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Dear Client:

Finally, some positives amid the gloom. First, the securities markets and economy have come a very long way from where we were. The farther they drop, of course, the closer we are to a bottom. By early March the S&P had lost over 57% from the market peak in the fall of 2007. Global equity and bond losses total around \$50 trillion dollars. One source notes that the amount of such losses exceeds all corporate profits since the Great Depression. While we haven't checked the accuracy of these last two numbers, they sound like they are in the ballpark.

While the Bureau of Labor Statistics' most well known measure of unemployment, known as U-3, is "only" at 8.1%, the jobless statistic that most closely matches that used in the Great Depression, referred to as U-6, now tops 16%. And U-6 doesn't count unemployed farmworkers, the idle self-employed, and certain other small categories, like unemployed domestic workers. Including them would, by some estimates, raise the comparable February unemployment rate to around 18%. U-6 puts unemployment at about two-thirds the 24.9% Depression peak in 1933.

Second, we're seeing some positive indicators, including the following:

- Monthly job losses have slowed slightly since December (but unemployment is still growing fast)
- Most energy stocks and China's stock market have not fallen since early November (important because China's market started falling before the global market, while the energy sell-off exceeded the stock market as a whole from mid 2008 through November)
- Unit sales of existing homes in the West have been flat or up for several months (these homes tanked first and most, so region should stabilize earlier)
- we're seeing securities prices that ordinarily would be considered big bargains
- average work and hourly pay are flat or up by a fraction over last few months
- merger activity has picked up, particularly in drug stocks
- Two of the most troubled large banks under the Treasury's TARP program, say they have been profitable for the last two months, and do not expect to seek further government assistance

#### Big risks still lurking: CDS market and unintended consequences.

So are we out of the woods yet? Is this the time to get buying? We think that's premature. There are still very serious concerns on the horizon. Most immediately, spreads on loans are still historically quite high, and climbing, suggesting significant fear among lenders, and tightening lending standards. As economist Gary Shilling notes, liquidity is still being destroyed at a faster rate than government is creating it.

There are also very large unknowns. First and foremost among these is the Credit Default Swap (CDS) market. This is an **unregulated** market in which one can buy guarantees against the failure of certain businesses. The CDS market involves contract exposures of over **\$60 trillion**, but sellers of these guarantees often are inadequately capitalized, and thus won't be able to satisfy their obligations if required. CDS contracts have been used to hedge a variety of exposures, including loans and bond investments. The market is essentially insurance, but at a lower price, and without insurance regulations, including minimum capital requirements, that have underpinned public confidence in the insurance industry.

Municipal bonds have been backed by both commercial insurance and CDS arrangements. Today, local governments face severe financial pressure from rapidly falling tax and other revenues, and many of these may default on their debt obligations. That pressure will get worse if municipal bond issuers lose their ability to get insurance and sell more bonds. Unfortunately, in many cases neither the commercial insurance (sold mostly by now troubled companies), nor the sellers of the CDS, may be able to satisfy all such defaults.

While the CDS exposures of many large American companies are a very serious concern, and would be worse if a very large financial institution was allowed to fail, some analysts believe that the more highly leveraged European banks face even greater exposure, both as buyers and sellers in the CDS market. If the CDS market were to crumble, the damage to our domestic business and to our

European trading partners could dwarf the domestic real estate crisis. At this point, we can't be sure whether the CDS market will hold. If the CDS market holds, and if the economy starts to turn, we would expect a solid rally in the stock market. If the CDS market takes a serious hit, we would expect that the market will tumble again, possibly to half its current level. One source of solace is that Warren Buffett's insurance company has recently entered this market, offering a well-capitalized source of such insurance at a heftier price. Clearly, a smart and disciplined investor, with careful risk assessment, finds that there is a business model here. Unfortunately, Buffet has in the last few months become more cautious about the risks from the CDS market.

Another serious concern is the unintended consequences of government action. In this case, regulations intended to protect us have instead put more of our money at risk. In our September 2008 newsletter we noted that accounting rules would force banks to write down certain instruments, including residential mortgage backed securities, to reflect the collapse in housing prices. Under current banking regulations, banks may be required to remove these instruments entirely from the calculation of their capital, even in cases where losses are minimal. Due to these regulations and the current imbalance in supply and demand, some of these banks are now selling these instruments at fire sale prices, resulting in outsized losses to the banks, and potentially large profits for the hedge funds that are buying them. As investment advisor John Mauldin has said, this is a bailout for hedge funds. It is unclear how large a role these regulations are playing in the last months upturn in loan spreads, but it may well be a factor.

Another unintended consequence is similar fire sales by pension funds. Pension funds are permitted to own certain illiquid assets, such as real estate, up to a specified fraction of their assets. The huge drop in value of stocks and bonds held by these funds has caused pension real estate holdings to exceed the maximum portion of assets allowed, and some are now required to sell a portion of their real estate. In one case, we heard that a public employee pension plan was selling off a large apartment complex purchased at or near the market peak, and yielding positive cash flow, at a very significant discount. These unintended consequences are bad for almost all of us, and government must provide exceptions from these rules in order to protect our financial institutions.

A third consequence of this crisis, though more foreseeable, is the bubble in US Treasury securities. As the crisis spread, investors flocked to the safety of US government bills, notes and bonds. This drove the prices of these instruments way up, and the interest rate yields down. According to many experts, there is now a bubble in the price of these instruments, which could reverse in vicious fashion if inflation arrives. Prices of short-term treasuries are now so low that money market fund operators are unable to earn a reasonable return on these instruments, and some money market funds have closed their doors to new investment.

**Government response to the crisis is also increasing debt, and refunding risk. In order to improve liquidity in the financial markets, the treasury is currently funding a significant part of its borrowing with short term bills with very low rates, and going into the market to buy long term federal instruments held by banks and other financial concerns. This carries with it the risk that when the economy rebounds, long term rates will shoot upward, reducing the value of the bonds held by the government, and leaving the government to replace short term borrowing with much more expensive long term bonds, possibly just when the market begins to worry about Uncle Sam's ability to carry all that debt. That's what happened to the Savings & Loans back in the 1980s, causing many of them to fail. While the government is not likely to fail, a massive rise in interest rates could dramatically slow the growth of our economy for years to come.**

### **Expected Long Term US Impact of Crisis**

The consequences of this economic crisis will be profound and long-lasting. At best, if government's part is well executed, we may see a deep reduction of indebtedness of consumers, business, and government, and a return to strong prosperity over time. At worst, our future will look much less promising than our recent past.

The real estate crisis is already transforming housing in America. Some of the suburban and rust belt communities that have been walloped by the housing crisis will never come back. Beset by foreclosures and blocks of unoccupied homes, as well as declining government revenue and services, the worst of these are caught in a downward spiral like the ghost towns of the Old West. The foreclosed homeowners will likely move to more tightly packed urban cores in regions with strong business growth, and their former homes may become low income housing.

Government subsidies of debt through interest deductions are likely to decline over time, and credit standards will likely remain tight for several years. This should have the effect of equalizing incentives for renters and homeowners, which now clearly favor the homeowner. Smaller loans for homes, with greater down payment requirements, will likely mean smaller homes. An increase in the cost of debt is also likely to reduce leveraged buyouts and other business borrowing. Combined with higher expected top tax rates,

these changes may initially decrease economic growth rates, but result in a more even distribution of wealth and income, which should boost consumer spending and middle class savings over time. That in turn may reduce the variability in economic growth, although much of that depends on the impact of global business. One equalizing benefit of the current crisis is likely to be restraint in compensation of corporate management, through regulation, taxation and public pressure on governing boards. That will increase compensation for rank and file. It will also benefit shareholders by increasing profits, and by reducing management incentives to take big risks with shareholders' funds.

Some of our older workers may be forced to extend their working careers, and some of the elderly may be forced back to work to rebuild their savings. The return to the workforce of our elderly may reduce job opportunities for our children for some years to come.

## **Bargain Hunting, and Where We Go From Here.**

Despite the oft-grim economic landscape, we are seeing some very exciting bargains in the investment markets. One fast growing and highly profitable technology company, which about 18 months ago enjoyed a market cap of about \$180 billion, recently had a market cap of only \$75 billion. That company also held about \$29 billion in cash, and no debt, meaning that you could buy the company for around \$46 billion after paying out the cash, making your net investment at about 10x earnings. A year ago, that would be a takeover target. Today, the company still has nice prospects for growth, but we are not sure that it has bottomed. Many companies are selling for less than their book value, and we found one fast growing Chinese company, making a small but growing profit, that has a market cap of \$180 million, and holds over \$140 million in cash and short term investments. Some of the most promising technology companies, with huge growth rates, are now available for about 25-30% of the price per share less than two years ago, though estimates of growth are down only slightly. The world's largest owner of deep-sea oil drilling platforms is selling for four times its very strong earnings. Of course there remains risk that earnings of these front-runners will continue to slip, so we are watching and calculating the risk for each of these opportunities.

Given the history of very large market downturns, including the Great Depression and the tech bubble, the market unwind has typically occurred over about 2.5 years. **That would mean a turnaround before April of 2010. Most market downturns are accompanied by a large rally, retracing about half of the decline to date. If we had one now, we'd see the Dow at around 9500 or better. Ultimately, given the continuing market uncertainty, we believe that a lower bottom is most likely. During the remaining months of this market decline, investors should continue to add to their cash and fixed income positions, both in regular and retirement accounts, in order to fully participate in the turnaround. We are being particularly cautious about accounts with short timelines to retirement. With regard to our clients with longer timelines and appetite for risk, we may begin to make purchases from the better bargains available.**

In brief, we're starting to see some silver lining, but big downside risks remain. The markets remain dependant upon government to help mitigate the crisis, and government faces some daunting challenges. Government must plan and execute well, provide strong regulatory guidance, and try to avoid, or quickly correct, the unintended consequences of its actions. We believe the new administration has the talent and intelligence to deal with these challenges. It will not be easy, but we are getting closer to a turnaround.

All the best,

Stanley Q. Mok  
President