



# UPDATE

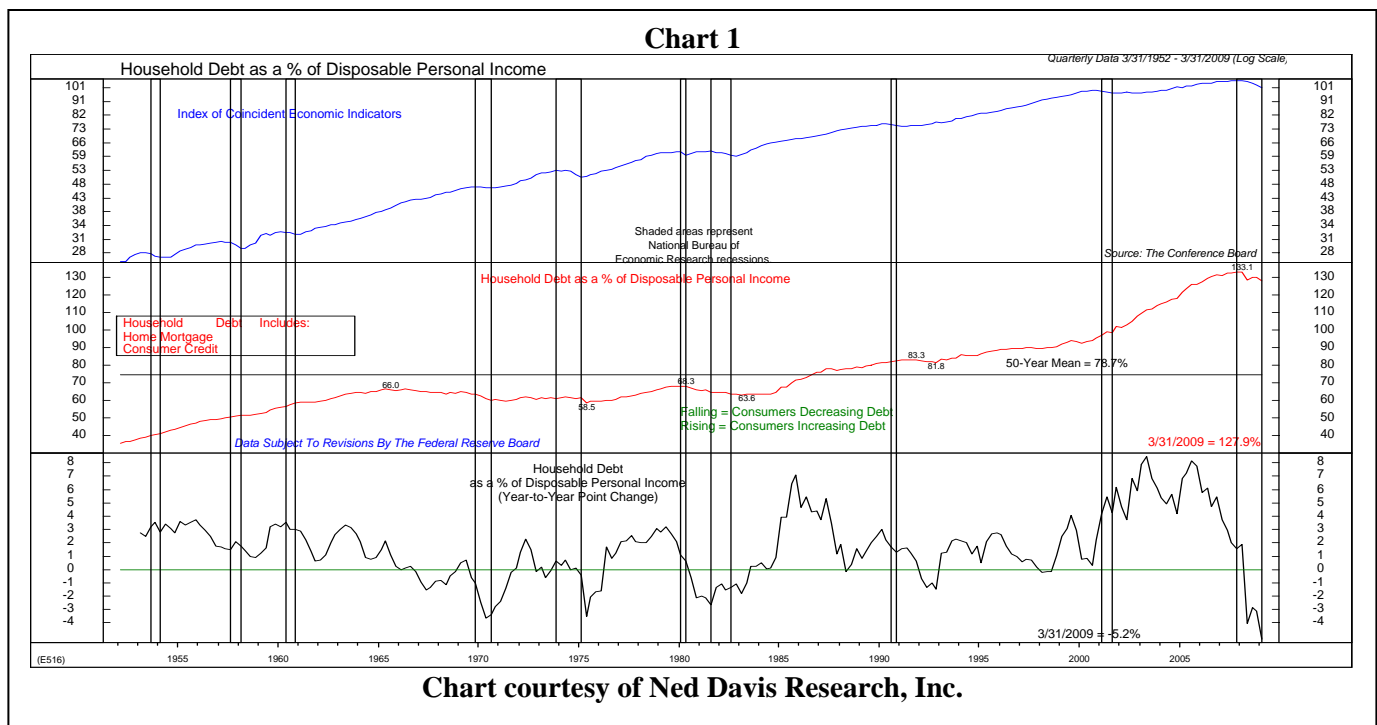
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*“Common sense tells us that consumer-spending growth comes from highly employed, well-compensated labor, and we are far-far from even approaching that elemental condition. The fact is that near double-digit unemployment has resulted from numerous business models that are now broken: autos, home construction, commercial real estate development, finance, and retail sales.”<sup>1</sup>*

-Bill Gross, CIO, PIMCO

## Consumer Thrift?

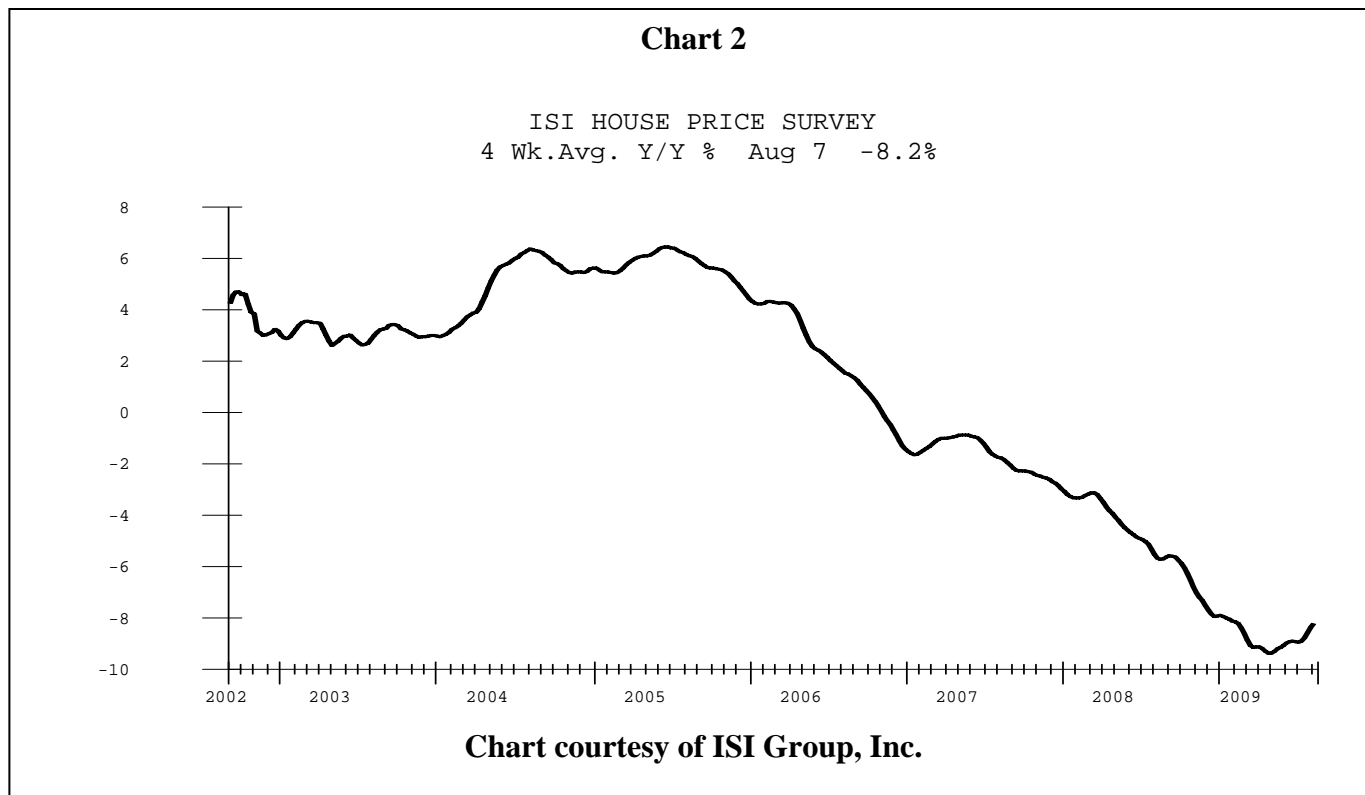


After more than two decades of conspicuous leverage-fueled consumption, the consumer has begun to chip away at the mountain of debt amassed when days were good. (See Chart 1.) Frozen out of the credit markets and devoid of home equity, the consumer socked away 6.9% of his income in May 2009. As savings have increased, early-stage credit card delinquencies have fallen. In short order prudence has replaced profligacy.

Consumer lending data analyzed by Mark Zandi, chief economist for Moody's Economy.com, found that the percentage of credit cards that were 30 days past due fell to 0.87% in June 2009 from 0.90% in March. Moreover, the data also indicates that mortgage delinquencies are slowing. The

<sup>1</sup> Bill Gross, "Investment Outlook," PIMCO, August 2009.

percentage of mortgages that were 30 days past due fell in June to 2.31% from 2.35% at the end of the first quarter, and the number of such mortgages is now running at an annualized pace of 1.15 million, compared with 1.19 million in March and 1.23 million in December 2008.<sup>2</sup>



The consumer's new found thrift is being accompanied by some much awaited good news from the housing market. After a record three-year plunge it appears house prices may be starting to bottom. According to data from the S&P/ Case Shiller Home Price Index, home prices rose 0.5% year-over-year in May 2009, the first gain for the index since July 2006. Data from ISI Group Inc.'s house price survey (see Chart 2) suggests the Case-Shiller index may continue to improve in June and July as well. In fact, housing market data is just one of the multiple positive data points that led Ed Hyman of ISI Group, Inc. to increase his 2010 real GDP (gross domestic product) forecast. "ISI's company surveys surged to a nine-month high last week, led by auto dealers and retailers," wrote Hyman. "ISI's truckers' survey increased for the 15<sup>th</sup> week. Unemployment claims 4-week average has now plunged -100,000. .. Stocks have surged around the world. Global money growth was probably 9.9% year over year in June. Here in the US, more and more cash for clunkers seems likely. Junk bond yields have plunged almost -1,100 basis points [-11%] from their peak. We are lifting our U.S. real GDP 2010 forecast to 4.0%. We can't recall a week with as much positive economic news as [the week of July 27, 2009]."

Like a classic game pitched by four-time Cy Young award winner Greg Maddux, rising housing and equity prices *and* falling interest rates could make some of the innings of the deleveraging game fly by. After all, the best remedy for a balance sheet heavy with debt is to add weight to the asset side of the

<sup>2</sup> Ruth Simon and Constance Mitchell Ford, "Consumer-Debt Picture Shows One Sign of Improvement," *The Wall Street Journal*, July 25-26, 2009.

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ledger, thereby balancing the scale. And while the market outlook has improved since the dark days of 666 levels on the S&P 500, we would highlight some caveats that suggest remaining guarded after the initial surge of fiscal and monetary liquidity takes hold.

For starters, it strikes us as a little bit curious where the consumer is finding money to save in an environment of falling incomes and rising unemployment. “One might reasonably wonder how the Saving Rate managed its impressive climb from 0.9% to 6.9% in nine short months, even as the economy shed a record 4.9 million jobs,” wrote Stephanie Pomboy of *MacroMavens*. “The bulk of the credit for increased saving belongs to Washington. Of the \$679 billion increase in savings over the 9-month stretch, fully \$371 billion came courtesy of direct government transfer payments and another \$351 billion in the form of reduced taxes. Together these two helped offset a -\$133 billion decline in wage income and -\$157 billion decline in “other” income, such as assets. So while the -\$247 billion reduction in consumer spending over the stretch is impressive (and unprecedented) had it not been for Washington, that parsimony still would not have kept pace with the -\$290 billion decline in earned income.<sup>3</sup>” Still, with no assistance from government transfer payments, the savings was 4.6% in June 2009. True, that’s down -2.3% from the month before, but the point is the consumer is saving!

Until we see more definitive signs of a trend, however, the budding good news on the mortgage and credit card delinquency data should be taken with a grain of salt or a spoon full of sugar (your choice). Some economists suspect that the improvement in mortgage delinquency data is the result of mortgage modifications that are being encouraged by the Obama administration. When a mortgage is modified, it is re-classified as current. But 40.0% or more of the “re-modified” borrowers have fallen at least 60 days behind within six months after their loan is modified.<sup>4</sup> So the improvement in mortgage delinquency data may yet prove to be temporary. As for the credit card data, the decline in early stage delinquencies coincided with a one-time increase in tax rebate checks this spring. Some economists anticipate a second wave of credit card delinquencies will hit, driven by the deterioration in the job market.

Despite the July 2009 employment data showing a decline in the unemployment rate to 9.4% and a better-than-expected loss of -247,000 jobs, we remain guardedly cautious on the overall job market. “After hitting record highs, continuing claims have started to fall,” observed Pomboy. “While smiley-faced pundits are spinning this as good news, the conspicuous absence of job creation suggests these folks aren’t finding new work. Quite the contrary, with the Unemployment Benefit Exhaustion Rate hitting record highs it is clear that the meter has simply run out.<sup>5</sup>” That said, a broader measure of the nation’s unemployment, which includes those who have fallen off the official unemployment roster, also fell month over month in July 2009 from 16.5% to 16.3%. No doubt 16.3% is an extraordinarily high number, but it’s an improvement nonetheless.

According to the minutes of the last meeting of the Federal Reserve’s Federal Open Market Committee (FOMC), the unemployment rate could be elevated for some time. The Fed’s quarterly

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<sup>3</sup> Stephanie Pomboy, “More Lies and Statistics,” *MacroMavens*, July 31, 2009.

<sup>4</sup> Ruth Simon and Constance Mitchell Ford, “Consumer-Debt Picture Shows One Sign of Improvement,” *The Wall Street Journal*, July 25-26, 2009.

<sup>5</sup> Stephanie Pomboy, “More Lies and Statistics,” *MacroMavens*, July 31, 2009.

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projections are for the jobless rate to reach between 9.8% and 10.1% at the end of 2009 and to remain above 9% in 2010 and 8% in 2011, staying well above its "longer run sustainable rate"<sup>6</sup> of 4.8-5.0%.

The second quarter 2009 earnings season has provided evidence supporting the Fed's employment forecast. With a theme of better margins, company after company has managed to beat earnings expectations despite lackluster sales (read: weak demand) through aggressive cost reductions in headcount and capital expenditures. "Because managements cut employment by a record amount, productivity has been unusually strong. Wages have been restrained to an unprecedented extent," wrote Hyman. "In short, managements in the second quarter slashed costs – employment, replacement capex, advertising, travel budgets, etc. to levels that are now unsustainable. Because it appeared that the economy was going into a depression, managements cut employment by a record –4.8%, much more than the –3.1% cut history would suggest given the decline in GDP." As a result, personal income fell 1.3% in June while private wages and salaries fell for a fourth month in a row, slipping \$28.6 billion,<sup>7</sup> or 0.56% month-over-month.

Unfortunately for the unemployed and underemployed, a recent study by Till von Wachter, an economics professor at Columbia University, found it can take years for a worker's earnings to bounce back after a layoff, and that it can take even longer to bounce back if the layoff occurs during a recession. "On average, most workers do not recover their old annual earnings," von Wachter said. He found that even 15 to 20 years later, most laid off workers on average had not returned to their old wage levels, and that their earnings were about 15-20% less than they would have been had they not been laid off.<sup>8</sup>

Despite these headwinds, the consumer is re-stocking the cookie jar. Coupled with the potential stabilization (if not appreciation, however temporary) of asset values, the acceleration in the pace of the deleveraging game could be significant. While a positive first step, we still have a long way to go to restore balance sheets to good health. We will be watching monetary aggregates, the dollar, interest rates and other variables to judge if and when to turn more or less defensive.

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<sup>6</sup> Brian Blackstone and Jon Hilsenrath, "Fed Girds for Rising Unemployment, Growth," *The Wall Street Journal*, July 16, 2009.

<sup>7</sup> Jack Healy, "Higher Prices Pushed Up Consumer Spending for June," *The New York Times*, August 5, 2009.

<sup>8</sup> Michael Luo, "Years After Layoffs, Many Still Struggle to Match Old Salaries," *The New York Times*, August 4, 2009.