

MARKET OUTLOOK

with Seligman CIO Jack Cunningham



JACK CUNNINGHAM

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At the start of the second quarter equities rallied as commodity prices pulled back and credit and recession concerns eased. By the end of the quarter, however, oil prices had reached new highs, credit woes returned and positive sentiment flagged.

S&P 500 Performance by Sector

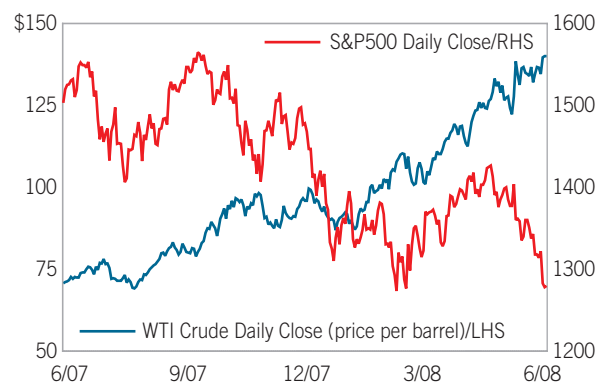
| | Q2 Return | YTD 2008 |
|----------------------------|-----------|----------|
| Consumer Discretionary | 7.8% | -13.3% |
| Consumer Staples | -5.3 | -7.4 |
| Energy | 17.3 | 8.9 |
| Financials | -18.3 | -29.7 |
| Health Care | -1.2 | -12.6 |
| Industrials | -10.1 | -13.6 |
| Information Technology | 2.5 | -13.1 |
| Materials | 4.4 | 1.3 |
| Telecommunication Services | -4.1 | -17.3 |
| Utilities | 8.0 | -2.8 |

Source: FactSet. Data as of June 30, 2008. Performance shown is total return and reflects the reinvestment of distributions if any. Returns presented do not reflect the investment performance of any Seligman Fund or product.

If there were any doubts that oil rules the markets, they were put to rest in the second quarter as a spike in oil prices weighed heavily on equity markets. The run up in oil has been driven by increasing demand from developing economies (which subsidize the commodity in some cases), by the weak US dollar, by speculation, and, perhaps, by a self-fulfilling prophecy, as a Goldman Sachs analyst warned of a forthcoming superspike in the price — perhaps to \$200 a barrel. Oil didn't get that high during the quarter but futures contracts did close above \$140 a barrel in June. Sustained \$150/barrel oil would shave 1.8% off annual gross domestic product (GDP) according to an estimate from the Dallas Federal Reserve Bank.¹ It is exactly this economic toll that has investors feeling panicky. US economic growth is positive but weak; higher energy prices could prompt negative growth levels.

OPEC producers met at the end of June to address price, supply and demand, and Saudi Arabia agreed to

Oil Prices Rose Sharply During The Quarter Weighing on Stocks



Source: Bloomberg as of June 30, 2008.

a marginal increase in production. In the end, this increase may simply offset the decrease in production we have seen from African producers whose daily output has fallen due to attacks on their oil infrastructure. There simply isn't much spare capacity in the system right now, and this has contributed to volatile price moves. The magnitude of price fluctuations has fueled criticism that the current high price is driven by speculation rather than by fundamentals of supply and demand and there have been calls for greater oversight of all commodity trading to reduce speculation.

Increasing inflation for other commodities also has investors worried. The price of nearly everything seems to be higher this year and central bankers have been vigilant about containing rising prices. Citing inflation concerns, the European Central Bank has kept rates steady for the past year despite weakening growth and calls for a rate cut. (The ECB's primary objective is price stability.) While the Fed started the second quarter with 25 basis point rate cut (bringing the overnight interest rate to 2%), the central bank's rhetoric changed markedly over the quarter, increasingly focusing on the inflationary threats to the economy. We expect the next move by the Fed to be a rate hike, rather than another cut, some time later this

¹ Wall Street Journal, May 7, 2008

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year. Until then, Chairman Bernanke may try to jawbone the dollar higher in an effort to curtail rising commodity prices — a strategy he began during the quarter with mixed results. Previously, the weak US currency was tacitly approved because it made US goods more attractive overseas, but now the inflation dangers may warrant intervention.

Commodity Price Inflation Has Been Widespread

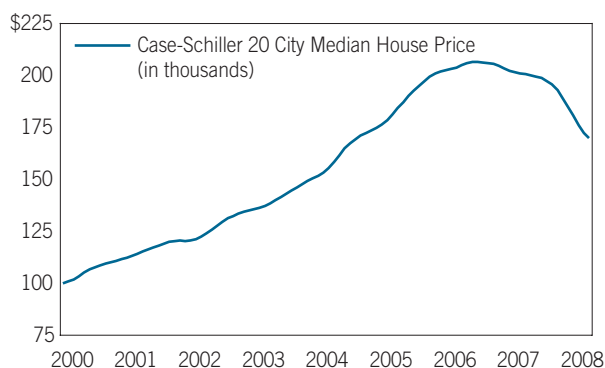
| | Price Increases in Last Twelve Months (%) |
|-------|---|
| Rice | 78 |
| Corn | 117 |
| Wheat | 47 |

Source: Bloomberg, June 30, 2008.

More than ever, we are in a stock-picker's market as there are negative stories on a macro level for most sectors. Energy and Materials stocks have been the strongest performers through the first half of 2008, but the volatility of the underlying commodities has fed concerns of a pullback. Within the Financials sector, fears of another wave of write-downs has weighed on banking stocks. Within the Consumer sector, the fall in housing prices and consumer spending have cast a shadow. Within Health Care, the upcoming presidential election is weighing on the sector. Of course, opportunities remain — natural gas stocks in the Energy sector, for example, large-cap pharma stocks within Health Care. In fact, there are company-specific bright spots within all sectors, and as investors that's what we are focused on. These include companies with solid earnings growth despite the macro-level conditions.

In spite of higher gas prices and falling housing prices, which have undermined consumer spending, growth in the US economy has been more resilient than many expected. During

House Prices Continued Their Steep Decline



Source: Bloomberg as of June 30, 2008.

the quarter, economists began to back away from their most dire recession forecasts. While consumer confidence is weak and consumer spending is anemic, the job market appears to be holding steady. A weak job report issued in June seemed a seasonal anomaly and we will be watching the next report closely. The massive policy response we saw earlier this year (i.e., Fed rate cuts and tax rebates) has been credited with staving off recession. In its place, many now expect a prolonged period of stagnation — further support for a stock-picker's market.

While stocks are significantly off their October highs (the S&P 500 is down 16% from its record high on Oct. 9, 2007), we continue to believe that the second half of the year holds promise for equity investors. In the near term, we believe stocks may remain in a trading range. They may even fall further if oil continues its vertiginous climb or banks undergo another round of significant balance sheet write downs. That said, low interest rates and tax rebates should help support the equity market and we expect the second half of the year to be a more positive environment for investors.

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