LION CAO

ASSET MANAGEMENT

Market Musings

December 20th

Light at the end of the tunnel……Not Yet!!

I have been thinking about this title for some time with the hope that I would not have to add **Not Yet**. I was hoping to just wish everyone a most happy holiday season and that we could see in the New Year better times coming sooner than later and we could just flush '08 away. I am optimistic but I will have to **put that optimism on the back burner for awhile** as we will have **a tough and sustained recession throughout '09 and perhaps even into '10.** I don't want to be overly pessimistic – perhaps realistic is a better term - but this year is certainly not ending on high notes.

HEADLINES

Let's just look at the headlines that have been screaming at us for the last week or more. We have just had **a mini bail out of 2 of what had been the Big 3** and as a commentator noted recently **now the Little 3**. The amount of the bail out was $17.4 billion but there was not enough money left in the TARP to make good on the whole amount and the last $4 billion will have to come from the next tranche of $350 billion next year, if not denied by Congress. The car companies said that they would not make it without this immediate hand out…even without the strings attached….much beyond the end of the year. It is pretty scary that our largest industry was **essentially on the brink of a forced bankruptcy,** for which they were ill prepared. However, the auto industry's lack of preparedness itself is not new, nor surprising.

Most smart people I have talked to or read about say that a **pre packaged bankruptcy with the Government support was the best solution**: backing the DIP paper; providing a support system for the supplier base, spare parts availability and warranties; and interestingly a voucher system for the retraining of displaced workers. It appears that this will all be dumped on the Obama team and Congress to sort out as the timing of **the loan is truly short term, March 31st**, if the numerous demands surrounding the loans are not met.

These demands include concessions from unions, creditors (two thirds of debt replaced with stock), suppliers and dealers. Also by March 31st, the companies need to "prove" viability going forward. We shall see what level of courage the Democrats will display regarding significant concessions demanded from their loyal constituency, the very powerful United Auto Workers. The government does receive some warrants for non-voting stock as part of the package. However, pushing this out to the Obama administration is probably political, as the Bush administration does not want to be blamed for the demise of the auto industry.

MADOFF

The talk of New York City and Suburbs, Palm Beach and now all over Europe and beyond is the **largest fraud in financial history; a scandal of truly epic proportions…$50 billion disappeared!** The number of unfortunate individuals and institutions, many of which are charitable, continues to grow with each day as the net of the scam continues to widen and we find many more were trapped in this mess. Often they were close friends or acquaintances of **Mr. Bernie Madoff** or members of his family. Also, many trapped were from what were purportedly reputable fund of funds, or feeder funds.

The number of people who will be blamed for this tragedy and sued and even prosecuted will grow dramatically. While his two sons turned their father in, most of the family seems to be involved with his brokerage operation if not with his money management activities and deny any involvement. Hard to imagine that "none knew" of the father's activities! Many who will be pursued are behind these feeder funds who did not do a proper level of due diligence and in some cases greed clearly overwhelmed common sense. **Why if it is "too good to be true," it almost never is.** Most of what I have read in the past several days is that Bernie was a great salesman; he did not encourage one to invest, but made it exclusive by not allowing everyone to be able to invest. This was the same story the feeder funds were telling: this Fund with year in and year out +/- 10% returns was not open, but we can get you in!

What were some of the most **telling signs that this was not all legit**? There appear to be numerous ones, briefly here are a few: he doesn't charge fees, but makes money off his trades with his own firm (remember Sam Israel of the Bayou hedge fund which was a fraud discovered 2 years ago did the same thing); Madoff had no outside administrator or custodian, most unusual; he had a "no-name" accounting firm which we now know numbered only 3 people, outrageous for this size activity; he would not meet with most people who wanted to invest- an absolutely common practice in diligence is to meet the principals; he could not, nor could his feeder funds, **explain in detail his strategy and why/how it worked so well always—when some professional investors attempted to back test the trades, the returns could not be replicated**; etc. Too bad more people did not see fit to kick those tires a bit sooner!

Madoff clearly was considered a "reputable" part of the financial, the philanthropic, and the country club set (he reportedly belonged to 7), primarily as part of the Jewish community. We will not know for some time, I would guess, as to when he started the fraud or if it was actually from the start. We will learn who his trusted co-conspirators were; and if there is any hope of getting any money back other than suing all the deep pockets which investors will find—banks, accounting firms, the feeder funds, and other fiduciaries who failed to do the proper amount of due diligence ("DD").

OTHER CROOKS

Bernie had to share the front page with another crook over the past few days when an attorney who owned a 250 person law firm was charged with selling fraudulent notes of $100s of millions and even impersonating people using their own conference rooms! **If Bernie's activities were not so juicy, Mark Drier would be taking up much more ink** in the newspapers. This is one of the more daring ploys I could imagine. Congrats to the folks who saw thru this charade with excellent DD and helped trap him.

I hope these are the only two sad chapters of massive frauds from this Financial Bubble, but I am afraid more are lurking out there. The phrase used by Warren Buffet and others seems to exemplify current events: **"When the tide goes out, you get to see who is wearing a bathing suit!"** With the vast number of redemptions that are occurring, as investors are desperate to get cash back from virtually any source, there may be more of these very unfortunate situations which will be uncovered. Of course, we **are not talking about bad performance**, there certainly has been way too much of that, **but about outright fraud**.

FALSE OPTIMISM

The reason **I was somewhat optimistic** that the light at the end of the tunnel would be beginning to brighten and I could talk about it by year end was that the government did what was noted in my Mini Musing of September 17th. The Fed began a systemic answer to the financial crises **with the TARP program**, although that was certainly bungled politically at the start and, of course, has changed course too many times to count at this point. The events which led to the government turnaround were precipitated by the decision to not bailout Lehman and then about 24 hours later arranged a massive bailout of the huge AIG insurance company.

I had no idea **how bad the ramifications would be from the Lehman decision,** but in some markets it was **cataclysmic**…the freezing up of short term paper, especially the commercial paper market, and the lack of confidence in one's counterparty. Banks did not trust other banks' credit worthiness; this continued even with the government bailouts in the US, the UK and throughout Europe. The markets were in turmoil for months and perhaps with the huge number of additional steps taken by the Fed and Treasury in the US and similar efforts in other parts of the world, including a massive stimulus package in China, I had expected a bit brighter outlook.

LENDING LIMITS / DELEVERAGING

That brighter outlook is not the case, we **still do not have the grease** which makes the system work….**banks lending to borrowers;** there are too many instances where they are not lending to credit worthy borrowers. This seems to still be the case and the auto industry is a shining example of credit not flowing and thus a massive number of cars are unable to be sold….some have estimated 25% more cars could be sold if normal credit was flowing.

However, I think the lending issue is much larger than that. There is such a **massive deleveraging and forced sale activity** occurring that one can't even begin to guess what securities/loans on a bank's books might be worth at any point in time. Citibank is selling at 0.39X book and Wells Fargo is at 1.9X book. I would suggest there is no belief in Citi's numbers. Thus, the banks are worried about their own balance sheets and are apparently only interested in deleveraging. I might add that **S&P has just decreased the rating on 11 of the largest global banks.**

Who else is deleveraging? Well, Goldman and Morgan Stanley are now banks, so their leverage has to go down from say 30 times to 10 or 12 times. The hedge funds can't borrow the same amounts as previously, not only from a leverage point of view, but also their assets are worth less and hence they must put up more collateral. They are unlikely to have enough collateral, so they must sell more securities which naturally put more pressure on the system because **with "mark to market" accounting**, everyone else has to also mark those same types of securities down to the new "market". This new market price was just created by a forced seller….not a willing seller to a willing buyer which usually marks a robust market.

In any case, the massive deleveraging which is going on worldwide has put enormous pressure on the entire system. US banks have gotten, I believe, now up to $250 billion in TARP money to help stabilize their balance sheets. However, **there is a huge non bank sector which has not gotten government funds**, such as hedge funds who lend, and as they reduce their balance sheets even more lending liquidity is unavailable.

ZIRP

In any case, lower interest rates and injections of capital into the banks will not automatically allow for greater lending. **The Fed has been unusually aggressive in moving short term rates down** and now has a ZIRP policy (Zero Interest Rate Policy), which has been instituted in about a year whereas in Japan it apparently took over 4 years to achieve that level during their protracted slump. In fact they went down to zero in 1994 and again in 1999 and it would not surprise me if it happens again in Japan. The markets reacted that there were few policy moves left in the Fed's arsenal but what I have read certainly doesn't indicate that and there are still many innovative initiatives that the Fed can make. They intend to buy newly issued Fannie and Freddie debt, open ABS facilities and much more.

However, I do worry that the **dollar will take a beating** over a reasonably short time frame. This will also push **oil prices up** as oil of course is dollar based, thus an unintended consequence. Also, our overseas Treasury investors may begin to question why they are buying such low interest bearing securities. The good news maybe is that in searching for yield, **investors are beginning to look at "riskier" securities and lending**

opportunities should increase in the economy as a result. This is an "intended" consequence of ZIRP. I would suggest thinking of moving dollars out of your Money Market account for a bit more yield!

DISINFLATION/DEFLATION

In my June 30th Market Musings we noted that virtually everyone was worried about inflation and even stagflation. Oil was on its way to $147 with even higher predictions and almost all commodities were still rising. We have now seen **a virtual collapse of commodities**, who would have believed oil at $35 or so, and an indicator of overall world activity, the Dry Bulk Index is off 95% from its high. This is **a staggering change** in the environment. We are now **worried about not disinflation but deflation**, a far more difficult problem to deal with once it sets in. Disinflation is a slowdown in inflation and deflation is actual decreases in prices and the general consequence is that the buyer expects prices to go down and thus waits, and that attitude is very difficult to break (that is truly a layman's description, apologies to all economists).

We had indicated that **decoupling was not going to happen** and that has certainly been the case with our "cold "(subprime defaults) turning into a massive "common" cold worldwide, if not an influenza! Europe is in a recession, as is the US and, as noted in the early part of the year, we were listening to David Rosenberg of ML who said we had begun a recession in December and now that is proven correct. In early July, the worry was a slowdown, perhaps a recession, but more concerns about inflation. We thought the slowdown would be worse and listening to Rosenberg and then Nouriel Roubini, we began to believe that the recession would not only be bad here but bad worldwide and of course that is now the case. As reported on a headline on Bloomberg on Thursday, "**World Economy to Shrink for First Time in 50 Years."** The Institute of International Finance is forecasting that the world economy will shrink 0.4% in 2009, which would be the first drop since at least 1960.

MORE "UGLIES"

More **indicators of a tough time** over the coming year and perhaps next year as well:

***Housing still is not fully bottomed out** and Goldman, Merrill and Roubini all believe it has at least another 15% to as much as 20% further to fall before we bottom out.

***Jobs are a disaster** and jobless rates are expected by many to rise from the current 6% plus expected this month to as much as 8 to 9% and some have projected even up to 10% unemployment by the end of '09 or beginning of '10. Jobless claims were just reported to be at a 26-year high (ML).

* **Consumers have a number of issues** facing them, their debt levels are too high; housing prices have fallen dramatically impacting what had been their ATM account (home equity loans from the never ending increase in home values); virtually no savings; savings rates will rise dramatically (Goldman had an excellent piece indicating the catch up necessary will be dramatic for most households and will impact the economy

significantly as the consumer forgoes purchasing in order to put funds into savings—an enormous change in consumer activity).

*We have already mentioned the **lack of credit available** for purchases of cars as well as generally tougher credit standards for all but the best credits.

***Commercial real estate will continue its downward movement**. Lehman's bankruptcy executors are probably not going to be selling its large real estate portfolio due to the low prices currently available. They intend to hold the portfolio pending more favorable markets.

*In addition to unemployment, there continues to be slowdowns in overtime, salary reductions or minimal increases, and as reported by FedEx today their executives and other salaried employees would receive **pay cuts up to 20%.**

***Bonuses are down dramatically** and my favorite: **Credit Suisse is paying bonuses to its executives with some modest percentage of cash and stock AND a large piece of the "toxic waste" paper that is hung up on its balance sheet**. As reported in the WSJ on Thursday, the bank plans to pool loans it can't sell and pay out the proceeds upon ultimate sale of the underlying assets to its executives. Many of these executives are not happy with this deal!!

EVEN MORE NEGATIVES

With that as a small spark to illuminate the not so happy prospects ahead of us this year, now I will pour more gas on the fire. Roubini thinks the market will go down 20% from here and Jim Rodgers(of motorcycle riding around the world fame, a Soros partner, and a huge bull long term on commodities) thinks the **Dow will fall to as low as 4000** from the current 8600 level. Several commentators have indicated that the likely earnings for the **S&P 500** will be in the $60 to $65 range, although many Wall Street analysts are still in the $80's. If you apply a bear market P/E multiple of 10X or so, or even 12X, you end up **in the 600's or low 700"s which from the current 880 range, would be down 15 to 20%.**

SOME OPTIMISM / OBAMA

Ok, now I will give you the optimistic view. Collectively the world's governments have put $8 trillion of stimulus to work so far. In the US, the Feds balance sheet has gone from about $900 billion to $2 trillion, on its way to almost $3 trillion, over the last several months. Similar efforts have been made around the world and the will seems to be there **to do what ever it will take. That is what the Fed said this week** effectively after going to ZIRP.

I am **encouraged on several fronts with Obama's new administration**. He is a **charismatic leader** and thus may be able to make people feel better about the situation than would otherwise be the case. He has brought together what appears to be an **excellent team, on average,** with more of a centrist approach than I would have expected based on his campaign. He has stated that he wants to create 2.5 million jobs and Joe

Biden has been quoted today as saying that a $600 to 700 billion **stimulus package** is likely. Others have mentioned $875 billion (WSJ) and some have **even suggested $1 trillion**, although perhaps Congress will show some restraint, of course that would be a new thought.

We have a **crumbling infrastructure, so his emphasis on projects** in that area makes sense to me, although it may not be able to be implemented as quickly as one might hope and the jobs needed to build infrastructure do not necessarily match the majority of the job seekers' current skill sets (how many office personnel have you seen laying tar recently?). The stimulus program actually is expected to be spent over a two year period which should help to prop things up longer than a quick fix approach.

I **worry about his "green" emphasis** as this may lead to massive expenditures which are not going to produce the results we might all expect or want. Lots of money could go to many impractical projects, I hope not but it is a concern. However, if the US wants to build a new industry base for the "post-recovery" period – the investment in "green," given our cutting edge innovative technological ability which is greater than most other countries' – may have longer-term benefits that offset some short term losses – longer term being 2011 – **setting the stage for US manufacturing resurgence** in relevant technologies vs. SUVs, etc. There is also a group of his environmental advisors who may wish to push industry faster than it can logically move to "clean up" carbon gases, as an example, at vast cost at a time when capital is in very short supply. Hopefully practical considerations will prevail, and I actually expect that to occur. **LCAM**, in fact, is currently **working on a biomass project** which will help reduce carbon emissions from coal fired plants. We will talk about this more in the future.

MORE POSITIVES

Also, in fact we have **had a "tax reduction"** effectively with the dramatic decrease of gasoline prices from $4 per gallon to somewhere currently ranging from $1.50 to $1.80, a truly remarkable decrease in less than 6 months. **Obama's stimulus plan also will contain tax relief to middle income people,** which should also be helpful. The gas reduction has been putting money back in the consumers pocket and combined with retailers reducing prices with dramatic sales with 50% to as much as 70% off original prices, **bargains abound before Christmas** and many are taking advantage of these deals. However, if you ask most retailers they are distressed by the lack of spending. It appears to be a bit of a standoff with retailers doing everything they can to bring the consumer into the store but **most seem to look only and be on "strike"** and unwilling to buy even at enormous discounts. We will see how the Christmas season finally plays out.

Wells Fargo's economists are quite optimistic and see the recession ending in late 2009. One of their economists, Scott Anderson, predicted that housing will lead the way back: "**One bright note** is that the sector that led the economy into this morass is about to turn the corner, **perhaps as soon as this summer**, and will start to lead us out." As noted above, I am skeptical of housing turning that early, although it would be great if it happened.

INFLATION WORRIES

Those concerned with **too much stimulus ramping inflation back up** in a year or so appear to have **somewhat misplaced** concerns according to a Goldman report which concludes that it will be several years before this will become an issue. This will provide the time for the Fed and other governments to begin to drain the excess liquidity with which they are currently flooding their economies. While a challenge, with sufficient time and diligence and in our case a Democratic Congress and President showing the appropriate spending constraints, we will avoid a significant problem from inflation. Of course, this will be quite a tough task to constrain their spending!

OUR VIEW

So is the **light at the end of the tunnel** a little brighter or is it really a freight train barreling down on us? I think not a freight train but unfortunately the light **is still dim**. This will be a challenging year to say the least. Opportunities for smart investors will surface and, for those investors willing to actively walk their way out of the tunnel, these opportunities can help them do just that. **LCAM** is certainly in that class and mindset. We are currently looking **at three "distress" funds in the Private Equity space** with firms that have done historically very well in times when distressed properties can be purchased advantageously. These firms have the appropriate skills in restructuring the "new" capital table and providing management insights and strategies which can then produce outsized capital gains. **If you are interested in learning more about these opportunities, which we may put together in one offering, please contact us in the New Year.**

As most of you know, we have a joint venture with **Ajia Partners** on an Asian Hedge Fund-of-Funds managed by Paul Heffner and his portfolio team of 15+ people located in Hong Kong, Tokyo and Beijing. **The Fund is performing remarkably well this year** with a November gain of +1.52% and a loss of only -7.48% year-to-date -- quite extraordinary given the losses shown in the comparable indices for the area. The Eurekahedge Asia Pacific FOFs Index and the MSCI AC Asia Pacific Index were down -0.05% and -3.79%, respectively, for November and YTD down -22.5 % and -47.61%, respectively.

At the moment, this fund is offered through an offshore vehicle and, unfortunately, is only available to our non-domestic and non-taxable investors. In the US, foundations can invest, as well as investors who have IRAs from which they can allocate or from other non-taxable assets. **If this is of interest please contact us.**

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.

If you want to **feel somewhat better regarding your portfolio**, just think, and it is hard to believe, but **Harvard, Yale and other endowments are down** or expected to be in the 20% to 30% range!

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

We wish you a Merry Christmas, a happy Chanukah, and in the now politically correct world some people live in….Happy Festivous (thanks Seinfeld) and happy Solstice which will occur tomorrow. Seriously, please enjoy whatever holiday you may wish to celebrate!!

Also, we mostly wish that 2008 will soon disappear and that you all will have a wonderful **New Year that will be Healthy, Happy and Very Prosperous**.

Thanks for your support and good luck.

DDL

David DeLeeuw
The Lion Companies
Co-Founder & Chairman
535 Madison Avenue
4th Floor
New York, NY 10022
T- 212-355-5500