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A Registered Investment Advisor

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June 30, 2008

Dear Client,
In the last year we've had a liquidity crisis, a commodities boom, and a declining dollar. What on earth is next?

Last quarter we considered the alternative evils of deep recession and "stagflation", and expressed a slight bias in favor of stagflation, with a short-term risk of a drop in stock prices. We also predicted that commodities prices would outperform because of long-term fundamentals, even in the face of a slowing economy. We were right about stagflation and commodities. The stock market has indeed moved to the downside, though not by as much as we thought possible.

Looking ahead, we see continued weakness in the economy and the dollar, at least until after the election, and probably for a good period afterwards. Much of the gains in commodity prices can be explained solely on US dollar weakness, rather than just energy shortages. Factoring out the drop in the dollar against the Euro between 2000 and 2008, oil prices would be about $75.00 per barrel, and San Jose gasoline prices would be about $2.67.

Some experts feel that the dollar has now reached attractive levels, and that a correction in its value, as well as commodity prices, is overdue. Absent a large decline in the global economy, we feel such a correction would require (1) a further decline in the dollar to the point that dollar denominated assets become irresistibly attractive, (2) a tightening of monetary and/or fiscal policy, or (3) a dramatic change in energy policy. We believe that none of these three events is imminent.

Tightening from the Federal Reserve Board is unlikely, at least until the election. First, the Fed rarely tightens interest rates much in Presidential election years. Second, weakness in the economy has caused the Fed to err on the side of loose money for the last year. Although the Fed is now talking tough, it probably can't afford to risk a second liquidity crisis. The sharp decline in home prices has left the American consumer with less security for loans, and thus declining borrowing and spending power. We expect that condition to spread, dampening global demand over time. Since the Fed is unlikely to raise rates now, the dollar can be expected to stay at or below current levels for at least the next few months. However, since energy prices have recaptured much, or all, of the drop in the value of the dollar, we would expect the current run-up in energy prices to slow or end at the close of the summer driving season.

Long term, the energy price spiral should continue until governments begin to make tough choices. Right now, governments aren't helping much. Developing countries like China, India and Indonesia are actually subsidizing the price of oil, while oil producing countries like Venezuela and Saudi Arabia are selling fuel to their own people at a tiny fraction of the market price. Developed nations like the US have recently cut incentives for alternative fuel research and development. If global action is not forthcoming, energy price increases should resume sometime next year, until there is a precipitous drop in the global economy, and thus demand for oil.

We remain concerned with the fallout from the housing loan debacle. Some clients have asked if we see opportunities in real estate or finance. We haven't, and don't expect to for awhile. The Mortgage Bankers Association reports that in the first quarter, 22% of sub-prime loans were delinquent (over 30 days past due), and

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approximately 6% of these loans entered the foreclosure process. At the same time, over 6% of ALL home loans were delinquent, and approximately 1% entered foreclosure. These are very large numbers, the highest on record. If interest rates rise, monthly mortgage payments under variable rate loans will climb out of reach for the owners, prompting additional defaults. If interest rates don't climb, but the economy remains weak, homeowners may choose to walk away from loans because they no longer have equity in the property. The decline in housing prices, which has reached nearly 30% in key markets, means that consumers have significantly less borrowing and purchasing power.

The combination of recession and high energy prices may have long-lasting repercussions. Giant companies like GM and Ford, and some airlines and trucking firms, may face bankruptcy. As these businesses retrench, the impact of plant closings and production slowdowns will be felt by employees and suppliers. These effects will ripple throughout the economy, particularly in the Midwest, which has suffered severe flooding as well. Many of you may wonder why we are not seeing energy and food price increases passed on throughout the economy. In some cases, such as with the airlines, business is attempting to pass on their higher costs. But in other cases energy and food price increases have been balanced by a drop in consumer purchasing power, and corporate profit margins. Under these conditions, pass-throughs of price increases and further reductions in consumer purchasing power will be followed by more plant closings, elimination of airline and truck routes, and a rash of bankruptcies. Many of these jobs will not be restored for years, if ever. The resulting layoffs will generate even more defaults on mortgages.

Despite the bad news, we see value in certain issues, particularly in solar power stocks, some of which has been discounted heavily in the last six months. We are also enthusiastic about makers of advanced materials, and companies whose products or services enable more efficient use of energy or other materials. In addition, a number of US companies are now relatively cheap to foreign investors, so we expect a growing number of acquisitions in the second half of this year.

Summer is traditionally a time of weakness for stocks, and given the sorry state of the economy, we don't expect any change this summer and throughout the year, regardless of the results of the upcoming election. In the meantime, we will continue to invest carefully.

Two more things: 1). Out of our concern for your assets in these uncertain times, we have placed the cash in your accounts exclusively in money market funds whose assets are only invested in U.S. government backed securities. That's important protection, as many money market funds are invested in pools of real estate loan instruments and short-term corporate loans. 2) Every year, we are required by the SEC and state regulators to offer you a copy of our form ADV-II disclosure. Please let us know if you would like a copy.

Regards,

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