



Recession, Depression, or Expansion?

The New Year is upon us, and 2008 is undoubtedly going to be more volatile than 2007. Even with the credit markets frozen for the later part of 2007 the M & A activity set a record. As we open 2008 the credit markets remain frozen and unlike the New England winters no thaw is in sight. On a positive note the New England sports scene is abuzz with positive vibes. The election looks too close to call for both the Republican and Democratic parties.

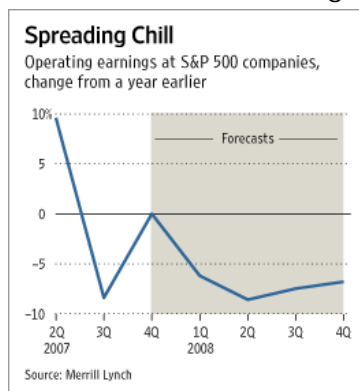
Your view of the economy may actually depend on what market sector you are servicing.

Sector	Growth	Recession	Depression
Housing – home builders			It may actually seem like a depression before it is over. <ul style="list-style-type: none"> • Land write offs, • inventory write downs • sale of companies at fire sale prices • Buyers are scarce • Increased financing costs
Retailers and wholesalers tied to housing section		No doubt they are feeling the pain and are in a declining state	
Financial Institutions	Smaller banks with no or limited sub prime and limited exposure to builders may find this a growth opportunity Large institutions that avoided the sub prime / CDO markets could experience substantial growth and profits	Institutions with large loans to builders, small exposure to sub prime and or LBOs will feel the pain and may not grow.	Citi, Merrill, Bear Sterns, etc are in a state of decline selling large stakes in their respective companies to avoid the unspeakable. Northern Rock had a run on the bank and is being sold
Automotive			US automotive may not survive and several large suppliers are in bankruptcy
Google Web Services	Looking to reach to moon		
Retail	Based upon the December sales results Growth is slow or zero	Consumer may finally be running out of gas	
Manufacturing for export	Life has been good with a declining dollar but the future may have some storm clouds		

Overall, the recession drums are starting to beat from many economists. Federal Reserve Chairman Ben Bernanke, citing the growing threat to the economy from fragile financial markets and weakening employment, opened the door to "substantive" cuts in U.S. interest rates. But Mr. Bernanke said the financial situation remained "fragile." Private-sector analysts agreed.¹ It appears that Bernanke is ready to through inflation under the bus to support the economy. I just do not understand how cutting borrowing rates is going to save the economy. The view from here is that the economy is in a credit crisis with the consumer feeling overwhelmed with energy and food costs escalating from the precipitous drop in the dollar.

The subprime meltdown is getting all the attention today but our concern lies with the extensive corporate junk bond debt hanging. Today Wall Street has a hang over of \$150 Billion of transactions that banks hoped to sell to investors.² Several LBO deals have fallen apart as buyers could not arrange financing. The credit squeeze is impairing earnings of many Private Equity and Hedge Funds.

What is more concerning is that corporate profits are starting to soften. Many companies from Cisco to Target are issuing earnings warnings. As the financial services firms strive to conserve cash they are cutting capital budgets which is negatively impacting technology companies. Consumers are feeling squeezed from escalating energy costs that impacts everything we consume. Millions of Americans are seeing their mortgage payments escalate as their ARMs adjust. This all takes disposable income out of the consumers hands yet GDP will not change.



The projections of decreased earnings by 10% over last year by the S & P 500 may not include the billions being written off by the financial service firms and the housing sector. Commercial real estate may not be fare behind. A slump in earnings could have a devastating effect on many large middle market firms that used leverage for stock buy back, dividends and such. Reduced cash flows will impair their ability to meet debt payments. This may create instability for private equity and hedge funds as they value of their portfolios decline. Please keep in mind that many buy out funds paid up to twelve times EBITDA for growth opportunities. These enterprises borrowed heavily to fund the buyout. Our experience is that multiplies in this range do not work unless the company experiences explosive growth. Declining cash flows will make for a challenging 2008.

¹ WSJ January 11, 2008

² failed deal rings in '08 – WSJ January 3, 2008