

2nd quarter of 2003.

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

The Performance of Stocks in the Second Quarter of 2003

The stock market has the best quarterly performance since 1998. SP500 Index was up by 15.4%, DJ Index up 13.13%, and NASDAQ up 21.01%. The strong performances can be attributed to the end of Iraq war and low valuation of stocks when the war started in mid-March. Accordingly, the business, consumer, and investor confidence have all been restored to the levels reached by the end of 2002.

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:

- The Iraqi war is over and geopolitical risks have significantly lessened. Fears of terrorist attacks in the United States have also receded. Consumers and businesses can make normal plans.
- There are massive monetary and fiscal stimuli to the economy. The interest rates are the lowest in 45 years 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 will begin to put more money in the pockets of consumers and small businesses in a few weeks.
- The corporate profitability has been improving for two quarters now and is expected to continue its recovery. Higher profitability allows companies to make investments in fixed assets.
- Interest rates on corporate bonds have declined significantly. Lower interest rates allow companies to refinance their debts and improve profit margins. Lower risk premiums on corporate bonds suggest that bondholders believe that companies have a lesser chance of going bankrupt in the near future.
- Oil prices and energy costs have come down significantly. Lower energy costs help businesses improve profitability and give consumers a break.
- Depreciation of the U.S. dollar against major international currencies such as Euro since the beginning of year 2002 begins to help U.S. manufacturers compete domestically and internationally against European and Japanese competitors.

Now most economists are forecasting economic growth of 3.5% for the second half of the year and 4.0% for the year 2004. Higher economic growth will lead to higher corporate profits, which is the foundation for 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 labor market is still contracting, though there are some tentative signs of stabilization. The economy has lost 2.7 million jobs since year 2000 and the 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.

- 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. Until there is strong recovery in business investments, consumers have to continue to shoulder the burden for the economy.
- 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 still undervalued by about 15%. 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, and corporate profitability and adjust our portfolios according to new information.