



## Market Commentary: Fourth Quarter 2005

### 1. Review of the Stock Market for the Quarter and for the year

After strong gains in the third quarter, the stock market managed to go up a little more in the fourth quarter. For the whole year, all three indexes (SP500, Dow Jones, and NASDAQ) achieved small, but nevertheless positive, returns. The 30-day Treasury Bills yielded about 3% last year, only the SP500 returned a little higher (4.67%). Investors who invested in Dow Jones and NASDAQ indexes would be disappointed, with returns of % and %, respectively.

It is actually very encouraging to see the resiliency of the stock market against the headwinds of climbing energy prices, rising interest rates, economic devastations caused by the hurricanes, and geopolitical uncertainties. The U.S. economy grew solidly last year, probably at a rate close to 4%. The principal components in the economic engine remain in place. Economic expansion is expected to continue in 2006 and beyond. The Federal Reserve is close to the end of its credit-tightening campaign. If and when energy prices fall back to reasonable levels (between \$55 and \$60 a barrel), the stock market should go higher because corporate earnings are still growing and the long-term interest rates are still very low. I expect that the stock market in 2006 would be much better than in 2005. But there are always pleasant and unpleasant surprises in the economy and the stock market. Managing investment risk due to these surprises is a very important part of my job as your investment manager. I will continuously monitor and watch these events to ensure that your portfolio's exposure to risk is reduced.

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

	<b>October</b>	<b>November</b>	<b>December</b>	<b>4th Quarter 2005</b>	
SP500 Index	-1.67%	3.78%	-0.18%	1.86%	
Dow Jones IA Index	-1.09%	3.92%	-0.95%	1.81%	
NASDAQ Index	-1.46%	5.31%	-1.77%	1.94%	

  

	<b>1<sup>st</sup> Quarter</b>	<b>2<sup>nd</sup> Quarter</b>	<b>3<sup>rd</sup> Quarter</b>	<b>4<sup>th</sup> Quarter</b>	<b>Y2005</b>
SP500 Index	-2.15%	1.36%	3.61%	1.86%	4.67%
Dow Jones IA Index	-2.06%	-1.61%	3.45%	1.81%	1.49%
NASDAQ Index	-8.11%	2.90%	4.61%	1.94%	0.82%

### 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:

- It is widely anticipated that the Federal Reserve Bank will complete its campaign of raising interest rates in either January or March. Most economists expect the Fed to raise interest rates by 0.25% in January and 0.25% again in March. Despite the fact that the Federal Reserve Bank has raised short-term interest rates 13 times or 3.25% from a 40-year record low of 1% in 2004, the long-term interest rates are actually lower than one year ago. 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 worry that the Fed may raise the interest rate too much is one of the reasons that the stock market did not do well in 2005.

- Although energy prices remain very high, the long-term expectation of inflation remains low. Inflation statistics reported in the last few months suggest that inflation is still mild. Overall consumer prices are increasing at 3.6% annually while the core inflation, excluding volatile energy and food, is going up by less than 2%. Globalization and outsourcing has been restraining the pricing power of firms and lessening wage pressures. 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 expansion will continue, though at a slower but still-respectable rate of 3.3% to 3.5% in 2006 after expanding 4.2% in 2004 and roughly 3.7% in 2005. Solid economic growth in the past three years has resulted in record growth in corporate earnings. So even if the bull market which started in October, 2002 ages, the valuation of stocks in the U.S. is still very reasonable because corporate earnings have been growing even faster than the stock prices.
- After reaching \$70 a barrel immediately after Hurricane Katrina, oil prices have retreated into a range of \$57 to \$64. Gas prices have also come down dramatically. If energy costs stay at current levels, or even gradually decline, it would be a significant boost to the economy and to the stock market.

### **3. Negative Factors or Risks Facing the Economy**

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

- The signs are emerging that the U.S. real estate sector is slowing down. According to Alan Greenspan, some markets on the West Coast and East Coast are in a “frothy state”. The strong housing market over the last five years is the most important driving force behind the economic growth. As the hot housing market cools off gradually in 2006, it will have a negative impact on consumer spending and employment growth as well. But most experts think that the housing sector will have a soft-landing in 2006, instead of nationwide collapse.
- Energy costs are still 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.
- The U.S. dollar performed well last year, defying expectations of a dramatic depreciation. In 2005, the dollar appreciated against the euro and the Japanese yen, the two major global

currencies. However, the risk is still there that the large depreciation of the dollar is needed to reduce the large U.S. trade deficits which now reach 6.0% of GDP. Foreigners own around \$2.0 trillion in Treasury Securities (as of June 2005), nearly 53% of outstanding public debts. If the U.S. dollar is to depreciate dramatically, long-term interests will go up significantly, threatening the ongoing economic expansion and increasing risk premiums in the U.S. financial markets.

#### 4. Valuations of Stocks and Investment Strategy

- With the yield of 30-year Treasury bond at 4.4% and the median P/E ratio of 18.6 for the SP500 stocks, U.S. stocks appear to be undervalued by about 15%. At the end of 2004, the long-term interest rate was at 4.9% and P/E at 19.3. In terms of P/E ratio, stocks are valued somewhat lower than one year ago. But long-term interest rates are much lower, making stocks more attractive than bonds. The undervaluation of stocks today are due to concerns about the Federal Reserve making mistakes raising interest rates too much, high energy costs, and geopolitical uncertainties.
- 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 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. I expect that the U.S. stocks would probably go up by 10% or more in 2006 if we do not have any ugly surprises in the economy or markets.