



UPDATE

June 2009

CALDWELL & ORKIN®

“Is anyone keeping score? Is it possible to keep score? Never in history has so much stimulus been applied – on a global scale, in such a short time.”

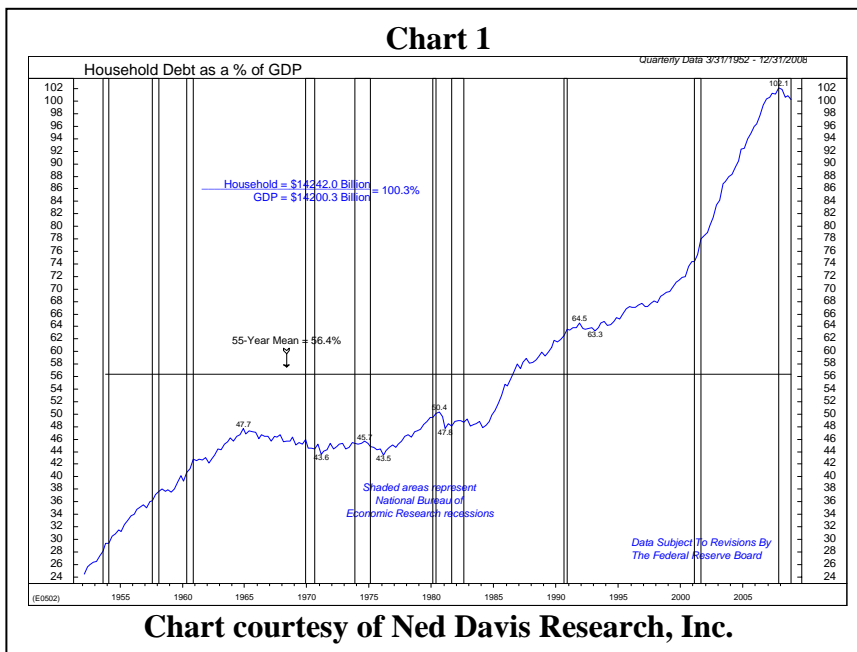
-Ed Hyman, Chairman of ISI Group, Inc.

“We have lent a huge amount of money to the U.S. Of course we are concerned about the safety of our assets. To be honest, I am definitely a little worried.”¹

-Wen Jiabao, prime minister of China

Mission Accomplished?

During the last eighteen months financial market participants have discovered that living in interesting economic times can be both a blessing and a curse. On the one hand we have witnessed an unprecedented worldwide economic collapse in the face of severe deleveraging. On the other, we have seen an equally unprecedented liquefaction effort in the form of 640 policy initiatives as part of a global policy response to these economic threats. As the first to strike in this economic war, deleveraging had the early upper hand. But policy makers, led by Federal Reserve Chairman Ben Bernanke, have battled back swiftly and valiantly to even the score as evidenced by the 126 “green shoots” of economic improvement since the woeful days of February 2009.

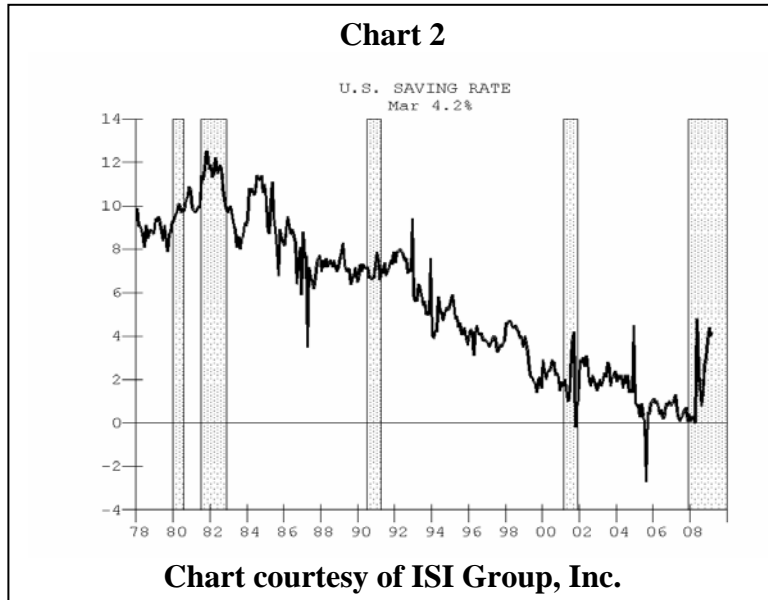


“Not in living memory have governments and their not-so-independent central banks attempted so radical a manipulation of prices and markets,” wrote Jim Grant of *Grant’s Interest Rate Observer*. “The truth is that the gravity of the credit contraction, set alongside the immensity of the fiscal and monetary attempts to reverse it, is calculated to confound prediction and raise the odds of chaos... As the central banks’ actions are untested, so are the consequences of those actions unpredictable.”² While the myriad of monetary and fiscal policy initiatives have done well to raise us

¹ Keith Bradsher, “China Grows More Picky About Debt,” *The New York Times*, May 21, 2009.

² Jim Grant, *Grant’s Interest Rate Observer*, May 1, 2009.

from the depths of despair we visited just a few short months ago, we would not hastily raise the Mission Accomplished banner. This war, despite what you may have read or heard, has not yet been won.



A recent survey by ISI Group, Inc. found that investors as a whole generally believe that we are in the “early-to-mid innings” of consumer deleveraging. Yet, consumer debt as a percentage of gross domestic product (GDP) has fallen -2.0% from a peak of 102% in the fourth quarter of 2007 (see Chart 1). While we concur that the deleveraging game is young, we believe that we are closer to The National Anthem than we are to the early-to-mid innings. Specifically, we are not convinced that the value of the assets supporting consumer debt, nor the income used to service this debt, has bottomed out.

After living beyond their means for far too long, consumers have finally found thrift. The overall consumer savings rate increased to 4.2% in March 2009 and is forecasted by ISI to rise to 7.0% by the end of 2009 (see Chart 2). But considering how high debt levels rose, we wonder how long it will take to work off this burden, especially given the perpetual, unrelenting decline in house prices. In the first quarter of 2009, the S&P/Case-Shiller U.S. National Home Price Index posted a -19.1% year-over-year decline, the largest quarterly decline in the index’s 21-year history. “Given various foreclosure moratoria that slowed the rate of foreclosure sales throughout the first quarter, we were surprised by the acceleration in price pressures reported in March’s index,” wrote Ivy Zelman of Zelman & Associates. “As we have highlighted in the past, home prices are likely to overshoot affordability equilibriums as measured by income or rents given the excess supply in the market and pending forced sales of repossessed homes, leading to our view that home prices will not bottom until 2010. Our home price forecast implies peak-to-trough decline in quarterly Case-Shiller national index of approximately -40.0%, implying another 11-12.0% decline from 1Q’09’s level.”

As the housing market decline matures, it is beginning to feed off of the traditional causes of cyclical stress, namely job losses. While the current unemployment rate of 8.9% is well below peaks of past recessions, it doesn’t include workers who have given up looking for work. And, this recession is unique in that, it is taking those out of work a considerable amount of time to find a job. Among the current jobless, 27.2% have been unemployed for more than six months, the highest figure since the government began tracking such data in 1948.³ “The displeasing point (to state the obvious) is that we may be shedding jobs less rapidly but, we aren’t creating any new ones,” wrote Stephanie Pomboy of MacroMavens. “Quite the contrary, the #1 creator of jobs – small businesses – have slashed hiring plans like never before in the last 36 years, according to the monthly National Federation of Independent Businesses (NFIB) Survey.” (See Chart 3.) According to Pomboy, small businesses have had their credit lines pulled in by risk-averse banks, leaving them unable to hire employees even if the need were there.

³ Peter S. Goodman and Jack Healy, “At 8.9%, Unemployment Still Rises, but Pace Slows,” *The New York Times*, May 9, 2009.

“Uniquely dependent on credit and lacking sufficient scale to raise that money in the capital markets, small businesses must subsist on what the banks will provide. That, in case you’re just back from spring break on Mars, ain’t much,” she concludes (see Chart 4).

Thanks to the rise in unemployment, a growing number of American homeowners with once-solid credit histories are falling behind on their mortgages, amplifying the tidal-wave of foreclosures.

Moody’s Economy.com expects that 60.0% of the mortgage defaults this year will be set off primarily by unemployment, up from 29.0% last year. “We’re right in the middle of this third wave [of foreclosures], and it’s intensifying,” said Mark Zandi, chief economist at Economy.com. “That loss of jobs and loss of overtime hours and being forced from a full-time to part-time job is resulting in defaults. They’re coast to coast.” According to *The New York Times*, between November 2008 and February 2009, the number of prime mortgages that were delinquent at least 90 days, were in foreclosure, or had deteriorated to the point that the lender took possession of the home increased more than 473,000, exceeding 1.5 million. Over all, more than four million loans worth \$717 billion were in those three distressed categories in February 2009, a jump of more than 60.0% in dollar terms compared with a year earlier.⁴

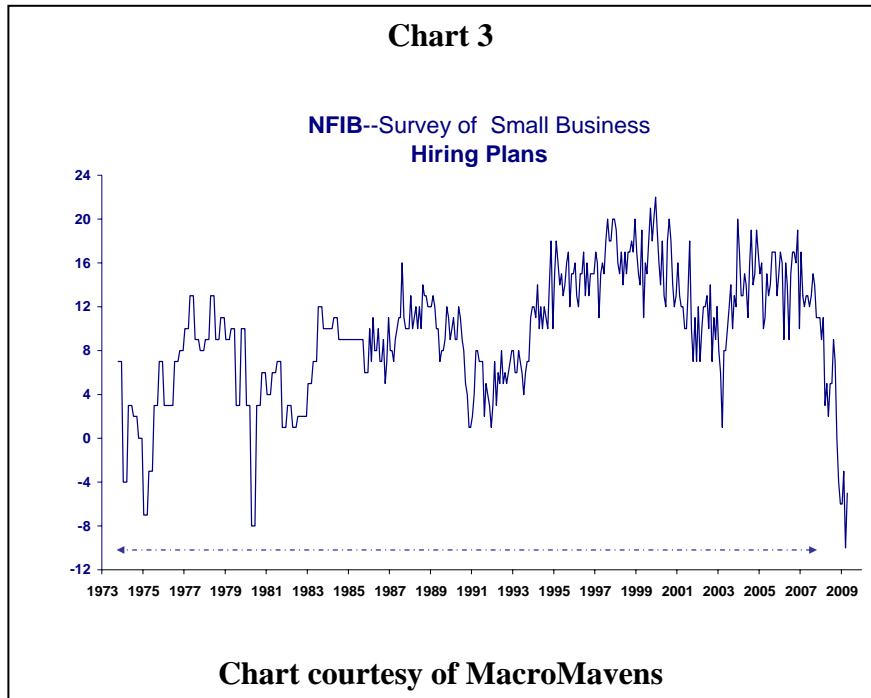


Chart courtesy of MacroMavens

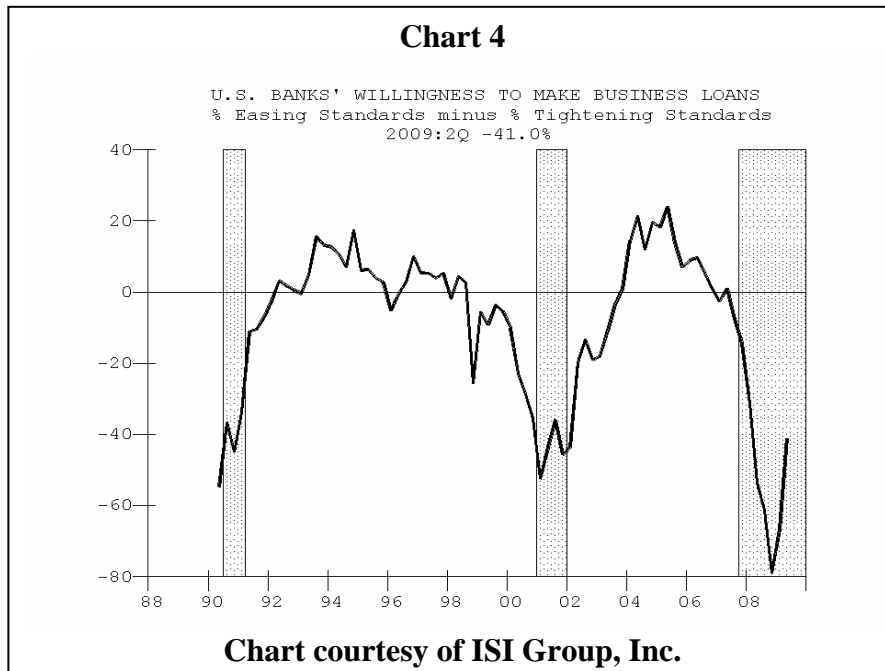
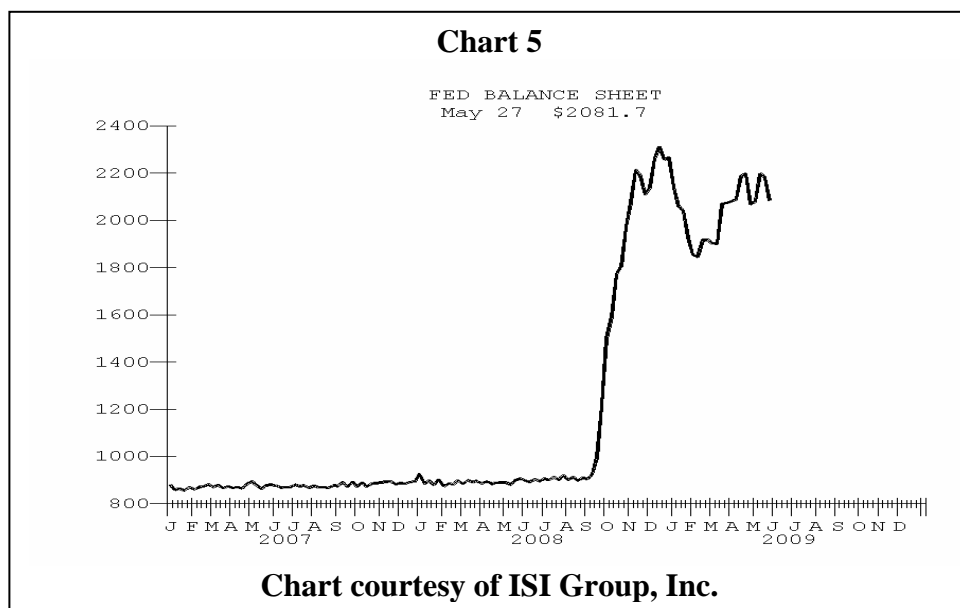


Chart courtesy of ISI Group, Inc.

“The stress in the housing market will be increasingly prime, increasingly high-end, and spread to more states,” wrote Tom Gallagher of ISI. “While growth in subprime delinquencies has begun to level off, serious delinquencies at the GSEs [Government Sponsored Enterprises] are still growing sharply. The [10-Q] filings of both companies [Fannie Mae and Freddie Mac] observe that delinquencies are spreading to loans with lower risk

⁴ Peter S. Goodman and Jack Healy, “Job Losses Push Safer Mortgages to Foreclosure,” *The New York Times*, May 25, 2009.

characteristics. According to Fannie, ‘We are beginning to experience some deterioration in the credit performance of loans in our single-family guaranty book of business with lower risk characteristics, reflecting the adverse impact of the sharp rise in unemployment and the continued decline in home prices.’ Not only are delinquency rates rising, but so are loss severities [the amount lost per dollar invested]. Freddie estimates that its loss severity [rate] has risen from 21.4% in the first quarter of 2008 to 37.0% in the first quarter of 2009, a 71.0% increase in its loss severity during the past year. Not surprisingly, credit losses at the two companies have exploded... With delinquency rates and loss severities rising sharply for the two GSEs, it’s hard to imagine the banks with jumbo, Alt-A, and second-lien mortgages on their balance sheets have seen the worst of it,” Gallagher concluded.



One can envision an ugly cycle in motion here: asset value declines have led to credit losses, which have led to decreased spending and demand destruction, which have led to job losses which could lead to further asset value declines, etc. The unfortunate constant in this equation is debt. And the frightening reality of deleveraging is that while asset values fluctuate, the debt stays constant. “If inflation is too much money chasing too few goods,

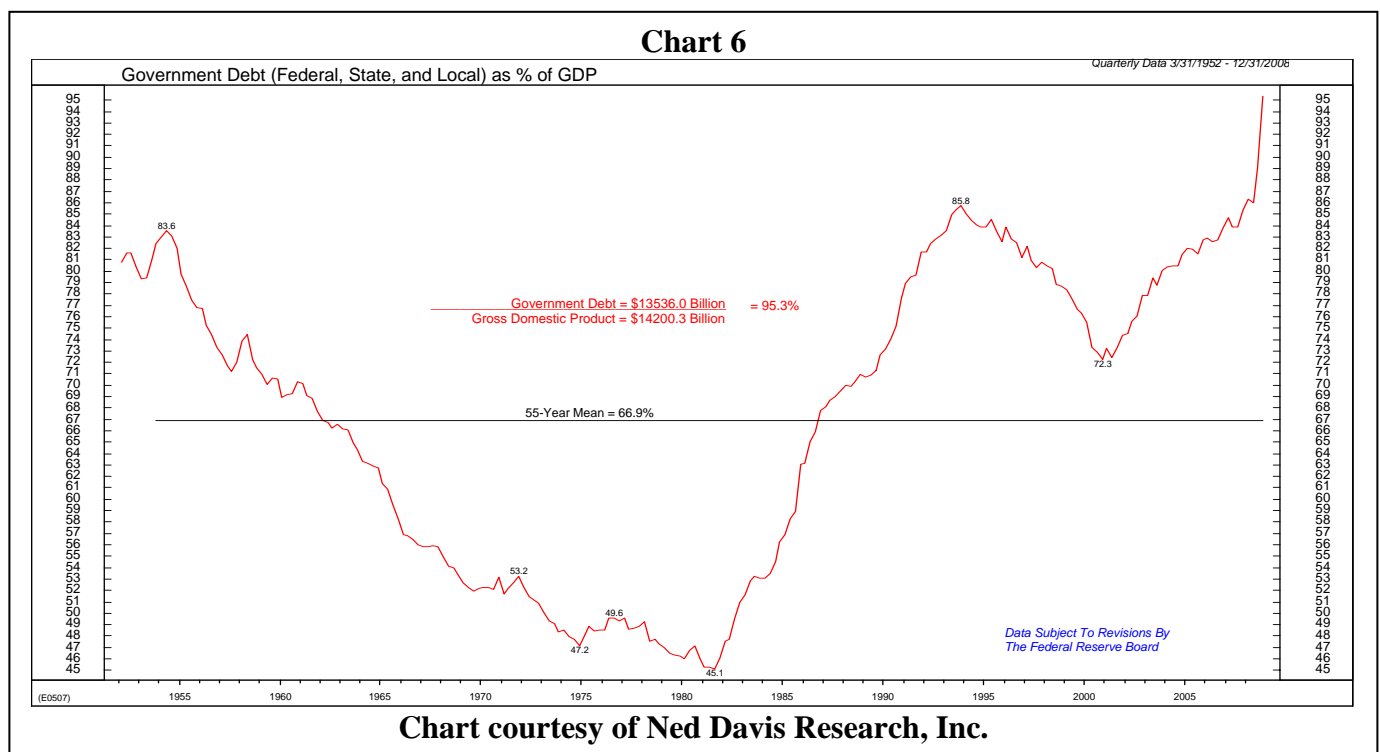
deflation is too much debt chasing too little income,” wrote Jim Grant. “The Fed can create dollar bills. Can it thereby create the nominal income with which to service the debts? It may have to redouble its efforts in that direction... It is an old saying that debts never really go unpaid. If the borrower can’t pay, the lender must. There is, of course, in this era of paper money and hyperactive central banking, another way out, and scarcely a day goes by without a reminder of it.⁵” The other way out, of course, is for the Fed and other central banks to monetize and reflate by increasing the supply of money in the economic system, and for the stewards of fiscal policy to spend like there’s no tomorrow. Sound familiar?

At the beginning of the Great Depression (before monetary authorities became accommodative), money supply fell more or less continuously. “This time, however, the money supply is actually increasing,” wrote Ian McCulley, an analyst for *Grant’s*. “M-1, i.e., currency and checking accounts, is up by nearly 14.0% since the start of the recession in December 2007 and is currently growing by 14.3%, year-over-year. At the equivalent point in the Depression, M-1 was lower by -1.6%. As Bernanke is a scholar of the Depression, he is keenly aware of the importance of maintaining growth in monetary aggregates to forestall deflation and further declines in economic activity. It won’t be easy, and it hasn’t been. Thus, it has taken a 140% rise in the size of the Fed’s balance sheet over the past fifteen months to generate a 14% increase in M1.⁶” (See Chart 5.)

⁵ Jim Grant, *Grant’s Interest Rate Observer*, May 1, 2009.

⁶ Jim Grant, *Grant’s Interest Rate Observer*, May 1, 2009.

We continue to maintain that this expansion in the Fed’s balance sheet was a necessary, prudent response to the credit-market shut-down. But that does not mean it is not without risks or limits. A primary concern is moral hazard. To say that the Fed has introduced moral hazard into the markets through its balance sheet growth would be to pretend that moral hazard wasn’t a causal factor in the ridiculous risk-taking that got us where we are today. “People learned some really bad economic lessons [in the Greenspan-era],” wrote Ned Davis of Ned Davis Research, Inc. “(1) The so-called ‘Greenspan put’ where people believed the Fed and government would always bail out stock market bulls, and that the Fed was more important than free market forces (Not!). 2) That even private hedge funds made up of very wealthy, risk-knowledgeable, sophisticated investors could be ‘too big to fail.’ 3) Thus, greed and leverage were good... Wall Street listened and learned well!”⁷



While Chairman Bernanke engages in a monetary policy of dropping dollars from choppers, Treasury Secretary Timothy Geithner and President Barack Obama’s Administration are ramping up fiscal policy. During the first few weeks of May 2009, government payouts rose \$21.4 billion, or at almost a \$560 billion annual rate. According to ISI, the cumulative stimulus funds available, currently \$102.9 billion, will probably grow to \$340 billion by the end of 2010. Unfortunately, unlike many of our trading partners, the U.S. has not saved the reserves necessary to fund this spending. Thus, we must borrow. Including the Troubled Asset Relief Program (TARP), fiscal stimulus and the Fannie Mae and Freddie Mac bailouts, the budget deficit this year will probably be -\$2.0 trillion on a financing basis, or almost 15.0% of GDP, a postwar record.

When looking at the record levels of U.S. government debt (see Chart 6), one can’t help but notice the similarities with U.S. consumer debt. The spent-up, lent-up consumer finally broke when the burdens

⁷ Ned Davis, “Institutional Hotline,” *Ned Davis Research, Inc.*, May 21, 2009.

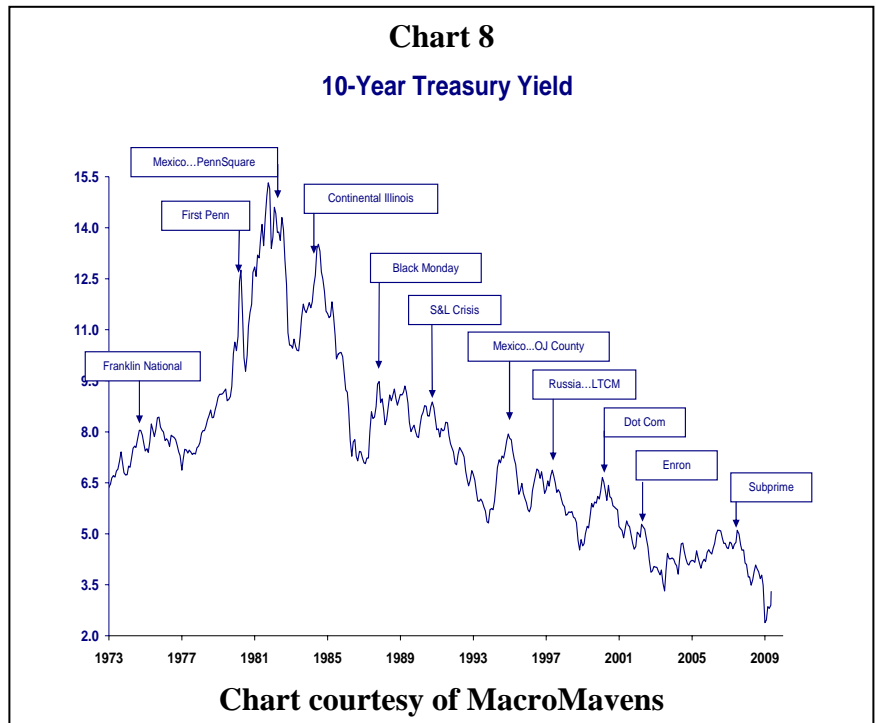
of his leverage became too great. The catalyst for the consumer capitulation was falling housing prices. Could the same thing happen to the U.S. government? And what could the catalyst be?



China, the U.S. government's biggest lender, is growing more cautious about its investments in the U.S. Recent data shows that China has sold most of its holdings of GSE debt in exchange for higher-quality Treasuries. Also, China has traded long-term Treasuries for short-term notes,

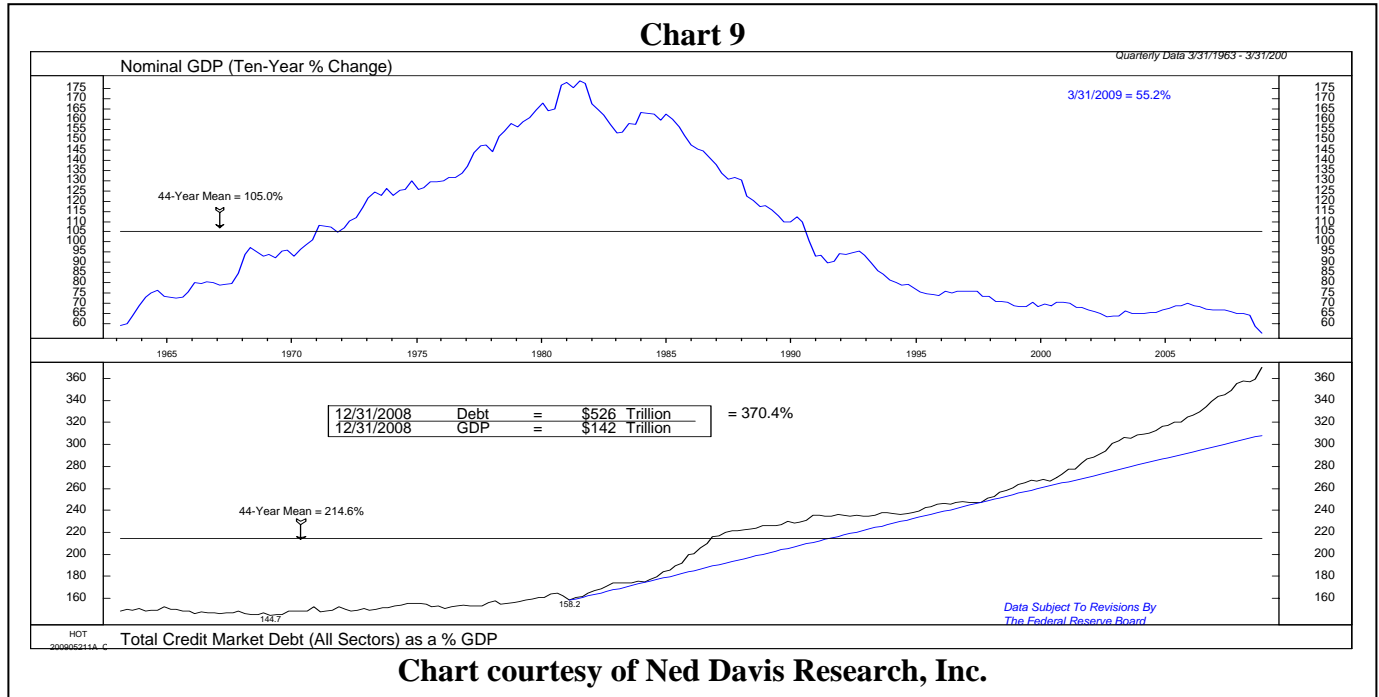
highlighting Beijing's concerns that inflation will erode the dollar's value in the long run as America amasses record debt. This switch gives China the option of cashing out its positions in a hurry by not rolling over its investments into new Treasury bills as they come due, and poses a significant funding risk to the U.S. government.⁸

Investor concerns over the Federal Reserve's balance sheet growth and China's Treasury appetite are manifesting themselves in dollar weakness (see Chart 7) and higher Treasury rates. "While Obama stands resolute in his determination to halve the deficit by 2011, the counter-cyclical (spending and tax) measures required to achieve that goal are sure to destroy whatever green-shoots are presently budding," wrote Stephanie Pomboy. "Of course, if the budget deficit maintains its torpid state and [interest] rates keep rising at their current pace (Fed monetization be damned) we'll be looking at 5.8% on the 10-year this time next year. That level, lest memory has dimmed, was



⁸ Keith Bradsher, "China Grows More Picky About Debt," *The New York Times*, May 21, 2009.

sufficient to bring Enron and the Subprime mortgage sector to their knees. Presumably, it would prove equally destructive to the storied green-shoots today.” (See Chart 8.)



“The critical question for policymakers and investors alike is whether [the dollar and Treasury weakness] represent[s] the start of a new trend in which financial market dynamics now represent a bigger constraint on policy and even on the economic outlook,” wrote Tom Gallagher. “The market moves have to represent a new constraint on policy. This isn’t a binding one but nonetheless a constraint on either further increases in the deficit or in taking on new contingent liabilities. There are already calls for [President] Obama and the Fed to outline how fiscal and monetary stimulus will be withdrawn. We can’t help but see this in the context of our argument that investors should worry at least as much about stimulus being withdrawn too soon as that it is withdrawn too late.”

Thus, in this epic war between deleveraging and liquefaction, in the long-run we think the ramifications of an overleveraged economy will win the day. The forces employed on the side of deleveraging are the natural forces of the business cycle, driven by the equally real and raw emotions of fear and greed. The forces employed on the side of liquefaction are man’s attempts to control the ramifications of those emotions. In the end, we believe nature will win. “I do think we have had a slow motion judgment day in that debt has been sucking life out of the economy for over 20 years,” wrote Ned Davis. “Note the key chart [see Chart 9] that nobody wants to talk about and the table [see Table 1] that goes with it. They show that around the late 1980s, when debt got above “normal” relative to GDP, that economic growth really began to fade.

“Clearly there would have been high risks and pain letting LTCM [Long-Term Capital Management] go under. My rhetorical question back to you would have been, history shows debt bubbles need to deflate to start new secular uptrends in stocks and the economy. Would we have been better off doing it in 1998 or in 20?? When the debt will be much higher relative to GDP with exploding liabilities to come in social security and Medicare/Medicaid? That will leave an incredible burden for my kids and

grandkids – how is that for real heartlessness? All we have done is prolong the agony and pass the problems on to others,” Ned concluded.

Table 1

Diminishing Returns from Debt-Financing by Decade
12/31/1949 - 12/31/2008

Date Range	Decade Change in Debt (billions \$)	Decade Change in GDP (billions \$)	Debt/GDP
12/31/1949-12/31/1959	337.6	248.0	1.36
12/31/1959-12/31/1969	752.1	491.4	1.53
12/31/1969-12/31/1979	2785.2	1655.9	1.68
12/31/1979-12/31/1989	8563.7	2923.8	2.93
12/31/1989-12/31/1999	12566.2	3935.2	3.19
12/31/1999-12/31/2008*	27186.5	4680.8	5.8

Table Courtesy of Ned Davis Research, Inc.

On May 1, 2003 the U.S. famously declared “Mission Accomplished” and an end to major combat operations in Iraq. Six years later we are still fighting the Iraq war, and there are more troops there now than were there then. The sprouting of green shoots has many investors thinking the major economic combat is behind us. Perhaps they are right. But considering the vast amount of deleveraging the economy has ahead of it, we think that declaration is likely as accurate as the one made in 2003.

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