



Market Commentary: Third Quarter 2007

1. Review of the Stock Market for the Quarter

The stock market was on a roller-coast ride for the quarter. After hitting historical highs for both the Dow Jones Industrial Average and Standard & Poor's 500 Index in mid-July, panic selling in all risky assets of investments followed woes of credit markets. A credit crunch occurred because of the trouble in the U.S. sub-prime mortgage market. Worried about its potentially severe damages to economic growth, the Federal Reserve Bank cut interest rates by 50 basis points in its September meeting. The Fed's bold action was enthusiastically received by the stock market. Now the market has almost recovered from the decline experienced from mid-July to mid-September.

For the quarter, S&P went up by about 1.3% while smaller stocks represented by Russell 2000 index went down by almost 4.0%. Since March of 2006, largecap stocks have been outperforming Midcap and Smallcap stocks because investors believe that in large companies can hold up better than smaller companies.

My quantitative model suggests that the stock market is slightly under priced. There will be ups and downs in the market for the rest of the year and in 2008. Be prepared for volatility.

The following table is a summary of the performances of the stock market, convertible bonds, and corporate high-yield bonds. Those are the asset classes we have been investing in.

	<u>July</u>	<u>August</u>	<u>September</u>	<u>3rd Quarter 2007</u>
SP500 Index	-3.1%	1.5%	3.0%	1.3%
Russell 2000 Index	-6.8%	2.3%	1.0%	-3.8%
Thomson Convertible	-1.5%	0.1%	1.0%	-0.4%
Lehman High Yield	-3.5%	1.4%	1.0%	-1.3% %

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 Federal Reserve Bank cut interest rates in its September meeting. The size of the cut was larger than expected by most analysts. The inflation continues to moderate. The Fed is getting more comfortable about the trend in core inflation which is gradually falling below its comfort level of 2%. The Federal Reserve Bank has more room to cut interest rates over the next few quarters to help the economy from being dragged into recession by the housing downturn.
- Overall consumer spending and personal income have been holding up well enough despite all the negative factors: higher energy prices, credit crunch since July, slower job growth, and declining house prices.

- Manufacturing is still expanding because international demands are strong due to weaker dollars and fast economic growth in developing economies.
- Valuations of stocks are very reasonable since the long-term interest rates have declined dramatically since June.

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 have not resulted in higher core inflation, they do squeeze companies and households in terms of profits and purchasing power, respectively.
- 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. All statistics related to the housing sector show that the bottom is not reached and the downturn may last well 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. Economists now estimate that there is about 40% of chance that the economy will experience a recession over the next few quarters.
- The U.S. dollar continues to decline. 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 4.81% and the median P/E ratio of 18.6 for the SP500 companies, U.S. stocks appear to be undervalued by 5 to 10%. The market valuation is very reasonable. If the interest rates do not go well up and the corporate earnings manage to grow over the next few quarters, I do not anticipate a bear market for stocks.
- 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 have been buying them for your accounts if I believe that they are a good fit for your portfolio.

