



Market Commentary: Forth Quarter 2006

1. Review of the Stock Market for the Quarter

The upward momentum started in August 2006 continued to the finish of the year. The Dow Jones Industrial Average is now over the record set in 2000, although both the Standard and Poor 500 Index and NASDAQ index are still far below their peaks. After being almost flat from 2004 to 2005, the stock market has a very strong year in 2006. The market performance in the 4th quarter surpassed expectations of almost every one. Energy prices have declined by more than 30% over the last few months. The Federal Reserve Bank stopped raising interest rate in June. Corporate earnings grew almost 20% again in the third quarter of 2006. Inflation rate is coming down. Long-term interest rates also declined.

However, not every stock or sector went up in the quarter. With the economy slowing down, growth companies suffered while the value strategy of investing benefited. The best performing stocks or sectors in 2006 are the laggards in the previous years. As expected, the government bond market continued to have low returns in 2006 as in the previous few years.

I am cautiously optimistic about the stock market and corporate bonds market for the next three to five years. Please read my comments in the next few pages.

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

	October	November	December	4th Quarter 2006	
SP500 Index	3.26%	1.90%	1.40%	6.70%	
Dow Jones IA	3.57%	1.55%	2.11%	7.39%	
NASDAQ Index	4.79%	2.75%	-0.68%	6.94%	

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	YTD
SP500 Index	4.16%	-2.35%	5.33%	6.70%	15.79%
Dow Jones IA	4.32%	-0.19%	5.18%	7.39%	19.06%
NASDAQ Index	6.24%	-7.17%	4.03%	6.94%	9.52%

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:

- Energy prices continue to decline significantly since July 2006. Speculators on energy products and commodities began to abandon their speculative positions. The demand for energy products is also slowing due to slower economic growth and warmer winter. Energy inventories worldwide

are higher than historical average. If energy prices do not flare up again, the economy and the stock market will get a significant boost over the next few years.

- The Fed seems to be aware the possibility that it might overshoot in raising interest rates to fight inflation as it did in the past. It is still worried about the inflation which is currently over its comfort level of 2%. But the Fed thinks that a slowing economy will bring down the inflation eventually. Hopefully, the inflation will continue to come down over the next few quarter as it did over the last two months. If the Fed begins to cut interest rates some time in 2007, as many Fed watchers and the bond market are betting, the stock market will continue to go higher.
- Long-term interest rates have come down over the last few months. Low long-term interest rates keep borrowing costs of corporations and consumers low and help the economy expand.
- The U.S. economy is still expanding, though at a pace lower than its potential. Economists believe that the economic growth will accelerate in the second half of 2007.

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:

- Situations in Iraq are getting worse by the day. The internal strife in Iraqi may lead to regional conflict that will definitely lead to very volatile oil prices. The biggest threat to the global economy is still the fragile oil supply from Middle East.
- The U.S. housing sector and automobile manufacturing sector are very weak. Average national house prices have been declining for the last few months. Unsold inventories are very high by historical standards. Though there are tentative signs that the housing sector is stabilizing, the weakness may last into 2008. The weakness in housing and auto sectors may spill over into other sectors of the economy and leads the national economy into a recession in 2007.
- The Fed is still worried about inflation. The labor market is very tight and labor compensations are increasing at a rate that will put pressure on both inflation rate and corporate profits.
- The U.S. dollar declined modestly in 2006. The risk is still there that large depreciation of the U.S. dollar is needed to reduce large U.S. trade deficits, 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.
- The growth rate in corporate earnings may finally slow down to a single-digit rate after growing at more than 15% a year from 2002-2006.

4. Valuations of Stocks and Investment Strategy

- With the yield of 30-year Treasury bond at 4.75% and the median P/E ratio of 18.3 for the SP500 companies, U.S. stocks appear to be undervalued by about 10%. I do not expect market crashes on the scale of 2000-2002 on the horizon since the stock market is NOT overvalued. However, market correction around 10% can happen anytime as it did in the summer of 2006. Since it is

difficult to forecast that kind of correction, I would recommend staying in the markets unless the market is to crash soon.

- I think that stocks and corporate bonds are still better investment vehicles for the next few years. If the U.S. economy does not go to recession in 2007 or 2008, it is very likely that the U.S. stock market will bring an average annual return between 10 to 12% over the next 3-5 years.
- Professional money manager have a tough year of comparing with market indexes in 2006. Only 20% of mutual fund managers beat market indexes last year. Even legendary manager such as Bill Miller of Legg Mason Value Fund trailed the market indexes badly. The best performing DOW stock in 2006 is General Motors, which is the worst performer in 2005. The worst performing DOW stock in 2006 is Intel, which is the best in 2005. Stocks picked by me did very well from 2003 to 2005 but lacked behind from April to October of 2006. I prefer to stick to the same investment strategy which attempts to have a higher long-term return. Chasing last quarter's winner is not a winning strategy.