



Market Commentary: Third Quarter 2004

1. Review of the Stock Market for the Quarter and for the Year

Just as in the first and second quarters, the stock market was trading in a narrow range again in the third quarter of 2004. The overall market declined modestly. The still growing, though at a slower rate, economy and significant increases in corporate earnings have been offset by worries about higher inflation, the unstable international situations, and the uncertainty engendered by the looming presidential election. The rising oil price, reaching above \$52 a barrel now, is a significant threat to global economy and financial markets. It is disappointing to see stocks not going higher so far this year. On the other hand, it can be argued that the resilience of the stock market in such uncertain environments may signal better quarters ahead because investors have been quite rational in looking beyond today. It is hoped that stocks will break out the trading range after the U.S. presidential election 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.

The following table is a summary of the stock market measured by three major indexes (including price changes and dividends paid):

	Dow Jones	SP500	NASDAQ
July	-2.69%	-3.31%	-7.83%
August	0.59%	0.40%	-2.61%
September	-0.80%	1.08%	3.20%
3Q04 (July to September)	-2.90%	-1.87%	-7.36%
1Q04 (January to March)	-0.43%	1.70%	-0.46%
2Q04 (April to June)	1.24%	1.71%	2.69%
YTD (January to September)	-2.12%	1.50%	-5.31%

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 quarters ahead:

- The inflation picture is brighter now than in the first and second quarter. Earlier last year, the financial markets were troubled by the prospects of the U.S. economy entering deflation. In the first half of this year, interest rates surged because of higher inflation due to higher energy and raw materials costs. If inflation expectations build up in the economy, both bonds and stocks would suffer heavily, just as in the 1970s. The slowing-down of the economy and significant slack in the labor market in the second quarter have damped the inflation rate now. High inflation is probably the worst enemy of financial markets and we need to watch it very closely.

- The economy is on a path of slower but sustainable growth. Economists are still forecasting GDP growing at a rate of 4.0% in the second half of 2004. The labor market is clearly recovering and jobs have been added in the last 11 months on a roll. More than 1.6 million jobs have been added so far and more are expected in the future. It seems reasonable to assume that the sustainable economy growth will last at several years, unless the oil prices continue to rise.
- Despite the fact that the Federal Reserve Bank have raised the interest rate by 0.75% so far, the long-term interest rates are actually lower than when the Fed began the credit tightening cycle in June. The Fed communicates that the tightening will be “measured” unless inflation picture gets uglier.
- Corporate earnings are expected to grow at 14.5% in the third quarter after four consecutive quarters of 20%+ growth. Restored corporate profitability and repaired corporate balance sheets have begun to lead to expansion in business investment and hiring. Continued growth in corporate earnings is the support for the stock market.
- Manufacturing is still expanding rapidly and business investment is growing strongly. 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 some of the old worries about and threats to the economy and the stock market are gone, new threats are emerging:

- Higher energy costs affect consumer confidence, reduce spending power of consumers, and reduce corporate profitability. They are also an issue in U.S. presidential campaign. Over longer term, high energy costs also tend to push up inflation rates. This is probably the most significant threat to the U.S. and global economy. However, we need to look at oil prices in historical perspective. After adjusting for inflation, the oil prices in the 1973-1974 would be equivalent to about \$100 a barrel in today’s dollar. Economists and government agencies believe that the higher prices, if not going much higher, would reduce U.S. economic growth but not push it into recession. I am watching this situation very closely. For your information, I have enclosed a few analyses by economists.
- 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.
- Consumer spending has clearly slowed this year to about 2 to 2.5% growth. Massive tax cuts and cash-out in mortgage refinancing are gone now and consumer debts are in high levels. Job market growth is slow and higher energy costs are reducing money available for other purchases. Healthcare costs are still increasing at double-digit rates.
- Presidential election is another uncertainty the stock market is worried about, especially in combination with terrorist threats before and around November 2. But the time is approaching and hopefully this uncertainty will be resolved soon.

4. Valuations of Stocks and Investment Strategy

- With the yield of 30-year Treasury bond at 4.9% and P/E ratio of 17.6 for the SP500, U.S. stocks appear to be undervalued by about 10 to 15%. At the end of the second quarter, the long-term interest rate was at 5.2% and P/E at 18. Lower interest and lower P/E ratio make stocks more competitively prices. Obviously, any further advance in stock prices depends on the expected growth in corporate earnings and stable long-term interest.
- 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 just break even this year. 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, energy costs, inflation expectations, 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.