Market Commentary: First Quarter 2005

1. Review of the Stock Market for the Quarter

After significant gains in the fourth quarter of 2004, the stock market in the United States has again been stuck in a narrow trading range in the first quarter this year, except for stocks listed in NASDAQ, which has given back all the gains earned in the whole year of 2004. Solid growth in the economy has been offset by the climbing energy prices and rising interest rates. While stocks are definitely not overpriced, they are also not cheap when compared with bonds with rising interest rates. It is my belief that oil prices will eventually come down when the supply and demand are fully restored to balance and speculators reduce their bets on higher energy prices due to the fact that their cost of borrowing continues to go up and the potential return diminishes. If and when energy prices fall back to reasonable levels, the stock market should go higher because corporate earnings are still growing and the long-term interest rates are still very low. However, when that happens is at most an educated guess.

The following table is a summary of the stock market performance measured by the three major indexes (including price changes and dividends paid):

	January	February	March	1st Quarter 2005
SP500 Index	-2.44%	2.10%	-1.77%	-2.15%
Dow Jones IA	-2.59%	2.92%	-2.31%	-2.06%
NASDAQ Index	-5.20%	-0.52%	-2.56%	-8.11%

2. Positive Factors for the Economy and the Stock Market

The following is a list of positive factors that will support strong economic growth and higher stock market valuation in the quarters ahead:

- Although pricing pressure continues to build in the economy due to higher energy prices, the long-term expectation of inflation remains low. With the Fed continuing the slow but steady pace of raising interest rates, the bond market does not anticipate a big flare-up of inflation. This expectation of low long-term inflation is reflected in the still very low long-term interest rates. However, if inflation expectations build up in the economy, both bonds and stocks would suffer heavily, just as they did in the 1970s. High inflation is probably the worst enemy of financial markets and we need to watch it very closely. However, it is an interesting fact, though often ignored by the financial markets, that low inflation in the neighborhood of 2%, is actually a good thing for stocks since companies can raise prices and debtors including the U.S. governments, households, and corporations, find their debt burdens reduced in terms of purchasing power.

- The economy is on a path of moderate and sustainable growth, despite the fact that energy prices reached new highs last week. Economists are now forecasting the U.S. GDP growing at a rate of 3.0 to 4.0% in 2005. The strengthening job market has boosted consumer confidence and increased their purchasing power. The fact that the job market is not expanding rapidly suggests that labor costs are not going up fast enough to add pressure to inflation. It seems reasonable to assume that a sustainable economic growth will last for several years, unless the oil prices continue to rise or there is an unexpected exogenous shock to the economy or the financial markets.

- Despite the fact that the Federal Reserve Bank has raised the short-term interest rates by 1.75% so far, the long-term interest rates are actually lower than one year ago. The Fed communicates that the pace of credit tightening will be "measured" unless inflation picture gets uglier.

- Manufacturing is still expanding rapidly and business investment is growing strongly. Manufacturing industries were hit really hard in the 2000-2001 Recession and slower in recovery. But now it is growing strongly. Lower U.S. dollar value against Euro and Japanese Yen makes U.S. manufacturers more competitive in international markets.

3. Negative Factors or Risks Facing the Economy

While some of the old worries about and threats to the economy and the stock market are gone, new threats are emerging:

- Energy costs are high. There is ample supply of oil and sufficient inventory in the U.S and international markets (please read the attached report on oil inventories). However, increasing demand from China and India is expected to result in permanently higher oil prices for a long time to come. Political uncertainties in oil-producing countries, especially in Middle East, drives up oil prices. Excess liquidity in the economy leads to frenzy speculations on energy and raw materials. Higher energy costs affect consumer confidence, reduce spending power of consumers, and reduce corporate profitability. Over longer term, high energy costs also tend to push up inflation rates. This is probably the most significant threat to the U.S. and global economy. At the least, persistently higher energy costs would push the Fed to raise interest rates more aggressively in order to contain inflation. Higher energy prices have already diminished the prospects of economic growth in Europe and Japan, which, in turn, has resulted in slower growth of demand for U.S. products and services.

- Consumer spending has clearly slowed. Massive tax-cuts and cash-out in mortgage refinancing are gone now and consumer debts are in high levels. Job market growth is steady but somewhat slow and the higher energy costs are reducing money available for other purchases. Healthcare costs are still increasing at double-digit rates.

- Interest rates will continue to increase this year. Higher interest rates of course lead to lower valuation of all types of financial securities, including bonds and stocks. The Fed is expected to raise interest rates until at least end of 2005.

- Corporate earnings will continue to increase, but on a much slower pace. Analysts are now anticipating growth rate of 6 to 10% this year, compared with more than 20% increase in 2004. If the growth in the sectors of energy and raw materials are removed, the growth rate of earnings in all other sectors would be even lower.

- Worries about inflation are affecting investor sentiments and raise the expectation that the Fed will raise interest rates more aggressively in the future.

4. Valuations of Stocks and Investment Strategy

- With the yield of 30-year Treasury bond at 4.74% and the median P/E ratio of 18.0 for the SP500, U.S. stocks appear to be undervalued by about 10 to 14%. At the beginning of 2004, the long-term interest rate was at 5.0% and P/E at 18.9. In terms of P/E ratio, stocks are valued somewhat lower than one year ago. But long-term interest rates are actually lower, making stocks slightly more attractive than bonds. Even if corporate earnings grow at slower rate this year, stocks are probably still the best investment class unless inflation fears come back to haunt the market and investors.

- If long-term interest rates remain stable, I would expect that the stock market would go up by 8 to 12% in 2005. Obviously, any further advance in stock prices depends on the expected growth in corporate earnings and stable long-term interest rates. *Oil prices would be a decisive factor for the directions of movements in the prices of stocks and bonds this year.*

- I would think that stocks and corporate bonds (including convertible corporate bonds and high-yield corporate bonds) are still better investment vehicles for the next few years. However, the easy money has been made in the stock market in 2003 and it needs more skills to pick out good stocks and corporate bonds in the future. We should also be watchful on the development of the *economy*, *energy costs*, *inflation expectations*, *global situations*, *stock valuation*, *interest rates*, *corporate profitability*, *etc*., and adjust our portfolios according to new information. The lessons of 2000-2002 bear market should always be in our minds: diversification and controlling risks, especially when the stock market is going up and everything about the economy and stock market appears perfect. By the same token, if investors are in a panic mood while the fundamentals for the stock markets are good, it might indicate better returns ahead and patient investors will be well rewarded for their patience. A disciplined approach is the only successful approach for long-term investors.