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 just completing a **maritime investment**, which we are confident will be a **wonderful opportunity for our investors.** We are taking advantage of distressed shipping assets which are well-positioned to be worth over time much more as the world economy grows and commodity movement increases. Importantly, this investment will also serve as an effective hedge against inflation when it reappears. More to come on this sector investment strategy!

My thoughts, as a non-economist, **on 2010** in **this Mini Musings** are generally **a bit less upbeat than most, though I do see opportunities out there for those with the right access and insight to act on them and the perseverance to see them through to fruition– there is money to be made!**

Overall Economic Outlook

- The overhang of **residential housing** issues, as foreclosures continue to be an enormous drag on recovery; the **slack in auto production** and industry in general; the gigantic wave coming in commercial real estate defaults (now at a 16 year high of 3.4% and heading to 5-6% over the next two years); the **uncertainty around government actions** (health care costs, financial regulation, carbon trade and now CO_2 emission controls from the EPA, and massive tax increases at the federal, state and city level); **reductions in state and local government expenditures** due to fiscal gaps (importantly this is only getting much worse); all lead me to be on the side of **a weaker economy with more risk to the downside than upside** compared to the consensus of 2 to 3% GDP growth for 2010. Interestingly, we could have a surprisingly strong 4th quarter this year which might approach 5% GDP!

Banks

- **Banks** generally still are not lending to smaller businesses, the engine for employment growth, or to households except under more strict credit standards. There have been **130 bank failures so far this year** (more than the combined total for the last 16 years) with **several hundred more that are likely to fail** in the next year or so. This will continue to put pressure on the FDIC and may provide some **extraordinary opportunities to purchase distressed loans, mortgages and real estate or even banks** for some investors (we are a co-investor in Indy-Mac which we believe has very excellent upside and is very much on track to date). **This is an area Lion Cao is currently and seriously investigating for potential opportunities for our investors, as we see great potential gains in this sector in the coming years (we will keep you informed of any banking deals we are considering in the coming months).**

Weaker Dollar and Commodity Boom

- **A weaker dollar** (which I think is more policy than anything else **-** even if this take on it is denied) will keep the **commodity boom alive**, including gold surprisingly, and the growth in the developing world will be a further driver. Although increases will not be in any straight upward line, it would also not surprise me to see a 10% to 20% pullback in the not too distant future, particularly in gold!

- The two commodities of great importance to many, particularly in the US, are **oil and natural gas (NG)**; and they have been at such a strange discontinuity between BTU values and market opportunities and speculation that I am reluctant to state a particular view. Once coal is added to the mix along with the new EPA potential mandates, the clouds further darken as to where things will end up even for the coming year. My "guess" is that oil doesn't move too much beyond the \$60- \$90 range, NG now about \$5 could spike up to \$8 or \$9 (albeit we just keep finding more NG through "unconventional" drilling methods which should keep a lid on any significant increases), and coal holds its own (again with increasing governmental pressure).

- In terms of **alternative energy sources**, coal is such a massive power producer that I find it difficult to see anything as an immediate replacement. “Clean” coal is still elusive and the costs are still extremely high. We are a long way off from green alternatives being material in providing energy (currently all green sources combined total to less than 5% of our energy needs) and we are unlikely to get there for years to come. Also, attempts at alternative fuels do not come free of their own potential hazards, just two examples of which are the ethanol debacle and the extreme distaste for nuclear energy even though it presents NO pollution from greenhouse gases. This will be an area of great debate and interest over the next few years…**hello Copenhagen!**

The Stock Market

- The **stock market**, I believe, will end up being relatively flat for the year and I certainly expect a pullback soon, although I have said that before! We may have a GDP W performance, or my elongated reverse “J” (which seems a bit like the Nike swoosh), which will put pressure on growth in revenues and earnings. I think this is the case, not withstanding the **huge operating leverage** created by the reduction in costs at almost all companies, but this leverage will be moderated by anemic revenue growth. There will of course be better opportunities in some industries versus others and this difference will prove advantageous for the astute trader. As David Rosenberg points out: **“this is a market to be rented not owned.”** I do believe we are in **a secular bear market** and that this is not a renewal of a bull market. However, it has been a great stock market revival this year even though we are still well below the previous peaks. Furthermore, the last decade has seen essentially all major stock market indices decline which has not occurred since the 1930s!

Emerging Markets

- **Emerging markets** should continue to do very well both in their GDP growth and their stock markets (Citi was suggesting 20% to 30% growth in Asia ex Japan!), but always with a potential for very high volatility. Incidentally, China has produced more cars (12.8 mil vs. 10.3mil) and more appliances (185mil vs.137mil) this year than the US. Still, China has only 38 cars per 1000 people, far less than our normal 3 cars per family!!

Credit Markets and Deflation

- **Credit markets** have had a spectacular run and for the astute player will continue to provide excellent opportunities (restructurings, bankruptcies, etc.). Also not a bad place to get some yield in contrast to money markets or the Treasury market. I think the Fed will continue its "no interest" Fed rate for all of 2010.

- **Deflation** will persist generally for the next year and possibly longer. However, inflation will return, which I think is inevitable due to most governments collectively needing to pay back their bloated debts with a cheaper currency. This position does take into account the huge un/under employment in the US (17 %+), which will take some time to be reabsorbed in this slower economic environment: there are 7.5 million people who have become unemployed since the onset of the recession and currently there are now 9.9 million people unemployed. We will see a first quarter boost in employment from the buildup of up to one million temporary workers being hired to conduct the census.

The Great Recession

- **The Great Recession may actually <u>not</u> be over**. As I have said in my past Musings, there are four elements to determining the end of a recession: (1) employment (interestingly, Goldman Sachs believes unemployment will peak at 10 3/4% in 2011), (2) real personal income (excluding government transfers), (3) industrial production, and (4) real sales. Only industrial production looks like it has actually hit bottom based on several elements although many of these statistics are disputed.

The New Normal

- **The "New Normal,"** as described by PIMCO, suggests longer term more modest growth than historically experienced, but also behavioral change in savings versus spending. **The "new frugal" consumer** is here to stay, at least for the next few years. For example, household net worth is still down 19% from its peak even after two quarters of good growth (4.7% and 5.3%, respectively).

Exit Strategies

- **Worries about the "Exit Strategies"** of the Fed and most other countries' central banks will be a true test of their skills in what will become a highly political backdrop for these decisions. An interesting note: the Federal government's borrowings have replaced all of the deleveraging in the states as well as the reductions in business/financials and households. We have not yet done what will be necessary to complete this overleveraged cycle which is to have government reduce expenditures and begin an effort to balance the budget. In general, I believe the current stimulus package has not been particularly effective nor will the recently proposed stimulus package which the President has just introduced be in creating long term jobs and economic growth. I would prefer a redirection of the current stimulus to primarily massive needed infrastructure efforts on our crumbling roads and bridges. Also, by not using the TARP money for a new stimulus, as proposed, we would show some restraint to our creditors. It should instead be used for debt repayment.

A Big Black Swan?

- 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 a Dubai World request for a six month stand still agreement, followed by Greece's downgrade (with perhaps no ECU support), with Spain and others following on its heels leading to a domino effect. 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.
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