July, 2008

## 2008 Second Quarter Update

Review: Stocks had a third poor quarter in a row, down 2.7%. Bonds, which did well in the first quarter, were also down. The Merrill Lynch Intermediate Government/Corporate Index dropped 1.4%.

| ***Quarters*** | ***2Q08*** | ***1Q08*** | ***4Q07*** | ***3Q07*** | ***2Q07*** |
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| ***S&P 500 Index*** | ***-2.7%*** | -9.4% | -3.3% | 2.0% | 6.3% |
| ***Merrill Lynch Int. Bond Index*** | ***-1.4%*** | 2.9% | 2.9% | 2.8% | -0.1% |

The Economy: The economic trends continue to be weak but not yet indicative of a recession: Real retail sales are sluggish but positive, up 2%, compared to the 3-4% rate of the past three years. Unemployment is at 5.5%. While elevated, it is below previous recessionary peaks. Businesses are faring somewhat better, aided by strong exports. The ISM Manufacturing Index, a broad measure of industrial health, is hovering in neutral territory, indicating business activity is not in recession.

Energy prices are the key to the economy. Prices have risen nearly 50% since the beginning of the year, creating a significant headwind for the US consumer. Yet, the fundamental supply and demand factors have not changed that dramatically. While the reasons for the increase are not entirely clear, we believe that prices will settle back as demand falls and additional supply is wrung out of existing wells. Energy demand in the U.S. has clearly declined and conservation efforts are increasing. The decline could be as dramatic as the rise.

Banks and financial firms have been under pressure due to the deflation of the massive mortgage bubble. However, this process has been under way for almost a year and a half. Pressed by regulators, U.S. banks have taken write-downs of $176 billion but have raised more than $159 billion in new capital since last September to strengthen balance sheets. Our assessment is that banks are well on their way to cleaning up problem loans. The process will continue until the housing market has bottomed-- an event we expect to take place in the first half of next year.

Inflation has become a concern as food and energy prices have spiked. However, core inflation, which excludes volatile food and energy prices rose only 2.1% in May. Wage increases, which were 3.2% in the first quarter, are being contained by the sluggish job market. Declining home prices are also putting downward pressure on inflation. The Fed has indicated its willingness to increase interest rates to blunt inflationary

pressures if they appear. We expect the softening of energy prices as the year goes on to help contain inflation.

Looking ahead, we see this period of economic weakness extending into the first part of next year, followed by a slow recovery.

International: Emerging economies are experiencing concerns about a slowdown in growth and higher inflation, calling into question the strength of export earnings. A good portion of the growth is due to building infrastructure which is part of a long-term development plan financed by central governments. Recent checks with companies indicate demand is healthy. Also, the emergence of a middle class adds stability to these economies.

The dollar has probably bottomed against the euro. Growth in Europe is slowing and European interest rates may decline just as our rates are rising, boosting the dollar. The dollar is still overvalued against the currency of China, benefiting investments in that country.

Stock Market: Having declined 20% from the high of last October, the stock market is already discounting a recession. However, there is an underlying strength in earnings that has been masked by the weak financial sector. Earnings, without financials, are expected to be up 10% in the second quarter. We believe bank stocks are already discounting a worst-case scenario. Even with additional provisions for bad loans, earnings comparisons will improve by year end. Stocks are attractive because of reasonable valuations and prospects for the resumption of growth next year. Stocks always rally ahead of the actual economic recovery.

Bond market: Bonds are not attractive because yields are low. The Fed has indicated it will raise rates once the period of weakness in the financial sector is past. Therefore, we are focusing on short maturities.

Strategy: While stocks are attractive, the uncertainty of the timing of an economic recovery and the potential for bumps in the road lead us to focus on strong companies that can weather adversity. There are several secular trends that are especially attractive investments.

The need for infrastructure in emerging economies will be an important theme for investment for many years. It is estimated that emerging economies will spend $5 trillion on infrastructure over the next ten years. We want to be well represented in this area.

Longer term, the growth of the emerging world will put pressure on energy supplies, providing a significant incentive for increasing energy efficiency and developing alternative energy sources. We are focusing on investing in this trend.