



December 20, 2011

**Seasons Greetings and a Mini Musings  
All of us at Lion Cao Asset Management and Lion Chemical  
Capital wish you the very best this Holiday Season and a most  
Happy, Healthy, Safe and  
Prosperous New Year!!**

This has been an exceptional year in many regards: from the excitement of the Arab Spring turning into far less excitement about the "Islamist Winter"; to Occupy Wall Street spreading into Occupy ... Everywhere; to the even more alarming eurozone gymnastics; to US politics with the get-nothing-done Congress/President re fiscal responsibility; and the even less-than-Super Committee, and Gang of Six (year-olds). Given this kind of environment, **I think that 2012 will be defined by continued challenges and even more political posturing in both Europe and the US, especially with a Presidential election upon us here.**

My thoughts on 2012, speaking as a non-economist, are not that dissimilar to those I offered for last year and even 2009. I continue to be somewhat less sanguine than the generally bullish view expressed by many economists, strategists, and pundits.

I am not going to try to predict specific outcomes with this Musings, maybe a few guesses, but I am generally not afraid to offer my views/opinions!!

We were all **worried at this time last year about the PIIGS, the probability of Greece defaulting**, and then the likelihood of **further contagion**. Our thoughts continue along these lines. I saw a chart recently which showed that Greece has a 96% chance of default. If a default were to occur, with the current lack of support from the rest of Europe, Greece would be out of the Euro and back to the Drachma. With Greece facing an aggressive austerity plan, which is extremely debilitating to its economy and in my view can not be accomplished, what will be their rescue plan in the almost unavoidable event of a default? Of course, they would immediately devalue the currency, impose additional austerity measures, and with IMF oversight, probably slowly work themselves back into the international capital markets over a period of time as the South American countries, Asia and even Russia have done.

**No Eurozone Progress**

The latest German/French solution at last week's Summit has set some very tough guidelines for the eurozone economies, but from what I have read it is definitely not enough. **Chancellor Merkel** is moving incrementally forward, methodically getting each piece that she wants, but **cannot ask for all that she needs at once**. So that process is going to play out over the next several months for sure. From what I have read, **until the ECB takes a major role and stands ready to back all of each required country's Eurobond fundings, this plan will fall short of what is needed**. John Paulson wrote an Op-Ed in the FT (12/15) about this topic suggesting **"a post-Lehman style firewall"** with the ECB backing the sovereign issuers' paper as a lender of last resort, which would bring down their borrowing costs and provide them time to implement their needed structural reforms.

What exacerbates the situation are the predictions that Moody's and S&P will downgrade the sovereign debt of almost all of the 17 eurozone countries, possibly even Germany, and the prospect that **France is either entering or already in a recession**. According to France's official statistics agency, INSEE, Europe's second largest economy is expected to fall into recession in the final three months of this year and the first quarter of 2012. What is an **even greater fear is that the rest of Europe will follow**.

According to a Goldman Sachs economist, as discussed on a client call: "...he does not expect the peripheral countries to experience as deep a recession as occurred during the financial crisis, he does expect **weak growth to persist through 2012 and perhaps even into 2013**. This is in part due to the vicious cycle of great austerity measures leading to weaker growth, which, in turn necessitates further austerity to meet the original fiscal targets." It goes on to say that **much will need to be done regarding structural and fiscal reforms and political will**. The title of the call: **"More of the Same in Europe: Two Steps Forward, one Step Back...or One Step Forward, Two Steps Back?"** and this call was on November 9<sup>th</sup>!!!

**Asia's Impact**

So the contagion in Europe seems quite clear. Additionally we see the **slowdown impacting Asia and China in particular**. Europe is a larger trading partner with China and has larger imports than the US. The FT (11/17) points out that China is seeing a large decrease in shipments to the European Union down 18.1% in the third quarter and continued decreases to follow: "most analysts believe that Chinese exports to Europe will fall into negative territory this month or next. Figures for new export orders were well down in November....we expect **China's export growth to drop to zero in 2012**, and expect that to have a sizeable negative impact on the economy." **South Korea is down even more and Japan is suffering as well**, exacerbated by the strong yen. Further, "Japan, Korea and other Asian countries export goods to China for processing and re-export to the west, so Chinese export sector problems have direct knock-on effects throughout the region." The article notes that China is diversifying to other Asian countries as well as Africa, but analysts doubt that this can make up for the decline in European demand.

There is a good deal of evidence that **China is moving towards a slowdown**. Manufacturing PMI is hovering around 50, and could dip below, as it did last month indicating a contraction. **India is also showing signs of a slowdown**. The FT (12/15) quotes India's finance minister as turning his attention to "reviving growth as quickly as possible" and an analyst commenting on China's most important Communist party's economic meeting said, "Growth has replaced inflation as Beijing's top policy concern."

**US Implications**

**None of the above bodes well for the US economy, although we seem to be holding our own for the moment**. In fact many economists still expect 4% growth for this quarter; this is what happened in Q4 last year, but was then followed by a weak first quarter, which I believe we'll see a repeat of in 2012. In a Bank of America/Merril Lynch daily reader (12/20) their economist stated they see "a slow tapering of growth to 1% by the fourth quarter... **uncertainty surrounding the 2012 elections, the expirations of the Bush Tax cuts and another debt-ceiling fight will increase uncertainty, causing consumers and businesses to pull back**. As we've said before, uncertainty is the enemy of growth." The contagion noted above will certainly impact the US within the next year. According to research performed by Eurostat, BEA and Haver Analytics and prepared by Gluskin Sheff, **there is a remarkable 86% historical correlation between the US' and Europe's real GDP growth. There will be no decoupling. If one has a recession, so will the other!**

**Consumer Demand???**

**I have seen weakness reported in consumer sales, a source for leading us out of this slump** (representing 65% to 70% of the economy), notwithstanding the big sales activity of Black Friday and Cyber Monday and in spite of a significant drop in gasoline prices at the pump. For example: Bank of America/Merril Lynch (12/13) states 4 reasons consumer spending will likely slow next year:

- income from wages and salaries grows slowly and a possible slowdown in government transfer payments
- savings rate has collapsed to 3.5% from a peak of 6.2% in mid-08, so one expects rebuilding of savings rather than spending
- household balance sheets have deteriorated as net worth was hit by declines in housing and financial assets and continued deleveraging
- their economic model for consumer spending explains half of the recent increase based on income, wealth, interest rates and inflation expectations but the other half is unexplained!!! (leading one to conclude it is not sustainable)

**Housing/Unemployment**

**Housing is still troubled with expectations of further deterioration in pricing primarily based on the excess inventory of distressed properties** that need to be liquidated out of foreclosure. Bank of America/Merril Lynch (11/17) forecasts: "...national home prices to fall another 8% from 2Q11 through 1Q13, translating to a cumulative 38% decline in the Case-Shiller index from the peak in 1Q06....We forecast nearly 8 million homes will be liquidated by the end of 2015. This adds to the 6 million homes that have already been liquidated since 2007."

In addition to **housing**, which many economists insist **needs to improve before we can rise above the existing economic malaise; there remains the high unemployment situation**. While the unemployment rate is hovering at the 9% level and could be even higher if the available labor force which is NOT looking for a job would once again start looking, the US Unemployment rate continues near record highs around the 16% level; this statistic includes all marginally attached workers and those employed part-time for economic reasons. Also, the number of unemployed for over 27 weeks and as a percentage of the total unemployed are both at record highs, as is the unemployment rate for ages 16 to 19 which stands at about 25%.

There are apparently **between 4 and 6 workers available for each job opening** (I have seen both statistics). However, there is a mismatch of skills and many positions go unfilled because the employer cannot find individuals with the appropriate skill base. This could bode well for an increase in wages to entice qualified workers, which would help the consumer. However the lack of demand, in general limiting higher sales for many companies, causes them to be cautious in hiring and/or increasing compensation for staff. Auto sales seem to be generally holding up at these higher levels at least for now, and hiring is continuing with both domestic and transplants. There are obviously other areas of positive activity, but most companies are pleased with their higher margins as a result of the extreme cost cutting done during the Great Recession and are reluctant to start hiring in anticipation of higher sales, unless they are convinced these higher revenues will develop.

**Political Gridlock**

This leads to a few comments on the **political gridlock which has businesses in a "wait and see" mode as to tax policy; energy policy; regulations; healthcare reform; and fiscal reform around debt, deficits and spending**. A great example is what occurred over the weekend, a two month extension of the **"payroll tax deal" passed by the Senate and now rejected by the House!**

In early November, **Erskine Bowles**, who was co-chair of the 2010 National Commission on Fiscal Responsibility and Reform (better known as the Simpson-Bowles Commission), spoke at a small gathering at Columbia Business School (Erskine and I are friends and classmates). **He was frustrated and adamant that significant action needed to be taken as quickly as possible or the consequences were assured that we would face a completely predictable train wreck in the economy!!** He spent time discussing what they had done on the Commission and how they reached the **bipartisan consensus with the members**. As you will recall, this **was dead on arrival** and, while it was very close to the needs of both parties and the President, in the end was met with no actionable support.

The Commission wanted to **achieve a minimum \$4 trillion in deficit reduction over 10 years**, with three quarters coming from spending cuts and one quarter from revenues, specifically with changes to the tax code, including a reduction in rates with offsetting eliminations of certain deductions. They had **six basic principles** which I will list but not amplify to keep this Musings as a Mini Musings....

1. do not do anything overtly stupid to disrupt the recovery – wait until 2013 before big cuts
2. do not hurt the truly disadvantaged, but deal with entitlements to make them sustainably solvent
3. defense should not need to spend more than the next 14 countries spend –laid out appropriate cuts
4. education should be a priority but in a fiscally responsible manner- reduce 82 programs to 2 or 3 good ones
5. tax code reform with \$1 trillion revenue gains targeted – reducing rates and loop holes and also get capital back from overseas
6. spending cuts need to be real, note: the Super Committee could not even reduce 1.1% over 10 years. Need to get serious!!

I frankly was most impressed by **Erskine's candor and bipartisan comments and also his passion that this is an imperative and absolutely needs to be done**. The politicians know it, but are so far apart ideologically that we have this gridlock that is intolerable and irresponsible. We face a very hard reality when we spend \$1.60 and take in \$1.00 and have no plan to change that. It is disgraceful and the low ratings of Congress and the President reflect this.

**Corporate Hesitancy**

US corporate balance sheets are currently holding approximately \$2 trillion in cash, \$1 trillion of which is currently held overseas and which could be brought back and deployed in the US if tax policies were more accommodating. However these corporations are reluctant to put these liquid assets to work in new factories and worker hiring/training programs until they have more clarity on the uncertainty described above. These unknowns will need to be clarified with **government policies that are not so adversarial to business**, for both large companies and smaller businesses, before we will see any active deployment of this capital or risk on expansion. Many smaller businesses also have had problems borrowing from banks, further limiting their ability to expand, which according to many results from government regulators.

It is **critical to deal with these issues so we don't face another recession with very few policy arrows left in the quiver**. We cannot lower rates as they are already at zero; the Fed's balance sheet is already enormous, so it would be difficult to purchase additional securities if needed to stabilize the markets; banks are at best currently stable; we still have no energy policy; there is no floor under home prices; and we have no real meaningful job creation program.

**There are some positives on the immediate horizon which are favorable for business**. We have had a relatively weak dollar, although the Euro just got a bit weaker, and this has helped our manufacturing base become more competitive globally both for imported goods being less competitive and exports increasingly more competitive. Hopefully a wave of protectionism is not at hand. Note however the "retaliation" from China in the last couple of days putting a substantial import duty on high end cars imported from the US. **We do NOT need any trade wars at this point!**

On a bullish note, Deutsche Bank published in their US Daily Economic Notes (12/20) "Since their recession low, profits are up at a **staggering 29.5% annualized pace**. The health of the corporate sector is the primary reason why we expect the economic expansion to continue over the next year. In the past, **corporate profits have been a leading indicator of the economy... the current robustness in corporate profits suggests that another recession should still be some time away**, notwithstanding the potential for negative spillover effects from the European sovereign debt crisis."

**Shipping**

We have seen commodity prices drop in a number of areas which has proven to be a bit of a double edged sword as it is indicative in part of a slowdown in consumption, primarily in China. We are in the shipping industry and are acutely aware of the exceptional slowdown of shipping activity and correspondingly charter rates and vessel values. However, this drop in rates and values is a result not only of a **slowdown in overall economic activity, but more importantly an increase in supply of ships both delivered and ordered but not yet delivered**. This increase in ship supply resulted from the very high utilization of ships and correspondingly high charter rates and ship prices that peaked in 2007 and early 2008. These high charter rates and ship prices induced shippers to order a large number of ships, which typically take between 2 and 3 years to deliver. Many of these ships have now been built, or are nearing completion, and have come on the market in the last couple of years, just as the Great Recession and following stagnation have reduced overall activity.

Though this situation has presented serious challenges to operators in all areas of shipping, it also **affords one an opportunity to purchase ships at attractive rates and to position oneself to benefit dramatically as the world's economy recovers over the next several years**. Through Maritime Equity Partners ("MEP") an investment platform structured to make opportunistic investments in the maritime sector and managed by leading shipping operator, Peter Georgiopoulos and team, **we and our investors retain dry powder to do exactly that!** To date, MEP's investors – Oaktree Capital Management, Lion Cao Private Equity Maritime and Peter Georgiopoulos – have made three fleet acquisitions of dry bulk vessels, which total approximately \$500M of transaction value and comprise 12 vessels of various sizes. We continue to look for and anticipate more opportunities to deploy capital in this space.

**Inflation**

As many of you know, I have been **consistent in my call for inflation to once again appear**. I would note however that there are certainly minimal signs of inflation at the moment, even signs that it is retreating in China and to some extent Brazil. I understand that in the US there is no wage pressure at this time, an unemployment rate that makes increased wages seem unlikely near term, and significant slack in production capacity utilization.

Two weeks ago I read a commentary from the Credit Suisse trading desk by Harley Bassman (12/7) which had some strong comments about inflation. Several comments I think are aligned with my own. He says that **there are only two ways out of a "Debt Crises: Default or Inflation"**. **Since the US can print money it won't default**. Thus the only remaining solution is inflation and as stated in the Commentary the only question is **whether it takes six months or six years**.

He notes that we have the two most powerful stewards of our economy highly motivated to solve our problems and thus create inflation. **Mr. Bernanke is widely regarded as an expert on the Great Depression and as such has said that he will not repeat the errors that lead to that calamity**. In a November 21, 2002 speech he emphasized that Japan, due to political constraints, failed to utilize their policy instrument which is why deflation persisted for so long. **President Obama will also do whatever it takes to not be remembered as the second coming of Herbert Hoover**, so he will do "whatever it takes" with the Fed's help to reduce the value of private and public debt. Bassman notes a number one rule of investing "Don't fight the Fed."

I am not sure it will play out exactly like he indicates, but see no other way out of this debt/fiscal dilemma, as I have said before.

**US Market**

As mentioned above, **there are a few things in the US which are positive** and the \$2 trillion on companies' balance sheets is one. Margins are excellent and thus earnings have been strong and the economy has not stagnated. The S&P 500 is up 100% since the low in March 2009. The predictions for profits of the S&P 500 for 2012 are also quite strong, and as reported in a JP Morgan report (Eye on the Market 12/13), ten large banks see the increase from \$98 in 2011 to a low of \$99 to a high of \$106 with P/E multiples ranging from 12.5X to 14.2X providing an increase in the S&P from about 1225 level to a range of 1325 to 1500.

After discussing views with David Rosenberg from Gluskin Sheff (formerly Merrill Lynch's chief strategist) in an hour-long one-on-one meeting in my office, I came to the conclusion that earnings will be less robust and perhaps closer to \$95 or even less, depending on Europe and other factors, with a lower P/E multiple and thus possibly the same or a lower finish than we currently have of about 1225. Many readers will recall David as a bear but he protests that he is definitely not a "perma-bear" and once we are out of this current bear market, there will be strong improvements and a renewed bull market. **My view is that 2012 will be a very difficult year primarily because of political gridlock in the US and in Europe, unless they get their act together soon**.

Somewhat more depressing is reading the **December GMO letter that Jeremy Grantham publishes**, and I quote below:

*Historians would notice that all major equity bubbles (like those in the US in 1929 and 1965 and in Japan in 1989) broke way below trend line values and stayed there for years. Greenspan, neurotic about slight economic declines while at the same time coasting on Volker's good work, introduced an effective overstimulation of markets that resulted in 20 years of overpriced markets and abnormally high profit margins. In this, Greenspan has been aided by Bernanke, his acolyte, who has continued his dangerous policy. The first of the two great bubbles that broke on their watch did not reach trend at all in 2002, and the second in 2009 – known by us as the first truly global bubble – took three months to recover to trend. This pattern is unique. Now, with wounded balance sheets, perhaps the arsenal is empty and the next bust may well be like the old days. GMO has looked at the 10 biggest bubbles of the pre-2000 era and has calculated that it typically takes 14 years to recover to trend. An important point here is that almost no current investors have experienced this more typical 1970's-type market setback. When one of these old fashioned but typical declines occurs, professional investors, conditioned by our more recent ephemeral bear markets, will have a permanent built-in expectation of an imminent recovery that will not come.... the S&P 500 might look like from today if it followed the average flight path of the 10 burst bubbles described above. [He then has a chart which shows the S&P 500 from 1990 to 2022 with actual to 2012 and then a dramatic decrease to about 800 followed by 8 more years in the 800 to 900 range and finally coming back starting in 2020/2022 to current levels of about 1200!!!!] He adds: Not very pretty.*

The point that he and other strategists have made and continue to make this type of recession, which is "financial" rather than a more typical "inventory adjustment," generally takes substantially longer to recover from, at least historically. What this means to me in **investing in companies, or personally investing in the market, is to maintain flexibility and do not over leverage**. I am not convinced that these more dire forecasts will be correct but it does lead one to be cautious. I think the **reward has to be substantial when one is making a more risk oriented investment**.

**David Rosenberg** suggested in his Outlook (December Special Report—2012 Outlook) and in our conversation: **An investment strategy of S.I.R.P. which is Safety and Income at a Reasonable Price:**

- focus on safe yield, such as high-quality corporate;
- focus on reliable dividend growth/yield; preferred shares (income orientation);
- whether credit or equities, focus on companies with low debt/equity ratios and high liquid asset ratios—balance sheet quality is even more important than usual;
- even hard assets that provide and income stream work well in a deflationary environment (i.e., oil and gas royalties, REITS, etc...);
- focus on sectors or companies with these micro characteristics: low fixed costs, high variable cost, high barriers to entry/some sort of oligopolistic features, a relatively high level of demand inelasticity (utilities, staples, health care—these sectors are also unloved and under owned by institutional portfolio managers);
- alternative assets—allocate significant portion of asset mix to strategies that are not reliant on rising equity markets and where volatility can be used to advantage and;
- Precious metals as a hedge against the deflationary policies aimed at defusing deflationary risks—money printing, rolling currency depreciations, heightened trade frictions and government procurement policies.

**A Big Black Swan**

While I always like to comment on this possibility, even after some of the comments above, we would be wise not to omit the potential (even if small and not on most screens) of **a catastrophic exogenous event – a big black swan so to speak**. These events can arise in the financial area (I would speculate mostly around Europe's financial mess and others such as a big nose dive by China), or can come from the political sector (such as further problems with the Arab Spring developing into an even worse Islamic Winter, terrorism is always a threat). We do not want to speculate that something like this might happen but we should bear in mind the theoretical possibility. And it is almost always a truly surprising event!

**Well where does this leave one?** I suggest, despite all of the above, a **cautious and modest optimism, but with major concerns regarding the political inertia facing the eurozone and the US**. I believe there are, as always, lots of opportunities for the prudent and well-positioned investor!! We at Lion Cao and Lion Chemical are actively involved in just such opportunities and believe our investors will be well served by our efforts.

Again, we all wish you the very best for a Happy Holiday season and a spectacular New Year. Thanks for your support and best of luck.

DDL

David DeLeuw

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