Tradition Capital Management, LLC

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ECONOMIC & MARKET COMMENTARY

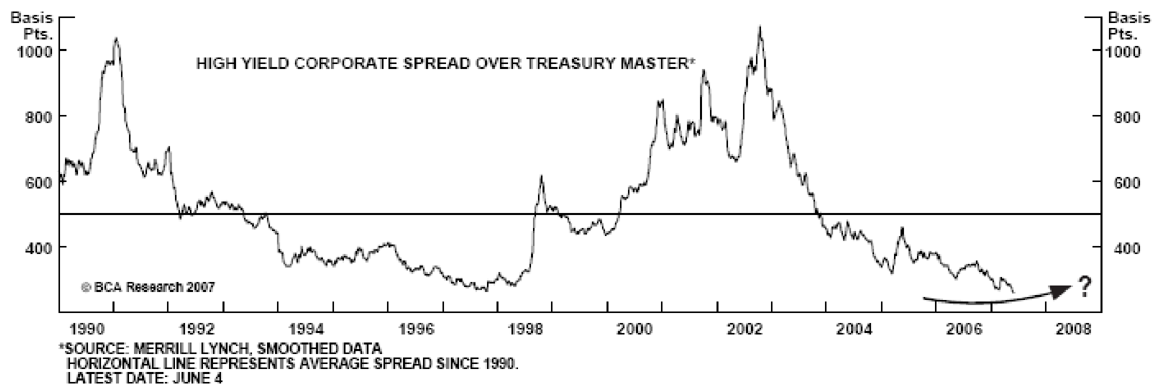
Stock markets around the world generated strong returns in the 2nd quarter, supported by better than expected earnings gains and readily available, cheap credit. The Standard & Poor's 500 index (a widely used proxy for the U.S. stock market) generated a 6.27% total return during the quarter and was finally able to exceed its March 2000 high.

When the preliminary estimate of 2nd quarter U.S. Gross Domestic Product is released, it should show a rebound from the anemic 0.7% growth rate in the January – March period. However, we have a somewhat more cautious view of the economy's prospects over the next six months than the consensus, due to the weak housing market (about which we have written in past quarterly Commentaries), higher energy prices, and flagging consumer confidence. Employment and incomes have continued to expand, but at a moderating pace. With consumers' balance sheets stretched and a limited opportunity to supplement their incomes with mortgage equity withdrawals, consumer spending should decelerate. Consumer spending represents more than 70% of U.S. economic activity.

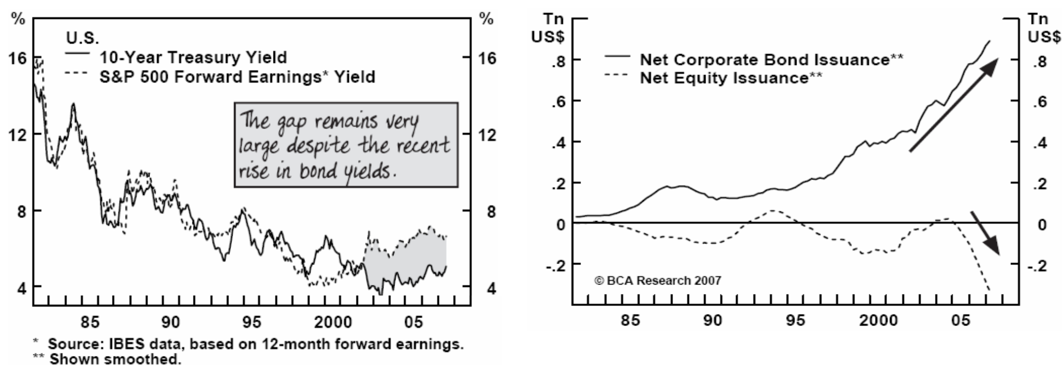
Globally, some of the European industrialized economies have finally picked up momentum, while the developing economies of Brazil, Russia, India and China (BRIC) continue to expand at a strong rate. Stronger international growth, combined with the weak dollar, should help U.S. companies' foreign sales, as well as the country's net export position.

We continue to believe that both headline and core inflation rates will turn down as the year progresses and get closer to the Federal Reserve's target range. While most investors now expect the U.S. central bank to keep the Fed Funds target rate steady at its current 5.25% level until next year, we believe an improving inflation outlook, coupled with weaker than expected economic and employment growth, could prompt a cut sooner. The inversion in the short end of the U.S. Treasury yield curve has diminished and we have been modestly extending the duration of our fixed income portfolios.

Real interest rates have begun to move higher throughout the world in the last few months and the U.S. Treasury market has been no exception. The yield on the 10 year U.S. Treasury Note increased from 4.75% to 5.30%, and is now approximately 5.00%. The "spread" (differential) between U.S. Treasuries and lower rated bonds has begun to widen, as investors are demanding higher yields given the problems in the sub-prime mortgage market and the increased supply of lower rated corporate bonds used to finance various acquisitions. Despite the recent widening in interest rate spreads, they remain well below historical averages, which is the reason we continue to focus on the highest credit quality securities in clients' fixed income portfolios. In our opinion, fixed income investors are not being adequately compensated (through a higher yield) to assume the increased risk of lower quality issuers currently.



The Standard and Poor's 500 index remains modestly undervalued, given our forecast for earnings and the current level of interest rates. The S&P 500 is trading at about 15.5 times 2008 estimated earnings, making the earnings yield (the reciprocal of the P/E ratio) 6.5% versus a 5.0% 10 year Treasury yield. This difference in the valuation of the stock market and relatively low corporate borrowing rates is one of the reasons for the high level of mergers and acquisitions, as well as the large number of corporate stock repurchase programs. U.S. companies, for the most part, are in very strong financial shape; however, we have been somewhat surprised that they have not been willing to increase capital spending at a somewhat faster pace. Instead, they are using their free cash flow to raise dividends, buy back significant amounts of their own shares or make acquisitions, which can be accretive for shareholders.



We expect companies that generate a greater proportion of their revenues and earnings from international operations will grow faster than their domestic-oriented peers. It has been clear over the last couple of quarters that faster international growth and the translation of foreign earnings back into the weaker dollar has helped the profits of U.S. multinationals. We expect this phenomenon to continue for the foreseeable future. In addition, we have been investing in foreign based companies through American Depository Receipts (ADRs) that trade on the U.S. stock exchanges. These foreign companies are also leaders in their respective industries and reasonably valued.

While slowing earnings growth, higher energy prices and widening credit spreads may act as headwinds for the broad stock market averages, we are still able to identify a sufficient number of individual stocks with attractive risk-adjusted potential returns.