



CALDWELL & ORKIN[®]

UPDATE

June 2006

The Broken Leg of Liquidity

On Saturday, May 22, 2006, the horse racing world and the nation as a whole held their collective breath in horror after Barbaro, the beautiful and mighty colt, broke his leg in the beginning stretch of the Preakness Stakes. Coming into this race, the second of the Triple-Crown, Barbaro was the much adored favorite, having gone undefeated in his young career and having won the Kentucky Derby by six-and-a-half lengths. Yet, in the blink of an eye, triumph turned to tragedy as one “bad step” resulted in three breaks of his right-hind leg.

The average horse weighs 1,200 pounds and supports that weight with four legs no wider than an average man’s forearm. The pounding pressure on each hoof in a race is tremendous. Thoroughbreds are strong and fast, but as Barbaro showed us, underneath that strength lies a fragile and vulnerable creature.

The equity markets share this dichotomy. They can achieve swift, powerful advances, as witnessed by the 6.20% advance of the S&P 500 or the 16.16% jump of the Russell 2000 year-to-date through May 5, 2006. Yet it took just days to wipe out much of those gains. By the end of May, the S&P 500 was up 2.60% and the Russell 2000 was up 7.10% for the year. What happened?

Like equines, equities love a good run. Lately, economic liquidity has been “the legs” upon which the markets have galloped. In his May 22, 2006 Cashin’s Comments, UBS Warburg floor trader Art Cashin argued that the market has seen a “huge, and relatively sudden, contraction of global liquidity...the BoJ [Bank of Japan] has taken about \$130 billion in excess liquidity off the table and in a very brief time.” Truth be told, it happened in less than a month. And the BoJ is not alone. Ed Hyman of ISI Group, Inc. notes that global short interest rates are now up 74 basis points (0.74 percentage points) from their lows, as much as they were prior to the 2001 recession. Through their own interest rate hikes, the European Central Bank (ECB), the Reserve Bank of Australia (RBA), the People’s Bank of China (PBoC) and our own Federal Reserve Bank (FED) have also been withdrawing liquidity from the markets. This, we believe, is the primary reason for the market’s recent sell-off: one of the market’s legs (monetary liquidity) has been disabled.

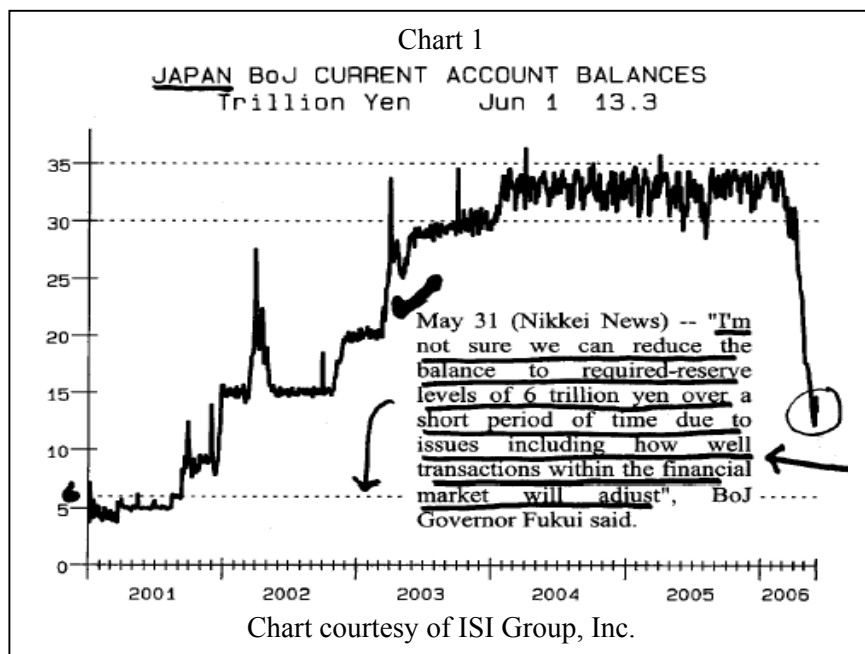
As we have written in past Updates, the flood of monetary liquidity fueled indiscriminate increases in financial assets around the world. The removal of this liquidity now threatens these gains. Already markets in India, Brazil and Saudi Arabia have been shocked by steep stock price declines. But how far can this go? Is the recent correction over? No crystal ball is clear enough to provide a definitive answer, but there are troubling signs that indicate the risks may remain elevated.

Because central banks ran their liquidity pumps in overdrive, market forces may now drive them to hawkish extremes. On April 6, 2006 Jean-Claude Trichet, President of the ECB, said “the stimulative impact of the low level of interest rates remains the dominant factor behind the high trend rate of monetary expansion...the annual growth rate of credit to the private sector has continued to increase over recent months, with borrowing by households - especially loans for house purchase - and non-financial corporations rising

rapidly. Overall, strong monetary and credit growth in an environment of ample liquidity in the Euro area continues to point to upside risks to price stability.” These hawkish words are troubling.

Equally disquieting are signs that inflation has begun to accelerate in China. ISI’s China team believes China’s real GDP is growing closer to 12% rather than the 10% growth reported by the government. They also think the continuous rise in raw material and labor costs, and the expected abolishment of preferential tax policies, will put upward pressure on the prices of their manufactured goods. A May 13, 2006 Wall Street Journal article by Terence Poon and Victoria Ruan entitled, China’s Trade, Inflation Data Signal Tightening Will Continue, indicates the PBoC may become more hawkish. The authors write, “China’s economy is growing at a blistering pace, fueled mainly by fixed-asset investment and easy credit. The April trade-surplus figure may prompt the government to tighten monetary policy.”

In Japan, the BoJ has moved with haste to remove monetary liquidity, but through the end of May they have only removed 56.0% of the excess reserves they put into the market, and their interest rates remain at 0.0% (see Chart 1). Also, Japan’s first quarter GDP price deflator was down -1.6% quarter-over-quarter, a sign that the BoJ may not have won its battle against deflation. It’s possible the BoJ’s monetary policy decisions have a different driver. In



his May Global Central Bank Focus, PIMCO’s Paul McCulley wrote, “both the ECB and the BoJ seem hell bent to “normalize” up their policy rates, not primarily to slow growth in aggregate demand for goods and services, but rather to slow growth in the demand for credit - and thus, money - that is supporting bubbly asset markets. There is a new breed of monetarism infecting Keynesian thought at the ECB and the BoJ: using credit and money growth as a symptom of bubbles.”

Removing liquidity to deflate asset bubbles is not a path to equity market advances.

And then we have our Fed. From the last Federal Open Market Committee (FOMC) meeting on May 10, 2006 until his May 24, 2006 comments in Greg Ip’s Wall Street Journal article entitled, Bernanke Says Fed Shares Inflation Worries, Federal Reserve Chairman Ben Bernanke has stressed that the FOMC’s next interest rate decision would depend on the economic data that is released before the next FOMC meeting on June 28, 2006. In his April 28, 2006 Thoughts from the Frontline letter to investors, author and fund-of-funds manager John Mauldin wrote, “it is clear from reading the speeches of the various Fed governors that they do not know when the end of the interest rate hike cycle will be. They will be looking at inflation, the housing market, consumer spending, overall growth, and a lot more.”

The June 28, 2006 interest rate decision will be one of the toughest policy moves for the FOMC in some time. When evaluating the economic landscape, Ed Hyman sees no less than 13 reasons for the Fed to take a pause in their tightening campaign, including: 16 previous interest rate increases, high oil and gas prices, declining mortgage equity withdraw (MEW), a significantly weakened housing market, increasing

personal tax rate, slow money growth, slowing unit labor costs and rising global short rates. At the same time, Hyman lists 11 reasons for the Fed to raise rates further. These reasons include the previously mentioned flood of liquidity, 7% nominal GDP, inflationary pressures as evidenced by the 3.5% year-over-year increase in the consumer price index (CPI), low unemployment and the falling dollar. What bothers the markets at this stage, and also makes the Fed's decision a particularly daunting one, is that the past interest rate increases will impact the economy with a lag, as will the rising price of oil, a one-two punch. Yet, at the same time, inflation is beginning to run above its perceived comfort zone.

ISI believes the Fed has a preference for pausing at the June meeting to take more time to evaluate the economic data. They believe that the Fed can pause in the face of rising inflationary pressures since inflation lags economic growth. The caviat - growth needs to slow. Supporting this argument, Ned Davis of Ned Davis Research, Inc. believes the Fed can afford to pause and see if inflation data become more benign. His work suggests that inflation falls more than 50% in the 24 months after the Fed's monetary policy gets tough. Interestingly, this conundrum is not without precedent. According to a May 22, 2006 Wall Street Journal article by Greg Ip entitled, Bernanke Weighs Risks of Rate Increase and Rising Inflation, former Federal Reserve Chairman Alan Greenspan faced a similar predicament in 1994. At that time, inflation concerns were dominant and the Fed raised rates steadily. Greenspan argued for a steep increase of three-quarters of a percentage point, but Alan Binder, then vice-chairman, objected. Binder said, "The classic mistake of monetary policy...is overdoing it. The classic reason for this error...is impatience in waiting for the aged effects of what already has been done."

What if the economy does not slow down? ISI has admitted to being early in their call for the economy to cool and they themselves realize their recent (and third) call for a slowdown may be early as well. Meanwhile, David Malpass, Chief Economist at Bear Stearns, has had a more accurate compass in this cycle and has become more cautious on the market outlook. Malpass recently told investors he is "increasingly concerned that the Fed has not taken adequate steps to address growing inflation expectations." He expects inflation to rise in 2006 and remain elevated in 2007. Elevated inflation implies elevated interest rates, with negative implications for stocks and bonds. He warns, "we now expect the Fed to have to carry out a bigger overshoot on interest rates over the next 6-12 months to undo the inflation impact of recent accommodation and dollar weakness."

So where does this all leave us? We can't say what the Fed will do come June 28. The only thing that seems certain is that investors can expect the market to remain more volatile as it digests each daily dose of economic data. It does seem a safer bet, however, that foreign central banks, whether to ward off traditional economic dangers of inflation or to remove the overly generous accommodative policies of the past, will remain in hawkish mode.

Like the beloved Barbaro, the fate of the markets is uncertain. With the leg of liquidity injured, it seems the best investors can hope for is a market that proceeds at a slower pace.

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