



## **UPDATE**

February 2009

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**CALDWELL & ORKIN**<sup>®</sup>

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*“Can you hear it ring  
It makes you wanna sing  
It's such a beautiful thing--Ka-ching!  
Lots of diamond rings  
The happiness it brings  
You'll live like a king  
With lots of money and things  
  
When you're broke go and get a loan  
Take out another mortgage on your home  
Consolidate so you can afford  
To go and spend some more when you get bored  
  
All we ever want is more  
A lot more than we had before  
So take me to the nearest store”*

-Shania Twain, Ka-Ching

### ***Reality Bites***

It was a mere ninety seconds after take-off when the Airbus 320 piloted by US Airways Captain Chesley “Sully” Sullenberger III flew into a flock of geese, disabling both of the airplane’s engines. “My initial reaction was one of disbelief: I can’t believe this is happening,” Captain Sully told CBS’s Katie Couric in an interview on 60 Minutes. “It was the worst, sickening, pit of your stomach falling through the floor feeling I’ve ever felt in my life. I knew immediately it was very bad.” Faced with the reality that his plane was going down, Sully weighed his options. The best choice would be an attempted return to LaGuardia airport, but he soon realized that such an attempt was impossible without the necessary thrust from his engines. Next best would be to land at a smaller, nearby airport, but again he realized his plane would not be able to reach the runway. Rapidly descending, he realized what he had to do. The only chance Sully had to save the 155 passengers and crew on his plane was to attempt a crash landing on the Hudson River.

The consumer spending engine, propelled by leverage, has stalled out. The economy’s resulting descent, remorseless and rapid, is destroying balance sheets as the financial equivalent of Newton’s Laws take hold and asset values (from housing to equities) plummet back towards Earth. Washington’s economic pilots are now in deep discussion as to how best reverse or slow this decline. Unlike Captain Sully, they believe they can avoid a crash landing. They hope that, despite the lack of demand thrust, and the laws of physio-economics, they can protect us from the economic trauma of deleveraging. But as the nation has learned all too well thus far in 2009, hope can get you only so far, especially when the economic reality is so harsh.

It’s a bitter pill to swallow, the collective decline in net worth suffered by consumers at the hands of this recession. According to the Federal Reserve, consumer net worth (CNW) has collapsed by -20% from its peak in 2007, wiping away some \$12 trillion in consumer assets. This decline has left a gaping hole in consumer balance sheets, one that leverage has made all the more acute. It is one thing to suffer a -20% decline in asset value if you own 100% of the asset. It’s quite another if you own, say, 10% and finance the

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rest. Now you now owe more than you own. And it seems likely that bill will continue to grow. “We have learned that this market has no precedent in the post World War II era,” wrote housing analyst Ivy Zelman of Zelman & Associates. “With the credit crisis and asset deflation gripping the banking industry, government stimulus unlikely to alter near-term [housing] demand and the foreclosure epidemic accelerating, we are revising lower our macro housing assumptions and postponing our expected recovery in demand until 2011. Our new assumptions have negative consequences for land values, home prices, housing production levels, the banking industry, homebuilding and building product equity valuations and consumer spending. We remain surprised by the apparent lack of foresight by policy makers to address the housing crisis first. Without stabilization in new home demand, an improvement in consumer confidence and a halt to foreclosures, we believe it is difficult for existing home prices to bottom. [We are] lowering [our] peak-to-trough home price decline to -32% in real terms...equivalent to a -40% reduction in the Case-Shiller national index,” she concluded.

The frightening reality of our current situation is that while our economy nose dives and brings the value of our collective asset base down with it, the debt we frivolously piled on as we acquired our homes, our cars, our exotic vacations, etc, etc, etc. remains in full flight. “Let us look for a minute at the extent of the loss in perceived wealth that is the main shock to our economic system,” wrote Jeremy Grantham, Chairman of GMO Capital. “If in real terms we assume write-downs of 50% in U.S. equities, 35% in U.S. housing, and 35% to 40% in commercial real estate, we will have had a total loss of about \$20 trillion of perceived wealth from a peak total of about \$50 trillion. These write-downs not only mean that we perceive ourselves as shockingly poorer, they also dramatically increase our real debt ratios...the National Private Asset Base of \$50 trillion supported about \$25 trillion of private debt... But now the asset values have fallen back to \$30 trillion, whereas the debt remains at \$25 trillion, give or take the miserly \$1 trillion we have written down so far... We really need to halve the level of private debt as a fraction of the underlying asset values. This implies that by hook or by crook, somewhere between \$10 trillion and \$15 trillion of debt will have to disappear.” By hooks or by crooks \$15 trillion off the books.

Realizing this, American consumers and businesses are embarking on an era of thrift, saving more money as they cut spending on just about everything. In December 2008, consumers reduced their spending for a sixth month as the unemployment rate climbed and confidence slumped. Despite a brief, discount-induced 1% increase in consumer spending in January 2009, the personal savings rate has risen to its highest level in six years. While putting away money and paying down debt may be good for one family’s kitchen-table economics, the broader economy suffers in the short-term when millions of families do it.<sup>1</sup> Consumer spending is now down year-over-year, and over the past six months has plunged at a -6.9% annual rate. According to Ed Hyman of ISI Group, Inc., the saving rate has increased from 1.2% in September 2008 to 3.6% in December 2008. “Based on the lagged effects of plunges in both Mortgage Equity Withdrawal (MEW) and CNW, we forecast the saving rate to increase to 7.2% [at its peak],” Ed wrote. “Every percentage point increase in the saving rate directly reduces real consumer spending by -1.0% and real GDP by -0.7%.”

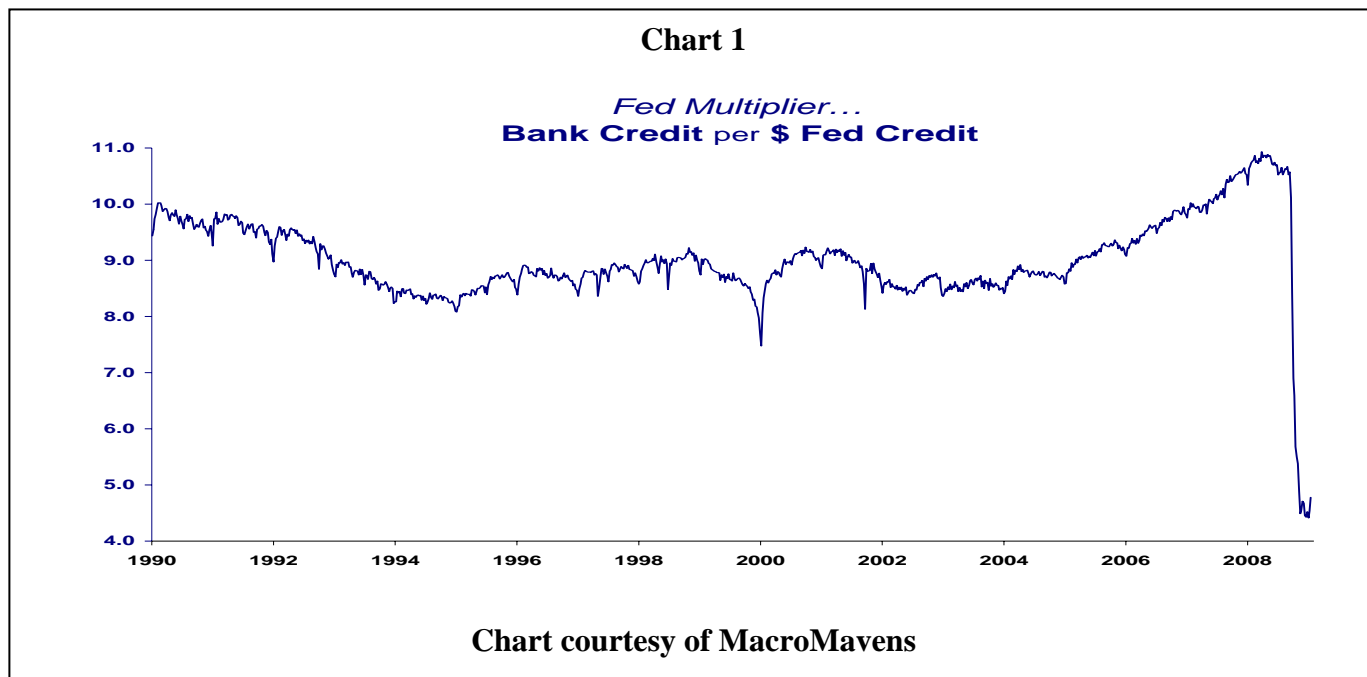
Deep in a hole, consumers have finally stopped digging. While that may be good for our economy in the long-term, for Federal Reserve Chairman Ben Bernanke and his policy co-pilots it is nothing but trouble in the short-term.

“Should the desire to borrow be fundamentally diminished, [Bernanke’s] ability to arrest deflation would be limited as well,” wrote Stephanie Pomboy of MacroMavens. “That’s the dirty little secret of monetary policy. The Fed’s power is only as good as the appetite for the credit it wields. Ben can print...all

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<sup>1</sup> Jack Healy, “As the Recession Worsens, Consumers Save More and Spend Less,” *The New York Times*, February 3, 2009.

the money in the world. If no one wants to borrow, it matters not a whit. Should it emerge that consumers have *not*, in fact, been tapping their toes waiting for the opportunity to lever-up again, the Fed would increase money but credit would not expand,” she concluded. (See Chart 1.)



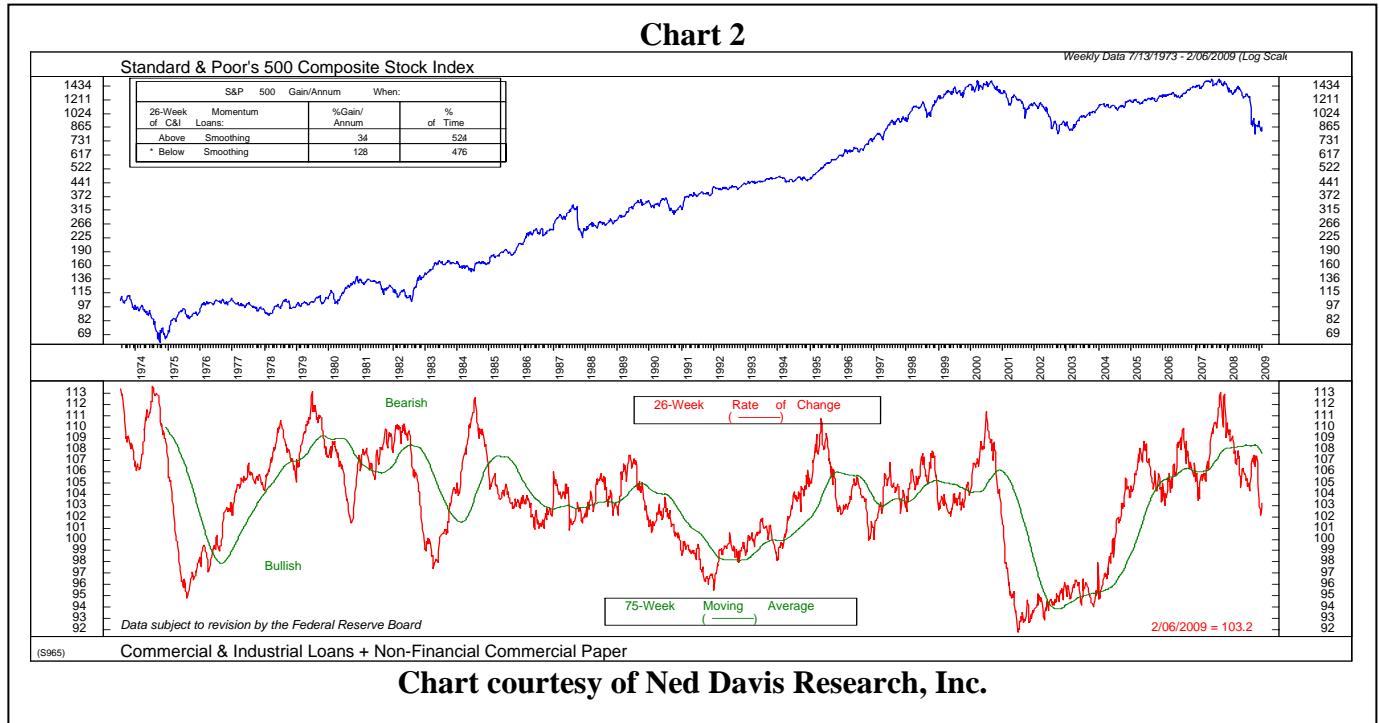
Got that, D.C? No matter how much you brow-beat banks to increase lending, the reality is consumers are tapped out and not borrowing. Plunging CNW has made millions of families feel poorer and led them to save more. They don't need more debt. They don't want more debt. And contrary to the "lend more" message broadcast from inside the Washington Beltway, bank examiners are scrutinizing weak loans and forcing banks to tighten lending standards. Bankers should always lend prudently, as they are now doing. If they are jawboned (or worse) by Washington into reckless lending, the U.S. will set itself up for another debt crisis, even before the present mess has been cleaned up<sup>2</sup>. "Somebody who 'gets it' is Richmond Fed President Jeffrey Lacker," wrote Ned Davis of Ned Davis Research, Inc. "He says, 'banks' abilities to make new loans are being constrained by a lack of credit-worthy borrowers. Banks are lending. They're chasing all the good borrowers they can find. It's just that there aren't as many around these days." Commercial lending "[plunged] in the recessions of 1975, 1982, 1990, and 2001... I would not excuse the banks for almost anything, but they are not at fault for not lending in this serious recession," Ned concluded. (See Chart 2.)

The amazing irony of the policy response to our current crisis is that we are trying to heal our economic wounds with the very thing that caused our them, more debt. It's as if our elected leadership believes they can restart our clogged economic engines in mid-flight. They can't. "We as a nation will be faced with policies designed to maintain the consumption-driven force of our domestic economy," wrote Michael Farrell, Chairman of Annaly Capital Management.

"Encouraging savings to preserve the nation's fiscal house is exactly what is needed to right the capsized ship of capitalism and truly secure the national interests... It...means fewer cars in the driveway; fewer travel vacations; fewer dollars allocated to private education choices; fewer dinners out; difficult choices about healthcare; smaller homes that are colder in the winter and warmer in the summer; fewer 'must have'

<sup>2</sup> Bert Ely, "Don't Push Banks to Make Bad Loans," *The Wall Street Journal*, February 2, 2009.

electronic toys; delayed retirements and, in general, tougher choices about personal disposable incomes... We are increasing our savings so we can reair the hole in our personal balance sheets... At this point in the economic cycle, savers are the key to survival, not consumers... If we truly think that there is a short term solution via consumption then we deserve our fate.<sup>3</sup>” You don’t hear that coming out of Washington!



Captain Sully is a hero because, faced with the harsh reality of a plane without power, he made tough, critical decisions that ultimately saved lives. Yes, he would have loved to have been able to guide his \$60 million plane back to LaGuardia, but the reality was that was impossible. Given the facts before him, he chose the only credible option with which he was left: sacrifice the asset to save lives.

Likewise, we have few credible options to get our economy flying safely again. The debt that has clogged our engines must be purged. Balance sheets must be repaired through savings and the passage of time. Losses must be taken on the loans that artificially stimulated demand for over-priced assets. And, as we celebrate the 200<sup>th</sup> birthday of Charles Darwin, we must allow for economic natural selection: we must let the weak banks fail. Assets must be sacrificed.

Reality Bites. Ka-Ching.

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<sup>3</sup> Michael Farrell, “Just Save, Baby, Just Save,” *Annaly Capital Management Fourth Quarter Earnings Call*, February 5, 2009.