



# LIVE OAK CAPITAL, LLC

6601 CENTER DRIVE WEST SUITE 500  
LOS ANGELES • CA • 90045  
TELEPHONE 310.348.8188  
FACSIMILE 310.348.8189

October 2003

Investors paused at last week's decline in the value of the dollar, although stocks did manage to post gains for the quarter. The old adage is that stocks "climb a wall of worry." After three tough years, it is understandable that investors remain sensitive to anything that might derail this burgeoning recovery in share prices. For the most part, this has been a good year. The majority of economic indicators are pointing higher, and stock prices are showing that they do remember how to go up.

One of the more interesting dynamics from the recent quarter took place in the bond market. Typically, an improving economy is good for stocks and more difficult for bonds. Yields tend to rise, which means bond prices decline. We got a clear view of that happening during the recent few months. A series of encouraging reports about the economy's progress caused interest rates to rise by roughly one percentage point. The resulting drop in bond prices certainly got the attention of investors. This validated our defensive position with respect to clients' bond holdings. Shorter maturities were spared the more dramatic price hit suffered by longer maturity obligations.

I get a lot of questions about the housing market. Of course, rising interest rates affect the housing market, which has been a source of strength during recent years. Household wealth has been supported by increasing home values, and homeowners have refinanced their mortgages to lower their monthly payments and draw out money for other needs. Refinancing activity has been a primary reason why consumer spending has held up rather well, even though employment has been weakened by the sluggish business conditions in recent years. Mortgage rates tend to rise and fall with the 10-year Treasury yield. So, as one would expect, mortgage rates moved higher by about one percent, in-line with the change in 10-year Treasury yields. Higher mortgage rates are likely to take some of the edge off the residential real estate market. However, even with the rate surge, today's mortgage rates remain attractive by historical standards, and the demographics of home buying remain favorable for home prices. Many homeowners who intended to refinance their mortgages have already done so. Housing prices are unlikely to continue rising at their recent clip, but neither are they likely to take a calamitous tumble. With respect to housing's contribution to consumer spending, further gains in spending will probably rely on the employment scenario.

Employment has been slow to rebound. Even though we are over a year into the "recovery," unemployment remains stuck at around the six percent level. Measures of business activity, corporate profits and productivity have shown dramatic improvement in recent months. Yet, businesses seem reluctant to add to their payrolls. This has important economic and political consequences. There is nothing like a weak job market to get Washington's attention during an election year. It is one of the most important determinants of people's satisfaction with an administration, and it was a primary

motivation behind the recently-enacted changes in the tax laws. Employment does tend to be a lagging indicator, which means it tends to improve after the economy gets back on track. Companies typically cut costs during a downturn to protect their profit margins, and they generally wait until they see a rising revenue picture before adding new employees. Corporate profits are back on track. This is the stage in the business cycle where we expect to see gains in employment.

Speaking of politics, the eyes of the nation will be on California during our historic Recall election next week. Polling continues to show Californians favor the recall. Frontrunners to take Governor Davis's spot are remarkably divided on their intended course of action to repair the state's dismal budget shortfall. It looks like a microcosm for the national debate that will take place in the coming year's Presidential election. In the meantime, I encourage investors to take a conservative posture with their holdings of California municipal bonds. I do not believe the state will default on their bonds, even though the credit rating for the state has slipped to nearly "junk" status. However, many bonds come with the additional security of insurance that raises the bonds' effective credit quality. I prefer bonds that have an underlying credit of A or better, and insurance protection that raises the effective credit quality to AAA. Californians have shown great tenacity in prior tough spots, and the state will eventually bet back on solid fiscal footing. In the meantime, investors do have options to protect their municipal bond holdings.

Overall, it was another encouraging quarter. Improving economic conditions and rising corporate profits bode well for stock prices. I remain more cautious regarding bonds and real estate. The fourth quarter usually provides a lot of information regarding companies' budgets and capital spending plans for the coming year. I will be watching those announcements carefully for signs that capital spending may finally be waking from its protracted slumber.

Sincerely,

Byron B. Snider