PATTERSON & ASSOCIATES

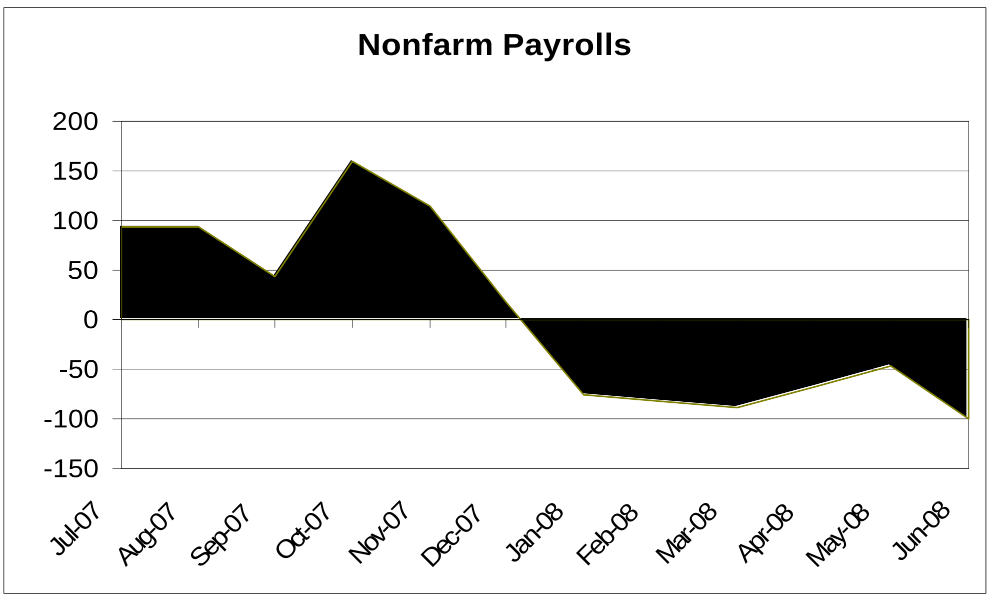
INVESTMENT PROFESSIONALS

Quarterly Economic Report – 2nd Quarter 2008
"The Beginning of the End" or "The End of the Beginning?"

All eyes have shifted to the energy markets as the price of Crude Oil has breached $140 per barrel and unleaded gasoline is about $5 per gallon in parts of the country. With economic activity already on the wane, there is pressure on all users of energy to either reduce usage or reduce operating costs.

Companies that are at the earliest stages of the chain that starts with raw material and ends with consumers, do have the ability to raise prices. However, as products are pushed closer to the end buyer there is less opportunity to do so. Consumers have shown they are no longer willing or able to pay "full price" for goods and services and that they will seek lower cost alternatives instead.

This has left those middle level companies extremely vulnerable and has forced them to begin to compress their operations. Companies with multiple locations have consolidated operations, closing factories and warehouses. In many cases, the workers at these closed locations are laid off. We have seen a steady trend of rising initial claims for unemployment and also continuing claims which shows that workers are losing their jobs and unable to find new work.

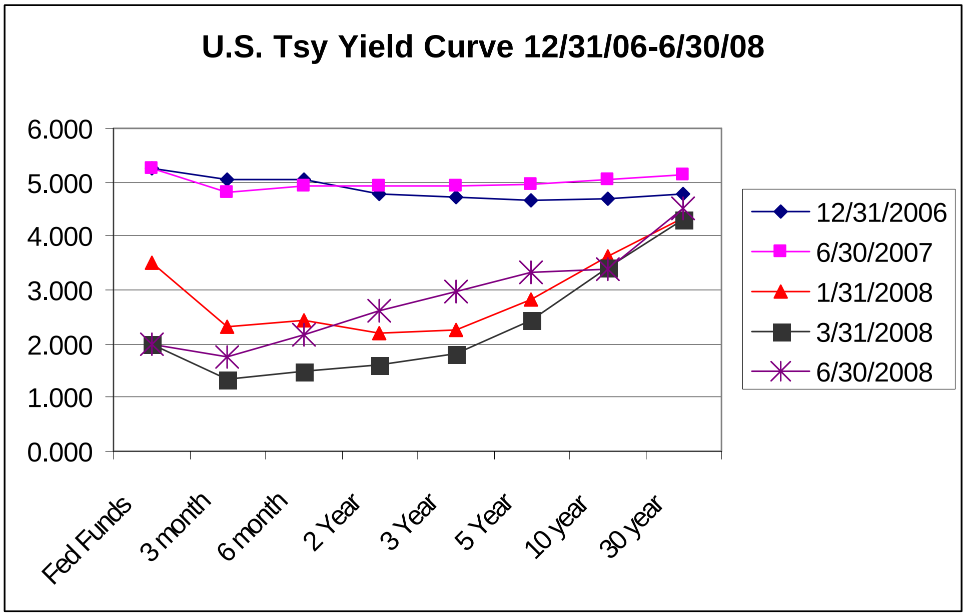


The chart above shows that the pace of job creation seen during the last 6 months of 2007 has reversed course and has become job "destruction". During the period from July to December the economy created 522,000 jobs. Since Jan. 1, 2008 we have seen 461,000 jobs disappear. This is a very serious concern as it is not likely to stop until we see energy prices decline and some of the bottom line pressure on employers dissipate.

Recent rhetoric by members of the Federal Reserve Open Market Committee has shown their stance on growth versus low inflation has moved to a bias towards possibly tightening monetary policy. The broad impact of rising energy costs across the entire spectrum of our economy is waving a red flag at members of the Committee.

Their fears are based on the idea on an inflationary wage-price spiral taking hold. In this scenario, businesses all along the production chain are "forced" to raise price to meet the higher costs of energy. As these hikes are passed through to consumers, workers who find themselves being pinched go back to employers and demand higher wages to maintain their standard of living. This puts renewed cost pressures on businesses and forces prices higher again in a series of cycles. It is extremely difficult to contain and ultimately requires a major tightening of monetary policy. This in turn causes a sharp decline in the economy and massive job losses, which is really the only way to stop the cycle.

It is this rhetoric that has changed the shape of the yield curve since the beginning of the year.



The rise in the "interior" portions of the yield curve (from 3 months to 5 years) shows that there IS a significant concern of inflation by investors. The levels shown indicate a growing concern the FOMC will begin to tighten monetary policy sooner than had been expected.

We do not feel this will occur. It is our opinion the Fed may "jawbone" their concerns, but the fact remains that the weak level of economic activity and the vulnerability of the credit markets to any further debacles (such as the failure of another major financial firm like Bear Stearns) would limit or prevent the Fed from taking any action.

We project the further slowing of spending by the US consumer will put GDP well below recent levels for the remainder of this year and into the beginning of 2009. This slowing will reduce demand for oil and energy related products and therefore cause a decline in the inflation indices being watched so closely by the Fed.

The real question that remains is whether or not we can see a plateau in that economic decline. If we can, then we can see the beginning of a recovery in 2009. If we can not, then there may be another wave lower ahead.