



UPDATE

July 2010

CALDWELL & ORKIN®

“The global financial markets are no longer focusing simply on the financial position of the banks. They want to know that the governments that have supported the banks over the last 18 months are taking the actions to bring their own finances under control. Greece stands as a warning of what happens to countries that lose their credibility, or whose governments pretend that difficult decisions can be avoided... How we deal with these things will affect our economy, our society — indeed our whole way of life. The decisions we make will affect every single person in our country. And the effects of those decisions will stay with us for years, perhaps decades, to come.¹”

-David Cameron, Prime Minister of Britain

“My best guess is that we’ll have a continued recovery, but it won’t feel terrific. And the reason it won’t feel terrific is that it’s not going to be fast enough to put back eight million people who lost their jobs within a few years.²”

-Ben Bernanke, Chairman of the Federal Reserve

Secular Ills

Greece changed everything. The inability of this small, economically insignificant nation to roll over its sovereign debt so that it could fund its operations and meet its obligations propelled the worldwide economy out of a period of stimulus-based recovery and into an austerity frenzy, the likes of which would make even the most rigid Austrian economist blush. Given the extreme over-indebtedness of many developed economies, reality was eventually bound to replace frivolity. However, these economies appear unable to walk without the crutch of government support, thus increasing the risk of a global double-dip recession.

It is almost impossible to open a newspaper and not find a story about budget cuts and deficit reduction. From Europe to the U.S. to China, Keynesian stimuli are being reigned in. European governments have little choice but to pull back on long-promised social benefits as tax revenues fall, populations age and deficits rise. Such cutbacks in conjunction with higher taxes have been announced in Ireland, Spain, Italy, Greece and Portugal.³ In Greece, the January 2010 – May 2010 budget deficit was \$8.98 billion, compared to \$14.66 billion during the same period in 2009 - a -38.7% decline in spending. In Britain, Chancellor of the Exchequer George Osborne has unveiled a sweeping emergency budget combining severe spending cuts and some tax increases in that nation’s deepest fiscal retrenchment since the early years of Margaret Thatcher’s rule. “Yes, it’s tough but it’s also fair,” Mr. Osborne told Parliament. “This is the unavoidable budget. I am not going to hide hard choices from the British people.” Mr. Osborne has already announced spending cuts of £6 billion (\$8.7 billion) out of the £661 billion

¹ Sarah Lyall, “Facing Deficit, Cameron Warns Britons of ‘Decades’ of Austerity,” *The New York Times*, June 8, 2010.

² David E. Sanger and Sewell Chan, “Stimulus Talk Yields To Calls To Cut Deficits,” *The New York Times*, June 9, 2010.

³ Suzanne Daley, “Safety Net Frays in Spain, As Elsewhere in Europe,” *The New York Times*, June 28, 2010.

budget. Analysts believe that Mr. Osborne will be compelled to cut as much as another £50 billion in the coming years if he is to reduce his nation's budget deficit from 12% of gross domestic product (GDP) in 2010 to the 3% of GDP level that the European Union has set as its broad measure of fiscal responsibility.⁴

“Tax and axe is global,” wrote Ed Hyman of ISI Group, Inc.. “VAT [Value Added Tax] hikes are starting in Spain and Greece, and in the U.K. in [the coming] months. The VAT hike of 2.0% in Japan in 1997 was widely viewed as unlikely to do much damage – just a few cents on a pack of cigarettes. But the more logical impact prevailed – real DPI [Disposable Personal Income] was cut roughly -2.1% at a time when it was not strong to begin with. The VAT in the U.K. will be lifted +2.5% in January of 2011. Next week, VATs in both Greece and Spain will both be lifted +2.0%, and Portugal and Finland +1.0%.”

As for the axe, according to the International Monetary Fund (IMF) budget cuts in the United States will equal 4.6% of GDP from 2009 to 2011, a number that is likely to increase should Republicans take over control of Congress. Worldwide, budget reductions will equal a little more than 2% of total output.⁵

Given that the mood in both parties of Congress has turned decidedly anti-deficit, many expiring U.S. government stimulus programs will likely not be extended. In recognition of that mood, President Barack Obama recently hailed an initiative by his administration to cut the budgets of most major government agencies by 5% at a time when Keynesian economic theory would call for more government spending to lift the economy.⁶

As federal economic-stimulus spending wanes, already-strapped states face a new fiscal squeeze. State leaders have long known stimulus funds sent their way early in the recession would taper off in the first half of 2011. But many hoped that an economic recovery would stimulate a rebound in tax receipts to close the gap. According to the National Association of State Budget Officers, legislatures now face aggregate deficits totaling \$127 billion over the next two fiscal years. "Stimulus is going to run out and there isn't sufficient economic growth and revenue growth that's going to come in and make up for the loss of those funds," said Scott Pattison, executive director of the budget officers' group.⁷

The climate in Congress is so anti-deficit that the Senate has thus far refused to pass a bill further extending unemployment insurance. “The difficulty of passing this bill consisting mainly of relatively non-controversial provisions shows that major new spending designed to stimulate the economy is a non-starter in Congress,” wrote Tom Gallagher of ISI. “Republicans and many Democrats do not want to be associated with additional deficit spending, which is why this bill has not already passed.”

Goldman Sachs economists described the Senate's inaction as “an increasingly important risk to growth as policy makers are betting that the private sector can make up for the withdrawal of stimulus over the next couple of years. If they're right, they will have made a head start on closing their enormous

⁴ Landon Thomas Jr. and Alan Cowell, “Facing Deficit, Britain Unveils Emergency Budget,” *The New York Times*, June 22, 2010.

⁵ David Leonhardt, “Pulling Back, Amid Echoes of the 1930s,” *The New York Times*, June 30, 2010.

⁶ David E. Sanger and Sewell Chan, “Stimulus Talk Yields To Calls To Cut Deficits,” *The New York Times*, June 9, 2010.

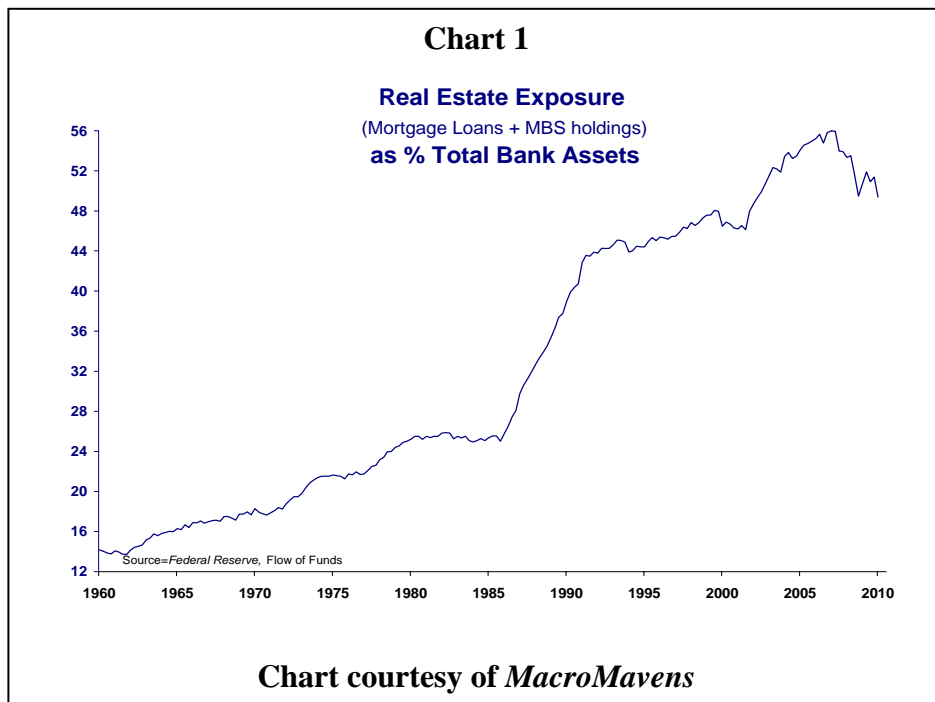
⁷ Deborah Solomon, “States Face New Pinch as Stimulus Ebbs,” *The Wall Street Journal*, June 23, 2010.

budget deficits. If they're wrong, they may set off a vicious new cycle, in which public spending cuts weaken the world economy and beget new private spending cuts.⁸

And if they're wrong, what happened in Ireland may be reproduced on a global scale. Nearly two years ago, an economic collapse forced Ireland to cut public spending and raise taxes, much like other nations are doing today. "When our public finance situation blew wide open, the dominant consideration was ensuring that there was international investor confidence in Ireland so we could continue to borrow," said Alan Barrett, chief economist at the Economic and Social Research Institute of Ireland. Rather than being rewarded for its actions, though, Ireland is being penalized with a sharper downturn than neighboring countries. Lacking stimulus money, the Irish economy shrank -7.1% in 2009 and remains in recession. A total of 4.5 million workers (or 13%) are out of work, and the ranks of the long-term unemployed — those out of work for a year or more — have more than doubled, to 5.3%. Now the Irish are being warned of more pain to come. "The facts are that there is no easy way to cut deficits," Irish Prime Minister Brian Cowen said in an interview. "Those who claim there's an easier way or a soft option — that's not the real world."⁹

So it is less than reassuring that the U.S. enters this period of new-found austerity on decidedly uneasy economic footing. In June 2010 the unemployment rate in the U.S. fell from 9.8% to 9.5%. But underneath this headline façade the foundation of the job market continues to crack. According to Goldman Sachs, the "guts" of the June employment report were much weaker than the headline suggests as household employment declined sharply and both the workweek and average hourly earnings declined. In Goldman's opinion, the report confirms that the labor market has not yet reached the self-sustaining

recovery stage, at a time when forward-looking indicators of economic activity are slackening. "[We saw] the biggest declines in the labor force (-652k) and Household Employment (-301k) since Dec '09," wrote Stephanie Pomboy of MacroMavens. "New records in both the Average and Median Duration of Unemployment (35.2 and 25.5 weeks, respectively). A return [of declining] Real Average Hourly Earnings. Yep... we're starting to get a picture of an economy deprived of stimulus supports."



Trumping the job market's weakness, the housing market fell flat on its face in May 2010. While economists expected housing to suffer at least a temporary hangover after the government's \$8,000 homebuyer tax credit

⁸ David Leonhardt, "Pulling Back, Amid Echoes of the 1930s," *The New York Times*, June 30, 2010.

⁹ Liz Alderman, "Ireland Paying A High Price for Austerity," *The New York Times*, June 29, 2010.

expired, the severity of the drop has been surprising. In some places, sales dropped more than 20% from May 2009, when the worst of the financial crisis had subsided. According to the Commerce Department, new home construction dropped -17.2% month-over-month in May while permits for future construction dropped -10%. The Mortgage Bankers Association said applications for loans to buy houses were down by a third compared with last year, despite the lowest mortgage rates in decades, and are back to the level of the mid-1990s.¹⁰

If home inventory is a good indicator, the situation will likely get worse over the summer. In a normal market, the supply of homes available is less than six months, but currently there are more than eight months' worth of both new and existing homes on the market. With shadow inventory [unoccupied, bank-owned homes not listed for sale) increasing and more foreclosures headed to the market, those numbers will likely go up. Recently released government data showed that newly-initiated foreclosures increased 18.6% during the first quarter of 2010 to 371,000. Foreclosures in process increased 8.5%, to 1.17 million in the first quarter.¹¹



“Policy measures designed to turn the housing market around were a uniform and dismal failure,” wrote Pomboy. “How much so is becoming painfully clear. The housing market has crumbled absent the government supports. Mortgage applications for home purchase have collapsed to 13-year lows. Foreclosure activity set new records in April and May [of 2010]... If, as MacroMavens suspects and the recent data bear out, housing is

double-dipping, the financial sector will face a whole new round of losses. And, contrary to popular perception, they would not be *de minimis*. As we’ve repeatedly observed (and is illustrated in [Chart 1]), the policy response to the housing bubble bust was to encourage banks to hold – rather than unload – their exposure to the problem. Operating on the assumption that time would heal the housing wounds, policymakers implemented measures to buy said time, from foreclosure moratoriums to the easing of mark-to-market accounting requirements. The upshot is that they succeeded in keeping bank exposure to real estate at multi-decade extremes.” Talk about unintended consequences!

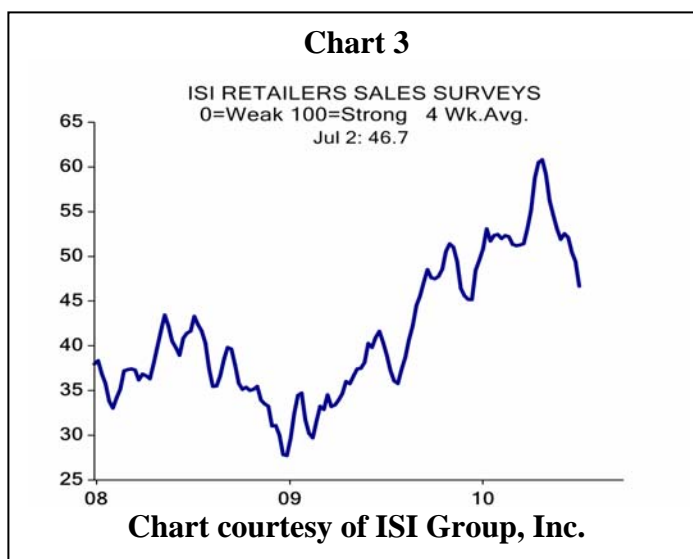
With the housing and job markets weakening it’s not surprising that consumers are ratcheting back spending. The Commerce Department reported that retail sales fell -1.2% in May 2010 from April 2010, the first decline since the -2.2% drop in September 2009. The surprisingly poor sales cast fresh doubt on

¹⁰ David Streitfeld, “As Buyers Get Picky, the Housing Market Slows,” *The New York Times*, June 17, 2010.

¹¹ David Streitfeld, “New-Home Sales Fall To New Low,” *The New York Times*, June 24, 2010.

the durability of a rebound in consumer spending that had allowed economists to raise their forecasts for U.S. economic growth this year.¹² “The U.S. soft patch remains stubbornly in place, with ISI’s company surveys ticking down to a 14-week low,” said Ed Hyman of ISI. “ISI’s retailers surveys edged up but remained -19.1 below their April peak. June chain-store sales reports are likely to be disappointing... A synchronized global slowdown is unfolding.” (See Charts 2 and 3)

The problem, of course, is that we are deep in debt. Fitch Ratings recently forecast that most borrowers who received an extremely low mortgage rate refinancing through the government’s Home Affordable Modification Program (HAMP) will default within 12 months. Diane Pendley, a managing director at Fitch, said the high failure rate forecast was largely because most of the borrowers were mired in credit-card debt, car loans and other obligations on top of their cumbersome mortgage. The Treasury Department reported that among people who have been given loan modifications under HAMP, the median ratio of total debt payments to pretax income is still 64%.¹³ “Who can afford to devote 64% of their pre-tax income on installment debt?,” asked Andy Laperriere of ISI. “We believe this has been underappreciated from the time three years ago when markets focused on rate resets to the current focus on sending in the keys. These borrowers are not walking away – they are drowning. Seen in this light, it’s pretty self-evident that no sensible policy can possibly save most of them from losing their unaffordable homes,” he concluded.



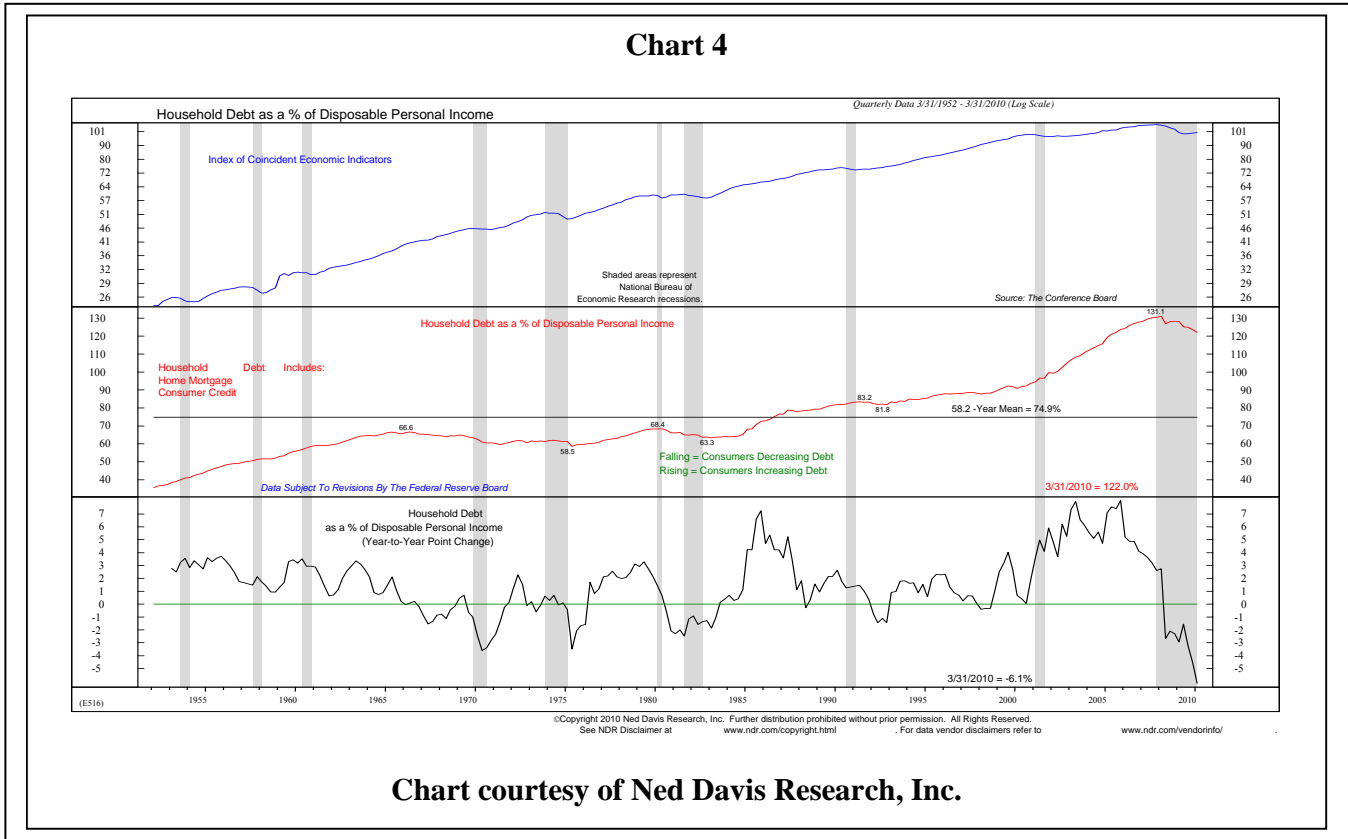
According to Portales Partners, the Federal Reserve’s Flow of Funds data indicates that despite consumers’ attempts to deleverage, total national debt grew by \$1.0 trillion, or 3% annualized, during the first quarter of 2010. (National debt is the sum of government, household and corporate debt.) Of that total, household debt shrank by an annualized \$330 billion, the second largest nominal quarterly decline on record and the 7th straight quarter of household debt declines, by far a record. “To put that streak in perspective, from 1953 through 2007 there were only two total quarters of household debt declines,” wrote Portales. Sadly, “the drivers of the declines are high defaults, no mortgage equity withdrawals (MEWs) and little new home construction (which requires new mortgage debt).”

“Despite massive foreclosures and defaults, curtailed credit lines by banks, and some effort to cut down on the use of credit, household debt relative to disposable personal income is still sky-high, as featured on [Chart 4],” wrote Ned Davis of Ned Davis Research, Inc. “This is not to say that consumers have not tried to deleverage, but the situation has actually worsened if one looks at debt relative to assets.

¹² Justin Lahart and Rachel Dodes, “Consumers Tighten Belts,” *The Wall Street Journal*, June 12-13, 2010.

¹³ James R. Hagerty, “High Default Rates Forecast on Modified Home Loans,” *The Wall Street Journal*, June 17, 2010.

As featured on [Chart 5], despite the recent improvement, mortgage debt is now higher relative to household real estate assets than it was at the 2005-2006 real estate peak.¹⁴



Uncle Sam’s balance sheet grew by an astronomical \$1.56 trillion in the first quarter of 2010 (WOW!). So, in reality, the economy as a whole has made little, if any, progress down the leverage mountain in the 12 months since the unofficial end of the recession. For this we owe thanks to the collective policy decision to go the route of Japan, pushing out realized loan losses until a later day, thereby allowing the rot on banks’ balance sheets to fester. As a result, housing prices have not settled into a natural equilibrium, weak creditors hide in plain sight decked out in their Troubled Asset Relief Program (TARP) camouflage, and strong creditors sit on cash, refusing to lend or trust. The businesses that wish to borrow find it hard to secure financing, partly crowded out by the flood of Treasury securities issued to finance the “stimulus” debt supporting the economy.

With the wheels of commerce clogged, money supply growth (a causal factor in equity market performance) has stagnated. “Chart S805 [6] shows that real M2 money growth has actually contracted over the past year,” wrote Ned Davis. M2 represents money and “close substitutes” for money in circulation. “There was a serious problem with real money growth in the 1930s in the U.S., and in the 1990s in Japan leading to ‘lost decades.’ I assume this was not what the Central Banks intended... In early 2009, I saw high real M2 growth as bullish for the economy and for halting deflation. Now that it is negative, I see it as trouble for the economy and an indicator of possible deflation.”¹⁵

¹⁴ Ned Davis, “Household Debt and Foreign Holdings,” *Institutional Hotline*, June 18, 2010.

¹⁵ Ned Davis, “Show Me The Money,” *Institutional Hotline*, June 25, 2010.

Chart 5

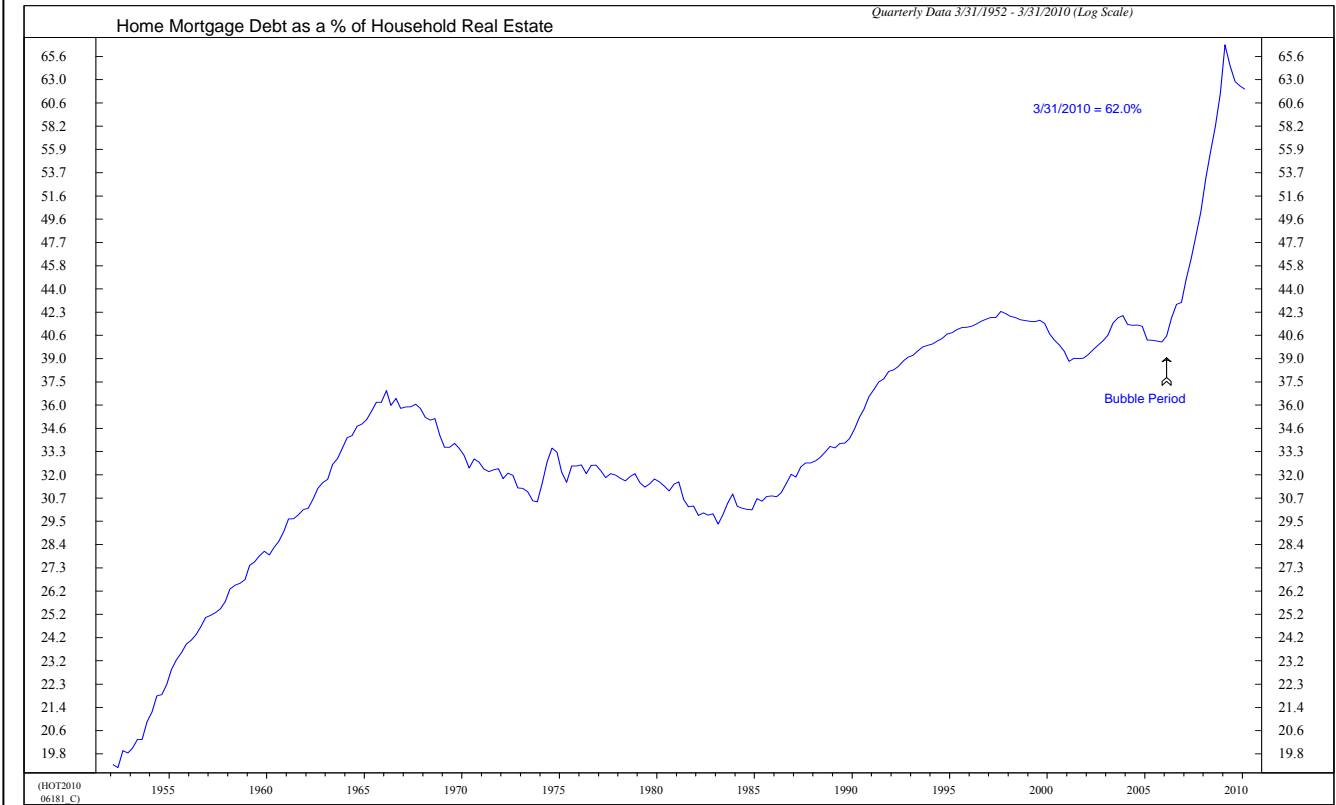
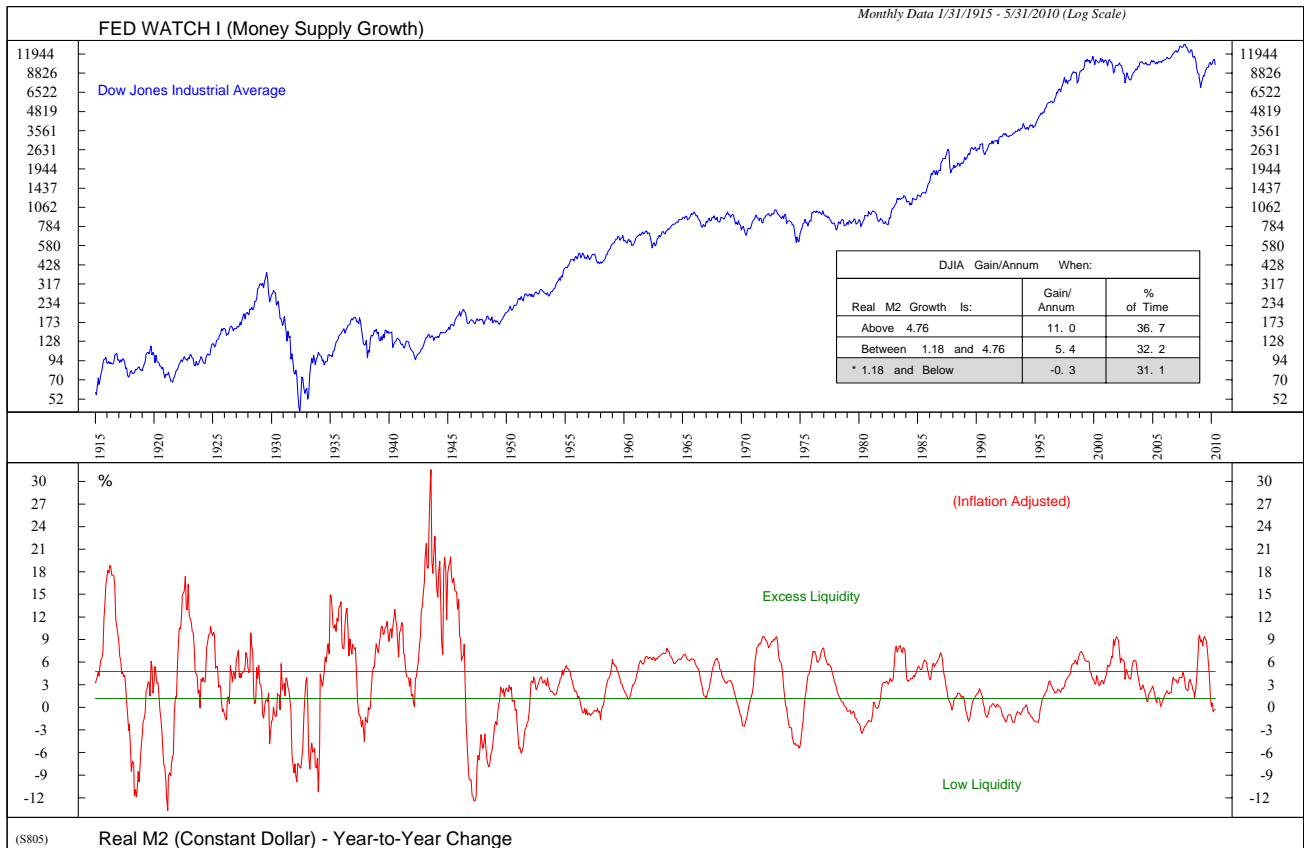


Chart courtesy of Ned Davis Research, Inc.

The U.S. today faces similar debt issues as in the 1930s and Japan confronted in the beginning of the 1990s. Then, as now, Keynesian stimuli served as only temporary steroids for a secularly ill economy. They gave the impression of a healing patient, but in reality only made the leverage disease worse. The current economic diagnosis is as simple as it is harsh: too much debt. The most likely long-term cure (as European nation's are beginning to recognize) is a strict diet of austerity. It may not taste too good, but we have left ourselves with few other options.

And a spoonful of sugar won't help.

Chart 6



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