



LIVE OAK CAPITAL, LLC

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

October 2005

There is a silver lining to the clouds receding from hurricanes Katrina and Rita. Natural disasters create spending, and the reconstruction program from these storms is going to be huge. We expect recovery efforts to pick up speed as we head into 2006, boosting the prospects for growth on top of an economy that was already doing reasonably well. Hundreds of billions of dollars will pour into the devastated areas, bringing an enormous demand for labor and materials. Corporations are in a good position to respond to this need, after five years of rebuilding their own profits and balance sheets.

It is not surprising that the storms wreaked havoc on consumer confidence and fuel costs. The Gulf is an important region for oil drilling and refining. Any potential disruption to the already sensitive balance of supply and demand for gasoline has an immediate impact at the pump. The decline in consumer confidence reflects the humanitarian in all of us, with our empathy for the people affected by these events. Both factors will recover as the initial shock gives way to a productive rebuilding program.

Companies have been steadily engaged in a rebuilding program of their own in recent years, as they recovered from the technology “bubble” that began deflating in 2000. Companies have strengthened their income statements and balance sheets, and valuations are back to attractive levels. Taking a look at the companies that comprise the S&P 500 Index offers an encouraging view of the progress achieved in the past five years:

- Revenues have increased nearly 24 percent.
- Profits have increased more than 40 percent.
- Cash on their balance sheets has more than doubled.
- Stocks are trading around 17 times earnings, a much more reasonable valuation level than the lofty 31 times earnings valuations of 1999 and early 2000.

In that time period, the nation’s economy has grown from roughly \$9.5 trillion to more than \$12.3 trillion, and companies are now in a strong position to respond to the additional demands placed on them by the hurricane relief efforts. The evidence for this may take a few quarters to reveal itself. Third and fourth quarter economic figures are likely to dip, reflecting the initial disruption caused by the hurricanes’ destruction. Then, as we progress through 2006, overall economic growth will be boosted, along with improved wage and employment figures as a result of the reconstruction program. Investors should see companies reporting an upswing in revenues and profits.

Economic conditions will support the recovery effort, although we expect considerable debate in Washington regarding fiscal and monetary policies. A good portion of the money backing recovery efforts will be financed through borrowing, much of it



LIVE OAK CAPITAL, LLC

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

supported by the Federal Government. That will add to the already substantial budget deficit, which places political pressure on various policies related to taxation of dividends, capital gains and estates. Concern over the budget deficit may postpone resolution on the debate to make “permanent” some of the tax relief that can benefit investors. Regarding monetary policy, we believe the Federal Reserve is correct to continue its vigilance over inflation. The most recent measure of inflation, the August reading of the Consumer Price Index, showed a year-over-year inflation rate of 3.6 percent. That figure is already higher than the Federal Reserve’s target of around two percent, and rising energy, materials and labor costs resulting from the hurricanes will add to inflationary pressures. Tax policy, bond issuance and inflation containment are likely to be prominent topics in Washington during the coming year.

This year’s modest stock market performance understates the good things that are percolating within companies’ operating results. In general, companies have been beating Wall Street estimates with their quarterly earnings reports, and estimates for the full year’s profit growth have risen notably since the beginning of the year, from an early estimate of six percent to a recent estimate of ten percent growth. We believe the same improvement in profit outlook is likely to develop in 2006, bolstered by the new business activity coming from the rebuilding efforts after the hurricanes. From a humanitarian and investment standpoint, it is good news that companies are in a strong position to respond to the additional demands emanating from Katrina and Rita.