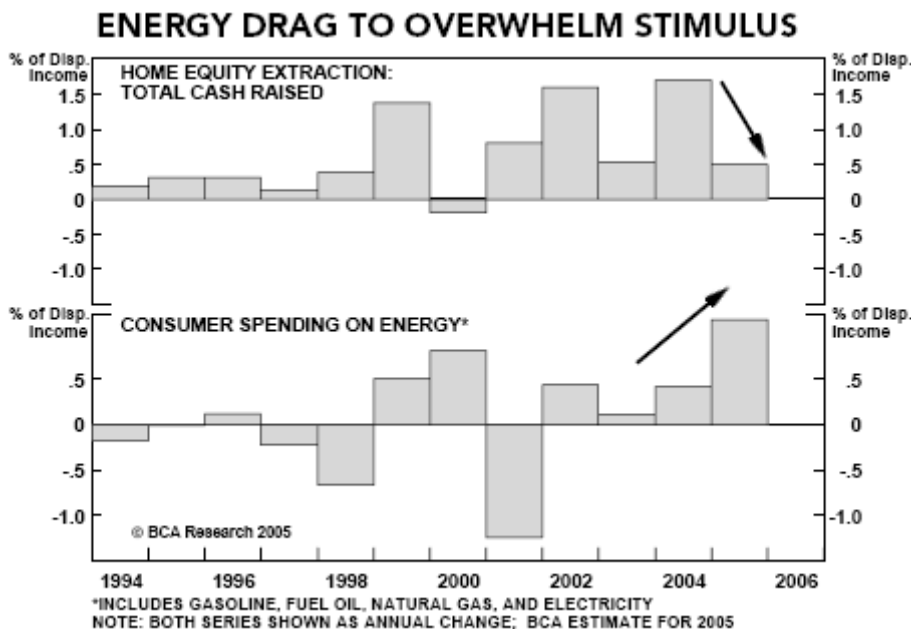




Economic & Market Commentary October 2005

The U.S. stock market, as measured by the Standard & Poor's 500 index, managed to shake off a number of concerns (ranging from Hurricanes Katrina and Rita, with their well-publicized impact on rising energy prices, as well as continued Federal Reserve interest rate increases) to post a 3.6% total return during the third quarter. Part of the reason for the stock market's resilience is related to strong operating earnings growth of 14% in the recently completed third quarter. The increase in third quarter earnings represents a continuation of the above trend line growth of 13-14% that we experienced during the first two quarters of this year. However, given the historically high profit margins corporations are currently generating, rising costs and slowing demand, we expect S&P 500 earnings growth to moderate this quarter and next year to around 6%.

Consumer spending, which represents approximately 2/3 of Gross Domestic Product, has grown at a much stronger pace in the last few years than would have been predicted by employment and income growth. As we have discussed in previous quarterly commentaries, consumers have been able to supplement their incomes by tapping the rising equity in their homes. We believe this trend has peaked and, coupled with rising energy prices, will cause a moderation in consumer spending to an approximately 2% pace.



The tremendous increase in energy prices has contributed to a rise in the producer and consumer price indices in the last few months. However, after subtracting the volatile food and energy components, core inflation is rising at a moderate rate. In many industries, companies have not been able to pass along higher costs to their customers because of intense global competition. While cyclical forces could continue to push headline inflation higher over the next few months, we believe that core inflation will remain constrained.

While the Fed has repeatedly raised short-term interest rates to slow the economy and restrain inflation, intermediate-to-longer term interest rates have risen only modestly. As the Federal Funds rate has increased from 1.00% to 3.75%, the yield on ten year U.S. Treasury Notes has risen from approximately 4% to 4.50% during the same time frame. The yield curve (which is the level of short to long-term interest rates) has become quite flat. In fact, we expect the yield curve may flatten or modestly invert as the Federal Reserve increases the Fed Funds rate a quarter of a point at each of its next few monthly meetings and the yield on the 10 year U.S. Treasury Note remains around its current level or declines in the face of a slowing economy. Some investors had hoped that the Fed would pause from their stated “measured pace” of increases because of the impact that Hurricane Katrina had on the Gulf Coast and the energy industry. However, in several speeches over the last few weeks, Federal Reserve governors signaled that the Fed Funds rate is likely to continue to rise.

We believe that a slowing economy, decelerating earnings growth and tighter monetary policy may create headwinds for the stock market in the short-term, resulting in modest equity returns. However, the valuation of the stock market continues to improve and, once investors become more confident the Federal Reserve is near the end of its tightening cycle, the market could have a strong rally. Historically when long-term interest rates are this low, the price/earnings (P/E) ratio for the overall market is substantially higher, implying there is some upside for stocks.

Tradition Capital Management utilizes a disciplined investment process that requires we own the stocks of superior companies whose share price is trading at a discount to our estimate of the value of the underlying business. We believe this approach should continue to generate above-average returns with below market risk, which we have been able to accomplish over the last five years.