



## **UPDATE**

October 2007

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**CALDWELL & ORKIN**<sup>®</sup>

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*“Up until just the other day, people were prepared to believe that they could understand the workings of today’s ‘large complex financial institutions,’ as the Bank of England styles them. The truth is that these behemoths are unfathomable to the outside observer. At that, the insiders may be none too well informed.”<sup>1</sup>*

-Jim Grant, editor of *Grant’s Interest Rate Observer*

### **What Ben Saw**

Harry Potter fans know that in the magical world pensieves are used to teach lessons by offering a view of other magicians’ memories and experiences. On Thursday, August 14, 2007, as it became clear that the credit crisis had reached panic levels, freezing debt markets and sending stocks tumbling, the management of PIMCO Bonds, led by Bill Gross, was updating high-ranking Treasury and Federal Reserve officials as to what exactly was happening to the markets in which they make their daily bread.<sup>2</sup> Judging by the Fed’s actions since that day, what they saw when they looked into Gross’ pensieve scared the daylights out of them.

Before the markets opened the next day, Fed Chairman Ben Bernanke, formerly resolute in his fight against inflation and moral hazard, announced a 50 basis point (bps), or 0.50%, reduction in the discount rate (the rate the Fed charges banks who run short on funds) to 5.75%. Nearly a month later, on September 18, 2007, unsatisfied that the discount rate stimuli had thawed the freeze, the Fed’s Federal Open Market Committee (FOMC) announced both a 50 bps reduction in the Fed funds rate to 4.75%, and another 50 bps reduction in the discount rate to 5.25%. These interest rate cuts signaled that Chairman Bernanke, fearing broad damage from the market turmoil that erupted in August, preferred to risk easing too much rather than too little.<sup>3</sup> So we ask: what did Bernanke see? What was it that could cause a man hell-bent on taming the evils of inflation to do an about face and release the hounds of monetary liquidity, inflation be damned?

Perhaps the folks at PIMCO gave Fed officials a much-needed education on the toxicity of certain leveraged derivative innovations such as collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs), and how the opacity of these financial structures froze the commercial paper market. Among these innovations appears a trouble-making newcomer, the Structured Investment Vehicle (SIV), or what Paul McCulley of PIMCO calls, the “shadow banking system.”

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<sup>1</sup> Jim Grant, *Grant’s Interest Rate Observer*, September 7, 2007.

<sup>2</sup> Bill Gross, “Investment Outlook,” *PIMCO Bonds*, October 2007.

<sup>3</sup> Greg Ip, “Fed Cut Aims to Contain Damage,” *The Wall Street Journal*, September 19, 2007.

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SIVs are entities through which banks make long-term, off-balance sheet investments that are funded through the short-term commercial paper market. Unfortunately, many bank SIVs were invested in subprime mortgages, and the banks were counting on selling more than \$1 trillion in short-term commercial paper to finance these holdings.<sup>4</sup> When it came time to renew the short-term paper backing these troubled loans, investors balked. “The shadow banking system is particularly vulnerable to runs – commercial paper investors refusing to re-up when their paper matures,” McCulley wrote, “leaving the shadow banks with a liquidity crisis – a need to tap their back-up lines of credit with real banks and/or to liquidate assets at fire sale prices.”<sup>5</sup> Suddenly, several-hundred billion dollars worth of junk-paper, dressed up in triple-A ratings drag, was about to emerge on the crowded balance sheets of banks.

Already these banks were swimming in hung leveraged buyout (LBO) debt for which nary an interested buyer could be found. The debt market was stuck in an Atlanta-style rush-hour style traffic jam. As evidence, CLO issuance in July and August 2007 totaled about \$12 billion, half the rate of the previous six months. And only \$2.5 billion of new high-yield bond paper emerged from Wall Street in August, compared to more than \$100 billion in the previous seven months.<sup>6</sup> Clearly, Fed intervention was needed to unclog this mess and get financing traffic flowing once again.

The good news: since the Fed rate cut, bankers have been able to move \$9.4 billion of First Data Corp LBO debt. The bad news: to entice buyers of this paper, bankers had to offer a 3% discount and tighten the covenants against the borrowers. And, there is still roughly \$300 billion of LBO loans stuck in the pipeline, \$16.6 billion of which is the remaining First Data LBO debt that could not be placed. “The problem, as I have repeatedly said, is not a liquidity problem but a credibility problem...no one wants to buy debt that they do not completely understand,” wrote fund of funds manager John Mauldin. “If you are a bond buyer for an institution, it is a career ending decision to buy an asset-backed investment grade bond even rated AAA if it goes bad. You might be able to explain buying such assets last spring. Buy a problem bond today and it is now your fault, not to mention your job.”<sup>7</sup>

According to a survey by Greenwich Associates, more than 65% of investors in mortgage-backed securities and 80% of CDO investors are struggling to find a bid for their holdings.<sup>8</sup> The commercial paper market remains locked-up as well, with the amount of commercial paper outstanding the week ended September 26, 2007 down 17% over a seven week period.<sup>9</sup> So, while some of the traffic jam has been relieved, we have yet to see a normal flow in the corporate credit markets.

As for the Fed’s ability to come to the rescue of the mortgage debt crisis, recall from the September 2007 *Update* that there is little anyone, including the Fed, can do to help the two-million homeowners who risk losing their homes due to the pending tsunami of adjustable rate mortgage resets. Despite the cuts to the discount and Fed funds rates and the Congressional proposals for a Federal

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<sup>4</sup> David Wessel, “Banks’ New Credit Austerity to Help Set Economy’s Path,” *The Wall Street Journal*, September 13, 2007.

<sup>5</sup> Paul McCulley, “Global Central Bank Focus,” *PIMCO Bonds*, August/September 2007.

<sup>6</sup> Steven Rattner, “The Credit Crunch Continues,” *The Wall Street Journal*, September 20, 2007.

<sup>7</sup> John Mauldin, “Should the Fed Cut Interest Rates?,” *Thoughts From the Frontline*, September 7, 2007.

<sup>8</sup> Caroline Salas, “Fed Fails to Restore Creditor Confidence, PIMCO says,” *Bloomberg News*, October 2, 2007.

<sup>9</sup> Salas, October 2007.

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Housing Authority (FHA) bailout, this outlook has not changed. “Many investors are convinced that the government will somehow reverse the vicious cycle of higher delinquencies, tighter credit conditions and lower home prices,” wrote Tom Gallagher at ISI Group, Inc. “We believe this optimism in a government rescue is misplaced. There is very little the federal government can do about the fact that a substantial number of borrowers cannot afford to pay back their loans. The vast majority of subprime mortgages that are delinquent are still paying below-market teaser rates and [those interest rates] have not reset. It is not the interest rate that is burying these borrowers. Instead, it is the fact that even with a low rate they are paying close to half of their gross incomes on their mortgage payment. Here’s why this is a problem. If rate resets have not played a significant role in the subprime debacle so far, then it is clear that a loan restructuring program won’t help the borrowers currently falling behind on their mortgage payments. These loans cannot be paid back using any reasonable interest rate. In many cases, the borrower simply has too much debt.” To Gallagher’s point, Countrywide Securities’ mortgage-backed research group estimates that the FHA assistance program will only help 1-3% of the mortgage reset population, a bailout truly worthy of a Congressional label.

That the Fed rate cuts have, thus far, offered only limited relief to the areas of the credit market that need it the most seems lost on the equity markets. Bolstered by the mantra, “don’t fight the Fed,” bullish market participants have uncurled from their fetal positions hiding under their desks and sent market averages back towards their highs. According to Investors Intelligence, sentiment surveys showed that, the week of September 24, 2007, 55.6% of investors were bullish and 25.6% bearish, a striking contrast to sentiment prior to the cut in the Fed funds rate, when bulls were barely over 40%, while bears weighed in around 37%.<sup>10</sup>

From an equity markets perspective, what’s not to like? After all, Fed rate cuts are another step along the typical path of the mid-cycle economic slowdown in which the U.S. economy narrowly avoids recession, and flush with abundant liquidity and subdued inflationary fears, equity prices are free to advance. While we have and continue to subscribe to this mid-cycle slowdown theory, we must admit that our allegiance is being tested on a daily basis. Among our concerns: 1) signs of accelerating inflation; 2) growing evidence of international economic weakness; and 3) the future impact of the continued contraction in the U.S. credit markets.

Chief among the rising inflation signals caused by the Fed’s rate cut is an accelerated decline in the U.S. dollar. Generally speaking, a weaker dollar causes inflationary pressure by making imported goods more expensive. The incidental devaluation of the U.S. dollar sent the price of crude oil, which is traded in dollars, barreling to an all-time high above \$84 a barrel on September 20, 2007. It also powered a spike in gold to \$747.90 an ounce on October 1, 2007, its highest price since January 1980, when it hit \$850.<sup>11</sup> Ed Hyman at ISI believes that if this combination of a rapid dollar decline and commodity price increases continues it poses a significant danger to his economic growth forecast, which currently calls for gross domestic product (GDP) growth slowing from 2.5% in the third quarter to 1.5% in the fourth quarter of 2007.

Internationally, a weak dollar is not welcome by countries whose currencies are pegged to the dollar and who are themselves adjusting to a secular rise in inflationary pressures. In the past, our trading

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<sup>10</sup>Abelson, September 24, 2007. “Up & Down Wall Street,” *Barron’s*, September 24, 2007.

<sup>11</sup>Abelson, September 24, 2007.

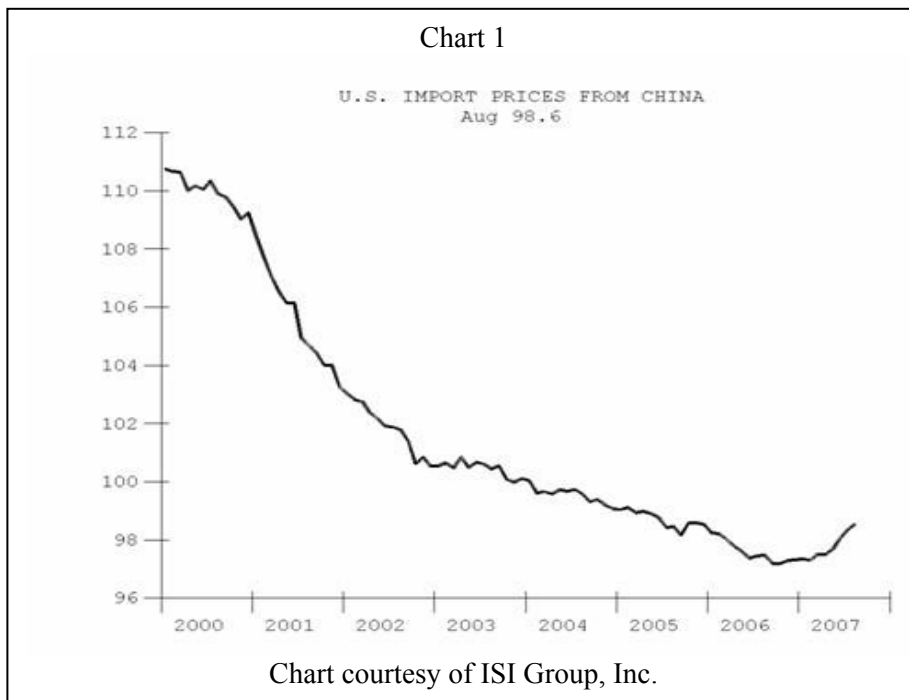
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partners who link their currencies to the dollar have followed interest rate moves by the Federal Reserve; however, a secular shift towards rising inflationary pressures is making this impossible.

Among oil exporters in the Middle East, inflation has jumped from an average annualized rate of 4.5% last year to 6.5% so far this year according to Morgan Stanley. Currency pegs in the Persian Gulf “are facing a perfect storm,” said Steve Brice, an economist at Standard Chartered Bank in Dubai. Moving to lower interest rates when there is “strong growth and soaring inflation is fundamentally inappropriate,” he added.<sup>12</sup> In China as well, inflation surged to an 11-year high 6.5% year-over-year in August 2007. In fact, due to rising inflationary pressures stemming from the country’s own hyper-growth monetary policy, China has now become an exporter of inflation as their currency costs and wages have increased and are being passed through to us (see Chart 1).

“America’s creditors...have stockpiled dollars because it suited them,” wrote Jim Grant, editor of *Grant’s Interest Rate Observer*. “They have printed enough renminbi or won or dinars to suppress the appreciation of their own currencies while muffling the depreciation of the dollar. These policies they have maintained through years of global disinflation. But, we believe, they will be hard-pressed to carry them forward in just the same way in what seems to be a dawning cycle of inflation. If that is correct, the dollar exchange rate will push lower and the gold price higher.”<sup>13</sup>

“Muffling the depreciation of the dollar” means these countries will likely purchase fewer Treasury securities. It is no secret that the recycling of trade surpluses back into Treasuries has been a powerful force keeping long-term interest rates low in the U.S. (Former Fed Chairman Alan “Easy Al” Greenspan now claims that is the reason for the housing market bubble, despite the fact that during his tenure he casually ignored its impact, refusing to adjust his monetary policy accordingly.) “From my perch, the Federal Reserve might have made a tactical mistake by freeing its monetary reins,” wrote Doug Kass, portfolio manager for Seabreeze Capital Partners. “The larger-than-expected rate cut will likely promote further inflation, a downward spiral in the U.S. dollar and, most importantly, will likely raise intermediate and long-dated bond yields. The latter point is important, as this



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<sup>12</sup> Joanna Slater, “Falling Dollar Squeezes U.S. Trade Partners,” *The Wall Street Journal*, September 21, 2007.

<sup>13</sup> Jim Grant, *Grant’s Interest Rate Observer*, September 21, 2007.

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will serve to further cripple the housing market by raising mortgage rates – especially for those who are facing an imminent reset problem.”<sup>14</sup>

According to Ed Hyman at ISI, as the U.S. housing market continued to crumble over the past several months, there has also been increasing evidence of housing weakening in many parts of the world. Home prices in Ireland were down 3.5% during the first-half of 2007. Declines were also seen in Germany, New Zealand, Spain, the UK, Latvia, and Italy. “The property bubble in Southern Euroland – particularly Spain – has gone bust not unlike the U.S. property market,” wrote Paul McCulley. “Thus, the cyclical decoupling of European growth from the U.S., while still a viable story, will depend primarily on Europe’s exports to the emerging market world.”<sup>15</sup>

Alarmingly, the financial health of the U.K. consumer is in worse shape than our own. “Mother England kicks U.S. colonial butt in mortgage equity withdrawals (MEWs),” wrote Portales Partners in a September 21, 2007 research note. “The Bank of England estimates that U.K. citizens withdrew about \$26 billion of their available home equity in Q1’07, equal to 6.1% of disposable income. In contrast, the U.S. homeowner withdrew a measly 3.8% of their disposable income from their homes in Q2’07,” Portales concluded. At the end of June, consumer debt in the U.K. totaled more than forecasted gross domestic product for 2007, and the ratio of debt to personal incomes surpassed even that of the U.S.<sup>16</sup> Total mortgage debt in the U.K. has reached 1.1 trillion pounds (\$2.2 trillion), more than double the level of 10 years earlier and equivalent to more than 80% of annual gross domestic product.<sup>17</sup> All told, British consumers owe \$2.7 trillion on credit cards, mortgages and other consumer loans, or, on average, an amount equal to 166% of the average consumer’s annual disposable income, 30% higher than in the United States.<sup>18</sup> The Brits are leveraged to the hilt!

Unsurprisingly, all this borrowing has left the Mother Country with a bit of a financial crisis to deal with. After Bank of England Governor Mervyn King refused to aid banks in a developing liquidity crunch, there was a run on deposits at mortgage lender Northern Rock. In their effort to respond to a bank run reminiscent of 19<sup>th</sup>-century panics, policy makers stepped in with the most spectacular bailout of all, taking the highly unusual step of guaranteeing all the deposits at Northern Rock. A U.K. Treasury spokesman said the guarantee extends to any solvent bank in similar circumstances.<sup>19</sup> With extended consumers and serious financial crises in two of the world’s five largest economies, the risks to sustaining international growth are clearly rising.

Turning back to our own credit mess, it has long been our belief that the U.S. markets were embarking on a cycle of credit contraction that would be an impediment on future economic growth. This

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<sup>14</sup> Doug Kass, “Shocked but Not In Awe,” *Street Insight*, September 19, 2007.

<sup>15</sup> Paul McCulley, “Cyclical Forum,” *PIMCO*, September 2007.

<sup>16</sup> Emma Charlton, “Growing Consumer Debt in U.K. Fuels Concern,” *The Wall Street Journal*, September 11, 2007.

<sup>17</sup> Carrick Mollenkamp and Mark Whitehouse, “Northern Rock May Point to U.K. Crunch,” *The Wall Street Journal*, September 24, 2007.

<sup>18</sup> Shelley Emling, “British Struggle in Sea of Debt,” *The Atlanta Journal & Constitution*, September 22, 2007.

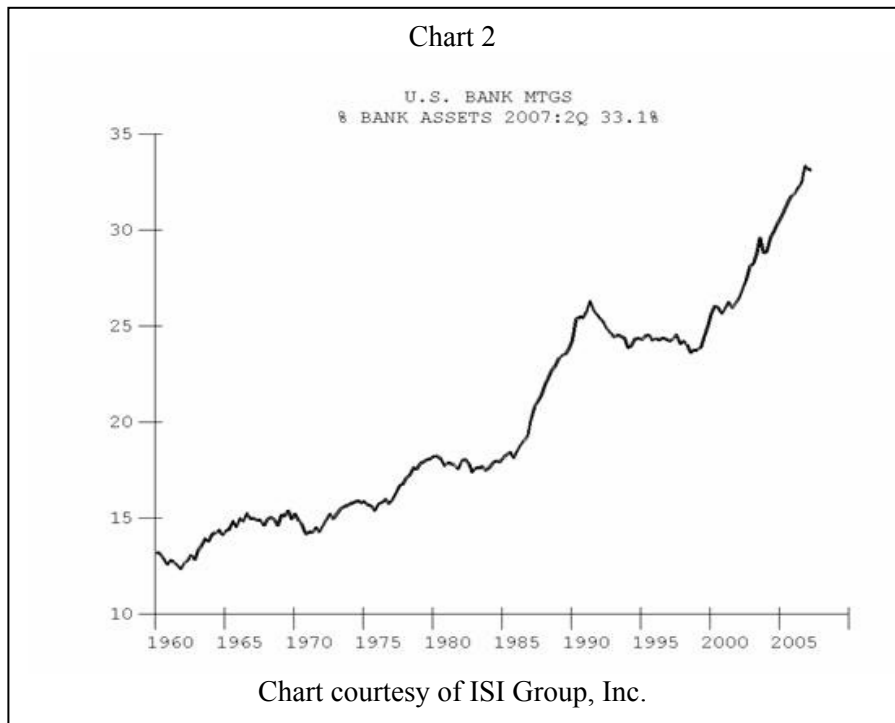
<sup>19</sup> Joellen Perry and Jason Singer, “Behind U.K.’s Shift on Bank Bailouts,” *The Wall Street Journal*, September 19, 2007.

outlook has less to do with the current liquidity crisis which the market is now struggling with, and more to do with a return to normal levels of credit creation after a period of record excess. The difference is important. Certainly, Fed rate cuts may eventually move the paper currently stuck in the pipeline. They cannot, however, improve upon the credit quality of this paper nor can they increase the risk appetites of banks already swimming in low-quality loans.

“In 2007 (until the market effectively shut down), more than 32% of new lending was to companies planted on the lowest rungs of the credit ladder,” wrote Steven Rattner of Quadrangle Group in an Op-Ed piece for *The Wall Street Journal*. “That brought these borrowers’ share of outstanding debt to above 25%, a new high. Research by Edward Altman of New York University shows that on average...CCC debt [has a] 37% default rate over three years. To believe that this cycle will be different requires an ignorance of the past and a vivid imagination.”<sup>20</sup>

Currently, bank holdings of mortgage loans are at record levels as a percentage of bank assets (see Chart 2). Until these loans are worked down, banks are likely to be less willing to lend to ordinary consumers and businesses or, at the very least, will be charging more for those loans. So, consumers and businesses are likely to borrow and spend a little less, increasing the probability that the U.S. is going to slide into a recession. The issue isn’t *whether* all this is happening. It is. The issue is *how big* an impact banks’ behavior will have on the economy.<sup>21</sup>

As bank lending dries up, house prices will continue to suffer, a process already in the works. “The marginal buyer sets the price for housing and during the past few years the marginal buyer has been an Alt-A and subprime borrower,” wrote ISI’s Tom Gallagher. “They represented 40% of demand for housing last year. ...As the artificial demand from easy lending practices is...withdrawn, house prices are likely to fall.”



According to the S&P/Case-Shiller home price index, home prices fell 3.9% year-over-year in July, the biggest decline since just after the 1990-91 recession. With the pending wave of mortgage resets, the removal of the demand from subprime and Alt-A borrowers and the likely rise in foreclosures, home prices seem destined to fall further. “We do not believe the market is discounting the [likely housing] outcome,” wrote Gallagher. “[The environment] will be extremely difficult for the mortgage finance

<sup>20</sup> Steven Rattner, “The Credit Crunch Continues,” *The Wall Street Journal*, September 20, 2007.

<sup>21</sup> Wessell, September 13, 2007.

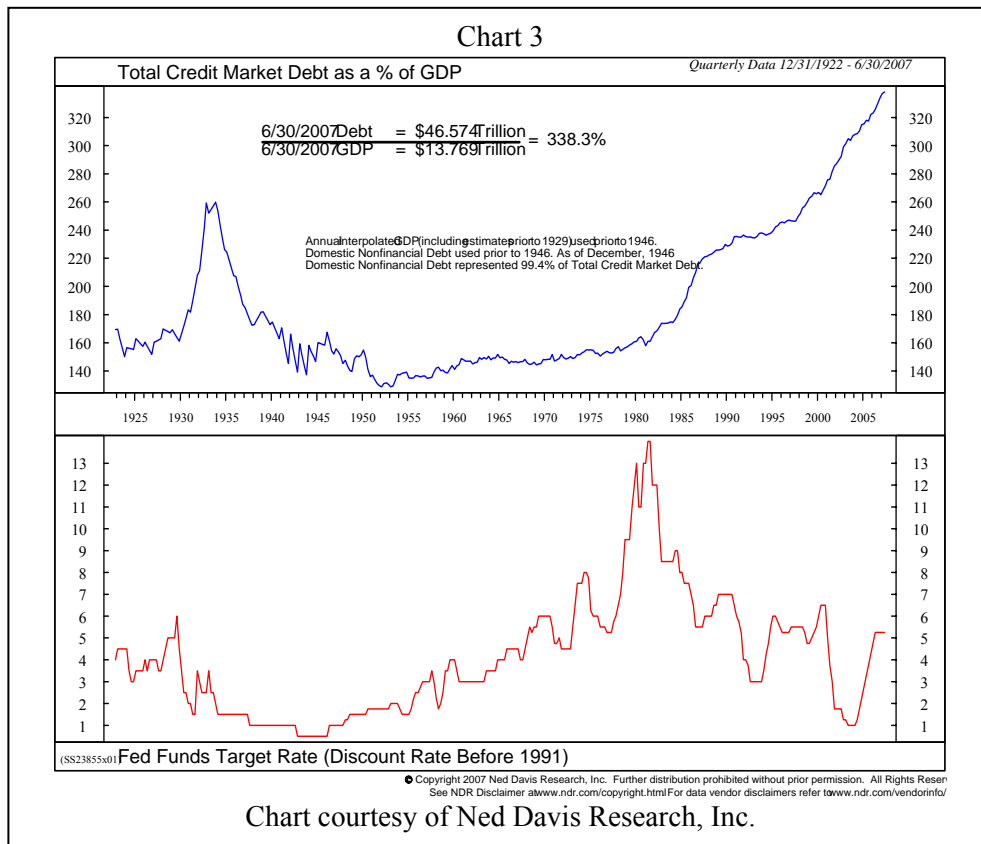
industry, particularly mortgage lenders, mortgage insurers, investment banks, credit rating agencies, title insurance companies and so on.”

As most consumers’ largest asset, it seems likely that the housing recession will have an impact on consumer spending. “Even though housing is only 5% of the economy, it is a huge part of the wealth effect,” wrote John Mauldin. “Gary Shilling [economist at Gary Shilling & Co.] suggests [house prices will drop] 25%. The total housing market value in the US is \$20 trillion. Knock off \$4-5 trillion, and you have a serious drop in the wealth of homeowners. \$4 trillion is not a small sum in the psychology of the consumer.”<sup>22</sup>

Another pillar in the mid-cycle slowdown theory is the idea that consumer wealth will continue to increase over the next few years. In the face of unprecedented declines in home values, this belief hinges on advances in the equity market. There is a troubling circular logic at work here. An equity market advance is dependant upon the economy staying in a mid-cycle slowdown; whereas, staying in a mid-cycle slowdown is dependant upon advances in the equity markets.

We believe that the Fed’s easing has set a temporary bottom for the equity market; however, how long this bottom holds is open for debate. Paul Desmond of Lowry’s Reports is thus far unimpressed with the market’s recent advance. “If we were to grade the quality of the recovery rally since mid-August,” Desmond wrote, “in terms of its likelihood to rise to new all-time highs and beyond, that grade would be a

D+. Consistent indications of weak demand suggest that prices did not drop low enough in mid-August to attract broad, sustained buying interest. Thus, even lower prices would be expected in the months ahead before demand is eventually revitalized.” He adds, “If the economy were as strong as the...’experts’ say, we would expect to see persistent strength within the consumer cyclical, industrial, and financial sectors. But, those three key economic areas have consistently been the weakest of our ten major sectors. The strongest sectors seem to fit into the themes of lower interest rates, a weakening



<sup>22</sup> John Mauldin, “Sea Change at the Fed,” *Thoughts From the Frontline*, September 21, 2007.

U.S. dollar and increasing inflation”<sup>23</sup>

While we will likely never know what Bill Gross showed Ben Bernanke on August 14, 2007, we are confident that what Bernanke saw in Gross’ pensieve was the very real risk of a recession. Now that Bernanke (the academic) has been given a real-world lesson by the Bond King, we do expect rains of liquidity to continue to fall upon markets.

Though bullish investors zealously proclaim that Fed rate cuts lead to equity market advances, history shows this is not always the case. “Lenders should beware that for all Mr. Greenspan’s willingness to provide liquidity,” wrote Steven Rattner, “plenty of money was lost in the high-yield arena in the early 1990s and again in the post [Internet] bubble swoon a decade later. The re-run of that movie has barely begun to play out.”<sup>24</sup>

Date Range	Decade Change in GDP (billions \$)	Decade Change in Debt (billions \$)	GDP/Debt
12/31/1949-12/31/1959	248.0	336.6	0.74
12/31/1959-12/31/1969	491.4	748.9	0.66
12/31/1969-12/31/1979	1655.9	2786.3	0.59
12/31/1979-12/31/1989	2923.8	8565.4	0.34
12/31/1989-12/31/1999	3935.2	12471.7	0.32
12/31/1999-06/30/2007*	4255.2	21263.2	0.20

\* Most recent data available

Table courtesy of Ned Davis Research, Inc.

The short-term relief the Fed has provided does not change our secular concerns regarding our debt-laden economy. As Chart 3 shows, decades of trigger-happy Fed intervention has left us at record levels of total credit market debt relative to gross domestic product. Unable to let the economy taste the sour, but cleansing, medicine of recession, past Fed officials encouraged excessive risk taking that ultimately created the crisis we now face. As you can see from Chart 3, the economy is continuing to run into trouble at lower and lower levels of the Fed funds rate. Moreover, as Table 1 shows, each additional dollar of debt we are adding to the overly-burdened economy is providing us with less marginal economic benefit.

Unless Bill Gross gave Ben Bernanke a magic wand with which to fix these secular problems, we expect that future credit creation, and the economic growth prospects that depend upon it, will remain subdued. In essence, for the Fed’s magic elixir to have a stimulative impact, it will require stronger medicine taken over a longer period of time.

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<sup>23</sup> Paul Desmond, “Lowry’s Primary Trend Perspective,” *Lowry’s Reports*, September 14, 2007.

<sup>24</sup> Rattner, September 20, 2007