



UPDATE

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CALDWELL & ORKIN®

“If investors learn nothing else from the debacle [in subprime lending], it should be that no matter how the financial markets have changed, no matter how smart people may think they are, no matter how much it may feel that this time is really different, one basic rule of investing stands: The higher the reward, the higher the risk.”

-Herb Greenberg, columnist for CBS MarketWatch

Bad Haircut

On Tuesday, February 27, 2007, long-lived market complacency turned to panic in less time than it took a has-been teen pop icon to grab a razor and shave her head. On the heels of a -9% decline in the Shanghai stock market, U.S. market averages opened that morning more than -1% lower, briefly rallied, then proceeded on a surreal waterfall decline that left the Dow Jones Industrial Average (DJIA) -3.3% below the closing level the day before. Now that’s a haircut!

Both during the bloodshed and after the battle many market watchers gave their diagnosis for the market’s ails. Some blamed the blubbing babble of former Federal Reserve Chairman Alan Greenspan, who, at a speech in Asia, let the word ‘recession’ slip from his semi-retired lips. Others blamed hedge funds (an easy lot at which to point fingers), whose leveraged exposure to China and other emerging markets supposedly forced margin calls and liquidations. And some blamed computerized systems at the New York Stock Exchange, whose inability to handle the day’s massive order flow led to an instant 180-point late afternoon drop in the DJIA, and an instant 180-point increase in the heart rates of many traders. All are interesting theories, but, in our view, likely off base. To us a simplistic explanation is more probable. That is, the market is beginning to price in risk.

The signs of a turn in the credit cycle have long been “hidden” in plain sight. It is amazing how investors can fail to act when their eyes are wide shut. We have long warned of excessive credit availability. For instance, in our September 2006 *Update*, we wrote:

“Evidence continues to mount that mortgages have been granted to already over-extended home buyers...as housing conditions worsen it will become clear just how much lending standards were relaxed during the boom. What’s more, a political backlash against the mortgage lenders on par or perhaps even greater than the one following...the collapse of the Nasdaq [remember the technology bubble of 2001?] appears likely.”

On February 8, 2007, thanks to a front page article in *The Wall Street Journal* by Carrick Mollenkamp entitled, [In Home-Lending Push, Banks Misjudged Risk](#), market participants began to open their eyes to the credit risks staring them in the face. The *Journal* article detailed how the second-largest subprime mortgage lender in the United States reached the conclusion that its systems for screening

subprime borrowers and for assessing default risk were flawed. In a statement, the lender said, “The impact of slowing house price growth is being reflected in accelerated delinquency trends across the U.S. subprime mortgage market, particularly in the more recent loans.”

Of course, delinquencies are expected. However, delinquency rates of 10%+ on loans less than a year old are indicative of failed, if not fraudulent, underwriting standards. According to a February 9, 2007 article in *The Wall Street Journal* by James R. Hagerty and Ruth Simon entitled, Default Jitters Batter Shares of Home Lenders, lenders are not fully insulated from loss once they sell the loans they originate. The authors wrote that, “Investors have been forcing lenders to buy back many dud loans, creating a sudden financial burden that has led to the closure of several smaller subprime lenders in the past two months.”

Market bulls will argue that the subprime blow-up does not matter because the subprime market is small and the problems therein are contained. In their February 26, 2006 weekly update, ISI wrote that nearly 100% of investors participating in their informal survey said they did not believe subprime problems would become a crisis. To be sure, on February 28, 2006 Federal Reserve Chairman Ben Bernanke told Congress, “there’s not much indication that subprime issues have spread into the broader mortgage market.” We simply disagree.

For starters, the subprime mortgage market has never been larger than it is today. In his February 8, 2007 *Street Insight* blog, Doug Kass, principle of Seabreeze Partners Management, wrote, “Nearly 15% of the mortgages made in 2006 were of subprime kind. That is almost triple the penetration of subprime compared to 2000-01...Subprime has never been more levered (just as the housing cycle has peaked). Loan-to-value ratios have risen from about 78% in 2000 to 86% today...Subprime has never been more dependent on the candor [or lack thereof] of borrowers. Low document loans have doubled to 42% of subprime loans over the last six years...Creative loans – non-interest paying, option ARMs, etc. – represented nearly half of all loans made over the last 12 months. At the turn of the decade these loans represented less than 2% of total mortgage loans.” Kass convincingly argues that if one conservatively assumes mortgage loan charge-offs reach their prior peak of 45 basis points of total loans, it would imply over \$40 billion in losses for the banks, hedge funds and brokerages that own these loans!

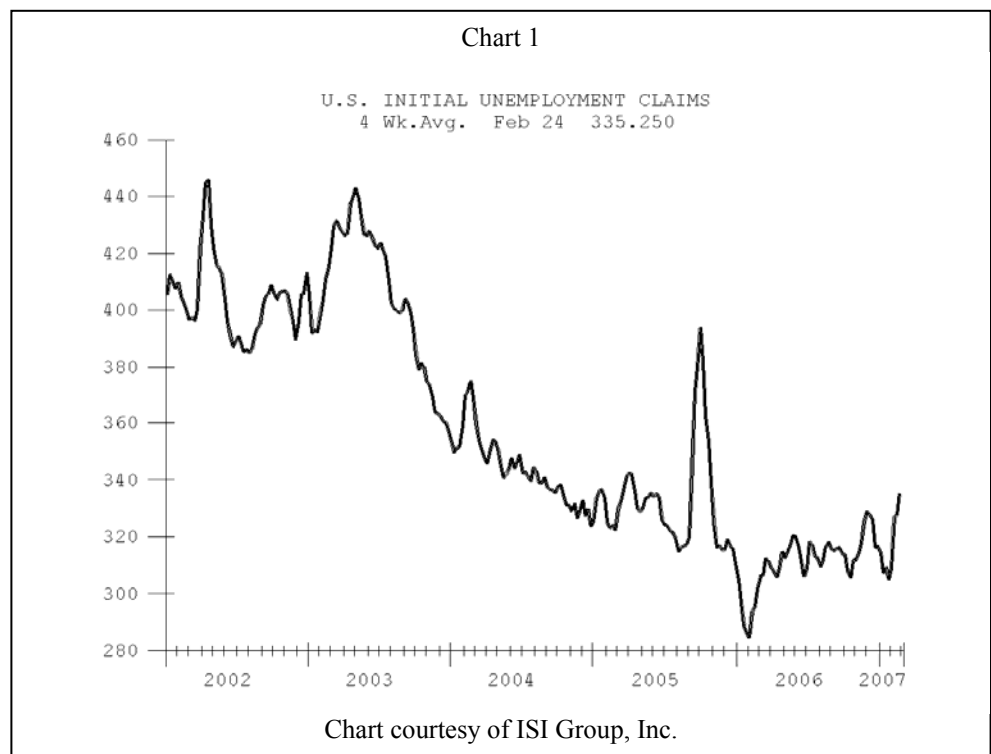
As to the issue of containment, recent evidence suggests that the woes of subprime are beginning to bleed up into the Alt-A (credit quality between prime and subprime) market. Tom Gallagher at ISI Group, Inc. believes the problems we are now seeing in the subprime market are the tip of the iceberg. On February 19, 2007 Gallagher wrote, “The subprime loans are failing first because most are 2/28 loans [mortgages that have a low teaser rate for two years and then reset higher] and because, by definition, the borrower is a higher credit risk. But the [Alt-A] loans – which probably represent at least 10% of the outstanding mortgages, similar in scope to the subprime market – have many of the same risky features as subprime loans (stated income high loan-to-value, high debt-to-income, payment shock, prepayment penalties.)” According to a March 1, 2007 *Wall Street Journal* article by Ruth Simon and James R. Hagerty entitled, Mortgage Defaults Start to Spread, data from UBS Securities Inc. shows that the default rate for Alt-A mortgages has doubled in the past 14 months. UBS mortgage analyst David Liu commented, “The credit deterioration has been almost parallel to what’s been happening in the subprime market.”

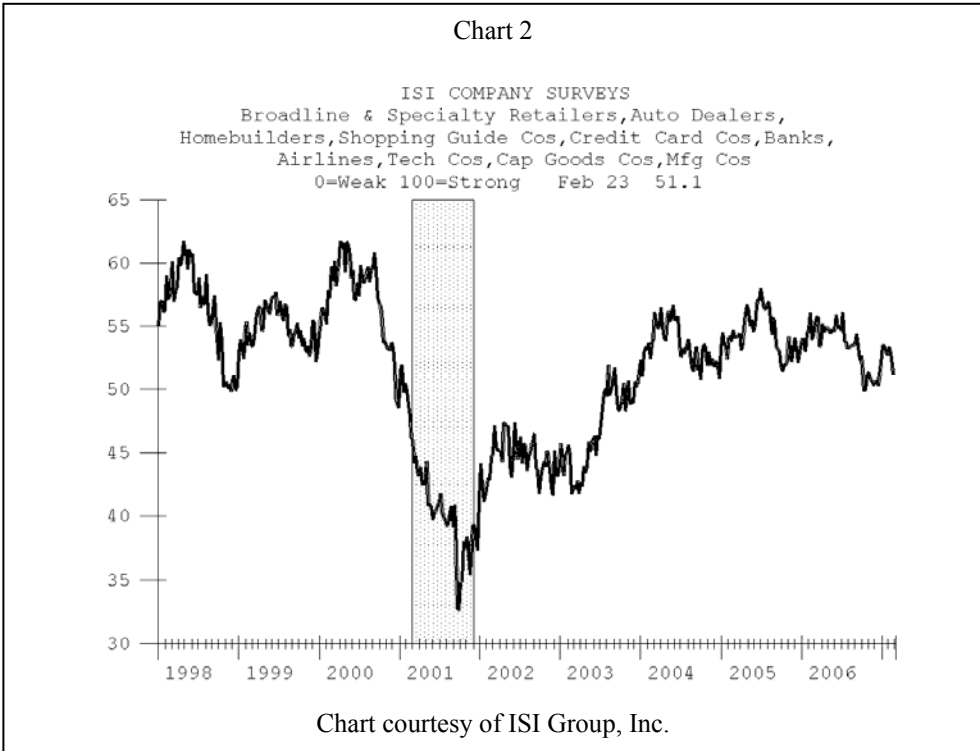
In our opinion, what we are witnessing is a turn in the credit cycle. As defaults have climbed, mortgage lenders have responded by tightening their standards. As Doug Kass eloquently puts it, “Defaults beget reassessment of risk. This begets a pullback in lending and a turn in the credit cycle which begets an economic contraction. The macro risk is...the impact on credit availability and spending.” According to a February 6, 2007 *Wall Street Journal* article by Serena Ng entitled, Bond Boom’s Thin Ice, just like the economy, the credit market goes through cycles, with periods of low defaults and periods of high defaults with widespread losses. The latest stretch of falling default rates has lasted for more than five years. Historically, past cycles have turned within five to seven years.

Adding to our conviction in the credit cycle’s turn is the fact that the mortgage market’s irrational exuberance has caught the eye of Congress. ISI’s Tom Gallagher thinks it is likely only a matter of weeks before the regulators take action barring lending abuses. According to a February 26, 2007 *Forbes* article by Matthew Swibel entitled, The Mortgage Nanny, Congress is contemplating enactments that would require mortgage brokers and lenders to make sure a loan is “suitable” for a borrower – just as stock brokers have to make sure an investment is suitable for a client. States are getting involved as well. Tennessee, Minnesota, Ohio, Pennsylvania, Washington and North Carolina have all either passed or are considering laws regulating the mortgage industry.

If the contraction of credit in the mortgage market forces lenders to re-access their total debt exposure, it could have negative implications for the availability of credit as a whole. Interestingly, *Business Week* (a magazine notorious for poor market timing) ran a February 19, 2007 cover article entitled, It’s A Low, Low, Low, Low-Rate World. The article, written by Michael Mandel and David Henry, credits financial market innovation for driving down credit spreads for a number of asset classes. According to the article, the spreads on triple-C rated bonds and lower – the junkiest of junk – are at a record low 4.7 percentage points over ultra-safe U.S. Treasuries, compared with the previous record low of 5.2 percentage points in 1997. Apparently, lenders of corporate credit are extending loans with fewer covenants than ever before to companies with poor credit scores. Does this sound uncomfortably familiar to the lending standards of the subprime market?

So where does this leave us? In our January 2007 *Update* we discussed the market’s concern over the potential for a short-lived, two-to-four month economic growth scare that could cause interest rates to rise



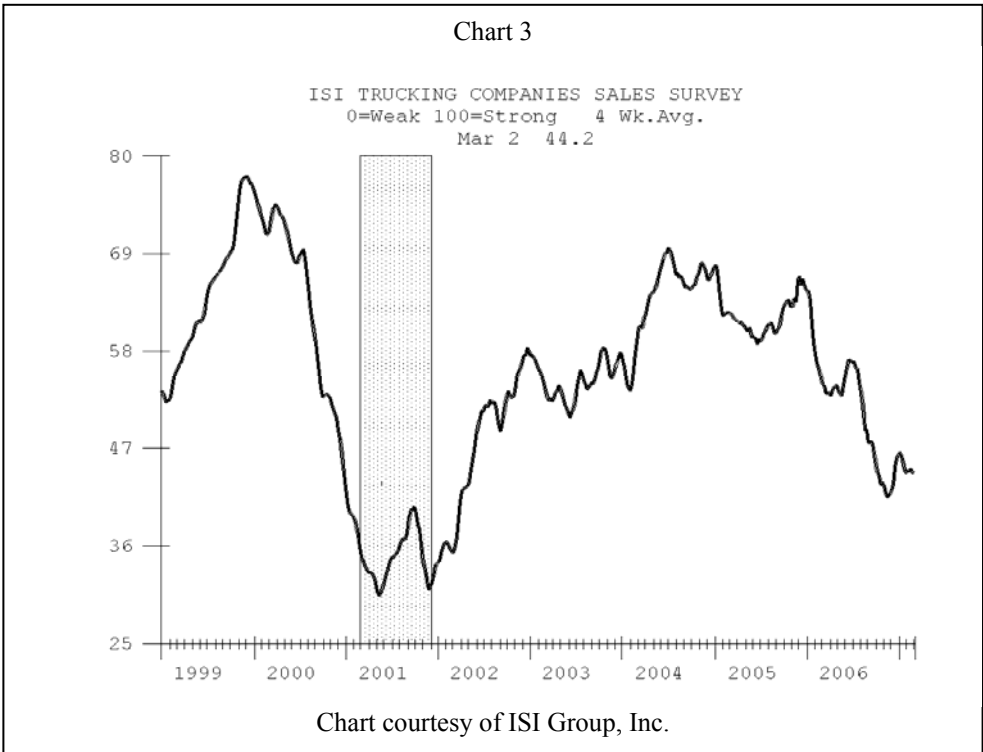


(as correctly anticipated by ISI’s Ed Hyman). In the Goldilocks scenario, this would be the too-hot economic environment. Two months later, the question facing us is, “will the contraction in credit leave the porridge edible, or will it turn it into cold, soggy cereal?”

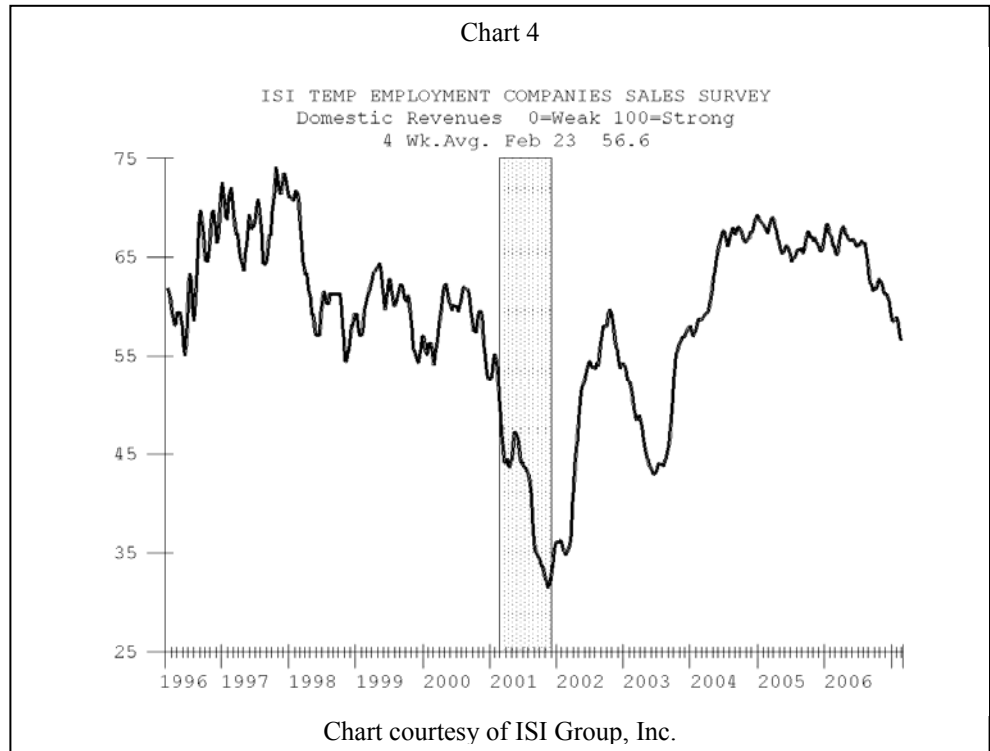
There is little doubt that the economic cycle has turned and the economy is slowing down. Due to a substantial increase in housing and auto inventories, fourth quarter gross domestic product (GDP) growth was revised

downward from 3.5% to 2.2%. Ed Hyman at ISI lists a number of indicators that all suggest the economy will grow at a slower rate in the near future, including the recent increase in unemployment claims (see Chart 1), the decline in ISI’s company surveys (see Chart 2), the decline in ISI’s trucking survey (see Chart 3) and the decline in ISI’s temporary employment survey (see Chart 4).

In many ways, credit contraction is having an impact on the economy. For starters, mortgage equity withdrawal has plunged -\$500 billion from its peak in late 2005 (see Chart 5) as creditors pull back on cash-out refinancing. Also, with credit less readily available, the demand for housing is not likely to rebound any time soon. (We took a month off from discussing housing in the *Update*, only for the picture there to darken considerably.) According to a February 5, 2007 *Wall Street Journal*

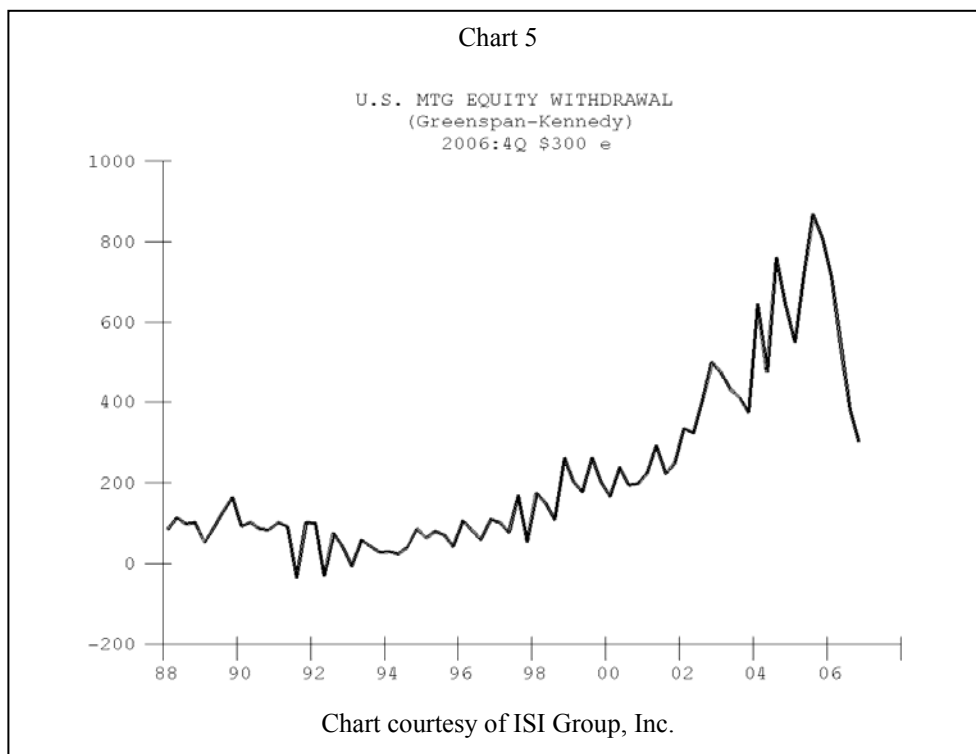


article by Michael Corkery entitled, Vacant Homes For Sale Cloud Economic Hopes, in the final three months of 2006 there were about 2.1 million vacant homes for sale. That put the national homeowner vacancy rate at 2.7%, up from 2.0% a year earlier. Before 2006, the number had never risen above 2.0%. According to a February 16, 2007 *Wall Street Journal* article by James R. Haggerty entitled, Home Prices Decline in Majority of Cities, in February, the National Association of Realtors (NAR) for the first time in



its history of data collection (which dates back to 1979) recorded declining or unchanged prices in the majority of the cities from which they receive reports. Bloated inventories and declining prices indicate homebuilders must continue to cut back on their construction, even after the -13% decline in new home starts in 2006. According to Ed Hyman, history tells us that big declines in housing starts always lead

significant slowdowns in GDP (see Chart 6).

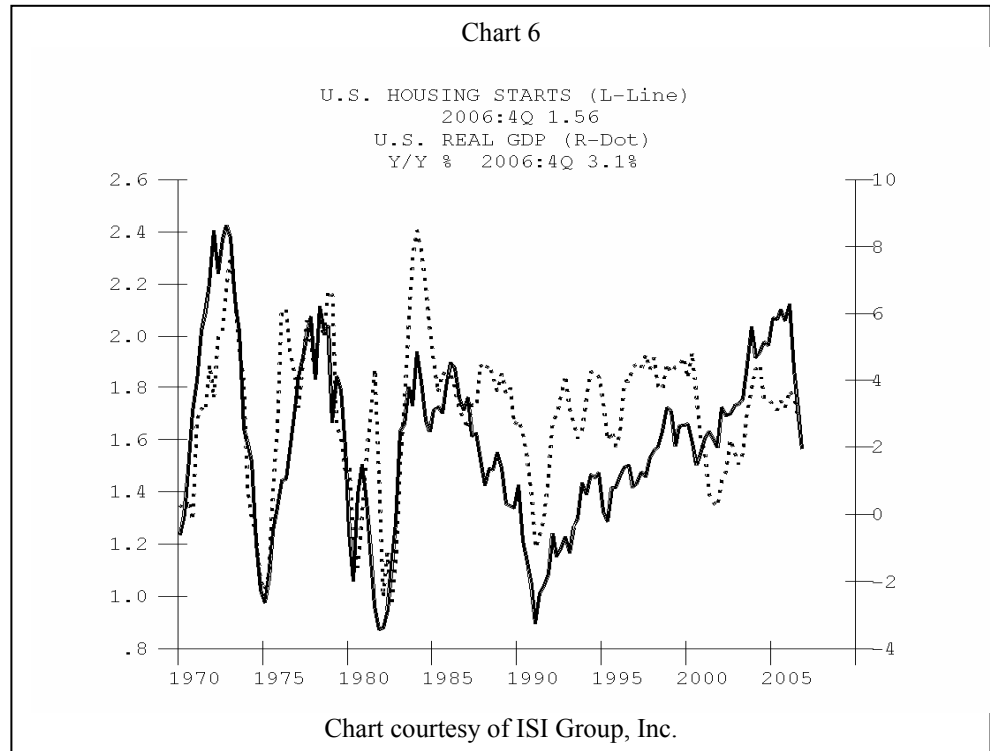


What remains in doubt is how much the GDP will slow. If a slowdown is in the cards, we expect financial markets to do well. If the slowdown turns into a recession, we foresee a bear market.

What is certain is that the market reacquainted itself with an old nemesis during the week of February 26, 2007: risk. Five years of financial market tranquility ushered in a sense of

market complacency. That week, unprepared participants were reminded that the scariest words in the capital markets are, “this time it’s different.”

For those who are prepared, risk can be a good thing. As the tremors and volatility associated with the February 27, 2007 market action reverberate through portfolios, stock selection should come front and center. For now, a rising tide will not lift all boats. Nor will good and bad news be treated with the same bullish slant, as the market learns to discriminate between winners and losers.



With eyes wide open to growing risks, we believe we are well positioned to avoid the bad haircuts that can be associated with increased volatility and credit contraction.

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