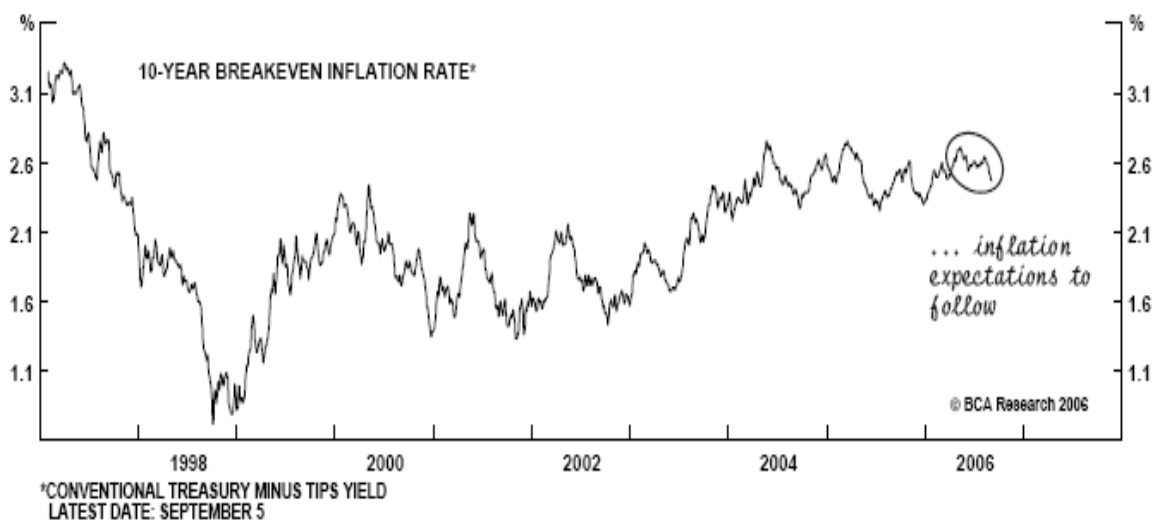


## ECONOMIC & MARKET COMMENTARY

As investors' concerns about high oil prices, increasing inflation, Federal Reserve monetary policy and geopolitical tensions dissipated somewhat during the summer, the U.S. stock and bond markets mounted strong, but almost stealth-like rallies. It was almost as if the business press was on vacation and did not notice the stock market advance until the Dow Jones Industrial Average approached its all-time high. The Standard and Poor's 500 Index bottomed on July 17 and yet managed to produce a 5.7% total return during the 3rd quarter, one of the best quarterly advances on record. Similarly, the ten year U.S. Treasury Note yield peaked at the end of June at 5.3% and was yielding 4.6% at the end of September, generating an almost four point increase in the Note's price.

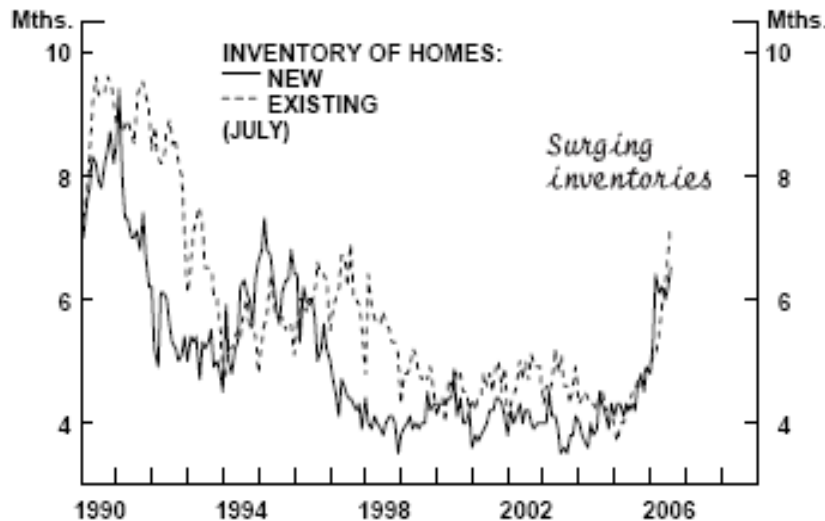
While the recent decline in energy prices is welcome relief for the economy, we think it was caused by unsustainable forces: a relatively warm winter last year and a cooler summer which temporarily reduced demand, causing energy inventories to rise and prices to fall. However, even as oil and gasoline prices were reaching all-time highs this summer, demand remained surprisingly strong for gasoline. If this winter is more typical, we expect oil and gas inventories will be reduced and prices to rise again. Additionally, a large risk premium, resulting from the Israel/Lebanon conflict and Iran's nuclear program, had driven oil prices above what the supply/demand fundamentals might otherwise have dictated. This premium has diminished for the time being.

Our expectation that U.S. inflation was peaking seems to be supported by the recent Consumer and Producer Price Index data, as well as market-based indicators such as the Treasury Inflation-Protected Securities (TIPS) spread. The TIPS spread (the difference in yield between a Treasury coupon security and a similar maturity TIPS) is a measure of fixed income investors' inflation expectations. For example, at the end of September, a ten year U.S. Treasury Note was yielding 4.6% and a ten year TIPS was 2.2%, making the TIPS spread (or breakeven inflation rate) 2.4%.



While Federal Reserve officials have continued to talk tough about their commitment to drive core inflation back under 2%, we believe they will hold the Fed Funds rate steady at the next several meetings and may even reduce the Fed Funds rate next year, if our expectations of a moderating economy and slowing inflation prove accurate.

We believe the U.S. economy will slow in the next few quarters, led by a decline in housing (with a loss of residential construction and related service industry jobs) and a negative wealth effect dampening consumers' seemingly insatiable propensity to spend. The decline in housing is no longer a matter of debate; the dramatic rise in the inventory of unsold homes and the first decline in the median price of homes in eleven years are now well documented. The issue that remains to be evaluated is how big an impact the housing slowdown will have on the overall U.S. economy. At this point, we continue to expect the proverbial soft landing (below trend, but positive economic growth of 1½ -2½%) is the most likely outcome. We believe overall employment and wages will continue to grow which, coupled with the recent decline in mortgage rates, should improve housing affordability and provide underlying support for the real estate market.



We expect earnings growth to slow next year to a high single digit pace from several years of 10%+ increases, while short-term interest rates decline and intermediate/longer rates remain around current levels. These factors, plus corporations' strong share repurchase activity and the large pool of liquidity in the hands of individual and institutional investors, should provide strong underlying support for the U.S. stock market.