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The 1970's had at least two features we would rather not see again – leisure suits and stagflation. Both are menacing in their own way, although stagflation would be more damaging from an economic standpoint. Just the thought of it chills Wall Street. Signs of inflation at a time when the economy is expected to be slowing bring back dismal memories of the seventies, when runaway oil prices contributed to a surge in interest rates and downdraft in economic progress. Such were the worries that brought hesitation to the stock and bond markets this past quarter. Fortunately, this is not the seventies.

Inflation, as measured by the Consumer Price Index (CPI), jumped to an annual rate of 4.2 percent. Even the “core” CPI figure, which excludes food and energy costs, rose at an annual rate of 3.7 percent. These data, along with a few candid comments from the new head of the Federal Reserve, Ben Bernanke, triggered a rough patch during the second quarter as investors worried interest rates may go higher than previously expected. We are not surprised by the inflation figures, and we do expect the economy to slow a notch from its first-half of the year pace. However, we also believe much of the second quarter's price volatility was overdone and the higher inflation figures do not foretell stagnation in the economy:

- These headline figures are a long way from the double-digit levels that precipitated stagflation during the seventies.
- The largest contributor to the rise in reported inflation is due to a quirk in how the CPI is calculated. The government looks at rising rental costs, not home prices, when measuring housing's contribution to inflation. Softness in home buying may simply be causing some firming in rental rates.
- This is not a new topic. We have been concerned about a modest upswing in inflation for quite awhile, and we have structured clients' bond investments defensively as a protection against rising interest rates. Within the stock holdings, we have focused on companies that have pricing power and the ability to protect their margins by passing along increased costs. Traditionally, inflation emanates from two primary causes – wage growth and rising energy costs. We have been watching both factors at work during the recent couple years.

Concerns regarding the Federal Reserve seem exaggerated. Whether the Federal Reserve raises rates another quarter point or two will probably not derail economic expansion. The Federal Reserve usually overshoots its target during campaigns to slow the economy, so it will not be surprising if they go a bit too far this time. It takes awhile for a rate increase to wind its way through consumer behavior and show up in reported economic statistics. We continue to believe the Federal Reserve is about done with its rate hikes,

and we will likely see mellowing of economic activity during the second half of the year. Mr. Bernanke got an education about Wall Street's sensitivity to candid commentary from the Federal Reserve, but we believe he is up to the task and cut from the same cloth as his inflation-vigilant predecessors, Alan Greenspan and Paul Volker.

Companies are in much stronger financial condition than they were heading into the period of stagflation during the seventies. Media attention has been focused on interest rates, while the strength in corporate profits seems to have gone largely unheralded. At the beginning of the year, analysts expected profits of companies in the S&P 500 to grow by roughly five percent during 2006. During the recent six months, those forecasts improved to the point where, now, those profits are expected to grow by more than eight percent. Profits are at record levels, companies are sitting on record amounts of cash, companies' purchases of their own stock have reached an all-time high, and dividends have risen roughly 42 percent from the level paid back in 1999 before the market downturn. We continue to see companies reporting solid quarterly results, and we expect profit growth will persist, even if the economy slows during the second half of the year. Market valuations appear reasonable, given the earnings anticipated from these firms.

We believe in stocks for long-term growth and bonds for safety. Most investors benefit from having both in their portfolios, because progress rarely moves in a straight line. These recent few years have been difficult, yet still productive, for investors. This year's two steps forward, one step back behavior has been characteristic of the old adage "stock prices climb a wall of worry." Our conservative posture with bonds and diversified participation in stocks should continue to serve clients well, while helping their portfolios weather the ups and downs along the way.

As always, we welcome the opportunity to discuss these ideas with you in greater detail. Please feel free to call or let us know if a meeting would be helpful. We won't show up wearing a leisure suit.