CAPITAL MANAGEMENT GROUP, INC.

CMG

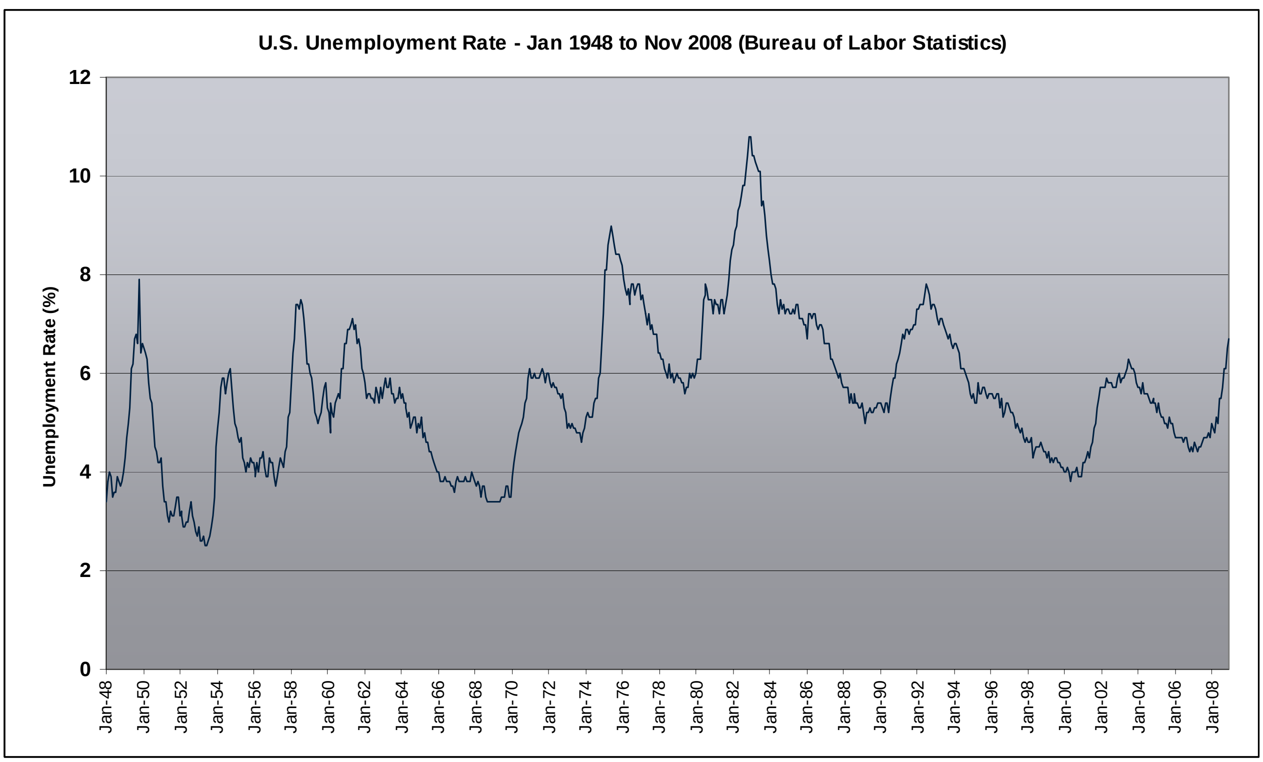
Alternative Investment Strategies

From Wall Street to Main Street

The documentation of when a recession starts is ceremonial, nothing more. Most Americans have been acting accordingly for months. The banking system may have stabilized but the real economy is hurting more than ever. Two months ago, Congress was voting on a politically painful bailout for Wall Street at the expense of Main Street. Now they are assessing the risks of bailing out one of the most important sectors of the US economy: auto manufacturers. It seems that everyone wants a piece of the TARP fund. The National Bureau of Economic Research (the NBER), a private research institute, gave the markets some sobering news, stating the US has been in recession since December 2007. It's not the traditional measure of a recession (two consecutive quarters of GDP contraction), but it is a strong declaration nonetheless. The NBER relies on different measures than the traditional definition, looking to identify the peak of economic expansion. The NBER looks at a number of indicators that measure economic activity, but they view the payroll employment measure as the most reliable and comprehensive estimate. This indicator peaked in December 2007 signaling an end to the 73 month expansion that began in November 2001.

The recent expansion was almost half as long as the previous one during the 1990s. As the bad news kept coming, markets dropped to their lowest levels since 2003. After dropping over 20 % through November 20, the major market indices staged a dramatic rally in the second half of the month. Despite a double digit rally over the last 10 days, the DJIA finished the month -4.86%, the NASDAQ Composite finished -10.77% and the S&P finished -7.18%.

To see if the current crisis is hitting Main Street, look no further than the dismal economic statistics released during the month. In the first week, the Bureau of Labor Statistics released employment numbers for the month of October. Unemployment spiked to 6.5%. As of this writing, the November numbers have been released, with another 533,000 jobs lost, bringing the unemployment rate up to 6.7%, the highest rate since 1993. More than 1.7 million jobs have been lost in the first 10 months of 2008, with the majority of the decrease coming in the last 4 months. Since the recession started in December 2007, more than 2.7 million Americans have lost their job.



The real estate market is trying to find a bottom but most indicators continue to trend lower. Housing starts were down 4.5% from September and more than 38% from a year before. Construction spending dropped 1.2% from September and is down over 5% since the start of the year. Home builders will continue to suffer as the housing market works off months of inventory with few willing buyers, as evidenced by the new home sales numbers released for October. Sales fell 5.3% during October and are down more than 40% from a year ago. The fundamentals of the real estate market have yet to show a sign of a bottom; much less a turnaround and the economic headwind will make that rebound even more difficult.

The difficult economic landscape has pushed the US auto manufacturing sector and its supply chain to the verge of collapse. The Big Three are hanging on by a thread and have come hat in hand to Congress looking for bailouts. Unfortunately, flying into Washington on private jets and asking for more than $30 billion with no plan did not generate the empathy from Congress that the three CEO's were looking for. A second approach this past week worked better, but arriving in a hybrid car is not going to seal the deal alone. The automakers have been trying for several years to restructure their business by retooling factories to produce more fuel efficient hybrid cars, negotiating with their unions and divesting themselves of underperforming brands. However, the current recession has created an environment where the consumer is tapped out and the companies are unlikely to meet even their most conservative sales projections that would have got them through a restructuring. Americans are more worried about losing their job and house than buying a new car. With sales plummeting, Ford, GM and Chrysler will likely run out of cash in the next couple of months.

The automakers do have some valid points. First and foremost, staggering amounts of government money are being used through the TARP to bail out financial companies, so why can't Congress spare $30 billion to help keep them solvent while they continue to restructure. They argue that the US auto manufacturing segment is as critical to the economy as the banking system, not to mention the fact that $30 billion is a rounding error compared to the amounts the government has injected into AIG, Citigroup, Fannie Mae and Freddie Mac. Nonetheless, Congress is wary of providing the capital the Big Three need as most congressmen believe they will be in the same position a few months from now. All three automakers believe they can return to profitability, but not before 2010. A lot can happen over that time and it is likely more capital will be needed if they are to avoid bankruptcy. The grim reality is that Congress must act at this time and will likely provide a lifeline to all three companies. The risk of failure is too great. If one of the Big Three were to fail, the ripple effect across suppliers, dealerships and the banks that have financed many of these businesses could significantly increase unemployment. The greatest immediate impact would be on the state of Michigan (along with Rhode Island), which already has the highest unemployment rate in the country at 9.3%.

Congress will provide the capital that is needed, but the source and how it will be distributed will be the key points of debate. However, most of Congress also believes there has to be moral hazard for poorly managed companies. After all, the spirit of competition and the risk of failure still remain the central tenants of the free market capitalist system. In this light, one of the Big Three may have to fail, but at a time when it is more economically and politically convenient. Chrysler is the likely candidate for a number of reasons. First, it is privately owned by Cerberus Capital Management LP, the private equity firm that saddled the company with billions of debt. It is difficult for taxpayers to stomach any more bailouts, but it's even tougher to see a private equity firm get bailed out of a poor investment. Chrysler was struggling before they were bought out but the incredible debt load from the buyout has made their restructuring even less probable. In this regard, Chrysler is not alone. Of the 86 major firms worldwide that have defaulted on their debt, according to ratings agency, Standard and Poors, 53 were subjected to takeover by private equity firms. It is only fair that corporations and investment groups that make bad investments with too much debt face the same consequences that homeowners with unaffordable mortgages are going through. Clearly, Cerberus has a lot at stake as in addition to owing Chrysler, it also has an investment in GMAC Financial Services, which is also seeking government money. Furthermore, its CEO, Robert Nardelli, has already stated that the cash infusion from the government will only put off the inevitable and Chrysler will likely need a strategic partnership to survive. The best solution for Congress could be to infuse capital now and put off failure until next year with the hope that private capital will be able to step in. As it stands, the current bailout is only a stopgap measure.

For many reasons, the automakers represent Main Street America. The political posturing to play Main Street vs. Wall Street has died down after the election as the gravity of the current recession is convincing Democratic and Republican congressmen alike that a second, more meaningful stimulus package is needed to stimulate the economy. The package should focus on stopping foreclosures and limiting delinquencies while encouraging potential first-time buyers with attractive rates. Infrastructure investment must be featured in any new stimulus as it presents one of the best opportunities for creating jobs. Improving the fundamentals of the real estate and construction sectors will help limit the depth of the recession. The gears of finance have started turning once again as credit markets have found their footing, but if the current recession is going to be tamed, much more government involvement will be needed.