CALDWELL & ORKIN®

# UPDATE

November 2006

*"We don't want to see the lending decisions bankers make today result in excessive foreclosures – and reduced affordable housing credit – tomorrow."*

John Dugan, Comptroller of the Currency, October 16, 2006

## *Signs of a Bottom?*

The month of October witnessed a continuation of the equity market rally that began in the third-quarter. Investors found comfort in indications of subsiding inflation and speculation of a bottom for the housing market. So pervasive is the market strength that Paul Desmond of *Lowry's Reports*, heretofore a skeptic of the market's advance, wrote in his October 20, 2006 weekly update that, "the primary focus for now is on identifying the best stocks to take advantage of the remaining bull market."

Two issues raised in our October 2006 *Update* have come to the forefront in the past few weeks. For starters, we questioned the market's assumption that the Federal Reserve would soon lower the Fed funds rate to stimulate economic growth, given our belief that the Fed did not share the market's optimism regarding ebbing inflationary pressures. Interestingly, while recent inflation reports including ISI's retail pricing power survey (see Chart 1) have shown that pricing pressures are subsiding, market participants at the same time have drastically reduced their expectations for a rate cut. Not only has the market awoken to the fact that despite recent good news, the Fed still believes core inflation is too high, but market participants are also coming to grips with the impact of the Fed's lowered estimate for *potential* gross domestic product (GDP).

Chart 1

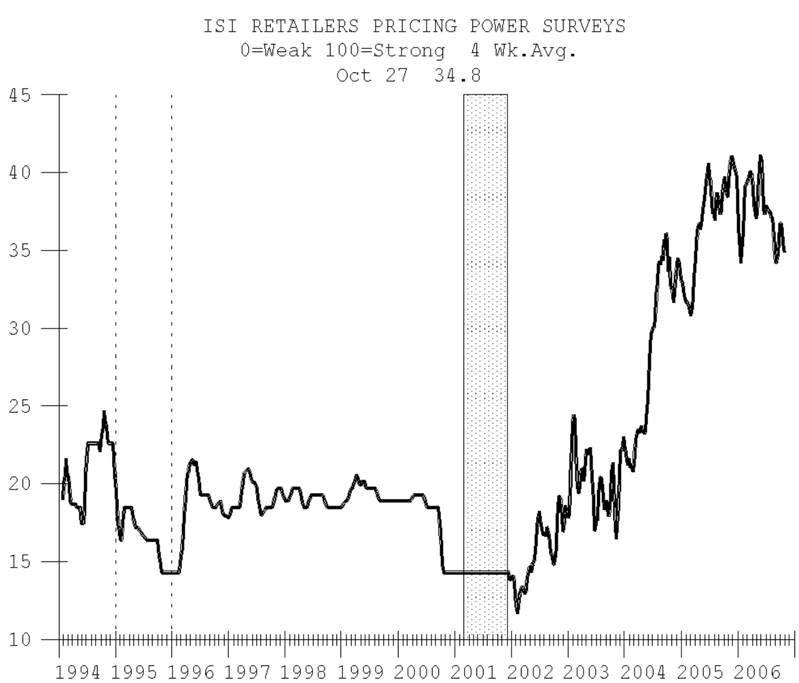


Chart courtesy of ISI Group, Inc.

Think of potential GDP as the nation's economic output assuming full employment producing at an optimal level of productivity. Importantly, economists believe that if GDP grows at a pace above its potential, it presents the risk of upward inflationary pressures. Unfortunately, the estimates the Fed uses for employment are based on statistical samples and have a high degree of variance. In the October non-farm payroll report, the Bureau of Labor Statistics (BLS) announced that the economy created 810,000 more jobs between April 2005 and March 2006 than previously estimated. While it is certainly good news that the labor force expanded, it also means that productivity was less of a contributor to past economic growth than previously believed. As a result, second quarter 2006 productivity estimates have been lowered from a 2.5% year-over-year gain to just 1.9%. Lower productivity means lower potential GDP growth, which, in turn, means the economy has to slow even more than originally expected for inflationary pressures to subside. According to Tom Gallagher at ISI Group, Inc., the Fed has lowered its potential GDP growth estimate to 2.5%, which he says could necessitate a Fed rate hike "even in a Goldilocks economic growth environment."

Last month we also discussed the new regulatory guidance for mortgage lenders. While the market believed the guidance would have little-to-no effect on mortgage lending, we sided with Andy Laperriere at ISI who argued that the new guidelines did, in fact, have teeth. Andy cautioned that the regulators would not have wasted their time writing guidance they believed would not have an impact.

So it came as no surprise to us that several large mortgage lenders announced in October that they are tightening their lending standards in response to the new supervisory guidance. In one telling press release a specific lender said, "We have re-evaluated our programs and practices and developed enhanced policies and techniques to reinforce our goal of providing fair and informed access to credit." This lender further indicated they will tighten their underwriting standards, enhance their process for confirming the income information on stated income loans and improve their disclosures to consumers.

Yet, regulators tell ISI that there is still much of the mortgage house to clean. According to an October 19, 2006 *Wall Street Journal* article by Ruth Simon entitled, More Home Loans Go Sour, rather than tightening standards lenders have been making it easier to get loans even as the housing market cools and the number of delinquencies rise. According to the article, the number of past-due mortgages continued to rise in the three months ended September 30. On October 16, 2006 John Dugan, Comptroller of the Currency, told the American Bankers Association that "new rules on non-traditional mortgages will pack more of a punch because, contrary to what many of the banks are telling investors, lenders will have to tighten their lending standards, which could…put downward pressure on home prices." He added, "What the underwriting survey says this year should give us pause. Loan standards have now eased for three consecutive years. The reasons most frequently cited are competition…and optimistic…expectations for loan volume, yield, and market share."

The more we hear about the environment that created the housing bubble, the more concerned we become. In this vein, the October 6, 2006 *Grant's Interest Rate Observer* provides perhaps the most troublesome insight into the process that enabled housing's historic run. At Jim Grant's annual investor conference, Paul Singer, general partner of Elliott Associates, presented his study of the collateralized debt obligations (CDOs) that are used to sell mortgage-backed securities to banks, brokerage houses, foreign countries, etc. According to Singer, the "structural insanity" of the CDO market transforms low quality debt into higher quality paper. In short, Wall Street packages stand-alone BBB and BBB- rated subprime mortgage tranches into CDOs in which most of the liabilities are rated AA or AAA. "The agencies confer a double-A or triple-A rating on as much as 87% of the CDO, though each of the component mortgage pieces is rated no higher than triple-B," the Grant's article states. "A CDO consisting of BBB and BBB- rated mortgage material can be blessed with ratings roughly as follows: AAA, 75%; AA, 12%; A, 4%; BBB, 4%; equity, 5%," even as housing fundamental have taken a negative turn.

Not surprisingly, mortgage engineers make slippery assumptions regarding the diversity of underlying mortgage collateral, liquidity, indulgent regulation and satisfactory default experience. Scariest of all, Singer's analysis suggests "extrapolating from limited historical experience, a flat to minus 4% house-price performance over two years is likely to ultimately result in a 10% subprime mortgage pool cumulative loss. This would create a wipeout of the CDO AA tranche and a partial loss on the AAA tranche. Eighty-four percent of the principal of the CDO – not just the BBBs – 84% of the whole principal would be wiped out."

Thank goodness that housing has bottomed! At least that is the belief of former Federal Reserve Chairman Alan Greenspan, who at an October 26, 2006 speech to the Commercial Finance Association in Washington said he sees "early signs of stabilization" in housing. To be frank, we must be looking at different data than Mr. Greenspan. Absolutely nothing in September's -9.7% year-over-year decline in new home prices (the largest such decline in 35 years) suggests a bottom to us. Nor do we find comfort in September's -14.2% year-over-year decline in existing home sales. Ed Hyman at ISI, one of the early proponents of the goldilocks economic slowdown, now says the year-over-year decline in the dollar value of new home sales, -22.5% in September, is at a level historically associated with past recessions! (See Chart 2.) Perhaps Mr. Greenspan sees these price declines as ordinary discounting to clear bloated inventories. However, Stephanie Pomboy of MacroMavens observes that even with the recent price slashing by the builders, inventories are still at record numbers in terms of units and dollar value (see chart 3). And now there is evidence this discounting is having an unintended effect. According to the National Association of Home Builders, cancellations on contracts to buy homes have increased 50% over the last year. In an October 27, 2006 *New York Times* article by Jeremy W. Peters entitled, New-Home Prices Fall Sharply, the Association's

Chart 2

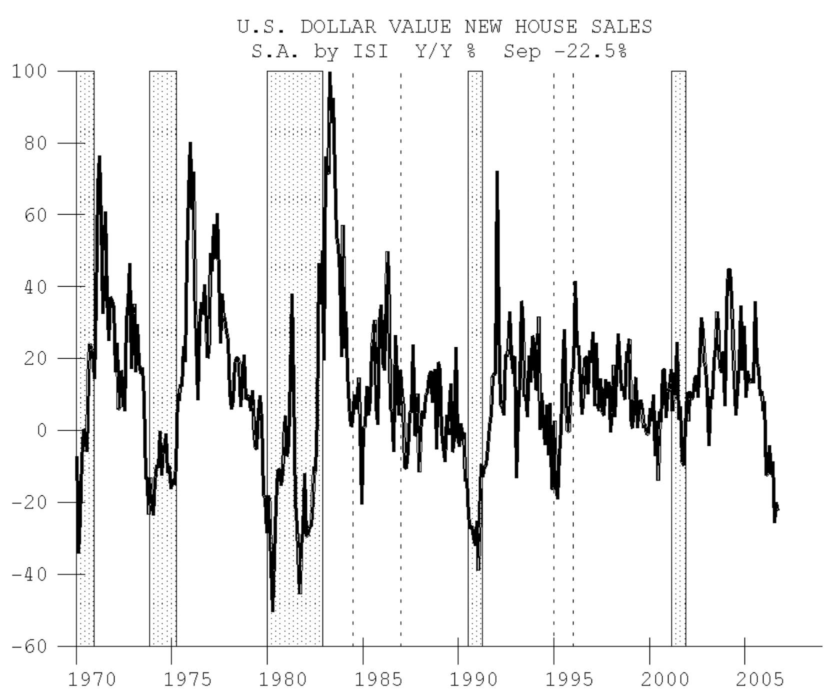


Chart courtesy of ISI Group, Inc.

chief economist, Dave Seiders said, “the cancellation rate is really big. It’s exploded over the last year.”

Despite the current rally in homebuilder stocks, Pomboy doubts the worst is over. In her October 26, 2006 MacroMinute she wrote, “Homebuilders have staged a nice comeback, rising +19% after their initial decline. But this is exactly how it worked with the Nasdaq! After its initial -55% decline…the Nasdaq staged an impressive rebound, rising 28% on the idea that ‘the worst was behind us.’ As we all know, buyers of that dip were treated to a -50% haircut.”

Chart 3

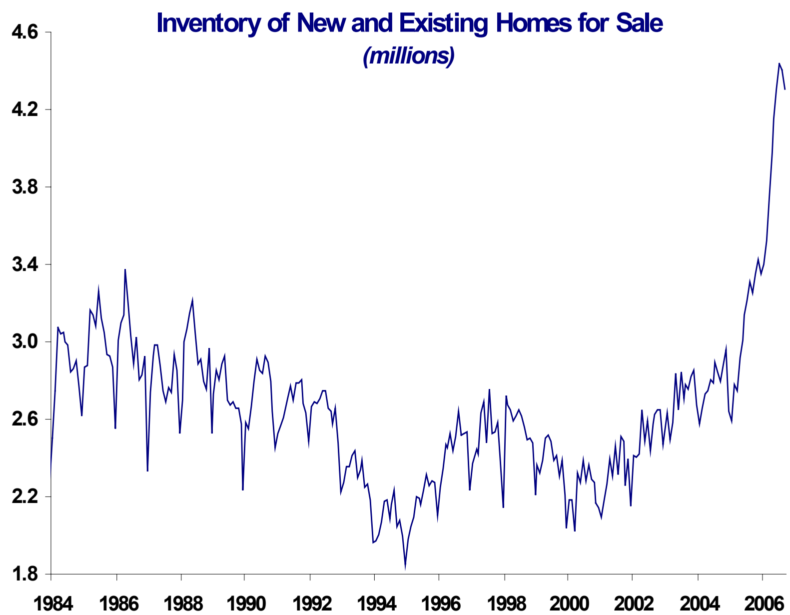


Chart courtesy of MacroMavens

Unfortunately, the collateral damage from the bursting housing bubble could be severe. Given the bloated level of current inventories, we believe additional home price declines lie ahead. Remember, according to Paul Singer, a -4% decline in home prices could wipe out 84% of the principal underlying the average subprime CDO. Remember, too, banks currently have a record exposure to these mortgage-backed securities.

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