

## The Shallow End of the Meme Pool

*Diving deeper reveals an underlying stability in the market despite the quarter's emotional swings*

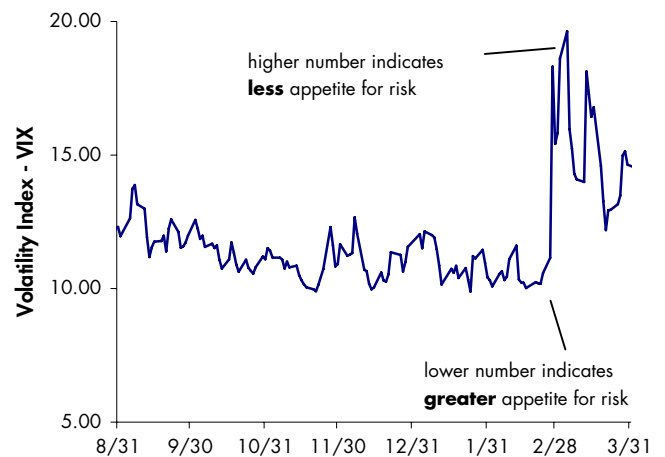
Google the word "meme" and you'll find that its a term coined by the biologist Richard Dawkins, referring to a unit of cultural information that can propagate from one mind to another in a manner analogous to genes. According to Wikipedia, examples of memes include tunes, ideas, catch-phrases, and beliefs. We at SCM Advisors would like to add another: those fleeting notions that find their way to the forefront of market consciousness.

Just as genes propagate in the gene pool by leaping from body to body via sperms or eggs, so financial memes propagate by speeding around the capital markets via all sorts of digital transmission mechanisms. Like genes, financial memes evolve and mutate naturally as they spread, especially when mixed with an ample dose of fear and greed. The story of the financial markets in the first quarter of 2007 was that these shifting animal spirits helped create significant turbulence in the financial meme pool.

For better or worse, one of the market's main transmission mechanisms is the media. And as volatility exploded in late February, this end of the meme pool heated up and began to feed off itself. Nothing like yelling "Fire" in a crowded movie theater. Was this the correction everyone was calling for, the big one? Everybody ran for the exits at the same time, as selling risk became the order of the day (see figure 1). A number of possible perpetrators were trotted out as being the cause of the massive spike

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**Figure 1. Volatility Index (VIX)**  
August 31, 2006 to March 31, 2007



Source: Bloomberg

in volatility – Chinese capital controls, the whole subprime mess, even the long awaited unwind on the vaunted yen-carry trade.

Not surprisingly, we have a different take. It's our contention that the real catalyst for the pop in risk premiums was a series of economic releases that caused the market to reassess its economic outlook. This is best represented by the wide, emotion-driven swings in the market's expectations of monetary policy as measured by Fed funds futures.

Think back to the beginning of the year. Market participants believed the economy was starting to reaccelerate, so much so that futures markets were pricing in the possibility of a hike in the funds rate. Seems like a lifetime ago, doesn't it? Anyway, thanks to a series of data released in February suggesting that the economy was actually continuing to slow – and then energized by the spasm of volatility, courtesy of the aforementioned wrongly accused perps – those same futures traders began toying with the notion that three eases would be needed before year-end to deal with all the problems. We believe it was this shift

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in economic memes, from being too optimistic about the economy to being too pessimistic, that was so jarring for the markets.

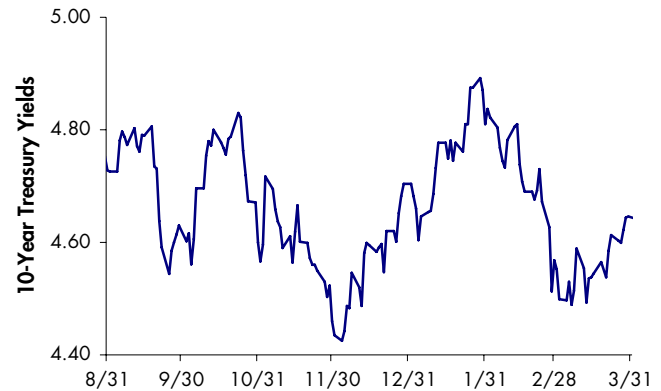
As often happens during such meme shifts, many are now claiming that the recent risk scare heralds a major change in the financial landscape, that the low volatility, low risk-premium world we've been living in for the last few years is ending. We're not so sure. No doubt a certain nervousness remains, as investors stare at each other waiting for the other shoe to drop. It's entirely possible that this queasiness may stick around for a while longer; these sorts of things do tend to linger. But rather than getting caught up in the rampant fear, we often use times like this to step back and re-examine our longer-term, more macro outlook for clues.

Sure, we watched the same screens that everyone else did during the recent risk flare. But upon re-examination of the secular investment themes we've written about so often, we find no reason to alter our stance yet. We continue to believe today's investment environment is best characterized as one where volatility and risk premiums will remain muted relative to historic levels. That is not to say, however, that we won't see periodic spikes, or that we shouldn't give them the proper respect. In fact, we expect further bouts with risk aversion in the near-term. It's just that we don't think recent events harken a trend change.

The low volatility low risk-premium story starts with the increased transparency of monetary policy. As we've explained before, thanks in large part to Fed policy, the nearly 20-year battle against inflation was won earlier in the decade and we believe we're now in a period of low and stable inflation. Importantly, this has led to a concomitant decrease in inflation expectations. With expectations for inflation lowered, businesses have more confidence about what to expect from not only the Fed, but from consumers and the market as well. When combined with the trend toward globalization – which aids in wage containment, the muting of the inventory cycle, and enhanced trade flow – the resultant environment is one where the economic swings have also become dampened. Muted swings in inflation and economic activity have led to relatively low interest rates, which in turn have caused the massive pools of global capital to leave compressed risk premiums in the wake of their frenzied yield grab.

Our economic outlook is little changed. We expect that U.S. economic growth will continue on its below-potential path for a while longer, troughing in-and-around the

**Figure 2. 10-Year Treasury Yields**  
August 31, 2006 to March 31, 2007



Source: Bloomberg

2.0% GDP level, before moving back toward its long run potential by the end of the year. The last three quarters of GDP growth have averaged 2.37%, and the first quarter of 2007 is shaping up to come in a bit lower. We think the markets are currently expecting too deep a downturn evolving from the subprime mess. While we expect housing to remain an economic headwind for the rest of the year, we don't envision the full-blown financial and economic crisis scenario that's been making the rounds.

After four consecutive quarters of sub-trend growth, it's probably not too surprising to find that some are extrapolating the trend all the way into recessionary levels. It's our belief, however, that a combination of an expanding money supply (MZM growing at a 10% annualized pace), a weaker dollar (helps exports), lower bond yields (see figure 2), a very healthy global economy, and a less hawkish Fed will be enough to soft land the U.S. economy somewhere around the 2.0% GDP level. At some point market participants will look across the valley and begin positioning for the economic upturn.

The task will no doubt be made more difficult by news on the inflation front. Inflation data have been frustratingly stuck at levels above the Fed's so-called comfort zone of 1½% - 2.0% core PCE. The seeming stickiness of recent data will likely prove transitory given the length of time economic growth has been below potential, thereby relieving the pressure on resource utilization. In fact, lagging inflation data generating fears that the Fed will delay easing at the same time that growth fears

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are rising is rather typical at this stage in the monetary cycle. Although the economy is indeed slowing faster than inflation, we see it as more of a timing issue. We expect that the current stagflation fear will be short-lived, and for the rates of change to cross over by mid-year.

In testimony before Congress, Bernanke indicated the FOMC is sticking with their official forecast that the slowing rate of economic growth, along with the lagged impact of 17 consecutive rate hikes, would bring inflation within their comfort zone. Bernanke made it clear, however, that recent events have increased the uncertainty surrounding that forecast. This makes sense in light of the fact that market uncertainty has gone up as well, as evidenced by the spikes in various measures of volatility.

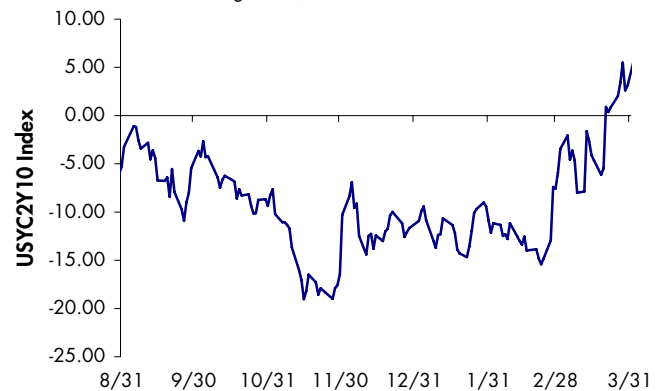
It appears the current thinking at the Fed is that it can reach its inflation goals by not easing, as opposed to tightening, especially in light of recent data showing nominal GDP is over 100 bps below the funds rate. Monetary policy is tight, and some of the hurdles to easing might have been removed by the expansion of the subprime woes and by weakening business spending. Nevertheless, Bernanke said he continued to believe the threats were manageable, and added that a little flexibility would be needed to track their progression... sounds a little like Paul Volker's fondness for "constructive uncertainty." We continue to look for one Fed ease by the end of the year, but only if inflation falls within the FOMC's comfort zone and the employment situation weakens a bit, both of which we expect.

10-year Treasury yields tested the bottom of our expected 4.50 - 5.00% trading range in the first quarter before bouncing up toward the 4.65% level, and we continue to believe most of the trading activity for the rest of the year will be within that range. Yields much below recent lows offer little value. More interesting, though, has been movement in the shape of the Treasury yield curve. It's likely that we have already seen the point of maximum inversion. Whether it's been concerns over heightened volatility, expanding risk premiums, expected Fed action, or even geopolitics, the one constant over the last few weeks has been a gradual, almost relentless disinversion of the yield curve. The spread between yields on 2-year Treasuries and 10-years, a popular measure of the shape of the curve, moved from -15 bps on Feb 22nd, to +3 bps by quarter end (see figure 3). Nevertheless, we continue to believe the curve will remain relatively flat by historic standards.

Even after all the recent volatility and expansion in risk premiums, spreads on so-called risk products – corporate bonds and asset-backed securities – remain tight by historic standards, and are unlikely to get a whole lot tighter. Although spreads may widen a bit over the next

**Figure 3. 10-Year Treasury Yield, 2-Year Treasury Yield Spread**

August 31, 2006 to March 31, 2007



Source: Bloomberg

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

year, we continue to believe that spreads will remain relatively contained thanks to the influence of what Bernanke has referred to as "The Great Moderation," and to a continuation of the global yield grab.

So let's see. Treasury yields remain stuck in a relatively narrow trading range, the yield curve is flat and not likely to re-steepen much, and risk spreads are tight and might widen only a bit from here... hardly the stuff of scintillating cocktail chatter. In fact, it's the kind of environment where buying and holding bonds – say, the Lehman Aggregate Portfolio – could produce little more than the risk free rate.

That isn't to say that opportunities don't exist. We wouldn't be surprised by periodic risk scares over the near-term that would allow us to lean against our longer-term views. To produce alpha in such an environment, managers are going to have to be active and nimble, constructing portfolios as much from the top-down as from the bottom-up. There remain plenty of risks to our secular low volatility, low risk premium forecast, as evidenced by the recent market dislocations. And with the constant supply of shiny new objects to attract the market's attention, it's easy to go looking for reasons for things to change. But as the market continues its inexorable fascination with ever-changing memes, we caution against slogging around too long in what often turns out to be nothing more than shallow muck. It can be exhausting and quite unpleasant. We much prefer swimming in the deep end of the meme pool.

# Equity Portfolios

## Quarterly Review

The equity market whipsawed investors in the first quarter of 2007 as volatility and lack of leadership characterized the year so far. Fueled by declining oil prices, high consumer confidence, and benign inflation readings, the equity market got off to a strong start in January. However February put an abrupt halt to an eight-month string of positive market returns\* with a mid-month sell-off triggered by a sharp correction in the Asian markets and further signs of deterioration in the domestic housing market. The markets recovered in March as the Fed removed its tightening bias and investors discovered undervalued stocks. We had an unusually high number of macroeconomic variables to digest during the quarter, resulting in cross-currents strong enough to make investors queasy. The end result was a substantial increase in volatility (the VIX jumped almost 30% this quarter) and flat broad index returns (DJIA -0.33%, S&P 500 +0.64%, and Nasdaq +0.44%).

Stylistically, there was little difference in the returns generated by Value or Growth stocks this quarter. Small caps outperformed large caps, albeit slightly. For several quarters the correlations across the equity indices have been high with dispersion trends amongst industry sectors low; the result has been a lack of sustained sector leadership. We feel liquidity, globalization, and the increasing interdependence of the capital markets are to blame. We continue to combat this trend by diversifying our holdings base, upgrading to higher quality positions within sectors, and lengthening holding periods.

*\*based on the S&P 500 Index*

We are pleased to report all of our equity strategies produced positive returns this quarter. While we made several changes to individual holdings, overall turnover remained relatively low and the ultimate change in our sector positioning was minimal. We remain committed to our investment philosophy of investing in high quality growth companies with strong fundamentals, which we believe will deliver superior long-term results.

## Market Outlook

We remain optimistic regarding the prospects for US equities in '07. Healthy corporate balance sheets, attractive valuations, and an unprecedented amount of M&A activity are tempered by decelerating profit growth and a slowing economy. As profit growth starts to become scarce in this mid-cycle slowdown, stocks that deliver above-average growth should begin to command a greater premium. This dynamic bodes well for our management style, as in today's environment greater opportunities exist in growth stocks versus value. Our comfort with the decelerating profit environment also stems from our belief that growth equity investors will now benefit more from multiple expansion, which we expect to transpire throughout the course of '07. For the past several years we have witnessed a contraction in P/E multiples for growth stocks. We also believe the Fed has subtly laid the groundwork for eventual rate cuts, albeit beholden to core inflation remaining within its comfort zone. We are confident a diligent Fed and a pick up in economic growth prospects in the latter part of '07 will quell any worries about stagflation and the potential fallout from the housing slowdown.

Equity  
COMMENTARY

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