Market Commentary
Second Quarter 2008

SCM ADVISORS

SCM ADVISORS LLC

Dueling Mandates

The second quarter highlighted why it might be better for members of the FOMC to all be on the same page... not to mention the same book.

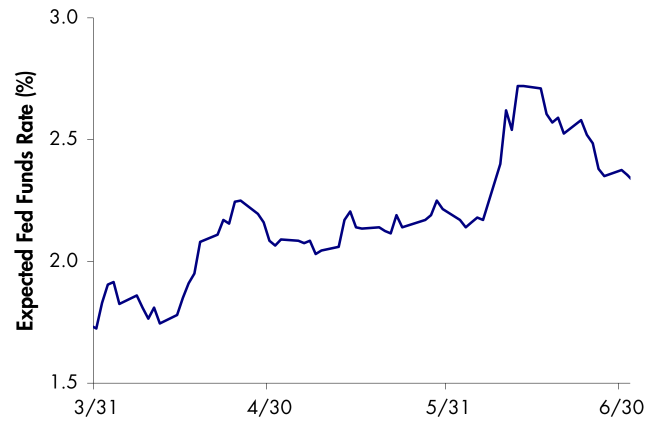
Things are getting a little testy at the Fed these days. There's a heated and, unfortunately, very public debate going on between the inflation hawks and economic doves. What makes it worse is that even though there are only a few extremists who are having trouble playing nice in the monetary sandbox, it's the whole class that has to stay after school.

By way of background, the Federal Reserve operates under a dual mandate, which requires the central bank to try to achieve both maximum sustainable employment and price stability. Not an easy task in even the best of times. But today's unprecedented challenges have come together in such a way as to make the Fed seem hell-bent on turning its dual mandate into dueling mandates. FOMC members have become increasingly polarized and strident regarding their views about which part of the policy duality poses the greater threat to the domestic economy. And when monetary policymakers are all-too-publicly on very different pages, who can really be surprised when markets hyperventilate about it? That, in a nutshell, was the second quarter of 2008.

Okay, so there was more to it, but we continue to pick at the Fed communication scab to illustrate how their comments became central to the amazing swings in market sentiment over the last three months. The second quarter began with the market expecting an additional 25 basis points (bps) easing by the end of the year, *[see figure 1]* on top of the 325 since last September. By mid-June, thanks to multiple hawkish trial balloons sent up by the Fed, expectations had shifted to a 75 bp hike in the funds rate by year end, an about-face of more than 100 bps in a matter of weeks. Markets promptly revolted, effectively shooting the trial balloons as soon as they left Fed hands, which led policymakers to quickly back-track via some not-so-clandestinely-planted articles in the popular press. As the quarter ended, expectations receded to a little more than 25 bps in tightening.

Inflation is at the core (pun intended) of these Fed-led debates. Surging food and energy prices have – for the time being, at least – shoved the housing mess, credit crunch and weakening economy aside to become the shiny objects of everyone's current attention. If items purchased as frequently as food and energy keep going up, it is thought, the wonderful period of low inflation that we've enjoyed must surely be coming to an end. And what is the Fed going to do to fix it?

Figure 1. Expected December 2008 Fed Funds Rate
March 31, 2008 - July 1, 2008



Source: Bloomberg

Hmmm, where to start? How about a proper definition? Remember that inflation is a rise in the general level of prices of goods and services over time, not a rise in specific prices. That is one of the reasons to look at the difference between the various reported "headline" measures of inflation (like PCE, CPI and PPI) and the corresponding so-called "core" measures, where the volatile food and energy components are removed. In spite of the ever-present cacophony emanating from the grassy knoll types who see the use of core measures as some great government conspiracy to pull the wool over our eyes, their use gives an indication of how recent food and energy trends reflect relative, as opposed to general, price increases.

The gap between the headline and core numbers is currently wide by historical standards. *[see figure 2]* For instance, the popular headline CPI measure has bounced around the 4.0% level this year, while the core rate has been closer to 2.0%. In other times when inflation has been front and center of everyone's attention, like during the inflation scare of the late-80s and early-90s, headline and core rates were far tighter and tracked each other far more closely. We find it very difficult to see how an environment characterized by the worst housing deflation since the depression, a massive and unprecedented shrinkage of the financial system, rising

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unemployment and falling capacity utilization can translate into inflation pressures. Nevertheless, it wouldn't surprise us to see the current gap widen a bit as we move into the summer months, thanks to the recent pop in food and energy prices, but we fully expect the gap to narrow by year-end as the headline numbers gravitate back toward core rates.

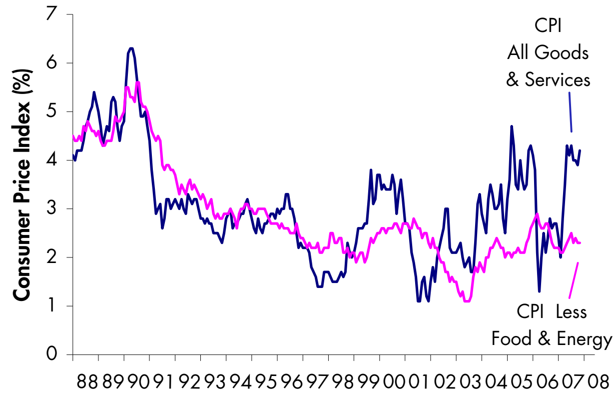
But even if headline inflation were to remain somewhat elevated – remember gang, we're not talking 70s-style double-digit numbers here – companies are finding it very difficult to pass higher prices on to the consumer. In a competitive effort to maintain or even increase market share, many companies are increasingly resorting to aggressive discounting, putting pressure on wages and profitability. The silver lining, however, has been that productivity continues to improve and, as a result, unit labor costs continue to fall. There is no evidence of a wage-price spiral developing. So at the end of the day, we agree with the Fed's forecast that inflation pressures, along with their attendant media-stoked fears, will moderate over the next few quarters and move within their target range.

One manifestation of the current handwringing over higher food and energy prices is the re-emergence of another longstanding American tradition: finger pointing. Targets abound, but there appears to be a particular fascination with such evil doers as pension funds, sovereign wealth funds and exchange traded funds, who believe that commodities can serve an asset class. The heretical idea is that stuff like food and energy products, which are presumed to be uncorrelated to financial assets, can actually be used to enhance the risk/return profile of an investment portfolio. These long-only investors have been branded as Speculators (capital S), which in turn has attracted the usual Washington-types who believe that a political hammer is the perfect tool for the correcting this grievous offense. Let's hope those so inclined take a deep breath, calm down and allow market forces to play out. Leave Congressional action for important things, like outing Roger Clemens.

That politicians would jump on the backward looking commodity-investors-as-evil-speculators bandwagon should come as no surprise. Far more productive, in our view, is to think about a couple of more forward looking issues. One is the notion of demand destruction brought on by the soaring energy prices. First off, it's inevitable. Car sales are plummeting in the U.S. Miles traveled have fallen for six straight months. Anyone who has flown recently has some anecdotal evidence of their own. On the international front, foreign gas subsidies are being lifted, as reflected in falling emerging market equity prices. Far more interesting to us are the future economic and investment implications of prices gone ballistic. We'll leave the backward looking finger pointing for the Congressional grandstanders.

Figure 2. Headline vs. Core CPI

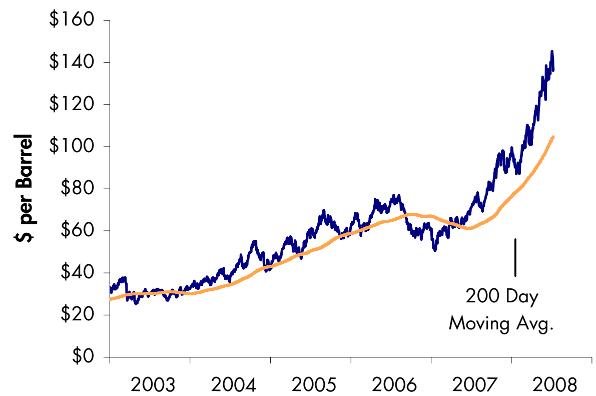
Consumer Price Index Urban Consumers Year-over-Year
July 31, 1988 to May 31, 2008*



Source: Bloomberg
** most recent data available at press time*

Figure 3. Oil Prices Going Ballistic

January 1, 2003 - July 1, 2008



Source: Bloomberg

Another forward looking issue involves the massive pools of capital waiting on the sidelines, looking for a place to earn reasonable returns. Remember when Greenspan's "conundrum" was all the rage. The basic idea was that these growing pools of global capital, some created by rising oil prices, caused longer-dated Treasury rates to fall at a time when the Fed was raising short rates. A quick glance at a chart of oil prices *[see figure 3]* suggests that any puzzling seismic asset shifts that occurred as a result of oil prices under $75/barrel might surely become more influential at nearly double the price. Many sovereign wealth funds have expressly stated their intent to more broadly diversify an ever-growing pile of oil-generated reserves. Where and how that money gets invested will significantly impact the investment landscape in the months and years ahead.

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Dueling Mandates (cont. from page 2)

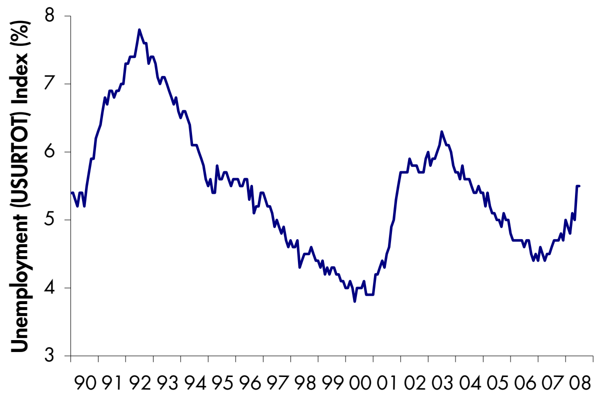
If we're right that inflation fears begin to recede toward year end, it seems that the markets might need some other shiny objects to focus on for a while. The most likely candidate at this stage appears to be the rapidly deteriorating state of the domestic consumer. Just as the housing debacle became the precursor to a broad-based credit crisis, so too have they both combined to take us to the next phase of the cycle, a significant consumer retrenchment. While it's our contention that we could be in the sixth or seventh inning of the housing deflation, and the fourth or fifth inning of the credit crunch, it's likely the consumer retrenchment game is still in the early innings.

The consumer's financial condition is taking hits on multiple fronts. Income statements are being stressed by rising unemployment, falling real wage growth, and higher food and energy prices. Balance sheets are getting marked down by falling home prices and shrinking equity portfolios. Even though consumer confidence has reached Carter era malaise-type levels, we don't expect this to be a deep economic downturn, thanks in part to the fiscal and monetary stimulus from earlier in the year, with perhaps more to follow. Rather, we expect a slow prolonged period of economic recovery, marked by sufficient demand destruction to effectively cap energy prices, a peak in the unemployment rate *[see figure 4]* around 6.0% by the end of the year, a gradual unclogging of the credit markets by the first half of 2009, and home prices bottoming by the second half of 2009. This should take us well into late 2009 to 2010 before economic growth has any real chance of reaching and sustaining the 2.75% to 3.0 % level of potential GDP the Fed targets. In the interim, we continue to expect GDP to bounce around 1.0%, as both consumers and businesses focus on much-needed financial repair.

This puts policymakers in a tough position, and given the current fascination with inflation, we expect the Fed to stay on the sidelines for a while. The current low level of the Fed funds rate elicits worries from the inflation hawks that the Fed's stance risks un-anchoring the inflation expectations they've worked so hard to bring down. While it may be true that near-term expectations have risen a bit, longer-term inflation expectations remain well-anchored. We continue to believe that the current low funds rate is more a function of the strains that remain in the financial system. Loan quality is still deteriorating, write-downs continue to mount, and more new capital will need to be raised. Given how badly the investors who provided capital over the last six months have fared, this could prove challenging. Further, it is not clear to us that we have felt the full impact of the housing deflation and credit crisis on the consumer, and think that it will be very tough for policymakers to begin to normalize rates until the significant economic slack that we envision diminishes.

In many ways, our expectations of a shallow economic downturn, coupled with a prolonged and tepid recovery is tougher for the markets to deal with than the steep, short variety. The much needed cleansing will be a drawn out affair and as a result, we shouldn't expect returns from financial assets to be all that exciting either. From a fixed income strategy standpoint, we began positioning for a bullish steepening of the Treasury curve in June, as well as gradually overweighting high quality spread product (versus Treasurys) after the flight-to-quality spasm in the first quarter. We continue to expect ample opportunities to add to these positions as the Chinese water torture of falling home prices, write-downs, de-leveraging, capital raises, dilution, foreclosures, high food and energy prices, senate hearings, finger-pointing, etc. trickles on. We believe there that are a number of quarters left before this cycle plays out, and remain concerned that breaking what the Fed has referred to as "a negative feedback loop" is not as easy as the markets expect.

Figure 4. Unemployment Rate
As a percent of the labor force - seasonally-adjusted
January 1, 1990 to June 30, 2008



Source: Bloomberg

Don't look for the very public bickering between the inflation hawks and the economic doves at the Fed to abate anytime soon, in fact, it will likely get worse before it gets better; hopefully by year end. And if it's on policymaker's minds, you can bet it will be on their mouths, and continue to rattle the markets. And as the markets jockey to choose sides in the debate, don't forget to add the ratcheting up of election noise, or the new "Where's Waldo" parlor game of how massive pools of global capital get allocated in today's low return world. We follow the dictum of that great investor, Roseanne Roseannadanna, who said "It's always something." There's always something that creates opportunity for alert investors. 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 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 or our clients to the dynamics of an ever-changing marketplace.

Equity COMMENTARY

Quarterly Review

Gains were hard to come by this quarter as the global economy, already hurt by the subprime fallout, threatened to weaken further in the wake of relentlessly higher commodity prices. Hopes of skirting a U.S. recession and better than expected earnings releases resulted in a relief rally in the first two months. By the end of June, however, investors were shunning riskier assets and the equity market limped back towards the lows of the year. Consumer confidence had fallen to its lowest level since 1974 as unemployment ticked up and the growth / inflation outlook was compromised.

Despite the heightened economic fears, we did receive some constructive data points: Manufacturing activity remained elevated, retail sales were above expectations, M&A activity showed signs of life, GDP growth rates remained in positive territory, and corporate profits were surprisingly resilient.

Growth stocks again powered ahead of their value counterparts this quarter. All value-based (i.e. the Russell Value indices) and broad based (i.e. S&P 500) indices were negative, but most growth-based indices managed to post gains. We continue to view this trend as a longer-term shift in style biases. The weaker macro backdrop should reward more stable (less cyclical) income streams. Additionally, profit trends within the 'growthier' industries remain relatively favorable and many companies have yet to be rewarded for their superior earnings prospects.

Market Outlook

Today's economic news and market backdrop isn't good and the 'wall of worry' is very high. While we expect near term volatility to continue, we are generally constructive on the prospects for stocks for a number of reasons:

First, the negative news is well documented as the media and consensus has quickly moved into the bear camp. We're mindful that market troughs usually occur when the news is most dire and consumer confidence is at its worst. Historically, the market has delivered an average return of almost 20% twelve months following a new low in consumer confidence, such as we witnessed in June. Secondly, money in liquid assets hits new highs daily. In our view, the Fed will continue to keep rates low and this will help stimulate those cash reserves which eventually will be put to work in risk assets such as equities. Finally, based on our forecast of avoiding a deep recession, declining inflation and better credit market conditions in the second half, we remain constructive about company earnings. As long as forward earnings estimates are maintained, the current valuation on stocks is compelling. The sustainability of any recovery in the economy and stocks, however, is dependent on oil prices, credit conditions, and the financial health of the consumer.

Now more than ever, diligence and patience is warranted. We remain consistent in our investment philosophy of isolating those higher-quality companies that can sustain profit levels above their peer groups. As always we are happy to share our thoughts with you in greater detail and welcome any questions and comments you may have.

Organizational Update: Second Quarter 2008

At the end of the quarter, a major step was taken in the spin-off of the asset management business from our parent company Phoenix Insurance. On June 30, 2008, the initial Form 10 was filed with the SEC. The initial registration statement contains important information about the new company and will be updated over the next several months through subsequent filings.

SCM Advisors is one of the partner firms making up what will be an independent publicly traded company. Following the spin-off, Phoenix will no longer have an interest in the asset management business and the new company will be a stand-alone entity. We continue to expect the transaction to be completed at the end of the third quarter. As reported in our previous quarterly Market Commentary, we are excited about the prospects of becoming part of a pure asset management company which will focus on that business alone. SCM Advisors will retain its own identity and the spin-off will not affect the day-to-day operations of the firm. The new company will allow for greater flexibility to grow our business and continue to retain and attract high caliber investment professionals.

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