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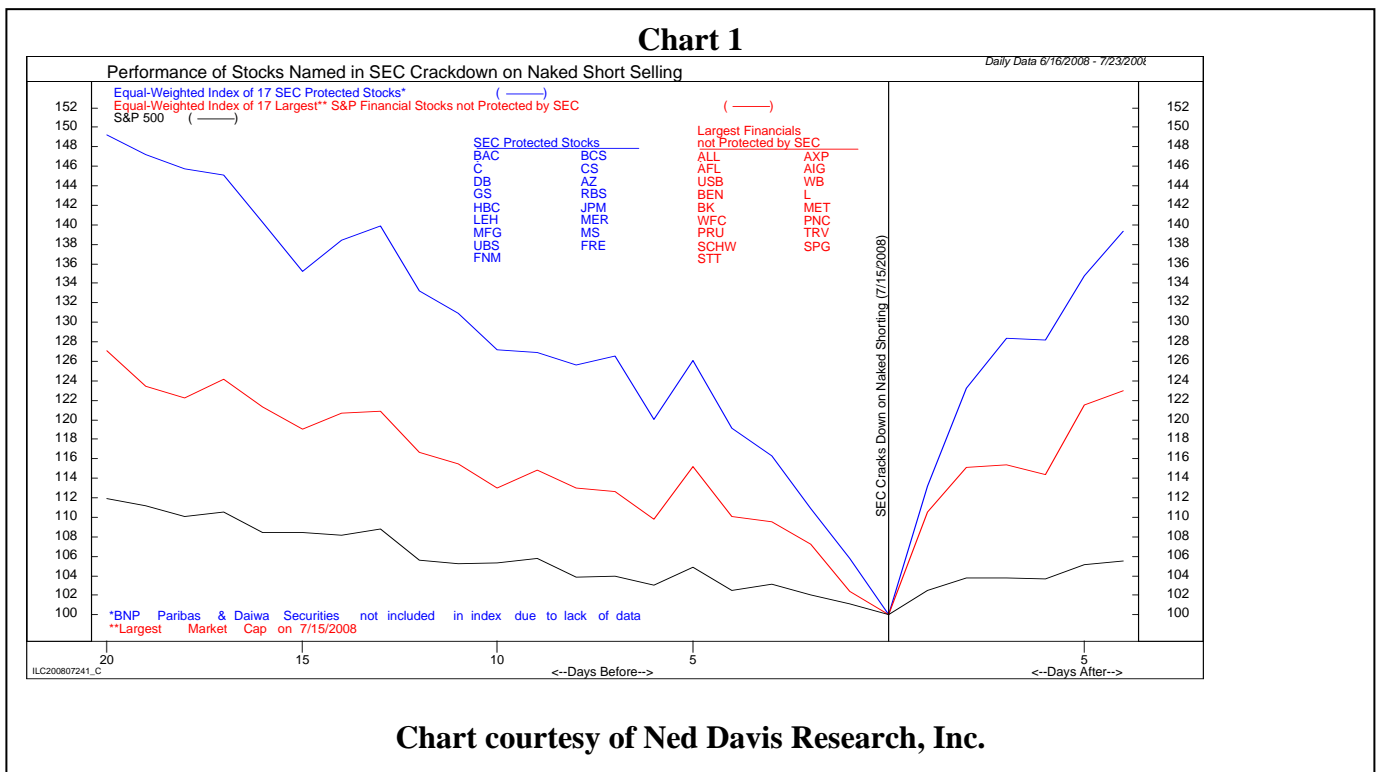
# UPDATE

August 2008

*“The Commission will continue exploring other remedies for the broader marketplace to further protect investors from ‘distort and short’ artists.”*

-Christopher Cox, Chairman of the SEC, July 2008

## Market Bull



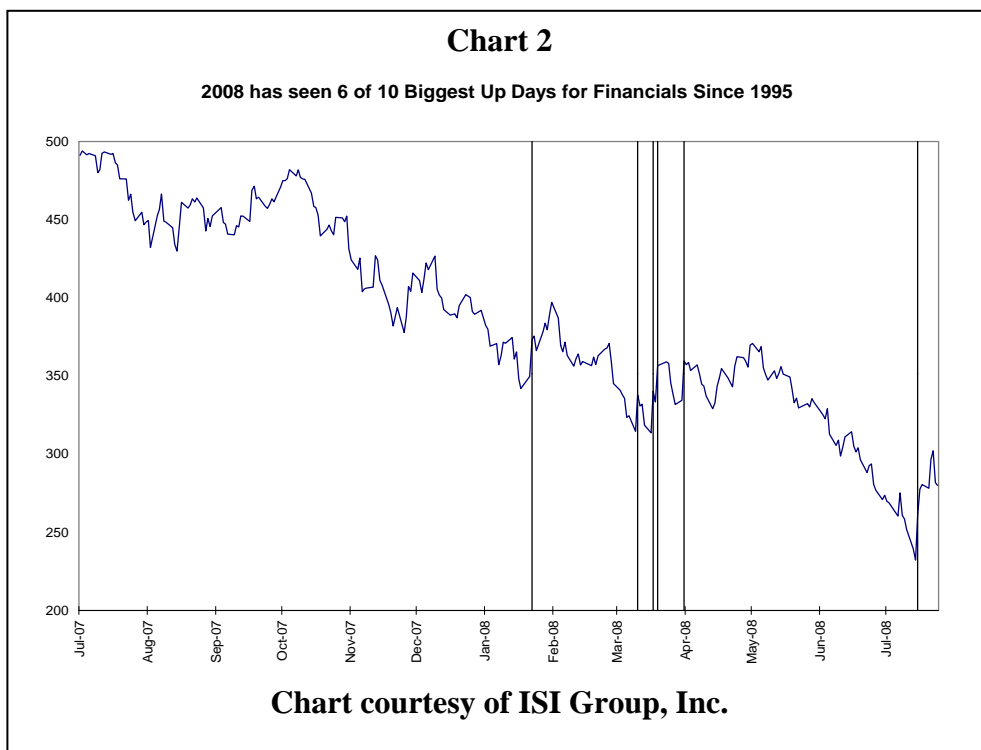
Securities and Exchange Commission (SEC) Chairman Christopher Cox is the latest in a series of government “leaders” to embrace a time-honored response to the nation's current economic turmoil: a witch hunt.<sup>1</sup> After being asleep at the wheel since taking the helm of the SEC in August 2005, Cox is now making a grand show by accusing investors of spreading false rumors and illegally naked shorting stocks in an effort to drive down the share prices.

<sup>1</sup> Greg Hitt, “Economic Woes Get A Fix: Witch Hunt,” *The Wall Street Journal*, July 19-20, 2008.

On July 15, 2008, with the stock market reeling and the shares of financial companies plummeting, Chairman Cox told Congress he would get tough on market manipulation. At the time of his testimony he had no plan and offered few specifics, but in a rushed announcement that evening the SEC declared it illegal to short 19 financial stocks without pre-arranging to borrow the shares first, a practice known as naked shorting. The following day financial stocks had their biggest rally in history, with the KBW Banking Index (BKX) shooting up 17.3%, followed by another 9.4% gain the day after. (See Chart 1.)

This impressive rally in the BKX is nothing new this year. According to Jeff deGraaf, Managing Director and Technical Strategist at ISI Group, Inc., six of the ten biggest one-day advances in financial stocks have occurred in 2008 (See Chart 2). On January 23, 2008, the BKX rallied 8.0% in response to an emergency 75 basis point (bps) reduction in the Federal Funds rate from 4.25% to 3.5%. On March 18, 2008 the BKX was up 7.2% following the Fed’s orchestrated rescue of Bear Stearns. Chairman Cox made the vague blanket allegation that ‘distort and short’ artists are manipulating the market, driving financial shares lower. Yet, as we see, throughout 2008 the market in general and financial stocks in particular have been whisked viciously (if not briefly) higher on the drunken hopes of salvation via government manipulation in the name of intervention.

Despite all this intervention, the BKX is down -25.3% year-to-date through August 4, 2008, a decline reflective of the poor fundamentals currently plaguing the financial sector. Since the credit crisis began, banks have written off a ghastly \$480 billion worth of bad loans while raising only \$354.6 billion in capital, a mathematical recipe for trouble. Yet, Chairman Cox points his finger not at the fundamentals, but at the shorts. “It seems that at the end of the bear market, people would love to blame short sellers for the misery,” wrote David Einhorn in his book *Fooling Some of the People All of the Time*.



In addition to blaming short sellers, perhaps Chairman Cox is also seeking to mask his own complicity in the credit crisis. After all, the agency preserved and protected the collective incompetence of a few favored "nationally recognized" credit-rating agencies that had rated certain collateralized debt obligation (CDOs) at Triple-A, despite the fact that the underlying bonds were junk. Ask Merrill Lynch about the risk of these assets. They just sold CDOs with a face value of \$31 billion for a potential \$.05 on the dollar. This sale was reported as

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\$.22 on the dollar, but after adjusting for the fact that Merrill provided 75.0% of the financing and is on the hook for the losses should the loans not perform, the effective price of the sale could be \$.05.<sup>2</sup>

The SEC also watched from the sidelines while financial statement auditors became corporate consultants, selling the kind of services that audits should detect, report and eliminate, and even selling methods of hiding deleterious facts from auditors.<sup>3</sup> Worse still, the SEC hasn't publicly cracked down on financial executives who have skirted the edge of the rules and it didn't force investment banks which had exposure to mortgage loans to maintain adequate capital even as the housing market was beginning its downturn.<sup>4</sup> "Never was a disaster better advertised than the one now washing over us," wrote Jim Grant, editor of *Grant's Interest Rate Observer*. "House prices stopped going up in 2005, and cracks in mortgage credit started appearing in 2006. Yet the big, ostensibly sophisticated banks only pushed harder. For every dollar of equity capital, a well-financed regional bank holds perhaps \$10 in loans or securities. At the end of 2007, Goldman Sachs had \$26 of assets for every dollar of equity. Merrill Lynch had \$32, Bear Stearns \$34, Morgan Stanley \$33 and Lehman Brothers \$31. On average, then, about \$3 in equity capital per \$100 of assets."<sup>5</sup> All the while Chairman Cox, charged with regulating broker activity, watched approvingly.

Chairman Cox's emergency action smacks of the regulatory responses of recent years: do nothing to curb the deal-making mania while it is occurring, but when the rout comes along, hurry up and rein it in.<sup>6</sup> His naked short investigations and regulations aren't designed to protect investors, but to deceive them. In his view, it seems it is best to support the market reputations of 19 banks and other financial institutions in the face of well-warranted, well-documented criticism,<sup>7</sup> and ignore the poor business decisions and blatant dishonesty within the leadership at many financial institutions.

For example, in his 2007 annual letter to investors, Ken Thompson, former CEO of Wachovia wrote, "As we enter 2008, we've built a plan that gives us confidence we will continue to generate sufficient earnings to fund growth in our businesses and cover dividend payments along with...increasing our capital ratios." Since publishing that letter, Wachovia has taken \$20.1 billion in write downs and raised \$11 billion in capital. On a March 18, 2008 conference call with investors, Erin Callan, former CFO of Lehman Brothers told investors, that a \$1.9 billion capital raise in February "took care of our full year needs." Thereafter the company took \$7.5 billion in additional write offs and raised \$13.9 billion in additional capital. Merrill Lynch's CEO John Thain, a serial foot chewer, assured investors on a conference call in March 2008 that his company had "more capital than we need, so we can say to the market that we don't need more injections. We can confirm that we have tackled the problem." Given the \$14.7 billion in write offs taken since that call and the \$17.3 billion in additional capital raised it appears the problem has tackled back. The most egregious example, however, comes from Alan Schwartz, the former CEO of Bear Stearns, who two days before filing bankruptcy in March 2008 told investors watching CNBC's Squawk Box that, "Bear Stearns' balance sheet, liquidity and capital remain strong... Our liquidity position has not changed at all, our balance sheet has not changed at all." The only investigation, legislation and/or regulation to come from Chairman Cox regarding these erroneous

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<sup>2</sup> Jenny Anderson, "An Investment Firm That Prospered From Past Crises Turns to Mortgages," *The New York Times*, July 30, 1008.

<sup>3</sup> Thomas G. Donlan, "Swatting an Imaginary Fly," *Barron's*, July 28, 2008.

<sup>4</sup> Robert Cyran and Antony Currie, "Clumsy SEC Arrives Late," *The Wall Street Journal*, July 19-20, 2008.

<sup>5</sup> James Grant, "Why No Outrage," *The Wall Street Journal*, July 19-20, 2008.

<sup>6</sup> Gretchen Morgenson, "Borrowers And Bankers: A Great Divide," *The New York Times*, July 20, 2008.

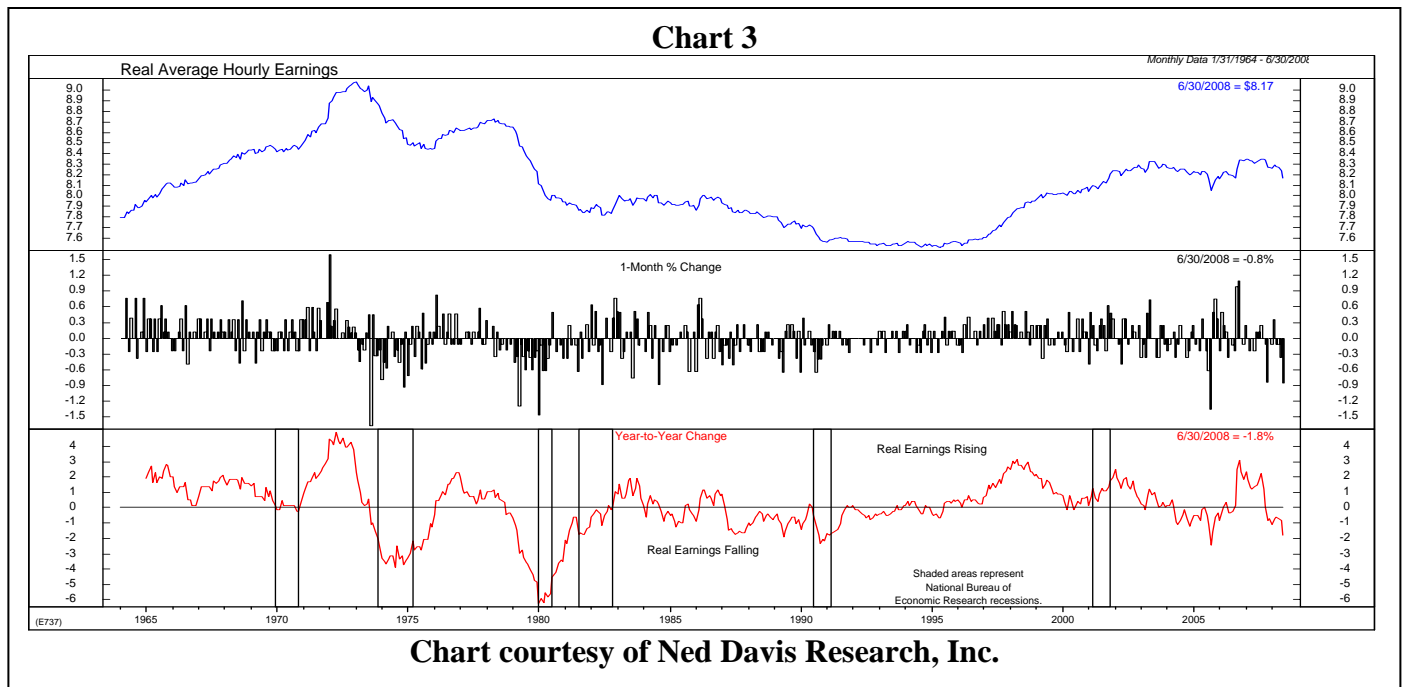
<sup>7</sup> Thomas G. Donlan, "Swatting an Imaginary Fly," *Barron's*, July 28, 2008.

statements was to formally declare that false rumors drove Bear Stearns over the edge. It would be funny, were it not so sad.

Sadder still is the fact that laws prohibiting naked short sales have been in place for 74 years, since the implementation of the Securities Exchange Act of 1934 which established the very agency Cox now runs. The Act, which outlined regulations for the secondary trading of all securities, stated that shares of stock could not be lent out for the purpose of shorting without owner approval and that all equity trades including short sales must settle three days after trade date. Therefore, any party implementing a short sale would have to borrow the shares, or else the trade will bust. (For the record, Caldwell & Orkin has always pre-borrowed shares of stock before implementing a short position.) Given that the naked short rule has been on the books since the SEC was established, we are left with one of two conclusions: 1) Chairman Cox is not well versed in the rules he is charged with implementing or 2) Chairman Cox had reason to artificially support (some may say manipulate) the 19 stocks his “new” rule protects. And we thought The Act applied to all equities!

What is most frustrating about Chairman Cox’s “plan” is that it does nothing to improve the underlying fundamentals of the economy, which continue to deteriorate by the day. This futility is a common thread amongst the government intervention plans announced to-date.

For their part, following the playbook of the last recession in 2001, Congress passed the tax rebate stimulus that put \$108 billion in consumers’ pockets. Unfortunately, according to The Federal Reserve, consumers now carry \$2.56 trillion in debt, up 22.0% since 2000 alone. The average household’s credit card debt is \$8,565, up almost 15.0% from 2000. Even as this debt was mounting, incomes stagnated for many Americans.



As a result, the percentage of disposable income that consumers must set aside to service their debt — a figure that includes monthly credit card payments, car loans, mortgage interest and principal —

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has risen to 14.5% from 11 percent just 15 years ago.<sup>8</sup> So while “there was recently a surge in income growth due to some \$108 billion in tax rebates,” wrote Ned Davis of Ned Davis Research, Inc. “When looking at real earnings growth note that it has been -1.8% over the past year. The average wage earner is under pressure.”<sup>9</sup> (See Chart 3)

No surprise then that according to Ed Hyman at ISI Group, Inc. after a couple of months of improving sales, ISI’s retailer and restaurant contacts have reported slower activity in the last few weeks of July 2008. “With most of the rebates now distributed,” wonders Ed, “is the stimulus behind us? If that is the case, the current experience would be different than in 2001, when the lift from the rebates was in the quarter of distribution and also the following quarter. With gas and food prices up, more of the rebates are ending up at the gas station and the supermarket than in 2001.”

Of course we shouldn’t overlook Congress’s Housing and Economic Recovery Act of 2008, a 700-page bill that hopes to save the heavily leveraged (their ratio of assets to equity is 60:1) government sponsored enterprises (GSEs) by giving Treasury Secretary Hank Paulson an open-ended “bazooka” mandate to bail out the housing market. This plan has been hailed by many on Wall Street as marking the end to the housing crisis. Never mind that taxpayers are already on the hook for the \$5.3 trillion in debt that is on the books of the GSEs (by comparison, the total national debt is \$8.8 trillion), the housing market is in dire need of drastic, game-changing legislation. Unfortunately, according to Andy Laperriere at ISI (who has been profoundly accurate with his analysis on the housing market), this legislation will do little to help stem the decline in home prices. “To be sure, the federal backstop for the GSEs prevents what could have been a disastrous outcome for the housing market,” wrote Laperriere, “but we believe [the GSEs] are left with no choice but to conserve capital – which means tighter standards, higher fees and shrinking their balance sheets.”

Remarkably, in this monumental legislation that bails out the GSEs, Congress balked at any efforts to reign in the GSE’s excesses by rejecting a proposal that the GSEs be barred from paying dividends if they are receiving capital from the federal government, not giving the taxpayer any of the upside from a potential recovery and passing on reforms that have been long sought by the marketplace.<sup>10</sup> “They are...bailing out troubled participants and intervening in every market. The SEC has accused others of trying to manipulate stocks, but the government itself is now the manipulator,” says Nouriel Roubini, economist and professor at New York University. “The regulators should investigate themselves for bailing out [the GSEs], the creditors of Bear Stearns and the financial system with new lending facilities... It is privatizing the gains and profits, and socializing the losses, as usual. This is socialism for Wall Street and the rich.”<sup>11</sup>

Despite these incessant interventions, the housing market remains in a state of disrepair as prices continue their trek downward. As such, the economy is left teetering on the brink of (if it is not already in) recession. “Housing, unlike other asset classes, carries with it an aura more like a bad dream than a fairy tale,” wrote Bill Gross of *PIMCOBonds*. “Unlike the frog that when kissed turns into a handsome prince, housing can morph a froglike economy into something resembling Godzilla. The dominoes fall

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<sup>8</sup> Gretchen Morgenson, “Given a Shovel, Americans Dig Deeper Into Debt,” *The New York Times*, July 20, 2008.

<sup>9</sup> Ned Davis, “Institutional Hotline,” *Ned Davis Research, Inc.*, July 25, 2008.

<sup>10</sup> Lawrence B. Lindsay, “Hank Paulson’s Fannie Gamble,” *The Wall Street Journal*, August 1, 2008.

<sup>11</sup> Robin Goldwyn Blementhal, “Yes, That’s \$2 Trillion of Debt-Related Losses,” *Barron’s*, August 4, 2008.

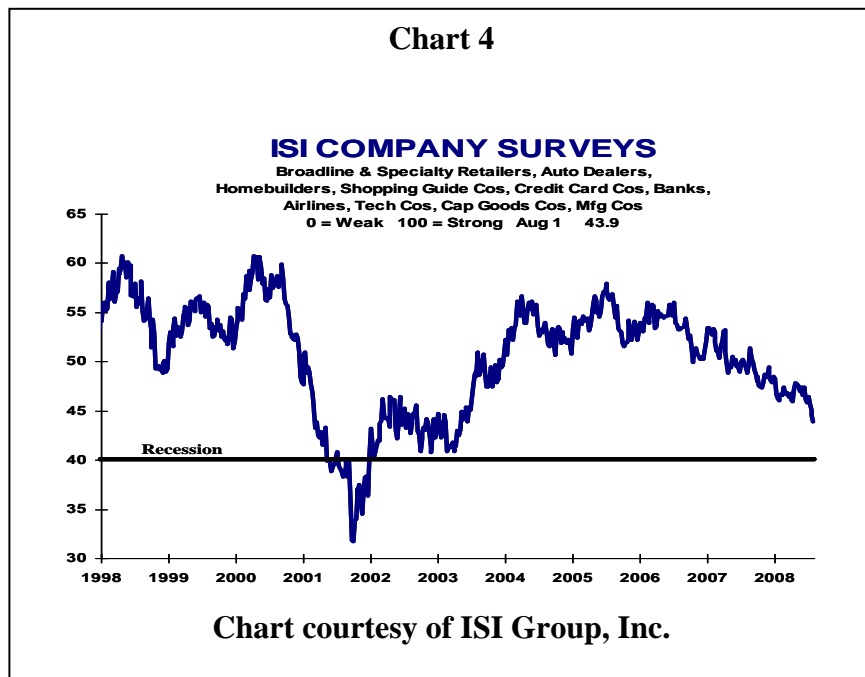
month-by-month, forcing prices ever lower. An asset deflation in turn becomes a debt deflation. PIMCO estimates...that nearly \$1 trillion of cumulative losses will finally mark the gravestone of this housing bubble. The problem with writing off \$1 trillion from the finance industry's cumulative balance sheet is that if not matched by capital raising, it necessitates a sale of assets, a reduction in lending or both that in turn begins to affect economic growth.<sup>12</sup> The dominoes fall.

Alarming, as severe as this credit crisis has been, to date banks have only written off their subprime loan exposure. "We are in the second inning of a severe, protracted recession," says NYU's Nouriel Roubini. Banks' "losses are mounting because they have written down only their subprime loans so far. They haven't started writing down most of their consumer credit losses, and reserves for losses are much less than they should have been... I estimate this financial crisis will lead to credit losses of at least \$1 trillion and most likely closer to \$2 trillion," he concluded.<sup>13</sup> His outlook suggests that subprime loans are just the tip of the iceberg. Interestingly, prime and Alt-A borrowers typically received a five-to-seven year grace period on their home loans before payments of principal were required. Now, some of these borrowers could see their payments jump 50% or more, on mortgages that are likely underwater.<sup>14</sup> And, of course, many of these loans were no-document "liar loans" where borrowers did not have to provide verification of their income. Perhaps this is what led Jamie Dimon, chief executive of JPMorgan Chase, to conclude that losses on prime loans at his bank will triple, describing the outlook for these loans as "terrible."<sup>15</sup>

No surprise then that banks struggling to recover from these multibillion-dollar losses on real estate are curtailing loans to American businesses, depriving even healthy companies of capital for expansion and hiring. By mid-June, bank credit was declining at an annualized pace of more than 6.0%.

That is a drop of nearly \$150 billion, an amount much larger than the value of the aforementioned tax rebates. According to a survey of senior loan officers conducted by the Federal Reserve in April, 55.0% of American banks tightened lending requirements for commercial and industrial loans to large and midsize companies — up from about 30.0% in the previous survey conducted in January. About 70.0% of the respondents said they have made such loans more expensive.<sup>16</sup>

As banks hold on to their



<sup>12</sup> Bill Gross, "Investment Outlook," *PIMCO Bonds*, August 2008.

<sup>13</sup> Robin Goldwyn Blementhal, "Yes, That's \$2 Trillion of Debt-Related Losses," *Barron's*, August 4, 2008.

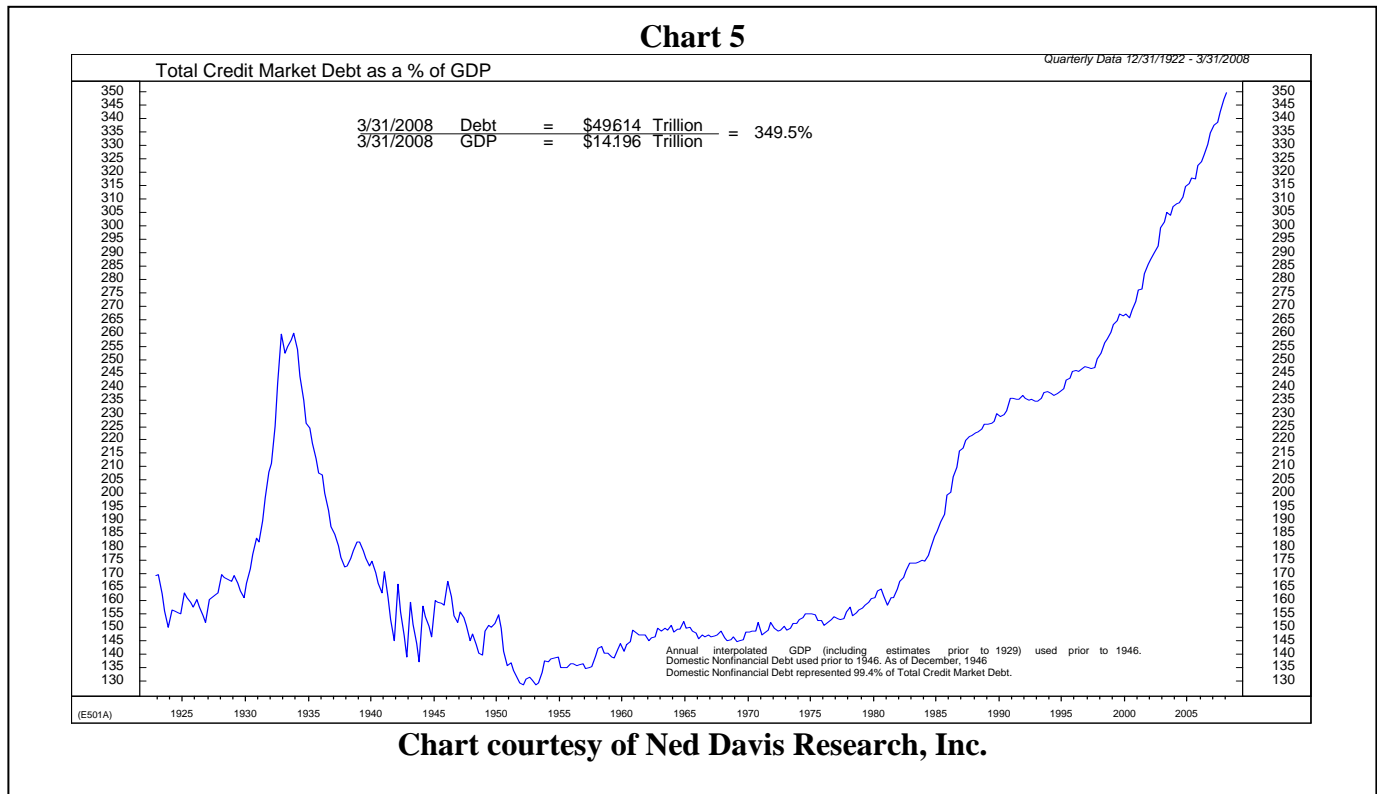
<sup>14</sup> Vikas Bajaj, "Housing Lenders Fear Bigger Wave of Loan Defaults," *The New York Times*, August 4, 2008.

<sup>15</sup> Vikas Bajaj, "Housing Lenders Fear Bigger Wave of Loan Defaults," *The New York Times*, August 4, 2008.

<sup>16</sup> Peter S. Goodman, "Worried Banks Sharply Reduce Business Loans," *The New York Times*, July 28, 2008.

dollars, mortgage rates are climbing as are borrowing costs for corporations. “The problem is that while the Fed-controlled interest rates have plunged...other longer-term free market interest rates...have actually risen,” wrote Ned Davis. “I understand the new housing bill should help keep a lot of people near foreclosure in their homes, but when I look at...the housing inventory-to-sales ratio, I wonder how long it will take that ratio to revert to the mean with mortgage yields rising?<sup>17</sup>”

Reflective of a tightening in credit, ISI’s company surveys have made a downside breakout and are inching closer to levels indicative of an economic recession. (See Chart 4) As companies cut back employment is suffering. In July 2008, the “official” unemployment rate ticked up to 5.7% - a new high for this downturn. But this rate masks the swelling ranks of those that would like to be working but cannot get full time employment: the underemployed. In this downturn 3.7 million Americans have seen their full-time jobs cut to part time because of weak business conditions, the largest figure since the government began tracking such data more than half a century ago. All told, people the government



classifies as working part time involuntarily swelled to 5.3 million in July 2008, a jump of greater than 1 million over the last year.<sup>18</sup> Add these people to the ranks of the “officially” unemployed and the unemployment/ underemployment rate swells to 10.3%.<sup>19</sup>

If the economic outlook is becoming so dire, we should probably embrace the government’s efforts to forestall its decline, right? Nope. The problem with this view is that the intervention-to-date is precisely the same intervention that was prescribed in past downturns and led to a build-up of over-leverage and instability in our financial system. (See Chart 5) “The Fed and Treasury have moved to bail

<sup>17</sup> Ned Davis, “Institutional Hotline,” *Ned Davis Research, Inc.*, August 1, 2008.

<sup>18</sup> Peter S. Goodman, “A Hidden Toll on employment: Cut to Part Time,” *The New York Times*, July 31, 2008.

<sup>19</sup> “Louis Uchitelle, “Jobless Rate Climbs to 5.7% as 51,000 Jobs Are Lost in July,” *The New York Times*, August 2, 2008.

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out large financial corporations under the smoke screen of a liquidity crisis,” wrote Jeremy Grantham, Chairman of GMO LLC. “As is increasingly realized, it was not a liquidity crisis primarily, but a solvency crisis... The bailouts are really providing what amounts to capital to insolvent firms as opposed to preventing the classic run on a bank...where a bank goes bust through no fault of its own. These bailouts permit a shameful lack of accountability for reckless behavior.<sup>20</sup>” Adds Roubini, “There are many ways to manage Bear or [the GSEs] in a fairer way. If public money is to be put at stake, first of all the shareholders of these companies have to be wiped out... The government bailed out everyone... In each one of these episodes the government bailed out the shareholders, the bondholders and to some degree, management,” he concluded<sup>21</sup>. Truth be told, the government didn’t bail everyone out. We taxpayers did.

Furthermore, there have been many market participants (like Roubini) who have warned of the storms approaching when they were still well off on the horizon, and much could have been done to prevent the damage now being wrought today. Rather than embrace the viewpoints of these prescient individuals, the government has chosen to go on a witch hunt and blame them for the very problems they foresaw. At the same time, the government proposes that Main Street bail out Wall Street and those that created this mess be saved on the public’s dime.

That “solution” is, to put it in Wall Street parlance, BULL! “Given the growing perception of incompetence that is broadly distributed throughout the system, we run a serious risk of meltdown in confidence in leadership,” wrote Grantham. “And with substantial justification! We should distrust the general competence of financial management: of governments and of corporations and of all bankers, whether commercial, investment, or central bankers.<sup>22</sup>”

Until a more formidable, painful and consequential plan out of this mess is offered, a true bottom for housing and the economy remains a distant wish. Given that this is an election year for a seemingly invertebrate Congress, we would advise against holding your breath, waiting on Washington for answers. But, given the bull emanating from our leadership, you may want to hold your nose.

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Note: As of August 5, 2008, certain portfolios managed by Caldwell & Orkin hold long positions in JPMorgan Chase (JPM).

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<sup>20</sup> Jeremy Grantham, “Meltdown! The Global Confidence Crisis,” *GMO LLC Quarterly Letter*, July 2008.

<sup>21</sup> Robin Goldwyn Blementhal, “Yes, That’s \$2 Trillion of Debt-Related Losses,” *Barron’s*, August 4, 2008.

<sup>22</sup> Jeremy Grantham, “Meltdown! The Global Confidence Crisis,” *GMO LLC Quarterly Letter*, July 2008.

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