Stagflation

Beyondbond

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The last trading day of 2006 ended with some minor corrections as the selling pressure started kicking in for the next year. With an unexpected strong job report overshadowing the possibility of an interest rate cut, Wall Street took another dive last Friday. For the week, the **Dow** was down 0.66% points to 12,398.01 and the **S&P 500** fell 0.61% to 1409.71. The **Nsadaq** gave back 0.78% and ended at 2434.25. Compared to the year of 2005, stock market without any doubt did much better especially the third and forth quarter. The Dow advanced 16.3%, the S&P 500 surged more than 13.6% and the Nasdaq caught up and added 9.5% for the year. On the bond side, the 10-year Treasury note fell by 10/32 to yield 4.65%.

As the market ended at an extreme overbought stage, traders and investors are waiting for the opportunity to hammer the sell button for a big profit taking. Wall Street currently still has a lot of liquidity flowing around. Two of the major liquidity sources are coming from Japan and China. While Japan's interest rate remains close to zero, traders and investors borrowed at low short term rates and finance the purchase of long-term bonds. If Japan raised the interest rate, carry trade could become unprofitable and then lead to a chain of unwinding reactions. Besides Japan, China has also been pouring a lot of cash to the US equity market. China's monetary tightening decisions, which are the increases in interest rate and bank's reserve rate, will cause another big wave of liquidity withdraws from the stock market. Although the market will drop when the liquidity drive loses its power, P/E (16 or 17) ratio is still relatively cheap. As a result, people might still jump in and pull the market back. The tug of war between these actions could lead the market to a very volatile performance. Investors should probably avoid most of the high beta sectors such as emerging markets, commodity, and small cap.

On top of this tug of war, stagflation, a sluggish economy with rapidly rising consumer prices bears two concerns on both growth and inflation. The market is at a period of high price inflation combined with slow output growth. The Fed's dilemma of whether to fight the war of slowdown or inflation continues in 2007. Single economic data creates little impact and reflection on the market trend among the smoke. Last week's strong report from the Labor Department, which added 167,000 jobs (above the expectation of 100,000 to 115,000) might have the market stumbled a little bit due to the extinguished hope of an interest rate cut . However, buyers weren't enticed by the data. If we took a closer look to the areas of jobs increased, it was mostly coming from the construction sector, which was benefited by the warm weather and retail sector, which needed more helping hands during the holiday season. The big jump on the job data might have the

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buyers raised their eyebrows but it didn't truly mirror the current status in economy.

An unseasonably warm winter has not only added more jobs to the construction sector but also kept the stocks in energy sector out of favor. Nevertheless, President Bush's recent decision of sending more troops to Iraq might put energy sector back to the center of attention. Oil prices have dropped 27% from July's peak in 2006 and lingered at around $56 per barrel. For the past two years, there has always been a support line at $55. If geopolitical concern is back in the picture, investors probably can start looking into some energy stocks such as **Chevron** (CVX) or even **Exxon Mobil** (XOM). On the other hand, investors should probably avoid individual stocks such as **DirectTV** (DTV), **General Motors** (GM), **Kohl's** (KSS), **Safeway** (SWY), **Boston Properties** (BXP), and **Deere& Co.** (DE). As for the technology sector, investors should probably sell on strength when the timing is right.

The forecast for the coming earning season might be able to shed some lights for the investors. According to a report from *Barron's*, compared to the previous quarter of 34% increase, financial sector will only expect 8% this quarter. Energy sector will regain its ground with an expectation of 13% compared to negative 9% previously. Information technology will have a big jump from the previous quarter of 1% to 17%. It is considered a popular area to enter now such as **Verizon** (VZ). Industrial sector will drop from 15% to 9% this quarter and Healthcare sector will have little change despite the congressional reform by the Democrats. Overall, investors should probably avoid sectors such as financial, industrial, telecommunication, and material.

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