



CALDWELL & ORKIN®

UPDATE

October 2009

Full Pool

For Atlanta residents the photographs of our flooded city that recently made national news were shocking and surreal, illustrating both Mother Nature's destructive wrath and, after years of a "level-four extreme" drought conditions, her petty fickleness. Steady rains brought our drought to its official end over the summer, and a deluge in the first few weeks of September was followed by a torrential downpour the morning of September 21, 2009 that dumped over 15 inches of rain in less than 12 hours in areas around the city. It was too much rain in too short a time for a saturated water table to absorb. Normally four-foot deep creeks swelled to 20-plus feet, making freeways impassable and flooding homes in poor and affluent areas alike.

Man-made Lake Lanier, the main water source for the city (and for some downstream residents of Alabama and Florida), got a much-needed boost from the rainfall. The one-two punch of the drought and the increased demands of the area's growing population had reduced the water level in the lake by 20 feet at its nadir, exposing decades of discards from boaters and fishermen. And it seems Mother Nature, despite her best efforts, can't keep up with the continuous demands of humanity as our record rainfall has not been enough to restore the lake to full pool.

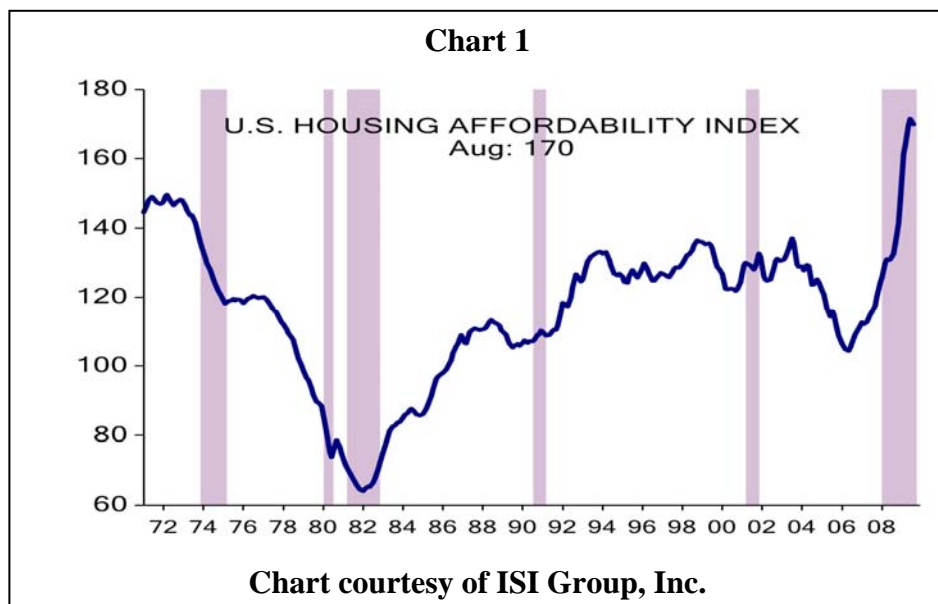
So too has the economic drought exposed the muddy banks of the economy as the deleveraging consumer drains the system's growth. Now a torrent of economic liquidity is irrigating the thirsty landscape. "In the post World War II era, the government has attacked recessions with an average fiscal stimulus of 2.6% of GDP and an average monetary stimulus of 0.3% of GDP, for a combined countercyclical lift of 2.9%," wrote Jim Grant, editor of *Grant's Interest Rate Observer*. "This time out, the fiscal stimulus is likely to measure 10.0% of GDP, monetary stimulus 9.5% of GDP, for a combined pick-me-up equivalent to 19.5% of GDP. Our Great Recession would be marked for greatness if for no other reason than by the [unprecedented] outpouring of federal dollars.¹" While this outpouring of liquidity has refreshed the parched economy, the incessant strain of the deleveraging private sector remains. And unlike Mother Nature's rainfall, the liquidity policymakers supply the economy has limits.

Since the Lehman Brothers shock in September 2008, the government has become a major player in the financing of the U.S. economy. Between bailouts and the economic stimulus program, government spending now accounts for a bigger share of the nation's economy than at any time since World War II.² One area where the government's presence is pervasive is in the housing market where Uncle Sam now subsidizes and underwrites home loans.

¹ Jim Grant, "From Bear to Bull," *The Wall Street Journal*, September 19-20, 2009.

² Edmund L. Andrews and David E. Sanger, "U.S. Is Finding Role In Business Hard To Unwind," *The New York Times*, September 14, 2009.

Last winter, Congress passed an \$8,000 tax credit for first-time home buyers intended to provide brief support to the floundering real estate industry. Today an estimated 40% of home purchasers will qualify for the credit which, if not extended, will expire in November 2009. The National Association of Realtors estimates that about 350,000 sales this year would not have happened without this incentive. With a price tag of \$15 billion, the credit will cost taxpayers more than twice the amount that was projected when Congress passed the stimulus bill in February 2009.³ Purchase a home today and there is a 90% probability your mortgage is being underwritten by a government entity which then securitizes your mortgage and sells it...to the government! That's right, since the beginning of this year, the Federal Reserve has purchased \$836 billion of such mortgage-backed securities issued by Fannie Mae, Freddie Mac and Ginnie Mae. These purchases have helped push down interest rates on 30-year fixed-rate mortgages guaranteed by the firms from more than 6.5% in October 2008 to 5.15% today,⁴ offering yet another incentive and pushing mortgage affordability to record highs. (See Chart 1)



Government spending is not just directed at housing. The cash-for-clunkers subsidies were aimed at spurring auto sales and, subsequently, auto production. The infrastructure spending and extended unemployment benefits passed in the stimulus package were efforts to get money flowing directly to the people who would spend it and spur economic growth. To a degree, this has worked, but the degree may be slight. "While it is true that to date 'only' \$3.4 trillion of the policy perfume has been

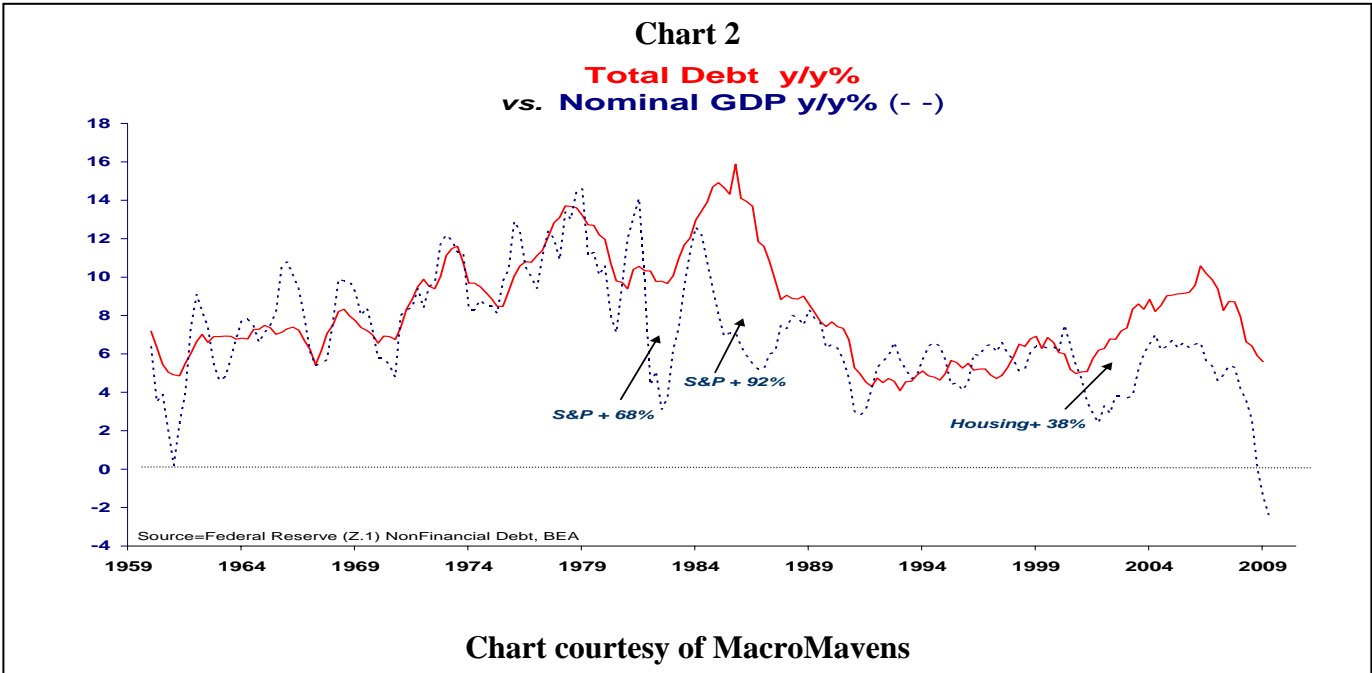
dispensed, even that figure is alarming when juxtaposed against the recovery in growth that has investors all atwitter," wrote the voluble Stephanie Pomboy of *MacroMavens*. "If the consensus forecast of 2.2% quarter-over-quarter annualized gain in third-quarter GDP is correct, we would enjoy a whopping \$77 billion increase in economic activity. To call this pitiful would be obsequious flattery. Far from relishing the scent of impending recovery, investors' eyes ought to be watering at the noxious need for \$44 in government goading to coax forth a \$1 increase in GDP... As [discussed] over the last several years of the bubble stretch, it was taking larger and larger (indeed, geometric) increases in credit to produce steady-state economic growth."⁵ (See Chart 2)

As the government's ability to offset the growth drain from the deleveraging consumer has been tested, policymakers have responded by increasing the flow of liquidity. "The government continues to

³ David Streitfeld, "Fight Looming On Tax Break To Buy Houses," *The New York Times*, September 16, 2009.

⁴ Deborah Solomon and Jon Hilsenrath, "No Easy Exit for Government As Housing Market's Savior," *The Wall Street Journal*, September 15, 2009.

⁵ Stephanie Pomboy, "Hard of Smelling," *MacroMavens*, September 11, 2009.



bail, borrow and spend like a wild person,” wrote Ned Davis of Ned Davis Research, Inc. “Chart E350 shows the unbelievable explosion in the budget deficit. The government spends like this is all free money... Households have indeed tried to be more responsible, but government has gone off on a wild Keynesian and monetary experiment.”⁶ (See Chart 3)

The money the government is borrowing is not free. Trillion dollar deficits sap the resources of a nation’s economy and crowd-out other debt issuers. What’s more, the Federal Reserve has been a large buyer of Treasuries, effectively monetizing the nation’s debt and, in the process, running the real risk of devaluing the dollar. “In the meetings I’ve had [with the Chinese] they tend to ask me about the Fed’s ability to buy Treasuries,” says Steve Orlins, a former State Department official and investment banker who now heads the National Committee on U.S.-China Relations. “The Chinese looked at that [and said], ‘There are two buyers: us and the Fed. That’s a little scary.’”⁷ With a majority of their \$2 trillion in foreign currency reserves invested in U.S. bonds, the Chinese are understandably concerned about our creditworthiness and they are growing increasingly leery of our perpetually and exponentially increasing deficits as evidenced by the laughter that met Treasury Secretary Timothy Geithner’s comments to a group of Chinese students when he told them that the United States supported a strong dollar policy.

Were China to stop buying our Treasury bonds we likely could not finance our deficits, but we shouldn’t expect this anytime soon. Thanks to the sheer size of their dollar holdings, the Chinese have limited options investing a trillion dollars without taking an enormous risk, massively driving up the price or being unable to cash out positions when they need to.⁸ Yet the depth and liquidity of the Treasury markets aren’t the only factors keeping the Chinese investing in the U.S. Our two countries are currently locked in a symbiotic economic relationship. While the Chinese economy surged at an annualized rate of 14.9% in the second quarter of 2009, China’s rebound in growth may slow if the

⁶ Ned Davis, “Quarterly Bifurcated Debt Update,” *Ned Davis Research, Inc.*, September 18, 2009.
⁷ Noam Scheiber, “Peking Over Our Shoulder,” *The New Republic*, September 15, 2009
⁸ Scheiber, September 15, 2009

Chart 3

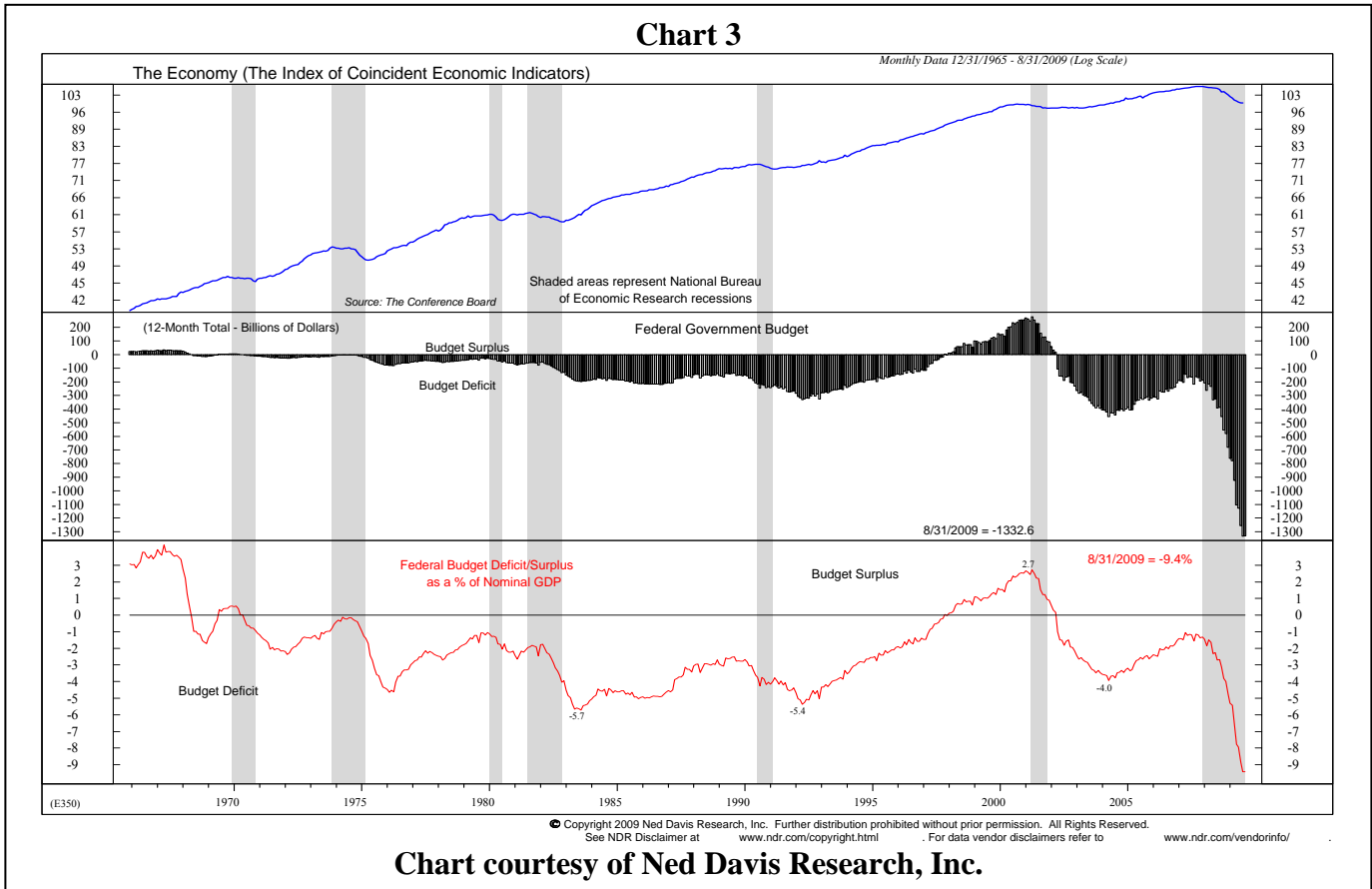


Chart courtesy of Ned Davis Research, Inc.

American economy does not pick up because the Chinese economy relies heavily on exports to the United States, which account for 6.0% of China’s entire economic output.⁹ In short, China needs the United States to buy its goods, and the United States needs China to continue to buy its debt. It is doing so. In July 2009, the Chinese purchased \$24.1 billion in Treasuries and have added 10.0% to their massive Treasury position thus far in 2009.

In response to deficit concerns, several members of the Federal Reserve Board of Governors have recently discussed paring back economic stimulus. “We must prepare diligently for an uneven road race ahead. If policy is not implemented with skill and force and some sense of proportionality, the success of the overall endeavor could suffer,” wrote Fed governor Kevin Warsh in an editorial for *The Wall Street Journal*. “The final recounting of economic history will judge that winning the battle against the panic of 2008 was a necessary but insufficient condition to win the peace and ensure a strong foundation for economic prosperity... If ‘whatever it takes’ was appropriate to arrest the panic, the refrain might turn out to be equally necessary at a stage during the recovery to ensure the Federal Reserve’s institutional credibility,” he concluded.¹⁰

Though the Fed may stand ready to slow the flow of liquidity when they deem necessary, we wonder if there is enough gas left in the stimulus tank to reach their destination. In an effort to support the housing market, the Federal Housing Administration (FHA), the insurer of \$750 billion in outstanding

⁹ Keith Bradsher, “China Moves to Beat Back A Tire Tariff,” *The New York Times*, September 14, 2009.

¹⁰ Kevin M. Warsh, “The Fed’s Job is Only Half Over,” *The Wall Street Journal*, September 25, 2009.

mortgages, lowered its underwriting standards, requiring an absurdly low 3.5% down payment. (Boy does that sound familiar.) Unsurprisingly, about 14.4% of the agency's loans in the second quarter were at least one payment past due but short of foreclosure. That is twice the delinquency rate for top-quality or prime loans. Increased underwriting has leveraged the agency 50-to-1 and cash reserves have fallen below 2.0% for the first time since the agency was founded in 1934.¹¹

Meanwhile, the Federal Deposit Insurance Corporation (FDIC) is running out of money to pay back the insured depositors of failed banks. With nearly 100 bank failures this year, the fund has encountered its greatest crisis since the savings and loan debacle of the early 1990s. On Tuesday, September 27, 2009, officials with the FDIC increased their estimated losses to the fund to rescue failed banks by 40% to \$100 billion.¹² The fund, which had reserves of \$50 billion before the credit crisis, will soon be out of money. To shore up its reserves, the FDIC just announced a plan to collect three years worth of pre-paid fees from well-capitalized member banks, raising \$45 billion. Still, taken together, the developments at the FHA and FDIC indicate "the limits of the government's ability to make all the bad stuff go away," said Ed Yardeni, President of Yardeni Research.¹³

As the reserves of these agencies dwindle there is little evidence that the credit crisis threatening their viability will soon abate. According to recently-released August mortgage data from Lender Processing Services, mortgage delinquencies have accelerated across-the-board while pending foreclosures in the pipeline continue to mount. "We view foreclosures as a significant overhang on the housing market, which is expected to result in higher distressed inventory [and] renewed home price deflation," wrote Ivy Zelman of *Zelman Associates*. "Bank repossessions are expected to accelerate in early fourth quarter of 2009, leading to more foreclosure supply in late fourth quarter and early first quarter of 2010... Many investors [hung] their bullish hat on early-stage delinquencies improving during second quarter 2009. August data challenges that view. We note that the problem that lies in the pipeline is already sufficiently large to alter the shape of the housing recovery... We estimate that there were almost 2.4 - 2.6 million homes either in the foreclosure process or owned by lenders, up an astounding 50% year over year," she concluded.

As this inventory hits the market it will weigh on home prices, potentially disrupting the hard-earned stabilization orchestrated by the myriad of government efforts this year. Should pricing pressure become acute can we count on more government assistance to stop the fall? With no cash on hand and mounting loan losses, how high can the FHA take their leverage as they continue to lend to homeowners? The Fed has roughly \$350 billion left of its \$1.25 trillion commitment to purchase mortgage-backed securities, but this level is expected to be reached early next year and they would likely need to borrow from the Treasury Department to extend the program. Extension of the home buyer tax credit seems increasingly unlikely as well. "The major issue is financing," wrote Tom Gallagher of ISI Group, Inc. "Extending [the tax credit] another 9 - 12 months would likely cost the Treasury about \$15 billion. Finding an offset that can raise \$15 billion (or passing it without an offset) won't be easy."

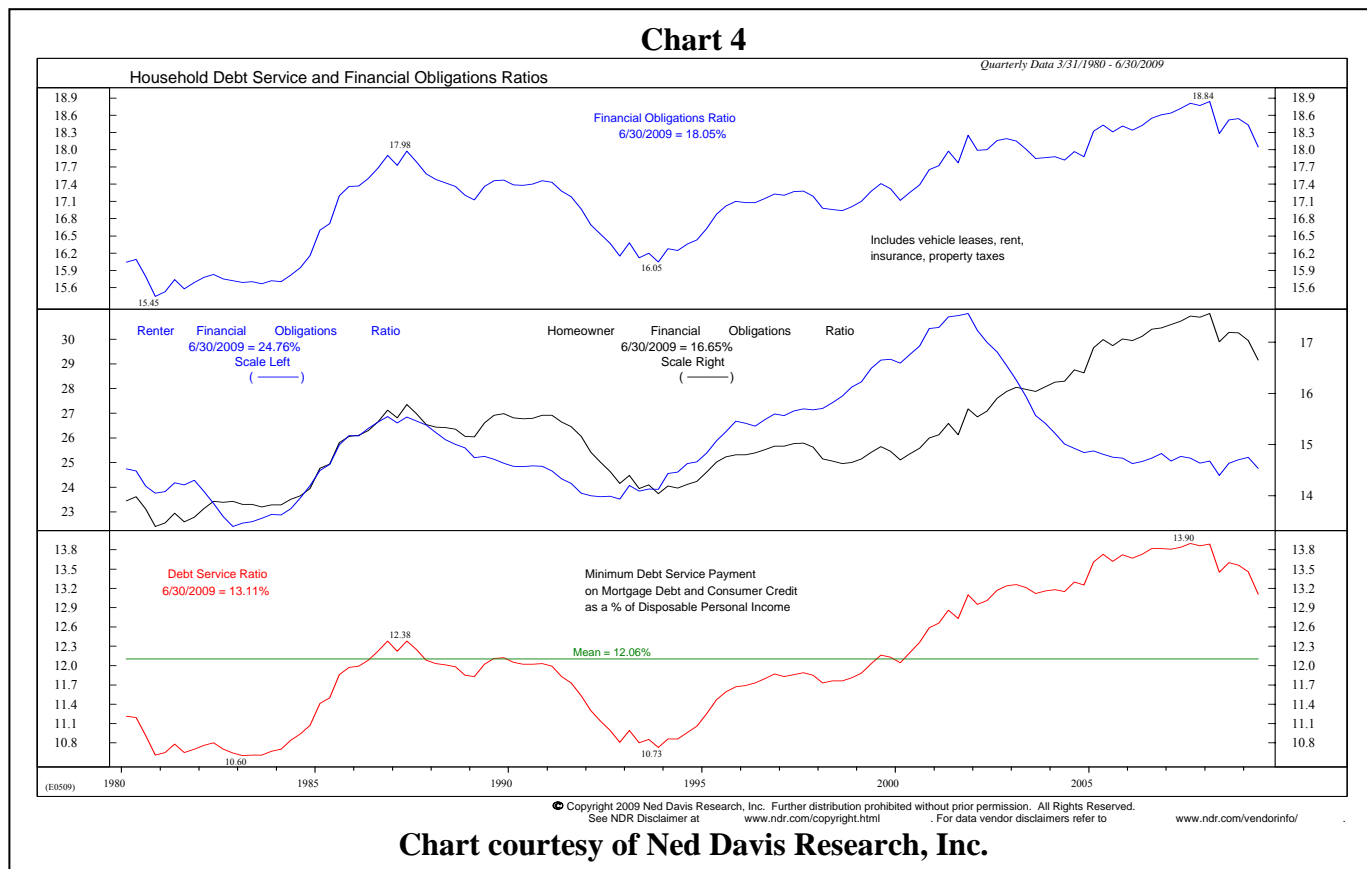
Yet, evidence suggests the economic deleveraging process has only just begun. "Debt service burden and financial obligation ratios...are still at very high levels," wrote Kathy Hartley of Ned Davis

¹¹ David Streitfeld, "The Bill Comes Due, Vexing Housing and Banking Agencies," *The New York Times*, September 19, 2009.

¹² Stephen Labaton, "Banks to Rescue Depleted FDIC," *The New York Times*, September 30, 2009.

¹³ Streitfeld, September 19, 2009.

Research. (See Chart 4) “Although they are off their highs, they need to come down further. The majority of deleveraging to date has been on the financial side, while the private sector has begun to deleverage modestly (mostly mortgages)... As we saw in the 1930s, deleveraging only happened when nominal GDP turned positive and started growing faster than debt. We will need to see this happen again here,” Hartley wrote.



But one wonders how much long-term GDP growth a deleveraging, government stimulus-dependent economy can muster. The government is operating at record levels of debt to GDP, seeing significantly diminishing returns on their leveraged rescue efforts and has many under-reserved agencies near the breaking point.

While the deleveraging consumer will continue to drain liquidity downstream, the forecast for continued rains of government stimulus is bleak. Near-term, economic lake levels may rise, providing a positive backdrop for equities, but until the leverage is unwound, a full pool is unlikely.

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