Second Quarter 2011 - Fixed Income Market Commentary

Is it too early to take down the sails and run to the cover of Treasuries? We think so.

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Fixed Income Market Review

The second quarter began on a positive note, with manufacturing ISM back to 2004 levels and unemployment below 9%. Optimism soon disappeared, however, as April talk of economic overheating morphed rapidly into double-dip recession fears by June. During the course of the month, Japanese supply disruptions slammed the brakes on the industrial economy, rising oil prices hobbled the consumer, and contagion anxiety re-emerged in Europe, as Portugal and Greece struggled to execute their austerity plans. Greece never really had a chance of success anyway (the country needs a budget surplus of 7 to 8 percent just to keep its head above water), but the Euro group was caught flat footed with no "plan B" response to its fiscal failure. Core Europe's subsequent scramble to keep the patient alive was unsettling, and the group's chaotic infighting pushed world markets into a tailspin. Closer to home, the political squabble over America's debt ceiling cast a pall on the U.S. investment environment.

Despite the end of quantitative ease, monetary policy is still accommodative.

Figure 1. 5-Year Treasuries
March 31, 2011 - June 30, 2011

Source: Bloomberg

The ensuing economic "soft patch" complicated the plans of Ben Bernanke, whose well telegraphed plan to end quantitative ease began to look more like a threat to prosperity than the triumphal exit it was expected to be. While the Fed remained confident about its decision to end QE, markets greeted it with trepidation. Fortunately, the quarter ended on an uptick, with several regional purchasing manager's surveys surprising on the upside, and the Eurogroup conjuring yet another last minute rescue package.

In fixed income, this economic and sovereign malaise drove interest rates down substantially, with 5 year rates declining by 90 basis points at their nadir *[Figure 1]*, and finishing the quarter 50 basis points lower than they started. The late June news of a Greek fiscal resolution provided some respite from the selloff in risk assets, but credit sensitive instruments such as corporate bonds still finished the quarter lower. Over the three month period, High Yield corporate bond spreads widened 60 basis points, in stark contrast to government-supported mortgage backed bonds, the only spread generating securities to outperform U.S. Treasuries.

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Market Outlook

We have long been skeptical of the strength of the economic recovery. As Ken Rogoff and Carmen Reinhart have shown, *[Figure 2]* economic growth after severe banking crises is typically slow, and compared to other similarly deep post-WWII recessions, this one is no different. We expect recovery to continue at a moderate pace due to the steep contraction of money and credit that accompanied the financial crisis. The monetary retrenchment encompassed both the traditional banking system and the "shadow banking system" and resurrection of the financial system will take time. Policy reforms may exacerbate the situation, as the unintended consequence of recasting the financial infrastructure may be a period of slower economic growth.

A concerted regulatory response was certainly in order given the official missteps that precipitated the subprime debacle, as banks had become over levered, and originate-to-sell mortgage securitization was fraught with conflicts. The policy response, primarily Basel III and the Dodd Frank legislation, has indeed been aggressive, forcing banks to triple their equity capital and pay penance through billions in legal settlements. Asset securitizers have also been impacted, with the Dodd Frank risk retention mandate encouraging more "skin in the game." These measures will bolster the solvency of the financial system and the integrity of the securitization market, but will also increase the cost of capital to the economy. While solvent and safe are always desirable, insurance comes at a cost and will likely curb growth for the foreseeable future.

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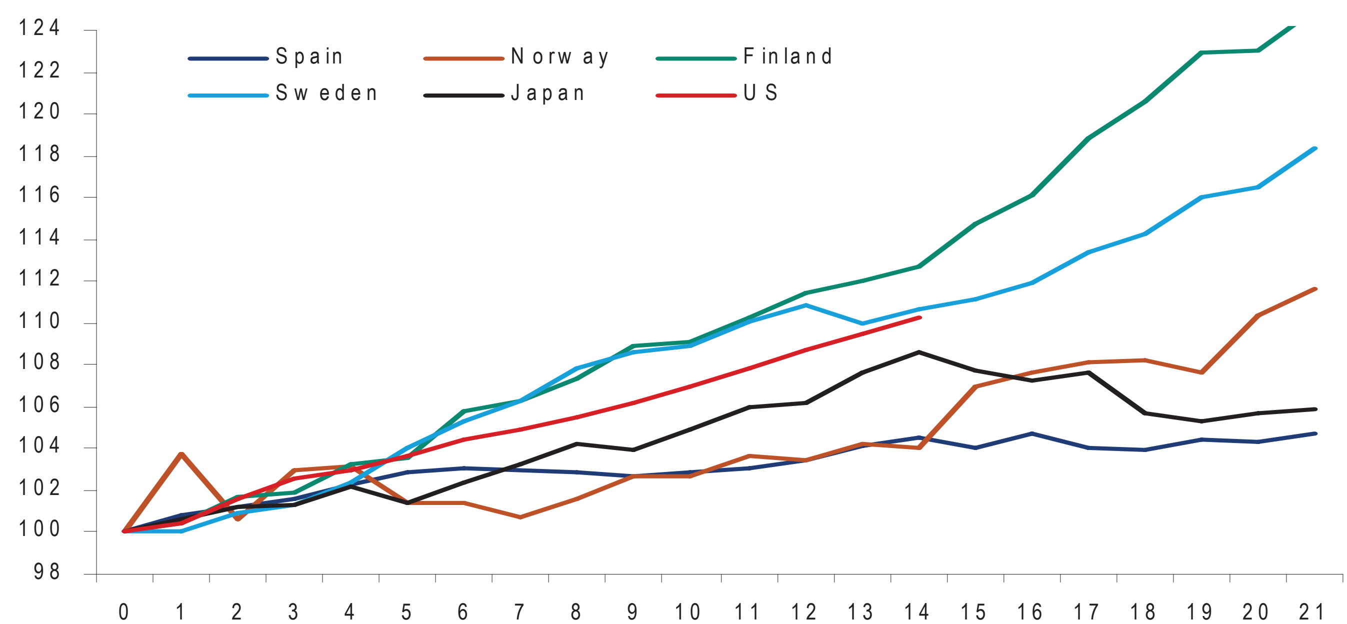
U.S. Recovery On Track With Other "Big Five" Banking Crises

Figure 2. GDP Growth



Index level, index to 100 at trough
Note: X-axis measures quarters since trough of recession.
Source: Haver Analytics, BofA Merrill Lynch Global Research, Rogoff and Reinhart

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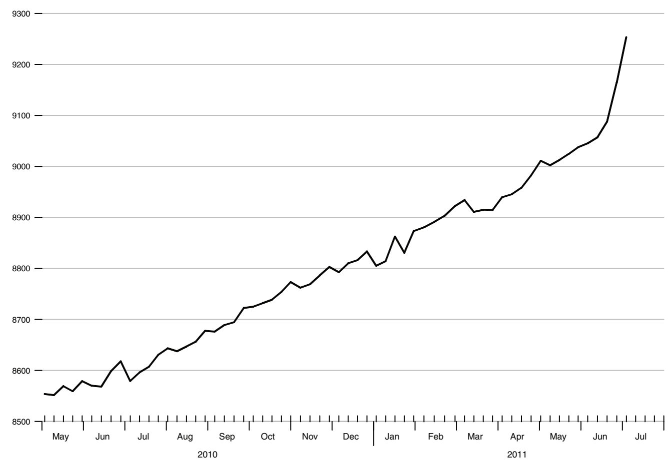
This secular skepticism towards the domestic economy's vigor is tempered by a cyclical monetary policy that remains accommodative. While the end of the Fed's second quantitative easing effort ended the *flow* of new money to the bond market, the salutary *stock* effects of the Fed's large balance sheet[1] will persist. This combination of balance sheet heft and zero percent Fed Funds should result in a continued cyclical tailwind. The economy will also benefit from the recent pickup in bank lending, which has already begun to manifest itself in a rapidly growing money supply *[Figure 3]*. This should be accompanied by a continuation of the modest reflationary trend already in place, which was sought by Ben Bernanke to mitigate deflationary pressures.

Figure 3. M2 Money Supply
April 31, 2010 - July 14, 2011



Averages of Daily Figures in billions of dollars. Seasonally Adjusted
Source: Federal Reserve Bank of St. Louis, Research Division

As always, there are winners and losers to every policy. The belt and suspenders approach to bank regulation will produce a much less risky financial sector, benefitting bondholders at the expense of shareholders. Ordinarily, a protective cushion of equity would restrain the yields available to bondholders, and as a consequence, diminish performance opportunities. However, the yields on financials remain unusually high in the aftermath of the financial crisis, producing a valuation opportunity that is substantial. In the industrial sector, economic growth will engender meaningful free cash flow generation and undergird the performance of credit, especially high yield bonds.

A comment is in order on Europe, where fiscal dysfunction in the peripheral countries challenges the integrity of the entire EU. In sovereign credit, size matters, and the states most likely to fail are also the smallest. It is important to note that the three most vulnerable states, Greece, Portugal and Ireland, have public debt equivalent to only 6% of Eurozone GDP. More importantly from a systemic risk standpoint, the European banking system has less than €200 billion in exposure to these three peripherals, a small fraction of the banks' equity capital. Italy has stumbled into the market's crosshairs recently as well, but the tumult appears to be overdone. It is a large country with a diversified economy, a modest primary deficit of 4% (though with an admittedly high level of total debt), and its external debt load is limited. Importantly, the Italians managed to completely avoid the housing bubble, leaving their banks in better condition than many of their northern counterparts.

Finally, closer to home, the drama of the debt ceiling soap opera continues to infest the airwaves. While the outcome at this writing is unknown, one thing is certain; none of the players is likely to gain from a default or a government shutdown. We anticipate an eventual accommodation, or at a minimum, a short term solution that buys the protagonists some time and keeps the economy on course. The combination of a gradually improving economy with increasing inflation should eventually put upward pressure on long term rates. Monetary accommodation should keep short term rates low however, and bolster the performance of risk assets such as corporate and mortgage credit. We acknowledge the potential for external surprises, whether from Europe, the Middle East, or from East Asia, but feel it is yet too early to take down the sails and run to the cover of Treasuries.

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[1] *Large-Scale Asset Purchases by the Federal Reserve: Did They Work?"; Brian Sack et al., "Flow and Stock Effects of Large-Scale Treasury Purchases": D'Amico and King*

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Investment Posture

Our economic forecast of modest growth and continued policy accommodation is supportive of credit risk versus more defensive positioning in Treasuries and government related bonds (including agency mortgage backed securities). It also suggests a shorter than benchmark duration and a bias towards yield curve steepening. We have little faith that the European peripherals, particularly Greece, will avoid default, but are confident that this risk will not metastasize to Core Europe (including Italy) and beyond. Our investment posture reflects this thesis, emphasizing corporate (and where permitted, High Yield) bonds, senior loans, and commercial mortgage backed securities. This posture seems appropriate as long as growth and inflation trends persist, and policy accommodation remains intact.

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.

Organizational Update: Second Quarter 2011

We are pleased to announce that effective June 2, 2011 SCM Advisors LLC has changed its name to Newfleet Asset Management LLC.

Newfleet is a comprehensive investment management firm that incorporates the existing capabilities of SCM, a wholly owned subsidiary of Virtus Investment Partners located in San Francisco, along with new investment teams located in Connecticut and Boston, MA. The combined full service, well-resourced firm has 28 investment professionals and manages more than $9 billion in assets.

For SCM, this is a name change only (the firm is the same legal entity with a new name). All the same investment professionals that are responsible for the management and servicing of our clients remain in place. The new team allows us to leverage our existing San Francisco investment operations and systems and to have additional resources and opportunities to offer new products and new markets in the future.

Newfleet
ASSET MANAGEMENT
A Virtus Investment Partner

This reflects our ever evolving approach to providing strategies and solutions to our clients. As a registered investment adviser that manages assets for institutional and individual clients in multiple strategies and multiple products, Newfleet Asset Management preserves the individual investment processes and autonomy of our existing strategies, leverages existing investment operations systems and resources to support a larger investment platform and provides growth opportunities for our clients across a diversified and growing array of investments.