



## UPDATE

November 2009

CALDWELL & ORKIN®

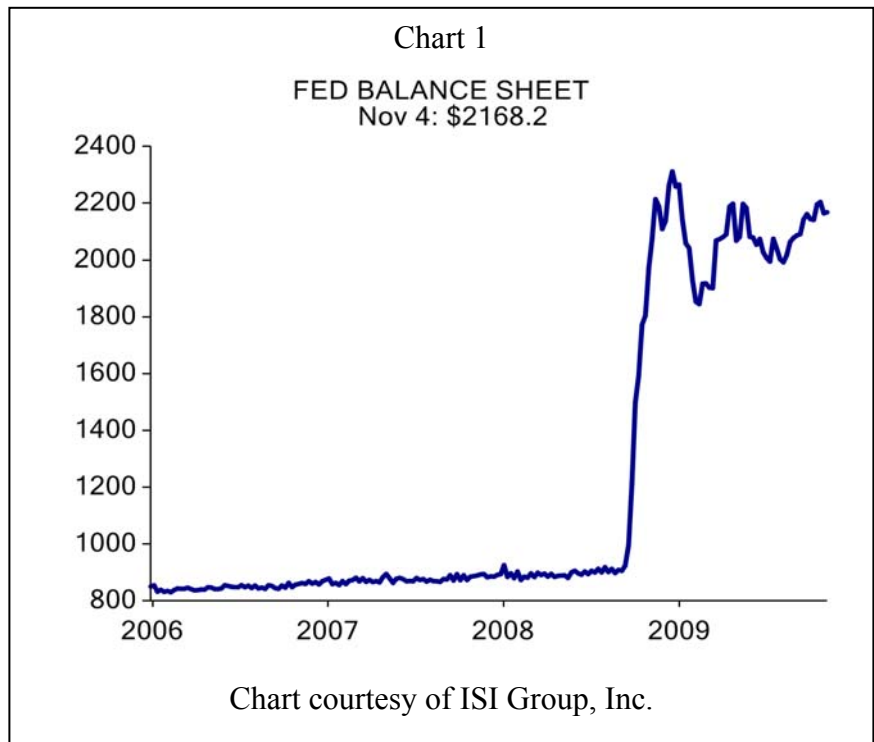
*“When you think things are bad, when you feel sour and blue, when you start to get mad... you should do what I do! Just tell yourself, Duckie, you’re really quite lucky! Some people are much more...oh, ever so much more...oh, muchly much-much more unlucky than you!”*

-Did I Ever Tell You How Lucky You Are? By Dr. Suess

### *Threading Needles in the Dark*

Federal Reserve Chairman Ben Bernanke must be crazy. We come to this conclusion not in judgment of past decisions or actions, but by virtue of his willingness to accept a second term for what has become one of the most difficult and thankless jobs in the country.

The unemployment rate hit 10.2% in October 2009, the highest rate of joblessness since 1983. After adding in those dropping out of the labor force and workers settling for part-time work, you get a ghastly “underemployment” rate of 17.5%, the highest level since the Great Depression. It seems as if structural weaknesses are making the labor markets resistant to policy makers’ resuscitation attempts, though it certainly is not for their lack of effort. Thanks in large part to Chairman Bernanke’s record-shattering monetary stimulus (see Chart 1) and Congress’ fiscal profligacy (see Chart 2), the economy posted 3.5% growth in the third quarter of 2009. If we dig under the surface, however we find that much of the economic activity in the third quarter was courtesy of temporary government stimulus programs. According to John Williams of Shadow Government Statistics, 1.7% of the growth in the third quarter came from “cash for clunkers” infused auto sales. An additional 0.6% was from new residential construction goosed by the first-time home buyer tax credit.<sup>1</sup> Kudos go out to these programs for



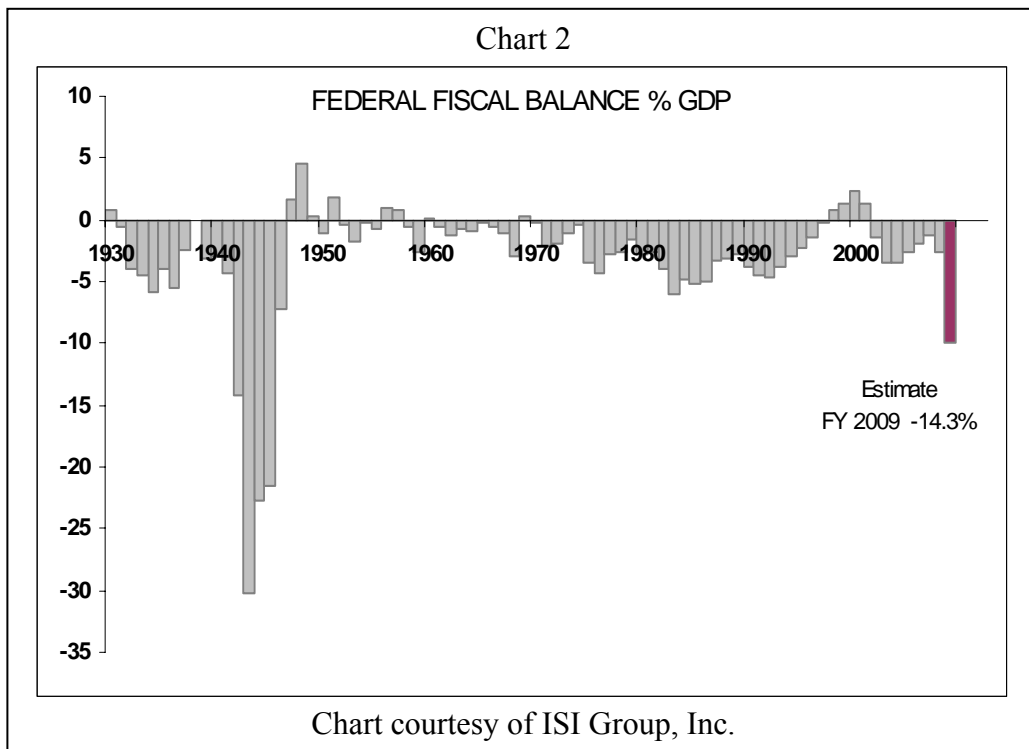
<sup>1</sup> Alan Abelson, “Going to Extremes,” *Barron’s*, November 2, 2009.

generating growth. That was, after all, their intent. But that growth (specifically that non-recurring growth) came with at a big price: we piled a lot of new debt onto our already record-high mountain of leverage, and that to us is a problem.

As of September 30, 2009, total national government debt was almost \$12 trillion. On that debt (most of which is short-term financed) we pay an average interest rate of 3.2%, or \$383 billion a year, according to the Treasury Department's Bureau of the Public Debt. The Congressional Budget Office (CBO) estimates that the 2009 budget deficit will add another \$1.4 trillion to the bill. Meanwhile, the Office of Management and Budget projects deficits of about \$9 trillion over the next 10 years, taking the national debt to almost \$21 trillion by 2019.<sup>2</sup>

A forecast of a near doubling of our national debt begs for higher interest rates (as higher rates of interest will likely be required to support the huge pipeline of debt). But even if we assume rates stay constant by 2019, we will be paying roughly \$670 billion annually in interest payments alone! Importantly, this number excludes significant liabilities for which the government is directly and indirectly responsible.

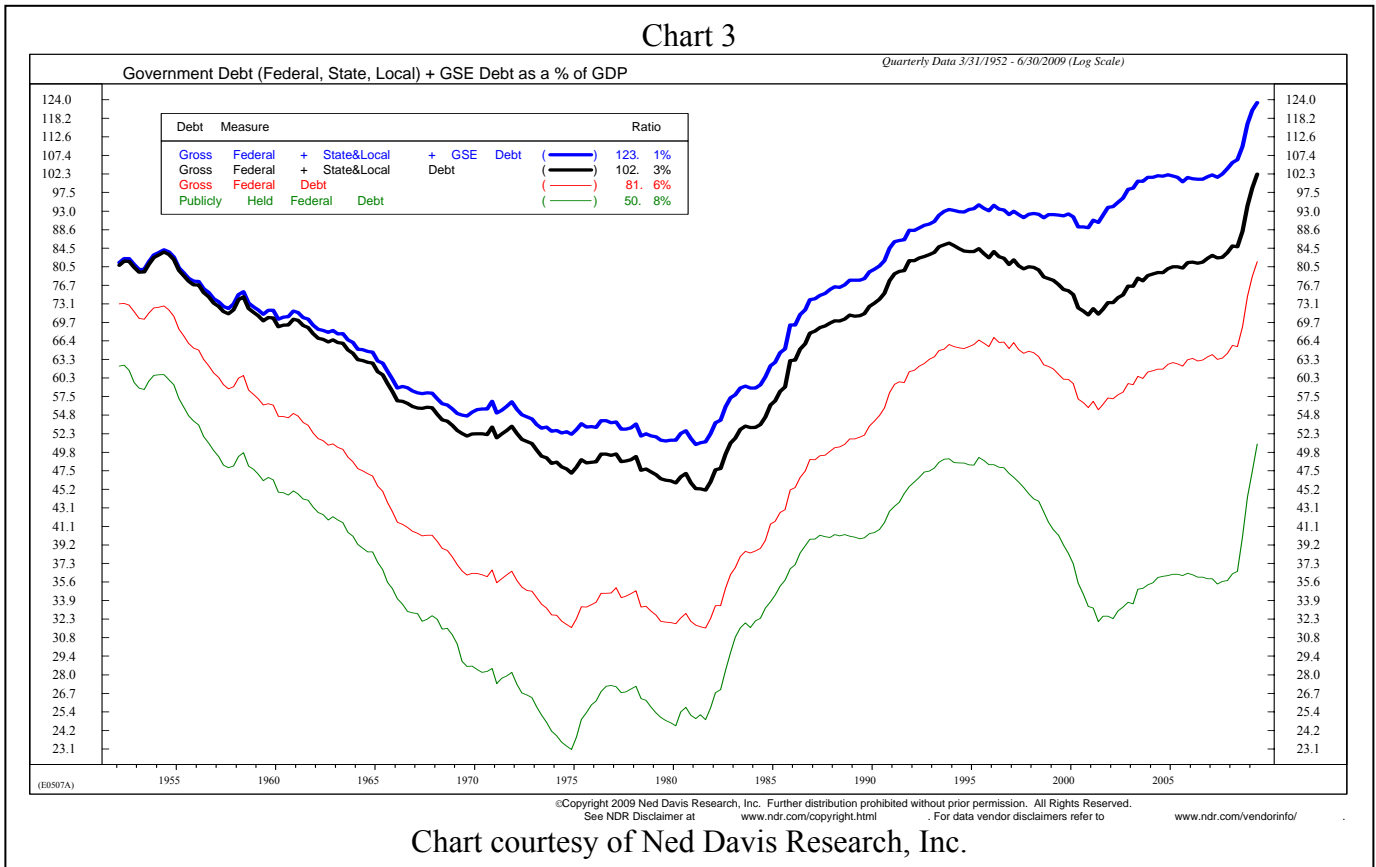
“[In the second quarter of 2009] the federal debt/GDP ratio surged a record 14.3 percentage points to 50.9%, the most in nearly 53 years,” wrote Joe Kalish of Ned David Research, Inc. “But...to obtain a complete picture of the debt size may require adding more layers of government liabilities: The first layer adds the nonmarketable Treasury debt held by the trust funds. This includes our future obligations for Social Security and Medicare.



The result, otherwise known as gross federal debt, has climbed to a record 81.6% of GDP. The second layer adds in state and local government debt, pushing the ratio above 100%. Of course the federal government does not have to assume or guarantee any of the \$2.983 trillion of state and local debt. But it is hard to imagine that it would let the State of California, one of the most fiscally challenged states and the sixth largest economy in the world, default on its \$77 billion state debt. The final layer adds the GSE[Government Sponsored Enterprise] debt. Since the government now practically owns Fannie Mae

<sup>2</sup> Lawrence Kadish, “Taking the National Debt Seriously,” *The Wall Street Journal*, October 12, 2009.

Chart 3



and Freddie Mac, it is liable for their debt as well, and by default implicitly guarantees the debt of other GSEs. Adding GSE liabilities brings total government debt to a staggering 123.2% of GDP.<sup>3</sup> (See Chart 3.)

With a debt to GDP ratio at 123.2%, even the most steadfast Keynesian economist must concede the limits of the U.S. government’s ability to stimulate the economy. Unfortunately, though some positive signs are emerging, it is not yet clear if the private sector is ready or willing to pick up the slack.

The raging economic fad in 2009 is liquidity. Perhaps this new craze will die a quick, merciful death, but given the need for balance sheet repair and the still unsettling shock of asset price destruction, we bet this trend could last longer than many expect. According to the Federal Reserve, consumer credit fell \$14.8 billion in September 2009, the eighth straight month of credit declines, the longest stretch since 1991.<sup>4</sup>

As yet, relatively few corporations are borrowing or spending. In the second quarter of 2009, the 500 largest nonfinancial U.S. corporations held \$994 billion in cash and short-term investments (9.8% of their total assets), more than at any time in the past 40 years.<sup>5</sup> This hoarding is the result of an unwillingness to make investments in the future and an uncertainty regarding the availability of future

<sup>3</sup> Joseph F. Kalish and Veneta Dimitrova, “Government Debt May Be A Lot Worse Than You Think,” *Ned Davis Research, Inc.*, October 6, 2009

<sup>4</sup> Associated Press, “Consumer Borrowing Fall Sharply,” *The New York Times*, November 7, 2009.

<sup>5</sup> Tom McGinty and Cari Tuna, “Jittery Companies Stash Cash,” *The Wall Street Journal*, November 2, 2009.

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financing as banks are either unable or disinclined to lend. While these large cash balances hinder current economic growth, they could foretell future spending. Just as companies are spending and investing less today, they are also left with more cash to deploy as the economy improves, giving them a freer hand to acquire, and to restart hiring and capital spending.<sup>6</sup>

Capital is still hard to come by for many small and midsize American businesses. Lacking the cash of their larger brethren, these companies are struggling to secure bank loans, in turn impeding their hiring and expansion plans. According to a survey of senior loan officers conducted by the Federal Reserve Board, most banks expect their lending standards to remain tighter than the levels of the last decade until at least the middle of 2010.

The lack of credit availability is not only the fault of tight-fisted banks. The debt securitization markets, which at their peak (a few years ago) accounted for 60% of all credit in the U.S., continue to be in disarray. The private market in securities backed by home mortgages has collapsed from \$744 billion in 2005 (at the peak of the housing boom), to \$8 billion during the first half of this year. “The securitization markets are dead,” said Yale economist Robert J. Shiller. While the government is currently supporting the securitization markets, it is unclear what will happen when these programs expire. “We’re stuck,” Shiller concluded.<sup>7</sup>

Can an economy in which credit remains tight generate employment growth? For some economists making the case for a pending cyclical employment recovery, the answer is...yes! Ed Hyman of ISI Group, Inc. is in this camp. Hyman believes there are many signs pointing to a cyclical employment recovery, including 1) a recovery in ISI’s temporary employment survey, 2) better Bureau of Labor Statistics (BLS) temporary employment data, 3) an improvement in the manufacturing and service Purchasing Managers Indices (PMIs), and 4) a moderation in employment losses and the improvement in international labor markets. “Employment is the key to sustainability,” wrote Hyman. “Unemployment claims, which have already declined at a faster pace than they did in the last two jobless recoveries, clearly point to employment continuing to improve (see Chart 4). If employment starts to



<sup>6</sup> Tom McGinty and Cari Tuna, “Jittery Companies Stash Cash,” *The Wall Street Journal*, November 2, 2009.

<sup>7</sup> Jenny Anderson, “A Thirst for Credit: Recovery Could Use Some Buyers of Debt (Other Than the U.S.),” *The New York Times*, October 7, 2009.

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increase, which will require roughly +4% real GDP growth, a self-sustaining recovery will have probably taken hold. If growth is only +2%, employment will probably continue to decline, and we will have had a failed attempt,” he concluded.

But the argument for a cyclical employment recovery ignores the labor market’s structural weaknesses. Long frowned upon, pay cuts are occurring more frequently than at any time since the Great Depression. The index of total weekly pay for production workers has fallen for nine consecutive months, an unprecedented string over the index’s 44-year life, and much longer than the previous record of a two-month decline during the 1981-1982 recession. “What this means,” said Thomas J. Nardone, an assistant commissioner at the BLS, “is that the amount of money people are paid has taken a big hit; not just those who have lost their jobs, but those who are still employed.”<sup>8</sup>

Employees are willing to accept these pay cuts because they are rightfully frightened by the prospect of looking for work in this job market. One of the more striking aspects of the Great Recession (originating in December 2007) is that most of its impact has fallen on a relatively narrow group of workers. The number of people who have experienced any unemployment is surprisingly low, given the severity of the recession. While the pace of layoffs has increased, the peak layoff rate this year was the same as it was during the 2001 recession, which was a fairly mild downturn. So fewer workers than might be expected have lost their jobs, but those without work are paying a steep price, because finding a new job is extremely difficult.<sup>9</sup>

“We are particularly concerned about the staggering rise in the number of long-term unemployed,” wrote Joe Kalish. “Those without a job for more than six months increased by 450,000 to 5.4 million in September, or a record 3.5% of the labor force. Many of the unemployed are not expected to be recalled to their old jobs, as the unemployment rate for those permanently laid off reached an all-time high of 5.5% in September. We believe this is mostly structural unemployment, which usually lingers longer than cyclical unemployment, as it requires the acquisition of new marketable [labor] skills, and thus keeps upward pressure on the overall unemployment rate and the natural unemployment rate... Persistent long-term unemployment has been shown to have a negative effect on consumer sentiment, personal income, and spending.”<sup>10</sup>

While record stimulus spending has not as yet generated job growth, the accompanying record deficits and debt are beginning to foster fears of an impending return of inflation as a weak dollar and higher commodity prices take hold. “Gasoline prices in the U.S. today are up 60% [from] December of last year,” (when energy prices plummeted to trough levels) wrote Ed Hyman. “They are 21% higher in Japan and +20% in Germany. The U.S. headline CPI [consumer price index] is on track to be up 3.3% year-over-year in December 2009 versus -1.9% in July, the biggest swing in almost 60 years. These headline accelerations are likely to stoke inflation fears that are already smoldering.” While true, it should be noted that the Fed’s preferred inflation barometer, the PCE deflator, should show a more subdued increase in inflation in coming months. Furthermore, as long as oil prices don’t increase

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<sup>8</sup> Louis Uchitelle, “Still on the Job, but Making Only Half as Much,” *The New York Times*, October 14, 2009.

<sup>9</sup> David Leonhardt, “Broader Measure of U.S. Unemployment Stands at 17.5%,” *The New York Times*, November 7, 2009.

<sup>10</sup> Joseph F. Kalish, “Structural Unemployment Pushing Up Exhaustion Rate,” *Ned Davis Research Inc.*, October 8, 2009.

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significantly from current levels, there should be relatively less upward price pressure from energy early next year.

To be sure, some central banks, including Australia, Norway, India and Israel, have begun to tighten economic policy. “We will start to see G-20 economies exiting now, starting with the emerging ones and then the advanced countries,” said Mridul Saggar, the Mumbai-based chief economist at Kotak Securities Ltd. “In India’s case, growth is coming back on track and inflation is becoming quite a concern.”<sup>11</sup>

The call for monetary and fiscal restraint is being made domestically as well. “The Fed has been flooding the world with dollars in the name of preventing a U.S. deflation after last year’s panic, and it shows no sign of tightening any time soon,” opined the editorial board of *The Wall Street Journal*. “The more immediate danger - in the coming months - would be if the fall of the dollar becomes a rout. This could cause a spike in commodity prices, such as oil, that are traded in dollars and jeopardize the nascent economic recovery. But even if there is no dollar panic, the volatility of currency markets is distorting investment decisions and creating more economic uncertainty. It could also lead to a round of competitive devaluations, as other nations try to placate their own domestic export constituencies.”

Allan Meltzer, a professor of political economics at Carnegie Mellon University and the author of the multi-volume *A History of the Federal Reserve*, has also called for restraint. “Banks’ idle reserves that are available for lending [have] reached \$1 trillion,” he wrote. “Once banks begin to expand loans or finance even more of the massive deficits, money growth will rise rapidly and the dollar will sink to new lows. Do we have to wait for a crisis before we replace promises with effective restraint?”<sup>12</sup> Excess reserves are what drove the Federal Reserve to tighten monetary policy in 1936 while the economy was experiencing rampant economic growth of 15.27%, 7.84% and 12.69% from 1935 – 1937. Curiously, Meltzer (as well as the current economic policy makers) faults the 1930s Fed for tightening reserve policy, saying the decision prolonged the Great Depression. “The Federal Reserve’s error was the belief that excess reserves could be reduced without consequence,” he wrote. “Its denial of the effect of doing so is puzzling in light of the efforts that banks made to restore excess reserves.”<sup>13</sup>

We are not sure what makes today’s environment different from the 1930s in Meltzer’s eyes. Now as then the Fed’s choices are limited. Thanks to record debt and deficits, further stimulating the economy to achieve increased employment risks a continued decline in the value of the dollar and eventual inflation. On the other hand, thanks to a structurally weak labor market, fighting inflation by reigning in stimulus risks deflation and depression.

While we fully support the actions taken to prevent economic Armageddon in 2008, we have always realized there would be consequences of both these actions and the imbalances that made them necessary. As long as government stimulus is necessary to support economic growth, we will remain prisoners to our creditors’ willingness to finance our deficits. Should they balk, the Fed would be at risk of failing to achieve economic stability.

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<sup>11</sup> Cherian Thomas, “India Central Bank Begins Exit From Monetary Stimulus,” *Bloomberg News*, October 27, 2009.

<sup>12</sup> Allan Meltzer, “Preventing the Next Financial Crisis,” *The Wall Street Journal*, October 23, 2009.

<sup>13</sup> Allan Meltzer, *A History of the Federal Reserve: Volume 1: 1913-1951*, 2003.

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For now we remain cyclically bullish, but we recognize this is an extraordinarily unusual economic environment and the dynamics can change suddenly. Our cyclical bullish disposition is predicated upon continued stimulus and our government's ability to finance its debt in a successful manner. At their October Reserve Board meeting, the Federal Open Market Committee (FOMC) voted unanimously to keep policy stimulus in place for an extended period. As long as the Fed can execute such stimulus without adverse consequences, we believe the secular bear market can be held off temporarily (acknowledging that this could mean months or possibly even years).

We recently had the opportunity to speak with Dino Kos, Managing Director of Portales Partners, about the Fed's current predicament. Dino worked for the Fed under former Fed Chairman Alan "Easy Al" Greenspan. He said given the environment, the Fed will be conducting much of their policy by trial and error.

How hard is their task? According to Kos, "It's like threading a needle....in the dark."

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