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Investors wrapped up a profitable, yet turbulent year in 2007. Stocks and bonds managed to post reasonable gains, although that point may feel overshadowed by the price swings that occurred along the way. Periods of volatility are triggered when extravagance suddenly gives way to reason. In this case, the mortgage market got overextended. We believe the economy is taking care of wringing out the excesses in the mortgage sector, although it is only mid-way through that process. Many of the issues that emerged last year still need time to unfold, so it will not be surprising to see the capital markets display a lack of conviction in the coming months. We are anticipating a difficult environment for 2008, and we are maintaining a steady, balanced approach to contend with the contradictory messages that are likely to come our way.

Financial services companies are at the center of the mortgage storm, and they have taken the brunt of the impact. That has caused the “value” category, which has a heavy weighting in financials, to relinquish its long-running leadership to the “growth” stocks. The Russell 1000 Growth Index gained 11.81 percent for the year, while the Russell 1000 Value Index actually posted a slight decline of 0.17 percent. Growth reigned supreme in the 1990s, then fell on hard times with the unraveling of technology stocks during the 2000-2002 bear market, at which time value took the lead. These trends tend to run in long, unpredictable cycles, which is why we continue to advise clients to participate in both areas with their core stock holdings. Clients have been well-served by our underweighted position in financials, yet we also believe some good opportunities are forming in that sector for patient shareholders.

With increased volatility in the equity markets, the bond market has made a remarkable “flight to quality” in recent weeks, driving up the prices for U.S. Treasury securities and reducing their yields. That has created some attractive opportunities in the corporate bond area, where corporate spreads have become enticing for the first time in about two years. As we are putting fixed income assets to work, we are finding corporate bonds with strong ratings of AA and even AAA providing a significantly better yield than comparable maturity Treasury issues.

In addition to the more healthy corporate spreads, the overall yield curve has resumed its normal, upward slope. Actions by the Federal Reserve to reduce short-term rates have helped to correct the unusual “inverted” yield curve that perplexed investors in recent years. Given the softening economic conditions, we anticipate the Federal Reserve will continue to cut short-term rates at upcoming meetings. We view this as a positive development, although we also believe longer-term bonds need to offer higher yields to

fairly compensate investors for inflation. Typically, we expect to see 10-year Treasury bonds providing a yield of roughly two percentage points over the rate of inflation. With inflation running around 3½ percent, that suggests a yield of around 5½ percent would be closer to fair value in today's environment. Yields have been driven down to under four percent, which is why we remain focused in the one to five year maturity range until the yield curve steepens.

There is a good chance the economy will experience a recession in 2008, but it is also likely to be over by the time economic statistics confirm that we had one. This year will be the "pig through the python" for the variable-rate mortgage resets, so we expect it will be a peak year for mortgage delinquencies, foreclosures and related concerns for housing's impact on consumer spending. At the onset of a housing downturn, the inventory of unsold homes builds up until sellers finally relent to price reductions. That stage of the cycle appears to be getting underway, so reports of home prices will reflect downward pressure even as transaction volumes improve and inventories get back to a more normal level. Prices are not likely to firm up until supply and demand forces are back in balance and mortgage lenders regain their footing. It will probably be 2009 or even 2010 before home prices resume an upward trend.

Stocks have weathered similar rough patches over the years. Housing went through a significant downturn around 1989-1994. During that time period, there was a recession (7/90 – 3/91), Gulf War (8/90 – 4/91), rising unemployment (from 5.3 percent in 1989 to 7.5 percent in 1992) and political pressure bearing on tax policies. That was a nervous time for investors, yet stock prices were able to make good progress, as the S&P 500 Index roughly doubled in value from 1989 through 1994. In spite of the uncertainties for the economy and outcome of the Presidential elections, fundamental valuations in the stock market are currently attractive, balance sheets are in solid shape, and profit reports in the coming year are forecast to be positive.

Our best wishes to you and your family for the New Year. As always, we welcome your call if you have any thoughts or questions you would like to discuss. We look forward to a productive 2008.