

## UPDATE

December 2007

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*“One ought to be deeply skeptical of the effectiveness of a [Bush administration housing bailout] proposal that, at root, is designed to repeal the laws of supply and demand...Policies designed to suspend the laws of economics inevitably produce unintended consequences. Today’s housing bust is itself the unintended consequence of an easy Federal Reserve monetary policy designed to cushion the economy from the fallout of the bursting of the tech bubble.<sup>1</sup>”*

-Andy Laperriere, Managing Director, ISI Group, Inc.

### Santa Paulson

*There he stood, an intimidating 6’5” tall, with the confident air that comes from playing football at Dartmouth and serving at the helm of the world’s largest investment bank. On this day, however, there was a particular lightness in his demeanor. He looked, in a word, happy! No, jubilant! It was, after all, the holiday season and Santa Paulson had more than just the holidays for which to be thankful. He had presents to deliver - a giant bag full of them that he hoped would bring joy to the boys and girls on Wall Street. As he walked the decked halls of his Treasury Department, Santa Paulson sang,*

*“All I want for Christmas  
Is my two front teeth  
And my Super SIV  
And my subprime rate freeze.”*

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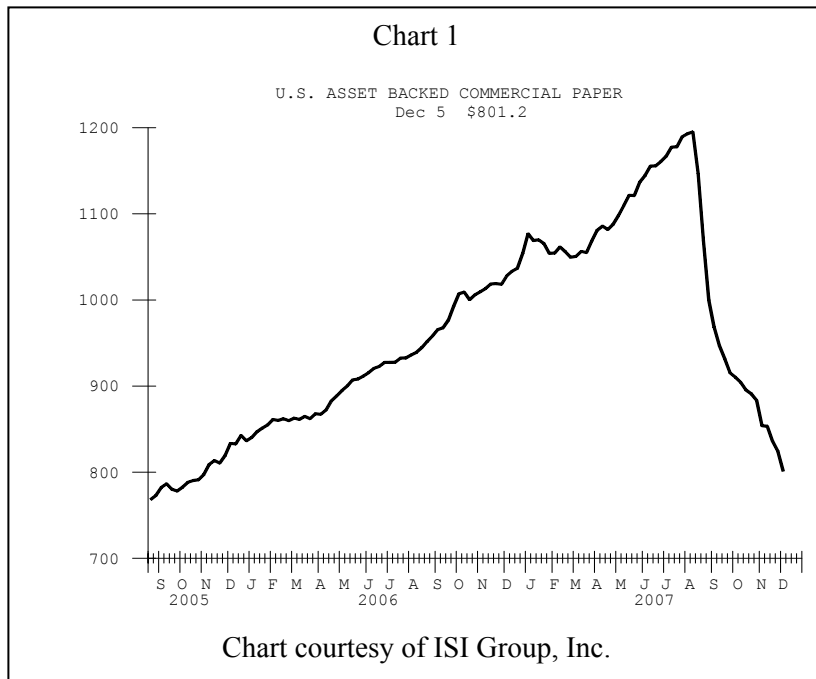
It is by a circuitous route that the U.S. economy finds itself standing at the edge of a cliff, looking down into the abyss of a potential recession. As is now evident, former Fed Chairman Alan “Easy Al” Greenspan’s expansionary monetary policy cure for coping with the technology bubble collapse had negative side effects. Greenspan’s real genius was in bubble inflation. (Fun while it lasts, but utterly destructive when the party ends.) Luckily, for Easy Al, he will not be the one cleaning up the mess caused by this latest bubble’s bursting. A mess, we now know, that has spread far and wide. “The credit crisis is contained,” quipped Jim Grant, editor of Grant’s Interest Rate Observer, mocking the government’s summer forecast in a recent Bloomberg TV interview. “Contained on planet Earth,” he added.

Indeed, what was once considered a subprime mortgage malaise now counts over 1,000 contagion victims, according to Ed Hyman’s unofficial “subprime casualty count” at ISI. Recently, a historic contraction in credit availability in markets unrelated to housing is threatening both the creation of jobs and the expansion of businesses, potentially adding to Hyman’s body count. According to Federal Reserve data, the combined value of outstanding commercial and industrial bank loans and short-term commercial paper peaked at about \$3.3 trillion in August, and had fallen to \$3 trillion by mid-November, a drop of nearly 9% in just three months (see Chart 1). This type of credit has not contracted at this fast a pace since the Fed began tracking the data in 1973. “This is a very big deal,” said Andrew Tilton, a senior economist in the United States Economic Research Group at Goldman Sachs. “You’re

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<sup>1</sup> Andy Laperriere, “No Bailouts for Borrowers,” *The Wall Street Journal*, December 4, 2007.

basically crimping the growth of the more vulnerable companies. If they can't borrow the money, their options are much more limited. They'd have to have less ambitious hiring plans, buy less machinery and cancel projects.<sup>2</sup>

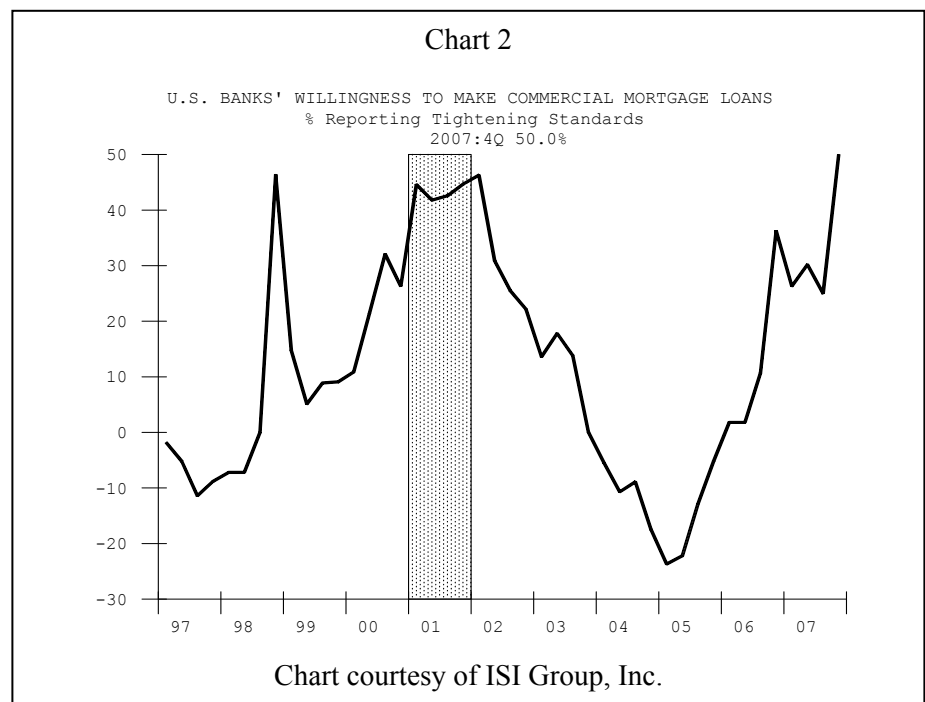


Part of the driver of this corporate credit contraction is the fear that, as with subprime mortgages, corporate credit was extended all too willingly to unworthy borrowers. Amid booming profits and extremely low default rates in recent years, many companies borrowed heavily to make acquisitions, go private, buy back stock or pay special dividends in activities designed to boost shareholder returns<sup>3</sup>. Now that the economy appears to be slowing, the prognosis for corporate balance sheets is looking less rosy. In the third quarter of 2007, \$92.1 billion in corporate debt was downgraded, the highest level in two years according to Fitch ratings. While the default rate on corporate debt (0.4%) is at its lowest level in more than 25 years, that can change fast as the business cycle turns. Consider: between 1998 and 2001, the

default rate on junk bonds jumped from less than 2% to more than 12 %<sup>4</sup>.

Commercial real estate is another sector feeling the credit contraction pinch. According to Moody's Investor Service, the value of commercial real estate, which nearly doubled in the past seven years, declined 1.2% month-over-month in September 2007. The Moody's report is an early sign that this sector is being dragged down by the growing reluctance of lenders to extend credit for anything related to real estate, which could create a new drag on the economy<sup>5</sup> (see Chart 2).

Unsurprisingly, consumer credit has begun to contract as well. This is mostly a reflection of the fact that after binging on debt, folks are simply tapped out. Despite historically low interest rates over

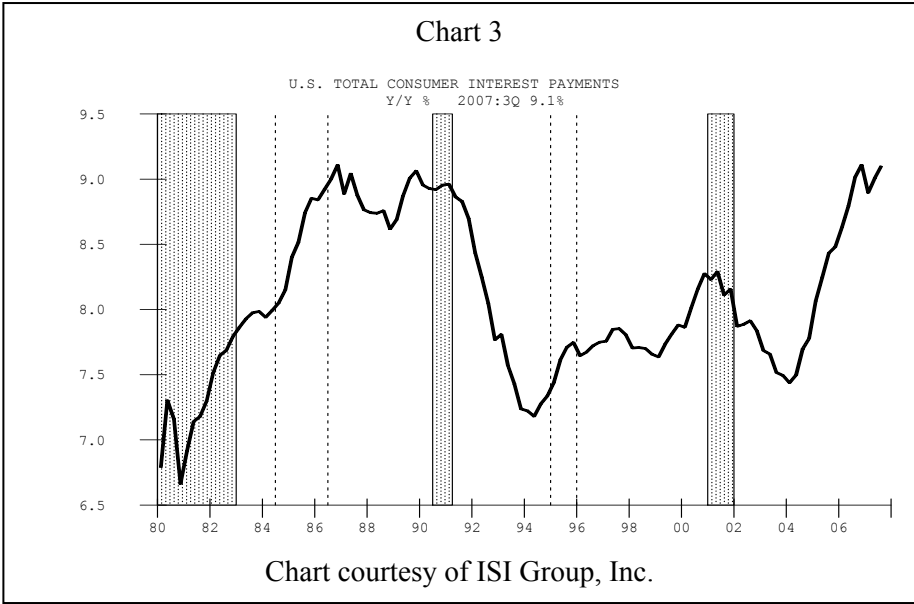


<sup>2</sup> Peter S. Goodman, "As Lenders Tighten Flow of Credit, Growth at Risk," *The New York Times*, November 29, 2007.

<sup>3</sup> Karen Richardson and Serena Ng, "Next Fear: Corporate Debt," *The Wall Street Journal*, November 7, 2007.

<sup>4</sup> Karen Richardson and Serena Ng, November 7, 2007.

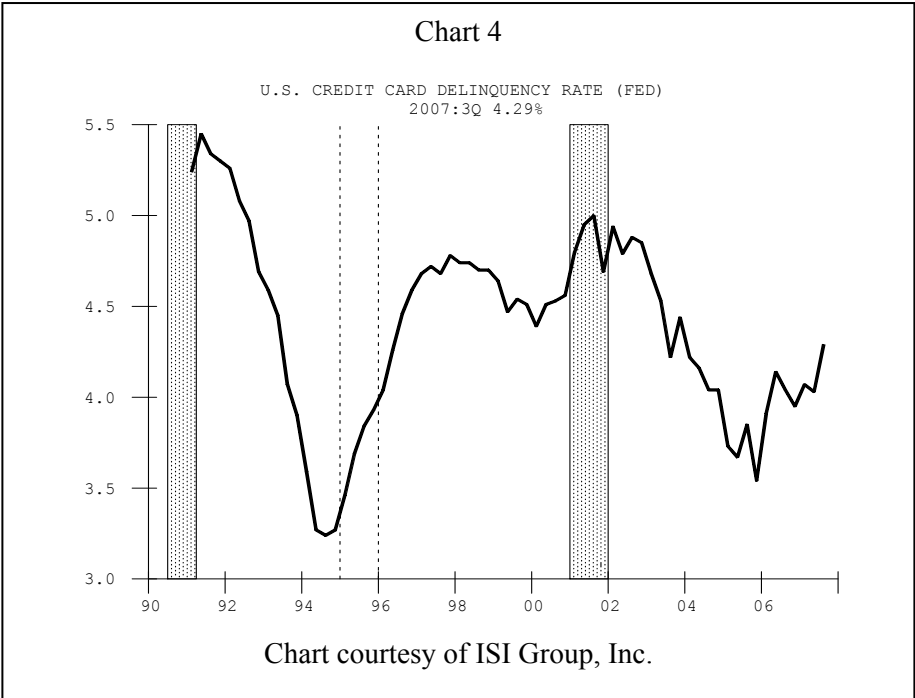
<sup>5</sup> Peter Grant, "Commercial Property Now Under Pressure," *The Wall Street Journal*, November 19, 2007.



the past five years, consumer interest payments as a percent of disposable personal income are at levels suggesting little margin for error (see Chart 3). Alarming, even with a solid employment backdrop, the consumer is falling behind on debt payments. According to Lehman Brothers, in September 2007 4.5% of auto loans made in 2006 are at least 30 days past due, up from 2.9% in August 2007. This represents the biggest one-month jump in delinquencies in eight years<sup>6</sup>. Credit card delinquencies are also on the rise, as can be seen in Chart 4.

Remember MEW? The home equity loan (HEL) machine that drove 10.3% of all personal consumption expenditures at its peak in 2005 through mortgage equity withdrawal (MEW) (and served as a substitute for lackluster wage growth) is now grinding to a halt, further pressuring the consumer. Ivy Zelman of Zelman & Associates estimates that MEW via HELs will decline to 9.4% of total home equity in 2007 from its peak of 15.4% in 2005. According to Mark Zandi, chief economist at Moody's Economy.com, this summer MEW fell to about one-third below the level of late last year. "This slide in equity withdrawal is very recent," Mr. Zandi said, "so you wouldn't expect the drop in spending to occur until now, or Christmas<sup>7</sup>." Bah Humbug!

A recent study by the National Association of Realtors found that 29% of all buyers and 45% of all first time buyers financed the entire purchase price of their home, and 53% of all homeowners made down payments of 10% or less. "Everybody was basically using their house as an ATM machine," said Dave Simonsen, a senior vice president for NAI Alliance, an industrial real estate firm in Reno, NV. "Now they are upside down on their house without

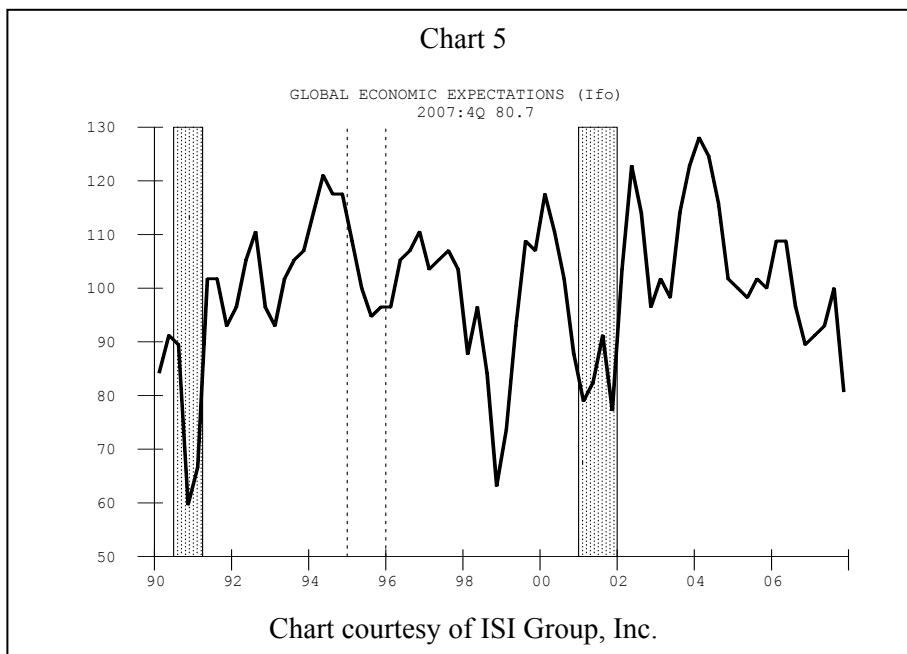


<sup>6</sup> Jeffrey McCracken and Gregory Zuckerman, "Surge in Auto-Loan Delinquencies Is Latest Trouble for the Economy," *The Wall Street Journal*, December 6, 2007.  
<sup>7</sup> Peter S. Goodman, "Homeowners' Reduced Equity Raises Fear of Slow Spending," *The New York Times*, November 8, 2007.

that piggybank to go back to<sup>8</sup>.” Translated, these individuals owe more on their house than it is currently worth, leaving no more equity left to spend. Adding insult to injury, house prices have now begun to decline in haste, as reflected by a -1.8% year-over-year decline in October 2007. Robert Schiller, economics professor at Yale University and co-founder of the S&P / Case-Schiller Home Price Index, suggests that, given the current environment, we have to seriously consider the possibility that the housing price downturn will eventually be as big as that of 1925 to 1933, when prices fell by a total of 30%.

Increasingly falling behind on their payments, with less credit available to help and the price of their largest asset in decline, is it any wonder that consumer confidence is in the tank? The consumer confidence index fell from 95.2 in September to 87.3 in October. A reading of consumers’ future expectations about the economy plunged from 80 in September to 68.7 in October, matching the gloom seen around oil-price shocks tied to the Iraq War in 2003 and Hurricane Katrina in 2005. Apart from those events, consumer expectation readings haven’t been this slow since the 1990-91 recession<sup>9</sup>. “People are not operating with a big cushion here,” said Nigel Gault, chief U.S. economist with Global Insight Inc., “especially at the lower end of the income scale. It’s not good to start the shopping season with consumer sentiment having dropped into a zone that is normally associated with a recession...it’s going to be a tough holiday season for retailers<sup>10</sup>.”

Luckily for our economy, international growth is going to save the day and keep the U.S. out of a recession, right? Perhaps, but here the outlook is clouding up as well. According to Ed Hyman, evidence is building that world economic growth is slowing. The CESifo Group’s Ifo World Economic Survey of 89 economies is at its lowest level since 2001 (see Chart 5). The story for the developed economies (which, including the U.S. accounts for 70% of worldwide GDP) is much the same as it is in the U.S. - after a long period of credit expansion and home price inflation, mounting mortgage and derivatives losses are crimping banks’ willingness to lend. Interest



rates are rising in the markets European banks use to borrow money, and the banks have grown wary of lending to each other because of anxiety about potential losses on investments tied to the U.S. mortgage market<sup>11</sup>. The London interbank offer rate (LIBOR), the short-term interest rate at which banks lend money to one another, increased sharply in November despite the European Central Bank’s (ECB) continued injections of monetary liquidity. The data “point to the Eurozone economy increasingly faltering in the face of the credit crunch, strong euro, elevated oil prices, higher interest rates and softer growth in key export markets,” said Howard Archer, an

<sup>8</sup> Peter S. Goodman, November 8, 2007.

<sup>9</sup> Sudeep Reddy, “Consumer Gloom Adds to Recession Risk,” *The Wall Street Journal*, November 28, 2007.

<sup>10</sup> Elizabeth Douglass and Ronald D. White, “Cost of Oil Felt Beyond Pump,” *The Los Angeles Times*, November 14, 2007.

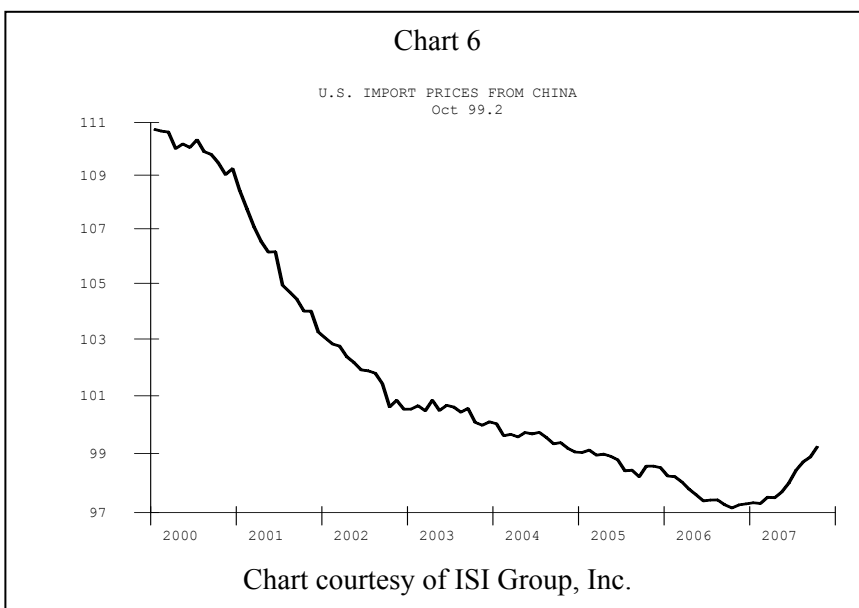
<sup>11</sup> Peter A. McKay and Kelly Evans, “Recession Fears Weigh Heavily On the Markets,” *The Wall Street Journal*, November 26, 2007.

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economist at Global Insight<sup>12</sup>. A little tidbit to keep in mind...many adjustable rate mortgages (ARMs) are tied to LIBOR.

As in the States, housing prices in the U.K., Ireland, Spain, France and Japan are on the decline. U.K. house prices fell -0.8% year-over-year in October 2007, the greatest decline in 12 years, albeit shy of the -1.8% decline in the U.S. during the same period, and mortgage approvals fell to the lowest level since February 2005, evidence that Britain's decade-long property boom is coming to an end. "Poor affordability, weaker house-price growth expectations and the effect of earlier increases in interest rates have all affected demand," said Fionnuala Earley, chief economist at Nationwide, a financial company in the U.K. "There are uncertainties in the market, not least from the continuing turmoil in the U.K.'s financial markets<sup>13</sup>." Sound familiar?

Given the muck the developed economies find themselves in, it can be well argued that the economic well being of the U.S. now rests on the back of the developing economic world. Here too, signs are troubling, but for a different reason. Many developing economies have currencies which are pegged to the U.S. dollar. As the U.S. Federal Reserve cut interest rates to battle the U.S. economic slowdown, central banks in developing countries have been forced to follow suit with their own monetary stimuli, despite the relative strength of their economies. Otherwise, their relatively higher interest rates would force their currencies to appreciate against the U.S. dollar, breaking their peg. The result:



rampant inflation. In China, consumer prices unexpectedly surged 6.5% in October 2007, despite price controls on a wide range of industries, matching August's gain which was the highest inflation rate in nearly 11 years<sup>14</sup>. Inflation woes in the developing world add to our stresses at home as the prices of imported goods increase, evidenced by the recent surge in the prices of goods imported from China (see Chart 6).

The market, however, appears to be unconcerned about accelerating inflation. Certainly, higher priced goods from China pose a problem, but the deflationary impact of rising production in emerging market economies coupled with the slowing U.S. economy should help temper inflationary forces here in the long-term. With ten-year Treasury bill rates around 4% - roughly 50 basis points (bps) below the Fed Funds rate of 4.5% - the financial markets are clearly more concerned with the pitfalls of the credit crisis that is now slowing growth the world over. Indeed, market commentators are clamoring for aggressive Fed action. The soft spoken and well respected Bill Gross of PIMCO Bonds is calling for an eventual cut of the Fed Funds rate to 3%, some 150 bps below the current level. Clamor as the market may, we maintain our reservations about the effectiveness of Fed easing policy in the early stages of this credit crisis.

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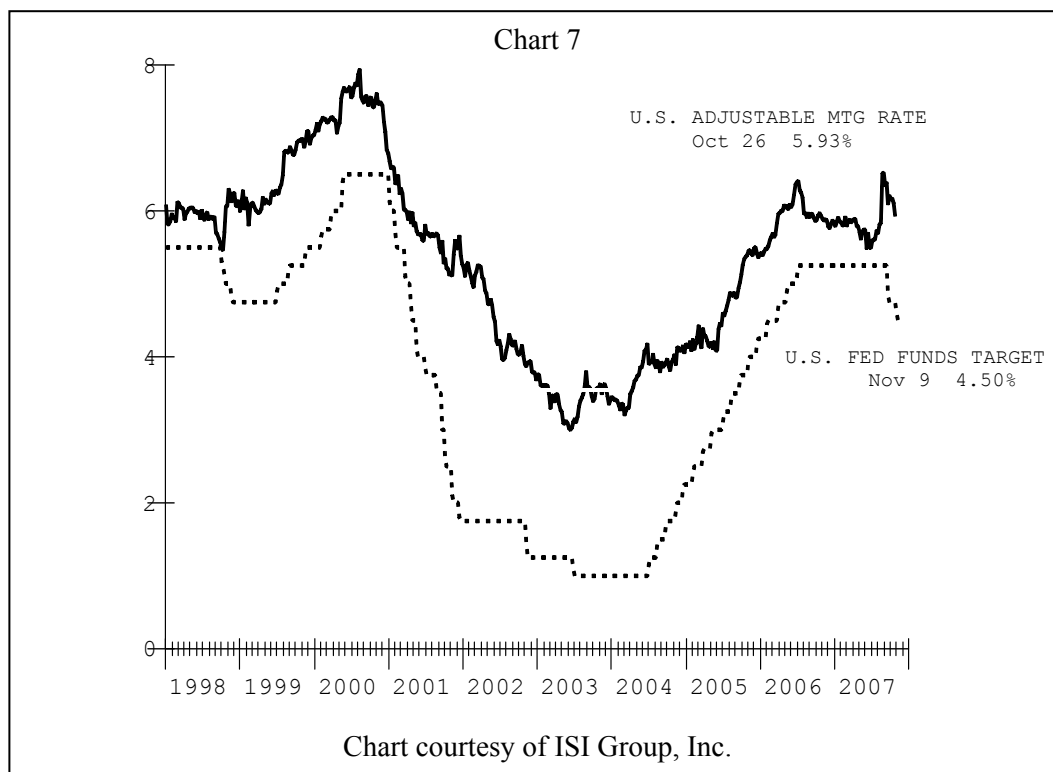
<sup>12</sup> Carrick Mollenkamp and Mark Whitehouse, "For Banks, the Hurt Just Goes On," *The Wall Street Journal*, November 26, 2007.

<sup>13</sup> Brian Swint and Svenja O'Donnell, "U.K. Home Prices Drop Most Since 1995, Loans Decline," *Bloomberg News*, November 29, 2007.

<sup>14</sup> Keith Bradsher, "Chinese Prices Surge Again, Despite New Controls," *The New York Times*, November 14, 2007.

On this score, we have good company. In a series of notes to his clients, Ned Davis of Ned Davis Research, Inc. has written on the challenges of Fed policy in the current environment. “I have made the point that after bubbles in financial / real estate markets...it can take a long while for Fed easing to impact the markets. Furthermore, banks are tightening credit standards for all kinds of loans including mortgages (see Chart 7), so we are clearly in some kind of credit crunch despite the Fed trying to be friendly. Thus, while the monetary outlook looks like the skies are clearing, the “market” says things are still somewhat cloudy<sup>15</sup>... We try to make the Fed our friend. But in looking at what has happened with the housing / debt boom and bust this cycle I am tempted to ask, ‘with friends like these, who needs enemies?’...Following the Fed probably works some 90% of the time, but occasionally...it can take a very long time for the Fed’s easing machine to begin to work.<sup>16</sup>...The questions I would ask if I were on the Fed: 1) Did the three rate cuts, which clearly hurt savers, offset that painful blow by significantly lowering mortgage rates? 2) Did they stabilize the dollar, making foreign investors want to keep their trillions in reserves in the U.S.? 3) Did the three rate cuts instead actually contribute to the surge in oil, which will make homes in suburbs cost more to heat and to drive to? The stock market action in financials and home building stocks tells me Fed policy was a mistake and a failure. In conclusion, with \$47 trillion in debt, the Fed may indeed have no way to deal with burst bubbles except by creating more bubbles. They may need to ‘inflate or die.’<sup>17</sup>”

Ugh. The Fed really has their work cut out for them. Perhaps Easy Al shouldn’t hold his breath waiting for that Holiday card from current Fed Chairman, Ben Bernanke. Bernanke shouldn’t fret, however, because Treasury Secretary Hank “Santa” Paulson is on the way with official fiscal relief for this mammoth credit malaise. After sitting on the sideline for months watching the credit crisis, Santa Paulson is now in the game with dual bailout relief for banks and subprime borrowers alike in the form of the Super SIV (Structured Investment Vehicle) and the subprime rate freeze, respectively.



Each of these proposed bailout plans sports a “clever” moniker. The Super SIV is named the Master Liquidity Enhancement Conduit (MLEC) and the subprime rate freeze is called The Hope Now Alliance. With names like these, is there any doubt they will be effective? Well, yes. These bailout plans are both built on the same premise - to inspire hope among investors.

Fundamentally, however, neither does much at all in terms of delivering real help to banks and consumers.

<sup>15</sup> Ned Davis, “Institutional Hotline,” *Ned Davis Research, Inc.*, November 30, 2007.

<sup>16</sup> Ned Davis, “Institutional Hotline,” *Ned Davis Research, Inc.*, November 16, 2007.

<sup>17</sup> Ned Davis, “Chart of the Day,” *Ned Davis Research, Inc.*, November 8, 2007.

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For its part, MLEC will only invest in SIVs that hold the highest quality mortgage bonds, and will not save troubled SIVs that hold billion of dollars in subprime packaged loans. “It is quickly being realized that [the Super SIV] doesn’t solve the problems,” said Joshua Rosner, a managing director at the research firm Graham Fisher & Company who had been skeptical of the proposal. “The path they have taken of skimming off the cream from the top doesn’t resolve the fact that there is poison at the bottom.”<sup>18</sup> Other investors are coming to this realization as well. While the original plan was to raise \$75 billion for the Super SIV, lack of investor demand has brought the anticipated asset raise down by half. Interestingly, the 30 or so SIVs that the Super SIV aims to help have about \$250 billion in assets they will need to unload in the coming months. “When you think about the buyers of this stuff,” Jim Grant wrote paraphrasing an investor, “the capital pool that is out there to buy it seems significantly smaller than the potential supply, which would imply that a lot of the paper could trade down below fundamental value. You don’t want to try to call the bottom.”<sup>19</sup> Thus, the Super SIV ain’t so super.

As for The Hope Now Alliance, the details are emerging daily. While specifics of the plan are still being worked out, enough is known to safely say its overall impact will be, at best, marginal. The plan is to freeze the rates on subprime ARMs at their teaser rate level for a period of five years for borrowers that meet the government’s criteria. Existing subprime loans fall into three buckets: 1) those who can’t afford the initial payments, 2) those who can afford the payment increase, and 3) those who can afford the current payment but not the higher payment once the teaser rate resets. It’s the third group the government is targeting. “We haven’t changed our conclusion that the widely reported proposal is likely to have only a marginal impact on the number of foreclosures and home prices,” wrote Andy Laperriere. “First, almost a quarter of the subprime mortgages that would reset next year are already delinquent and presumably would not be eligible for fast-track modification. Those with debt to incomes (remember Chart 3) above roughly 50% or more would also experience payment increases because they are probably living on borrowed time and simply cannot sustain payments that already represent such a large share of their income. Because so many subprime loans were ‘stated income,’ the number with sky-high debt-to-incomes is large. The group that can’t afford their current payment accounts for the vast majority of subprime loans that are currently delinquent. Therefore, most of the loans in the delinquency / foreclosure pipeline would be unaffected by this proposal.”

With help from an outside contact, we confirmed Andy’s math. There are \$1.5 trillion in outstanding subprime mortgage loans. According to the government, two million loans will reset in 2008 that are subject to the rate stabilization plan. The average value of a subprime mortgage is \$180,000. Two million times the \$180,000 average loan amount equals \$360 billion that could qualify (or fall into the three buckets). Using the current delinquency rate of 20% eliminates \$72 billion of these loans because borrowers have to be current on their payments to qualify. That leaves \$288 billion. Assuming 50% of the remaining subprime borrowers could pay for the house regardless of reset, and would, therefore, be ineligible for this relief, that leaves \$144 billion that would qualify. So, about 10% of the \$1.5 trillion outstanding subprime loan market will be eligible to have their interest rates frozen for a brief period of five years. “The push for loan modifications will probably help the economy a little in the short run if they slow the increase in foreclosures that would result in a sharper fall in home prices,” wrote Laperriere. “Of course, home prices need to fall considerably to reach a new equilibrium supported by economic fundamentals, so this would merely moderate the pace of home price declines but not change the end point.” A more accurate name for this bailout would be The Hope “for Now” Alliance.

It was only a short four years ago that Easy Al threw moral hazard by the wayside, slashing the Fed funds rate to 1.0%, in an effort to soften the economic blow caused by the bursting of the technology stock bubble. The blow was softened, but what was the price that we paid? If, in order to avoid recession we must imperil future economic well being, then sooner or later the question must be asked, “Should a recession be avoided at all costs?” According to a majority on Wall Street, the answer is, “yes.” Brian Bethune, U.S. economist at Global Insight,

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<sup>18</sup> Eric Dash, “Some Wonder if the Banks’ Stabilization Fund Will Work,” *The New York Times*, November 12, 2007.

<sup>19</sup> Jim Grant, *Grant’s Interest Rate Observer*, November 16, 2007.

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summed up the market's opinion saying, "There seems to be a vacuum in terms of leadership." Mr. Paulson and Federal Reserve Chairman Ben Bernanke need "to build up the public's confidence that they will do what is necessary to avoid recession," he concluded<sup>20</sup>.

Hearing this call, the Treasury Department, Congress and the White House have jumped head first into the moral hazard fray. While MLEC and The New Hope Alliance may be all sauce and little substance, one can bet that, in an election year, with 1.35 million homes set to be foreclosed upon this year and an estimated 1.44 million in 2008, politicians will be licking their chops to offer up more aid.

Children are encouraged to believe in Santa Claus, but most reasoned adults have done the chimney math and know that someone has to pay for the gifts under the Christmas tree. Santa Paulson may indeed be in a giving spirit this holiday season, and we may avoid a recession in 2008. But rest assured, just as with bubbles past, a price will be paid for muting the fallout from this bubble's implosion.

Those that strive to avoid a recession, no matter the costs, forfeit the right of sticker shock when the bill for their actions comes due.

Given substantial monetary and fiscal policy easing, a market that is technically oversold and the fact that we are in a time period of historic seasonal strength, we are currently anticipating a short-term market rally and our portfolios are positioned net long. In the medium-to-longer-term, however, we remain guardedly cautious.

Happy Holidays from all of us at Caldwell & Orkin, Inc.

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<sup>20</sup> Deborah Solomon and Michael M. Phillips, "U.S., Banks Near A Plan to Freeze Subprime Rates," *The Wall Street Journal*, November 30, 2007.