



CALDWELL & ORKIN[®]

UPDATE

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Waiting for Clarity

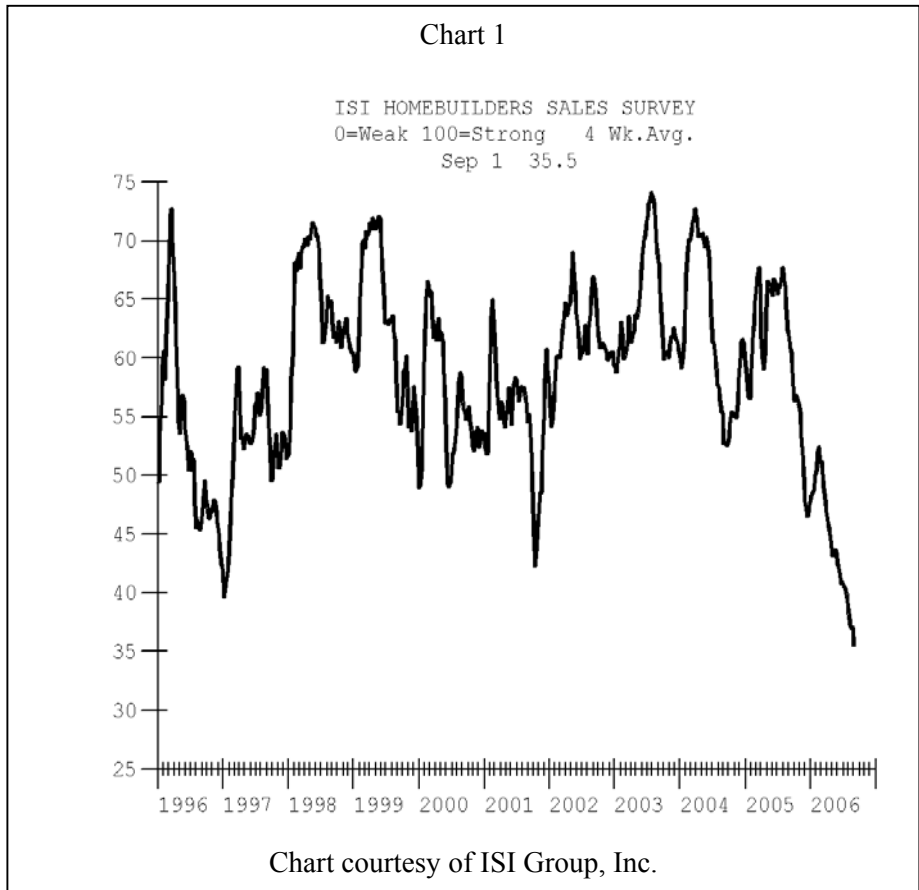
We are currently at a transitional point in the economic cycle in which there is little clarity in the future growth outlook. After increasing the Fed Funds rate from 1.0% to 5.25%, the Federal Reserve has now come to a pause in their interest rate tightening cycle. Does this mean the Fed is done? We do not know and neither do they. In an August 7, 2006 *Wall Street Journal* article by Christopher Conkey entitled, Growth in Consumer Prices Slows, Richard Fisher, president of the Federal Reserve Bank of Dallas, said, "If anybody tells you with absolute conviction that the Fed is done raising interest rates or with equal conviction that they have only paused and will raise rates more...remind yourself that, at best...they are only guessing." According to Greg Ip, the supposed voice of the Fed at *The Wall Street Journal*, the decision by the Fed to pause was not easy. In his August 30, 2006 article entitled, Fed Policy Makers Saw Rate Pause as 'Close Call', Ip writes that the Fed "characterized the purpose of the pause as enabling them to 'accumulate more information before judging' whether further increases would be needed."

Certainly we must give credit to Federal Reserve Board Chairman Ben Bernanke and his crew at the Fed. While we may still see a few months of higher inflation readings, Economy.com's latest inflation survey reported price pressures have notably declined in the past several weeks. Moreover, the economic releases since the last Fed meeting have, thus far, supported their bold bet to pause. Domestically, inflation readings including the Producer Price Index (PPI) and the Consumer Price Index (CPI) have come in below expectations and the gross domestic product (GDP) for the second quarter showed weaker than expected annualized growth of 2.9%. Internationally, it appears that interest rate tightening by the European Central Bank (ECB) and the Bank of Japan (BoJ) is beginning to take hold. Recent inflation data from Germany and Japan was weaker than expected and economic growth forecasts in these countries have been lowered. One could reason that these statistics fit well into the bullish mid-cycle slowdown scenario made popular by Ed Hyman at ISI Group Inc. (See May 2006 and August 2006 *Updates*.)

We wonder what sort of economic growth, or lack thereof, can be expected going forward. Ed Hyman's mid-cycle slowdown outlook is for annualized GDP growth to experience a soft landing in the 2-3% range. Nouriel Roubini, Chairman of Roubini Global Economic Monitor wonders if this level of growth is possible given the Fed's outlook on inflation. In an August 11, 2006 *New York Times* article by Edmund L. Andrews entitled Economy Often Defies Soft Landing Roubini says, "Either the Fed does not believe its own inflation forecast, which I don't think is the case, or the slowdown is going to be greater than what they have been saying. They can't have it both ways." Ed Hyman has mentioned the risk that the economy could experience a "rough landing" in which annualized GDP growth slows to the 1-2% range. While Hyman still has faith in his soft landing scenario, the mention of the risk of a rough landing was notable in that it evidenced a small, but growing lack of clarity in his forecast. The culprit: weakness in the housing market.

The precipitous decline in ISI's housing survey (see Chart 1) has led Hyman to forecast a nationwide year-over-year decline in home prices, something many investors not-to-long-ago believed to be "unthinkable."

But, according to Yale University economist Robert J. Shiller, the "unthinkable" aspect of housing prices, in reality, is the remarkable gains experienced over the last eight years (see Chart 2). According to Shiller, residential real estate prices rose 66% between 1890 and 2004, adjusted for inflation, or just 0.4% a year. But between 1997 and 2005, they rose by 52% or an unprecedented 6.2% per year. According to David Rosenberg, North American economist for Merrill Lynch, we can trace



almost two-percentage points of the 3.5% average annual rate in real GDP over that time frame to the boom in housing construction and home prices. These bubblicious gains in house prices were clearly the fuel for economic growth during this expansion and are now a thing of the past.

Were it not for the use of sales incentives, home prices would now actually be falling. According to an August 25, 2006 *New York Times* article by Vikas Bajaj and David Leonhard entitled, Home for Sale by Anxious Owner, sellers are offering thousands of dollars in incentives so they do not have to lower their asking prices. Executives at the nation's biggest builders say incentives on their newly built homes can equal 3% to 8% of a home's sale price. The article concludes that builders tend to use discounts in a slowdown because they worry that reductions in the list price would send a clear signal that the market is in trouble. Sounds like something out of the automakers' playbook...and we can see where that led.

Certainly the Fed has taken note of the housing woes. In an August 23, 2006 *Wall Street Journal* article by James Hagerly and Michael Corkery entitled, Housing Slump Proves Painful For Some Owners and Builders, Michael Moskow, President of the Federal Reserve Bank of Chicago, said, "While we factor a housing slowdown into our outlook, there is some evidence that the slowdown could be more extensive." Evidence, that is, like the following quote from the CEO of one of the nation's largest home builders on his company's quarterly conference call: "It would be difficult to characterize the position of home builders as other than in a hard landing."

Chart 2

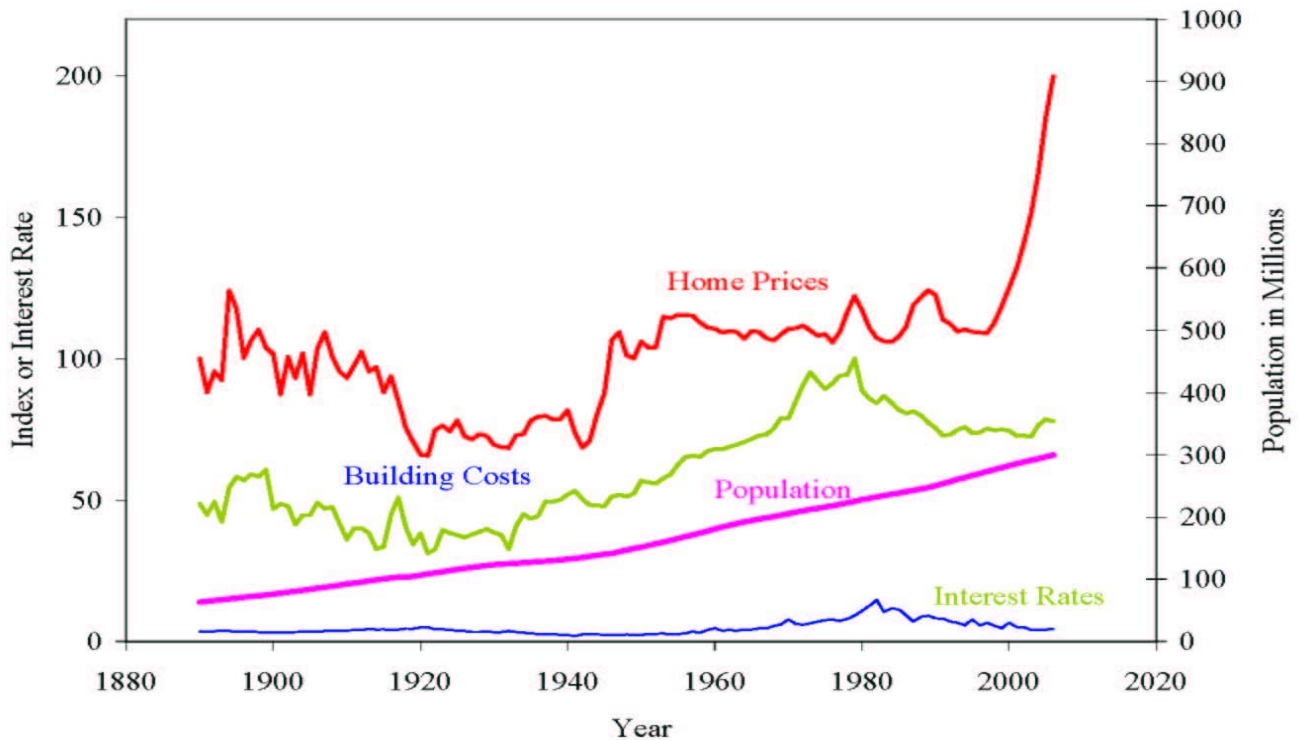


Chart courtesy of *Irrational Exuberance*, Second Edition, Princeton University Press 2005, by Robert J. Shiller

It seems there is little way for the consumer to escape a hard landing in housing. Stagnating or falling house prices make it more unlikely that leveraged consumers will continue to withdraw equity from their homes, thus removing the fuel that drove consumption which in turn accounted for 75% of GDP growth during this current expansion. In his August 11, 2006 *Grant's Interest Rate Observer*, Jim Grant writes, "The present day is the most openhanded in the long history of lending and borrowing. At no time prior to the present was home-equity extraction so temptingly easy. Since 2002, according to Goldman Sachs, American homeowners have withdrawn funds enough to add 2.5% of growth a year to real GDP." Wow!

Worse yet, evidence continues to mount that mortgages have been granted to already overextended homebuyers. After analyzing recent mortgage statistics, David Rosenberg found that 32.6% of new mortgages and home equity loans in 2005 were interest-only, up from 0.6% in 2000. Shockingly, 43% of first-time home buyers in 2005 put no money down, 15.2% of 2005 buyers owe at least 10% more than their home is worth (what is called negative equity or being under water), 10% of all home owners with mortgages have no equity in their homes and \$2.7 trillion dollars in loans will adjust to higher rates in 2006 and 2007. According to an August 22, 2006 *Wall Street Journal* article by LingLing Wei entitled, [Stated Income Home Mortgages Raise Red Flags](#), industry experts say loans with reduced documentation now account for about 40% of the entire mortgage pool. Apparently, greater competition and the desire to simplify and quicken the loan origination process have led more lenders to extend stated-income loans to borrowers with lower credit scores and higher loan-to-value and debt-to-income ratios than traditionally allowed. Not a pretty picture.

Noted political expert and Washington insider Tom Gallagher of ISI believes bank regulators are about to put a halt to these aggressive lending practices. Gallagher believes investors should expect bank regulators to crack down on option-ARM (adjustable rate mortgages that give the buyer the option of paying less than the monthly payment) and interest-only (IO) loans, and they should also expect a major Congressional backlash to develop over the next year or two against the banks that have offered these loans, particularly to low-income borrowers. According to Gallagher, as housing “conditions worsen it will become clear just how much lending standards were relaxed during the boom. What’s more, a political backlash against the mortgage lenders on par or perhaps even greater than the one following...the collapse of the Nasdaq [remember the technology bubble of 2001?] appears likely.”

In conclusion, recent economic data is validating the mid-cycle slowdown view. Due to housing weakness, we believe that growth will likely slow more than this forecast predicts. After all, it’s hard to breathe when you’re under water.

We continue to have long exposure to sectors we believe will do well in an environment of slowing economic growth, including consumer staples, utilities and pharmaceuticals. We also remain confident that a significant cooling in the housing market will have a retarding affect on both lending and consumption and will negatively impact companies with the most exposure to a leveraged consumer. To this end we maintain short exposure to select homebuilders, mortgage lenders, furniture manufacturers, the consumer discretionary sector, casual dining restaurants and residential loan-sensitive banks.

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