CAPITAL MANAGEMENT GROUP, INC.

Alternative Investment Strategies

A Consumer Margin Call

August is typically the quietest month of the year in the stock market as many investors take their vacations, rest or regroup and then prepare for the final stretch run into year end. Not much has been "typical" in 2008 from a historical perspective and the headlines that dominated in August kept investors on edge all month long. The majority of macroeconomic indicators continued to deteriorate and as the credit crisis reached its one year anniversary, broad credit conditions have not shown signs of improvement despite the Fed's aggressive easing since last August. Bank sub-prime losses reached $500 billion worldwide, bankruptcy filings surged 29%, and US thrifts lost $5.4 billion in the second quarter. The FDIC said the number of troubled banks and thrifts jumped to 117, the highest level since 2003. The FDIC may soon have to borrow money from the Treasury as higher mortgage delinquency rates will increase the probability for additional bank failures. The added anxiety surrounding Fannie Mae and Freddie Mac caused volatility to spike as investors gauged Hank Paulson's resolve to use as he put it his "bazooka" to support the failing GSEs. Consumers are also showing signs that they are tapped out and "margin calls" on home equity loans are further curbing American's ability to spend. A further slide in consumer spending added to dismal news regarding asset write-downs, bankruptcies and bank failures. The equity markets tried desperately to break resistance levels tied to the March 2008 lows to no avail. The S&P 500 tested its resistance level of 1300 several times, before finishing at 1282, up +1.45% for the month. The DJIA finished +1.81% and the NASDAQ was +1.80%.

It was August 17, 2007 when the Fed first cut the discount rate in response to the then brewing credit crisis. A month later, the Fed cut the Fed Funds rate 50 bps. Both rates have plummeted in the past year as the Fed has used both tools to help maintain liquidity in the credit markets. Over the past 12 months, the discount rate (the rate at which the Fed lends to sound depository institutions) has dropped from 5.75% to 2.25% while the Fed Funds rate (the rate at which banks can loan each other federal reserves) has dropped from 5.25% to 2.00%. However, as both rates have decreased dramatically, the credit markets have actually gotten tighter across a number of areas as indicated in the table below. Investment grade, HY and emerging market yields have all moved up, indicating tighter credit conditions. The 30-year fixed rate for mortgages has barely moved, dropping 10 bps in the past year despite the aggressive cuts by the Fed and unprecedented moves by Congress to help individuals refinance existing mortgages. Furthermore, the CDS market is significantly tighter with investment grade and emerging market spreads tightening approximately 60 bps. High yield swaps tightened 300 bps, more than any other segment of the credit market, indicating the market expects more defaults. While junk bond yields are significantly below where they were in past cycles, the likelihood of more defaults will probably move rates even higher. So why have most indicators of credit conditions tightened while the Fed has aggressively cut rates?

Selected Indicators of Credit Conditions

	8/17/07	8/13/08	Change (in bps)	Tighter or Easier
Interest Rate:				
Fed Funds	5.25	2.00	(325)	Easier
Discount Rate (primary)	5.75	2.25	(350)	Easier
10-Year Treasury	4.68	3.94	(74)	Easier
30-Year FRM (conforming)	6.62	6.52	(10)	Easier
Baa Corporate	6.75	7.19	44	Tighter
High Yield (Lehman)	9.20	11.50	230	Tighter
Emerging Markets (Lehman)	7.03	7.29	26	Tighter
Spreads and Swaps (in basis points)				
Investment Grade CDS	73	134	61	Tighter
High Yield CDS	412	710	298	Tighter
Emerging Markets CDS	198	260	62	Tighter

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We think the answer lies with the "paradox of deleveraging" that Paul McCulley, Managing Director at PIMCO, dissects in his July commentary. In short, Mr. McCulley identified that as the housing bubble burst, every levered financial institution decided to delever their balance sheets and reduce risk. However, not all of these institutions can shed assets and debt at the same time without driving those asset prices down further, thereby having the converse effect of actually increasing leverage. The resulting asset sales have created an environment where fixed income assets, including bank loans, corporate credit and asset backed securities, have lost value, thus leading to higher spreads. In this type of deflationary spiral, with few investors willing to step in, the buyer of last resort will be the Fed and the US Treasury.

The signal to be a buyer of last resort is clear with respect to Fannie Mae and Freddie Mac as Treasury Secretary Paulson indicated he has a “bazooka” that he is willing to use. Mr. Paulson hoped that the mention of the “bazooka”, the explicit government backstop for the two agencies passed by Congress last month, would be enough to stop the assault on Fannie and Freddie during the month. While senior debt holders, including many foreign central banks (that are financing the current government deficit) feel secure, it is unclear how the rest of the capital structure for the companies would be treated, specifically the common shares. The potential for bailouts had shares of both companies vacillating 20-30% a day in August. Despite the declaration of government support, Fannie and Freddie are in need of capital to shore up their balance sheets and for the time being will look to the capital markets. If housing prices continue their decline and mortgage delinquency rates keep moving higher, nationalization of Fannie and Freddie will look more likely.

Tighter credit conditions and institutional deleveraging is also showing its effects on consumers. Consumer spending has been driving US economic growth for several years now as inflated home values allowed Americans to tap into their home equity ATM. As major banks have gotten their own margin calls and attempted to raise capital, they have also clamped down on home equity lending, causing a consumer “margin call”. In early August, Morgan Stanley told thousands of clients they will not be allowed to withdraw money on their home equity lines of credit. Other lenders, including J.P. Morgan and Washington Mutual have also made similar statements to clients in areas where housing prices have declined, effectively decreasing the collateral for those loans. The combination of tighter lending standards and consumers adjusting their spending habits is starting to show in the data. According to the Commerce Department, consumer spending rose just 0.2% in July, but after adjusting for inflation, actually declined 0.4% for the month after declining 0.1% in June. Inflation (as measured by the CPI) rose 0.6%, excluding food and energy in July and is up 2.4% from 2007. Although oil prices have come down from their highs, that figure is still above the range that Fed officials view as reasonable for price stability. In addition to paying more for goods, Americans also have less personal income to spend. Personal income fell in July by 0.7% as most of the economic stimulus checks have made their way through the system (mostly in May when personal income rose 1.8%). A slow back to school season is also pointing to lower spending in August. The potential three month drop in consumer spending could be the first such drop since the 1990-1991 recession.

One of the few bright spots in August was that second quarter GDP showed the economy grew at 3.3%, primarily due to the stimulus checks that pushed up spending in May. It is unlikely that level of growth is sustainable as consumer spending will continue to weaken. Exports, on the back of a cheap dollar, helped prop up growth, but as the dollar strengthened during the month, those goods and services look less competitive globally. A slowdown in exports will lower growth expectations further. Investors will be looking to third quarter earnings as a barometer for growth expectations as companies issue guidance for the coming quarters. Retailers will be particularly scrutinized as analysts attempt to determine consumer sentiment ahead of the biggest shopping days of the year in November and December. The current data is not good and points to a strong likelihood of slower growth or contraction for the second half of 2008. The banking system remains fragile as credit is still tight and more write-downs are likely. The consumer is tapped out and has adjusted his spending to the tighter economic conditions we are now seeing. The housing market may be close to a bottom, but a potential rebound in real estate will be hamstrung by the bottlenecks in the mortgage industry. Fannie and Freddie were counted on as a lender of last resort and they now have plenty of problems themselves. The US economy has proven resilient in recent months given the systemic problems it has faced, but it will be difficult to maintain growth moving forward. For most of 2008, the talk has been about inflation, but if consumer sentiment sours further, and institutions maintain their path of deleveraging, the US could be looking at a deflationary environment much like Japan in the 1990’s when growth was stagnant in spite of cheap money.