



AKROS CAPITAL, LLC

Deleveraging Cycle Kicks into Gear

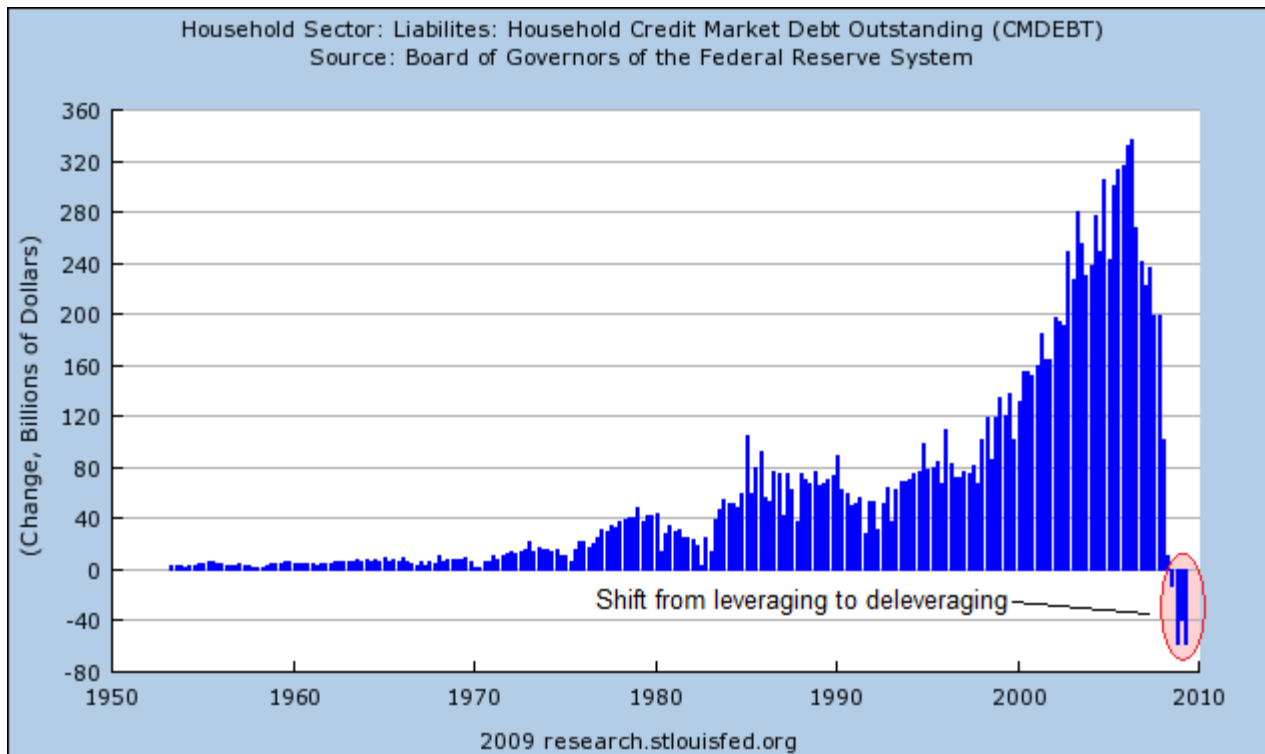
November 9, 2009

"The nearly 9 percent increase in consumer bankruptcy filings in October, together with a 7 percent jump reported in business cases, demonstrates the sustained stress on the U.S. economy."

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

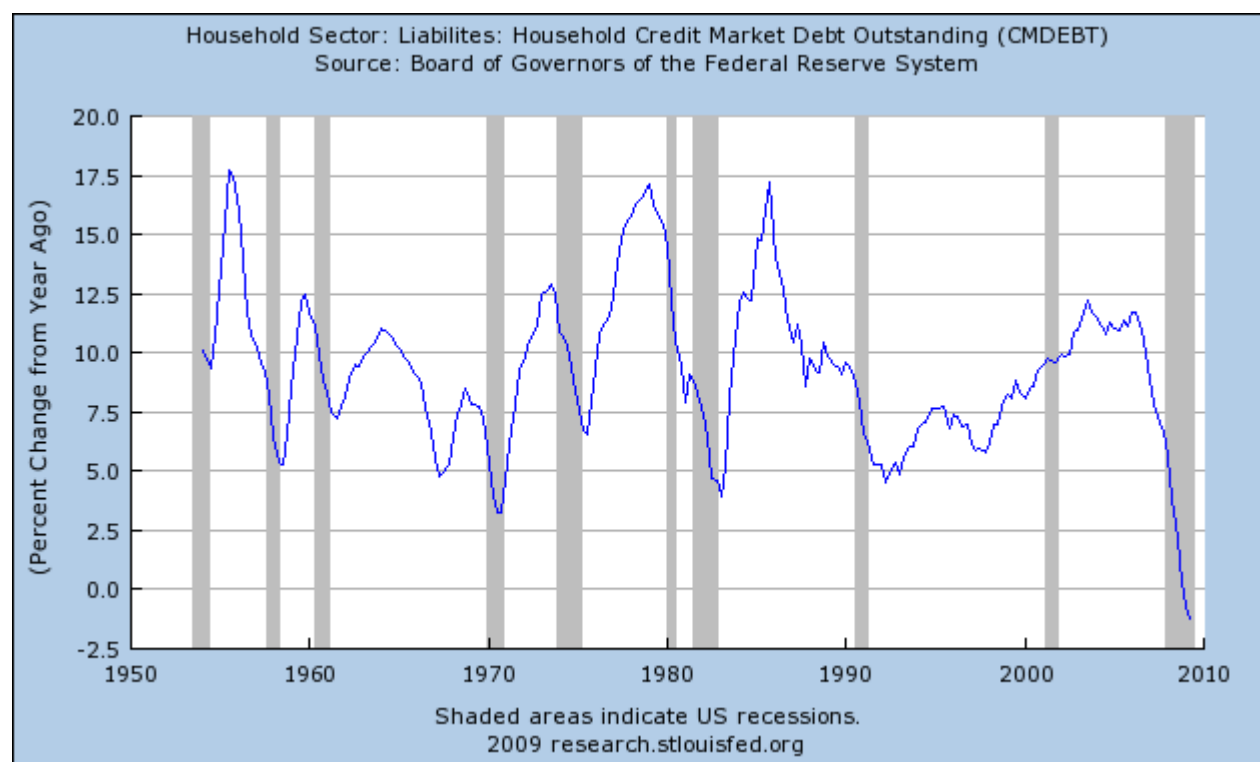
While real-estate prices were rising, many Americans viewed their homes as funding vehicles for current consumption and future retirement. Falling house prices and an uncertain job outlook have shattered that paradigm. The credit cycle now has shifted from leveraging to deleveraging, as the borrowing binge has given way to paying down debt and saving. This paradigm shift will have long-term implications for the U.S. economy.

The bar chart below shows the quarterly change in total household debt outstanding from 1953 through the second quarter of 2009 (Q2 2009). Notice how Americans continued piling on debt every quarter, year-in and year-out, through Q2 2008. For each of the subsequent four quarters the change has been negative as a deleveraging cycle has taken hold.



Over the past four quarters household credit balances have fallen by 1.22%, or \$169 billion. While that may not seem like much, it is a dramatic reversal from the situation that prevailed during 2006, when households *increased* their total indebtedness by nearly \$1.2 trillion.

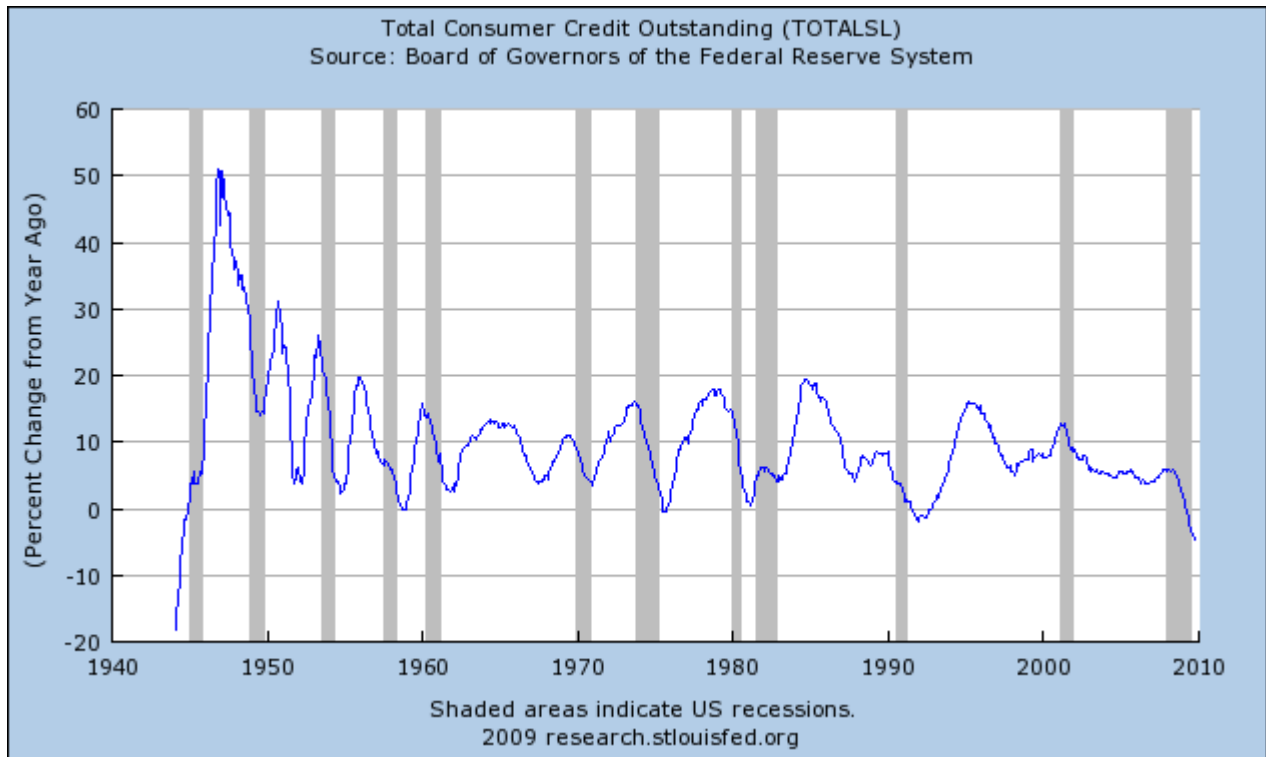
The following graph depicts the same data differently. It shows the percent change in household credit from the year-ago period. Over the past half-century, household credit expanded every quarter vs. the same period a year earlier – up until the two most-recent quarters, both of which registered year-over-year declines.



Clearly, something has changed. Household credit is now contracting. Note that this has occurred despite massive government efforts to stimulate borrowing, including Cash-for-Clunkers, homebuyer tax credits, government intervention in the mortgage market and a federal-funds rate near zero. So far, it appears the changes in household behavior have been stronger than anything the government can muster in opposition.

Recoveries Are Driven by Credit Expansion

The previous graph reveals a clear, regular pattern. An expansion of household credit has jump-started every post-war recovery. If, as many believe, the recent recession ended in Q2 2009, then we might expect to see a pickup in household borrowing. However, that does not appear to be the case. Although household-credit data is not yet available for Q3 2009, we can look at the monthly data series for consumer credit, which excludes mortgages but does include the important categories of credit-card debt and auto loans. The graph below plots the year-over-year percent changes in consumer credit through September 2009.



As the graph shows, the typical post-recession surge is notably absent. Instead, consumer borrowing has continued to contract, which itself is rare even during recessions. Consumer credit plunged by \$14.8 billion in September, which was a 7.19% annual rate of decline from August and the eighth monthly decline in a row. The year-over-year decline of 4.75% shown in the graph was the largest since June 1944. For Q3 2009 overall, and despite Cash-for-Clunkers, consumer borrowing fell at an annual rate of 6.08%.

If past recoveries are any indication, true economic growth will not occur until household borrowing picks up for the purchase of big-ticket items such as autos and housing. As demand returns, production will accelerate and jobs will begin to come back. Instead, what we are witnessing is ongoing credit contraction, weak demand and continuing job losses. The 3.75% increase in GDP during the third quarter was entirely attributable to government stimulus.

Employment Remains Weak

With the economy still shedding hundreds of thousands of jobs per month, it is little wonder that consumers are not in a borrowing mood. The unemployment rate rose to 10.2% in October, as the number of unemployed Americans increased by 558,000 to 15.7 million. Unfortunately, the majority of them (8.8 million or 55.1% of the unemployed) have suffered permanent job loss – an increase of 306,000 from September. Only 10.9% of the unemployed are on temporary layoffs. The remaining 34.0% consist of job leavers, re-entrants and new entrants into the work force.

Workers involuntarily employed part-time rose by 105,000 in October to an all-time high of 9.3 million. This is nearly double the 4.7 million involuntary part-timers at the beginning of the

recession in December 2007. As a fraction of the labor force, those working part-time against their wishes have doubled from 3.0% of total in December 2007 to 6.0% of total in October 2009. A full 75% of these workers report their hours were cut back because of slack work conditions, as opposed to those who could only find part-time work to begin with. This is up from 68% of all involuntary part-timers when the recession began.

Deleveraging by Default

Households that can afford to pay down debt are doing so. Those who cannot are trying at least to remain current in their payments. However, the worsening employment situation has resulted in a steady increase in foreclosures and bankruptcies. Last Wednesday the American Bankruptcy Institute reported there were 135,913 consumer-bankruptcy filings in October. This represents a 27.9% increase over last October's monthly total of 106,266 and an 8.9% increase from the September 2009 total of 124,790. With banks and other private-sector lenders already very cautious, the government has become the lender of last resort. The key question for investors is, "How much longer can economic growth be sustained entirely through government borrowing and spending/lending?"

The Picture

The chart on the next page shows the S&P 500 Index encountering overhead resistance from its 20-day moving average near 1,071. The area from 1,070 to 1,080 represents a significant "line in the sand." Breaking through that resistance zone would set up a run to 1,120, which signifies a 50% retracement of the entire bear-market decline from October 2007 to the March 2009 low. Supporting that outcome are very bearish sentiment readings (which are bullish for stocks) from the American Association of Individual Investors and other sources.

With that having been said, the index has been struggling since early August. RSI and MACD have traced out successively lower highs and lower lows, even as the index has continued higher. In particular, the run-up from the recent low near 1,030 has been somewhat more ragged than previous moves, and volume has tailed off sharply in recent sessions. MACD remains in negative territory and has not yet crossed above its red signal line. Finally, in a sign that breadth may be starting to deteriorate, the McClellan Oscillator (bottom panel) has been stuck below or near zero since late September.

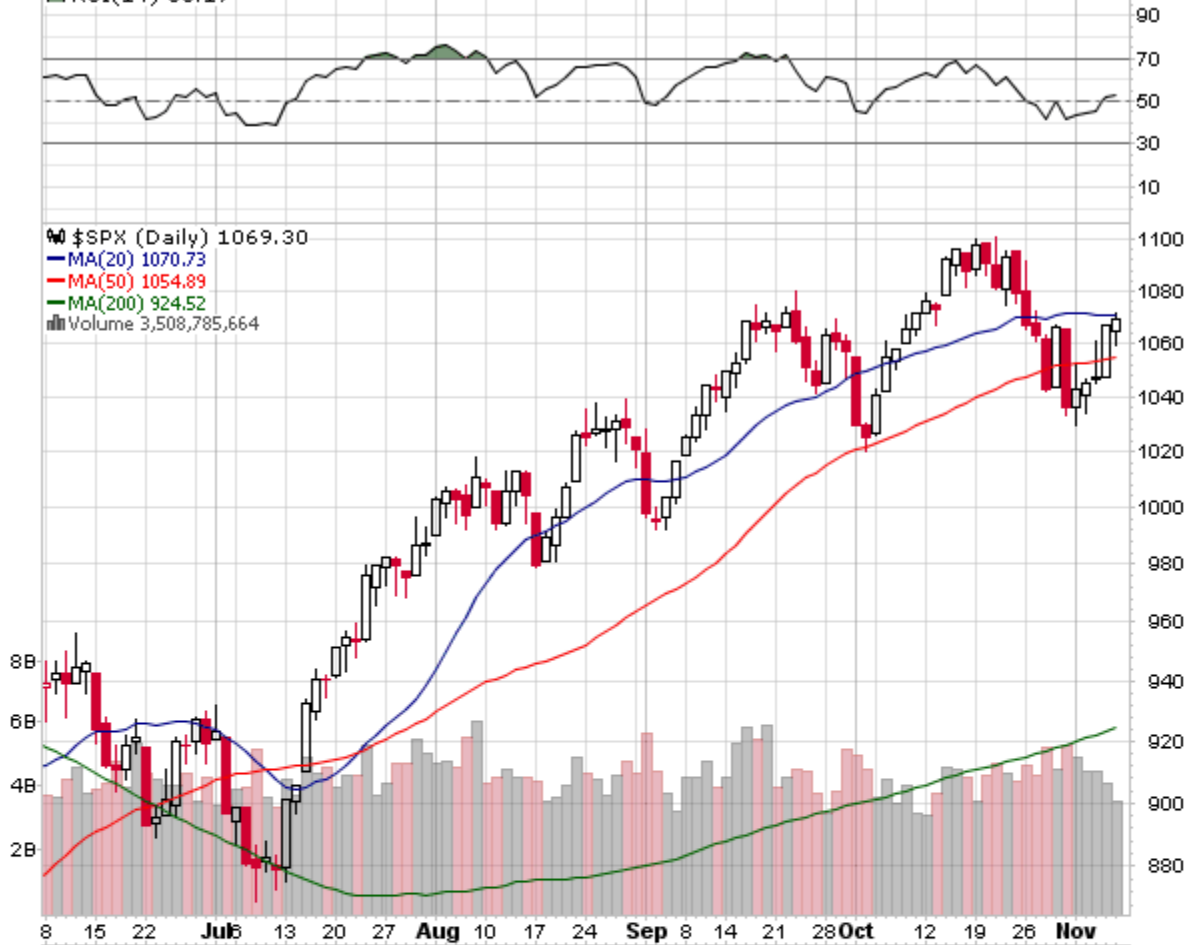
In summary, the picture is a bit mixed. The uptrend may be weakening, and risk is elevated. Failure of last week's rally near current levels would set up a test of 1,020 and a possible move down to 950 to 990. However, strong investor sentiment readings and residual upward momentum favor a move to 1,120 if near-term resistance can be overcome.

\$SPX (S&P 500 Large Cap Index) INDX

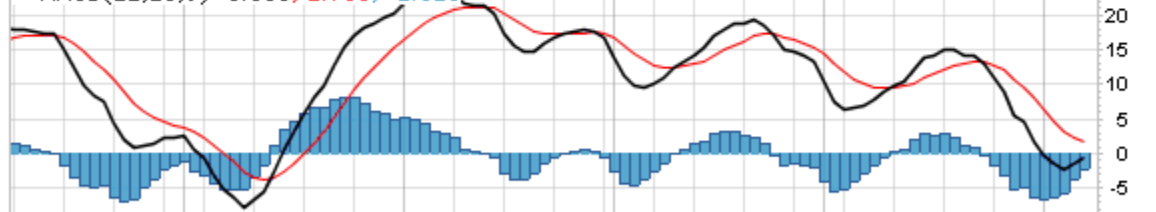
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6-Nov-2009 **Open** 1064.95 **High** 1071.48 **Low** 1059.32 **Close** 1069.30 **Volume** 3.5B **Chg** +2.67 (+0.25%) ▲

▲ RSI(14) 53.17



— MACD(12,26,9) -0.566, 1.760, -2.326



— \$NYMO (Daily) -13.35

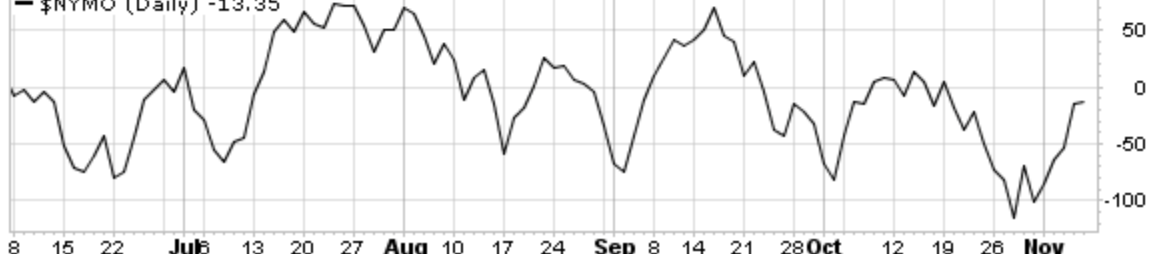


Chart courtesy of StockCharts.com

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Akros Capital, LLC 230 Park Avenue, Suite 453 New York, NY 10169

Telephone: 212-937-9738 Fax: 212-499-2589

www.akroscapital.com info@akroscapital.com