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UPDATE

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“At some point in the future the Fed may decide to take no [interest rate] action...in the interest of allowing more time to receive information relevant to the [economic] outlook.”

-Federal Reserve Chairman Ben Bernanke in testimony given to the Joint Economic Committee of Congress on April 27, 2006

As the #1 ranked economist on Wall Street for 26 consecutive years, Ed Hyman of ISI Group, Inc. has developed quite a following among investors, including the authors of this *Update*. Ed's forecast for 2006 is for the U.S. economy to experience a slowdown in which the annualized growth in real Gross Domestic Product (GDP) will moderate to around 2.5% from a torrid 4.8% in the first quarter of this year. By Hyman's calculation, such moderation would be welcome, as it would allow the Fed to halt its policy of monetary tightening (through which they have raised the Fed Funds rate from 1.00% to 4.75%). Many on Wall Street believe this should unleash a price/earnings multiple expansion for the equity markets similar to what was experienced in the mid-cycle slowdown of 1995. Judging by the behavior of the markets over the last few weeks, Wall Street is following this script.

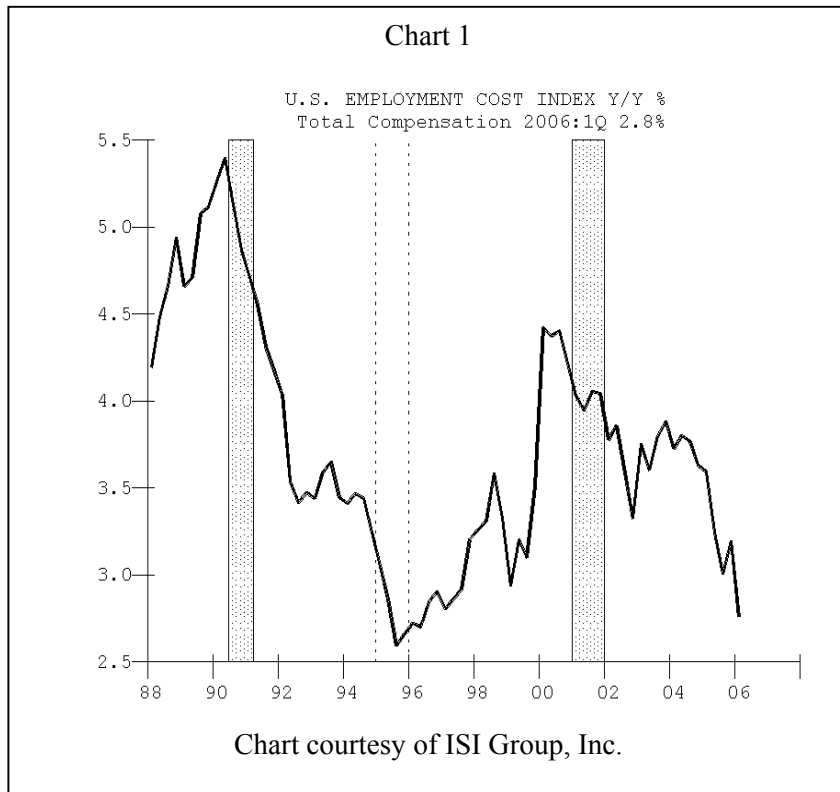
On Friday April 14, 2006, a day the markets were closed for trading, Greg Ip of *The Wall Street Journal* (who is viewed by some as the Fed's media conduit of choice) wrote an article entitled Some Fed Officials: No Commitment to May Rate Hike. Indicating the Fed may be close to pausing, Ip wrote, "Some Fed officials say [the latest Federal Open Market Committee (FOMC) minutes] were trying to convey an inclination, not a commitment, to move rates in May, and weren't sending any signal about June. With short-term rates now close to normal levels...the Fed believes [they] can soon pause."

You could almost hear the announcer screaming, "and they're off!" as the market, anxiously anticipating any sign of a pause in this now 23-month-old tightening phase, ran out of the gates the following Monday morning. From the day Ip's article was published through the end of April, the S&P 500 with income appreciated 1.74%. But is this rally a harbinger for significant equity market gains in 2006? Or, has Wall Street's prediction become so popular that the markets have fully anticipated this move and driven valuations up in anticipation of the pause?

To help answer these questions we must consider both the current inflation and economic outlooks, and what they might mean for future FOMC decisions. To be sure, the inflation picture is cloudy. There are currently multiple signs of accelerating inflation, including gold now trading at over \$650 a troy ounce and oil (as our politicians keep reminding us) continuing to trend higher with the 52-week average price now above \$65 a barrel. The Goldman Sachs Commodity Index (GSCI) is now above 470, up from 200 in 2003. ISI notes that in the past, such surges in inflation have been met with Fed tightening and recessions. Additionally, the consumer price index (CPI) for rents is forecasted to increase 3.5% year-over-year in the first quarter of 2006. Doug Kass, President of Seabreeze Partners

Management, Inc., notes that with rental costs representing about 38% of the core CPI, this increase in rent prices “raises the specter of a far more hawkish Fed.” In market parlance, the doves giveth (through policy accommodation) and the hawks taketh away.

Yet, despite these significant signs of accelerating inflationary pressures, actual year-over-year inflation readings in March remained remarkably subdued both in the U.S. and abroad. In the U.S., the core CPI rose 2.1%. In Brazil, the General Price Index (GPI) declined -0.3%, Taiwan’s CPI rose 0.4%, Korea’s core CPI rose 0.5% and Germany’s CPI rose 1.8%. Importantly, the U.S. employment cost index (ECI) actually decelerated to a 0.6% quarter-over-quarter gain in the first quarter of 2006 from a 0.8% quarter-over-quarter gain in the fourth quarter of 2005. On a year-over-year basis, the ECI is up only 2.8% and is in a clear pattern of deceleration (see chart 1).



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It certainly seems that the emergence of Brazil, Russia, India and China (the BRIC’s - discussed in past *Updates*) continue to impact the inflationary horizon as these countries inflate the prices of what they consume (commodities and raw materials) by increasing demand, and deflate the cost of what they produce (consumer and capital goods for export) given lower cost structures enabled by cheaper money and lower wages.

The economic picture is no clearer than the picture for inflation. On the one hand, first quarter real GDP growth was a sizzling 4.8%, and March readings on industrial production, capacity utilization and retail sales were solid. Our economy is also being boosted by a synchronized worldwide expansion as economic growth is being registered from Germany to Japan.

On the other hand, we know that both increases in the Fed Funds rate and the price of oil impact the economy with a lag, and both are up markedly over year-ago levels. Additionally, there are numerous signs that the once white-hot housing market has begun to cool. The ISI homebuilders survey has declined to its lowest level since 2001, as has the National Association of Home Builders survey. Over the past six months, U.S. new home prices have declined -8.1%. According to ISI, this is the sharpest drop since the recessions of 1970 and 1982. Unfortunately, this slowdown in housing is beginning to have an impact on the consumer. A survey conducted by RealtyTrac showed a 68% year-over-year increase in mortgage loans in foreclosure in February. Anecdotally, the signs on local telephone poles advertising, “We buy your house for cash!” have been replaced with, “Avoid foreclosure, call us!” And, housing is not the only thing slowing the consumer. The aforementioned rise in oil prices has led to \$3+

per gallon gasoline, which acts as a tax increase on the consumer and negatively impacts discretionary spending.

The ambiguous state of our current outlook raises the possibility that Greg Ip's article was a red herring. Mike Santoli wrote in the *Barron's Up & Down Wall Street* column on April 17, 2006 that, "even the most bearishly inclined grump is confident...that any clear clue of a Fed pause or finale could ignite a ripping short-term rally." However, it seems that neither the current state of the economy nor the current inflation outlook give "clear clues" to the Fed. What seems more likely is that the Fed is at a less-certain phase in its monetary policy - a phase in which they will be increasingly data dependent. Even if the Fed decides to pause, there is no guarantee that they won't continue to raise rates if data deems it necessary in the future. As Chairman Bernanke said in his April 27, 2006 Congressional testimony, "A decision to take no action at a particular meeting does not preclude actions at subsequent meetings." Given this ambiguity, we cannot make the currently in vogue assumption that Fed rate increases will soon come to an end.

More importantly, it is possible that the underlying assumption driving this rally, that the Fed Funds rate may have peaked, is misplaced. It would be imprudent for investors not to at least consider some notable differences between the 2006 equity market and the markets of 1995. For starters, in 1995 investors feared a hawkish Fed. Evidence of this could be seen in the Treasury market where 10-year Treasuries yielded 8%. This was a clear sign investors were worried about inflation and the need for the Fed to continue to raise rates. Tom McManus, equity market strategist at Bank of America, notes that, "it was the unwinding of these fears that helped propel stocks to their heroic gains in 1995." When the Fed decided to pause in early 1995, the Fed Funds rate was 6% and yields on 10-year Treasuries fell to 5.5%, reflecting the bond market's less pessimistic view towards inflation and the Fed. Currently, 10-year Treasury yields are at 5%, precisely the level at which the market anticipates the Fed will pause in this tightening cycle. Thus, the bond market does not anticipate an overly-hawkish Fed. This sentiment leaves much less room for a "surprise" drop in yields that could fuel an equity and bond market boom.

Additionally, this economic expansion has seen extraordinary worldwide economic growth. This growth has led central banks around the world to raise interest rates. According to an April 28-29, 2006 *Wall Street Journal* article by Yuka Hayashi entitled Bank of Japan Shows Optimism, May Change Policy, the Bank of Japan now sees signs that the Japanese economy is strong enough to bring an end to the 0% interest-rate policy they have had in place since 2001. In fact, the economy may be strong enough for several rate increases over the next several years. The same edition of *The Wall Street Journal* had an article by Andrew Batson entitled China Likely to Take More Steps to Cool Economy, which indicated that market watchers believe the Chinese central bank will need to do more than the April 28, 2006 0.27% increase in their benchmark interest rate if they really want to slow their economy. Even if the Fed decides it is time to take a breather, they can't control the impact of interest rate decisions of central bankers abroad, an important consideration in today's global economy, especially in light of the fact that U.S. economic growth has a higher correlation with global short rates than it does with the Fed Funds rate. Does this imply the Fed has lost control of the U.S. economy? No, but it does make their job that much more difficult.

Also, the surge in oil prices has left oil exporting nations with a surplus reserve of dollars. As the Fed moves towards a pause in rate increases, while their global counterparts continue to tighten, dollar returns become less attractive, and these nations are likely to begin diversifying out of their dollar

holdings. Comments from finance ministers in Russia and Iran suggest that this exodus has already begun, as does the year-to-date -5.6% decline in the dollar spot index. Dollar weakness could force a more hawkish Fed in that it would make the price of U.S. exports more competitive abroad, thereby raising the risk that economic strength continues, and it could also add to inflationary pressures via rising import prices.

Lastly, corporate profitability was in the beginning stages of an expansion in 1995, but profits seem to be peaking in 2006. In his April 10, 2006 letter to investors entitled Rich Valuations and Rising Yields are a Dangerous Combination, John Hussman of the Hussman Funds notes that, "U.S. earnings have never grown by more than 6% peak to peak since 1950. Right now we are at the very top edge of this 6% limiting channel. That strongly suggests that U.S. earnings are at a cyclical peak."

Cyclical peaks in earnings historically do not translate into peak price/earnings multiples for stocks. Yet the market today remains richly valued according to James Montier, global equity strategist at Dresdner, Kleinwort, Wasserstein. In a note published in John Mauldin's April 7, 2006 *Thoughts from the Frontline* newsletter, Montier wrote, "Perhaps I am missing something but in my naïve view of the world, peak earnings deserve discount multiples. Yet investors seem to be willing to pay pretty much top dollar for cyclically high earnings. This amounts to a display of faith in a new era. The one thing that history teaches us is that such faith has never been appropriate. Both the U.S. and European markets are significantly overvalued."

To us, the 2006 backdrop and the 1995 backdrop are not birds of the same feather. As such, the willingness with which the market has accepted this comparison is troubling. Equally troubling are internal market indicators that continue to weaken even as markets make new highs. According to Paul Desmond equity strategist with Lowry's Reports, Inc., "most measurements of supply and demand continue to show that the number of stocks still in bull market patterns is shrinking and that an increasing number of stocks are no longer participating in rally attempts."

We can't ignore the strong performance of the economy and the markets thus far in 2006. We also can't ignore the troubling signs of complacency among market participants at such an uncertain time for the economy, for inflation and for the Fed, keeping in mind a study from Birinyi Associates indicating that since 1962, the S&P 500 has suffered an average decline of -7.0% from the time of the Fed's last rate hike until they first decide to reverse themselves and cut rates. We continue to manage for risk as well as return.

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