“Melt-Up”

As of November 10, 2006

Wall Street was a lot cleaner last week with several obstacles out of the way. As the curtain finally fell on the midterm elections and earning season, the stock market continued to rev up its horse power toward a clearer direction. For the week, the **Dow** finished up 1% to 12,106.35 and has now gone over 900 days without a 10% correction. The **S&P 500** added 1.2% to close at 1380.77 and the **Nasdaq** was up 2.5% to 2389.72, boosted by **Cisco Systems** (CSCO). The Energy sector has had a tough ride during this quiet hurricane season. To worsen the matter, the warm winter outlook forecasted by the National Weather Service overshadowed the demands. While oil prices keep struggling at $58 to $59 per barrel, a better buying opportunity is probably around $55. As for the bond market, with more signs of slowdown kicking in, all yields reflected the pessimistic view of the economy. The 10-year Treasury note yielded 4.59% while the 30-year note yielded 4.69%, a more than 10 basis points drop for each from last Friday.

This week, the markets’ numb responses to the election results showed the limited weight of political influence on investors’ concern list at least until 2008. One interpretation could be investors’ faith in President Bush’s veto power to maintain the “current status at the White House” despite the anticipated congressional reform by the Democrats. However, the traditional phenomenon in pharmaceutical and health care stocks was still observed as the Democrats gained control. Selling activities picked up particularly in these two areas last Thursday. Biotech companies would probably be a better choice for the investors such as **AstraZeneca** (AZN). Also winding down the week, the third quarter’s earning result was up 18% compared to the same quarter last year and 75% of S&P 500 companies have beaten the estimates. Even if we weighed in the Katrina factor to this year, the earnings still grew by 15%. What investors should be more cautious of is the coming holiday shopping season. On the retail sector, the stocks of **J C Penney** (JCP) or **Kohl’s** (KSS) will probably be a better choice than **Walmart** (WMT).

While the markets are greeting the holiday shopping waves, Wall Street’s earning prediction for the forth quarter so far has dropped to 10%. In addition to the economic slowdown, investors are also concerned about where a liquidity-driven rally will lead. The third quarter was boosted from a slew of M&A and private equity deals. The private equity boom tells us how much excess liquidity we have in the system. Instead of using IPOs to absorb public liquidity, M&A nowadays takes public companies private. Due to the doubts on the economy, companies use lots of side capital to buy back their stocks rather than commit in expanding. In 1980s, debt (junk bond) based M&A lead to a debt crisis and in 1990s, equity based M&A lead to an equity crisis. While the stock market is experiencing

Eric Chen, Ph. D.
610.565.6891
echen@beyondbond.com

Chiung Chiu
Financial Analyst
646.313.3331
cchiu@beyondbond.com

cash based M&A for the first time in the history, it may result in a "melt-up" in pricing, which means buyers are willing to pay above the offerings for stocks. If too many dollars are chasing too few things, it will lead to a soaring inflation. Investors should be aware of this concern.

Although the stock market is hungry for a major pull back, many hedge fund managers who either missed the opportunities in the beginning or have free money will jump in during the intraday pull backs and then possibly help to extend the rally. The markets are likely to remain positive next week. Investors should go with the flow and take profits proportionally as a major pull back probably won't occur in the short term. Investors who own junk bonds can start unloading them since the spread has become too tight and the risk has become too high. Both residential and commercial REITs are on the watch-out list. The values have been too high and the coming week might be the turning point from this peak. On the other hand, tax deductible municipal bonds are more attractive such as New York Municipal bond with 9.6% return before tax.

On the Commodity sector, copper is going to drop down even further to 2.4 or 2.6 from 3.08. This is affected by the ripple effect of housing market slowdown. However, other metals remain relatively better with the ongoing demands from China and India.

Finally, one of the winners in the following weeks can be the video gaming stocks. For instance, continued with its phenomenally successful products like the PlayStation 2 and PSP portable, the new release of PlayStation 3 this holiday season will be able to get **Sony** (SNE) back on track. Shares of Sony were up 26 cents, or 0.7%, to $40.10 in recent trading. The company's stock had been down 15.6% in the last six months.