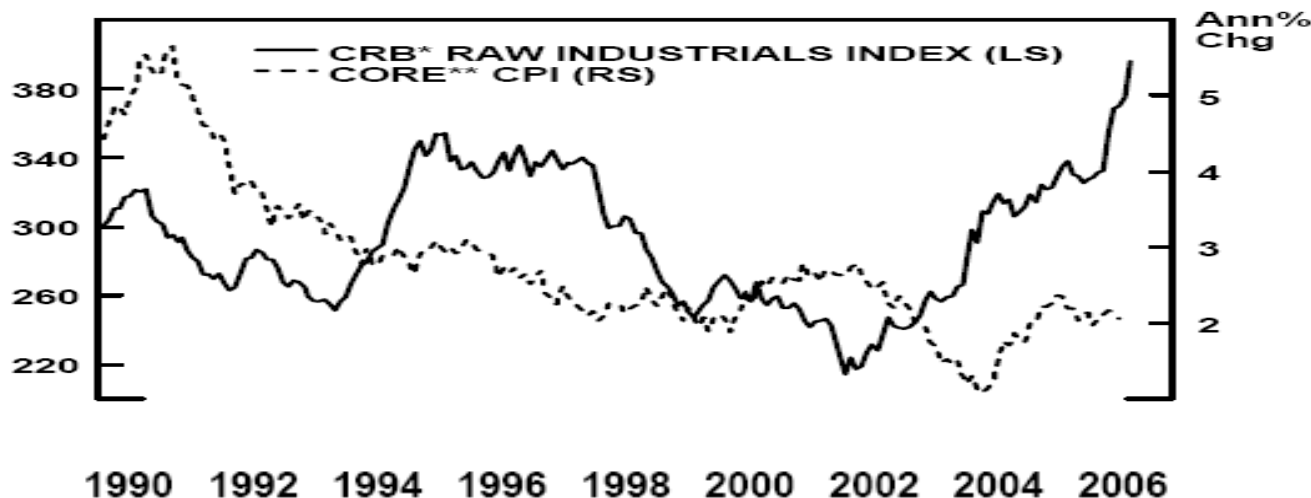


## ECONOMIC & MARKET COMMENTARY

With the U.S. economy growing strongly and the prices of many commodities (such as oil, copper, gold, and silver) making new highs recently, inflation expectations have started to rise. As a result, intermediate to long-term U.S. interest rates have recently increased to over 5%, after holding steady for much of the last year in the face of the significant rise in short-term rates. We do not think the recent commodity price rise spells much higher core inflation, as some investors currently fear. In our opinion, the spike in many commodities is due to a broad range of factors that have recently come together: the historically poor returns earned by companies operating in the materials sector, which discouraged new investment in this area over the last decade; a huge increase in liquidity that central banks have created to stimulate their respective economies; the positive impact this global liquidity has had on both global aggregate demand and the deployment of some of this liquidity by investors into commodities themselves or the stocks of companies that operate in the raw materials sector. Since it will take a number of years of additional investment to increase the supply of various commodities, and we expect global growth to continue, we do not expect a sustained retrenchment in most commodity prices. However, it seems pretty clear that investors/speculators have recently directed significant amounts of capital into the actual commodities and the stocks of materials-oriented companies. History, both long-term and recent, provides many examples of how investor sentiment can change quickly and lead to large changes in the price of commodities and prices of commodity-oriented stocks. While we are not traders, we will use our valuation discipline to take advantage of these expected cycles of enthusiasm and despair. In particular, we continue to believe that the energy sector possesses some of the best long-term fundamental drivers and attractively valued equities in the commodity-oriented sectors.

The primary reason we believe the spike in commodity prices will not lead to a sustained rise in core inflation is that there is sufficient manufacturing and labor capacity available worldwide, constraining the ability of many suppliers to pass on these increased costs to their respective purchasers. Until global capacity utilization tightens further, if companies try to raise prices, consumers may balk and buy from another cheaper manufacturer. With profit margins at historically high levels, we think this inability to pass along increased costs may have negative implications for the earnings of many companies.





We believe the rise in energy prices and U.S. interest rates will be negative headwinds for the economy, causing a moderation in the current above-average rate of Gross Domestic Product (GDP) growth. The Federal Reserve's goal of stimulating the post-2001 recessionary economy by lowering the Fed Funds rate increased the demand for housing, causing a rise in housing construction and home prices. However, we think the housing market has already shifted from a sellers' market to a buyers' market, with the inventory of unsold homes increasing and the median new home price actually declining modestly. We do not expect the U.S. housing market to collapse, given our expectation that employment continues to expand with the growth in the U.S. economy and U.S. intermediate to long-term rates do not increase significantly, keeping fixed rate mortgages affordable. Nevertheless, some of the excessive investment that took place in the housing market may shift to other sectors of the economy, such as capital goods. Corporations' balance sheets are very strong and they have the cash flow and financial incentive to invest in a variety of productivity enhancing projects. We believe capital spending will grow faster than consumer spending, providing a strong foundation for the Industrial and Information Technology sectors.

