

3rd Quarter, 2003.

The following are some of my observations on the issues related to the economy and stock markets:

The Performance of the Stock Market in the Third Quarter of 2003

The stock market continued the upward movement that started in October of 2002. In the third quarter, S&P 500 Index was up by 2.64%, DJ Index up 3.77%, and NASDAQ up 10.12%. The stock market rally over the last 8 months appears increasingly sustainable and possibly the beginning of a long-lasting bull market. Of course, only time will.

Positive Factors for the Economy and Stock Market

The following is a list of positive factors that will support the stronger economic growth in the second half of this year and the next year:

- Although the Iraqi security situation is still very unstable, it is probably reasonable to expect that the situation will improve over time. Geopolitical risks are lessened significantly and are not a significant factor in consumer and business decisions.
- There are still massive monetary and fiscal stimuli to the economy. The interest rates are still very low and the Federal Reserve Bank Governing Committee communicates to the market that it intends to hold interest rates low in the foreseeable future. The third massive tax cut since President Bush took office already boosted consumer spending since August and will continue to do so. The reduction of tax rates on capital gains and dividends make stock investments more attractive now.
- The corporate profitability continues to improve and the total corporate profits are now almost back to the pre-recession levels in 2000. The third quarter and fourth quarter earnings are expected to show close to 20% growth over the same periods of 2003. Restored corporate profitability is the key to economic revival and stock market performance.
- Unprecedented increases in labor productivity over the last two years are delaying labor market revival but are the reason why we can be optimistic about the long-term health of the U.S. economy.
- Vast majority of economic data published over the last few months are positive and point to strong economic growth for the next few quarters. Now most economists are forecasting economic growth of 4.5% for the second half of the year and 4.0% for the year 2004. Higher economic growth will lead to higher corporate profits, which in turn will result in higher stock valuation.

Negative Factors or Risks Facing the Economy

While the stars are almost aligned for faster economic growth down the road, there are still significant hurdles facing the economy:

- The weak labor market is the most significant risk to the sustainability of economic growth in 2004. The economy has lost 2.8 million jobs since year 2000 and businesses are still cutting jobs instead of hiring more workers in order to control the costs. Weak labor market hurt consumer confidence and consumer spending. Since consumer spending is about two-thirds of national economic activity, economic growth cannot continue without job market expansions. Economists recognize the fact that in a economic recovery, labor market statistics are lagging indicators

because businesses are reluctant to hire employees unless they are certain that the final demand for their products or services will continue to increase. For those reasons, economists and investors pay particular attention to all the latest news about labor market conditions. The labor market statistics over the last few weeks seem to suggest that the labor market is being stabilized. There are few signs of increasing hiring activities but also less pressure to lay off workers. Let us hope that higher economic growth this year will lead to final turnaround of the labor market soon.

- There are still significant overcapacity in many industries such as Airlines, Telecommunications, Automobile Manufacturing, Computer Hardware and Software, etc., that reduces the need for business investments. Business investment is increasing but will be constrained by the overcapacity.
- European economy has no sign of growth and Japanese economy is still in deflation. Even with lower U.S. dollar, the weak global economy limits the demand for U.S. products.

Valuations of Stocks

Compared with Treasury Bonds, U.S. stocks appear to be undervalued by about 5 to 10%. So, if the economy continues to recover as economists are forecasting and, corporate profits continue to improve as analysts are expecting, then the rally in the stock market should be sustainable. However, we should also be watchful on the development of the economy, stock valuation, interest rate, corporate profitability, etc., and adjust our portfolios according to new information.