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What was that? As if hitting a bump while driving on an otherwise smooth road, investors were startled by a 416 point drop in the Dow Jones Industrial Average on February 27. It was the first notable pothole since stock prices began their graceful ascent last summer. Even though stock prices recovered during March, the experience left some uneasy feelings that may make investors more sensitive to any evidence of changes in the economic outlook in the months ahead.

We believe the ongoing debate over the risk of inflation versus recession is at the heart of recent price volatility. In the bond market, this debate contributes to the oddly shaped “inverted” yield curve, in which the yield on short-term maturities is higher than the yield on longer-term bonds. Inflation hawks point to the strong employment numbers and rising wages, along with surging prices for oil and other commodities. Recession is on the minds of folks watching the soft housing market, subprime mortgages and potential problems with rising mortgage delinquencies. When the markets focus on inflation, they move away from bonds, worried about rising yields. When the markets focus on recession, they run toward bonds seeking a safe haven from risk. Wall Street appears eager for input on this debate, poring over minutes from each meeting of the Federal Reserve and attentive to every word from Chairman Ben Bernanke.

There is some possibility that the economy could drift off either side of the road, into the inflation weeds or a recession rut, although the most likely scenario continues to be one of modest growth. In our view, monetary policy holding short rates at 5¼ percent already represents a foot on the brakes that should be sufficient to keep the economy from overheating. There also appears to be plenty of forward momentum to keep it from stalling, particularly when we see growth in virtually every geographic sector of the globe. American companies have an expanding customer base all over the world. Weakness in the housing market may affect some local spending patterns, but it is unlikely to derail the global economy that drives corporate profits.

We do anticipate the road ahead could be bumpier than the smooth ride we enjoyed during the second half of 2006. Given all the potential hazards navigated during 2006, we were pleasantly surprised at how well the markets reacted. Many of those hazards are

still with us, particularly the geopolitical issues that will probably get more attention as we head into the 2008 Presidential elections. Also, we believe there are too many hedge funds chasing the same strategies. That kind of fast-money traffic creates the potential for big, leveraged bets to go awry somewhere, causing a pile-up and related gawkers' block on Wall Street. We refer to those as "headline risks," the potential for scary news headlines that cause nervous traders to run for cover.

The current economic environment should continue to be productive for investors, and yet we also understand how it can be challenging. Bond yields are too low to get most investors up to their desired rate of return to meet their long-term objectives. That means relying upon stocks to grow portfolio values, even though stock prices can be periodically rattled by news headlines along the way. The combination of low-yielding bonds and volatile stocks presents a tough portfolio management assignment.

We continue to focus on earnings and interest rates when taking measure of the capital markets, and those factors remain encouraging. Corporate profits are still on a positive path, and balance sheets are in excellent shape. Low interest rates promote capital investment and mergers/acquisitions, both of which are generally supportive of stock prices. Economies around the world are in a growth mode, which creates an opportunity for businesses to expand their sales, payrolls and profits. Valuations, as measured by price-earnings multiples, are reasonable by historical standards.

Sometimes, just having the right expectations can make a difference in comfort levels. The path to progress rarely runs in a straight line, and bumps in the road are normal for the capital markets. We continue to believe the most likely scenario for the remainder of the year is one of modest economic growth and reasonable gains in corporate profits. Anytime you have thoughts or concerns you would like to discuss, please feel free to give us a call. We welcome your input and the opportunity to take this drive together.