



**CALDWELL & ORKIN**<sup>®</sup>

## **UPDATE**

January / February 2006

*“When we become complacent and think everything is going OK,  
it is very easy to lose one’s focus and fall into mediocrity.  
Complacency breeds self-satisfaction and indifference.  
It is also the same in business...when we become complacent...  
we tend to lose our competitive edge, and the results are inevitably  
unpleasant. It is not a good thing to feel secure.”*

- Derek C. Hathaway, Chairman, President and CEO of Harsco Corp.

Security is defined by [www.dictionary.com](http://www.dictionary.com) as “freedom from risk or danger; safety,” or “freedom from doubt, anxiety, or fear; confidence.” In the capital markets these freedoms do not exist. Risks and uncertainties are inherent facets of the market. Managing these risks requires vigilance and a willingness to stand away from consensus thinking. Of course, standing away from the trend has its own pitfalls, as John Maynard Keynes emphasized when he said, “The markets can remain irrational longer than you can remain solvent.”

At Caldwell & Orkin, Inc., we agree with the enlightened thinking of Harsco’s Chairman. We walk that fine line between managing money with a disciplined approach while at the same time maintaining flexibility in the event that the market’s direction diverges from our own convictions.

### ***The Year Ahead***

*“As the Anglo-Saxon economies lost their competitive edge in manufacturing, they tried to make up for it by encouraging consumption. This is the biggest fraud of all. At first, higher consumption feels good. It is like burning the furniture to keep warm; it feels good for a moment. But the sense of well-being is extremely short-lived. When people borrow and spend, they feel as though they are getting richer – especially when their houses are rising in price. The increased consumption even shows up, indirectly, in the GDP figures as growth. But you don’t really become wealthier by consuming. You become wealthier by making things you can sell to others - at a profit. The point is obvious but, at this stage of imperial finance, it [is] inconvenient.”*

- *Empire of Debt* by Bill Bonner and Addison Wiggin

The consumer has led the way during this economic expansion. Aided by a galactic \$800 billion (annualized) of mortgage equity withdrawal (MEW), consumer spending accounted for 76% of our nation’s GDP during the third quarter of 2005. Old news, right? Yes, but investors seem to be betting that either the consumer can continue spending at this break-neck rate, or pass the baton off to corporations for the next leg of the race. But this thinking fails to recognize just how stretched and stressed the consumers’ collective balance sheet has become, and it fails to recognize how much his pace has been fueled by excessive mortgage debt.

Is it plausible to suppose that corporations can really fuel economic growth should the consumer begin to weaken? And what about that other baton-passing relay at the Federal Reserve - will it go as smoothly as the markets anticipate?

With these questions in mind, we wonder if those watching this economic marathon have grown unrealistically accustomed to the current sprinter's pace, and we turn our attention to some of the hurdles we see on the course ahead.

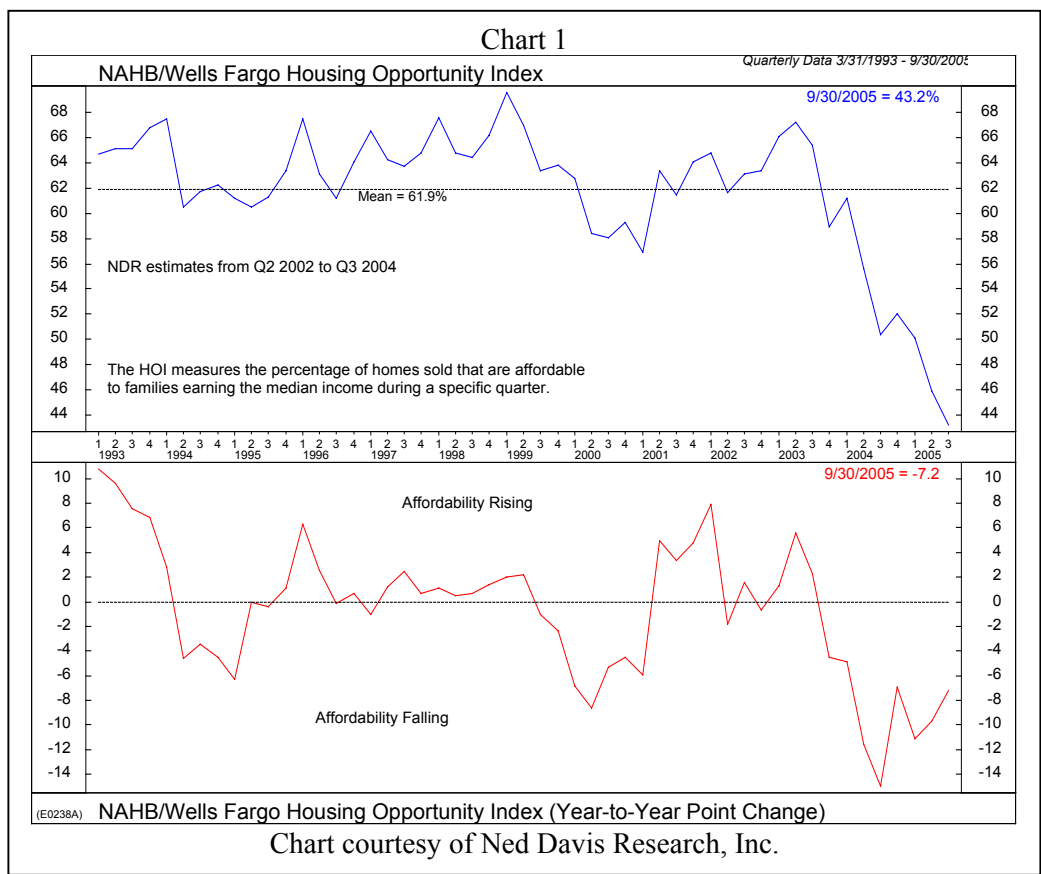
### *Housing*

After a multi-year expansion in housing prices, the last few months of 2005 brought evidence that the stimulative effect of MEW has begun to fade. In his December 2005 *Fed Focus*, PIMCO Managing Director Paul A. McCulley writes, "The property market has been the star of [the] show in recent years, fostering MEW. Most Americans look at MEW as the closest thing there is to a free lunch: home prices magically go up, generating unrealized capital gains, which can be magically magnetized, if not realized, by borrowing against them." The symbiotic relationship McCulley describes between MEW, rising home prices and consumer spending has been dependent upon a complicit Federal Reserve maintaining artificially low interest rates and mortgage brokers' willingness to peddle low-priced liquidity to a decreasingly credit-worthy consumer. Whereas mortgage loan interest rates are determined by the bond market, home equity loan (the vehicle a homeowner would use to extract equity) rates are most often pegged to the prime rate, which moves with the Fed Funds rate. Therefore, by raising Fed Funds rate from a low of 1% to a current rate of 4.25%, the Fed has removed a good deal of stimulus, and made home equity loans less attractive. According to McCulley, "Fed tightening has finally put the half Nelson on the ability of the mortgage industry to price [exotic mortgages] at a level that prospective home buyers can afford and the mortgage industry can also make a profit. I think consensus is going to be really surprised just how quickly and materially home price appreciations slow, taking MEW with it."

Further, more rigorous regulation is working in tandem with higher Fed Funds rates to cool off the housing market. On December 20, 2005, the Treasury Department's Comptroller of the Currency and Office of Thrift Supervision, the Federal Reserve, the Federal Deposit Insurance Corp., and the National Credit Union Administration issued stringent regulatory proposals for risky mortgage loans. Tom Gallagher of ISI Group, Inc. writes that the "guidance clearly discourages certain practices, such as offering ARMs (adjustable rate mortgages; mortgages that feature adjustments of the interest rate at regular intervals based on market conditions) and IOs (interest only loans; loans in which only the interest portion is paid at regular intervals, while the full principle is due when the mortgage matures) to borrowers with high loan-to-value, high debt-to-income and low credit scores."

Indications of a meaningful slowing in the housing market suggest that higher rates and regulatory scrutiny appear to be having an impact. In early January 2006, homebuilders Brookfield Homes Corp. (BHS) and MDC Holdings Inc. (MDC) reported year-over-year declines in fourth quarter orders due primarily to weakness in the Arizona and Washington D.C. markets. Additionally, in Manhattan, apartment sales fell -27% to a ten-year low in the last three months of 2005, and in Sacramento, sales of new homes fell to their lowest level since September 2001 as builders continued to be hammered by canceled deals. Overall, in November 2005 sales of new homes fell -11% month-over-month, their largest one-month drop since January 1994. Sales of existing homes fared a little better as they fell -1.7% month-over-month, while inventories rose 14.3% year-over-year. Ed Hyman of ISI writes that "housing activity and house price appreciation are slowing significantly....a further slowdown seems likely given [the] number of drags" for the housing market.

Slower home sales and rising inventories are the inevitable result of declining housing affordability. Yet, some debate remains as to whether, on a historical basis, housing remains affordable. In a December 29, 2005 article in *The New York Times* entitled, Twenty Years Later, Buying a House is Less of a Bite, David Leonhardt and Motoko Rich argue that, despite the recent rise in rates, housing is still more affordable than it was in the early 1980's. The authors contend that, "Nationwide, a family earning the median income would have to spend 22% of its pre-tax pay this year on mortgage payments to buy the median priced home. This remains below the levels of the early 1980's when it topped 30%, but more than the 17% in 1998." While their data may be true, the authors are comparing today's housing affordability to that of a time period of heightened inflation and mid-teen interest rates. In a December 22, 2005 *Wall Street Journal* article entitled, Housing Affordability Hits 14-Year Low, author Ruth Simon uses a more normalized period for interest rates in her housing affordability comparison and derives a different conclusion. Simon writes that, "Affordability [has] dropped by more than 20% in nearly two-dozen markets, including Phoenix and Tucson, AZ, Spokane, WA and Orlando and Lakeland, FL. The National Association of Home Builders and Wells Fargo affordability analysis shows that just over 43% of all new and existing homes sold in the third-quarter were affordable to families earning the median income, the lowest level since the index was first released in 1992." (See Chart 1.)



Regardless of what time period current housing affordability is compared to, consumers believe homes are getting less affordable. Their beliefs are evidenced by the early December 2005 decline in the University of Michigan housing survey to a level of 56%, below the 2001 recession low of 61% and just above the 1990 recession low of 50%.

Despite the abundance of data indicating weakness in the housing market, executives for many homebuilders would have investors believe the market is still robust.

According to a December 22, 2005 *Wall Street Journal* article by Kemba J. Dunham entitled, A Housing Slowdown? Not if You Ask Builders, homebuilders are telling investors that the market remains strong and is merely slowing to a more normalized pace. Dunham writes, "The companies that build homes are not going to let popular wisdom gum up their works - or their stocks - if they can help it. ...Executives say they are managing their projects...in a way that won't leave them or [their] shareholders exposed. Yet some of these same executives have been net sellers of their companies' stock this year, even as they cite the health of their industry." In the article, Peter Schiff, president of Euro Pacific Capital Inc. says, "Home builders are now in

the business of selling shares, not houses. ...To maintain a market for the former they must keep building the latter. That is the only logical way to explain building new houses amid a growing glut of unsold inventory. If the builders pulled back heavily on construction, Wall Street would say, 'We have to reduce our earnings estimates a year forward,' and the stocks would take a huge hit." Indeed, Merrill Lynch strategist Richard Bernstein said he saw record net insider selling in 2005 at eight of the twelve home building companies he tracks. This executive behavior is a classic example of corporate insiders asking investors to pay attention to what they say and to ignore what they do. It appears the charade is working for now; however, this behavior poses serious risks to the housing market as homebuilders continue to build homes in the face of a slowdown just so they can live up to Wall Street's growth expectations.

Contrary to what homebuilder executives want the public to believe, housing markets do not always go up. A December 25, 2005 *New York Times* article by Martin Fackler entitled, Take it from Japan: Bubbles Hurt, indicates that Japan's experience demonstrates the need to be skeptical of that fundamental myth behind all asset bubbles: that prices will inevitably keep rising. According to Yukio Noguchi, a finance professor at Waseda University in Tokyo, "The biggest lesson from Japan is not to fall into the same state of denial that existed here. During the bubble, people don't believe that prices will fall. This has been proven wrong so many times in the past. But there's something in human nature that makes us unable to learn from history." Noguchi sees similarities between the Japanese property market in the 1980's and the current U.S. housing market. He says, "It's [like] déjà vu. People were in a rush to buy, and at extraordinary prices. I saw this same haste psychology in Japan. The classic definition of a bubble is people buying on false expectations about future prices, and buying with the hope of selling in the future."

Unfortunately, given the levels to which prices have ascended in some areas of the country and the nature of the housing asset, this boom is unlikely to end without pain. According to PIMCO's Paul McCulley, "The housing market is a reflexive market, once the momentum breaks - reflexive demand becomes reflexive supply, as former speculative buyers become eager sellers. Reflexive markets inherently tend to have V-shaped tops, not rolling tops. Thus, both volumes in total home sales, particularly existing home sales, and MEW are set to fall sharply in the year ahead."

We are already seeing indications of a V-top forming in certain segments of the housing market in the form of a small sellers' panic in the Boston area. In a December 9, 2005 *Boston Globe* article entitled Sellers Chop Asking Prices as Housing Market Slows, Kimberly Blanton writes, "Boston area home owners...are sharply reducing asking prices, in some cases by \$100,000 or more. Reductions in asking prices of 10-20% are now common in both high and moderately priced neighborhoods...Price reductions on homes between \$500,000 and \$1 million increased 36%." Whether the Boston market experience will be repeated nation-wide is yet to be determined. What is less in doubt is that, given affordability constraints, price appreciation will at least slow, if not come to halt. For the consumer, such a housing price plateau would likely have a slowing effect on spending that echoes to all corners of the economy.

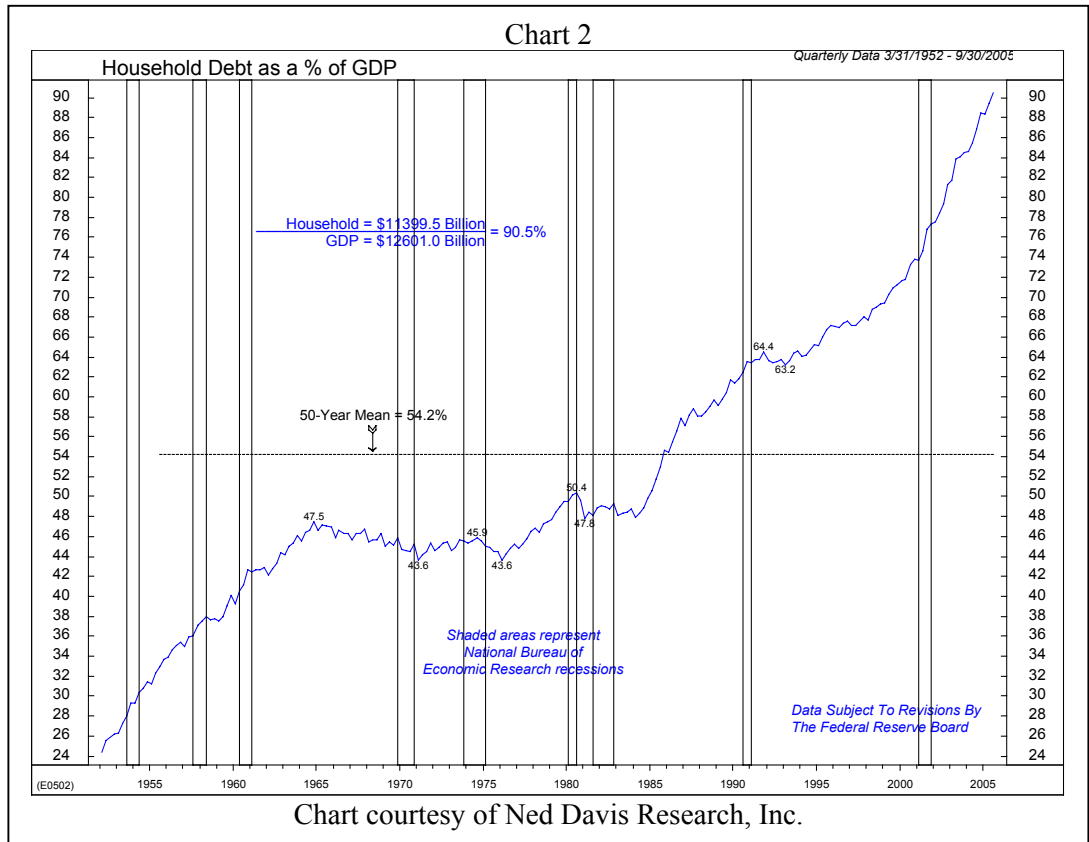
### *The Consumer*

As cliché as it might sound, the consumer is using his house as an ATM. At a cash ATM, a person can withdraw money from his account until all funds have been liquidated. Once the funds run out, that person must deposit more money into their account if they want to make additional withdrawals. With a home ATM, the equity in the home is the account balance. Once this equity has been withdrawn, the account is dependent upon further increases in home value to increase the balance available. Absent these increases, the account will rest at zero (or less than zero), and further withdraws will be impossible. As noted, withdrawals from the home ATM (a.k.a. MEW) have significantly boosted consumer spending. With affordability constraints now putting a lid on housing appreciation, many consumers are getting the "funds not available" warning. This is

why we expect a slowdown in MEW that could have a negative impact on consumer spending. According to PIMCO's McCulley, "the key issue for the year ahead is that MEW is very likely to decline, as the huge run-up in property prices of recent years hoists itself on its own affordability petard."

Regrettably for the consumer, a MEW decline is just one of the elements that may slow his spending pace in 2006. After falling to a still-elevated \$55-a-barrel in November 2005, crude oil prices have resumed their upward march. The sudden stroke of Israeli Prime Minister Ariel Sharon, militant attacks on the oil infrastructure in Nigeria and the nuclear ambitions of Iranian President Mahmoud Ahmamejad have led to doubts regarding the reliability of future oil supplies. According to a January 16, 2006 article in *The Guardian* by Robert Tait entitled, Iran Issues Stark Warning On Oil Prices, Iran's economy minister, Davoud Danesh-Jafari, has warned the United Nation's Security Council that sanctions from the West in response to Iran's nuclear ambitions "could possibly, by disturbing Iran's political and economic situation, raise oil prices beyond levels the West expects." With threats such as these lurking in the political background, crude oil prices are likely to stay elevated.

Doug Kass, the Principal of Seabreeze Capital and a blogger for TheStreet.com, sees more issues (some of which we have highlighted in past *Updates*) facing the consumer in the year ahead. Kass says, "Investors can't overlook the headwinds for the consumer forever. These include: a mountain of consumer debt (see Chart 2), ARMs that are on the cusp of being reset upwards, [and] minimum payments for credit card balances [that]



are rising and may soon double due to pressure from [government agencies]. This will give holiday-laden consumers an extra jolt of pain just as their spending sprees come due. Consumers will have more than the usual seasonal hangover. Holiday spending and high energy prices are fueling a nasty winter storm, and the doubling in credit card bills could push many consumers over the edge into bankruptcy."

As if this weren't enough, consumers are now just getting their first winter home heating bills. Although natural gas prices have significantly retreated from their December 2005 highs, current prices are still 50% higher than they were this time last year. As such, consumers can expect a bit of a sticker-shock when they open their bill.

On the other side of the ledger, ISI's Ed Hyman argues that consumers have built up a respectable looking balance sheet with cash savings of \$5.3 trillion and a net worth of \$52 trillion. In his opinion, this cushion could prevent or mute a slowdown in consumer spending. Ned Davis of Ned Davis Research, Inc. agrees that the recent rise in consumer net worth is good news, but also warns that, "this is questionable good news because following bubbles, net worth can actually decline." Even considering the \$5.3 trillion cash stash, last year Americans spent more than they earned. That hasn't happened since the Great Depression. Financial writer Ben Stein writes in *Forbes*, "With less than 20% of U.S. workers now in employer pension plans and with Social Security typically replacing less than 40% of pre-retirement income, personal saving has never been more important. [Yet] savings rates have never been lower. You can jabber to people about saving money until your jaw falls off; they're not going to put an extra dime in a savings account. ...Eventually, however, the things that must happen sooner or later do happen. Of course, that's when people wish they had saved money. That's when they'll really need it. That's when the whining really begins."

With a falling home equity balance and limited savings, consumers will be dependent upon employment gains and wage increases to meet rising debt and energy payments, lest they begin whining in earnest. Here again, the news is troubling. In his January 9, 2006 Up & Down Wall Street column for *Barron's*, Alan Abelson writes, "The December employment report was weak. Instead of the 200,000 addition to the payrolls that were expected, there were 108,000 additions." The December payroll report did include a 90,000 upward revision to the November additions, but this increase is likely evidence of a temporary lift from the post-Hurricane Katrina cleanup effort. On the overall weakness of these employment figures, Philippa Dunne and Doug Henwood, who publish the Liscio Report, say, "[the employment figure] was a disappointment by any standard. ...Few sectors really stood out as leaders except for restaurants and bars, which have been the source of 11% of all the job gains over the last year. Average weekly hours worked slipped -0.1%, and average hourly earnings were up a modest 0.1%." As for wages, the pair says, "on a yearly basis, earnings gains are still lagging inflation. If the labor market were really as tight as some claim, wouldn't we be seeing stronger wage gains?"

Ned Davis summarized the current environment for the consumer thusly: "The bad news is that Americans are consuming a near-record 96.7% of disposable personal income and their debt service is a record 13.8% of disposable personal income. Individual income taxes are rising; common sense argues that the consumer is dependent on further rises in asset prices to be able to consume and service debts at current levels. Bottom Line - the consumer is in a fragile situation should stocks and homes not continue to rise."

### *The Economy*

According to Ed Hyman, most of the stimuli that helped the economy from 2001-2005 have either reversed or moderated. These include tax cuts, a decline in oil from \$37 to \$17 per barrel, a decline in the Fed Funds rate from 6.5% to 1%, a decline in bond yields from 6.8% to 3.1%, a decline in the savings rate from 3% to -1%, an increase in MEW (annualized) from \$200 billion to \$800 billion, and a 34% increase in Federal debt. All of these former tailwinds have reversed and become headwinds.

In mid-December 2005, for the first time since early 2003, all four of ISI's key economic signals tentatively pointed to a slowdown: housing weakened, unemployment claims hooked up, ISI's company surveys turned down and bond yields fell below 4.5%. These signals came amidst weaker economic headlines including December's unexpected 4 point decline in the manufacturing Purchasing Managers Index (PMI) to 54.2, soft retail sales and the previously mentioned weak employment numbers.

Despite the fading economic stimulus, the economy has shown some recent signs of strength. In the last two weeks of December, Business Week's production index surged 4.6%, the biggest increase in 20 years.

MZM, a measure of monetary liquidity in the economy, increased \$118 billion in the last four weeks of December. Additionally, economies around the world are showing signs of strength. Eurozone economic activity is improving, German business expectations have improved, the U.K. economy is rebounding after a cycle of rate hikes, and the economies of Singapore, Hungary, Mexico and China are all showing signs of strength. These global forces could partially offset the drags the U.S. economy faces in 2006.

One important tool in forecasting the future direction of the economy is the shape of the yield curve (the difference between the short-term rates at which financial institutions borrow and the long-term rates at which they lend). Recently, much attention has been devoted to the flattening (and the brief inversion) of the yield curve, and what it means for the economic outlook.

The December 30, 2005 *Wall Street Journal* [Ahead of the Tape](#) article by Justin La Hart explained that when yields on the ten-year note fall below that of the two-year, it has, with rare exception in the past 50 years, predicted a recession. According to La Hart, “It was a signal that bond traders thought the Federal Reserve was being too aggressive about slowing down the economy and they purchased long-term bonds because they thought the Fed would have to cut rates in an attempt to revive the economy.”

Yet not all market observers believe in the predictive powers of the yield curve. In particular, in testimony before the Joint Economic Committee of Congress, outgoing Federal Reserve Chairman Alan Greenspan testified that the yield curve had lost its forecasting ability. Greenspan argued that overseas demand was the driving force behind lower long-term bond rates. China has been a lead player in this game, recycling their massive dollar reserves back into U.S. government securities in an effort to restrain appreciation in their own currency and sustain the strong competitive position of their manufactured goods.

Now that the yield curve has flattened, should we fear a recession? Or, in the often-repeated Wall Street words of wishes, is this time different? Lakshman Achuthan, managing director at the Economics Cycle Research Institute warns we should not read too much into the shape of the yield curve. A January 8, 2006 *New York Times* article by Daniel Gross entitled, [The World Isn't Flat, but It's Yield Curve May Be](#), claims Achuthan's work indicates that since World War II, flattening yield curves, as measured by the difference between rates on 3-month and 10-year government debt in the five largest economies – the U.S., Japan, Germany, Britain and France – have issued false alarms of recession 38% of the time. However, flattening curves have done a better job of indicating economic slowdowns. According to Achuthan, a flattening yield curve predicted slowdowns 94% of the time in the U.S. and 66% of the time in Japan. In his January outlook, PIMCO Managing Director Bill Gross contends that the yield curve may not be indicating a recession, but the flat curve strongly suggests an economic slowdown. He writes, “Since higher yields worked with a 12-18 month lag in terms of their economic impact, it seem[s] clear to me that 2006 [will] be a year of slower growth, perhaps 2%, and that the Fed and indeed the yield curve [has reached] a plateau around 4.5%.”

In a December 18, 2005 *New York Times* article entitled, [Thrown for a Yield Curve](#); Mark Hulbert convincingly argues the yield curve is just as useful today as it was in the past. He writes, the “yield curve's track record helps explain why it is among the factors in the index of leading economic indicators maintained by the Conference Board.” According to Hulbert, this past summer the Board conducted a review as to whether the yield curve indicator should continue as part of the index. The answer was “yes.” Ken Goldstein, a Conference Board economist, says his group's research “does not show that the yield curve has lost its predictive power.”

Supporting the Conference Board's conclusion is a 1996 article entitled, [Current Issues in Economics and Finance](#) written by Arturo Estrella and Frederic Mishkin, both economists for the New York Federal Reserve Bank. “The yield curve - specifically, the spread between the interest rates on the ten-year Treasury

note and the three-month Treasury bill - is a valuable forecasting tool. It is simple to use and significantly outperforms other financial and macroeconomic indicators in predicting recessions two to six quarters ahead," the authors wrote.

It seems there is truth in the wisdom of both these camps. At least, that's the position taken by Ed Hyman in describing the forces he believes are working to drive longer-term bond yields lower around the world. These forces include a global glut of liquidity, inflation that is generally low and slowing, and improving central bank credibility. The global glut of liquidity supports Greenspan's theory that overseas demand has been a driving force to bring down yields on long-term bonds. But, Hyman also believes low bond yields are telling the markets something about the current growth outlook as well. Given the headwinds facing housing and the consumer, Hyman forecasts a slowdown in real GDP (GDP adjusted for inflation) from the actual rate of 4.1% in Q3 2005 to 2.5% in Q2 2006.

### *The Fed*

On December 13, 2005, for the first time since they started raising rates in June 2004, the Fed did not refer to its monetary policy as accommodative. The stock and bond markets celebrated this news, concluding that rate hikes were therefore coming to an end and the Fed was poised to enter into a new dovish policy phase.

Two key factors driving Fed actions are inflation and economic growth. On the inflation front, the weight of the evidence is tilted towards price stability. For example, globalization, competition and technology are forcing automotive price cuts, lower airfares, a broadband price war, lower cost of video conferencing units, free shipping from most online stores and lower fees on mortgage products. After struggling to understand the absence of inflationary pressures over the expansion of the past two decades, Fed Chairman Alan Greenspan has concluded that, "the disinflationary pressures that have been evident in the global economy [are in part due to] the integration of the former Soviet Union, China and India into world markets." In a January 9, 2006 *Wall Street Journal* article entitled, Greenspan's Final Act: Calculating the Impact of Globalization on Inflation, Greg Ip writes, "in the minutes from the Fed's December 13 policy meeting, officials noted that robust competition - including from foreign producers - [was] helping to contain cost and price pressures."

Although Fed officials credit globalization for keeping inflationary pressures low, they have not yet declared victory in their battle for price stability. A December 29, 2005 *Investor's Business Daily* article by Laura Mandaro entitled Factory Slack Starting To Run Out: New Worry for Fed highlights a December 13, 2005 post-meeting statement, in which the Federal Open Market Committee (FOMC) noted that "possible increases in resource utilization...have the potential to add to inflation pressures." According to the article, this marked the first time since November 2000 that the rate-setting committee referred to capacity constraints, rather than just energy prices, as lingering inflation concerns. Last year, inflation grew at its fastest pace since 2000, rising 3.4%. While the brief December -0.1% dip in the consumer price index (CPI) echoed a year-end fall in energy prices, Michael Wald, economist for the Bureau of Labor Statistics, said, "We already know [this] is an old story because in the past days we have been seeing increases at the pump."

ISI's Tom Gallagher thinks as long as growth is above trend, it will be hard for the Fed to pause, even after the widely-anticipated January 2006 rate hike [the Fed's next meeting is January 31, 2006]. Gallagher believes investors overreacted to the Fed's new policy statement contained in the January 3, 2006 release of the FOMC minutes from the December 13, 2005 meeting. The statement read, "The number of additional firming steps required would not be large." The markets viewed this statement as yet another sign the Fed's tightening was close to finished and rallied on that interpretation. Gallagher counters, "Stock and bond

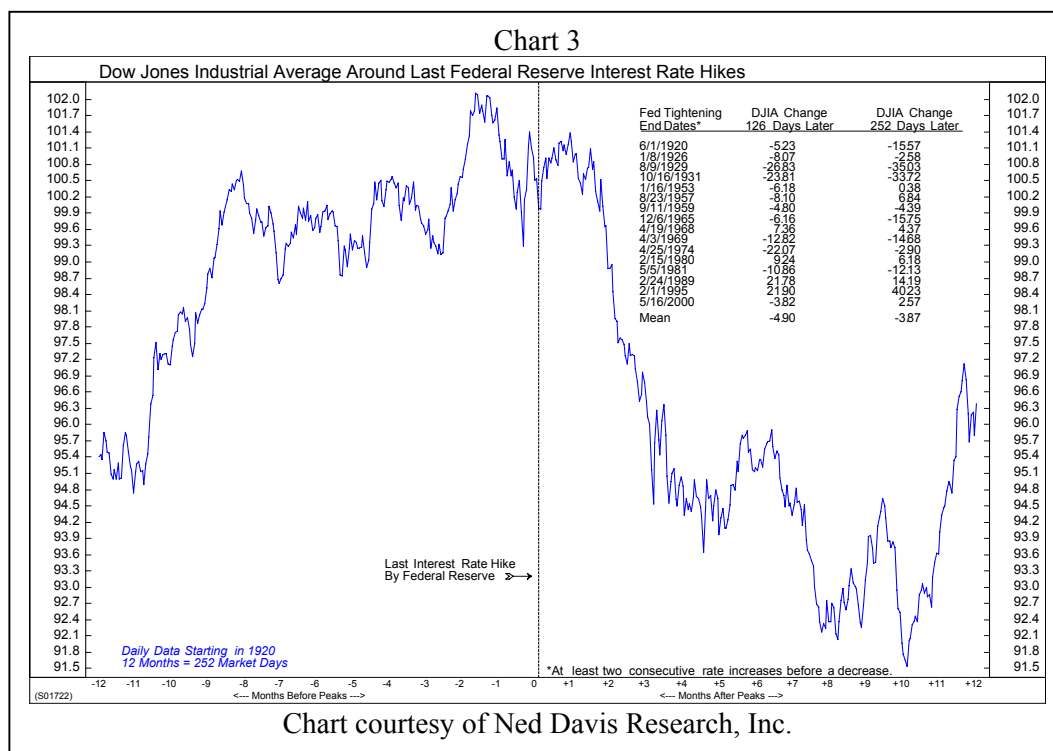
markets rallied on the misinterpretation of the dropping of ‘accommodative’ as a sign that the Fed is done because it’s now at the neutral funds rate. But this statement no longer implicitly promises to stop at neutral, and the policy firming phase leaves open the possibility that the Fed will go beyond neutral into restrictive territory.”

Adds Edmund L. Andrews in a December 14, 2005 *New York Times* article entitled, Fed Gives Mixed Sign on Rates, “By all accounts, Fed officials are entering a more uncertain new phase, when the need to raise rates even higher is less clear but inflation remains a source of worry.”

Gallagher’s point may be valid, but whether the Fed stops its tightening phase with one, two or even three more rate hikes is less important than what the end to their tightening infers for the markets. We do, in fact, believe the Fed is in the latter stages of their tightening cycle. However, we also think investors may be misinterpreting what an end to the current cycle means for the markets. As a basis for their current euphoria, investors are taking their cue from the experience of the U.S. equity market in 1995, when the Fed stopped tightening during a mid-cycle economic slowdown and the S&P 500 rallied 34%. They also cite last year’s 16% rally in the FTSE 100 Index following a mid-cycle pause in tightening by the Bank of England. Yet, predicting the market’s reaction to a halt in Fed tightening may prove less formulaic than this calculus would suggest. Banc of America Securities strategist Tom McManus studied 20 previous periods of Fed tightening and concluded that, once the tightening phase ended, the markets posted only “so-so” gains on average.

Ned Davis writes that, “one of the major pieces of conventional wisdom on Wall Street currently is that the market will do fine once the Fed quits raising rates...[when] on average, the market declines over the six-month period and 12-month period following the last interest rate hike.” (See Chart 3.)

According to Davis, at the end of a tightening cycle the shape of the yield curve is the key to determining market performance. He writes that, “Our work shows that even a flat or inverted yield curve [at the end of a tightening cycle] has negative implications for stocks.”



On January 31, 2006, after 18.5 years as Chairman of the Federal Reserve (the second longest tenure in Fed history), Alan Greenspan passes the baton to Dr. Ben S. Bernanke. Bernanke, Chairman of the President's Council of Economic Advisers and Professor of Economics and Public Affairs at Princeton University, has served as a member of the Fed’s Board of Governors. He is inheriting an economy

that, on the surface, is healthy. Greenspan is leaving his successor quite the gift horse; an economy that is four years into a market expansion phase with high valuation and high levels of leverage. But not all agree.

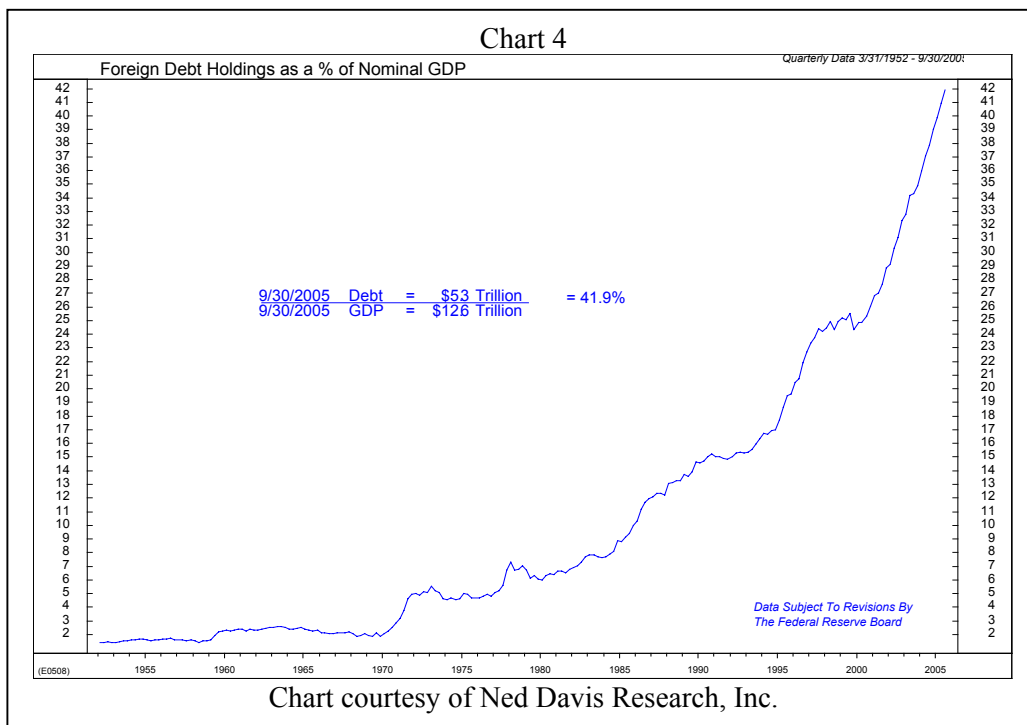
In a January 3, 2006 *Wall Street Journal* article by Greg Ip entitled Starting in the Shadow of Greenspan, Martin Barnes, editor of the *Bank Credit Analyst* says, “It could be argued that Greenspan is handing Bernanke a poisoned chalice: an economy with an impressive track record, but one burdened with unprecedented financial imbalances. It will be hard to rebuild household savings, reduce the current-account deficit and stabilize the housing sector without some economic pain.” Despite his success, the January 12, 2006 issue of *The Economist* argues that Greenspan is leaving behind an economy in “a much less healthy state than is popularly assumed; [one that has] the biggest economic imbalances in American history.” The magazine says the “main reason for America’s growth in recent years was a massive monetary stimulus as the Fed held real interest rates negative for several years.” The market is full of imbalances that the Greenspan Fed has encouraged through loose money, and Chairman Bernanke will have to deal with these vexing issues.

Will Dr. Bernanke dare look the gift horse in the mouth? He may have no choice.

### *Fiscal Policy*

In the fourth quarter of 2005 the Federal government accelerated its spending to a \$2.7 trillion annual rate. Since Federal outlays are one-fifth of GDP, it stands to reason that this unsustainable 28% quarter-over-quarter increase was a major force behind the economy’s strength in Q4. Thanks to this spending, the Federal deficit averaged -\$456 billion during the last three months of 2005. While much of the fourth-quarter spending increase can be attributed to Hurricane Katrina rebuilding efforts, Ned Davis notes, “the growth rate for spending on defense and healthcare, which had been in a two-year downtrend, has now turned up and net interest spending has soared 16%.” As a result, Davis concludes, “the lack of spending control almost certainly means we cannot grow ourselves out of the deficit.”

It certainly seems future deficits will grow, requiring more help from our friends abroad to plug our budget gap. While they have been willing to lend us their funds up to this point, there is no guarantee that their appetite for U.S. debt instruments won’t fade (see Chart 4). Notably, earlier this month China indicated that it could begin to diversify its rapidly growing foreign currency reserves away from the U.S. This move may not have a large overall impact on demand for our debt, but it does highlight the risks inherent in thinking the demand will always be constant.



Another risk not mentioned by deficit doves is that running deficits requires the surrendering of control. In this regard, the City of Chicago's experience, highlighted in a December 6, 2005 *Wall Street Journal* article by Patrick Barta and Marty Kissel entitled, From Australia, Money Chases Roads, Airports Around the Globe, serves as a warning. Last year Chicago faced a \$220 million budget deficit and voters feared a jump in property taxes. Macquarie Bank, Australia's biggest investment bank, organized a deal to take over Chicago's historic Skyway toll road under a 99-year lease for \$1.8 billion, hundreds of millions more than some Chicago officials thought it would fetch. The windfall helped plug a budget hole and set up a \$500 million rainy day fund. What the Windy City politicians didn't bank on was that the Australians quickly raised the tolls, and Chicago officials were powerless to stop them.

### *The Market*

The 2005 year-end equity market rally and the continuation of that rally into the new-year can be attributed to the anticipation of an end to the Fed's tightening cycle. Yet, the flat yield curve is troubling for Wall Street. The mainstay of the traditional banking business is borrowing money at low, short-term rates, lending it out at higher, long-term rates, and pocketing the difference. Many Wall Street firms are involved in this carry-trade too, using short-term debt to fund riskier long-term investments. When the yield curve inverts, many of these profit-making opportunities go away. According to Justin La Hart, "If the inverted yield curve hits financial company earnings, it could have an outsized effect on the stock market. Financial firms account for a fifth of the S&P 500 market capitalization and a quarter of its earnings-per-share (EPS), and many non-financial firms (General Electric and General Motors to name a few) have substantial financial divisions."

Additionally, increased regulatory scrutiny, higher rates, a flat yield curve and declining affordability are likely to lead to weakening fundamentals in the mortgage industry, a sector in which we currently hold many short positions. Similarly, despite executive claims that the industry will fair well in 2006 in the face of weakening fundamentals, we remain short select homebuilder stocks. We find it somewhat schizophrenic that several homebuilders' managements sold massive amounts of stock during 2005 while promoting their firms' stunningly positive outlook to the investment community. We do not trust managers who tell us to do one thing while they are doing the opposite for themselves. We also remain short select banks that are vulnerable to a flat yield curve, to a slowdown in mortgage origination and to the deteriorating credit conditions that would result from a flat to declining residential real estate market.

The decline in MEW and the lack of real wage gains this business cycle could leave the consumer in a precarious position in 2006. We may or may not have our first consumer recession in decades, but a consumer spending slowdown seems inevitable. As consumer spending slows, consumers will be forced to curtail their purchases of discretionary items in order to afford the necessities needed to live. With this in mind, we are currently short select consumer discretionary shares and we are long consumer staples that are executing well.

Due to limited availability of raw materials in a fast growing global economy, commodity prices continue to rise. In this environment we have established long positions in select metals securities. Also, as the population grows older there will be an increased need for elder care services. Assisted living remains a fragmented market where substantial consolidation efficiencies can be realized and current supply/demand characteristics look promising. We have long exposure to the two largest publicly-traded assisted living companies.

## ***Outlook***

The likely theme for 2006 is transition. After four years of expansion, the economy is poised to transition into a period of slower growth. The Fed prepares to transition to a period of monetary balance after the removal of extraordinary accommodation. The markets prepare to transition from the monetary policy leadership of Alan Greenspan to that of his successor, Ben Bernanke. Fiscal policy inevitably must transition from a period of untenable largesse to one of restraint. In short, we see lots of change ahead – more hurdles to jump.

Within each of these transitions lies risk. Under Greenspan's stewardship, the economy has grown with the help of a flood of liquidity. A financial system flush with liquidity has enabled an impressive rate of growth in recent years at the cost of financial imbalances. With liquidity now receding, the outcome for the markets and the real economy seems cloudy. The markets also seem to believe that Bernanke's leadership will be a continuation of Greenspan's legacy, when in fact the two may prove to have different approaches to monetary policy.

From their current unsustainable heights, fiscal spending will likely transition to more normalized levels, in the process removing a significant lift to the economy.

The underlying theme within all of these risks is market complacency. While these transitions may occur without incident, the risks of the baton being dropped should not be ignored.

MICHAEL B. ORKIN, CFA  
ROBERT H. GREENBLATT  
J. PATRICK FLEMING, CFA  
WILLIAM C. HORNE

Note: The portfolios managed by Caldwell & Orkin, Inc. and/or its affiliates may or may not have positions in any of the companies mentioned herein.

Caldwell & Orkin, Inc.  
6200 The Corners Parkway  
Suite 150  
Norcross, GA 30092  
Telephone (800) 237-7073 or (678) 533-7850  
E-mail: [Update@CaldwellOrkin.com](mailto:Update@CaldwellOrkin.com)