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## UPDATE

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*“It’s sort of a little poetic justice, in that the people that brewed this toxic Kool-Aid found themselves drinking a lot of it in the end.”<sup>1</sup>*

- Warren Buffett

*“Especially do highly leveraged economies require Federal Reserve money printing and congressional check writing during a presidential election year.”<sup>2</sup>*

- Jim Grant, editor of Grant’s Interest Rate Observer

### Atlas Hugged

Don’t tread on me. That is the mantra during good times. But isn’t it amusing that the potential for a deep, ugly, consumer-led recession has turned heretofore free market capitalist financial leaders into champions of big government, supporting publicly-funded measures to keep the housing market from sinking the economy and, more importantly, sinking their businesses? Let’s not forget, however, that when signs of this housing market bubble, one of the greatest bubbles in history, were abundant, these leaders played dumb, denying the existence of market excess and shunning government regulation. Now that Frankenstein has turned on his masters, they hold out their hands in hopes the government can help. “Hey Mr. Bernanke, can you spare a few hundred billion?”

If it’s the government’s call to protect individuals from the excesses of capitalism, it can safely be said that this government is answering. For evidence, we offer a remarkable listing of government-led financial stimuli / intervention proposals to “save” our economy from potential recession. To date, the Federal Reserve, led by Chairman Ben Bernanke has cut the discount rate -275 basis points from 6.25% to 3.5%, cut the Fed funds rate -225 basis points from 5.25% to 3.0%, coordinated unprecedented liquidity injections with the Bank of England (BoE) and the European Central Bank (ECB), and installed a new term auction facility (TAF) in which the Fed will accept almost any assets as collateral for short-term loans in an effort to heal the asset-backed commercial paper (ABCP) market. At the Treasury Department, Secretary Hank Paulson is sprinting to keep pace with the Fed Chairman. Thus far he has proposed a super-SIV plan to rescue troubled off-balance sheet bank investments, an interest rate freeze on subprime loans, and the Hope Now Alliance aimed at keeping subprime homeowners from foreclosure. He has also led a coalition to convince a previously partisan Congress to approve an increase in FHA loan limits, a \$150 billion tax rebate, a faster depreciation of proposed investments, a raising of conforming loan limits for the GSEs, and a rescue of bond insurers.

No doubt that there is cause for the government’s action. In the fourth quarter of 2007, gross domestic product (GDP) growth slowed to 0.6% year-over-year from 4.9% in the third quarter. In January, 17,000 jobs were lost, the first such decline in more than four years, with the broad-based declines painting the clearest picture yet of a nation headed toward recession.<sup>3</sup> Indeed, the consensus call amongst economists and business leaders now is for a recession. Goldilocks, R.I.P. “We already have a depression in the housing industry and a recession in the auto

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<sup>1</sup> Warren Buffett, “Warren Buffett: What Credit Crisis?,” *The New York Times*, February 8, 2008.

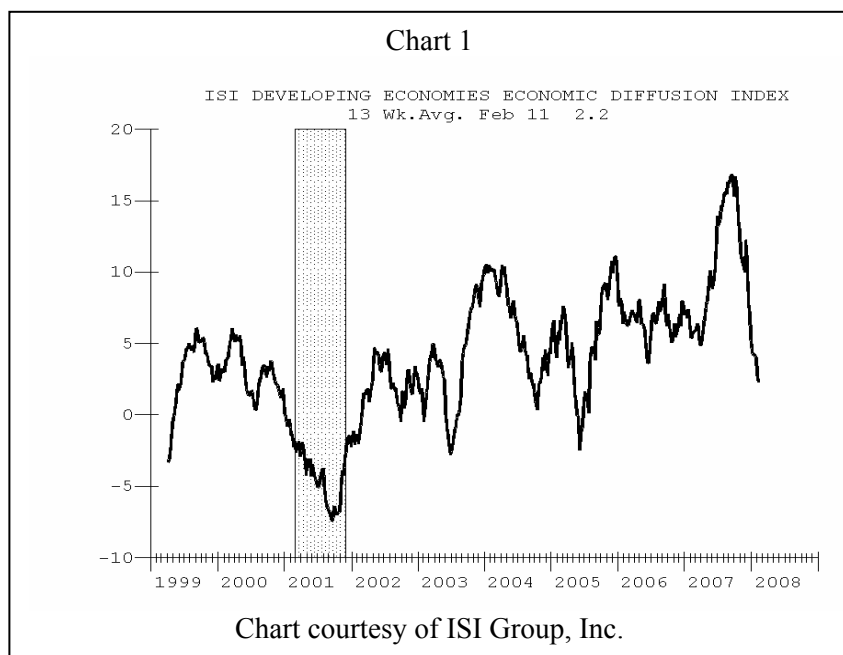
<sup>2</sup> Jim Grant, *Grant’s Interest Rate Observer*, January 25, 2008.

<sup>3</sup> Kelly Evans, “Jobs Data Add Fuel to Recession Fears,” *The Wall Street Journal*, February 2-3, 2008.

industry,” said Michael J. Jackson, chairman and chief executive of AutoNation Inc. He added, “We’ll see if it spills over into a full recession, but the economy is very vulnerable right now.”<sup>4</sup>

As the economy slows, evidence mounts that the lack of lending standards that proved toxic for the mortgage market were also present in the markets for auto loans and commercial real-estate. “The problem of lax loan underwriting standards was not just concentrated in the mortgage sector; it’s looking like it took place across the consumer-finance sector, from credit card loans to auto loans to motorcycle loans,” said William Ryan, consumer finance analyst at Portales Partners.<sup>5</sup> The latest data shows that 2.06% of prime auto loans made in 2006-07 were more than 30 days past due in November 2007. This number exceeds the historical high rate recorded in 2001, and it is well up from 1.75% in 2005.<sup>6</sup> “The problems in the credit market are spreading, they are spreading to the consumer sector,” said John Thain, chief executive officer of Merrill Lynch. “We are likely to see another wave of problems on the consumer credit side,” he said.<sup>7</sup>

Since 1997, consumer debt has risen 7.5% per year, on average, an increase from the previous 10-year average annual rate of 4.2%. “Going forward, we’re not going to see this credit-driven growth,” says Alistair Milne, a professor and banking expert at City University in London. “Banks are saying, ‘we have to be more careful here.’”<sup>8</sup> Indeed, after staying low for years as investors used their home equity to pay down revolving debt, credit card delinquencies have begun to rise and banks are pulling in the reins, cutting credit availability and adding another risk to a consumer spending slowdown.<sup>9</sup>



The acuteness of the pain the consumer is now enduring has laid to rest any argument that developing economies have decoupled with the United States (see Chart 1). Evidence mounts that developing economies are slowing as the spent-up, lent-up U.S. consumer pulls back. “The U.S. consumer is, by far, the biggest consumer in the world. Americans spent over \$9.5 trillion last year, whereas the Chinese consumer spent around \$1 trillion and Indian consumers another \$650 billion,” wrote Stephen Roach, chief Asian economist at Morgan Stanley. “The bottom line for the global economy: When the U.S. sneezes, the rest of the world can still catch a cold. It makes no sense to preach the gospel of decoupling in an era of globalization.”<sup>10</sup>

<sup>4</sup> Neal E. Boudette, “Auto-Sales Angst Reaches the High End,” *The Wall Street Journal*, January 15, 2008.

<sup>5</sup> Peter Eavis, “Lax Lending Standards Could End Up Fueling Sudden Acceleration in Auto-Loan Delinquencies,” *The Wall Street Journal*, January 16, 2008.

<sup>6</sup> Peter Eavis, “Lac Lending Standards Could End Up Fueling Sudden Acceleration in Auto-Loan Delinquencies,” *The Wall Street Journal*, January 16, 2008.

<sup>7</sup> Adrian Cox and Simon Kennedy, “Bankers at Davos See Recession, Companies Yet to Feel Slump,” *Bloomberg News*, January 28, 2008.

<sup>8</sup> Roben Farzad, Benjamin Levisohn and Ben Steverman, “What Could Cage the Bear,” *Business Week*, February 4, 2008.

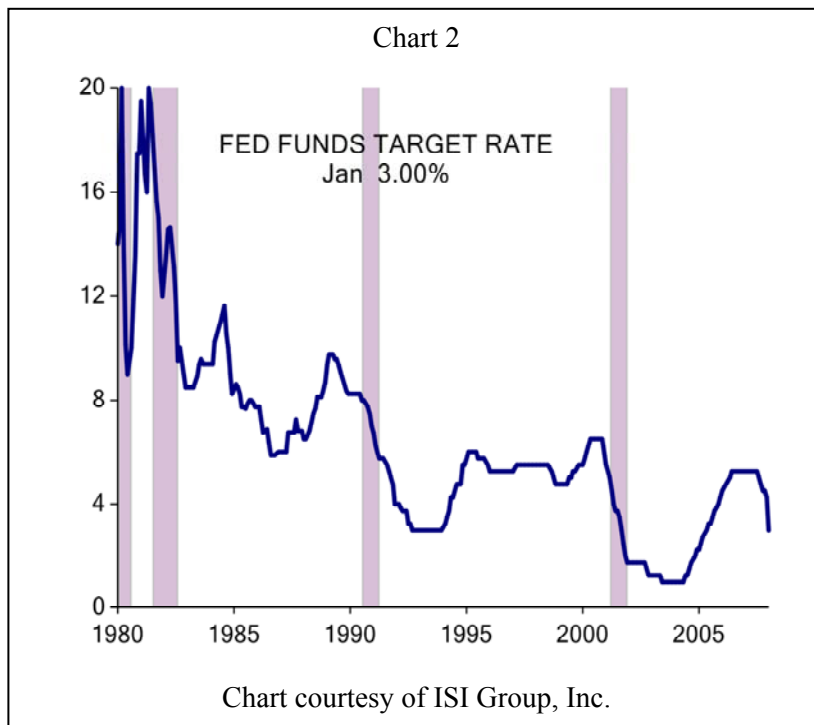
<sup>9</sup> Robin Sidel, Sudeep Reddy and Jane J. Kim, “Credit-Card Pinch Leads To Pullback In Spending,” *The Wall Street Journal*, February 8, 2008.

<sup>10</sup> Stephen Roach, “Coping With A Different Recession,” *Morgan Stanley*, January 17, 2008

To be sure, we have been expecting a consumer-led economic slowdown for some time. The new, perhaps more important development is the fact that the U.S. economy is beginning to show signs of healing. Amazingly, despite the combined pressures of a depressed housing market, the credit crunch and the consumer spending retrenchment, the economy still has a pulse. Perhaps a weak pulse, but a pulse nonetheless. “The probability remains that what our economy faces is less a plunge into the dark ages than a cyclical purging of excesses... akin to the eight-month recession in 2001,” wrote Steven Rattner of Quadrangle Group.<sup>11</sup>

The all-out assault the government is waging against this slowdown (a real shock and awe campaign of moral hazard) is beginning to have an impact. Thirty-year mortgage rates have declined from a peak of 6.42% in June 2007 to 5.49% in February 2008. In 2007, the London Interbank Offer Rate (Libor) remained stubbornly high as banks, suspicious of each other’s creditworthiness, refused to lend to each other. That began to change with the introduction of the TAF. In December 2007, the three-month Libor rate was 5.15%, or 90 basis points above the Fed funds rate. In February 2008, the three-month Libor rate had fallen 200 basis points to 3.15%, only 15 basis points above Fed funds. The significance of this decline should not be underestimated as Libor is used as a benchmark for many adjustable rate mortgages (ARMs). According to Randall Forsyth of *Barron’s*, “a homeowner with a \$200,000 adjustable rate mortgage, with an initial rate of 8% and a starting monthly payment of \$1,468 last August, was looking at a 24% increase to \$1,817 for a loan at Libor plus 600 basis points. Now the increase will be to \$1,639. If Libor were to drop to 2.25%, the payment would be \$1,501, just about the same monthly as the borrower had initially.”

In the opinion of many observers, the Fed should have been much quicker in lowering the Fed funds rate, given the stresses in the credit markets. According to Ed Hyman at ISI Group, Inc., however, compared to the last two recessions, the Fed has been “early” and aggressive with their rate reductions. Hyman argues that in the past two business cycle downturns, by the time the fed funds rate was cut -225 basis points, the economy was weaker than it is this cycle (see Chart 2). Though Bernanke has admittedly missed the severity of the impact that the credit crunch has had on the economy, Hyman still believes that we will avoid an outright recession. In defense of his stance, Hyman points out that many of ISI’s economic indicators, including their economic diffusion index, trucker’s survey and homebuilder’s survey, are showing signs of a bottoming.



Helping future economic growth prospects is the \$170 billion windfall stimulus package about to be rained on voters by the previously partisan Congressional leadership. It seems all is fair in love, war and election years. This plan is not without its critics. “[The] government writing checks for American consumers which then flow to foreign central banks is not the permanent solution,” wrote Bill Gross of PIMCO Bonds, “it only makes sense in the short-term as a life preserver.”<sup>12</sup> But, we would argue, that is exactly the point. While monetary stimulus acts with

<sup>11</sup> Steven Rattner, “Let’s Get Real About the Economy,” *The Wall Street Journal*, January 29, 2008.

<sup>12</sup> Bill Gross, “PIMCO Investment Outlook,” *PIMCO Bonds*, February 2008.

a lag, fiscal stimulus can have an immediate impact. If you're the one treading water, that's important. The government writes you a check, mails it, and, if you listen to our Commander-in-Chief, you spend it. "The stimulus plan sets up a bridge to the full impact of accelerated rate cuts," wrote Tom Gallagher of ISI. "Lots of people are criticizing the stimulus plan. We think this is a time when markets will take a 'don't let the best be the enemy of the good' approach." Steven Rattner added, "Of all stimulus measures that have been assembled in our Washington sausage factory in past decades, this may well be the best."

Let's be straight. We are not signaling the "all clear" for the economy, nor for the equity markets. Rather, we maintain our view that significant risks remain for both. While the swift, decisive and drastic action taken by the Fed and its counterparts may blunt this downturn, the fact remains that dangerous imbalances exist in our economy. Imbalances, it should be noted, that were built via monetary policy action similar to what is currently being implemented.

"As [has been] demonstrated, the Fed can move with the speed of light, or at least sound, when the market is hurting," wrote Alan Abelson in *Barron's*. "But it plays deaf, dumb and blind when the market's on a tear. In other words, our beloved monetary monitors feign not to be concerned with asset prices when bubbles are madly inflating; yet, they're typically Johnnies-on-the-spot when markets are in trouble... For at least three decades now we have had bull markets and robust economies increasingly powered by credit, the very stuff that's evaporating rapidly and is odds on to stay in short supply for a long, maybe a very long, stretch."<sup>13</sup>

Another risk for the economic outlook is leverage. As we have frequently pointed out, the U.S. economy is currently laboring under a debt burden that is now 342.7% of GDP, the highest level in history. The impact this debt has had on our economy can be seen in Chart 3. During the 1950s, our economy derived a \$0.73 increase in GDP for every dollar of debt we assumed. During the last decade, that number has fallen to \$0.20. "If the debt/GDP indicator is indeed a sentiment indicator, it tells us that this economy is probably over-borrowed, over-invested, and over-consumed, which could hurt future growth rates," wrote Ned Davis of Ned Davis Research, Inc. "This raises the question: 'How many are left to aggressively borrow and spend, and, as importantly, who is willing to lend to them?' In the 1970s GDP rose 164.8%...it is up just 46.7% this decade despite huge productivity gains, low tax rates, a surge in profits and record profit margins, a global economic boom, the Internet, low interest rates, and a deficit-financed war, etc.," Davis concluded.<sup>14</sup>

In every tightening cycle since the [Paul] Volcker Fed's inflation battle in the 1980s, the Fed funds rate has peaked at lower highs. The current path of monetary policy has a futile dead-end of a 0.0% Fed funds rate and an economy that derives less than \$0.2 for every \$1 of debt we create. Then what? "Chairman Bernanke must recognize the reduced benefits and obvious dangers of a déjà vu trek to 1% short rates,"

**Chart 3**  
Diminishing Returns from Debt-Financing by Decade  
12/31/1949 - 6/30/2007

Date Range	Decade Change in GDP (billions \$)	Decade Change in Debt (billions \$)	GDP/Debt
12/31/1949-12/31/1959	248.0	336.6	0.74
12/31/1959-12/31/1969	491.4	748.9	0.66
12/31/1969-12/31/1979	1,655.9	2,786.3	0.59
12/31/1979-12/31/1989	2,923.8	8,565.4	0.34
12/31/1989-12/31/1999	3,935.2	12,471.7	0.32
12/31/1999-06/30/2007*	4,255.2	21,263.2	0.20

\* Most recent data available

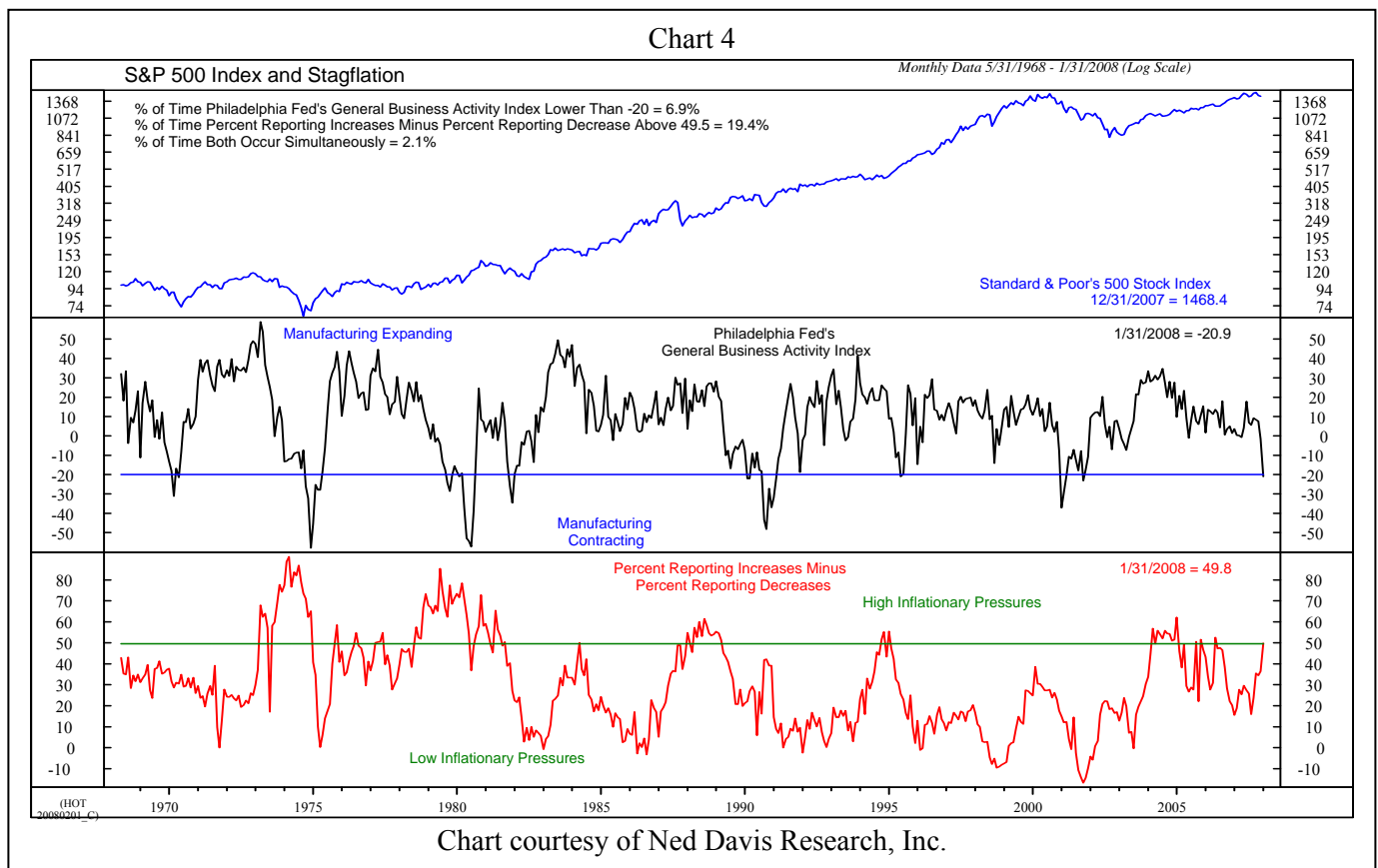
Chart courtesy of Ned Davis Research, Inc.

<sup>13</sup> Alan Abelson, "Up & Down Wall Street," *Barron's*, January 28, 2008.

<sup>14</sup> Ned Davis, "Institutional Hotline," *Ned Davis Research Inc.*, January 23, 2008.

wrote Bill Gross. “Those yields produced 5% 30-year mortgage rates to the homeowner for a 2-3 month period in 2003 and they could do so again, but bubble-creating, inflation-inducing damage to the U.S. dollar would be the likely result now.”<sup>15</sup>

We agree. Inflation is another risk for the economic outlook. More accurately, stagflation is the risk, as inflation remains significantly elevated despite the economic slowdown. In the fourth quarter of 2007, the consumer price index (CPI) averaged roughly 4.0% annualized, up from 2.0% in the third quarter, while fourth quarter GDP growth slowed to 0.6% from 4.9% in the third quarter. “The Philadelphia Fed’s General Business Activity Index is below -20, a reading so weak it has happened only 6.9% of the time since 1968,” wrote Ned Davis, “the Philadelphia Fed Prices Paid Index [is] above 49.5, suggesting such strong inflationary pressures have only happened 19.4% of the time since 1968. To have both a weak economy and strong inflation has only happened 2.1% of the time [since 1968]!”<sup>16</sup> See Chart 4.



The current inflation backdrop is akin to that of the 1970s. “In July 1971, the month before President Nixon imposed a nationwide freeze on prices and suspended the convertibility of the dollar into gold, the American CPI was rising by 4.4%,” wrote Jim Grant. “Here was a full-blown national economic emergency provoked, in part, by an inflation rate only 10 basis points higher than the one...reported for November.”<sup>17</sup> Amazingly, even with this troubling historic stagflationary precedent, most economists and policymakers are downplaying the current dangers to the economy. Many believe that the global glut of labor is restraining wage growth, keeping future inflationary pressures in check. The employment cost index (ECI) slowed to 3.2% in the fourth quarter of

<sup>15</sup> Bill Gross, “PIMCO Investment Outlook,” *PIMCO Bonds*, February 2008.

<sup>16</sup> Ned Davis, “Institutional Hotline,” *Ned Davis Research, Inc.*, February 1, 2008.

<sup>17</sup> Jim Grant, *Grant's Interest Rate Observer*, January 11, 2008.

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2007, within what many believe is a secular downtrend in inflation ongoing since the early 1990s when the ECI was 5.3%. Despite the global credit crunch, economists also argue that a global glut of capital is leading to increasing worldwide market competition that has a deflationary impact on pricing. Furthermore, it is anticipated that a worldwide slowdown in economic growth will restrain inflationary pressures as demand recedes. All true.

However, inflation is being led by commodity prices as worldwide demand for energy, food and raw materials increases, suggesting that inflation may have become less elastic in the globalized economy. Despite a worldwide economic slowdown, oil prices are hovering around \$90 a barrel, over 50.0% higher than a year ago. Copper contracts fetch \$352.80, almost 50.0% more than what they went for in February 2007. According to Bank of America, food price inflation is running at an 11.0% annual rate in developed economies, up from 4.5% in 2006. This cost spiral stems, in part, from improving diets in the developing world where better wages have led to an increased demand for healthier food. North American food companies are feeling the pinch from these unprecedented cost pressures. Despite implementing price increases, one major food company missed their earnings estimates as their margins were squeezed by a 50.0% year-over-year increase in dairy costs. Another was forced to lower guidance as wheat costs soared 73.0% during the fourth quarter of 2007. After years of cost cutting to combat inflationary pressures, these companies are left with little choice but to raise prices again, with one company announcing a 5.0-10.0% price increase for some of its products.

As these food prices escalate, more nations are implementing price controls. Last month, China said it would require producers of pork, eggs, and other farm goods to seek government permission before raising prices. Thailand is taking similar steps on instant noodles and cooking oil, while Russia is trying to cap prices on certain types of bread, eggs and milk. Mexico is trying to control the price of tortillas, and Venezuela is capping prices on staples including milk and sugar.<sup>18</sup> Price controls have risks as they can artificially stimulate demand and suppress supply, eventually putting the world's economy in a worse position than it would otherwise have been. With the Fed and Washington pushing the stimulus pedal to the metal, we would not be surprised if the inflation car began to veer out of control. In fact, with no identifiable asset bubbles left to inflate, we expect inflation could be the next Fed policy-induced bubble.

In conclusion, it now looks as if the great credit crunch was a 2007 story. With all hands on deck in Washington D.C., both fiscal and monetary policy are in full-on stimulus mode. While economic imbalances will limit the long-term effectiveness of this stimulus, the short-term impact will likely be a less-severe economic downturn. To this end, our asset allocation has changed since the beginning of the year. We now have a net long position in financials. In particular, we have purchased securities set to benefit from the lowering of the Fed funds rate and the increases to FHA and GSE loan limits. We have also greatly reduced our exposure to building products shorts. While we anticipate a difficult operating environment for these companies as commercial construction slows, this group has outperformed the market as investors hope stimulative economic policies will lead to an earlier bottoming in the housing market. At January's month-end, we were in a net-long invested position.

Given the existing levels of leverage and the ongoing inflationary pressures, the Fed can't travel too much farther down the road of monetary stimulus. However, even as the end of this road approaches, it is clear that Bernanke & Co. have their foot on the gas. For now, it's best to stay out of their way and, where prudent, go along for the ride.

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<sup>18</sup> Patrick Barta, "The Unsavory Cost of Capping Food Prices," *The Wall Street Journal*, February 4, 2008.