



UPDATE

September 2008

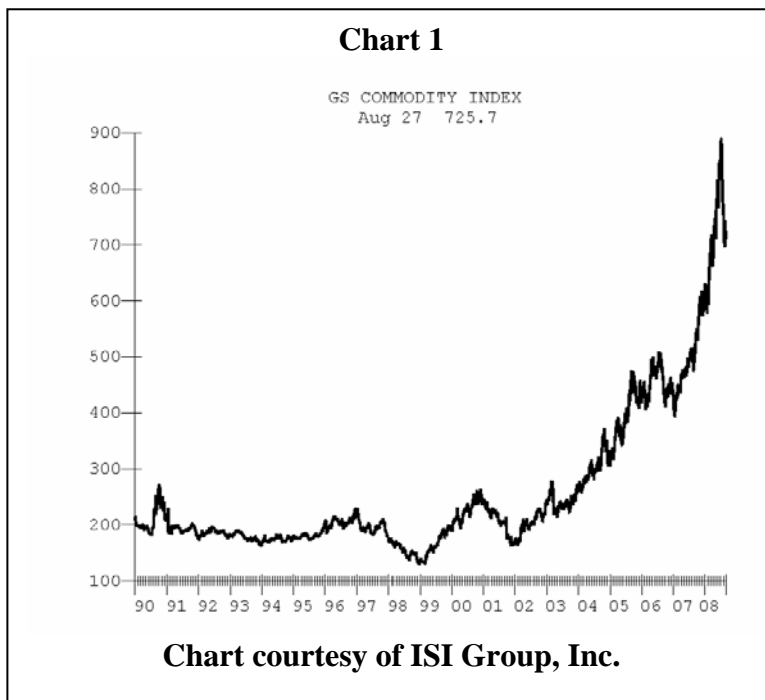
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“The recent decline in commodity prices as well as the increased stability of the dollar has been encouraging. If not reversed, these developments, together with a pace of growth that is likely to fall short of potential for a time should lead inflation to moderate later this year and next year.”

-Ben Bernanke, Chairman of the Federal Reserve

Belt Tightening

The theory of worldwide economic decoupling has been laid to rest in the crowded graveyard of Pollyannic economic thought. Over the past few weeks it has become clear that, just as in downturns of the past, the world has indeed caught our economic cold. In the second quarter of 2008, real gross domestic product (GDP) growth in the United Kingdom was 0.0%, the weakest growth in 16 years. The Eurozone GDP growth rate fell to -0.2% in the second quarter, the first time since the early 1990s that overall GDP has fallen in the 15 countries that use the euro¹. Japan, with the second largest economy in the world, fared worse still, with a real GDP decline of -2.4% in the second quarter.



This worldwide economic malaise has been greeted with a casual indifference by the equity markets that is to some degree understandable. Whereas bullish investors can no longer rely on the decoupling theory and the foreign economic and earnings growth it encompassed, they now rest their case on the precipitous decline in inflation wrought by the destruction of demand that comes with slowing economic growth. By being wrong, they hope maybe they will be right.

This month, the market shrugged off news that in July producer prices rose 9.8% year-over-year and consumer prices rose 5.6% year-over-year, the fastest rate for both since the early '90s. “The cure for the inflation problem is a recession in

¹ Justin Lahart, Alistair MacDonald and Marcus Walker, “World Economy Shows New Strain,” *The Wall Street Journal*, August 15, 2008.

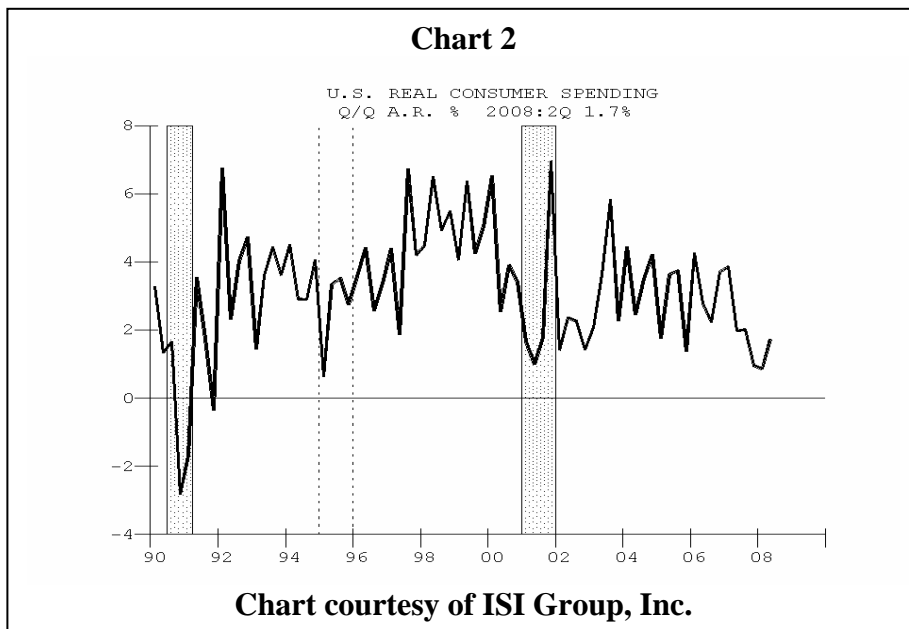
the United States and Europe,” said Robert Barbera, chief economist at the research and trading firm ITG. “We have a recession, and while that’s lamentable, it makes the inflation numbers old news.”² Perhaps Mr. Barbera is correct. After all, the Goldman Sachs Commodity Index (GSCI) has declined -29.7% from its peak on July 3, 2008 to its August 15, 2008 low. (See Chart 1.) Fueling this decline was a -24.4% peak-to-trough drop in the price of a barrel of crude oil and a -44.5% peak-to-trough decline in natural gas prices.

While we agree that inflation pressures may ebb, we disagree that the default implication for equities is bullish. After all, the decline in commodity prices is largely being driven by a disturbing lack of consumer purchasing power. In July, rank-and-file workers — those in production or nonsupervisory roles — earned 3.1% less than they did a year ago, the 10th consecutive month that the weekly average salary failed to keep pace with inflation, according to statistics from the Labor Department.³ “There’s nothing in here to feel good about,” said [Jared Bernstein](#), senior economist at the labor-oriented [Economic Policy Institute](#) in Washington. “The consumer is either going to get smacked around by inflation or a sagging economy. If you’re someone who depends on a paycheck, neither one helps you very much.”⁴

According to Ed Hyman at ISI Group, Inc., the lack of disposable personal income has brought consumer spending to its weakest levels in 17 years. “Over the past year, real consumer spending has increased just 1.3%,” Hyman said, “the weakest since the end of the 1990s recession. And judging by ISI’s retailers surveys and vehicles sales for July, consumer spending is starting 3Q on an even weaker note.” (See Chart 2.)

Consumers are tightening their belts.

The inflation decline should also be exacerbated by the recent stagnation of the money supply. “One of the reasons I am more optimistic that the upward trend in inflation is about to moderate,” wrote Ned Davis of Ned Davis Research, Inc., “is that despite the Fed panic to bring short-term interest rates to negative real yields (which is usually inflationary) they have not monetized this past year’s price increases by pumping up the money supply excessively. Inflation-adjusted money supply growth is barely

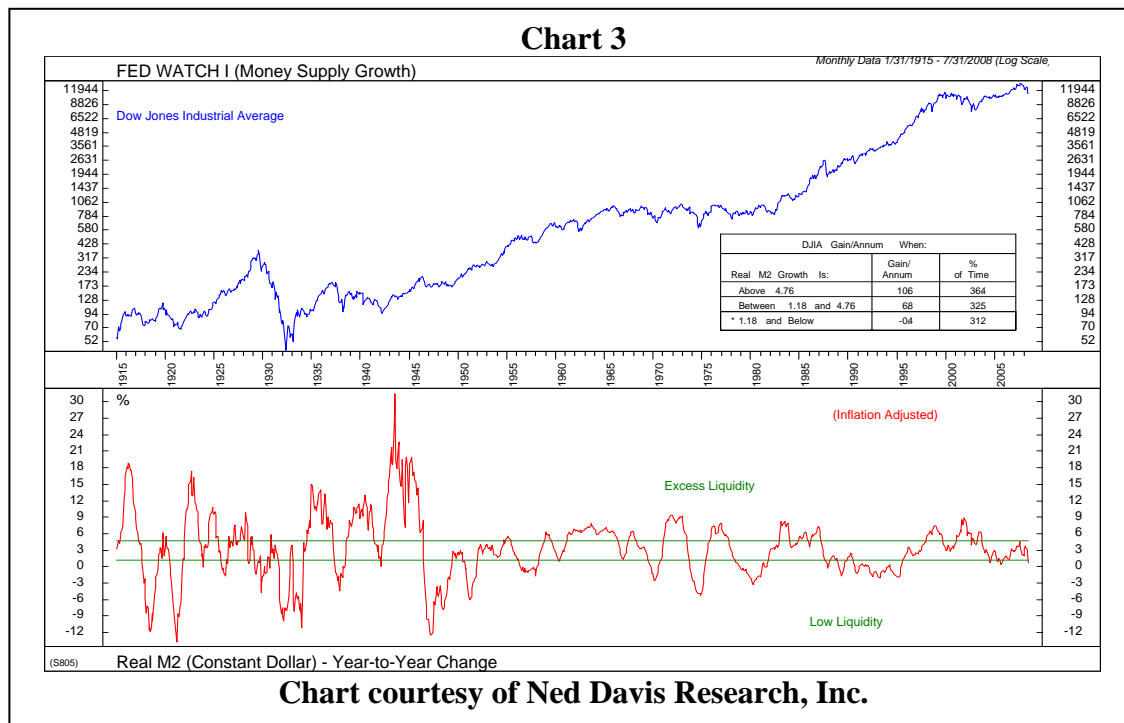


² Michael M. Grynbaum and Peter S. Goodman, “Higher Costs Taking a Toll On Business,” *The New York Times*, August 20, 2008.

³ Michael M. Grynbaum, “Living Costs Rising Fast, And Wages Are Trailing,” *The New York Times*, August 15, 2008.

⁴ Michael M. Grynbaum and Peter S. Goodman, “Higher Costs Taking a Toll On Business,” *The New York Times*, August 20, 2008.

positive. This should be positive for a peak in inflation, but also suggests a sluggish environment for stocks and the economy.⁵ (See Chart 3)



Sluggish money supply growth is a reflection of the new-found risk aversion among deleveraging financial institutions. As these firms have continued to raise capital and digest mounting losses from their past lending sins, banks have found their bellies simply too full to digest further

loan growth, no matter how tasty the spreads may be. Indeed, two-thirds of domestic banks tightened lending terms between April and July 2008 for credit cards and other consumer loans and almost half tightened standards for other loans such as mortgages and business loans.⁶ “We have never been this low on lending practices [and] not [been] in a recession,” wrote Ned Davis. “Less demand and less supply sound like a weak economy with credit problems.”⁷ (See chart 4.)

Banks are tightening their belts.

Non-financial companies are struggling with a stagflationary environment in which their costs have soared while their end market demand has weakened. Wholesale prices for goods purchased by American businesses jumped by nearly 10.0% over the last year, the sharpest increase since 1981. While businesses have been absorbing some of the higher costs themselves, they have tried to pass much of the increase to consumers, intensifying the strain on households just as joblessness expands and spending power shrinks⁸. Adding to their woes, corporations joined consumers in the debt bonanza and now find themselves with overly-leveraged balance sheets. “During the bull market, corporations raised lots of new debt and used that to reduce equity on balance sheets through buybacks, mergers, leveraged buyouts, and acquisitions,” wrote Ned Davis. “What this did was to greatly add leverage to corporate balance

⁵ Ned Davis, “Institutional Hotline,” *Ned Davis Research, Inc.*, August 22, 2008.

⁶ Sudeep Reddy, “More Banks Tighten Lending Standards,” *The Wall Street Journal*, August 12, 2008.

⁷ Ned Davis, “Institutional Hotline,” *Ned Davis Research, Inc.*, August 19, 2008.

⁸ Michael M. Grynbaum and Peter S. Goodman, “Higher Costs Taking a Toll On Business,” *The New York Times*, August 20, 2008.

Chart 4

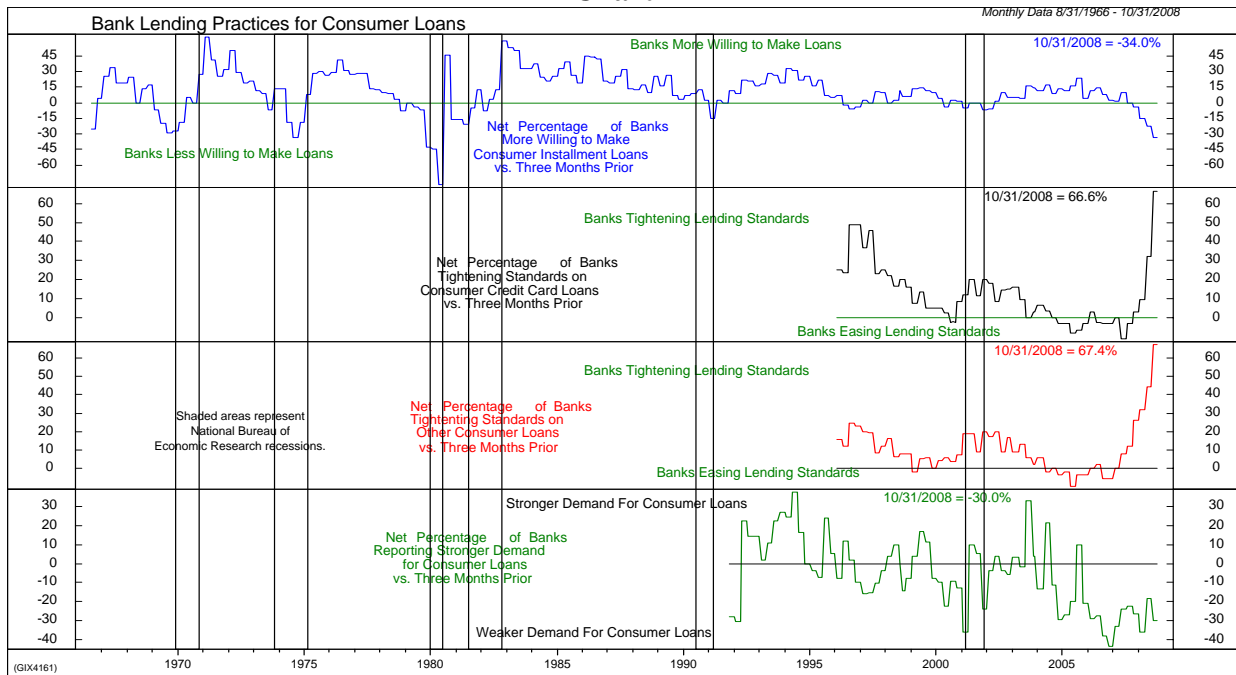


Chart courtesy of Ned Davis Research, Inc.

sheets... Since 1984, corporate balance sheets have seen the net addition of \$5.2 trillion in debt while equity on balance sheets has plunged some \$3.5 trillion. Despite strong productivity and low unit labor costs, [this] leverage has probably already begun to make itself felt. The latest four quarters of actual Dow Jones Industrial earnings [per share] are -\$108.53, quite a drop from \$830.94 a year earlier.⁹” (See chart 5.)

Corporations are tightening their belts.

Chart 5

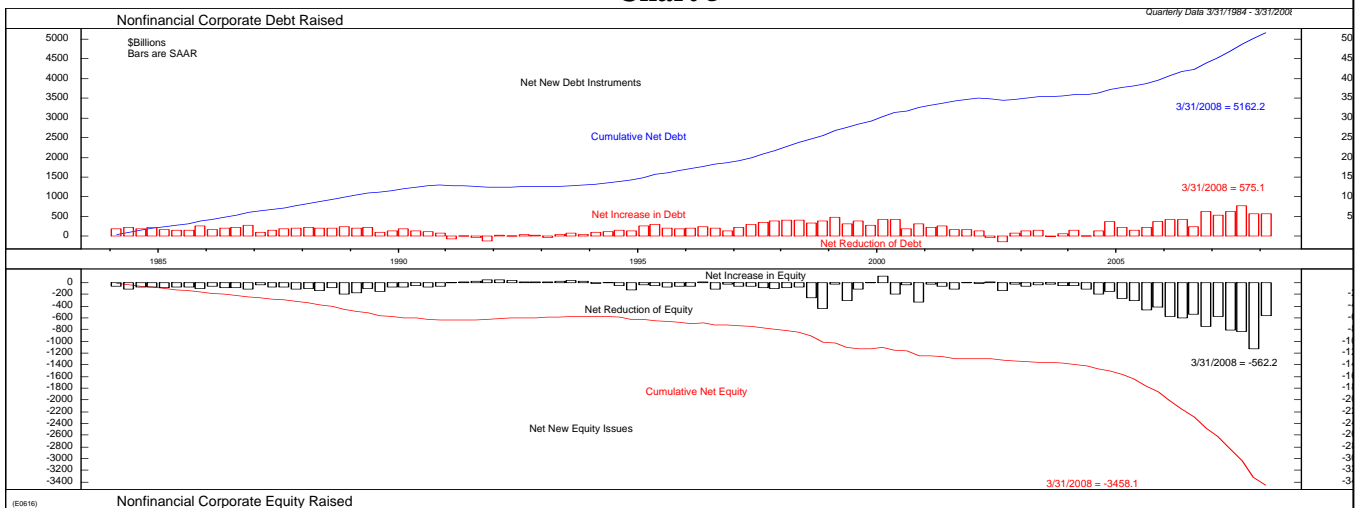
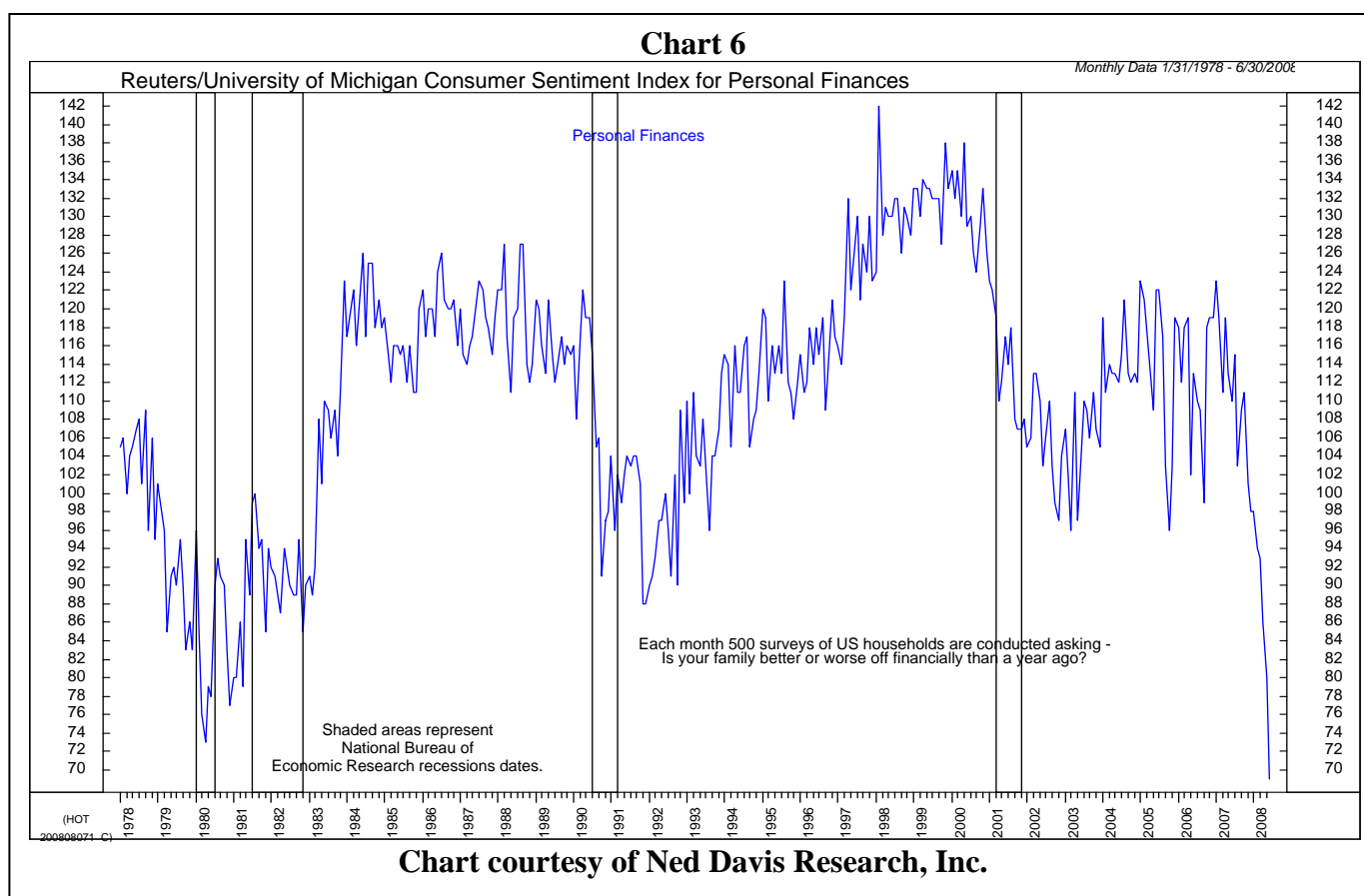


Chart courtesy of Ned Davis Research, Inc.

⁹ Ned Davis, “Institutional Hotline,” *Ned Davis Research, Inc.*, August 19, 2008.

Given the considerable belt tightening by consumers, banks and corporations, we anticipate that the recent period of extraordinary inflationary pressure will quickly be replaced by deflationary fears as the credit crisis continues to play out. While a disinflationary environment has historically provided a positive backdrop for business returns as well as equity returns, what makes this period different, and keeps us guarded in our investment outlook, is the degree to which the consumer is now stretched. “My contention is that debt and over-consumption problems are not limited to housing...personal finances [are] at a record low,” wrote Ned Davis. (See Chart 6.) “Mind you, this comes in the face of the most aggressive Fed easing in history to 2.0% Fed Funds rate, rapid action by Bush and Congress to send out massive tax rebates, all kinds of housing stimulus, and unbelievable bailouts of anybody big in trouble, and still rising GDP... Consumers are overbought and overborrowed. Goldilocks has no clothes. Consumers are not dreaming this up. The debt is real and there is \$50 trillion of it.”



Adding to Ned’s caution, data from *Lowry’s Reports* indicates that investors should remain skeptical that a true bottom in equity prices has been found. “It is the very nature of bear markets to constantly entice investors to jump back in too soon,” wrote Paul Desmond. “The lesson to be learned is to remain skeptical of every rally attempt until the evidence is compelling that the Supply of stock being offered for sale is drying up, and that renewed investor Demand is both broad and strong. [The] increase in selling pressure, to its highest level of the bear market...shows no signs of diminishing selling [which is] so vital to the start of a sustained market advance... Bear market rallies often seem very attractive

while they are occurring, but they typically end abruptly, often wiping out in a few days gains that took weeks to achieve.”

We remain guarded in our investment outlook as we doubt this will be a positive environment for equity investment. However, given the increased volatility in the equity markets (thanks in no small part to continued serial real and rumored government intervention) we have greatly reduced our market exposure.

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