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A welcome surge in March helped the capital markets stay on the recovery path during the first quarter. Reports of economic activity and employment have generally shown improvement, although the main support for the upswing in stock prices has been the rebound in corporate profits. We expect the recovery will progress in three important phases – 1. Return of liquidity to the bond market, 2. Rebound in corporate profits, then finally 3. Job creation.

The bond marketplace is much healthier than it was a year ago. That is good news for borrowers of all types who look to the capital markets for financing equipment, cars, homes, the purchase or start-up of new businesses, and routine cyclical cash needs. One of the largest borrowers is the United States government, which meets its financing needs by issuing United States Treasury securities. In recent months, the routine auctions of those government securities have gone smoothly, which is an important factor in our nation's overall economic health. The Federal Reserve has kept their target levels for short-term interest rates unchanged, and the yield on the bellwether 10-year Treasury is still quite low, by historical standards, at around four percent. Corporate yield spreads over comparable maturity Treasury issues have returned to a much more normal level in the past year as liquidity and investor confidence has improved.

Today's low interest rates are helping to get the economy back on a productive track, although it seems likely that rates will eventually move upward as the economy improves. Over time, short-term rates are usually around the rate of inflation, while longer maturities typically offer two to three percentage points above inflation. Those historical relationships suggest that short-term rates will recover to around three percent, and the yield on the 10-year Treasury bond should move to around six percent. As protection against rising interest rates, we are keeping the average maturity of bond portfolios fairly short term.

The last quarterly earnings season went well, marking the fourth consecutive quarter in which companies reported improving results that generally met or exceeded analyst forecasts. We expect to see continued strength in earnings in coming weeks as companies report their results for the first quarter of 2010. While consumer spending has been lackluster here in the United States, there are countries that are growing at a faster clip and creating a population of consumers for products and services that are provided by companies we own in client portfolios. Many of our investments are focused on large, multi-national businesses that are in a good position to advance their sales in countries that have rapidly rising levels of discretionary spending. Basic infrastructure, as well as brand-name consumer and healthcare products are likely to benefit from the growth in emerging economies.

Employment is just beginning to show the earliest signs of recovery. The most recent report of new job creation was the best we have seen in about three years, although the national rate of unemployment still remains stubbornly high at 9.7 percent. A more productive environment would bring that figure down to around six percent.

Employment and housing are related, because there are a lot of jobs in the construction industry. Homebuilding activity is in a terrible slump, with an annual build rate of approximately 500,000 new homes. A more typical level of activity is 1.2 to 1.5 million new homes built each year. As the recession fades, we expect new household formation to pick back up. Young people will be able to afford to move out of their parents' homes, and immigration will result in demand for new housing. Getting construction workers back on the job will improve the national rate of unemployment, and will benefit states such as California that have traditionally seen high levels of new construction activity.

Politics will remain an interesting topic of conversation, especially as we head into the contentious mid-term Congressional elections this November. In a controversial effort split along party lines, Congress recently passed an historic healthcare bill that expands healthcare coverage to tens of millions of Americans. However, it remains unclear what the new healthcare plan will mean for taxation, corporate profits and consumer spending patterns in coming years. Also, at some point this year, we anticipate Congress will advance bills for financial services reform, estate taxes and expiring tax breaks for dividends and capital gains. Most analysts expect tax rates will increase, but it is not clear by how much and by what type of tax programs.

For most people, the state of the economy is measured by their job and home value. However, employment and housing are often slow to rebound from a downturn in the economy, which is why consumer confidence levels typically trail the actual recovery. In this recession, as with most previous down cycles, we expect employment and housing to begin improving well after other measures of the economy have already turned upward. The bond market and corporate profits have made big strides toward getting back on track, and those areas represent the first two phases of our anticipated three-phase recovery process. The economy is steadily improving, and that bodes well for a gradual improvement in the outlook for jobs.