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October 2007

Michael Josephson of the Josephson Institute for Ethics provided the following tale in one of his recent articles:

> A father gave his 7-year-old son a baseball, and the boy went outside to practice. After awhile, the father went out to check on the son's progress. *"Show me what you can do."* The son threw the ball in the air, took a mighty swing and missed. *"Strike one,"* the boy said enthusiastically. He tossed the ball again and missed again. *"Strike two,"* he yelled. The father offered some encouragement, *"concentrate, son."* The boy threw the ball again and swung so hard he fell to the ground after hitting nothing but air. The father winced, but the boy had a triumphant grin. *"You struck out. Why are you happy?"* asked the father. The boy declared, *"'Cause I'm really good at pitching!"*

It is a fun story about the importance of perspective, and we see similarities to the current debate over the Federal Reserve's decision to ease interest rates by a half-percent at their September 18 meeting. At the time, Wall Street cheered the move, essentially declaring "the Fed is really good at pitching…" as the news sent the Dow Jones Industrial Average soaring more than 335 points that day. However, there are others who worry about the Fed's ability to swing the bat when it comes to warding off inflationary threats. This debate continues as we head toward another meeting of the Federal Reserve at the end of this month. Is the Fed being too accommodating by rescuing Wall Street from the mortgage mess, or are they simply acting in a responsible manner to get the economy over a tough hurdle with the malaise in housing?

We believe the Federal Reserve arrived at the right place, even though they took an unexpected path to get here. In our opinion, the Fed waited too long to begin their interest rate easing, given the anticipated slowing of economic conditions even before attention was focused on the subprime mortgage issues. As recently as their August 7 meeting, it seemed the Fed was not planning to take their foot off the brakes. However, in the days following that August meeting, mortgage issues that had been percolating for months suddenly gelled into a crisis. That motivated the Fed to abruptly reverse their position by injecting liquidity into the financial system and taking a big bite out of rates. Instead of a gradual easing of monetary policy, the Fed delayed and then took a sharp turn to get back on track. With the recent adjustment, the slope of the Treasury yield curve has steepened to a much more normal shape, which signals the bond market's opinion that the rate cut will help the economy avoid recession.

The oversized action by the Fed sparked a surge in stock prices that carried the third quarter back into positive territory, although investors had to endure remarkable volatility along the way. There were plenty of days when the Dow Jones Industrial Average swung up or down by more than two hundred points. Much of that volatility derived from the weak conditions in residential real estate, a situation that is likely to persist for awhile. It will not be surprising to hear more stories about mortgage delinquencies and rising foreclosure rates in the coming months. Down cycles in the housing market are worrisome, although we continue to believe the economy is strong enough to weather those issues and deliver modest growth heading into 2008.

We are now entering earnings season, when companies report their quarterly operating results. This is also the time of year when companies provide longer-term guidance on their budgets for hiring and capital expenditures, which is an important reason why the months of September and October have traditionally been sensitive for the stock market. There is a lot of information to digest each autumn. The exceptional gains in corporate profits, stock buybacks and private equity transactions over the recent few years have been a tremendous support for rising stock prices. As these factors moderate, there will be some companies that fall short of Wall Street expectations, and that may cause additional turbulence in the capital markets.

Housing, the Federal Reserve and corporate profits. These are important topics that will influence stock and bond prices in the months ahead, and we anticipate there could be more of the big price swings that characterized this past quarter. Getting back to our tale of the budding baseball player, perhaps it is just a matter of perspective whether the Federal Reserve's latest action represents "good pitching" or "lousy batting." In either case, we believe they have found their way back onto a monetary path that balances the risks of recession and inflation, and we view the return to a normal, upward slope for the Treasury yield curve as a positive development.

Please call us if you have any questions.