

Saved by the Margin Clerks

The recent rise in Treasury notes has been capped by fears of a subprime meltdown... for now.

The second quarter of 2007 started out innocently enough. The bond market appeared set to continue its recent stretch of somnolence, with interest rates stuck near the midpoint of their narrow nine-month trading range. 2-year and 10-year Treasury yields barely budged in April, closing the month within spitting distance of each other and mere basis points from where they ended the first quarter. Expectations of at least one hike in the Fed funds rate were comfortably priced into the market. Only 3-month Treasury bill yields showed any life at all, falling in rather strange fashion by almost 20 bps. This, however, was only a hint of what was to come. By mid-May all heck began to break loose.

The bond market was hit with a massive amount of supply in May and June, as the Wall Street deal-making machine took flight, with dealers using Treasuries to hedge the near record amount of corporate bond and CMBS issuance. As Treasury yields rose from the hedge-related selling, so too did the durations of benchmark indexes used by portfolio managers. Longer durations led to the first meaningful selling by mortgage originators – known as convexity selling in bond market jargon – in well over a year. When coupled with the rise in global real rates, and the overly bullish positions held by many market participants going into the sell-off, the resultant bond purge triggered even more selling as important technical levels were breached. Volatility exploded as Merrill Lynch's MOVE Index (a measure of bond market volatility) jumped 66% after hitting an all-time low only a few weeks earlier [See figure 1]. Yields on 10-year Treasuries blew straight through the psychologically important 5.00% level, reaching a five-year high of 5.32% before falling back toward 5.00% as the quarter ended. Interestingly, the last five-year high occurred in 1981, near the start of one of the greatest bull markets in history.

What finally put a stop to the technically driven rise in Treasury yields was news that a couple of terminally ill hedge funds were being put on ventilators. It turns out that they had used copious amounts of leverage to purchase Collateralized Debt Obligations (CDOs) backed by securities derived from the (too?) much-maligned subprime mortgage sector. As often happens during such episodes, it was the margin clerks who stepped in and shook things up in their effort to protect the interests of the lenders. As a result, the Treasury market caught a flight-to-quality bid as the "Mortgage Crisis" was back once again on the front page. Fears of financial contagion and a systemic meltdown rippled through the market, sending

Figure 1. Merrill Option Volatility Estimate (MOVE)
December 31, 2006 to June 30, 2007



Source: Bloomberg

investors scrambling to shed risk in favor of Treasuries. Margin clerks reversing the yield rally, who'd have think it? As the quarter came to an end, members of the media stumbled over each other in a frenzied effort to leap on the Blackstone-IPO-as-the-end-of-the-credit-cycle bandwagon. Spreads on most risk assets gapped wider, and quarter end pricing was expected to attract all sorts of gimlet-eyed scrutiny. A faltering stock market, Congressional dog piling, and the ever-present specter of terrorism also added juice to the flight-to-quality, which all helped put a stop to the technically driven rise in Treasury rates... at least for the time being.

As the smoke begins to clear, it seems to us that most of the market's concerns are about what might happen as opposed to what is actually happening. History suggests that this hyperventilating might last for a while before a more rational view of the fundamentals returns. Stepping back a bit to view those fundamentals, members of the Fed have to be pretty happy with things. They no doubt believed that investors had become too complacent about the pricing of risk. The recent turmoil has had the effect of tightening financial conditions – rates are higher, the curve is steeper, risk spreads are wider, the stock market is nervous – and policymakers didn't have to do anything. The housing bubble has burst, the economy has slowed and inflation has turned down. Fed policy and market expectations appear to be in better alignment now, thanks to the rather volatile technically driven adjustment.

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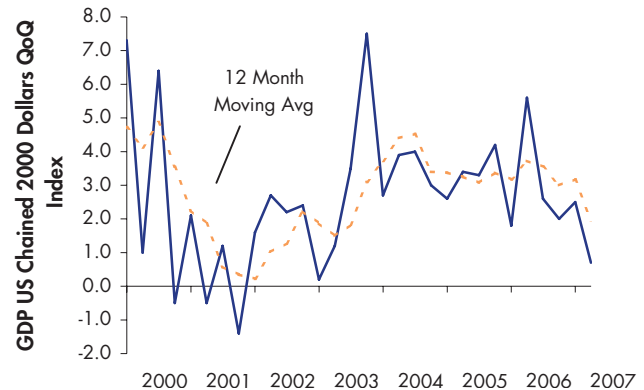
We remain in the soft-landing camp. The economic downturn looks to have troughed in the first half of the year [See figure 2] and we expect GDP to grow at a sub-potential level for the second half of the year. GDP growth rebounded in the second quarter from the first quarter's 0.7%, but this only represented an unwinding of a slump in inventories and net trade. It is not clear to us that the domestic economy can handle higher rates. We've written often about the economy's sensitivity to interest rates and how rising rates become self-limiting in such an environment. Rising mortgage costs should impact the ongoing housing correction, and this story has yet to be played out. Housing will remain a modest headwind for the consumer.

Higher energy costs – oil is over \$70 a barrel [See figure 3] – and the negative wealth effect from the housing recession should keep the domestic economy from reaching full potential this year. While consumption could be soggy through the fourth quarter, a domestic recession is not in the cards. We expect U.S. GDP to grow in the 2¼% to 2½% area for the rest of 2007. At a minimum, we believe it should take any chance of a Fed hike off the table. The global economy continues to expand at a steady pace, despite the slowdown in the U.S. This highlights the increased balance of the global economy.

Economic slack generated by prolonged below-potential domestic growth has helped pull inflation into the Fed's so-called comfort zone sooner than they forecasted, although we don't expect the Fed to ease without the job market weakening. Its important to understand that the recent rise in yields has NOT been accompanied by a rise in inflation expectations, a sign that the markets are comfortable with the inflation fighting resolve of global central banker. The inability of consumer price inflation to rise meaningfully has been driven by the factors we've written about often: globalization, international labor arbitrage, and technology. The rise in real yields is simply a reflection of the healthiest global economic backdrop in decades. Inflation remains remarkably tame, despite bond trader's squawking to the contrary. Sure, global central bankers continue to jawbone about inflation – indeed, it's their job – but most future tightening is already priced into the markets.

As former chairman Greenspan's "conundrum" is slowly being unwound, the term premium is being built back into the Treasury yield curve. The forces that led to the conundrum remain largely in place, and we do not expect them to dissipate fully over the near term. The story of the conundrum starts and ends with the unprecedented injection of liquidity into the global financial system over the last few years. It began with an extended period of easy monetary policies by the world's central banks, was magnified by the rampant expansion of credit by the financial sector (largely outside the banking system), and super-sized by what current Fed Chairman Ben Bernanke has referred to as the "global saving glut" in emerging market countries.

Figure 2. GDP Quarter over Quarter (2000 Dollars)
December 31, 1999 to March 31, 2007*



Source: Bloomberg

* most recent data available at press time

Figure 3. Crude Oil Futures (CL1)

December 31, 2006 to June 30, 2007



Source: Bloomberg

CL1 is a measurement of NYMEX light sweet crude oil futures contracts

While it's tempting to try to define and quantify liquidity of the above, recent events have shined a light on a more meaningful definition, at least over the short term. Liquidity can surely be thought of in the Milton Friedman sense; of central bank generated money. It can even be thought of as the piles of money looking to be spent (and levered) by various types of investors. But in the short term, liquidity is really about the ability to transact – about decent bids and offers – as the recent subprime CDO scare exposed. True, these periods most often prove temporary, but that means little when the margin clerks are large and in charge. Liquidity becomes just another word for confidence.

As the second quarter ended, the market's biggest fear was about the onset of a massive credit crunch, with far too many comparisons to the Long Term Capital Management fiasco

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of the late 1990s for our taste. We expect market skittishness resulting from the more psychological of liquidity's definitions to linger a bit longer this summer. Ultimately, however, it's the tangible definitions of liquidity that will prevail. The massive pools of global capital looking for higher risk, higher return homes are still out there. Whether its unspent (and as yet unlevered) Private Equity money, or Pension and High Net Worth money waiting to pay "2-and-20" to a Hedge Fund manager, or even the growing number of Sovereign Wealth Funds looking to imitate Yale's asset allocation poster boy David Swensen by reallocating central bank reserves into all manner of stocks, bonds, commodities and currencies, they all have one thing in common: they're all waiting (and incented) to put those piles of money to work. Our bet is the money will get invested – the math behind re-leveraging corporate balance sheets still works – and that it will most likely flow into those areas that have been immune to recent pain.

We continue to believe that investors buying and holding portfolios of bonds benchmarked against such indexes as the Lehman Aggregate will, over the intermediate term, be hard pressed to earn much more than the risk free rate. We believe the only way to earn more is by the disciplined, active approach followed by SCM Advisors. Over the next 12 to 24 months, we expect a slight upward bias in rates, a slightly steeper yield curve, wider risk spreads and more volatility than the recent past. The liquidity boom is slowly unwinding and real bond yields should grind higher. As the conundrum gets unwound, the recent 4½% to 5% trading range for 10-year Treasuries has likely been shifted a bit higher [See figure 4]. So far it appears that about 25 to 30 basis points have been added to the 4½% - 5% range, and it's possible the recent pop in volatility could add to the width of the range as well.

The bond market showed no signs of being the master of its own domain as the second quarter drew to a close, as action in other markets has been shaping activity. Nervousness about stocks and financial engineering, the mortgage mess, credit concerns, \$70 oil, and fears of terrorism will continue to keep the bond market in a technical reactive mode over the near term. The market's short attention span will eventually

Figure 4. 10-Year Treasury Yields

December 31, 2006 to June 30, 2007



Source: Bloomberg

wander back toward the fundamental as the summer wears on, although it will likely be an added transition, one that will provide us the chance to lean against our intermediate term outlook.

We look forward to such a transition because of the opportunities it affords us; 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 intrinsic 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. Our 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.

Organizational Update: First Half 2007

SCM Advisors ended the first half of 2007 with \$12.7 billion of assets under management, an increase of over \$1.4 billion for the year. The active first half of the year was exemplified by several additions to our professional investment staff:

Chris Smith joined us as a Credit Analyst in February with several years of credit experience. Chris is focused on the Media, Publishing and other sectors, and joins a team which has now increased to seven credit analysts. In addition, we added two Quantitative Analysts, Joe Dawson, who started at year-end, and Jacob Travisino, who joined the team in April. Our Equity Team welcomed the addition of Andy Hicks in April. Andy joined us as Equity Trader and Associate Equity Analyst and has several years of experience in trading and research.

Tom Haag, co-Portfolio Manager of the High Yield Fixed Income team left SCM in April to return to the Midwest with his family. We wish Tom well in his new endeavors. Our High Yield team continues to be led by Albert "Bert" Gutierrez, Chief Investment Officer and Al Alaimo, Portfolio Manager. Al, who has been with SCM for over six years as Director of High Yield Research and Co-Portfolio Manager, is an Institutional Investor-ranked analyst in high yield research.

Equity Portfolios

Quarterly Review

Broadly speaking, stocks had a terrific second quarter. April provided the strongest one-month return (S&P 500) in almost three years as first quarter earnings came in above 8%, well ahead of expectations, and sparked a strong rally. May continued the trend as strong economic readings, benign inflation reports, and confirmation from the Fed that it remains "on hold" added to the already supportive technical backdrop. M&A and LBO activity continued at a torrid pace and provided additional support for the market. Early June saw volatility pick up as rates increased (the 10-Year Treasury quickly popped above 5%) and investors sold equities on fears of a global asset allocation shift. The Chinese market experienced both a bear market (declining 22%) and a bull market (recovering to all time highs) in no less than 15 trading days. Stocks closed the quarter with another spike in volatility as markets debated the effects of the abrupt rise in long-term rates on the credit cycle and the reflux of subprime mortgage problems surfaced.

Equity COMMENTARY

For stock investors, there was plenty to chew on this quarter, but most of it tasted good. Second quarter readings on inflation, jobs, manufacturing, inventory levels, and services have all been well-received by investors. There are clear signs that the economy is recovering from the low-growth first quarter (0.7% GDP), and stocks did a good job forecasting the acceleration by posting strong performance in the quarter. Stylistically, Growth outperformed Value across capitalizations, a trend we see continuing. Historically, growth stocks have tended to outperform in periods similar to the market environment we are facing today: periods with reaccelerating economic activity, tight credit spreads, and lower relative earnings growth. We continue to see intra-sector valuation spreads at record lows. Simply put, the valuation spreads between 'good' and 'bad' companies have tightened, a result of the rise in global liquidity and the popularity of ETFs. We have responded to this trend by diversifying our holdings base, upgrading to higher quality positions within sectors, and lengthening holding periods. Large caps slightly outperformed small caps this quarter, albeit by a small amount.

All of our equity strategies again produced positive returns this quarter, some with significant gains. While we made several changes to individual holdings, overall turnover remained relatively low and the net 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 believe volatility will be with us for a while, but remain optimistic regarding further gains in the stock market. Higher rates reflect a more robust global economic outlook, not increasing inflation pressures. Credit standards will tighten, and while the housing market and private equity / M&A have been the obvious beneficiaries of low cost credit, we don't believe the cash-spigot has been turned off just yet. 2006 was by far the best year for LBOs in over a decade, and now at only the mid-year mark, the total value of LBO deals in 2007 has already surpassed 2006. We see the liquidity-driven buyout wave lasting well into '08.

Our primary concerns still center on the continued fallout from the housing market, but at this point we feel the problem is localized. Inflation and higher energy prices will continue to be a source of anxiety in the interim, but the economic downturn has passed. Sub-par, yet stable growth with contained inflation has provided a solid backdrop for equity investors. We expect overall corporate profits to once again come in above expectations and equity valuations to remain relatively attractive. Supply continues to be taken out of the market via buybacks and buyouts and demand trends remain positive. In the asset allocation game, the outlook for equities continues to look promising (relative to bonds, housing, etc.). We see better opportunities in higher quality growth stocks over value stocks as investors look to capture the opportunity of buying growth stocks at historically low 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.

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.