



CALDWELL & ORKIN®

UPDATE

May 2008

“Are you going to believe me or what you see with your own eyes?”

-Groucho Marx

Smoldering Fire

It's the short sellers fault, dontcha know! Those cynical crepe hangers colluded to bring misfortune and crisis to the market's doorstep. If not for them, Bear Stearns and Countrywide Financial would still be independent wholly functioning entities, and financial institutions around the world would not be diluting their shareholders interests via hundreds of billions of newly raised equity capital. That is what Ben Stein and the raving Jim Cramer would have you believe. That was also the line taken by Alan Schwartz, the current President and CEO of Bear Stearns when testifying before Congress as to why the Federal Reserve was forced to rescue his investment bank and repeated by the CFO of another investment bank when explaining why her company's stock price was plummeting and its net capital position inadequate. Perhaps they forget that they brought misfortune on themselves by leveraging their balance sheets by ratios north of 30:1 with risky and sometimes fraudulent mortgages backed by ever-inflating housing assets. A memory lapse for sure.

The scapegoating by those in the hot seat is not particularly surprising, but it is illustrative. The consensus thinking from financial and governmental leadership is that the housing market downfall and credit crisis was a sucker punch that caught everyone offguard - an unforeseeable market dislocation of sorts. We believe this is not true. The same short sellers now being blamed for this crisis were the ones warning of problems when they were still manageable, and much could have been done to avert the mess we now find ourselves in. They saw it coming. The leaders that never saw the troubles on the horizon are now forecasting smoother sailing from here on. They tell us the majority of the necessary write-downs have been taken and their capital base is now adequate. Forgive our skepticism, but we are hesitant to trust those who blame others for their past problems, particularly when they continue to mask the status of their current health.

Take the investment banks, for example. There has been much bellyaching lately about mark-to-market accounting rules for hard-to-value, infrequently traded securities, so-called Level 3 assets. These “investors” have been screaming their heads off about these rules as they would have us believe that much of the pain they have experienced over the last few quarters was due to the illiquidity of the markets, not the quality of their investment decisions. Oddly, there has been no attention drawn to the same, fuzzy mark-to-market accounting rules that allow companies post unrealized *gains* on equally illiquid securities. Yet, if it weren't for these unrealized gains on Level 3 assets, many of these investment banks would have had substantially less, and in some cases no, profit during the first quarter of 2008.¹

But, alas, the squeaky wheel gets the grease. Last month, under what must have been considerable pressure, the Securities & Exchange Commission (SEC) folded like a tent and gave the investment banks the leeway they so desired in valuing their portfolios. In a statement, the SEC said, “It is appropriate for you to consider actual market prices, or observable inputs, even when the market is less liquid than historical market volumes, **unless those prices are the result of a forced liquidation or distress sale.**” (Emphasis ours.) In other

¹ Jonathan Weil, “Goldman, Morgan Stanley Hit ‘Level 3’ Jackpot,” *Bloomberg News*, April 23, 2008.

words, if the market has turned against your forecast, and as a result, is harming the value of your securities, just make the values up until the market corrects itself.

According to Dennis Gartman, editor of the Gartman Letter, there is little doubt as to the effects of the new interpretation by the SEC. “We’ve asked friends in the business for their take and...we’ve come to the conclusion that mark-to-market has quietly died with this letter, and with it transparency in financial accounting,” he said.² Unsurprisingly, we are seeing a surge in the amount of Level 3 assets on the balance sheets of investment banks. One notably troubled investment bank now has \$37 billion in Level 3 assets, equal to 3.1 times the bank’s equity. Another (believed to have remained above the credit fray) has Level 3 assets of \$96 billion, or 2 times its level of equity. Given the SEC’s complicity in hiding loan losses from investors (the Commission is currently being scrutinized and examined by Congress for the role it played in this crisis via poor oversight of the investment banks³), we expect Level 3 asset growth to continue in the near future.

Fortunately, the investment banks have greatly reduced the amount of equally illiquid leveraged buyout (LBO) loans that have been stuck on their books since last summer, right? Not so fast. In its latest earnings report, a large bank highlighted a sale of \$8 billion of LBO debt to private-equity firms. The catch: the loans were sold at a discount to par value and the bank had to offer the buyers \$6 billion of financing at a rate of around 4.3%, almost half the 8.5% rate the bank must pay on its own loans. “They’re substituting one credit for another but they’re still ultimately on the hook for the debt,” said Robert Willens, a former managing director Lehman Brothers Holdings Inc. who runs a tax-advisory firm in New York.⁴

We should point out that banks have (with guns to their heads) raised \$150 billion in new, dilutive capital in 2008 to help close the \$170 billion hole left in their balance sheets from losses on leveraged loans thus far. The capital raising is the last part in what ISI Group’s Tom Gallagher sees as a three part strategy that Ben Bernanke, chairman of the Federal Reserve, is using to navigate the credit crisis. “First, aggressive Fed rate cuts have restored a positive slope to the yield curve,” wrote Gallagher. “Second, there is a certain amount of forbearance going on that allows some delay in recognition of losses. Third, bank regulators have been encouraging banks to raise capital.” To Bernanke’s credit, his strategy has worked insofar as he has re-established some liquidity in the financial system. The stock market’s rally from its March lows is indicative of that fact. However, as Gallagher points out, “The Fed has the tools to prevent serious liquidity problems from getting out of hand, but they don’t address solvency issues raised by falling home prices and inadequate bank capital... This makes the liquidity facilities like a bridge loan, but a bridge to what?” To us, this is the critical question as we contemplate the investment outlook. Liquidity may have been restored to the markets for now, but simply having liquidity in the markets does not turn bad loans good, nor does it restore faith in and amongst the banks.

We continue to believe that the outlook for both credit and the economy is heavily influenced by home prices, which, we would wager, are likely to continue to fall precipitously. “The reason that home prices are so critical,” wrote Bill Gross, Managing Director at PIMCO Bonds, “is that they are at the forefront of potential asset deflation. Because the U.S...economy [is] now substantially asset-based and dependent on stable and upward tilting prices, a deflation of an economy’s primary financial asset can be ruinous.”⁵

Not good then that, in February, the Standard & Poor’s/Case Shiller home price index dropped 12.7% from a year earlier, the sharpest decline in the data’s two-decade history. “There remains an eleven month supply of unsold homes on the market which should accelerate the pace of price declines at least through the end of this

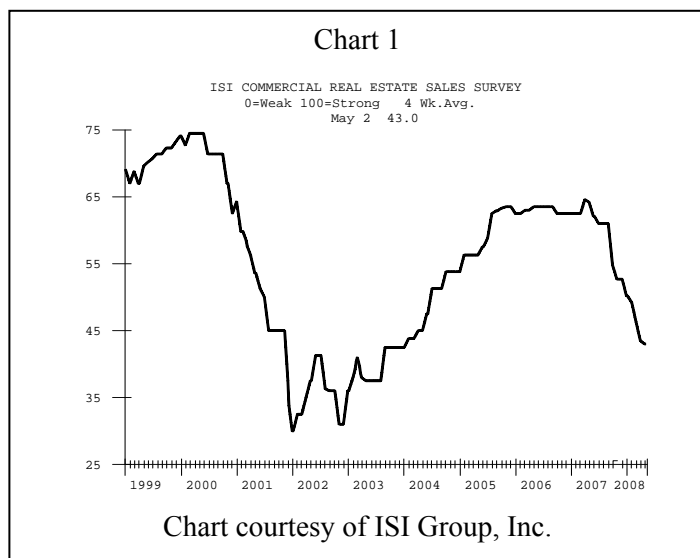
² Jonathan Weil, “SEC Fuels New Mark-to-Market Conspiracy Theories,” *Bloomberg News*, April 2, 2008.

³ Kara Scannell, “SEC to Come Under Scrutiny,” *The Wall Street Journal*, May 6, 2008.

⁴ Pierre Paulden and Cecile Gutscher, “Pandit’s ‘Closer to End’ Means No Escaping LBO Loans,” *Bloomberg News*, April 29, 2008.

⁵ Bill Gross, *PIMCO Investment Outlook*, May 2008.

year,” said Joshua Shapiro, chief U.S. economist at consulting firm MFR Inc.⁶ An acceleration in the decline of home prices is confirmed by both ISI’s survey of over forty real estate companies (See Chart 1) and by a pending wave of foreclosures set to hit the market, causing yet another increase in the supply of homes for sale. “The failure of the lenders to address their issues with defaults is compounding the inventory problem to the point where we will see a tidal wave of inventory hit the market,” wrote Mike Morgan, owner of Morgan Florida, a residential and commercial real estate firm, in an op-ed for *Barron’s*. “Lenders may be telling Wall Street and Capitol Hill that they are developing plans to keep owners in their homes, but we are seeing the exact opposite in the world of reality. Even when we try to work with lenders, most of the time there is no one at the helm with the authority to process a cup of coffee, let alone the sale of a property in default. The easy answer is to simply let the property flow through to the foreclosure auction, even when that means 30% to 50% less in sale price.”⁷



For the lenders and homeowners who are hoping the government is readying a solution for the housing markets that will support prices and keep people in their homes, we offer four words of caution: don’t hold your breath. At every step of the way, thus far, the government’s efforts to support housing have fallen flat on their face. For example, President George W. Bush’s FHASecure program, introduced on August 31, 2007, was supposed to help 80,000 borrowers and has to date helped only 3,000. There are three main reasons the government has not been successful in blunting the severity of the housing crises: 1) Their liquidity is being met with the deleveraging sasquatch (see March 2008 *Update*); 2) They can’t overcome their partisan differences; and 3) Their solutions have been ill-conceived.

Transpiring before our eyes is a war of attrition between the forces of deleveraging and liquidity. Even after raising \$150 billion in new capital, the most optimistic forecasters say banks will suffer billions of dollars in additional write-downs on mortgage investments and other debt in the months ahead, and that the final figure for bank write-downs will potentially exceed \$750 billion. “It’s too early to strike up the band and say that happy days are here again,” said the chief executive of a large national bank⁸. “[Banks] need more capital now, and they’re likely to need even more in the next year or two,” said Jeffrey E. Garten, a professor at the Yale School of Management. “We’re in kind of a Catch-22 situation: a recession that is not too severe depends on the resumption of bank lending. Without that resumption, the recession is going to become deeper and longer.”⁹ Imagine what the most pessimistic forecasters have to say!

“Before the August crisis, margin clerks were as friendly as bartenders,” wrote Jim Grant, editor of Grant’s *Interest Rate Observer*. “They would lend against 95% of the face value of triple-A-rated [non-agency] mortgage-backed securities [MBS]. Nowadays, the same lenders are unwilling to extend accommodation for much more than 80% of face; i.e., the standard haircut has risen to 20% from 5%.” He continued, “The standard sources of financing have receded or vanished. The asset-backed commercial paper market has shrunk by \$418 billion from the summertime peak of \$1.2 trillion, and the Wall Street CDO machine has gone cold.” To combat this onslaught, regulators are “pushing the GSE’s [Government Sponsored Entities] to re-extend themselves...the GSEs’ combined

⁶ Sudeep Reddy, “Home-Price Drop Accelerates, Damping Hopes,” *The Wall Street Journal*, April 30, 2008.

⁷ Mike Morgan, “In the Eye of the Housing Hurricane,” *Barron’s*, April 21, 2008.

⁸ Louise Story, “Banks Hunting for More Cash,” *The New York Times*, April 22, 2008.

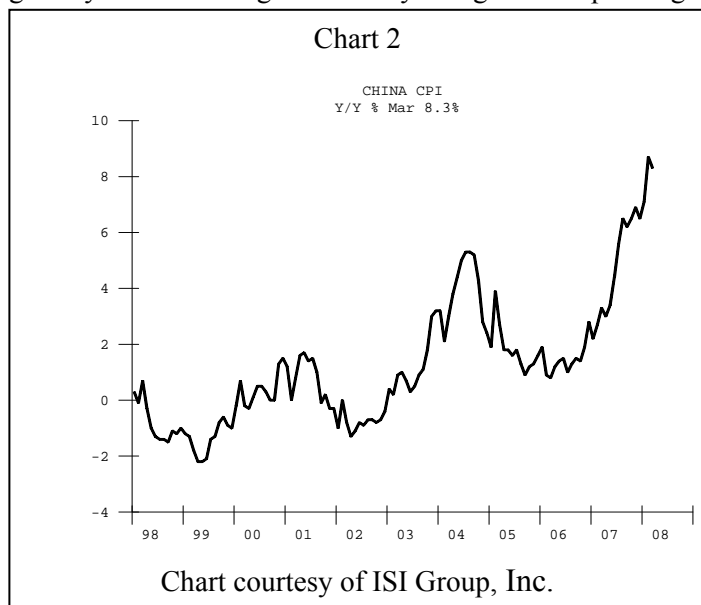
⁹ Louise Story, “Banks Hunting for More Cash,” *The New York Times*, April 22, 2008.

balance sheets...are leveraged 23.7:1. The reduction in [capital requirements now] allows the wayward giants to invest in \$200 billion more MBS. This would boost their leverage to 26.5:1. A \$20 billion capital infusion would permit the purchase of \$667 billion more. That would boost the pair's combined leverage to 28:1," Grant concluded.¹⁰ Sounds like a typical government solution - combat a problem caused by excess leverage with more leverage. Hair of the dog, anyone?

Still the stock market holds out hope. In particular, there is much faith being placed in a bill sponsored by Congressman Barney Frank that would allow borrowers to refinance with the Federal Housing Authority (FHA) after the current holder of the mortgage takes a significant writedown. After showing initial promise, however, the bill has been watered down so that its impact will be negligible. It seems Republican congressmen couldn't stomach passing a taxpayer-funded bailout for borrowers who lied on their loan applications.

From the beginning of this crisis, Andy Laperriere at ISI has argued (correctly in our view) that the housing market's fundamental problem is that too many people have been given loans they cannot afford. Therefore, there is no free lunch restructuring solution. Someone has to pay to keep people who have unaffordable mortgages in their homes. Try as Congress may to attempt a socialist force-feeding of risk down the mouth of lenders, at the end of the day it is the risk-averse arbiters of credit who allocate resources, and they are turning up their noses, unwilling to suffer more losses. While Congress recently approved legislation that raises the ceiling on loans the FHA can insure to as much as \$729,750 (up from a previous \$362,790), the market responded with muted demand for the loans and countered by requiring minimum credit scores for borrowers seeking FHA loans even though minimums are not an FHA requirement. Kevin W. Lynch, a mortgage broker at A. Anderson Scott Mortgage Group in Rockville, Md., said he has been quoted rates of nearly 7% on jumbo FHA loans. The loans are so expensive they "aren't going to sell," Mr. Lynch said. "It's a waste of everybody's time."¹¹

While the issue of solvency hangs over the market's head, we must deal with the inflationary pitfalls of excess liquidity. From the gas pump to the check-out aisle at the grocery store, American consumers are being hit with soaring prices of their everyday necessities at a time when they can ill afford it. In March, thanks to record gas prices, sales at gasoline stations soared almost 19% year-over-year. At the same time, food inflation led sales at grocery stores 4% higher than a year ago. But spending more money on food and gasoline leaves less money for other things, and sales were down, even without adjusting for inflation, at department stores, clothing stores and furniture stores, as well as auto dealers.¹²



Of course, inflation is not only a domestic problem. Across the world, prices of commodities and everyday necessities continue a relentless march higher. In March, China's CPI rose 8.3% year-over-year (See Chart 2), Singapore's CPI rose 6.7% (See Chart 3) and Hong Kong's CPI rose 4.1% (See Chart 4). "There is also good reason to worry that China is on the cusp of a worrisome deterioration in inflationary expectations," wrote Stephen Roach, chief Asian economist at Morgan Stanley. "Newly enacted labor reforms are boosting minimum wages at precisely the time when headline inflation has surged. There are also reports of special subsidy payments to hard-strapped Chinese households - providing

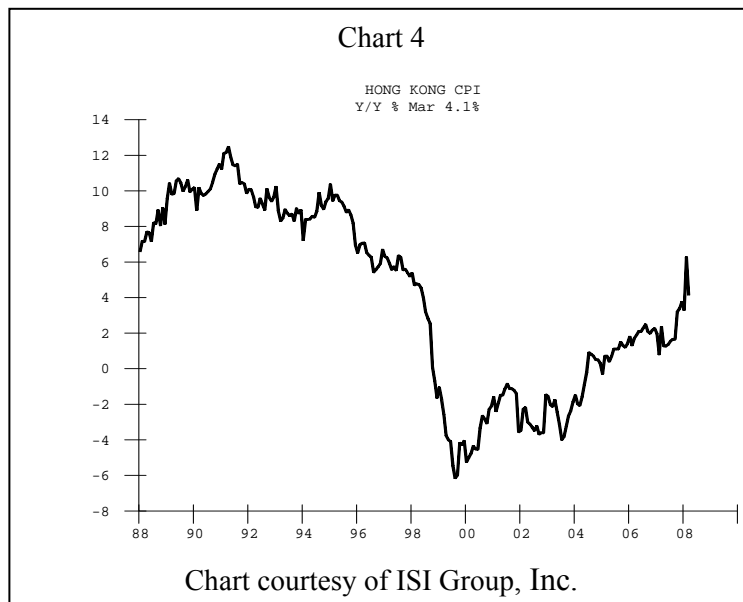
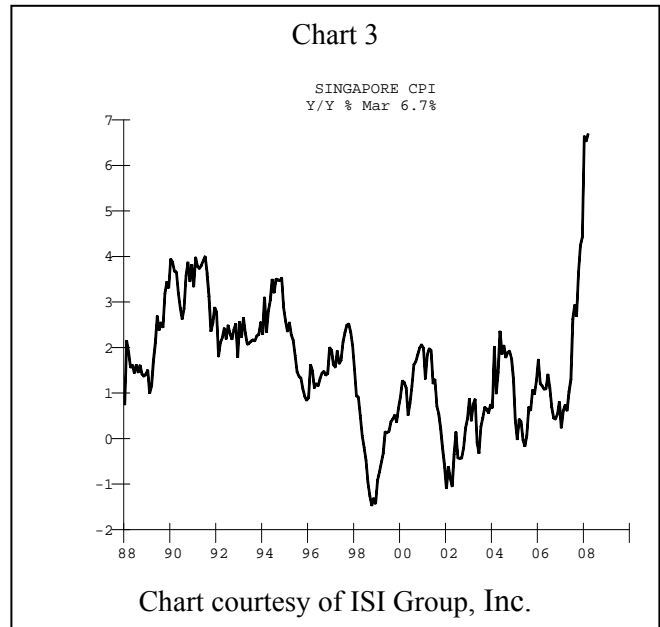
¹⁰ Jim Grant, *Grant's Interest Rate Observer*, April 4, 2008.

¹¹ James R. Hagerty, "FHA Loans Grow Costly as Banks Add Fees," *The Wall Street Journal*, April 4, 2008.

¹² Floyd Norris, "Except at Gas Pump, Not Much Spending Going On," *The New York Times*, April 19, 2008.

compensation for higher food and energy prices.¹³ Alarmingly, inflation is running rampant in much of the developing world even as governments there are attempting to control inflation through price controls on necessities like gas and rice. Inflation is particularly hot in Asia, where rising energy and labor costs have already made exports to the United States more expensive. Unfortunately for consumers, developing countries now produce nearly half of all American imports. The free ride for the American consumer is over.¹⁴

According to the American Bankers Association, consumer-credit delinquencies in the fourth quarter of 2007, when gas and food prices were lower than they are now, were at their highest levels in nearly 16 years. Ominously, they predict that delinquencies will continue to rise in the first half of 2008, warning that “no relief for the consumer is in sight” amid “stubbornly high” food and gas prices and “anemic” income growth.¹⁵ As stretched as they currently are to meet their bills, we doubt seriously that consumers will spend much of the windfall tax rebate



checks being bestowed upon them this spring on many discretionary items. Merrill Lynch’s David Rosenberg is not “bullied up” over the \$120 billion tax rebate coming consumers’ way, either. Rosenberg cites a recent Brookings Institution survey that found an unprecedented number of Americans behind on mortgage payments, auto leases, utility expenses and medical bills, and that only 20% of the rebates are apt to be spent in the real economy. That translates into barely a 0.5% annualized “boost” to GDP growth over the June and September quarters, all of which might easily be “siphoned off” if gas prices at the pump rise another \$.20 a gallon.¹⁶

We have a less bullish stance on the efforts of the government to combat the effects of the credit crisis and blunt the economic impact of the system’s deleveraging. Our position has not

been a profitable one of late. To this, we give credit to the liquidity being pumped into system. “It is called a capital market for a reason,” wrote Dennis Gartman. “Capital, created by the central banks, floods into the system as the economy wanes, but not being needed as inventories are worn down, as employees are laid off, and as business conditions deteriorate, that capital finds its way into equities. Therefore, equities rise even in the midst of recession.”¹⁷

¹³ Stephen Roach, “China and Core Inflation,” *The Wall Street Journal Asia*, April 1, 2008.

¹⁴ Keith Bradsher, “Asian Inflation Begins to Sting U.S. Shoppers,” *The New York Times*, April 8, 2008.

¹⁵ Liz Rappaport and Donna Kardos, “Tough Forecast Released,” *The Wall Street Journal*, April 4, 2008.

¹⁶ Alan Abelson, “Up & Down Wall Street,” *Barron’s*, April 21, 2008.

¹⁷ Dennis Gartman, *The Gartman Letter*, April 4, 2008.

While we expected (and even anticipated) this outcome, we did not believe the money would go into the two sectors with the most dismal of fundamental outlooks, financials and consumer discretionary, of which we were short in our long/short investment products. These positions have now been reduced due to our risk control discipline. With the SECs complicity in the masking of loan losses, the accumulating evidence of the futility of the combined interventionist efforts of the government, the continued deleveraging of the credit markets, the downward trajectory of home prices and the spent-up, lent-up consumer, we believe more trouble could lie ahead. The once raging credit market blaze has been reduced to a smoldering fire, but an ill-wind could blow at any moment, reigniting many hot spots. In such a circumstance, we would likely revisit our shorts in the financial and discretionary sectors.

“We travel in a world with a systemic bias to optimism,” wrote Jeremy Grantham, Chairman of GMO Capital. “In the investment business, pessimism or realism in the face of probable trouble is just plain bad for business and bad for careers.¹⁸” We couldn’t disagree more. We would argue that glasses of any shade, be they rose or dark, serve only to obscure the picture; while a realistic outlook allows investors to see the horizon for what it is.

And invest accordingly.

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Note: As of May 8, 2008 the portfolios managed by Caldwell & Orkin do not hold positions in any of the companies mentioned herein.

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¹⁸ Jeremy Grantham, *GMO Quarterly Letter*, April 2008