



LIVE OAK CAPITAL, LLC

2535 TOWNSGATE ROAD SUITE 310
WESTLAKE VILLAGE • CA • 91361
TELEPHONE 805.230.8282
FACSIMILE 805.230.8283

January 2006

Investors wrapped up 2005 with modest gains. An encouraging year-end stock market rally stalled as analysts puzzled over the meaning of an unusual interest rate situation. It was a fitting finale to a hesitant year in the capital markets. Some of the headwinds that buffeted stock and bond markets during 2005 are expected to subside in the new year, and we believe the economy is generally in good shape to continue its pattern of expansion and wealth creation.

Wall Street is fond of naming its enemy, and the unusual interest rate situation that derailed December's progress is called an "inverted yield curve." It occurs when interest rates on long-term bonds are below the yields on shorter maturities. Normally, investors earn a higher yield for bearing the risk of longer maturities. Technically speaking, the yield curve inverted last month as the yield on ten-year Treasuries fell *slightly* below the yield on two-year Treasuries. That has analysts puzzled, because an inverted yield curve has historically been a reliable, although not perfect, predictor of economic recessions.

"I think the bond market is on drugs."

Ethan Harris, chief U.S. economist at Lehman Brothers
quoted in The Wall Street Journal, December 29, 2005

As Ethan Harris's quote shown above suggests, the idea of a recession is at considerable odds with the current economic climate. Even a devastating hurricane season and record high oil prices could not stop the economy from growing in 2005. Throughout the recent year, corporate America produced profits that significantly outpaced expectations while creating jobs that eased the unemployment rate back down to five percent. Real household net worth grew to a new record high in 2005, surpassing the previous record set roughly five years ago.

Interest rates have been a topic of debate for quite awhile, as yields on longer maturity bonds have been surprisingly low for more than a year. Outgoing Federal Reserve Chairman Alan Greenspan has referred to it as a "conundrum," and economists have struggled to come up with plausible explanations for the persistently low yields. However, from the standpoint of recessionary risk, an upward spike in long bond yields could be more problematic by undermining the housing sector and potentially triggering a slowdown in consumer spending. The low yields causing the conundrum and inverted yield curve have actually been helping to support household wealth, spending and consumer confidence levels.

We take the bond market seriously, but we do not believe the economy is headed for a tailspin. There may be rational, yet to be determined, reasons why long bond yields



LIVE OAK CAPITAL, LLC

2535 TOWNSGATE ROAD SUITE 310
WESTLAKE VILLAGE • CA • 91361
TELEPHONE 805.230.8282
FACSIMILE 805.230.8283

remain low. In the meantime, we believe the likely economic scenario for the coming year is a productive one that should reveal the following:

- Moderate, but still solid economic expansion. It would be fine to see the economy growing at a two to three percent clip, easing back from its recent three to four percent rate of growth.
- The Federal Reserve will complete their program of raising short term interest rates, and it is possible that we will see them actually *reduce* short term interest rates slightly prior to year-end.
- Unemployment should stay in the five percent range, which is considered “full employment” by historical measures. Consumer spending will be supported by wage growth, which we expect to be solid at three to four percent.
- Corporate spending and government spending will be strong in 2006, and these will be the primary drivers of economic expansion.
- Companies will continue to report rising revenues and profits in the coming year, and we believe reported earnings will generally exceed Wall Street forecasts.

It would be convenient if one indicator allowed us to accurately forecast the economy. However, it is not generally in the nature of the capital markets to be predictable. Positive and negative events will occur in the coming year that are not on Wall Street’s radar at this moment. We will continue to monitor the interest rate puzzle, although we do not believe changes are merited in our investment program at this time. We continue to recommend a balanced, diversified participation in equities and a conservative posture with the bond portion of client accounts that focuses on the one to five year maturity range with high credit quality instruments. The events of 2005 are another example for investors that our nation’s economy has a powerful resilience to overcome setbacks and find its way back onto the path of progress.

Our best wishes to you and your family for a healthy, happy and productive 2006.