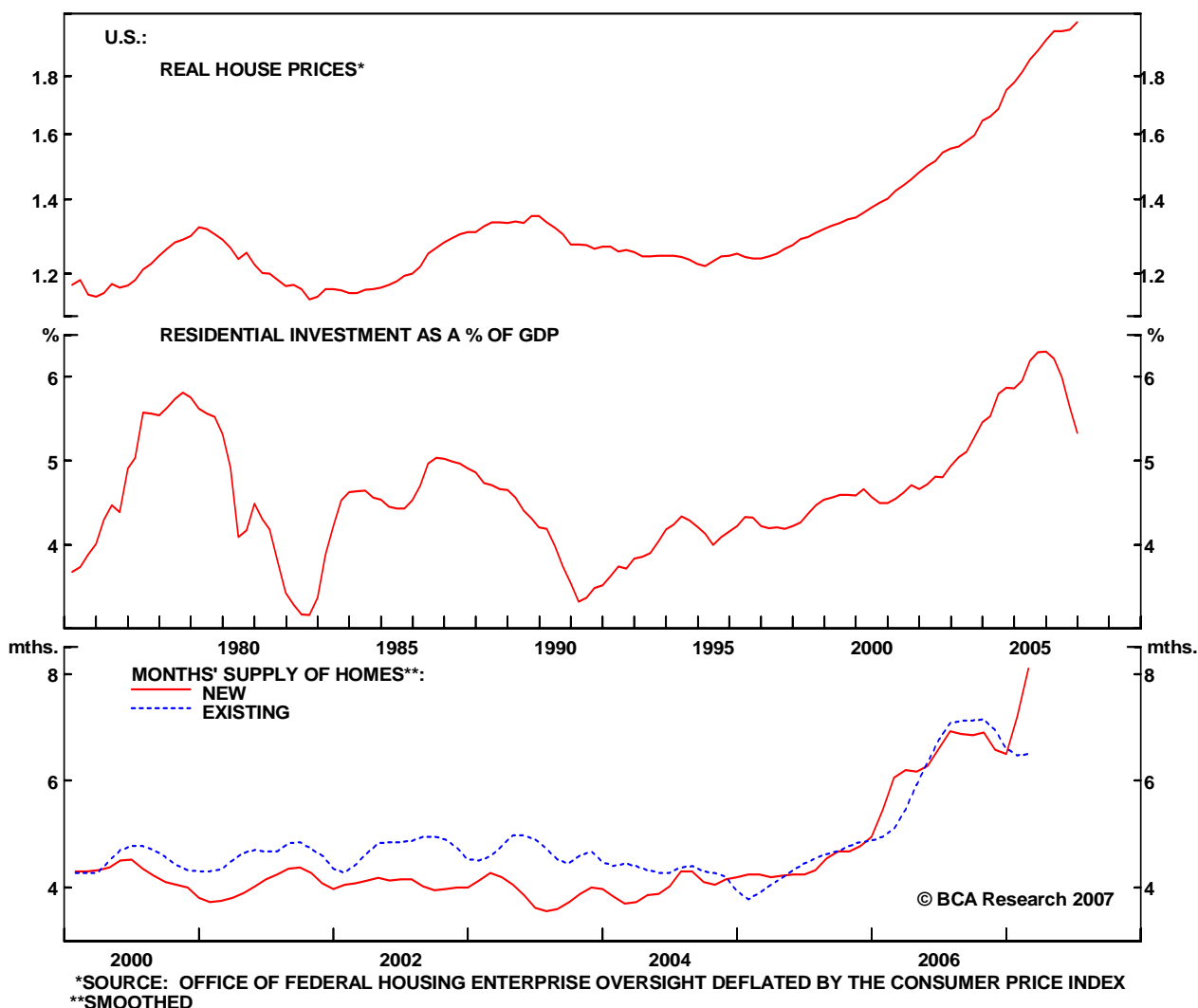


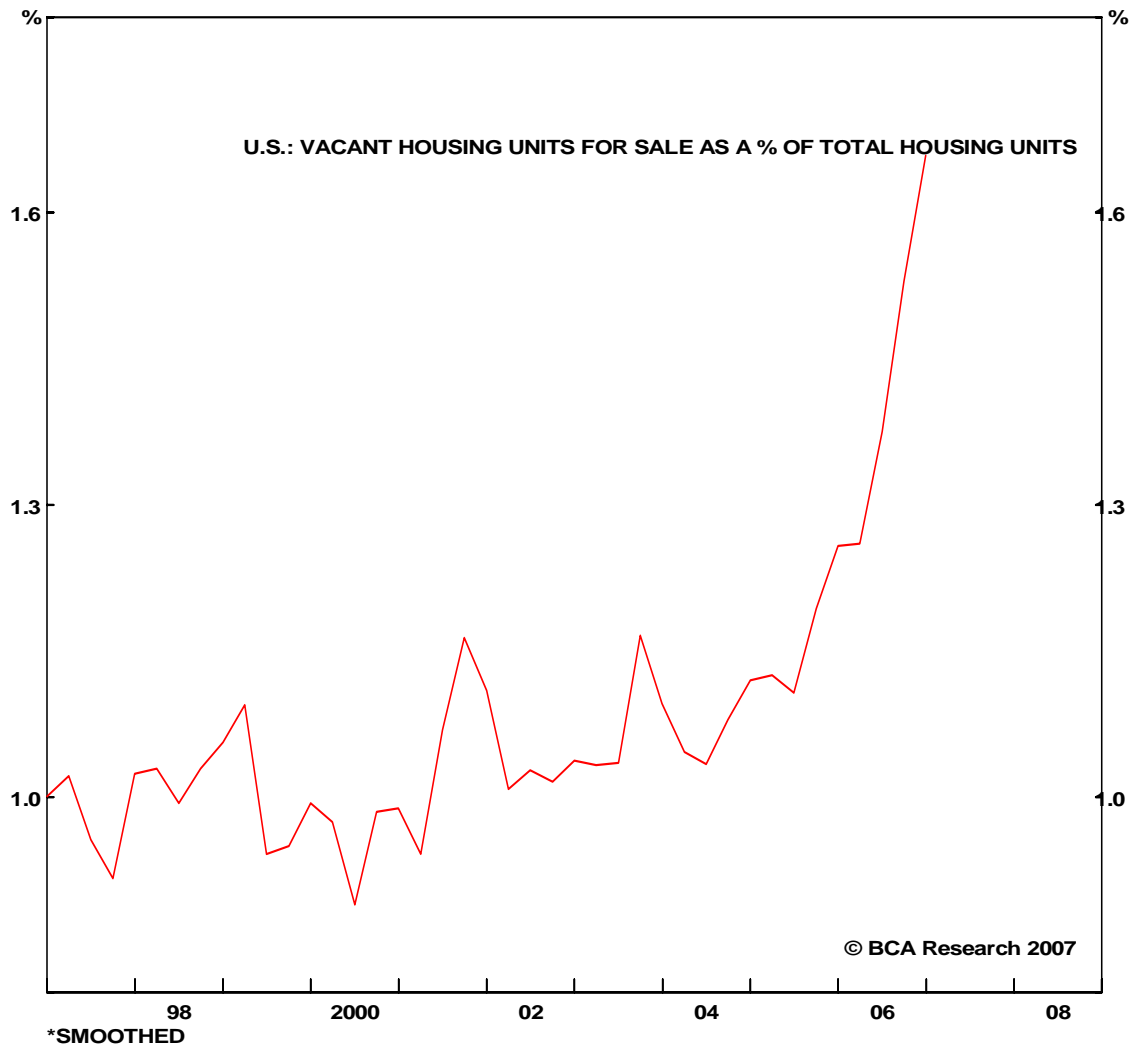
ECONOMIC & MARKET COMMENTARY

The housing construction industry is poised to have another leg down. Prices have held up reasonably well to date but could experience further weakness. Nonetheless, our biggest concern with housing is its impact on Gross Domestic Product and thus employment. As shown on the middle chart below, “Residential Investment as a Percent of GDP” peaked a little over a year ago at over 6%. The troughs usually occur when this percentage falls below 4%. We are approaching 5% now in this current cycle, as the downward trend shows.

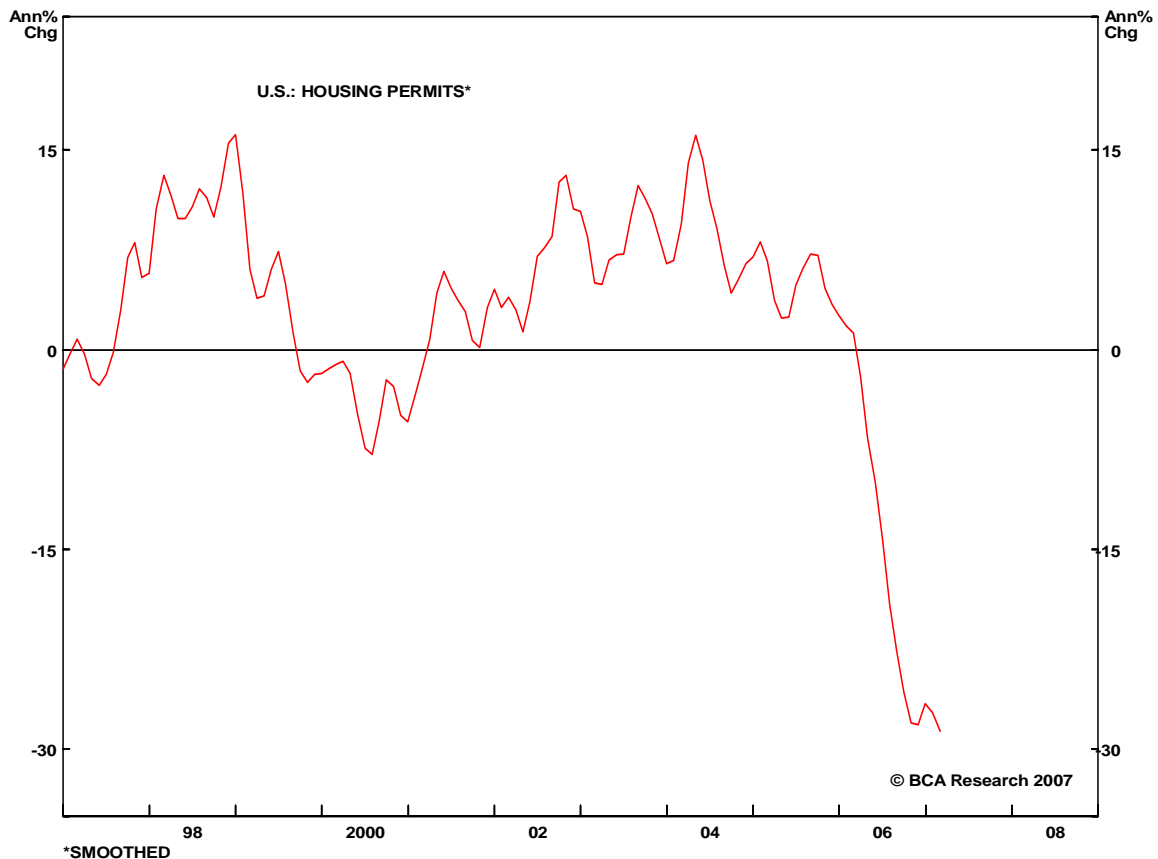
MORE DOWNSIDE IN HOUSING



Inventory for sale of both new and existing homes is at unsustainably high levels when measured as months of inventory as shown above. Even more disturbing, the vacant homes for sale as a percent of the overall housing stock has surged, as shown in the next chart.



This equates to approximately 900,000 empty units above normal levels for sale inventory. This extra empty-for-sale inventory will be abated over time by sales and a dramatic decline in new home completions. Housing permits have indeed contracted as shown below. Permits lead completions by about six to nine months so we can be reasonably assured that completions are due for a significant decline by midyear.



As completions decline and the number of homes under construction decreases, “Residential Investment as a Percent of GDP” will continue to fall and many of the associated workers in the housing industry will not be retained. We expect this phenomenon to be readily apparent to all during the seasonal Spring quarter. The usual Spring housing strength will give way to weakness as the excess supply of housing is worked down and housing employment falters. We expect housing related industries to shed approximately one million jobs out of nine million over the next year.

The housing industry has been a key component to the current economic expansion but is quickly morphing into a liability. The problems in the mortgage finance industry, Subprime and Alt-A in particular, raise the specter that this cycle could be more severe than most. We are watching this cautiously.

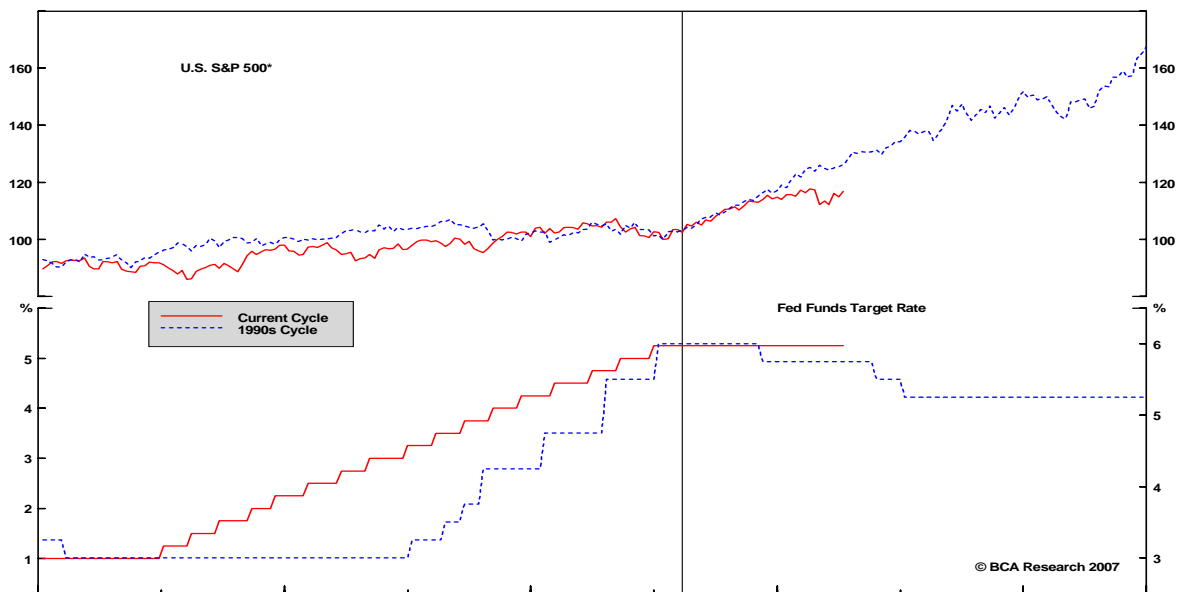
In our view, the contraction of the housing industry is not really a forecast but more a recognition of the gestation period of permits and housing starts, and the delayed impact on the GDP, employment and completions.



If our economy (ex-housing) can continue to add employees and grow, we should be able to avoid a recession. If the contraction in housing and housing employment spills over into the rest of the economy, a recession will be unavoidable. The chance of a recession looks to be approaching 50-50 in our view, and we think it is prudent to position portfolios for an economic slowdown and potentially a recession. We are overweighted in the Healthcare and Consumer Staples sectors because they are reasonably valued and are expected to grow faster than the overall market in a slowing economy.

This economic pause should allow inflation pressures to lessen and allow the Fed to ease. If this can occur without a recession, stocks should be able to move higher in the second half of the year as the Fed cuts rates. If the Fed fails to cut rates in the second half of 2007, the probability of a recession increases and the impact on corporate profitability would be severe in our opinion. Stocks would be extremely unlikely to rally in the second half if this situation were to occur.

MID-EXPANSION PAUSE: A CYCLE-ON-CYCLE COMPARISON



* Shown rebased to July 2006 = 100.
Note: Vertical line denotes first Fed pause.

We believe that the Federal Reserve Chairman, Ben Bernanke, is more afraid of our overleveraged economy falling into a recession than he is of modest inflation. Remember, this is “Helicopter Ben” who back in 2002 promised that the Fed could liquefy the economy and prevent a deflationary spiral by unconventional means if necessary even if that meant dropping money from helicopters. Hyperbole for sure, but we got his drift. We expect the Fed to start cutting rates around midyear, the economy to avoid a recession and stocks to post a modest rally in the second half. As we are currently more bearish on the economy than most, we will continue to monitor the employment situation closely.