August 27, 2007

As of August 27, 2007		
Index	**YTD % Change***	**Market Value**
Dow Jones Industrials	8.49%	13322.13
S&P 500	4.68%	1466.79
Nasdaq Composite	6.04%	2561.25

*YTD % Changes use the index with dividends

Global economic growth continues to be very positive not withstanding the current debate in the financial markets about the U.S. economy, sub-prime mortgages and interest rates. The sectors we have emphasized in the past remain strong in spite of recent fixed-income and equity market turmoil. We expect the equity market sectors we favor to continue to offer significant investment opportunity**. In past periods there has been a strong trend for those sectors that have been doing well prior to market setbacks and sharp percentage declines to once again be among the most favored areas for investment when the market settles down. The U.S. represents about 25% of the world's economy, but U.S. companies that have large overseas operations are experiencing an unprecedented boom in international sales and earnings. Overseas profits are registering a record 20th consecutive quarter of double-digit growth.**

Credit and Financial Leverage

Since 2001 the current U.S. economic expansion has relied increasingly on credit and financial leverage. **Contrary to recent predictions by the U.S. Federal Reserve that the sub-prime mortgage collapse would be contained and would not be a serious threat to financial institutions, the problem quickly spread to hedge funds, foreign banks, prime mortgage lenders and foreign currency markets.** Global lending practices have now become more cautious, and in many cases lenders have effectively cut off funding to traditional longtime customers. They have, in effect, reduced the flow of funds and overall liquidity in the global financial system. **This has caused the need for repeated injections of funds into the financial system by the U.S. Federal Reserve and their foreign central bank counterparts in order to contain the damage and counter a potential contraction in global economic activity.**

The Mortgage Market

Mortgages and other innovative types of residential housing loans taken out by buyers with questionable or weak credit developed into a hugely profitable sub-prime mortgage market of $1.1 trillion. Underwriters creatively converted these mortgages into other types of securities which allowed the rating agencies to then endow them with higher credit ratings than the risk level actually merited. These pools of securities were purchased by pension funds, hedge funds and other financial institutions. As interest rates declined and home prices increased, the temptation to generate additional lower-quality mortgages by lenders that could be pooled into both superior credit and higher yielding securities became too great to resist.

As interest rates increased and sub-prime borrowers began to struggle and default, stunning financial blowups among certain hedge funds and major financial institutions started occurring. Significant losses occurred in widely scattered and often unexpected places, and the credit markets quickly began to cease functioning normally. Hedge funds managing over $1.7 trillion and complex off-balance sheet legal entities of major banks had been significant buyers of sub-prime mortgage asset backed securities. **Unable to sell these assets or properly value them, other assets - namely equities of high quality companies - were hurriedly sold to raise cash to meet loan covenant requirements and margin calls.**

The theory was that financing sub-prime loans by buying the mortgages from the originating institutions, repackaging them as AAA securities and then selling them to hedge funds and other financial institutions would spread the credit risk throughout the global system. Even former Federal Reserve Chairman Alan Greenspan thought this was a superior way to distribute risk, until loans began defaulting and no one fully understood who was going to suffer significant losses. The credit markets essentially froze under pressure from the escalating sub-prime mortgage sector's problems**. The U.S. Federal Reserve is now in the process of trying to restore confidence and bring the system back into balance.**

Asset-Backed Commercial Paper Debt

As of March 31, 2007, $983 billion of short-term, asset-backed commercial paper debt was outstanding globally. This represents a five-fold increase over the last ten years. More than 1,700 U.S. corporations rely on commercial paper debt to fund their daily cash operating needs. **It has become very difficult for many businesses to roll over their commercial paper as the debt comes due. Commercial paper is generally issued with maturities of 30 to 180 days so the difficulty will continue to play out over the coming months. The**

situation forced the U.S. Federal Reserve to pump more than $100 billion into the financial system last week to help stabilize the short-term credit markets.

Foreign Currency Investors/Speculators

Turmoil in the credit markets has also spread to other asset classes. Foreign currency investors/speculators have been forced to reduce their trading; as a result there has been a sharp unwinding of the so-called carry trade. The carry trade involves funds that are borrowed in currencies of countries which have low interest rates (Japan) to invest in higher yielding assets elsewhere. In addition, the carry trade often involves the use of heavy leverage which enhances the returns when it works, wipes out capital when it does not, and accentuates volatility when it is reversed. **Investors are now extremely nervous about holding anything that has an above average yield associated with an elevated level of credit risk. Risk aversion has become the overriding lending criteria in the credit markets.**

The Credit Markets and Interest Rates

If the credit markets cannot stabilize and return to equilibrium, the U.S. Federal Reserve, in our view, will have little choice but to cut interest rates much deeper than most analysts now expect. **Under these circumstances it is possible to see the Federal Funds Rate that has been trading below the official target rate of 5.25% being reduced to 4.00% or even to 3.50% by midyear 2008.** The Federal Reserve had to lower the rate that they charge banks for loans at its discount window last week from 6.25% to 5.75%. This enabled the banks to more easily act as financial intermediaries and thereby ease the liquidity crunch for hedge funds, investment banks, and others who had generally good assets but were unable to sell them at sensible prices to raise cash. Troubled financial institutions had to sell loan portfolios to raise cash in order to function in a significantly more difficult operating environment.

Cash infusions into the banking system will obviously help the liquidity of the mortgage market where the amount of adjustable rate mortgages that reset each month will be increasing well into next year. In the first six months of next year the amount will exceed the $521 billion mortgage resets anticipated for all of 2007. **If these circumstances persist, the residential housing market will continue to remain weak and home prices should continue to decline. This could also have a serious effect on consumer spending. However, the stock market will inevitably discount all the expected weakness in the economy well in advance of the actual economic events. As this occurs the financial markets will create a significant buying opportunity.** When the market bottoms, negative sentiment is at a peak and is often a good indicator of a major buying opportunity. We may in fact now be close to a pivotal point in the correction.

<u>Infrastructure Demand for Industrial Materials and Machinery</u>

In past *Outlooks* we have focused on the investment opportunities amongst infrastructure companies. Bridges, roads, ports, railways, water systems, sewers, air traffic control and the national electrical power grid are among many infrastructure related areas needing enormous capital investment. **The underground steam pipe explosion in New York City, the recent bridge collapse in Minnesota, and the New Orleans levees are recent examples of needs that can no longer be postponed. As we have indicated in the past, an estimated $1.5 trillion must be spent over the coming decade.** The National Infrastructure Bank Act of 2007 has been submitted to the U.S. Senate; it is to create a bank through which the U.S. Federal Government can finance major projects using public and private capital. The bank would issue up to $60 billion of bonds with additional funds coming from other sources.

The demand and pricing for industrial materials is being supported by infrastructure requirements in China, India, South East Asia, Brazil, Russia and Eastern Europe. There appears to be an absence of potential development of new supplies of copper, nickel, titanium and other important industrial materials over the near term that would bring on any significant additional supply. Moreover, industrial materials could be given additional support by disruptions in output, due to transportation bottlenecks, equipment shortages and labor strikes. **The positive demand environment has enabled the companies that we favor in this industry to generate substantial amounts of free cash flow, which is being used to increase dividends, repurchase common stock, reduce debt and reinvest in capital assets.** All things considered, we believe that the companies that we favor will add substantially to their free cash flow and earnings per share over the next several years. Healthy corporate cash flow and profits are particularly likely this year.

Over the past several years, heavy machinery sales and parts, particularly for heavy construction equipment, have advanced at a significant pace. Net profit margins for heavy machinery companies have also increased. The managements of the companies in this sector have maintained good earnings growth by implementing modest price hikes, tightly controlling inventories, enhancing operating efficiencies, consolidating production and improving product designs. The cash flow from operations has been excellent, allowing the companies we favor to invest in their product lines and make small bolt-on acquisitions. At the same time, the companies have been able to pay down debt, buy back common stock and raise dividends. The industry has a number of both domestic and foreign markets that are positioned for solid growth over the next several years. Demand for products is especially strong in developing countries such as China and India. **The heavy machinery industry's long-term prospects are benefiting from strengthening oil and gas exploration, electric power generation, highway construction, Asian industrialization, mining and expanding agricultural markets.**

Chinese Investment

We must touch upon one more significant topic before we conclude this *Outlook*. **The Chinese government just announced that Chinese citizens will now for the first time be allowed to buy securities abroad. They will be allowed to open accounts at The Bank of China to trade Hong Kong-listed securities, thereby giving Chinese investors direct access to global capital markets in addition to the Government's investments.** This is an important step toward Chinese banking and investment reform. China has monetary reserves of $1.3 trillion, large trading surpluses and a growing middle class. The Chinese will likely become major buyers of equity securities in the global markets. Clearly this could have a significant impact on equity markets.

Conclusion

There is a strong likelihood that further U.S. Federal Reserve interest rate easing will occur over the coming months. Consumers are likely to slow their spending and more carefully manage household debt, resulting in a more subdued but still expanding U.S. economy. Global growth should remain strong and our basic investment themes should remain intact. **Any further market weakness will likely provide an important buying opportunity. We should never forget that the U.S. Federal Reserve is committed to providing non-inflationary full employment and fighting any significant weakness in the U.S. economy. The Federal Reserve fulfills this commitment by ensuring that the capital markets always have adequate liquidity. The equity markets should be the prime beneficiaries of actions stemming from this commitment.**