

## **UPDATE**

June 2007

---

**CALDWELL & ORKIN**<sup>®</sup>

---

*“The [subprime] market was feeding an addict at its neediest point...Individuals will resist reductions in their standard of living with everything in their power, including mortgaging their futures.”*

-Diane Swonk, Chief Economist at Mesirow Financial

*“We are close to a time when we’ll look back and say we did some stupid things...We need a little more sanity in a period in which everyone feels invincible and thinks this is different.”*

-Ken Lewis, Chairman and CEO of Bank of America

### ***Say Anything***

U.S. Treasury Secretary Henry Paulson has struck a deal with China that may have profound implications for our nation’s economy. No, we are not talking about a negotiated agreement with the Chinese to allow the value of the Renminbi to rise a bit more against the U.S. dollar. Rather, it would appear that Mr. Paulson has found a more creative solution to curing our enormous trade imbalance with our friends in the Far East that leverages their significant population migration issues: sell them two million of the roughly 4.2 million single-family homes currently on the market in the U.S.

Of course, we are being coy. No such agreement exists, and despite the flattening of the world we are not sure it would be logistically possible. But we can’t find any other fundamental reason for Secretary Paulson to declare, as he recently did in a CNBC interview, that the housing market’s correction was largely contained and mostly behind us.

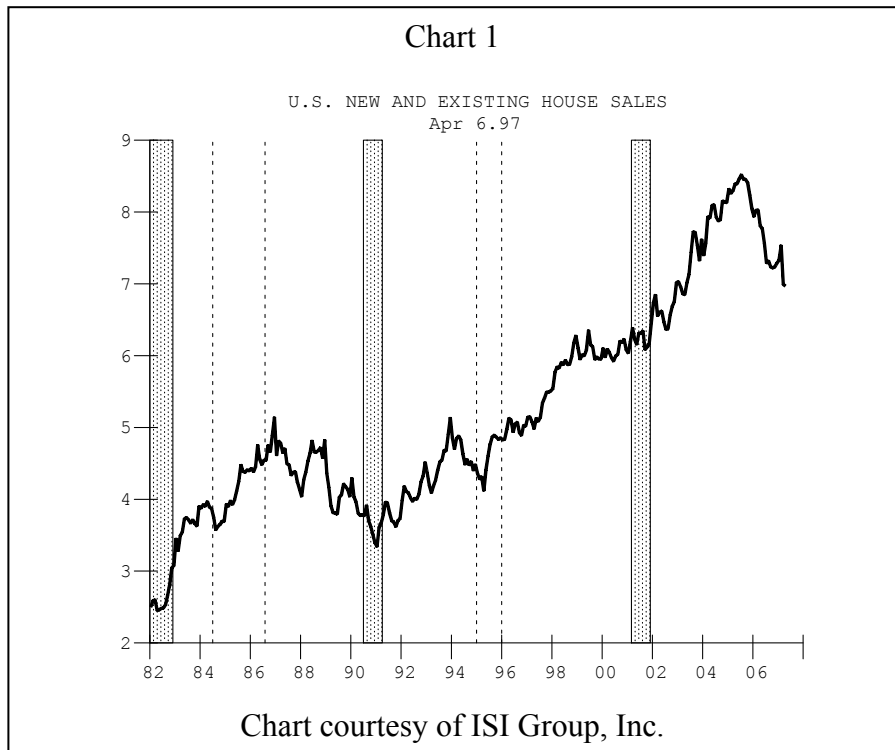
On Thursday, May 24, 2007, the markets rallied on news of a 16.2% month-over-month increase in the sale of newly-built homes in April 2007. The rally was short-lived, however, as the same report indicated that the prices for these new homes fell -10.9% year-over-year, the largest decline on record. The next day came news of a -2.6% month-over-over decline in existing home sales in April. Netting the data out, single-family housing inventories at the end of April stood at 8.4 months of supply, the highest since September of 1992.<sup>1</sup> In fact, from the peak in 2004, Ed Hyman at ISI Group, Inc. says we have witnessed an unprecedented -18% decline in annual house sales (see Chart 1), which is leading to an unprecedented decline in home prices (see Chart 2). We believe these charts do not depict a housing market correction that is “behind us.”

David Rosenberg, North American Economist at Merrill Lynch, believes this burgeoning inventory of unsold homes needs to be reduced by 60% in order to return the housing market to the

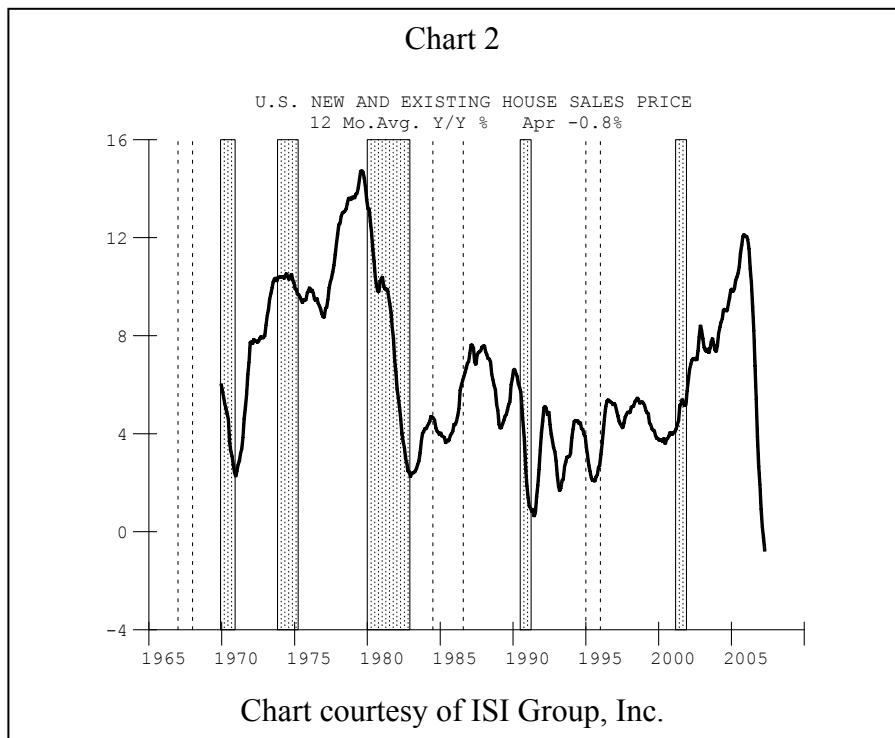
---

<sup>1</sup> Jeremy W. Peters, “Existing Home Sales and Prices Fall in April,” *The New York Times*, May 26, 2007.

equanimity that Secretary Paulson believes it has already achieved.<sup>2</sup> Barring our fictitious bulk order from China, we are not sure where the demand needed to lower this inventory will be generated.



As the subprime mortgage catastrophe unwinds, it is becoming increasingly apparent that there will, in fact, be damaging spillovers for the economy. By some estimates, subprime borrowers accounted for half of the increase in the home ownership rate in this country over the last decade. And, it is clear that subprime mortgage excesses encouraged borrowers to take on more debt than they could afford, ultimately worsening some of the nation's most acute economic problems.<sup>3</sup> The result: experts predict the unwinding of these excesses could end up eliminating more homeowners than the subprime boom originally created.



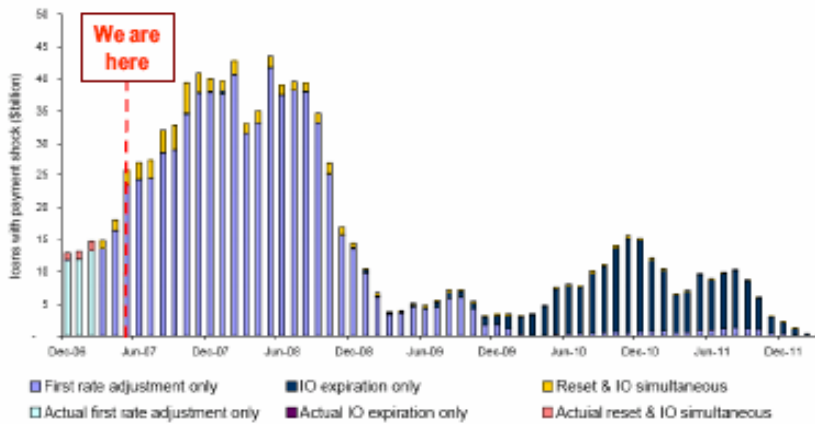
Hard to believe? Then we recommend taking a brief glance at Chart 3 on the following page. This chart graphically depicts the tsunami of mortgage resets about to hit the shores of consumers' financial health. The latest subprime index tracking data shows borrowers continue to struggle to make monthly payments at low introductory teaser rates (see Chart 4). We shudder to think what will happen when these teaser rates reset to much higher levels. Unfortunately, it appears that is exactly what is about to happen. Last week, the rate on a 30-year fixed rate mortgage rose to 6.42%, the highest level since September

<sup>2</sup> David A. Rosenberg, "Would the Real Housing Report Please Stand Up?," *Merrill Lynch & Co*, May 25, 2007

<sup>3</sup> Mark Whitehouse, "'Subprime' Aftermath: Losing the Family Home," *The Wall Street Journal*, May 30, 2007.

Chart 3  
**Sub-Prime Fallout: It is Going to Get Worse...**

~\$800 Billion of sub-prime mortgages to reset



Source: LoanPerformance, Deutsche Bank

Chart courtesy of Loan Performance, Deutsche Bank

2006. Interest rates in general have risen in reaction to a second-quarter re-acceleration in economic growth. In fact, Ed Hyman has raised his second quarter 2007 growth forecast from 1.5% to 3%. As a result, Tom Gallagher at ISI now expects less Fed funds rate cuts in 2007. Rising rates and surging resets are not the brew for increased housing demand.

Scared stiff by the subprime mortgage mess (and the resultant

pressures from Capitol Hill), lenders are tightening the screws on mortgage availability to the subprime and Alt-A (the credit class between prime and subprime) strata. Now they are doing “antiquated things” like appraising property values and peering further into clients’ financials.<sup>4</sup> And there is good reason to believe the credit tightening will intensify. Many major subprime lenders have said that 60% of the subprime loans they are making today won’t meet the strict lending guidelines proposed by bank regulators that are likely to take effect this summer. That’s a scary thought!

These lenders’ fears are warranted. It appears John Dugan, the Comptroller of the Currency and one of the top banking regulators, seems determined to put an end to mortgage credit excesses. In a recent speech on so-called “stated income” loans (loans with no income verification that are prevalent in both the subprime and the Alt-A market), Dugan said, “It seems to me that stated income...invites misrepresentation and potentially fraud; undermines transparency,

Chart 4

ABX INDEX BBB-  
 May 29 71.8

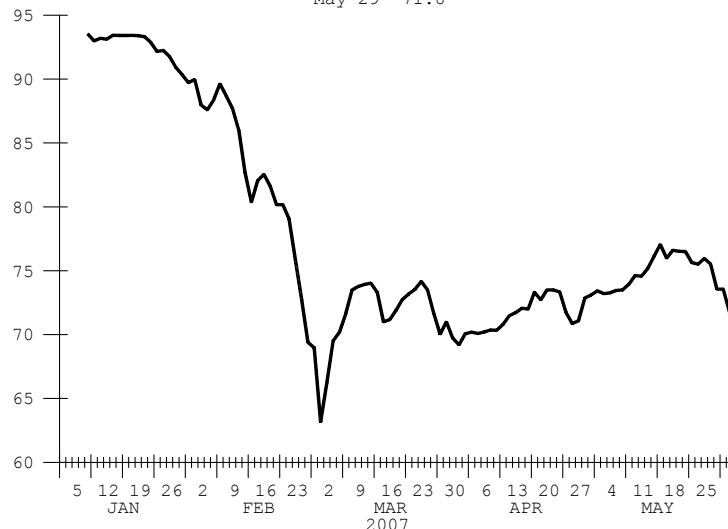


Chart courtesy of ISI Group, Inc.

<sup>4</sup>Ruth Simon, “Lenders Get Tougher,” *The Wall Street Journal*, May 15, 2007.

---

and relies too heavily on collateral appreciation...In most cases, either the lender is unnecessarily deceiving the borrower into paying higher fees for a stated income feature he doesn't need, or the borrower (often with the tacit approval of the lender) is inflating his income and committing fraud to get the loan...Let's not sugar-coat what's going on here. The practice of inflating income is at best misleading, and at worst fraudulent."<sup>5</sup> Andy Laperriere at ISI Group, Inc. believes that the combined efforts of Dugan and Congress will strongly discourage stated income loans and ultimately reduce the number of people who qualify for such loans, reduce the availability of credit, and thus put further downward pressure on home prices.

Perhaps the excess housing inventory will be gobbled up by the beneficiaries of a rock-solid labor market in which the unemployment rate currently rests at a remarkable 4.5%. While recent employment reports from the Bureau of Labor Statistics (BLS) have been robust, the accuracy of these reports is being called into question by industrious economists. Incorporated in the BLS employment data is the business birth/death model that is used to estimate the gains/losses in jobs from the launching and closing of businesses. According to Paul McCulley, Managing Director at PIMCO, the birth/death estimates used by the BLS are inherently inaccurate. "In the early years of expansions," McCulley argues, "the birth assumption systematically is too low and the death assumption is systematically too high. The exact opposite holds in the late years of expansions and particularly in recessions."<sup>6</sup>

Luckily, the BLS has a more accurate sister employment measure that is released with a several quarter lag called the Business Employment Dynamics (BED) report. The BED is based on actual data provided by the unemployment insurance system so it is, therefore, more accurate. As Paul McCulley suggests, it appears the original BLS employment report over-stated actual employment. In the third quarter of 2006 the BLS employment report showed a gain of 442,000 jobs, while the BED showed an increase of only 19,000. Thanks to the birth/death estimate used by the BLS employment report data, 156,000 jobs were added in the third quarter. What about the robust employment numbers reported by the BLS in 2007? Officially, 674,000 jobs were added to the payrolls from January to May 2007 with the birth/death adjustment contributing 591,000 job additions. According to the BLS web site, these numbers are not directly comparable because the 674,000 additions include a seasonal adjustment factor, while the 591,000 birth/death adjustment does not. Still, it seems reasonable that the reported BLS employment numbers are significantly overstating the health of the job market.

Perhaps we are too distracted by fundamentals. The accelerating growth of worldwide monetary aggregates which we wrote about in the May *Update* is proving to be one of the bullish trump cards over a negative fundamental outlook, regardless of the sector. As we predicted, this money growth has helped create a bullish environment for equity markets, with the deal-a-day buyout bingo currently en-vogue on Wall Street, it seems that fundamentals, at times, have taken a back seat to leveraged buyout (LBO) speculation as market participants bathe in the bubbles of the gushing monetary liquidity. As of May 21, 2007 there has been at least one \$5 billion-or-larger acquisition announced on 26 of the year's 95 trading days.<sup>7</sup>

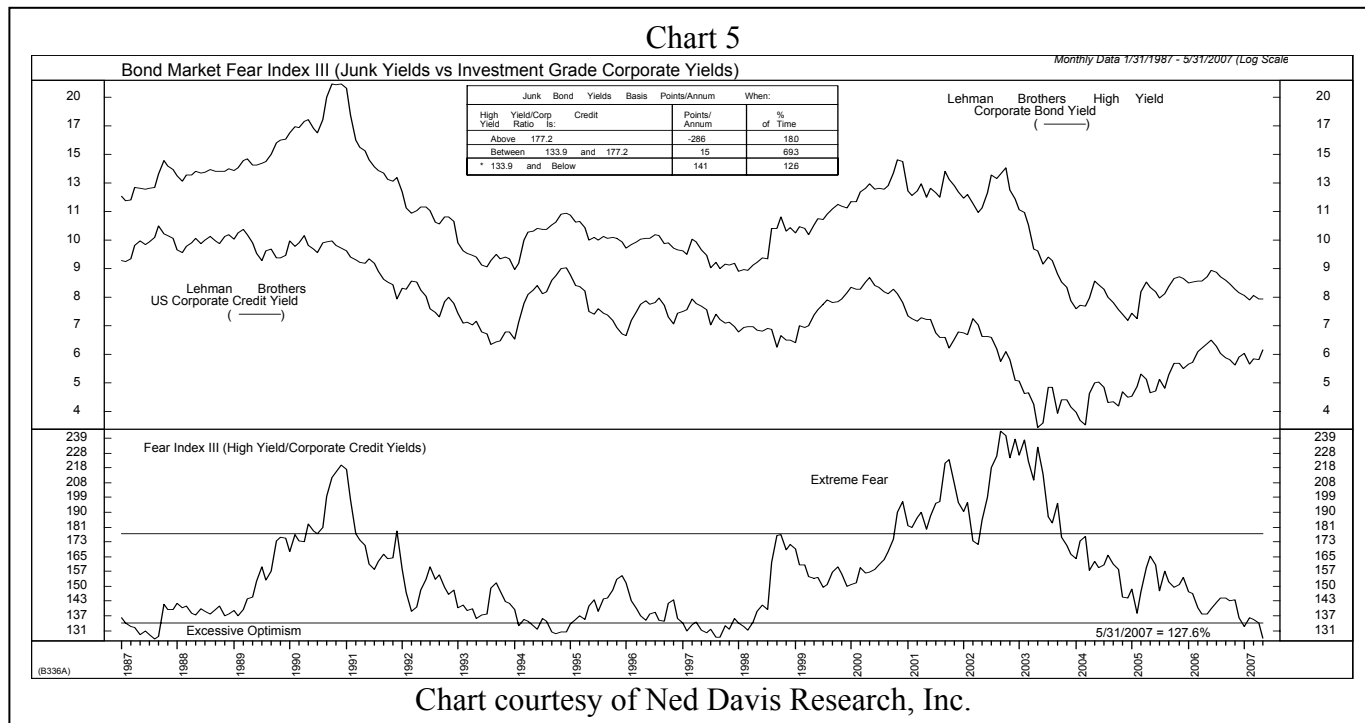
---

<sup>5</sup>John C Dugan. 2007. Remarks by John C Dugan Comptroller of Currency Before the Neighborhood Housing Services of New York, May 23, 2007. Retrieved May 29, 2007 from the *Office of the Comptroller of Currency website* at <http://www.occ.treas.gov/ftp/release/2007-48a.pdf>.

<sup>6</sup>Paul McCulley, "Global Central Bank Focus," *PIMCO*, May 2007.

<sup>7</sup>Mike Santoli, "Streetwise," *Barron's*, May 21, 2007.

This buoyant financing environment has led investors and lenders to accept declining returns on all sorts of risky assets. Junk bond spreads over high-grade bonds are near lows seen just a handful of times in the past 20 years, driving the corporate debt market to excesses that regulators find troublesome (see Chart 5). Year-to-date, the volume of so-called “covenant-lite” debt (bonds that give the lender little recourse for recovering the principle on loans should the borrower default) has soared to \$64.5 billion, up from \$8.2 billion for the comparable period last year. This year’s volume amounts to twice that of the prior 10 years combined.<sup>8</sup>



Defaults on these bonds may be low for now. We can’t help but be reminded, though, of the loosening standards that ultimately led to the demise of the subprime market and the ongoing fallout of the housing market. As Randall Forsyth of *Barron’s* wrote, “For now, no worries, as cov-lite loans keep the global boom in private equity, LBOs, M&A and buybacks growing. But lowering of lending standards is an integral ingredient of any asset bubble, as subprime boom and bust shows.”<sup>9</sup>

We continue to forecast a bullish environment for equity investments, and we are also monitoring what we believe is the development of yet another liquidity-driven bubble in leveraged buyout financing. At the same time, we wholeheartedly disagree with those who believe the worst is over for the housing and mortgage markets. While bullish jawboning can temporarily add supportive hot-air, most bubbles ultimately succumb to the gravitational pull of fundamentals.

MICHAEL B. ORKIN, CFA, J. PATRICK FLEMING, CFA & WILLIAM C. HORNE

Caldwell & Orkin, Inc., 6200 The Corners Parkway, Suite 150, Norcross, GA 30092  
 (800) 237-7073 or (678) 533-7850; E-mail: [Update@CaldwellOrkin.com](mailto:Update@CaldwellOrkin.com)

<sup>8</sup> Henry Sender, “Freescale Tests Private-Equity Gumption,” *The Wall Street Journal*, May 17, 2007.

<sup>9</sup> Randall W. Forsyth, “Current Yield,” *Barron’s*, May 26, 2007.