A.R.Schmeidler & Co., Inc. The Outlook

December 28, 2004

As of December 27, 2004		
Index	**YTD % Change**	**Market Value**
Dow Jones Industrials	3.08%	10776.13
S&P 500	8.36%	1204.92
Nasdaq Composite	7.53%	2154.22

The U.S. Dollar And Structural Imbalances

For over two years we have been anticipating and writing about a decline in the U.S. dollar and investing assets in industries and companies that benefit from such a decline. Today, we re-examine the outlook for the currency and touch on some of the more attractive investment opportunities that benefit from a further devaluation of the U.S. dollar but whose success does not depend on a weaker currency. **Some of the opportunities include U.S. multinational companies that participate in infrastructure, heavy industry, manufacturing and materials and whose products and services are growing with rising global demand.**

On November 19th, Federal Reserve Board Chairman Alan Greenspan gave a speech in Frankfurt, Germany, which actually encouraged further dollar weakness, and had the effect of giving many money managers the all-clear signal to short the U.S. dollar. **Normally a protracted pressure on a currency leads one to expect that at some point a temporary counter-trend rally could develop.** Moreover, recent legislative tax changes have encouraged U.S. corporations to repatriate significant amounts of cash that they have in their overseas divisions, which could also result in short-term strength in the dollar. However, it has been an uphill battle for the dollar to rally as the U.S. current account deficit continues to climb.

On November 1st the British pound was trading at 1.83 and it is now at 1.93. The Euro stood at 1.27 and it is now almost 1.36. Mr. Greenspan has also made clear his opinion that interest rates are in a rising trend around the world. The growing U.S. current account deficit is adding to the risk of a further decline in the dollar, which would cause world growth to slow. The current account deficit for

October rose to $55.5 billion or an increase of 9% from September. Part of this was due to imports of oil that totaled more than 400 million barrels at a price of $41.79 a barrel. This compared to the prior month's imports of 330 million barrels at a price of a little more than $36 a barrel. Moreover, our trade deficit with China was $16.8 billion and could total a record $160 billion for the year or double what it was three years ago. **The current global trade imbalance is at the root of the dollar's problem. The U.S. savings rate is almost zero, while the Asian economies have high savings rates and depend on exports rather than their domestic demand to generate economic growth** – although domestic demand in China is growing rapidly. As we export dollars through our trade and fiscal deficits, they are being financed by foreign economies that hold over 1 trillion dollars of U.S. treasury debt, thereby making up for the lack of U.S. household savings to finance our needs.

The question for us now is how much should we expect the dollar to decline to bring these imbalances into a healthier balance. **A brief historical analysis could be revealing. In the late 1980's, our current account deficit had peaked at 3.5% of GDP and the trade-weighted dollar fell 40% versus the currencies of our major U.S. trading partners. At the present time our current account deficit is approaching 6% of GDP and the trade-weighted dollar has fallen only approximately 15% from its 2002 peak.**

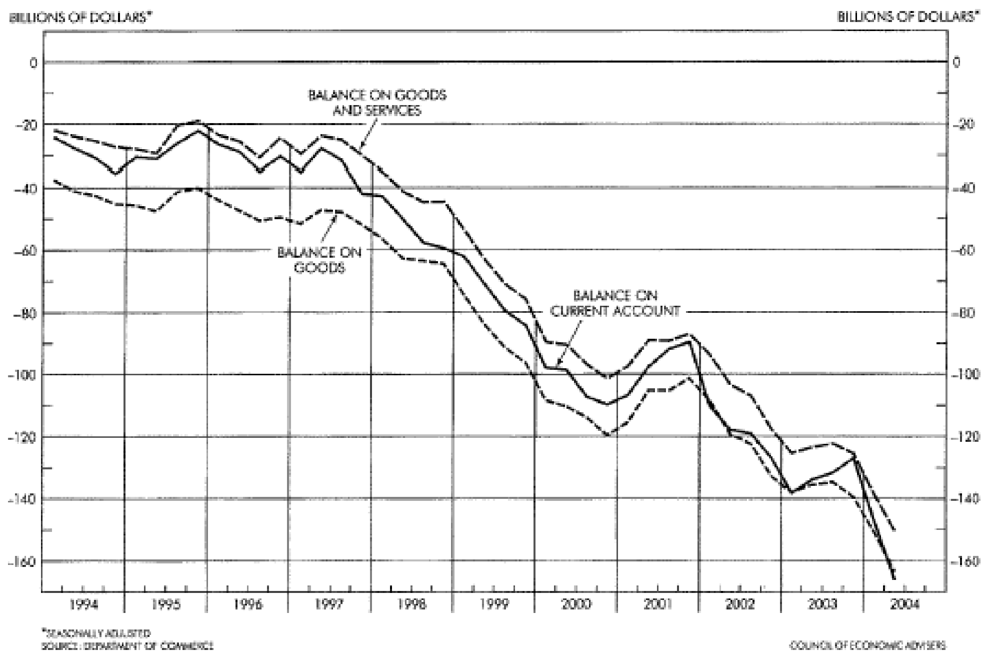
We should note that it is apparent to us that if China were to revalue its currency, it would cushion a dollar decline versus the euro, yen, and the other currencies of our trading partners, which are bearing the brunt of dollar weakness. However, **we do not believe that a significant revaluation of China's currency is a high probability.** Therefore we expect further dollar weakness vs. the non-Asian currencies.

In addition to the current account deficit and its impact on the U.S. dollar, which can be seen in the chart below, the U.S. fiscal deficit of $400 billion is clearly too large for this stage of our economic recovery cycle. Moreover, the supplemental budget for our commitments to the war in Iraq and Afghanistan will add a further $80 billion to the fiscal deficit. **Therefore the combined fiscal and current account deficits will total about $1.1 trillion or 10% of GDP.** How long this can be sustained is an unanswerable question.

The Current Account Deficit:

U.S. INTERNATIONAL TRANSACTIONS

In the second quarter of 2004, the goods deficit rose to $163.6 billion, from $150.8 billion in the first quarter. The current account deficit rose to $166.2 billion in the second quarter from $147.2 billion in the first quarter.



To make matters worse the capital needs of the U.S. economy have grown very large particularly with respect to our infrastructure. In addition our heavy industrial and manufacturing sectors have been shrinking and consolidating for decades. One can even go back thirty years and find numerous examples of under-investment in our infrastructure and heavy industrial and manufacturing sectors.

The administration's current policy is to let the dollar decline in the hopes that the trade deficit would be brought into better balance. **However, the point needs to be made that the heavy industrial and manufacturing base of the United States has shrunk considerably over the years, and we anticipate that it is highly unlikely that the same improvements of the trade imbalance that occurred in the past with devaluation as the tool to increase exports can occur at this time. The mathematics just does not support this approach to the degree that it did in the past.**

As we have indicated in past Outlooks, the industrial base is an important beneficiary of both devaluation and the infrastructure needs of the U.S. and global economy. One of the basic components of infrastructure and heavy manufacturing demand is steel. The steel market has been quite strong and in some markets prices have risen as much as 60% since last year, and we expect further price increases in 2005. It is possible that steel supplies could remain tight for a considerable period of time as China and India as well as other countries experience strong demand. Steel demand from China is expected to grow 10% next year, and China has displaced Japan as the number one importer of iron ore. The Chinese have secured long-term contracts with Brazil as well as other suppliers. Iron ore prices are expected to rise as much as 30% next March and this in turn will put upward pressure on finished steel prices.

Whether we are talking about steel, copper, nickel, iron ore, coking coal, or oil we believe that world demand for raw materials will continue to remain strong. In our view, investment portfolios should include the common stocks of companies that benefit from global industrialization. Many of these companies sell at cash flow and earnings multiples of less than 10x. Moreover, the dividend yield and the prospects for dividend growth can also significantly improve the total return outlook for these companies and portfolios.

For many investors the market has been difficult for most of the year. Up to the Presidential election the Dow Jones average had been down -4.0%, the S&P up +1.7%, the NASDAQ was off -0.93%. All of the market's strength occurred after the Presidential election in early November. In contrast, most of our equity investments performed well throughout the year. **This has not been a product of market forecasting but an outgrowth of our focus on investing in the opportunities that are created by the imbalances in the system.** This outlook focuses on select areas that benefit from the continuing imbalances in the fiscal and trade areas as well as the ongoing weakness of the U.S. dollar. **Overall, in a weakening dollar environment it is not enough to emphasize just capital preservation; investors must also protect against a potential loss of purchasing power.**

We want to wish our readers a happy and healthy New Year.

- -