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Good economic reports fueled a nice rally in stock prices during the third quarter, propelling the Dow Jones Industrial Average and the broader S&P 500 Index to new five-year highs. As expected, the Federal Reserve finally paused in its long-running campaign to raise interest rates. Fighting between Israel and Hezbollah abated, for now, and oil prices retreated from their peaks. So far, hurricane season has been relatively calm. By many measures, it is hard to complain about the market's progress in recent months, so why are we still cautious?

The capital markets seem to be experiencing a mild form of bipolar disorder. A little bad news, and the markets react as though the sky is falling. A little good news, and you would think there is not a care in the world. We continue to believe the "truth" is somewhere in the middle, which is why we felt the markets overreacted on the downside in the second quarter and probably got a bit too giddy in the third quarter. These mood swings seem overdone for an economic environment that has generally brought few, if any, surprises since the beginning of the year.

Moderate economic conditions make for dull news, which may explain why some of the topics getting a lot of air-time on cable news channels are more entertaining than they are action-worthy. The big themes are not really new:

- Geopolitical risks, Iraq, terrorism and their potential for economic disruption.
- The high cost of housing, and related mortgage and consumer spending worries.
- Hedge fund speculation in the energy markets that may be exaggerating the volatility of oil prices.
- Gradual improvement in employment and wage increases leading to a modest upswing in inflation.
- Partisan politics in Washington delaying resolution of tax issues.

Considerable attention in recent weeks has been focused on the slowdown in residential housing. Softness in that sector seems long-overdue. While it is true that consumers have been relying upon home equity to support their spending patterns, we believe the resourceful consumer will find new ways to fund their trips to the mall. Traditionally, consumer spending relies upon wage growth, and that picture is encouraging, with wages rising at roughly a four percent clip. Investors will recall the last rough patch for housing, in the 1989-'94 time period. During those six years, home prices were a traumatic headline and the economy did experience a brief recession. However, investors

who held their course did just fine, as the S&P 500 Index generated an annualized return in excess of 12 percent during the 1989-'94 time period.

The bond market appears to be divided between its concerns for recession and inflation. The recession camp was vocal during the recent quarter, which caused the yield on bellwether 10-year Treasury bonds to slip back from around 5.25 percent to around 4.60 percent. We are more in the inflation camp. Government and corporate spending should more than compensate for any softness in consumer spending, allowing the economy to maintain a modest upward trajectory. We continue to view bonds as expensive at these levels, and retain our defensive posture with high credit quality instruments laddered out to around five years in maturity.

November's mid-term elections should be interesting, with a close race for control over the House of Representatives. A big win for the Democrats would allow them to gain majority in the House, while the Republicans are expected to narrowly retain majority in the Senate. A politically divided Congress would raise the likelihood of legislative gridlock for the remaining two years of Bush's presidency, suggesting the two-year extension of tax breaks for dividends and capital gains (through 2010) may be all investors can expect for now.

We believe the market's progress will continue to be characterized by positive economics interrupted periodically by scary headlines. The difficulty for investors is that scary headlines can pop up at any time, and they create an oversized reaction in the capital markets. Bad things are still lurking, and the best defense for investors is to exercise patience. We continue to believe the most prominent risks come from places where people are not playing nicely with others. The Middle East and Korea are regions that remain troublesome. Patience is the best defense against the headline risk that is likely to be exerting influence over the investment climate for the foreseeable future.