



## **UPDATE**

January 2009

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*"Little by little, business is enlarged with easy money. With the exhaustless reservoir of the Government of the United States furnishing easy money, the sales increase, the businesses enlarge, more new enterprises are started, the spirit of optimism pervades the community... Bankers are not free from it. They are human. The members of the Federal Reserve board will not be free of it. They are human....Everyone is making money. Everyone is growing rich. It goes up and up, the margin between costs and sales continually growing smaller as a result of the operation of inevitable laws, until finally someone whose judgment was bad, someone whose capacity for business was small, breaks; and as he falls he hits the next brick in the row, and then another, and then another, and down comes the whole structure."<sup>1</sup>*

-Elihu Root, New York Senator 1909-1915

### ***Down the Mountain***

The Comrades Marathon is the oldest and largest ultramarathon in the world. Run in South Africa, the approximately 56-mile race is unique in that the route reverses each year. One year the runners will start in the seaport town of Durban and wind their way up through the mountains to Pietmaritzburg. The next year they reverse course, beginning in the mountains and running down to the sea. Uphill one year, downhill the next. While it would seem that running the uphill course would be more difficult, the downhill run has pitfalls of its own. Certainly the descent from the peak is faster than the climb up, but with that speed comes considerably less control. On the downhill run, momentum pulls the body forward forcing the runner's body to fight against the forces of inertia in an effort to maintain a stable pace and stride. This battle, waged over 56 miles, taxes the runner's muscles and joints. Towards the end of the race, fighting the inertia is all he can do as he tries to keep a stable pace, to maintain control. Sadly, due to the long-term structural damage inflicted on the body, many runners are ruined after running the downhill course.

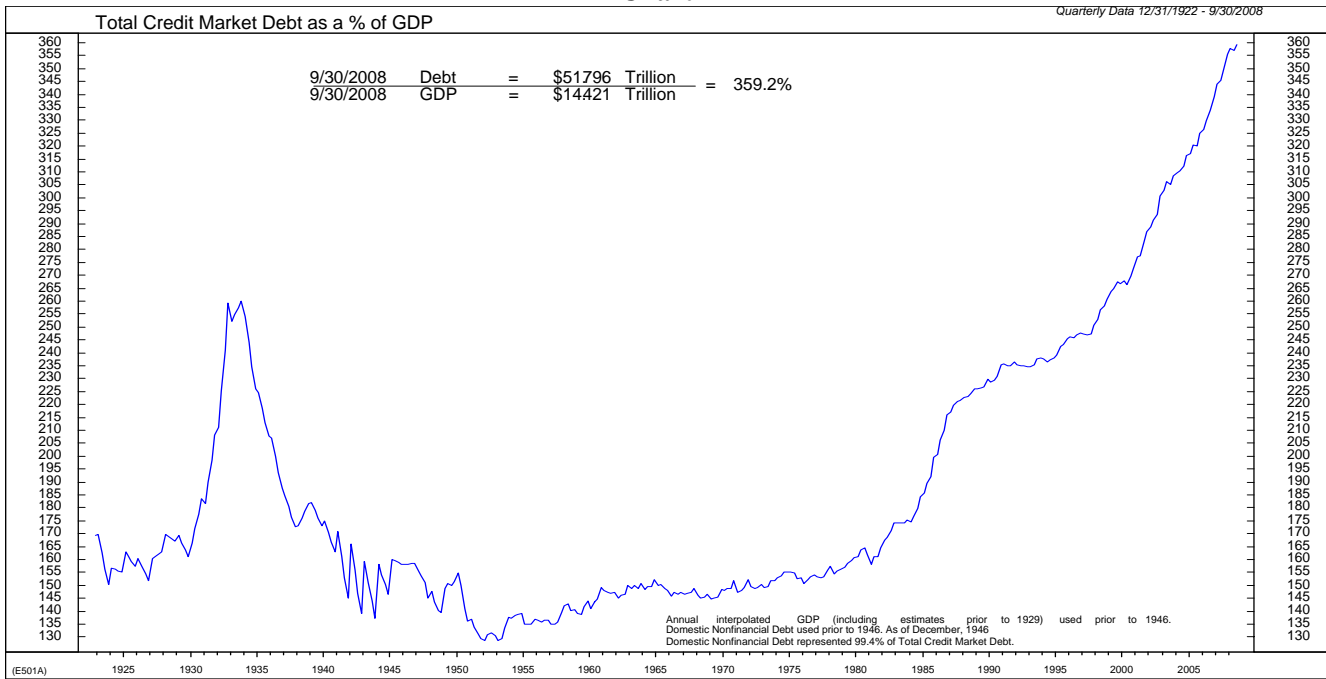
Like The Comrades Marathon, the U.S. economy enters 2009 tumbling downhill from a mountain of leverage that it spent 20 years ascending. (See Chart 1) This descent has destroyed asset values (real estate, housing and stocks) while, as always, the debt that was used to secure these assets remains steadfastly in place, leaving consumers with tattered balance sheets, negative home equity and stock margin calls. Meanwhile their lenders are left with escalating write-offs that have wiped out capital and ravaged the country's banking system.

In short, the borrowing binge is over. In its place awaits an era of balance sheet repair characterized by deleveraging and, believe it or not, saving! "With asset inflation no longer providing the Barbara Walters Backlight to flatter an otherwise grim financial position, households will begin to change

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<sup>1</sup> James Grant, "Is the Medicine Worse Than the Illness," *The Wall Street Journal*, December 20-21, 2008.

**Chart 1**

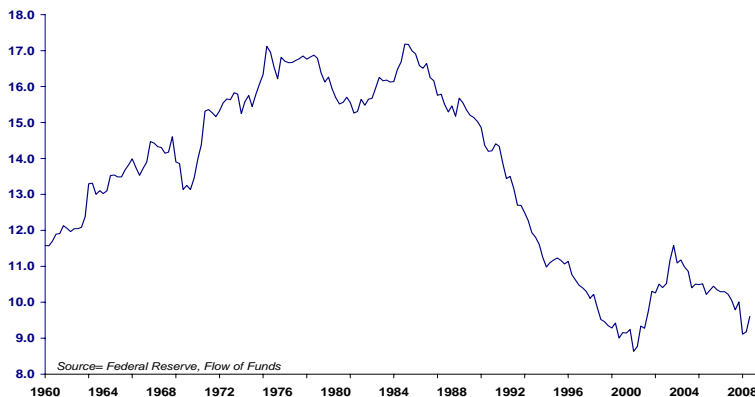


**Chart courtesy of Ned Davis Research, Inc.**

their behavior,” wrote Stephanie Pomboy of MacroMavens. “It will be a long and difficult journey if households mean to bring cash back to levels that existed before [Alan] Greenspan started blowing bubbles as chairman of the Fed in 1986.” (See Chart 2) Ironically, the more consumers save and the more balance sheet repair they undertake, the faster economic growth will fall. The momentum of deleveraging could wipe-out consumer spending which accounted for 70% of U.S. gross domestic product (GDP) growth in 2008, pushing the economy flat on its face. Standing in the way of these forces are monetary and fiscal policy. The effectiveness of the Federal Reserve, the Treasury Department, Congress and President-elect Barack Obama to craft policies that slow the pace of deleveraging will be a key determinant of economic prospects for 2009, and beyond.

**Chart 2**

**Cash as % Household Assets**



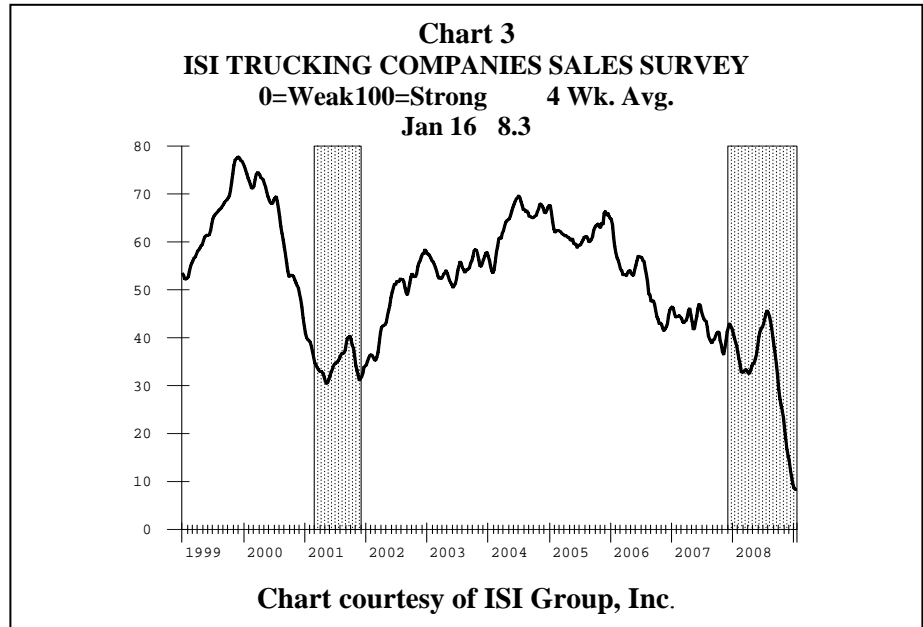
**Chart courtesy of MacroMavens**

***The Economy***

To be blunt, the current worldwide economic downturn is horrific. With credit markets in deep distress and the U.S. consumer retrenching, goods production has ground to a virtual halt. In December 2008, The Institute for Supply Management’s (ISM) index of manufacturing activity sank to 32.4, the lowest level since June 1980. New orders plunged to their worst level since the ISM started collecting

data back in 1948.<sup>2</sup> After selling cars at an anemic annual rate of 10.3 million units in December 2008 (down from the peak of 20.5 million in July of 2005), the auto makers, with lots that are awash with unsold vehicles, are pulling the plug on production. Chrysler has idled their manufacturing for an entire month, and automakers as a whole have scheduled a -60.0% quarter-over-quarter decline in vehicle production for the first quarter of 2009.

Homebuilders are faring no better. Flooded with a persistent glut of new and resale home inventory and hampered by ever-declining prices, builders slashed new housing starts to a mere 625,000 units on an annualized basis in November 2008, a -47.0% year-over-year decline. Reflective of these declines in our nation's output, ISI's trucking survey (which has the highest correlation with GDP) has plummeted. (See Chart 3) If nothing is being built, nothing needs to be shipped.



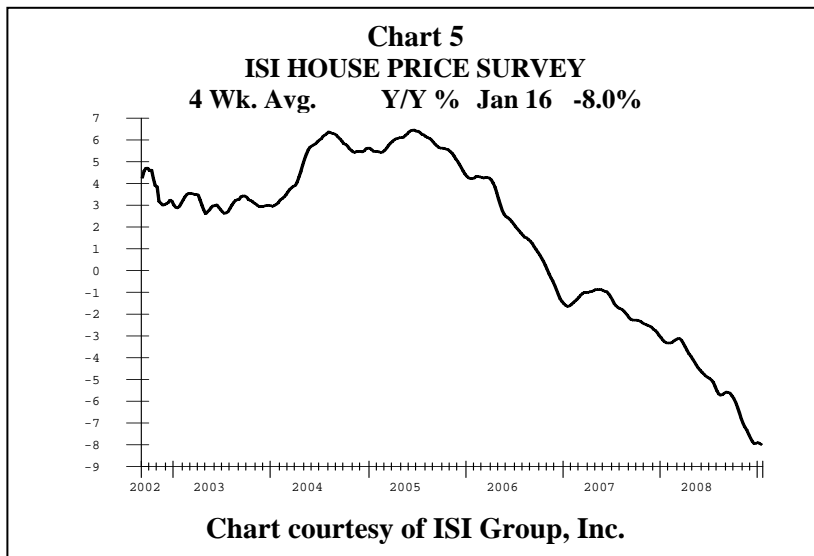
This downturn in demand for manufactured goods is forcing companies to lay off workers and shut down plants. Manufacturers around the world have already begun layoffs to conserve cash and reduce production, but many more layoffs are expected this year.<sup>3</sup> The U.S. lost 524,000 jobs in December 2008, sending the unemployment rate to a 16-year high of 7.2%. If we include the number of people working part-time, but seeking full-time work, the so-called total unemployment rate hit 13.5%<sup>4</sup>. It likely will not peak there.

<sup>2</sup> Alan Abelson, "A Plague of Prophecy," *Barron's*, January 5, 2009.

<sup>3</sup> Kelly Evans and Robert Guy Matthews, "Manufacturing Tumbles Globally," *The Wall Street Journal*, January 3-4, 2008.

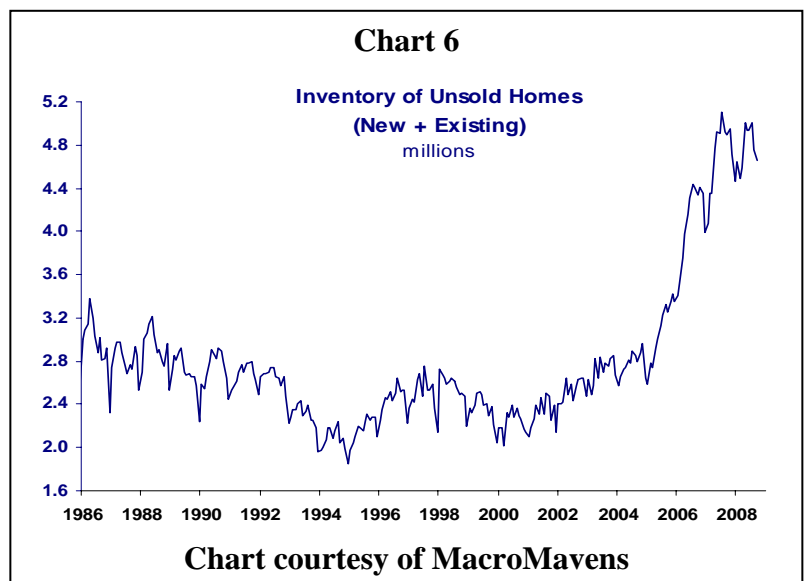
<sup>4</sup> Louis Uchitelle, "Broad Job Losses As Companies Face Sharp Downturn," *The New York Times*, January 10, 2009.

The spike in involuntary part-time workers suggests more cuts are coming. The ranks of these workers rose to 7.3 million in November 2008, up by 1.6 million since August. They now account for 5.1% of all those employed, the highest percentage since December 1993. “We have obviously seen a very rapid deterioration in the employment situation,” said Sophia Koropeckyj, an economist at Moody’s Economy.com. “There are fewer people working and the people who are working are working fewer hours.”<sup>5</sup> Already, ISI’s employment diffusion index (an index that weighs positives versus negatives) has fallen to 25.4%, its lowest level since 1977 (See Chart 4), suggesting the headline unemployment rate could hit 9.0%, and you can guess what that means for the total unemployment rate.



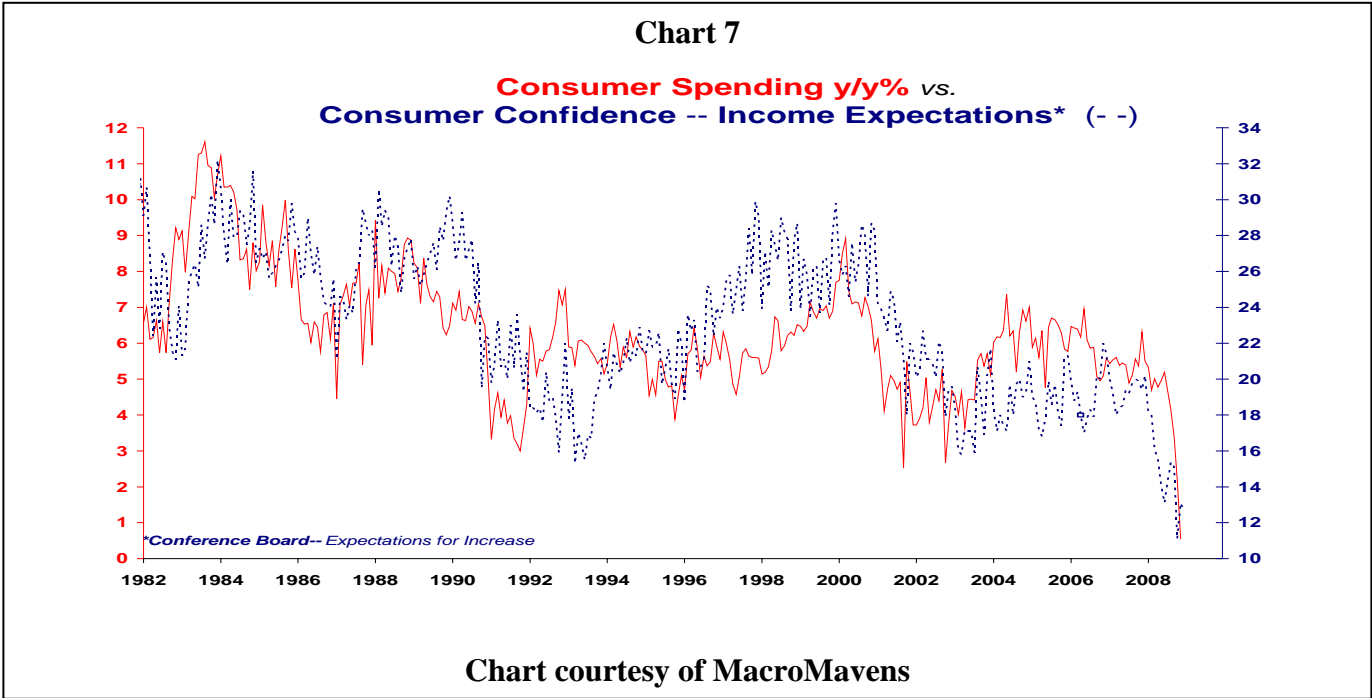
The deteriorating employment situation is only one spoke in the wheel rolling the consumer down the hill of deleveraging at ever greater speed. Thanks in large part to the destruction wrought by declining housing and equity markets, consumer net worth (CNW) in the U.S. fell -5.0% to \$56 trillion in the third quarter of 2008, down \$2.8 trillion quarter-over-quarter and -11.0%, or \$7 trillion, from its peak in 2007. CNW is forecast to decline -18.0% in the fourth quarter to \$45.9 trillion. The deleveraging is picking up speed.

According to the National Association of Realtors, the median sale price of an existing home fell -13.2% year-over-year in November 2008 to \$181,300. That is the largest drop in the four-decade history of the NAR survey and likely the sharpest decline since the Great Depression.<sup>6</sup> As we enter 2009, ISI’s house price survey is accelerating to the downside, falling to a new low of -8.1% year-over-year. (See Chart 5) At this accelerated pace of decline, house prices relative to incomes are projected to reach normalized levels by mid-2009, but that does not guarantee the price decline will stop. “On the bright side, the dramatic decline in home prices witnessed since the third quarter of [2008] suggests we’ve made considerable progress toward our ultimate destination – whatever that may be,” wrote Pomboy. “On the not so bright side, there’s still a ton of inventory to be unwound, Three years after the housing



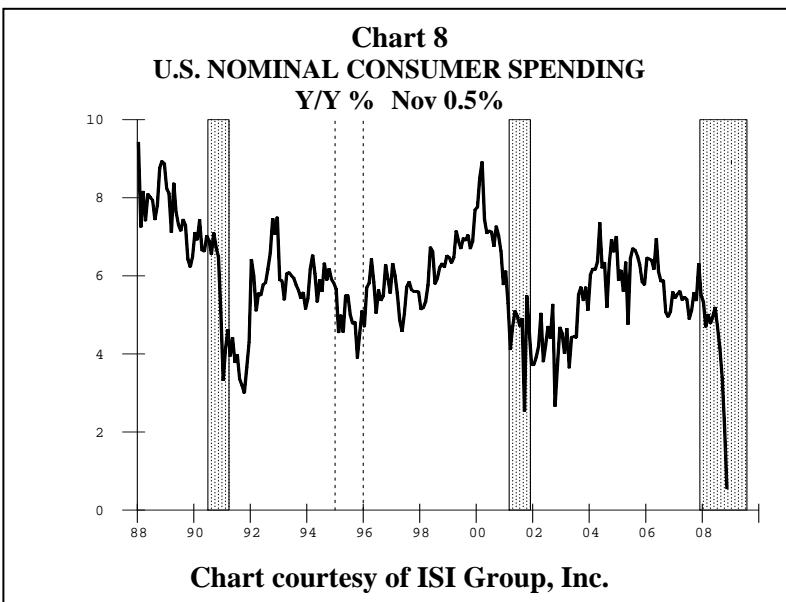
<sup>5</sup> Scott Stoddard, “Workers Giving Up And Part-Time Jobs Mask Labor Woes,” *Investors Business Daily*, December 30, 2008.  
<sup>6</sup> Sudeep Reddy, “Recession, Tight Credit Compound Housing Woes,” *The Wall Street Journal*, December 24, 2008.

market peaked, we're still carrying two million more units than normal, making the risk of an overshoot to the downside [on pricing] even more likely.” (See Chart 6)



Rising unemployment and falling home prices have consumers re-thinking their once-profligate spending habits. “Headlines bemoaning the rapid deterioration in the labor market have weighed so heavily on expectations for future income that even those with jobs are clinching their wallets shut,” wrote Pomboy. “Income expectations have never been more glum!” (See Chart 7) “And now that [housing and stock] assets can no longer be relied upon to provide an alternate source of funds, it is no

wonder consumers have concluded they must close the income-consumption void they allowed to explode lo these past 20 years,” she concluded.



Despite a flurry of last-minute shoppers lured by the deep discounts, retail sales (excluding autos) fell -2.5% year-over-year in November 2008, and were down -2.7% year-over-year in December 2008.<sup>7</sup> According to Ed Hyman of ISI Group Inc., nominal consumer spending is falling at an alarming annual rate of -10.0%, its fastest pace in 49 years. (See Chart 8)

<sup>7</sup> Ann Zimmerman, Jennifer Saranow and Miguel Bustillo, “Retail Sales Plummet,” *The Wall Street Journal*, December 26, 2008.

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If the consumer is no longer spending, what are they doing with the money they earn? New Fed data shows that U.S. households paid down debt for the first time since the central bank started collecting the information in 1952. The Fed's quarterly flow-of-funds report, the most comprehensive snapshot of the household sector available, showed that household debt contracted at a -0.8% rate, the first drop on record. While this is a positive longer-term trend, the higher savings rate means that consumers are spending less,<sup>8</sup> a relatively short-term negative for economic growth.

While a retrenching, savings-first consumer is a long-term positive, this retrenchment is dangerous for an economy so singularly reliant on consumption for its growth. "I feel very strongly that savings is one of the main keys to a healthy economy, and a lack of savings, since the late 1990s, is one of the main reasons we have gotten into such a secular mess," wrote Ned Davis of Ned Davis Research, Inc. "Yet, the paradox of savings is that while we need more savings, during the period until we get to a 'normal' saving rate, the economy will likely grow slowly, at best. I think the paradox of savings is going to be with us for a number of years. Economic growth will be slow as savings are rebuilt."

The spending outlook has turned so dour that consumers are no longer buying Lotto tickets. Across the country, many state lotteries are reporting hefty declines in sales of Lotto tickets. Over the past few months, sales have fallen more than -4.0% in Texas and nearly -10.0% in California. Lottery sales nationwide fell about \$215 million from July through September 2008, or nearly -2.0% year-over-year. In past recessions Lotto sales have been somewhat recession proof, but this year is different. "Now [consumers] are thinking, 'my retirement is gone, I might lose my job, I'd better start putting money away,'" said Jack Boehm, director of the Colorado Lottery. "That means fewer dollars for lottery tickets."<sup>9</sup>

Plunging lottery sales are hurting states' education budgets at a time when states are suffering from the worst budget crises in decades and are being forced to cut funding to cash-strapped cities. The cities in turn are slashing police, firefighters and other services. States typically reduce city aid during budget shortfalls, but localities will be hurt more during this recession because property taxes, the primary source of local government funds, have fallen dramatically with the housing market. The budget shortfall in California is so great that instead of cash, the state is considering issuing taxpayer refunds in the form of IOUs. We certainly wouldn't bank on those.

All tolled, states are facing \$30 billion in budget deficits for the current fiscal year according to the Fiscal Survey of States released by the National Governors Association and National Association of State Budget Officers.<sup>10</sup> In light of this shortfall, the nation's governors got in a growing line behind banks, insurers, brokerages and auto makers, urging Congress to pass an economic-stimulus package for states, warning that their now \$30 billion budget shortfall could rise to \$140 billion by mid-2010.<sup>11</sup>

The consumer retrenchment is also assaulting business profits, giving momentum to a self-fulfilling negative feedback loop. Lower profits lead to layoffs, which lead to less demand which leads to

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<sup>8</sup> Phil Izzo, Brenda Cronin and Sudeep Reddy, "Debt Shows First Drop As Slump Squeezes Consumers," *The Wall Street Journal*, December 12, 2008.

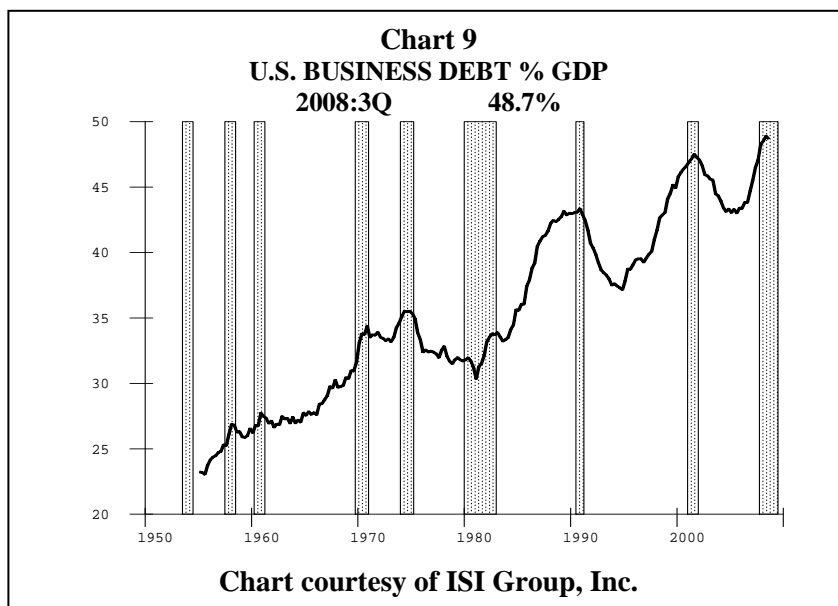
<sup>9</sup> Leslie Eaton, "State Lotteries Show Big Declines," *The Wall Street Journal*, December 26, 2008.

<sup>10</sup> Conor Dougherty and Amy Merrick, "States Squeeze Cities, Spreading the Economic Pain," *The Wall Street Journal*, December 18, 2008.

<sup>11</sup> Christopher Cooper and Brad Haynes, "States Paint Grim Picture, Ask for Help," *The Wall Street Journal*, December 2, 2008.

lower profits. “As [consumers] have shunned consumption and begun to save, corporate revenues have collapsed, cost cutting has intensified, layoffs have accelerated,” wrote Pomboy. “And, lo and behold, downbeat [consumer] income expectations have become reality.”

One area where this is particularly evident is in the continued escalation in credit losses for financial companies. Banks and savings institutions in the U.S. appear headed for their first overall quarterly loss since 1990, as troubled loans pile up faster than the federal government's unprecedented efforts to aid the battered industry.<sup>12</sup> In one such case, a major national bank, which has already received \$25 billion in capital from the Treasury Department’s Troubled Asset Relief Plan (TARP), is seeking billions more to shore up its balance sheet. With these mounting losses, regulators are struggling to restore confidence in the nation’s financial system, threatening to further devalue the assets held on the banks books. “It feels like a black hole,” said John McDonald, a banking analyst at Sanford C. Bernstein. “Investors are having a difficult time sizing the scope and magnitude of the credit losses in the banks’ balance sheets, and their earnings are under attack from a worsening economy.<sup>13</sup>” Meanwhile, policy makers are demanding more accountability before releasing additional funds.



The worst holiday spending season in decades has raised concerns that a rash of additional store closings and bankruptcies loom. “The fallout from the holiday season exacerbates the situation at the retail level and shopping center level,” said Howard Davidowitz, chairman of Davidowitz & Associates, a retail consulting firm. “It’s another nail in the coffin, leading to massive bankruptcies, store closings, problems in shopping centers and problems with suppliers.<sup>14</sup>”

According to the Small Business Administration, businesses with 500 or fewer employees accounted for 60-80% of the nation’s job creation over the past decade. But the dramatic pullback in consumer spending is threatening to push many strapped small businesses out of existence. In a recent survey from the National Federation of Independent Business, more than a quarter of small business owners said the current economic downturn is threatening their ability to survive.<sup>15</sup> It seems as if businesses of all sizes have not planned well for this downturn as they currently have more leverage than one would anticipate after so many years of prosperity. (See Chart 9) Perhaps all the debt-financed stock repurchases weren’t such a good idea after all!

<sup>12</sup> Robin Sidel, “Banks to Post a Rare Quarterly Loss,” *The Wall Street Journal*, December 30, 2008.

<sup>13</sup> Julie Creswell, “Bank of America May Get More Bailout Money,” *The New York Times*, January 15, 2009.

<sup>14</sup> Marilyn Much, “Holiday Retail Sales Worst In Decades; Many Store Closures, Bankruptcies Loom,” *Investor’s Business Daily*, December 31, 2008.

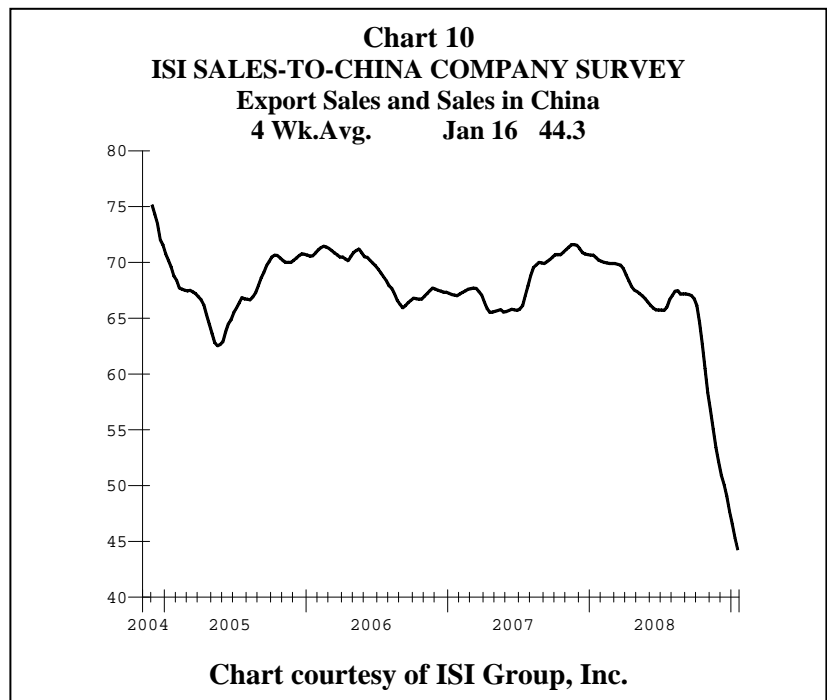
<sup>15</sup> Simona Covell, “Slump Batters Small Business, Threatening Owners’ Dreams,” *The Wall Street Journal*, December 26, 2008.

“The fundamental situation is dire and likely to deteriorate,” wrote Ed Hyman of ISI Group, Inc. “Going into the first quarter, negative feedback loops are in full force. State and local governments cutting back, layoffs, capacity cuts, pay freezes, etc. Fourth quarter GDP is a disaster for the U.S., the Eurozone and Japan. On average, real GDP [GDP adjusted for inflation/deflation] for these big three probably plunged at a stunning -6.2% quarter-over-quarter annual rate in the fourth quarter, the biggest decline on record by a wide margin. On average, nominal GDP [GDP including inflation/deflation] probably plunged at a -8.0% quarter-over-quarter annual rate in the fourth quarter. There’s really nothing in history to compare this to. This recession is likely to last at least another 6 months, perhaps another 12 months.”

### *Worldwide Economies*

The theory of economic decoupling (the idea that foreign economies were strong enough to withstand a downturn in the U.S. economy) has died. Just as the consumer is the main driver of the U.S. economy, the U.S. economy remains the most important determinant of worldwide economic growth. As such, we are now experiencing the first worldwide decline in economic growth in generations.

For China, this crisis has been a time of reckoning. Americans are buying fewer Chinese goods, collapsing trade and putting thousands of people out of work. In November 2008, Chinese exports registered their largest monthly drop in nearly a decade, falling -2.2%. China’s slowing trade will also be another sharp blow to global growth, suggesting that China will not be a savior to the global economy, taking up the slack from the slumping United States, Europe and Japan, as some had hoped. Indeed, when combined with further signs of a slowing economy in Japan, the picture of Asia, once the fastest-growing continent, becomes one of spreading economic gloom.<sup>16</sup> Reflecting this weakness, ISI’s company survey of China sales has fallen to 43.9 (See Chart 10), suggesting that China’s GDP could actually contract in the first quarter. This prospect has Chinese leaders terrified of social unrest as millions of people have migrated from farms to cities seeking manufacturing jobs that no longer exist.



For Russia, the economic downturn has proven that the more things change, the more they stay the same. After enjoying years of booming economic growth fueled by oil wealth, the Russian economy is faltering and the country’s oil-fired economic miracle is unraveling as the industrial base shrinks and job

<sup>16</sup> Andrew Jacobs and David Barboza, “China Surprised by Abrupt Drop In Exports and Foreign Investment,” *The New York Times*, December 11, 2008.

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losses mount. In November 2008, Russian industrial production fell -8.7% year-over-year. Russia is just beginning to feel the impact of the slowdown that economists say could take the economy from nearly 8% growth earlier this year to near recession in the next few months. As in China, the first stirring of social unrest has the Kremlin groping for a response. "They're incredibly scared of this," says Yevgeny Gontmakher, an economic adviser to the Kremlin. "They don't know how to operate in this environment." Perhaps they should think of something quickly for previous periods of low oil prices in the 1980s and 1990s contributed to the downfall of Mikhail Gorbachev and Boris Yeltsin.<sup>17</sup>

### *The Fed*

Given this economic backdrop it would be understandable if Federal Reserve Chairman Ben Bernanke politely resigned his post and returned to his tenured position at Princeton University. Understandable, yet regrettable, for we struggle to think of anyone more capable of tending to our nation's sick economy at this time of need. To be sure, the pathways out of our current economic mess are riddled with danger. Whichever road he chooses, Bernanke's actions are likely to have negative consequences. Undoubtedly, mistakes will be made. However, Bernanke's background and his execution to date give us confidence that he is the man for the job. (His position as Chairman expires on January 31, 2010.)

On December 16, 2008 the Federal Reserve entered a new era for U.S. monetary policy, lowering its benchmark interest rate to virtually zero and declaring that it would now fight the recession by pumping out vast amounts of money to businesses and consumers through an expanding array of new lending programs. The Fed bluntly announced that it would print as much money as necessary to revive the frozen credit markets and fight what is shaping up as the nation's worst economic downturn since World War II.<sup>18</sup> "The Federal Reserve will employ all available tools to promote the resumption of sustainable economic growth and to preserve price stability," the Fed said in a statement accompanying the dramatic move. It added that it expected interest rates to remain "exceptionally" low for some time.<sup>19</sup> "The message has to be to expect an aggressive Fed until a bottom is put in the economy," wrote Tom Gallagher of ISI. "The Fed has been the policymaker most committed to a full throttle approach to policy. It is likely to be joined by the Obama economic team in that trait."

Beyond lowering interest rates, the central bank said it could expand lending programs, including a plan to buy mortgage-backed securities. The Fed also said it was studying such rescue measures as purchasing U.S. Treasury securities, which could help reduce long-term borrowing rates.<sup>20</sup> In effect, the Fed is stepping in as a substitute for banks and other lenders and acting more like a bank itself. By such lending, the Fed has effectively concluded that if banks, encumbered by the weight of their faltering balance sheets, won't extend credit, it will do part of the job for them.<sup>21</sup>

The all-hands-on-deck response from the Fed is born out of the fear of deflation, or persistently falling prices. "The U.S. headline consumer price index (CPI) is already deflating at a faster pace than

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<sup>17</sup> Andrew Osborn and Alan Cullison, "Oil's Crash Stirs Unrest In Russia As Slump Hits Home," *The Wall Street Journal*, December 19, 2008.

<sup>18</sup> Edmund L. Andrews and Jackie Calmes, "In a Bold Action, Fed Cuts Key Rate to Virtually Zero," *The New York Times*, December 17, 2008.

<sup>19</sup> Jon Hilsenrath, "Fed Cuts Rates Near Zero to Battle Slump," *The Wall Street Journal*, December 17, 2008.

<sup>20</sup> Hilsenrath, December 17, 2008.

<sup>21</sup> Andrews and Calmes, December 17, 2008.

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even in the 1930s,” wrote Ed Hyman of ISI. “From autos to airlines, from hotels to steel, excess capacity is building. Capital spending is likely to be cut significantly around the world.”

Deflation is one of the worst diseases an economy can contract. As prices fall, consumers opt to put off purchases of goods that they believe will be cheaper tomorrow. Very few Americans alive today can remember a time when prices across the economy were falling as they are now. The cost of fruit, vegetables, clothing and vehicles are all dropping, housing prices have been falling for more than two years, and a barrel of oil costs about \$35 as of January 16, 2009, down from \$145 in July 2008. The drop in prices, which isn’t over yet, will make life easier for millions of people.<sup>22</sup> However, there is an ugly side to deflation as well. While these price declines help many consumers in the short run, in the long-run a bout of falling consumer prices could be dangerous, giving households even more incentive to slow spending and hoard cash.<sup>23</sup> “As the consumer’s grasp on hope for a brighter tomorrow [grows] increasingly tenuous, the impulse to save [will] grow more acute,” wrote Pomboy. “And before you know it the vicious circle of deflation would be spinning out of control.”

The Fed has announced or outlined a range of unorthodox new tools it is deploying to fight this deflationary threat. The recently-announced Term Asset Backed Securities Loan Facility (TALF) is one such example. “The TALF will effectively step around the risk averse commercial banking system and provide warehouse financing directly for securitization of new consumer and business loans to Main Street,” wrote Paul McCulley of *PIMCO Bonds*. “It’s a really cool innovation, which is likely to be expanded or replicated. And most important, it is likely to get reflationary traction. The Fed also stands ready to print \$600 billion of money to buy directly \$500 billion of Agency Mortgage Backed Securities (MBS) and \$100 billion of Agency debentures, so as to pull down and hold down long-term mortgage rates.<sup>24</sup>”

With these moves, the Fed is trying to drive down the spreads between U.S. Treasury yields and consumer and corporate loans, making it cheaper for households and businesses to borrow. Specifically, Chairman Bernanke sees the thawing of frozen credit markets as critical to a recovery and he is determined to try to prevent a second wave of credit distress as the U.S. weathers horrific economic news over the next two quarters.<sup>25</sup> “The operative phrase [is] ‘more than proportionate.’ That is indeed what is needed to save capitalism from its inherent debt-deflation pathologies,” wrote McCulley. “The paradox of deleveraging and the paradox of thrift are beasts of burden that capitalism simply can’t bear alone... It is indeed a fact, a glorious fact, in my view, that the Fed does presently stand ready to print as much money as necessary to accommodate the financing of an all-in reflationary fiscal policy thrust, as promised by President-elect Obama... Call it good, very good: the monetary and fiscal authorities, separately yet together, are going all in. And call me cautiously optimistic that Reflation will gain traction,<sup>26</sup>” he concluded.

There are signs that the Fed’s policy prescriptions are working. For starters, the three-month London Interbank Offer Rate (LIBOR) has fallen from its October 2008 peak of 4.81% to 1.08%. Additionally, the Fed’s mortgage backed security (MBS) purchases have helped push thirty-year

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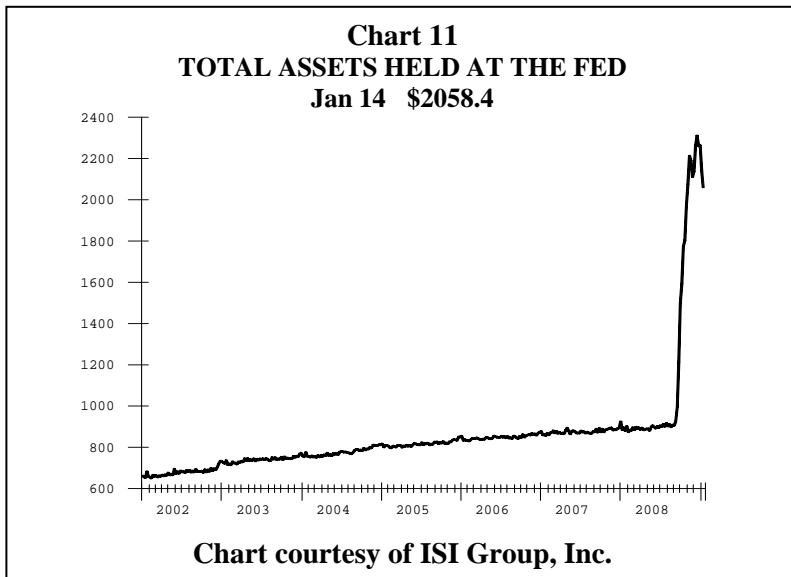
<sup>22</sup> David Leonhardt, “Finding Good News In Prices,” *The New York Times*, December 17, 2008.

<sup>23</sup> Hilsenrath, December 17, 2008.

<sup>24</sup> Paul McCulley, “Global Central Bank Focus,” *PIMCO Bonds*, December 2008/January 2009.

<sup>25</sup> Craig Torres, “Fed Focuses on Consumer, Corporate Rate Spreads Over Treasuries,” *Bloomberg News*, January 6, 2009.

<sup>26</sup> McCulley, December 2008/January 2009.



mortgage rates down to 5.1%. The decline in rates coupled with home price declines has resulted in near record high housing affordability. And in a sign that credit markets might be loosening up, corporations issued \$41 billion in debt during the week of January 5, 2008, the most in eight months. “With policymakers throwing everything they’ve got at this sucker, it stands to reason that investors would begin to anticipate that something will stick,” wrote Pomboy. “The Fed has chivalrously vowed to deploy its infinite balance sheet to rescue any Debts in Distress. With the private sector thus assured the ability to borrow, credit worthiness be damned, the risk of

default no longer exists.” Credit worthiness be damned? Isn’t that how we got into this mess in the first place?

However, as glorious as the Fed’s policy decisions may seem, they are not without risks. For starters, the Fed’s policy expansion has come via the leveraging of its own balance sheet with risky assets. (See Chart 11) Since early August 2007, the Fed’s balance sheet has grown from \$851 billion to \$2.245 trillion. In addition, it has drawn down its stockpile of safe Treasury securities from \$791 billion to \$476 billion to finance programs and lent out \$185 billion of Treasury securities to Wall Street firms in exchange for riskier securities. In all, the central bank has already committed about \$1.9 trillion to support the financial markets.<sup>27</sup> “The truth is that the Federal Reserve is itself a highly leveraged financial institution,” wrote Jim Grant, editor of *Grant’s Interest Rate Observer*. “The flagship branch of the 12-bank system, the Federal Reserve Bank of New York, shows assets of \$1.3 trillion and capital of just \$12.2 billion. Its leverage ratio, a mere 0.9%, is less than one-third of that prescribed for banks in the private sector... The mystery meat acquired from Bear Stearns and AIG foats to \$66.6 billion. A writedown of just 18.3% in the value of those risky portfolios would erase the New York Fed’s capital account... And what is the significance of this stunning rate of asset growth,” Grant asks. “Simply this: The Fed pays for its assets with freshly made dollars.<sup>28</sup>”

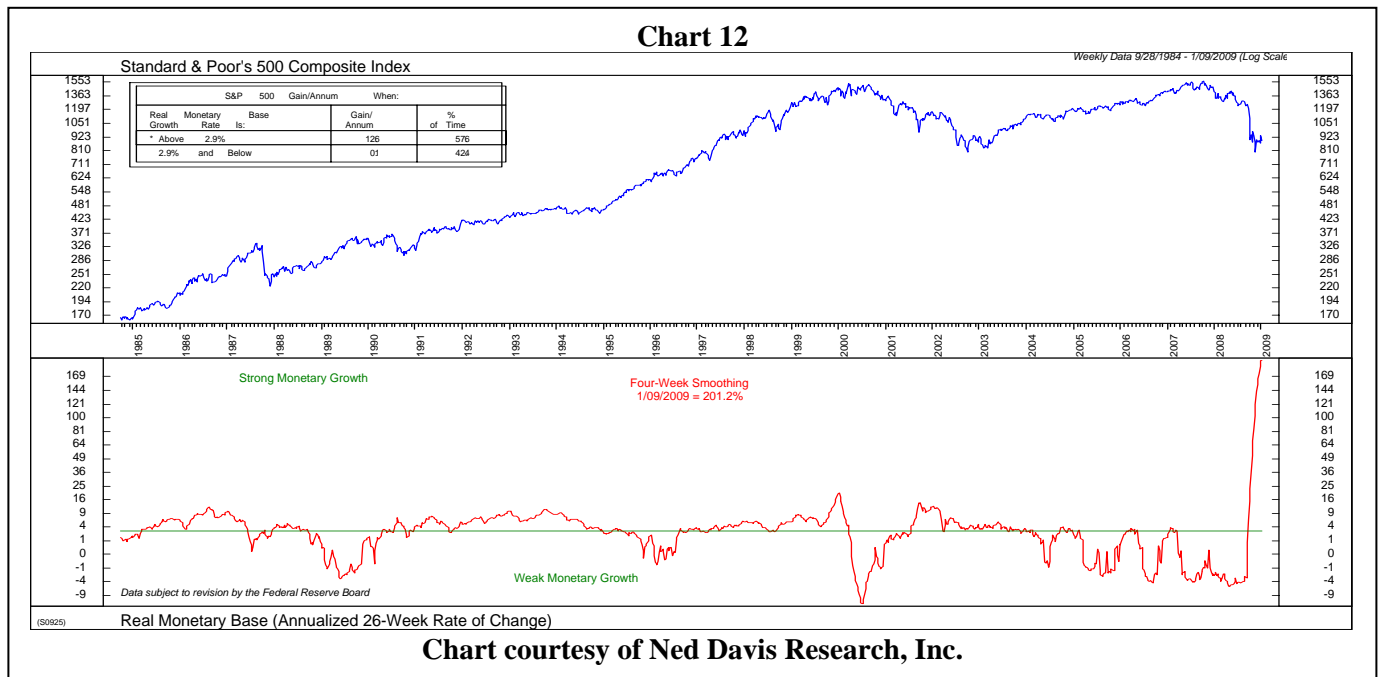
In fact, virtually the only area of growth for our economy is monetary growth stemming from the dollars with which the Fed is buying up toxic assets. “Over the past few weeks, M2 has surged almost \$120 billion,” wrote Ed Hyman on January 5, 2009. “Over the past 14 weeks, M2 has increased \$440 billion, or at a 12.6% annual rate. Similar increases have been associated with the end of recessions... Money declined in the 1930s and was anemic in Japan’s 1990s. Bernanke needs to make sure it’s different this time. So far, it is different. That’s certainly what Bernanke wants to see.”

“Three measures of money supply growth have exploded over the past 13 weeks,” wrote Ned Davis. “The monetary base is up 188.2% on a four-week smoothing basis! Are you kidding me? (See

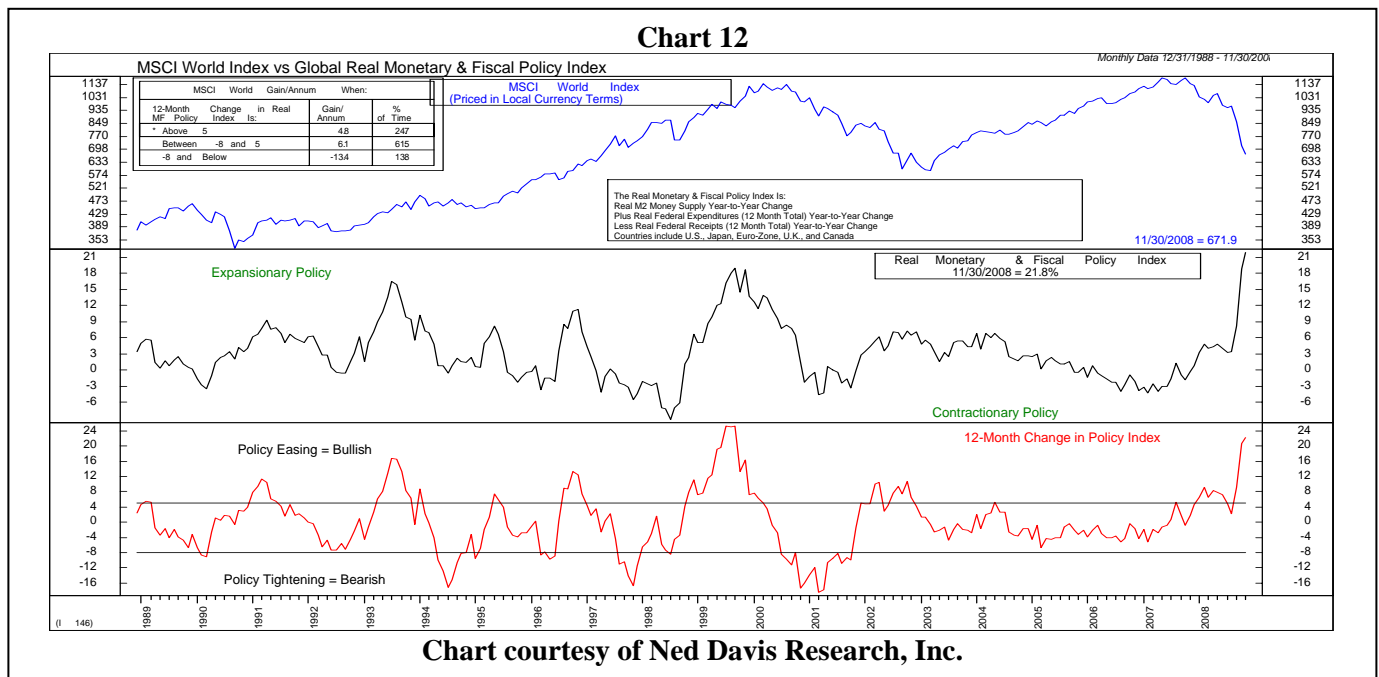
<sup>27</sup> Jon Hilsenrath, “The Big Numbers Behind the Bailouts,” *The Wall Street Journal*, December 13-14, 2008.

<sup>28</sup> James Grant, December 20-21, 2008.

Chart 12) It is not just stimulus from the U.S. Our Global Real Monetary and Fiscal Policy Index through



October [2008] is nearly a record high, and I believe it will show record stimulus with the November numbers.<sup>29</sup> (See Chart 12)



Indeed the Fed is not alone in its effort to stimulate economic growth. Virtually every country in the world is enacting some form of stimulus to revive their respective economies. During the week of January 5, 2009, six central banks cut interest rates, including The Bank of England who took their

<sup>29</sup> Ned Davis, "Institutional Hotline," *Ned Davis Research, Inc.*, December 30, 2008.

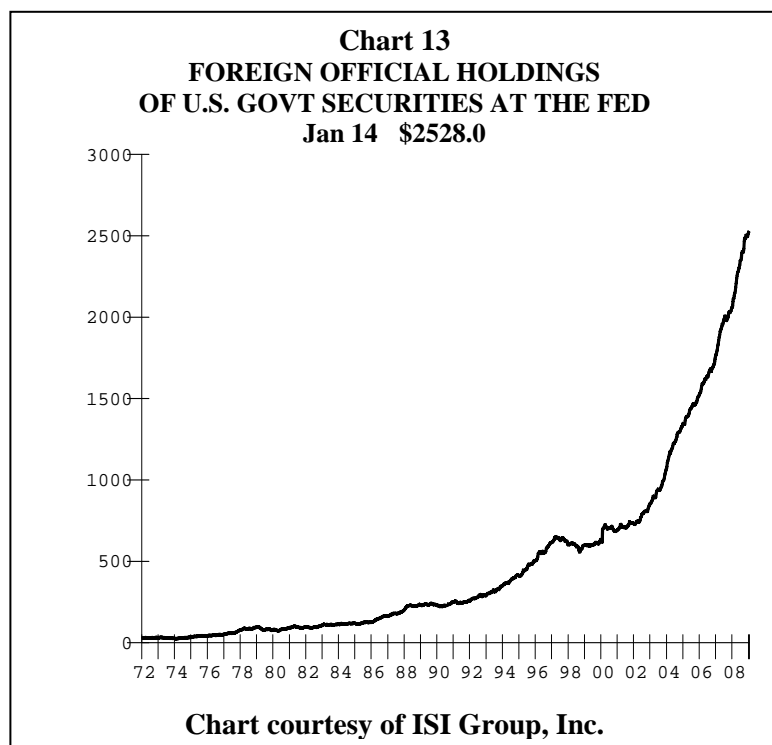
benchmark lending rate to 1.5%, the lowest since the bank's founding in 1664. Furthermore, fiscal stimulus packages are being implemented in Germany, Canada, China, India and Korea. J.P. Morgan estimates that worldwide fiscal stimulus through tax cuts and government spending could amount to 1.5% of global gross domestic product in 2009, or about a trillion dollars.<sup>30</sup>

For now the policy stimuli are a welcome aid to suffering economies, but the rapid growth in the money supply carries with it the risk of inflation. "At some point, and without knowing the timing, the Fed is going to have to destroy all that money it is creating," said Alan Blinder, a professor of economics at Princeton and a former vice chairman of the Federal Reserve. "Right now, the crisis is created by the huge demand by banks for hoarding cash. The Fed is providing cash, and the banks want to hoard it. When things start returning to normal, the banks will want to start lending it out. If that much money is left in the monetary base, it would be extremely inflationary."<sup>31</sup>

To be sure it sounds silly to worry about inflation when deleveraging and deflation are the concerns of the day. Even still, printing dollars with reckless abandon has negative consequences whether or not inflation becomes an issue. "We are acting as though there are no consequences to basically running the money off the printing press and handing it to the Federal government to backstop financial markets or bail out homeowners or what not," wrote Pomboy. "There is no consequence to doing this, unless or until the rest of the world says to us, 'We don't like this game' and 'We don't want to have all the dollar claims we are holding debased by [Fed Chairman Ben Bernanke] running his printing press.' We

are really abusing the privilege of dollar hegemony by printing all this money."

Put simply, this is an abuse we can't afford to continue. In the past decade, China has invested upward of \$1 trillion, mostly earnings from manufacturing exports, into American government bonds and government-backed mortgage debt. That has lowered interest rates and helped fuel a historic consumption binge and housing bubble in the United States. It is estimated that China now owns \$1 of every \$10 of America's public debt.<sup>32</sup> Now, however, the downturn in the global economy is curtailing China's appetite for our debt. Specifically, with economic problems of their own, China is keeping more of their trade surplus at home, using the money to help fund a \$600 billion economic stimulus program. "All the key drivers of China's Treasury purchases are



<sup>30</sup> Jon Hilsenrath, "Global Crisis Resists Central-Bank Moves," *The Wall Street Journal*, December 18, 2008.

<sup>31</sup> Andrews and Calmes, December 17, 2008.

<sup>32</sup> Mark Lander, "Chinese Savings Helped Inflate American Bubble," *The New York Times*, December 26, 2008.

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disappearing,” said Ben Simpfendorfer, an economist at Royal Bank of Scotland. There’s a waning appetite for dollars and a waning appetite for Treasuries, and that complicates the outlook for interest rates.<sup>33</sup>”

For the time being, investor flight to safety has stimulated demand for U.S. government debt, (See Chart 13) and with 10-year Treasuries yielding less than 2.2% the government’s cost of borrowing remains exceptionally low. The risk going forward is that future supply of government paper will overwhelm demand, pushing U.S. interest rates higher. This risk is exacerbated by President-elect Barack Obama’s projection of trillion-dollar deficits for years to come. At \$1 trillion, the deficit would not only shatter the largest previous deficit in dollar terms, but it would also exceed the post-World War II-era record as a percentage of GDP. Deficits this large force the government to borrow more money, saddling future generations with large financial burdens and leaving the nation reliant on foreign governments to lend it cash.<sup>34</sup> “Who will finance the Obama administration's looming titanic fiscal deficits?,” asks Jim Grant. “Who will finance America's annual surplus of consumption over production (after 25 more or less continuous years, almost a national trait)? Inflation is a kind of governmentally sanctioned white-collar crime. Every crime needs a dupe. Now that the Fed has announced its plan to deceive, where will it find its victims?”<sup>35</sup>”

### *Regulation*

There is little doubt that 2008 was a year to forget for market regulators in general and the Securities & Exchange Commission (SEC) specifically. Forget about the fact that the collateralized, leveraged lending machine that is largely responsible for our current woes was built and operated while regulators casually looked the other way, trusting Mr. Market to police the thugs. What is appalling and galling about our current regulatory regime is that when the stuff finally did hit the fan, regulators finally engaged, but with their targets locked on friendly forces. The fratricide that followed the SEC’s unprecedented ban on short sales of financial companies is, according to SEC Chairman Christopher Cox, regrettable. In a recent interview in *The Washington Post*, Cox said the biggest mistake of his tenure was agreeing to this ban on short sales. But in publicly acknowledging for the first time that this ban was not productive, Cox said he had been under intense pressure from Treasury Secretary Henry M. Paulson Jr. and Fed Chairman Ben S. Bernanke to take this action and did so reluctantly. They “were of the view that if we did not act and act at that instant, these financial institutions could fail as a result and there would be nothing left to save,” Cox said.<sup>36</sup>

If there was still any doubt as to the effectiveness of the SEC, the failure of the agency to detect or thoroughly investigate the Bernie Madoff Ponzi scheme has erased it. The SEC admitted it received credible allegations about the scheme at least nine years ago and it plans to immediately open an internal investigation to examine why it had failed to pursue them aggressively. “Our initial findings have been deeply troubling,” said Cox. “The commission received credible and specific allegations regarding Mr. Madoff’s financial wrongdoing, but did not respond aggressively. I am gravely concerned by the

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<sup>33</sup> Keith Bradsher, “China Losing Taste for Debt From the U.S.,” *The New York Times*, January 8, 2009.

<sup>34</sup> Jeff Zeleny and Edmund L. Andrews, “Obama Warns of Prospect for Trillion-Dollar Deficits,” *The New York Times*, January 7, 2009.

<sup>35</sup> James Grant, December 20-21, 2008.

<sup>36</sup> Amit R. Paley and David S. Hilzenrath, “SEC Chief Defends His Restraint,” *The Washington Post*, December 24, 2008.

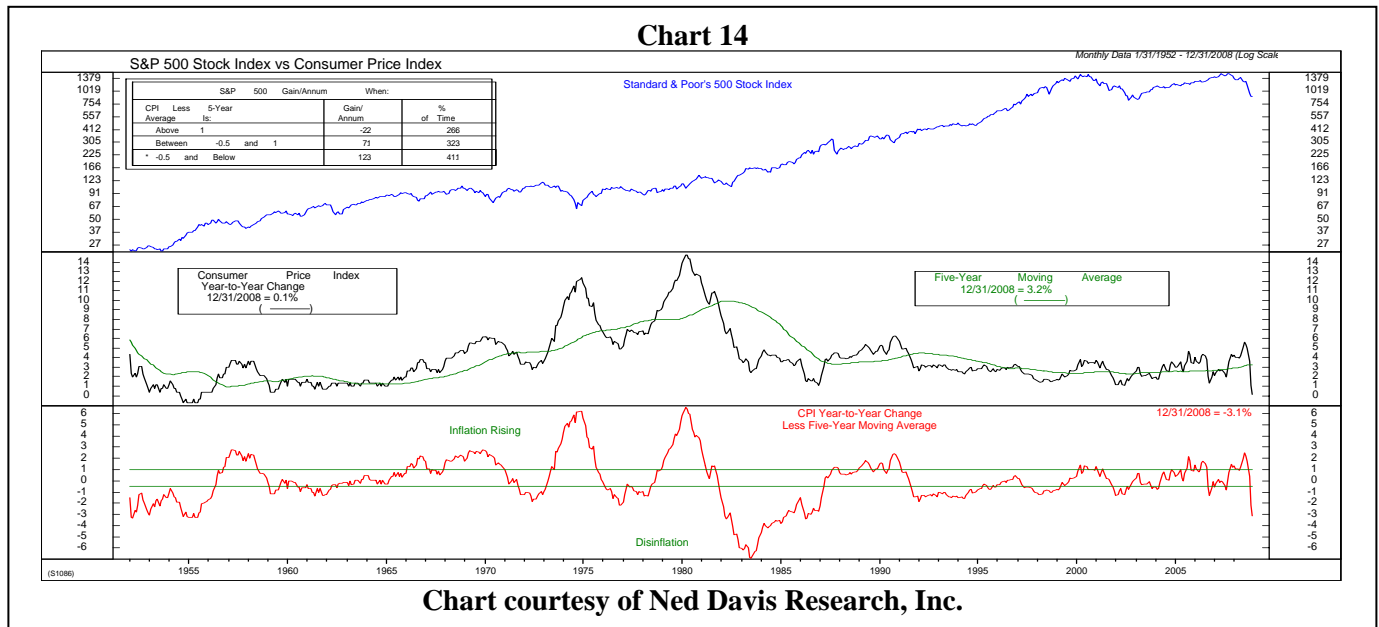
apparent multiple failures over at least a decade to thoroughly investigate these allegations or at any point to seek formal authority to pursue them.<sup>37</sup>

Thankfully, Chairman Cox’s term at the SEC is about to expire. What is left to question is, given the agency’s apparent dereliction of duty, whether there is a place for the SEC in the market’s current regulatory structure. “One of the great social benefits of the Madoff scandal may be to finally reveal the SEC for what it has become,” wrote David Einhorn, manager of Greenlight Capital and author of *Fooling Some of the People All of the Time* and Michael Lewis, author of *Liar’s Poker*. “Created to protect investors from financial predators, the commission has somehow evolved into a mechanism for protecting financial predators with political clout from investors. The task it has performed most diligently during this crisis has been to question, intimidate and impose rules on short-sellers — the only market players who have a financial incentive to expose fraud and abuse.”<sup>38</sup>

### The Market

As we evaluate the market outlook we see a mixture of bullish and bearish factors. In the short-term, the impact of monetary and fiscal policy is providing a bullish backdrop for equities. With 0% interest rates, the Fed has trashed cash, forcing investors to take on risk which has helped bring junk-bond yields down from their crisis peaks. As we noted, the Fed’s printing press has resulted in dramatic money supply growth. With economic growth collapsing, Marshallian K theory (which holds that when the money supply is growing faster than economic growth, money will first flow into liquid financial assets) suggests that this money supply growth is bullish for financial assets. However, the intense deleveraging of our nation’s balance sheet is giving this massive stimulus a major battle.

Currently, the lack of inflation is also a bullish factor for the market. “Inflation is now in its most bullish zone for the stock market,” wrote Ned Davis. (See Chart 14) “I think this improvement in



<sup>37</sup> Alex Berenson and Diana B. Henriques, “SEC Issues Mea Culpa on Madoff,” *The New York Times*, December 17, 2008.

<sup>38</sup> Michael Lewis and David Einhorn, “The End of the Financial World as We Know It,” *The New York Times*, January 4, 2009.

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inflation...is a critical first step in starting to repair battered consumers. The longer-term picture is very questionable, but hopefully this supports at least a good trading rally.<sup>39</sup>”

A trading rally is, we think, the best we can hope for out of this market. “The economic deleveraging has barely begun,” wrote Pomboy. “U.S. consumers are actually going to do the unthinkable -- they are going to save -- and we will be more like Japan than anyone believes is possible.”

Adding to that happy deflationary thought is the continued negative trend of market demand as tracked by Lowry’s Reports. “The primary trend of the market at the end of 2008 continues to call for a skeptical approach toward equities,” wrote Paul Desmond of Lowry’s. “Our principal measurement of investor Demand, the Buying Power Index, has been in a well-defined downtrend pattern since mid-July’07, when the broad list of NYSE stocks reached their bull market top. During those 17 ½ months, there have been a number of rally attempts, including the recent recovery from the mid-November low. Thus far, none of them have attracted enough buying interest to cause the Buying Power Index to break out of its downtrend pattern. The lack of broad investor demand on the most recent rally attempt suggests that prices may not have dropped low enough in mid-November to fuel a sustained market advance.”

Given the deleveraging we must undergo, we wonder when investor demand will again be sufficient to drive the markets sustainably higher. The debt our economy has amassed over the last 20 years is simply too great to work through in a few years time. To be sure, we have only just begun our descent down the mountain from our leverage peak. Fiscal and monetary policy, while necessary and positive, can’t magically take us to our destination by the seaport of savings. All they can do is attempt to control the pace at which we get there.

With this as the investment backdrop, we continue to anticipate a secular bear market, punctuated by periodic cyclical rallies.

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The portfolios managed by Caldwell & Orkin may or may not have positions in any of the companies referenced herein as of January 16, 2009.

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<sup>39</sup> Ned Davis, “Institutional Hotline,” *Ned Davis Research, Inc.*, December 26, 2008.