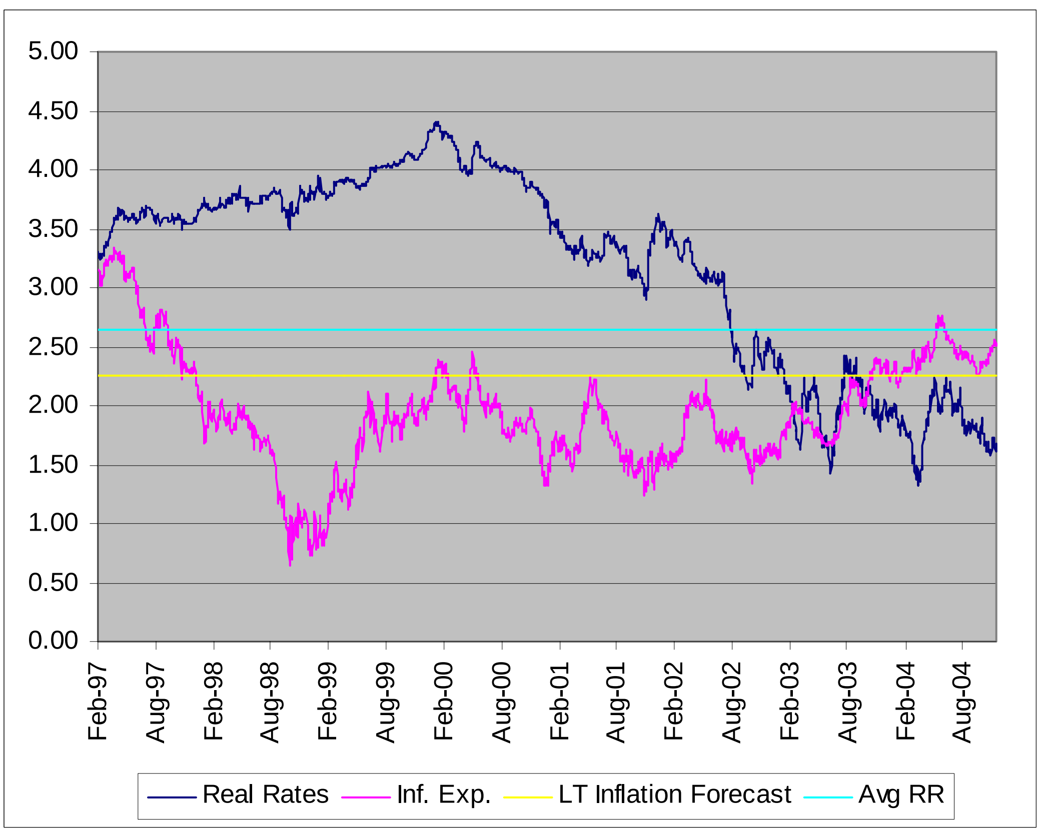
A significant risk for TIPS is that real rates will probably move higher which would render TIPS unattractive given current valuations. Therefore for a longer term investor there is no intrinsic advantage to owning TIPS over regular Treasury notes.

What is discounted in 10 year TIPS prices?

Inflation expectations represented by the pink line have already moved higher and are now above our long term forecast for inflation- the yellow line.

Real rates or the TIPS yield represented by the dark blue line has moved quite a bit lower over time and is well below equilibrium – the light blue line.

Real rates or TIPS yields need to move higher. Not Good for TIPS.



Strategy

	Expected Return	Hurdle Return	Strategy	Comment
Equities				
US	5.9%	6.9%	neutral	Slightly overvalued but strategy still neutral
Non-US Developed				
Euro-zone	8.7%	6.7%	neutral	Attractiveness is offset by an overvalued euro
Japan	2.2%	4.3%	under	Market has already priced in economic recovery
UK	11.1%	8.3%	neutral	Attractiveness is offset by an overvalued pound
Emerging	12.3%	12.4%	neutral	High expected return covers its high risk
Bonds				
10-Yr US Treasury	3.4%	4.8%	under	Real rates are too low
10-Yr Municipal	3.5%	3.7%	neutral	For taxable accounts still okay
High Yield	3.0%	5.4%	under	Too much risk for the yield
Emerging	4.0%	5.6%	under	Too much risk for the yield
Cash	3.5%	---	over	

Historical Returns

		Prior 12 Months		Prior 3 Years		Prior 5 Years	
		Local Currency	In US Dollars	Local Currency	In US Dollars	Local Currency	In US Dollars
Market	Index						
US Equities	Russell 3000	13.0%	13.0%	4.1%	4.1%	-0.6%	-0.6%
Non US - Developed	MSCI EAFE	13.1%	24.2%	-0.5%	10.5%	-3.9%	-0.3%
Europe	MSCI EMU	13.4%	25.7%	-3.7%	9.9%	-4.7%	0.7%
Japan	MSCI Japan	10.6%	17.9%	1.5%	7.8%	-6.2%	-6.3%
UK	MSCI UK	12.0%	24.5%	-0.3%	9.9%	-2.8%	0.8%
Emerging Countries	MSCI Emerging	20.3%	28.5%	18.7%	23.6%	6.4%	5.9%
US Investment Grade	Lehman US Aggregate	4.4%	---	5.6%	---	7.4%	---
Municipals	Lehman Municipal	4.1%	---	5.7%	---	6.8%	---
High Yield	Lehman High Yield	12.0%	---	11.5%	---	6.9%	---
Emerging Market Debt	Lehman Emerging	12.5%	---	16.2%	---	13.4%	---

Exchange Rate Changes

	Expected	Prior 12 Months	Prior 3 Years	Prior 5 Years
Currencies				
Euro	-4.0%	10.7%	14.3%	5.6%
Yen	1.0%	6.2%	6.3%	-0.1%
Pound	-4.7%	10.5%	10.2%	3.5%

Sources: Russell, MSCI, Lehman, Bloomberg **As of: 11/30/2004**

Notes:

Historical and expected 3-year and 5-year returns are annualized.
The expected return represents our estimates of the returns likely to be generated over a short-term time horizon - 3 years.
Expected returns are expressed in local currencies (e.g., Japanese equities in yen terms).
The hurdle rate represents the return that an asset needs to generate in order to cover its risk.

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About Stairway Partners, LLC

Stairway Partners was formed to provide our clients (starting with ourselves) with an effective and comprehensive solution for managing their wealth. Our disciplined and rigorous approach comes from our collective knowledge in serving large institutional clients over many years.

Our core investment belief is that Asset Allocation is the single most important determinant of success in any investment plan. 90% of risk and return comes not from your choice of individual investments but from your asset class mix. Stairway Partners focuses our resources on risk management – building your custom blueprint (investment policy and benchmark) and asset allocation (aligning your custom blueprint with the global capital markets).

STAIRWAY PARTNERS, LLC REGISTRATION AS AN INVESTMENT ADVISOR IS EFFECTIVE WITH THE SECURITIES AND EXCHANGE COMMISSION

The Current Account Deficit—Continued

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keep their currencies from appreciating.

Will they sell now? Probably not because it is not in the best interests of their domestic economies.

Investment Implications

The US dollar has already declined significantly and may be pressured lower due to momentum and an overwhelming belief that dollar depreciation is the solution to curing the US current account deficit.

At current levels the yen is priced appropriately and the euro is now above our assessment of fair value versus the US dollar.

A further depreciation of the US dollar versus the yen and euro is likely to harm their respective economies. This is because economic growth in Japan and Europe has been export driven rather than resulting from healthy domestic demand. The idea of a further dollar depreciation "solution" is likely to be worse than the current account "symptom".

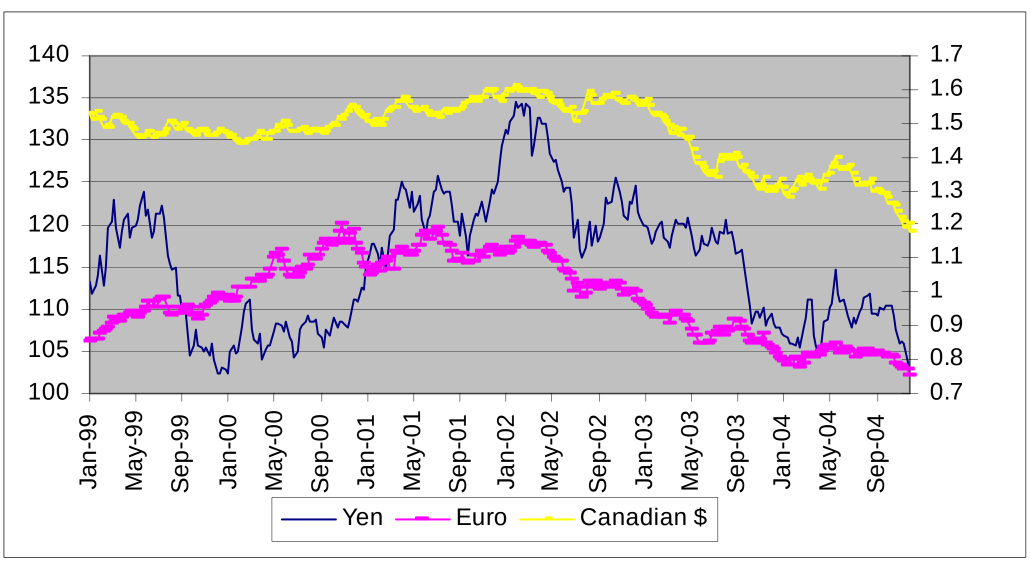
China will need to let the yuan float freely and potentially appreciate versus the dollar. This should take pressure off the yen and the euro but is unlikely to occur in the near future.

Summary

The US over time will need to address its budget deficit and create policies that encourage savings versus spending. These facts are well known in Washington.

In global portfolios it is time to move against the herd and reduce exposure to foreign currencies in favor of a neutral stance on the US dollar.

"THE LAUNDRY LIST OF US DOLLAR WOES IS LONG BUT CURRENCY MARKETS HAVE ALREADY MOVED CONSIDERABLY"



Note: Foreign currency per US Dollar Source: Bloomberg