



LION CAO

ASSET MANAGEMENT

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Seasons Greetings and a.....

Mini Musings

All of us at Lion Cao Asset Management want to wish you the very best this Holiday Season and a most Happy, Healthy and Prosperous New Year!!

We are delighted to report that we have closed on approximately \$65 million of capital during the year for our maritime investment, with a final close this week. We have purchased with other investors 12 dry bulk ships and look forward to increasing our fleet in both dry bulk and wet (tankers) ships. We continue to believe that we will take advantage of distressed shipping assets which will increase in value as the world economy grows and commodity movement increases. Importantly, this investment will also serve as an effective hedge against inflation when it reappears.

My thoughts, as a non-economist, on 2011 are not dissimilar to those of last year's view on 2010. **I continue to be somewhat less sanguine than the generally bullish view expressed by many economists and pundits.**

I believe there is a great deal one must think about this coming year regarding the US economy, the political scene, the rising power of emerging economies (most dramatically of course China and India but also Brazil and Indonesia, etc), commodity price inflation, European financial issues re PIIGS (Portugal, Ireland, Italy, Greece and Spain) as well as overall stability, currency issues, deflation and inflation here in the US and elsewhere, and so on.

I am not going to try to predict specific outcomes, but I am generally not afraid to offer my views/opinions!

I had an interesting discussion with my wife and son (an author/novelist not involved in Wall Street) a few days ago over a wonderful dinner at Del Posto (I highly recommend this restaurant). Our conversation started with **a number of questions my son asked about Fed policy, inflation/deflation and our debt and how and what China might**

consider doing regarding the Treasuries they hold, amongst a broad array of interrelated issues which came up as our discussion preceded. He had a conversation with a friend who works for a hedge fund and provides the fund with political insights regarding economic matters. Brian asked my views, and I thought if he were interested in these topics, it was quite likely that many other people would be as well.

Fed Policy

Clearly, this is an amazingly difficult topic to review in a modest amount of space but **with QE2 out there** (i.e., another round of quantitative easing), **it does seem to be highly relevant in today's economic environment**. What the Fed is doing is taking on its dual mandates-- "control" of both inflation and unemployment-- and the only tools they have are monetary. When first proposed, the need seemed overwhelming to many who thought that we were headed for disinflation, or worse deflation. The unemployment problem, whether the 9.8% number or the larger almost 20% when one includes underemployed workers, has to be dealt with as well to bring the economy back to adequate growth levels.

This \$600 billion monetary stimulus, QE2, per Bernanke and others, was needed to get the economy moving and reduce unemployment and "inflate" thru economic activity so that we would avoid disinflation or worse. There was a clear lack of Fiscal policy from the White House and Congress at that time.

Since approving QE2 formally by the FOMC, **fiscal policy, thru the just enacted \$858 billion package**, has been greatly accelerated, providing for two year extensions of:

- ✓ the Bush tax reductions,
- ✓ continuation of unemployment benefits from a 99 week limit for an additional 26 weeks,
- ✓ elimination of most employee contributions for FICA, and
- ✓ depreciation acceleration for businesses; among other benefits.

With the recently released better economic data being reported, the question arises, is QE2 now needed?! Bernanke certainly thinks so and has reconfirmed the need for it this past week. **What does he see or know that is so different from many who are far more bullish?**

I actually agree with Bernanke, and believe that the economy is still in a fragile stage of recovery and could easily tip back into a very slow growth mode, probably not a double dip though, **as I do think there is momentum**. While many are projecting as much as 4% growth for 2011 and a few others closer to 2% (Goldman Sachs just increased their target from 2% to 2.7% and Merrill Lynch also is now at 2.8%), I would side with the lower number crowd. If things do go well, the higher figure is certainly attainable, but I believe there are many risks to the rosier picture. For example, Nouriel Roubini, a well known economist and often referred to as "Dr. Doom", told the WSJ last week that he put the chances of the US slipping back into recession at 40%!

By announcing that the Fed will put another \$600 billion injection into the economy, thru the purchase of Treasuries, the expectation was that interest rates would go down from what were already very low levels. This would provide stimulus to the economy as mortgage rates and corporate borrowing would be at lower levels spurring greater activity. Well, we know now that **actually rates have gone up**, which should have been perplexing and was to the Fed. Alas, the markets felt that this stimulus along with the recent fiscal stimulus would lead to inflation and rates actually rose. Indeed, I believe that we are in for real inflation risks, more to come on that topic. Of course, currently inflation is very much under control and there are only limited signs of inflation recently or on the immediate horizon.

China's Response

So what will China do as a result of all this? Our current administration continues to pressure China to let its currency rise. This policy is based on the theory that a floating Yuan will give the US a more competitive position with them for our exports, although as a result of a weaker dollar, we may also benefit from oil and other dollar denominated resources. Our agricultural products have recently become even more heavily exported but I believe more based on need than price!

This may be part of the “inflation” plan which I believe is underway by our government. Although I am not sure that such a competitive devaluation is in our best interest, as we have lost much of our competitive industrial manufacturing base. While a stronger Yuan may feel good and may work on a marginal basis, many of the goods we now import will cost more. Thus, in particular, the lower and middle class may find many products substantially more expensive; including many clothing items, electronic items, etc. Is this really worth having Boeing, John Deere and Caterpillar able to sell more to China and the world market? This issue then becomes political as well as economic! **I am still wondering why the White House believes that the middle class benefits from this so much. Of course, the thesis is with a more competitive dollar, we will create jobs in the US. But if others devalue as well, where will that leave us?**

China has and will continue to do what it believes is in its best interest and seems to have a gut rejection to any form of coercion, in particular from the US. I suspect that indeed they will find it in their best interest to let the Yuan appreciate. China itself has many concerns particularly with internal issues regarding growth and their inflation rate.

More important to our “good health” in the financial markets is the need for China to buy our Treasuries and I suspect that it will be in their interest to continue to do so, even if our interest rates go up. In my opinion, they have too much of our debt already (around \$3 trillion) and while they can “just say no”, they will find that self defeating. Thus they will do what they can to keep their portfolio of bonds as healthy as possible and will continue to buy our bonds even if the bonds are selling at higher yields (what they own is worth less as a result). Buying our bonds feeds their export economy with the money we pay them for the goods they export to us. **Is the Euro really a better alternative?**

Inflation versus Austerity

I think one of the US's biggest risks over time will be inflation. We have now seen monetary and fiscal stimulus once again in the US increasing our debt and even Moody's is looking at a downgrade in our ratings, if we don't right this ship. Per a Merrill Lynch note last week, the fiscal stimulus has added \$400 billion to the budget deficit and they forecast a \$1.52 trillion 2011 budget deficit.

In contrast to the US stimulus activities, Europe is moving in the other direction with austerity as the most important element to solving their economic situation. There is extremely low growth in most of the European economies with Germany being the main exception, and France somewhat so, and yet the collective decision seems to be that to get their house in order, they need to emphasize austerity over stimulus/growth.

Of course **saving the Euro is an important element in the collective reaction** undertaken in Europe and given the problems with the PIIGS, starting with Greece and its bailout and the Irish bailout of a few days ago, it is critical to stabilize the banking system and maintain the ability of each country to issue bonds.

The social network system in Europe is clearly coming under the austerity attack and the resulting disruptions from those workers impacted have been remarkably violent relative to the changes which are being implemented, at least from my point of view. I believe the risk of contagion continues to be very high and Spain is clearly the next to be tested; a much larger country than either Greece or Ireland and thus a far greater risk to the Euro and European stability. All of the major banks throughout Europe own many billions of national debt in these other countries, thus putting their own countries' financial system once again at risk.

Which program is right: the US stimulus or the European austerity? The answer to this question will be an unknown for the next year or so.

However, we have many of the same issues that plague Europe:

- Our financial institutions are still fragile and subject, in particular, to the continuing risks associated with a further decrease in real estate values;
- Our Federal, State and Municipal workers have pension and health plans which are essentially unaffordable and have become an entitlement program which, without being addressed, will potentially bankrupt states and municipalities (Merrill commented today that states and municipalities "face the toughest budget outlook since the Great Depression");
- Health care (primarily Medicare and Medicaid) and Social Security are totally broken and, even with Obamacare, have not been addressed. These entitlement programs will need to be dealt with; and

- We also have to address the two institutions which are providing essentially all of the conventional mortgages in the US currently -- Fannie Mae and Freddie Mac which are on life support and essentially bankrupt and living only because their losses are funded by the Federal government.

The **Deficit Commission** which just provided its results earlier this month, with Erskin Bowles as one of the co-chairman (a Columbia Business School colleague and friend of mine), provided a number of highly constructive ways in which to deal with the fiscal issues. **The huge budget gap we face and the enormous debt burden which we need to reduce are critical issues for the country.** If we don't reduce our debt burden, rates will rise and we will be forced to spend even greater amounts to deal with the spiraling increases in our debt payments. China and others, including the rating agencies, will demand it. I believe the next Congress will take up these issues, but it is not clear if there is the political will or muscle to accomplish much given our current economic and political realities.

The Commission's recommendations seem to have been forgotten on delivery. With the more urgent need to deal with Tax legislation, primarily with extending the Bush tax reductions and other fiscal stimulus, and worse an attempt by Harry Reid and others to stuff a debt limit bill with billions of new Pork legislation...at least this was shot down for the moment. The debt limit battle looms large for the new Congress as Republicans for austerity fight with Democrats for stimulus and growth are surely so at odds it will be difficult to see how they can find a practical way to proceed!

Economic Positives and Inflation

I think we are seeing green shoots in the most recent economic data. The stock market is rallying with the S&P 500 index now the highest since before Lehman collapsed in 2008 up 11.6% this year so far and a 20% rally from the summer lows. Small cap stocks are now up 24.8% on the S&P 600. Jobless claims are sinking and regional manufacturing orders are picking up. The Conference Board leading economic indicators rose 1.1% in November. Retail sales appear to be strong (up 7.8% three-month annualized pace and up 5.9% on the year), and most commentators think Christmas sales will be robust. Small business is even showing some optimism and rose in November to 93.2 up from 91.7 in October and is at its highest level since December '07. FedEx and UPS also reported optimism about global growth.

This all is directionally what we are looking for if we are to have a better economic growth scenario. Obviously, as mentioned above, both fiscal and monetary policy is aimed at making sure this trend continues. I agree we have to fire with all guns to be sure we don't slump again, but not for too much longer as a stab at austerity would be most welcome. The problem is what happens when all this winds down and we **MUST** deal with the debt. by the way the current debt ceiling is \$14.3 trillion and needs to be raised by Congress immediately!

My guess is that the US, and most countries, other than Germany which will avoid inflation at almost any cost given their Weimer Republic experience (I incidentally did a paper on that in college), will find a way to inflate their economy and pay back the debt with an inflated currency. This will be more difficult in Euroland with Germany's anti-inflation stance. We already have had depreciation in our currency (recent strength against the Euro notwithstanding) and Bernanke has indicated he is worried more about disinflation and QE2 is meant to help bring inflation within the higher range of his mandate.

Gold and many other commodities have been on a tear this year. Gold is up 22% with corn, cotton, wheat and a number of metals such as copper also continuing to show strength (precious metals are up 36% for the year per the FT). Much of this has been very good for farmers and miners and fortunately for the consumer, not as much as usual has been passed thru to the consumer, as slack final demand has not allowed producers to do so.

China is now showing signs of inflation accelerating (reported at 5%). Chinese authorities are very concerned and are attempting to slow down the great growth engine that has been so powerful coming out of the financial crises. The stimulus was inordinately successful thru infrastructure projects, extensive real estate activities and massive lending by the banks. That is all now being curtailed to some degree but **once the inflation genie is out of the bottle; it is very hard to get him back in. It will be interesting if Chinese bureaucrats can achieve this!**

We have seen crude oil fluctuating in the \$60 to \$90 range and now once again is at the top of that range. This has translated in the US to \$3 gas at the pump and that always causes a drag on consumption as consumers divert their spending to fill their gas tank from other spending. Merrill Lynch estimates that a \$15 rise in oil from here could reduce growth by 0.5% in 2011, enough to wipe out the Fed's \$600 billion QE2 effort!

At \$4 for gas from much higher crude prices, I have read that this would dramatically slow down our economy and a double dip could more likely be in the cards. This would be an incredible outcome after all of the stimulus spending that has occurred and would be a further transfer of our wealth offshore, causing massive additional borrowings to pay for the higher priced oil.

[The Stock, Bond, Real Estate and Commodity Markets](#)

Given my view on inflation, **I would not want to bet on the bond markets improving over the next couple of years.** That is not to say one can't make money trading in the bond market but I would avoid it as a longer play. Also, given my inflation view, one should consider hard assets. I think the real estate market is quite likely to suffer some additional declines over the near term, but real estate is always location driven, and there are some sectors in real estate many of which could be attractive in price, location, type of property and a good play over time.

We believe that shipping offers an excellent way to play the inflation game, as chartering rates will rise with additional economic activity which will translate into higher values for the underlying ship assets, providing an excellent inflation hedge.

Commodities have generally moved up dramatically, as noted earlier, I would have a very cautious view betting that this trend will continue, remember \$147 oil, then \$50 oil. Commodities are typically extremely volatile and best played by the true pros! Gold as a general currency hedge may be OK for some, although price fluctuations could be a significant issue over time.

I do not think the stock market will do as well next year as it has this year and would guess a move in the mid to high single digits. Earnings have been great and increasing revenues are needed to sustain this as the cost cutting successfully implemented can only go so far. This is one of the reasons unemployment has stayed so high, the workers already employed –or still employed—can do most of the work at the same level of sales. It is only with some sustained sales that businesses will start to hire with enthusiasm. As an alternative, many companies are hiring temporary workers but have not converted them to full time yet pending confirmation of revenue increases.

For those of you who have read several of my prior Musings, **you may wonder what David Rosenberg thinks**, now of Gluskin Sheff formerly of Merrill, as I frequently mention his views. **I will quote his take on the stock market and let you decide how you feel about it.**

What makes this entirely different from the secular lows reached in either 1949 or in 1982 is that the cult of equities never did get extinguished this time around. Greed and risk have found a way to replace fear and prudence literally just months after the global economy was on the precipice. The lesson here is that memories are very short—but not ours. Many who are long this market and heeding the advice of perma-bulls will once again look back, as they have already done twice in the past decade, and scream “what the hell was I thinking”? Investing is a marathon, not a race, and the winners will be the current laggards who continued to pursue the virtues of capital preservation and income-orientation strategies. Remember, in the final analysis all returns have to be risk-adjusted. Managing the risk is every bit as important in the current and prospective uncertain macro and market landscape as generating the nominal returns.

This market is overextended and overbought. Sentiment is completely off the charts. (DR Dec 17, 2010).

A Big Black Swan

As we have commented in the past, we would be wise not to omit the potential (even if small and not on most pundits’ radar screens) of **a catastrophic exogenous event** – big black swan so to speak. On the financial front for example, this could start with Spain having a failed bailout and others following on its heels leading to a further domino effect or perhaps a massive nose dive by China; or a reenactment of terrorist activities on a

global scale. One does not want to speculate on the disruption something like this would have on world economies and financial systems! But we should bear these black swans in mind as not as theoretically impossible as we once thought.

Well where does this leave one? I suggest, despite all of the above, **a cautious optimism, but certainly no euphoria**, rather with a balanced view of risk and reward. There is, as always, lots of opportunity for the prudent and well-positioned investor!

Again, we all wish you the very best for a Happy Holiday season and a spectacular New Year. Thanks for your support and good luck.

DDL

David De Leeuw
Lion Cao Asset Management
535 Madison Ave, 4th Floor
New York, NY 10022
(212) 355-550

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Important Note:

A suggestion for a Holiday Gift (this is an unabashed promotion); *In This Way I Was Saved* by Brian DeLeeuw, published by Simon & Shuster.

See **inthiswayiwassaved.com** or **briandeleeuw.com** and if you want to meet him, watch the video interview with Simon & Shuster on the website. Yes, this is my son and I am very proud of him.