LION CAO

ASSET MANAGEMENT

Mini Musings

July 8th

Is it Over?

I would submit not yet! The economy has seen **"glimmers"** and **"green shoots"** at least as reported by many.

> **Residential housing**—is it over?—**Not yet** as sales are still falling in May (0.7%) and YOY (32.8%) and 75% form the peak in July '05 and prices are still falling.
>
> **Commercial real estate**—is it over?—**Not yet** as it is just beginning with Moody's report of -8.6% MOM from April and -25% YOY.
>
> **Labor markets**—is it over?--**Not yet** as we continue to lose jobs, 467k reported last week and almost 9 million lost jobs since the start of this cycle. Also there is a current unemployment rate of 9.5% with everyone including Obama saying 10% this year and many saying more than that in 2010.

However**, inventories are so low that perhaps we will see a rebound in sales** as manufacturers restock. I believe a great deal will depend upon the velocity of auto output, particularly GM, perhaps unbelievably coming out of bankruptcy today!? There are other positives out there but most are of the second derivative type suggesting good things because they are less bad than the trend, but NOT really an upswing!

In our last Musings (3/29), we said we were **experiencing a "dead cat bounce"** in the stock market and expected **a retest of the lows**. I have not given up on my view that the markets have primarily been in a bear market rally. It is, however, an astounding 40% increase (peaking on 6/12) from the lows (3/9) and while not unprecedented, I have seen numerous charts showing this rally compared to 1932 and the outcome subsequently is not what we want to see! I believe there is a **strong possibility that we will test the 700 level** of the S&P, probably this September or October or possibly sooner. Perhaps we should have all **"sold in May and gone away".**

The recession may be approaching an end but based on the facts as I see them reported we generally are still seeing anemic activity and the indication of a positive view is simply a slowdown in the declines, NOT a reversal in the trends. Accordingly, while the stock markets generally start their recovery +/- 6 months before the end of a recession, I think **this rally as a start of a bull market is too early!** The probable recession end is at least the end of the year if not well into next year. This market is ahead of itself and the statistics seem overwhelming in that regard with, as just one example, P/E multiples at 23.3X and these represent an expansion from the lows of 17.0X or **6X multiple as compared to 3X multiple gained in the post-1982 powerful surge** (Rosenberg 7/7)

HEADLINES

In the last couple of Musings we have mentioned some headlines and certainly they have been filled with a tremendous amount of important economic news. The Administration continues with **virtually a daily barrage of new programs** all with some enormous implication for the economy. We have noted some shift in emphasis in the headlines. We had been shocked; at least I was, by the enormous outpouring of **displeasure in Iran as a result of the election results**. It is sad however that it was so harshly squashed by an autocratic regime willing to beat and kill its own people.

.

While it seems that the situation in **North Korea** is absurd, it is indeed a very frightening prospect when a totally rogue state with an “insane” leader, but one with nuclear arms, can threaten its neighbors and even the US. Why doesn’t China step in here? This is particularly frightening as **only China**, in my view, has **the ability to do something** meaningful to shut these threats down.

Of course, the headlines on **Michael Jackson** are of great interest, apparently world wide. How did he die exactly? Who was involved? What is his fortune really as there appears to be significant debt against most of his assets? Of course, this is not AIG, Bear Stearns, Lehman, Citi, GM, Chrysler or Merrill/Bank America scale of worry—just lots of great curiosity.

The reason these **headlines are important** regarding Iran and North Korea (and also the daily bomb blasts as we depart the Iraq cities and the very slow progress in Afghanistan) is that **they are tests for Obama**, as are his current visits to Russia and the G 8, and how he will react! The importance of this, of course, is obvious on the surface and simply is **what will his actions (not words) indicate** for US policy vs. our historical role of “Global Policeman”, our job since WW II. To me the further importance is that many commentators/analysts/pundits see the stock market continuing its bull run unless there is a shock to the “system.” Since it is increasingly unlikely that the next shock will be another financial failure, it thus may be more likely to be geopolitical or a terrorist act in the US (God forbid). This is not a prediction but is a meaningful concern if one simply is going to ride the bull surge.

If there were to be another **financial crisis** at home, my guess is that **commercial real estate** is the likely biggest potential problem area. There is a total of $1.7 trillion of commercial real estate loans at banks and write downs could be unusually high as vacancies and lower property values prevent refinancing to occur on rollovers.

Of course we are not predicting a shock to the system, however, the stock market still appears to be much too far ahead and a **pullback I think is inevitable of at least 10 to 15%** --a 40% run is too much without a further test of some sort of the lows.

INFLATION/ DEFLATION

I am in agreement, with what I believe is the consensus, that we should be much **more concerned with deflation** in the short to medium term. With the consumer, representing 70% of the economy, hurting from unemployment of 9.5% or underemployment now an unprecedented 16.5%; an ongoing credit squeeze; and asset depreciation particularly in housing, the **consumer is an unlikely leader out of this current recession.** Also, industrial production is very low and the output gap that is frequently talked about, causes us to view **little stimulus from industry** notwithstanding some "semi positive" ISM numbers which really are indicating less of a slowdown or only a modest pickup in activity—some of those "green shoots".

Oil is a bit of a wildcard in that the volatility is certainly causing many to worry about gasoline prices again hitting the consumer but there seems to be a consensus of sorts that oil will not pick up dramatically in price until we see a bit more of an economic pickup.

Nouriel Roubini disagrees with the consensus that the recession will end sometime in the second half of 2009, Merrill Lynch says it has ended in April, and Roubini expects that **it will be mid 2010**. As we have pointed out in the past, the end of a recession is more complex than simply an up quarter or two. As a reminder, Unemployment, industrial production, real manufacturing, wholesale retail trade sales and real personal income (less transfers) are all considered when it is time for the National Bureau of Economic Research to indicate an end date to a recession.

While there are some positive developments in the economy most are stabilizations rather than any significant increases, so as I heard on Bloomberg this morning**, someone has put Roundup (the weed killer) on the green shoots!**

There are three issues which **concern me the most about inflation**, other than an oil shock or some other geopolitical issue: **outsized fiscal deficits; another stimulus program; and the Fed's ability, and the other central banks, to rein in their monetary stimulus when they should.** Goldman has been advocating for some time another stimulus package and Paul Krugman in his column late last week strongly urged the Administration to implement one and, of course, acknowledged the difficulty of accomplishing that task. Apparently, even the quoted **10% of the stimulus package that has been spent may be overstated** as much of it went to the states and it is unclear if it has put shovels in the ground. The administration, I believe, will have huge fiscal deficits over the next several years and raising taxes on the "wealthy" will not bridge the gap. Joe Biden seems to think that a stimulus is a good idea and Obama has not ruled it out, even if it is politically toxic now.

Furthermore, I think **the Fed** will be in at best an awkward situation when it comes time to rein in its vast monetary stimulus programs, primarily because they do not want to repeat what occurred before the 1937 recession when the expansive policies in place were taken off the table too soon. Secondly, politically this will be very tough to do if it looks like it could hurt the working person, which it probably would. Goldman has published several notes, as have others, indicating that the Fed has many tools and ways to reduce these programs. I certainly am not disagreeing with that however, I believe that **a lack of will and politics will cause them to be too slow when the time come**s. This is likely to be true for other countries as well, perhaps excluding Germany!

What all of this means is that our **country's lenders**, as well as other countries' lenders, will be concerned that this **will lead to inflation** and interest rates will rise and we will have an igniting of inflation expectations, a **weakening of the dollar**, thus an increase in **commodity prices, particularly oil**, which will increase gasoline prices, etc.

We see in a couple of years a **very meaningful risk of inflation, perhaps significant inflation!**

DOUBLE DIP?

Recession will end sometime in the next 9 to 12 months, in my view, but the likelihood of a double dip is very high. Much of the stimulus will be out of the system and how long **the "Frugal Consumer**" will be out there is an unknown. But as mentioned above the consumer is not in great shape and coming out of this recession will still be looking at tougher credit, still lower housing prices than previously and a strong will to save more. Many commentators are indicating that current estimates of 5 to 6% savings rate will be too low for the future as the Baby Boomers continue to worry about retirement and the longer life span in retirement.

I am not convinced by any means that savings will go to 10% but even getting close to that will put an enormous dent in the consumption patterns of the consumer. Let's not forget that most of the nation is still trying to delever, particularly the consumer either by choice or forced to by circumstances.

THE SHAPE OF RECOVERY

I had come up with not a V or W or L as the way I saw this recovery but rather as a **"reverse elongated J" more like an L that finally went up**. Essentially, I was thinking we would not come out of this until well into 2010 and then slowly work our way out of a bottom over time. I now see more of a W, after these government programs begin to fade there will be a settling back down in the economy again before the convincing uptrend. I also see the commercial real estate market as a potential additional catalyst for significant problems. This leads one to want to be **more of a trader in this market**, as Dave Rosenberg suggests, "**rent the market**" rather than "buying it". Perhaps a buy and hold strategy may cause whiplash, particularly as there will be different leaders and laggards at different times in the market. Of course, if you pick great companies with great management and products in the right markets, maybe it doesn't matter but that is not "buying the market" or an index!!

DECOUPLING

I have been very surprised by **the strength of China and India and even Brazil, not Russia** which is too oil dependent and is an economic mess still, so there may be a different view of decoupling than I have had in the past. While these countries' growth rates are in the mid to high single digits, with China closing in on 10%--latest guesstimate by Merrill of 9.6% for 2010, However, **I do not see these three pulling the rest of the world out of recession** immediately but they will certainly be an increasingly important part of the world economy! China has had a very successful stimulus package with massive lending support from the government controlled banks. These programs became shovel ready immediately. (Even France is doing much better with their stimulus program than the US according to a couple of recent articles).

What we do see is the enormous activity within these countries and the continuing **development of a middle class of consumers**. This is positive for these countries but unlikely to make up for the enormous demand from the US and Europe which is not likely for some time. This positive activity will obviously increase trade **but will not lead us out of the slower world economy** which will need the US in particular and Europe to once again be active participants in the import and export trade.

A BONUS

As I have frequently proclaimed, I am not an economist but Dave Rosenberg is and I believe he has been one of the best in helping to parse through the last year or so of economic and market gyrations. He has moved from Merrill to Gluskin Sheff in Canada, where he is from, and I continue to avidly read his material. He put out a note on July 3rd and included some of the **remarks from San Francisco Fed President Janet Yellen's speech on June 30th.** I have included these remarks and would urge you to read her comments for the **most clearly articulated view of our economy** from her perspective. Please see the attached Appendix**- do take a look**. As David said in his piece: "…**Yellin**, as lucid as ever, **delivered a tremendous speech. Lingering recession, muted recovery when it comes, consumer frugality, and deflation were cited as the major macro risks."**

A LION CAO OPPORTUNIY

We have been working on a number of projects to take advantage of the current economic situation as discussed in previous Musings. Currently, we are concentrating in the distressed area in shipping. While we believe that there are numerous opportunities in the distressed credit markets, we find this **shipping opportunity to be among the most compelling**.

We have obtained a large co-investment allocation, and the only firm to do so other than a couple of Private Equity Funds, to participate with a **proven management team** to acquire shipping assets primarily in the tanker and dry bulk areas, which is where the management team has been very successful in the past. One of the PE funds participating has **invested with this group twice before and made approximately 7X their investment each time**. The capital being raised is a little less than $1 billion and will be deployed over an 18 to 24 month time frame. We believe the markets are beginning to be very favorable for those with capital to buy ships from ship owners with lending/covenant issues, banks which have foreclosed on ships, and shipyards which need to find new buyers, to replace defaulting owners, for their new ships. As an example of favorable market trends, the Baltic Dry Index increased dramatically with the build up of Chinese stockpiling of numerous commodities early this spring. It is now down a massive 28% in less than a month!

We believe this is **a particularly good investment opportunity currently** as one will be able to buy **assets at distressed prices,** charter the ships at adequate levels, and be in a position to **sell the vessels at much better prices as the world economy improves** in the next few years and commodity activity is at heightened levels.

We would welcome your inquiries regarding this co-investment opportunity but please do move quickly as the **allocation, while meaningful, is filling up rapidly.**

****

We continue to always attempt to recognize **the proper balance between risk and reward** and bear that in mind in our efforts. We truly believe that we have the skills and perseverance to do that and the ethical compass to appropriately steer us in all that we do.

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

Here in New York summer seems to be finally arriving and we hope that you will have a chance to enjoy these next few months, even with the treacherous waters of the economy and markets continuing to be in turmoil.

Thanks for your support and good luck and we trust you enjoyed celebrating the 4th of July, Bastille Day soon, or just the summer in this part of the world.

DDL

David DeLeeuw
Lion Cao Asset Management
535 Madison Avenue
New York, NY 10022
212 355-5500