

Market Musings

February 18th

Dear Friends,

As I sat down to write this note, I reflected on the number of issues of significance that are swirling around the financial market place and it is both overwhelming and daunting to put all of it into proper perspective.

As an avid reader of the financial news, I am most impressed with the debates that are going on presently: **are we in a recession**, will we be soon; **what will the Fed do**, have they done enough, will it be 25 bps or more likely 50bps to even a 75bps decrease at the March 18th meeting; **is inflation a real problem**...note the terrific increases in wheat and corn and thus food and via ethanol/oil increases in energy and other raw materials; **is there decoupling** from the rest of the world from our slow down/recession and credit issues; will housing and other issues, most importantly jobs, finally **kill the consumer** which has been the prime ingredient in keeping this economy growing; and finally will the continuing **credit crises spread** and finally drag not only the US markets and economy down but the rest of the world?? **Great food for thought!!**

Admittedly, I am not a market expert or economist, but have a number of thoughts which I would like to share with you. Thus I am going to take on the risk/task of commenting while limiting this note to a reasonably short length. Who says I don't like a challenge?

I also want to share some information from a conversation late last week with **Paul Heffner** who is the **Portfolio Manager of Ajia Partners Asian Opportunity Fund**, a pan Asian Hedge Fund of Funds, with which we have a Joint Venture arrangement. The Fund is a part of Ajia Partners which is headquartered in Hong Kong and was started about 3 years ago by 15 wealthy Asian families. The Chairman is Moses Tsang who previously was Chairman of Goldman Sachs Asia. They currently manage over \$2 billion in a number of different areas including large real estate funds in Japan and China. Paul will be traveling to Brazil with us this week to talk with a number of our clients and prospective clients about the Fund. We believe this could be an excellent time for investors to enhance or commence their exposure to Asia through a **Fund which was up 19.1% last year but with only 5% volatility** (see attached).

The Fed

Based on most of my reading and listening to the experts, there is an excellent chance that the Fed will reduce the Fed Funds rate by **50bps at their March 18th meeting**. The futures markets are now predicting a one-third chance that it will be 75bps. There has been much criticism of the Fed and Bernanke on not having moved sooner to head off much of the swoon in the markets, but also cheering for his decisive 125bps decrease within 10 days in January. My guess is that it will be 50bps and have a comment that they will continue to do what is necessary for the markets to properly function. At last week's Senate Banking Committee, he cautioned that housing and labor markets could deteriorate more than anticipated, emphasizing that "downside risks to growth remain." **The big problem is that the Fed can not fix the slow down in the issuance of credit if the banks are unwilling to lend even with lower rates.** Japan provides a good historical example of this dilemma.

The Recession

The debate continues as to whether we are in a recession, will be, or will have a slowdown and even a negative quarter. The definition of a recession is typically two consecutive negative GDP quarters. Goldman suggests that the National Bureau of Economic Research is the accepted arbiter and in making the decision, the committee places particular emphasis on the behavior of four economic indicators: (1) real income less

transfers, (2) employment, (3) industrial production and (4) real retail, manufacturing and wholesale sales. . Even GS who **believes we are in recession** cannot point to all of these elements being met definitively, but believes they will. After assessing the reports from a number of Wall Street firms and my own non-economist's view, I believe we are in a recession and will be for some time.

I heard an interesting comment on Maria Bartiromo's show yesterday by her economist guest. He thought we might slide past a recession this year because of the aggressive Fed moves and the \$168 billion Stimulus Package just signed by the President. However, **2009 could be a significant problem** due to the same economic issues potentially still existing, but there will be no more bullets to fire to stimulate the economy. This made me worry even more about the potential length of this downturn.

We are all aware of the housing issues that continue to plague us, but the new worry recently reported is the **"negative equity problem."** This issue was surfaced as a major concern by GS which estimates that home prices will slide 10% nationwide, ML is even higher at 20+%, meaning 15million mortgages, 30% of all outstanding, will be attached to negative equity. Thus **\$3 trillion worth of mortgages** could be worth more than the homes they financed, per the WSJ. This is an incredible number and potentially devastating to the banks. They also call this phenomenon **"mortgage walkers"** wherein people with negative equity simply hand back the keys and walk away!

One other worry for the banks and additional pressure on a slowdown is the significant increase in **commercial properties going into default**. Again, GS said that commercial real estate loans could have **losses of \$183 billion** compared with \$211 billion on subprime loans and commercial real estate prices could fall 26%. GS comments that banks have recognized 91% of their subprime losses, but only 17% of expected commercial real estate losses. A comment from JPMorgan notes that the cap rates had been driven down to 5% and easy credit made these deals possible. That will need to be reversed and the credit markets are essentially shut down, with the Fed survey of senior lenders indicating that 80% of the banks were tightening credit to this market.

I have to add that ML came up with another "leading indicator," a **Survey of Professional Forecasters** (great name, right?), which has predicted all recessions since 1968 when the survey indicates a decline in first quarter GDP is above 40%, the latest was 47%.

Inflation

I believe inflation is a real and continuing threat even with a slowdown/recession in the US. I do not believe decoupling from the US woes will be possible in the rest of the world and there will be slowdowns virtually everywhere as a consequence. However, the BRIC countries will continue to grow as will most of Asia and certain other countries, it will just be more modest in most cases. Therefore, the pressure on commodities from the continued growth in China and India will largely go unabated. We are selling more wheat abroad than at any time in the recent past and **prices have hit record highs** at \$18.53 per bushel last week and corn is above \$5 per bushel due to corn's use for both ethanol and food demands, and soybeans at more than \$13; all are 25% or more above their year ago prices. The price of oil and its derivatives has eased a bit, but not dramatically and most commentators do not expect a large decrease.

So we have housing deflation, but our day to day needs are costing us more....Food and Energy. WalMart has indicated that people are using their gift cards from Christmas for food and other necessities rather than electronics or other discretionary items.

One of the largest acquisitions ever is to control two mining giants in the BHP Billiton takeover of Rio Tinto valued at \$147 billion. While we don't know if this deal will happen, the control over the iron ore and other minerals in these companies is clearly an enormously attractive move. The need for iron ore, the principal reason for the takeover, is being fiercely fought by Japan and China, as well as Europe, as they all have limited iron ore of their own. In my view, this deal would not be of interest unless the principals were convinced of the longer term strength of these commodities.

There are also a number of Wall Street advisors suggesting one stay clear of the commodities markets warning that if they have not peaked, they are certainly near their highs and are **more than likely to decrease**. I don't argue that point in general, but believe that demand is sufficient to keep these commodities tight.

The Consumer

There is much to say about the consumer and the trouble many people are currently experiencing. I would say that tightening credit is the latest issue for most people. Not only for their potential for refinancing their homes, but also credit cards are being severely tightened for people with lower credit scores. The biggest issue still is jobs and the reports continue to be somewhat mixed on actual job losses versus the consumer's sentiment that things will be getting worse. The gift card comment noted above is a good indicator.

Consumer confidence is waning if not plummeting.

ML reported the latest ABC News/Washington Post consumer comfort index plunged with the largest three week decline since 1990, immediately after we entered a recession and in the 2001 hard landing it slipped less and we were in recession two months later. ML comments in their February 13th memo: "The consumer recession seems to have started, and we think this will be the **worst downturn in this sector since the early 1980's**." Remember, the consumer has been the mainstay of this economy since the 2001 downturn leading us out and continuing to provide the support to the economy. It looks like that will no longer be the case.

The Credit Crises

I wish I could have come up with this one the "**Growing Global Credit Pandemic**" but ML gets the credit. The list of things to worry about is astoundingly long and incredibly worrisome. As this note is creeping ever higher in word count, I will try to briefly address the 10 critical issues that I see.

- 1) **Subprime**- we all know about this one with almost \$200 billion in losses already accounted for and this list is likely to grow perhaps more from foreign banks which we have not heard much from. Just this past week another stunning write down, \$11.3 billion by UBS. I mentioned negative equity above and that will push losses up as more people who are NOT subprime will be walking away.
- 2) **LBO Loans**-approximately \$150 billion LBO loans (I have also heard \$200 billion) are still on the books of the banks. Many loans currently are selling in the 80's and thus prospects for new loans to be sold at par with the preexisting terms is highly unlikely as evidenced by the recent failure of the Harrah's \$7.25 billion loan. Per GS "The failure of the Harrah's deal ...is widely expected to **set the tone for 2008**." They added that Citigroup alone could have a write down of \$2.2billion from LBO loans which would hit earnings by 5% and ML's earnings from such losses would be hit by 6%.
- 3) **Monoline Insurers**-The insurers who guaranteed **\$3.1 trillion** of primarily municipal bonds, but moved into also providing guarantees for other types of loans are in grave danger of having their credit ratings dropped by the rating agencies from AAA, which would have a severe effect on the credit ratings of the guaranteed underlying securities. This will cause write downs as the underlying securities drop in value as a result of a lower rating. There are numerous schemes being worked on from splitting the two parts of the Monolines business, to large capital injections, and even Warren Buffet has said he would take on \$800 billion of municipal bond guarantees....for a price and this seems to have been rejected so far by all of the Monolines. I have only seen one estimate of losses and I doubt it is terribly scientific but is \$40 billion.
- 4) **Auction Rate Loans**-These are short term securities which are issued by municipalities, private schools, museums, etc. and over the last couple of weeks, the number of failed auctions has increased dramatically with **100's failing last week** alone. Some of the issuers were forced to pay 10 to 20% including the MTA! This is primarily a result of the fear that the underlying issuer will have a lowered credit rating or even default. This has also impacted some money market funds which also

rely on these auctions. The point here is **another freezing up of the credit markets** due to fear by the buyers.

- 5) **SocGen**- While this is supposedly a rogue trader acting on his own, I find it remarkable that \$7-8 billion or so can somehow get lost in the system. I wonder given the exotic nature of so many of the securities that are being traded if some more of this will unfold. I also find the French response quite amazing with no one yet being fired other than the trader and he is currently in jail?!
- 6) **The CDO/CLO Market**-Most of the subprime issuers utilized CDOs to place these securities with the buyers and we now know what has happened here. The CLO market, Collateralized Loan Obligations, are primarily loans from the LBOs that were done over the last several years peaking in the 18 months leading up to June 2007 when the market came to a halt. The belief of many is that the underlying securities in these CLOs will not be selling at par or close to it and **they may unravel** as have the CDOs, but perhaps not with the vicious velocity that occurred with the CDOs. The defaults are not expected to be nearly as significant, so it is more of a pricing issue of the CLO at least so far.
- 7) **The CDS Market**-This is one of the largest, unregulated markets and one of the vehicles Wall Street has created to reduce risk. CDS stands for Credit Default Swaps which are created by one party which wants to protect itself against a potential default of a company's debt and a counter party which is willing to take on that risk. The key here ultimately is twofold; the risk of default and perhaps more of a risk is that of the counterparty being there to pay the full amount of the defaulting loan. This market has grown since 2000 from \$900 billion to **\$45.5 trillion- about twice the size of the US stock market**. In many cases the amount of CDS is far greater than the underlying debt of the issuer, for example, when Delphi went into bankruptcy the CDS were 10 times the underlying debt. There is a fabulous front page article in the Sunday NYT yesterday which deals with this in tremendous detail and it further notes that there **is only \$5.7 trillion of underlying bonds that the \$45.5 trillion swaps were created to protect**.
- 8) **Derivative Risk/ AIG**- AIG had to write down \$4.88 billion more than it had expected in CDS or roughly 5 times the charge in December. Their accountants required them to do this and stated that it was a "material weakness" which you don't want to have your accountants state. Last Tuesday the NYT quoted a former SEC accountant; "We are going to see more and more problems come to light like this." And "this is an indication that these large financial institutions do not have the risk management systems in place to give us accurate data." The real surprise is that this is AIG one of the most sophisticated financial firms, particularly in insurance!! I am afraid that this is the **ticking time bomb**....if we have a soft economy for an extended time and there are significant defaults by issuers as a result, I believe this could result in enormous losses. Based on a tally by ML, the same unscientific one I mentioned above, **losses were estimated approaching \$265 billion**. I don't find this reasonable, but I guess possible. All the counterparties are not necessarily large banks or even large hedge funds, but in some cases may be smaller institutions without the capacity to live up to their obligations. One more reason to worry here, this is from Lehman, AIG per its 10Q valued its \$500 billion credit derivative portfolio using among other thingsits "**Binomial Expansion Technique**" models. The Lehman CIO says: "I think I liked the 1990 recession better: I didn't need a PhD to figure out how bad things could get."
- 9) **and 10) Politics**- I am combining the last two as they both are more political and are still mostly talk but I think merit some concern. The \$3 trillion **Sovereign Funds** are under severe attack by a number of Congress members and this usually becomes an increasing problem particularly in an election year. If the heat gets too high I think a number of these Funds will go somewhere else with their dollars and we can use them, as already demonstrated by the \$40+ billion or so that has come into Wall Street and more than \$30 billion more to other large financial institutions in Europe. The other issue is **taxes** and the debate in the presidential election on the increases in corporate, wealthier individuals, dividend and capital gains taxes, and the extension or not of the Bush tax cuts. I will not comment directly yet, we have a ways to go on the presidential election, but I do think these

are issues which could significantly impact the markets.

Finally to **Asia**, we are delighted to be working with **Ajia Partners** and with **Paul Heffner** on their Asian HFOFs where we are an Advisor to the Fund. I spoke with Paul last week to get updated on his views on the Asian market in general and the specific countries and strategies he would endorse for the coming months for the Fund. Paul's general view has been one of caution as the US Subprime and other credit issues have been playing out in the US, as the direct impact on Asia and specific countries there has not been totally clear. He continues to be cautious, but optimistic for a good performance year, if one is highly selective and somewhat bold while maintaining a level of skepticism.

For example the markets in Asia were down quite dramatically in January while Ajia Opportunities was down just -2.6%. In contrast Asia was negative -14% (MSCI Asia ex-Japan index). Specifically, Hong Kong fell -16%, India -16%, Shanghai -17%, Taiwan -11%, Korea -14%, Singapore -14%, Australia -11%, etc. **Clearly Ajia Opportunities was properly positioned.**

Some of these market have come back a bit in February but some have continued to be down as the US market has and with significant volatility. Paul believes this may be an excellent time to begin to move into some of these markets aggressively as we could be near the lows in several. For example he believes China and India are still a bit rich but getting very interesting in certain areas while **Japan** is beginning to look cheap and in particular Japanese REITs with 7% yields in contrast to Government bonds at 1.4% and dividend yields at 2%.

The consensus is emerging that Japan's markets may be near the bottom. The government is assisting smaller companies which have been struggling in this economic malaise and the markets poor performance have been getting increased media exposure highlighting the need for some relief by the government. The Subprime issues have not particularly afflicted Japan and exposure is reported as only \$6 billion. Valuations are compelling; by some measures the lowest in the world and the average P/E is only 14X, a record low. **I will be travelling to Japan next month and will have the opportunity to assess the situation first hand.**

Paul and I agree that **decoupling will be difficult** for most countries. He does think that India is well positioned and may be one of the most resilient with a strong domestic economy and huge infrastructure needs. They have one of the youngest populations in the world, a 65 to 70% internal consumption and Paul tested me by asking what I thought the IT component of GDP was, well of course I was way off as it is only 1.5%, not as big a worry as one would assume. He is beginning to nibble in this market and believes up to a 10% allocation is potentially warranted. This is up from about 1% in the last year or so. Paul's view is that the multiples are coming down currently for many excellent companies in the 17X range but growth rates are likely to stay in the 20 to 30% range.

China is going through a difficult time as inflation is dramatically increasing, particularly food and energy with consumers worried about the basics like rice, vegetables and pork. The economy may be slowing down on its own but the government is also trying to moderate inflation and has targeted property development as an example of an area of excess. However the economy is still growing at a double digit rate and even with a substantial decrease in exports to the US and elsewhere, the economy should grow at 8 to 9%. The phenomenal savings rate in many cases 45% of wages...remember there are two grandparents, two parents and one grandchild living together....provides a strong cushion and potential upside.

Hong Kong could be in for a tough time with huge property inflation based amazingly on the benefits of the cheap US dollar and abundance of credit. **Korea** could surprise to the upside. **Taiwan** is gong thru an election which could actually be more pro China which could greatly expand its activities in China particularly in Tech and prompt increased Chinese tourism. However, there is a high correlation to the US markets especially in electronics. **Australia** is a bit of an anomaly, and Paul is cutting exposure here. Yes, there is tremendous demand for its commodities from China and India but any slowdown is an issue with an over

inflated stock market and economy. The demand from China will not abate any time soon; it is just valuations with which we are concerned.

In general, Asia is and will be a **market for individual opportunities**. Paul believes that smart tactical allocations should produce good returns in 2008. Japan is a value play...even if a slowdown in the economy occurs. Again, India is a positive, as is China in smaller companies growing rapidly but not with high P/Es, and be cautious of China in 2009 after the Olympics. There will also be selective M&A plays in a number of these countries, Japan for one and others as state owned enterprises are spun out.

Here is a bit more detail on Ajia Partners' Fund: The Fund typically consists of 15 to 25 underlying managers with a core group of about 10 managers. Other managers are more tactically chosen and also redeemed from as the circumstances for the specific country or strategy are assessed as less than optimal for the Fund. We think that Paul and his team of 14 people do an exceptional job. The Fund targets a 10 to 15% annualized return with low volatility of 5 to 7%. As mentioned above, in 2007 the Fund produced **gains of 19.1% and volatility of about 5%**, which I believe is remarkable in such a volatile market environment. Two benchmarks which Paul uses are the Eureka Hedge Asia Pacific Fund of Funds Index +16.72 and the MSCI AC Asia Pacific +12.28.

My strong belief is that it is great to have an extensive team on the ground working every day in these very diverse markets and we are delighted with our partnership with Ajia Partners. Please let us know if you **have an interest in talking with Paul and potentially investing with us in Asia**.

Conclusion

I appear to have lost the challenge of making this reasonably short. I knew when I started that it would be difficult, but truly wanted to provide our friends and investors with a sense of the markets and the potentially treacherous path out there. Of course, the right managers will make you money in good and bad markets and we are always in search of and wanting to invest with such managers. It is recognizing the proper balance between risk and reward and we try always to bear that in mind in our efforts.

Please call or email with any questions or comments.

Thank you for your support and good luck in the "Chinese year of the Rat".

DDL

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