



AKROS CAPITAL, LLC

Rising Bankruptcies Are a Sign of the Times

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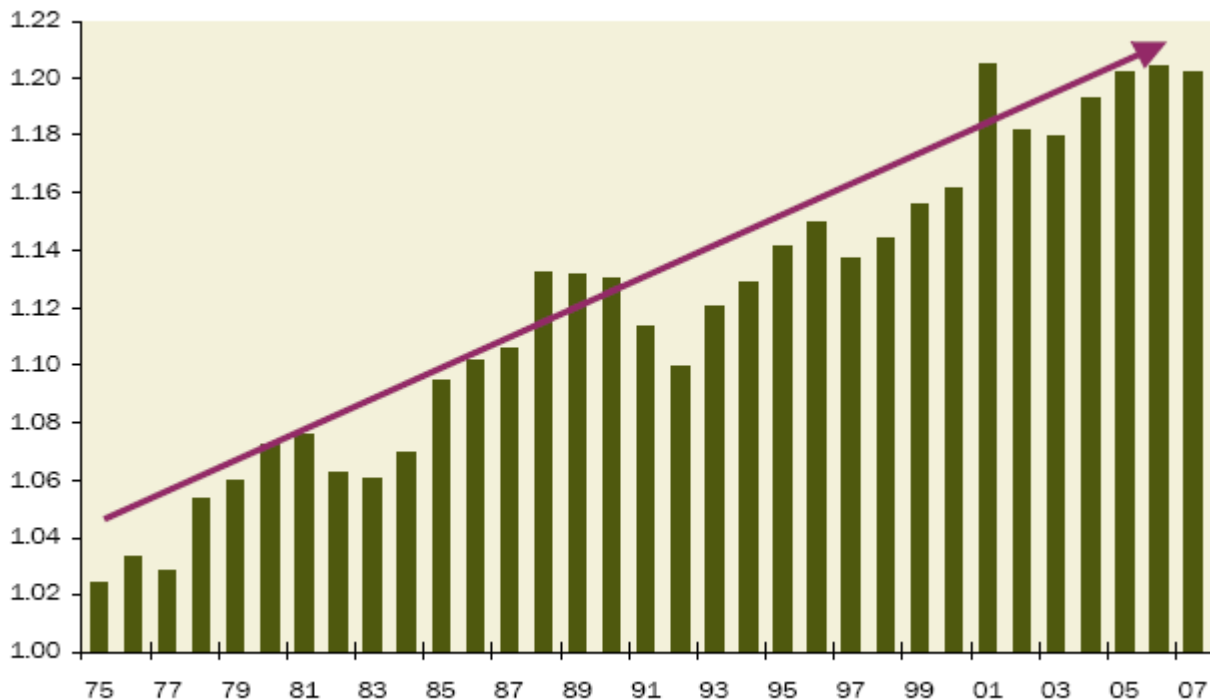
"Today's bankruptcy filing number reflects the sustained and growing financial stress on U.S. households. Rising unemployment on top of high pre-existing debt burdens is a formula for higher bankruptcies through the end of this year."

– Samuel J. Gerdano, Executive Director, American Bankruptcy Institute

When considering the prospects for U.S. economic growth, it is important to remember consumer spending typically accounts for about 70% of GDP. Persistent and uncharacteristic weakness in retail sales and consumer credit suggest the consumer is in no position to lead a sustainable economic recovery. Escalating bankruptcies and foreclosures underscore the precarious financial condition of many U.S. households and imply an extended period of difficulty for both the consumer and the economy.

Last Thursday's retail-sales report showed a 0.1% drop in July from the previous month. The decline would have been worse had it not been for a 2.4% uptick in motor-vehicle sales, which received a boost from the government's Cash for Clunkers program.

Ratio of Vehicles to Licensed Drivers



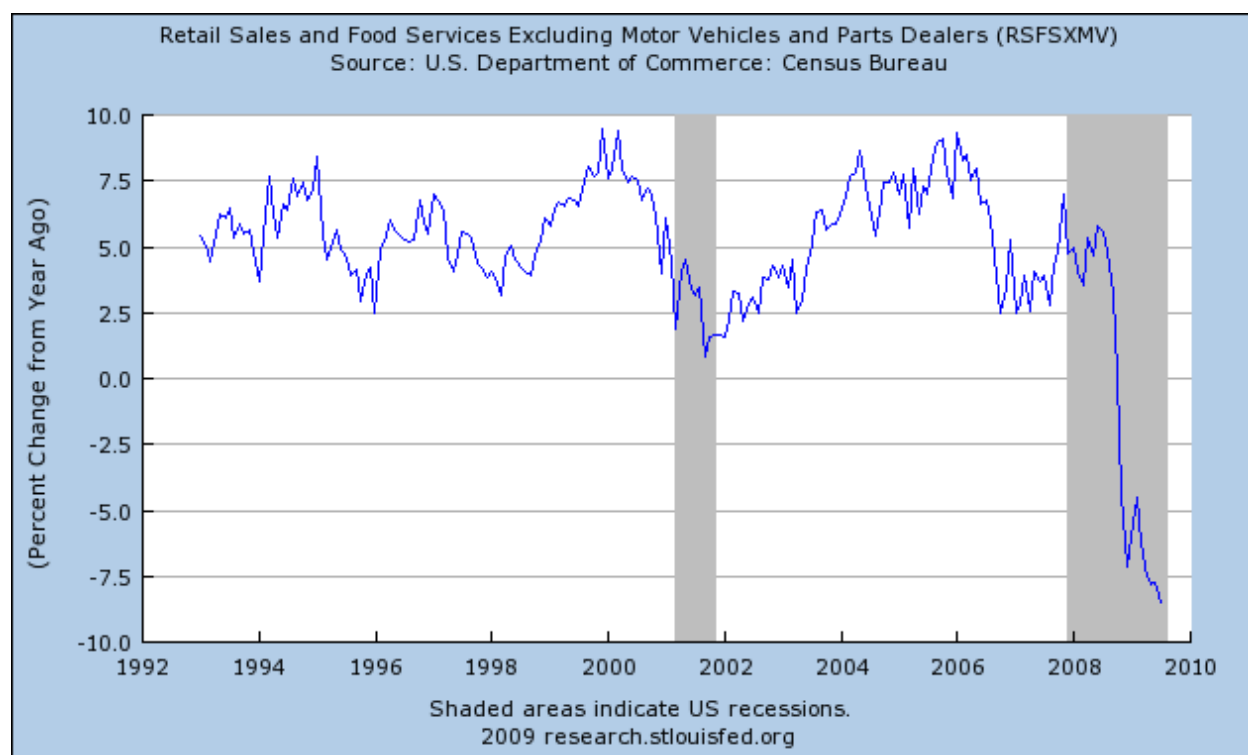
Source: Haver Analytics, Gluskin Sheff

Graph courtesy of Zero Hedge

Despite this temporary improvement, auto sales are not going to propel consumer spending anytime soon. As the graph above illustrates, there already are too many cars on the streets. The ratio of vehicles to licensed drivers is near historical highs, and roughly one-quarter of households already have three or more cars. Accordingly, July motor-vehicle sales were down 8.0% from a year earlier. Auto sales now have fallen well below replacement as extra cars gradually are taken out of service in an ongoing adjustment that should continue for at least another five to seven years. For the time being, the government-rebate program has borrowed sales from future periods and moved them into the present at taxpayer expense.

Non-Auto Retail Sales Also Have Plummeted

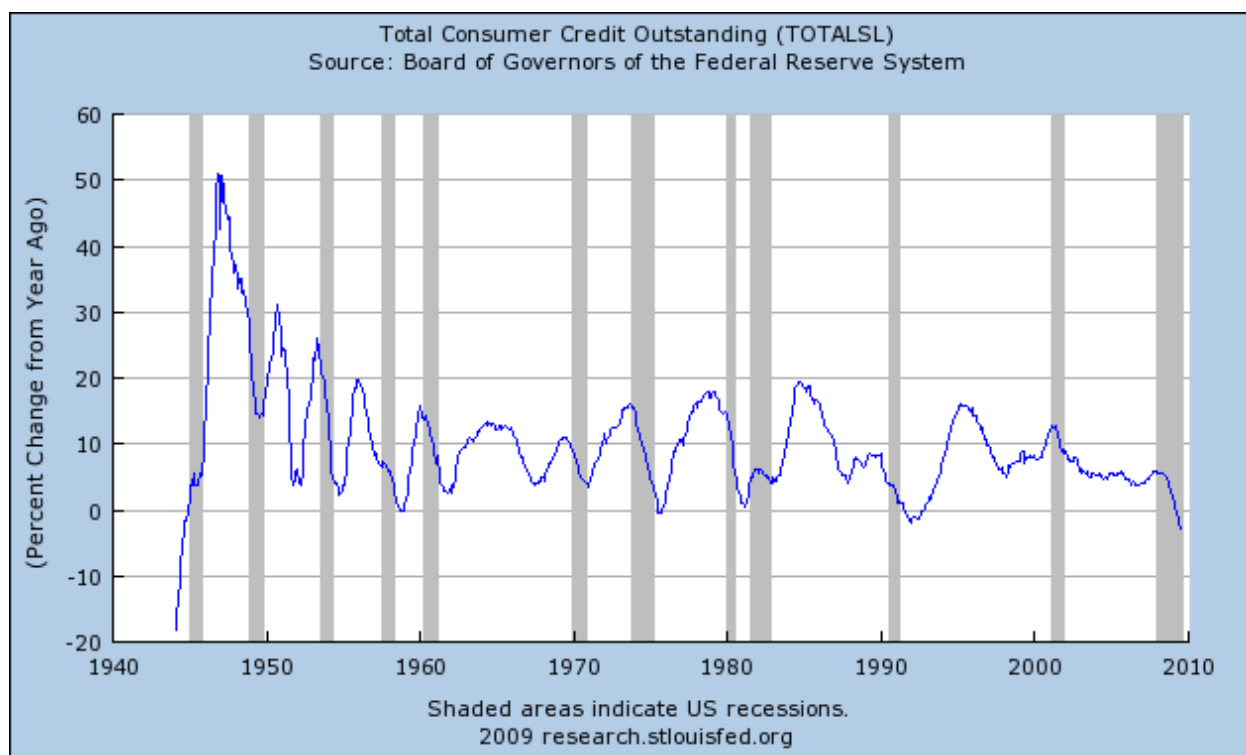
Excluding motor vehicles and parts, retail sales fell 0.6% in July. The decline from year-ago levels was 8.5% (vs. 8.3% when vehicles and parts are included). As the graph below shows, the recent year-over-year drops are the first such declines in this series since it began in 1992. In general, year-over-year declines in retail sales have been rare since the late 1960s, even during recessions. The difference this time is household deleveraging, which will continue to constrain consumer spending for years after the recession technically has ended.



A portion of the recent retail-sales declines are attributable to fluctuations in gasoline prices. These effects can be eliminated by looking at core retail sales, which excludes not only motor vehicles and parts, but also gasoline and building products. By this measure, July retail sales were down 0.2% from the previous month and down 3.4% from the previous year. Core retail sales now have fallen for five consecutive months. The annual rate of decline during that period was a steep 4.0%. Until there is a broad-based increase in demand for goods, any rebound in employment is likely to be weak.

Consumer Credit Has Turned Ugly

Earlier this month the Federal Reserve reported that consumer credit fell 2.8% in June from the same period a year ago. As the next graph reveals, this was the largest year-over-year contraction since July 1944. The five straight monthly declines in consumer credit mark the longest such stretch since consumer borrowing fell for seven consecutive months in 1991.



As the graph nicely illustrates, consumer credit typically expands rapidly following a recession as consumer spending picks up. However, that is unlikely to happen this time because consumer credit remains near all-time highs as a percent of disposable personal income. Instead, any acceleration in spending will be dampened as households continue to pay down credit cards and cut other debt.

Bankruptcies and Foreclosures Are Climbing

Consumer bankruptcy filings jumped 8.7% in July to 126,434 – the most for a single month since bankruptcy reform took effect in October 2005. Year over year, bankruptcies are up 34.3%. Meanwhile, foreclosure filings in July rose 7% from June and 32% from a year earlier. July's total of 360,000 foreclosures is the highest on record in data going back to January 2005.

For those who care to remember, it was a spike in foreclosures two years ago that ultimately led to the downturns in spending and credit described above. Now those effects are feeding back into additional foreclosures. While this process is not necessarily destined to spiral out of control, it must be recognized that rising bankruptcies and foreclosures are both a cause and a consequence of the current economic malaise.

The Picture

The chart below shows the S&P 500 Index up against an area of resistance from 1,008 to around 1,014. The upper boundary of the resistance has been drawn in green.



Chart courtesy of StockCharts.com

Generally, a retracement of 3/8 of a bear campaign's losses is sufficient to indicate a new bull market is underway. However, in the current circumstance a zone of resistance has set up at the 3/8-retracement level of 1,008. So, as a practical matter, convincingly clearing the 1,008 level will entail overcoming the resistance zone. If or when that happens, there should be little doubt that a new leg up has begun.

In the meantime, nothing should be taken for granted. Momentum waned last week as RSI moved down out of overbought territory and MACD registered a bearish moving-average crossover. (In terms of its individual components, MACD fell to 20.268, which is slightly below its red moving-average signal line at 20.932; the difference of -0.664 is depicted as an inverted blue bar in the histogram.) Moreover, the anatomy of the resistance zone itself suggests it may prove strong, as it represents a confluence of resistance levels from various branches of technical analysis.

On the plus side, support quickly developed at 992 and has held for the past two weeks as the index has consolidated and worked off some of its overbought condition. If that support (shown in orange) is broken, additional support should come in near 980, 950 and at the 50-day moving average (shown in blue).

If the resistance area at 1,008 is going to stop this rally, a strong probability would be for a lower high to set in following a pullback toward the 50-day moving average. That pattern of trending would suggest the spike upward from 875 had exhausted the buyers and ended the rally. On the other hand, overcoming the resistance zone would indicate further near-term upside until the next bear campaign can get underway.

Regardless of which way this market breaks, the longer-term fundamentals are weak. Caution is called for at these levels, as we believe the secular bear market that began in March 2000 remains in force.

Graphs and chart are courtesy of:

- ❖ www.zerohedge.com
- ❖ www.research.stlouisfed.org
- ❖ www.stockcharts.com

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