



## Market Commentary: First Quarter 2007

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

The first quarter was a tale of two markets. Initial upbeat reports on the economy and corporate profits sent stock prices higher steadily into mid-February. As February ended, though, perception changed and investors lost some of their appetites on taking investment risks. The volatility was highlighted by a one-day plunge of more than 400 points in the Dow Jones Industrials and similar percentage losses in the other major averages. The end result was a mixed first quarter.

As we start the second quarter, there are supports for both bulls and bears in the stock market. The economy is still growing, although at rate below its potential. The Federal Reserve Bank stopped raising interest rates since last August and hinted cutting interest rate as a possible next move. However, energy prices are still high. The housing market has been still going 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):

	<b>January</b>	<b>February</b>	<b>March</b>	<b>1<sup>st</sup> Quarter 2007</b>
SP500 Index	1.51%	-1.96%	1.12%	0.64%
Dow Jones IA	1.40%	-2.52%	0.84%	-0.32%
NASDAQ Index	2.01%	-1.94%	0.23%	0.26%

### 2. Positive Factors for the Economy and the Stock Market

The following is a list of positive factors that will support moderate economic growth and higher stock market valuation in the quarters ahead:

- The inflation is moderating. The Fed is getting more comfortable about the trend in core inflation which is gradually falling below its comfort level of 2%. If the Fed begins to cut interest rates sometime in late 2007 or early 2008 to stimulate economic growth, as many Fed watchers and the bond market are betting, the stock market will continue to go higher.
- Personal income and spending continue to increase. Consumer spending accounts for about two-thirds of national product. It seems that the declining housing markets have not affected consumer spending yet.
- The U.S. economy is still expanding, though at a pace lower than its potential. Economists believe that the economic expansion will continue for the next few years.

- Valuations of stocks are not low, but not so high as causing concern of crash among investors.

### **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 prices flare up again in the last few months. Even if higher energy prices do not lead to higher core inflation, they do squeeze companies and households in terms of profits and purchasing power, respectively.
- There are no signs of progress in Iraq. The internal strife in Iraqi may lead to regional conflict that will definitely result in 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 still spill over into other sectors of the economy and leads the national economy into a recession in 2008. Troubles in the sub-prime mortgage market spells more troubles for the housing market.
- 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 in the first quarter is about 7.8%, a single-digit rate for the first time, after growing at more than 15% a year from 2002-2006. They are expected to stay below 10% for the next few quarters as well.

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

- With the yield of 30-year Treasury bond at 5.15% and the median P/E ratio of 19.4 for the SP500 companies, U.S. stocks appear to be no longer undervalued. 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 market unless the market is forecast 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 9 to 11% over the next 3-5 years.
- I have been doing extensive research in a new type of investment vehicle: Exchange Traded Funds (ETF) this year. They are traded as stocks and have very low costs. They present opportunities for participating in certain market segments or investment strategies. I will buy them in your accounts if I believe that they are a good fit for your portfolio.

