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The stock market got the New Year off to a strong start, while bonds were under some pressure with the Federal Reserve's 15th consecutive interest rate increase. Economic conditions continue to look good, although there are some interesting developments on the political front that might bring a surprise down the road. Investors may want to keep an eye on this fall's Congressional elections.

The *Jobs and Growth Tax Relief Reconciliation Act of 2003* trimmed the taxation of dividends and capital gains, effectively lowering the rate on both items to 15 percent for many investors. However, these benefits came with a sunset provision that causes them to revert back to their prior tax rates at the end of 2008. Similarly, the *Economic Growth and Tax Relief Reconciliation Act of 2001* reduces the taxation of estates in a phased out program that completely repeals estate taxes in 2010, but then reverts back to 2002 levels in 2011. Dramatic shifts in tax policy over time create confusion for investors, and efforts to resolve these bizarre sunset provisions appear to have stalled.

We tread lightly and respectfully on political subjects, and this is not a commentary on whether the tax policies of Republicans or Democrats would be better for the economy. Rather, we simply want to point out that an issue investors expected to be resolved may become uncertain as a result of changes in the political landscape. Given the decline in President Bush's approval ratings and the seats coming up for this fall's Congressional elections, it is possible that the balance of power in the House of Representatives could shift toward a Democrat majority. A politically-divided Congress, with a Republican majority in the Senate and a Democrat majority in the House, could make it more difficult to resolve these cumbersome tax policy issues.

It may also mark a shift of focus in Washington from monetary policy back toward fiscal policy. Congress controls fiscal policy, determining the taxation necessary to fund government-sponsored benefits programs. Monetary policy is set by the Federal Reserve and relates to efforts to control inflation and the rate of economic growth in the country. Attention in recent months has been on monetary policy, as the Federal Reserve has been gradually raising their target overnight lending rate. Those monetary concerns are likely to subside, as we believe the long sequence of rate increases is just about done, and the chairmanship of the Federal Reserve has completed a smooth transition from Alan Greenspan to Ben Bernanke. By summer, investors could become less concerned about

monetary policy and more intent on the fall elections and their implications for dividends, capital gains and estate taxes.

The economic environment generally remains positive for stock prices. Corporate profits continue to do well, and valuations are fair by historical measures. The economy is strong. The employment outlook is constructive, with relatively low unemployment and wages rising at around a three to four percent clip. There is evidence that companies are finally engaging in new hiring and capital spending. Interest rates have moved higher, but they remain at a level which should be conducive to further growth. From an economic standpoint, there is good reason to believe 2006 will be a productive year for investors, and we do not believe political uncertainty will derail that positive scenario.

Taxes often spark controversy during election years, and this fall's Congressional elections are made even more relevant by the recent slide in President Bush's approval ratings. If the elections produce a shift in leadership for the House of Representatives, it could create a Congress that becomes deadlocked along party lines. That would likely delay resolution of the strange sunset provisions in tax relief for dividends, capital gains and estates that investors had expected to be settled. The upcoming debate on Capitol Hill should not overwhelm the otherwise productive economic conditions, but it is likely to have an impact on investors' wallets.