Market Commentary: Second Quarter 2006

1. Review of the Stock Market for the Quarter

After enjoying the best first quarter since 2002, the stock market in the United States experienced the worst second quarter since 2002. So the gains made in the first quarter were basically offset by the losses in the second quarter. Investors are increasingly worried about the prospect that the Federal Reserve Bank may push the U.S. economy into recession in 2007 because it may overshoot in its interest rate-raising campaign. After hitting a soft patch in the last months of 2005, the U.S. economy grew by 5.6% in the first quarter of 2006. The growth rate in the U.S. economy might be too strong and the core inflation rate excluding energy and foods is above the comfort level of the Fed officials so that they will continue to raise interest rates in order to bring the inflation rate to be below 2%.

Economic landscape usually changes slowly in any given quarter. But risk attitudes of investors can change in a matter of hours. That is the reason why there was a global sell-off in the last two months. Hopefully, the panic selling has run its course and investors may begin to see more the positive sides of the growing economy and strong corporate earnings growth. But the stock market will probably see more volatility this year before climbing to higher level.

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

	April	May	June	2nd Quarter 2006
SP500 Index	1.34%	-2.88%	-0.78%	-2.35%
Dow Jones IA	2.48%	-1.46%	-1.16%	-0.19%
NASDAQ Index	0.96%	-7.76%	-0.32%	-7.17%

	1st Quarter	2nd Quarter	YTD (6/30/2006)
SP500 Index	4.16%	-2.35%	1.76%
Dow Jones IA	4.32%	-0.19%	4.04%
NASDAQ Index	6.24%	-7.17%	-1.51%

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:

- More signs are emerging that the U.S. real estate sector is slowing down. Many analysts are worried that there will be a big real estate bubble bursting. So far the decline of the housing sector appears to be slow and orderly.

- The economy grew very strongly at the rate of 5.6% in the first quarter of 2006. The growth rate in the second quarter is forecasted to be around 2.6%. The economy is expected to grow between

2.5% and 3.0% over the next six quarters. Economists are forecasting only 20% of a recession in 2007. The strong growth in the economy supports income growth of consumers, which is now even more important given the fact that energy costs are reducing consumers' purchasing power.

- The solid economic growth in the past three years has resulted in record growth in corporate earnings. The strong growth in corporate earnings is one of the foundations supporting stock market valuations.

- Long-term interest rates are still very low. The 30-year treasury bonds now yield only 5.28%. Low long-term interest rates keep borrowing costs of corporations low and help the economy expand.

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:

- Most economists expect the Fed to raise interest rates by 0.25% again in August and then pause. If the Fed finishes this interest-raising 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 the last two months.

- The inflation picture remains mixed. While the core inflation rate excluding volatile energy and foods is slightly above 2% level, it is not even remotely close to the dreadful hyperinflation experienced in the 1970s and early 1980s. 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.

- 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.

- 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. 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 5.28% and the median P/E ratio of 17.8 for the SP500, U.S. stocks appear to be slightly undervalued. 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. <u>*Oil prices will be a decisive factor for the direction of movements in the prices of stocks and bonds this year.*</u> The U.S. stock market will probably be very volatile until the Fed concludes its campaign of raising interest rates to prevent inflation from getting out of control.

- 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.