UPDATE

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CALDWELL & ORKIN®

"In our view, saying that subprime is contained as spreads move higher is the equivalent of saying a car wreck is over while the wheels are still screeching."

-Jeff deGraaf, ISI Market Technician

"It just takes a long time to change, to turn a battleship around. This is a huge battleship, and it's headed in the wrong direction.[1]"

-Anthony Mozilo, CEO Countrywide Financial Corporation

The "Reversal"

On July 4, 2007 Takeru Kobayashi, the six-time Nathan's hot dog eating champion from Japan, was dethroned by American Joey Chesnut. In the contest, both contestants easily surpassed Kobayashi's hot dog consumption record of 53 ¾ set in 2006 as this year's competition went down to the wire. Then, as time was running out, in somewhat unappetizing fashion, Kobayashi had what announcers termed a "reversal," leading to the disqualification of his last three hot dogs.

Chart 1

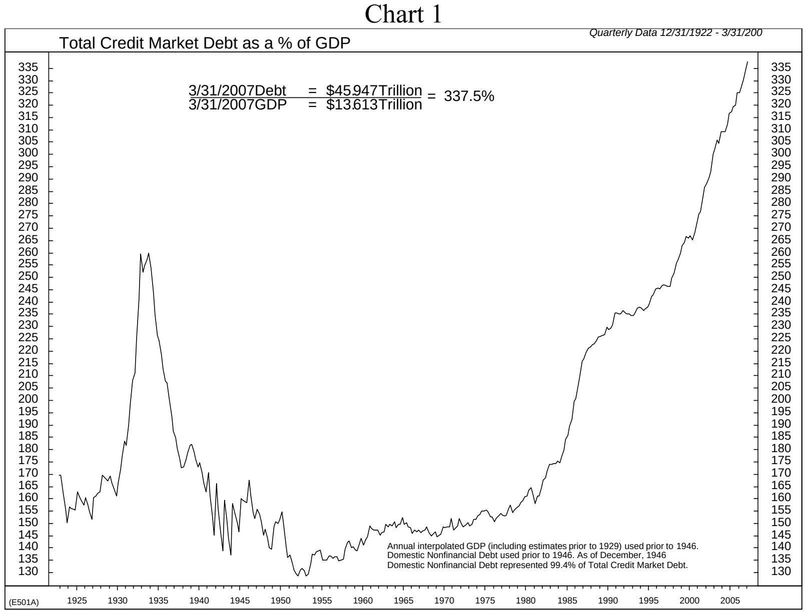

Chart courtesy of Ned Davis Research, Inc.

After a long period of over-indulgence (see Chart 1), the credit market too is puking. This credit market "reversal" is evidenced by the continued decline in the ABX index that tracks the performance of subprime bonds (see Chart 2), the persistent decline in the LCDX index that tracks the performance of corporate credit (see Chart 3) and the sudden widening of credit spreads from an unprecedented low level (see Chart 4).

We have long believed that the market's deployment of leverage coupled with the birth of structured financial innovations

[1] Lingling Wei, "Countrywide Report Signals Slow Recovery," The Wall Street Journal, July 25, 2007.

(collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs)) would eventually lead to a credit dislocation. Leverage has been ratcheting up on Wall Street to the point where, today, a bank or broker-dealer must set aside only 56 cents in capital to hold $100 of triple-A-rated securitizations.[2] Thus, unbelievably, a realized loss of little more than one-half of one percent would wipe out all the collateral these institutions are required to reserve in order to invest in these securities.

Chart 2

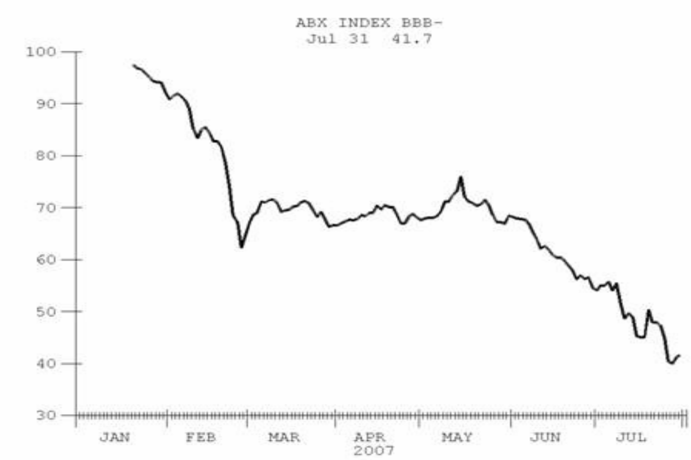

Chart courtesy of ISI Group, Inc.

But we are talking about triple-A securities here – the best of the best. So, what's the worry, right? Well, as the market has painfully learned, the "investment-grade" rating bestowed upon many asset-backed securities by the rating agencies is little more than a mirage.

The rating downgrades started, belatedly, with subprime mortgages. "I track this market every single day and performance has been a disaster now for months," said Steven Eisman, who helps manage $6.5 billion at Frontpoint Partners in New York, during a conference call hosted by a rating agency to discuss their downgrades. "I'd like to understand why you made this move now when you could have done this months ago.[3]" We're sure he's not alone.

Chart 3

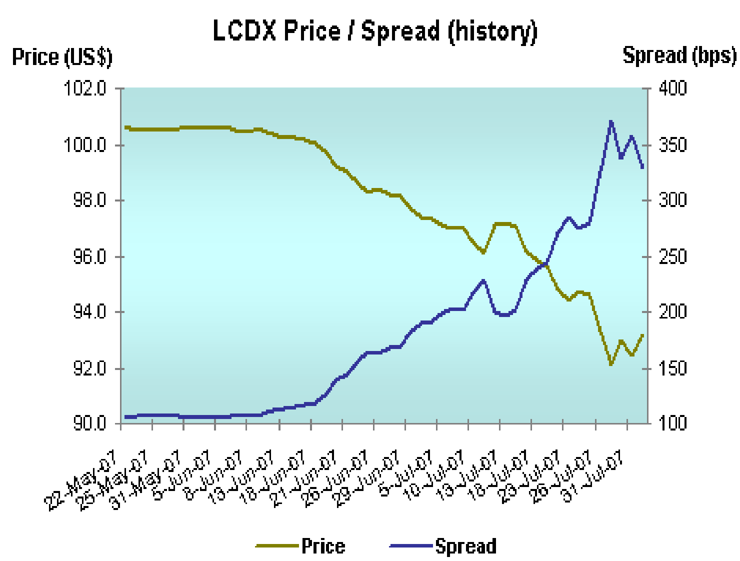

Chart courtesy of Markit Group, Ltd.

As we have maintained for some time, the over-extension of credit to unworthy borrowers was not limited to subprime mortgages. According to Tom Gallagher of ISI Group, Inc., the same risky loans that were made during the boom (stated income, no down payments, teaser rates, interest only) were made to people with poor credit scores (subprime) and to people with good credit scores (Alt-A and even the prime market). So, it came as little surprise when the ratings agencies next downgraded investment pools backed by Alt-

[2] Jim Grant, Grant's Interest Rate Observer, June 29, 2007.

[3] Caroline Salas and Mark Pittman, "Subprime Losses Drub Debt Securities as Credit Ratings Decline," Bloomberg News, July 11, 2007

A mortgages and issued warnings of downgrades to come in CDO and CLO structures supported by these "assets," particularly after the nation's largest mortgage lender said they were seeing delinquencies on loans to borrowers with prime credit.[4] Gallagher believes we are now only at the beginning of the downgrade cycle. On July 11, 2007 he wrote, "If a larger-than-modeled share of subprime and Alt-A loans are not going to get paid back, then the financial instruments into which those loans were packaged must suffer losses…and there will be a parade of downgrades."

Chart 4

Chart courtesy of ISI Group, Inc.

The enormity of the financial impact of these downgrades is matched only by their impact on investor psychology. According to Bill Gross at PIMCO, "When institutional investors began to see the ratings downgrades in ABS subprime space [they asked themselves] could the same thing happen to leveraged structures with pure corporate backing? To be blunt, they seem to be thinking that if [the rating agencies] have done such a lousy job of rating subprime structures, how can the market have confidence that they're not repeating the same structural, formulaic mistake with CLOs and CDOs? That growing lack of confidence…has frozen future lending and backed up the market for high yield new issues such that it resembles a constipated owl: absolutely nothing is moving.[5]" Now we bear witness to the credit crunch we most recently forecast in our March 2007 *Update*.

Slowly but surely, investors are opening their eyes to the reality of the widespread credit excesses of the past, and tightening the noose around the neck of future credit availability. As such, interest rates are rising and taking on debt is becoming costlier. In residential and commercial mortgages, and in junk bonds and leveraged loans, it is becoming harder by the day to wheedle a loan on the kind of terms that made the creditors the butts of jokes by the deal-doers.[6] Junk bond spreads are now up 100 basis points in two months, evidence that credit instability is spreading into junk bonds, emerging market debt and all the arcane structured products Wall Street concocted during the boom.[7] With the cost of financing everything increasing, private equity firms are finding it harder to acquire target companies. Some 15 to 20 debt offerings have been modified or postponed as anxious investors have demanded better terms for high-yield bonds, the lifeblood of the leveraged buyout.[8] In the blink of an eye, the best market in history for leveraged buyouts has shut-down. Now, the world's biggest bondholders such as TIAA-CREF and Fidelity International are saying they have no interest in leveraged buyouts, convinced that increasing

[4] Vikas Bajaj, "Top Lender Sees Mortgage Woes for 'Good' Risks, The New York Times, July 25, 2007.
[5] Bill Gross, PIMCO Investment Outlook, August 2007.
[6] Jim Grant, Grant's Interest Rate Observer, June 29, 2007.
[7] *Belkin Report*, July 23, 2007.
[8] Michael J. de la Merced, "Debt Market Is Squeezing Private Equity," The New York Times, July 21, 2007.

mortgage delinquencies will drag down the U.S. economy and drive debt-laden companies into default. According to Portales Partners, this is a critical issue at present because investors are being asked to absorb 1) $400 billion of junk corporate debt related to deals already announced, 2) an undetermined amount of junk commercial real estate debt to finance highly-leveraged building acquisitions, and 3) still more junk mortgage paper. Economics 101: increasing supply + falling demand = lower prices, or, in the case of the credit market, higher yields.

Chart 5

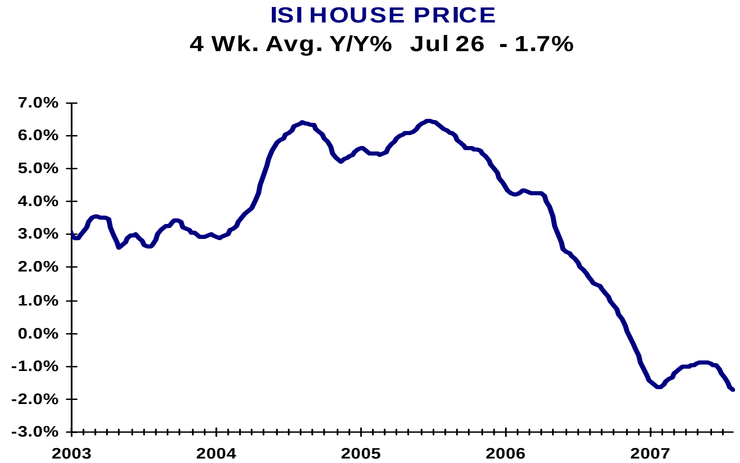

Chart courtesy of ISI Group, Inc.

What is most amazing about this credit contraction is how long market participants have played dumb. Even after multiple hedge fund collapses and the continued widening of junk bond spreads, the preachers of the gospel of containment have not been silenced. "We are told on all sides, even by The Secretary of the Treasury, that even for the subprime market all is 'contained,'" says Jeremy Grantham, portfolio manager for GMO LLC. "We have to wonder if the container, in this case, will turn out to be Pandora's [Box].[9]" Andy Laperriere adds, "The fact the market sold off as a result of the widely anticipated downgrades by the rating agencies reinforces our view that the market has not discounted the more bearish case for housing. If there is an analyst who was surprised [by these downgrades], we haven't met him. This tells us the market has a long way to go to discounting the implications of the housing bust now unfolding."

Chart 6

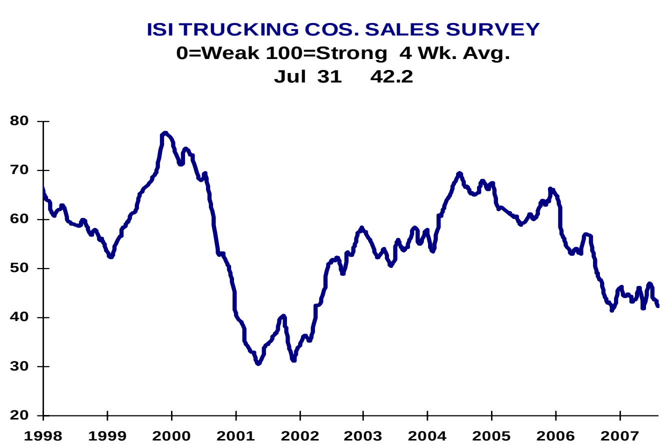

Chart courtesy of ISI Group, Inc.

To be sure, only the delusional (and those under the employ of the National Association of Realtors) now argue that the state of the housing market is anything but a bust. June new home sales, as reported by the U.S. Census Bureau, were down 22% year-over-year, house prices through June have plunged an unprecedented -2.9% from their peak in late 2005. And judging by ISI's house price survey (see Chart 5), house prices are down even more in July. And with inventories high and lending standards tightening, prices are likely going lower.

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[9] Jeremy Grantham, GMO Quarterly Letter, July 2007.

Obviously, the implosion of the housing market is having an impact on the economy. According to Ed Hyman, housing weakness is leading to a decline in ISI's trucking company surveys (see Chart 6) as a slowdown in residential construction leads to weaker shipments of goods. Housing weakness is impacting the earnings of industrial corporations, as evidenced by a major machinery company widely missing Wall Street analysts' earnings estimates. Hyman believes the key issue for the economy going forward is house prices. "To the extent prices continue to decline," Hyman wrote, "subprime woes worsen, unplanned resets kick in, mortgage equity withdrawal (MEW) declines, and consumers' propensity to spend declines." ISI's retail sales surveys do not paint an optimistic picture in this regard (see Chart 7). Importantly, Hyman believes it is the consumers who don't default on their mortgages that matter the most for the economy. "As pressure mounts, the families that tighten their belts and don't default [will have less to spend elsewhere]," he says.

Chart 7

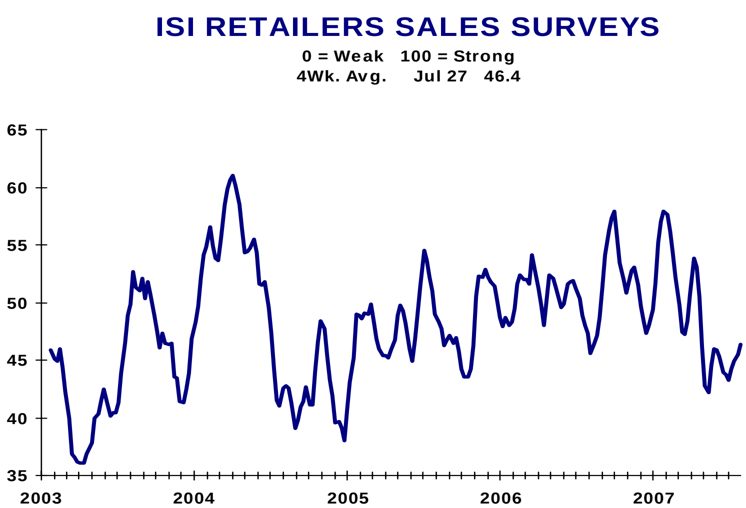

Chart courtesy of ISI Group, Inc.

Despite all the weaker news, the economy is not falling apart. Exports are growing on the back of a weaker dollar and continued strength in developing economies which now account for a record 30% of worldwide gross domestic product (GDP). This strength has held ISI Company surveys close to 50 (on a scale of 0 to 100), a level indicative of annualized U.S. GDP growth of 2.0%.

Given the persistent strength of the economy and the continued acceleration in worldwide money growth, we continue to see ample opportunities for investments in the long portion of our portfolio. Specifically, we remain invested in companies with exposure to strong international markets. We also have exposure to companies with exciting new technological developments in areas including clean fuel technology and internet services. Also, we are invested in a number of companies that are undergoing catalyzing changes and restructurings led by new management teams. It may come as a surprise to some *Update* readers, but throughout this credit crunch we have maintained a predominantly net-long invested position, meaning a greater portion of our assets are invested in securities on the long side than are invested on the short side.

That said, we also remain positioned to benefit from the ongoing purge of credit excesses as it seems nary a day passes where we don't hear of a hedge fund collapse, a mortgage company losing its lines of credit or a pending bankruptcy. The situation is getting serious enough that many market participants are agitating for the Federal Reserve to come to the rescue with a rate cut. While this is certainly a possibility (and a risk to our short credit thesis), the Fed's most recent body language indicates it is not likely. In a July speech, William Poole, President of the St. Louis Federal Reserve Bank, said, "The punishment has been meted out to those who have done misdeeds and made bad judgments. We are getting good evidence that the companies and hedge funds that are being hit are the ones who deserve it."

Those that pigged out on the junk are likely to get sick.

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