

## Government Sponsored Financial Methadone

*Monetary and fiscal policymakers are desperately trying to replace various forms of economic stimulus*

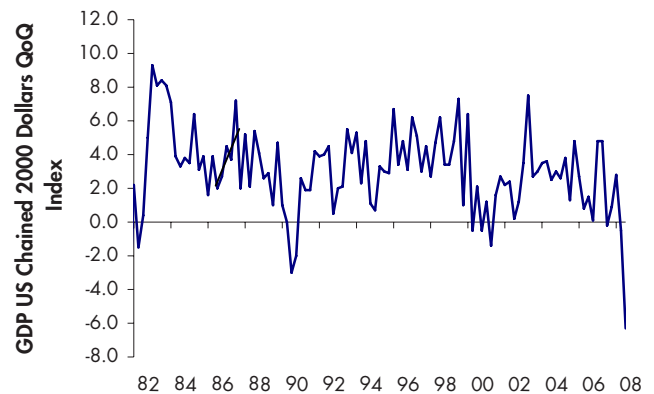
In numerous issues of SCM's Quarterly Commentary over the last few years we've referred to the U.S. economy's "jones," or addiction, to credit. We explained that without the massive injection of credit (read: leverage) – fully half of which was created through the now-defunct, unregulated Shadow Banking System (SBS) – the economy this decade would hardly have been able to produce breath on a mirror. We suggested that the inability for the economy to grow in a healthy manner without the artificial growth stimulant, did not bode well when the inevitable withdrawal symptoms kicked in... a crude analogy perhaps, but pretty accurate as it turns out. The devastating impact of the virtual disintegration of the SBS has played a large part in the global financial and economic grand mal seizure, in much the same way a severely jonesing heroin addict might when the drug is discontinued.

One of the most successful treatments medical science has come up with for dealing with addictions is to introduce a synthetic chemical that produces many of the same effects as the original addictive drug, but without the most deleterious of the effects. Enter the U.S. government. Among the seemingly endless and mind-blowingly massive government stimulus programs introduced during the past twenty months (not to mention all the catchy acronyms) has been the Obama Administration's Public-Private Investment Program (P-PIP), a not-so-veiled attempt to synthetically recreate the SBS... albeit in a highly-regulated form. Think of it as a government sponsored – and administered – financial Methadone Treatment Center for the economic addict.

The economic patient is currently in the throes of self-feeding debt deflation, a phrase used by economist Irving Fisher when he examined the Great Depression. His work focused on the meltdown in the financial markets, the devastating effects of a downward spiral connecting the deflation of assets and goods prices, the process of deleveraging by households and firms, and the contraction in economic activity.

*Make no mistake about it; the U.S. economy is seriously struggling with the cold turkey shutdown of the Shadow Banking System.*

Figure 1. U.S. Gross Domestic Product  
June 30, 1982 - December 31, 2008\*



Source: Bloomberg

\* Most recent data available as of press time

But what makes this era's debt deflation unique has been the degree to which the debt (credit) creation process had become dominated by, and in many ways dependent upon, the SBS. Make no mistake about it; the U.S. economy is seriously struggling with the cold turkey shutdown of the SBS [see figure 1]. While it's clear that we can't return to the Wild West (unregulated) version of the SBS – those days are over – it's equally clear that some form of it must return for the credit creation system to function more fully. This is where the P-PIP comes in.

That is not to say that government-sponsored credit is any less addicting, but the goal is to keep withdrawal symptoms at tolerable levels as the patient gets healthy. The idea is that just like any drug used to treat addiction, when it's released more slowly and in a more controlled fashion, it stops many of the destructive processes that can interfere with normal functioning... like, say, 33 -1 leverage.

Whether the P-PIP is ultimately successful in recreating the SBS, and whether it in turn helps to regenerate economic health, are altogether different matters. Time will tell. The key takeaway, however, is that it's all about government taking over for the still-shrinking, still retrenching private sector; in many ways, classic Keynesianism. While surely not a panacea, it is a piece of an acronym-laden puzzle that will temper the severity of

(cont. on page 2)

## Government Sponsored Financial Methadone... (cont. from page 1)

the economic issues that must be dealt with. And as we've explained in past Quarterly Commentaries, this is not your father's recession.

One of the defining characteristics of the recent financial and economic upheaval has been the way that expectations about how things might unravel have generally lagged the way things actually did. Whether referring to the economy, jobs, write-downs, bailouts, defaults, earnings, or even the proper multiple to place on those earnings, one significant constant during this period has been that the breathtaking deterioration has continued to catch many by surprise. This tells us something important.

Markets, economies – and even social mood – tend to ebb and flow over time in inter-related cycles of varying length and degree... longer-dated cycles are often referred to as secular. Semantics aside, cycles are simply sequential progressions that lead to repetitious patterns. These cyclical and secular rhythms are inevitable; busts follow booms as surely as night follows day. Indeed, they cause them. Much has been written about how the current crisis is serving to unwind the excesses of this decade's credit cycle. We believe, however, that what's currently being unwound is something more secular in nature, encapsulating multiple cycles going back perhaps as far as the early 1980s, and in some cases beyond.

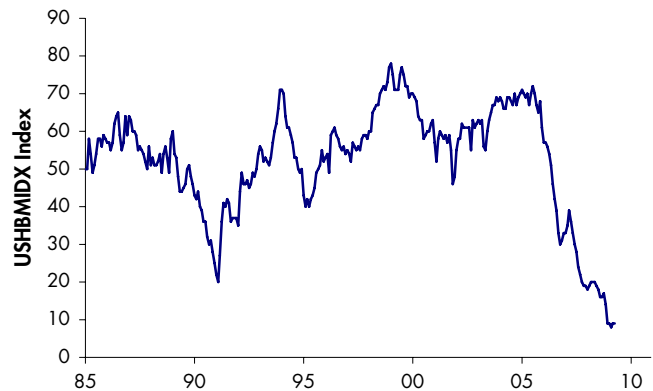
That expectations about the current state of financial and economic affairs have lagged the devastating reality suggests that many remain locked in a shorter-term cyclical mind-set. This is not surprising as today's tectonic events are clearly outside most participants' personal experience. As the secular reality unfolds, those with a cyclical reference point are doomed to anxiously seek – and hope – for typical V-shaped recoveries around every corner.

Cyclical corrections do most of their cleansing via sharp contractions in price, and are characterized by spiky, distinct bottoms. Secular turning points, however, are long drawn-out affairs and accomplish their cleansing in the more psychologically devastating manner of time, where the drip-drip-drip of negativity simply wears everyone out. As a result, we've come to view the current gap between expectations and reality as a race to the secular bottom, with cyclical expectations still trailing the secular reality. And if history is any guide, we won't get there until negative expectations catch up with, and importantly, pass the economic and financial reality.

While it's possible that the worst of the economic contraction can be behind us by the second or third quarters of this year, we believe that the consensus estimate of positive 2.0% GDP by the third and fourth quarters will prove too optimistic. We think the domestic economy will do well to have a positive sign in front of GDP as we end the year. We expect housing prices to fall another 5 – 10% [see figure 2], for unemployment to peak close to 10% (in 2010) [see figure 3], for bank solvency issues to re-emerge and for corporate default rates on junk

**Figure 2. NAHB Housing Market Index**

National Association of Home Builders Index - Seasonally Adjusted  
January 31, 1985 - March 31, 2009



Source: Bloomberg

**Figure 3. U.S. Continuing Jobless Claims**

Insured unemployment numbers (thousands)  
April 2, 1982 - March 20, 2009\*



Source: Bloomberg

\* Most recent data available as of press time

bonds to peak around 20%. How much of that is priced in is uncertain, but the potential for serial data bombs to catch the market on the wrong foot remains, and expectations will have to run hard to keep up with the news flow of the economic and financial reality.

Another manifestation of the cyclical versus secular struggle can be found in the current debate surrounding whether or not the recent explosion in monetary stimulus from the Federal Reserve is necessarily inflationary. Yes, money and inflation are linked if the normal transmission mechanisms are functioning. But we need to be careful about trotting out tired cyclical bromides when something else is going on. As we explained in our

(cont. on page 3)

## Government Sponsored Financial Methadone... (cont. from page 2)

last Quarterly, in an environment where the velocity of money is almost non-existent, where the economic output gap is wide and growing wider every month, where capacity utilization is collapsing, where unemployment is skyrocketing and wage pressures are shrinking, it would probably be more useful to replace the first two letters in inflation with "re" every time you read it over the next few months. Even when economic activity bottoms, the large amount of slack will ensure that corporate pricing power should be slow to improve. In fact, we have moved beyond the cyclical disinflation of the last year into a secular deflationary environment unseen for many decades. Yes, there may be a time in the future when the economic transmission mechanisms actually do begin functioning in ways that raise concern about monetary stimulus generating inflation, although probably not in 2009. But in the meantime, let's just agree to refer to it as much-needed reflation.

As for the stimulus efforts from the fiscal side, things are rapidly devolving into a theater of the surreal with ideologues digging in on all sides. Keynesians are squaring off with combatants from the Austrian school, monetarists are going at it with supply-siders, and calls for a New Deal 2.0 are being met with chants for John Galt. These are not simply mundane cyclical discussions; rather, they are the types of national debate we've encountered only a few times in the last 90 years. The sad spectacle of Alan Greenspan struggling with both his philosophical foundation as well as his tarnished legacy marks an unfortunate metaphor for the secular turning point we're going through. In many tangible ways, reading about history is more fun than living it.

Monetary and fiscal policy reflation will eventually work because policymakers will likely keep going until they succeed. The real trick will be when the economy starts to approach potential and the reins get handed back to the private sector. At that point, the markets will no doubt begin to focus on the long-run implications of the unprecedented reflation efforts, but as we described earlier, that remains down the road. In the meantime, expect more volatility as we shift back to a smaller, less complex, but more highly regulated financial system. The transition will no doubt continue to be painful, and history suggests that massive policy interventions can have equally massive unintended consequences. You don't have to be a historian to remember that many of the seeds of today's issues are the result of the reflation efforts used to deal with the bursting of the Tech Bubble. Grassy knoll types will have a field day with what the unintended consequences of the current effort might be. We'll use the future Quarterly Commentaries to survey the potential candidates.

Shifting gears to the bond market, we began the year expecting 10 year Treasuries to spend most of 2009 flapping around between 2.0% and 3.0%, and given that the economic fallout of the credit crisis has continued to spread, we would have thought that the long-end of the curve would be lower than the 2.70% level it ended the quarter. The stickiness in yields seems inconsistent with the breakdown in the equity markets, which we would have expected to generate a stronger flight-to-quality spasm. This change in how Treasury rates and other

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asset classes responded to the further deterioration of economic and financial conditions is also manifested in slightly reduced correlations between assets (that should really exhibit very little correlation). These correlations – between Treasury yields, stock prices, and most other asset classes – while remaining ridiculously close to one, have slowly begun to turn. A hint of sentiment change can also be felt in the volatility measures of the various asset classes, which are well off the highs even as prices continue to break to new lows. All of which simply reinforces the notion that any forecast must be bound by a very wide confidence interval, and be constantly reviewed.

That said, we're going to stick for now with the possibility that the 3.0% to 3.10% resistance level in 10 year Treasury yields will continue to hold, as the recession is still in the self-reinforcing stage and because expectations continue to lag reality. Higher rates, which would be lethal for the economy if the situation became worse, are ultimately self-correcting as they act as a de facto monetary tightening, especially when matched with the stronger dollar. It does appear, however, that the 2009 version of flight-to-quality freak-outs will be less emotional affairs than 2008's, as traders and investors move inexorably through the five stages of the Kubler-Ross process. As we end the quarter, however, the "less-bad-is-the-new-killing-it" meme is making the rounds again and suggests that the grieving process isn't over.

So from our vantage point, it seems that we remain locked in a race to the bottom, if only because so many are spending so much time claiming this point or that stimulus plan will mark it. Perhaps we've already seen the bottom; we'll only really know in retrospect. But one thing we do know is that the race is largely about psychology, with the rot of failed expectations ultimately forming the nutrients for recovery as the cycle inexorably begins anew. And as the markets and the economy struggle through a painful period of withdrawal, with the help of government sponsored financial methadone, there will be plenty of opportunity for active portfolio 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 inevitable 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 broader equity market posted its sixth straight quarterly decline, although a late quarter rally helped to limit the damage. With the economic and political landscape changing daily, equity investors had a considerable number of relevant data points to digest this quarter. Many of the market-moving specifics confirmed weakness in the economic backdrop (record earnings declines, continued unemployment rate increases, global GDP contractions, etc.), while other data points painted a more promising picture (demand stabilization in housing, improvements in retail sales and the ISM index, etc.). While forecasting sustained economic stabilization, and thus corporate profits and stock prices, is a challenging exercise in 'normal' markets, the current environment adds several layers of uncertainty. While a number of macro indicators continue to be troubling, at present the rate of decline in economic activity seems to be moderating. It is undeniable that in the past few months we have witnessed the largest number of rate cuts and fiscal stimulus actions ever enacted on a global basis.

### Equity COMMENTARY

Coming off the broad, indiscriminate sell-off and convergence in valuation multiples, the market was overdue for a bounce. As the quarter progressed and the market digested "less bad" headlines, equity investors ratcheted up their risk tolerance levels and posted the best March return in five years. Simultaneously, several of the anomalous trading patterns we highlighted in last quarter's commentary have begun to correct. Correlations amongst asset classes and between equity sectors continued to fall and valuation disparities continued to widen. As the market became more discriminate this quarter, investment opportunities acted upon during the sell-off began to bear fruit. Growth stocks powered ahead of their value counterparts as profit trends within the 'growthier' industries remained relatively attractive and cheap. Large caps generally outperformed small caps. Activity levels were high in our portfolios as heightened volatility, and opportunity, was ever present.

## Market Outlook

We feel we are approaching the later stages of this severe economic contraction. Stocks are evaluating the downward pull of the recession while adjusting to new stimuli and prospects for growth. This juggling act is a delicate process and investors shouldn't expect a flawless routine. The duration of this deep recession is highly dependent on the significant amount of stimulative actions gaining traction. While it appears we are making progress working through the weakness, several secular concerns remain. Navigating these concerns while taking advantage of cyclic opportunities will be the key to generating returns in the equity markets in the near term. Investors will need to be nimble.

Visibility, while limited, has improved. Lower prices on everything from sweaters to TVs, along with improved credit availability, has helped to replenish depleted inventories and provide immediate revenue growth for several industries. The sustainability of these trends will be subject to further economic stabilization. Volatility has ebbed from the record levels set last quarter, but we suspect further spikes as this bottoming process will be messy and uneven at times. Equity investors are generally anticipatory in nature and have a willingness to discount improving fundamentals at the back end of the recessionary periods. With record cash balances and bearish sentiment, signs of economic stabilization can be met with outsized gains. While time will judge the accuracy of such rallies, we expect our growth-biased investing style to continue to outperform at this point in the cycle.

This remains a highly volatile, politically-charged environment where outlooks change in seconds. The investment professionals here at SCM 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 Strategist Max Bublitz



*Given the 20-year history of SCM Advisors, we'd like to take this opportunity to introduce you to some of the key individuals who help manage the portfolios and the direction of the firm.*

*The first subject of this new periodic series, entitled "Getting to Know SCM Advisors," is Chief Strategist Max Bublitz.*

**Maxwell Bublitz** joined SCM Advisors in 2005, primarily focused on economic analysis and strategy. In addition to his role as Chief Strategist, Mr. Bublitz has taken on portfolio management responsibilities for SCM's multi-sector opportunistic bond fund, "All-Weather Bond Fund."

Mr. Bublitz, an investment professional for 25 years, is author of the firm's widely-distributed quarterly market commentaries and is a regular contributor to Credit magazine. His economic analysis has been featured in a wide range of publications and services including The New York Times, Bloomberg News, The Washington Post, Financial Times, Investor's Business Daily, BusinessWeek, Dow Jones Newswires, Barron's, and CNBC.

Prior to joining SCM Advisors, he was President and CEO of Conesco Capital Management, which managed over \$40 billion of fixed income assets for insurance, institutional and retail clients.

Mr. Bublitz received his MBA in investment and finance from the University of Southern California and holds the Chartered Financial Analyst designation.