



Market Commentary: First Quarter 2006

1. Review of the Stock Market for the Quarter

After modest gains in the fourth quarter of 2005, the stock market in the United States has seen the best first quarter since 2002. Investors are hopeful that the Federal Reserve Bank will soon end its interest rate-raising campaign. After hitting a soft patch in the last months of 2005, the U.S. economy grew strongly in the just ended first quarter of 2006. Corporate earnings are still growing at double-digit rates. The aforementioned reasons, as well as mild inflation, are behind the good market performance in the first quarter.

However, energy prices are still high. Prices of other raw materials are continuing to rise. The Fed raised interest rates for the 15th time in March and is now expected to raise interest rates at least one more time. There is a risk that the Fed may overdo the rate raising, pushing the economy into recession in 2007. The long-term interest rates are slowly going up. The housing market is cooling down. Stocks are no longer undervalued.

My quantitative model suggests that the stock market is properly priced. There will be ups and downs in the market for the rest of the year. Be prepared for volatility.

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 2006
SP500 Index	2.65%	0.27%	1.20%	4.16%
Dow Jones IA	1.50%	1.48%	1.28%	4.32%
NASDAQ Index	4.56%	-1.06%	2.70%	6.24%

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 soon. Most economists expect the Fed to raise interest rates by 0.25% in May and, possibly, 0.25% again in June. Despite the fact that the Federal Reserve Bank has raised short-term interest rates 15 times or 3.75% from a 40-year record low of 1% in 2004, the long-term interest rates are still low by historical standards. If the Fed finishes this campaign without pushing the economy into a recession or causing a major financial disaster, 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 stock prices.

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:

- 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. 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.
- More 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 a nationwide collapse.
- 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 deficit, which now reaches 6.0% of U.S. 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 4.9% and the median P/E ratio of 19.6 for the SP500, U.S. stocks appear to be properly valued. If long-term interest rates rise above 5.5%, we might conclude that stocks are not as attractive as bonds.
- Obviously, any further advance in stock prices depends on the expected growth in corporate earnings and stable long-term interest rates. *Oil prices will be a decisive factor for the direction 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 still expect that U.S. stocks will probably go up by 10% or more in 2006 if we do not have any ugly surprises in the economy or markets.