



Market Commentary: First Quarter 2004

1. 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. In the first quarter, SP500 Index was up by 1.29%, DJ Index down 0.92%, and NASDAQ down 0.46%. As we remarked in January of 2004, the stock market performance down the road will pretty much depend on the growth of corporate profits and change in long-term interest rates.

2. 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:

- The labor market is showing clear signs of recovery and growth. On Friday, April 2, 2004, the Government reports 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 in the first quarter.
- 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. Now economists are expecting that the Fed will begin to raise short-term interest rate in August. 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. Investors continue to increase cash flows into stocks and mutual funds.
- The corporate profitability continues to improve and the total corporate profits are now above the pre-recession levels in 2000. Corporate earnings in the first quarter of 2004 are expected to show more than 20% growth over the same period of 2003. 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. Now most economists are forecasting economic growth of 4.5% for the year 2004.

3. 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:

- 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 affect consumer confidence, reduce spending power of consumers, and reduce corporate profitability. They are also becoming an issue in U.S. presidential campaign. Over longer term, high energy costs also tend to push up inflation rates.
- 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.

4. Valuations of Stocks and Investment Strategy for 2004 (There are no changes from last letter)

- With the yield of 30-year Treasury bond at 5.04% and significant run-up of stock markets over the last year, U.S. stocks appear to be properly valued. The P/E ratio of SP500 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.