

“When The Going Gets Weird, The Weird Turn Pro”

- Hunter S. Thompson

The faint outlines of a “brave new world” of credit are beginning to take shape

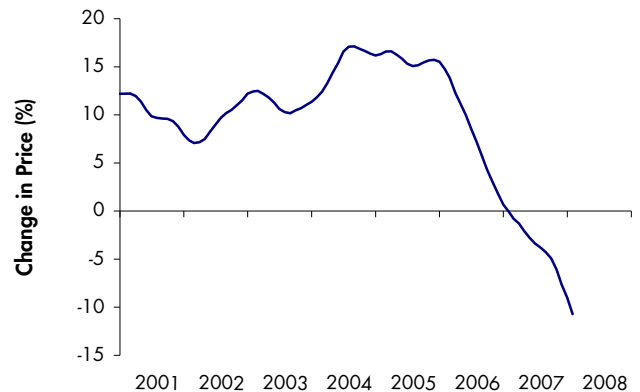
As we sit down to try to cobble together this edition of SCM’s quarterly commentary, we can’t help but marvel at how the events of each new quarter seem to outdo the previous one by reaching ever higher levels of just plain weird. In last quarter’s commentary, titled “The Times They Are A-Changin’,” we discussed the weird and profound transformation taking place in the credit markets. We explained that since the unwinding of this credit cycle’s massive excesses had no clear historical analogs, these were largely uncharted waters and that a brave new world of credit creation awaited. But this quarter has taken weird to an entirely new level. The first three months of 2008 saw the game of quarterly one-upmanship turn into a veritable all-star showcase of the weird. Who will ever forget Jerome Kerviel’s trading shenanigans, Bear Stearns being deemed too-connected-to-fail, and Abbey Joseph Cohen giving up her bullish market calls? Countless books and doctoral dissertations (not to mention regulations) will be written about this period. But through it all, as the quarter comes to an end, the faint outlines of that brave new world of credit are beginning to take shape.

Let’s take a step back. The credit cycle is one of the more enduring cycles around. The ebbs and flows of borrowing and lending are as natural as the tides, as fear and greed take their turns at the plate. At the top of the cycle, when credit is expanding, people seem oblivious to risk. At the bottom of the cycle, when credit is contracting, they become obsessed by it. We’re currently living through the risk-obsessed phase, sometimes referred to as a credit crunch. And as a result the financial system is shrinking... in quantum chunks.

What complicates this cycle’s shrinkage, however, is just how dependent our economy had become to that economic growth hormone known as credit. Over the last few years we at SCM have gone so far as to characterize the seemingly insatiable need for this brand of growth stimulant as our economy’s jones, or addiction, to it. And as the stimulation gets cyclically withdrawn, many are shocked, just shocked, to find that going cold turkey is no walk in the park. Watching the domestic economy whither is not for the faint of heart.

So as credit gets withdrawn and the economy slows, policymakers have been left to scramble for responses. For its part, the Fed has become engaged in a battle of dueling acronyms, creating its own array of entities – TAF, TSLF, and PDCF – to combat a credit crisis brought on by the meltdown of entities with acronyms of their own – such as ABCP, CDO,

Figure 1. Home Price Index
S&P/Case-Shiller Composite - 20 City Home Price Index Year-over-Year
January 31, 2001 - January 31, 2008*



Source: Bloomberg

* most recent data available at press time

SIV, and ARP – dubbed the shadow banking system. As we explained in last quarter’s commentary, the unregulated shadow banking system that had driven a majority of the growth in credit this decade had actually swelled to such a size that it became larger than its more traditional, regulated cousin.

This is largely a battle of the Fed’s own making. As we’ve argued since last fall, the FOMC has been painfully slow to comprehend the full market and economic consequences of the cyclical shrinkage of the financial system brought on by the dismantling of the shadow banking system. The decade’s massive expansion of leverage is in the process of being unwound through serial bouts of forced selling, which has led to the Fed’s worst fears coming to fruition; an adverse feedback loop has developed.

While the Fed actions have greatly reduced the risk of an otherwise sound counterparty going under as a result of funding issues, the key problem remains. The forced selling of assets that has occurred is largely the result of the continued fall in home prices [see figure 1], which show no signs of slowing. With each new decline in house prices, loans must be marked down on financial institutions’ balance sheets under the gimlet eye of auditors afraid to become the next Arthur Andersen. As capital shrinks with each write-down, the ability and desire to lend also falls, depriving the economy of its growth juice. As economic growth slows, added pressure is placed on housing and employment, intensifying the

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deleveraging process. From the demand side, the continued fall in home prices puts an increasing portion of homeowners in a negative equity position, drying up their appetite (not to mention their ability) to make payments. This further inflates the number of delinquencies and foreclosures, leading to additional write-downs and rounds of forced deleveraging.

The Fed's recent efforts have showed that despite being initially slow to recognize how quickly this negative spiral could develop, it is now fully engaged in muting the self-feeding nature of the cyclical unwind [see figure 2]. While there are admittedly only 225 basis points left in their blunt rate-cutting instrument, there are other more precise and targeted tools for the Fed to utilize, including the outright purchase of Mortgage Backed Securities.

But the policy responses to date – on both the monetary and fiscal fronts – have only dealt indirectly with the general economic and liquidity symptoms, and not directly with the real problem; namely falling home prices. Some of the ways currently being discussed of dealing directly with the problem include nationalizing Fannie Mae and Freddie Mac, and the creation of a taxpayer funded, RTC-like entity to buy distressed loans from the banks. Nevertheless, until home prices stop falling, and/or banks find a way to raise more capital than they write off, the cyclical deleveraging process will continue to act as a serious economic headwind.

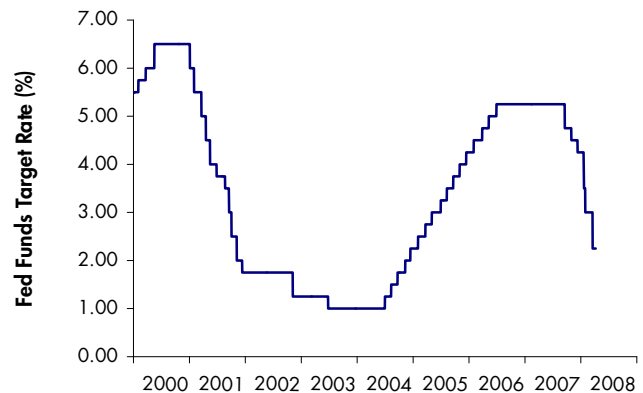
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We don't expect home price declines to turn around this year given the sheer size of the inventory of unsold homes, which is being fed by the growing rate of foreclosures and constrained by ever-tighter credit standards. As for bank re-capitalization, there are massive pools of capital on the sidelines waiting to be deployed at the first sign that the write-down cycle is being broken. Investors representing a few of these pools have even dipped their toes in the water recently in an effort to time the bottom in risk aversion, only to have their foot chopped off by yet another round of the serial deleveraging that marks this unwind phase. But at some point, a bottom will indeed be found and the credit cycle will start anew. Until such time, expect the financial system to continue to shrink.

Given that this decade's massive expansion of credit – when combined with multiple and sizable injections of additional monetary and fiscal stimulants after 9/11 – could only produce a meager 3.0% to 3.5% GDP during the best years,

Figure 2. Federal Funds Target Rate

January 1, 2000 to March 31, 2008



Source: Bloomberg

suggests the prospects for the domestic economy are lackluster at best as the cycle plays out. We expect GDP to remain well below potential throughout the remainder of 2008 and well into 2009, bouncing in and around 0%, constrained by the gravitational pull of deleveraging. Debating whether or not economic growth currently falls within – or ultimately finds its way into – the technical definition of a recession misses the point. The trend is pointing down and we don't expect to see anything but the shallowest of recoveries for some time.

Inflation remains a hot button for many, including, regrettably, a few members of the FOMC. They point to surging commodity prices and a blip in headline inflation indicators as evidence that policymaker's efforts to mute the economic downturn will necessarily result in runaway inflation. Let's approach these worries piece by piece. First, the recent rise in commodity prices is more about the fact that they have come to be viewed as financial assets by the asset allocators of the world, and have been purchased by these new entrants to the commodity markets in long-only index fashion. As prices rose, they were joined by the "2-and-20" momentum crowd, who tend to simply latch on to anything that moves up (or down... as a reminder). Add to that the recent weakness in the denominator of any dollar-based trade – that would be the dollar itself – and it's not surprising to see why commodity prices went ballistic.

With regard to the headline inflation indicators, it must be remembered that these are notoriously lagging series, which we believe currently reflect the export-led economic bounce seen in the second and third quarters of last year. We, however, prefer to view the counter-cyclical stimulus efforts of policymakers as reflationary rather than inflationary. We

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find it difficult to see how the wide-and-getting-wider output gap, the largest housing deflation in decades, and the type of debt deflation unseen since the Depression, can be deemed inflationary when all point the other way. We agree that in the long-run, inflation is a monetary phenomenon, as Uncle Milty (Friedman) taught us. But in the short-run, monetary policy can be used to soften the cyclic swings of an economic cycle, as Lord Keynes taught.

Further, if consumers can't get higher wages – which they aren't – to offset higher food and energy prices, then these higher costs represent yet another drag on consumer spending. The impacts are not limited to consumer's income statements either. We think higher commodity prices say more about company earnings than about pass-through inflation pressures, and as such produce a negative wealth effect on consumers via the declining value of their stock portfolios. Since this is occurring at the same time that their largest balance sheet item (their house) is also shrinking in value, the impact on consumer confidence is compounded [see figure 3].

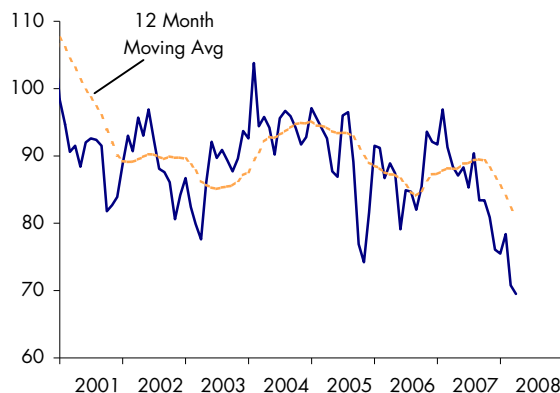
If and when these factors begin to reverse course and turn up, we will re-evaluate our inflation outlook. Until then, we will continue to expect the recent angst to blow over in the coming months. In fact we wouldn't be surprised if the current obsessions about inflation to give way to media-stoked fears of a Japanese-style deflation.

This has implications for our fixed income investment strategy. After generally being long our benchmark duration targets and under-weight risk for the second half of last year, we used the first quarter's serial flight-to-quality bullish steepening surges in the Treasury curve to begin to move toward more neutral levels. As the credit cycle unfolds, we will look for opportunities to eventually move to below-benchmark durations over the next few months while slowly layering risk back into the portfolios. Nevertheless, given that we expect any economic recovery to be shallow and prolonged, we are not in any hurry to make these moves. We're going to need to see signs that financial institutions can raise more capital than they write-off, evidence that the decline in home prices is slowing, and indications that the employment outlook has stopped deteriorating [see figure 4]. Any fiscal action that directly addresses bank capital or home prices could help trigger our transition a bit sooner, but given the carnage that has taken place, we'd rather be a bit late than risk being early.

It's clearly tempting, perhaps even fashionable, to conclude that the worst of the classic credit-driven boom/bust cycle is behind us. We have our doubts, but who really knows. As we've explained, we're not yet ready to get aggressive, as we expect the financial system to continue to shrink. Accordingly, risk will be viewed through a changing set of cyclic lenses. It's a time of transition, but whether it's quarterly one-upmanship of weird events, disagreements over inflation, or even more dramatic monetary and fiscal policy responses, there is one thing we know for sure: Opportunity will abound. Opportunity

Figure 3. Consumer Confidence

University of Michigan Survey of Consumer Confidence Present Sentiment
January 1, 2001 - March 31, 2008

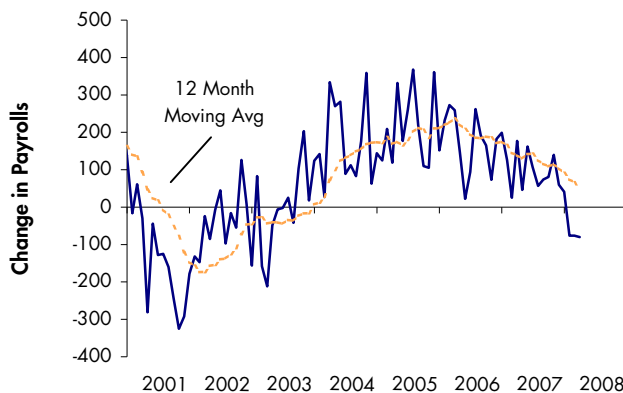


Source: Bloomberg

Base Year 1966=100

Figure 4. Nonfarm Payrolls Index

US Employees on Nonfarm Payrolls Total Month-over-Month Net Change
January 1, 2001 to March 31, 2008



Source: Bloomberg

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 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 on behalf of our clients to the dynamics of an ever-changing marketplace.

Quarterly Review

Selling risk was a popular theme this quarter and equity investors suffered because of it. The broad markets were down each month contributing to the worst quarterly return in the equity markets in over five years. A host of deteriorating economic data, further credit market strains, and heightened volatility made for a difficult investing environment. Deleveraging resulted in forced selling and caused market leadership to invert as many of the 'winners' of 2007 quickly became the 'losers' of the current quarter. The uncertain backdrop brought daily volatility to multi-year highs, providing equity investors with its customary problems, and opportunities.

All equity size and style categories were in the red this quarter. Large caps managed to slightly outperform small caps and value beat growth. Valuations improved throughout the quarter with all sectors exhibiting multiple contractions. Earnings expectations were revised down this quarter, although ex-Financials growth rates remain near 10%. Recession talk is widespread, but fiscal and monetary response this quarter has been unprecedented.

Market Outlook

We have stated in the past that the headwinds the financial markets face will be felt most acutely in the first half of 2008. We certainly felt them this quarter. While it is clear to us that further risks remain, it is also clear the response

to these risks will eventually take hold. There will be more fallout from the credit concerns and slowing economy, but the market has appropriately priced in a lower earnings outcome. The amount of money sitting on the sidelines waiting for a positive catalyst to re-deploy into risk assets is substantial. We are hopeful that financial stability, born from an aggressive policy response, will ultimately prove to be that catalyst.

We expect further volatility during what we now view as a bottoming process that ultimately should carry broad equity prices higher over coming months. Sustained advances will be predicated on an improved credit environment. We expect growth stocks to outperform value stocks. The growth sector shows strong relative earnings revision momentum and remains undervalued relative to the value sector based on historical relative valuations. We will remain consistent with our investment philosophy and continue to isolate those higher quality companies that can sustain profit levels above their peer groups. We plan to use times of extreme volatility to our advantage as we capitalize on perceived oversold situations and trim back securities with stretched valuations.

We are happy to share our thoughts with you in greater detail and welcome any questions and comments you may have. Thank you for your continued support.

Equity
COMMENTARY

Firm Update: First Quarter 2008

In February 2008 SCM Advisors' parent company, The Phoenix Companies, announced that it intends to spin off its asset management subsidiary as a separate, publicly-traded asset management firm sometime near the end of the third quarter. The Phoenix Companies has two primary businesses, a life insurance business and the asset management business. We believe this is a very positive event as there are many benefits to being an independent asset management company. As a separate public company our new firm will have its own equity to retain and attract high caliber investment professionals and from a growth perspective be able to use capital and borrow to invest and expand. The spin-off itself will not impact SCM's day-to-day operations as one of the independent boutique managers affiliated with the new firm, but it will have a positive impact on our strategic flexibility. Historically, one of our strengths has been the strong brand and identity of SCM Advisors and this will be reinforced as part of an independent asset management company.

In an unrelated announcement also taking place in February, SCM Advisors named Bob Bishop Chief Investment Officer of Fixed Income. Bob has been with SCM Advisors for six years as Senior Portfolio Manager and Head of Trading. He has 28 years of investment experience and was previously with Goldman Sachs and Merrill Lynch. Bob Bishop and Max Bublitz, Chief Strategist for the firm, were named to the firm's management committee. This announcement coincided with Albert Gutierrez tendering his resignation as Chief Investment Officer of our Fixed Income group. Mr. Gutierrez had been with SCM Advisors since 2002 and had assisted in the growth of our fixed income businesses. His decision was a personal one and there are no other personnel changes affecting our traditional fixed income businesses as a result of his departure. We want to wish him well in all his future endeavors.

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.

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