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Fourth Quarter 2003 Newsletter

The Performance of the Stock Market in the 4th Quarter of 2003

The stock market continued the upward movement that started in October of 2002. In the fourth quarter, S&P 500 Index was up by 12.18%, Dow Jones Index was up 13.39%, and NASDAQ up 12.11%. The stock market rally over the last 15 months was a very remarkable recovery and may well be the beginning of a long-lasting bull market. Of course, only time will tell.

The Performance of the Stock Market in year 2003

After experiencing three years of negative returns from 2000 to 2002, the stock market recovered strongly in 2003. For the whole year, S&P 500 Index was up by 28.69%, Dow Jones Index up 28.28%, and NASDAQ up 50.03%. The decline of S&P 500 and NASDAQ over the bear market of 2000-2002 was as severe as in 1929-1932 and 1973-1974. If the histories of the stock market after 1932 and after 1974 are repeated in the future, we can expect to recover all the losses occurred during the market crash within the next two to four years. Historically, a market crash was often followed with sustainable bull market lasting about a decade. Let us hope that will be the case in the next ten years.

Our Performance

Generally our goal is to assist clients with portfolio performance superior to the S&P 500 over the long term. In 2003, our composite of all equities managed gained 44.6% while the S&P 500 index returned 28.69%. (Individual investor's gain may vary from this composite due to risk tolerance and investment timing.) We are honored that recently *Effron-PSN* and *Money Manager Review* acknowledged that John Shao Portfolio Management's annualized equity composite performance over the past ten years outperformed the S&P 500 annualized performance enough to be ranked among the top money managers reported on.

At the end of 2003, our client's portfolios are well diversified with no one industry category comprising more than 10% of the portfolio. The largest single security held is only 2.4% of the composite portfolio. During 2003 our top performing sectors and securities included:

- Consumer-cyclical securities like by Lennar, Best Buy and Centex. Low interest rates support home improvement and building.
- Technology companies with strong recurring sales such as Intel Corporation and Symantec. As the business recovery continues, selected technology companies are likely to continue enjoying improving results.
- The finance and healthcare sectors. Citigroup and Barr Lab are examples of 2003 performers. Healthcare stocks demonstrate long term earnings growth.

Positive Factors for the Economy and Stock Market

The following is a list of positive factors that will support stronger economic growth and stock market valuation in year 2004:

- 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 above the pre-recession levels in 2000. Corporate earnings in the fourth quarter of 2003 are expected to show more than 20% growth over the same period of 2002. Restored corporate profitability and repaired corporate balance sheets have begun to lead to expansion in business investment and hiring. Recovering stock prices and corporate bond prices are boosting confidence of businesses, which is a pre-condition for business expansion.
- Unprecedented increases in labor productivity over the last three years increases 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. Higher economic growth in the U.S.A will attract foreign investors to buy U.S. securities and make direct investment in the U.S. as well.
- The worries about deflation last spring proved to be a false alarm, even though many economists expect price increases to continue to decline in 2004. The U.S. economy has avoided the fate of dangerous deflation associated with the Japanese economy since the crash of Japanese stock market and real estate market in 1989.
- Vast majority of economic data published over the last few months is positive and point to strong economic growth for the next few quarters. Consumer spending is still strong while business investment and hiring is showing signs of growth. Companies are replacing their computer hardware and software. They are stockpiling inventories. Manufacturing is expanding rapidly. Layoffs are continuing to decline while there are net increases of jobs over the last four months. The labor market is clearly turning around. Now most economists are forecasting economic growth of 4.5% for the year 2004.

Negative Factors or Risks Facing the Economy

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

- The contribution to growth in GDP from consumers will be smaller in 2004. Three factors will hold back gains on consumer spending: 1) largely spent-up demand in housing and autos, 2) highly leveraged household balance sheets, and 3) the recovery of the labor market will be very gradual. Housing markets will still be strong but will not be an engine of economic growth for some time to come.
- 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.

- Widening federal budget deficits and trade deficits are pushing down U.S. dollars and pushing up interest rates. Foreign investors have significantly reduced their purchase of U.S. securities. Inflation pressure may begin to emerge in the second half of the year. Economists are now expecting the Federal Reserve Bank to begin the cycle of raising interest rates in June or July. Higher interest rates will dampen economic activities and result in lower valuations of stocks and bonds.

Valuations of Stocks and Investment Strategy for 2004

With the yield of 30-year Treasury bond at 5.0% and significant run-up of stock markets over the last year, U.S. stocks appear to be properly valued. The Price Earnings ratio of S&P 500 based on the expected earnings of 2004 is about 20 and that of NASDAQ over 40. Obviously, any further advance in stock prices depends on the expected growth in corporate earnings and stable long-term interest. When interest rates begin to rise in the second half of the year, stocks may be less appealing and more susceptible to corrections if there is some type of exogenous shocks to the economy such as terrorist attacks or natural disasters. It is also doubtful that the corporate earnings will be able to continue to post double-digit growth in year 2004.

Since interest rates are expected to go up, treasury bonds are not a good choice for investments this year. Government bond investors actually lost money in 2003 and will probably see a bear market in bonds over the next few years.

Conclusion

I think that stocks and corporate bonds (including convertible corporate bonds) are still better investment vehicles for the next few years. However, the easy money has been made in the stock market and it needs more skills to pick out good stocks and corporate bonds in the future. We should also be watchful on the development of the economy, global situations, stock valuation, interest rates, corporate profitability, etc., and adjust our portfolios according to new information. The lessons of 2000-2002 bear market should always be in our minds: diversification and controlling risks, especially when the stock market is going up and everything about the economy and stock market appears perfect.