Market Commentary: Fourth Quarter 2004

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

The stock market ended year 2004 on a cheery note. After a lackluster and mostly lower first three quarters, stocks came on strongly over the final three months of 2004 on the apparent relief that the election was decided quickly and conclusively in contrast to 2000. The market performance over the fourth quarter confirms my expectation put down in the letter to you along with the quarterly reports for the third quarter of 2004. Let me quote my own words from that letter: "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 overall performance of the stock market in 2004 is also in line with my expectations at the end of year 2003. We were anticipating a return between 8 and 12% for 2004.

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

	Dow Jones	SP500	NASDAQ
October	-0.36%	1.53%	4.12%
November	4.29%	4.05%	6.17%
December	3.54%	3.40%	3.75%
4Q04 (October to December)	7.59%	9.23%	14.69%
2004 (January to December)	5.32%	10.87%	8.60%

There were always surprises in the economy and financial markets. The three biggest surprises in year 2004 are (1) long-term interest rates did not go up; (2) oil prices went up significantly; and (3) corporate earnings grew significantly higher (20%) than anticipated (12%) by analysts.

2. Positive Factors for the Economy and Stock Market

The following is a list of positive factors that will support strong economic growth and higher stock market valuation in the quarters ahead:

- The inflation picture is brighter now than in the summer of 2004. Oil prices have retreated from mid-50 levels and prices of raw materials have also begun to decline. It seems that the peak of inflation risk has passed. If inflation expectations build up in the economy, both bonds and stocks would suffer heavily, just as they did in the 1970s. 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 moderate and sustainable growth. Economists are now forecasting the U.S. GDP growing at a rate of 3.0 to 4.0% in 2005. The strengthening job market has boosted consumer confidence. It seems reasonable to assume that the sustainable economy growth will last at several years, unless the oil prices continue to rise or there is an unexpected exogenous shock to the economy or financial markets.

- Despite the fact that the Federal Reserve Bank has raised the interest rate by 1.25% so far, the long-term interest rates are actually lower than one year ago. The Fed communicates that the pace of credit tightening will be "measured" unless inflation picture gets uglier.

- 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. Lower U.S. dollar value against Euro and Japanese Yen makes U.S. manufacturers more competitive in international markets.

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:

- Energy costs are still high. There is ample supply of oil and sufficient inventory in the U.S and international markets. However, increasing demand from China and India is expected to result in higher oil prices for a long time to come. Political uncertainties in oil-producing countries, especially in Mid-East, probably induce a risk premium up to $10 a barrel of oil. Higher energy costs affect consumer confidence, reduce spending power of consumers, and reduce corporate profitability. 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. In the least, persistently higher energy costs would push the Fed to raise interest rates more aggressively in order to contain inflation.

- Consumer spending has clearly slowed this as year 2004 progressed. 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.

- Interest rates will continue to increase this year. Higher interest rates of course lead to lower valuation of all types of financial securities, including bonds and stocks. The Fed is expected to raise interest rates until Mid-2006.

- Corporate earnings will continue to increase, but on a much slower pace. Analysts are now anticipating growth rate of 6 to 10% this year, compared with almost 20% increase in 2004.

4. Valuations of Stocks and Investment Strategy

- With the yield of 30-year Treasury bond at 4.8% and P/E ratio of 18.8 for the SP500, U.S. stocks appear to be undervalued by about 5 to 10%. At the beginning of 2004, the long-term interest rate was at 5.0% and P/E at 18.9. In terms of P/E ratio, stocks are valued on the same level as one year ago. But long-term interest rates are actually lower, making stocks slightly more attractive than bonds. Even if corporate earnings grow at slower rate this year, stocks are probably still the best investment class unless inflation fears come back to haunt the market and investors.

- If long-term interest rates remain stable, I would expect that the stock market would go up by 8 to 12% in 2005. Obviously, any further advance in stock prices depends on the expected growth in corporate earnings and stable long-term interest rates.

- I would think that stocks and corporate bonds (including convertible corporate bonds and high-yield 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. A disciplined approach is the only successful approach for long-term investors.