TRADITION CAPITAL MANAGEMENT, LLC

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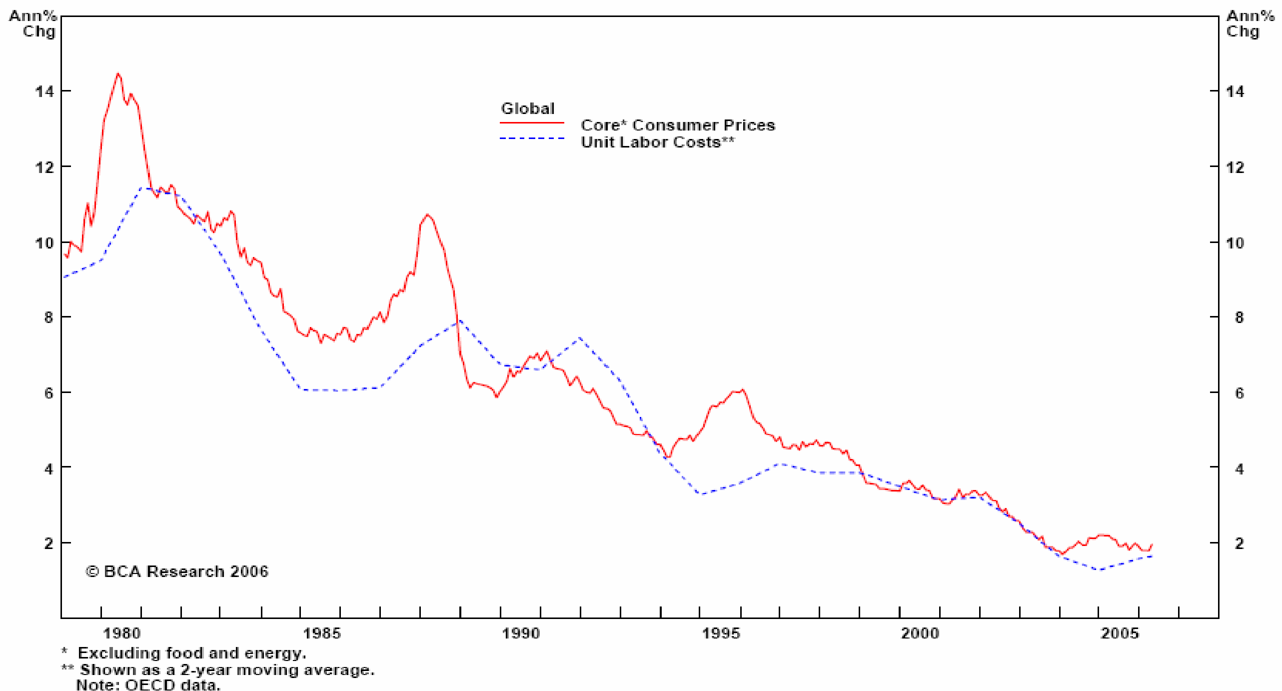
ECONOMIC & MARKET COMMENTARY

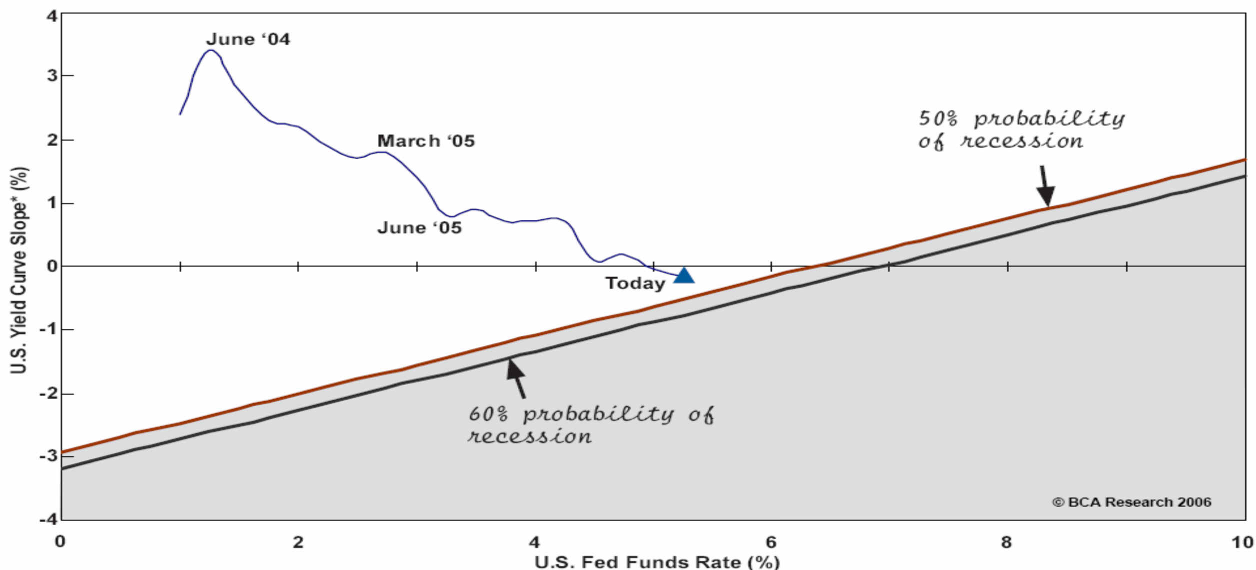
Stagflation is generally defined as a period characterized by anemic economic growth, high unemployment and high inflation. We do not believe current economic conditions, which we will address in greater detail, meet the definition of stagflation and would label it a myth.

Inflation has rebounded from its recession-induced lows of 2001 and 2002, but still remains manageable. Over the past year, the core CPI (Consumer Price Index) has run at a 2.4% pace and total CPI, including food and energy, reached 4.1%. While core CPI is above the Federal Reserve's long-term target of 2%, inflation is set to moderate. The Fed's aggressive actions on the interest rate front have caused an increase in consumer interest rates, especially adjustable rate mortgages, creating a slowdown in housing and autos, which should relieve some of the cyclical pressures on inflation. In addition, the energy pig has almost moved through the inflation snake and will allow total inflation to lessen as we get to September. Core inflation will remain below 3% in our opinion, and total CPI is near its peak and ready to roll back down to under 3% as well. Below is a chart showing global CPI and unit labor costs. Please note both have drifted down over the past 25 years and are at relatively benign levels.



Inflation remains benign for several reasons. Productivity continues to expand at robust levels, allowing compensation to rise while unit labor costs remain low. During the first quarter, unit labor cost growth came in at 1.6% with productivity growth at 3.7%. The other element keeping a lid on prices is foreign competition in both goods and labor. Imported goods have actually been experiencing deflation and labor is plentiful overseas. U.S. labor must try to remain competitive with foreign workers, whether they are competing directly for jobs or if they are competing with imported goods produced by low cost foreign labor. The other structural change in the U.S. labor market is the weakening influence of organized labor. The decline of many of the industries where labor unions were strong has not only greatly reduced their ability to negotiate in those industries; this decline has negatively impacted labor's ability to organize in other sectors as well. The bottom line is most employees are not in a position to demand raises, and businesses have been partially sharing productivity improvements through modest compensation increases. An additional aspect of the productivity improvements is the greater capital efficiency of businesses compared to the 1970's. Companies only deploy capital when it can be efficiently utilized thus driving productivity improvements.

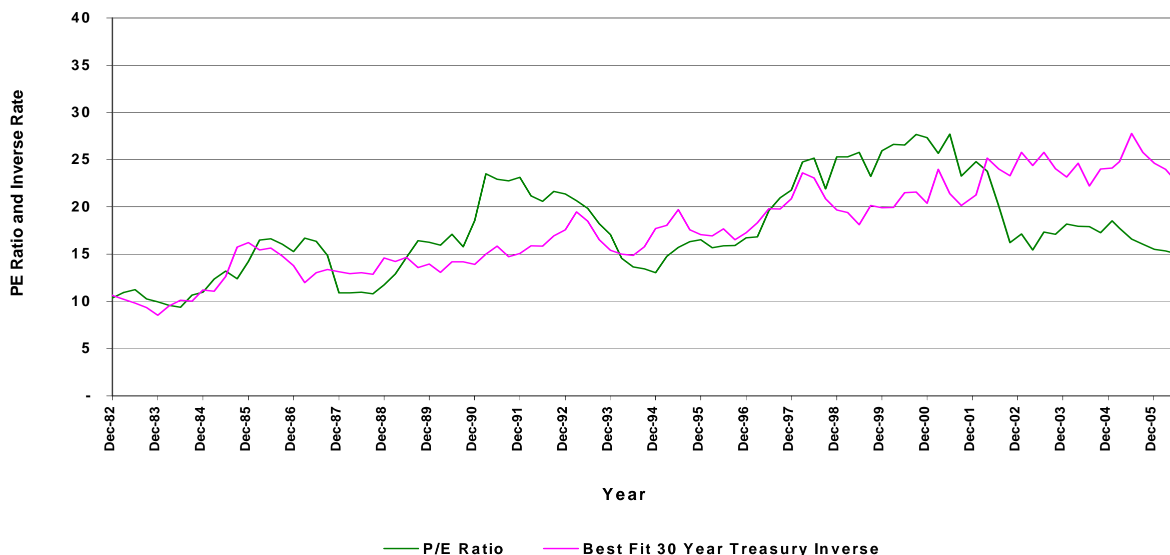
U.S. Gross Domestic Product growth during the first quarter came in at a recovery high of 5.3%, after the hurricanes-influenced slowdown in 4Q 2005. However, we believe the U.S. economy decelerated during the second quarter and could decelerate further in the second half of the year. Although the flattening of the yield curve, with the rise in U.S. Fed Funds Rate, increases the probability of a recession to 40-50%, we believe a recession will be avoided.



Federal Reserve Chairman Bernanke's July 19, 2006 testimony recognized that the economy is slowing and that inflation is near a peak. If the data continues to support this assertion, the Fed will mostly likely pause after the August meeting, thus allowing the economy to avoid a recession.

With regard to the third leg of stagflation, unemployment, the evidence is not supportive of the case. With unemployment at 4.6%, the job market is relatively tight. Any complaints about the job market should be limited to the level of wages. Global labor competition has pressured real U.S. wages, creating the need for greater work force participation and more dual income families. Although some Americans are currently not enjoying the golden era of the 1950's and 1960's, jobs are available and unemployment is not a major economic problem.

Overall the economic numbers point to the following "Goldilocks" scenario. The economy slows enough to relieve capacity constraints on both raw materials and labor, thus allowing inflation to slow. This slowdown is accomplished before the Federal Reserve is forced to raise rates too high in order to combat inflation. The slowdown is mild and does not result in a recession. The economy decelerates but continues to grow and create jobs, thus keeping a lid on unemployment. In this environment, long-term interest rates can remain low, thus implying higher equity market valuations as shown below.



The offset to this favorable economic backdrop is the negative geopolitical landscape. With the events in the Middle East deteriorating, the potential for crude oil supply disruptions increases. With hot spots in Israel/Lebanon/Gaza, Iraq and Afghanistan, the Middle East is in crisis. The Iranian and Syrian involvement in the Israeli situation highlight the potential for this conflict to engulf the Middle East. The developing nuclear potential from both Iran and North Korea further complicates and escalates the potential threats. In a related negative, the death toll and economic damage from radical Islamic terrorism continues to mount. Mumbai must now be included in the tragic list of Islamic hatred which includes London, Madrid, Belsan, Bali, Nairobi and New York. We believe these geopolitical dangers will prevent stocks from achieving the normal valuations that would be warranted strictly by the economic fundamentals. Although inflation, interest rates and economic growth would justify price/earnings ratios in the 20 to 22 range, a discount must be applied because of the unstable geopolitical situation. The price/earnings ratio on our estimate of next year's earnings is 14.2. It is impossible to accurately forecast how big the geopolitical discount should be, but the current 30% discount seems to us to be too big, reflecting too much fear. We believe the discount will narrow, and we think stocks will have a positive, upward bias in the second half of the year and into next.

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