



Market Commentary: Second Quarter 2004

1. Midyear Review of the Stock Market

After significant gains in 2003, the stock market has been trading in a narrow range so far in 2004. The improvement in the economy and significant increases in corporate earnings have been offset by worries about higher inflation, rising interest rates, unstable international situations, and uncertainty engendered by the looming presidential election. It is somewhat disappointing to see stocks not going higher so far this year. But stocks have managed to hold their own in this setting. In the second half of 2004, it is hoped that stocks will break out the trading range and go higher if solid gains in economy and corporate earnings will continue as forecast by analysts and the worries and uncertainties will dissipate over time.

	Second Quarter	First Half
Dow Jones Industrial Average	1.24%	0.81%
Standard & Poor's 500 Index	1.71%	3.44%
NASDAQ Composite	2.69%	2.22%

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 the second half of 2004:

- The economy is on a path of sustainable growth. Economists are now forecasting the fastest growth rate in GDP (4.5%) in more than two decades in 2004. The labor market is clearly recovering and jobs have been created 8 months on a roll. More than 1.3 million jobs have been created so far this year and more job additions are expected in the future. It seems reasonable to assume that a sustainable economy growth will last at least several years.
- Despite the fact that the Federal Reserve Bank began the process of tightening credit with a 0.25% increase in late June, the long-term interest rates are still low compared with historical averages. The Fed communicates that the tightening will be “measured” unless inflation picture gets uglier.
- The corporate profitability continues to improve and the total corporate profits are now above the pre-recession levels in 2000. Corporate earnings in the 2nd 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. The second half of 2004 is also expected to have higher than 15% growth in corporate earnings.
- Manufacturing is expanding rapidly. Manufacturing industries were hit really hard in the 2000-2001 Recession and slower in recovery. But now it is growing strongly.

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 limits 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.
- Inflation rates have stopped falling and are increasing faster than many analysts have anticipated. But many factors behind higher inflation rates in the first half of 2004 may be temporary, such as significantly higher prices for raw materials due to strong demand in China. The prices of raw materials except oil prices have already begun to decline since May. In addition, about two-third of input in the U.S. economy is from labor. The wages have been growing slowly due to the fact that there is still significant slack in labor market. My observation is that analysts and investors are too quick to draw conclusions about future inflation, just as they were over-worried about deflation in the spring of 2003.

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 5.2% and P/E ratio of 18 for the SP500, U.S. stocks appear to be slightly undervalued. 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.
- 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 again the first half of 2004. The Treasury bond markets may have begun with a long bear market which can last for years.
- I would 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.