



UPDATE

July 2009

CALDWELL & ORKIN®

Debt Detox

Chart 1

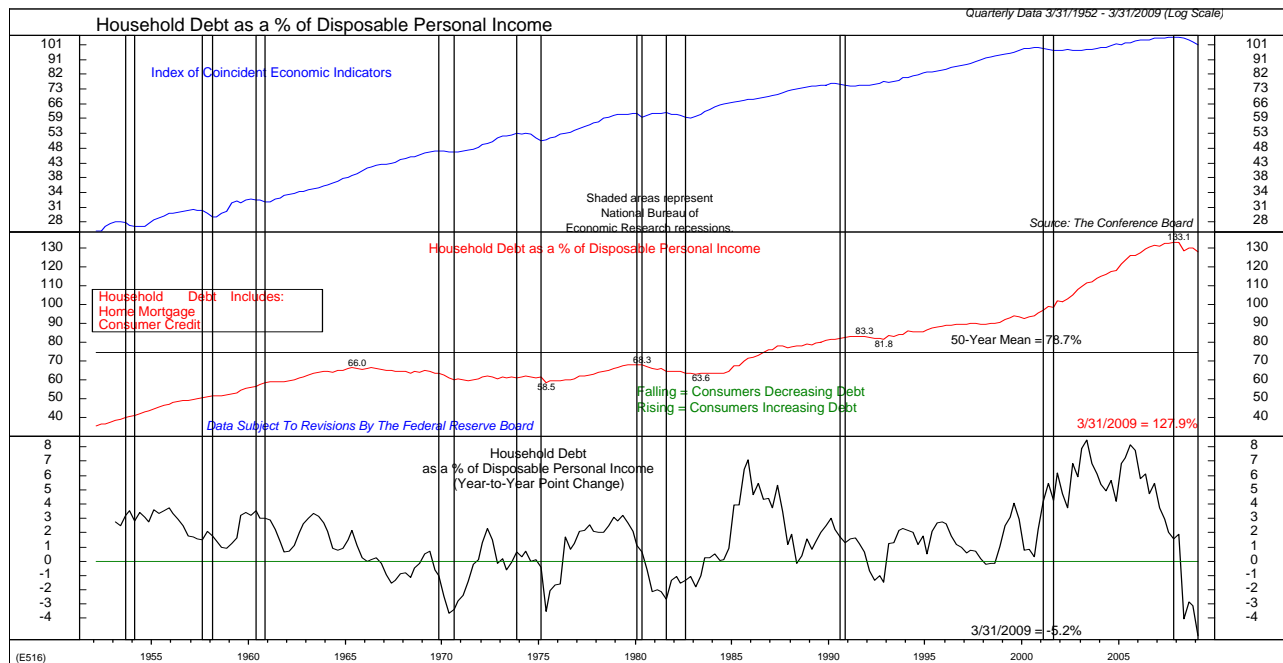


Chart courtesy of Ned Davis Research, Inc.

At long last the debt-addicted American consumer has checked into deleverage rehab (see Chart 1). But like most addicts, he refused to accept that he had a problem until it was undeniable and his path unsustainable. Ridding his system of this debt drug will no doubt incur nasty side effects: A historic -32.6% decline in home values from their peak in July 2006, and an “official” unemployment rate quickly approaching double digits quickly come to mind. As such, the economy will be in a state of debt detox that is likely to leave it weakened in the near future. Yet these shivers and shakes are an absolute necessity if we wish to return to the rigor and vitality that our once-healthy economic system enjoyed.

On Thursday July 2, 2009 the Department of Labor’s release of the June employment report sprayed a healthy dose of weed killer on the budding green shoots that many had hoped were signaling the emergence of an economic recovery. From the report we learned that the U.S. economy lost 467,000 jobs in June, taking the “official” unemployment rate to 9.5%. Alarming in its own right, this unemployment number only tells part of the increasingly dire employment story. “As unemployment approaches 10.0%, what is less well publicized is that the

Chart 2

Corporate Sector Expenditures
Compensation of Employees y/y%

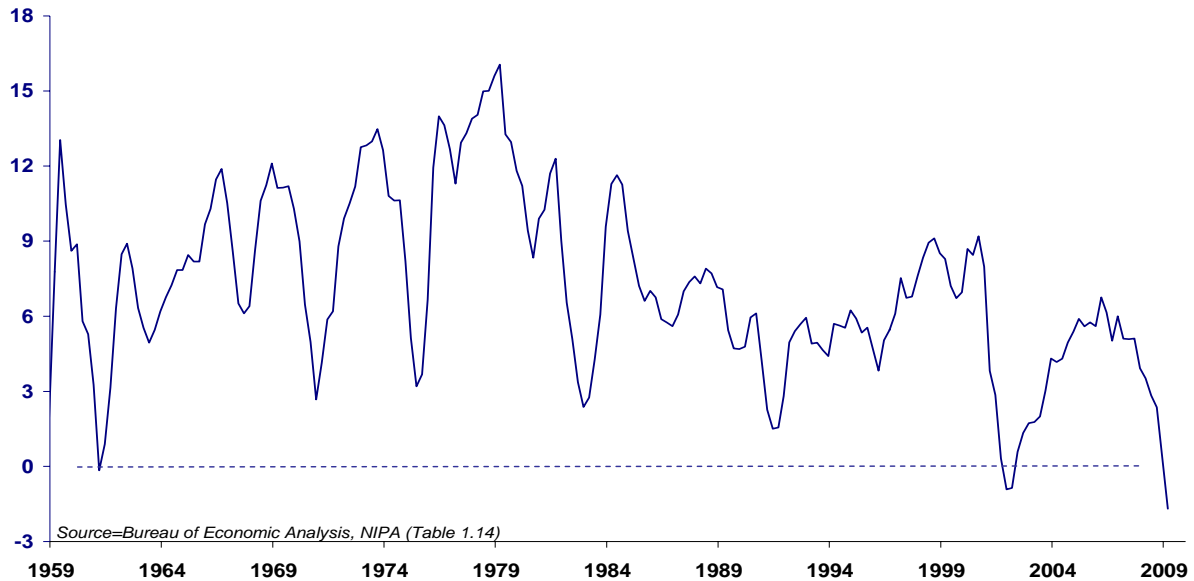


Chart courtesy of MacroMavens

number of ‘underutilized’ workers in the U.S. has increased dramatically from 15 to 30 million,” wrote Bill Gross, Managing Director at *PIMCOBonds*. In other words, “those without jobs, as well as those individuals who only work part-time and have become discouraged and stopped looking, total 30 million.¹” On a percentage basis, this swath of “underemployed” and unemployed workers now equals 16.5% - a record high. What’s more, in June the average length of official unemployment increased to 24.5 weeks, the highest level since the government began tracking data in 1948.² As for those who have been lucky enough to maintain employment, the average workweek has dipped to 33 hours, an all-time low, and yearly aggregate hours worked have declined by -7.0% to the lowest level since the category was added in 1964.³ “Not only has the corporate sector cut compensation at a pace not seen in the latest 40 years,” wrote Stephanie Pomboy of *MacroMavens*, “but it has made these cuts from an already low base⁴” (see Chart 2). While unemployment typically peaks long after economic growth has bottomed, the lack of compensation growth confirms that our economy remains in an extremely vulnerable position.

As draconian as the current employment reality is, the outlook isn’t any better. Throughout this downturn the government sector has been the sole sector that has been able to muster job growth. But thanks to a significant decline in tax receipts states are being forced to make politically and economically difficult choices in order to balance their budgets. “These are some of the worst numbers we have ever seen,” said Scott D. Pattison, executive director of the National Association of State Budget Officers, who added that the federal stimulus dollars that began flowing this spring was the only thing preventing widespread paralysis, particularly in the areas of education and

¹ Bill Gross, “Investment Outlook,” *PIMCOBonds*, July 2009.

² Peter S. Goodman, “Joblessness Hits 9.5%, Deflating Recovery Hopes,” *The New York Times*, July 3, 2009.

³ Alan Abelson, “Up & Down Wall Street,” *Barron’s*, July 6, 2009.

⁴ Stephanie Pomboy, “Now... The Hard Part,” *MacroMavens*, June 19, 2009.

Chart 3

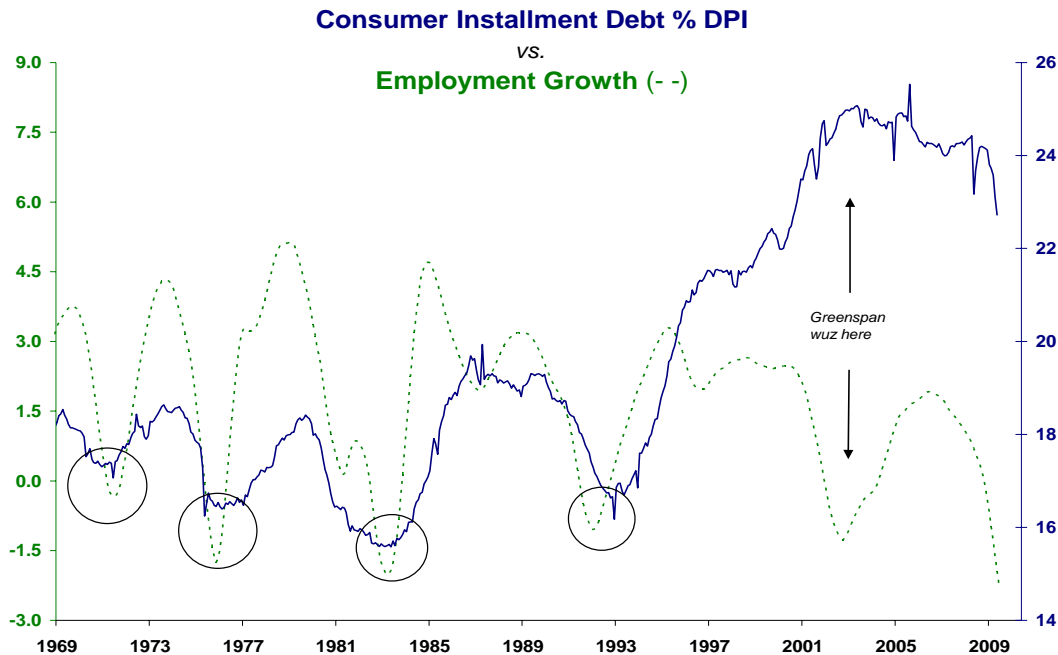


Chart courtesy of MacroMavens

health care. “If we didn’t have those funds, I think we’d have an incredible number of states just really unsure of how they were going to get a new budget out.” In total, states will face a \$121 billion budget gap in the coming fiscal year according to a recent report by the National Conference of State Legislatures. That compares to a \$102.4 billion gap for this fiscal year.⁵ Given these significant budgetary constraints, it is highly unlikely that state and local governments will continue to be a source for job growth. “To the extent employment remains weak,” wrote Ed Hyman of ISI Group, Inc., “a host of negative and dangerous feedback loops will continue to work, eg, employment declines, defaults increase, employment declines further, foreclosures increase, house prices decline, state and local governments cut back, etc...”

As the shock waves of underemployment reverberate throughout the system, a large swath of consumers is getting a first-hand glimpse at the destruction of their debt addiction and, subsequently, they are cleaning themselves up. “Consumers appear to be battling a major crisis of faith. Their willingness to spend money they don’t have today in the hope that it materializes tomorrow, is crumbling...fast,” wrote Stephanie Pomboy (see Chart 3). “Consumers [just] paid down debt for the 7th time in the last nine months. Not exactly the type of behavior you’d describe as “temporary” or “a fluke”. Indeed, including the \$15.7 billion they paid down in April, consumers have paid down a record \$34 billion of installment debt over the last year.”⁶

As valiant as these efforts are, they come at a time in the economic cycle that makes progress impossible. “It’s difficult to de-lever with nominal GDP declining,” wrote Hyman. “The Flow of Funds data release shows total non-financial debt in the U.S. rose at almost a 5.0% quarter over quarter annual rate in the first quarter [of 2009]. When combined with the decline in the first quarter GDP, the total non-financial debt to GDP ratio now stands at just over 2.4 to 1, a post-war record.” The fight simply doesn’t seem fair. A lack of income growth,

⁵ Abby Goodnough, “States Turning To Last Resorts In Budget Crisis,” *The New York Times*, June 22, 2009.

⁶ Stephanie Pomboy, “Immaculate Expansion,” *MacroMavens*, June 12, 2009.

Chart 4

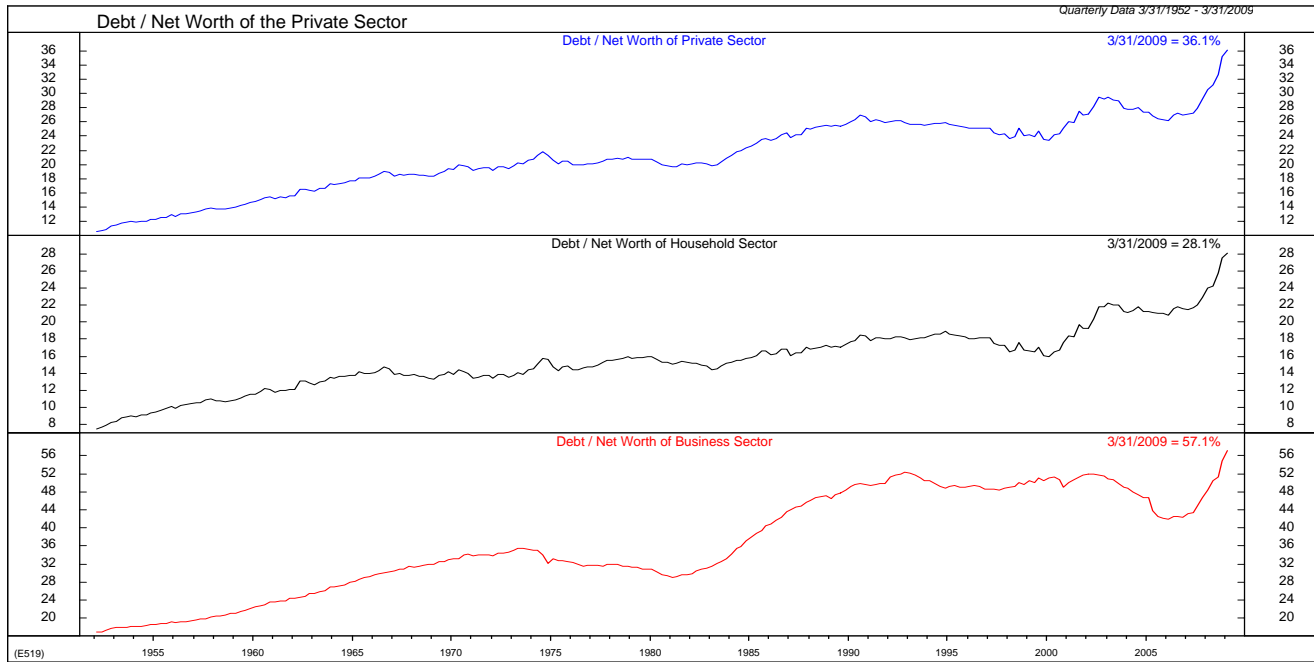


Chart courtesy of Ned Davis Research, Inc

combined with job losses are hampering the consumer’s ability to pay down his debt. At the same time the inability to commit any money to discretionary spending weighs negatively on the economy. And that, in turn, accelerates the decline in the value of certain assets supporting the debt. “Debt to net worth for both households and the business sector is [still] at record highs,” wrote Ned Davis of Ned Davis Research, Inc. “Both of these are caused by plunging net worth. So while there are some signs of ‘deleveraging,’ when looking at the big picture, bottom line, there is still too much debt.”⁷ The picture painted in Chart 4 shows why we have said in the past that we were still listening to the “Star Spangled Banner” of the credit crisis ballgame (see Chart 4).

While this balance sheet retrenchment is good and sobering for the consumer, it continues to negatively impact an economic system that is heavily reliant on consumer spending for its growth (like 67.0% of GDP). Going cold turkey on debt is one thing. Going cold turkey on debt at record heights of leverage is another. Enter the government.

According to ISI, in the first quarter of 2009 total debt in the U.S grew \$1,368 billion quarter-over-quarter to \$33,995 billion. The quarterly increase came entirely from government debt, rising \$1,548 billion while private debt fell -\$180 billion. As the Obama Administration primes the Keynesian pump, we can expect the federal government (much like the consumer in year’s past) to run deficits until they can run them no more. “Private sector deleveraging, reregulation and reduced consumption all argue for a real growth rate in the U.S. that requires a government checkbook for years to come just to keep its head above the 1% required to stabilize unemployment,” wrote Bill Gross. “We are reaping the consequences of that long period of overconsumption and undersavings... The current annual deficit of \$1.5 trillion does not even address the ‘pig in the python,’ baby boomer, demographic squeeze on resources that looms straight ahead. Private think tanks such as The Blackstone Group and even studies by government agencies, such as the Congressional Budget Office, promise that Federal spending for Social

⁷ Ned Davis, “Institutional Hotline: Four Trend Indicators Consistent With Current Bull/Bear Fight” *Ned Davis Research, Inc.*, June 15, 2009.

Chart 5

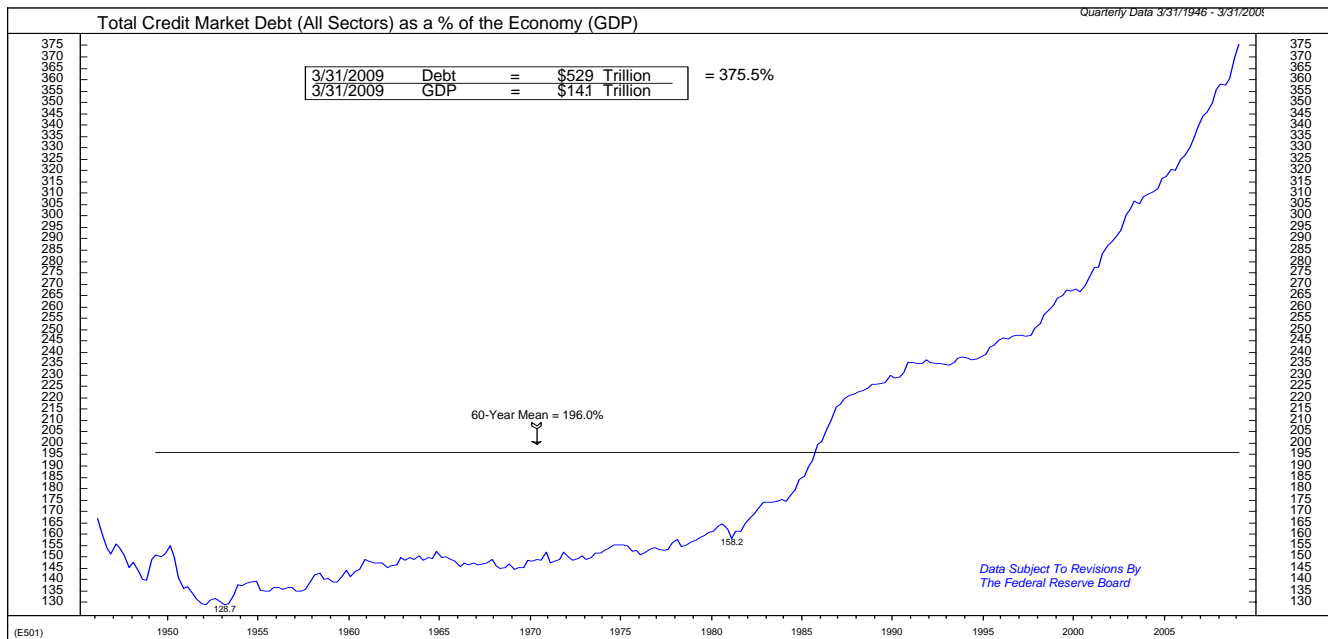


Chart courtesy of Ned Davis Research, Inc.

Security, Medicare, and Medicaid will collectively increase by 6% of GDP over the next 20 years, leading to even larger deficits unless taxes are increased proportionately.⁸

The reality is, however, that the federal government was operating under massive debt levels long before we entered this recession. In 2001, the Congressional Budget Office estimated that the federal government would run an average annual surplus of more than \$800 billion a year from 2009 to 2012. Today, the government is expected to run a \$-1.2 trillion annual deficit in those years. So what happened? The downturn in the business cycle accounts for 37.0% of the \$2 trillion swing. Another 33.0% comes from new legislation enacted by the Bush Administration. President Obama’s main contribution to the deficit is his extension of several Bush policies, like the Middle East wars and tax cuts for households making less than \$250,000. These policies, together with the Wall Street bailout, account for 20.0% of the swing. Only 7.0% of the \$2 trillion swing comes from the Keynesian spending in the stimulus bill that President Obama signed in February 2009. The remaining 3.0% comes from Obama’s agenda on health care, education, energy and other areas.⁹ “Bush behaved incredibly irresponsibly for eight years,” said Alan Auerbach, an economist at the University of California, Berkeley. “On the other hand, [President Obama] is not fixing it. And, not fixing it is, in a sense, making it worse,” he said.¹⁰

“For about a decade now I have been featuring [Total Credit Market Debt as a Percentage of GDP] as the poster child for the secular backdrop,” wrote Ned Davis (see Chart 5). “As can be seen, debt has risen to a record \$53 trillion, which is 375.5% of GDP. But this chart is somewhat misleading because I feel the private sector is trying to lower its debt load, and it is our government that is driving the debt bubble. Thus, my new poster child for the next bubble we will have to deal with is [Government Debt as a Percentage of GDP]. This number, if updated

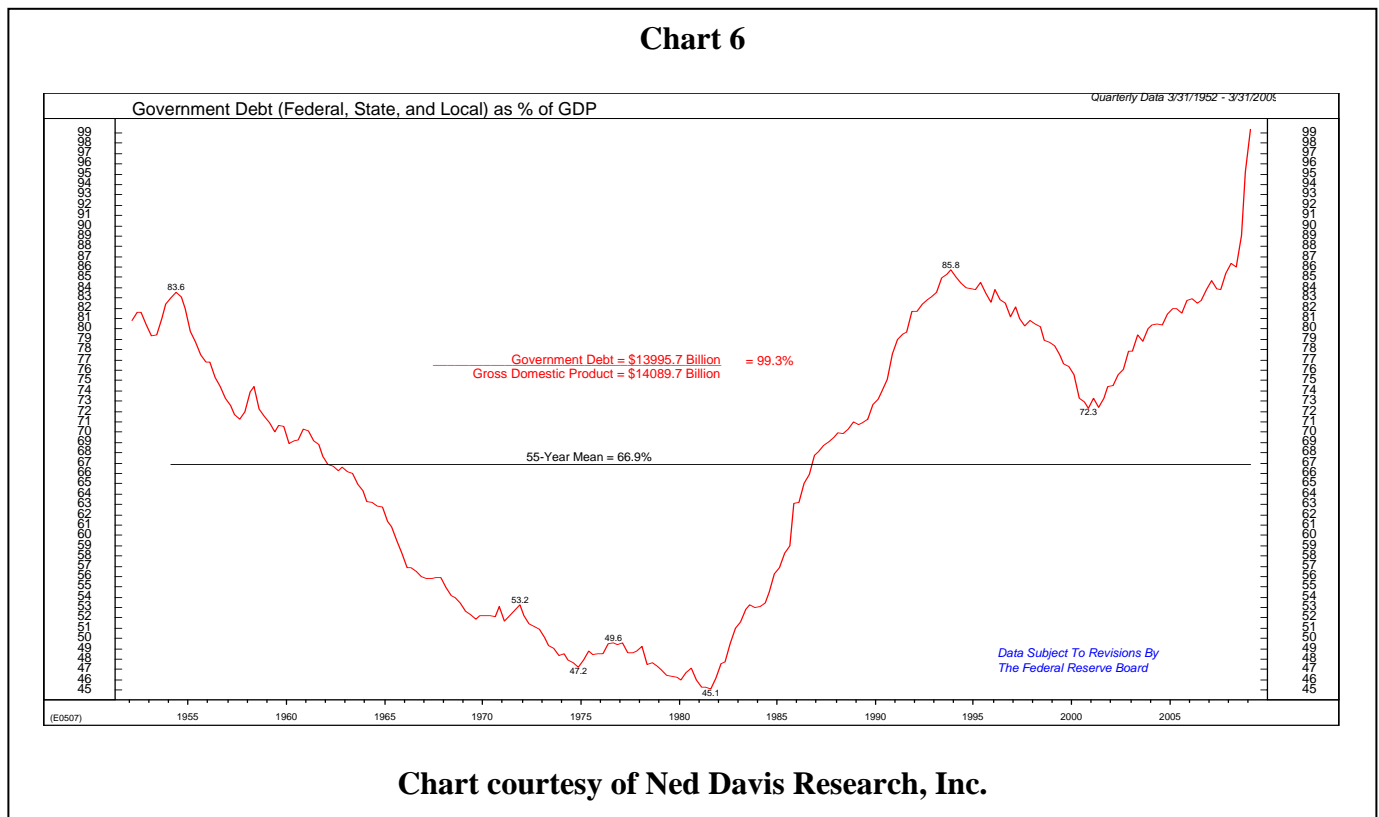
⁸ Bill Gross, “Investment Outlook,” *PIMCOBonds*, June 2009.

⁹ David Leonhardt, “Sea of Red Ink: How It Spread From a Puddle,” *The New York Times*, June 10, 2009.

¹⁰ David Leonhardt, “Sea of Red Ink: How It Spread From a Puddle,” *The New York Times*, June 10, 2009.

further, would clearly be over 100%, and is not the number you will see quoted as government debt. The popular number looks at only federal debt, but state and local government debt is also soaring¹¹” (see Chart 6).

As alarming as these record numbers are, they still do not include the debt underwritten by the Federal Reserve as it has expanded its balance sheet to shore up the nation’s banking system. “The new, super-size Fed piles a high superstructure of risky assets on a tiny sliver of capital. In that sense, it more than a little resembles Bear Stearns before the skies opened,” wrote Jim Grant editor of *Grant’s Interest Rate Observer*. “Then again, the Fed, unlike the old Bear, can fund itself at no cost. It can, indeed, print money. But, the Fed is light in its capital accounts. We will go so far as to say that if the Fed’s own examiners were handed the Fed’s own financials (unlabeled, of course) and asked to render a regulatory decisions, they would order the place shut down... Through 2006, there were Treasuries on the left-hand side of the Federal Reserve’s balance sheet, currency and a dash of repo and bank reserves on the right-hand side. It was just about that simple. Today’s balance sheet is a collage of the credit crisis... What is the outside reasonable estimate of loss on these assets? [Some estimates] put it at 9%, or \$183 billion out of a projected \$2.05 trillion of credit exposure. For perspective, on June 3, the Fed showed total capital of \$45.7 billion... The fundamental problem is, rather, the one that is staring the world in the face. To save the American financial system, the Fed has found it necessary to expand the stock of potentially inflationary high-powered money by orders of magnitude higher than the mere doubling in the size of its consolidated footings. So doing, it has incurred unprecedented credit risk as well as the not immaterial risk of a capital call.¹²”



As consumers have well learned, debt has a cost. This is true whether the borrower is a subprime mortgage borrower or the federal government (assuming there is a difference). The Congressional Budget Office recently released estimates of the federal government’s future interest costs on the substantial debt it is currently amassing.

¹¹ Ned Davis, “Institutional Hotline: Trends In Interest Rates and Inflation,” *Ned Davis Research, Inc.*, June 16, 2009.
¹² Jim Grant, “Horrible? Certainly. Bearish? Not necessarily,” *Grant’s Interest Rate Observer*, June 12, 2009.

Currently, the CBO is assuming net interest costs through 2019 of \$4.8 trillion. Should interest rates return to levels of the 1990s, the CBO estimates net interest costs would increase to \$6.1 trillion. Should interest rates reach the more burdensome levels of the 1980s, the CBO estimates net interest costs would increase to \$10.4 trillion. Interest burdens such as these could put unprecedented pressure on government spending and weigh on economic growth by forcing up rates on debt held by corporations and consumers.¹³

In this light, though prices have since recovered a bit, the massive Treasury bond sell-off in June 2009 is problematic. “[It puts] pressures on other markets in the economy,” wrote Mohamed El-Erian, co-CEO and co-CIO of *PIMCO Ponds*. “We should worry most about housing... Housing is still central to the stabilization and eventual recovery of the U.S. and global economies. Any further decline in house prices will erode the collateral many Americans borrowed against, dampen their already-fragile consumption appetite, and increase the headwinds facing a banking system that is finally regaining its footing. The U.S. can ill-afford a further sell-off in U.S. bonds at this stage in the economy’s rehabilitation process. Yet there is no easy way for policymakers to address this challenge.¹⁴”

Outside of market machinations, there are other forces that could serve to limit the government’s ability to gradually wean the economy from debt. According to a recent Gallup Poll, independent voters are deserting President Obama nationally and especially in key swing states. Obama’s job approval rating hit a low of 56.0% and pollsters are debating whether Obama’s expansive and expensive policy proposals or the ground-level realities of a still-faltering economy are driving the falling numbers. “This is a huge sea change that is playing itself out in American politics,” said Democratic pollster Doug Schoen. “Independents who had become effectively operational Democrats in 2006 and 2008 are now up for grabs and are trending Republican. They’re saying, ‘Costing too much, no results, see the downside, not sure of the upside,’” he said.¹⁵

Clearly, the economy is walking a fine line. Since late last year fiscal and monetary policies have been the elixir minimizing the side effects of private debt withdrawal. There is a chance these policies continue to operate as they have over the last few months, with a money supply growing fast enough and a federal deficit large enough to spur economic growth, but neither ignite inflation nor a run on the dollar. However, should market forces serve to thwart the government’s efforts to wean the system of private debt, we could be forced to quit debt cold turkey. That wouldn’t be pretty.

For a system so addicted, that sort of debt detox would likely put to bed any debate over green shoots and economic recovery in the near term. Especially since debt has been the consumers economic lifeblood over the last two decades.

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¹³ Nelson D. Schwartz, “Rising Interest on Federal Debt May Sap Growth,” *The New York Times*, June 4, 2009.

¹⁴ Mohamed El-Erian, “U.S. Bond Sell-off Putting Pressure on Other Parts of the Economy,” *The Daily Telegraph*, May 30, 2009.

¹⁵ Ben Smith, “Independents Begin to Edge Away From President Obama,” *Politico.com*, July 9, 2009.