



UPDATE

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CALDWELL & ORKIN®

Rent or Buy

Wait a second! Headlines can be deceiving, so please hear us out. You may think we're writing another *Update* on the housing market, but we guarantee we will not once mention the "H" word in this piece. Cross our hearts and all that.

This month we pick-up on a topic we touched upon in our January *Update*, the potential for economic growth re-acceleration. Recall that there has been a tendency in recent years for both gross domestic product (GDP) and inflation to experience an up-tick in the first few months of the calendar year due to, among other factors, the new found popularity of gift cards, increases in bonus payments and unseasonably warm weather. It appears the first quarter of 2007 will be no exception: Christmas gift card purchases were 50% higher in the fourth quarter of 2006 than in the same period in 2005; bonus payments set a new record; and temperatures reached all-time highs.

The truly surprising news, however, is the consumer-spending-led acceleration in GDP. Fourth quarter 2006 GDP came in at 3.5% (annualized), up from 2.0% in the third quarter. Not only was this growth higher than the consensus estimates of economists, but it was also accompanied by decelerating inflationary pressures. In the fourth quarter, the core (excluding food and energy) GDP Personal Consumption Price Index (PCE) rose at an annual rate of 2.1%, down from 2.2% in the third quarter. Indeed, on Wednesday January 31, 2007, the Federal Reserve's Federal Open Market Committee voted to hold the Fed funds rate steady at 5.25%. Justifying their decision to take no action, the Committee said they saw signs of "firmer economic growth" coupled with "readings on core inflation [that] have improved modestly in recent months." Accelerating growth and falling inflation...Goldilocks defined!

This outlook, as always, is not without risks. For starters, declining energy prices played a large role in the recent drop in inflation readings and gave consumers more cash for discretionary spending. In a January 12, 2007 *Wall Street Journal* article entitled, [Rapid Plunge In Price of Oil May Fuel Growth](#), authors Mark Whitehouse, Ann Davis and Bhushan Bahree wrote, "lower oil prices could lead to increased consumer spending. That spending could provide a welcome cushion for the U.S. economy, which is grappling with a sharp downturn in [construction]." (We almost said the "H" word, but we didn't.)

The risk then lies in energy prices. There has been debate recently about what drove energy prices lower. Conspiracy theories hold that Saudi Arabia, the largest oil producer in the world and controlling member of OPEC, is in favor of lower oil prices as a method to counter the growing influence of their rival Arab neighbor, Iran. While this theory is intellectually stimulating, it is more likely that prices have weakened primarily because of weakening demand precipitated by slowing worldwide economic growth and unseasonably warm weather. Now that we have seen the extent which growth accelerated in the

fourth quarter, and with the El Nino weather phenomenon giving way to much colder temperatures in the U.S., it seems likely that oil prices are headed higher.

Also, ISI Group, Inc. forecasts that disposable personal income (DPI) increased 0.5% month-over-month in December and 6.0% quarter-over-quarter in 4Q. In other words, now that we're five years into this economic expansion, consumers are starting to see real income gains. These gains, taken in concert with the aforementioned factors that have been attributed to recent first quarter growth accelerations, argue that GDP growth may be strong in the first quarter of 2007.

The question going forward is, "do we rent or buy this re-acceleration?" To rent, one must believe that this will be a self-correcting "growth scare" in the middle of an economic cycle, while a buyer must believe growth will continue to accelerate. Counter-intuitively, a self-correcting growth scare would eventually be bullish for equity markets as it would allow the Fed to continue its migration towards a dovish (prone to ease or lower interest rates) outlook. To be a buyer of this re-acceleration is to take a more bearish stance, for, if economic growth gathers steam, the economy could risk leaving Goldilocks territory and the current neutral Fed outlook that is crucial for the market's advance could turn hawkish.

For the time being we are renters - we believe this growth scare will be self-correcting. Aside from concerns for a "too-hot" economy, all seems to be well in early 2007. But, then again, there is the unresolved issue surrounding hou....

Stay tuned.

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