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Dear Client:
Last quarter we told you we were seeing more positives in the market. We got a nice rally this quarter, particularly in commodities and energy, and in certain oversold technology stocks, as well as in hedges against dollar decline.

During just the last few weeks we've seen a sharp rise in interest rates, and a big drop in rate spreads to the most secure borrowers. The so-called TED spread has dropped from around 1.00% in March to around .45 in mid June, very closely approaching the normal historical margin of around .20 to .40%. This indicator represents the difference between the London Inter-bank Offer Rate (the rate banks charge each other for three month dollar loans) and the rate for three month U.S. Treasury Bills. This declining loan margin shows that the market is less fearful of a near term total meltdown, and that investors are moving funds out of treasury bills and into higher risk instruments, whether inter-bank lending or even stocks.

We expect this liquidity, including the huge amount of cash still on the sidelines, to limit the immediate downside to the market, and to provide the possibility of some further upside in the next few weeks. Nevertheless, we remain profoundly concerned about the longer-term economic conditions. We would expect substantial volatility during the lower volume "summer doldrums," and possibly another market decline by the fall, or earlier, before we begin to really emerge from this crisis with a slow recovery starting early next year.

Short term again, we see continued relief in the market. Federal funds will begin to flow this summer from the federal stimulus plan, and from similar investment in China and other countries. Other positives or stimulus include:

- An estimated 50% reduction from peak in credit default swaps outstanding
- Real estate prices are down over 50% in the most volatile markets, with sales volume (not prices) recently to the upside, and inventories declining.
- Proposed tax legislation would provide one-time tax credits of up to $15,000 (up from $8,000 in the stimulus package) to home buyers, regardless of taxpayer income or whether these are first time buyers.
- The RATE of job losses has been declining for most of the last quarter (total unemployment is still growing).

Ongoing Problems in Financial Markets

One big area of continuing concern will be transparency and risk in financial markets. During the last few months, we've seen a change in lending practices (much tougher), and a rise in rates for existing credit card borrowing. This will raise profit margins for banks, but at the same time, some cardholders will become unable to meet their obligations as a result of unemployment and the growing interest burden. Bank of America's non-performing credit card accounts soared from 10.47% in April, to 12.5% in May. During the last quarter, a number of leading banks have announced strong profits, while making repayments on their Troubled Asset Relief Program ("TARP") bailout funds. Investors should view this information skeptically. SFAS 157, the accounting rule that was to force banks to mark their assets to market value, was indefinitely postponed in the last quarter. Some banks had already begun reporting such markdowns in prior quarters, but instead will now record these loans at full historical value. In a prior newsletter, we had suggested that SFAS 157 needed reform to avoid overstating the decline in value of certain bank assets, but the delay in any application of the rule will make bank financial statements even less reliable. As a consequence, banks can be expected to take few markdowns now, but to show decidedly lower profitability, or even large losses going forward, probably for years to come. SFAS 157 should be revised to require banks to report loans at the present value of the stream of income that they can reasonably expect to collect, given current information. The deviousness of bank accounting remains astounding. While banks are not taking their losses on their assets, some are apparently taking accounting profits relating to the decline in the price of their bonds. Recent reports describe how several major banks' profits last quarter were in large part due to this accounting gimmick, despite the fact that some of these banks lack the funds to actually repurchase their debt at a discount from face value.

Recently some banks have made repayments of TARP funds. But the Fed is making large loans to unidentified banks at the so-called "discount window", and it is therefore impossible to know whether the source of a portion of the TARP repayment is further borrowing from the government. In addition, banks used the last quarter to raise additional capital in the public markets, some of which has been used to repay the TARP. Moreover, with SFAS 157 suspended, the Fed is reportedly working with banks to reduce interest rates in order to avoid more foreclosures, particularly in large commercial real estate loans. Banks that reduce interest rates will not need to mark down these loans, but will in the future show lower loan collections and thus reduced profitability. Some analysts have recently predicted that banks have years of strong profits ahead due to higher margins and low borrowing costs. Don't count on it. They may all too soon face exactly the opposite conditions.

Banks are also facing new pressures in the residential real estate loan arena. Just as sub-prime loans have mostly reset from introductory rates, banks are facing a new wave of resets on so-called ALT-A and Option ARM loans, many of which involved inadequate documentation on borrowers, inadequate collateral, no amortization of principal, or negative amortization (allowing borrowers to add payment deficiencies to loan principal). These loan resets will occur over the next 18 months or so. In addition, if for any reason we run into inflation, banks will face even more pressure, as foreclosures would be expected to rise and investors will move funds from bank deposits into higher yielding assets, or short term CDs, while some banks will be stuck with low income from fixed rate real estate and business loans. For all of these reasons, we are generally not investing in financial stocks, even after the big drop in share prices seen in the last year.

Real estate prospects remain worrisome as well. Although the price of the average home in California is down over 37% during the last year, and about 50% from peak, prices of the most expensive homes, which previously rose in value due to easy jumbo loans terms, are expected to continue to fall, until possibly 2012 by some estimates. As unemployment increases and automakers continue to cut production, there will be additional foreclosures, business failures of suppliers and local retailers, and growing vacancies in commercial and industrial properties. Finally, states like California, which has a $24 billion deficit this year, will be forced to dramatically cut services, leading to further declines in property values in certain hard-hit communities.

Government Issues:

Before President Obama took office, he promised:

- financial industry reform
- increases in taxation to moderate inevitable deficits during this financial crisis
- that the stimulus package would be spent almost entirely on badly needed infrastructure
- that TARP funds would be used to restructure unwise residential loans

Thus far, reforms have only begun to take shape and political realities in Congress required that a significant portion of the stimulus be allocated to tax breaks for business, and for car and home buyers. At the same time, the Fed, under the leadership of Secretary Timothy Geithner, has followed the policy established under Bush Treasury Secretary Henry Paulson, who determined that the TARP funds went solely to banks, investment firms and insurance companies. The result of the TARP allocation is that these funds bailed out the bondholders for these institutions, without doing much to improve the finances of America's consumers or relieve the downturn in real estate.

We believe that our financial crisis is a result of unsustainable indebtedness, including consumer, business and government debt. Consumer spending is the largest driver of our economy, accounting for about two-thirds of all spending. We are just concluding several decades of growing disparity in wealth and income. During that period, consumers were encouraged, by subsidized interest rates, and tax and trade policy, to incur debt to improve their lifestyles. We believe that the economy will only be able to push forward when the consumer has reduced indebtedness and increased his or her savings rate to sustainable levels. That will require new policies that our government has not yet put in place. Making these kinds of changes requires new ways of thinking, and a new political consensus, and we may not have arrived at that point.

Recent deficit spending by the government has merely shifted some of society's private debt to public obligations. It is anybody's guess whether we will make the necessary policy changes in short order, or if instead we will continue to issue public debt to the point that it is no longer sustainable, and must either be repudiated, or will result in a long period of national decline. Economists like Nouriel Roubini warn that rising government debt will lead to a declining dollar, higher costs of borrowing for business and consumers, and slower growth. Even conservative investment advisors like John Mauldin suggest that increased taxation may be necessary for some time to stop runaway deficits.

We wonder if Treasury Secretary Geithner is up to the challenge. He certainly didn't see this coming. Geithner faces his own challenges on home borrowing. Unable to sell his New York residence for near the original purchase price, Geithner faces negative cash flow, with payments on the reported $1.25 million loan principal (two loans) and annual property tax seriously exceeding the $7,500 in monthly rental income he derives from the home while he lives in other quarters in Washington. Geithner himself has managed to dramatically increase our national debt for the benefit of banks that should have been closed, without doing a thing to lighten debt loads on consumers. Obama himself seems to underestimate our financial problems, and nobody is talking about a bank holiday, in which banks are briefly closed and seriously assessed for solvency. We believe the stress tests were inadequate, but it may take some time to fully reveal the extent of their inadequacy.

The next immediate hurdle for the government will be healthcare spending, which represents nearly 17% of gross domestic product. That compares to about 10% of GDP in other developed nations, which cover all their citizens, have slightly longer lifespan, and better average health outcomes. Unfortunately, our healthcare costs are also growing much faster than other costs, and leave American companies, which shoulder most of that burden, uncompetitive with many of their foreign counterparts. The existing system is broken, and can't be fixed with minor tweaks. Powerful insurance companies, law firms, drug companies and medical providers are lobbying to protect their existing stakes in our current system. We think it unlikely that all necessary change will occur in one bill, but healthcare is this nation's top immediate priority. Real reforms must take place now or this country will soon be either unable to compete, or facing the collapse of corporate provided healthcare as we know it. Obama's speech to the AMA was a good start, but follow through is critical. If the government does a good job on healthcare, we can expect a slowdown in costs, and greater funds available for savings, plus more competitive American industry. In addition, the giant healthcare burdens on state and local government will decline over time.

The Promise of Technology:

In the meantime, we see some promise for the economy in technology, which at least for the time being remains a sphere of national competitive advantage. Biotech companies are making advances in the battle against aging and related diseases, including cancer, type II diabetes, obesity and Alzheimer's disease. Exciting new medical devices are also coming to market. We hope to further discuss these areas in our next newsletter. If we can lower healthcare costs and improve the health of Americans, we may yet get a double whammy of lower social costs and greater productivity.

In summary, the outlook is improved over for the very short run, meaning that panic has subsided. Unfortunately, very large systemic risks remain on the horizon, and government action has, to date, failed to improve the long-range prognosis for the American economy. We will be watching your investments closely, for systemic change, and an opportunity for gains, regardless of market direction.

As always, we remain grateful for your continued confidence in our firm. In these difficult times, we are honored by your loyalty. We are also grateful that you speak kindly of our services, and, where appropriate, introduce us to your family and friends. Your kind words are our best form of promotion.

One final item: 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.

Sincerely,

Stanley Q. Mok
President