



UPDATE

July 2008

CALDWELL & ORKIN®

*“As it happens, our trusty dictionary, in fact, defines inflation as:
‘A persistent increase in the level of consumer prices or a persistent decline in
the purchasing power of money, caused by an increase in available currency
and credit beyond the proportion of goods and services.’”*¹

-Alan Abelson, columnist for *Barron’s*

Sour Inflation

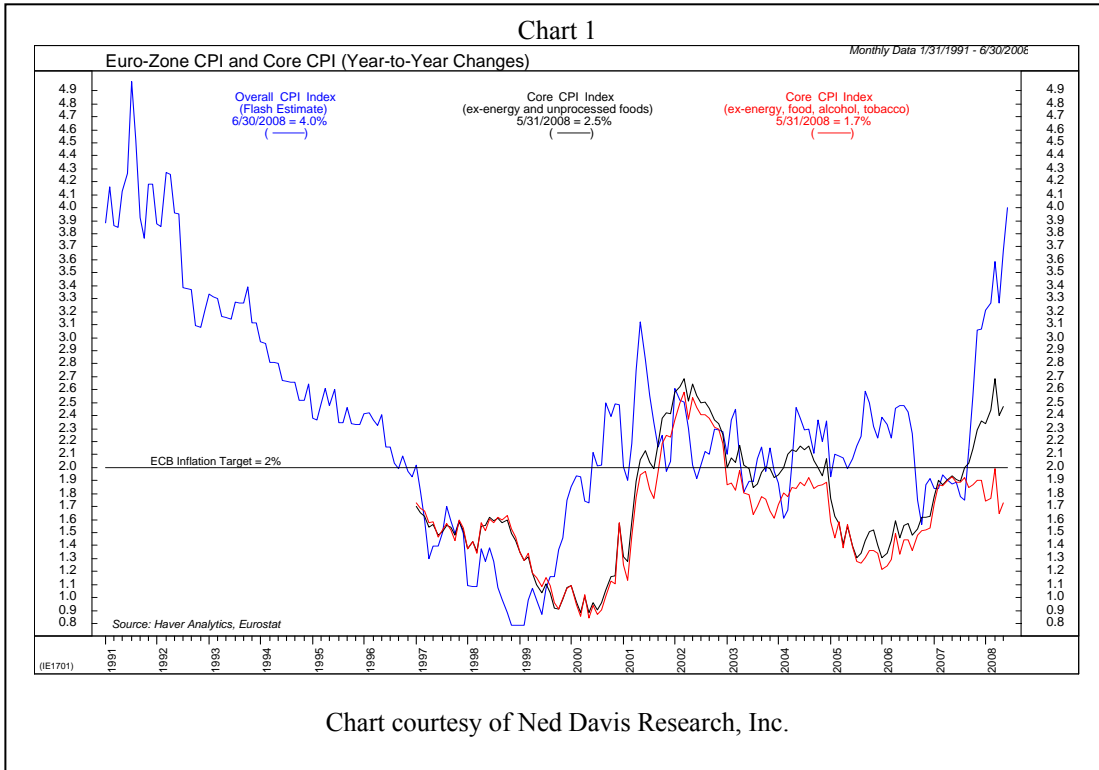
Despite the risks of moral hazard and inflation, the world’s central bankers have tried skipping down the worn path of easy monetary policy, cleared for them by former Federal Reserve Chairman, “Easy Al” Greenspan. In Brazil the money supply has grown 19.6% year-over-year. In Russia the growth rate is 33.4%. India’s is 22.5% and China’s is 18.1%. In Saudi Arabia the growth rate is 26.2%, in the United Kingdom 11.1% and, finally, the U.S. at 6.5%. Disciples of “Easy Al” may view this money growth as an appropriate response to an unprecedented global credit crisis. The fallacy of this view is that today’s environment is different: the productivity miracle (which helped keep inflation subdued) is over and the glorious benefits of debt growth have been used up. As a result, this newly printed money is proving more persnickety than expected, and many central bankers are being forced to reverse their easy money policies.

Even though he has given several speeches in which he has voiced inflation concerns, current Fed head Ben Bernanke has followed Greenspan’s easy money recipe, adding his own PDCF (Primary Dealer Credit Facility) sugar here and TSLF (Term Securities Lending Facility) spice there. When his (and other central banks’) printed money was unleashed on a weakening, overleveraged economy, this money generally ignored the assets it was intended to support, equities and housing. Bernanke quickly learned that while he could grow the money supply ad nauseum, in a capitalist economy that money is going to be drawn to strength, not weakness. Unfortunately, the strength it found was in commodities. As a result, instead of producing the economically delicious sweets of rising asset prices (a la Easy Al with technology stocks and housing), Bernanke’s monetary stimulus helped to create the sour tarts of rising cost inflation.

It should be of little surprise that, this go-round, global expansive monetary policy is helping to inflate commodity prices. After all, commodities have been in a bull market since the bursting of the tech bubble in 2001. From that time through June 2008 the price of crude has risen 550% from \$20 a barrel to \$130+ a barrel and gold has risen 250% from \$256 an ounce to over \$900 an ounce. During the same time period, the S&P 500 has gained a mere 9%. “For a long time, we’ve believed rapid money growth was adding more capacity than demand,” wrote Ed Hyman at ISI Group, Inc. “But now, these rapid increases [in money growth] in the face of limited supplies of raw materials may have reached a tipping point.” Thus, the worldwide expansion in money supply has fueled a worldwide outbreak of inflation.

In May 2008, the overall Eurozone inflation rate surged to a 16-year high (See Chart 1), led by year-over-year consumer price index (CPI) increases of 7.0% in Hungary, 6.8% in the Czech Republic and 4.2% in Poland. Inflation is sourer still in Asia. In China, the CPI is up 7.9% year-over-year while India’s WPI (India’s CPI) is up 8.8%. These inflation rates pale in comparison to Vietnam, which takes the inflation cake with a 25.2% year-over-year CPI increase. The result, according to ISI, is that the global CPI is now at its highest level in almost a decade (See Chart 2).

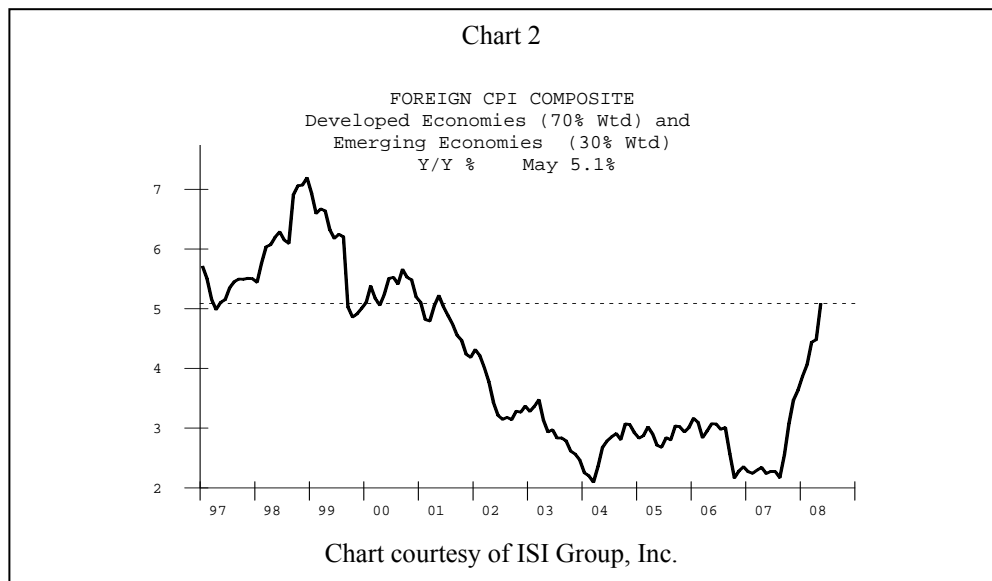
¹ Alan Abelson, “Up & Down Wall Street,” *Barron’s*, June 23, 2008.



Inflation is most dire in the developing economies. A year ago, Bank of America tracked the inflation status of a group of 24 large developing nations and found about three-quarters were either meeting or staying below their inflation targets. Today none of them are.² “In emerging market economies, rapid inflation is contributing to unsustainable nominal GDP growth,” wrote Ed Hyman. “In addition, many emerging market

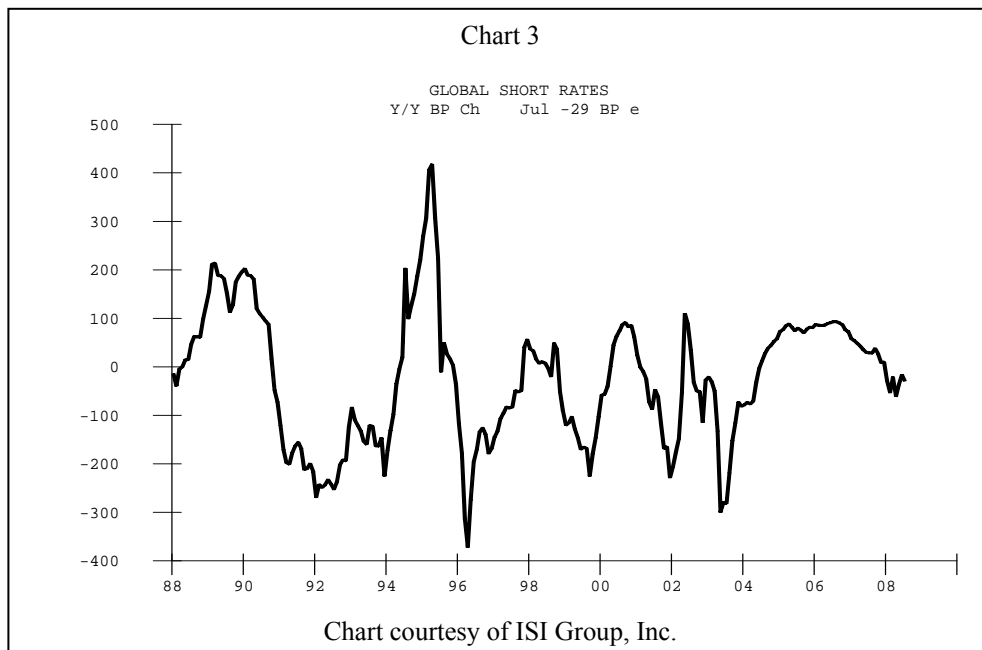
stock markets have plunged. These developments indicate that the economic and financial situation in many emerging economies is becoming unstable.”

That these countries have an inflation problem is, in part, thanks to the easy monetary policies of the U.S. In response to the credit crisis the Federal Reserve Open Market Committee (FOMC) has cut the Fed funds 325 basis points to 2.0% since September of 2007, a monetary policy action that has helped send the U.S. dollar down -10.2% through June 2008. Several currencies and important commodities (specifically oil) are pegged to the U.S. dollar. Many emerging



market central banks added to the rising inflation problem as they were forced into an easy monetary policy necessitating lower rates and money supply growth, despite the fact that their economies were humming along at a brisk pace. Michael Belkin, editor of the *Belkin Report*, adds that many of these governments have made matters worse via energy and food price controls they can no longer afford. “Many developing nations have shielded their population from rising

² Joanna Slater, “Inflation’s Bite Worsens Around World,” *The Wall Street Journal*, June 11, 2008.



energy prices with price controls and subsidies that now threaten to bankrupt government finances. Unaffordable energy and food subsidies are now being jettisoned, with a consequent surge of inflation and popular discontent.³

As price controls are abandoned and food and energy costs rise, workers are demanding more pay for their labor, threatening the worst of all inflation scenarios, a wage / price spiral similar to the U.S. circa the 1970s. In response, no less than 24 developing economy central banks have been forced to tighten their

monetary policy thus far in 2008. “Negative real interest rates and burgeoning money supply are destined to stoke overheated economies and kite inflation higher,” wrote S. Dewey Keesler, CIO of SDK Capital. “There’s no way out for developing nations, but to adopt more stringent monetary policies, which means higher interest rates and stronger currencies and, inevitably, a sharp economic downturn.⁴” Higher global short rates (See Chart 3) bode ill for the languishing U.S. economy as our growth has a higher correlation with global short rates than it does with Fed funds rates. Just as our easy money policy helped to over-stimulate their economic growth so too will their tightening depress ours.

If higher global short rates can tame worldwide inflation, then emerging market monetary tightening is, to some degree, welcome. It is no secret that increasing commodity price pressure threatens to throw the U.S. economy into a recession as the inflationary forces trickle through the economy. Chemical companies are raising prices on ingredients used to make paint, computer and television screens, mobile phones, light bulbs, cushions, paper, mattresses, car seats, carpets, steering wheels and polyesters - all products refined from oil and natural gas. The companies that use these refined materials are watching their costs skyrocket, and they find themselves forced into unpleasant choices: should they raise prices, shift to less costly production, cut workers, or all of the above?⁵ The picture is uglier in the auto market. In June 2008, sales of new cars and trucks plunged to their lowest level in more than a decade, as high gas prices and a weak economy kept consumers away from showrooms.⁶ The deepening auto slump has The Big 3 U.S. auto companies considering a fresh round of layoffs and plant closings.

Higher fuel prices are hurting consumers as their discretionary income is eaten away by the rising cost of necessities. In some cases, people are giving up meat so they can buy fuel. Gasoline theft is rising and drivers are running out of gas more often, leaving their cars by the side of the road until they can scrape together gas money.⁷ ISI surveys indicate that because of the rising costs of necessities, consumers have been acting conservatively with their tax rebate checks. “According to credit card companies, food, gas and other basic products are taking up much of the increase in people’s spending in recent weeks,” wrote Ed Hyman. “Some of the drags on the consumer today are bigger than they were during the last tax rebate stimulus in July of 2001. As a result of these headwinds and the temporary

³ Belkin, June 22, 2008.

⁴ Alan Abelson, “Up & Down Wall Street,” *Barron’s*, June 23, 2008.

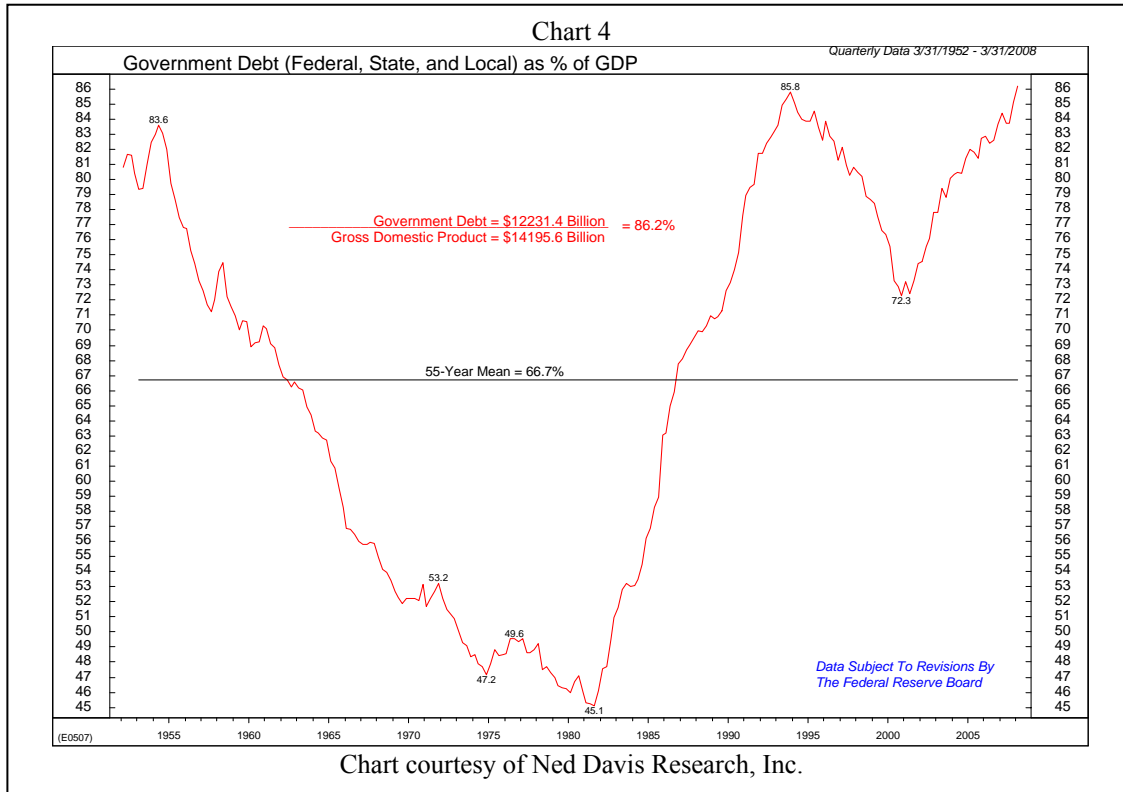
⁵ Louis Uchitelle, “Oil Prices Raise Cost of Making Range of Goods,” *The New York Times*, June 8, 2008.

⁶ Bill Vlasic, “Car Sales at a 10-Year Low,” *The New York Times*, July 2, 2008.

⁷ Clifford Krauss, “Rural U.S. Takes Worst Hit As Gas Tops \$4 Average,” *The New York Times*, June 9, 2008.

nature of the stimulus, the near term positive impact of the rebates is unlikely to create a lasting improvement in consumer spending.”

While relief from rising commodity prices would be a welcome sign, a fall in inflation will not mean the coast is clear for the consumer or for the economy. As we wrote in our March 2008 *Update*, after years of unprecedented debt growth, the U.S. economy must face a Deleverage Sasquatch as massive amounts of leverage are unwound, a process that will likely keep economic growth subdued. And one that is made more burdensome by higher global short rates.

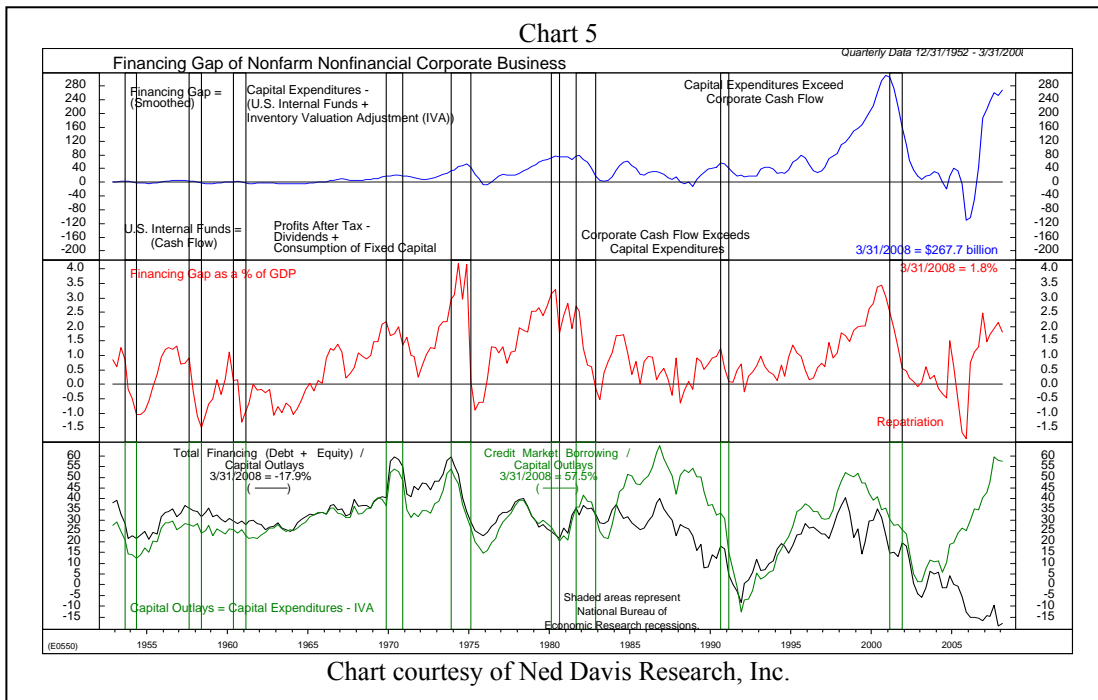


To be sure, it makes perfect sense for the U.S. economy to start taking its medicine and deleverage. After all, we simply are not getting the growth bang for our borrowed buck that we used to. According to Ned Davis of Ned Davis Research, Inc., total debt (consumer, corporate and government) this decade has grown \$24.3 trillion, while nominal GDP has only risen \$4.7 trillion. “From around 1960 to around 1980, for each dollar of debt growth we got

almost the same increase in GDP,” wrote Ned. “However, following that period, debt growth has been excessive relative to GDP. The old debt magic is gone!” Perhaps Easy Al took it with him when he left.

Unfortunately, the federal government does not have a monopoly on leverage. As we enter into this period of debt unwinding, the balance sheets of state and local governments and corporations are also not in good health. “What I believe are some other misconceptions are that the government and corporations have little debt problems,” said Ned Davis. Yet “total government debt is at \$12.2 trillion or a record 86.2% of GDP. (See Chart 4) Nearly everyone believes that corporations are flush with cash and with very healthy balance sheets in terms of debt, [but] non-financial corporate expenditures [are] exceeding cash flow at a \$268 billion rate... (See Chart 5) I do not want to add to gloomy sentiment, but this is a highly levered economy across the board, and it is weighing on our growth prospects.”⁸

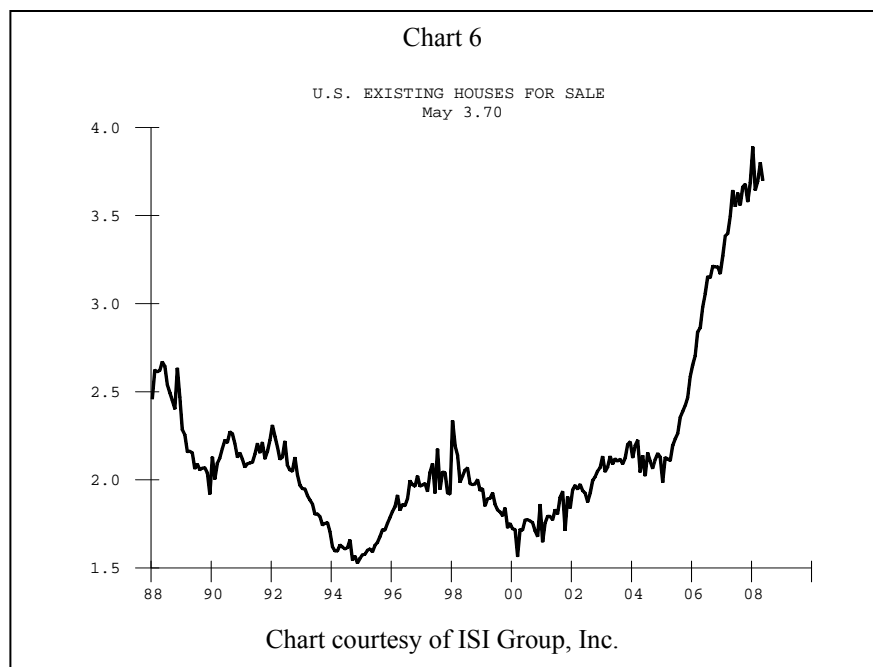
⁸ Ned Davis, “Institutional Hotline,” *Ned Davis Research, Inc.*, June 10, 2008.



As our economy attempts to come down from this debt cliff, we can expect a government billet, with a price of course. “We believe the long era of financial deregulation is over,” wrote Tom Gallagher at ISI. “Policy developments are likely to be a significant headwind in the coming years as investors should expect tougher safety and soundness

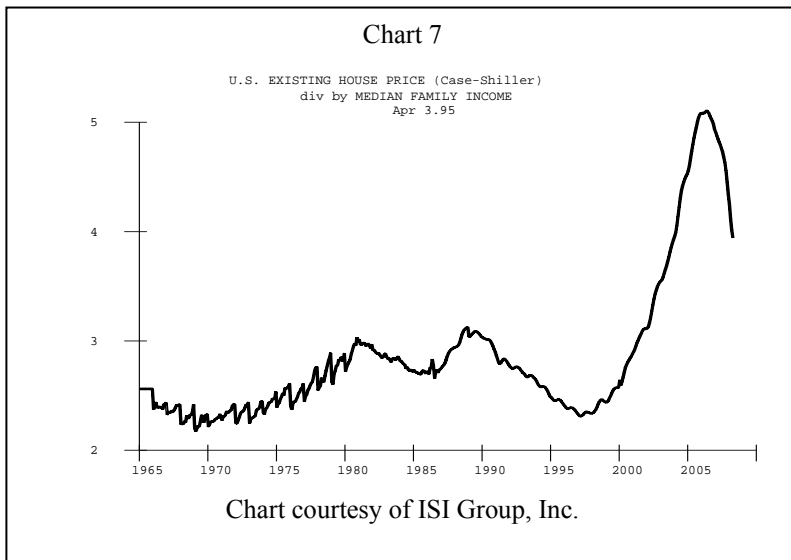
regulation, more consumer protection, and a larger government role in the marketplace... With the Fed having used taxpayer funds to bail out Bear Stearns’ creditors, it seems likely that the investment banks will be the subject of much tougher regulatory oversight that will reduce their leverage and profitability.”

Tougher regulatory oversight will no doubt lead to lower profitability for financial companies. As securities firms curtail their use of borrowed cash, it will be much harder for them to generate the kind of profit growth investors had become accustomed to. Also, the market’s turbulence has all but caused the disappearance of certain businesses that were a gold mine for Wall Street. The loss of those cash cows means it will take even longer to recover from the current credit crisis.⁹ Meredith Whitney, an Oppenheimer banking analyst, believes the impact of the Credit Card Reform Act on lender credit card profits could be so severe that the industry may pull back \$2 trillion in outstanding credit lines by 2010, no less than a 45% reduction in credit available to consumers.¹⁰



⁹ Susanne Craig and Tom Lauricella, “Big Loss At Lehman Intensifies Crisis Jitters,” *The Wall Street Journal*, June 10, 2008.

¹⁰ Eric Dash, “Banks Trim Credit Lines, And It Hurts,” *The New York Times*, June 21, 2008.

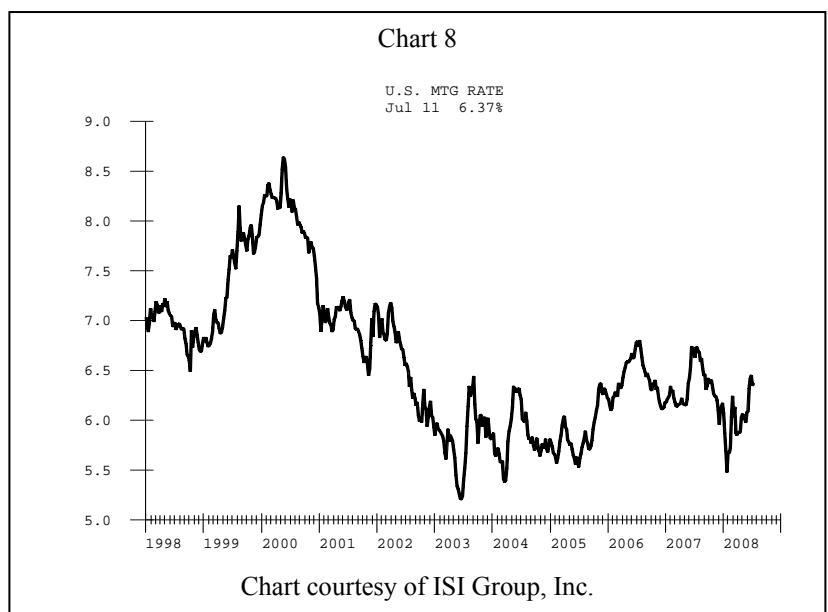


Given this economic backdrop, we believe that asset deflation will eventually trump cost inflation as the economic concern de jour. “When I look at our debt bubble, low saving rate, falling real income growth, plus a bursting housing bubble,” wrote Ned Davis, “I believe this inflationary upcycle is in its late phases.”¹¹

In the first quarter of 2008, U.S. household wealth fell \$1.7 trillion, the most in more than five years.¹² Given the incredibly high number of unsold existing houses on the market (See Chart 6), the still elevated level of existing house prices to median family income (See Chart 7), the recent tick up in mortgage rates (See Chart 8) and the surging level of bank-owned foreclosures, it is unlikely that house price deflation will slow in the near term.

We continue to maintain that the credit crisis will not truly be over until housing prices have bottomed and there has been a market clearing event for the bad loans that are still held on bank balance sheets. “In order to fix what’s going on in the United States there’s going to have to be a certain amount of pain,” said Theodore Forstmann, founding partner of Forstmann Little & Company. “The market’s going to have to clear somehow... Enterprises are going to fail. The economy is going to slow.”¹³

While the economic outlook is not pretty, we anticipate any decline in cost inflation will likely present a short-term bullish environment for equities. How long this bullish environment lasts is hard to tell. Most likely, it will be a short-term pause in this secular bear market.



Cost inflation may taste sour, but after more deleveraging and capital raising leads to another serving of asset deflation, it may seem semi-sweet.

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¹¹ Ned Davis, “Institutional Hotline,” *Ned Davis Research, Inc.*, July 3, 2008.

¹² Carlos Torres, “U.S. Household Net Worth Fell the Most in 5 Years Last Quarter,” *Bloomberg News*, June 5, 2008.

¹³ Brian M. Carney, “The Credit crisis Is Going to Get Worse,” *The Wall Street Journal*, July 5-6, 2008.