HAMRICK
INVESTMENT
COUNSEL LLC

POLITICAL, ECONOMIC AND CAPITAL MARKETS
REVIEW & OUTLOOK FOR 2006

Summary

- Globalization remains the dominant political issue. Quagmires in Iraq and Washington, D.C. create a stagnant political environment, yet one which is favorable for investors.

- Moderating but overall positive economic growth in 2006 in the United States and worldwide also bodes well for investors.

- Economic outlook for U.S. "heartland" businesses and consumer markets is relatively weak, dampening the outlook for investments related to those sectors.

- Ongoing high energy costs will continue to pressure consumer spending power and will restrain global economic growth over the long term.

- We anticipate modest yet reasonable capital market returns in 2006. Well diversified portfolios with selected equity investments should perform well in this environment.

Political Commentary

The underlying political issue in our society remains globalization. For now, however, we are engaged in two quagmires: one in Iraq and one in Washington D.C. Neither appears likely to be resolved over the next two years.

With regard to Iraq, U.S. troops will remain and the violence will go on. U.S. efforts to sustain a democratic government will continue. There will be sufficient support – both within the United States and around the world – to sustain the efforts of the U.S. through the end of President Bush's second administration.

With regard to Washington, the debate about the U.S. presence in Iraq will persist – though it may subside as it becomes clear that Bush will not change his policy. The debate will begin to shift from current policy to that of upcoming Congressional and presidential elections.

U.S. troubles in Iraq will hinder much of any progress on other domestic agendas, such as Social Security and Medicare reform, major tax overhaul or other ideological political agendas. The military action in Iraq will remain divisive, expensive and distracting.

However, political quagmire can be favorable from a business standpoint. Business likes the status quo. Quagmire may mean lack of action – but it also implies 'no harm done,' particularly in the short term. These "twin quagmires" – Baghdad and Washington – will remain as centers of focus for the War on Terror and political gridlock.

We believe that this stagnation will enable the international political and business communities to proceed – albeit fitfully – with the arduous task of globalization. It will also create a relatively benign political environment for investors.

Economic Review and Outlook

Despite numerous adverse headwinds, including extraordinary natural disasters and rapidly escalating energy prices, domestic and foreign economies were strong in 2005. U.S. GDP grew approximately 3.5% in 2005, while worldwide GDP increased 4.5% for the year.

In 2006, we estimate U.S. and worldwide GDP growth rates will decelerate modestly towards 3.0% and 4.0%, respectively. Due to high levels of personal debt, slowing home price appreciation, high energy prices and the lagging impact of the Federal Reserve Board's monetary tightening policy, we anticipate a decline in growth of U.S. consumer spending. However, efforts to rebuild in the Gulf Coast area following the recent hurricane damage will likely offset some of this weakness.

Thus, while moderating somewhat from 2005 levels, we anticipate economic growth will remain favorable in 2006. We expect the positive impacts of this stability will be apparent across a spectrum of economic and capital market indicators: business and government spending, interest rates, inflation, foreign currency exchange rates and commodities.

Similar to the relatively stable political environment, these moderate but favorable economic trends also bode well for investors. Moving forward into 2006 and beyond, however, we see two emerging economic trends that have significant investment implications: (1) disparity in growth rates between different economic sectors within the United States; and (2) rising energy costs.

(1) <u>Disparate U.S. Economic Sectors</u>. Beneath our expectations for an overall favorable economic environment, we see widening disparity between different sectors within the U.S. economy. Specifically, we perceive disparity between relatively affluent coastal urban centers versus Mid-Western and rural communities, which we have dubbed the U.S. "heartland." The affluent urban centers are often home to industries, such as software and biotechnology, which have strong growth rates and job growth, spurring regional economic growth. On the other hand, heartland communities are often more dependent on older industries, such as auto and textile manufacturers, that have poor growth rates, noncompetitive operating costs and burdensome legacy costs.

Given increasing global competition, we are concerned about the outlook for these older heartland businesses. In addition, we believe consumers in communities tied to heartland businesses are more vulnerable to the economic stresses we anticipate, including low (or declining) job and wage growth, increasing energy and commodity costs, as well as higher interest rates and more restrictive credit. We are, therefore, also concerned about businesses that are dependent on selling into these relatively weak heartland consumer markets.

(2) Energy Costs. Over the long term, we expect the price of oil will remain high relative to the recent past. Oil is a finite resource, and tight supplies increase the potential for temporary periodic shocks that are disruptive to investment markets. While current prices are spurring additional exploration, exploration costs are rising. Many recent discoveries require more advanced technology to extract the oil or are located in politically volatile regions of the world. The rising exploration costs will likely rein in oil company profits.

In addition, while high oil prices drive up inflation as measured by the CPI, the long term impact of high energy prices may actually be deflationary as consumers are forced to reallocate funds from other needs and wants to purchase fuel for transportation and heating/cooling. We believe that this reallocation of funds will retard long-term global economic activity and growth.

Capital Markets Outlook

Despite our concerns about economic weakness in the U.S. heartland and high energy prices, we believe the general outlook for securities markets in 2006 is favorable.

Equity Markets

We consider the domestic and foreign equity markets reasonably valued and, therefore, somewhat attractive going into 2006. At present, we do not see significant discrepancies between domestic and foreign equity market valuations. However, as more companies operate and compete globally, the line between domestic and international companies is blurring further. In addition, whether based inside or outside of the U.S., multinational corporations primarily operate in currencies tied to U.S. dollars, mitigating the impact of currency volatility on long term business valuations. Expanding the field of prospective investments to that of a global perspective diversifies risk and greatly enhances investment opportunities. We anticipate equity market returns in the mid to upper single digits in 2006.

Fixed Income Markets

We expect a relatively flat yield curve in 2006, with perhaps a modest increase in the yield of long-term bonds in the first half as the Fed curtails its current monetary tightening policy. We anticipate that short-term Treasury rates will top out in the range of 4.25% to 4.5%. In addition, while corporate profit margins and cash flows may well be squeezed in 2006, we believe that current market valuations compensate investors poorly for assuming greater credit risk. Returns on bonds with lower credit quality may therefore be disappointing.

Strategy for 2006

As always, our overriding investment strategy remains that of highly diversified portfolios which hold a variety of equity and fixed income securities spread across an array of markets.

Within this context, given our outlook for overall political and economic stability as well as modest, yet reasonable investment market returns, we believe that the best investment opportunity for 2006 is in common stocks. As we head into 2006, therefore, we will hold equity weightings at least equal to target allocations.

In addition, we will seek to enhance portfolio returns with selected equity investments. We favor companies that are able to take advantage of ongoing globalization trends and that are less vulnerable to weakness in the U.S. heartland. We also favor large, multinational corporations that have superior access to global markets and favorable operating costs. Specifically, we favor investments in companies that:

- Are nimble and flexible in their cost structures, products and services offered and markets served;
- Provide products/services that are crucial in a highly competitive, integrating global economy, such as transportation, communications and technology;
- Provide products/services to more affluent U.S. consumers or a worldwide customer base;
- Provide products/services for which demand is stable and growing, such as energy, water, healthcare, natural resources and security.

Summary

Beyond 2006, we see potential for economic slowdown. At present, the relatively flat yield curve in the bond markets suggests such a scenario. In addition to our concerns about the negative impact of high energy costs, we recognize that U.S. consumers have limited resources and anticipate that growth in consumer spending will eventually slow. Also, political pressure on the U.S. government to exercise budget control will likely increase. Retrenchment in the U.S. may slow the global economy given the dependence of many countries on U.S. demand for export growth.

For the coming year, however, we anticipate that stable political and economic conditions, as well as reasonable capital market returns – particularly for stocks of large but nimble multinational companies operating in healthy industries – will result in favorable returns for investors.

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