

UPDATE

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“We must conclude that innovation and structural change in the financial services industry has been critical in providing expanded access to credit for the vast majority of consumers, including those of limited means. Without these forces, it would have been impossible for lower-income consumers to have the degree of access to credit markets that they now have. This fact underscores the importance of our roles as policymakers, researchers, bankers, and consumer advocates in fostering constructive innovation that is both responsive to market demand and beneficial to consumers.”

-Former Federal Reserve Chairman Alan Greenspan, April 8, 2005

“To suggest the Fed was pushing subprime mortgages or even adjustable-rate mortgages is just not accurate. I was merely identifying an arithmetically obvious issue, that some mortgage borrowers, admittedly a very small segment, would do better with a different product. But I always viewed it as a very small segment of the market.”

-Former Federal Reserve Chairman Alan Greenspan, March 23, 2007

Abused Prescription

It must be difficult being the Chairman of the Federal Reserve. The pressure of successfully navigating the world's largest economy seems palpable. Moreover, the scrutiny with which your words are studied does not allow for even a moment's carelessness. Such constant intensity would imaginably be enough to break even the most able economic minds. As the quotes above suggest, former Federal Reserve chairman Alan Greenspan, the man the markets hastily dubbed “the maestro,” has been driven into a serious state of denial in response to warranted Congressional criticism that his encouragement of “*providing expanded access to credit for the vast majority of consumers, including those of limited means*” aided and abetted the recent implosion in subprime mortgage credit.

We have long viewed Easy AI as an enabler of economic excesses. As such, we certainly don't find it shocking that his past actions are now coming back to haunt him. Try as he will to avoid the torrent of criticism, his reputation will likely be tainted from the financial wounds his policies inflicted. Looking forward, we wonder what impact Greenspan's policies will have on the current Chairman, Ben Bernanke. In his March 28, 2007 testimony to the Joint Economic Committee of Congress Mr. Bernanke told congressmen that he thought the problems within the subprime mortgage market remain contained, but that they would need to be monitored closely because they could spread into other markets. We believe there is substantial evidence suggesting the credit virus has already spread. As such, we remain confident that the subprime meltdown is simply a red herring for a coming credit contraction.

With just a quick glance at the shared characteristics between subprime and Alt-A mortgages (see Table 1), one sees reason for concern. Andy Laperriere at ISI Group, Inc. was one of the first to warn of

the potential contagion in the Alt-A space. According to a March 16, 2007 *Bloomberg News* article by Mark Pittman entitled, PIMCO Says Subprime Collapse May Spread to Alt-A, Jumbo Loans, the mortgage group at PIMCO thinks “It is likely that the poor performance we have seen in subprime loans will carry over...into the most aggressively underwritten loans in the Alt-A...markets.” Further, recent research from Portales Partners uncovered a mortgage real estate investment trust (REIT) specializing in Alt-A loans that was just forced into bankruptcy due to early payment defaults (EPDs) that have, thus far, been the calling card of the subprime mortgage crisis. (EPDs occur when delinquency rates on mortgage loans spike early enough in the loan’s life to force a repurchase by the loan originator.) In a statement a spokesman for the failed REIT said, “Despite the fact that we have no sub-prime credit exposure, we have experienced a marked increase in the number of EPDs of the Atl-A loans.” According to a March 13, 2007 *Dow Jones Newswires* article by Alistair Barr entitled, Alt-A Mortgage Losses Accelerate, Threatening MBS, Alt-A adjustable rate mortgages that were originated last year have seen a fourfold increase in delinquencies of at least 60 days. The article concludes that this alarming deterioration could have dire consequences for some investors in lower-rated mortgage backed securities.

Table 1

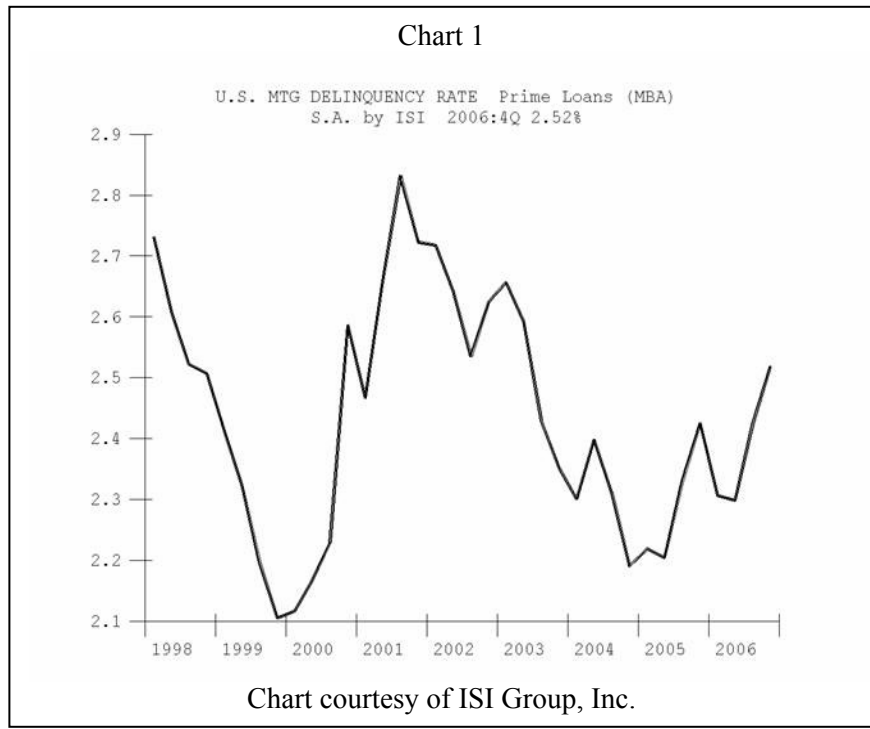
	<u>Subprime</u>	<u>Alt-A</u>
ARM share	92%	63%
Interest-only share	22%	27%
Neg am share (option ARMs)	0%	32%
Average debt-to-income	42%	38%
Piggyback loan share	55%	54%
No or low documentation share	50%	81%
Prepayment penalty share	70%	48%
Non-owner occupied share	10%	22%
Average FICO score	627	710

Sources: Loan Performance, Lehman, Fannie Mae, UBS, Fitch.

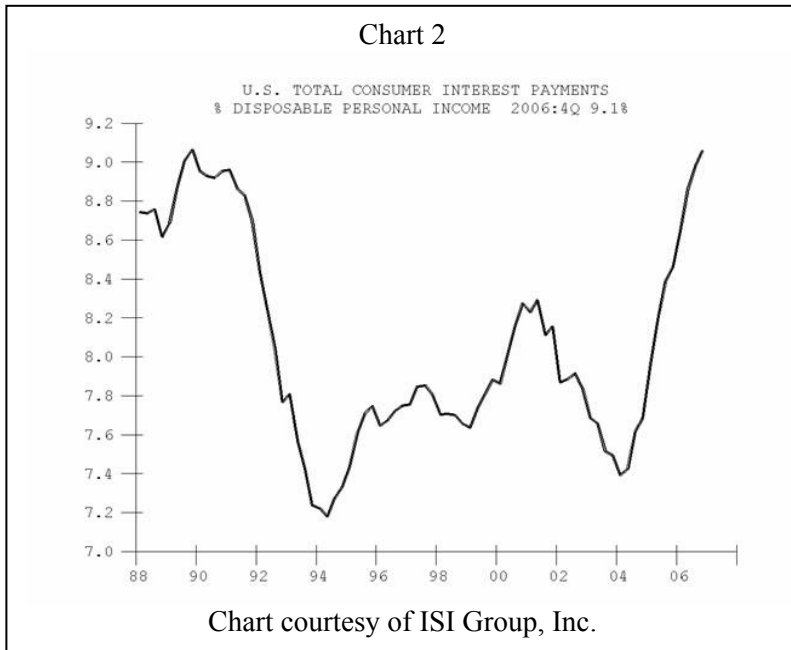
Table courtesy of ISI Group, Inc.

Laperriere says the mortgage delinquency rate for prime loans has risen as well. And, if the economy slows further as ISI expects after a brief growth spurt, the prime mortgage delinquency rate should climb further (see Chart 1). According to a March 24-25, 2007 *Wall Street Journal* staff article

entitled, Signs of Subprime Spill, a large non-subprime lender was forced to shut down due to lack of credit availability. The company’s CEO said, “We didn’t have a big subprime explosion. That’s not what happened here. But a tightening of credit did affect us. We just did not have the capital to withstand the continuing of the credit crunch.”



Alarming, the signs of borrower strain are coming during a period of rising employment and, thus far, economic expansion. However, as fund-of-funds manager John Mauldin points out in his March 16, 2007 *Thoughts From the Frontline* newsletter, “The main

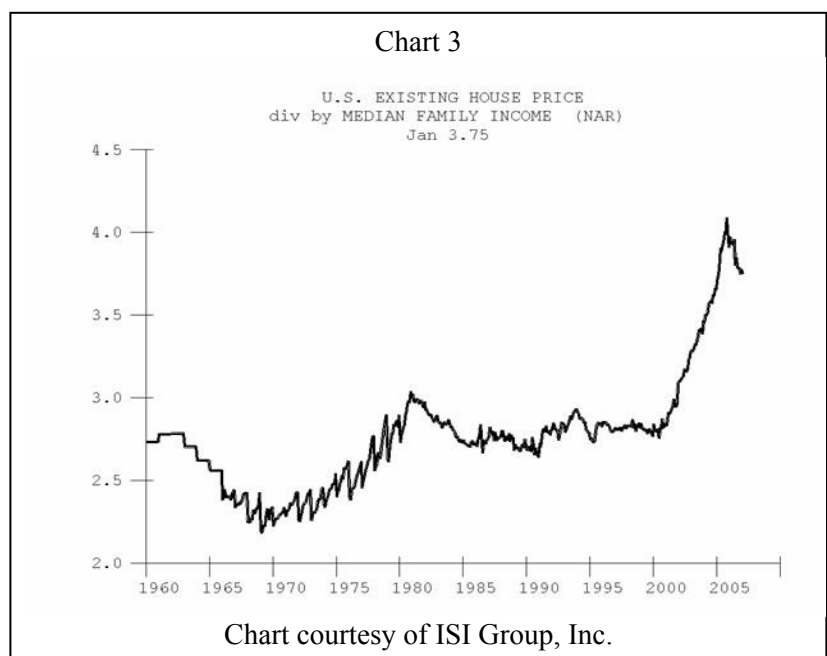


reason homeowners give for falling behind on their mortgage payments is not a change in personal circumstances, but instead, they are not able to make the increased payments on their adjustable rate mortgages (ARMs).” This is because total consumer interest payments are currently at the highest level as a percentage of disposable personal income (DPI) in history (see Chart 2). Part of the reason for these high interest payments is that consumers collectively stretched to buy houses that were drastically overvalued by many historical measures (see Chart 3). Homes became overvalued because consumers and investors had unprecedented easy access to credit with which to purchase homes. ARM

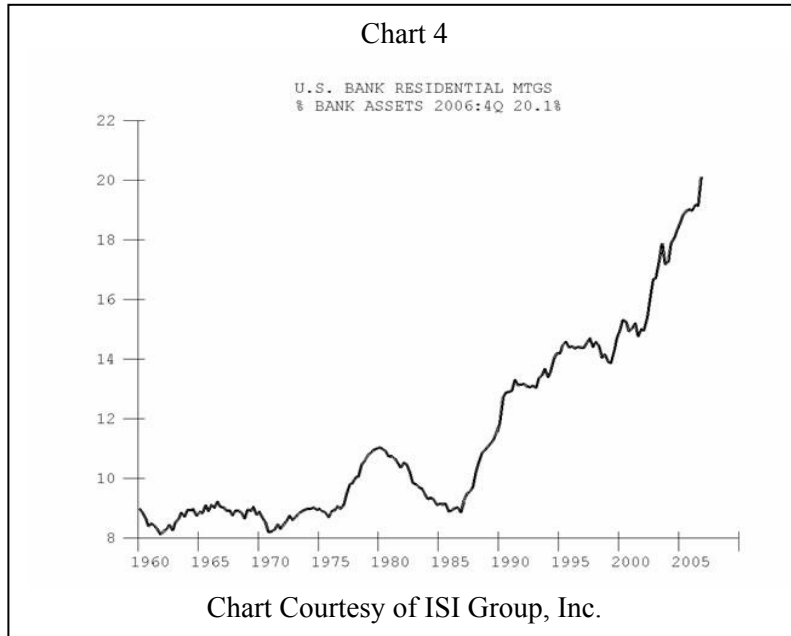
adjustments will only exacerbate an already deteriorating situation. We have come full circle.

Easy access to credit is now a thing of the past and the credit contraction has only just begun. Tom Gallagher at ISI believes it is highly likely that Congress will pass legislation placing overly tight regulation on the mortgage industry. According to a March 17, 2007 *New York Times* article by Stephen Labaton entitled, [Lawmakers Aim to Curb Loan Abuses](#), Senator Chuck Schumer (D-NY) predicted that the Senate would approve such legislation within the next six months. According to Gallagher, “Executives at some of the largest mortgage companies say that 60% of the subprime loans being made today will not meet the subprime guidance that will take effect this summer.”

Congress is also looking at the mortgage credit rating agencies whose triple-A credit blessings on the worst subprime junk have become a hot-button issue. Senator Richard Shelby (R-AL) has asked regulators how these dangerous subprime loans could have received the such high ratings and he has called on the Senate Banking Committee to pursue the issue. Under pressure, a leading U.S. credit rating agency took a highly embarrassing U-turn by declaring it would review its controversial new rating methodology. ISI says their best guess is that the credit rating agencies will soon be forced to downgrade subprime mortgage-backed securities and collateralized debt obligations,



calling into question their ratings for Alt-A and other mortgage-related securities. According to a March 12, 2007 *New York Times* article by Gretchen Morgenson entitled, Crisis Looms in Market for Mortgages, many pension plans and insurance companies who have been buying mortgage-backed bonds cannot own securities that are rated below investment grade. The same holds true for many non-profit foundations and other entities whose investment policies forbid or restrict portfolio exposure to riskier investments. A downgrade of these securities would trigger forced selling, putting potentially enormous pressure on an already beleaguered market. It looks like major banks may also be on the hook. According to the Federal Reserve's flow of funds data, banks added to an already poorly-timed asset allocation by increasing their real estate mortgage holdings 16% year-over-year in the fourth quarter of 2006. The Fed data indicates banks could hold a record 20% of their total assets in residential real estate mortgages (see Chart 4).



As Bill Gross notably pointed out in his April *PIMCO Investment Outlook*, “it will not be loan losses that threaten future economic growth...but the tightening of credit conditions that are in part a result of those losses. Such tightening conditions will likely continue to wreak havoc on the already suffering housing sector.” A recent survey of private homebuilders and mortgage lenders by Ivy Zelman, the prescient housing and building materials analyst at Credit Suisse First Boston suggests that 40% of housing market demand is at risk of significant fallout from tightening credit and increased regulatory scrutiny. Zelman estimates that the peak-to-trough drop in housing starts will be on the order of -35% to -45% (versus only a 16% decline thus far), based on her analysis of the reduction in demand from credit tightening, the excessive level of investor speculation in recent years and the risks of a softening economy. In other words, the housing market decline has just begun.

Indeed, February's housing statistics tell the story. New home sales in February were down -18% year-over-year. Inventory was also higher, ringing in at 8.1 months supply, well up from the 6.4 months supply a year ago and, according to Portales Partners, the highest reading since January 1991. Dave Seiders, the chief economist for the National Association of Home Builder's called the housing data, “very sobering.”

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To be sure, mortgages are not the only credit market experiencing lending excesses. According to a March 27, 2007 *Wall Street Journal* article by Dennis K. Berman entitled, Sketchy Loans Abound, lenders have been doling out increasingly large sums of money and accepting increasingly crummy conditions and meager returns on their loans to corporate borrowers. A study by Standard & Poor's found that since the beginning of 2007, debt buyers have taken on \$41 billion of these “covenant lite” loans, a figure greater than the last 10 years combined. (Covenant lite loans subject the borrower to few, if any, performance requirements and allow the lender little recourse should the borrower default.) These loans

represent 37% of the dollar value of institutional loans written thus far in 2007, compared with just 1% in 2005. In a troubling case of déjà vu, the buyers of these loans say that structural changes in the debt markets have fundamentally changed the landscape by spreading risk far and wide. In an April 2, 2007 research note, Portales Partners wrote, “U.S. high yield default rates hit an all time low of 0.76% in 2006 [due in part to] unprecedented amounts of rescue financing.” In other words, before the loans went bad, they were restructured. S&P analyst Steven Miller believes the corporate debt markets, “have reached a point where [they] can’t go any further. Some of the deals introduced into the market [this year] felt like they were at the edge of a cliff, leaning over. With someone holding their belt loops.”

As for the ability of financial innovations, i.e. derivatives, to help absorb the shocks associated with credit losses, don’t hold your breath. Moody’s Senior Credit Officer, Matthew Noll, says, “We haven’t had a hard shock to the credit markets since 2001. It’s yet to be seen how the new shock absorbers actually take the shock.” Portales concludes, “considering the size of the high yield markets, the unprecedented low spreads and default rates, the weakening of covenants and lax regulation for the markets...the recent widening of junk bond spreads seems to be a harbinger of things to come. One does not need to believe in something as strong as a recession to envision a coming junk bond dislocation...you just need to believe in mean reversion.”

As credit quality and availability both turn south, so too will economic growth. Economist Ed Hyman recently retooled his economic forecasting model to include the effects of declining mortgage equity withdrawal (MEW). The result: he now believes gross domestic product (GDP) growth for this economic cycle will bottom at 1%, versus his previous estimate of 1.6%. While Ed still has faith in his 2% economic growth forecast for the second-half of 2007 he says that if he was forced to change this forecast, he would be more inclined to lower it to 1% than he would be to raise it to 3%.

There is a belief among many in the medical community that the over-prescription of antibiotics is having an adverse impact on our ability to fight off infections. It is believed that prescribing these medications for common colds and other minor illnesses has led to newer, stronger infections that are immune to these drugs. There are parallels in current monetary policy.

No matter how he remembers it, Alan Greenspan’s willingness and eagerness to inject the economy with liquidity at the first signs of sickness, over time, has led to the belief that the equity market would never be allowed to fall too far, a.k.a. the notorious “Greenspan put.” Many bullish market participants champion the new era of liquidity that began with the Greenspan Fed. But, as Paul McCulley said in the March *PIMCO Cyclical Forum*, “At the end of the day, liquidity isn’t about money stock growth, but a risk-seeking state of mind. In other words, liquidity isn’t about money on the sidelines per se, but rather about the risk appetite of those on the sidelines. And when risk appetite turns, no amount of liquidity on the sidelines matters.”

For some time there has been evidence that Greenspan’s liquidity antibiotic is losing its effect. As Table 2 clearly indicates, for each extra \$1 of debt we assume in our system, we are now getting only \$0.34 in GDP expansion, a record-low return for modern debt-financed economic expansions, and evidence that our economic woes are showing liquidity immunity due to Greenspan’s over-prescription. A look at Chart 5 shows that total credit market debt (the combination of corporate, household and government borrowing) is \$44.5 trillion, or a record 331% of GDP. The amount of “drugs” injected in our economic system under Greenspan has had the nasty side effect of feeding our addiction to debt at the

expense of future economic growth with the added cost of reducing our country's ability to withstand potential economic shocks. Have we compromised our ability to fight future illness? Another glance at Chart 5 shows that the Fed has been forced to stop tightening liquidity at incrementally lower levels of the Fed funds rate. In other words, once off the meds, the economy gets sicker, quicker.

As Ned Davis of Ned Davis Research, Inc. concludes, "easy and nearly free credit...encourages risk taking to excess, and whether it be the dot.com bubble of 1998-2000 or the subprime mortgage excesses of 2005-2006, it always leads to serious corrections. It is my 'two-cents worth' that the debt is sapping our economic strength longer-term...and despite some of the lowest interest rates in decades, it has forced debt service to near-record levels relative to income."

Table 2

Debt-Financed Expansions			
03/31/1961 - 12/31/2006			
Economic Expansion	Increase in GDP in billions \$	Increase in Debt in billions \$	GDP / Debt
03/31/1961 - 12/31/1969	476.7	604.0	0.79
12/31/1970 - 12/31/1973	379.4	475.3	0.80
03/31/1975 - 12/31/1979	1,090.5	1,503.6	0.73
06/30/1980 - 06/30/1981	356.6	391.6	0.91
12/31/1982 - 06/30/1990	2,483.3	5,727.4	0.43
03/31/1991 - 03/31/2001	4,133.5	7,428.0	0.56
12/31/2001 - 12/31/2006*	3,223.6	9,487.3	0.34
Median			0.73

Table courtesy of Ned Davis Research, Inc.

Rest assured Fed Chairman Ben Bernanke knows that the credit cycle has turned, and that the losses associated with this turn will be widespread. However, the policies of his predecessor have left him with little room to maneuver. Given the historically low levels of the Fed funds rate coupled with the record level of debt in our system (331% of GDP), Bernanke has little choice but to subversively labor in an effort to facilitate a gradual progression back down the slope of our credit apex. Bernanke does not wish to cause a credit crisis by giving the Fed's acknowledgement to a widespread credit contagion. To do so would send lenders rushing for the exits and would force him to write a prescription that he knows

would have little initial impact during a time of heightened inflation fears. In such a scenario, the Fed may find itself pushing on a string in an effort to resuscitate an economy whose health is becoming increasingly immune to liquidity interventions.

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