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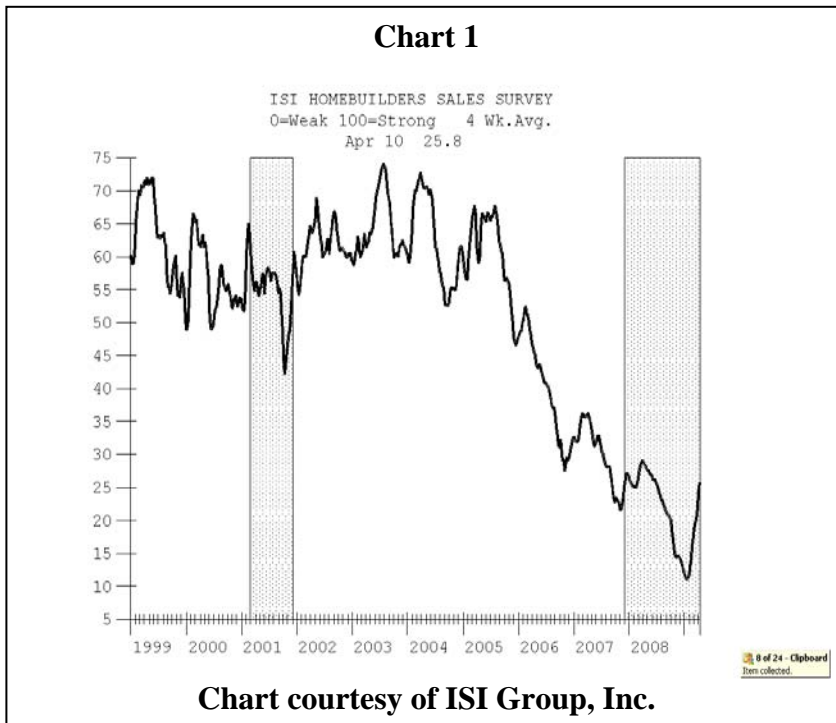
UPDATE

April 2009

“Your people, sir, is nothing but a great beast!”

-Alexander Hamilton

Beasts with Burdens

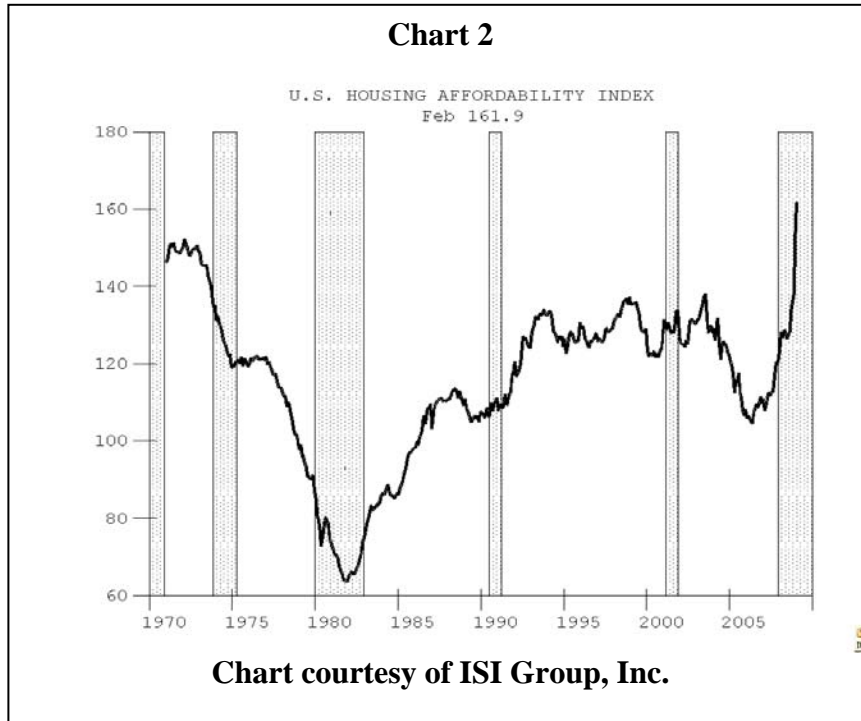


How far we have come in one month's time! At the beginning of March 2009, the consensus belief was that the U.S. economy was spiraling inevitably into depression, sending investor pessimism to record highs and shares of major banks to record lows. The nation was whipped into such frenzy over the bonuses paid to an embattled insurance company's employees that the lives of the company's executives were threatened. Congressional representatives, in a futile bipartisan witch hunt, (that trampled over the very Constitution they swore to uphold) buckled to constituent pressure, and voted to tax 90% of any bonuses paid to employees of companies receiving TARP funds.

To be bullish then was to bet against the pending death of the U.S. economy, and to bet for the effectiveness of monetary and fiscal policy. It was a bet against the battered psyche of investors and for the continued existence of capitalism. It was a bet against populist rage and for the triumph of cooler heads. Now with the arrival of spring has bloomed a petal of hope for the beleaguered economy, and with it a sense that maybe the depression many had feared is not as near as some had forecast.

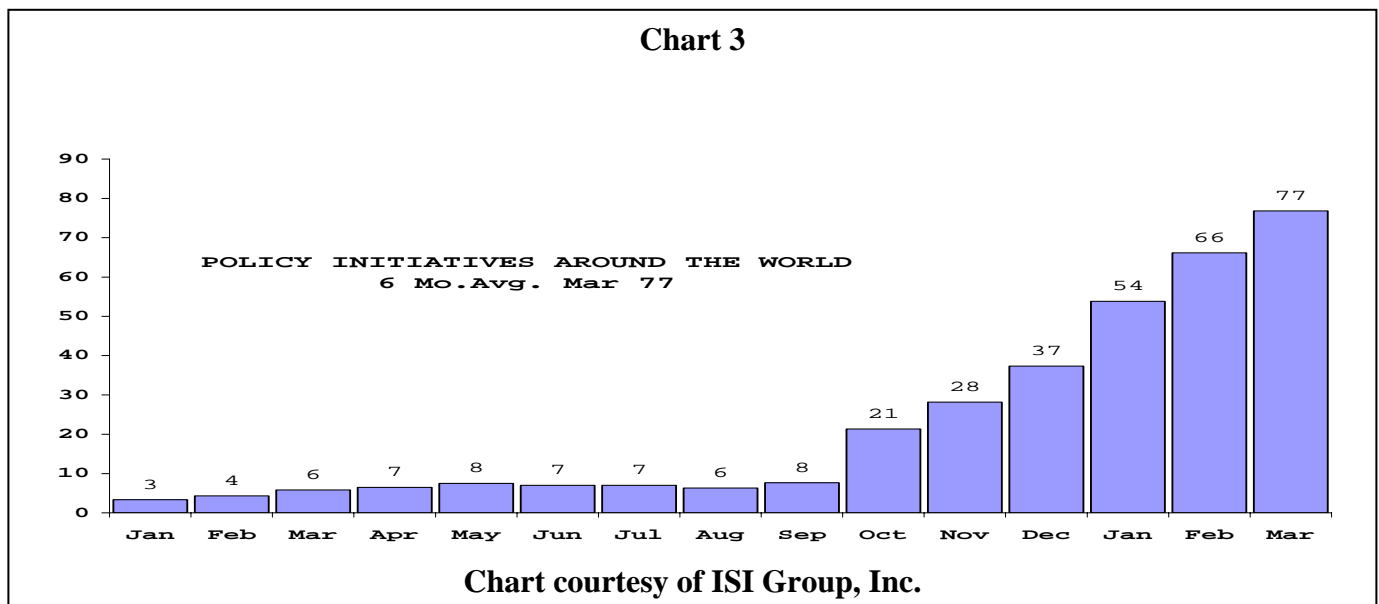
“For eleven weeks in a row, our homebuilder's survey has risen, and is at the highest level since March 2008,” wrote Ed Hyman of ISI Group, Inc on April 1, 2009. (See Chart 1.) “Existing and new home sales have ticked up. Housing affordability is already at a record high [and] will move into the stratosphere if house prices continue to decline and mortgage rates continue to decline as well,” he

concluded. (See Chart 2.) To Hyman’s point, the 30-year fixed mortgage rate averaged 4.85% in the week ended March 26, 2009, its lowest level since Freddie Mac began its weekly survey in 1971.¹



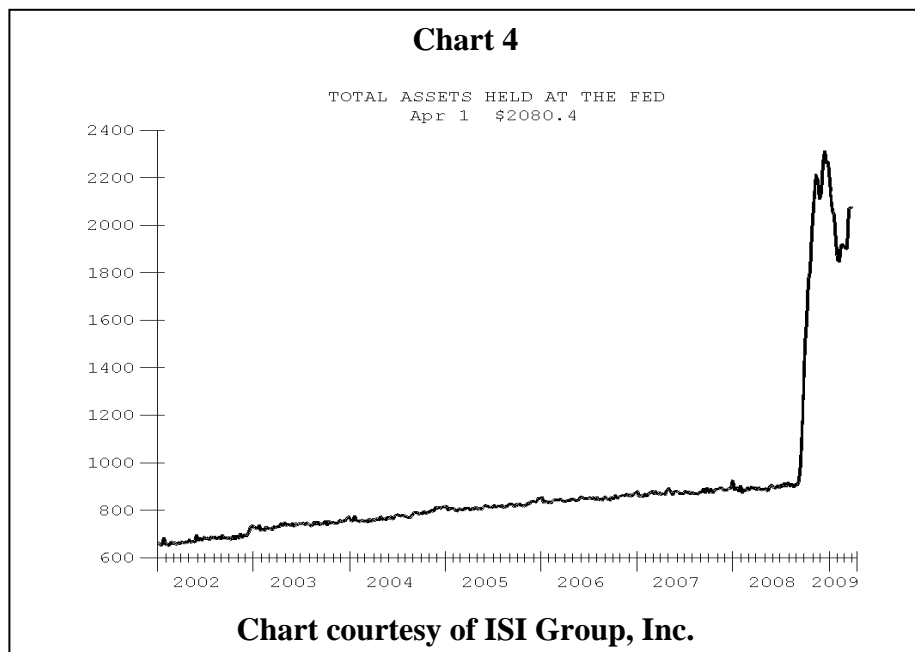
As ground zero for our economic destruction, the housing market has rightly been the focus of many of the stimulus efforts to-date, efforts that have recently picked up a very large head of steam. “There is a global policy tsunami,” wrote Ed Hyman. “Over the past six months, around the world, 500+ policy initiatives have been announced. Here in the U.S., the S&P 500 plunge to 677 on March 9, 2009 may have prompted President [Barack] Obama to pull out all the stops... Virtually every day since then, policymakers have either announced new stimulus initiatives or appeared publicly to increase confidence.” (See Chart 3 on policy initiatives around the world.)

Highlighting this policy push, in a March 24, 2009 editorial published in newspapers around the world, President Obama called on worldwide leaders to join in a combined stimulus effort aimed at lessening the downside of this recession. “My message is clear,” the President wrote, “The United States



¹ E.S. Browning, “Bears Are Wary as Bull Returns,” *The Wall Street Journal*, March 27, 2009.

is ready to lead, and we call on our partners to join us with a sense of urgency and common purpose. Much good work has been done, but much more remains. Our leadership is grounded in a simple premise: We will act boldly to lift the American economy out of crisis and reform our regulatory structure, and these actions will be strengthened by complementary action abroad.²”



This policy charge is being led by Federal Reserve Chairman Ben Bernanke. As a student of The Great Depression, Gentle Ben is keenly aware of the monetary policy mistakes made during the 1930s and seems determined not to repeat them. In a massive display of Keynesian force, the Federal Reserve has unleashed the power of its virtually unlimited balance sheet in an effort to defrost our frozen debt markets. On March 18, 2009 the Federal Reserve, acting in response to tight credit conditions, fragile, unsettled financial markets, and pressure

on financial institutions, announced that it would pump an extra \$1 trillion into the financial system by purchasing Treasury bonds and mortgage-backed securities. The Fed’s goal is to encourage more economic activity by lowering interest rates, including those on home loans, and to help the financial system as it struggles under the crushing weight of bad loans and poor investments.³ Since September 2008, the Fed’s lending programs have roughly doubled the size of its balance sheet to about \$1.8 trillion. The actions announced on March 18, 2009 are likely to expand that to well over \$3 trillion over the next year.⁴ (See Chart 4.)

For his part, Treasury Secretary Tim Geithner finally made good on his promise to present a bold plan to help banks rid themselves of the toxic assets that plague their books. Secretary Geithner thoroughly outlined his Public Private Investment Program (PPIP) in a March 23, 2009 *Wall Street Journal* editorial. Geithner wrote that he hopes the PPIP will “address legacy loans and securities as part of an overall strategy to resolve the crisis as quickly and effectively as possible at the least cost to the taxpayer.” Geithner also said his plan “shares risk with the private sector, efficiently leverages taxpayer dollars, and deploys private-sector competition to determine market prices for currently illiquid assets.”⁵ In essence, under the PPIP the Treasury and the Federal Reserve will be offering a tablespoon of financial sugar for every teaspoon of risk that investors agree to swallow. The crucial incentive for investors is that the government will lend as much as 85% of the purchase price for each portfolio of mortgages. On top

² Barack Obama, “Making the World Work Again,” *The Los Angeles Times*, March 24, 2009.

³ Edmund L. Andrews, “Fed Will Inject \$1 Trillion More To Aid Economy,” *The New York Times*, March 19, 2009.

⁴ Edmund L. Andrews, “Fed Will Inject \$1 Trillion More To Aid Economy,” *The New York Times*, March 19, 2009.

⁵ Timothy Geithner, “My Plan for Bad Bank Assets,” *The Wall Street Journal*, March 23, 2009.

of that, the Treasury would invest one dollar of taxpayer money for every dollar of private equity capital to cover the remaining 15% of the portfolio's purchase price.⁶ "These provisions need to be designed and applied in a way that does not deter the participation by the private sector in generally available programs to stabilize the housing markets, jump-start the credit markets, and rid banks of legacy assets," wrote Geithner. "We cannot solve this crisis without making it possible for investors to take risks. While this crisis was caused by banks taking too much risk, the danger now is that they will take too little."⁷

Geithner hopes the PPIP will be able to boost the prices of bad assets enough to encourage banks, insurers and hedge funds to sell them and make new loans. There is some doubt, however, whether the incentives he has offered will be enough to bridge the gap between the bid and offer prices for these loans. It seems accounting standards have allowed banks to keep these loans on their books at cost. (The often vilified mark-to-market accounting standards did not impact most of the loans on banks' balance sheets.) Because banks would probably have to sell their mortgages at a substantial discount to the value they hold on their books, they would also have to write down the value of the mortgages and book a loss in the process. In turn, that could force many banks to raise more capital.⁸ "We still have our doubts the PPIP will produce a credibly well capitalized banking system," wrote Tom Gallagher at ISI. "We don't see the size of the program as sufficient, and we doubt the program will get to the \$500 billion - \$1 trillion level. There are unlikely to be enough buyers at marks close to what banks now carry their assets at to reach this level. [Pimco Bond's] Bill Gross was quoted saying that he would be interested in buying toxic assets at 50-60 cents on the dollar, but not many banks have marks close to that level."

While Gallagher may be correct in his evaluation of the PPIP, we doubt that the policy initiatives will stop there. In fact, if Gallagher's appraisal of the PPIP is accurate, then we can almost certainly expect to see more action taken by the government to battle this economic crisis. "The Obama [stimulus] package represents the sum total of what was minimally necessary to prevent systemic breakdown, what was politically possible with a Congress that was in no mood to shell out another dime to bail out Wall Street, and what was operationally preferable — at this time — which was a strategy that did not require nationalizing Citigroup & Friends," wrote Tom Friedman, author of *The World is Flat*. "Mr. Obama is betting that the totality of economic policies his team and the Federal Reserve have put in place will act, like radiation therapy, to halt the spread and reduce the size of the cancerous tumors eating away at our financial system — and stimulate enough new growth and optimism so that Phase II will be small enough to get past Congress and the public... Have no doubt, Phase II is coming. At best, it will require hundreds of billions of dollars more, at worst more than a trillion, to deal with more bad loans and toxic assets weakening the economy — problems that Phase I can't fully absorb."⁹

While we appreciate the fortitude shown by our policy prescription writers, we do worry about the side effects of the treatment they prescribe... what amounts to another debt hit for the leveraged addict. In a dangerous early warning sign that the patient is not tolerating these meds well, investors have hesitated at buying recent government debt issues. If the appetite for Treasuries continues to wane, and yields continue to increase, it could spell trouble for the Obama administration (not to mention its economic

⁶ Edmund L. Andrews and Eric Dash, "U.S. Expands Plan to Buy Banks' Troubled Assets," *The New York Times*, March 24, 2009.

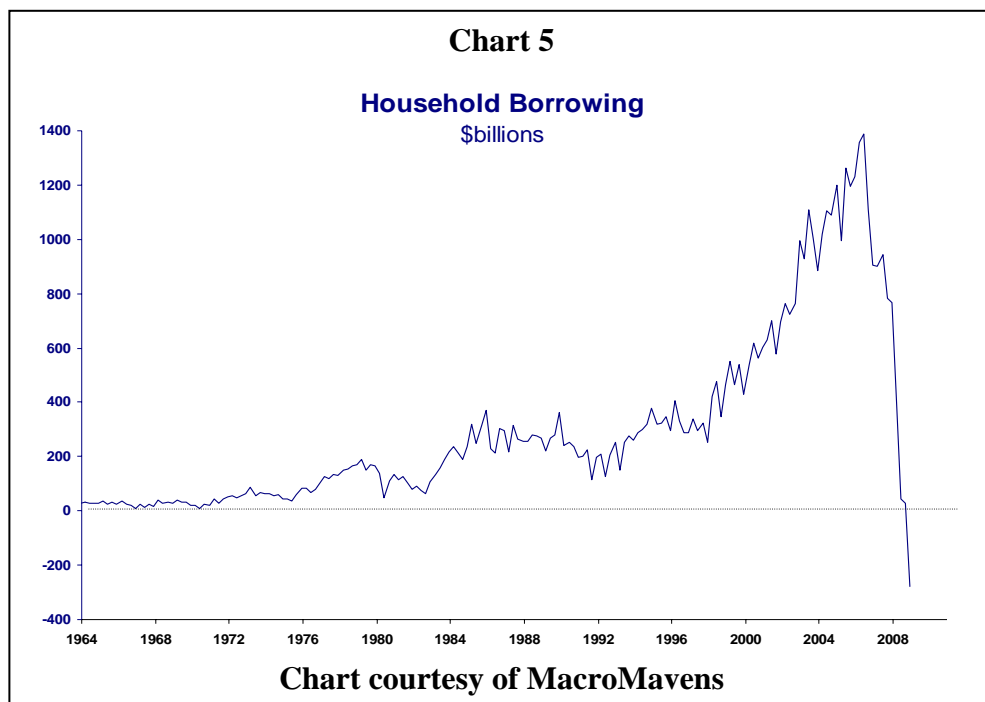
⁷ Timothy Geithner, "My Plan for Bad Bank Assets," *The Wall Street Journal*, March 23, 2009.

⁸ Jody Shenn, "Geithner's Non-Recourse Gift That Keeps on Giving to Bill Gross," *Bloomberg News*, April 2, 2009.

⁹ Tomas Friedman, "Obama's Big, Bold Bet," *The New York Times*, April 5, 2009.

patient) as it borrows unprecedented sums to pay for the hundreds of billions of dollars it is spending to fight the economic downturn.¹⁰ “While it remains to be seen whether policymakers’ efforts succeed or fail, the one thing we know for sure is that they will do so spectacularly,” wrote Stephanie Pomboy of MacroMavens. “How could it be otherwise? At \$13 trillion the sum total of commitments to rescue our economy and financial system made thus far (a figure I continue to fear is nowhere close to final) amounts to 90% of GDP. That statistic would be staggering enough if we were using money we had – ya know, stuff we had shrewdly squirreled away for just such an occasion,¹¹” she wrote.

Normally we would shun this increase in debt-financed government spending, but we think the current economic situation renders it appropriate. Yes, it is detrimental to the long-term health of our economy for the government to run trillion-dollar deficits for years to come, but to have a long-term outlook you first must survive the short-term. This Keynesian prescription, despite its risk, is what is necessary to combat the unprecedented deleveraging of the American consumer. “According to the just-released Flow of Funds report, households paid down debt last quarter for the first time in the 56-year history of the series,” wrote Pomboy. “We’ve seen plenty of cyclical ebbs in borrowing before. This ain’t one. Nothing about this chart says ‘standard cyclical retrenchment.’¹²” (See Chart 5.)



How frustrating it must be for households that, despite their new-found thrift, are making no progress repairing their (out-of) balance sheets. “Household debt has skyrocketed relative to household assets,” wrote Ned Davis of Ned Davis Research, Inc. “But it was plunging assets and only modest credit growth that caused this [increase]. While credit growth is actually pretty moderate, this chart suggests secular problems remain.¹³” (See Chart 6.)

We concur. But while we still believe we are in a secular bear market, we maintain that even the worst secular bear markets have swift and significant bull rallies, like the one we are currently experiencing. “I respectfully disagree with the prevailing negative consensus, most of whose members failed to properly analyze the cracks in the foundation of credit, in the economy and in equities two years

¹⁰ Jack Healy, “Weak Demand at Auction Leads Treasury to Pay Higher Rate,” *The New York Times*, March 26, 2009

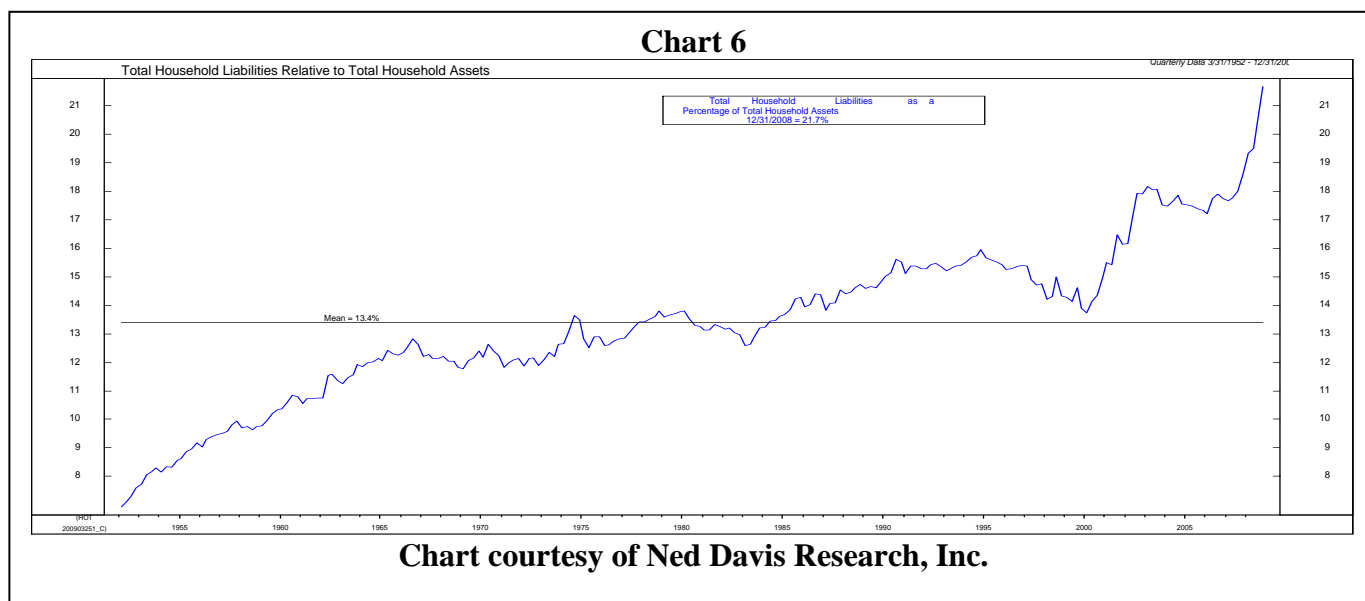
¹¹ Stephanie Pomboy, “The Bernanke Glut,” *MacroMavens*, April 3, 2009.

¹² Stephanie Pomboy, “”, *MacroMavens*, March 20, 2009.

¹³ Ned Davis, “Institutional Hotline,” *Ned Davis Research, Inc.*, March 25, 2009.

ago,” wrote Doug Kass, General Partner at Seabreeze Partners Management, Inc., in support of his own bullish outlook. Kass added that, “in the fullness of time, public policy aimed at stimulating the economy (in general) and in housing (in particular) should bear fruit, as will the ring-fencing of toxic bank assets serve to unclog the transmission of credit.”

On this last point we part from Kass and side with Gallagher of ISI. “We think policy has taken out material downside economic and financial risks and has put in place meaningful fiscal stimulus,” Gallagher wrote. “But we are more concerned about whether a stimulus-induced bounce in growth can be sustained, due to inadequately capitalized banks.” Thus it seems Friedman’s prediction for a stimulus “Phase II” will likely come to fruition.



Alexander Hamilton, our nation’s first Treasury Secretary, believed the people to be a great beast. When strengthened by numbers and collectively provoked the crowds will often act against their own self interest. Today, the beast bears the burden of leverage and is understandably aroused when others with leveraged balance sheets are bailed out on the people’s dime. Thus, we wonder how receptive the beast will be to another round of bank aid. If the people balk, Congress may wither as well, leaving Obama’s “Phase II” dead on arrival.

However, the genesis of our current market rally was expansionary monetary and fiscal policy. Should populist backlash serve to retard these policy measures, it could pose a threat to the progress the markets have made since the March 2009 lows.

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