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First Quarter of 2004 Newsletter

The Performance of the Stock Market in the First Quarter of 2004

The stock market lost some of the upward momentum in the first quarter and was basically flat. The S&P 500 Index was **up by 1.69%**; Dow Jones Industrial Index was **down 0.43%**; and NASDAQ was **down 0.46%**. As the January of 2004 newsletter said, the stock market performance down the road will pretty much depend on the growth of corporate profits and change in long-term interest rates.

Our Performance

The first quarter, 2004, my client's equity portfolios generally outperformed the S&P 500 index for the sixth consecutive quarter. I was honored again when *Effron-PSN* and *Money Manager Review* said a composite of all my client's equity returns for the past ten years outperformed the S&P 500 index enough to be ranked at the top of their lists of money managers.

My goal is to not only generate returns in excess of the S&P 500 but also positive absolute returns. I remain hopeful that I can deliver results that are positive and modestly above the market average.

The first quarter's 2004 top performing industries sectors include:

- Home building company's valuations remain low compared with their earnings growth rate. Even though mortgage rates may well trend higher in the coming year, rising employment and a more-confident consumers will probably keep new housing starts at healthy levels. Considering just how low mortgage rates are now, a moderate increase would still leave them at relatively low historical levels. The companies we invest in have good sized backlogs and should continue to perform well the remainder of 2004.
- The Financial Services (Diversified) industry continued to perform well and is still poised for above-average performance in the year ahead. While interest rates remain low, short-term gains should be available for good quality stocks in this broad sector.
- Selected medical supplies and pharmacy service companies also perform well driven by consumer demand.

Positive Factors for the Economy and Stock Market

This past quarter the labor market is showing clear signs of recovery and growth. On Friday, April 2, 2004, the Government reported a net creation of 308,000 jobs in March, far above even the most optimistic expectation of economists. Other statistics are painting the picture of job market expanding at faster rate than the last six months. This might be the last missing piece of data supporting a sustainable economic recovery and growth. It is the most important piece of economic news reported so far in the first quarter.

Otherwise, most of my economic observations in January remain true today:

- Massive monetary and fiscal stimuli remains in the economy. 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. Economists are still expecting that the Fed will begin to raise short-term interest rate in August.

- Corporate profitability continues to improve. Corporate earnings in the first quarter of 2004 are expected to show more than 20% growth over the same period of 2003.
- Labor productivity over the last three years has increased significantly and holds the potential of higher economic growth without inflation over the next business cycle. U.S. economy will continue to grow much faster than other developed countries.
- Deflation does not appear to be a threat any more.

Economic data continues to be positive and points to strong economic growth for the next few quarters. Most economists are still forecasting economic growth of 4.5% for the year 2004.

Negative Factors or Risks Facing the Economy

The last few newsletters I have observed the stars appeared to be aligned for faster economic growth. While they still are aligned, there are still significant hurdles facing the economy:

- Heightened terrorist worries are affecting consumer confidence, especially in European economies. The weak European economy and Japanese economy limit the demand for U.S. products, offsetting the positive impact of weaker dollar on U.S. exports.
- Higher energy costs affects consumer confidence also, reducing spending power of consumers, and reducing corporate profitability. Over longer term, high energy costs also tend to push up inflation.
- As I reported in the January newsletter, there is still significant overcapacity in many industries that reduces the need for business investments. Business investment is increasing but will be constrained by the overcapacity.

Valuations of Stocks and Investment Strategy

Generally, U.S. stocks continued to be properly valued. My view towards the overall valuation of the markets is that any further advance in stock prices depends on corporate earnings and long-term interest rates. Remember as we enter corporate earnings reporting season, it is doubtful that earnings will continue the double digit growth rates of late. When interest rates begin to rise in the second half of the year, stocks may be less appealing and more susceptible to corrections.

Also remember since interest rates are expected to go up, treasury bonds are not a good choice for investments this year. I expect a bear market in treasury bonds over the next few years.

I continue to think that stocks and corporate bonds (especially convertible corporate bonds) are the best investment vehicles for the foreseeable future. However, 2004 will not be as easy as 2003 to make money in the stock market and more skill is needed to pick out good stocks and corporate bonds.

John Zhao