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LION CAO

ASSET MANAGEMENT

Mini Musings

PANIC HAS SET IN, WHEN WILL IT END??

As you are already being inundated by information from your advisors, brokers, money managers and the news coverage from papers, TV, radio, the Internet, etc, I did not think you needed yet more advice from another pundit (which I am not), so I thought instead I would share with you some observations and comments– the short version! Everyone seems to be asking the same questions**: "What the hell is going on?" and "When will it end"??** While I certainly do not have the answers, I would like to provide some thoughts on the topic for your consideration.

Frankly, I am not sure that anyone truly knows the answer to **"what the hell is going on?"** and I think that may include the people who are calling the truly big shots like: save Lehman or not, in this case not; save AIG and Freddie and Fannie, OK; etc., but these decisions are being made on a truly ad hoc basis and it is hard to know what will be the next decision. **They sure are keeping us guessing!!**

I think Morgan Stanley and Goldman maybe forced to join forces with a bank as the market seems to be demanding this. At one point today MS was down 42% and GS was down 22% and they both had better earnings than expected when they reported yesterday, of course far worse than last year's. I now see MS is supposedly talking merger with Wachovia; **is this two drunken sailors trying to hold each other up?** I do like the rumors that GS and Wells Fargo could get together. Washington Mutual will be gone one way or the other.

I don't know anything about the books of the other insurance giants, but the NYT showed charts today indicating that not many businesses of **AIG** were making money. So is the next part of this **crisis going to be the insurance companies**? **When will it end?**

We have a systemic credit/liquidity/financial problem and it is being addressed on a rolling ad hoc basis with no one aware of who is too big to fail, if that is the presumptive criterion. I have read and heard that an RTC type effort as with the S&L crises is called for. I actually am in favor of this as a concept. It is important however that the pain is great for those who use that type of bailout. As I recall the RTC only took assets in from busted banks, not crippled ones.

I do think we are in for a **long period of distress, as the housing crises** which started this problem has yet to be resolved. You know: the house goes down in value (negative equity); the payments stop; foreclosure occurs; the banks take write-downs; the banks lend less and with tighter criteria at higher rates; buyers can't borrow; prices of houses go down….**the cycle continues**. We will see this for some time to come as I have indicated in all of my Musings since

January. We of course have continued worries about Alt A loans, even some prime mortgages, car loans, student loans, credit card loans, etc.

All of this is being exacerbated by an economy **which is and has been in recession** for some time. I know, many people, including some very smart economists and investment advisors…and government officials….deny it, but we have also been saying this since January. We have suggested in earlier Musings that many indicators which have historically accurately predicted that the circumstances noted have always presaged recession. Just a comment from an Investment Letter I received today from JPM "….tax receipts, small business optimism, the US manpower employment survey, the Baltic Freight index, retail sales, Eurozone industrial production, hotel occupancy rates and just about everything related to growth or construction in China **all look the same: plummeting."**

As we have been saying for some time, this **slow economy will be extended well into 2009 and while long it, I believe, may be reasonably shallow**. We are also moving into an extended period of **consumer recession** and many facts bear this out. I think the government will go for another stimulus program and it will work, but it will also be temporary as was the one this spring. And thus we go further into a deficit! Along with all the bailouts by the Fed pretty soon a billion here (or in this case several billion) and a billion there will begin to add up. How much more can we allow the government to do and still be prudent? I don't think raising taxes will be the answer. That would only add to the distress in the economy. This is a further looming issue, although far from a crises.

We were **debunking the idea of decoupling** all year and said many times that there would be no real decoupling. We now see once again that when the US sneezes, the world catches a cold. In this case it is a double whammy: our economy is slow and we have allowed the flu to spread with the credit crises particularly in Europe. We now know that Spain, the UK and Germany are in recession. The stock markets in Europe are down more than here, but that may change if these 5% drops in our markets keep occurring. Russia shut down its market today after almost a 20% drop yesterday and I think it is now down over 50%. You can say the same order of magnitude for a number of the Asian countries' stock markets! **When will it end?**

Finally, in this short or Mini Musing, I think the other systemic risk is around the use of derivatives. This is where the idea of **Moral Hazard meets Practical Policy Solutions**! Did Lehman not get saved because it had time for the counterparties to settle up on their Credit Default Swaps (CDS)…remember the Fed and Treasury said get together this past Sunday and fix things up!! On the other hand was AIG just so big and had so much exposure in CDS and was so global that the consequences were too catastrophic to imagine? I think so. This is why I go back to we need a clear set of established procedures to deal with these institutions, particularly those outside the banking system. The banks have FDIC and pay an insurance premium so that the depositors may get paid in a meltdown. That is apparently not the case at all for investment banks and insurance companies (although they have somewhat stringent rules for their insurance subs)…we have the taxpayer standing ready to make these payments it appears. I do however think the deal done by Paulson, et al with **AIG will be a big win for the taxpayer.**

When will it end? My answer on the **economy** is sometime in mid to late 2009. I would think housing would have hit bottom….perhaps another 10 to 15% down from here…by then so that will sort itself out. The banking system has to be positively resolved and then lending will return and the rest of the economy can once again begin moving.

When will it end? The **financial crisis** has to be solved, and it will be, as the Fed and Treasury figure out what to do to effect a more systemic resolution of the situation. GS has some ideas as well and published today a piece which had options for Fed and Treasury officials which "include 1) cutting the funds rate (a growing possibility), 2) expanding existing liquidity facilities (possible, though the scope is limited), 3) creating new facilities (less likely), 4) expanding Treasury issuance (announced today, with terms yet to continue (sic)), 5) paying interest on Fed reserves (an issue of when rather than if), and 6) buying assets directly in the marketplace (a last resort move)."

I am convinced that we will come thru this crisis as we have successfully exited them in the past and we will this one as well. When you are in one, they all seem worse than the last one. I agree with that and we will look back and say **this was one of the worst**! But we will survive. Of course cash is king…or so we thought when it was in a money market account…and there will be sensational buying opportunities. I would think these buying opportunities in some sectors will be soon but we are not done with this downdraft, so I would not put caution to the wind.

I have included some excellent material from our partner is Hong Kong, Ajia Partners. I hope you enjoy the video and write up. Ajia Partners had made some great decisions as outlined in their report attached, particularly in the past several months, given the volatility of the markets.

Click here to view Paul Heffner's interview on CNBC – Trends in the Hedge Fund Industry

We continue to always attempt to recognize the **proper balance between risk and reward** and bear that in mind in our efforts.

Please call or email with questions or comments. We do enjoy hearing from you.

Thanks for your support and good luck. We hope that you will come out of the recent "storms" with limited damage and a positive outlook for the long-term future.

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