CALDWELL & ORKIN®

UPDATE

July 2007

"No exaggeration is required to pronounce unequivocally that money is available today in quantities, at prices and on terms never before seen in the 100-plus years since U.S. financial markets reached full flower."[1]

\- Steven Rattner, Managing Principal of Quadrangle Group LLC

"To death and taxes you can add this to your list of inevitable: the subprime crisis is not an isolated event and it won't be contained by a few days of headlines in The New York Times."[2]

-Bill Gross, Managing Director of PIMCO

Lipstick on a Pig

Less than a month after his prediction that the worst was over for the U.S. housing market, it is safe to say that Treasury Secretary Henry Paulson's crystal ball is a bit foggy. Of course, no one's batting average is 1.000, but his call seemed foolhardy from the get go, and honestly, Mr. Paulson should have known better. For, in making his bold prediction, the ex-Goldman Sachs chief was in the same bullish camp as former Federal Reserve Chairman Alan Greenspan. Never mind the fundamentals, company such as that should have given him pause.

But don't take our word for it. The housing market's precipitous decline has indeed not yet found bottom, as the CEO of the nation's largest homebuilder bluntly stated while pre-announcing a disastrous second-quarter loss. "Market conditions have eroded so much over the past six months we are now focused on limiting the loss this year,"[3] he said.

If the nation's largest homebuilder is feeling the pain, then you can bet other homebuilders are as well. In June 2007, The National Association of Homebuilders' (NAHB) survey of builder confidence fell to its lowest level in sixteen years[4] (see Chart 1). Commenting on the ongoing weakness, David Seiders, chief economist of the NAHB, said the housing market is weaker than he initially thought, and he expects housing starts to drop throughout the rest of 2007.[5]

The current state of the housing market is growing worse by the day. In April, the inventory of new homes for sale stood at 538,000. That represented 40% of the homes built in 2006, the highest

[1] Steven Rattner, "The Coming Credit Meltdown," *The Wall Street Journal*, June 18, 2007.
[2] Bill Gross, "PIMCO Investment Outlook," July 2007.
[3] Brian Louis, "Lennar Reports Second-Quarter Loss as Revenue Slumps," *Bloomberg News*, June 26, 2007.
[4] Jeff Bate, "Home Builders' Confidence Drops," *The Wall Street Journal*, June 19, 2006.
[5] Kelly Evans "Home Builders Cut Output, Lending Support to Prices," *The Wall Street Journal*, June 20, 2007.

percentage in history.[6] According to Ed Hyman at ISI Group, Inc., the increase in houses for sale through May 2007 suggests the vacancy rate, which hit a record high in the first quarter of 2007, increased further in the second quarter (see Chart 2). Combined, the record level of inventory and the record vacancy rate will likely force home prices lower from their already unprecedented levels of decline (see Chart 3). Largely due to these price declines, Hyman expects mortgage equity withdrawal (MEW) to decline from a current $450 billion annualized rate to a $100 billion annualized rate (see Chart 4), and remain a drag on economic growth in the quarters to come.

Chart 1

Chart courtesy of ISI Group, Inc.

Just as housing's bull market was elevated and extended by credit availability, its bear market will likely be longer in duration and worse in decline as credit excesses are removed. Indeed, the pain from aggressive lending to borrowers with subprime credit histories continues to be felt. In May 2007, foreclosures surged 90% year-over-year to 176,137, or roughly a 2 million annual rate (see Chart 5). Unsurprisingly then, the ABX index (an index that tracks the performance of subprime mortgages) fell to its lowest level since its introduction (see Chart 6). It seems likely that the situation will get worse. Robert Lacoursiere, credit analyst at Bank of America, doesn't expect a peak in mortgage losses until the second-half of 2008.[7] We concur.

In the June 2007 *Update*, we wrote about pending Congressional legislation on mortgage suitability. This legislation has now been released, and, as expected, it has teeth. According to Andy Laperriere at ISI, one mortgage company that voluntarily adopted the Congressional guidance in early June has indicated that it expects the new standards will reduce the number of subprime hybrid adjustable rate mortgages (ARMs) it writes by 50%. While this legislation is needed, it is long overdue. And, as usual, Congress may be doing more harm than good. Just as they passed

Chart 2

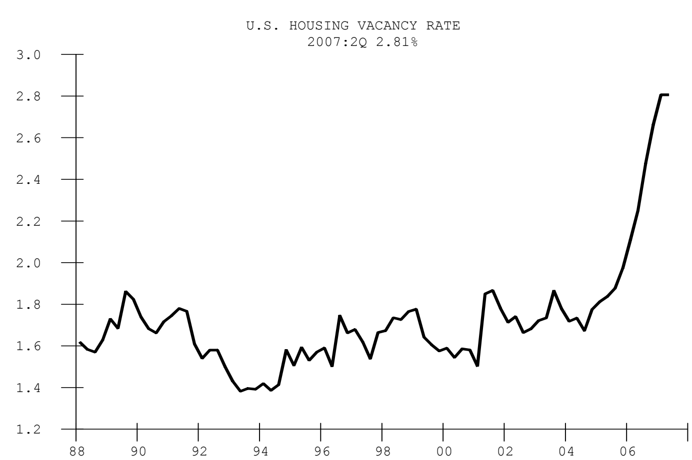

Chart courtesy of ISI Group, Inc.

[6] Floyd Norris, "Homes Sell. Homes Don't Sell. Builders Still Build," *The New York Times,* June 23, 2007.
[7] Alan Abelson, "Up & Down Wall Street," *Barron's*, June 25, 2007

the legislation limiting access to mortgage credit, the toxic mortgages of the past few years are entering their rate reset phase. No less than $25 billion of subprime mortgages were due to reset from their low introductory rates to higher, more painful market-based rates in June. These subprime resets will swell to a peak of around $40 billion a month through the second half of 2008. Describing this coming tsunami of ARM resets, David Lowman, head of the mortgage business at J.P. Morgan Chase & Co., warned, "The largest part of the problem in the subprime space is ahead of us, not behind us."[8]

Chart 3

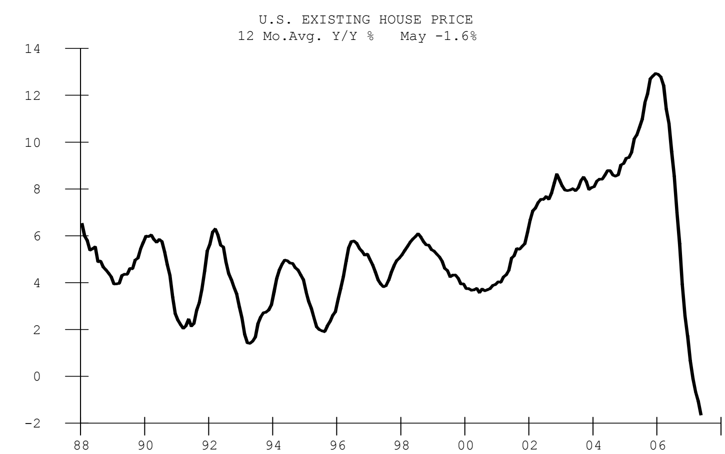

Chart courtesy of ISI Group, Inc.

Chart 4

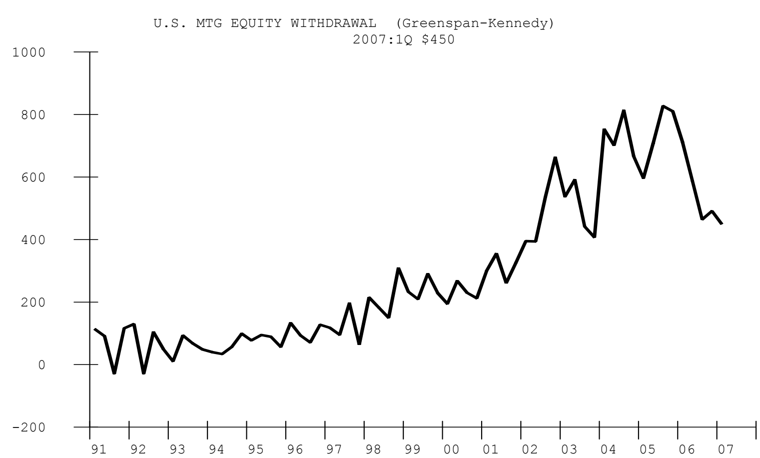

Chart courtesy of ISI Group, Inc.

Yes, we have covered this ground before. While we certainly do not mean to beat a dead horse, it seems as if every time headlines of housing or mortgage trouble hit the front pages of financial publications, there is a race to see which noted market commentator or governmental official can be the first to call a fundamental bottom (Mr. Paulson simply being the most recent.) As we see it, those who are looking for a bottom in fundamentals as an "all clear" sign for the equity markets specifically, and the U.S. economy in general, are missing the point entirely. As the housing bubble deflates, we are learning more about the voracious forces that drove its inflation. Forces of credit largess are clear and present in other areas of leveraged finance.

Flashback approximately five years. In response to the Internet bubble blow up and to the attacks of September 11, 2001, the Fed's Open Market Committee, under the guidance of Alan Greenspan, lowered the fed funds rate to 1.0%. The Fed left it at that level for a year, and proceeded on a gradual (some would say slow) course of monetary policy tightening in quarter point increments. Speaking on the merit of this policy, Richard Fisher, President of the Dallas Fed, said, "In retrospect, the real fed funds rate turned out to be lower than what was deemed appropriate at the time and was held lower longer than

[8] James R Hagerty, Jonathan Karp and Mark Whitehouse, "Economists See Housing Slump Enduring Longer," *The Wall Street Journal,* June 9-10, 2007.

Chart 5

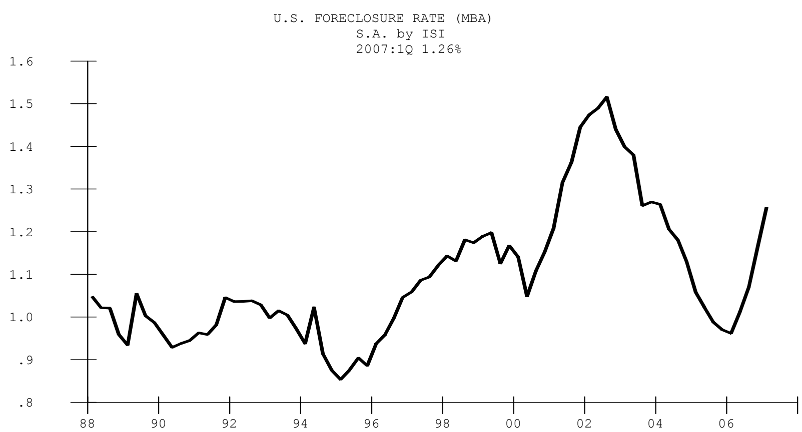

Chart courtesy of ISI Group, Inc.

it should have been."[9] Translation: monetary policy was too easy. Then came "the conundrum." As the Federal Reserve began raising the short-term fed funds rate, long-term interest rates remained stubbornly low. As can be seen on Chart 7, this dynamic was at least partly the result of increased foreign demand for long-term Treasuries stemming from the recycling of U.S. dollars accumulated through oil sales and trade surpluses.

This unusually long, artificially-created period of low interest rates gave birth to a ravenous hunger for credit (increased demand), and a desperate need to increase portfolio yield (increased supply). The problem was that those seeking the debt had dubious (at best) borrowing histories, while those offering the debt had high-grade investment mandates. Enter Wall Street. To solve the this problem, Wall Street created leveraged debt instruments called collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs). Through these vehicles, loans backed by various asset classes (mortgages, credit cards, commercial real estate, corporate debt) were sliced and diced into different risk tranches and distributed to investors. The magic of the process was Wall Street's ability to take junk quality debt and turn it into investment grade paper by leveraging the assets and buffering the highest-grade tranches with first-loss risk absorbers.

Chart 6

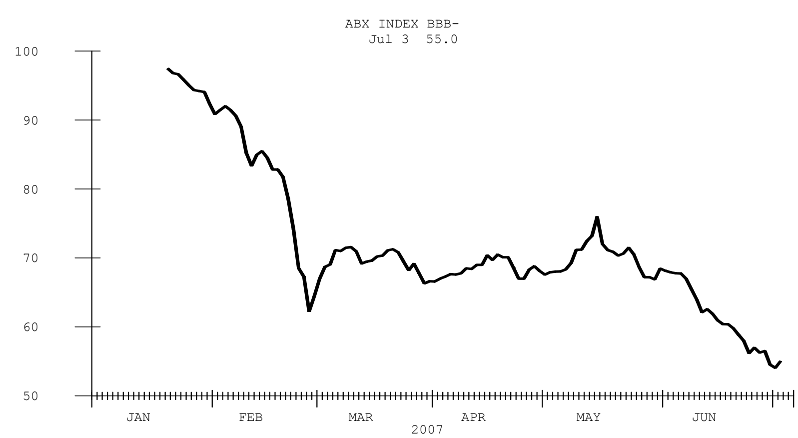

Chart courtesy of ISI Group, Inc.

From a revenue generating standpoint, the process worked fabulously. According to Dealogic, since 2004, more than $210 billion of loans have been packaged into CLOs, up from $51 billion over the prior four years.[10] Investors searching for higher yields have put so much money into CLOs that weak companies were able to get loans at relatively low interest rates. In one such case, a board member of a company deep in debt and on the verge of bankruptcy recalls being shocked at how easy it was for his company to raise money. "I'll never forget being in a board meeting and saying to our investment

[9] Editorial Board, "The Fed and 'Liquidity'," *The Wall Street Journal*, June 28, 2007.
[10] Serena Ng and Henny Sender, "Behind Buyout Surge, A Debt Market Booms," *The Wall Street Journal*, June 26, 2006.

bankers: 'How on God's Earth was this so easy?,'" the director said. "They said: 'there's a lot of money out there.'"[11]

For its part, the CDO market has served to facilitate the largest leveraged buyout (LBO) boom since the 1980s. So euphoric has the market been for this latest brand of M&A, that rumors of acquisitions have not only sent the rumored target's stock propelling higher, but also juiced other stocks in the same sector. These rumors have been common place as investors tried to game which companies would get taken out next in the great private equity led buyout wave.[12]

Chart 7

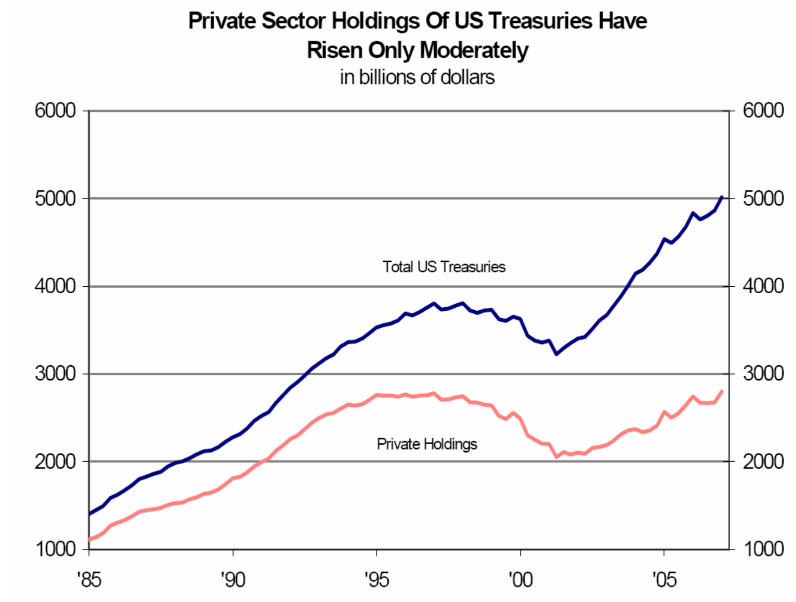

Chart courtesy of ISI Group, Inc.

A critical driver for the demand for these collateralized securities was the investment grade ratings they received from the major rating agencies. It was the rating agencies' blessings that enabled historically risk-averse pension funds, endowment funds, insurance companies, etc. to invest in these securities. Peter Schiff, president of Euro Pacific Capital, said he does not doubt that pension funds and mutual funds have been active players in the risky CDO tranches. "There's always a lot of pressure on fund managers to get a better return," Schiff said. "Everybody is judged versus their peers, but nobody looks under the surface to see how much risk did you take."[13] Many pension funds, facing growing numbers of retirees, are still reeling from poor technology investments from 2000. In their quest for yield, fund managers have actually purchased the riskiest "first-loss" bearing portions of CDOs. Chriss Street, treasurer of Orange County, California,. said, "It's grossly inappropriate to take this level of risk. Fund managers wanted the high yield, so Wall Street sold it to them. The beauty of Wall Street is they put lipstick on a pig."[14] We would further add that Wall Street no longer eats the pork from the pig it cooks.

A terrifying aspect of the packaging and selling of these loans is that the loan underwriters no longer have a vested interest in the loan's performance once the loan is sold. "The banks making the loans don't have a continuing interest in how the loans play out because they don't have much money at risk," said Don Fuss, vice chairman of Loomis Sayles, a large money manager. This has led to a "progressive deterioration of underwriting standards."[15] Now where have we heard this before? Subprime ring a bell?

---

[11] Bernard Wysocki, "For Troubled Firms, A Flood of Big Loans*," The Wall Street Journal*, June 12, 2007.
[12] David Reilly, "Game of Buyout Bingo May Be Ending," *The Wall Street Journal*, June 28, 2007.
[13] Daisy Maxey, "Getting Personal: Many Funds Permitted CDO Investments," *Dow Jones Newswires,* June 25, 2007.
[14] David Evans, "The Poison in Your Pension," *Bloomberg Markets*, July 2007.
[15] *The Wall Street Journal*, June 26, 2006.

According to Steven Rattner, Managing Principal of Quadrangle Group, record low credit spreads, "have been accompanied by less tangible indicia of imprudent lending practices: the easing of loan conditions, options for borrowers to pay interest in more paper instead of cash, financings to deliver large dividends to shareholders and perhaps most importantly, a general deterioration in the credit quality of borrowers… Like past bubbles, the current ahistorical performance of high-yield markets has led seers and prognosticators to proclaim yet another new paradigm, one in which the likelihood of bankruptcy has diminished so much that lenders need not demand the same added value over the Treasury or "risk-free" rate that they did in the past. But to think that corporate recessions have been outlawed would be as foolhardy as believing that mortgages should be issued to home buyers with no down payments, and no verification of financial status."[16]

Then came the week of June 18, 2007, and the news of the demise of the High-Grade Structured Credit Strategies Fund, a hedge fund devoted to CDO investments backed by subprime mortgages. This news was a heart-stopping shot across the bow of Wall Street's collateralized loan machine. In an instant, the liquidity that oiled this machine's engine evaporated. In an effort to liquidate holdings in the fund, both the fund managers and the fund's lenders tried to sell some of the fund's assets. Their auctions received shockingly low bids rumored to be at $.50 on the dollar on some assets. Importantly, 90% of this funds' investments were in CDOs rated no lower than AA.

After this portfolio blowup, credit market participants justly fear that even highly-rated CDOs could prove problematic. Indeed, concerns are growing that CLOs have made it too easy for shaky or debt-laden companies to borrow money as buyout deals have been getting larger and larger, and companies have been piling on more debt in relation to the cash they generate.[17] Currently, companies that have gone private in buyouts are generating cash that exceeds their debt interest payments by just 1.7 times, versus 2.4 times last year and 3.4 times in 2004. This ratio is at a 10-year low and shows how the margin for error for companies is shrinking as their profit growth is slowing, with a few deals completed earlier this year already running into problems.[18] Again, this sounds familiar.

And wouldn't you know it, there is a new index that tracks the pain being felt in the buyout loan market. According to ISI, the spreads on the LCDX index (an index that is to buyout loans roughly what the ABX index is to subprime mortgages) widened from 105 when it started trading a month ago, to 165 recently. (Widening credit spreads are indicative of increased risk aversion as investors require greater return for a given level of risk.)

Just as in the subprime debacle, as these loans turn sour, the credit spigot is shutting down. Kenneth D. Lewis, the CEO of Bank of America, recently told Bloomberg News, "We, at least for one, and I'm sure there are other banks, are starting to say no more than we were before. And it's not because we are out of money."[19] Lewis is correct, other banks are also tightening the screws. Recent research from Portales Partners shows credit availability is currently in a phase of contraction. As shown in Chart 8, the sharp decline in Portales' policy stimulus index (PSI) suggests further slowing of credit growth ahead.

[16] *The Wall Street Journal*, June 18, 2007.
[17] *The Wall Street Journal*, June 26, 2006.
[18] Gregory Zuckerman and Serena Ng, "Boom Aside, Not All LBOs Look So Hot," *The Wall Street Journal*, June 8, 2007.
[19] Andrew Ross Sorkin and Michael J. de la Merced, "Private Equity Investors Hint at Cool Down," *The New York Times*, June 26, 2007.

While the contraction of credit will have an impact on the deal pipeline, perhaps more worrisome is the impact that it will have on the asset values of CDO and CLO investments held on the books of asset managers. These securities trade infrequently and can be hard to sell quickly without incurring steep losses, particularly when leverage is involved as it can amplify losses when bets turn sour. This is leading to a growing fear on Wall Street that hard-to-trade investments may suddenly lose their value in a period of distress.[20] According to a new report out by Fitch ratings analysts Roger Merritt and Eileen Fahey entitled, *Hedge Funds: The Credit Market's New Paradigm*, "The next credit downturn may very well involve more sudden, correlated declines in asset prices as hedge funds and prime brokers seek to unwind their positions in a more risk-averse market…A deleveraging event is likely to affect most, if not all, sectors of the credit market, resulting in an increase in correlation as hedge funds and prime brokers seek to monetize their most liquid positions first."[21] Hmmm…correlated declines fueled by investors selling their most liquid securities to meet margin calls…sounds exactly like what took down Long Term Capital Management in the late 1990s!

Chart 8

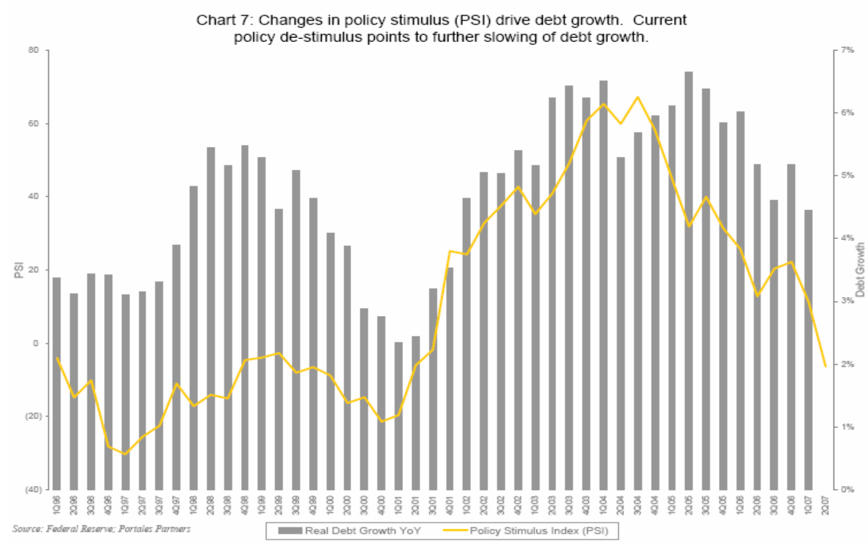

Chart courtesy of Portales Partners

Perhaps asset managers can avoid taking painful hits to the value of these CDO and CLO holdings by riding out the current storm in the hopes that the market will recover. However, even if a fund wants to hold an investment for the long haul, creditors can force its hand. If a leveraged investment racks up losses, the fund's lenders may demand more collateral, or even repayment of their loans. To meet those demands, the fund, whose losses are already magnified by leverage, could be forced to sell the investment well before the market recovers.[22]

Forced selling may also ensue if the rating agencies decide to downgrade these loan pools. In an out-of-character letter to investors, PIMCO's Bill Gross ripped the ratings agencies for the major role they have played in the creation of this credit bubble. "AAA?," Gross quipped, "You were wooed Mr. Moody's and Mr. Poor's by the makeup, those six-inch hooker heels, and a 'tramp stamp.' Many of these good looking girls are not high class assets worth 100 cents on the dollar."[23] But Mr. Gross is assuming

[20] Justin Lahart and Aaron Lucchetti, "Wall Street Fears Bear Stearns Is Tip of an Iceberg, " *The Wall Street Journal*, June 25, 2007.
[21] Jim Grant, *Grant's Interest Rate Observer*, June 15, 2007.
[22] *The Wall Street Journal*, June 25, 2007.
[23] "PIMCO Investment Outlook," July 2007.

the rating agencies believe they should accurately rate bond issues. That is not how Kim Diamond, managing director in Standard & Poor's real estate group, sees things. At a recent conference of mortgage investors, Diamond said, "securities firms and investors should stop relying on ratings companies and take responsibility for upholding lending standards in the commercial mortgage-backed securities market." In other words, "you do your job and you do mine."

It is in their own best interest for the rating agencies to play dumb. After all, the explosive growth in CDOs and CLOs has been a revenue producing cash cow for them. Standard & Poor's charges almost three times the fee to value a CDO as it would a standard corporate bond.[24]

It is no surprise then that these rating agencies are masking burgeoning losses in subprime mortgage bonds by failing to cut the credit ratings on about $200 billion of subprime-filled CDOs.[25] Almost 65% of the bonds in indexes that track subprime mortgage debt don't meet the ratings criteria in place when they were sold. For investors with investment-grade mandates, a ratings downgrade would lead to forced fire-sales. According to Joshua Rosner, a managing director at investment research firm Graham Fisher & Co., should these downgrades occur, we "will see massive losses from banks, insurance companies and pension managers." Losses that some believe will rival the losses incurred during the savings and loan crisis. Rosner adds, "The longer [the rating agencies] wait, the worse it's going to be."[26]

Rest assured, over the next few weeks and months market participants will sing the praises of the collateralized loan markets. "The system works," they will say. "Investors are overreacting to an isolated event." To us, this tune is getting played out.

The cold truth is that the collateralized debt machine is a house of cards built largely on fraud. A fraud whose dealers and shufflers have profited handsomely by extending credit to the unworthy and selling it to the unknowing. Until market stakeholders as a collective whole wise up to this fact, the worst of this credit contraction is, in fact, ahead of us.

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

[24] Richard Tomlinson and David Evans, "The Ratings Charade," *Bloomberg News*, July 2007.
[25] Mark Pittman, "S&P, Moody's Hide Rising Risk on $200 Billion of Mortgage Bonds," *Bloomberg News*, June 29, 2007.
[26] *Bloomberg News*, June 29, 2007.