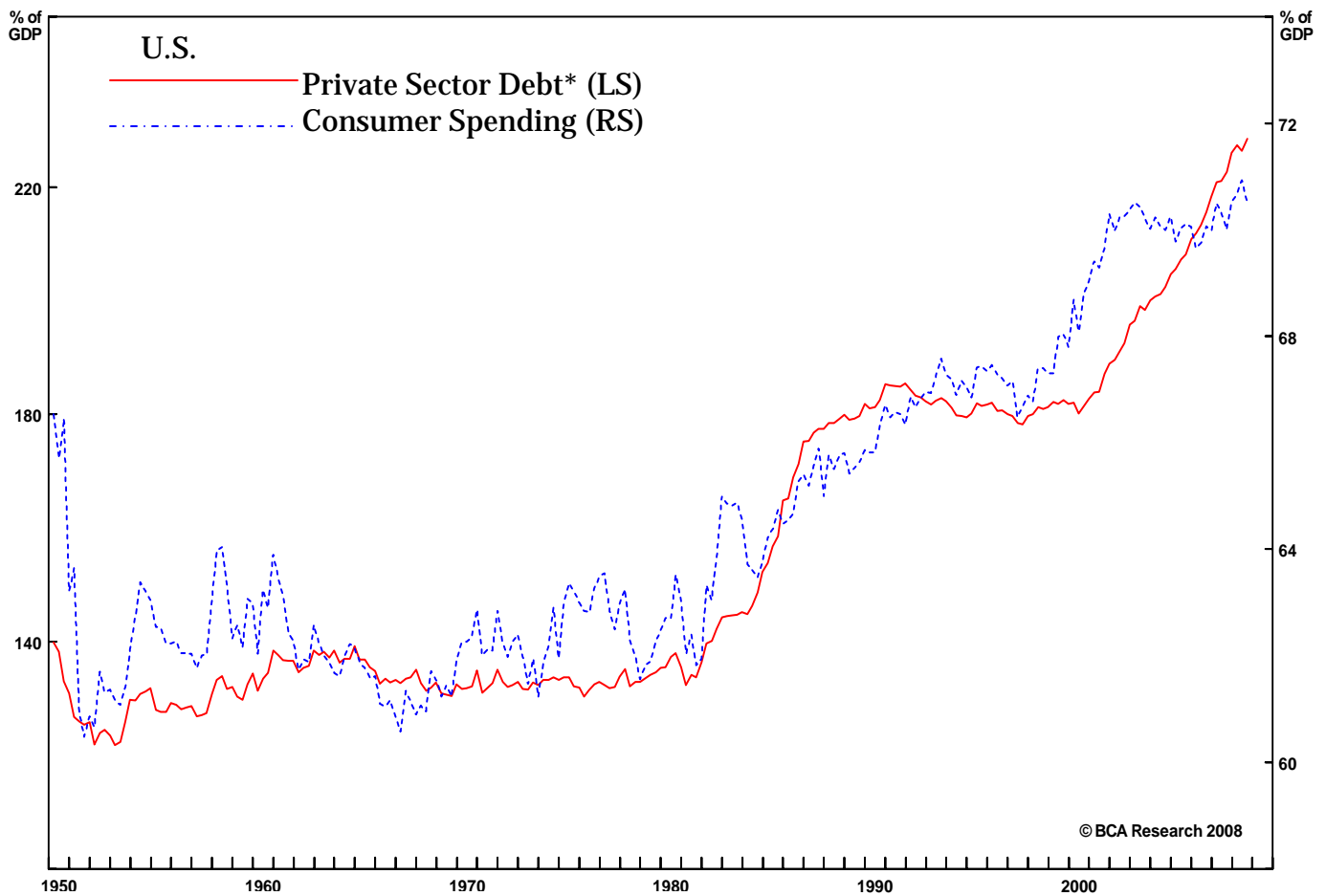


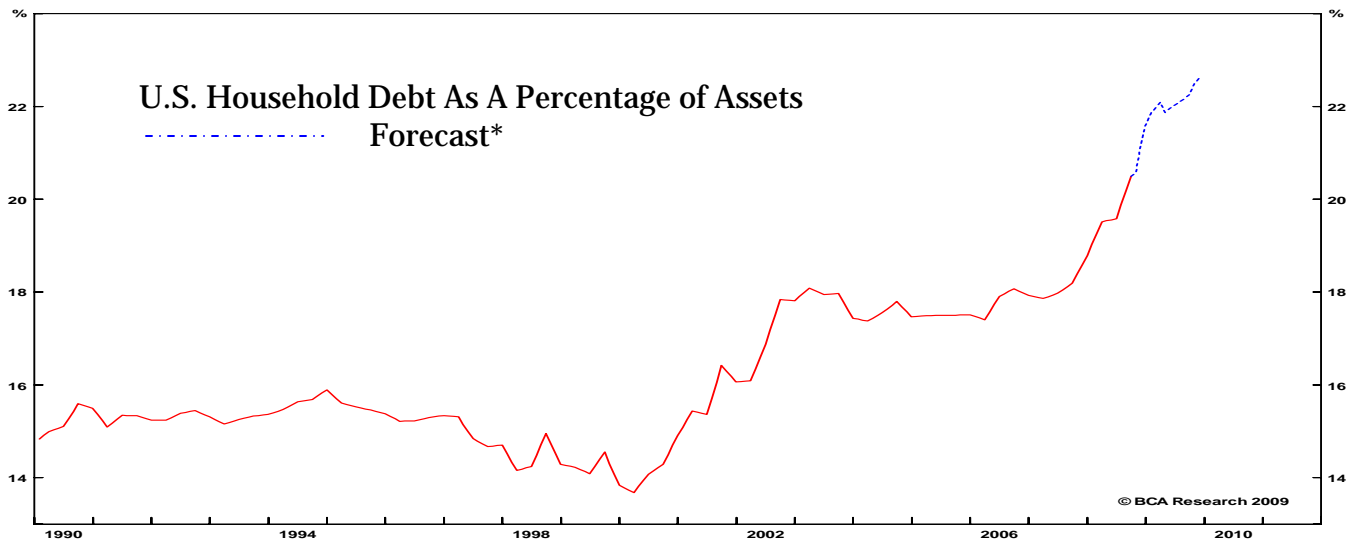
## Economic & Market Commentary

The great U.S. debt unwind has begun. In 1951, Total U.S. Credit Market Debt stood at 143% of GDP (Gross Domestic Product). We appear to have reached an inflection point at 350% of GDP in 2008 and expect a large decline over the next few years. The build up of debt fueled excess consumption and accelerated growth in the U.S. economy and a reversal will cause consumption to contract and its associated economic activity to wane. As shown in the chart below, U.S. Private Sector debt went from 132% of GDP in 1951 to 225% in 2008. This allowed consumer spending to grow from 61% of GDP to nearly 72% of GDP. Consumption increased nearly 11 percentage points of share of GDP. The U.S. consumer had become the driving force of the global economy.



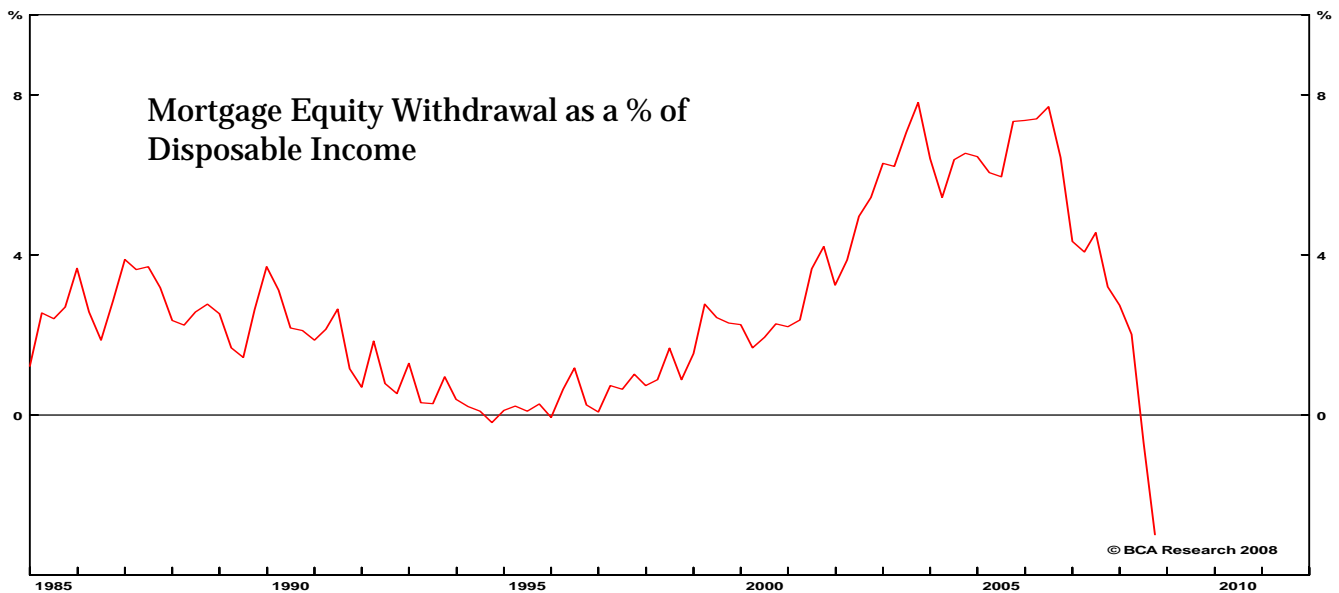
\* Excludes financial sector debt Source: Flow of Funds

This increased consumer debt to fund growing consumption degraded U.S. household balance sheets. U.S. Household Debt as a Percentage of Assets appears poised to surge over 22% from only 14% in 2000. The 2002 to 2007 economic expansion was fueled by consumer leverage.



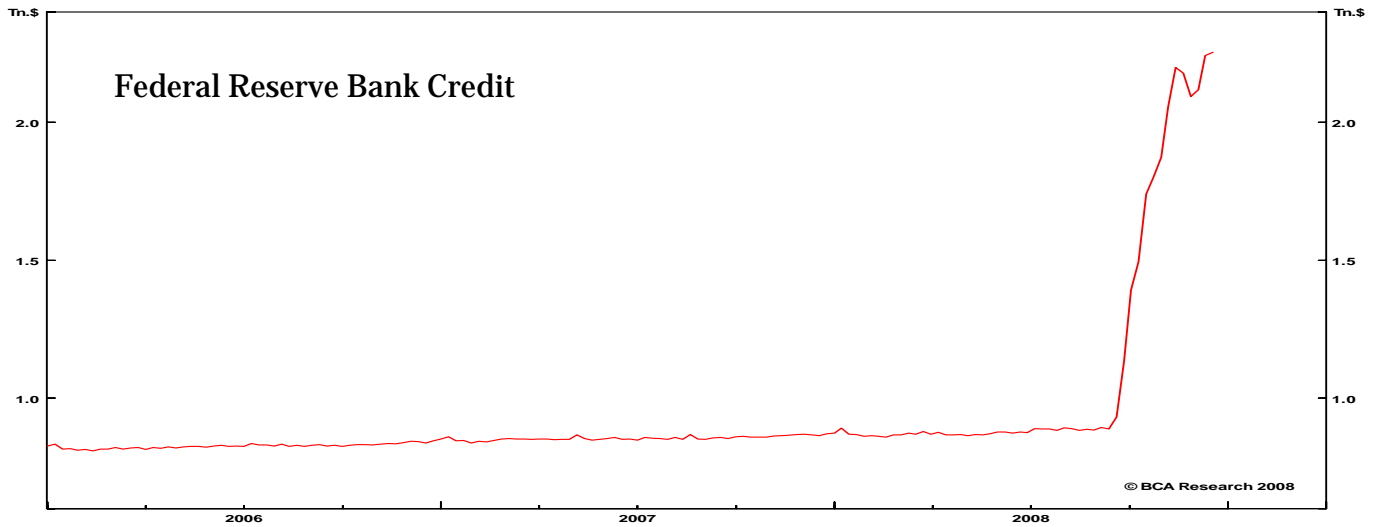
\* Based on a regression of household wealth versus house prices and equities. Assumes debt level and stock prices stay constant and house prices fall another 10% over the next 12 months.

The biggest swing factor as far as debt and the ability to fund spending was the growth of mortgage equity withdrawals. As shown, it got to almost positive 8% of disposable income and is now moving towards negative 3-4%.

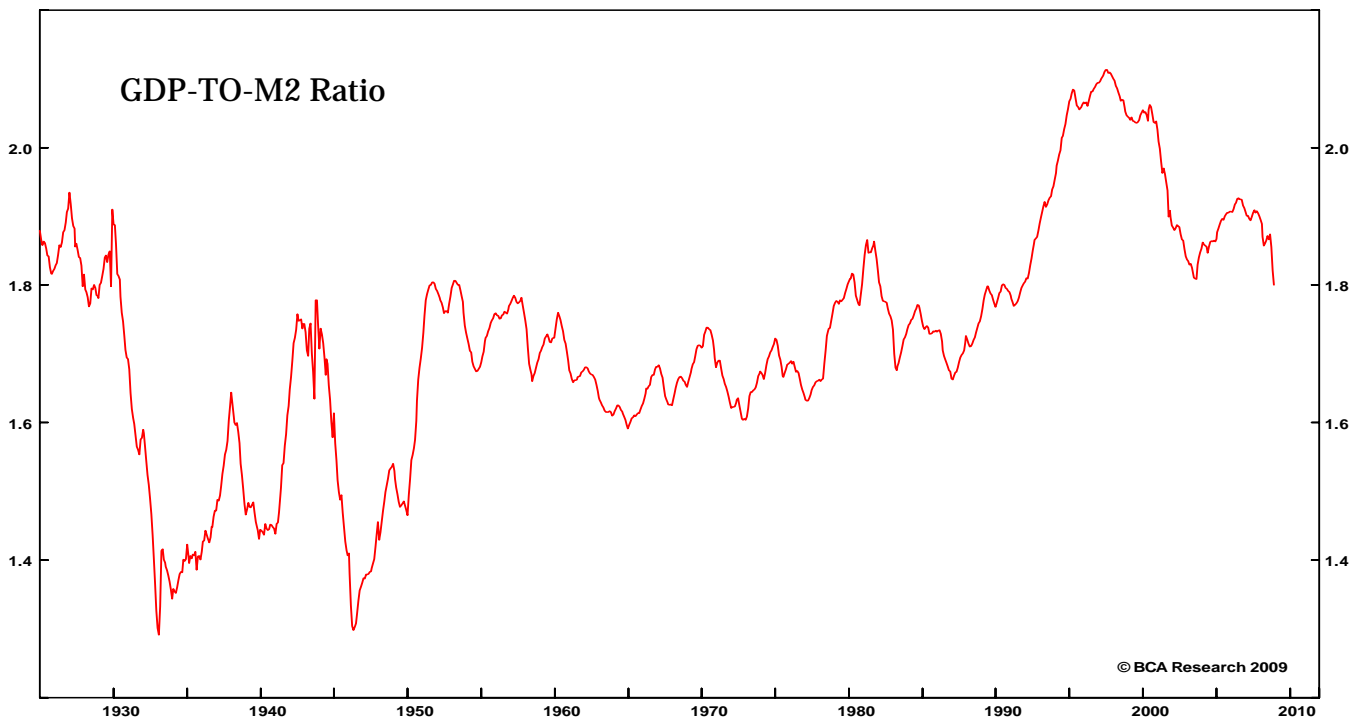


This reversal will cut consumer spending. We believe U.S. consumption is poised to contract by at least 5-10% over the next few years as debts are repaid (or written off) and consumers retrench. The debt build up created an unsustainable level of consumption that can no longer be supported, and a consumption bust is a real possibility as most consumers are overly satiated with consumer discretionary items (housing, autos, and electronics).

The government monetary and fiscal actions to date should help mitigate and limit the damage of this great debt unwind but will not prevent major changes. The credit contraction is deflationary and the Federal Reserve's (The Fed) recent aggressive moves to increase the money supply are only partially offsetting this deflationary trend.



The Fed's balance sheet is expanding rapidly but the velocity of money is imploding as credit contracts. As credit (lending) becomes scarce, broad money contracts even in the face of the Federal Reserve's expanding balance sheet.

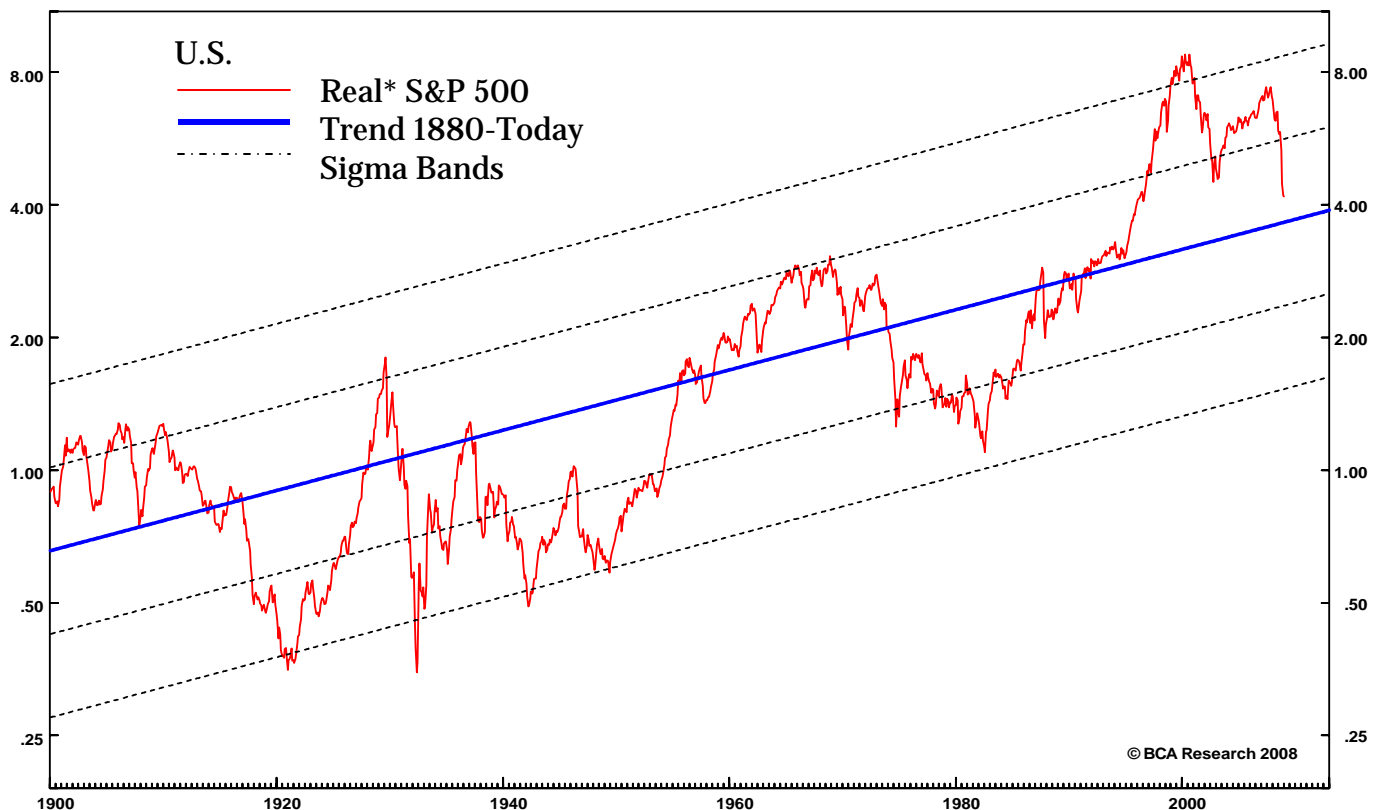


We are relieved that the Federal Government finally seems to appreciate the magnitude of the problem, but we fear that unwinding \$10-15 trillion in debt in the U.S. economy will be more than the Federal Government can offset.

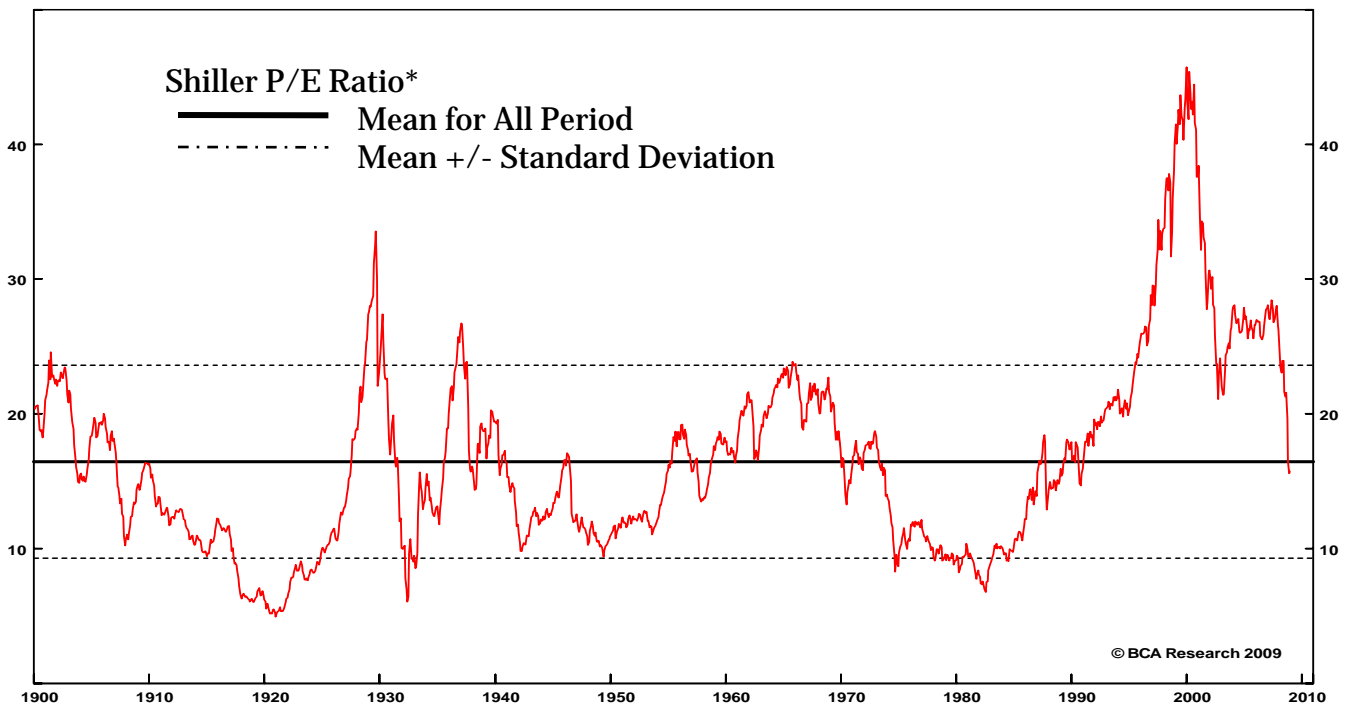
Our view is that this recession will not be typical, and that most of Wall Street and investors are complacent given that the last two recessions (1990-1991, 2000-2001) have been relatively very mild. A recession of the magnitude of the 1981-82 period would bring the Standard and Poor's (S&P) 500 index Return on Equity (ROE) down to under 10% and an even more severe recession down to 5%. This gives a range for the 2009 S&P 500 earnings of \$52 to \$26 per share and a possible downside price range for the index of \$500 to \$600. The S&P 500 index closed December 31, 2008 at \$903.25.

The 2009 consensus earnings estimate for the S&P 500 index has dropped to \$63, from \$93 a month ago. Most investors are looking at the decline in earnings from the recent highs, but the top included the debt-financed consumption boom. Corporate profits peaked at abnormally high levels, so the decline from these all time highs could be more severe as profitability moves towards normal or severe recession levels.

From a very long-term trend and valuation analysis, the stock market is selling near the middle of its ranges. Unfortunately, we have moved from extreme readings in 1999-2000 to the middle, not bottom, of the range. The severity of the current recession will determine the stock market's levels over the next couple of years.



\* Deflated using headline consumer prices.



\*Real Stock Price Index Divided by 10-Year Average of Real Earnings

Tradition Capital Management anticipated the recession that is now upon us. Unfortunately, the severity of the recession is surpassing the initial expectations we established a year ago. Given that corporations (excluding financials and consumer cyclicals) were in good shape from a balance sheet and profitability standpoint, we hoped their strength would partially offset the problems in the consumer sector.

This is not proving to be the case as the declines in spending by the consumer and financial sectors are overwhelming the rest of the economy. While we had been concerned about the ever increasing debt levels and the likelihood of a recession, a rapid contraction in the debt bubble was an event we thought we could avoid. Unfortunately, this debt unwind now appears to be unavoidable and has started in earnest. The fall off in consumption and its associated debt destruction will have a negative impact on the financial services, retail, restaurant, home construction, and auto, as well as other consumer discretionary industries creating layoffs in these sectors. This increase in unemployment will further depress demand and create a negative feedback loop that will, in our opinion, cause the unemployment rate to go over 10%. The U.S. secular boom of consumption is coming to an end and the economy must retool and redeploy the labor force. We expect this secular change in labor, capital, production and consumption to take years as the country redeploys both capital and labor away from consumer discretionary industries and into industrial and production industries. The economy, consumption, profits, employment, stock prices and housing prices are all part of a feedback loop. News in one area impacts another and the impact is circular and self reinforcing. The reversal of debt accumulation has a long lasting negative impact on the economy, and we are uncertain how deep this recession will be. The government's actions, both fiscal and monetary, to date and in the future, will help mitigate and limit the damage of this great debt unwind but will not prevent a severe recession. We think a conservative asset allocation and equity exposure is the prudent course of action for most of our clients, given this high degree of uncertainty.

As long-term investors, the difficult challenge is gauging how much of our current economic forecast may already be discounted in stock prices. Traditional measures of investor sentiment such as put/call ratios and bullish versus bearish equity investor ratios were, not surprisingly, very negative but have moved to neutral or bullish levels over the past couple of weeks. Investors have pulled billions of dollars from equity mutual funds. Hedge funds have been forced to sell huge amounts of stocks, bonds and commodities to meet redemption requests from their investors. Money market balances have grown so large that they represent 90% of the S&P 500 index's market value. As you are painfully aware, money market fund yields are below 1%. Alternatively, the S&P 500 index dividend yield is now 3%. While we expect some of the companies (particularly in the financial and consumer discretionary sectors) that make up the index could reduce their dividends, we believe investors are being paid a reasonable cash return. This is certainly true when compared to the yields that can be earned by investing in US Treasury or agency bonds and money market funds.

We continue to have confidence in the stocks we have purchased for clients. The companies have strong balance sheets, generate significant cash flow, and possess competitive advantages that should allow them to weather the difficult economic environment we are anticipating.