



Market Commentary: Third Quarter 2005

1. Review of the Stock Market for the Quarter

After modest declines in the first two quarters, the stock market managed to show some strength in the third quarter. Solid growth in the economy has been offset by the climbing energy prices and rising interest rates. After the worst natural disaster in American history, Hurricane Katrina, came with Hurricane Rita. It is quite a pleasant surprise to see the stock market did not go down significantly after the disasters. However, for the first three quarters of this year, the stock market remained mixed.

While stocks were modestly down so far this year as of yesterday, it is still encouraging to see the resilience of the stock market against the headwind of climbing energy prices, rising interest rates, economic devastations caused by the hurricanes, and geopolitical uncertainties. 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):

	July	August	September	3rd Quarter 2005
SP500 Index	3.72%	-0.91%	0.81%	3.61%
Dow Jones IA	3.72%	-1.19%	0.94%	3.45%
NASDAQ Index	6.22%	-1.50%	-0.02%	4.61%

	1st Quarter	2nd Quarter	3rd Quarter	YTD (9/30/2005)
SP500 Index	-2.15%	1.36%	3.61%	2.76%
Dow Jones IA	-2.06%	-1.61%	3.45%	-0.32%
NASDAQ Index	-8.11%	2.90%	4.61%	-1.09%

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 energy prices remain very high, the long-term expectation of inflation remains low. Prices of basic materials such as steel and ocean shipping rates have declined quite significantly since the end of 2004. Inflation statistics reported in the last few months suggest that the inflation is still mild. Overall consumer prices are increasing at 3.6% annually while the core inflation excluding volatile energy and foods is going up by less than 2%. 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. It is also worth noting 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 economic growth will be slower in the fourth quarter due to the impact of Hurricane Katrina, although economic data reported so far seems to suggest that the economy withstood the impact better than expected. In addition, the massive Federal aids to the affected states will actually strengthen economic growth in 2006. The net effect of natural disasters on aggregate economy tends to be positive. It seems reasonable to assume that a sustainable economic growth will last for several more years, unless the oil prices continue to rise or there is an unexpected exogenous shock to the economy or the financial markets. Solid economic growth generates healthy growth of corporate profits, which is one of the two fundamental factors driving the stock market higher. The other factor is low and stable interest rates.
- Despite the fact that the Federal Reserve Bank has raised the short-term interest rates 11 times or by 2.75% 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. There are already some talks or speculations about the end of the Fed’s credit-tightening campaign before the year end or the first half of 2006. If the Fed could finish this campaign without pushing the economy into a recession or causing major financial disasters, it would be a major plus for the stock markets.
- The housing market is still going strongly despite signs of bubbles in some cities on the East and West Coasts. The housing sector has been the major support for the U.S. economy since 2001. So long as the long-term interest rates stay low, the housing sector will not collapse as some analysts are worried about.

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. However, increasing demand from China and India is expected to result in permanently higher oil prices for a long time to come. Political uncertainty in oil-producing countries, especially in the Middle East, drives up oil prices. Excess liquidity in the economy leads to frenzied speculations on energy. Higher energy costs affect consumer confidence, reduce spending power of consumers, and reduce corporate profitability. Over the long term, high energy costs also tend to push up inflation. 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.
- The Fed will continue to raise the short-term interest rate until it feels comfortable about inflation. The market now anticipates that the Fed will raise the interest rates three more times by the end of January 2006. There is always a risk that the Fed may raise it by too much and too fast. The worry about over-tightening credit will always be an obstacle to higher stock prices.

- Corporate earnings will continue to increase, but on a much slower pace. Corporate earnings have 8th consecutive quarter of double-digit growth for the SP500 Index. Analysts are now anticipating growth rate of 16.4% for the third quarter of 2005. If economy continues its steady and modest growth, the corporate earnings should also continue to grow at reasonable pace.

4. Valuations of Stocks and Investment Strategy

- With the yield of 30-year Treasury bond at 4.57% and the median P/E ratio of 17.7 for the SP500 stocks, U.S. stocks appear to be undervalued by about 20%. At the end of 2004, the long-term interest rate was at 4.92% and P/E at 19.3. In terms of P/E ratio, stocks are valued somewhat lower than nine months ago. But long-term interest rates are much lower, making stocks more attractive than bonds. The analysts at Thompson Financial, a major financial company, believe that the stock market is most undervalued since September 2002!
- 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 and the next year. Also, the ending of the Fed's credit tightening process would help the stock market a lot.*
- 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.