

## UPDATE

January 2007

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*“According to [mathematical research], sudden [stock market] upheavals are far from being highly unlikely, and may indeed even be inevitable. In direct conflict with everything the efficient market hypothesis stands for, large fluctuations in market prices seem to result from the natural, internal workings of markets, and so [they] flare up from time to time.”*

- Ubiquity by Mark Buchanan

As the books close on 2006, one wonders how this past year in the equity markets will be remembered in history. It was a year that saw the bursting of the housing market bubble as evidenced by the -33.45% peak-to-trough decline in the Philadelphia Housing Index. 2006 also witnessed: inflationary spikes in the price of a barrel of oil, from a February 16, 2006 low of \$57.55 to a July 14, 2006 high of \$78.40; a 2.9% year-over-year change in the core consumer price index; and a resultantly hawkish (prone to tighten, or raise interest rates) Federal Reserve which through the year raised the Fed funds rate a total of 100 basis points to 5.25%.

Yet, despite these headwinds, the S&P 500 with Income Index gained 15.8%. This rally was fueled, in part, by an ebbing of the aforementioned oil and inflation spike pressures. Indeed, oil prices plummeted throughout August and September, settling in the low-\$60 range. In addition to lower energy prices, decelerating economic growth also had a dampening impact on inflationary pressures, easing investors' concerns regarding a hawkish Fed. What's more, the strength of the Far-Eastern export-based economies and the oil wealth from the Middle East resulted in a continued recycling of U.S. Dollars into our economy, providing a source of economic liquidity that supported our financial markets. (At the expense, it should be noted, of the U.S. trade deficit.) Awash with this monetary liquidity, investors gave more weight towards the bullish headlines and bought stocks. And, in an environment with excess liquidity, beaten up stocks become targets of value investors and private equity players.

Perhaps 2006 will be remembered as the Goldilocks year for financial markets, a year in which the “bad news” from housing and slowing economic growth became “good news,” as it tempered inflationary concerns in the hopes that Federal Reserve Chairman Ben Bernanke would successfully navigate a not-too-hot, not-too-cold economic slowdown. While the Goldilocks scenario would be a net positive for the U.S. economy and financial markets, recent signs of economic acceleration suggest there may be a slight detour along the way. The “good news” of an accelerating economy would likely be “bad news” for financial markets anticipating slower growth and a dovish (prone to ease, or lower rates) Fed. Recall from our October 2006 *Update* that it has been over three-and-a-half years since the last 10% decline in the S&P 500. According to Ned Davis Research, Inc. such a correction has occurred, on average, every seven months since 1928. The recent bifurcation between investors' expectations for slowing economic growth and the potential for a first-quarter growth acceleration, at a time when the market continues on an unprecedented stretch without experiencing what author Mark Buchanan dubbed a “sudden upheaval,” gives us pause going into 2007.

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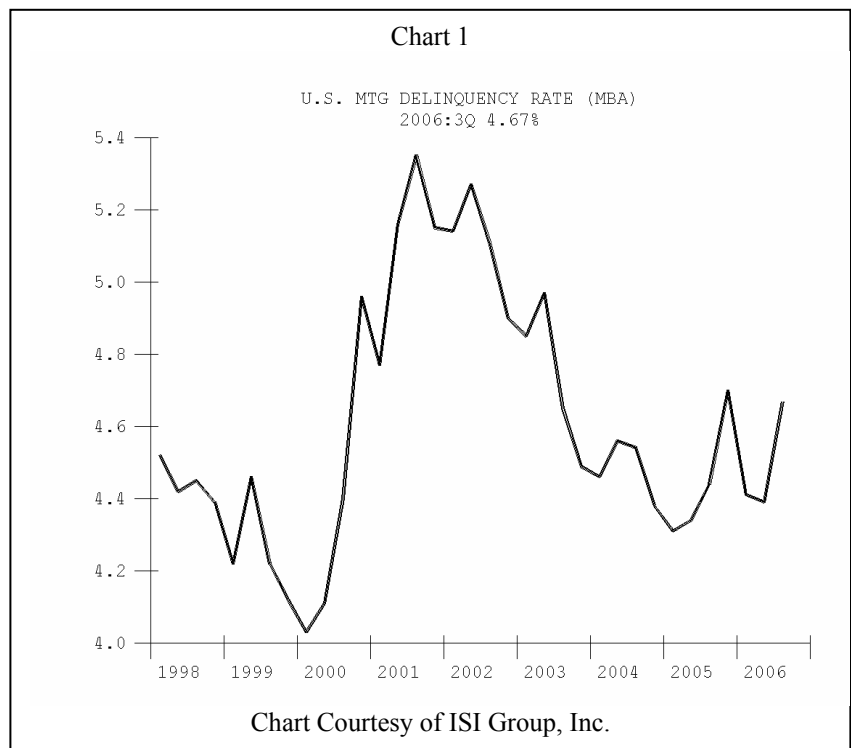
## The Year Ahead

### Subprime Mortgages

Throughout last year it became clear that borrowers stretched themselves too far to purchase, refinance and monetize (withdraw equity from) homes that were overvalued. According to a December 6, 2006 *New York Times* article by Vikas Bajaj and Ron Nixon entitled, Subprime Loans Going From Boon to Housing Bane, by the end of June 2006 lending to subprime borrowers accounted for a lofty 13.4% of total mortgages outstanding. In his December 15, 2006 edition of *Grant's Interest Rate Observer*, editor Jim Grant pegs subprime mortgage origination at 22.2% of total mortgage issuance year-to-date through September 30, 2006, with another 17.5% of production coming from Alt-A, the credit quality class between subprime and prime. Thus, even as the housing market was showing signs of distress, lending to less credit worthy borrowers accelerated and became a much larger portion of overall mortgage loan production.

This reckless acceleration in subprime production was enabled by demand from the collateralized debt obligation (CDO) market. CDOs purchase asset-backed securities (ABS) from loan originators using leverage (borrowed money) to generate hoped-for sizable returns for their investors. According to Jim Grant, "it is all important to the subprime market that new mortgage-packed CDOs continue to come tumbling down the Wall Street production lines as, indeed, they have been: According to the latest data, [December 2006] year-to-date CDO issuance totals \$223.7 billion, no less than 89% higher than in the like period a year ago...Mortgage traders speak lovingly of CDO [demand]. It is mother's milk to the ABS market. Without it, fewer asset-backed structures could be built, and those that were would have to meet a much more conservative standard of design." The question for 2007 then becomes, "how long will this demand remain robust?" Or, "how long will the milk continue to flow?"

Here the news turns sour. As we first mentioned in our December *Update*, 2006 subprime loan performance has been, in a word, sub-par. According to a December 14, 2006 *New York Times* article by Jeremy W. Peters entitled, Bankers Report More Mortgages Being Paid Late or Not at All, a Mortgage Banker's Association (MBA) survey of more than 42 million mortgages found the rate of subprime delinquencies rose to 12.6% in the third quarter, up from 11.7% in the second quarter (see Chart 1). Worse still, as reported in a December 20, 2006 *Wall Street Journal* staff article entitled, Subprime Blues, the Center for Responsible Lending in Durham, N.C. estimated that 2.2 million



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subprime loans were generated between 1998 and the third quarter of 2006, and of these loans, ultimately 15% will likely end in foreclosure. The Center blamed lenders for making loans without adequately considering whether homeowners would be able to meet increased payments from interest-rate resets, and criticized lenders for reducing requirements for borrowers to verify their income, i.e. no-documentation loans. In agreement, Jim Grant writes, “There is something about the sudden blight of delinquencies and foreclosures at the bottom of the 2006 mortgage barrel that doesn’t quite add up... Blame for the distress at the fringes of subprime, we judge, cannot be laid at the feet of the U.S. economy. It should, rather, attach to the lenders and borrowers who piled debt on debt until the edifice sways even in a dead calm.” That is to say, this house of cards was being built on a shaky debt foundation.

Now these lenders are embarking on a mass exodus from subprime mortgage origination. (Sorry borrowers, you’re stuck with the loans.) In just the month of December, two of the largest subprime originators announced their closure, and two others were put up for sale. Good luck to the guys trying to sell: or, borrowing from the title of the December 2006 *Update*, Caveat Emptor – Buyer Beware!

Back in the spring of 2003 a large, troubled subprime mortgage lender (which we were short at the time) was acquired by a London bank. The deal came as a surprise to us as the target company’s fundamentals were clearly wretched, yet the acquirer’s appetite for the high yield associated with subprime risk ruled the day. What comes as less of a surprise is the stomach churn caused by this acquisition. In December 2006, the London bank warned investors about rising delinquencies in their U.S. mortgage services business (the very business they acquired in 2003). Behind this problem appears to be a poor assessment of the default rates in the adjustable rate mortgage (ARM) portfolios. According to a December 5, 2006 *Wall Street Journal* article by Lingling Wei entitled Subprime Lenders Are A Hard Sell, any potential buyer of these originators seeks to avoid inheriting the subprime sellers’ costly obligation of having to buy back the loans already sold in the secondary market because of borrowers’ defaults. This is certainly not a ringing endorsement of a business plan to gobble-up subprime lenders, in general, nor of past acquisitions, in particular, no matter how “cheap” the target company may have appeared at the time. Acquisition indigestion can be painful.

Amazingly, we are likely only in the first innings of the subprime mortgage downturn. A December 9-10, 2006 *Wall Street Journal* article by Danielle Reed and Anusha Shrivastava entitled, Mortgage Sector Withstands Subprime’s Fallout, explored the possible repercussions from the subprime mortgage market blues. According to the article, Wall Street investors could have a diminished appetite for the subprime mortgage product if they were to experience losses in their lending subsidiaries. This diminished appetite alone could cause interest rate spreads to widen between the Alt-A and prime mortgage markets, a sentiment that is echoed by Stephanie Pomboy at *Macro Mavens*. In a December 2006 piece Pomboy writes, “now that the horse is out of the barn, lenders are predictably rushing to shut the door. After letting their loan loss reserves dwindle to 20-year lows, they are now frantically trying to rebuild them. Indeed, according to the FDIC, the -\$375 million decline in earnings in the [third] quarter was entirely attributable to the \$1.1 billion increase in loan loss provisions. At the rate charge offs and past-due loans are growing, one presumes the need to rebuild reserves will act as a drain on earnings for many a quarter to come.”

On the regulatory front, the screws are likely to continue to tighten on the lending industry. Andy Lapperriere at ISI Group, Inc. believes the ensuing increase in foreclosure rates will likely cause Congress to pressure regulators to crack down even more on nontraditional and subprime loans. This brings us

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back to the CDO market. On the other side of the subprime trade lies the end buyer of the CDO, who is almost certainly looking at these mounting delinquencies and thinking twice about whether it is prudent to risk leveraged capital in a market experiencing losses and potentially on the brink of collapse.

For now, we are comfortable pitching a tent with Jim Grant who recently wrote, “A few – a minority – believe that the troubles now unfolding at the margins of subprime are the leading edge of much deeper problems. We are in that camp.”

### *Housing*

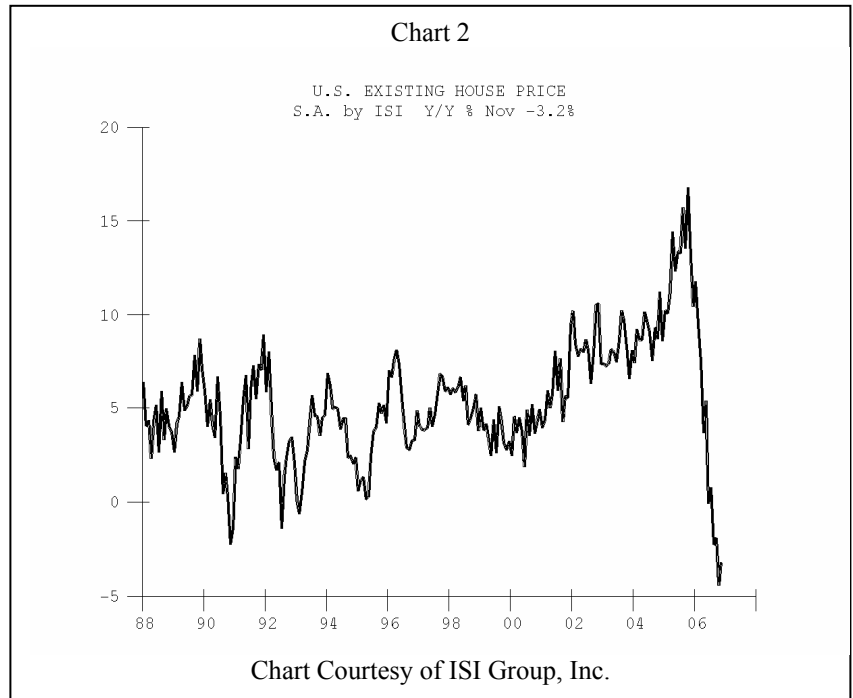
“The housing slump is over.” Not our words, but the point of view of the National Association of Realtors (NAR) and former Federal Reserve chairman Alan Greenspan. According to a December 11, 2006 *Bloomberg News* article by Kathleen M. Howley entitled, Housing Will Recover in First Quarter, Realtors Say, the NAR forecasts that sales of previously owned U.S. homes will increase to an annualized rate of 6.29 million in the first quarter of 2007, snapping five consecutive quarterly declines. We question the NAR’s and Greenspan’s credibility. Until recently, the NAR claimed there was no housing bubble. And, this is the same Alan Greenspan who was recommending ARMs to borrowers in 2005 as the Fed was entering a tightening phase that would result in a 425 basis point interest rate increase.

In the second half of 2006, homebuilders were able to improve sales by aggressively increasing incentives (read: take a bite out of profit margins) to move bloated inventory. But, despite the NAR’s bullishness, this does not mean the ominous clouds looming over the industry have cleared. A December 20, 2006 *Wall Street Journal* by Christopher Conkey entitled, Housing Industry May Slow Despite Rebound in Starts, suggests the housing sector is likely to remain a drag on the economy until the large inventory of unsold homes is reduced. Conkey writes that, “building permits, a sign of future activity...fell 3% in November from October and were 31.3% lower than a year earlier. Moreover, a fundamental imbalance between supply and demand suggests builders will have to scale back production in the months ahead. The main reason: Builders haven’t cut back construction enough to match the weaker pace of sales this year.”

In truth, many of the recent housing market statistics suggesting a turnaround are misleading if not outright fraudulent. For starters, there is the Commerce Department’s inventory of new homes for sale estimate which in October was pegged at a seven-month supply. The Commerce Department does not include contract cancellations in their estimates, however. A review of cancellation rates provided by Doug Kass of Seabreeze Advisors shows that the average cancellation rate for the leading homebuilders was 43% in the third quarter of 2006. John Mauldin wrote in his December 8, 2006 *Thoughts From the Frontline* newsletter, “As for the recent [inventory] data that shows new home sales as possibly, maybe, getting to a bottom of the cycle...with north of 30% cancellations, the number of actual sales is certainly less than the data is showing.”

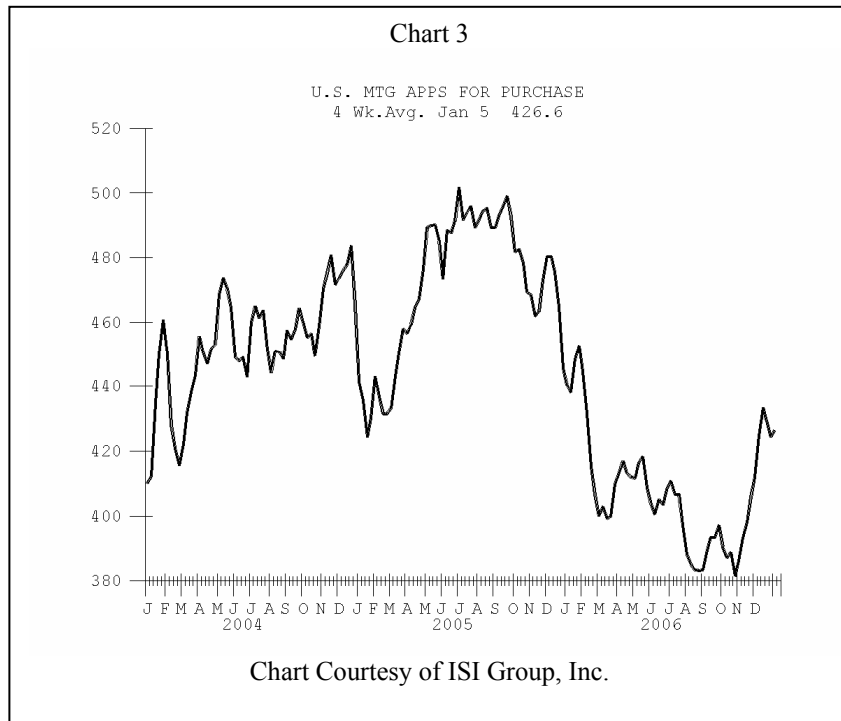
If the cancellation data wasn’t bad enough, a December 6, 2006 *New York Times* article by David Leonhardt entitled, What Statistics on Home Sales Aren’t Saying, suggests that the average home sale price data computed by the Office of Federal Housing Enterprise Oversight (OFHEO) is much worse. Leonhardt writes, “According to one widely followed real estate index...the average house in Naples sold for 20% more this summer than it would have a year earlier. This is in stark contrast from a recent house auction in Naples where the average selling price was 25% lower than 2005. Naples is not as unusual as

you may think. The truth is that the official numbers on house prices... are deeply misleading.” Among the flaws in the government’s statistics: they are based only on houses that have sold, in some areas they exclude homes with jumbo (over \$417,000) mortgages, and they do not factor in giveaways such as new BMWs or Caribbean vacations that have become a homebuilders’ tactic de-jour for moving bloated inventory. ISI recently conducted a house price survey that showed that the four-week average year-over-year change in house prices fell an unprecedented -1.4% in December 2006 (see Chart 2). If house prices simply remain unchanged through February 2007, they will post their first annual decline on record. Also, mortgage applications for house purchases showed declines in December as well (see Chart 3).



Given the ugliness of these fundamentals, we reiterate our disagreement with Sir Alan’s rosy housing market forecast. In our camp is Jeffrey Gundlach, chief investment officer at TCW Group. In a December 4, 2006 *Barron’s* article by Jonathan R. Laing entitled, Housing’s Woes May Be in Early Innings, Mr. Gundlach, a manager of mortgage-backed securities portfolios, says, “Greenspan is out of his

mind to declare a bottom in the housing market after just a six-month slide. This is the kind of silly optimism that one would expect from somebody who’d just passed his real-estate brokerage exam and was hoping to drum up some business.” Perhaps the former Fed chairman should pay heed to recent comments by the CEO of a leading homebuilder. In a January 3, 2007 *Wall Street Journal* article by Janet Morrisey about the homebuilding sector, the CEO of a large national homebuilder said he sees no signs the home-building market has hit bottom. Specifically, “Market conditions continued to weaken throughout the fourth quarter, and we have not yet seen tangible evidence of a market recovery.”



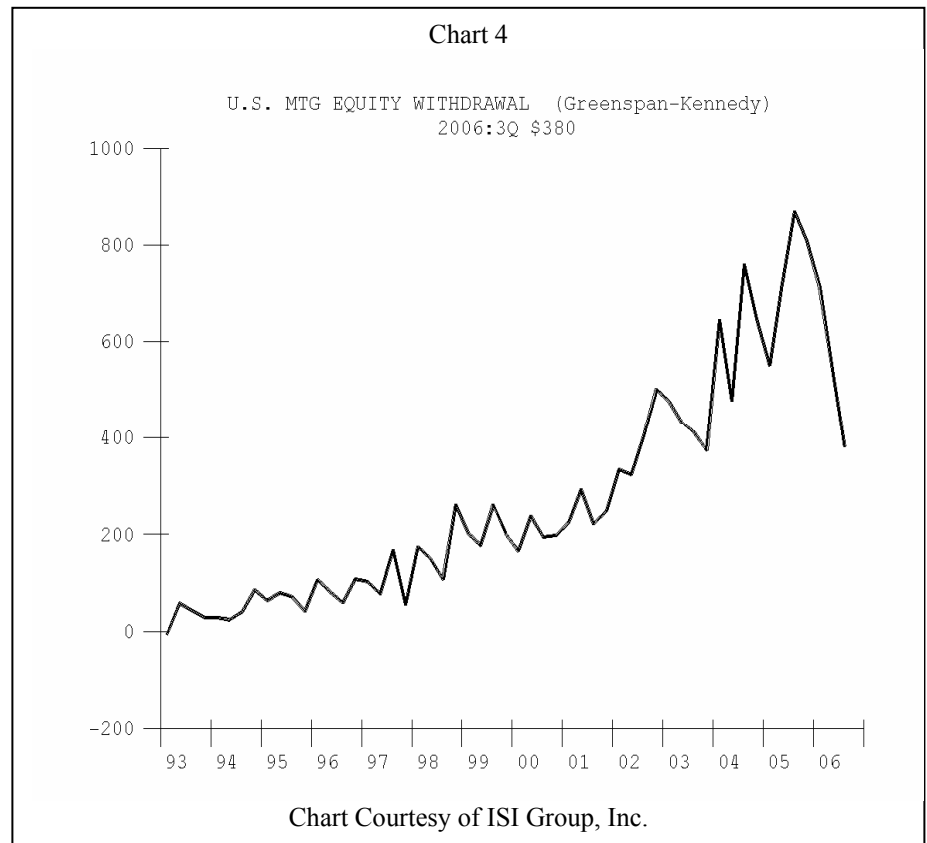
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## Consumer

During the inflation phase of the housing bubble, consumers increasingly relied on mortgage equity withdrawal (MEW) from their appreciating homes to meet their spending demands. The home turned into an ATM. The surge in MEW had a positive impact on the economy's growth. According to John Mauldin, MEW added between one-half and one percent to gross domestic product over the past five years. As evidence of the housing bubble deflation mounted, we believed the pace of MEW would cool, having a negative impact on consumer spending specifically, and on the economy as a whole, considering the fact that the economy depends on consumer spending for two-thirds of its growth.

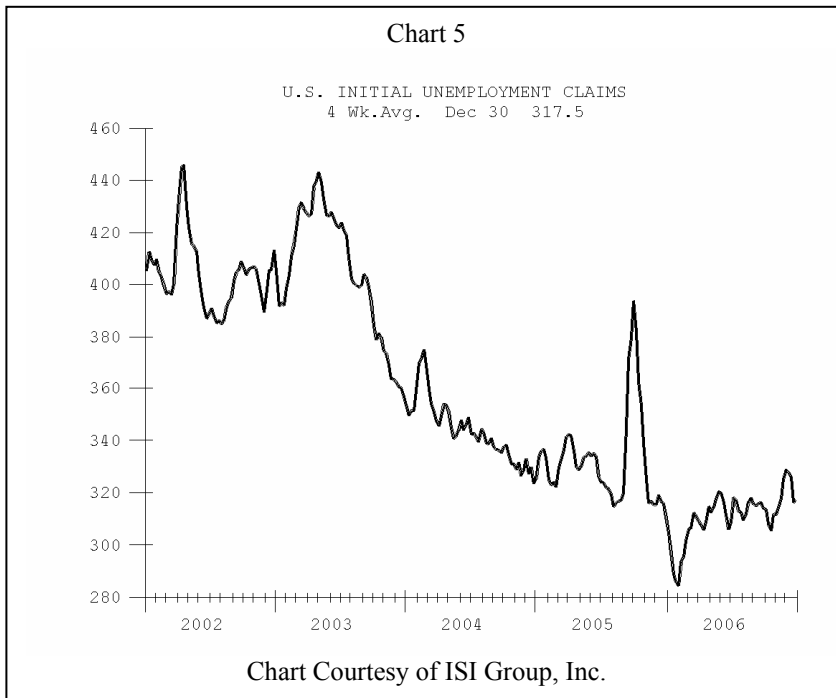
Given our pessimistic outlook for MEW, the strength in consumer spending in the second half of 2006 was surprising. To be sure, we were correct in forecasting a decline in MEW due to weakening house prices. According to ISI,

the Greenspan-Kennedy measure of MEW peaked in the third quarter of 2005 at an annualized rate of almost \$870 billion and was down to an annualized rate of \$380 billion in the third quarter of this year (see Chart 4). Yet, despite this decline, consumer spending remained robust. In his December 15, 2006 *Thoughts From the Frontline* newsletter, John Mauldin offers a few reasons for the consumer's resiliency. For starters, despite the recent declines, MEW relative to disposable personal income remains at roughly twice its 1991-2000 average. Secondly, disposable income was up 6.0% year-over-year in the third quarter, but Mauldin does not believe this increase comes close to explaining how we can see



huge drops in MEW, yet no apparent side effect on spending. Mauldin suggests the real bridge for the spending gap came from other personal assets. Phillippa Dunne from the *Liscio Report* writes, "Individuals have been sellers of stocks forever, but the levels in the third quarter Flow of Funds report are at record highs. The first three quarters of 2006 averaged \$770 billion at an annualized rate; in 2000 it was \$630 billion, and no other year comes even close. It's currently 11% of disposable personal income (DPI) and the previous peak was 9% in 2000. Putting it all together, we have decent income growth, but households are still doing a lot of dissaving to keep up their spending. We keep looking to credit card debt to cover loss of mortgage equity, but perhaps people are also selling assets to finance spending."

## Economy

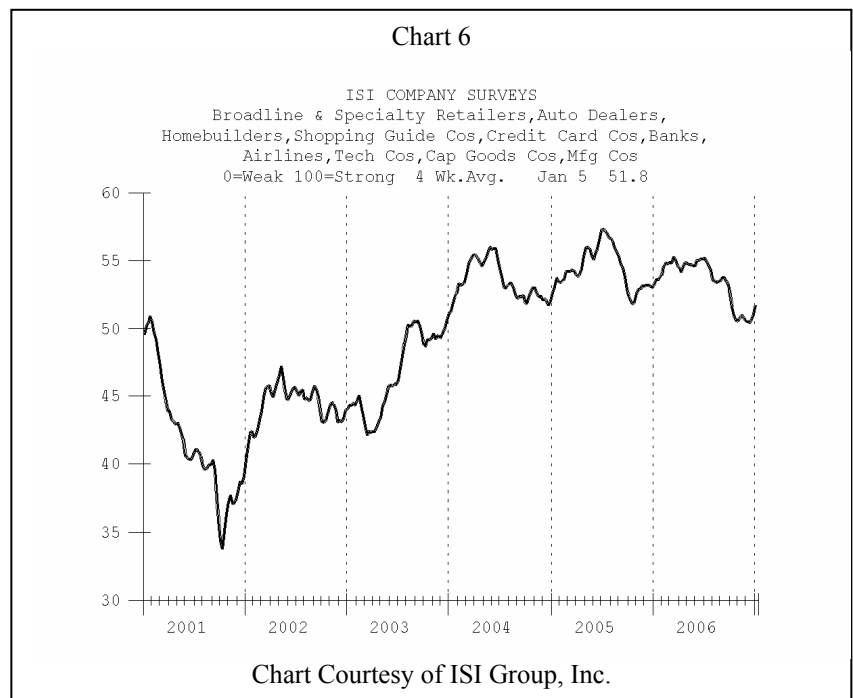


In 2006, market analysts and economists enjoyed telling the story of the Goldilocks economy that was not-too-hot and not-too-cold, but one which would grow at just the right pace (the “just-right” economy) to bring about a slowdown in inflation, and cuts in the Fed funds rate. However, according to Ed Hyman at ISI, the economy is expected to accelerate during the first quarter of 2007.

Given a tendency for the economy to accelerate in the first quarter of the year (as it has done for the last five years), Hyman has increased his first quarter 2007 gross domestic product (GDP) growth estimate from 2.5% to 3.0%. In his

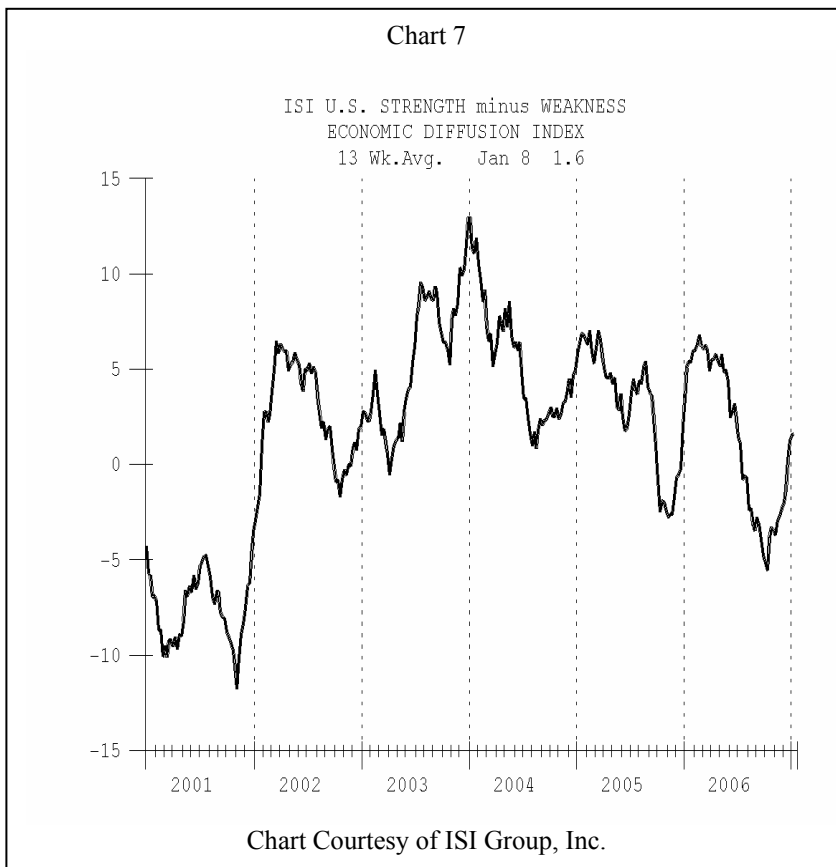
January 3, 2007 weekly economic update, Hyman wrote, “Our three favorite indicators are now pointing to stronger GDP. Unemployment claims have hooked down (see Chart 5). ISI’s company surveys have edged up (see Chart 6). And ISI’s economic diffusion index has turned up (see Chart 7).” Driving this acceleration is the recent rise in popularity of gift cards, which delays Christmas gift purchases until the recipient goes shopping, massive discounting by both retailers and automobile manufacturers, large December bonus checks and a much warmer than expected winter. Notably, Hyman is also raising his fourth-quarter 2006 GDP growth estimate from 2.0% to 2.5% on the back of strength in consumer spending, stronger vehicle sales and a reacceleration in the December Chicago Purchasing Managers Index to 51.4%. (A reading above 50% indicates economic expansion.)

We began to see a certain level of unexpected strength in the economy with the December jobs report, which showed upward revisions of 42,000 jobs in October and an increase of



132,000 in November. If anything, this strength gained momentum in December. The January jobs data reflected a total of 167,000 new jobs added in December, with an additional 22,000 jobs added to the November total. According to a January 6, 2007 *New York Times* article by Jeremy W. Peters entitled, Job Growth Is Strong, Surprising Economists, the strength in these employment figures has “dashed cold water on those who were expecting the Federal Reserve to lower interest rates anytime soon.” Indeed, last month Federal Reserve Chairman Ben Bernanke cited “tight” labor markets as a potential inflation threat and the minutes from the December Federal Open Market Committee (FOMC) meeting suggest the Fed is still concerned about inflation. Greg Ip, believed to be the voice of the Fed at the *Wall Street Journal*, wrote in a January 4, 2007 article entitled, Fed Worry Tests Rosy Outlook, that “inflation was

[the Fed’s] principle concern and that any decision on raising rates would depend on incoming data.”



Despite this concern, there has been evidence that inflation may be in retreat. According to a December 16, 2006 *Wall Street Journal* by Christopher Conkey entitled, Ebbing Inflation Gives Economy Breathing Room, “core” inflation measures closely monitored by Fed policymakers...are now 2.6% higher than a year ago, the lowest reading since June 2006. Further, a January 6-7, 2006 *Wall Street Journal* article by Rafael Gerena-Morales and Greg Ip entitled, Jobs Date Brighten Economic Picture, suggests that the Fed may be looking past the strength in the January jobs report as they still expect slowing economic growth to eventually reign in the acceleration in the labor market.

Given the expectation of a near-term “growth scare,” Tom Gallagher at ISI has pushed back his expectations of a Fed rate cut to the third quarter of 2007, a move that illustrates a problem facing equities. In order for stocks to continue their advance, investors need to expect a Fed rate cut. Before raising his growth forecast, Hyman wrote that “stocks don’t want strong earnings or a Goldilocks economy. The Fed will not ease if GDP growth is Goldilocks. Sub-potential growth is needed for the Fed to ease.”

Importantly, although Hyman raised his first quarter 2007 GDP estimate, he still anticipates an economic slowdown in 2007. Among the headwinds for the economy are falling leading indicators, the past 17 Fed rate hikes which take a year or two to be fully felt, MEW’s decline and a significantly inverted yield curve (a situation in which short-term interest rates are higher than long-term interest rates). In his December 26, 2006 *New York Times* article entitled, An Economy of Extremes, author Eduardo

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Porter argues, “the Fed must decide which risk is greater: that housing will drag down the rest of the economy, pushing the Fed to cut rates, or that inflation will remain above the Fed’s comfort zone, forcing it to push up rates instead.” Jan Hatzius, Chief United States Economist at Goldman Sachs, says she finds it “very hard to believe that what started in housing ends in housing. That you are not going to get any spillovers from a major recession in a sector that accounts for 6 percent of the economy.” In his December 2006 *PIMCO Cyclical Forum Update*, Paul McCulley shares similar sentiments. McCulley writes, “the latest data we reviewed confirms that the housing sector recession is every bit as nasty as we thought it would be.” Interestingly, McCulley believes that much of the pain from the housing recession is yet to be felt in the overall economy. “Indeed, if there has been one major surprise since our September Forum, it has been the strength of employment growth, pulling the employment rate below 4.5%. We believe part of the employment strength is simply due to the lagging nature of construction employment versus housing permits and starts. Builders have to complete their existing stock of housing starts before the job destruction associated with plummeting new housing permits, and housing starts, kicks in.”

### *Markets*

With the equity markets anticipating an economic slowdown, a first quarter growth scare is not a prescription for higher equity prices. Moreover, some surveys suggest that the sentiment of investment managers has reached a bullish extreme, a contrary indicator suggesting the potential for a market pullback. John P. Hussman Ph.D., President of Hussman Investment Trust, wrote in his December 26, 2006 letter to investors that, “The Russell Investment Group just published their quarterly money managers poll, which shows a fairly stunning 86% of advisors bullish for the coming year. That’s amazing given that this is already the second-longest span on record for which the market has not experienced even a 10% correction. The last time we saw this much bullishness was at the start of 2001, which preceded an awful 2-year period for stocks.” Hussman continued, “The ‘smart-money’ shows a distinctly different pattern. The latest figures from Vickers show heavy insider selling at 8.4 shares sold for every 1 share purchased. As Paul Macrae Montgomery asks, ‘We keep reading about how the share buy-backs, cash takeovers, and leveraged buyouts are proof positive that stock prices are a great ‘value’. Well if stock prices are such great values, why is it that all this buying is being done with ‘other peoples’ money,’ and why are the savvy insiders simultaneously selling their own stock?’” An interesting thought to ponder.

Paul Desmond of *Lowry’s Reports* gave a note of caution in his December 22, 2006 market update. Desmond wrote, “while the primary trend of the market remains healthy, our measurements of Supply and Demand have been showing that the internal condition of the market has been changing. Buying Power has dropped...showing that prices may have moved too far too fast. These signs of weakening demand and increasing profit taking suggest that investors should probably hold back on new buying temporarily in anticipation of a short-term correction in the days ahead.”

Recall in the December *Update* we wrote about the Marshallian K theory that suggests accelerating money growth in the face of declining GDP growth can be a powerful positive force for financial markets. Money growth as measured by MZM (money at zero maturity) has accelerated to almost 5.5% year-over-year in the U.S., but, importantly, the short-term forecast now calls for an acceleration in GDP growth. As a result, this acceleration in money supply may have less of an impact on financial market returns as the liquidity is absorbed by a growing economy.

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## *Conclusion*

The past three-and-three-quarter years seem to have instilled in investors the belief that the market can surmount any obstacle. Indeed, 2007 may yet yield fantastic returns for the market averages, but the near-term risks associated with that outlook are considerable. As Bill Gross wrote in PIMCO's *November Outlook*, we "agree with...economist Hyman Minsky that stability can in time be inherently destabilizing as overconfidence leads to lower and lower risk spreads, more and more financial leverage and an ultimate vulnerability to the economy and its financial markets on the downside. We have a collective sense that...instability – whether it be sparked by U.S. housing, global overinvestment, or geopolitical events – will one day temporarily resurface."

As we enter 2007, the market is focused on the Goldilocks theme that drove returns in 2006. Current market sentiment suggests that a not-too-hot and not-too-cold rate of economic growth has become a necessity for further market advances, and there are valid arguments that the fairy tale economic conditions may continue to be realized. Given the potential for a first quarter "growth scare," however, and the overly-bullish market sentiment, we have moved towards a market-neutral invested position. As seen in the direction of our year-end 2006 asset allocation shift, we believe the market will consolidate some gains before moving ahead. Partly propelled by bonus checks and gift card sales (which impact corporate earnings once redeemed), we expect to see an economic acceleration within this longer-term economic slowdown. That could result in rising interest rates, putting temporary downward pressure on the equity markets. Thereafter, assuming good economic conditions, stock prices may be poised to rise again. In the meantime, we're keeping a watchful eye on factors that give us cause for concern: the deflating housing bubble bleeding into the economy, continuing problems in the subprime mortgage sector, elevated levels of consumer debt, the trade deficit, the federal budget deficit and the falling U.S. Dollar.

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