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Inflation's shadow darkened Wall Street in recent weeks, causing a modest retreat in stocks and bonds. High oil prices are certainly a contributing factor, although we believe inflation extends beyond the energy markets. The specter of inflation is generating some turbulence for the capital markets, and those forces are likely to be with us throughout the year. Now, let us explain why we believe that is good news.

The recent quarter-century has been an extraordinary period in our nation's economic history, and the Federal Reserve deserves considerable credit for the important role they have played in setting the stage for innovation and employment. Paul Volcker was appointed chairman of the Federal Reserve in 1979 with a mission to drive down the inflationary pressures that had wracked the economy during the 1970s. You may recall there was an energy shortage at the time, and inflation pushed interest rates well into the double digits while the economy stalled. Paul Volcker and his successor at the Federal Reserve, Alan Greenspan, have labored diligently to beat inflation into submission, and that has resulted in more than two decades of interest rates generally trending downward. Lower interest rates reduce the cost of capital, which, in turn, supports business and consumer spending patterns. Business investment and consumer demand translate into new job creation. In other words, low interest rates promoted a prosperous cycle of earning and spending.

That prosperous cycle nearly overheated about five years ago. Concern for heading off "Y2K" computer snafus caused a synchronized surge in capital spending during 1998 and 1999. Economic growth rates spiked, and unemployment dropped to remarkably low levels. Then, by mid-2000, it became shockingly apparent that business spending was exhausted. Analysts dramatically cut their forecasts for the technology companies that had powered much of the productivity and employment gains. Corporate profits collapsed, triggering layoffs and revealing scandals that shook investor confidence. Then, the September 11, 2001 terrorist attacks hit, further threatening to stall the world's largest economic engine.

The Federal Reserve pushed monetary policy to its natural limits to re-stimulate economic activity. Interest rates hit rock bottom. It was a profound moment, and the U.S. economy proved resilient. Motivated by low interest rates, consumer spending brought the cycle back up to speed, allowing companies to rebuild their profit margins and shore up their balance sheets. Job creation has been slow but positive, and the unemployment rate has held at the mid-five percent level.

That's nice, but why would inflation be good news? At this point in the recovery process, the economy can either grow or slow. Companies' operating expenses are rising, with materials and labor costs moving higher. Inflation is evidence that

companies are able to pass along rising costs to consumers, which suggests they can afford to create additional jobs and fund new development projects. The growth scenario means the prosperous cycle continues. The alternative scenario is rather bleak. Lacking pricing power, companies revert to trimming costs and laying off employees. Rising unemployment wilts consumer confidence and buying activity slows down. The economy slips back into malaise.

Our expectation for the economy in 2005 is a battle between the “inflation” and “recession” scenarios, with the inflation scenario ultimately proving victorious. We believe inflation will track in the three to four percent area, which should motivate a return to neutral monetary policy and stimulate rising yields on the bellwether 10-year Treasury bond. It also suggests companies will successfully protect their profit margins, which could provide an upside surprise relative to Wall Street earnings forecasts. Investors count on rising corporate profits to drive stock prices higher. It is a turbulent scenario, but one that can create progress for investors. Activity in the capital markets during the recent quarter affirms our outlook, and we continue to recommend a defensive posture with the bond portion of client accounts and well-diversified equity holdings.

On a personal note, we are pleased to let you know that Live Oak Capital has taken an important step in its continued growth. Todd J. Walklett, CFA will be joining the firm as Senior Partner. Todd brings over 16 years of investment experience managing portfolios for institutional clients and affluent families, with a focus on providing a high level of client service. Todd earned his Bachelor of Science degree in 1989 from the University of Delaware, with a major in Business and Finance and a minor in Management Information Systems. He completed the program to earn his Chartered Financial Analyst designation in 1996. Todd lives in Pasadena with his wife and two children.

As always, we appreciate the opportunity to be of service, and we welcome your call if you have any thoughts or questions.