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Economic and Market Summary

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In an unusual twist, the U.S. economy is experiencing strong deflationary and inflationary forces simultaneously. Deflation is resulting from the bursting of the credit and housing bubbles, and the associated deleveraging of balance sheets, lower credit availability, declining home prices, and downward pressure on financial asset values. These forces have resulted in slower economic growth. Conversely, inflation has been moving higher due to looser monetary policy, higher energy prices, and rising food costs. The Federal Reserve just ended a rapid nine month easing cycle that included seven interest rate reductions, bringing the federal funds rate down from 5.25% to 2.0%. These reductions have further weakened the U.S. dollar, pushing the dollar price of oil higher. Crude oil near $140 a barrel is up more than 45% since January and up 100% over the last 12 months. The high growth in demand for oil among fast growing and urbanizing emerging market economies is occurring at a time when capacity constraints and political instability in some producing countries is limiting supply. The fear premium has also increased due to geopolitical risk. Worldwide demand for grain is growing faster than supply resulting in higher food prices. Growing affluence in emerging markets has led to changes in diet and overall food demand. The diversion of land to bio-fuels production has reduced supply.

Although financial markets remain under considerable stress, the Federal Reserve recently indicated that downside risks to growth have diminished. The market is now pricing in a series of rate hikes due to suggestions by Chairman Bernanke that he is willing to act quickly if inflation expectations rise. Headline inflation is above 4.0% and has been elevated for quite some time. The market fears that once the “inflation genie” is out of the bottle, it can be difficult to put back in. Our view on inflation is more constructive for three reasons. One, the Federal Reserve is taking an important first step to prop up the dollar by signaling they are serious about combating inflation. Two, market factors should cause the supply and demand imbalance in the food and energy sectors to normalize over time. Three, subpar economic growth along with weak unionization should limit unit labor cost gains.

Headwinds for consumer spending, which makes up about 70% of GDP, have included the combination of falling real incomes and declining household wealth. The $107 billion in rebate checks have contributed to a timely pickup in retail sales. Overall economic activity continues to expand, and non-financial corporate profits remain healthy. A substantial portion of profits comes from outside the U.S. through currency adjustments and greater growth in foreign markets. We maintain our U.S. GDP forecast of +1-2% for full year 2008.

Inflation concerns have caused bond yields to trend higher, creating value in select investment grade bonds. While the stock market has had a rocky first half, we remain focused on company fundamentals. The long term prospects have not materially changed, while valuations have become increasingly attractive.

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