



UPDATE

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CALDWELL & ORKIN

“Risky assets have performed well and...market shocks have been subdued. That’s the classic history of risk surprise. The volcano hasn’t erupted in a number of years so let’s build a village on the slope. The soil is rich. What could happen? Net/net, when danger is not evident or even seemingly current, humans take on more and more risk. Just stay alert to rumbles.”

-Art Cashin, Floor Trader for UBS and author of *Cashin’s Comments*

The World is Liquid

In a discovery announced April 25, 2007, scientists are believed to have found a new planet in a solar system 20.5 light years (120 or so trillion miles) from Earth. Creatively named 581 c, our newly discovered neighbor appears to have an atmospheric environment much like our own. Most notably, 581 c is believed to contain liquid water, a key source for sustaining biological life (as we know it).

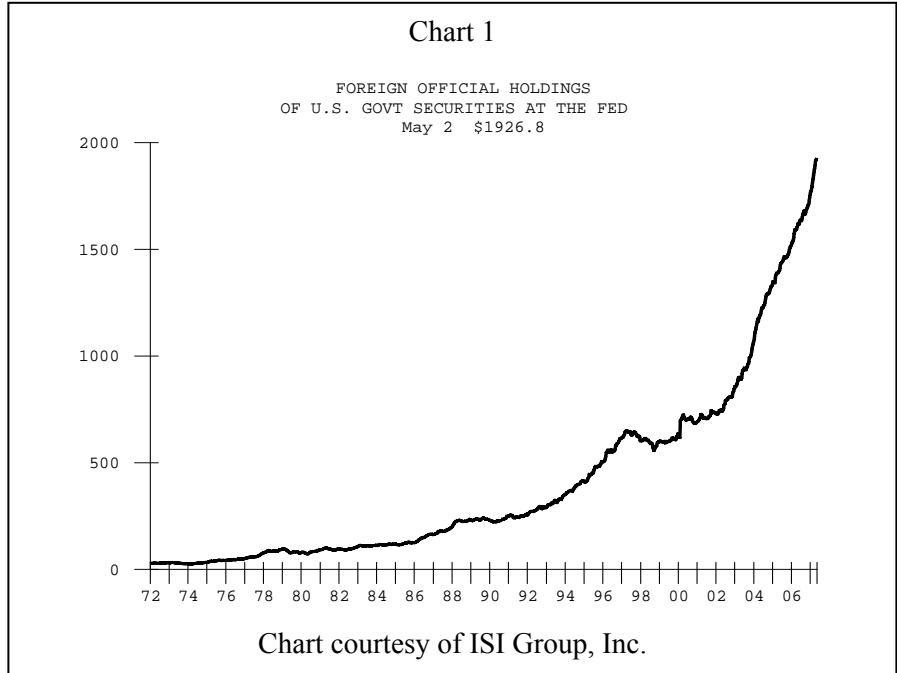
After reading about this astronomical marvel, we could not help but ponder if the potential inhabitants of this planet have a developed economy and capital markets. If so, have they evolved to levels of intelligence high enough to contemplate wonders such as a preemptive Fed tightening? Moreover, do they deal with issues like inter-continental trade deficits, governmental budget deficits, asset bubbles, currency manipulation and/or political populism? We are not sure if our intergalactic financial contemporaries wrestle with these problems, and we will likely never know. After all, it would take the length of Alan Greenspan’s life (and then some) to travel the distance between us. However, we can be certain of one thing: if the capital markets on this world far, far away, are anything like our own, they too subsist on liquid. Liquid, that is, of a monetary form.

We agree with Francois Trahan at ISI Group, Inc. that the liquidity environment is currently very positive for financial markets. Three main sources are driving liquidity expansion, and rarely are they all positively in sync as they are now. These sources include: 1) corporate liquidity, whose cash balances are driving mergers, acquisitions and share repurchases; 2) financial liquidity, where innovations are encouraging the increased use of leverage in the form of derivatives and leveraged buyouts, and recurring foreign accumulation of our nation’s debt is suppressing interest rates (see Chart 1); and 3) global monetary liquidity, where worldwide money growth is expanding in excess of underlying economic growth.

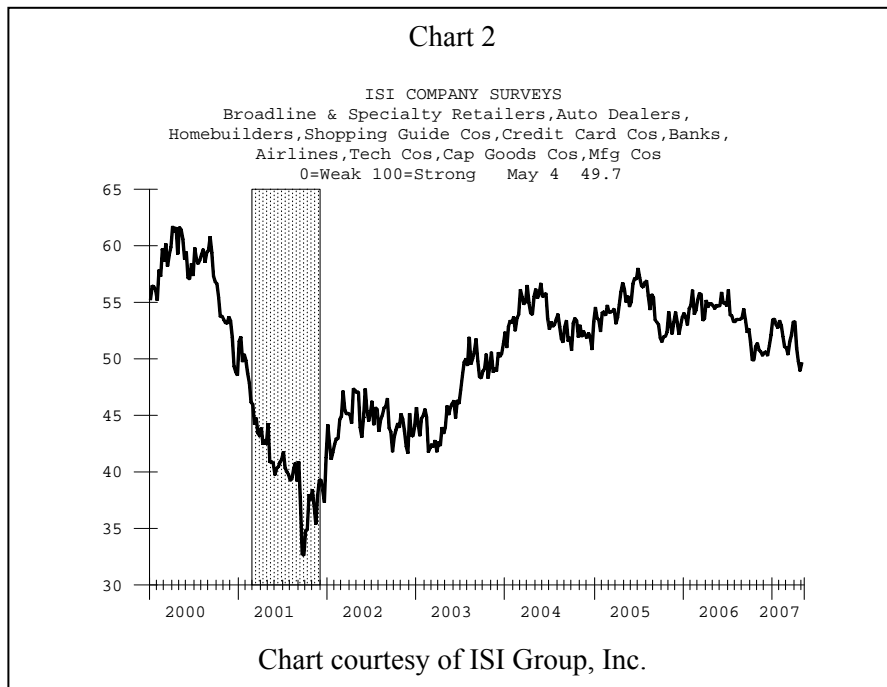
From a capital markets perspective, the acceleration in worldwide monetary liquidity growth continues to be the trump card over the deceleration in U.S. economic growth. First quarter 2007 annualized gross domestic product (GDP) growth was reported at 1.3%, a marked slowdown from the 2.5% pace set in the fourth quarter of 2006, and the 5.6% pace in the first quarter a year ago. Certainly this economic slowdown comes as no big surprise. The well-documented bursting of the housing market

bubble, and its ancillary impact on construction, mortgage equity withdrawal (MEW) and consumer spending, continues to dampen economic growth prospects.

It now appears the exhausted consumer, whose spending accounts for roughly three-quarters of our economic growth, may finally be crying uncle. According to an April 13, 2007 *Wall Street Journal* article by James Covert entitled, Retail Sales Gain, but Slowdown is Seen, rising debt and a wobbly housing market are likely to continue to slow consumer spending growth in the months ahead. Bill Hampel, the chief economist at the Credit Union National Association was quoted, “loan demand has hardly grown at all, and savings is picking up. A stumbling housing market and troubles in the subprime mortgage market have led to tightening credit terms which is pressuring home prices and home equity withdrawals that have been used for big ticket items.”



This economic slowdown is evident in the survey work by ISI. According to Ed Hyman, ISI’s company surveys recently declined to a level not seen since prior to the 2001 recession (see Chart 2).

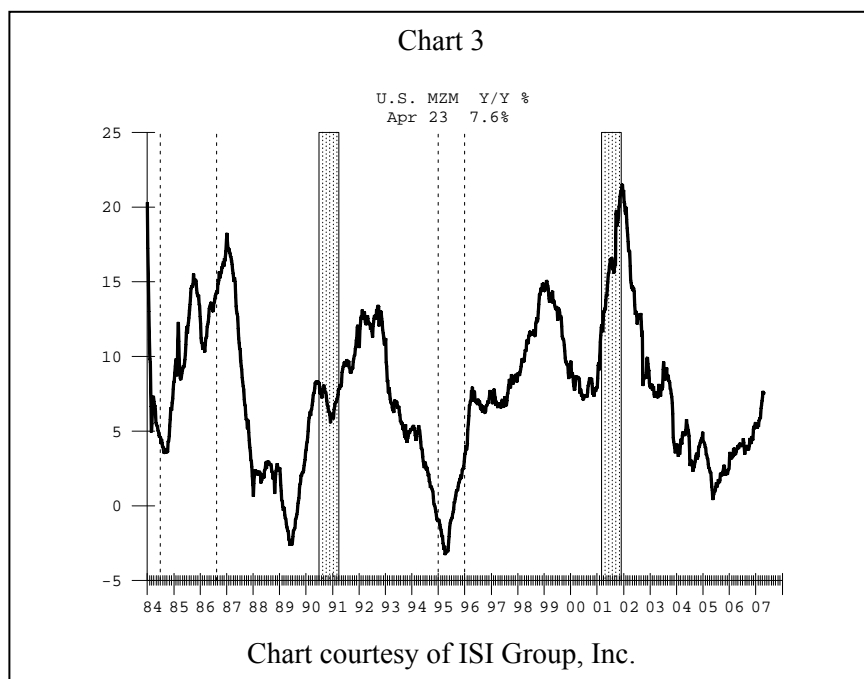


ISI’s survey clearly shows that the consumer’s collective belt tightening is weighing on the psyche of corporations. As a result, according to a April 13, 2007 *Wall Street Journal* article by Phil Izzo and Dean Treftz entitled, Economy Enemy No.1: Soft Capital Spending, businesses currently see little reason to invest in production. A report issued by the Commerce Department indicates that overall business investment declined an inflation-adjusted -3.1% in the fourth quarter of 2006, the first drop since early 2003. And government measures of orders for and shipments of capital goods so far

this year have been unexpectedly weak. In fact, this weakness has drawn the attention of Federal Reserve Chairman Ben Bernanke, who last month told Congress that, “the magnitude of the slowdown [in capital spending] has been somewhat greater than would be expected given the normal evolution of the business cycle.”

And yet, the market has powered through these economic headwinds with the force of a Nike golf ball off the driver of Tiger Woods. In an April 26, 2007 *Wall Street Journal* article by Greg Ip entitled, Why Market Strength and Economic Growth Don't Always Line Up, Ed Hyman explained the force propelling markets higher: “The Federal Reserve has raised interest rates enough to slow the economy and bring inflation under control,” said Hyman. “That reassures investors that even higher rates won't be needed later that could tip the economy into recession.”

This is the development predicted by the mid-cycle slowdown theory. If this theory continues to hold, future equity market advances will not be propelled by earnings growth. Rather, they will come via multiple expansions driven by growth in money supply. (Recall from the December 2006 *Update* that accelerating growth in money supply during a period of slowing economic growth can be explosive for asset markets, as the new money must be put to work.)

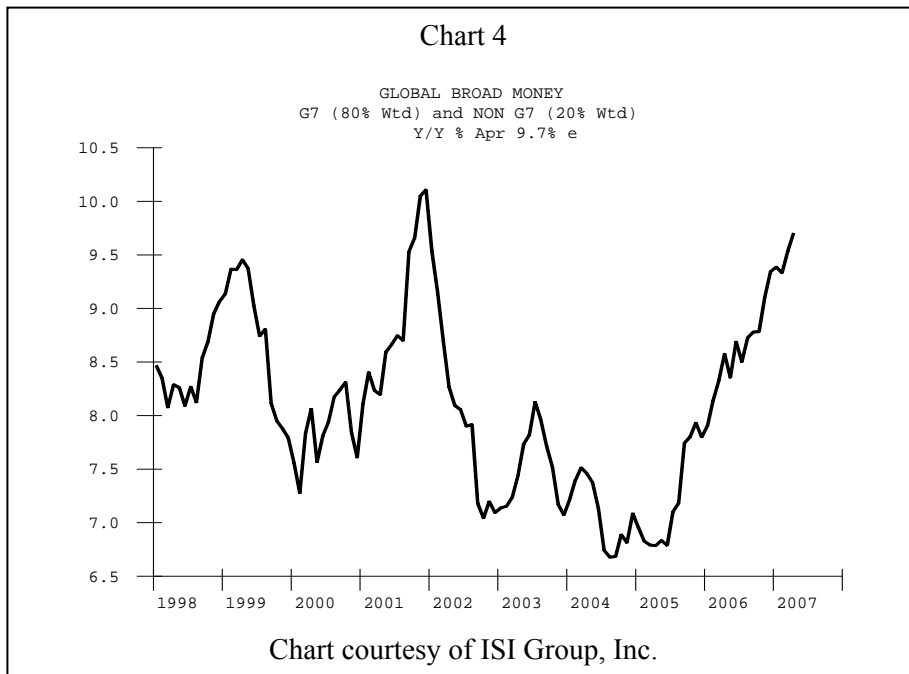


In the U.S., money supply (as measured by money at zero maturity, or MZM) started to expand when the Fed stopped raising rates last June, and it continues to grow today at a 7.6% annualized rate (see Chart 3). While this growth is certainly impressive, it pales in comparison to the monetary expansion occurring around the globe. In Brazil, Russia, India and Mexico, the annualized growth in the monetary base is over 25%. In China, the growth rate is 17.8%. In the U.K., money is growing at a 12.7% clip. Worldwide, annualized money growth is currently averaging 9.7% (see Chart 4).

It seems likely that monetary growth will continue to have a levitating impact on equity market valuations. However, abundant liquidity becomes troubling when assets no longer efficiently price for risk, as was recently witnessed in the subprime mortgage implosion. Amazingly, it appears as if the financial markets are already on the way to building the next asset bubble. In a recent interview, Larry Fink, Chairman and CEO of BlackRock Asset Management, indicated the money that was invested in subprime is simply finding its way into other credit markets. “The way we were looking at the subprime market where we saw standards and covenants deteriorated...we're seeing the same thing in the credit markets. I believe if I was the chairman of the Federal Reserve I'd be paying more attention to that, because to me this is going to be tomorrow's problem.” Indeed, according to an April 11, 2007 *Wall*

Street Journal article by David Enrich entitled, Banks Court Small Businesses, banks have begun extending credit to start-up businesses with no track records, are accepting lower-quality assets as collateral, and are imposing fewer restrictive covenants on these borrowers.

This easy money policy is raising concerns that some banks have weakened their lending standards, and could be on the hook for costly defaults if the economy cools. And, these financial institutions may be weakening their standards at precisely the wrong time. According to an April 14-15, 2007 *Wall Street Journal* article by Michael Aneiro entitled, Cash Flows May Be Drying Up, the most recent flow-of-funds data released by the Federal Reserve



shows that free cash flow in the non-financial corporate sector plummeted late last year. While free cash flow typically runs slightly negative and at most reaches about -2% of gross domestic product, it plummeted to -5% of GDP. Dominic Konstam, head of rates research at Credit Suisse First Boston, thinks this, “is alarming, and I think a lot of people are unaware.”

Capital markets awash with cash lead complacent investors to stretch for higher yields with increased risk. According to an April 30, 2007 *Wall Street Journal* article by Randall Simon and Susan Pullman entitled, As Funds Leverage Up, Fears of Reckoning Rise, the use of leverage to juice returns is becoming more commonplace among traditional money managers, including the Pennsylvania State Employees’ Retirement System. Alarming, the competition to acquire these leveraged trades has become so heated that many Wall Street brokerage firms are requiring less and less capital to secure their risk in these derivative products.

When this music stops it will likely be ugly. As simply stated by Warren Buffett, “it’s easy to put on leverage, but not as easy to take it off.” However, nobody can know with any certainty when the great unwinding will occur. For now, it seems likely that the monetary expansion driving this market advance will continue. Our game plan during this stage mirrors that of Ned Davis at Ned Davis Research, Inc., who recently wrote, “currently the potential minefields are huge...my view is that the best offense in this environment is a good defense by not fighting the tape and being wary of following the crowd at extremes.”

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