



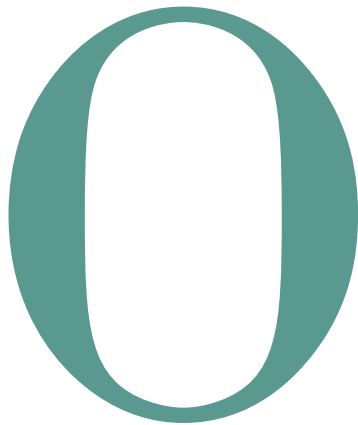
ECONOMIC OVERVIEW

As we move through 2007, the economy is expected to show continuing well-balanced, albeit moderating, positive growth trends. Following an estimated 3.3% growth in real Gross Domestic Product (GDP) in 2006, the economy is projected to record GDP growth of 2.9% in 2007. This level of growth is a positive given that we are in the sixth year of the current economic recovery and the rate is expected to slow to the long-term averages for GDP experienced over the past twenty years. The economic recovery that began in the fourth quarter of 2001 was initially based on aggressive monetary and fiscal stimulus by the federal government coupled with a relatively strong consumer spending rebound. The continuing recovery going into 2007 is now composed of moderating positive consumer spending growth that should continue to be fueled by rising real wage rates and low unemployment levels. Governmental spending growth will continue based on our current commitments in Iraq, while corporate spending should continue to show robust growth given the sector's last three years of solid corporate profits expansion, healthier balance sheet trends, and improved corporate liquidity. Current projections call for Real Consumer Spending to increase by 2.8% in 2007. Real Business Investment Spending is expected to grow by 6% in 2007 while Real Government Spending should continue to increase over 2% for the full year.

Over the next four quarters, the inflation rate, measured by the CPI, should be held in a fairly tight trading range bordered by 2.2% on the low end and 2.8% on the high side as increased commodity costs and a return of pricing power are partially offset by productivity gains. The Federal Funds Rate is expected to end 2007 near 5.25% where it began the year with the potential for a temporary move of twenty-five basis points in either direction during the year depending on the near term economic momentum. By the end of 2007, we would expect the ten-year Treasury bond yield to reach 5.5% resulting in a very modest positive slope to the yield curve for the first time in almost two years.

While the outlook for the economy has continued to show positive growth over the past year, the financial markets have been impacted by numerous near term cross currents. On the positive side, the fourth quarter of 2006 is expected to have been the fifteenth consecutive quarter of double digit earnings growth for the major market averages. The strength and durability of this rapid earnings gain has outperformed any comparable period in the past twenty years. Productivity gains remain strong and the general market, as represented by the S&P 500, is currently enjoying record earnings and profit margin levels. Corporate balance sheets remain strong and liquidity levels continue to be at historically high levels with the average S&P 500 company having close to 7% of their assets in short-term marketable securities. Countering the positive news, inflation has gradually moved up over the past year, commodity prices have experienced wide short-term price moves, the United States trade deficit and budget deficit remain at relative high levels, and the legislative outlook has become increasingly uncertain as a democratic Congress begins to function with a republican White House.

Following a consolidation in the first half of 2006, the major equity markets have all recorded solid rebounds through the second half of the year and entered 2007 at or near record levels. Full year 2006 reported earnings, as measured by the S&P 500, are expected to be in the area of \$83, representing an increase of 13% over comparable 2005 levels. Current projections for 2007 call for an incremental gain of 8% to \$90, representing a growth rate that continues to be slightly higher than the longer term average of 7%. In spite of our relatively sanguine earnings outlook for the year ahead, we should be aware that even in positive economic environments the markets tend to continually climb a wall of worry based on areas of near term uncertainty and risk. We would expect performance to become more selective with incremental market gains tied directly to the specific companies and their ability to record solid fundamental growth on a continuing basis even as the general economic momentum slows and the future peak in economic activity begins to be contemplated.



HOUSING

One of the major areas of current financial weakness in the economy is the slowdown in the residential construction market. Over the past year housing starts and building permits have both declined by approximately 20% from the robust levels of 2005. According to the National Association of Realtors, sales of existing homes have also declined by over 12% in 2006 and the median sales price has fallen by more than 4%. At year-end 2006, it was estimated that the total inventory of unsold homes in the United States had increased to its highest level since 1993. The extent of this weakness in single home sales is expected to be further prolonged by the unusually large number of adjustable rate mortgages that are scheduled to reset during 2007. Industry economists estimate that close to \$1 trillion in adjustable rate mortgages will be reset or renegotiated over the next year. While the continued relatively low interest rate environment should do much to moderate this negative pressure on consumers, the resulting pressure on disposable personal income will still be significant. The weakness created by the housing decline on the economy has recently surfaced in two primary areas. First, the increase in mortgage interest payments has put pressure on discretionary spending that in turn will continue to impact other major consumer product categories including autos and furniture. Secondly, employee layoffs within the home building sector will continue to have an underlying upward pressure on unemployment rates and consumer confidence.

While homebuilding weakness has had a general dampening effect on economic growth trends over the past six months, the gradual decline in energy prices experienced over this same period has served to offset pressure on consumer's discretionary purchasing power. With crude oil prices now down \$20 per barrel, or over 30% from the highs in the summer of 2006, the estimated savings from lower gas and heating oil prices have had a significant impact on freeing up discretionary income trends and

Based on consensus earnings figures, the market is currently being valued at 17 times 2006 estimated earnings and less than 16 times preliminary 2007 estimated earnings of \$90. This valuation level, while no longer historically inexpensive, continues to be in line with past market average valuation levels, especially during periods of relatively low and stable underlying inflationary trends.

stimulating spending. The combined net impact of these two factors should, in fact, result in a modest reacceleration of economic activity as we move into 2007.

INTEREST RATES

In June of 2006 the Federal Reserve Board completed their continuing policy of gradually tightening the Federal Funds Rate by 25 basis points at each meeting. During the preceding two years the Federal Reserve Board had increased the Federal Funds Rate seventeen times from 1% to 5.25%.

Since June of last year the Fed has maintained the 5.25% rate as a level that is viewed as representing an attractive investment rate on an international basis and therefore positive for the U.S. dollar while not being overly restrictive domestically especially given the high levels of domestic corporate liquidity.

During the past 6 months, the Treasury Yield Curve has remained flat to inverted (short-term rate higher than long-term rate) as the increases in the short-term rate (Federal Funds Rate) were not followed by corresponding increases in the ten-year Treasury bond yield. Traditionally, an inverted yield curve has been the early harbinger of impending economic weakness as short-term illiquidity causes an increase in short term rates. Currently, there is a great deal of liquidity within the economy and the cause of the yield curve inversion has been the high demand for the longer term bonds based on a number of factors that include: foreign demand; hedge fund activity; portfolio duration management; pension actuarial balancing; and the relatively modest supply of long-term Treasury bonds available currently. As several of these pressures moderate over the next year, we expect the ten-year Treasury bond to reflect a more realistic interest rate level and move above 5% during 2007.

CORPORATE DIVIDENDS

In viewing the current valuation levels of the equity market, one of the primary factors for consideration is the current dividend yield provided by the equity market in relation to the fixed income alternatives. The market, as measured by the S&P 500, is currently providing a current dividend yield of 1.7%. While this dividend yield is well below the 3.5% provided in the mid 1980's, it has posted strong increases from the economic trough averaging 10% per annum growth over the past five years. With corporate liquidity at historically high levels and corporate profit growth continuing to register solid gains, the outlook for continuing above average growth is excellent. During the 1990's dividend yield growth slowed as more corporate managers placed increased emphasis on corporate share repurchases in order to improve earnings per share trends and in turn increase the value of their company's stock and their employee option programs. (continued>)



Based on the wide publicity surrounding the excesses included in many corporate option plans and the accounting changes that have been put in place to more accurately reflect the cost of option expenses, companies are now placing increasing emphasis on rewarding shareholders through improved dividend growth rates. Over the last twenty-five years dividend payout ratios have gradually slipped from a level of 45% of earnings to the current level of 30%. While underlying earnings growth is expected to gradually moderate as the economic cycle matures, we would expect dividend growth levels to continue to record strong gains with an increasing portion of the earnings stream being passed back to the shareholders. This outlook for strong dividend income growth becomes especially attractive to the investors when it is accompanied with the current 15% effective federal income tax rate.

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