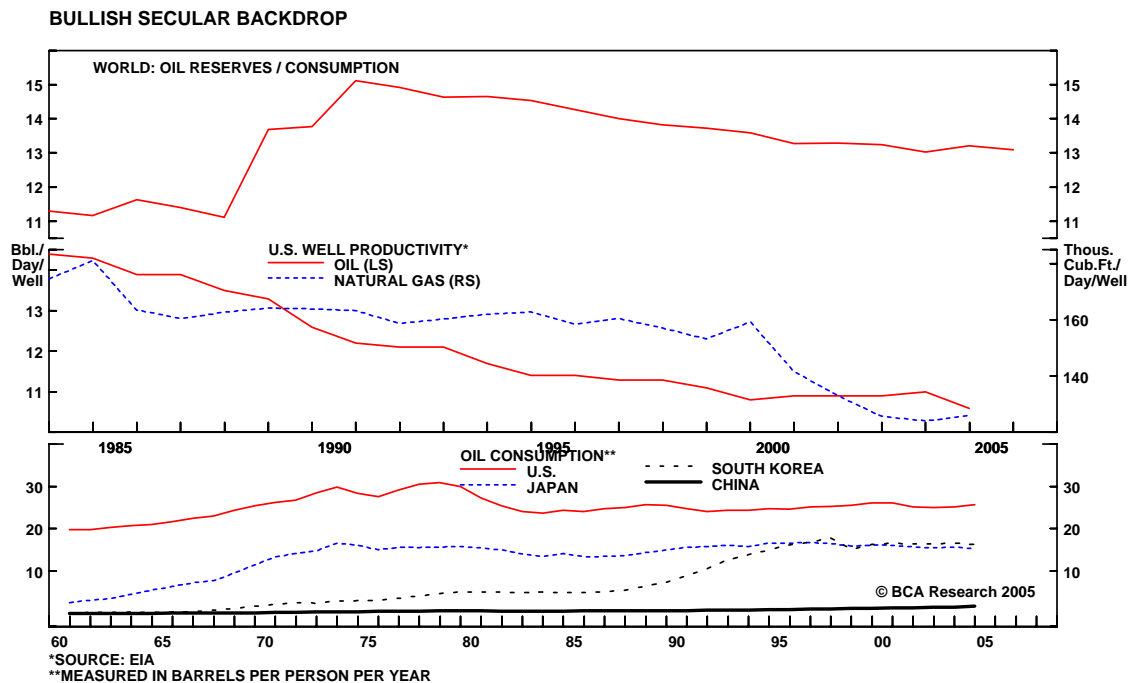




Economic & Market Commentary January 2006

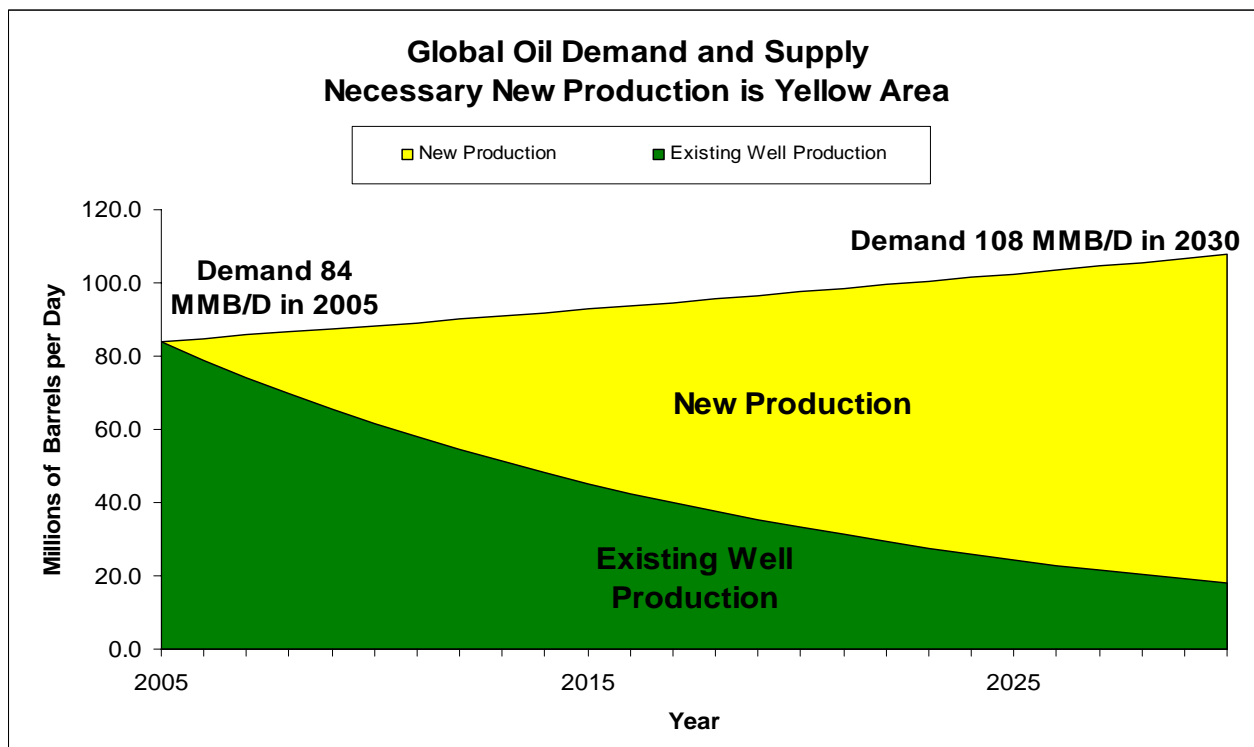
In our opinion, the era of cheap energy is drawing to a close. Energy prices have moved up dramatically over the past two and a half years, as demand has increased at a faster pace than supply. When compared to the recent past, prices may seem high, but compared to energy's relative value and the developing supply/demand imbalance, prices remain low. For example, a gallon of regular gas currently costs about \$2.30 in Summit, New Jersey, while a gallon of milk or bottled water sells for a similar price. Most consumers find the gallon of gasoline more valuable than the gallon of milk or water and would be willing to pay considerably more for the gasoline before opting to do without it. While the brief spike in the price of gasoline to over \$3.00 per gallon after the hurricanes caused a brief contraction in U.S. demand, global oil demand continued to expand during this period, driven by the developing world.

The bottom third of the chart below illustrates per capita annual oil consumption for several industrialized and developing countries. The key item of note is that Chinese consumption would triple if it reached the levels of Japan and South Korea, implying that there is considerable room for continued growth in consumption in China and the rest of the developing world.



The top third of the chart above illustrates the decline in the global reserve life to thirteen years, which means there is thirteen years of production based on current proven reserves. This does not mean that we will run out of oil in thirteen years, but it does indicate that spare proven reserves are becoming scarce. The middle third of the chart shows the decreasing productivity per U.S. well, as production per well for both oil and natural gas have shown severe declines over the past 20 years. Unfortunately, the U.S. reserve basin is the most mature in the world and reached peak production in the 1970s. The declining productivity per well is an indication that production and reserves are becoming increasingly difficult to bring on line in the U.S.

The global problem of meeting modest consumption growth in the face of a depleting asset is shown below. Once oil is pumped and consumed, it is gone; it is nonrenewable. Producing wells face declines of about 8% per year. For the chart below, we have assumed 7% production declines because higher energy prices should incentivize producers to maintain incrementally higher production longer. For the purposes of the illustration below, we have assumed 1% per year consumption growth, which is down from the 20 year average of 1.6%. Under this scenario, 2030 demand grows to 108 MMB/D (Millions of Barrels per Day) from 84 MMB/D in 2005 and production from currently producing wells falls to 18 MMB/D from 84 MMB/D. The difference in 2030 demand of 108 MMB/D and the production of 18 MMB/D from 2005 producing wells is 90 MMB/D, which will need to come from new wells and nonconventional sources such heavy oil, oil sands, oil shale and bitumen. This necessary 90 MMB/D of additional production needs a price floor near current levels, or possibly higher, in order to justify the economics of this expensive to find, produce and/or refine commodity.



Please note that the concept of the chart above is from Simmons and Company International, but the actual forecasts above are from Tradition Capital Management, LLC.

Most observers of the global oil market believe that Saudi Arabia has extensive underutilized resources that will allow it to dramatically increase production. In our opinion, the evidence does not support that case. Given the age of the major Saudi fields and their output profile in the face of intensive recovery techniques, the ability to increase production appears extremely limited. For a detailed and more extensive discussion of this situation, please refer to Simmons and Company International's website (www.simmonsco-intl.com).

While energy prices at levels considerably above the depressed averages of 1986 to 2002 are a price shock, several positives should result. Global consumption growth should begin to moderate and consumption in the energy intensive U.S. could actually fall, as conservation makes a comeback and more energy efficient vehicles replace the current low mileage vehicle installed base. Alternative and renewable energy sources could compete for some aspects of the energy market on a cost effective basis. Over time, prices over \$50 per barrel should result in a moderation of consumption through conservation and a greater supply of energy alternatives.

We have viewed investment in the energy sector favorably since 2002. Our initial forecast that oil prices needed to be in \$35-50 per barrel range to stimulate enough supply to meet the growing global demand for energy has proven to be too conservative. We have been surprised that the onset of higher energy prices over the past several years has had such a limited impact on supply and demand. Given the current pricing environment, we would have anticipated more persistent consumption destruction and greater supplies. The muted demand response and the inability of the industry to dramatically increase supplies have caused us to increase our long-term oil price assumption to \$50-70 per barrel. Based on this outlook, many energy stocks offer very attractive return profiles at current prices. Although we reduced our exposure to the energy sector during the hurricane-induced price spike, we have recently been recommitting capital to the area in order to take advantage of some attractive values.