

## The “What, Me Worry?” Market

*In the first quarter of 2011, markets shook off a series of worries of near-biblical proportions.*

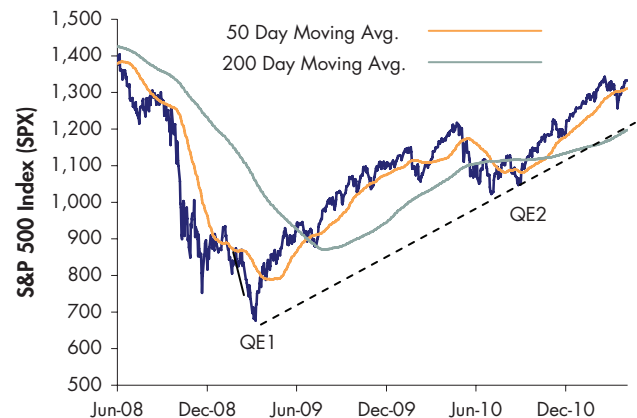
By Maxwell E. Bublitz, CFA, Chief Strategist

The dictionary defines worry as a state of engaging in chains of thoughts and images that are negative and uncontrollable in nature. Excessive worry, we’re told, can trigger a whole host of physical and emotional problems. So it should not be surprising that ridding oneself of worry is a theme universal to many of the world’s great religions, and an admonition that consistently finds its way into pop culture. The “What, me worry?” in our title was made famous by Alfred E. Neuman, the fictional cover boy for *Mad* magazine whose goofy, carefree grin is captured perfectly by the phrase. But we could have just as easily referenced Bobby McFerrin’s song *Don’t Worry, Be Happy*, or even the *Hakuna Matata* tune from the movie *Lion King*. But in the end we felt the dim-witted *Mad* mascot better represented many aspects of 2011’s first quarter, as markets shook off a series of worries of near-biblical proportions.

It’s been said that bull markets climb a wall of worry, but the recent highly-correlated ascent by risk assets has been made all that much easier by standing atop – and being supported by – a veritable mountain of money. This mountain was very purposefully constructed by monetary policymakers as part of what we call *The Great Reflation Experiment*. The global financial crisis effectively shut down the traditional method that monetary authorities – like the Federal Reserve – used to stimulate economies during economic downturns. Typically, the Fed would feed money into the fractional reserve banking system and the increased lending would spur economic growth. With banks now scrambling to deal with crashing loan collateral values and an outburst of knee-jerk regulation, the traditional monetary policy transmission mechanism has proven all but useless. So here’s where the reflation experiment began.

In an effort to keep the recession from metastasizing into a depression, and to keep a plummeting inflation rate from falling into outright deflation, the Fed chose instead to target higher prices of risk assets, such as stocks, as a way to mute the deleterious impact of systemic deleveraging. Higher asset prices were expected to re-energize animal spirits, which in

**Figure 1. S&P 500 Index**  
June 9, 2008 - April 5, 2011



Source: Bloomberg

turn would juice the economy via the so-called wealth effect. The idea was that a self-sustaining recovery would emerge and allow the traditional monetary transmission mechanisms to reopen.

We have long been on record as saying that Quantitative Easing (QE) has been the primary driver of the cyclical recovery, both in terms of the economy and risk markets, from the dark and very scary days of late-2008/early-2009 [See Figure 1]. Sure, there have been other important drivers, but QE remains the primary source. So to the extent that the economy has expanded, stock prices have doubled, disinflation has likely bottomed, and the dollar has declined, then QE should be deemed a success... so far. The real question, however, is when the responsibility for being the primary catalyst of economic growth can finally be handed from the manipulations of the public sector back into the rightful hands of the private sector. There are four key indicators that we’ll keep an eye on to let us know when that handoff can successfully be made.

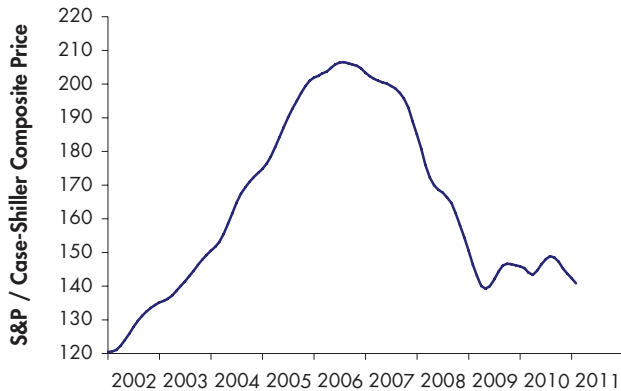
### Four Key Indicators

First is the housing market. At the very least, we would like to see to see home prices stop falling. The Case-Shiller Index [See Figure 2] has now fallen seven months in a row, prompting fears of a “double-dip” in the housing sector. But from an economic standpoint it doesn’t appear that the first dip ever ended, at least when you look at the residential

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**Figure 2. S&P / Case-Shiller Home Prices Composite**  
January 31, 2002 to January 31, 2011



Source: Bloomberg

Most recent data available as of publication date

investment component of GDP. Real residential investment has contracted in almost every quarter over the past four years, and probably contracted further in the first quarter of 2011. For most Americans their home is the largest asset they own, and the negative wealth effect of falling home prices has serious knock-on effects throughout the entire economy. We're not saying we need to see prices rise; we just need to see signs of stability. While some measures of valuations are returning to longer-term norms, the specter of the massive glut of inventories – both existing and shadow – suggests that stabilization is not around the corner. We entered 2011 expecting home prices to establish a bottom later in the year and we will (very nervously) stick with that call.

The next indicator we'll be watching to see when the handoff can safely be made is the jobs market, and here things are looking a little better. As can be seen in the chart of Nonfarm Payrolls (NFP) [See Figure 3], a bottom has clearly been put in and the trend is unambiguously up. That said, with over 8.5 million jobs lost during the recession and only a small fraction of that made up during the economy's recovery phase, there has been significant damage done. We would like to see at least four months of NFP well north of the 200,000 level before a self-sustaining expansion can be inferred from this indicator. The March report showing a NFP increase of 216,000 was a good start, indicating a labor market that is indeed in the process of healing.

The third key to a successful handoff is bank lending. Remember that this is the traditional path that the monetary transmission mechanism travels and can be measured by such things as velocity and the money multiplier. Recall also that the financial crisis effectively neutered this path. So why do we need to keep watching the bank channel rendered impotent by the collapse in the shadow banking system and a still-nowhere-near-complete deleveraging process? Because no healthy economy can survive without

the lifeblood of credit, and even though total bank credit will likely continue to contract, we can decompose bank lending into pieces that can actually provide decent early-warning signs of impending economic health.

The largest part of total bank credit is residential real estate lending, most recently dominated by the now-defunct shadow banking system. Continued contraction is still the order of the day as deleveraging continues and the housing market works through its issues. The next component of total bank credit, Commercial Real Estate (CRE) lending, is no great shakes either, but has far less of the speculative excesses found in the residential market to work off. Nonetheless, the trend in the CRE market remains down. The Commercial and Industrial (C&I) component (those loans made to businesses and corporations) is actually showing some signs of life and may be poised to move higher as the economy transitions into expansion [See Figure 4]. Finally, we come to consumer lending which has recently taken a decided turn for the better after wallowing in 2009 and early 2010. So with residential real estate being far-and-away the biggest piece of bank lending, we know that the deleveraging-to-come will keep total lending under pressure. Nevertheless, keeping an eye on the rest of the components of bank lending will tell us – and the Fed – a lot about whether the more traditional monetary transmission mechanism is beginning to work and when the handoff might be considered.

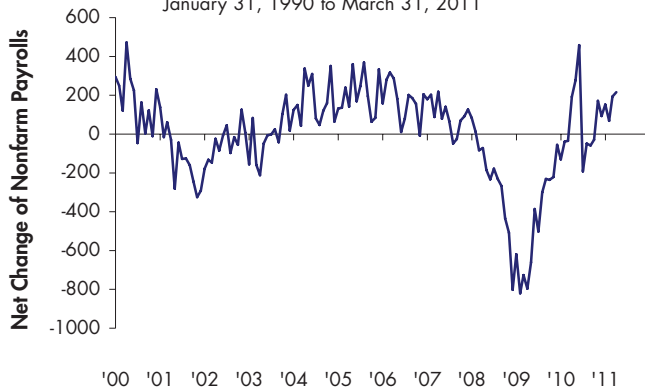
*No healthy economy can survive without the lifeblood of credit.*

The final indicator is probably the most important. Remember that it is our contention that Quantitative Easing has been the primary catalyst for recovery in both the economy and the risk markets. As you'll recall, QE involves the outright purchase of securities by the Fed and has led to a meteoric rise in the amount of assets held on the Fed's balance sheet. Since the introduction of QE1 in early 2009, there has been 0.87 correlation between the change in the size of the Fed's balance sheet and the change in the level of the S&P 500 (as a proxy for risk assets). This should not be surprising given that Fed Chairman Bernanke last fall explicitly stated that higher stock prices were one of primary goals of QE2, along with higher inflation. So this leads us to our fourth key indicator of whether the economy has become self-sufficient enough to begin the process of being weaned off governmental life support: Can stock prices hold up when the QE2 purchase program reaches its targeted June 30 completion date, and avoid a repeat of the 17+% correction seen between April and July of last year when discussions of a premature unwinding of QE1 led to a wave of paranoia about a double-dip recession?

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## The “What, Me Worry?” Market... (cont. from page 2)

**Figure 3. Nonfarm Payrolls**  
**Month-over-Month Net Change**  
January 31, 1990 to March 31, 2011



Source: Bloomberg

The linkage between the size of the Fed's balance sheet, risk markets, and the economy is far from straightforward. And importantly, it will be difficult to observe and analyze that linkage until well after the size of the Fed's balance sheet peaks when QE2 ends on June 30. As a result, we expect that the process of de-linking QE/stocks/the economy will end up being iterative and very choppy. We continue to believe that the Fed will use the full \$600 billion slated for QE2 per its original schedule. Further, we expect the Fed to keep its balance sheet at peak levels until it has ample evidence that a true economic expansion has gained traction. Any real shrinkage of the balance sheet will ultimately be a data-driven and possibly very volatile process.

We expect the Fed will initially keep its balance sheet from shrinking by reinvesting all cash flows from its mortgage-backed securities (MBS) portfolio, estimated at about \$35 billion per month, at least through the third quarter of the year as they monitor conditions. At that point, and as conditions warrant, policymakers can slowly begin to let the MBS cash flows roll off, again monitoring conditions, before they begin the very dicey process of shrinking their balance sheet in earnest through a variety of well-documented measures. Only then will they consider hiking rates, which we continue to think is unlikely to happen until well into 2012. And remember, throughout the entire process, we expect that there will be ample and conflicting data to worry about, which should make policy decisions anything but straightforward.

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### Economy

Domestic GDP grew by 3.1% in the fourth quarter of 2010 and officially marked the economy's transition from the recovery phase to the expansion phase. Unfortunately, much of the momentum gained in the latter part of 2010 was lost in the first quarter of 2011 as the global economy was hit by a series of exogenous shocks to growth. The mess in the Euro-periphery, the Middle East revolutionary-contagion-induced oil spike, and the horrific disasters in Japan sent economists everywhere scrambling to slash their GDP forecasts and jack up their inflation estimates.

In our last *Market Commentary*, we forecast 3.0% - 3.5% GDP growth for the first half of the year and 2.0% - 2.5% for the second, which put us well below the consensus. We also expected inflation to bottom in the first half and gradually move back toward the Fed's 1.7% - 2.0% core PCE target by year end, a bit slower than consensus. No doubt that these events will have a negative impact on economic growth, but as can be seen by the immediate and powerful monetary response by the Bank of Japan (BOJ), these events should at the margin allow policymakers to keep policy leaning to the accommodative side longer than they otherwise would have. And because risk markets have held up remarkably well for now, we'll resist the knee-jerk temptation to downgrade our forecast, and (again, very nervously) stick with the bottom-end of our original GDP range.

As for inflation, we really don't want to get sucked into the debate again about whether higher food and energy prices reflect the general rise in the level of goods and services that define true inflation, or whether they're simply changes in *relative prices*... you know our thoughts on that. We do believe that inflation has likely bottomed for this cycle and

**Figure 4. Commercial and Industrial Loans**  
**at all Commercial Banks**



Source: Board of Governors of the Federal Reserve System  
Most recent available data as of publication date

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the risks of outright deflation have diminished – remember, that was the Fed’s goal. But we also believe that in the current environment, relative price shocks act as an economic depressant, and that there remains limited ability for those relative shocks to be passed through to the consumer or into wage inflation. Given the confluence of events in the first quarter, we think that the period of maximum price pressures is likely being felt right now, so we’ll stick with our forecast of core PCE moving gradually toward the Fed’s 2.0% target by year’s end.

### The Dollar, Stocks and Bonds

There’s also been a lot of chatter among the financial chatterati recently that the Fed’s QE2 program has been directly responsible for rising inflation in Emerging Market (EM) countries. Even a cursory glance at exploding money growth in many of the key emerging countries, when combined with the way they manipulate their currencies to maintain a peg to the dollar, should be enough evidence to put that tired argument to rest; they’ve created their own inflation. And as those emerging countries tighten policy and back off their currency-pegs in an effort to fight inflation at home, it’s not much of a stretch to imagine that global growth could be negatively impacted as well. And by tightening policy at the same time that the Fed remains highly accommodative, it should allow the dollar to continue its orderly decline against EM currencies... which doesn’t seem to concern U.S. policymakers one bit. You see, by allowing the denominator in the stuff we buy to deflate instead of having the numerator inflate, they create a kind of stealth inflation, which they hope will fly under the radar. Remember, higher inflation – stealth or otherwise – was one of Bernanke’s goals for QE2.

In our previous *Market Commentary* we described that we felt the S&P500 had scope to approach 1400 during the first half of the year, in part because QE2 was only partially implemented at the time. QE2 remains unfinished, and given that the BOJ responded to the disasters in Japan by implementing *in just three days* an emergency QE program equivalent on a GDP basis to the entire eight months of QE2, we remain comfortable that enough stimulus remains in the system to get the market to the 1400 level. Nevertheless, in the second half of the year, we are not yet convinced that the stock market can continue its cyclical rally at a time when the primary catalyst for the rally is in the process of being withdrawn.

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As for the bond market, we continue to believe the path of least resistance for yields is higher over the next few years, but as we’ve explained previously, it will likely be a bumpy path. Secular headwinds and cyclical tailwinds led us to begin the year expecting 10yr Treasury yields to trade within a broad 3.0% - 4.0% range for most of 2011. In the first quarter 10yr Treasurys remained comfortably inside that range with rates backing up early in the quarter to 3.75%, followed by a sharp flight-to-safety rally to

3.15% during the Japanese disaster, before closing the quarter near the middle of the range. We’ll stick with our 3.0% - 4.0% call for now. We continue to find opportunities in both investment grade and high yield corporate bonds, and see particular value in the bank loan market.

Worry is a constant state for those in the investment business, and the first quarter gave us all plenty to worry about. As the smoke clears, however, the markets are decidedly in the “What, me worry?” mode made famous by *Mad* magazine’s gapped-tooth icon. Sure, growth may be a bit slower, inflation may edge higher, and the Fed could some day tighten policy. But what the heck, the story goes, we’re still left with good growth, low inflation and supportive monetary policy. Ever the worriers, however, we must remind you that in no small measure of irony, Alfred E. Neuman’s oblivious-to-the-world motto was changed only once in the history of the magazine, to “Yes, me worry!” for the issue published just after the Three Mile Island accident in 1979. So color us worried; these are volatile and highly uncertain times. But 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. Our firm’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.

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