



Market Commentary: Forth Quarter 2007

1. Review of the Stock Market for the Quarter

The volatility in the stock markets remained high for the quarter. After recovering from a correction (defined as more than 10% decline) in August and reaching new highs in early October, worries about credit markets resurfaced in October and stocks of all caps went down and the U.S. stock markets had a worst fourth quarter in ten years.

For the quarter, S&P went down by about 3.3% while smaller stocks represented by Russell 2000 index went down by almost 4.6%. For the whole year, Large-cap and Mid-cap stocks moved up slightly while smaller companies went down. It is a volatile and mixed year for stocks in general. Several industrial groups, such as Aerospace/Defense, Oilfield Services, Computer Software, and the Internet Industry advanced nicely while sectors associated with real estate, financial institutions, and retailing went down significantly. Since March of 2006, largecap stocks have been outperforming Midcap and Smallcap stocks because investors believe that large companies can hold up better than smaller companies in an economic recession.

The New Year is starting out on the sluggish side. While central banks began to have successes in injecting liquidity into money markets and preventing credit crisis spread from the housing sector to other areas of the economy with their coordinated and bold actions, the U.S. economy maybe be entering, if not already in, a recession due to high energy prices, housing slump, and credit woes. The stock market in 2008 will be as volatile, at least in the first half of 2008, as in 2007.

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

	October	November	December	Q4 of 2007	2007
SP500 Index	1.59%	-4.18%	-0.69%	-3.33%	5.49%
Russell Midcap Index	1.61%	-4.78%	-0.32%	-3.54%	5.60%
Russell 2000 Index	2.87%	-7.18%	-0.06%	-4.58%	-1.57%
Lehman High Yield	0.60%	-2.17%	0.29%	-1.30%	1.88%

2. Positive Factors for the Economy and the Stock Market

The Good News:

- The Federal Reserve Bank has cut the federal funds rate (the interest rate it controls directly) three times since last summer, bringing that short-term interest rate down from 5.25% to 4.25%. It is widely expected that the Fed is going to aggressively cut interest rate in its January and March meeting, perhaps bringing the Federal funds rate down to 3% in 2008. Since the monetary actions by the Fed take from 6 to 12 months to have impact on the real economy, the Fed may not be able to prevent a recession, but will definitely limit the severity of a recession.

- 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.
- Strong economic growth overseas is the bright spot for U.S. companies as lower dollar values make U.S.-made goods and services more competitive. International trades have begun to make positive contributions to the U.S. GDP since late 2006.

3. Negative Factors or Risks Facing the Economy and the Stock Market

The Bad News:

- The economy has taken a sudden turn for the worse. Recent reports show declining levels of manufacturing activity, sluggish employment growth and a rising unemployment rate, and a slowing rate of increase in nonmanufacturing activity. The economy may be already in recession (commonly defined as two consecutive quarters of declines in gross national product). A recession will result declining or very slow growing corporate earnings. Corporate earnings are one of two fundamental supports for higher stock prices. Another is long-term interest rate.
- Energy prices flare up again in the last few months. Even if higher energy prices have not resulted in higher core inflation yet, they do squeeze companies and households in terms of profits and purchasing power, respectively. Higher inflation numbers as reported in the last few months complicate the job facing the Federal Reserve Bank in maintaining overall price stability and sustaining economic growth.
- The U.S. housing sector has not seen the bottom yet. Financial companies are in a mess. They fooled themselves in believing that national housing prices will never go down. They made easy money in sub-prime and option mortgages a few years ago. Now the payback in those securities is so big that even largest financial institutions such as Citicorp and Merrill Lynch are scrambling for capital infusion from overseas investors. It will take at least a few more quarters before the financial mess is cleared up.
- Credit markets began to show signs of thawing after central banks in the developed economies injected unprecedented amount of liquidity into money markets since last August. But the foundation of credit markets is still very shaky. Only time and forceful actions of central banks will heal this very important market.
- Investors are clearly frightened. The flight to safety pushed down prices of all risky asset classes: corporate bonds, stocks, and real estate trusts. Rumors fly wide and high. Even banks do not want to lend to each other for fear of counter-party risks.

4. Valuations of Stocks and Investment Strategy

- With the yield of 30-year Treasury bond at 4.29% and the median P/E ratio of 15.8 for the SP500 companies, U.S. stocks appear to be significantly undervalued. The market valuation is very reasonable comparing with historical averages. Should the outlook for the economy not prove as dire as the data now, suggest stocks could trend higher for 2008 as a whole. Market rallies very often get under way during periods of intense despair, such as we are seeing now.

- I think that stocks and corporate bonds are still better investment vehicles for the next few years. If the U.S. economy does not repeat the experience of 1970s, namely, stagflation, it is very likely that the U.S. stock market will bring an average annual return more than 12% over the next 3-5 years. Since timing market turns is impossible on a consistent basis, patience is prerequisite of achieving long-term investment objectives.
- I have been doing extensive research in a new type of investment vehicle: Exchange Traded Funds (ETF) last 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.
- With a significant percentage of your portfolio invested in various ETFs, your portfolio risk is reduced to the extent that we can reduce the number of individual stocks. I think 20 to 50 companies with strong growth potentials will give your portfolio decent growth potential. Smaller number of individual stocks will also allow me to react more quickly to market conditions. This process of consolidating your portfolio is expected to be completed by April of 2008.