Schaper, Benz & Wise
INVESTMENT COUNSEL, INC.

# Economic and Market Summary
# July 2010

We strongly believe that fundamentals are the driving force behind the direction of the stock market longer term. However, investor confidence and psychology can heavily influence stock prices over a shorter time horizon. When times are good, it is easy for investors to become complacent and believe that the good times will never end. Valuations become stretched, and investors find creative ways to justify inflated prices (e.g. technology stocks in the late 1990s.) When times are challenging, the prevailing emotions of fear and pessimism make it difficult for investors to believe that conditions will ever improve; consequently, valuations contract. In the last couple of months, investor psychology has shifted from nascent optimism to uncertainty, confusion, and heightened risk aversion. Investors are afraid – that we'll experience a double dip recession; that the unemployment rate will remain stubbornly high; that higher taxes and increased regulation are inevitable; and that global growth will be dampened by Europe's sovereign debt issues and China's policy-induced slowdown. Negativity has been exacerbated by the fact that there have been two severe bear markets over the past ten years, and that memories of the 2008-09 credit crisis are still fresh.

It is impossible to know precisely when and how the prevailing uncertainty will abate. Perceptions can change quickly. The mid-term elections may be a catalyst for change, as many Americans are increasingly uncomfortable with the level of government involvement in many facets of our economy. Health care reform passed earlier this year, and passage of a financial reform bill appears likely. Interpretation and implementation of these controversial bills will have important investment implications, including the increased taxes necessary to fund these programs. We are hopeful Congress will act before year end to preserve the current tax policy. Without any action, all taxpayers (alive and deceased) will face higher marginal tax rates. We find most problematic increased tax rates on investment activity. Higher taxes on capital gains (to as high as 20%) and dividends (to as high as 39.6%) are being contemplated. These taxes deter investment at a time when investment should be highly encouraged to drive economic growth.

U.S. growth slowed from 5.6% in the fourth quarter of 2009 to 2.7% in the first quarter of this year. Our GDP estimate for the remainder of 2010 is about 3%. While this rate of growth is less than ideal, it is consistent with moderate gains in both the labor market and household spending. Corporate balance sheets are in great shape, and corporate profits advanced 34% year-over-year in the first quarter. While firms remain reluctant to hire new workers due to uncertainty about the economy and public policy, they are increasingly comfortable spending on productivity-enhancing equipment and software.

Most broad measures of inflation remain subdued, while long-term inflation expectations appear stable. Treasury yields are near historic lows, in part because risk averse investors are seeking refuge in highly liquid assets. We find the current low level of bond yields unappealing. Until yields move high enough to provide adequate compensation for inflation and credit risk, we remain cautious on bonds.

Fundamentals which are supportive of stocks include robust corporate profits, moderate economic growth, low inflation, and accommodative monetary policy. Massive corporate cash balances provide the means for capital investment, dividend hikes, stock buybacks, and/or a pickup in merger and acquisition activity. Valuation measures appear attractive with the S&P 500 index trading at 13x our 2010 EPS estimate, compared to a historical average of about 15x. We have entered a period when emotions have overtaken fundamentals. With pessimism so rampant, any positive news should propel the stock market higher.

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