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Economic and Market Summary

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An abundant supply of easy credit, lax lending standards, and unsustainable price appreciation has resulted in the housing downturn we are experiencing today. Problems that first emerged in subprime mortgages have since spilled over into the broader credit market. Deteriorating credit quality and mounting losses are resulting in asset write downs, the tightening of lending standards, and in some cases, the addition of capital from state-owned sovereign wealth funds. Because these market strains pose risks to the overall economy, the Federal Reserve lowered the federal funds rate from 5.25% to 4.25% last year. We expect further rate reductions before the year is through. Lower rates will help the economy generally, but central banks cannot force financial institutions to lend. The lending industry has been hurt by a lack of transparency, difficulties in accurately valuing and/or selling some complex debt instruments, insolvency among reckless firms, and a general feeling of distrust. While it may take some time to work through these challenges, market confidence will ultimately return, and financial institutions that maintained strong credit underwriting discipline will emerge stronger.

Despite the housing downturn and issues plaguing the credit markets, the economy grew at a solid pace for much of 2007. Consumer and business spending remained supportive during this time, and exports were booming due to the strong global economy. However, as the year came to a close, U.S. economic growth appeared to have decelerated meaningfully. The unemployment rate rose to 5% in December, up from 4.7% the prior month, and 4.4% in March. Private payrolls contracted by 13,000 in December, the first such decline in four years. While we should never read too much into one report, it definitely bears watching because the labor market, with typically steady gains in wage and salary income, provides the foundation for consumption. At the margin, consumers have also been tapping their home equity to support spending. With equity dwindling and banks more hesitant to lend money, this source of funds has diminished. We also note that persistently high prices of energy and food have crowded out other consumer discretionary items. Businesses are cutting back their own capital spending plans due to the slowdown in consumer spending, high input prices, and overall economic and political uncertainty. Although we are seeing some weakness emerge from Europe and Japan, the global economy is still holding up well. All in all, this leads us to expect a slower pace of U.S. GDP growth in 2008 (+1-2%).

We are maintaining our vigilant watch over inflation. The U.S. dollar has been weak causing import prices to rise, and aggressive rate cuts by the Federal Reserve could further undermine the dollar. High energy prices have increased the cost of food production. Numerous other commodity prices remain elevated. Offsetting these pressures is the deflationary impact of tightening credit and the housing correction. Various home price measures are still weakening and demand continues to fall. We believe widening credit risks and defaults, along with falling real wage growth, will ultimately exert a moderating effect on inflation as we move through 2008.

The muted economic tone keeps bond yields low, although we could see periodic spikes upward occurring primarily in response to surprises on the inflation front. We remain most comfortable owning the highest quality bonds. As for stocks, volatility will likely continue given that we are at an inflection point in the economy. While news regarding the current environment can be unsettling, this is a time when attractive values are being created in the financially solid and fundamentally strong companies that we favor. We are poised to take advantage of these opportunities as the year unfolds.

Christi Salm, CFA

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