



UPDATE

June 2008

CALDWELL & ORKIN®

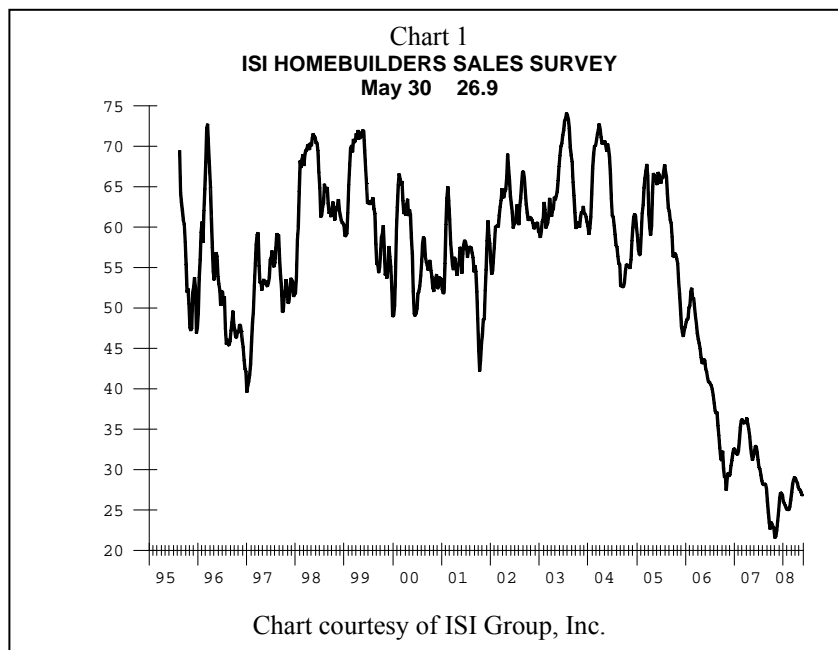
"The worst part about being fooled is fooling yourself, and as a nation, we've been doing a pretty good job of that for a long time now."¹

-Bill Gross, Managing Director, PIMCO Bonds

Lost

Don't blame the U.S. consumer for feeling jaded. Like the survivors on the hit television show *Lost*, the consumer wants, needs and expects to be saved, but is continually being let down by rescue attempts that don't go as planned. For the survivors a conflict develops on whether it is best to be rescued or to stay and play the hand they were dealt on the island. Those that choose rescue soon regret their decision, as their salvation proves a mirage. These survivors begin to realize that efforts to rescue them are not all they were cracked up to be, and ultimately, they wish they had never been rescued at all.

For the consumer, the FHA rescue bill (a \$300 billion life vest thrown homeowners' way) is the last in a series of hyped rescue efforts. In final form this housing bill, trumpeted to help delinquent homeowners on the brink of foreclosure, was a homeowner rescue plan in name only. The great majority of the bill's legalese is dedicated to reforming the government sponsored enterprises (GSEs), not helping desperate homeowners. The reforms for the GSEs include the formation of a new, more powerful regulator with the ability to set higher capital requirements on the GSEs' balance sheets, effectively eliminating the ability of the GSEs to operate at levels of leverage with which they had grown accustomed². With lower allowable leverage the GSEs will no longer be able to originate or guarantee as many mortgages as they have in the past. What's more, with Congress' blessing, the Office of Federal Housing Enterprise Oversight (OFHEO) has announced that the GSEs must implement significantly stricter guidelines for borrowers refinancing through the Federal Housing Authority (FHA). These stricter guidelines include lower loan-to-value ratios, lower debt-to-income qualifying



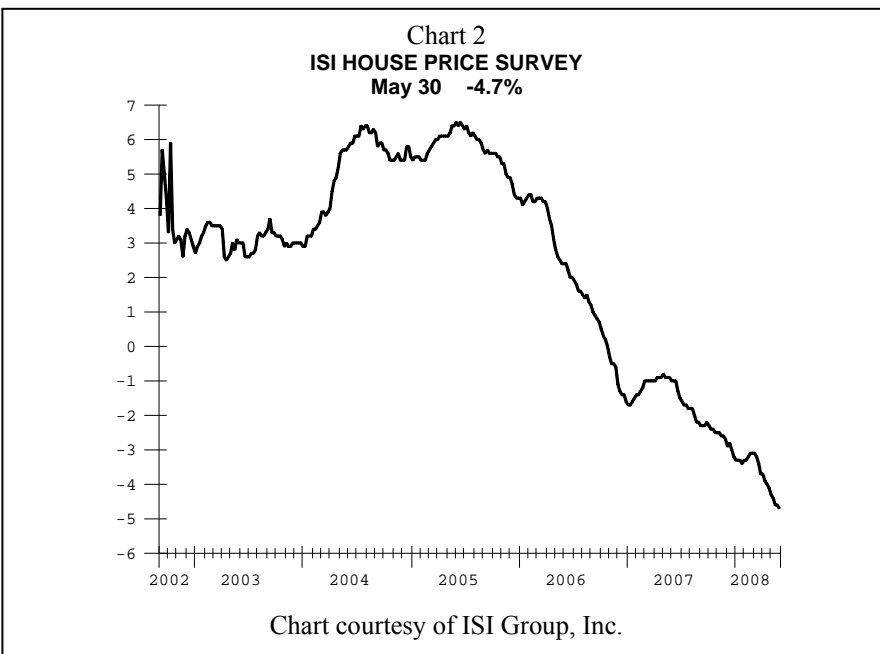
¹ Bill Gross, PIMCO Bonds Investment Outlook, June 2008.

² Damian Paletta and James R. Hagerty, "Senate Strikes Housing Rescue Deal," *The Wall Street Journal*, May 20, 2008.

ratios and higher credit scores. Since the credit crisis hit the fan, many mortgage originators are no longer in business. The GSEs have become just about the only game in town for buyers looking to purchase a home or borrowers trying to refinance themselves out from under the suffering weight of their adjustable rate mortgages (ARMs). The GSEs have long been in need of stricter oversight. It is not the intentions of this law that should be questioned. It's the timing.

The likelihood that house prices are heading much lower from their already depressed levels is increasing. According to the S&P/Case Shiller Home Price Index, prices nationwide fell -14.4% year-over-year in March, an acceleration from their -12.7% decline in February. With help from the new GSE regulations, the tightening noose on credit availability should continue to push home prices lower. Ivy Zelman of Zelman & Associates says her survey of mortgage brokers indicates that, like the GSEs, mortgage lenders are also tightening their lending standards. As a result, Zelman concludes, "our contacts have seen approval rates on attempted refinancings drop in half, from just about anyone getting approved to now just 40%, on average...most of our contacts indicated that refinancing existing homeowners is extremely difficult to get done. The lack of equity was cited as the biggest reason." According to Andy Laperierre at ISI Group, Inc., the part of the housing bill that is actually dedicated to preventing foreclosures will not help stem the slide in home prices until and unless these prices fall much farther than the current consensus estimate. "Foreclosures don't peak until late this year or early next year," wrote Laperierre. "So if the [Barney] Frank bill is going to materially help cushion the blow from falling home prices being pushed lower because of a flood of foreclosures, then home prices have to be falling significantly later this year and into next year. But if one assumes prices are falling a lot later this year and into next year, one must embrace a very pessimistic price outlook – and one that is much more negative than the investor consensus."

Ed Hyman of ISI also sees worrisome signs in the fundamentals of the housing market, including a sharp deterioration in homebuilder sentiment (See Chart 1), an acceleration in the decline in ISI's weekly house price survey (See Chart 2) and a sky-high level of existing home inventory (See Chart 3). "To me, the big question is what happens as more and more homes move into negative equity," wrote Martin Feldstein the president of the National Bureau of Economic Research. "If we see a big increase in defaults, ultimately in foreclosures, that's going to push us definitely into a significant recession." He continued, "We saw house prices overshoot by 60% relative to costs of building and



relative to rents. And I worry about the possibility that they will keep falling; they will spiral downwards... And if that happens, then we are going to see individuals feeling a lot poorer, cutting back on their spending, defaulting on mortgages, and we're going to see the holders of those mortgages see their assets, their capital being cut and therefore their ability to make loans being cut.³ Not only do house prices remain elevated relative to building costs and rents, as Feldstein highlights, but, according to Ned Davis of Ned Davis Research, Inc., prices also remain elevated relative to income (See Chart 4). Considering the fundamental backdrop, it is possible that home prices

³ John P. Hussman, Ph.D., "Round Two – Home Price Erosion," *Hussman Funds Weekly Market Comment*, May 12, 2008.

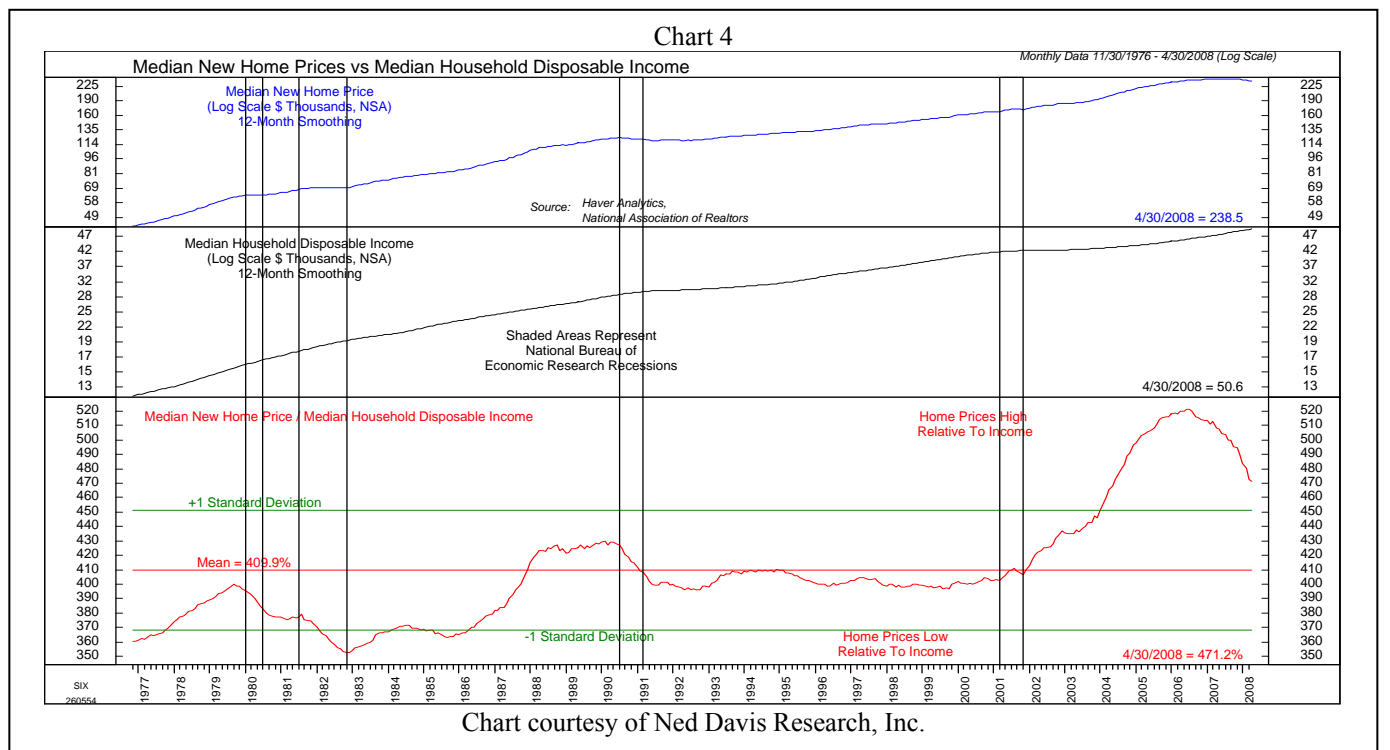
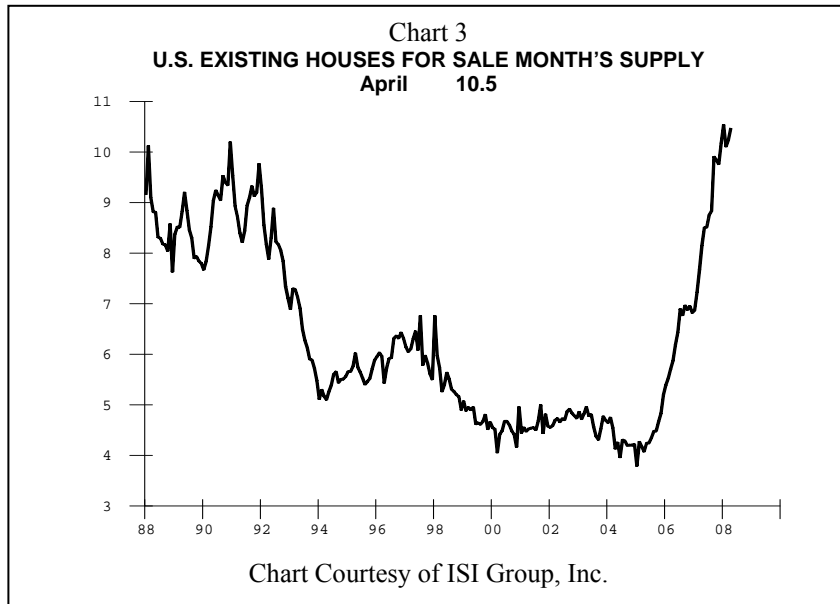
will fall enough such that Congress' bill will be of some benefit. However, as Laperierre concludes, "a double digit drop in home prices from February's level by the end of the year...is hardly a reason to be bullish."

For its part the Federal Reserve, led by Chairman Ben Bernanke, has been laboring to rescue the suffering banks under its charge through a lancing of the fed funds rate by 325 basis points to 2.0%, and liquidity facilities that are unprecedented in both size and structure.

Cut & Print, as we are now well aware, is the *modus operandi* of our central bank after the bursting of an asset bubble. The Fed's efforts to stave off a deep recession have devalued the U.S. dollar and helped ignite inflation. As such, the Fed now finds itself stuck between an economic rock and an inflation hard place.

Let's quickly rewind to the glory days of Former Fed Chairman "Easy Al" Greenspan. To fend off a recession caused by the fallout from his previous liquidity-induced bubble in tech stocks and the 9/11 attacks, Easy Al lowered the Fed funds rate to 1.0%, the negative real rate territory (not far from today) that is

known to produce bubbles. Easy Al's easy money policy created a credit bubble, enabling marginal and less than marginal borrowers to qualify for mortgages, auto loans, small business loans, etc. Housing boomed, and consumers borrowed against everything they could leverage and in turn spent their borrowed funds lavishly. While we were spending, the emerging economies of the world were saving. We were borrowing and spending the same

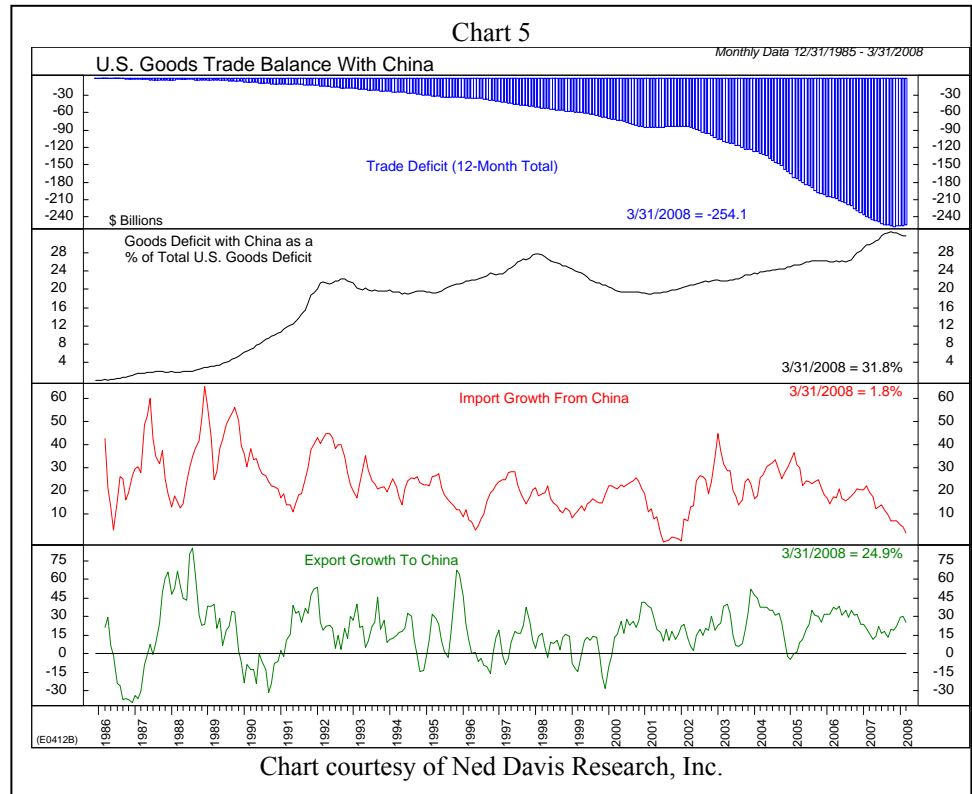


money they were saving. “In effect, our country has been behaving like an extraordinarily rich family that possesses an immense farm,” wrote Warren Buffett in a 2003 *Fortune* article. “In order to consume 4% more than we produce – that’s the trade deficit – we have, day by day, been both selling pieces of the farm and increasing the mortgage on what we still own.”⁴ From 2001- 2008 our trade deficit ballooned. By the end of March 2008, our 12-month trade deficit with China had skyrocketed to -\$254.1 billion (See Chart 5.) Easy AI’s credit bubble bought us nice new electronics, furniture, clothes, etc., and it also helped to fictitiously accelerate an economic boom for China and other exporter nations.

As more people in the world prospered, demand for commodities increased. It seems now that the world is flat, all the people in it want to live that. As a result, despite our current economic slowdown, we face yet another unintended consequence from Easy AI’s overly-stimulative monetary policy - inflation.

Nowhere is this more evident than in the demand for oil, where the price of a barrel of crude as of May 30, 2008 hovers around \$130, more than double the level of a year ago. According to noted oil investor T. Boone Pickens, worldwide oil demand is 87 million barrels a day, 2 million barrels more than world can produce.⁵ “The U.S. uses 21 million barrels a day, or 25% of the total, or roughly 25 barrels per person per year,” wrote Ned Davis. “The good news is that [China and India] consume only two and one barrels of oil per person, but their demand is growing sharply and they have lots more people, so their combined demand is now nine million barrels per day or 11% of world demand.”⁶

Making matters worse, the increase in emerging market demand is coming at a time when long-dependable oil wells are showing their age. In Russia, oil production dipped -0.8% year-over-year, to its lowest level in 18 months. “Aging fields, heavy taxes and remote development are challenging Russian oil development,” wrote Jeff Dietert, oil economics analyst for Simmons & Company International. Cantarell, Mexico’s largest oil field, saw production decline -25.0% year-over-year in the first quarter of 2008, after falling -18% in 2007. It is also believed that the Saudis are having production issues with Ghawar, the largest oil field in the world. “The Saudis claim they have more oil. They don’t,” said T. Boone Pickens. “The President wasted his time to go to Saudi Arabia, to say ‘Give us more oil.’ They



⁴ Warren Buffett, “America’s Growing Trade Defecit Is Selling the Nation Out From Under Us. Here’s a Way to Fix the Problem – And We Need to Do It Now,” *Fortune*, November 10, 2003.

⁵ Staff, “Pickens:Oil Going to \$150, So Move to Gas,” *CNBC.com*, May 20, 2008.

⁶ Ned Davis, “Institutional Hotline,” *Ned Davis Research, Inc.*, May 16, 2008.

can't give more oil.⁷”

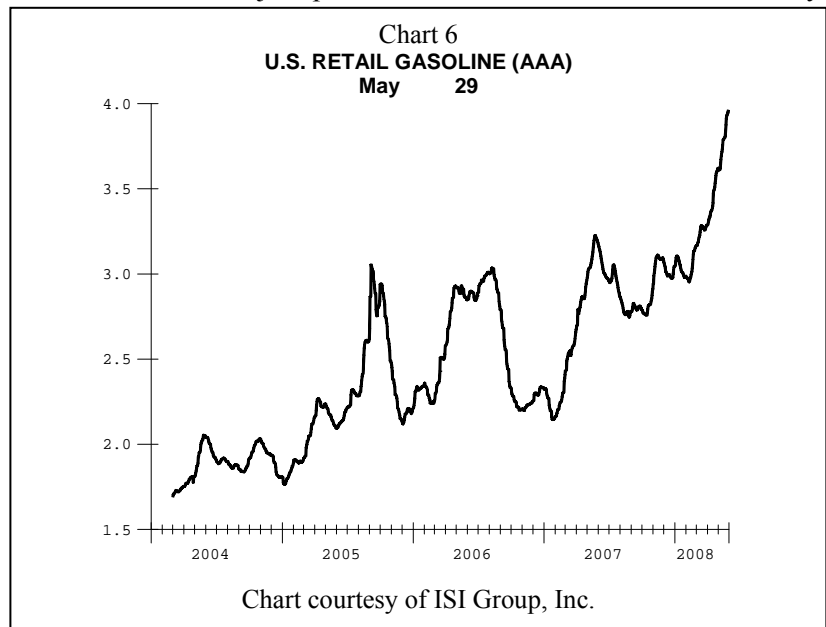
Of course, oil is not the only commodity for which prices are rising. As the middle class worker in the emerging world gains wealth his diet is evolving to include more protein-rich food. This, along with an ill-conceived mandate to use corn-based ethanol as a bio-fuel, has sent prices for food higher around the world. In the U.S., non-petroleum import prices rose 6.2% year-over-year in April, the fastest increase in almost 20 years. For their part, import prices for food and beverages were up 12.5% year-over year in April⁸. Noting these pressures, the Agriculture Department recently raised the 2008 food inflation forecast by half a percentage point to a range of 4.5% to 5.5%. For consumers, this forecast signals that the typical household will probably pay about \$350 more for the same basket of goods they bought last year⁹.

To be sure, we are not the only ones feeling the pain from these inflationary pressures. During the “flattening” of the world, American companies moved much of their manufacturing capacity to low-wage countries, but these companies are now seeing the cost of doing business in these locales increase. “American clothing companies import textiles and apparel valued at close to \$100 billion a year from such low-wage sanctuaries as Bangladesh, Vietnam and Pakistan,” wrote Jim Grant, editor of *Grant’s Interest Rate Observer*. “But strikes, civil unrest and supply-chain disruptions are on the rise in those places as inflation robs the low wage workers of what little they earned in the blessed days of disinflation. Striking for higher wages...19,000 workers recently walked off the job at a...plant in Ching Luh, Vietnam. The Vietnamese government ordered a 13% rise in the minimum wage in January, but the officially acknowledged inflation rate is 19%, with food and energy prices tripping along at 40%.¹⁰”

After 10 years during which U.S. footwear prices fell -4.3%, shoe makers are about to institute 5.0-15.0% price increases. The moves reflect higher costs in China, which just passed a new labor law that is drastically

increasing the cost of production. The price increases could presage increases in handbags, belts and other leather accessories that are made in the same region in China.¹¹ “The president of the World Bank, Robert Zoellick, speculates that inflation has pushed 33 countries to the edge of civil insurrection,” concluded Jim Grant. “If globalization has made one world economy out of a myriad of national economies, it follows that inflation is a world problem, not a localized one.¹²”

The price of a gallon of gasoline has surged in the last few months (See Chart 6), offsetting dollar-for-dollar much of the tax rebate consumers are currently receiving. “The primary impact of higher energy prices is a rise in costs,” wrote Ed Hyman.



⁷ Staff, “Pickens:Oil Going to \$150, So Move to Gas,” *CNBC.com*, May 20, 2008.

⁸ Floyd Norris, “It’s Not Just Petroleum, All Imports Cost More,” *The Wall Street Journal*, May 17, 2008.

⁹ Scott Kilman, “Government Again Raises Forecast for Food Prices,” *The Wall Street Journal*, May 20, 2008.

¹⁰ Jim Grant, *Grant’s Interest Rate Observer*, May 2, 2008.

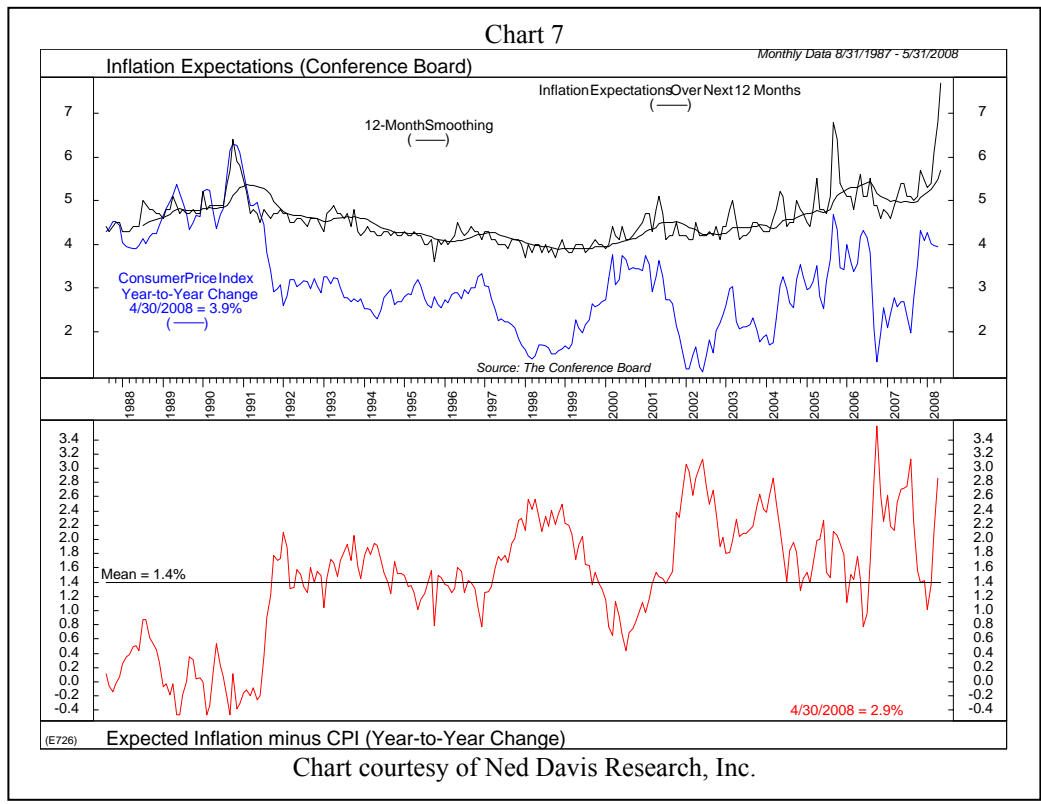
¹¹ Rachel Dodes and Ray A. Smith, “Pain at the Other Pump: Shoe Prices Rise,” *The Wall Street Journal*, May 13, 2008.

¹² Jim Grant, *Grant’s Interest Rate Observer*, May 2, 2008.

“Increasingly companies are raising prices for goods that are closely associated with energy. For companies closely tied to the consumer, high gasoline prices are leading to weak traffic at stores and budget conscious consumers.” Of course, the true inflation picture is much more dire than the statistics are currently showing. In April, the headline consumer price index (CPI) reportedly increased 3.9% year-over-year. However, “If you use the methodology Reagan used [to calculate] inflation,” said Dick Bove, the financial strategist at Landenburg Thalman, “the CPI is actually up over 11.0%.”

In April, retail sales grew 1.8% year-over-year, -2.1% less than the rate of inflation. “But there was growth,” wrote John Mauldin, President of Millenium Wave Investments. Due to rising prices, “gasoline sales were up 16.3%. And food sales were up 6.1%. 77% of the increase in retail sales this year has been from increases in food and gas sales. If you take out food and gas, retail sales are down by about 2% in the last three months,” Mauldin concluded.¹³ So stretched is the consumer that the nation’s largest retailer, a discount store no-less, said there is evidence that “the paycheck cycle” is more pronounced, meaning customers’ incomes aren’t taking them as far as they did previously¹⁴. “As gas and food prices continue to rise and the housing market slows, consumers are facing increased financial pressure and reducing their spending, especially in discretionary categories,” said the CEO of another discount retailer¹⁵.

Not surprisingly, the University of Michigan survey of consumer confidence fell to 59.5 in May, its lowest level since this country’s last serious bout with inflation in 1980. The report showed that one-year inflation expectations surged to 5.2% from 4.8% in April. The surge in inflation expectations (See Chart 7) challenges the Fed’s view that soaring commodity prices have not yet led to an increase in long-term inflation expectations¹⁶.



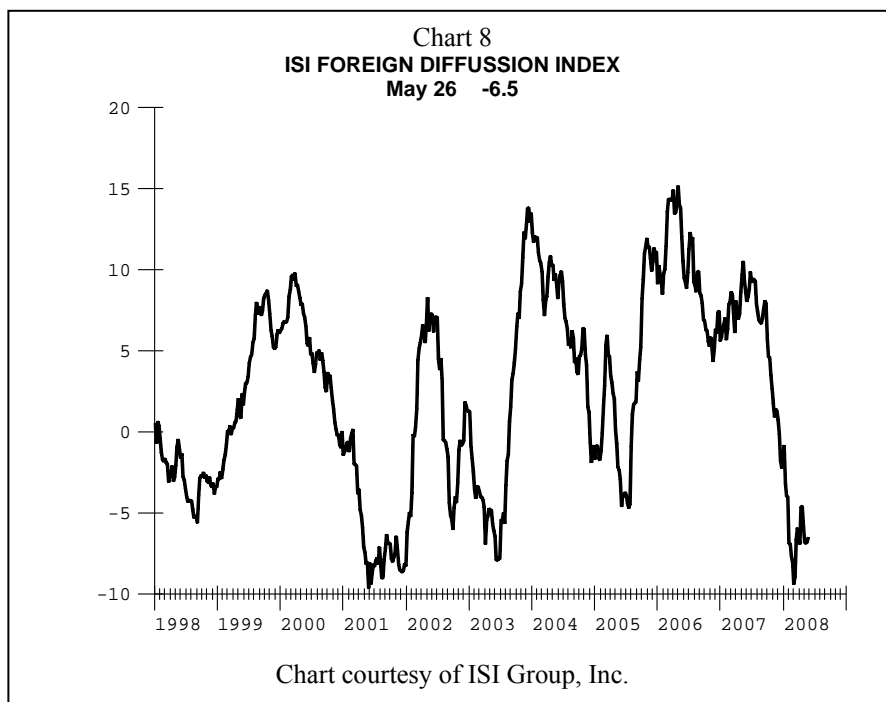
“This situation reminds me of the early 1970s when we had explosions in oil prices [and] in food prices against the background of low underlying inflation, and it was not dealt with forcefully because of concerns about the economy,” former Federal Reserve Chairman Paul Volcker testified before Congress’s Joint Economic Committee. “If we lose confidence in the ability and willingness of the Federal Reserve to deal with inflation pressures and to sustain the needed underlying confidence in the dollar, we’ll be in real

¹³ John Mauldin, “The Fed at the Crossroads,” *Thoughts from the Frontline*, May 16, 2008.
¹⁴ Ann Zimmerman, “Wal-Mart’s Profit Rose 6.9% in Quarter,” *The Wall Street Journal*, May 14, 2008.
¹⁵ Reuters, “Shoppers Stick to Buying Only Basics, Retailers Say,” *The New York Times*, May 21, 2008.
¹⁶ Reuters, “Lowest Reading Since 1980 For Consumer Confidence,” *The Wall Street Journal*, May 17, 2008.

trouble,” Mr. Volcker said. “That has to be very much in the forefront of thinking. If we lose that, we’ll be back in the 1970s, or worse.”¹⁷

It should be noted that the combination of the credit crisis and surging price pressures are causing a slowdown in growth for economies around the world. Evidence of this slowdown can be seen in ISI’s foreign economic diffusion index (See Chart 8) and in ISI’s emerging economies ex-China diffusion index (See Chart 9.) Ed Hyman believes this global slowdown will likely intensify in upcoming months, and, with it, commodity price pressures will cool off. Some emerging countries are beginning to experience wage inflation which, if it persists, could lead to stagflation (a period of slowing economic growth and rising prices) and pose a risk to worldwide economic stability.

As world economies fade, so to will the belief that an export-led recovery will keep the U.S. from falling into a recession. Unfortunately, the U.S. enters this period of economic slumber with little savings cushion to fall back on. Our record level of total debt to gross domestic product (GDP) is yet another negative by-product of Easy Al’s now discredited monetary policy (See Chart 10). “I think our debt bubble may clearly diminish our future long-term growth rates,” wrote Ned Davis. “It is true that in real terms, the 1990s were better than the 1970s, where inflation ravaged stocks and many consumers. Yet, I still think the boom in debt has unmistakable secular risks.”¹⁸



Going forward, as our policy makers plan their continued response to the current economic environment, we hope they pause to reflect on lessons of the past. Easy Al’s quick fix, The Cut & Print era, is over and it has left our nation in a position of weakness vis-à-vis the more thrifty economies of the world. Our leaders would be wise to consider the secular (long-term) ramifications of the actions they are now taking.

The plain truth is that our economy is likely in a position of secular weakness. Try as they may to help with legislative aid packages and negative real interest rates, both Congress and the Fed are left with tools less capable of pulling off a clean rescue. As a result, confidence has plunged and inflation expectations have soared. The “Lost” consumer, whoafter anticipating an economic resuce, is starting to lose faith in his saviors.

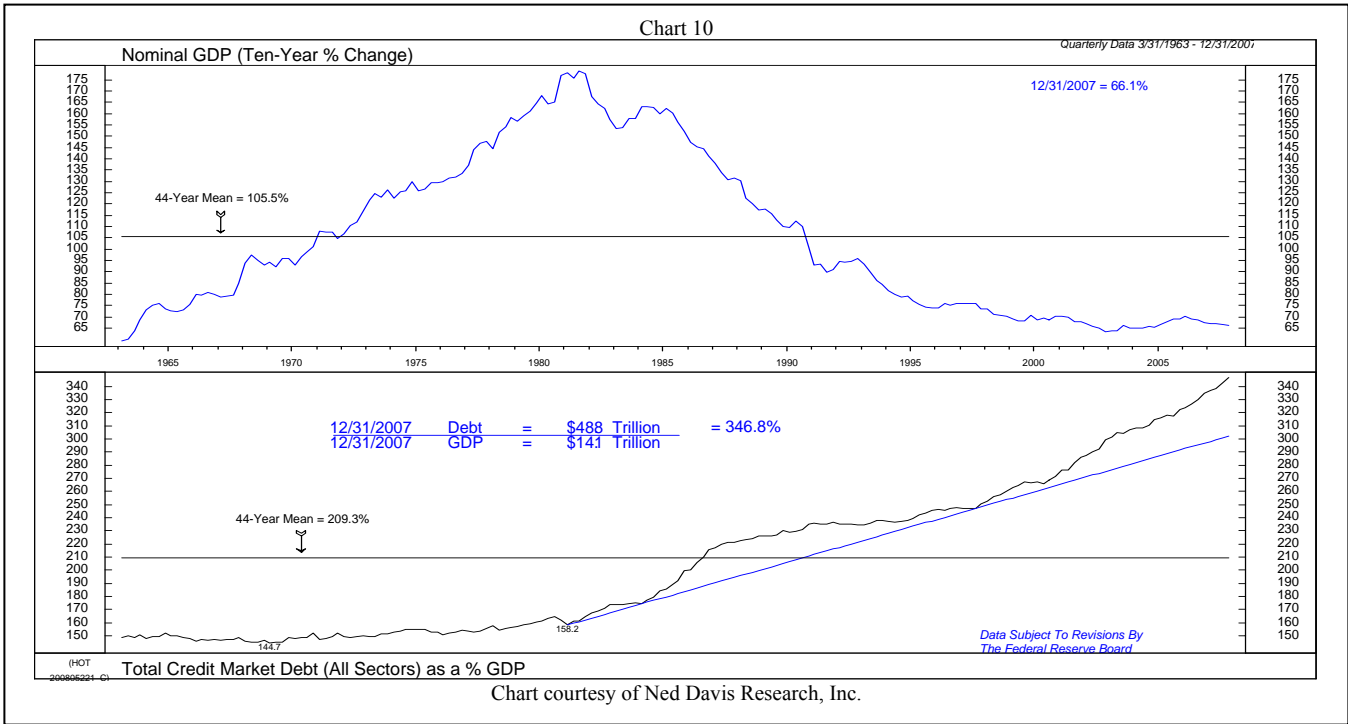
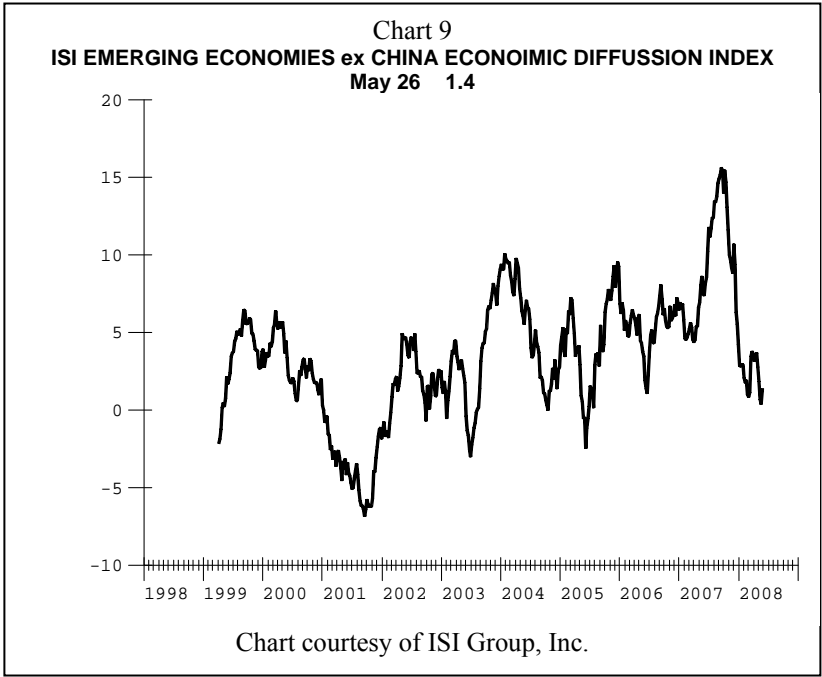
Perhaps a new plan is in order.

Michael B. Orkin, CFA
J. Patrick Fleming, CFA
William C. Horne

Portfolio Management Team:
Michael B. Orkin, CFA
J. Patrick Fleming, CFA
David R. Bockel, Jr.

¹⁷ Sudeep Reddy, “Consumer Prices Rose At Modest Pace in April,” *The Wall Street Journal*, May 15, 2008.

¹⁸ Ned Davis, *Institutional Hotline*, May 22, 2008.



Note: As of May 30, 2008 the portfolios managed by Caldwell & Orkin do not hold positions in any of the companies mentioned herein.

Caldwell & Orkin, Inc., 5185 Peachtree Parkway, Suite 370, Norcross, GA 30092-6542
 (800) 237-7073 or (678) 533-7850 / E-mail: Update@CaldwellOrkin.com