Market Musings

March 16th

Dear Friends,

News flash from 3/17—the morning after postscript

Today Bear Stearns is being taken over by JP Morgan at $2.00 per share or $157 less than its 52 week high; other financials are down dramatically; the Fed reduced its discount rate by 25 bps and extended maturities for certain borrowings from 30 to 90 days to enhance liquidity; gold traded as high as $1025 per ounce; the Yen traded down to $.96; oil was at $111; and markets in general around the world have been tumbling. Also, Lehman's shares are down 40% and continue to decline today, as both Moody's and UBS have changed their outlook on Lehman to "stable" and "neutral" from positive, respectively. Moreover, Citigroup's analysts have rated Lehman as "high risk."

I fear more bad news in the financial sector will appear and a very clever bail-out will need to be orchestrated by the Fed and Treasury Secretary Paulson. Word is that a fiscal stimulus package that helps would have to go to the root cause of our problems which is to increase housing prices and also Fed action which would provide for a return of confidence and trust in the system. This is a very tall order.

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While I was reading the papers and watching the news over the last week or so, I was shocked and disappointed by Governor **Spitzer's** behavior resulting in his **resignation** but for his many enemies I guess his comeuppance was a delight. I missed most of the New York Post's coverage which I understand was beyond sensational. Then Spitzer was no longer front page everywhere but replaced by **Bear Stearns, Carlyle, KKR and Thornburg** and finally on Friday by Bear Stearns and the **bail out by JP Morgan and the Fed** which truly took over. I would not have predicted either of these headlines in my wildest dreams, even a month ago for the Bear situation. What has happened? Well I am not going to talk anymore about Spitzer other than to refer you to last night's **Saturday Nite Live** with one of the all time great skits regarding Spitzer's new career.

We will try to make some comments about the credit markets and a few other relevant comments I trust that will be of interest. I actually want to start this note with the beginning of my February 18th Musings. Please bear with me.

> 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!!**
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> 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?

These are all still with us! While it was not a short note, we did deal with many issues including a very long list of specific comments on the credit markets. I will refer you to that note rather than repeating many of the issues we highlighted. Thanks to all of you who wrote in or commented in person in response to the last Market Musings letter. This time, I will talk about each of the above "questions" briefly, starting with the current hot button of the Credit Crises which last month I thanked Merrill for having come up with the characterization of our credit markets with the **"Growing Global Credit Pandemic".**

I have already read several notes/articles on the **Bear Stearns Bailout** and how it was a bold and decisive move by the Fed and one that was necessary and helpful to the market to opinions which were quite the opposite and that the Fed had overstepped and there now was a crossing of the line on **"moral hazard" and now they must save almost any large financial institution**. Sunday's New York Times had an interesting front page Business Section article entitled "Rescue Me: A Fed Bailout Crosses a Line" by Gretchen Morgenson on the topic. My view is that this was a necessity because of the extraordinary risk that the entire system would begin a very rapid unwind. Each individual, hedge fund and institution including the other investment banks and banks would no longer accept Bear as a counterparty, which was already underway, and each would be similarly looking to see who might be the next one that was in trouble. On Friday, **Lehman** announced it had gotten a three year loan, thereby insuring that it had a more permanent access to liquidity, and the stock went down 15% on this supposedly positive move.

I have commented several times that we were and continue to be worried about the use of models in assessing the value of one's portfolio. I suggested that we had gone from

Mark to Market, to Mark to Model and finally to Mark to Make Believe. In the Morgenson article she notes from the Bear annual report regarding mortgage values: $29 billion of them were valued using computer models "derived from" or "supported by" some kind of observable market data. The value of the remaining $17billion is an estimate based on "internally developed models or methodologies utilizing significant **inputs that are generally less readily observable**." She goes on to say "In other words, your guess is as good as mine." This situation is ongoing in all institutions as they try to calculate what their securities or loans or currently worth.

In the case of **Carlyle Capital**, the same banks who have been paid hundreds of million dollars in fees over the last few years by Carlyle Group, the large private equity firm and sponsor of Carlyle Capital, were concerned about their loans as Carlyle Capital was leveraged about 30X, and with the market for Carlyle's underlying securities depreciating, demanded more collateral. These banks did not give them a break but were protecting themselves. If one sells into a declining market, prices continue to deteriorate and more collateral is requested and the cycle continues. Now Carlyle Capital is or will be in bankruptcy. All this has occurred very rapidly and this is what the Fed is trying to prevent in the larger institutions.

If I had to predict, I would say **Thornburg** is unlikely to make it as well without a rescue which won't be Fed backed in my view. Even though they have essentially no Sub Prime exposure, they have a massive amount of Alt A mortgages which are mortgages that are not quite prime. They are now faced with the same type of squeeze which took down Carlyle even if not as leveraged. Thornburg's stock has gone from $30 a year ago to $10 a month ago to under a $1 on Friday, although it closed at $2.28.

There is apparently **$500billion to $1trillion of Alt A loans** and this could be the next nightmare for Wall Street. Last month I reported that Merrill had an estimate of potential losses from various different potential write offs which would be extraordinary, but that I did not find likely or even believable, I am now in the camp that the **write offs** could approach their suggested **$500 to $600 billion** for all of the loans and securities which are on their books. I, however, find it extremely hard to believe that the Fed and perhaps some of the overseas equivalents will not have to make a concerted effort to slow this all down. There is a massive and collective "run on the bank" mentality building in my view and we have to find a way to reverse the psychology of this and it will be action not words, or perhaps lots of action with a few encouraging words.

One thing which I have heard is the accounting rules which are forcing all of these institutions to write down their assets based on the need to use some form of "Mark to Market". Historically, if one were expected to hold onto the loan until maturity it could be generally carried at cost if the loan would be logically expected to pay off at maturity. Today one must write it down to "market" particularly if it is a security and perhaps this concept could be modified so that the ever faster cycle of a decrease begetting another and so on and so on can be slowed or halted. If something like this is not done the ramifications are beginning to have things spinning out of control as **counter parties or lenders become increasingly frightened by the prospect of yet another series of write downs.**

Of course, the Fed has been doing many things much of which is new and innovative with $100's of billions of liquidity being injected into the banking system in a variety of ways, some with help from other Central Banks, but most being creatively done just by the Fed. Very few people seem to believe that conventional efforts, such as lowering interest rates, will do much to cure what ails the system currently. Of course, almost all of the pundits/economists (90% in the futures market) are now indicating another decrease of 75 bps for next Tuesday's Fed meeting. I just read a Deutsche Bank release dated tomorrow that says odds of **100bps cut is growing and is likely to depend on the market reactions and if more of Friday's activity occur it may tip the scale!!**

RECESSION

We have been believers for some time that recession was/is upon us not withstanding the need for a formal definition. Friday's WSJ reported that **70% of the economists surveyed indicated that we are IN a recession**. Furthermore, almost half of these economists said a recession this year would be **worse than the 2001 and 1990-91 downturns**. Furthermore, 63% said that the use of public money would be used to deal with the housing crises. I hope nothing like the S&L bailout will occur as almost everyone would admit that was a disaster for virtually all. However, those "vultures" that picked up the almost dead S&Ls and severely depressed junk bonds, which were sold at a fraction of intrinsic value, made a killing when prices rationalized.

I frequently use Merrill's economic work as I think they have been particularly on target on predicting what has actually happened in the economy. Well, on Friday they sent out a report from David Rosenberg, their North American economist, and it was titled "How do you spell **C-A-P-I-T-U-L-A-T-I-O-N?"** He notes that finally most economists are admitting that we are in a recession and that the skeptics have been largely put to rest on the topic. He goes on to note that a number of data suggest an increasing number of investors are becoming discouraged and negative. **CFOs** from a recent survey indicated that **80% think we are or will be in a recession in 2008 and do not see a recovery until late in 2009**. He notes that pessimism abounds. So I intend to keep a close eye on when he decides that a turnaround is coming which he currently does not see. Of course the stock market may have a further ways to go before we can say it has capitulated.

INFLATION / STAGFLATION

This seems to be a topic of increasing debate and how this will all turn out over the near term is certainly up in the air. The normal view is that if you are in a recession then the fear of inflation should not be terribly important even if there is some increased inflation at the outset of a recession, the normal consequence is that the slow down will generally defuse the inflationary activities. We have a truly bifurcated situation in the US. We are in a **massive housing asset depreciation** situation with **Goldman** saying that median US house price has fallen 10% from the peak and they see **another**

10-12% decline from here. Merrill is even higher in the decrease from here and I read that in Southern California some counties had housing prices down 18% so far this year. Goldman points out that essentially the root cause of the credit and funding issues has been the depreciation of housing assets. We have talked about the incredibly important negative equity issue and how that impacts what people's attitudes may be with regard to continuing to pay their mortgage. The greater the depreciation in housing prices, the greater the negative equity and thus the expansion into more defaults and this is not just in sub prime or Alt – A mortgages, but in the increasing delinquencies in prime loans as well. We also are facing serious **decreases in commercial real estate** properties according to Goldman but not yet of the level of residential.

The actual numbers for CPI have not indicated a huge increase in inflation even when one considers the food and energy component. However, if you asked a typical consumer they would clearly indicate that inflation is running rampant, particularly energy and food. The dollar continues to collapse and much of our imported goods have also increased at a rapid pace. **Oil and gold hit new highs last week** at over $110 for oil and over $1000 briefly for gold. There continues to be high prices for chemicals, natural rubber and most grains with corn and wheat continuing to escalate. Some metals have begun to slightly decline and there is a case to be made that it will continue. The case being made for **industrial metals to decline** is that decoupling of the world's activities is a myth and that the US recession will severely dampen demand and that the newly emerging middle classes of India and China cannot make up the difference. Gary Shilling in a Forbes column of 3/10 believes that **copper is a great short** and notes that there is no OPEC to prop it up. He also notes as do others that the droughts causing shortages particularly in wheat are not sustainable. Many people other than the corn lobbyists and their political supporters know that **corn for biofuel is NOT a realistic substitute** as it is an enormous energy and water user and pollutant. At some point we should see corn reverse, it is better for food and live stock feed uses than as a fuel.

While I am becoming more of a bear on commodities as is Lehman among others, I read an interesting article in Market Watch on 3/11 by Morning Zhu, a blog, which states that **China plans to build up its strategic oil reserve** to the equivalent of a 30 days supply or 100million barrels by 2010. This is estimated to increase China's demand by only 2% but will simply add to the pressure on oil prices. In contrast Merrill's analyst is saying by the fourth quarter of 2008 crude will be down to $78 but that estimate was dated about a month ago before the most recent spike, so hard to hold them to it. However, they do make the case in the same piece that there are several reasons for a lower oil price and thus as an investment strategy to **reduce one's energy exposure**. Apparently legendary oil man, Boone Pickens has been severely punished for his bet that oil prices would be coming down as reflected in his hedge fund's performance.

Net of all of this in my opinion is **most commodities should trade down** but there are few sure bets on when and how much and each may act in a very specific way. Our portfolio companies in chemicals are receiving price increases at unprecedented amounts and frequency. Raising prices to our customers is a battle worth fighting as it is necessary but a bloody fight in virtually each instance.

There is a long discourse one could get into regarding the **weakness in the dollar** but at $1.56 to the EURO, a new record, and touching less than a $1.00 to the yen for the first time since 1995, makes the job of the Fed to strengthen the dollar difficult. The markets, including commodities many of which are traded in dollars, of course including oil, makes it an almost impossible task. We need to find a way to **renew the confidence** of the world in our currency and start to have the dollar once again become the most respected and trusted currency in the world. It may hurt exports but that is not sufficient to deter policy makers from doing the right thing and putting in place those measures which will bring about a stronger dollar once again.

THE CONSUMER

We have talked about the consumer in some detail in the last couple of Musings and I would only note that things are not looking good and perhaps even worse than we had discussed. Anyone who has filled up their gas tank recently has had major sticker shock and many are predicting $4 to $4.50 gasoline in the summer. **Deutsch Bank** did a study and noted for every **one cent rise in gas prices real consumer spending declines $1billion (annualized**). If gas increases by 50 cents from their quoted $3.27 per gallon, it alone would eat up one third of the fiscal stimulus package recently enacted. Clearly **housing prices are a colossal depressant** for most consumers as are the resets, although lower interest rates may help a bit on the reset price. Food prices continue to escalate and it will take a while for that to adjust down if the commodity prices do abate as mentioned above. The worst part is employment and the statistics are getting increasingly weak, including the number of people who no longer are looking for jobs which continues to increase. Consumer confidence continues to erode which is only to be expected

This will clearly be a tough time for almost all but the very wealthy, and many of them will be impacted by the stock markets and bond markets which are currently in such an upheaval, but those markets have a way of returning to an upward trend it is just the pain of going through the dip or severe trough which is the challenge. Morgan is advising its clients to increase their **cash portion of their portfolio from 5% to 18%** and to be sure it really is in true **liquid cash and NOT the toxic offerings** which were not really cash and now investors are stuck in illiquid investments with some small increase in rate but not with the liquidity expected. My auction rate and LC backed issues are not liquid and seem to fail each week providing in several cases 6% plus tax free, hopefully I will again soon have liquid investments albeit, at much lower rates.

ASIA

As I mentioned last month I am on my way to Japan this week for a couple of weeks with perhaps a visit to China included for a few days. I will give you my impressions upon my return. I mentioned our Joint Venture with **Ajia Partners** and specifically the

Asian Hedge Fund of Funds to which we are an investment advisor. We received a note from **Paul Heffner** who heads the Asian HFOFs and recently was with our team in Brazil. As a follow up to our clients and potential clients in Brazil, he sent the following note on Japan and India as excellent places to invest currently. Here's an excerpt from Paul's note:

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Below are comments from our India manager – Helios.

> ***March 10th Email*** - *We are putting our neck on the line to stress that we strongly believe that this month end will be one of the better times to buy Indian equities. Either the prices would continue to get marked down and the market will be down another few % points by then and make any entry that much more attractive or the markets would do nothing for the balance of the month and have bottomed out.*
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> *The P/E of the Indian market now is around 15 based on 2009 March earnings. Removing the valuations of subsidiaries which have value but do not have any current earnings would reduce the P/E of the market to between 13 and 14.*
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> *One more reason why we believe in our call is due to the attractive value of Indian Rupee for new buyers. In an entirely unexpected move, the Indian rupee has depreciated by 3.15% against the USD this year. In an era where there are so many fears about the future of the US$, buying the Indian market at such levels of the rupee makes the trade more attractive. Since December 31st, 2007 India's FX reserves have increased by over US$ 20 billion and crossed US$ 300 billion as of Feb 29th, 2008.*
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> *Since December 31st, 2007 foreign institutional investors have sold stocks worth US$ 2.4 billion and have bought single stock and index futures worth US$ 1.5 billion. Domestic mutual funds have bought stocks worth US$ 1.8 billion over the same period and are sitting on estimated US$ 7 -8 billion of cash waiting for the "uncertainty to end".*
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> *One investor asked us as to what is our pain tolerance level and when will we make changes to our view (ie. throw in the towel). We do not intend to do that for we believe that the best thing to do right now is to get through this stage w/o getting whipsawed. We are not living in our own world here but are saying this after evaluating all the factors and the relative strengths of our market and our stocks.*
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> *One more reason why we feel bullish is because we are not able to find anyone else who is.*

While it is difficult to call a bottom, my team and I have been meeting with managers and investors and concluded there is a major gap between the two groups – investors are sitting on the sidelines waiting while fund managers are finding increasing more opportunities to invest. This pattern was similar to what I experienced in the fall of 1998 and the spring of 2003. These were major turning points and an opportunity for outsized returns. As I mentioned during our meeting, Japan is the best risk adjusted return in Asia. Please let me know if you need any additional material or would like to have a conference call to further discuss our investment process, risk management and/or our views on the general markets.

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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 located in Hong Kong and Tokyo 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 Eurekahedge Asia Pacific Fund-of-Funds Index and the MSCI AC Asia Pacific, which were up +16.72% and +12.28%, respectively in 2007. Paul's **fund was up net 1.29% in February** against +1.10% on the Eurekahedge Asia Pacific Fund-of-Funds Index.

My strong belief is that it is critical to have an extensive local team who speak the language on the ground working every day in these very diverse and dynamic markets. 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

Once again, I hope this edition of Market Musings was of interest as I truly want to provide our friends and investors with a sense of the markets and the potentially treacherous path I think is currently 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 you support and good luck with an Irish twist….**Happy St Patrick's Day!**

DDL

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