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UPDATE

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“Under the placid surface, there are disturbing trends: huge imbalances, disequilibria, risks – call them what you will. Altogether the circumstances seem to me as dangerous and intractable as any I can remember, and I can remember quite a lot.”¹

-Paul Volcker, former Federal Reserve Chairman

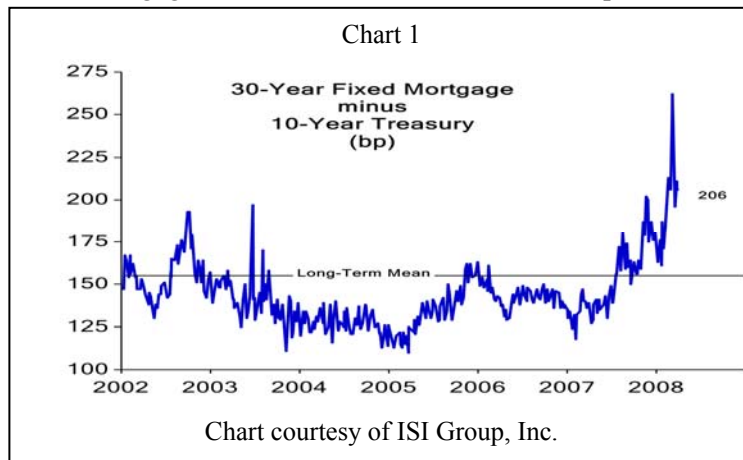
“If you have 10 bottles of water, and one bottle had poison in it, and you didn’t know which one, you probably wouldn’t drink out of any of the 10 bottles; that’s basically what we’ve got [here].”²

-Paul O’Neill, former Treasury Secretary

Fait Accompli

It was three years ago that former Federal Reserve Chairman Paul Volcker noted that “imbalances” in the U.S. economy were as “dangerous and intractable” as any he could remember. Since then, the imbalances have only grown, the danger is more severe and, seemingly, the hour of reckoning is now upon us. Frustrated by the impotence of their previous policy measures (and frightened by the ruin of a long-standing Wall Street institution) the U.S. government, led by the Federal Reserve and the Treasury Department, is waging vigorous interventionist warfare against the inevitable backlashes of deleveraging that come, part and parcel, with the unwinding of an economy’s imbalances and the resultant illiquidity when trust is betrayed.

On Tuesday, March 11, 2008 the Fed introduced the Term Securities Lending Facility (TSLF) through which it would lend up to \$200 billion in U.S. Treasuries, and, for the first time in its history, accept mortgage-backed securities (MBS) as collateral for their loans. The move was a much-applauded direct assault on illiquidity in the mortgage market. However, rumors of the possible demise of a major Wall Street investment bank kept the



markets frozen, diluting the hoped-for psychological benefits of the TSLF. The rumors were true and three days later, on Friday, March 14, 2008, the Fed announced that they would extend a temporary, emergency loan to the insolvent brokerage firm. Before the weekend was over, that firm had been sold, at auction, for \$2 a share. “It was just clear that this franchise was going to unravel if the deal wasn’t done by the end of the weekend,” said Treasury Secretary Hank Paulson³. Even though Secretary Paulson was desperate to demonstrate to Main Street that he wouldn’t rescue Wall Street on the government’s dime,⁴ that is exactly what the

¹ Paul A. Volcker, “An Economy on Thin Ice,” *The Washington Post*, April 10, 2005

² Deborah Solomon, “Market Leader,” *The New York Times Magazine*, March 30, 2008.

³ Robin Sidel, Greg Ip, Michael M. Phillips and Kate Kelly, “The Week That Shook Wall Street: Inside the Bailout of Bear Stearns,” *The Wall Street Journal*, March 18, 2008.

⁴ Andrew Ross Sorkin, “Behind the Deal, the Hand of the Fed,” *The New York Times*, March 25, 2008.

federal government did, going against decades of policy and crossing a self-imposed threshold by propping up a specific investment bank.

The days that followed witnessed a shock-and-awe campaign of interventionist policy from both Fed Chairman Ben Bernanke and Paulson that included hundreds-of-billions of dollars in new liquidity for the mortgage markets through increases in the government sponsored entities' (GSEs) loan limits and decreases in their capital restrictions, and an increase in the amount of mortgage loans the federal home loan banks (FHLBs) can purchase. Further, the Fed announced that it would open up its discount window to investment banks via the Primary Dealer Credit Facility (PDCF). Thus, for the first time in history, investment banks have the same access to loans from the nation's lender of last resort as do other, more regulated banking institutions. It was enough to make a socialist blush. "The Fed seems to be drawing a line...letting [one] firm go but setting up a new facility to try to prevent a similar run on other investment banks," wrote Andy Laperriere at ISI Group, Inc. As collateral for the loans to investment banks, the Fed announced they would accept just about anything short of used lottery tickets.



Much like a patient in a psychiatrist's office, with each move the Fed makes it is revealing to the markets what it wishes to conceal. For all its creativity, the Fed's actions are an acknowledgement that its previous steps have failed to stem the collapse in investor confidence.⁵ As evidence, spreads between 30-year mortgage yields (see Chart 1 on previous page), corporate bond yields (see Chart 2) and high-yield corporate bond yields (see Chart 3) and 10-year Treasury yields remain at elevated levels. Additionally, after falling precipitously since November 2007, the three-month London Interbank Offer Rate (LIBOR) increased during the last two weeks of March 2008, suggesting

that banks may still be wary of lending to one another. What the Fed knows and the market senses is that after several years of unprecedented debt growth and lax underwriting standards, losses will, eventually, be recognized and more pain will be felt. "Deleveraging out of the most recent cycle will be a rabid bitch," wrote Doug Kass, general partner and investment manager for Seabreeze Partners. "There will be many more currency, economic and hedge fund casualties. The Fed can only do so much – any more could jeopardize the world's view of its creditworthiness."⁶

To be sure, we have not yet seen the end of losses and charge-offs related to the housing market and mortgage security calamities. Despite calls of a bottom by many market observers, the fundamentals for



⁵ Greg Ip, "Central Bank Offers Loans To Brokers, Cuts Key Rate," *The Wall Street Journal*, March 17, 2008.

⁶ Doug Kass, March 17, 2008.

housing are not indicative that the worst is over. Housing inventories remain elevated well above their historical mean (see Chart 4) while house prices remain unaffordable for the average prospective homeowner (see Chart 5). This suggests that house prices, which fell -10.7% in January 2008 on a year-over-year basis, have more downside.

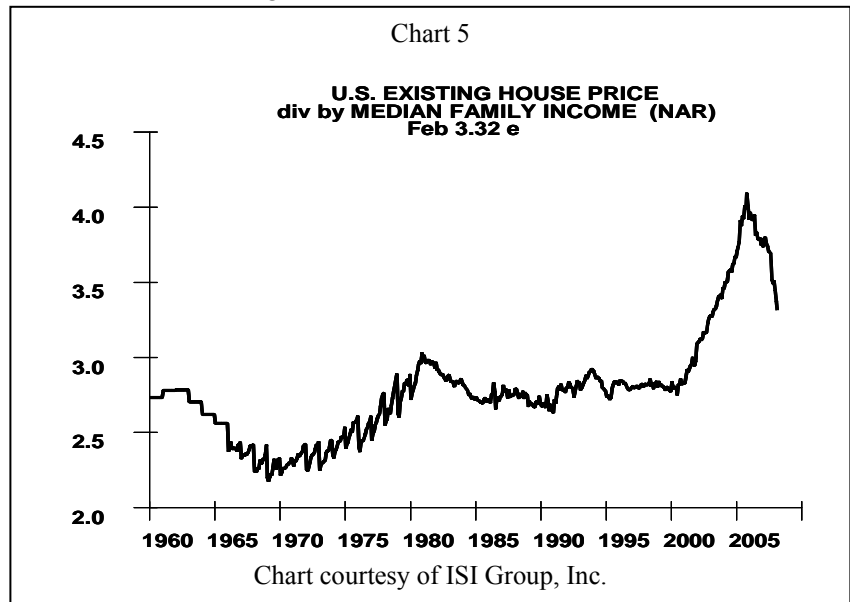
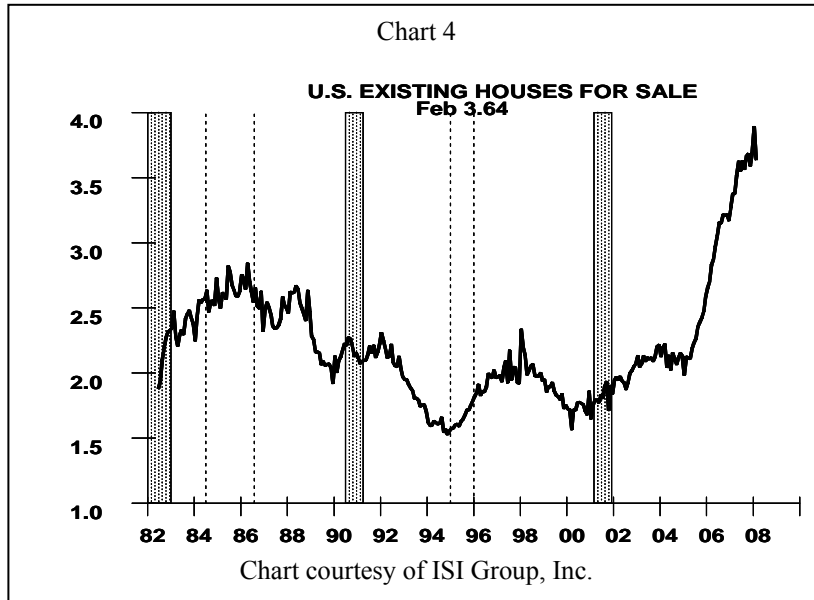
The housing asset is the collateral underlying much of the derivatives-based debt that currently sits on banks' balance sheets, packaged as residential mortgage securities (MBS), collateralized debt obligation (CDOs), collateralized mortgage obligations (CMOs), etc. Interestingly, in March 1999, formal Federal Reserve Chairman

“Easy Al” Greenspan, long an opponent of derivatives regulation, told the Futures Industry Association that derivatives “enhance the ability to differentiate risk and allocate it to those investors most willing and able to take it.”⁷ And take it they will. Goldman Sachs estimates there will be another \$400 billion in write offs from derivative losses on banks' balance sheets. “In reality,” says Michael Greenberger, a former regulator at the Commodity Futures Trading Commission, “derivatives spread a virus through the economy because these products are so opaque and hard to value.”⁸

Legendary investor Warren Buffett long-ago labeled derivatives “financial weapons of mass destruction.” With housing fundamentals suggesting additional

price declines, the fuse on these WMDs has been lit. The federal government wants investors to believe that the situation is under control and that, with enough infused liquidity, these bombs can be diffused. But in reality, they can't. “The basic macroeconomic problem markets are contending with is the uncertain hole in the balance sheets of banks and other financial institutions that is causing them to restrict lending,” wrote Andy Laperriere. “The process of finding a market-clearing price for asset markets threatens to become a downward spiral, in the eyes of many.”

As Laperriere highlights, banks are suffering from much more than a liquidity crisis. “It is time to step back and recognize that the current situation isn't a liquidity issue and hasn't been for some time now,” says Bob Eisenbeis, a former executive vice-president of the Federal Reserve Bank of Atlanta. “Rather, there is uncertainty about the underlying quality of assets – which is a solvency issue, driven by a breakdown in



⁷ Nelson D. Schwartz and Julie Creswell, “What Created This Monster?,” *The New York Times*, March 23, 2008.

⁸ Nelson D. Schwartz and Julie Creswell, “What Created This Monster?,” *The New York Times*, March 23, 2008.

highly leveraged positions.⁹”

“If the market was ‘certain to crash’ in the event that [an investment bank] failed, then the market is certain to crash anyway, because [that investment bank] wasn't the last shoe to drop – it was one of the first. Unfortunately, we're standing in a shoe store,” wrote John P. Hussman, Ph.D., President of Hussman Investment Trust. “Wasn't the market ‘certain to crash’ without the Fed's surprise rate cut in January too? At what point will investors figure out that the liquidity problems are nothing but the *precursors* of insolvency problems? At what point will investors stop begging the government to save private companies and recognize that the losses should be taken by the stock and bondholders of the offending financial institutions?¹⁰”

The fact is, too many loans with too liberal underwriting standards were extended to too many unworthy borrowers. Our government's attempts to suspend the laws of economics, and make these bad loans good, are likely a practice in futility. They may ultimately transfer the toxic waste off the banks' books and onto the public's balance sheet, but in the end our economy will suffer via higher taxation and the swinging of the pendulum back towards more regulation.

Meanwhile, equities have rallied off their lows on the belief that Bernanke and Paulson are steadfastly resolved to fix the mortgage mess. While equity market sentiment became overly pessimistic with the fall of a large investment bank, allowing for a period of market advances, we are yet unconvinced that this cyclical period can long endure. U.S. economic growth this past cycle has been largely dependent on debt creation rather than organic economic growth.

No matter who atones for the lending sins of the past, as consumers' and banks' balance sheets repair and regulatory oversight increases, a working off of our imbalances is a must. We believe future loan losses, financial deleveraging and a prolonged period of anemic economic growth are a fait accompli.

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⁹ Liz Rappaport, “Debt Reckoning: U.S. Receives a Margin Call,” *The Wall Street Journal*, March 15-16, 2008.

¹⁰ John P. Hussman, Ph.D., “Why Is Bear Stearns Trading at \$6 Instead of \$2?,” www.hussmanfunds.com, March 24, 2008.