

There's battle lines being drawn... - Stephen Stills of Buffalo Springfield

There are increasingly polarized views regarding not only what actually did happen with the recent market meltdown but, more importantly, what it portends for the future.

Think back to the beginning of 2009. Even with the benefit of hindsight, there's no getting around the sense of panic that prevailed. All manner of financial chaos seemed to be unleashed. Most of the world's economies were mired in deep recession. Capital markets everywhere had literally seized up. Liquidity was virtually nonexistent. Many feared that Armageddon loomed. And to make matters worse, monetary and fiscal authorities appeared to be making policy up as they went along. Indeed, the global financial system had become an emotional wreck, essentially exiting 2008 curled tightly in a fetal position [see figure 1]. We at SCM chose to title our year-end Market Commentary, "There's something happening here... what it is ain't exactly clear," from the first verse of Buffalo Springfield's song "For What It's Worth." And now, only a few short quarters later, we again feel compelled to lift our title from that same song; this time from the second verse. For it seems to us that there are increasingly polarized views regarding not only what actually did happen but, more importantly, what it portends for the future. To be sure, vastly different views are normal enough, especially given the sheer magnitude of financial shock; it will take years to really sort it all out. But what really grabs our attention is the mounting intensity of those views.

At their core, the battle lines being drawn are basically debates about two key issues. When most of the noise and rhetoric get toned down, however, the first of the two issues really comes down to a debate about the historical context of the last few quarters. One side is convinced that global markets and economies have left behind the temporary madness of crowds and successfully transitioned into sustainable recoveries. The other side believes that the recent bounce is little more than a natural snapback from unsustainable, ridiculously overstretched extremes, and that the foundations of recovery are illusory. While each side feels that history supports their increasingly adamant views, neither is shy about stretching historic interpretations to amplify a point. Those who stake their claim on a sustainable recovery point to any number of recent downturns where economic activity rebounded after cyclic excesses had been cleansed by recession. The illusory crowd claims that no such cleansing has taken place this time around, and that many of the factors that precipitated this recession have only been made worse by policy responses.

Figure 1. S&P 500 Index
January 1, 2007 - September 30, 2009



Source: Bloomberg

And this transitions us conveniently to the second line of battle: the role of policy stimulus. That policy stimulus should become such a hotly debated topic is hardly surprising given how poorly the financial community grasps the stakes. Hardliners pound the table and say it's okay to let the economic chips fall where they may without meddling, economies function best when left alone; we'll be all the better for it in the long run. Others counter that only through constant tinkering by enlightened policymakers can we be saved from ourselves... and economic oblivion. And this gets us to the crux of the matter; much of one's view about this second of our two key battle lines – the role of policy responses – is predicated on how one views the first; namely, the historical context in which it is placed. Frankly, we don't believe either has cornered the market on historical accuracy. Since each of the two battles has become such lightning rods for debate, and because the intensity of debate has gotten so extreme of late, we thought it might be useful to weigh in by first revisiting some of our views from past commentaries.

Long-time readers know we've never been shy about borrowing from and building upon the theories of economic luminaries to help us get a handle on what might be going down. You'll recall that we've often referred to Akerloff and Shiller's work on the care and feeding of Keynes' animal spirits. In April, we described how the economy is "... in the throes of a self-feeding debt deflation, a phrase used by economist Irving Fisher when he examined the Great Depression." Last January we utilized Milton Friedman's Quantity Theory of Money to help explain the economic predicament. In July, we wrote how ironic it was that "... the view of government has flip-flopped from problem

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to solution." And recently, we stumbled across a fascinating book that encapsulates many of our secular thoughts, and establishes an accurate, if unconventional, context for understanding today's environment.

In his book *The Holy Grail of Macroeconomics* (John Wiley, 2008) economist Richard Koo introduces the concept of a "balance sheet recession" in explaining the difference between economic downturns such as Japan's Great Recession (as well as our own Great Depression), and the more typical recession where private sector balance sheets are not badly affected. Koo states that a recession caused by excessive debt and collapsing net worth is a very different beast from one caused by a central bank's desire to squeeze inflation out of the system. The difference rests importantly on the need to throw out one of mainstream economic dogma's most prized possessions; the notion of profit maximization. Much like the Reinhart and Rogoff paper to which we often refer, Koo points out that when recessions are combined with massive asset deflations – thereby pushing private sector balance sheets significantly under water – the first priority shifts from maximizing profits to minimizing debt. The issue becomes less about the supply and the cost of credit, and more about the demand for it.

The decline in private spending and borrowing is driven by the perfectly rational microeconomic goal of balance sheet repair. In such an environment, Koo describes how the effectiveness of monetary policy becomes secondary to fiscal policy – as we are finding out here in the U.S. – especially with interest rates asymptotically approaching zero. What you end up with is a situation where fiscal policy actually controls the effectiveness of monetary policy, a complete reversal of what almost every economist had shoved down their throat in school. When everyone is minimizing debt instead of maximizing profits, all sorts of economic dogma get flushed down the toilet. And given that mainstream economic thinking came up so woefully short in diagnosing the credit crisis, it behooves us all to try to expand our economic tool chest.

Fed Chairman Bernanke, while initially slow to grasp how this crisis could metastasize from being largely a financial issue into something with significantly broader economic and social implications, has been very aggressive and even downright creative in the use of monetary policy... once he clued in. That said, the zero bound on the cost front (N-ZIRP), and bank hoarding of liquidity in the form of excess reserves on the supply front (QE), have used up a lot of his policy ammo. This leaves him with but one significant tool left: time, which by our analysis is the key takeaway from the history of such episodes. Whether it's described like the just-released study from the IMF examining economic downturns tied to financial recessions, or Reinhart and Rogoff's analysis of financial crises, or Koo's balance sheet recessions, or even Gary Shilling's bad side of his good/bad deflation dichotomy, the punch line is the same: the time intervals needed to work through the crisis are always measured in years, not weeks or months. As such, it would not surprise us to see the FOMC remain accommodative until deep into 2010 or even into 2011.

Clearly, the wild card this time around has been the sheer scale of the policy responses to date; there are no true historic analogues for them. In fact, the unprecedented size and scope of responses have really been at the core of why the battle lines we mentioned earlier have been drawn. Did the stimulus work or is it a temporary band-aid? Was it even needed or do we need more? The answers to these questions will ultimately determine the historical context of this period, and we believe that the intensity of opinion about them is highly correlated to the severity of damage inflicted by the crisis.

While monetary policy has so far been responsible for much of the earlier-mentioned polarization, recent rumblings of another round of fiscal stimulus suggest to us that monetary policy could take a back seat for awhile. Even though many fear that there's been way too much fiscal stimulus already, Koo's work suggests otherwise. His data indicate that the amount of stimulus ultimately needed to offset the economic damage is directly proportional to the amount of de-leveraging that must occur. If the stimulus does not come, then the difference must be made up via a significant contraction in the economy... which we suspect few will tolerate. Given how little de-leveraging has occurred so far, and the amount of anger that "government" stimulus has already engendered, it makes us wonder whether policymakers have the political courage to keep the fiscal pedal to the medal during this growing wave of populist discontent. We have our doubts.

History is clear, however, that if policymakers succumb to populist pressures by becoming overly concerned about budgets or protecting the currency, and take their eye off the secular forces at work – call it a debt deflation, a financial recession, or even Koo's balance sheet recession – then they risk extending the amount of time needed to deal with those secular forces. As we finish up this year and move into 2010, we believe it is likely that economic benefits from initial fiscal stimulus efforts, stunningly large as they were, will begin to wane. Given our skepticism about political will, it wouldn't surprise us if this led to another negative GDP print by late next year.

Meantime, that's not to say we won't see a statistical improvement in some of the economic data over the near-term. For instance, we fully expect GDP in the second half of 2009 to reflect measurable, if only temporary, impacts on domestic demand from such stimulus efforts as cash-for-clunkers. We should also see positive contribution to GDP from a rebuilding of recession-depleted inventories and from net exports, where imports into the U.S. fall at a quicker pace than U.S. exports to regions around the world with healthier consumption prospects. These factors should combine to produce 3.0% to 3.5% GDP growth in Q3, tapering back to 2.0% to 3.0% for Q4 and Q1 of 2010.

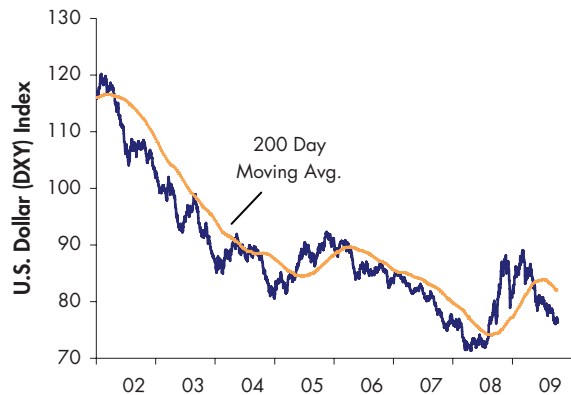
Domestically, consumption will continue to be weighed down by two key factors, neither of which appears poised to get better any time soon. First is a housing market struggling to absorb the increasing numbers of homes that result from a still-swelling foreclosure pipeline. This so-called shadow inventory is difficult to quantify, but there's little doubt that it will continue

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Figure 2. U.S. Dollar Index

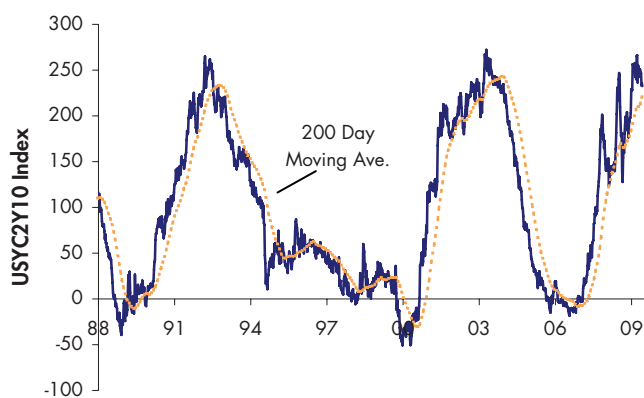
January 1, 2002 to September 30, 2009



Source: Bloomberg

Figure 3. Treasury Yield Curve

May 6, 1988 to September 30, 2009



Source: Bloomberg

USYC2Y10 Index is the 10-Year US Treasury Yield minus the 2-Year US Treasury Yield

to grow faster than sales for quite a while. The second factor that will weigh on U.S. consumers is the bleak job market. Recent employment data – such as a crumbling labor participation rate (discouraged workers simply exiting the job market) and a record exhaustion rate (those who have started collecting unemployment and have used up their allotted payments before finding a job) – are not suggestive of the quick turnaround for which many are hoping. Don't look for the jobs picture to meaningfully improve until well after the unemployment rate peaks, which we think won't occur until at least mid-2010 with the rate approaching 11.0%.

Primary market trends in place since early March remain firmly intact as the fourth quarter begins. During the heat of the financial panic, the flight-to-safety into the U.S. dollar caused a sharp counter-trend rally in the greenback, which has since

started to unwind as panic has subsided and risk appetites have returned [see figure 2]. The resumption of its bear market has made the dollar now cheaper to borrow on world markets than the yen, the old favorite currency of choice for the vaunted carry trade (borrow at super-low rates to invest in higher earning assets, while paying back with depreciating currency). With the dollar now one of the favored funding currencies, the correlation between it and risk assets – called the reflation trade, which includes stocks and commodities – is skyrocketing. For instance, the correlation between the S&P500 (still the best proxy for risk) and the dollar is -.92. For those playing at home, 92% is the real deal. With most of the normal monetary and fiscal policy transmission mechanisms not functioning as intended (if at all), it seems that higher asset prices have become the only current means for policy stimulus to influence the economy, even if only indirectly. Higher asset prices are helping to heal animal spirits by improving consumer's severely damaged balance sheets.

As carry traders increasingly use the dollar to fund the reflation trade, the knee-jerk relationship between stocks and Treasury bonds (stocks up, yields up), which has been in place for most of 2009, has changed recently. This has led to a bullish flattening of the Treasury yield curve, potentially reversing the steepening trend in place since the summer of 2007 [see figure 3]. And keep in mind that this demand for longer-dated Treasuries has had to overcome the mountainous supply that resulted from unprecedented government stimulus. That the Treasury market could absorb such a massive flood of supply speaks to the new-discovered appetite from banks for government debt. Balance sheet constrained banks currently prefer to lend to the government where they don't have to set aside reserves, rather than to the private sector where credit concerns still exist and where reserves must be established.

How long these trends remain in place is, obviously, anyone's guess. With battle lines being drawn and well-rehearsed battle cries seemingly getting louder by the minute, we can only hope to glean some semblance of historic context by continuing to add to our economic tool chest. Many of these tools suggest that recovery from the damage inflicted by what some have taken to calling the Great Recession will take a lot more time. The wild card, of course, is the sheer scale of policy responses. How it all plays out, can never be certain; but we suspect that the drip, drip, drip of demand disappointment may eventually take a toll on the domestic economy. Nevertheless, we can be certain of one thing: this is an environment that will provide plenty of opportunity for active managers. Opportunity born of change, nurtured by uncertainty, and laid bare by volatility. These changing times demand that our investment decisions be built on a solid foundation of fundamental research. They demand that we be prepared to take advantage of opportunities that inevitably arise when price deviates from fundamental value. And because each of our clients has unique needs, these times demand that we create, manage and administer a portfolio that meets those specialized needs. SCM's disciplined approach to rational decision-making, when combined with the integration of research, trading and portfolio management, ensures that we will remain ready to respond to the dynamics of an ever-changing marketplace.

Past performance is not a guarantee of future results. This commentary is the opinion of the advisor. There is no assurance that the advisor's opinions or expectations will be correct. This report is intended for informational purposes and not as investment advice.

Quarterly Review

The recession ended this quarter and the stock market showed its appreciation by posting one of its best third quarters in 50 years. Stocks reacted to further signs of economic stability, highlighted by an increase in leading indicators, house price stability, gains in consumer confidence, and better than expected profit reports and forecasts. The exceptional amount of monetary and fiscal stimulus, anchored by the largest and broadest easing cycle in history, continued to work its way through the system and provide the support investors needed to circumvent nagging secular concerns – credit contraction, high savings rates, unemployment, etc. Sentiment gauges improved and credit spreads contracted as investors discount better times ahead. Small caps outperformed large caps, and value styles bested growth. The weak dollar helped our portfolio which is positioned to take advantage of a global growth rebound.

Equity COMMENTARY

Profit revisions continued their upward trajectory as corporations exhibited considerable operating leverage after multiple quarters of aggressive expense reductions. Any modicum of revenue recovery has produced outsized earnings that have easily surpassed overly pessimistic assumptions. This leverage drove several points of multiple expansion in the quarter, elevating valuation metrics back to levels typical of this point in the cycle. As the economy continues to heal, management teams

will increasingly focus on driving top-line performance to sustain above consensus profit growth. We recognized that during these recovery periods, more cyclical portfolios tend to generate greater returns, and we were positioned accordingly. However, as the third quarter progressed, economic data became mixed, compelling us to lighten up our pro-global growth positioning late in the quarter. Despite the modifications, our funds still have a cyclical bent. We are pleased to see correlations between stocks and within sectors continue to fall and valuation disparities continue to widen. The market is once again placing higher multiples on higher quality growth companies, an indication of a more normalized market and, given the volatility over the last 18 months, a welcome sign.

Market Outlook

A global economic recovery has begun, and stocks have benefited. We believe the cyclical recovery is real and stock returns are justified. Going forward, we expect choppy trading with further gains subject to a multitude of factors that will undoubtedly test the resolve of this equity market. We are focusing on three. 1) Will sales growth catch up to price? Given the rally, sales growth will need to catch up to justify multiple expansion or the market will become vulnerable to pullbacks. Recent trends are encouraging as top line growth coincides with an economic recovery. 2) Will we get real, “first derivative” economic growth? It’s been six months since the leading indicators troughed. To avoid a consolidation (or “moderation”) phase, we think equity investors are now going to need to see visible expansion data. With the strong market recovery, “less bad” headlines will not have the same positive effect on stocks and could cause investors to take profits. Finally, 3) What will be the impact of the labor market on this recovery? The last two recessions had unemployment bottoming a full year and a half into the recovery. Jobless recoveries can happen, but stock market returns associated with those recoveries tend to be nominal. We do see payroll indicators picking up, but the process will be slow and certainly not linear. Of course, with the unemployment situation as weak as it is, any moves to significantly adjust Fed policy are unlikely before the middle of next year.

We also think stock picking will matter more as we move through the remainder of 2009. We are beginning to see signs that the macro driven market of 2008 and the beginning of 2009 are giving way to an environment of security selection and investor discernment. A year ago security selection simply didn’t matter as correlations across the investable landscape (and amongst most asset classes) spiked to one and all equity returns were decidedly negative. With stabilization signs appearing earlier this year amidst an oversold market, a “greater the beta, greater the return” mantra took hold. Security selection helped, but cyclical risk mattered more (the riskier the better so far this year). Going forward, a disciplined investment approach will be mandatory as return patterns become influenced more by micro considerations, and less by macro forces.

The investment professionals here are an experienced, stress tested group that always has our clients’ best interest at heart. We will continue to work hard and remain consistent in our investment philosophy of isolating those higher quality companies that can sustain profit levels above their peer groups. We are happy to share our thoughts with you in greater detail and welcome any questions and comments you may have.

Getting to Know SCM Advisors : Meet Chief Investment Officer, Fixed Income Bob Bishop



Given the 20-year history of SCM Advisors, “Getting to Know SCM Advisors” is a periodic series designed to introduce you to some of the key individuals of the firm.

With over 30 years of investment experience, **Bob Bishop** is SCM Advisors’ Chief Investment Officer of Fixed Income as well as being a member of the firm’s Executive Committee.

Prior to joining SCM Advisors in 2002, Bob was a director of corporate bond sales for Merrill Lynch and restructured corporate pension funds for Salomon Brothers. Bob received his MBA in finance from the Kellogg School of Management at Northwestern University.

SCM Advisors LLC 909 Montgomery Street, Suite 500, San Francisco, CA 94133
(415) 486-6500 (800) 828-1212 www.scmadv.com