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INVESTMENT COMMENTARY

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Economic and Monetary Climate

The latest reports on the economy provide evidence from a variety of sources that point to a continuation of the current period of weakness. The outlook for the service sector had strengthened earlier, but is now showing signs of deterioration as many companies are experiencing a squeeze on profit margins. Various manufacturing firms have been facing similar pressures from higher raw material costs, and recent surveys indicate the need for additional reductions in factory jobs over the next few months. The demand for new business in both the service and manufacturing sectors is expected to be fairly steady, although inventory levels are elevated relative to current order trends.

The above conditions have placed additional stress on the labor markets, which is reflected in a significant increase in the number of new unemployment claims during June. The unemployment rate remained level at 5.5% in this period, due in part to a reduction in the number of job applicants. A sizable portion of the reduction was in construction related positions, largely in the homebuilding segment, which remains under significant pressure. At the same time, a moderate expansion in commercial construction indicates that various businesses continue to have a degree of optimism for the economy over the intermediate term.

The extraordinary rise in energy prices was a primary factor in higher business costs, and also contributed to both the sluggishness of the economy and a 4.1% year over year increase in the Consumer Price Index. In this environment, the Federal Reserve has elected to maintain the Federal Funds rate at 2.0%. In this respect, the Committee stated their belief that inflation would moderate during the latter half of the year, while at the same time acknowledging that there is a considerable amount of uncertainty regarding the outlook for price increases. The Committee appears to be somewhat more focused on inflation than was the case at the beginning of the year.

In regard to the international economy, the European Central Bank raised its benchmark interest rate by 25 basis points to 4.25%. This action was taken in response to inflationary pressures on the euro where prices rose by an annualized 4.0% in June. Overnight bank lending rates for the euro are now 2.25 percentage points above the bank rate that is available on United States Federal Funds deposits. The Reserve Bank of Australia has set interest rates at 7.25% in an effort to slow the economy and restrain that country's 4.4% annual rate of increase in consumer prices. Governments in other major economies, such as China and Korea, have taken various steps to restrain inflation as well. The yield differentials between domestic and foreign interest rates have contributed to the depreciation in the international dollar that has taken place over the past several months.

Fixed Income Markets

In reference to the fixed income markets, the pressure on corporate earnings from rising costs and a lower overall demand for goods and services has stimulated some rotation toward investment in the comparatively low risk issues of the U. S. Treasury. The latter trend has raised prices for these securities, although the degree of increase has been muted because of the change in the Federal Reserve's focus from economic weakness to inflation. At the same time, apprehension over corporate profits has exerted

pressure on the prices of good quality corporate issues, making the yields available from these securities more attractive. These changes widened the differential between interest rates on U.S. Treasury obligations and all grades of corporate bonds, thereby highlighting an increasing perception of investment credit risk.

An exceptionally large supply of new issues has also raised the rates on high yield obligations. The increased borrowing costs are expected to have a dampening effect on the volume of new offerings over the next several months. In this environment, the managements of a number of companies have become more shareholder conscious, and are taking various steps to enhance stock values. New pressures on the credit ratings of the highest quality municipal bond insurers have had a somewhat negative impact on the prices for an array of tax-exempt bonds. As a result, many of these bonds are now being valued in terms of their individual credit positions.

Equity Markets

A significant amount of selling pressure on equity securities in recent weeks has reflected investor concerns about the impact of rising oil prices on the level of consumer spending and on corporate earnings for the second and third quarters. There had been indications earlier that the earnings weakness would be relatively well contained within the financial sector and consumer oriented businesses such as housing and retail. However, this situation has broadened and now includes certain transportation and industrial companies. More recently, the slowing of the international economy has diminished the benefits that many firms had derived from a lower valuation of the international dollar. The capital restraint on various financial institutions has been disconcerting to investors as well.

Following the sizable writedowns in the financial sector, there is some evidence that earnings weakness has begun to stabilize among companies that have been most affected by loan losses. In this regard, certain firms have announced that earnings for the second quarter will contain a lower level of credit charges than many analysts had expected. Concurrently, supply/demand conditions appear to be showing some improvement in the oil markets, and this condition has produced sporadic liquidations of different oil and gas related names. In the prevailing environment, the values of a number of common stocks have become more attractive over the past twelve months. However, many investors are likely to need greater visibility for earnings potential prior to resuming any significant amount of accumulation.

Individual Market Sectors

Regarding the consumer, confidence has declined to unusually low levels. With respect to durable goods, a rise in unemployment and the high price of fuel has put pressure on automobile sales, particularly for domestic truck and SUV models, with many consumers favoring smaller, gas efficient models including hybrid cars. Because of relatively high inventories, the housing market appears likely to remain weak until the economy recovers. In addition to the pressure on personal income, tight credit conditions are limiting the availability of mortgages. In the current environment, several non-durable goods companies have defensive appeal in such areas as foods, beverages, tobacco, hospital supply, household and personal care products, healthcare and biotechnology. Many of these companies have taken steps to improve their product mix, reduce their cost structure, increase their exposure to foreign markets and implement favorable pricing strategies. Healthcare and biotechnology in particular are benefiting from new drugs and recent technological advancements in their fields. In the retail area, sales have been negatively impacted by the rising cost of food and energy. Certain mass merchandisers have been less affected by these trends, since their goods are offered at deeply discounted prices. For the most part, investor interest in this market sector has been relatively limited.

Regarding the energy sector, a growing demand for crude oil from several emerging markets, notably China and India, is placing upward pressure on the price of crude oil. Natural gas storage inventories are

lower than at the same time last year, which is supporting a high price for this commodity as well. Importantly, supply is expected to rise with several new fields coming on-stream over the next two years, although project delays and the emergence of new gas imports are likely to keep the LNG market tight. Iraq is opening up certain fields for production, and additional output will be coming from offshore fields in Saudi Arabia and Brazil. West Africa has also emerged as an important area for exploration by the large international companies. Nigeria has continued to dominate that region's oil scene, while Angola has achieved a remarkable increase in production from its previously untapped deepwater basins. These trends bode well for major integrated companies, as well as exploration and oil service firms.

In the basic goods area, strong increases in fuel prices have had a negative effect on company earnings in the transportation sector because many companies have been unable to pass through the added costs to customers. The degree of difficulty varies among various modes of transportation, with railroad companies showing the least impact. A broad decline in the level of shipments continues to pressure revenues as well. In the paper and forest products field, capacity appears to be nearly in balance with the current level of demand. However, high energy prices and soft sales trends have lowered earnings expectations for containerboard producers. Nevertheless, the U.S. remains the most competitive manufacturing region for this product because of a good supply of raw material. The fundamentals for steel remain constructive despite some pressure on the stock prices in recent weeks. China is preparing to shutdown a major steel plant for the duration of the Beijing Olympics, and this action will temporarily reduce supply. Among the base metals, copper producers are expected to post strong earnings while the profitability levels for several other metals have weakened. The outlook for investments in this sector remains mixed.

In the capital goods field, a decrease in corporate profit levels has had a negative impact on orders for new business jets, thereby lowering backlog expansion and earnings visibility for some aerospace manufacturers beyond 2010. Nevertheless, the strong increase in jet fuel costs has positive implications for orders of more efficient new passenger aircraft, despite service reductions in the airline industry and the difficulty involved in funding new purchases. The overseas market for military aircraft appears to be constructive and a sizable level of orders for U.S. fighter planes is expected at an air show this month. In spite of the moderation in the short term outlook for the manufacturing sector, the weakness in the international dollar and inflated foreign shipping costs have made the United States attractive for investment in new manufacturing facilities by both foreign and domestic firms. In other areas, the outlook remains favorable for infrastructure investment along with the engineering and construction activity, which continues to be supported by strong commodity prices. This market sector contains various constructive investment opportunities.

In the technology sector, the semiconductor industry is expected to report profit gains as many companies expand into international markets that are growing more rapidly than is the case domestically. Also, chip manufacturers continue to improve production efficiencies to meet the ever-changing demands. The Semiconductor Capital Equipment group showed relatively negative results during the first half of 2008, reflecting decelerating order rates for semiconductor production equipment. The duration and magnitude of the current downturn will depend on the relative weakness in capital spending by memory manufacturers, which expanded unit production materially in 2007. Weak pricing conditions have also had an adverse effect on the sales of DRAM memory chips, which declined in the first quarter of 2008, and are likely to be impacted by a softer global economy. Nonetheless, the demand for chips is expected to improve by the fourth quarter of 2008 or the first half of 2009, aided by a prospective upturn in the industry. Bookings for advanced technologies, such as 300mm wafer production equipment and products that handle small-geometry (sub-100 nanometer) chip designs, should also drive an eventual recovery for the semiconductor equipment industry, as production requirements expand for personal computers, cell-phones, MP3 players, digital cameras, and digital televisions. The market sector continues to offer selective opportunities for long-term growth.

The telecommunications sector continues to take steps, which participants expect will enhance operating results. In this regard, the major telephone firms have begun to restructure declining landline operations through purchases and divestitures. An expansion in broadband services is also helping to offset the loss of landline voice revenue. Investments are being made in fiber-optic networks in order to offer wide-margin, high-speed voice and data services, which are now competing well against cable company packages. In the Internet industry, online advertising is expected to gain popularity in the coming years, supported by greater usage and improvements in technology that will foster more-effective advertising formats. Large, brand-oriented companies and overseas expansion should continue to be an important part of this trend, which benefits industry participants. It is pertinent to note that revenues from international operations now comprise a greater percentage of the total for several companies. In the Cable TV industry, stations will soon transmit broadcasts over the air exclusively in digital format. Millions of consumers will then have the choice of buying government-subsidized digital converter boxes or new digital TVs. A third option will be to upgrade to pay TV service. Since there are still some 13 million households that rely on analog-signal reception, the potential migration of a number of these viewers to pay-TV would represent a significant benefit for the industry. This investment sector is providing several of favorable investment opportunities.

In the current environment, a number of banks are raising capital to adjust for the sizable writedowns of bad loans on their balance sheets. The recognition of sub-prime bad loans appears to have peaked, although the potential for further writedowns is pressuring various stock prices. Credit card companies are being affected by a modest increase in charge-offs, rising delinquency rates related to the weak consumer market, declining home prices and the growth in unemployment. The property/casualty insurance companies are being impacted somewhat by weather related catastrophes, including crop losses which could become more apparent in the third and fourth quarters, and will be offset to some extent by Federally sponsored re-insurance. The overall insurance industry is likely to be affected by the combination of a soft market, low interest rates and weak asset quality. In the electric utilities field, several companies will benefit from an increasing demand for power generation for residential and commercial sites and also from the use of hybrid cars. Regarding real estate investment trusts, rising unemployment, a slowdown in the demand for real estate, and higher funding costs are likely to exert pressure on occupancy rates and rents for several quarters.

Conclusion

Recent reports point to a continuation of the current period of weakness in the nation's economy. In this respect, several consumer, transportation and industrial sectors have recently been impacted by a reduction in the availability of credit and rising raw material prices. The latter condition has contributed to an increasing amount of concern about inflation and the possibility of monetary action to deal with any future pressures. The bond market has been relatively soft in this climate, while the stock market has been impacted by uncertainty regarding commodity prices and near-term earnings reports.

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