ECONOMIC & MARKET COMMENTARY

We have believed for a number of quarters that the combination of a weakening housing market, overleveraged consumers and modest income growth would cause the U.S. economy to slip into a relatively short, shallow recession. Despite continued deterioration in these macroeconomic factors, the U.S. economy has managed to post slightly positive real Gross Domestic Product (GDP) growth so far. Certainly stronger international economic growth has been helping US-based multinationals and our net exports for a while. More recently, the tax rebate stimulus checks appear to be sustaining consumer spending. Unfortunately, the spike in commodity prices (particularly energy) during the second quarter is probably the proverbial straw that will break the camel's back. Higher food and gasoline prices are sapping what little income growth consumers are able to generate. Consumer confidence is at decade lows and we are barraged daily with new stories of problems in the housing and financial services industries. We thought that the Fed's aggressive monetary easing would pick up the economic slack in the second half of the year, once the benefit from the stimulus checks waned. However, the financial system is under such severe strain that lending institutions' abilities to maintain or increase the level of credit has been significantly curtailed.

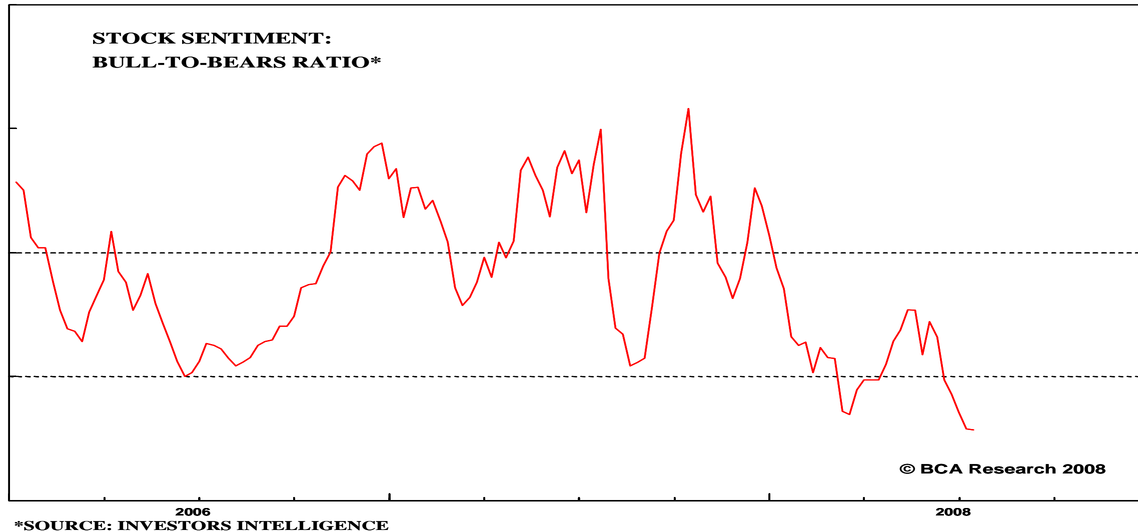
There are a number of economic commentators that have described the current state of affairs in the U.S. as stagflation. While headline inflation is clearly higher than the Fed and we would like to see, core inflation (headline less food and energy) remains relatively behaved. Global labor markets are keeping competitive pressure on U.S. wages, thus preventing labor price inflation. At the same time, global growth is moderating, which should result in weakening demand for commodities and lower prices

While it has been a volatile period for investors, our clients' portfolios have performed much better than the stock market indices. We have been able to achieve these better than average results by significantly overweighting the energy sector the last few years and significantly underweighting the financial sector. Additionally, our individual stock selection has provided incremental returns by investing in companies that generally have done better than their peers in the energy and financial sectors.

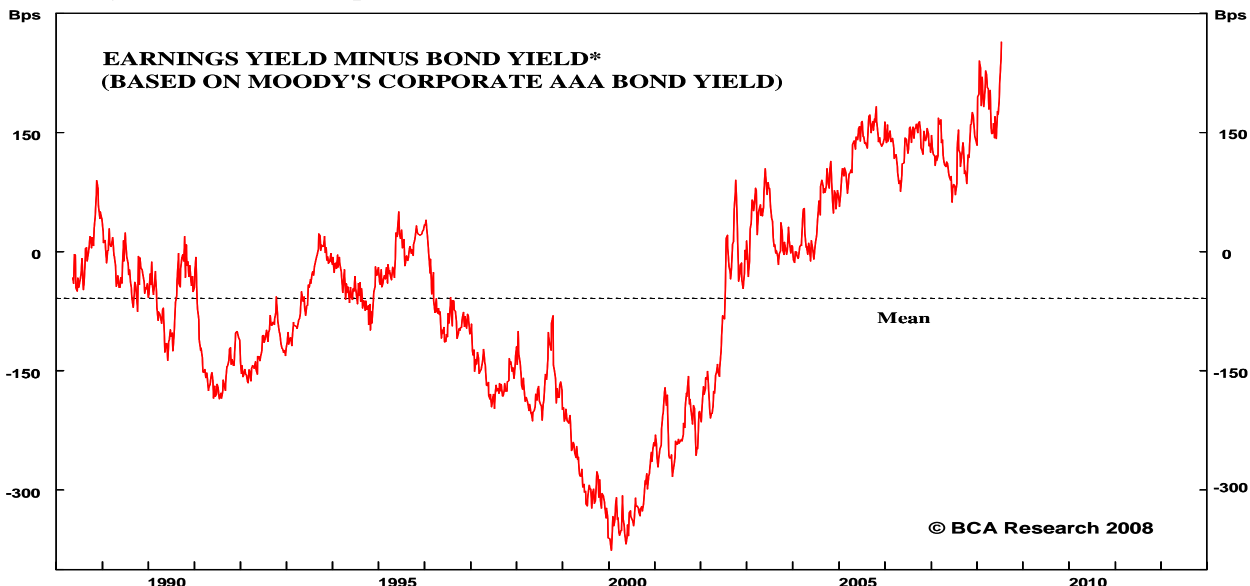
While we continue to believe that global economic growth will cause increasing demand for energy and that supply will have a difficult time keeping pace, the recent spike in prices has started to cause some energy demand destruction. In the U.S., miles driven and gasoline demand have started to decline, while sales of vehicles with poor gas mileage are falling. In international markets, governments are reducing the subsidies they were previously providing. We believe moderating demand and some increased supply near-term (in the absence of any additional geopolitical supply disruptions) should cause energy prices to retrace some of their recent advance. Given the sharp rise in the price of many of our energy company stocks, we have reduced clients' exposure to the energy companies that are trading near our estimate of fair value.

There is no question that we are facing a number of difficult economic problems. We believe the U.S. economy has been close to a recession during the last couple of quarters. Unfortunately it appears that it is going to take even longer than we feared to fix the problems in the housing and credit markets. While we expect the U.S. economy to show minimal growth over the next few quarters, the average length of a recession is generally about 11 months. If we assume that the U.S. recession started in June, we should be more than half way through it by the end of this year.

We believe our economic problems have been widely publicized and reflected in security prices. The U.S. stock market is currently oversold and the major ingredients are in place for a rebound. Cash on the sidelines and equity short positions are at high levels. Investor sentiment is at a historically low level, as reflected in the bull-to- bears ratio below.



Non-financial earnings have held up quite well and are expected to grow over the next year, in spite of the cost/margin pressure many companies are grappling with. The valuation of the US stock is quite attractive, particularly compared to interest rates. The Standard and Poor's 500 index dividend yield is approximately 2.3%, which is about the yield on most money market funds. The earnings yield (the inverse of the traditional price/earnings ratio) is currently 6.6%, well in excess of the yield an investor could earn in U.S. Treasury Notes or AAA corporate bonds.



In summary, despite significant economic problems, we believe stocks are more attractive than any other asset class (bonds of various maturities, real estate, commodities) for longer-term investors. We expect the stock market to continue to exhibit above average volatility. However, unstable markets can present good opportunities for investors with a longer-term time horizon to make advantageous purchases or to reposition portfolios. We will continue to search for financially strong, leading companies in attractive industries that are trading at big discounts to our estimate of fair value.