Schaper, Benz & Wise
INVESTMENT COUNSEL, INC.

Economic and Market Summary

July 2007

After four consecutive quarters of sluggish growth, the U.S. economy regained some momentum in the second quarter, expanding an estimated +3%. Improvement in GDP growth was driven by strong net exports due to booming growth in many overseas economies, inventory accumulation which likely expanded in the second quarter after contracting the two previous quarters, and faster growth in business investment. The largest contributor to GDP growth, consumption, decelerated during the quarter. Though consumption continues to be supported by healthy employment and compensation growth, rising interest rates and tougher lending standards along with significant increases in energy and food costs are weighing on consumer discretionary spending power. Low interest rates and easy access to credit over the past few years fueled robust consumption growth and led to heavily-indebted American consumers. We expect the U.S. economy will continue to grow, but at a less vigorous +2–2 ½% as consumers grapple with a more restrictive borrowing environment that eventually takes consumer debt levels back down toward historical averages. Strong corporate profits and balance sheets should help business investment contribute to GDP growth, tempered somewhat by tightening credit conditions and by a rising allocation of investment spending toward foreign market operations.

Inflation remains an underappreciated problem, in our opinion. Despite reports of declining "core" inflation (excluding food and energy items), reported inflation is likely to exceed 3% in 2007 for the third consecutive year. "Core" inflation has been lower than reported inflation for 4½ years now, rendering the indicator less meaningful considering the significance of food and energy items in our economy. We think inflation can be contained longer-term, but only with tighter worldwide monetary conditions.

We have a somewhat split view of investment markets. Many speculative and illiquid asset classes seem vulnerable to setbacks as evidenced by recent problems within several hedge funds that were betting on commodities prices and on sub-prime mortgages, and by recent volatility in the Chinese stock market. The buzz of "alternative investments" has grown loud recently and reminds us of other past investment bubbles that eventually popped. Astounding levels of investment dollars have flowed into "alternative investments" in recent years, which in and of itself should elicit caution. Unusually accommodative monetary conditions have led to booming economic growth and spectacular returns on commodities and emerging market stocks and bonds. With interest rates now on the rise throughout the world, growth is likely to slow and could negatively impact returns on many "alternative investment" strategies, especially those that employ leverage and are closely correlated with rapid worldwide economic growth.

On the other hand, we believe good value exists in many stocks of financially sound and fundamentally strong companies capable of generating consistent levels of profitability and growth. When turmoil hits speculative investment markets, it is not uncommon for high quality "blue chip" companies to shine. It is also notable that cash-rich, consistent growth companies have become prime targets for private equity investors that are in the business of identifying and profiting from the purchase of undervalued companies. While, in some cases, we've been annoyed by the low buyout prices agreed to by the management and directors of companies we own, it's reassuring to have our fundamental research efforts validated and our patience rewarded.

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To request our SEC Form ADV Part II, please contact Michael L. Wise, Chief Compliance Officer, at the address below.

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