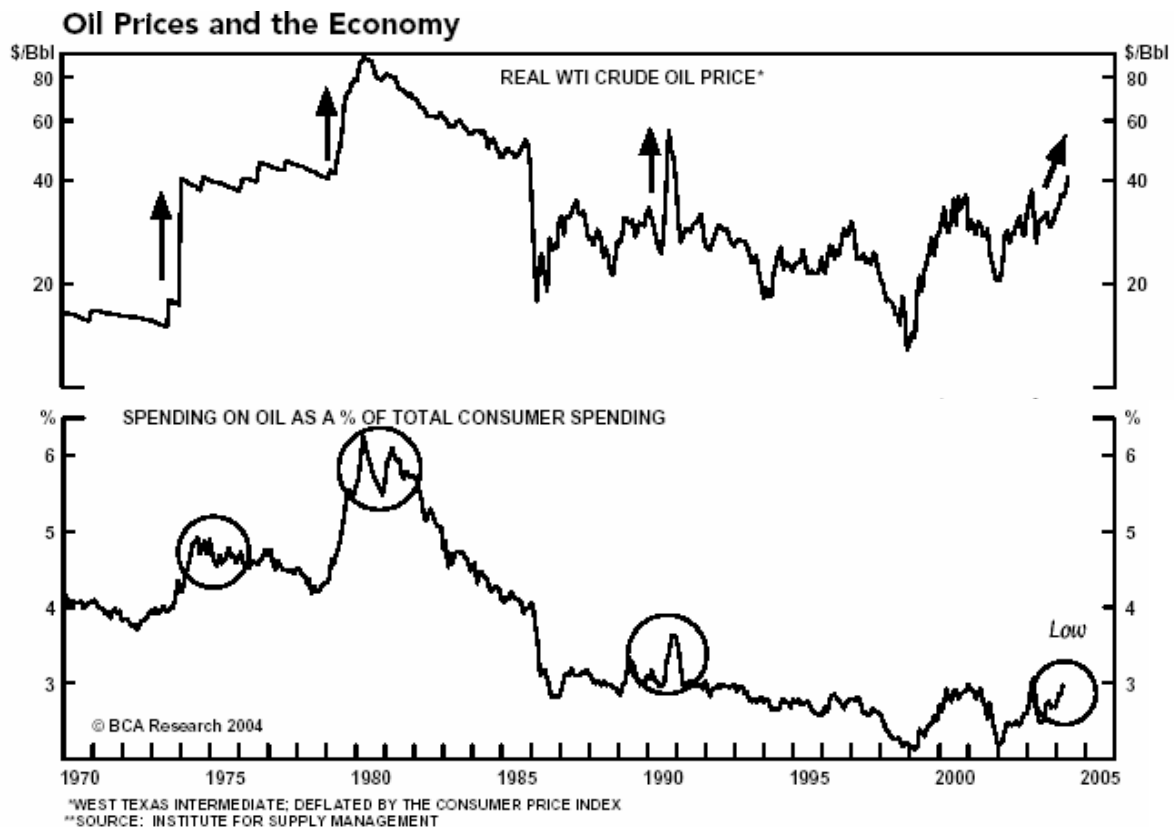
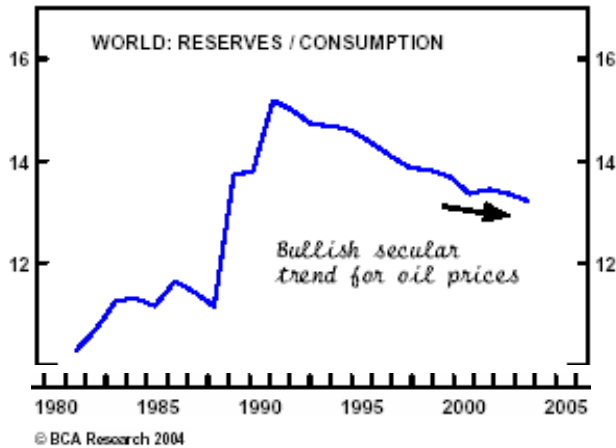


**Economic & Market Commentary  
July 2004**

Energy prices have moved up sharply over the past couple of years. Geopolitical concerns have been part of the story, but underlying economic developments have been the more important piece. As shown below, Real WTI (West Texas Intermediate) Crude Oil Prices have recovered from depressed levels but still remain well below their 1979-80 peaks. Moreover, spending on oil as a percentage of total consumer spending remains low and at half the levels experienced in 1979-80. Contrary to popular opinion, real energy prices are not at historical highs but have merely recovered from depressed levels.



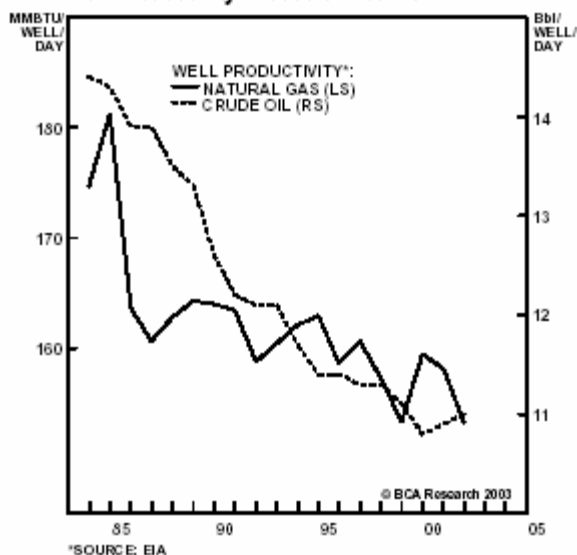
... But any Correction should Prove Modest



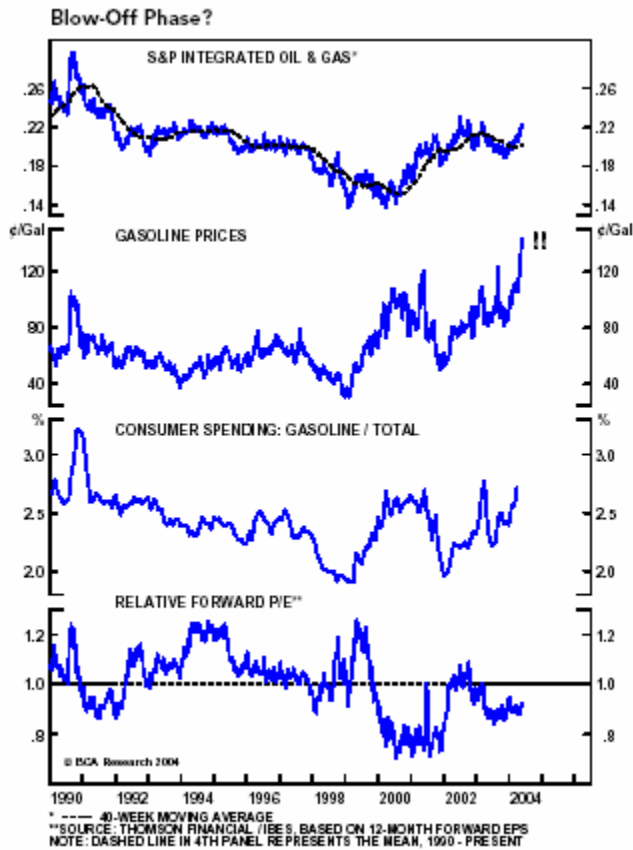
The recovery in energy prices will probably be sustained as global reserves divided by consumption ratios decline. In simple terms, there are fewer reserves available for each unit of consumption, increasing the scarcity value of reserves.

In addition, the reserves outside of the Middle East are in decline, thus increasing the Western World's dependence on Middle East reserves and production. The combination of political instability in Saudi Arabia, transitional government in Iraq, and a dangerous regime in Iran make this reserve basin unpredictable at best. On the demand side, China and India are quickly becoming industrialized and are driving energy consumption growth. In our view, crude oil prices need to remain at a minimum of \$30 per barrel to induce increased production that is needed to meet demand. The potential problems in the Middle East represent a wild card that could create a price spike to significantly higher levels of \$60-80 per barrel.

Well Productivity In Secular Decline



An additional point that indicates energy prices have moved to new sustained equilibrium is the difficulty in finding new reserves and production. As shown at left, productivity per well has declined sharply as easy targets have been drilled, leaving higher risk prospects that are more likely to be a dry hole or uneconomical. Higher prices will help make borderline projects feasible, but the drop in well productivity is unlikely to be reversed.



Energy stocks have been solid performers over the past four years but do not reflect the secular change of higher energy prices in our opinion. We believe the estimates for most energy companies are too low for 2005 and will be revised up over the next 18 months. In addition as shown at left, the relative valuations have significant room for improvement. In our view, the evidence points towards continued out-performance for Energy stocks. We think that the secular bull market in Energy stocks is in the early to mid stages. We have positioned our portfolios accordingly with a significantly over-weighted position in the Energy sector.