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# Economic and Market Summary

**October, 2006**

Conventional wisdom regarding current economic conditions in the U.S. is that the housing bust, high energy prices and rising interest rates are threatening the current expansion. A deeper look at these and other key variables suggest otherwise. Housing activity is slowing, but the most severe impact is in specific segments, such as high-end homes in coastal areas and south Florida condominiums, that over-heated in recent years. For the broader housing market, it feels more like an inventory correction than a bust. It's also important to note that commercial construction activity is strong. Energy prices in recent weeks have been falling after peaking in July. Demand growth for energy is slowing and supply is rising as evidenced by the announcements of significant oil and gas field discoveries in the Gulf of Mexico and offshore China. Oil and gas in storage throughout the world is also well above normal. Short-term interest rates have risen substantially in recent years from deeply depressed levels to a level that is still far from restrictive. Longer-term interest rates, meanwhile, remain unusually low on a historical basis. Money remains relatively easy to obtain and inexpensive. Employment is growing steadily and compensation growth is accelerating, which suggests that the labor market is tight and that inflation remains a bigger threat to the economy than recession. One fairly reliable indicator that does signal economic trouble is the inverted yield curve (short-term interest rates are higher than long-term rates). Currently, the inversion is slight and prior to past recessions, the inversion was much greater than it is today. It does bear watching, however. Therefore, despite some headwind from slower housing activity, we believe economic growth will be in the 3.0-3.5% range over the next year, which is consistent with the past 3 years and with the longer-term growth potential of the U.S. economy. It is easy to get caught up in sensationalist headlines reported by mainstream media. In reality, the economy is not nearly as volatile as these reports suggest. It takes major policy errors or severe shocks to drive the U.S. economy into recession. While there is talk of higher taxes and protectionism in Congress, both of which would be damaging to economic growth, there is no serious threat of harmful legislation being passed until 2009.

Rising inflation still seems to be a risk to the economy, although recent price declines in many commodities are a welcome development. Global competition and strong productivity growth are also terrific inflation deterrents. The Federal Reserve evidently believes that inflation will revert back into its 1-2% comfort zone, from around 2.5% currently, and has kept the federal funds rate steady at 5.25% since June after 17 consecutive ¼ point increases beginning July, 2004. We're not convinced that inflation is contained and, therefore, continue to have a cautious outlook toward bonds. Yields remain below levels that we believe reflect underlying inflationary pressure and a fair "real" return.

Stocks continue to look attractive. P.E. ratios have been declining for six years and are in line with long-term averages. Since 2002, double-digit growth in corporate profits has consistently exceeded expectations, although a slowdown to the 7-8% range is likely as the huge profits earned by energy and commodity producers begin to reverse in upcoming quarters. This development would actually favor the many companies in our universe that are net buyers of energy and commodities. Our outlook for moderate and steady economic growth, along with attractive valuations, is supportive of a continued rotation from cyclical companies toward the type of high quality, consistent growth companies that our investment approach favors.

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*To request our SEC Form ADV Part II, please contact Michael L. Wise, Chief Compliance Officer, at the address below.*