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CALDWELL & ORKIN®

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## UPDATE

December 2006

### *Caveat Emptor*

Has it really been six years since...

- Price-per-click and “eyeball capture” were commonly used valuation methodologies?
- A \$250 internet stock received a \$1,000 price target?
- The Nasdaq Composite Index rallied 2,000 points in two-months?

Even as time has distanced us from that raucous era, the lessons learned from the bursting of the Internet stock bubble will not be lost on investors. Or will they?

In March of 2000, the Nasdaq Composite Index peaked at 5,132.52. By May of that year, it had sold off 40.7% to 3,042.66, but then rebounded 41% to 4,289.06 in less than two months. During that rally, analysts celebrated the end to the correction in technology stocks and released bullish forecasts. With the benefit of hindsight, we know that the Nasdaq would proceed to hit a yearly low of 2,288.16 in December of 2000 (a 46.7% decline from the rebound-high) and would not find a bottom until October 2002 at 1,108.49 (some 74% lower than the rebound-high). This is how bubbles usually unwind. Not in the form of a one-time sell-off that does little to damage investor sentiment, but rather in a gradual, prolonged, gut-wrenching march lower as investors slowly and painfully release their bullish grip on miscalculated prognoses.

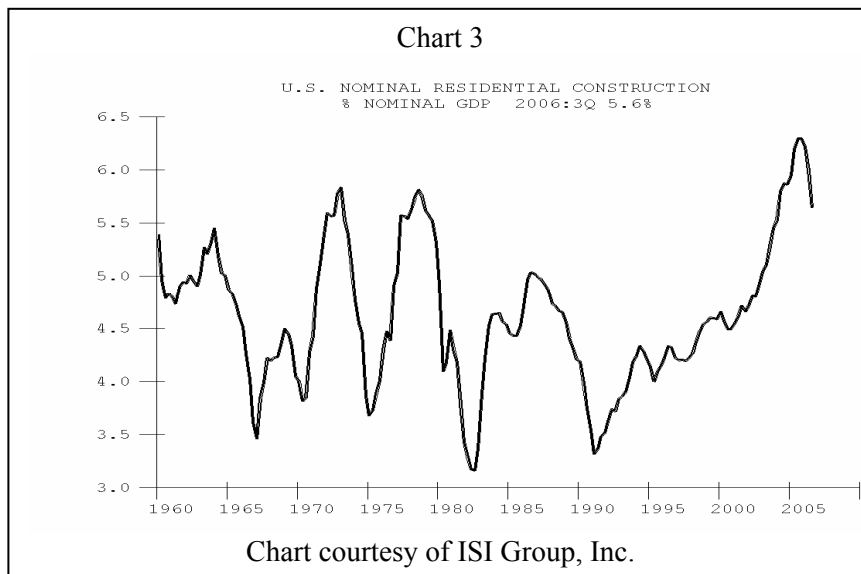
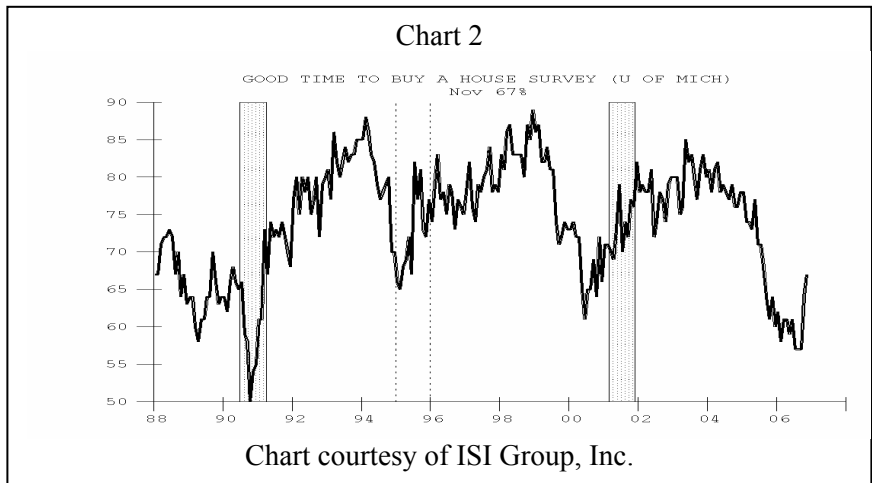
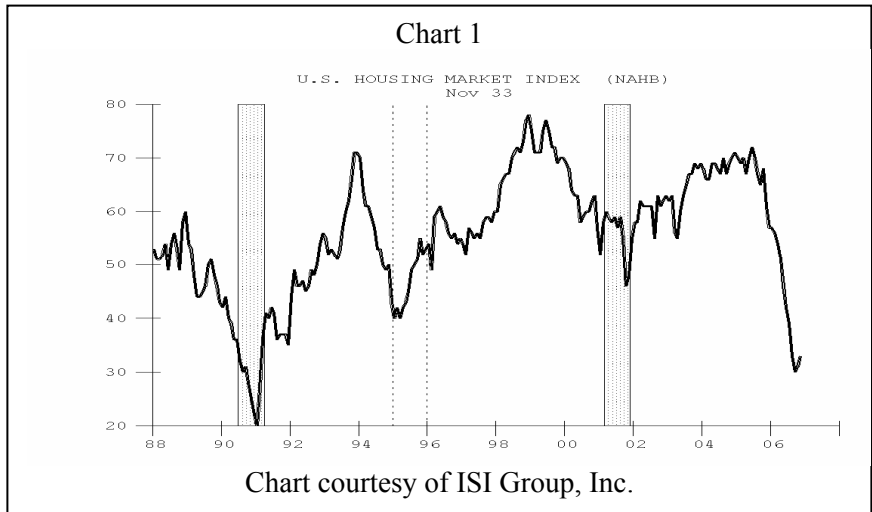
And so it is that we now find investors giddy on the outlook for housing stocks. From the July low of 186.82, the Philadelphia Housing Index has rebounded nearly 20% on hopes that the worst for the housing market is over. Sharing this optimism is Alan Greenspan (ever-blind to bubbles and ambivalent to their formation), who recently declared that the latest and last bubble of his creation has finished deflating. In an October 26, 2006 speech in Washington D.C., the former chairman of the Federal Reserve assured his audience that, “most of the negatives in housing are probably behind us.”

We don’t know for certain if they were in the audience that day, but it does appear that some heavy hitters in the investment world received an invitation to Sir Alan’s house party. Indeed, the funds of Fidelity Management & Research, the Bill & Melinda Gates Foundation and Ichan Management L.P. each reported purchases of home building stocks in the month of November. Perhaps there is legitimate reason for their optimism. After all, the National Association of Home Builder’s housing index (see Chart 1) and the University of Michigan’s housing survey (see Chart 2) both indicate housing market sentiment is on the rebound.

Further, in a bullish take on bad news, Mark Whitehouse and Michael Corkery of *The Wall Street Journal* suggested in their November 18-19, 2006 article entitled, [New-Home Construction Slid 14.6% Last Month](#), that September’s -14.6% year-over-year drop in housing starts could help stabilize a housing market suffering from a glut of inventory.

For the record (and probably of little surprise), we are not buyers of this bullish housing story. Importantly, Ed Hyman of ISI Group, Inc. still believes the housing correction has a good way to go because inventories are still high and the ratio of residential construction to Gross Domestic Product (GDP) is also still high by historical standards. (see Chart 3).

Also, it is important to heed those who correctly forecast the housing market's decline, and follow less-closely those who missed the boat. On that note, Ivy Zelman, the prescient housing analyst at Credit Suisse First Boston, who correctly forecast the housing market downturn, remains bearish. In a November 22, 2006 *Wall Street Journal* article by Michael Corkery and Marilyn Chase entitled, Builders Find Strong Foundation, Zelman is quoted, "Just because large investors that have big names are buying stocks doesn't mean they are going to be right. The market so badly wants to believe we are near a bottom and it will be back to the races, that it is forgetting that there is a boatload of inventory out there."



Unlike her bullish peers, Zelman doesn't expect the housing market to stabilize until the spring of 2008. Despite our confidence in this generally bearish housing outlook, we currently are not short any homebuilders as we prefer to stay on the sidelines during this rally in the hopes for a better entry point in the future.

Just as we see a murky future for housing, so too do we expect trouble ahead for the sector that helped fuel housing's meteoric rise - subprime mortgage companies. While most mortgage stocks have not experienced the recent reprieve enjoyed by housing shares, some analysts are nonetheless turning bullish on the sector.

One mortgage analyst recently upgraded a mortgage company stock under his coverage to a “Buy.” In his upgrade note he provided the following rationale to investors: “headwinds will persist over much of our forecast horizon...we have reduced our estimates...there are formidable challenges ahead...we are raising our price target.” Stellar analysis such as this gives us greater confidence that lower prices will be seen for this group.

We also draw confidence from recent cautious comments by Andy Laperriere at ISI. According to Laperriere, the two associations of state bank regulators (the Conference of State Bank Regulators and the American Association of Residential Mortgage Regulators) recently released model rules for mortgage lending that are very similar to the regulatory guidance released by the five federal bank regulatory agencies a few weeks ago (see October and November *Updates*.) “The significance of these model rules is that most state bank regulators will now follow the federal regulators in cracking down on nontraditional loans,” Laperriere wrote, “which means almost all mortgage originators will soon have to tighten underwriting standards...We believe the federal and state regulators will force a tightening in lending standards, thus reducing demand for housing.”

According to a recent analysis done by brokerage firm UBS Warburg, the regulators may be too late. UBS’ analysis indicates that residential mortgage loans extended to subprime borrowers in 2006 are going bad 50% faster than those made in 2005, illustrating the erosion in lending standards. As credit quality begins to deteriorate, we expect the under-reserved subprime mortgage companies will be forced to raise capital in a manner that will not be beneficial to their stock prices.

It appears, for now, that the economy is settling into a Goldilocks-like slowdown that is the Holiday wish for most portfolio managers – not too hot, not too cold, but just right. Inflation readings in October showed monumental declines in both consumer and producer price indices and world-wide inflation readings continue to decelerate as well. Importantly for financial markets, nominal GDP growth slowed to a 3.4% annual rate in the third quarter at the same time that money growth, as measured by MZM (money at zero maturity), accelerated to a 4.7% year-over-year clip. Accelerating money growth in the face of slowing nominal GDP growth can be explosive for financial markets as, according to Marshallian K money supply theory, the excess supply of money will find its home in financial assets.

In response to our market outlook, an *Update* reader recently told us, “it sounds to me like you all are cautiously pessimistic.” Perhaps it is fair to judge us this way when reading our market *Updates*, but this description is only half-true. While we currently remain cautious in our outlook, we also retain the flexibility to shift our asset allocation exposure when necessitated by the markets. For now, despite our pessimism on the housing and mortgage sectors, and our ongoing concerns surrounding elevated levels of consumer debt, the trade deficit, the federal budget deficit, and the falling U.S. Dollar, we are cautiously optimistic in our outlook for the economy and for stocks in general heading into year-end. Or, quoting Ned Davis of Ned Davis Research, Inc., “[We] remain in the soft landing (goldilocks) camp for now, but this does not mean [we are] not alert for high risks.” Caveat emptor – let the buyer beware.

Happy Holidays!

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