



UPDATE

May 2009

CALDWELL & ORKIN®

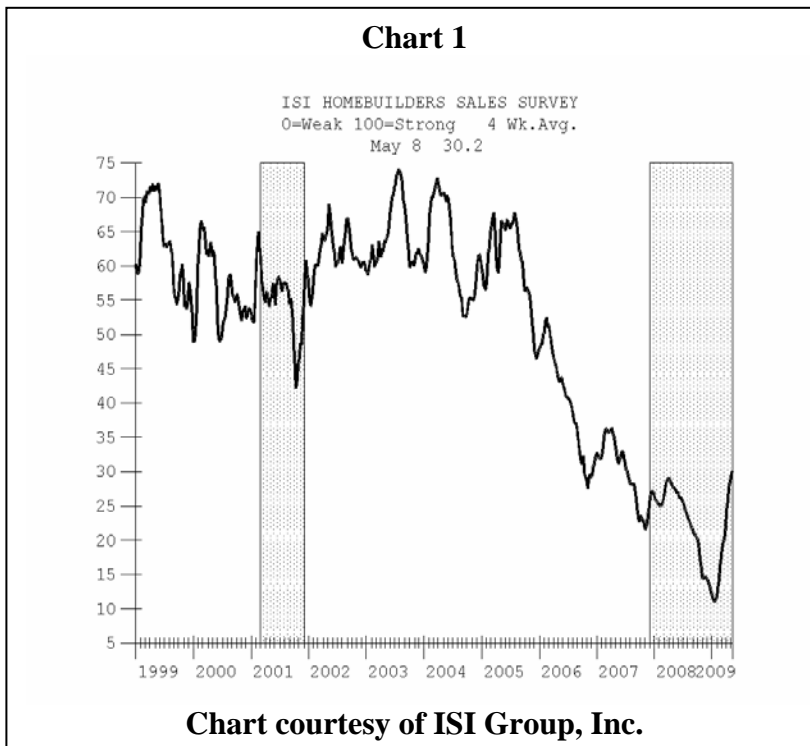
“In a financial crisis, the biggest mistake that a government can make is to do too little, not too much.”¹
-Treasury Secretary Timothy Geithner

Cautious Optimism

The markets have come a long, long way from their March 2009 abyss, with the S&P 500 rallying 39.5% from its devilish 666 low, the fourth largest bear market bounce in history. If the severe oversold conditions and extremely negative investor sentiment were the kindling for this rally, the spark was the unprecedented priming of the liquidity pump by the nation’s chief policy makers, primarily Federal Reserve Chairman Ben Bernanke. Consider the plethora of measures our policy makers have put in place to combat this crisis: a \$787 billion stimulus package, the \$1.2 billion expansion of the Federal Reserve’s balance sheet, a Fed Funds rate close to 0.0%, Federal Reserve purchases of commercial paper, treasuries and mortgage-backed securities (MBS), raising the FDIC guarantee limits on money market funds,

guaranteeing inter-bank loans, lifting conforming loan limits for mortgages, modifying first and second mortgages, the TARP, TALF, TAF, TSLF, PPIP, etc, etc. “It’s impossible to determine how much stimulus we’ve put in the U.S. economy,” wrote Ed Hyman of ISI Group, Inc. “It’s impossible to determine how much stimulus we’ve put in the global economy. And new initiatives keep coming every week.”

This largesse of fiscal and monetary stimulus has galvanized the growth of the money supply around the world. The brisk U.S. money supply growth rate of 8.3% year-over-year lags the 10.2% average growth of the rest of the world. Indeed, money supply is growing at an annualized rate of 35.6% in Brazil, 30.0% in Switzerland, 25.5%



¹ Rich Miller and Matthew Benjamin, “Obama Overthrows Reagan’s Government-Bad Dogma to Rescue Market,” *Bloomberg*, April 26, 2009.

in China, 17.6% in the United Kingdom and 14.2% in Canada. In the face of a contraction in economic growth, this robust money supply growth has fueled the rally in financial assets as this liquidity seeks a home before it cycles through and is absorbed into the economy.

As this stimulus makes its way through the economic system, there are emerging signs of economic life – signs that have become known as “green shoots.” Specifically, the national purchasing managers index (PMI) has risen from its March 2009 low of 36.3 to 41.0 in April 2009, suggesting manufacturers could be ready to resume production after shuttering plants and working down inventories. ISI’s homebuilder survey has also hooked up (see Chart 1), reflecting the -46.0% decline in new home inventory to levels not seen in 37 years. According to Ed Hyman, the increase in ISI’s company surveys hints that the rate of decline in GDP is indeed moderating (see Chart 2). As such, Ed has raised his fourth quarter 2009 GDP growth forecast from flat to 2.0%. “I’m not there yet, but the recession could already be over,” Ed wrote. “And looking ahead, a global inventory upswing could be unfolding at the same time policy initiatives...are kicking in.”

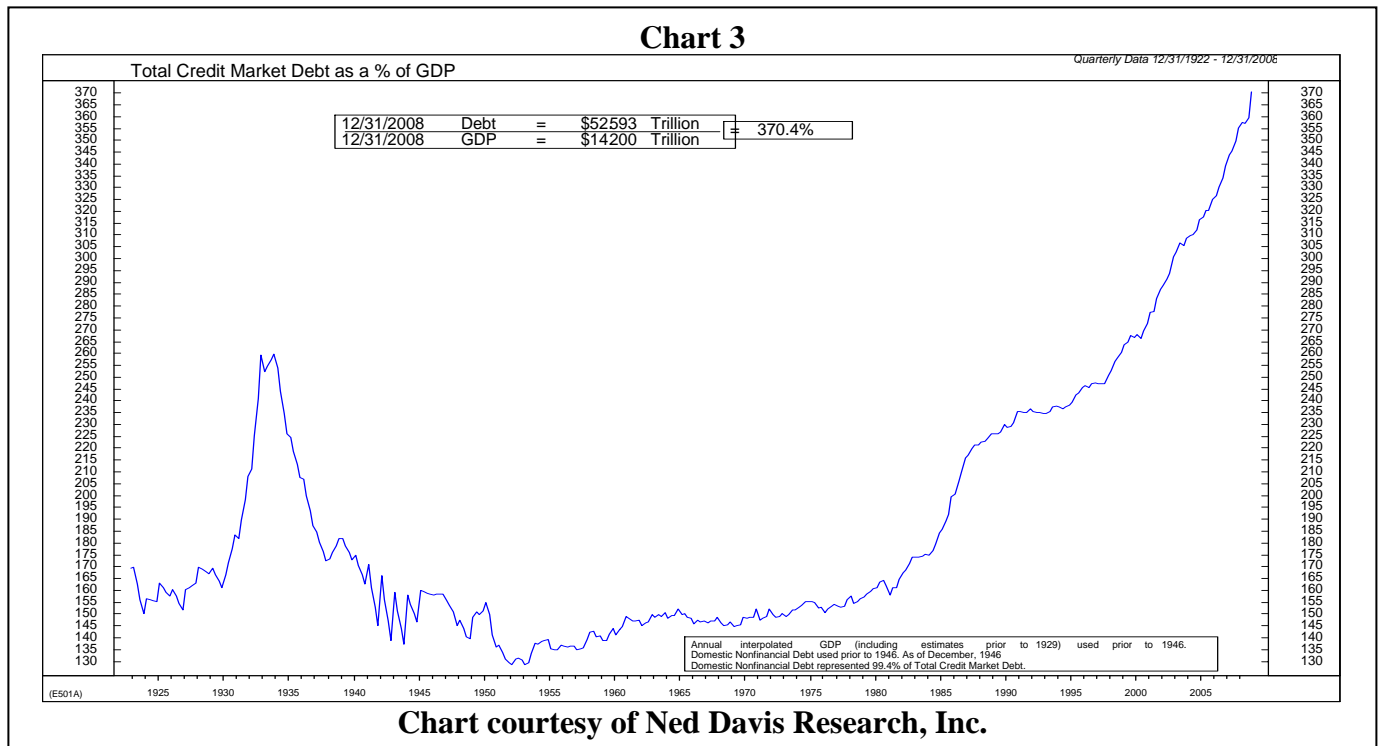


While it is to be celebrated that we have apparently averted economic Armageddon (aka a depression), we are in no rush to sound the all clear for economic growth. The fact that most banks have passed an allegedly stressful stress test does nothing to lessen the weight of the secular over-indebtedness that hangs around the economy’s neck. To wit, despite prodding from the federal government, lending at the biggest U.S. banks has fallen. According to an analysis of Treasury Department data by *The Wall Street Journal*, the biggest recipients of taxpayer aid made or refinanced 23.0% less in new loans in February 2009, the latest available data, than in October 2008, the month the Treasury kicked off the Troubled Asset Relief Program (TARP). Banks say that they’re eager to issue new loans, but they

are seeing a decline in demand among consumers and businesses.² “After a huge build-up in debt over many decades (see Chart 3), it is hard to believe there are that many credit-worthy borrowers who want to borrow, or that many clean banks that want to lend to questionable borrowers,” wrote Ned Davis of Ned Davis Research, Inc. “One can see [on Chart 4] that banks are still at tight standards for loans to consumers.”

² David Enrich, Michael R. Crittenden and Maurice Tamman, “Bank Lending Keeps Dropping,” *The Wall Street Journal*, April 20, 2009.

During the hedonism of the bubble era consumer spending accounted for 70% of our nation's economic growth. Thanks to the deflation of the housing market bubble and the 2008 equity market



crash, consumers have found religion as evidenced by the -\$11.1 billion month-over-month decline in consumer credit in March 2009. “If households are going to tighten their belts, exactly how tight are we talking here?,” asks Stephanie Pomboy of MacroMavens. “At its most extreme, consumers were spending \$1.1 trillion more than they were making in spendable income. Newly parsimonious, they have already shaved that down to \$714 billion. But, clearly, they’ve still got a long way to go [see Chart 5]. Should households endeavor to bring cash back to ratios of debt they obtained for the 30 some-odd years before Greenspan encouraged them to lever up his asset bubbles as chairman of the Federal Reserve, cash would have to more than double from \$7.5 trillion to \$16 trillion. Lest the implication is too subtle here, that \$8.5 trillion increase is \$8.5 trillion that can’t be spent. Whether that happens over three years, eight years or twenty years...spending seems sure to be under pressure for some time to come.”³

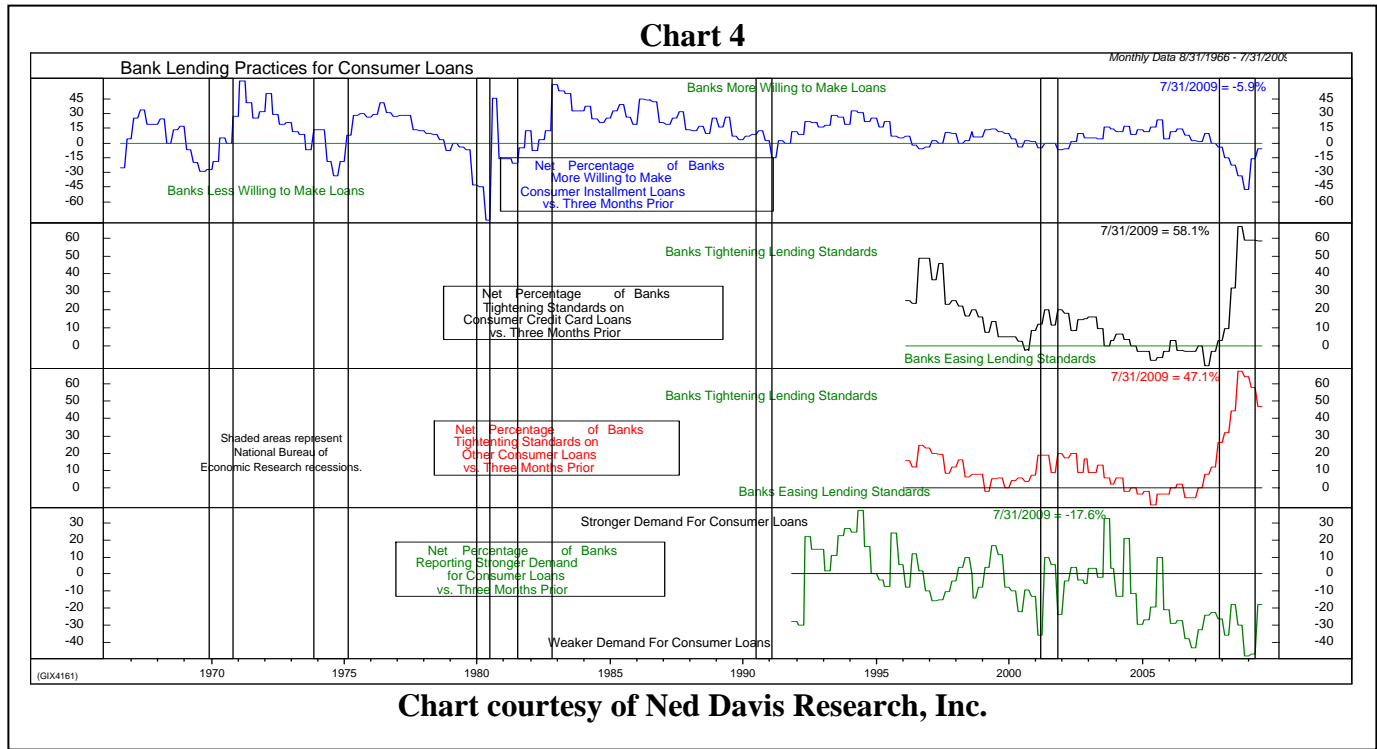
As consumers pull back, from where will we harvest our economic growth? And from where will banks harvest the profits they are counting on to bring their balance sheets back in balance? While much is being made of the results of the bank stress test, there is reason to take these results with a healthy dose of salt. The stress tests were aimed at estimating how much each bank would lose if the economic downturn proved even deeper than currently expected. But regulators gave the banks a break by letting them bolster their capital with fictitious first-quarter 2009 profits and also by letting them predict modest profits even if the economy again turns down.⁴

A major driver of the banks’ strong first quarter profits was a surge in fees from home refinancing. According to The Mortgage Bankers Association, mortgage-refinance applications have almost tripled

³ Stephanie Pomboy, “The Macro May: A Guided Tour,” *MacroMavens*, April 2009.

⁴ Edmund L Andrews, “Banks Told They Need \$75 Billion in Extra Capital,” *The New York Times*, May 8, 2009.

their level of a year ago as government officials have pushed to lower-mortgage payments in part to help



consumers avoid foreclosures and to support the overall economy.⁵ This refinance activity has been driven by falling interest rates, but growing investor concern over the government’s ability to finance its activities has helped push 10-year Treasury bond yields back above 3.3%, making refinancing less attractive.

According to Meredith A. Whitney of Meredith Whitney Advisory Group, LLC, most of the first-quarter earnings banks just reported were bogus. For instance, by taking a credit value adjustment to account for the decline in the value of their own debt, one bank added \$2.7 billion to their bottom line during the quarter, a figure that dwarfed their reported net income. “It’s junk income,” said Jack T. Ciesielski, the publisher of an accounting advisory service. “They are making more money from being a lousy credit than from extending loans to good credits.”⁶

Banks are also being helped by recent changes in mark-to-market accounting rules that allow them to mark securities on their books at cost if they plan on holding them until they mature, irregardless of where the securities are trading. This change in accounting rules is the reason Charles Bowsher recently resigned as Chairman of the Federal Home Loan Bank System’s Office of Finance. The Office of Finance issues and services all the debt for the 12 regional Federal Home Loan Banks, making the FHLB System the largest U.S. borrower after the federal government. “I was not comfortable as an audit-committee member in signing off on the financial statements,” Bowsher said, “after I became aware of the standards and processes for valuing the mortgage-backed securities.”

⁵ Sudeep Reddy, “Homeowners Refinance in Drove Unseen Since ‘03,” *The Wall Street Journal*, April 23, 2009.

⁶ Eric Dash, “Sharp Pencil Lets Citigroup Declare Profit,” *The New York Times*, April 18, 2009.

Chart 5

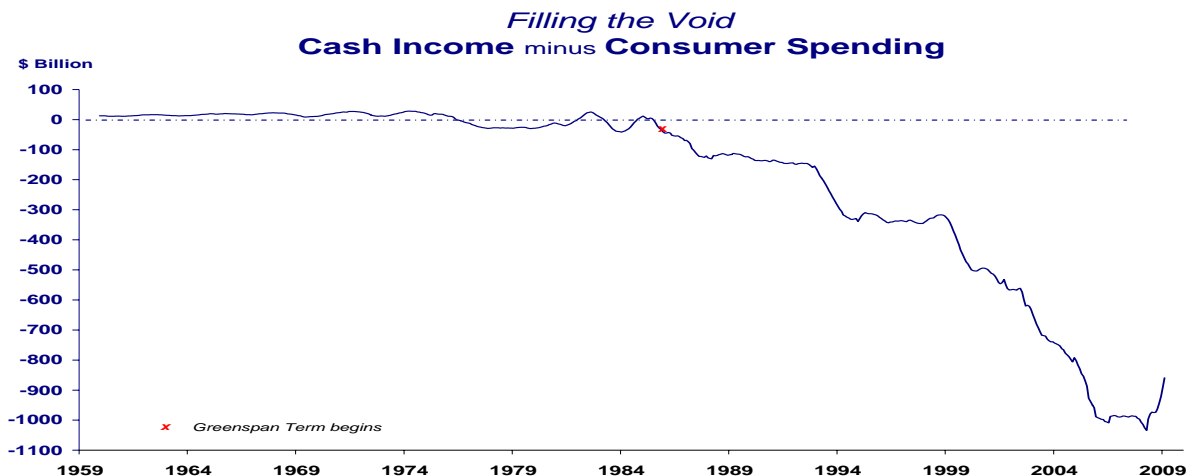


Chart courtesy of MacroMavens

Bowsher's complaint concerned the methods used for determining when losses on hard-to-value securities should be included in banks' earnings and regulatory capital. For example, the year-end balance sheet at the FHLB of Seattle showed \$5.6 billion of non-government mortgage-backed securities that it says it will hold until maturity. Yet the estimated current market value of those securities was just \$3.6 billion. The bank, which reported a \$199.4 million net loss for 2008, said the declines were only temporary and did not need to be considered in their earnings.⁷ What's good for the goose is good for the gander, right?

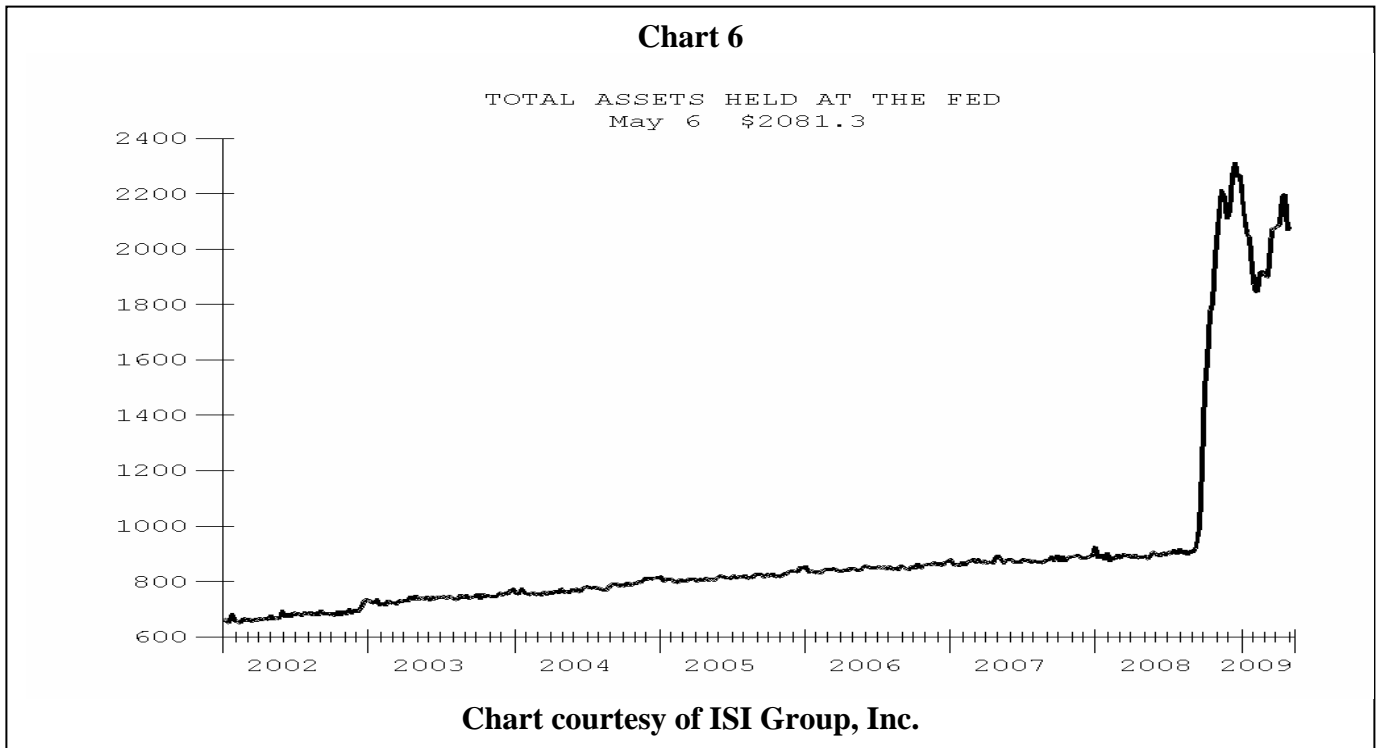
Not only are current bank earnings of poor quality, but there is also reason to question future earnings growth. It appears that losses on leveraged loans and corporate bonds will soon rise to levels not seen since the Great Depression, as the default rate on leveraged loans and speculative grade bonds is rising rapidly. "We expect the default rate to get to the range of 14 percent by the end of the year," said Kenneth Emery, a senior vice president of Moody's. That compares to peak default rates of 10-12% during the last two recessions, in 1991 and 2001.⁸ The reason for the high default rate forecast is that corporate bonds were issued, packaged and sold just like mortgages. "The key question going forward is what will earnings power be and can these banks earn their way out of this?," asks Whitney. "At a minimum, we believe earnings power will be considerably lower than consensus estimates and investor expectations. In brief, we have too little detail and not enough confidence in earnings power to be anything less than fundamentally cautious on the banks here."

Given the low-quality bank earnings, the limited information disseminated in the bank stress test and the likelihood of future credit shocks, we simply can't put our faith behind the rally in financial stocks. While we maintain the bullish bias we have held since March 2009, a risk to this outlook is an ebbing of monetary stimulus. To be sure, there is a record amount of fiscal and monetary stimulus

⁷ Jonathan Weil, "Honest Man Emerges From Muck of Banking Crisis," *Bloomberg*, April 2, 2009.

⁸ Floyd Norris, "Subprime: Corporate Version," *The New York Times*, April 24, 2009.

currently at work in our financial system. The Fed, however, has recently begun to contract its balance sheet (see Chart 6), and money supply growth, while still at a high level, has contracted over the last several weeks. After the impressive run the markets have had it seems prudent to temper our own optimism with a small dose of caution, and remind ourselves that we believe this is a cyclical rally within a secular bear market.



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