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Dear Client:
At the end of March, as the stock market finally stopped declining at 6400 and moved past 7700 on the Dow, our newsletter said that we were beginning to see a silver lining. We also said: "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."

Well we've crossed 9500, and we're still climbing. And the downside risks remain.

So what are we doing? We're buying from a diminishing group of stocks which are fairly valued, and some technology and commodity stocks that have long-term growth stories and/or offer solid income. We're also putting funds into a limited number of dividend and other income producing investments that we believe offer value. But we are concerned with prices, which are getting rather lofty.

Market Prospects

We believe that the current stock market is, generally speaking, overpriced. Yale Economics Professor Robert Shiller, who warned in 2006 that real estate was at nearly double the inflation adjusted average over the last century, is now concerned about the stock market. He notes that at the market low in March, prices were at 11.7x average earnings for last 10 yrs, adjusted for inflation, the lowest valuation since January 1986. By August of this year, stocks were at 18.4x the 10 year average earnings, or well above the long-term average of 16.3x.

Meanwhile, insider selling is up dramatically. Normally around 7:1 over buys, and 2:1 from last September to March, by last month it had reached 31:1. This is a sell signal. In 1930, during the Great Depression, the stock market took a second dive, after a strong rally. While government action has been far bolder today than under the early years of President Hoover's administration, debt levels are much higher, and almost nothing has been done to reduce the debt burden of the average consumer, who we look to in order to restart the economy.

Normally, we would expect rallies to fizzle at about this point. The market can be hazardous in the early fall, and particularly in October, which has witnessed some of the largest market declines of the last century. We're not sure of the precise timing of the next downturn. The current rally could end in October. On the other hand it might extend, somewhat haltingly, into the beginning of next year, based on year-over-year improvements in earnings (which will almost surely come in above the abysmal earnings of last year's third and fourth quarters) and the return of merger and acquisition activity.

Eventually however, this market will retrace itself. Will this lead to another financial crisis? We don't know. We know that government funds are still streaming into global credit markets. The so-called "Ted Spread", a measure of the risk of immediate financial gridlock, has dropped to levels not seen this decade. What does that mean? We are unlikely to experience the same level of panic seen after the Lehman Brothers bankruptcy. On the other hand, as discussed below, we don't see signs of general inflation.

Clearly this ocean of government money is not providing much assistance to consumers. We do believe however, that it could produce localized bubbles, leading to misallocation of credit. Some observers warn that some large financial institutions and investors may be using the credits to take risky positions, in the hope of quick profits to make up their losses over the past year. We may not know the effect of these financial decisions for some time. Lots of bad investments may be the consequence of the flood of federal money, rather than any immediate inflation or global bubble.

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Meanwhile, credit is only reaching businesses with extremely strong balance sheets and cash flows. You can expect these businesses to either squeeze out competition, or use their borrowing capacity to buy competitors at fire-sale prices. After these acquisitions, you can expect the acquiring firms to reduce capacity, putting even more workers on the street. While this activity will eventually put a floor under prices, it will take a few years for unemployment to stop rising and job growth to resume. With a weak labor market, the average consumer will likely continue to downsize purchasing. So we're not done yet.

Competition will be particularly hard-hit in banking, where a select few banks have seen their costs of borrowing reduced to almost nothing, as the result of government assistance, while their smaller competitors are allowed to fail. The troubled bank list now numbers nearly 1000. These banks are largely outside the too-big-to-fail group, and we believe a significant portion of them will fail.

The U.S. private industry workweek is now down to 33.0 hours per week. This is the lowest rate recorded since this statistic was maintained, well below both the peak of 34.7 hours seen in 1988, and the 34 hours recorded before the current recession. Meanwhile, unemployment continues to rise. While the so-called headline unemployment rate, known as U-3, is slowing, at 9.7%, real unemployment, including those who did not seek work last month, and those seeking full-time work, is approaching 17%. The U-3 rate in some states is well above the national headline rate, with California now above 12%, and those who have recently graduated are about 25%.

Unemployment is expected to rise until sometime next year. If this recession follows the path of other recent downturns, we can expect that as unemployment growth comes to a halt, employers will raise the hourly workweek for many months before adding new employees. We expect a largely jobless recovery for several years at least, with a real possibility that the US will experience long-term higher unemployment for a decade or more. According to investment advisor John Mauldin, the country will need to average 250,000 new jobs per month for five years in order to bring back the unemployed and accommodate the 125,000 monthly new entrants into the job market. We have never sustained that kind of job creation.

Meanwhile, the safety net has largely frayed. Unemployed Americans without requisite job skills will find a lack of job training programs, and current welfare laws that will leave them without long-term benefits. Many new high school and college graduates risk becoming part of a lost generation, without meaningful job prospects, and possibly several years of adult life at home with their parents.

Shuttered and underutilized plants and equipment, so-called "unused capacity", has reached levels not seen since records have been kept. Industrial utilization came in at 69.6 percent, or just above the lows in May-June, and has climbed only a bit since then. By comparison, utilization bottomed at 73.5% in 2001-2, averaged about 81% for the last 37 years, and peaked at about 87% in 1987-88.

Overall, we remain very cautious, and, with some exceptions, still avoid most companies in real estate and finance. The smartest people we know continue to warn of coming or undisclosed losses in banking and real estate. They warn that recent improvements in real estate prices, and much of the improvement in manufacturing, is attributable largely to government assistance, such as tax credits for first time home buyers which may equal or exceed the downpayment on some homes, and programs like the "cash for clunkers" initiative. Meanwhile, a great deal of housing inventory remains on the sidelines with a variety of foreclosure moratorium programs in place, but achieving little permanent benefit. Credit card "charge off" rates - loans the bank does not expect to be repaid - rose to record levels in August at two of the nation's top card issuing banks. The rise in delinquencies at some companies was double or triple the levels expected. There are more losses and pain around the corner. Credit card regulations were broadly relaxed in 2005, when cardholders lost their right to file for bankruptcy. Card issuers have moved to make up for losses on some accounts by dramatically raising interest rates on the remaining cardholders who carry a balance. Also, missing a payment due date by just one day can now bring higher rates and large penalties.

With the holiday shopping season now underway, we expect that consumers will not be doing much spending. Consumers are saddled with huge amounts of debt, while their real pay, adjusted for inflation, has been flat for years. You can expect that the burden of declining real income, high debt levels, and increasing credit card interest have pretty much depleted the consumer piggy bank, as well as his line of credit. So retailers will have a tough season, and that will work its way back through to their suppliers, their landlords and those that count on the holiday for extra income.

With government spending on the upswing, income taxes for the wealthiest Americans is bound to increase next year. The Bush tax cuts, which dropped the top marginal rate to 35%, are set to expire at the end of 2010, and almost nobody expects these to be renewed. Expiration of the current tax law will bring the top rate to about 40%, but we think that tax rates on the highest earning Americans will rise even further. During the last Depression a Republican President and Congress raised that rate to 63%.

As many economists have noted, the recession occurred because debt levels were unsustainable. Some have suggested that the underlying cause of the debt was historically high inequality of income. Income of top executives, athletes, entertainers, attorneys and financial industry stars have grown disproportionately to the rest of the population. The income of the top 1% of all Americans grew from a low of 8.6% of total income in 1976, to about 23% of income in 2007, a rate unmatched since the year before the Great Depression. Meanwhile, wages for the average American worker, adjusted for inflation, rose only 2% over the last thirty years. Over that same period, the U.S. savings rate dropped from 11.2% of income in 1982, to –1.1% in 2006.

When the wealthy depend on an increasingly indebted consumer, eventually either wages must increase or consumption will decline and loans will go unpaid. In the end, we got a decline in consumption, and uncollectible debts. As the wealthiest Americans enjoyed growing incomes, they needed a place to invest those funds. Their investments fueled a supply of goods and services which exceeded the sustainable long term demand for those goods and services. The imbalance between supply and demand led to bubbles in the global economy by the late 1990s, and we are paying the price for that today. While the bubbles were in part caused by Federal Reserve Board policy supporting low interest rates, higher interest rates would have led to politically unacceptable levels of long-term unemployment. If the government had instead maintained tax rates in 2001, it would have absorbed much of the income of those with the highest earnings, resulting in a tightening of the money supply, while helping to maintain a balanced budget.

We don't like tax hikes any more than the next guy, but they will have the effect of further narrowing the income gap, and raising the average savings rate, as we eventually pull out of the recession. Over the next few years we can expect the income gap to decline, savings to rise, and tax rates to increase, but the economy will not recover until consumer debt levels have declined dramatically.

Inflation? We Think Not Yet.

Governments around the world are engaged in deficit spending – they are printing money. This has many people, including some clients, worried about the risk of inflation. For the moment, we are not very concerned. Asset price increases seem to be limited to just a few markets, namely stocks, a few precious metals, and possibly a brief and very small blip in housing. Metals are rising, but not dramatically, and apart from gold and silver, seem to be tracking advanced materials purchases for infrastructure construction under stimulus packages in China and the US. Prices for labor, agricultural commodities, industrial products and consumer goods all remain weak. We believe that the drop in overall economic activity, will, for at least another year or two, outweigh any risk of inflation. Huge unused capacity, in the form of plants and equipment, and very high unemployment, will need to be absorbed prior to the onset of inflation. That said, we continue to watch for pricing pressures in isolated markets, both as an opportunity, and as a warning of future inflation.

A decline in the U.S. dollar could also result in inflation, and the Federal Reserve might move to raise interest rates if it feels that the dollar needed strengthening against other currencies. While the dollar has dropped about 20% against the Euro since it peaked in the spring, and by similar amounts against many other currencies, in most cases it remains well above the lows it registered in 2008. While high levels of US government debt and the continuing trade balance remain problematic, and would ordinarily cause the dollar to decline, many of the world's other large economies also have very high levels of debt, and the Chinese stock market has been declining since mid July. As a result, and because the U.S. dollar remains the dominant currency for international trade, we expect that the dollar will not face heavy downward pressure for at least the next year. Nevertheless, we continue to monitor the exchange rates for the dollar and will take action if that situation changes.

Our strategy, then, in brief, is selective, cautious investment. As the market climbs, we will harvest our gains, and adjust our hedge (which profits from market downturns), anticipating an eventual reversal in the markets.

Sincerely,

Stanley Q. Mok
President