January 1, 2008

Market Musings

Dear Friends,

Happy New Year! I hope you have been enjoying my monthly market "musings letter" which I introduced in August, primarily in response to the turmoil in the markets, to provide some observations on the market environment. My focus has been to address some questions of particular interest to our readers/investors, for example, what the Fed might do, the consumer's reaction to the economic situation, and of course the debacle that has been unfolding in the credit markets…in 2007 and continuing, much of this in the context of how our hedge fund managers might be reacting to both the risks and opportunities presented by that environment.

The Hedge Fund-of-Funds (HFOF) we have been reporting on is one of our "product lines", and we will continue to send out the HFOF performance sheets only to investors in those funds.

Going forward in 2008, I will continue to make observations on the economy and note issues which I think could be of interest to a number of investors and potential investors in our various other investment activities. We also offer our investors opportunities to invest in top-tier Private Equity funds and other special private equity projects, our joint-ventured Asian hedge fund-of-funds, and a Film and Entertainment private equity fund.

With the above in mind, I do want to note that our HFOFs have performed reasonably well in both November and December and we are pleased that our approach for these funds being primarily fixed income substitutes, with even lower volatility than fixed income, continue to do what we had promised our investors. Given the very difficult markets we have experienced, we are particularly pleased that we have not suffered the way certain other hedge funds have or even some of the HFOFs who somehow could not avoid the credit market debacle that has really been disastrous to their performance.

HERE ARE SOME NUMBERS

$18.1Billion, $12.5 billion, $4.1 billion, 4200, 41%, and 2 ½.

What does all this mean and why would I start my commentary in such a strange way. When I was starting this letter, I found that **Citicorp** had just announced these numbers and if one had asked in the spring what would they mean, somehow it would have been all good news. Well, we all know the news is awful and to me represents some of the worst of what is currently going on in the US. The $18.1billion is the losses on primarily subprime loans; the $12.5 billion is the amount

of new capital from primarily large institutions, most of it from Sovereign Funds; the $4.1 billion is losses from other than subprime loans "increased delinquencies on 1st and 2nd mortgages and unsecured personal loans, credit cards and auto loans"; the 4,200 is the number of employees which will be let go in the latest round of cuts; the 41% is the amount the dividend will be cut; and 21/2 is about what Citi's stock was down for the day, almost 10%!

I believe this is emblematic of why I think many economists and other pundits are correct, including Greenspan, that we are in or shortly will be in a **RECESSION**. Now the technical definition will take a while to be proven out, but I do think this is upon us. Merrill Lynch says we are in a recession and has been a bear for several months and has indicated that recessions have followed tightening by the Fed every time post war, that an inverted yield curve has preceded every recession and they and others go on with the slow down in jobs, the continuing housing debacle, etc. All historic indicators are pointing in one direction and that seems to be a recession. Both Goldman Sachs and Morgan Stanley agree with Merrill that we are in a recession. There are certainly many others who are still in the camp of 50/50 or perhaps even less that we will go into recession but even those optimists are predicting a tough environment for 2008 and perhaps beyond. My brother has told me that I have been predicting a slowdown/recession for so long that I eventually have to be right. In this case I would like to be wrong.

By the way the stock market has started the year with the worst performance since 1990-91, and I also read 1982, but in either case, it is awful and many people have noted that the decline reflects a new reality on what the corporate earnings outlook will be for 2008, perhaps double digit down. News just in the worst beginning ever!!

I will come back to some of these numbers in just a bit but who can come to the rescue…will Bernanke ride in on a white horse or will exports explode and imports go away or will the dollar come roaring back and oil prices halve, will the President and Congress give us that much stimulus?? Perhaps, but I find each a difficult story to save us from our current fate.

THE FED

Several weeks back when inflation talk was still in the air, it was a debate of whether the Fed could go from 25bps to perhaps 50bps lower. Now there is very limited discussion of inflation and I keep reading and hearing on Bloomberg and elsewhere that the odds keep rising, per ML futures are priced at 42%, to an almost unprecedented 75bps (once in 1984 actually) and thus what signal would that be sending….panic perhaps?

My bet is 50bps and a continuing commentary by the Fed that they will do what is necessary and thus would anticipate additional reductions over the next several meetings. Deutsch Bank suggests 50bps at both the January and March18th meeting. Former Fed Governor Moskow, actually a professor of mine in college, noted in the last week that the Fed would be "very aggressive" in reducing rates. Bernanke said that there would be "substantive additional action"

on rates and a number of other Fed members repeated this type of commentary in several comments/speeches in the last week or so.

In my letter of mid September I said that the Fed would have to be bold in action to prevent us from going into recession. I am not sure they have the means at this point to do what is needed to keep us from being/going into recession. The rest of the world is not as dependent on the US as it once was and we have a very weak dollar which lower rates will only exacerbate and may bring even higher oil prices which the consumer will have to deal with. Not a great place for the Fed at the moment.

THE CONSUMER

The consumer is in a real fix. We all know that housing has become a disaster area for many. ML states that home prices are down in 85% of the country and in all major cities in the past three months. Prices are down on average 7% in the last year which equals the total amount from 1989 to 1992. Inventories of unsold homes are up dramatically and they report that over 1 million excess residential housing units are vacant putting pressure on home prices. Importantly ML points out in a January 15th report that in their view **home price will go down another 20 to 30% this year**. That is astounding to me. In any case, we all recognize that housing has a ways to go before stabilizing.

Mortgage resets which are to peak in April will be another burden on many consumers, and refinancing is to say the least difficult with banks as reluctant lenders; instead of being happy in many cases to “package” loans which were less than stellar (one commentator called them “liars loans” which I thought was somewhat catchy) and sell them into the market, this gambit is no longer available.

We all know that oil is high and pinching everyone, Christmas sales were not great except for sale items and now it has been reported that even luxury goods sales have slowed, per Tiffany and American Express. Jobs are the biggest driver for the consumer and there has clearly been a slowing in job creation and a concern about the future for jobs, although the job news continues to be mixed. The **Presidential candidates are now putting out ideas for stimulus programs, as has President Bush** and Congress, and they have focused on the economy recently and not just in Michigan, which is in recession per Mitt Romney and others. These programs are likely to be too little too late but it will be interesting to see what is finally implemented.

THE NUMBERS

Before this note gets too long, I want to go back to the numbers that I quoted at the outset with a few additional thoughts.

The **$18.1 billion** loss from loan losses leads the pack. I believe that we still have not seen the bottom, perhaps we now have from ML and Citi, but there are additional bombs which will be dropped by others. To put this in context, the losses quoted to date by Wall Street, according to the WSJ, is over $100 billion, equivalent to 0.7% of GDP and in comparison, the S&L and Bank Crises in 1986 to 1995 was $189 billion and 3.2% of GDP. I am not sure if this is good news or presages much more pain. I hope it is the former. The Economist last week noted that the remaining exposure to subprime loans is $380 billion and "analysts think they are still only roughly two thirds of the way through tallying their mortgage losses".

I also was astounded to learn that Citi wrote down a package of mortgage securities which in September they said was worth $2.7 billion **to 5% of that value**, taking a $2.6 billion loss! Obviously they have a gloomy view of the future.

The **$12.5 billion** of new capital is indicative of the need to build up the capital base in light of all of these losses. While they did not get the money just from Sovereign Funds, these entities have been the most active participants in this arena. Interestingly, the Sovereign Funds of six Gulf States, according to Business Week, have control of $1.7 trillion which is greater than all the hedge funds in the world at $1.3 trillion and dwarfs the private equity total of $1trillion and is expected to grow at $400 billion annually for the next several years. These numbers do not include Singapore and others who have participated in the banking rescues with more than $12 billion. Many are concerned with this vast amount of primarily new wealth and how active these entities will be and how politically motivated they are or could be. Stay tuned this is **a huge shift in the world's capital markets.**

The **$4.1 billion** in losses other than subprime is concerning as we do not yet know how far the problems which started with subprime will reach into other credit areas. The larger banks in addition to credit cards and auto loans, etc also still have a fair amount of LBO debt hanging over them. This LBO overhang has gotten much less attention recently as many deals have been called off or restructured, and in several cases simply by the Sponsors paying the Break Up fees to get out of the deals which have frequently been in the $100's of millions. AMEX reported an increase in delinquencies and this is from a reportedly higher end credit card company, so one wonders again how far this problem will reach.

The **4200** number is how many people will be let go in this latest round of layoffs. There have clearly been a number of layoffs in the financial sector and this is likely to continue. The campaigning in Michigan certainly put a light on the auto industries woes….and as noted above, Michigan is in a recession. We own two chemical companies and both are suffering from the woes of the auto and housing industries and I believe that many other companies are experiencing the same and we are certainly not hiring additional employees and are looking for ways to reduce our headcounts. The jobs area has actually been one of the bright spots and seems to be largely defying the overall difficulties engendered by the housing swoon. We should all be watching the data carefully **as a real dip in employment is the last straw** for recession even for the optimists who think we may miss a recession.

The **41%** is the amount of the dividend cut. While I am not necessarily predicting massive dividend cuts even within most of the financial sector, I did note above that a number of analysts

are predicting a possible double digit decline in corporate earnings. I think the continuing increases in raw materials and the consequent attempt to raise prices to ones customers will put enormous pressure on margins. We are not just talking about oil, but most of the major commodities as we battle with China and India for the world's supplies. If it is mined, it takes years to increase output from new mines and that has shown up in copper, tripling in five years, zinc doubling, with silver, nickel and gold also with 200% plus increases, per the NYT. We also see food stocks increasing dramatically with wheat and soybeans up 70% in 2007 and corn up dramatically as it is now a food stock and a fuel. Most of us have heard predictions of $100 oil being somewhat of a base and I have now heard lots of analysts saying $150 per barrel. I am skeptical of that prediction given the economic scenario I have been outlining….and this is not just a view of the US but my sense of **a slowdown in most of the world, particularly Europe**. With a slower economy perhaps there will be some relief in these commodities, some already appearing, but we have not seen it yet in the ones we have to deal with in our chemical companies.

Finally the **21/2** represents the decline in Citi's stock, the actual closing was down $2.12 or about 7% but when I first heard the news it was down about 21/2. I mentioned how badly the stock market has been and when I look at the numbers coming in from most of our Hedge Funds for the first couple of weeks of January, I feel the pain along with them. I am not a stock market prognosticator but I do believe we are in for a tough 2008. We will all be wondering about the impact of the slowdown/recession on earnings and thus the markets response to potentially much lower earnings or certainly at best a slowdown in growth rates. As noted above, the impact on margins in many industries due to much higher raw material costs will also be an area of concern. We are benefiting from the weaker dollar however in one way and that is exports. We continue to increase our exports and are finding our typical foreign competitors not much of a threat as they are finding it difficult to compete due to currency differentials. I think there could be some interesting merger opportunities but I don't see that buoying the market as it might normally do….I also wonder when the large LBO boys will be back in force given the state of the credit markets?

As the stock market generally is a predictor of the economy 6 months or so into the future, we may see **a rebound in the markets** as we start to climb out of the recession by year end or early next year. It is likely however to be a tough market environment until then. The best of the hedge fund managers will clearly take advantage of the opportunities presented and will do well for their investors. We want to work with those managers of course.

We continue to be active in a number of areas in addition to our Hedge Fund of Funds and I would like to talk about Asia next month as we have a joint venture with an excellent Asian HFOFs. That fund did quite well last year with returns of roughly net 18.9% and extremely low volatility of about 5% which given the Asian market environment is quite remarkable in my mind.

Please call or email with any questions or thoughts.

Thank you for your support and interest and please have a healthy and prosperous 2008.

DDL

David De Leeuw
The Lion Companies
535 Madison Avenue
4th Floor
New York, NY 10022
T: (212) 355-5500