



CALDWELL & ORKIN®

UPDATE

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“One of the lessons investors seem to have to learn over and over again, and will in the future, is that not only can you not turn a toad into a prince by kissing it but you cannot turn a toad into a prince by repackaging it.”

-Warren Buffett

*“I’d like to know what those damn things are worth.
[Until investors] are confident in their evaluations,
they are not going to be willing to fund these vehicles.”¹*

-Federal Reserve Chairman Ben Bernanke

Wake Up Call

The time has come for the current gamesmanship on Wall Street to end.

Since the first shot was fired across the credit bow in February 2007, investors have been force fed a constant diet of half-truths and whole lies regarding the nature and status of the mammoth mortgage-based derivative machine and the housing market bubble it inflated.

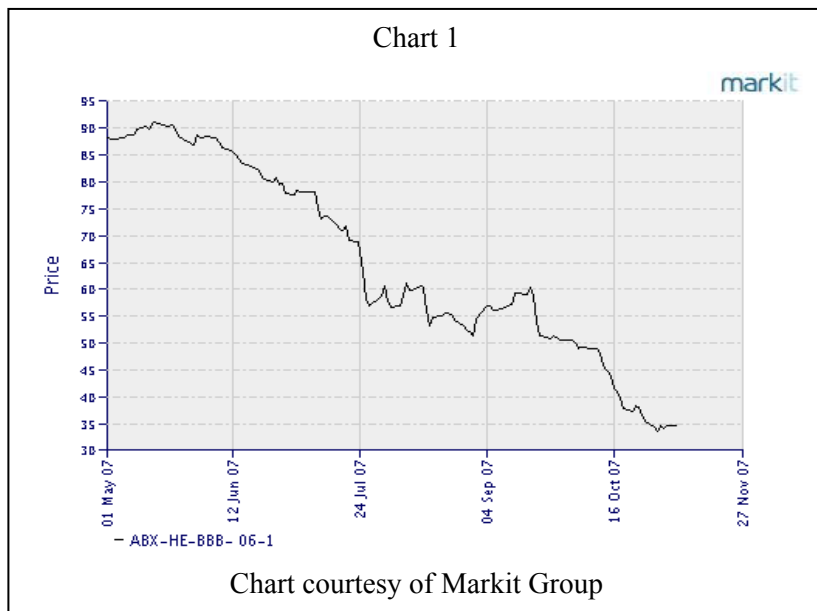
In March 2007, we were told by Ben Bernanke, the chairman of the U.S. Federal Reserve, that the fallout from the subprime mortgage credit dislocation was contained (see April 2007 *Update*). Then it was disclosed that subprime mortgages were used to purchase homes in nearly every corner of the nation, from small towns in the middle of nowhere to inner cities and affluent suburbs.² And those subprime loans were the backbone of collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs) that were packaged by Wall Street and sold to banks and other financial investors all around the world on the basis of their “investment grade” ratings. Of course, the ratings were a sham. On Friday, October 26, 2007, Moody’s Investor Service downgraded 45 CDOs that hold \$33 billion of subprime bonds that the rating agency had previously downgraded. Some of the CDOs were cut from the highest possible AAA rating to junk. The CDO downgrades show there is “no quick fix for the subprime problem,” said Cynthia Cole, senior portfolio manager at Allegiant Asset Management. “There won’t be any pickup anytime soon, and it will last at least until summer next year,” she concluded.³ Ed Hyman of ISI Group, Inc. now counts no less than 762 global casualties (i.e. write-offs at banks, tightening of lending standards and ratings downgrades) of the subprime mortgage contagion. The ABX Index that tracks the performance of subprime bonds has fallen precipitously (see Chart 1). The subprime mortgage credit dislocation is not contained.

¹ Edmund L. Andrews, “Treasury Chief Aims to Steady Credit Markets,” *The New York Times*, October 16, 2007.

² Rick Brooks and Constance Mitchell Ford, “The United States of Subprime,” *The Wall Street Journal*, October 11, 2007.

³ Aparajita Saha-Bubna and Carrick Mollenkamp, “CDO Ratings Are Whacked By Moody’s,” *The Wall Street Journal*, October 27-28, 2007.

Strike one.



In May 2007, we were told by U.S. Treasury Secretary Hank Paulson that the housing market correction was contained and is “largely behind us,” (see June 2007 *Update*). Then we saw home sales and home prices nose dive as foreclosures and inventory skyrocketed. According to the S&P Case-Shiller Home Price Index, house prices fell -4.4% year-over-year in August, the largest decline in six years. “The fall in home prices is showing no real signs of a slowdown or turnaround,” said Robert Shiller, chief economist at MacroMarkets LLC. “There really is no positive news in today’s report.”⁴ In October 2007, existing home sales were down 19% year-over-year, the worst decline since 1982. The inventory of unsold homes is now at 4.4 million, up roughly 60% from inventory levels two

years ago. The housing market correction is not contained.

Strike two.

In July 2007, we were told by the banks and brokers that the poor investments they made in subprime mortgages, CDOs and CLOs would not harm their balance sheets and would lead to, at most, minimal charges recognized in the second quarter (see September 2007 *Update*). Then we learned that the banks and brokers were valuing these securities at 97 cents on the dollar, even while the bonds held by these securities had lost more than half their value. These charges were justified via internal valuation models that clearly had no basis in reality. The sum of the parts did not equal the whole.

When valuing hard-to-trade securities, institutional investors are allowed to classify assets as Level 1, 2, or 3. Level 1 asset values are the most transparent, as they are frequently traded and have readily available pricing. Level 2 assets are less frequently traded, but are marked to market-listed prices. Level 3 asset values are the least transparent as they seldom trade and are, therefore, dependent upon subjective inputs determined by the asset holder, or what Warren Buffett calls “marked to myth.” According to Portales Partners, three of the top five brokerage firms increased their Level 3 “marked to myth” asset classifications by over 30% during the third quarter of 2007. “Everyone has an incentive in the short run to put the best face” on valuations, says Peter J. Solomon, a former Lehman Brothers vice chairman. “Their compensation is totally based on it. In securities that don’t have ready markets, particularly when the markets are troubled, it makes one totally suspicious.”⁵ Executives at UBS AG fired hedge fund manager John Niblo for his refusal to play along with this “mark to myth” game. According to *The Wall Street Journal*, Niblo was fired after marking some of the mortgage-backed securities in his fund in the range of 50 to 80 cents on the dollar. The problem: UBS held similar securities in other accounts that they had valued in the range of 80-89 cents on the dollar. Mr. Niblo is alleged to have asked his bosses at UBS how they

⁴ Courtney Schlisserman, “S&P/Case-Shiller Home Prices Fell 4.4% in August,” *Bloomberg News*, October 30, 2007.

⁵ Susan Pulliam, Randall Smith and Michael Siconolfi, “U.S. Investors Face An Age of Murky Pricing,” *The Wall Street Journal*, October 12, 2007.

could value the securities at a higher level “if [they] can’t sell them at these prices?”⁶ “Good question,” his bosses probably responded. “Now go find another job.”

J.P. Morgan Chase & Co. analyst Kedran Panageas estimates that 29% of lower-quality CDOs and 12% of higher-quality CDOs will eventually lose all of their value. Overall, she estimates the lost value is roughly \$85 billion of the \$475 billion of such securities outstanding, with investors having only recognized a fraction of those losses.⁷ Even with the additional write-downs that accompanied the firing of a few brokerage firm CEOs in late October 2007, we are yet to see realistic, market-based charges taken against subprime mortgage, CDO and CLO holdings.

Strike three.

Remarkably, with three strikes against him, this hitter is not yet out. For evidence of Wall Street’s desire to continue its slight-of hand trickery, look no further than the proposed structured investment vehicle (SIV –long-term, off-balance sheet investment vehicle that is funded via short-term commercial paper), brought to us by the aforementioned Treasury Secretary Paulson. To rescue smaller (multi-billion dollar) SIVs who are at risk of going belly-up as investors balk at funding their subprime mortgage investments (see October 2007 *Update*), the Treasury Secretary has reached into his bag of tricks and proposed a gigantic \$100 billion Super-SIV. “Decent, compassionate folk can only cheer the speed with which Mr. Paulson whistled up a \$100 billion bail-out for a posse of banks that found themselves stuck on a sandbar when the sea of liquidity they have been so happily splashing about in suddenly went bone dry,” wrote Alan Abelson.⁸ The idea for the Super-SIV was generated at a critical meeting of top bank officials convened by the Treasury Department on Sunday, September 16, 2007. At that meeting, the bankers told Treasury officials that their tainted assets could be sold, but they would face huge losses if their SIVs were forced to unload billions of dollars in mortgage-backed securities and other assets because it would drive down prices and lead to big write-offs.⁹ In other words, they could sell them, but not at the inflated prices that their models had valued them. Shudder the thought. So much for an efficient market!

“Paulson’s SIV rescue plan...is based on a diagnosis we don’t really agree with,” wrote Tom Gallagher at ISI. “The premise of the plan is that prices of SIV assets are lower than justified by fundamentals due to illiquidity and to fire sales; we suspect low prices are justified by expected default rates.”

Yet again, we have government officials teaming with Wall Street to roadblock the price discovery process. The difference this time is that many onlookers remain skeptical. “There’s still a very serious problem of lack of transparency in [the] markets, lack of trust on the part of market participants in the value of securities and the lack of trust in their counterparties,” said Martin Feldstein, an economist at Harvard University.¹⁰ Richard Bove, financial services analyst at Punk Ziegel, called the SIV bailout “a horrible idea” that “would do nothing to solve any subprime debt questions, mortgage issues, bad bank-loan problems, etc...It would not bail out any bad loans from anyone, anywhere...It will not solve the liquidity problems where the SIVs need the most help and it will not reduce the debt problems facing the economy.”¹¹ According to Tom Gallagher, “This could be one of those times when, given the lack of transparency on the subprime losses, the magnitude of the solution can increase market perceptions of the size of the problem.” Echoing Gallagher’s thoughts, the editorial board at *The Wall Street Journal* wrote, “To the extent there are bad loans, the public interest is served by having the market clear. If [the

⁶ Pulliam, October 12, 2007.

⁷ Pulliam, October 12, 2007.

⁸ Alan Abelson, “Up & Down Wall Street,” *Barron’s*, October 22, 2007.

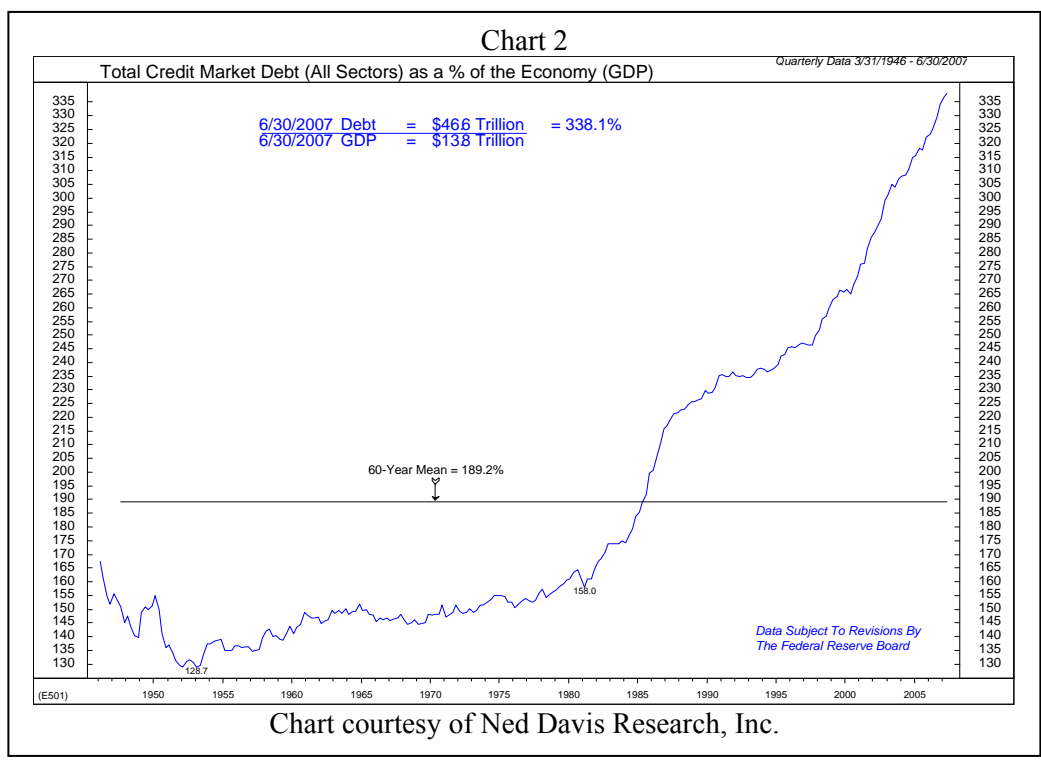
⁹ Carrick Mollenkamp, Deborah Solomon and Robin Sidel, “Rescue Readied By Banks Is Bet To Spur Market,” *The Wall Street Journal*, October 15, 2007.

¹⁰ Shannon D. Harrington and Neil Unmack, “O’Neal’s Subprime Shakeout Shows Peril of SIV Bailout,” *Bloomberg News*, October 25, 2007.

¹¹ Abelson, October 22, 2007.

Super SIV] has the effect not of clearing the market but of preventing it from clearing by throwing good money after bad, then we risk a banking paralysis of the kind Japan suffered during the 1990s because its banks refused to write-down bad assets. The current credit problems are causing enough trouble without letting them hang over the fixed income market for many more months or years.”¹²

Perhaps Wall Street is delaying taking painful charges on their mortgage holdings in the hopes that the Fed will continue to come to their rescue with aggressive monetary stimuli in the form of additional liquidity injections and Fed rate cuts. This is, after all, how the Fed manages the downfalls caused by the bursting of the bubbles they create...by creating newer, bigger bubbles. While this is certainly possible, there is some doubt that the Fed’s traditional crisis response will save Wall Street’s hide. “There are a number of factors that make me believe this is not a normal period,” wrote Ned Davis of Ned Davis Research, Inc. “Firstly, after financial bubbles it often takes a long series of Fed ease before the markets are safe. At least a selective bubble in housing is starting to unravel. Secondly... Fed ease may not directly make exotic derivative instruments [CDOs, CLOs], which the average person cannot understand, attractive or liquid.”



But don’t count the Fed out just yet. In a stunningly irresponsible Op-Ed piece written in *The Wall Street Journal*, Harvey Rosenblum, executive vice president and director of research at the Federal Reserve Bank of Dallas, argues that our current episode of financial turmoil is “an impediment that must be addressed as a prerequisite to achieving the FOMC’s other goals.”¹³ True, but this ignores the role the Fed played in creating the mountain of debt under which we now struggle. Rosenblum added, “In a modern, credit-dependent

economy like ours, a sharp reduction in the willingness or ability of lenders to grant, extend or renew credit can set off a contraction of economic activity and employment.” True again, but how, we wonder, did our economy become “credit-dependent” for growth? Given the explosion of credit creation during the Greenspan-led Fed era (see Chart 2), one can’t help but conclude that the policy of preemptive Fed easing (i.e. cutting rates in anticipation of a recession) has left the U.S. heavily reliant on growth via credit creation and vulnerable to the risks inherent in such growth. Without realizing it, Rosenblum admits as much when he concludes by writing, “So what’s the bottom line? Simply that moral hazard [the belief that the Fed will save risk takers from losses] is an inevitable, inescapable and unavoidable byproduct of the FOMC’s provision of macroeconomic stability. The better the FOMC’s job performance, the greater the recession insurance and the moral hazard that accompanies it.”

¹² Editorial Board, “House of Paulson?,” *The Wall Street Journal*, October 16, 2007.

¹³ Harvey Rosenblum, “Fed Policy and Moral Hazard,” *The Wall Street Journal*, October 18, 2007.

Translation: if the Fed is doing its job in saving us from the perils of recession, we will just have to deal with the downfalls of moral hazard. The problem with this conclusion is that the downfalls are becoming larger and the fallout risks to our economy (recession and a plummeting U.S. dollar to name two) are becoming much greater. “If you don’t act to at least moderately restrain major asset bubbles...then you will be backed into ever more corners and be forced to extend moral hazard until...no intervention is enough,” wrote Jeremy Grantham, Chairman of GMO. “We wonder, when housing prices were roaring, why the reverse was not argued and rates raised preemptively to cool housing so that excesses of consumption, extended consumer borrowing, and extended subprime nonsense would not have caused such problems.”¹⁴

Economists estimate that credit losses in the mortgage market could cost financial firms and investors up to \$400 billion, far more than the roughly \$240 billion inflation-adjusted cost of the savings and loan crisis of the early 1990s. The loss in total real estate wealth is expected to range from \$2 trillion to \$4 trillion.¹⁵

While major banks and brokerage houses continue to hide their losses, regional banks, who have less ability to hide portfolio hits given their smaller balance sheets, may be the canary in the coal mine of credit losses coming our way. In an earnings release typical for these regional banks, a small bank based in the West reported a 580% quarterly increase in delinquent loans and a 2,200% quarterly increase in non-performing assets. While these loss levels are concerning enough, adding to the drama is the fact that banks entered this credit contraction with record low levels of loan loss reserves. Zach Gast, an analyst at the RiskMetrics Group, believes a series of reserve increases will put pressure on bank earnings for several years. “Over the past 17 years,” Gast said, “loss reserves as a percent of total loans held for investment at banks have plummeted, falling to 1.23% in the second quarter of 2007 from 2.46% in 1990.” Gast believes that deteriorating credit quality, combined with historically low reserve levels, could force the banks to bolster their loans loss provisions by \$30 billion to \$85 billion.¹⁶

So what does this mean for the markets? This contraction in credit has been met with a flood of liquidity from the Fed which has driven money growth through the roof, with the three month annualized growth rate of money at zero maturity (MZM) at 20.9%. Typically, according to Marshallian K theory, when money supply is growing faster than the rate of economic growth, equity prices should move higher. However, this is not a typical period. In effect, Wall Street’s collective refusal to appropriately mark their portfolios to market reality is acting as a dam against the flood of liquidity the Fed has gushed into the markets. “Liquidity is not a pool of money but rather a state of mind,” wrote Paul McCulley of PIMCO bonds. “At the macro (systemic) level, liquidity is not about how many pieces of paper with pictures of dead presidents on them we have in our wallets, but rather about how much utility we derive from having them in our wallets. Or, as the cliché went in my youth in rural Virginia, liquidity is about whether the dead presidents are burning a hole in our wallets, or our pockets, as it were.”¹⁷

So dire is the current environment that Ned Davis, normally reliant on his monetary indicators to guide his investment outlook, is questioning the bullish indicators he sees. “With most of my traditional monetary indicators on buy signals, and the Fed sounding friendly, it is impossible for me to rate monetary conditions as anything but favorable,” Ned wrote in an October 25, 2007 piece. “On September 18, the Fed surprised the markets with a huge rate cut, and Wall Street partied like crazy. But...the dollar, along with banks, financials and housing stocks, are all down since September 18, and the big winner has been gold (and oil), suggesting inflation may not be dead. Thus the hard cold verdict from the market is that this is not a normal cycle.” (See Chart 3.)

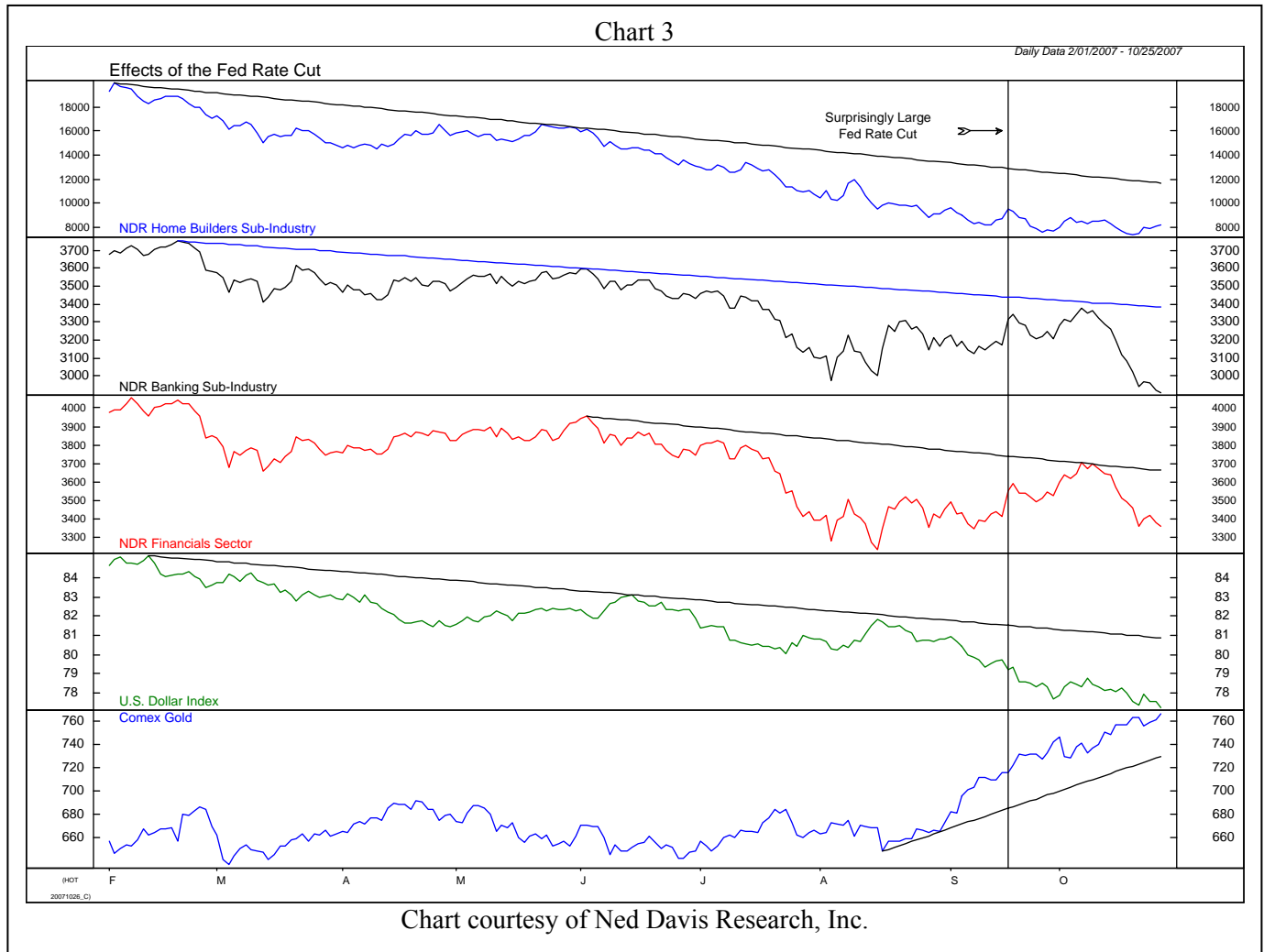
¹⁴ Jeremy Grantham, *GMO Quarterly Letter*, October 2007.

¹⁵ Vikas Bajaj and Edmund L. Andrews, “Reports Suggest Broader Losses From Mortgages,” *The New York Times*, October 25, 2007.

¹⁶ Gretchen Morgenson, “Get Ready For the Big Squeeze,” *The New York Times*, October 21, 2007.

¹⁷ Paul McCulley, “Global Central Bank Focus,” *PIMCO Bonds*, October 2007.

The fact that the credit crisis has now turned into a confidence crisis should serve as a wake up call to Wall Street, the Treasury and the Fed. Their continued obfuscation suggests they have been playing investors for fools, which leaves the risk that their efforts to stimulate credit and economic growth may end in jest. Collectively, they could be pushing on a string, thereby imperiling the economic well-being they claim to be protecting.



Michael B. Orkin, CFA
 J. Patrick Fleming, CFA
 William C. Horne

Portfolio Management Team:
 Michael B. Orkin, CFA
 J. Patrick Fleming, CFA
 David R. Bockel, Jr.