MOK CAPITAL MANAGEMENT
A Registered Investment Advisor

Stanley Q. Mok
President

4962 El Camino Real Suite 235
Los Altos, CA. 94022-1456

650 318 8077 tel 650 318 8070 fax 866 822 4384 toll free
smok@rr.firstallied.com www.mokcapital.com

April 2, 2010

Dear Client:

There's a lot of news on the economic front. Two major stories are interest rates and healthcare. But first we pause to look at current market conditions.

Current Conditions

The government seems to have stabilized the financial markets with very low rates of interest, and a great deal of financial support for key banks and insurance companies. Most large banks are now out of any immediate risk. Stock markets, perceiving reduced risk levels, have climbed several percentage points the last quarter, with reduced rates of market volatility. This is good for investor confidence. Low interest rates have been good for government and business. These rates have permitted government to reduce the portion of GDP needed to service the debt. Corporate debt sales have also been at record levels this last year. Businesses are building cash piles and paying down higher rate debt.

Certain riskier markets are doing well. High-yield debt is being sold in record amounts, driving the risk premium for such instruments to recent lows. This provides valuable funding for a segment of the market, and helps compensate for low levels of new bank lending. We bought some high yield instruments for client accounts when the markets were near collapse, and yields were at panic levels, and returns on these have been good. But we think the current yields are less attractive, and may not reflect the systemic risk today, nor the individual risks faced by their issuers.

Many areas of the economy remain under pressure. We expect real estate prices to get hit by a double whammy as foreclosures of both housing and commercial real estate continue to rise, while government tax incentives for home buyers expire, and tougher lending standards continue to take hold. Our friends in real estate tell us that U.S. businesses are sitting on very large amounts of empty facilities. As these leases expire, this should flood the market with additional commercial and industrial property, depressing rents and property values. US housing prices were soft the last couple of months, and could slide further. If real estate prices decline again, we would expect further pressure on state and local governments that rely on property taxes, many of which are already on the edge of insolvency.

Some regions and industries are outperforming the economy as a whole, including exporting industrial businesses and certain core technology companies. We like the long-term prospects for stocks in countries with reasonable national debt loads and large domestic natural resources, particularly Canada and Brazil, and biotech and medical device stocks, particularly now that there is greater certainty about healthcare revenues. We like the stability of utility revenues, though we are mindful of the impact of rising interest rates on these firms.

As I have said before, in order for the global economy to thrive, debt levels will need to decline. Since the financial crisis began in late 2007, individual debt has been declining, but government debt has grown faster. Instead of seizing banks and writing down their debt, government has borrowed money and bailed out the largest banks. As government debt climbs, government risks a loss of confidence by investors. If this were to occur, interest rates could rise very rapidly. Low interest rates have allowed the government to run unprecedented deficits. If interest rates rise, the cost of servicing the federal debt would rise quickly, reducing the amount available for other government spending, including entitlements. With a projected deficit this year of nearly $1.6 billion, many experts believe we are rapidly approaching the limits of government borrowing.

Securities offered through **First Allied Securities, INC.** Broker/Dealer Member FINRA/SIPC clearing through **J. P. Morgan Clearing Corp.** This report is prepared for general circulation and is for informational purposes only. It is not intended as an offer or solicitation for the purchase or sale of any financial instrument or service. Market prices and other data may be obtained from outside sources and is not warranted as to completeness or accuracy. Past performance does not guarantee future results. Any comments, statements and/or recommendations made herein do not necessarily reflect those of **First Allied Securities, INC.**, its subsidiaries or affiliates, and are subject to change without notice.

With debt levels at such stratospheric heights, government options are limited. Government could encourage the forgiveness of huge amounts of private debt through changes to the bankruptcy laws or other means, while reducing government deficits. Such a scenario could return us to economic decline, with even higher unemployment than we have now, but would eventually restore good growth and a strong currency.

Alternatively, we could try to grow the economy faster than private debt, by very heavy federal spending combined with high taxation. Hoover and Roosevelt followed this path during the recovery from the Great Depression after the spring of 1932, but on a relatively modest scale. Such spending would focus on infrastructure, education and worker training, as well as industrial projects that could advance U.S. industries. This policy has the advantage of higher employment, and thus lower levels of potential social unrest, but risks a loss of faith in the currency.

Today it looks like the government is trying to follow the second path, by growing out of our financial troubles. This road is very difficult, as it requires significant economic engineering by government, and implies a long walk on the knife-edge between economic malaise on one side and runaway inflation or financial bubbles on the other. There is no precedent for an economy to outgrow debt at these levels, given recent historical growth rates.

At the moment, inflation remains unlikely for several years, due to the abundance of underutilized labor and equipment. However interest rates could climb rapidly if foreign investors begin to lose confidence in the dollar, and reduce the allocation of dollar denominated debt in their portfolios. Such a rise in rates would bring back foreign investment, but at a cost to domestic growth. Fortunately, rising interest rates tend to correct the outflows, and provide support for the currency. Another possibility is that the dollar will slowly decline against key foreign currencies for many years, which will validate investment in fast growing emerging and resource based economies.

<u>Interest Rates</u>
Rates have begun to climb the last few weeks, and we think this may become a continuing fact of life. The U.S. Federal Reserve Board recently raised the so-called discount rate, or the rate that US banks can borrow from the Fed, from zero to .25%. The Fed's long-term ability to control key rates is limited, particularly when the government has unprecedented borrowing needs. We think rates should rise across all maturities. Many leading analysts see us now at the end of a bond rally that has gone on for more than 25 years (with some interruptions). As rates rise, bond prices, which move in the opposite direction, could fall dramatically, particularly for the longer-term bonds. A rise in long AAA corporate bonds from around 5% to 8%, for example, could hit bondholders with losses of 30% or more.

In the short-run, rising rates will require that investors turn to shorter-term instruments bearing lower rates of return in order to avoid large losses of principal. In the near-term, rising rates may lead to a flattening or correction to the equities markets, as rising costs of capital drive down corporate returns and reduce exports. During such a downturn, we believe that certain defensive stocks like food and beverages will outperform. Longer term, rising rates have the potential to bring some level of fiscal discipline to government, which will not be able to afford an endless spiral of such rate hikes. While higher rates would reward savers over time, a policy encouraging high rates would be counter to the government's objective of outgrowing current debt levels. An alternative strategy would be to create a phased plan for reducing deficits, raise taxes, particularly on consumption of consumer goods and energy, most of which are imported, and curtail foreign borrowing. This would over time reduce both the fiscal and trade deficits, while encouraging savings. We are not sure if this can be done, given the political challenges, but it more closely fits the stated aims of this administration.

<u>Healthcare</u>
Last week the President signed into law an historic healthcare bill. Supporters of the bill tell us it will provide coverage for millions of additional Americans, while also controlling costs. This was possible, given that the US spends nearly double the amount per capita for healthcare as other developed nations, while having worse average longevity and other health outcomes. But we think the projections for future cost savings are too optimistic, as the bill makes no radical change in the way we pay for care (private insurance).

The bill is long and complex, and it will take time for both the intended and unintended results to become clear. Our best guess is that the law will leave plenty of room for profits at insurance companies and health care providers, who will gain more than 32 million new customers. However, what's good for these firms may not be good for the rest of us. Other businesses are already setting aside large reserves for the costs of the program. Benefits are phased in over the next eight years. The bill expands medicare payroll tax to include unearned income (like rents, interest, dividends and royalties) for those making more than $200,000 for individuals, and $250,000 for joint filers. The bill was only a first pass, and we can expect amendments to the law over the next few years. Unfortunately, we missed a major opportunity for real reform.

With healthcare now receiving a bit less national focus, the administration and Congress can turn to other pressing matters. Foremost among these are: (1) putting the social security program and government pensions on a more sustainable path, (2) balancing the budget by a combination of higher revenue and lower spending, (3) reforming the financial system, (4) boosting job creation, possibly through spending on infrastructure and worker training, and (5) encouraging higher savings and a lower trade deficit, particularly in oil.

Other Risks

We remain concerned about a number of other risks not covered in our recent newsletters, including:

(1) Underfunded Defined Benefit Pensions, Both Public and Private. These plans,which guaranty retirees a specified annual income, are increasingly underfunded. This underfunding is caused by a variety of problems, ranging from mismanagement to large losses in principal due to the stock market decline, and as a result of lower interest rates and dividend yields. Absent a very strong level of economic growth, these plans will require either very large support from government and industry in order to meet their obligations, or significant reform to reduce future obligations to retirees. Many of our government pension plans are now drawing on general revenues to fund retiree benefits. If a 65-year-old retiree is entitled to an annual benefit of $50,000, and has an expected remaining life of 17 years, and an assumed yield of 5.5% on assets, the plan will need assets of about $554,000 in order to cover the expected costs. But if the plan now holds less than that "fully funded" amount, the government must pay the difference from current tax revenues. That bill will grow over time as the retirement fund, such as California's CALPERS, is exhausted. And the problem will be compounded if the fund becomes unable to keep up with inflation, or if the plan fails to earn the required rate of return. According to Forbes magazine, California has unfunded pension obligations that are among the highest in the country, at around $13,000 per person, in addition to current state debt of around $1,800 per resident. That implies that higher taxes are coming.

(2) Loan Rate and Refunding Risk for US Treasury. The US government has been taking short-term loans in order to take advantage of current low rates. While the Treasury is now lengthening the average maturity of its debt to protect against the impact of future rate increases, according to Bloomberg News, approximately $1.63 trillion, or 23% of the total U.S. debt, will become due in 2010. Expected new borrowings should raise the total treasury fundraising requirement to nearly $3 trillion. During the downturn in 2008-2009, the Treasury also bought large amounts of its own long bonds in order to increase the money supply. In order to control the money supply, it is expected that the Fed will eventually resell these bonds. These bonds carry a fixed rate of interest. When interest rates rise, the interest costs for the federal government could skyrocket on new and refunded debt. Also, the bonds it holds will continue to yield the same fixed rates at which they were issued, reducing their resale value. In the early 1980's savings and loans had most of their assets invested in long-term fixed-rate loans, while their funding came largely from short-term deposits. As interest rates rose, but S&L loan portfolios continued to pay them the same fixed yield, profits rapidly turned to losses and new loans ceased, resulting in the S&L crisis. We hope we don't see the same kind of squeeze at the Treasury.

Over the last quarter, the market has enjoyed modest gains. We think the market has fully priced in a modest recovery. Historically, when a market has a good start to the year, it often runs into weakness by late spring or the so-called "summer doldrums", when traders take their vacations. We would expect that the modest recent runup in the market to end by early May, at slightly above the current level, and then decline into the fall. Progress in late fall will depend in large part on news about the economy. A shock in the financial sector, including a spike in rates, could set stocks back on a path of sharp decline. Alternatively, if news is good and hiring looks strong, which we think unlikely, stocks could

resume climbing by November. Overall, we think that at the current prices, equity and bond prices are near to a top, and downside risk exceeds upside potential. Some exceptions exist in the asset classes and industries discussed above.

We hope you all are starting to enjoy some benefit from the slowly improving economic conditions, and the lovely spring weather.

Sincerely,

Stanley Q. Mok
President