

October 12, 2011

Dear Client:

In our last newsletter, at the end of June, we expressed deep concern with deflationary pressures from a variety of sources, including excessive European government debt, the weak housing market, and government austerity measures. We warned that “the cycle of deflation that may be coming is really troubling.”

We didn’t profess to know the exact timing or cause, but we did offer a guess, and it seems we got it right. We thought it “might start with some European nations, then move on to the banks and others holding their debt...” We noted that “anything could set this off, including further troubles with national debt in the Eurozone, but one strong candidate is the U.S. debt ceiling. “

We suggested that “the Fed might use this crisis to announce their latest monetary easing program sometime in August, and **we expect that economic conditions will deteriorate between August and year’s end.** But everything now depends on government, and we’re watching it closely.” (Emphasis added).

As we now know, the market began to drop sharply about July 22, or shortly before the deadline for the debt ceiling extension, and when an agreement was reached, fears about European sovereign debt and the health of European banks really moved the markets. From a Dow reading on the 22nd of about 12,700 (near the post 2008 high seen in May), the index tumbled to a low of nearly 10,700 on August 8. Since then the Dow has been range bound between 10,700 and 11,600. The market retested the lower end of that range on September 22, the first trading day after the announcement of the Fed’s newest program, designed to reduce rates of interest on the US long bond, which was met by a wave of skepticism. The Fed’s “twist” program involves the purchase of longer term bonds using proceeds from the sale of shorter term instruments, so the program does not actually ease the money supply, and is just designed to bring down long term interest rates, including mortgage rates. That move could help the housing market, but the effect would likely be temporary.

Large nation central banks are working overtime to provide liquidity to certain European banks, which are having a hard time borrowing in the interbank and public marketplace. We think that a concerted effort by these central banks should avoid any banking collapse into next year. We also think that with sufficient coordination and commitment, Europe could come up with a plan that would further integrate Europe, allow the debtor nations to reschedule or reduce some debt, and avoid a banking disaster. But such a long term solution will require a level of leadership and cooperation that is unlikely.

The clock is ticking in Europe. The large European banks reportedly have satisfied their funding needs through the end of the year, but they face nearly a trillion dollars of refunding requirements in 2012, and even more the following year or two. Much of this is currently being funded by CD like instruments, with depositors blindly chasing yields a few points higher than recent inflation. While it looks like Europe will take care of Greek funding requirements that come due this month, and may be structuring some longer term solutions, unemployment in Spain is now around 20%, and European leaders face increasing threats of instability from hard pressed citizens of Greece, Spain, Italy and Portugal.

Set forth below is a table showing the relative sizes of the troubled European nations, and the leading European powers, by GDP, according to the International Monetary Fund:

Global Rank	Nation	GDP (Trillions)
4	Germany	3.286
5	France	2.563
8	Italy	2.055
12	Spain	1.410
32	Greece	.305
38	Portugal	.229

Clearly, economies of Germany and France, with a combined GDP of approximately \$6 trillion, are not that much bigger than the troubled nations (total GDP of \$4 trillion), and would need assistance from the entire European Union (total \$16 trillion GDP) in supporting these nations.

Meanwhile, a global slowdown in business means that the U.S. probably entered a recession in early August, or will do so shortly, and we think it likely that markets will be weak, if not dangerous, going forward. Growth has dropped below 2%, which is considered stall speed for the economy. All recent times when growth has slowed below 2%, the economy has dropped into recession.

Some analysts note that profits at the S&P 500 are at record highs, and that price-earnings ratios show that stock prices are cheap. These analysts expect that equity markets will advance. Corporate earnings could indeed be strong in the just completed quarter, possibly giving a brief shot in the arm to stock prices. But prior quarter profits are a lagging indicator, and we believe that profits going forward will decline, as will price-earnings ratios. Corporate profit margins, and P/E ratios, tend, over the long haul, to revert to historical norms, and we think that this is now due for a correction. During the latter stage of an economic upturn, P/E ratios tend to seem modest, based on very strong recent profits. A more accurate indicator, formulated by Professor Robert Schiller (the Yale economist who predicted the housing bubble), uses a P/E ratio based on ten year profit averages. Schiller's numbers show that P/E ratios are still high by historical norms, and they are very high when compared to the figure at the close of the last economic downturn in the spring of 2009.

President Obama took the slowdown as an opportunity to offer up a new jobs program, largely consisting of tax breaks for the middle class and some employers, with a rather modest infrastructure focus, and some aid to states to prevent job cuts. A portion of this is to be funded by tax increases on the wealthy. We believe this may increase spending briefly, but is unlikely to have the kind of prolonged benefit that one might expect from a strong infrastructure and energy program, designed to improve economic competitiveness and reduce American purchases of foreign oil. Also, any investment in jobs is unlikely to have much impact for months, meaning things could decline further before the program takes effect. Finally, with GOP control of the House of Representatives, it's not clear whether any meaningful part of the President's bill will be passed.

Besides the economy and the Euro-debt Crisis, here are some other things we're watching:

1. The Budget Process. Congress has already started wrangling over the budget. If a new budget is not in place by the start of the new fiscal year on October 1, the government will need to dramatically cut back on expenditures, which could further damage the economy.

2. Deficit Reduction. The special committee on deficit reduction (Committee of 12) is due to start discussions on the deficit this quarter. To get the long term budget under control, they will need to focus on a rapid end to the wars in Iraq and Afghanistan, a general reduction in military spending, and a reduction in entitlement benefits, particularly social security and medicare. Entitlement cuts will mean strengthening cost controls under the President's healthcare plan, including allowing the government to negotiate low cost drug pricing, and for social security, negotiating a higher age for benefits, and/or eliminating social security benefits for the wealthiest citizens. No such deficit reduction plan will be complete without some increases in tax rates or broad elimination of tax deductions and credits. US troops are due to leave Iraq this year, but continuing instability has Iraq looking for more long range support, most likely from US troops moved to bases in neighboring Kuwait. Congress will need to say no to this if it wants to keep costs down. Similarly, we will need to recognize our limits in Afghanistan and Pakistan and wind down the efforts there more rapidly. We're skeptical of results from this Congress.
3. Post Office. The US Postal Service faces severe structural problems, including a forecasted loss of nearly \$10 billion for the current year. First class mail is declining as people communicate more and pay bills online. The President has advanced a plan to eliminate Saturday service and permit the USPS to offer additional products and services. We think these changes, recommended by the Postal Service, will be adopted.
4. Instability. Growing income inequality and unemployment tend to increase global instability. This usually results in hunger, increased migrations/refugees, crime and sometimes even war. We've seen this in the Arab Spring, and in increased domestic tension in China. In particular, we are watching the escalating Mexican Drug War, and expect greater consequences here at home.
5. Bonds. Bond prices are still rising, but this now simply reflects horrid economic prospects for the next ten years, and limited growth for possibly longer, as well as investor fears of asset deflation. Nevertheless, bond prices can't fall much below their current levels. The current ten year bond yields have dropped below 2%. When you take out taxes on interest, and the current rate of inflation, investors are now paying for the privilege of holding bonds. For that reason we expect that over the next five to ten years, bond holders face considerable risks from increases in interest rates. As rates rise, bonds decline in value, particularly bonds with long maturities. This puts at particular risk investments in the 20- year U.S. Treasury bond and similar corporate instruments, which comprise a very large portion of standard asset allocations for retirement accounts, such as pension plans and 401k plans. We believe that interest rates could climb, even in a slow growth economy, particularly if sovereign debt ratings continue to slide. Rates on Greek bonds have climbed above 20% recently.
6. Upside. While most asset classes will face deflationary pressure for the next couple of years, we see long term upside in currencies and equities of certain developing nations, such as Brazil and India, and nations with fiscal strength, particularly Canada, Brazil, Australia, New Zealand and Norway, which have considerable natural resources reserves. The dollar will be stronger for the next year or so, as typically happens to the global medium of exchange and lending during times of stress, but some nations are trying to diversify holdings away from the dollar, and these five nations should do well even before the US economy begins to strengthen.

7. China will be forced to float its currency or pay too heavy a price in inflation. When it does that, the change will also benefit countries like Brazil that already have a strong economy, but suffer competition from China's artificially low exchange rate. As their currency gets more expensive, and real interest rates rise, domestic bubbles, and some commodity bubbles, will burst. There is strong evidence this is already underway in China, where the Shanghai Exchange has declined sharply in recent weeks, as have commodities like iron and copper, which have been particularly sensitive to construction in China.

In summary then, we think near term market risk is largely to the downside, but much continues to depend on government's response to crisis. We are watching with interest. We live in very interesting times.

Sincerely,

Stanley Q. Mok
President