CAPITAL MANAGEMENT GROUP, INC.

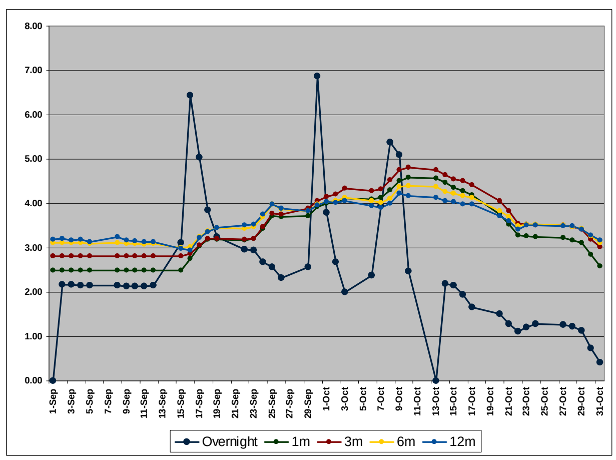
Alternative Investment Strategies

Category 6

A Category 6 hurricane. A Black Swan. A dying patient in need of medicine. Any one of these terms has been used to describe the flailing U.S. stock market in the past month but none of them can really do the current situation justice. As we wrote in September, the magnitude and complexity of the current economic crisis is remarkable. What the past month has shown us is that the globalization of financial markets has created nebulous risks that can't be quantified by even the greatest of economic minds. The crisis reached a point during the month that even the great Alan Greenspan admitted there was "a flaw in the model", prompting him to suggest that some regulatory changes were needed. While the housing crisis and sub-prime mortgages are now terms thrown around most dinner tables in America, commercial paper and LIBOR were much less well known terms until the past couple of weeks when the credit crisis took a significantly nastier turn. Credit markets simply stopped functioning as companies had little confidence that their counterparties would still be around in 24 hours. Markets stabilized only after unprecedented measures were taken by central banks and government agencies around the world. Despite an 11% one day move on October 13,the DJIA still finished the month -13.89%, while the S&P 500 and NASDAQ Composite lagged the Dow with larger losses of -16.80% and -17.73%, respectively, for the month. The final numbers mask the intra-month lows when the major indices were down as much as 28%. As of October 31, the DJIA is down 28.18%, the S&P is down 32.84% and NASDAQ Composite is down 35.11% year to date.

The old saying about the global economy goes, "When the U.S. sneezes, the world catches a cold". As emerging markets, particularly the BRIC nations, rose meteorically over the past couple years, the prospects for decoupling those economies from the U.S. seemed as good as ever and for once, that old saying would be proven wrong. What the past month has shown is that when the U.S. economy falters, there is no place for international markets to hide. The first week of October was particularly tumultuous as the collapse of Iceland's banking sector set the tone for the month. The three major Icelandic banks were unable to secure short-term funding and with assets representing nine times the country's $19 billion GDP, the government was forced to take over the banks. This was the first in a series of government interventions that spread across the European continent with countries taking stakes in major banks and extending deposit guarantees. On October 6, British equity markets had their worst one day loss in history and the DJIA closed below 10,000, representing a 30% drop from its all-time high in October 2007. The crisis accelerated quickly, prompting the ECB (European Central Bank), the Bank of England, the Federal Reserve, the Bank of Canada, the Swedish Riksbank and the Swiss National Bank to simultaneously cut rates by 0.5% on October 8. Equity markets reacted with sharp losses: Japan lost 9% while Russia and Indonesia suspended trading. On October 9, the one year anniversary of its all-time high, the DJIA dropped below 8,600, reaching a five year low. On Friday, October 10, global stock markets crashed with London, Paris and Frankfurt down over 10% within an hour of trading. For global markets it was the worst week since 1987 and for the S&P 500 it was the worst week since the crash of 1929.

What is particularly amazing about the events that unfolded during that week is the speed with which the crisis spread around the world. No country has been spared and every major equity index in the world is down over 20% for the year. The crisis may have originated in the U.S., but counterparty risk has become a global concern and short-term funding costs reflected these risks as overnight LIBOR rates spiked to panic levels (See Chart Below).



Source: British Bankers' Association

LIBOR, the London Interbank Offered Rate, is a daily reference rate based on the interest rates at which banks lend unsecured funds to each other in the London interbank market. It is extremely important as it is the most widely used reference rate for short-term interest rates, ranging from overnight rates to one year rates. LIBOR is the benchmark for over $300 trillion of financial products worldwide, including variable rate mortgages. The chart above shows the overnight, 1 month, 3 month, 6 month and 1 year LIBOR rates for September and October. There were several days over the past two months where the overnight rates jumped to more than 6%; irrational levels as fear paralyzed the credit market. Overnight LIBOR rates finally came back in line with the Fed Funds rate and the Discount rate after the G7 meeting in Washington over Columbus Day weekend. During the meeting, the G7 nations pledged to "support systemically important financial institutions and prevent their failure". The consequences of the Lehman Brothers failure influenced their decision as Lehman's failure triggered a massive tightening of credit as other banks ceased lending to each other. The overnight LIBOR rates show what can happen when confidence in counterparties evaporates. Equity markets skyrocketed on Columbus Day, with the DJIA rising 936 points, a record rise of 11% in one day.

Hollywood script writers couldn't dream up the daily twists and turns the market withstood throughout October. Volatility was at all-time highs during the month and 5% swings were a daily occurrence during the month. It seemed that as soon as the Treasury or the Fed could solve one problem, another manifested itself with even more severe repercussions. The commercial paper market is an often overlooked part of the credit markets but it made headlines during the month as it most closely exhibited how the current crisis affects Main Street. Commercial paper is typically used by companies in need of short-term loans with maturities up to 270 days. Most commercial paper matures within 30 to 45 days, prompting companies to roll it over and tap the market again and again. Commercial paper is used for transaction purposes only (i.e. buying supplies, paying vendors or making payroll) making it exempt from SEC registration and thereby making it the cheapest form of financing for large companies. However, since most commercial paper is unsecured (no assets serve as collateral), the borrowing is typically backed by the high credit quality of the issuing company. During October, the commercial paper markets were severely impaired, with interest rates doubling in many cases. Although counterparty risk was one reason for the rising rates, the other was the risk aversion of money market funds and the flight to quality. Money market funds are by far the largest buyers of commercial paper, but as the crisis worsened, those funds invested more heavily in short-term government debt. The flight of money market funds away from commercial paper left companies facing higher short-term financing costs as investors demanded a larger risk premium for holding their paper. The commercial paper market has shrunk significantly from $2.2 trillion in July 2007 to $1.5 trillion, its lowest level in two years. Commercial paper keeps business flowing on a daily basis and when funding dries up, it makes financing prohibitively high for many companies and the gears of commerce grind to a halt. In response, the Federal Reserve announced the creation of the Commercial Paper Funding Facility for the purpose of providing liquidity by purchasing short-term debt from companies. The plan got credit flowing again, but is it just another in a series of band-aids?

What happens next? It is likely that the credit crisis will now take hold on the real economy, driving it into deeper recession. Consumer spending continues to slow and the effect on many retailers could be fatal as we are now entering the most important retail months of the year and American consumers are in no mood for shopping. The Big Three auto manufacturers could soon be big zeros and AIG is asking for help, again (and getting it to the tune of another $65 billion). As demand for all ranges of goods decreases, unemployment will move higher. To keep the current recession as mild as possible, there are two things that the government can do: lower interest rates and increase government spending. Both will hopefully lead to job creation. While lowering interest rates is very popular, increasing spending is the last thing any American wants to hear. However, the current recession cannot be tamed without fiscal stimulus, whether it is a bailout of the auto industry, the banking sector or through a second economic stimulus package. With respect to rising unemployment, the best opportunity for job creation lies with infrastructure development. The U.S. has not invested in infrastructure for decades and our roads, bridges, electrical grids, etc. are in dire need of retooling. As U.S. consumer spending has slowed, China has focused even more on infrastructure while the manufacturing sector slows. China must create jobs to limit social unrest. The U.S. can apply a similar approach to create an infrastructure for the new millennium.

Currently, the S&P 500 P/E Ratio is about 12 times earnings. That is down significantly from recent years where it was well over 20x, mostly due to financial sector. Stock prices have come down, but earnings have not been revised to represent the current state of the global economy. We contend that stocks become attractive when PE ratios drop below 10x. It is likely that it will take another couple quarters before investors see what the fundamentals really are.

There are no quick fixes for the myriad of problems facing the U.S. economy, but the picture is slowly getting clearer. The credit crisis has been contained and the deleveraging process has become more orderly as the banking sector has been recapitalized. Whether those capital injections help the housing market form a bottom is yet to be seen. The commodity inflation headwind has abated which will support a recovery. However, if markets are going to move up from their lows, investors and banks need clearer earnings guidance from companies before they will commit capital.