



CALDWELL & ORKIN®

UPDATE

August 2006

Goldilocks

We like new Federal Reserve Board Chairman Ben Bernanke. Honestly, we do. His straightforward communication method is a breath of fresh air after nineteen years of coughing on obfuscated dust. Unfortunately, we seem to share this admiration with the learned (we use this term loosely) representatives on the Congressional Banking Committees. Unlike us, these representatives favor the new Chairman not because he speaks clearly, but because he tells them what they want to hear.

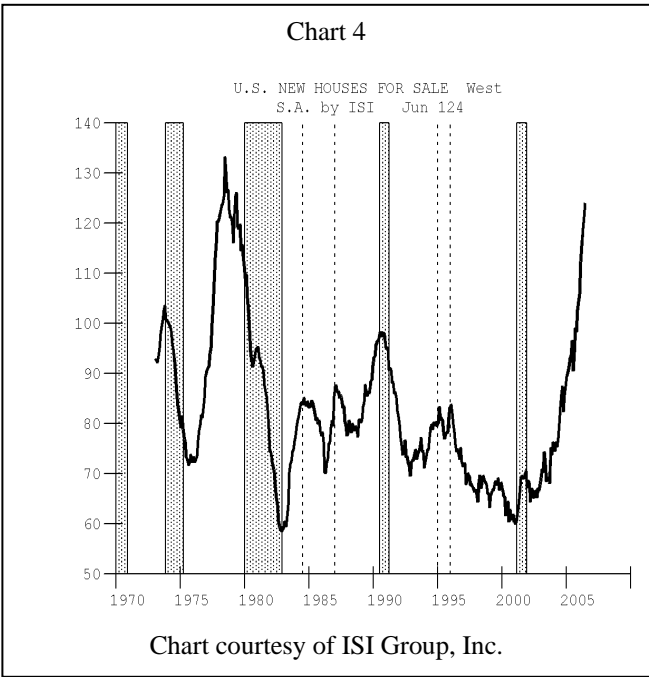
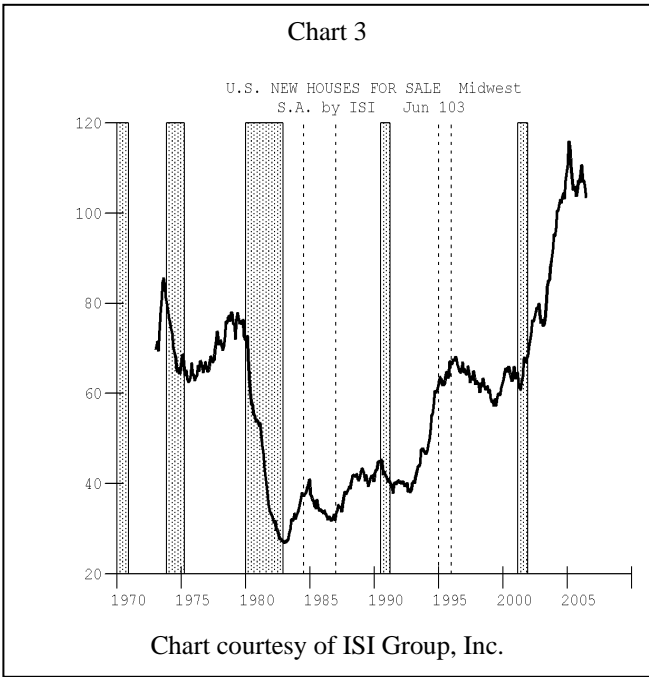
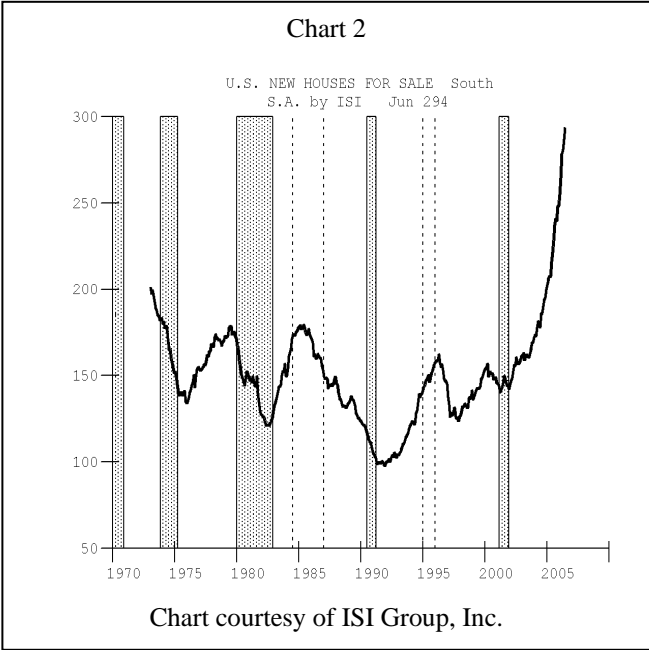
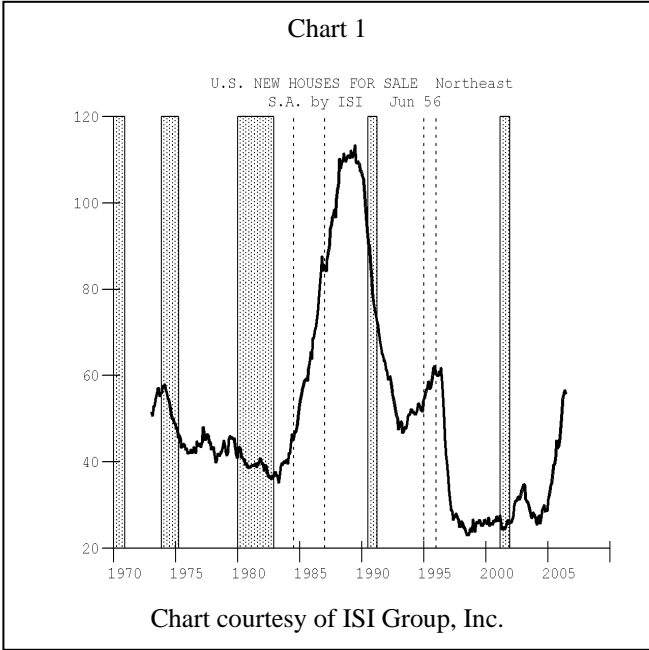
On Wednesday, July 18th, 2006, Chairman Bernanke testified before the Senate Banking Committee. After patiently listening to bellicose grumblings regarding the pain gentle Ben's interest rate increases were inflicting on each of the Senators' constituents, Ben calmly put the Senators' concerns to bed saying, "The economy should continue to expand at a solid and sustainable pace and core inflation should decline from its recent level."

Perhaps it is of little coincidence that this outlook fits almost perfectly with the now Street consensus mid-cycle-slowdown thesis postulated by Ed Hyman at ISI Group, Inc. (see the May 2006 *Update*). Indeed, the market loved Ben's rosy forecast as evidenced by that day's 1.86% advance in the S&P 500 and the 1.97% rise in the Dow Jones Industrial Average. We believe, however, realizing this forecast seems less than a sure thing. While it certainly is a natural course of the business cycle for inflation to peak as economic growth cools, for the economy to thread this needle given the current macro backdrop may prove more difficult than the consensus now believes.

The fact that the inflation genie is out of the bottle is no great secret. The second quarter personal consumption core (ex-food and energy) price index registered a 2.9% year-over-year increase, a marked acceleration from the 2.1% rate of the first quarter. And despite the claims of many pundits, it is not just rents that are on the rise. In fact, education costs are 6% higher than they were a year prior, public transportation costs have risen 5.4%, water and trash collection is up 4.8%, medical care is up 4.1% and fruits and vegetables are up 4%. Against these cost increases corporate unit labor costs are down -1.5%, a number that tells the Fed the future inflation picture looks much less worrisome than today's numbers might suggest.

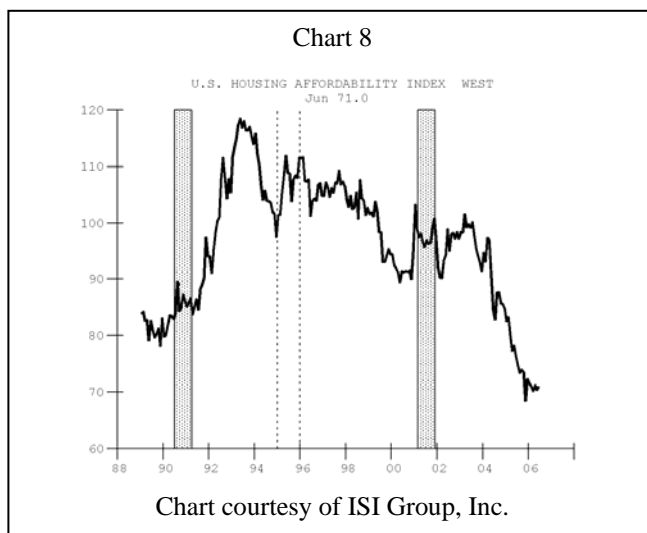
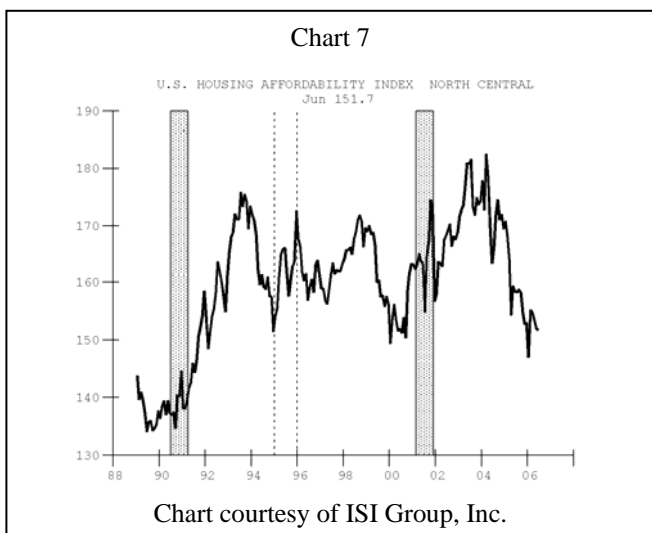
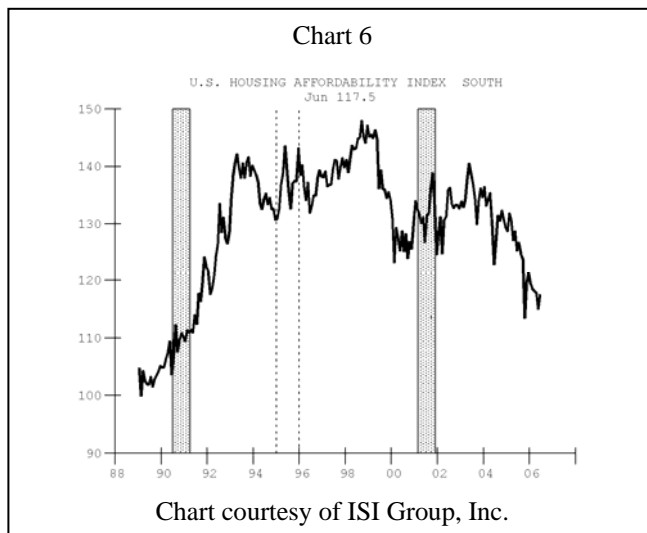
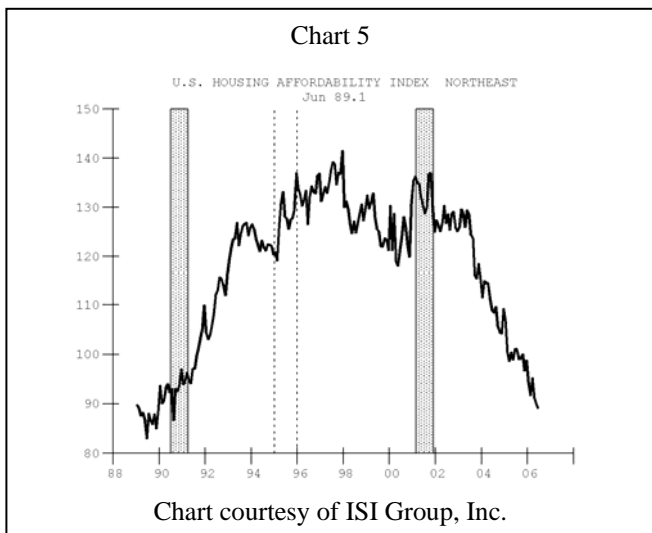
The predominant reason to expect inflation to cool is that Joe Consumer, whose spending accounts for 70% of our nation's economy, is facing a shopping slowdown. According to ISI, inflation has cut into Joe's paltry annual compensation gains, leaving his real disposable income up just 1.1% over the past twelve months, the weakest increase since the early 1990s. The punch bowl that kept Joe partying in the absence of real wage gains (a housing bubble) has been taken away with the removal of monetary accommodation. In the July 21, 2006 *Thoughts From the Frontline* newsletter, guest writers Louis-Vincent Gave and Anatole Kaletsky of GaveKal Research wrote, "It is when we consider [what] might have to turn up (or down) to relieve America's inflationary [woes], that we start to worry."

Bringing us, yet again, to the housing market. As each month passes, signs of a housing market bubble burst grow increasingly persuasive. Across the country, inventories have increased to record levels as housing affordability continues to decline (see Charts 1 through 8).



(An Atlanta-area billboard sponsored by a local mortgage company tracks the city's inventory levels. At last count inventory was roughly 98,000, bringing the level of unsold homes precariously close to the six-digit level, a threshold this billboard will not be able to register.)

Given these dire fundamentals, it is no surprise that prices have also begun to decline. In South Bend, Indiana home prices fell -10.2% in the first quarter of 2006. Residents of Danville, Illinois have seen their home values fall -11.6% from last year's levels, while those in Akron, Ohio have suffered -6.3% declines. These aren't exotic beach locales – this is the heartland. Clearly, the crutch upon which Joe Consumer has been leaning will not support him in the future. According to the CEO of a major homebuilder (they're in the top five by market capitalization), a soft landing in which the consumer has a chance to catch his breath is unlikely. On his company's most recent quarterly conference call, Mr. CEO told investors, "Every time we've gone into a downturn in the home-building industry, they've always been longer and deeper than we've imagined, so we're preparing for the worst."

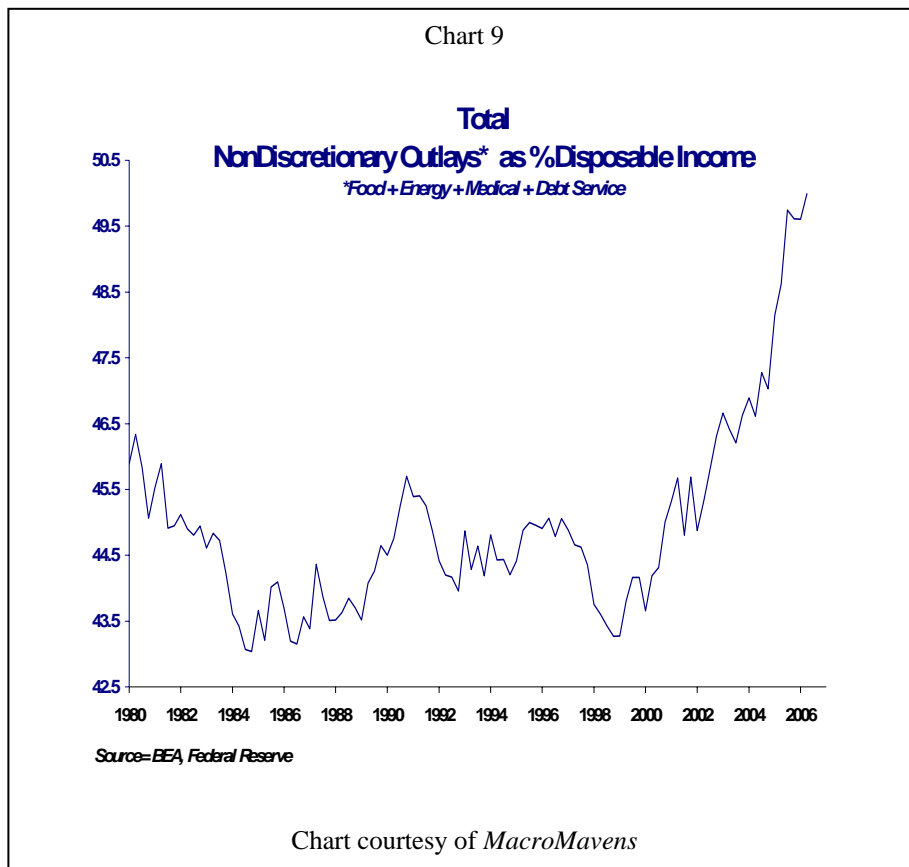


So, as the housing bubble bursts inflation may indeed cool off, but we wonder how the economy “continues to expand at a solid and sustainable pace” with consumers starting to feel such intense pain. On July 21, 2006 Stephanie Pomboy of *MacroMavens* wrote, “When bubbles burst, behavior tends to change. Here we sit, six years after the dot-com bubble bust and the corporate sector is still holding the most cash on its balance sheet in forty years. Isn't it reasonable to expect the bursting/deflation of the housing bubble will find consumers doing the same [thing].”

And if gentle Ben manages to steer us clear of a recession and leads us through the bullish “mid-cycle slowdown,” is that necessarily good for the stock market? A July 25, 2006 report by Paul Desmond of Lowry’s Reports argues that the current internal market conditions are much different than they were in the last mid-cycle slowdown. Desmond wrote, “favorable comparisons between 2006 and 1994 have been made in the financial media, carrying the implication that the current market decline is only a pause in the bull market and will be quickly followed by a resumption of a strong primary uptrend. Our measures of Supply and Demand, however, paint a different picture in which the contrasts between 1994 and 2006 are much more important than the similarities.”

Desmond highlights three distinct differences between today’s market and the market in 1994. Most notably, the Treasury Bill/Eurodollar Spread (TED Spread), a popular measure of credit risk, has been rising and currently stands just below its highest level in over 4 years. In 1994, the TED Spread was essentially flat. Second, the New York Stock Exchange Advance-Delay Line failed to match the May 10 rally highs in the market. These market divergences have typically marked major market tops. Last, investor demand has been much weaker in the current market than in 1994. In particular, the advances off the June 14th market low have been accompanied by contracting volume with a drop in both the supply of and demand for stocks. Desmond wrote that “rallies based on reduced selling rather than renewed demand have, historically, proved to be of short-lived variety.”

Regarding credit risk, Stephanie Pomboy thinks the market may be on to something. According to Pomboy, “When the Fed stops [raising rates], the real tightening will begin. The reasons for this are manifold. But the number one by far is that the deterioration in the credit outlook seems sure to curb bank willingness to lend.” Pomboy believes that the housing bubble was the consumers’ substitute for punk wage increases and, unlike the U.K. consumer (whose example is often cited by housing bulls), the U.S. consumer does not have a cushion on which to fall. For starters, consumers in the U.K. have seen real annual wage growth of 3% versus -0.4% over that time period in the U.S. Also, the U.K. consumer has a nice 6% savings cushion to fall back on while our savings rate is averaging -1.7%. Now, with non-discretionary outlays accounting for 50.2% of disposable income (the most since 1982) and the housing well running dry, the outlook is not pretty (see Chart 9).



“The Fed’s frantic efforts to lower the cost of capital will fail to goad bankers to extend credit to a sector trying to dig its way out from post-bubble debris,” Pomboy wrote in her July 21, 2006 *MacroMavens* report. “Bankers have built record exposure to the housing bubble while they’ve allowed their loan loss reserves to dwindle to 20-year lows.... This is what happened in the summer of 2000. While investors cheered the end of Fed tightening, once it became clear that conditions warranted a *CUT* the mood quickly soured. In the 12 months that followed the markets got spanked...hard. The S&P 500 dropped -26.0%, NASDAQ 100 Stock Index plunged -67.0% and the 10 year Treasury yield fell -85 basis points.”

In the Goldilocks and The Three Bears fairy tale, Goldilocks finds perfection in the home of three bears. Despite the risks, she feasts on the bears’ porridge (not too hot and not too cold) and naps in their beds (not too soft and not too hard), yet her idea of perfection is laid to rest when the not-so-happy bears come home to find a stranger in their house.

Investors may have found perfection in their prescription for a bull market advance. If inflation can stay not too hot, economic growth can stay not too cold and the landing for the housing market is not too hard the equity markets may see solid advances. But we caution to beware of the inherent risks in this outlook and believe certain companies remain vulnerable.

Our strategy remains focused on stock selection and we believe our portfolio is well-constructed for an economic slowdown, no matter the severity. We are currently long consumer staple stocks in areas of Utilities, Personal Care, Food and Beverage and Pharmaceuticals. Our short exposure remains in areas most leveraged to this economic downturn such as Homebuilders, Mortgage Finance and Consumer Discretionary.

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