

You're Gonna Need a Bigger Boat

*Financial fear is back...
but can policymakers
do anything about it?*

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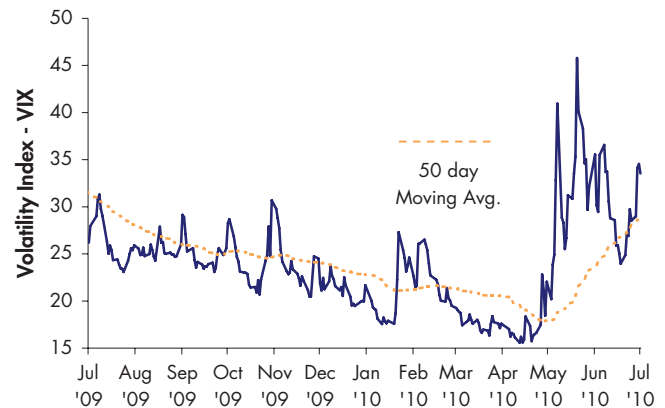
Oscar Wilde once wrote that "Life imitates art far more than art imitates life." And as the tumult that was the spring of 2010 rolls into summer, we can't help but be struck by how it's beginning to imitate scenes from the classic 1975 movie thriller *Jaws*. In that summer blockbuster, you'll remember, Amity Island Police Chief Martin Brody found himself in a politically complicated situation. After an enormous great white shark killed a number of people, Brody wanted to take drastic action and close the beaches. He was initially overruled by Amity's mayor, who feared that closing down the beaches would threaten the summer tourist season, the town's largest source of income. Only after his own son barely escaped becoming the shark's next victim did Brody finally force the mayor to close the beaches and hire Quint, an expert shark hunter, to solve Amity's growing fiscal dilemma (see what we did there?).

And it was on Quint's boat that Brody, after viewing the enormity of the task at hand, staggered back into the cabin and uttered in stunned realization our title phrase. While promising not to push our giant-great-white-shark-as-financial-crisis parable too far, we get the distinct impression that many policymakers today are staggering around with their Chief Brody face on, realizing that a bigger boat may indeed be needed. But we're getting ahead of ourselves.

In numerous past *Market Commentaries*, we've stated how we didn't think the narrative of the financial crisis was being properly written. In our efforts to remedy that injustice, we often referenced the work by Carmen Reinhart and Ken Rogoff describing the effects of financial crisis caused by debt deflations. They explored eight centuries of such episodes around the globe, and it should hopefully be clear by now that debt crises are nothing new. What is new, however, is the response – the scale and the global coordination of both monetary and fiscal policymakers – which we've called *The Great Reflation Experiment*.

In many ways, this has actually morphed into an experiment of a new model of statist capitalism, but we'll leave that discussion for another day. Nevertheless, however you want to depict the unprecedented policy response, it brings with it an incredibly wide range of potential economic and financial outcomes. So today we find ourselves buffeted between the primary long-term Reinhart/Rogoff trend of debt deflation (and its serial balance sheet explosions) and the shorter, post-panic, cyclical

"Fear Index"
June 29, 2009 to June 30, 2010



Source: Bloomberg

reflationary efforts of policymakers who believe they have absorbed the lessons of history and think that they can alter – or at least mute – the primary trend.

There can be little doubt that there's been both an economic and market bounce from these reflationary efforts. Global and domestic economic growth troughed in the first quarter of 2009, on the heels of the largest globally-synchronized downturn since the depression, while economic activity turned positive in the second half of the year. But the recovery has been extremely fragile and significantly weaker than what many expected after such a vicious downturn. Money and credit growth is non-existent, the labor markets have been slow to respond, and most important, debt – the root cause of the crisis – has not been meaningfully reduced. It has either been shifted from the private sector, as Reinhart and Rogoff prescribe, or it has been rolled into 2012-14.

And so the financial system now finds itself in the next phase of the crisis – an echo crisis, if you will. Nobody ever said that escaping from the self-feeding spiral of late 2008 early 2009 was going to be painless, and how we precede from here in large part boils down to your macro outlook. While many pundits pound the table claiming to be sure of that outlook, the probability distribution of outcomes is as wide as anything we've ever come across... and decidedly not bell-shaped!

As we see it, the outcomes fall into three broad categories domestically. The first tends to attract the end-of-the-world-as-we-know-it crowd, where the attempted handoff of the driver of

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economic growth from the public sector back to the private sector gets repeatedly fumbled. We'll call this the *fumbled handoff* scenario. In this scenario, the thinking goes; the private sector can't drive economic growth under the massive weight of its debt, while soaring public sector debt renders fiscal policymakers effectively impotent. The global economy then sinks back into recession, develops into a full-blown depression, which leads to massive deflation and collapsing markets. Despite the growing popularity of this outcome as the second quarter comes to a close, we currently place the odds of the *fumbled handoff* scenario at a relatively low 20% (up from 10% earlier in the year) because we believe policymakers will likely keep trying until some semblance of handoff is made.

This leads us naturally to what we call the *turning Japanese* scenario, where repeated sloppy handoff attempts lead to an extended period of feeble growth and serial bouts of mild deflation. As supporting evidence for this scenario, proponents point to the ongoing balance sheet recession in Japan, which is now bumping up on 20 years in length, thanks to numerous policy mistakes by officials who believed they had successfully defeated the secular effects of debt deflation and removed stimulus prematurely.

We place the odds for *turning Japanese* scenario at 30%, but these odds have again increased, up from 20% earlier in the year. Consumer and business confidence will likely be hurt by the recent market turmoil, and as we wrote above, money and credit growth remain extremely weak. Most monetary aggregates have turned negative for the first time since the depression and the velocity of that money, as well as the money multiplier, are going nowhere fast. Banks continue to have no incentive to lend, not that there's all that much demand for loans in a deleveraging environment. And the labor market is, well... laboring.

The final scenario is one we'll call the *successful handoff* scenario, where economic recovery is sustained enough for private sector earnings to help offset the effects of deleveraging (with a little left over for the effort), leaving the government to go about the business of putting its fiscal house in order. While the successful handoff scenario is currently our most likely, at a 50% probability, it's hardly a slam dunk. Further, we expect whatever economic growth that does develop to be weak and well below potential, weighed down by the secular forces of debt deflation.

The *successful handoff* scenario isn't without risks, not the least of which is the dollar [See Figure 1]. Longtime readers will recall that we like to break domestic GDP into three categories; domestic demand, change in inventories, and net exports. When both private and public sectors are hamstrung by debt, domestic demand will likely not be the key driver of economic growth for the next few years. And since changes in inventories tend to net out over time, they too won't be a long-term driver. The key to economic growth in the U.S. over the next few years will be net exports; selling more to healthier economies than we import to meet our muted demand. And the recent flight-to-(perceived)-safety fueled stronger dollar hurts that. Think of it as a form of monetary tightening.

Figure 1. "The Dollar Index"

June 29, 2009 to June 30, 2010



Source: Bloomberg

Like it or not, we still live in a world of competitive currency devaluation where a weak currency actually makes a country's goods more attractive on world markets. And in the current flight-to-safety, the dollar – as the world's reserve currency – is losing the race to devalue, making our exported goods less competitive. The dollar needs to weaken, but won't likely do so against other developed countries; it remains the best looking horse in the G-4 glue factory. No, where it needs to weaken is against Chinese Yuan and other Asian currencies. While the recent news that China will allow the Yuan to strengthen against the dollar is positive for the U.S. economy, this remains a political hot-potato and as such, makes the outcome highly uncertain. What's more certain longer-term, however, is that it really isn't all that healthy to have the two biggest countries in the world engaged in a politically charged debtor-creditor relationship.

Much of the initial financial and economic momentum generated by The Great Reflation Experiment has clearly begun to wane in recent months, and has caused policymakers around the globe to seriously reconsider their current stances. Clearly, Europe is no longer lagging the stimulus train. Policymakers in China, who had actually been in a tightening mode since last autumn, now appear ready to take their foot off the stimulus brake. In the U.S., the administration has floated a number of additional fiscal stimulus trial balloons of late, as the effects of earlier efforts are rapidly wearing off. And because the normal mechanisms for monetary stimulus remain seriously clogged up, at the same time that economic growth appears to be slowing due to an echo crisis in Europe, many of the core members of the FOMC, like Chief Brody, are considering a bigger boat – in the form of another round of Quantitative Easing (QE).

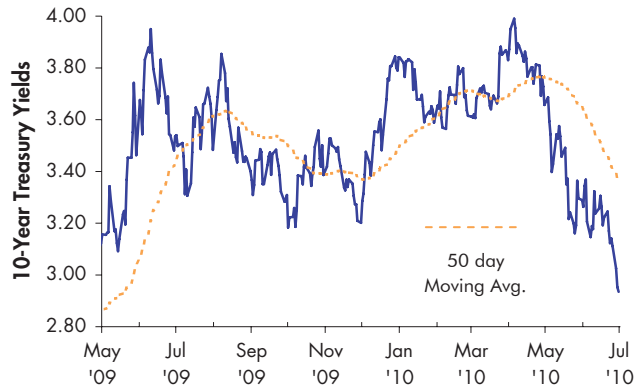
As much fun as it is to call members of the Fed idiots (and it is fun), none of these challenges are lost on them; they see the same data that we all do. They see that the primary trend on inflation is down and dangerously close to zero, a level below

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Figure 2. "10-Year Treasury Yields"

April 28, 2009 to June 30, 2010



Source: Bloomberg

which debtors would be repaying debt with ever-more-dear dollars. They see the unemployment rate still hovering around 10%. They see their efforts to stimulate the economy thwarted by the paradox of thrift, by the financial constipation still evident in the banking system, and by the de facto monetary tightening caused by a flight-to-safety in the dollar. And they also see the weakening political will for additional fiscal stimulus, thereby placing any reflationary burden on the back of monetary policy. As a result, we don't expect any Fed rate hikes until well into 2011, and actually expect to see another (potentially large) round of QE. Bernanke can't and won't tolerate a double dip recession out of fear of creating a cut and paste version of the 1930s. Like Amity's mayor, he knows full well the impact of closing the economic beaches.

Nevertheless, economic growth for this cycle, both here and abroad, has likely peaked. We expect periodic growth scares, like the one we're currently experiencing, over the next few years, and we look for generally slower growth in the second half of 2010 with domestic GDP falling below 2.0%. Both the housing and labor markets are in the process of troughing, although it is highly likely that neither has found a bottom yet. Likewise, inflation is also in the process of forming a bottom, but the timeframe for concern about inflation becoming an issue is measured in years from now as opposed to months.

None of this has been lost on the markets either, as the echo crisis has led to an echo in volatility. Looking at the yield curve as the second quarter came to a close, 10-year Treasury note yields were probing the lower end of their 14-month trading range between 3.0 and 4.0% [See Figure 2]. And this was only three short months after testing the upper end at 4.0%. The rapid 100 basis point (bp) drop in 10-year yields caused the entire Treasury curve to flatten by almost 50 bps. Recent messages out of the Fed strongly suggest that whatever one's expectations were for rates earlier in the year, they now need

to be ratcheted lower for a longer period. Nevertheless, even though the 3.0% level will likely be breached over the near-term, we suspect 10-year Treasury yields could still spend more time above the 3.0% level over the rest of the year than below it.

In the stock market, we continue to view the rally off the March 2009 lows as a cyclical bounce within the secular bear market that began in 2000. As of this writing, the major indexes are retesting their lows for the year for the fourth time, and we're left with many more questions than we have answers. We have argued the cyclical rally that began last March was kicked off in earnest by the Fed's Quantitative Easing (QE) portion of The Great Reflation Experiment, which leads us to the first of our questions. Since we think that another round of QE could be possible, does that mean the reflation cycle is not over, and by extension, that the cyclical rally in risk assets is merely correcting? The main risk to a positive response to that question is that, while we don't think policymakers will tolerate deflation, it may take the cover of even more market turmoil to pull off QE 2.0. Given how the quarter is ending, the markets may be testing that tolerance as we write.

Like us, policymakers will need to keep their eye on a number of things to help them decide, such as consumer and business confidence, money and credit trends, the jobs picture, as well as the direction of the dollar. The larger question is whether all this manipulation is really even possible. Can the strong and ever-shifting secular headwinds from a Reinhart & Rogoff financial retrenchment really be altered by cyclical tailwinds generated by policymakers who believe they are fully versed in the lessons of history? And like our shark hunter friend Quint, will this obsessive belief ultimately prove fatal?

One thing is clear, however; those cyclical tailwinds are currently waning. And it's ironic that the recent market turmoil in Europe, which we've called an echo of the financial crisis, could actually increase the chances of the *successful handoff* by forcing a bunch of policymakers in full Chief Brody stagger into an echo reflation effort. But however they respond, we're definitely in the middle of one hell of a lab experiment. No doubt, these are highly uncertain and likely very volatile 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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Quarterly Equity Market Review

After reaching cycle highs in late April, the equity market retreated sharply as investors questioned the sustainability of the economic recovery. Weaker than expected economic data over the past few weeks has highlighted the vulnerability of this expansion and ushered in a bout of negative sentiment. The most common concern is that the cyclical reflationary efforts of policy makers may be running out of steam. Moreover, the developments in the EU appeared to convince investors worldwide that its private sector debt problems had been transferred to the public sector. There was more evidence of continued growth in capital equipment spending, exports, and manufacturing this quarter, but this was somewhat offset by weakness in the housing market and contraction in state and local government spending. After ten months of positive revisions, profit forecasts leveled out this quarter, but remain at supportive levels.

While all equity sectors recorded negative returns this quarter, defensives outperformed. The high beta leadership in April shifted quickly to low beta and defensive sectors in May and June. We kept our growth cyclical and reflation positioning largely intact for the balance of the quarter. Tactically, our portfolios continue to have a global cyclical bias due to stronger sales and earnings growth expectations and compelling valuation. However, the effective braking policies implemented by China early in 2010 pressured many global cyclical stocks this quarter. As the sell-off gained strength late in the quarter, individual stock fundamentals mattered little as correlations increased and volatility spiked. The VIX doubled, heading back to levels not seen since the cycle lows of early 2009. The quarter closed on its biggest cumulative sell-off since the cyclical rally began and with investor sentiment decidedly negative.

Equity Market Outlook

We think it is too early to call the end of the cyclical recovery and view recent developments as a corrective phase. The economic data received during the latter part of the quarter confirmed growth moderated, and stalled in some cases, however extrapolating a "double dip" in the economy at this point is premature. We do expect weaker growth in the second half of 2010, but we don't see the fundamental story as bearish as the technical one. While it's clear there is a crisis of confidence resonating in the marketplace, to us the

fundamentals have yet to convincingly signal anything more than a slowdown in growth. We are managing our portfolios accordingly, with a more modest growth profile in mind. With equity valuations where they are today, moderate growth is discounted in our view.

From a secular point of view, the resolution of debt induced financial crisis issues will undoubtedly set the stage for the next sustained advance, or decline, in stocks. In the near term, from the political shenanigans of an election year to the oil spill, there is plenty to focus on. It's hard to recall a time when so many events, each highly influential in their own right, are playing out simultaneously. We will be focusing on three we think will be most impactful to near term equity returns.

1) China – is it just a slowdown or is the party over for the world's strongest economy?

The data are clearly pointing to a slowdown, but we are banking on a soft landing. Our cyclically-exposed portfolio is built on our expectations of a well-engineered soft landing; we feel the Chinese authorities are up to the task.

2) Second quarter earnings reports – what will the data (and management teams)

say? Earnings season is always a good time to get a read on micro trends. With expectations lowered, we think an "in-line" reporting season would actually be a positive surprise for the market. 3) Jobs - when will we see growth? Unemployment rates remain stubbornly high and should have recovered further given this stage of a recovery. Simply, more jobs leads to more confidence and a better backdrop for risk. We anticipate that a gradual employment recovery is still in the cards. Clarity on these three issues will have an outsized impact on near term stock performance.

The investment professionals here are an experienced, stress tested group that always has our clients' best interest at heart. We will continue to work hard and remain consistent in our investment philosophy of isolating those higher quality companies that can sustain profit levels above their peer groups. 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

By Doug S. Couden,
*Director of Equity & Senior
Equity Portfolio Manager*

Getting to Know SCM Advisors : Meet our Municipal Bond Management Team



*Municipal Bond
Manager*
Tim Heaney



*Municipal Bond
Manager*
Lisa Leonard

Tim Heaney and Lisa Leonard joined SCM's Fixed Income Team in May as portfolio managers responsible for municipal bond management. Tim and Lisa have been working as a team for 12 years and each bring over 20 years of experience in the fixed income market. In addition to separate account management, they have a successful long term record of managing a California municipal bond mutual fund and a National closed-end municipal bond fund for our partner firms.

Tim and Lisa's investment approach is consistent with SCM's investment philosophy of managing municipal bond portfolios with an emphasis on high quality, diversification, and special attention to the underlying creditworthiness of issuers. We are excited about the talent and experience this team brings to this important sector of the fixed income market where both individual investors - and increasingly, institutions - are engaged.

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