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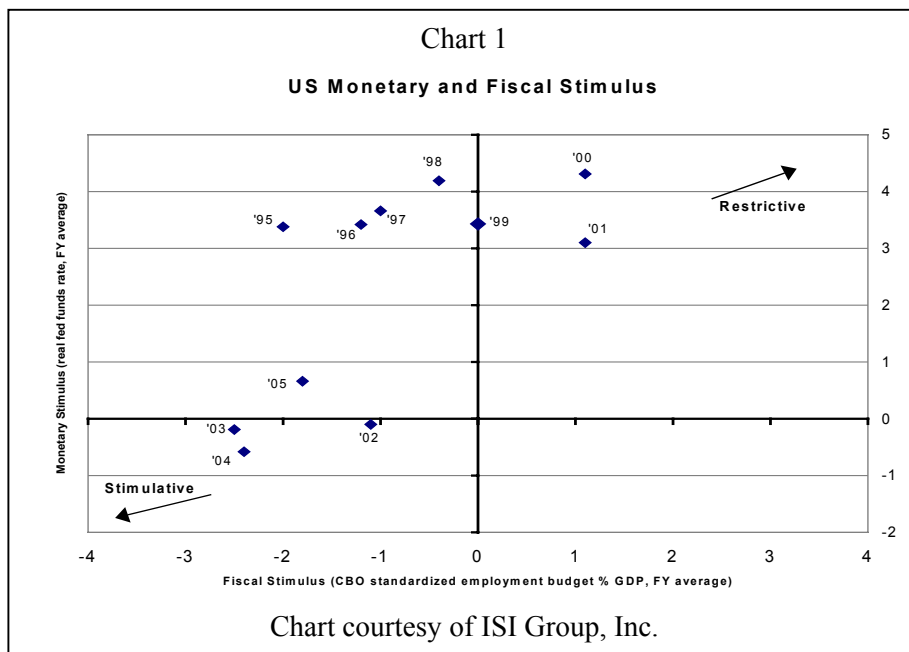
UPDATE

March 2006

Wow! Did you see the January employment report? At 4.7%, the unemployment rate is now at its lowest level since July 2001. Better yet, the January decline in the unemployment rate from December's 4.9% came not from frustrated job seekers giving up their employment pursuits (as it has throughout this expansion), but rather from unemployed people actually finding work. It should be noted that the January report received an assist from Mother Nature as unseasonably warm weather gave a strong 46,000 boost to construction jobs. Nevertheless, the current employment strength is a contributing factor leading Ed Hyman of ISI Group, Inc. to raise his first-quarter gross domestic product (GDP) annualized growth estimate from 4% to 5.5%.

Economies around the world seem to be in a synchronized expansion phase. Annualized, fourth-quarter GDP grew 8.7% in Singapore and 5.5% in Japan. Across the Atlantic, the U.K.'s leading economic indicator suggests that their economy is poised for reacceleration. Each of these examples is clear evidence of the salutary impact of globalization on the world economy.

In India, manufacturing compensation per hour averages \$0.64. In China, the average is \$0.75. In the U.S., the same output would cost \$23.17. The emergence of these developing economies is providing the U.S. economy a source of inexpensive labor and low consumer price inflation, but it is also spurring asset-based inflation as the emerging world builds-up infrastructure and demand increases for raw materials. Asset-based inflation is being tolerated, so far, since "core" (ex-food and energy) prices have been mostly constrained. However, the core producer price index (PPI) rose 0.4% month-over-month in January, its fastest pace of growth in a year. In the just released minutes from the Fed's January 31, 2006 policy meeting (at which the Federal Reserve Board unanimously voted to raise the Fed Funds rate to 4.5%), Fed officials voiced concern that underlying inflation could drift higher in the coming months, and noted that core inflation data reinforced the odds of future rate hikes.



Despite the 350 basis point increase in the Fed Funds rate since June 2003, both the economy and inflation continue their ascent. After guiding the Fed Funds into negative real rate territory (where the Fed Funds rate is below the rate of inflation) following the 2001 recession, the Fed has had to come a long way to remove substantial monetary stimulus from the economy. Yet, as the accompanying chart from ISI shows, although monetary policy has become less accommodative, fiscal policy remains stimulative and has largely offset much of the Fed's interest rate increases (see chart 1).

According to ISI, over the past two quarters increased spending on the part of both federal and state governments has led to deterioration in the combined budget deficit from -\$165 billion to -\$468 billion, representing a roughly \$300 billion fiscal stimulus, or \$600 billion at an annual rate.

Thanks in part to this deficit spending driven fiscal stimulus, accelerating core inflation may put the Fed in the unenviable position of raising short term rates at a time when the yield curve (the difference between the short-term rates at which financial institutions borrow and the long-term rates at which they lend) is inverted. The inverted yield curve may negatively impact profit margins at financial institutions and other companies who have significant financing arms as the spread at which these companies borrow and lend narrows. We maintain short exposure to financial companies we think are most vulnerable to the yield curve inversion.

On the other hand, the largest decline in the Commodity Research Bureau's (CRB) Commodity Index in 25 years, a potential peak in the Goldman Sachs Commodity Index (GSCI), and the significant February decline in the University of Michigan survey of consumer inflation expectations suggest rising price pressures may begin to subside after a temporary lift attributable to unseasonably warm January weather. Moreover, despite the acceleration in core inflation, the January 31, 2006 FOMC minutes explicitly said monetary policy "seemed close to where it needed to be."

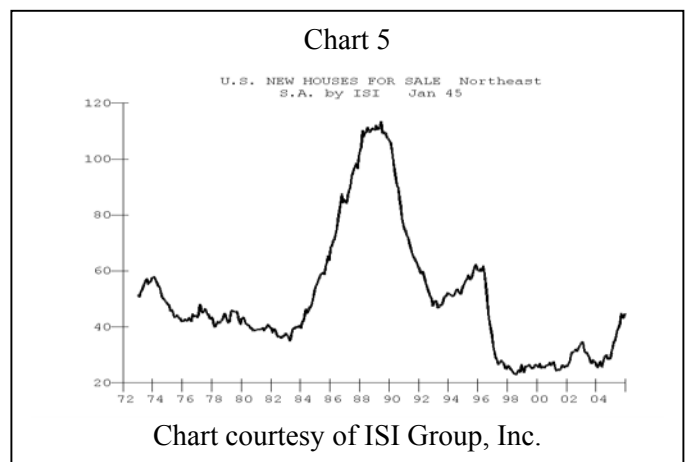
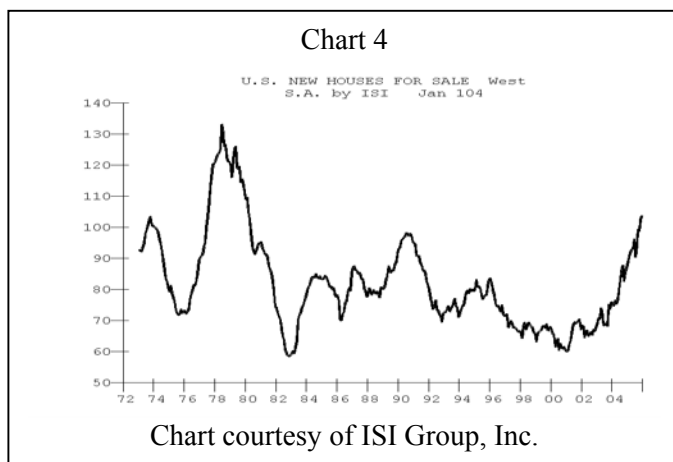
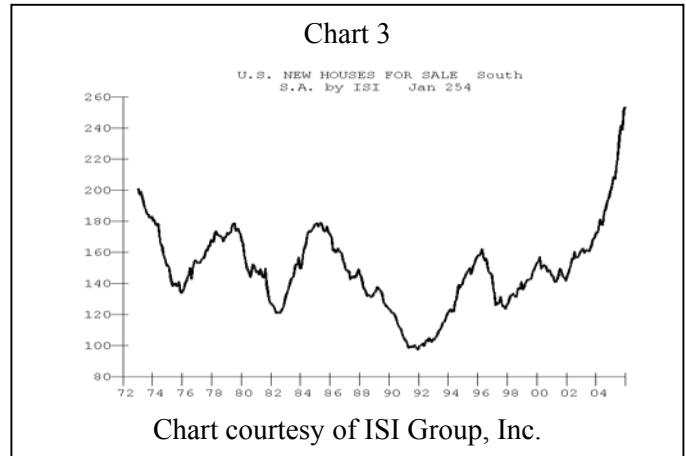
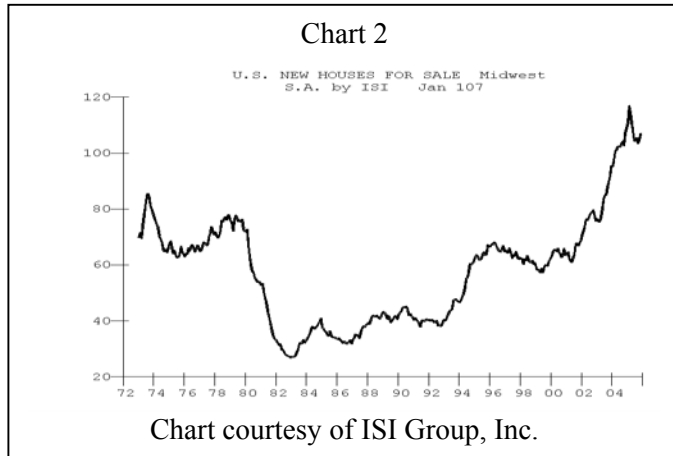
ISI believes wage growth will be the key factor in determining how far the Fed is forced to tighten. Thus far, total compensation (wages plus benefits) gains have remained muted as wage increases have been offset by a decline in benefits. However, a -0.6% decline in January productivity could endanger the currently benign wage environment. In a February 6, 2006 *Barron's Up & Down Wall Street* column by Alan Abelson, Philippa Dunne and Doug Henwood, authors of the *Liscio Report*, voiced their concern that the "seriously disappointing productivity showing...could irk the Fed." They cite a speech that recently appointed Federal Reserve Chairman Ben Bernanke gave last year in which he warned that if productivity were to weaken and labor costs to rise, there would probably be reason enough to nudge the Fed toward tightening.

According to Ed Hyman, how far the Fed raises rates could be critical in determining the end result for the economy. Should wages begin an upward spiral, the Fed will be forced to continue to raise the Fed Funds rate, potentially causing further inversion to the yield curve. In 2000, 10-year bond yields and Fed Funds converged at 6%, but the Fed kept tightening to 6.5% and a recession followed. If wages remain contained, the Fed will be under less pressure to raise the Fed Funds rate, a much more benign scenario for the economy and, likely, the market.

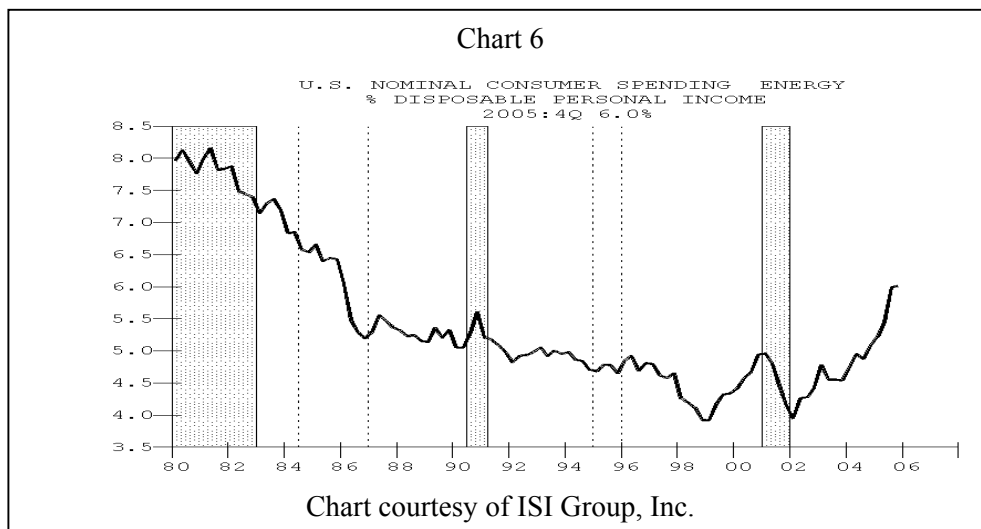
The economic tailwinds with which we started this expansion (\$20 per barrel oil, a 1% Fed Funds rate and surging mortgage equity withdraw (MEW)) have reversed into economic headwinds. Both the Fed Funds and oil have increased significantly over the past two years, and are now higher than prior to the 2001 recession. Importantly, a study by the Fed indicates that oil prices and the Fed Funds rate impact the economy with a two-year lag, an economic gestation period that is just now ending. Also, according to the Fed's survey of banking activity, bank mortgage lending is weakening and MEW is on the decline.

All of these headwinds strike at the heart of U.S. economic strength, the consumer. Doug Kass, the principal of Seabreeze Capital and a blogger for TheStreet.com writes, "The most consequential of the consumer headwinds is a stretched and bloated balance sheet dependent not upon wages and other income but on the appreciation of equities and homes." And from coast to coast it is becoming clear that a significant slowdown in housing is underway. In San Diego County (CA) month-over-month resale house prices tumbled in December 2005 by the biggest number in 18 years of record keeping. The number of foreclosure notices filed against Massachusetts homeowners last year reached their highest level since the housing bust of the early 1990s. In a January 20, 2006 *Sarasota Herald Tribune* article by Michael Pollick and Stephen Frater entitled, Local Home Builders Say That Slump Has Arrived, Lee Wetherington, a prominent Southwest Florida builder, says he saw sales drop 50-70% in Q4 2005 compared to the stellar performance of Q4 2004. "Sales have just fallen off the cliff," Wetherington said. "There's going to be a dramatic slowdown over the next six months." According to ISI, new

house inventories are up roughly 80% in the Midwest and South, and are at record levels by a wide margin; and up roughly 70% in the West, but below their 1978 peak; and up roughly 80% in the Northeast, but clearly below their 1989 peak (see charts 2 through 5).

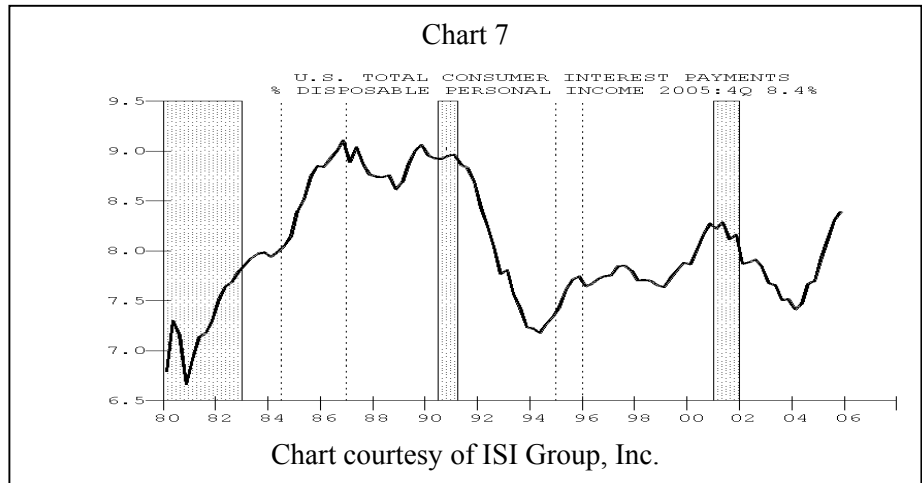


According to Seabreeze’s Doug Kass, “every measure of consumer debt is at record levels. The consumer has no safety net and remains on a collision course with reset teaser and adjustable rate mortgage loans, rising inflation, generally rising interests rates, a slowdown in withdrawals from that ATM called housing, (and)



stubbornly high energy prices.” Indeed, consumer spending on energy was up over 20% year-over-year in the fourth quarter of 2005, and as a share of disposable personal income (DPI), it was the highest since the 1985 mid-cycle slowdown. In this same period, total consumer interest payments were up almost 13% year-over-year, and as a share of DPI are the highest since 1992 (see charts 6 and 7).

Is now a bad time to reiterate that the consumer is 76% of U.S. GDP? In his February 3, 2006 Thoughts from the Frontline newsletter, John Mauldin argues that, “We have seen real consumer spending begin to peak and slow down.” Mauldin thinks this slowdown is forecasting the peak in GDP. He continues, “even though (first quarter GDP) is likely to be higher than last, the trending average will be down.” Mauldin worries that this slowdown in GDP will be the start of a bear market.



“The (2000) bear market began as the rate of growth in consumer spending peaked and began to slow...Bear markets start because of relatively small earnings disappointments. Not so much as to be alarming, but it starts a trend of slower earnings growth. Investors project earnings well into the future. When earnings have been growing well over a period of several years, as they have been recently, stocks get priced to perfection. Management is not allowed to disappoint without getting punished, and we are starting to see that happen. We should be looking for a real economic slowdown later this year, and a bear market to start anytime,” he wrote.

Hold the phone. Mauldin is forecasting a bear market when the Dow Jones Industrial Average (DJIA) is breaking out to all time highs and the S&P 500 is at levels not seen since 2001? These market moves are impressive; however, underlying this pricing strength is a growing weakness in market breadth. Paul Desmond, equity strategist with Lowry’s Reports, Inc., writes, “Even though the DJIA (recently) rose to five-year highs, only four of the stocks in the index rose to five-year highs. Fifteen stocks in the index (half of the total index) were down 20% or more from their five-year highs. The average price change for the 30 stocks was a loss of 21.2% from their five-year high.” For the broader market, only 11.9% of the stocks in Lowry’s NYSE Operating Company Only (OCO) Index were at new highs. Meanwhile, 24.6% of the stocks had lost 20% or more.

Desmond recently conducted a study of the last 14 bull market tops from 1929 to 2000. His research indicates that the average percentage of stocks making new highs when the DJIA reached its zenith was 5.98%, while the average percentage of stocks within 2% of their highs was 16.88%. The study showed that an average 21.97% of stocks were down by 20% or more from their highs, and 10.54% were down by more than 30%. According to Desmond, “the internal condition of the market is not as strong as the major price indicators suggest and they show the deteriorating market breadth typically found during the final stages of a bull market.”

While the economic expansion in the U.S. appears to be gaining steam, the fuel for this expansion – strength in the housing market – is in question. Given these uncertainties, it’s too early to tell whether or not we are heading for a bear market. But a number of the precursor signs are there. We remain invested close to a market neutral position. We do believe that evidence of a coming economic slowdown is convincing, and we will be intently watching the yield curve and market breadth for further signs that the bear’s hibernation is over.

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