Tradition Capital Management, LLC

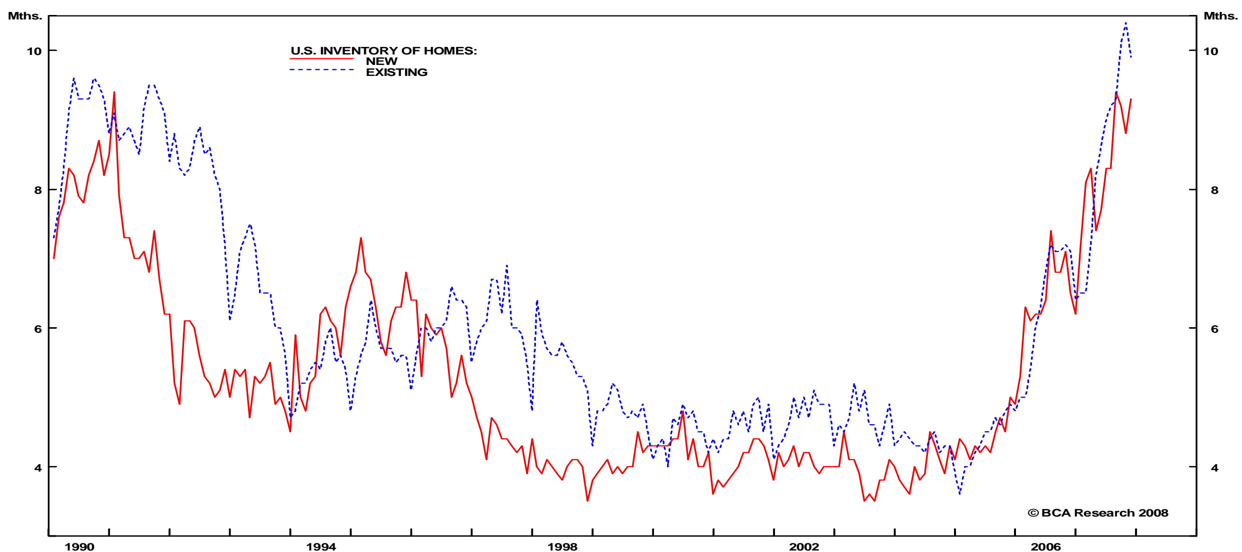
January 2008

ECONOMIC & MARKET COMMENTARY

The breadth of the housing market's problems has finally been appreciated by most policymakers and investors. The anticipated weak residential construction employment, the psychological impact from the negative wealth effect of falling home prices and the cessation of mortgage equity withdrawals has started to dampen consumer confidence and spending. However, other parts of the economy have been sufficiently strong to offset the housing market weakness and to prevent a slide into recession until recently.

Lax credit standards and aggressive highly levered mortgages have damaged the broader credit markets and the entire financial system. Not only is the problem bigger and more severe than we and most believed, but it will be harder and take longer to resolve.

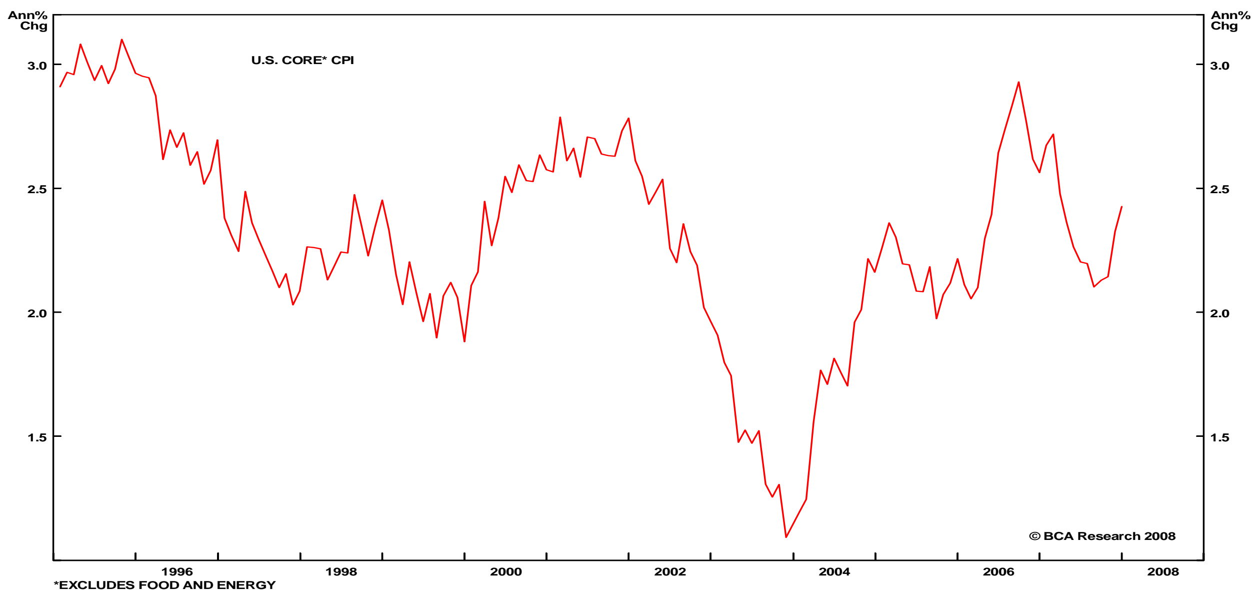
The exaggerated boom in residential housing that developed earlier this decade will contract deeper and longer than a normal cycle. Inventories of unsold homes are at historically high levels. The problems that many borrowers are currently experiencing may increase the risk of foreclosures and will thus further increase the supply of empty homes for sale. We believe further home price declines (although this may exacerbate the credit and foreclosure problems in the short run) and lower mortgage rates will be necessary to work off the overhang.



As 2008 unfolds, the outlooks for some of the key economic and investment fundamentals (economic growth, corporate profits, inflation and Federal Reserve policy) that influence the capital markets are highly uncertain and more difficult to anticipate than the normal ambiguity. The consensus currently believes the U.S. economy will grow at a subdued rate of approximately 1% during the first two quarters of the year. We expect that the headwinds from the weak housing market, credit problems and softening consumer spending argue for an even slower, possibly negative, outcome. In our view, we are most likely in a recession now, but it will take a couple of quarters before it is officially declared.

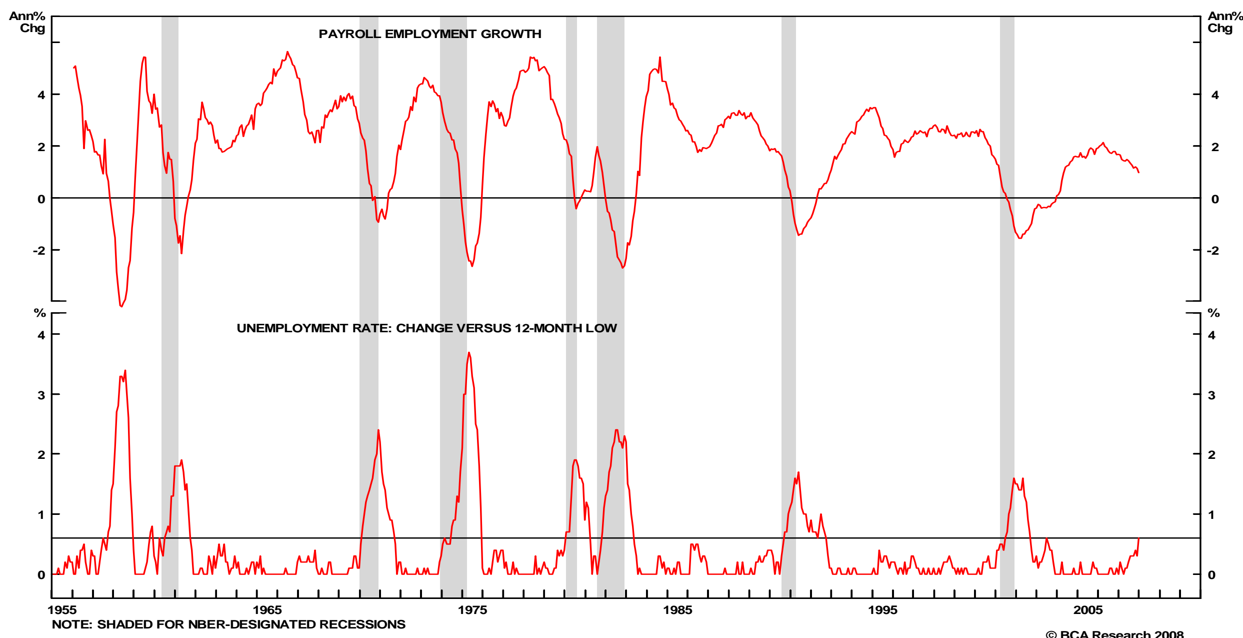
While growth in Europe seems to be moderating, economic activity remains strong in the emerging economies (Asia, Latin America) of the world. This, combined with the weakening dollar relative to many currencies, has caused the U.S.'s export position to improve markedly. In fact, net exports have added approximately one percentage point to real gross domestic product recently. However, given that the U.S. market represents such a large export market for many foreign countries, we do not think these economies can completely "decouple" from the slowing U.S.; hence, we expect the global economy to slow as well.

While rising energy and food costs have put upward pressure on the headline inflation statistics, core (excluding food and energy) inflation remains close to the Federal Reserve's target. We believe the combination of global competition, productivity increases and slackening economic activity will cause U.S. inflation to recede from its current level, providing the flexibility the central bank needs to further lower the Fed Funds rate.



In last quarter's Economic and Market Commentary we wrote that the Federal Reserve was caught between a rock and a hard place from a policy point of view. On the one hand, the Fed was trying to address the weakening economy, but was mindful of the impact that lower rates might have on the dollar and inflation. We continue to think the greater risk is the threat a weakening economy will have on individuals' abilities to satisfy the large debts they have assumed over the last five years. While headline and, to a lesser degree, core inflation rates are above the Federal Reserve's target ranges, they are not so worrisome nor have they become embedded in investors' expectations that the central bank cannot reduce the Federal Funds target rate. The bond market is indicating through Treasury yields, Treasury Inflation Protected Services (TIPS) yields and corporate bond spreads that a recession, not inflation is the biggest worry of investors. We believe the Fed is behind the curve but will continue to cut as it needs to make up for lost time. However, monetary policy operates with a significant lag, often times taking more than six months to have an impact on economic activity.

So far, employment has held up, but it appears to be weakening as well. December employment growth was only 19,000, well below expectations and the unemployment rate increased from 4.7% to 5.0%. As shown on the lower chart below, whenever the unemployment rate increases by more than 0.5% from its trough, the economy has entered a recession. The current cycle has experienced an increase of 0.6%, thus making a recession the most likely course of events.



During the six years since the last recession, corporations have cut costs and their profit margins widened to historic highs. Faced with sluggish revenue growth and increasing raw material and labor costs, their margins will, in our opinion, be under pressure. As a result, companies will be very careful about making significant capital and employment increases. Accordingly, we expect employment to slow and the unemployment rate to continue to rise. Real incomes will, in our view, stagnate and consumer spending should slow. The slowing economic activity and higher costs will cause profit margins and earnings to suffer. As a result, we expect very little if any growth in corporate profits as measured by the S&P 500 in 2008.

With investor psychology and conviction low, we expect the stock and bond markets to remain volatile. However, concerns are now well documented and investor psychology very negative, thus we have already experienced a contraction in valuations which make stocks relatively inexpensive versus interest rates and inflation. Each new economic and earnings release will be parsed for clues about the near-term direction of economic growth, corporate profits and inflation and could cause wild swings in both the broad market and individual stocks. While this volatility may be challenging from an emotional and execution point of view, it should also create opportunities for us to apply our disciplined process of buying good companies at discounts to our estimate of fair value.