

INVESTMENT UPDATE

Executive Summary

- The underlying strength of the economy remains solid despite a weak first quarter GDP growth rate. We expect GDP growth to rebound to +3.5% in the second quarter and +3.0-3.5% in the second half of the 2007.
- Although headline inflation is rising again, core inflation remains well contained at approximately +2.3%.
- The Federal Reserve will likely hold interest rates at current levels for the remainder of 2007 as economic growth and inflation remain at acceptable levels.
- Rising corporate profits are starting to be reflected in the stock market. The S&P 500 price/earnings ratio (P/E) at 15.7x 2007E EPS and only 14.3x 2008E EPS is attractive for long-term investors.
- The long-term bond market is finally reflecting the strong underlying growth of the economy. We believe that the yield on the 10-year Treasury note will climb modestly to fair value of 5.25% during the second half of 2007.

Economy

The economy remains healthy despite the relatively weak +0.7% GDP growth in the first quarter of 2007. Real GDP growth should rebound to a +3.5% rate in the second quarter and +3.0-3.5% in the second half of 2007. First quarter GDP growth was negatively affected by an unexpected decline in inventories and net exports along with an unusually high GDP price deflator (which is used to adjust nominal GDP growth to real GDP). All of these items are expected to reverse in the second quarter and in the second half of the year.

After adjusting for the unusual items, we estimate first quarter GDP growth was +3.5%, much higher than the reported +0.7% growth in the first quarter and consistent with our 2007 GDP growth forecast of +3.0-3.5%. Underlying consumption growth in the first quarter was even stronger at +4.2%, constant with the +4.2% in the fourth quarter and up from the +2.8% in the third quarter of 2006. The strength in consumption supports our analysis that the underlying growth of the economy remains healthy. Other factors supporting a growing economy are: corporate earnings continue to grow at a rapid rate with +9.4% year-over-year (YOY) growth in the first quarter; tax revenues are up +8% for the fiscal year-to-date, indicating strong growth in personal incomes and

corporate profits; and exports are up +11% through April as a result of strong worldwide economic growth of +5%.

Overall, the underlying fundamentals of sound monetary, fiscal, and trade policies continue to support economic growth. We are encouraged by the recent rise in the dollar, the decline in gold prices from over \$700 to under \$650, the rise in the 10-year Treasury note yield to over 5%, several interest rate increases by Central Banks around the world, and some weakness in commodity prices as signs that excess liquidity is gradually being removed. This should result in a return to more normal economic conditions of +2.5%-3.0% real GDP growth and a gradual slowing in the global economy in 2008. The Federal Reserve has engineered a soft landing with U.S. economic growth remaining above +3% for the remainder of the year, driven by the powerful forces of excess liquidity, capitalism, entrepreneurship, and free trade. As a result, we continue to expect continued growth in corporate profits, healthy growth in wages, low unemployment, strong growth in exports, modest inflation, higher stock prices and relatively stable interest rates for the remainder of 2007.

Federal Reserve

In the last twenty years, the Federal Reserve had to increase the real Fed Funds rate above 4.5% before the economy fell into a recession. With the real Fed Funds rate around 3% (see Chart 1), current monetary policy should continue to support economic growth at a sustainable non-inflationary level. This suggests the Fed has found a reasonable balance between maintaining economic growth and modest inflation. For that reason, we believe the Fed will maintain the Fed Funds rate at 5.25% for the foreseeable future.

Chart 1: Real Federal Fund Rate Supports Economic Growth



