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Dear Client:

Time for some positive news! Here's three happy items:

1. Crude oil has declined so much that, assuming prices stay at this level, the U.S. will save, over the next two years, an amount that is about equal to either the cost of the Iraq War to date, or the annual interest on the national debt.
2. We are about to inaugurate a new President, with a crack team of economic advisors, and enjoying the confidence of a substantial majority of Americans.
3. Markets have upward spikes, even in the midst of a depression.

Update: The last quarter, of course, was not so rosy. While there is no agreed definition of a depression, one seems to be on the way. The inflation-adjusted yields for long-term corporate bonds are at levels not seen since 1931. Currency markets have been in turmoil and some companies in developing countries have suffered huge losses on currency bets. Daily we hear stories of layoffs, airplanes flying nearly empty, cancellations of appointments at doctors' offices and hair salons, and delays in payment to suppliers by even the healthiest of businesses. Large, well-known retailers are shutting their doors for good. Service industries, the core of U.S. employment, are seeing a sharp drop-off in business. Aircraft, ships and trucks are being pulled from service, and factory production and shifts are being eliminated. Farm crops and even size of retail stores are being reduced, all in an effort to match productive capacity with expected demand. As retailers go out of business, malls and shopping centers face declining occupancy and lease rates, and a decline in cash flow.

The only immediate hope for Americans is government. While reducing consumer and business indebtedness is a necessary condition to the resumption of growth, government can limit the damage by increasing the money supply, lending to key institutions, and providing individuals with unemployment benefits, food stamps and even infrastructure and employment programs.

The government is doing many of these things, but not as effectively as one would hope. The U.S. Treasury is providing assistance to banks, insurers and other financial firms. This aid seems to be stemming the tide of bank collapse, but balance sheets are still deteriorating, and credit is only trickling out in tiny amounts. The Treasury's TARP plan, originally intended to pull bad assets from the books of the banks, and, most critically, restructure mortgages, has instead focused solely on direct investment in the banks. The Treasury did this because renegotiating mortgages or reorganizing financial institutions was too cumbersome a process to complete in time to prevent economic collapse, as housing markets deteriorated ever more quickly. We believe that it might have been better to shut more banks, and provide fresh credit to the markets through investment in healthy banks, unencumbered with bad loans.

Significantly, the intervention has calmed some of the worst of the panic. The so-called TED spread, a measure of the short-term risk of inter-bank loans, has stabilized, and is now dropping nicely. Nevertheless, we are in what many are calling a "liquidity trap" where credit is still not reaching most consumers or business, and confidence has not been restored. Investors remain obsessed with credit quality, driving interest rates for short-term federal instruments, literally, to zero. With interest rates so low, bond prices have jumped sharply.

Perspective: So how does our present downturn compare with the Great Depression, and the government's response to that crisis? We think that the present government is way out ahead of the early response by the

Hoover administration. Margin levels for stocks were much higher during the Great Depression, causing the markets to drop by more than we expect this time around. However, the scope of private and public debt is larger today, and thus requires a more aggressive response.

When the Great Depression began in 1929, President Herbert Hoover avoided major intervention in the markets. By 1932, Hoover faced a strong reelection challenge from Franklin Roosevelt. Realizing that his prospects for reelection were slim, and that the markets were not producing a correction, Hoover changed his strategy. That year, Hoover and Congress began passing major legislation, raising marginal tax rates from 25% to 63%, creating the Reconstruction Finance Corporation (assistance to business), Glass Steagall Act I (permitted easier credit to member banks) and the Federal Home Loan Bank Act (aid to banks and savings and loans). Hoover's Fed also sharply raised the money supply.

These actions began to turn the tide. The market bottomed and began to climb. A strong rally started in June of 1932 and the Dow Jones Industrial Average (which had dropped from the Dow peak of 380 in 1929) rose from a low of 42 to about 102. By Roosevelt's inauguration in March of 1933, the economy, down nearly 50%, had bottomed.

Roosevelt, using revenues generated by the new higher tax rate, developed public projects to reduce unemployment, which had reached 24.9% in his first year in office. Contrary to general belief however, Roosevelt refused to use significant deficit financing to grow the economy, at least until the start of World War II. As a result, while the economy began to grow, unemployment responded very slowly, remaining between 12% and 19% until 1939, when the coming of WWII caused a sharp rise in employment. Meanwhile, European countries (Sweden and Germany) with strong deficit financing in the early 1930s began to pull out of the Depression at a much faster rate. As to the U.S. stock market, after the Depression it took 25 years, or until 1954, before the Dow returned to the 380 level of mid-1929.

Given the relatively strong assistance to banks by the Bush administration, we could see a market rebound begin within months, followed with a lag by a slow rebound in the economy. But if the problem lies, as we believe, as much with consumers and homeowners as with the banks, real recovery will require more. Obama's proposed infrastructure program will help with employment, and reduction of mortgage debt should help, but these will take awhile, at best.

How far will the economy sink, and how fast will the market rebound? While we don't expect the same decline as in the 1930's, actual business activity and joblessness will depend to a great extent on what action government takes, and whether the world will buy enough US debt to fund the required deficit.

Will it take equally long for the economy and capital markets to recover this time? While there is no way to know for sure, we think that neither the public nor the government will stomach such a lengthy ordeal. To be sure, there are much greater obstacles for the government today, because of the high rate of total US debt. If the government encounters resistance in its effort to fund a very large budget deficit, it may need to (1) devalue the currency, which will help a little with our trade balance but provide plenty of pain to consumers, or (2) raise taxes and/or abandon any hope of deficit spending, which would greatly extend the time required for recovery.

Aside from debt levels, housing prices clearly differ from the Great Depression. In the 1920s, housing prices had actually fallen since the onset of World War I, and any further drop in housing prices was fairly limited. This time around, from 1999 to 2006 housing prices climbed to levels far beyond long-term historical averages. A return to historical levels would depress home prices by an average of nearly 50%, with more extreme drops in certain markets that experienced the highest price increases. Such declines will be most apparent in less expensive housing in key growth markets, as such homes had the largest percentage gains. Declining housing prices and loan defaults will accelerate the decline in spending, which in turn leads to layoffs and further housing foreclosures. We

are in a vicious cycle, and it is unclear when it will slow. We think that even with strong government action, unemployment will reach double digits, likely by 2010.

The only way that the economy can resume growth is through massive reduction of household debt, while avoiding equal growth in government debt. That level of restructuring is unparalleled in recent history, and would fundamentally change the world we live in. But dramatically lower interest rates will help to reduce debt burdens for those homeowners who still have access to credit.

For investors, not all news during the Depression was bad. Some companies had mixed results in the market but enjoyed strong profitability and paid attractive dividends. One company that prospered in the 1930s was IBM, which grew its staff, facilities and R&D throughout, and received major contracts from the U.S. government, including the new Social Security Administration. And those who kept saving and investing were able to take advantage of the principle of dollar cost averaging, which states that by making continuous investments over long periods, an investor will buy the most shares when prices are cheap.

What's Next? Many clients have asked us whether we see inflation on the horizon. We are not certain. We do believe we are witnessing another bubble, this time in bonds. Interest rates are dropping very rapidly, and treasury bond prices are conversely climbing to record levels. We think that this may end shortly. Indeed, with interest rates on short term US treasury notes and bills now at zero, there is little room for further increases in bond prices.

But when bond prices stop rising, will we see a rise in inflation or interest rates? Nobody knows. Inflation occurs when the money supply grows faster than the production of goods and services. The size of the economy, or Gross Domestic Product, is generally determined by the product of the money supply and a number called "velocity of money," which measures the number of times that money circulates during the year. In normal times, velocity is fairly constant, so one can look at the money supply to determine whether inflation is a problem. During a depression, velocity drops dramatically as people hoard cash. In such times, even very large growth in the money supply, through deficit spending, may not match the drop in velocity. Such a drop in velocity is so large that an increase of several trillion dollars in the money supply would be required for inflation to become a concern. Even the smartest people we know aren't sure what level of money supply increase will cause inflation, or whether recent actions by the government have us approaching those levels. Our guess is that we may be a ways from inflation, but that with giant US borrowing, confidence in the dollar may decline before inflation becomes an imminent concern.

So what's next? We think that based on the steep drop in stock prices into last month, we may experience a brief rally in the markets over the holidays, and into the first week or two of the Obama administration. Such corrections occur even in a severe bear market, and may be overdue. We have also seen a reversal in the run-up of the dollar, and may yet see at least a brief reversal in the price of certain commodities. But we are cautious about taking on more than a small exposure to the market, as we expect that this rally, if it materializes, will be followed by another sharp drop in the markets, to new lows. We may however, take certain steps to provide at least some measure of protection against a long-term drop in the value of the dollar. By fall of 2009, the market decline will likely have concluded, and then we will begin to see whether the economic rebound moves quickly, or takes many years.

Ultimately, there may be reason to be more optimistic, particularly with our new administration. These are smart people, with a pragmatic approach to the world. They may find some very innovative ways of reducing consumer debt, dealing with government debt and entitlements, and restoring confidence in the markets. Solutions may not come fast, but they may indeed come.

Several areas of reform will be critical to our economic future. First, we need to get health care costs under control. U.S. spending on healthcare consumes 17% of GDP, compared to about 9% in almost all developed economies.

That difference, around 8% of GDP, constitutes most of the savings gap between ourselves and the economies in Canada, Europe and Japan. Yet these nations cover 100% of their populations, while a material part of our society is not covered. That means we have poorer average life expectancy, and huge emergency care burdens at our hospitals that are passed on to consumers and local government. American businesses are saddled with a very large piece of these health care costs, making it harder for them to compete. The costs of this inefficiency are paid for by all of us. Bold steps in health care reform would have a massive economic benefit for America, which we should start to see within just a year or two.

Secondly, we need to improve education and job training, which our competitors are doing better than we.

Third, we will need regulatory reform in a number of areas, including lending and credit markets, SEC oversight, and derivatives markets. What we need is not more regulation, but more effective regulation.

Lastly, as we move several years out, we will need to cut spending in areas that are less critical to our economic future, and raise revenue, so we can eliminate the deficits, both public and private.

This is a critical time to have good professional management of your money. We are keeping our finger on the pulse of the economy, looking for signs that it is time to put more of your money into the market, or alternatively that you need protection against deflation, devaluation or an eroding dollar. You too will play an important role in your financial future, by doing everything in your power to keep the savings flowing, enabling you to benefit from dollar cost averaging, as we buy back in at historically low prices.

Finally, may you and your family have a happy New Year, and may good fortune carry you through these challenging times.

Sincerely,

Stanley Q. Mok
President