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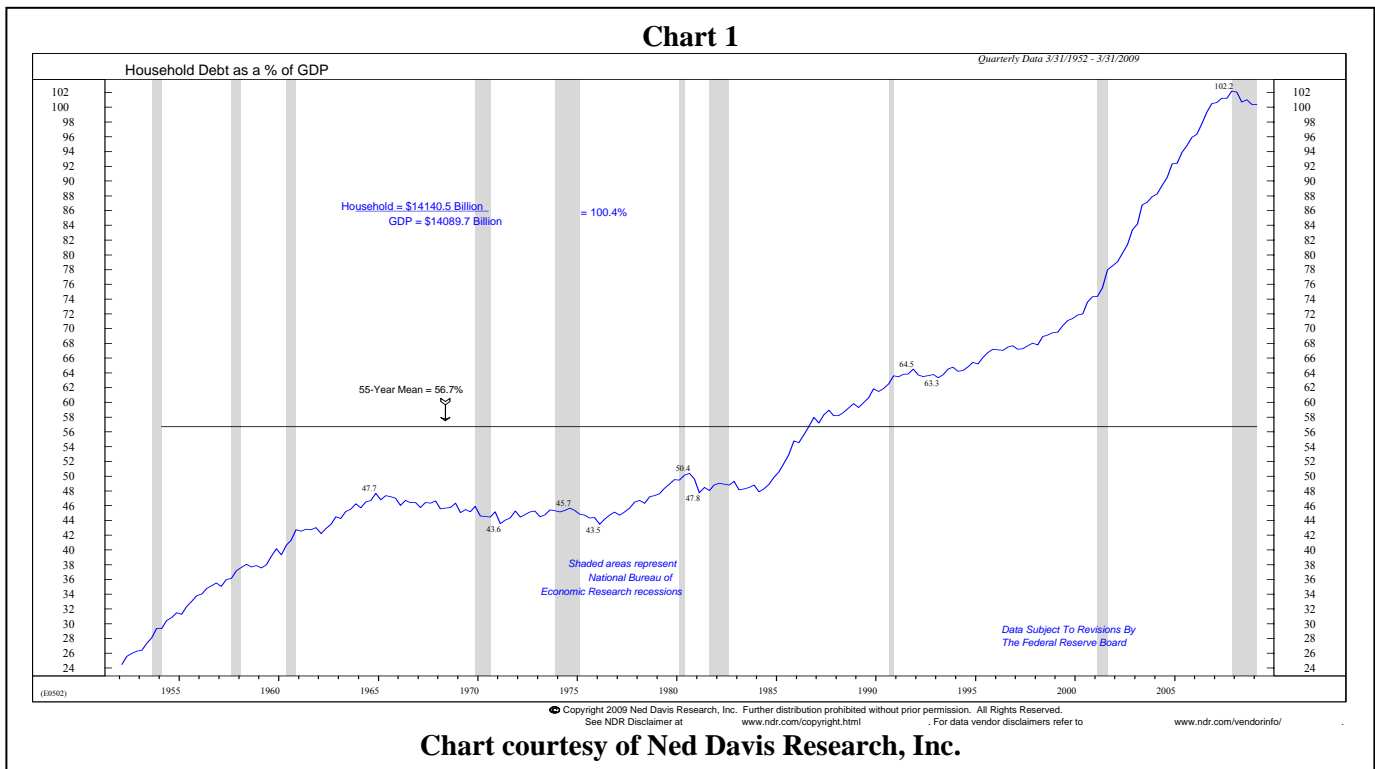
September 2009

CALDWELL & ORKIN®

“The error of optimism dies in the crisis, but in dying it gives birth to an error of pessimism. This new error is born, not an infant, but a giant.”

-A.C. Pigou, 1877 -1959

The Great Unwind

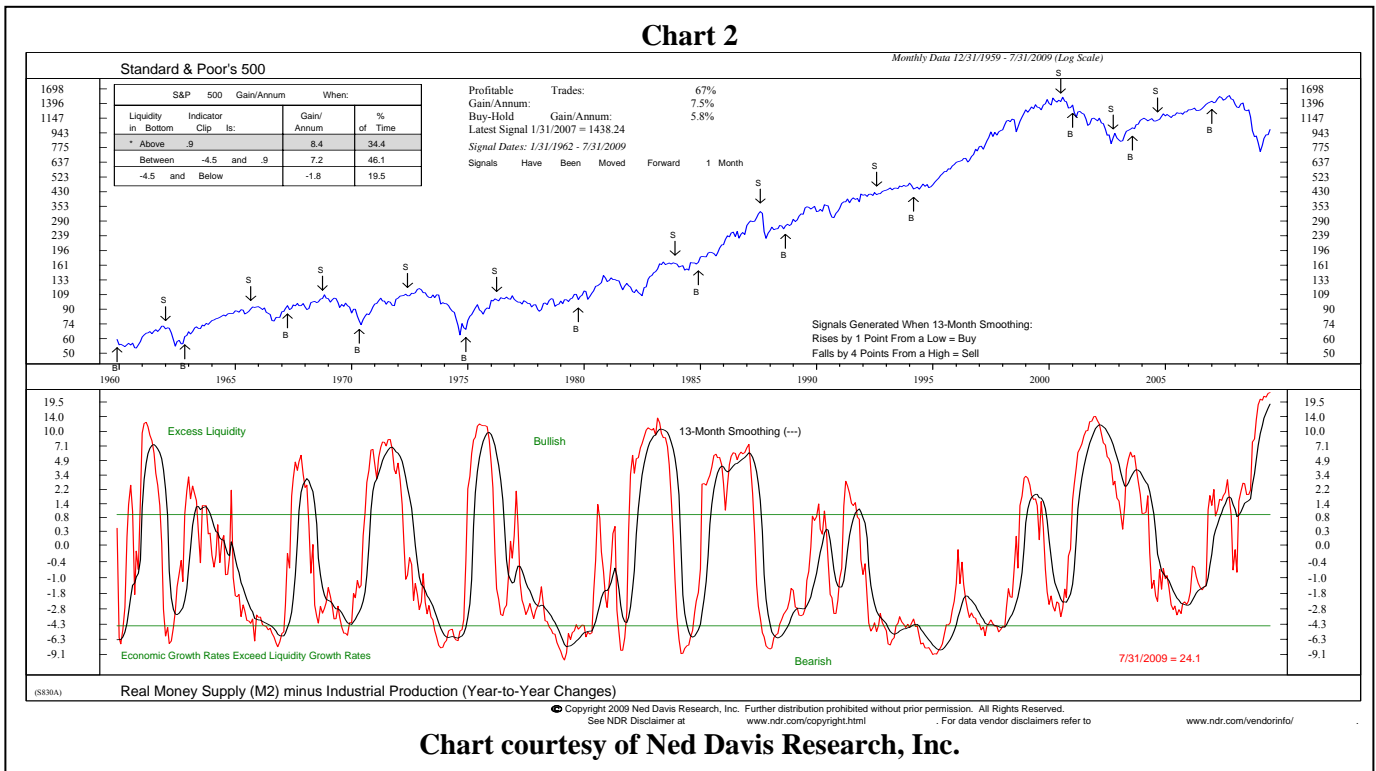


Judging by July's record -\$21.6 billion borrowing free-fall, the consumer continues his economic retrenchment. The monthly decline in credit was not only the largest on record, but it also marked the sixth straight month that consumer credit has declined, the longest such streak since 1991.¹ During the boom, consumers frivolously drove their savings into negative territory by running up credit card balances and tapping the equity in once-rising home values so they could spend in excess of what they earned. Now, a 9.7% unemployment rate and a historic decline in home values have left even those who still have the means feeling pressure to save. Some economists suggest this recession has endured so long and spread pain so broadly that it has seeped into the culture, downgrading expectations, clouding assumptions about the future and eroding the once unstoppable impulse to buy.²

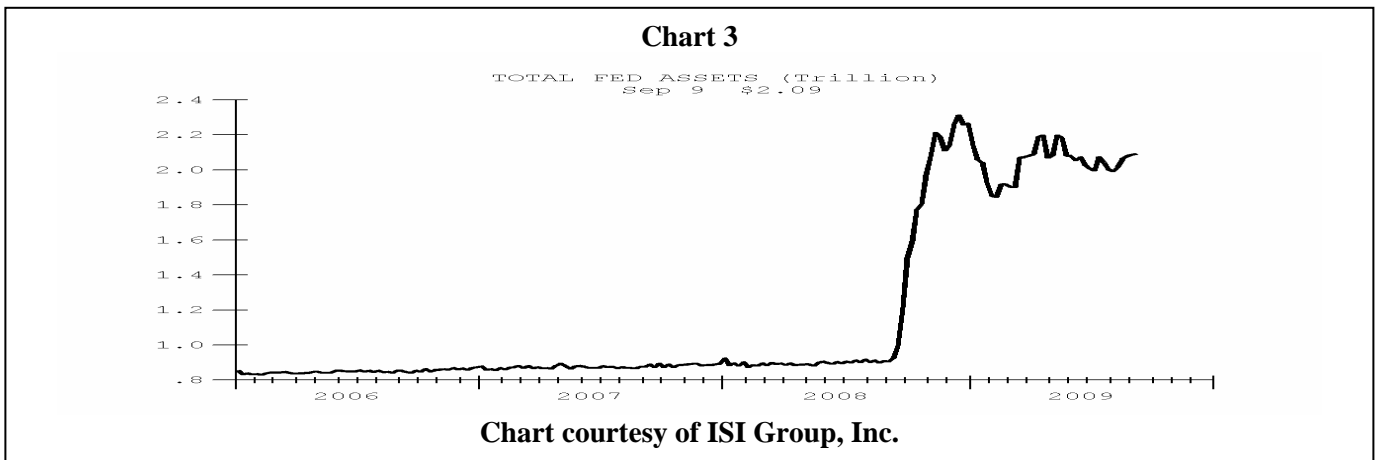
¹ Bob Willis and Vincent Del Giudice, "Record Plunge in U.S. Consumer Credit Signals Weakened Spending," *Bloomberg News*, September 9, 2009.

² Peter S. Goodman, "Consumer Thrift in U.S. May Last After Recession," *The New York Times*, August 29, 2009.

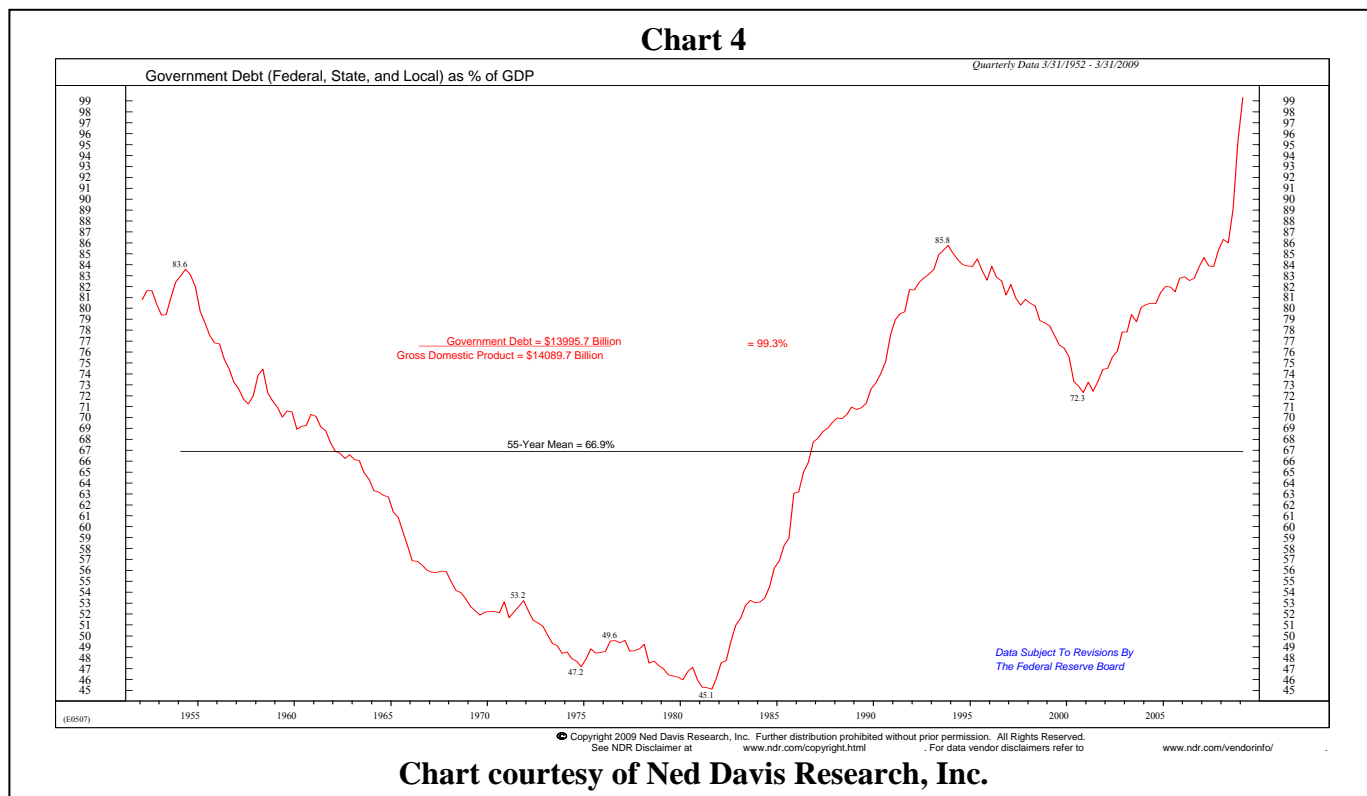
Consumer deleveraging is long overdue and, in the long run, healthy for our economy on both a micro and macro level. However, as can be seen on Chart 1, the good work of consumer balance sheet repair is in its infancy. Amassing this \$14 trillion mountain of debt was a fast, unencumbered task thanks to former Federal Reserve Chairman Easy Al Greenspan's easy money and the abandonment of underwriting standards. The unwind will likely be a painstaking paycheck by paycheck descent as consumers labor with shrinking incomes to retire debt that is no longer supported by inflated asset prices.



Not willing to sit back while 70% of the economy goes into hibernation, the government fired up the policy engines to offset consumer thrift. The stimulus charge has been led by the monetary policy decisions of current Fed Chairman, Ben Bernanke, focusing on unprecedented growth in the money supply (see Chart 2) and equally unprecedented balance sheet expansion (see Chart 3). Not to be outdone,



fiscal policy has kicked into high gear as well, while overall government debt (state and federal) as a percentage of GDP has moon-shot from a record 86.0% to a still higher 99.3% over the last several quarters (see Chart 4). Given the Congressional Budget Office's (CBO) estimated federal budget deficit of -\$1.4 trillion for 2010 (roughly 10.0% of GDP), this ascent is likely to grow steeper in the near future.



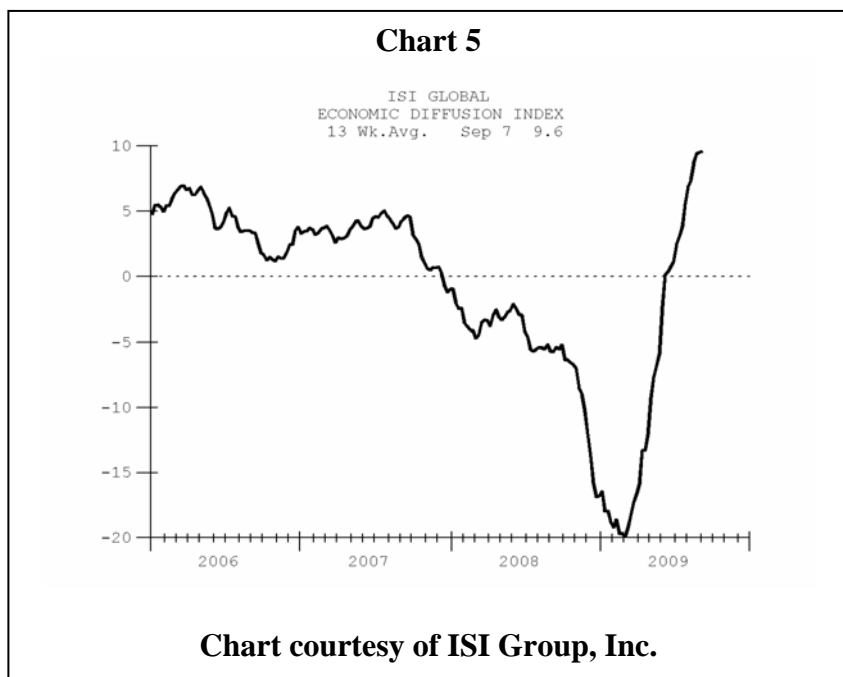
While economists debate the government's policy prescriptions, debt-fueled growth knows no master. Just as easy-money mortgages fueled growth in the middle of this decade, so to the government's printing press is fueling a resumption of growth today. According to Ed Hyman of ISI Group, Inc., we are likely seeing an unprecedented synchronized global upturn. "The Lehman shock put virtually every economy in the world on the same page and prompted synchronized policy responses," Ed wrote. "As a result, to an unusual – and perhaps unprecedented – extent, economies are improving across the world at the same time, as reflected in ISI's global economic diffusion index, which has moved up sharply." (See Chart 5)

Lo and behold, the government-sponsored fuel is also helping to stabilize housing. According to the S&P Case Shiller home price index, second quarter home prices rose 1.4% quarter-over-quarter. The rise in prices in June marked the first time the index has risen two months in a row since 2006. Sales are on the rebound as well. Sales of single-family homes increased 7.2% in July from a month earlier to a seasonally adjusted annual rate of 5.24 million units, the largest monthly increase since 1999.³ "Momentum matters," said Robert Shiller, the Yale University economist who helped create the Case Shiller index. "This is a sudden break in [downside] momentum."⁴

³ James R. Hagerty and Nick Timiraos, "Housing Lifts Recovery Hopes," *The Wall Street Journal*, August 22-23, 2009.

⁴ Nick Timiraos, "Home Prices in Major U.S. Cities Rise for a Second Month," *The Wall Street Journal*, August 26, 2009

At issue is whether the consumer can navigate his way down the debt mountain before the government reaches its own leverage peak. With the government running historic and unprecedented deficits, subsidized in part by an expiring program of Treasury purchases by the Fed, we wonder at what point the market's appetite for Treasuries is sated. "Policy changes beyond what have been proposed so far will be needed to reach a sustainable deficit," wrote Tom Gallagher of ISI. "Relative to the current policy deficit line, getting to 3% deficits would require deficit reduction of close to 5.0% of GDP, or \$700 billion in today's dollars... The only question...is whether Congress will move first or the markets will move first and force Congress to act."



Certainly, the Obama Administration does not want to take the foot off the accelerator anytime soon. Their read of history indicates it is better to err on the side of continued expansionary policies than to turn off the money spigot before the drought is over. "What you learned from the 1937 [recession] is that it's not enough to be recovering," says Christina Romer, chairman of the president's Council of Economic Advisers. "You don't want to do anything when you start recovering that nips it off too soon."⁵

The problem is the market may force the government's hand. Already there are signs that bellies are filling with Treasuries as many Asian countries

are showing a reduced willingness to finance U.S. deficits. Figures released by the Treasury Department indicate that China reduced its holdings of Treasury securities by -\$25 billion in June 2009, the most China has ever sold in a month.⁶

"Enormous dosages of monetary medicine continue to be administered and, before long, we will need to deal with their side effects," wrote Warren Buffett, Chairman of Berkshire Hathaway. "For now, most of those effects are invisible and could indeed remain latent for a long time. Still, their threat may be as ominous as that posed by the financial crisis itself... During this fiscal year, [the federal deficit] will increase more than one percentage point per month, climbing to about 56% of GDP from 41%...no one can know the precise level of net debt to GDP at which the United States will lose its reputation for financial integrity. But a few more years like this one and we will find out."⁷

If investors demand higher interest rates to compensate for the risk associated with huge chronic deficits, the impact on the government's financing, and on the economy as a whole, could be devastating.

⁵ Michael M. Phillips, "Policy Makers Seek to Learn From 1936'2 Stalled Comeback," *The Wall Street Journal*, August 24, 2009.

⁶ Floyd Norris, "America May Need To Find Another Financier," *The New York Times*, August 22, 2009.

⁷ Warren E. Buffett, "The Greenback Effect," *The New York Times*, August 19, 2009.

“The CBO assumes government’s borrowing costs will remain very low despite record high deficits,” wrote Gallagher. “For example, CBO estimates the government will pay less in 2011 to finance its debt than it did in 2008 even though the debt will be 52.0% larger. It assumes the federal government will be able to finance its debt for less than 250 basis points in 2011... Even if inflation stays low, at some point the government won’t be able to borrow at the risk-free rate running deficits 7-10% of GDP.” The CBO’s interest rate assumptions are striking. We recall an issue arising when homeowners took on debt they couldn’t afford based on the assumption of perpetually low interest rates and perpetually rising asset prices. It’s as if all the king’s horses and all the king’s men think they are immune to the same forces that brought Humpty Dumpty down.

Debt and deficits and the risk they pose to the value of the U.S. dollar keep us in the secular bear camp. Nevertheless, we are reminded of the markets performance in 1933, 1935 and 1936 during The Great Depression and the period from 2003-2006 when these and other concerns were prevalent, yet markets responded positively to monetary and fiscal stimulus and the economy grew. “Fear colors decisions in the bust just as surely as faith did in the boom,” wrote Jim Grant of Grant’s Interest Rate Observer. “It wasn’t pure reason that led American manufacturers to cut inventories and their customers to slash purchases in June at the fastest rate since World War II... In one way or another, all fell victim to the boom-time error of optimism. Now, in atonement, they’re committing the symmetrical error of pessimism. The money that our distinguished policy makers are printing and spending in such profusion will almost certainly fail to boost American enterprise in the long run. But it may stoke current-dollar GDP in the short run.”⁸

“We have dug ourselves into a 12-foot hole over the past two years,” wrote John Mauldin, President of Millennium Wave Advisors, LLC. “The data now suggests that we have stopped digging, which is always a good idea if you are in a hole. At some point we will have figured out how to add some dirt to the bottom to get us back up to an 8-foot hole. Will we be better off statistically? Absolutely. But we will still be in a hole.”⁹

Thus, we remain in a guardedly optimistic, cyclically bullish positioning. Given the heightened level of risks, we hold this positioning with much trepidation.

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⁸ Jim Grant, “Green Light for Recovery,” *Grant’s Interest Rate Observer*, September 4, 2009.

⁹ John Mauldin, Best-Selling author and recognized financial expert, is also editor of the free Thoughts From the Frontline that goes to over 1 million readers each week. For more information on John or his FREE weekly economic letter go to: <http://www.frontlinethoughts.com/learnmore>