

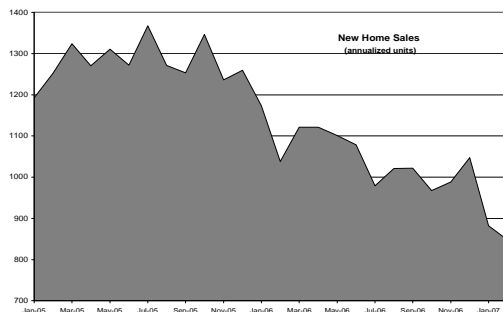


## Quarterly Economic Report – 1st Quarter 2007 (March)

*The More Things Change, the More They Stay The Same*

The following statement was the opening paragraph of our last quarterly report:

The questions for the new quarter are the same ones with which we left 2006 and that is 1) how much underlying strength is there in this economy and, 2) is there significant inflation lurking in the shadows? As to the strength issue, economists can make sound arguments for either a weakening economy or underlying strength. Those arguing for weakness can look conveniently to manufacturing and housing for support. Those arguing strength can point to employment and the consumer. Those waiting for inflation need only look at commodity prices and oil to bolster their position and those against point out we haven't seen it.

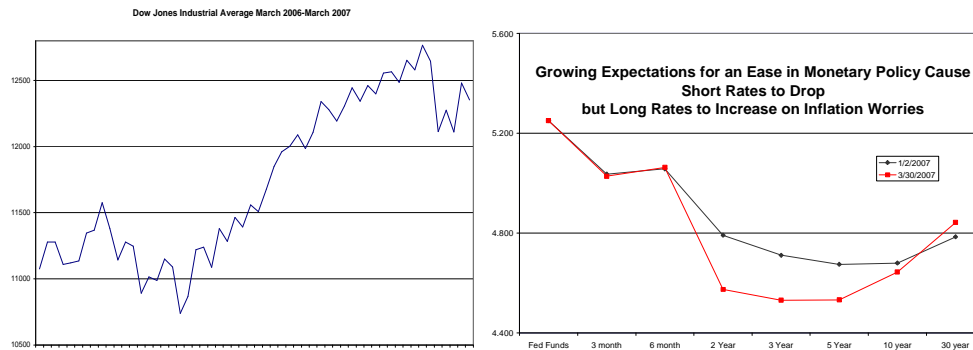


New Home Sales have plummeted as oversupply has created a buyers market

Without a doubt, all of these topics still remain open to debate. In fact, the arguments by both sides have gotten more ammunition as both bulls and bears saw economic data to strengthen their views but neither side has a totally convincing argument.

The first quarter of 2007 has seen a 25% rise in energy prices as unseasonably warm winter weather created demand for gasoline at a time when refiners shut down operations to repair and refurbish plants in preparation for the peak demand period of Memorial Day to Labor Day. With supplies of refined product running 5% below last year's inventories, producers are now scrambling to catch up and the imbalance of supply and demand is pushing prices at the pump higher. The debate here is whether the pass through of higher energy prices to consumers will be successful (spiking inflationary fears) or will this become an energy "tax" that pulls disposable income out of the pockets of consumers and slows discretionary spending. Several months ago, the American Bankers Association released a report that showed during last summer's run up in gas prices there was a great deal of correlation between those prices and the amount of revolving credit outstanding. People were using credit cards to buy gas at almost any price and many of them then paid off the credit cards with home equity loans and refinancing of their mortgages.

A new wrinkle for many of these people may be the inability for them to access new financing or they may find that the rise in home equity values has abated preventing them from extracting more cash.



Recent reports have pointed to the rise in both delinquencies on mortgage payments and foreclosures. Much of this has been in the area called “sub-prime” loans where borrowers were given loans in spite of their credit status, low or no down payment or other considerations. With real estate prices unchanged or in decline, these homes no longer have equity and a distressed borrower may well just “walk away”, adding more properties to the near record supply of unsold homes already on the market. Although these loans constitute only about 25% of all mortgages, the Federal Reserve has acknowledged this is an area they are watching closely in the event it carries over into more conventional funding arenas.

Equity investors have shown they don’t see anything to concern them as the Dow Jones Index made a new all time high in February. Moderate growth coupled with stable Fed policy point to a continued economic expansion with low inflationary pressures.

Fed Chairman Ben Bernanke has been a champion of this “Goldilocks” scenario. Although the FOMC has continued to express concerns over current inflation reports they have stated on many occasions that they expect those pressures to moderate as demand subsides. At the last FOMC meeting on March 21, the Committee deleted references to any further policy tightening in the near future and instead moved to a more balanced stance, weighing inflation concerns and a sharper than desired slowdown in the economy as being of equal concern. The incoming economic reports will give the Committee members more data to put into the mix as they modify their outlook for the remainder of the year and 2008.

It is the elections of 2008 that may turn out to be the final piece of the puzzle. With no clear frontrunner for either party, business leaders may become reluctant to make capital investments in their own companies until the tax policies and growth strategies of the new administration become clearer.

Since the beginning of the year the likelihood of an easing in monetary policy has grown but it is still not a sure thing. The long end of the yield curve has looked very skeptically at softer monetary policy as a potential for inflationary pressures to return. The short end has priced itself to include this easing of policy and if the inflation pressures do return, that part of the market could find itself having to sharply reverse itself. If inflation is truly disarmed, then the long end will need to reevaluate itself as well and bring long rates lower as economic growth slows. All things being equal, we will soon find out if the economy is too hot, too cold or just right!