Amending The Bard… it's the *Summer* of our Discontent

The market is re-discovering the notion of risk, and getting a painful re-education about the ebbs and flows of credit.

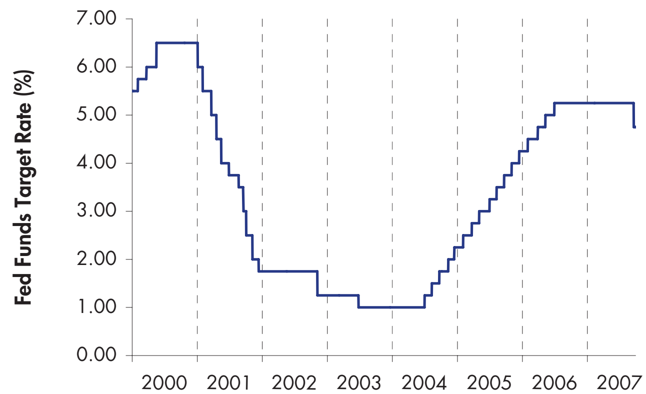
Financial types like to break the year up into quarters, presumably to make things more manageable and easier to digest. Seeing as this is SCM Advisors' quarterly commentary, you'd probably have to include us in that group as well. But years from now, it's this past summer that everyone will be talking about, not the third quarter. In a season usually reserved for sleeping-in while on vacation, "The Summer of 2007" will be remembered as the time when the global credit markets received a massive wake-up call… not to mention an even bigger margin call. In contrast to what turned out to be a piker of a panic last spring, this summer's full-blown freakage ranks right up there with some of the credit market's all-time biggies.

Financial market crack-ups come in all varieties, but those that originate in the credit markets tend to follow an eerily familiar path. The link that ultimately ties them all together is the use of leverage, which inexorably exaggerates the market's natural cyclic flow between fear and greed. Fear follows greed as surely as night follows day. Greed-induced leverage grows slowly, almost imperceptibly, as risk gets relegated to an afterthought. But when fear returns – and it always does – levered, over-crowded momentum trades get unwound at dizzying speeds as risk gets shorn.

These transitions are emotional affairs and illicit knee-jerk responses from all sides. Liquidity dries up as lenders stop lending, borrowers stop borrowing, and markets wig out. Wall Street disappears, doomsayers move front and center, and margin clerks rule. Congress, of course, feels compelled to get involved. In hindsight, it becomes obvious that investors (and ratings agencies) were not altogether clear about the risks they had undertaken (rated). Fingers get pointed, conveniently, just in time for campaign season.

We will look back on this transition as yet another where lessons were re-learned, products re-tooled and risk re-priced.

Figure 1. Federal Funds Target Rate
January 1, 2000 to September 30, 2007



Source: Bloomberg

What the credit markets began this spring is a cyclical cleansing process, where the price paid for bearing risk gets marked up after years where investors had grown increasingly oblivious to what it means. The market is re-discovering the notion of risk, and is getting a painful re-education about the ebbs and flows of credit. But hey, they don't call it a credit cycle for nothing.

Right smack in the middle of things, as usual, is the Federal Reserve. Every monetary tightening cycle in recent memory has ended with some kind of financial calamity. Think back to the bursting of the dot-com bubble, the mid-nineties derivative mess (remember Orange County), or even the S&L blow-up. Tighten policy until something breaks; it's how you know you've reached the end of the monetary cycle. This one is no different, and in a strange sort of way, the events of this summer have given legitimacy to this era's tightening cycle.

Just because credit crises are similar doesn't mean that they're identical. This one differs importantly from its earlier brethren in that so much of today's credit creation process lies outside the banking system, and thus outside the Fed control. The current crisis is further differentiated by the fact that markets have become increasingly interconnected through the proliferation of both derivatives and those who traffic in them. This has combined to make markets more prone to emotional spasm, with more compressed times frames than past cycles.

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As a result, the Fed is obliged to play a different role than during earlier episodes. Not only must it provide the obvious benefits of injecting liquidity into the monetary system when the economy weakens, a subtler and increasingly important aspect of a central bank's job these days is to help take some of the emotion out of the price-discovery process when those outside the banking system freak out. That is exactly what the Fed was attempting to do on August 17 when it began this cycle's version of easing.

For years we've written about the economy's "jones" – or addiction – to credit, and about how sensitive it was to the price. When the price of credit gets too high, the economy contracts. When the price gets too low, the economy expands. The Fed had engineered a gradual tightening of financial conditions over the last few years, and got to the inevitable point of tightening until something in the credit markets broke – namely, the subprime mortgage market. Just as investors were beginning to transition from the old, risk-oblivious world to whatever the new credit environment might look like, the price-discovery process shut down as credit markets seized. Needless to say, when the economy is denied credit altogether – at any price – all sorts of weird withdrawal symptoms pop up.

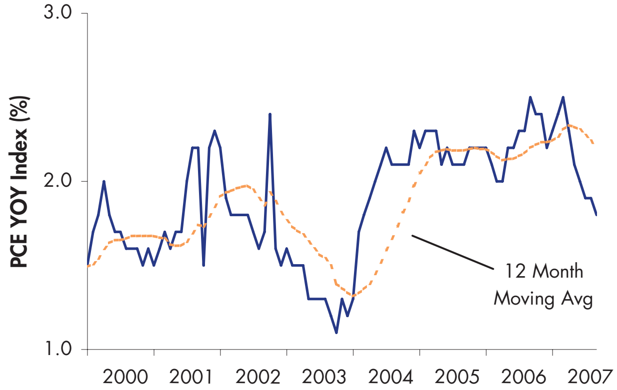
Fear spread into areas that had nothing to do with the subprime market, or the U.S. housing market, or even hedge funds. It had spread into the entire credit creation process, the very lifeblood of the capitalistic system. When the Fed announced on September 18th a 50 basis point cut in both the Fed funds rate *[See figure 1]* and the discount rate, we believe the most important thing it accomplished was to take some of the emotion out of the price discovery process as the market attempts to transition into a brave new credit world. Sure, the FOMC believed that risk spreads had become too tight over the last few years. And sure, they wanted to see a higher, more rational pricing of risk. But they could not allow the entire transition to shut down and deprive an already weakening economy of its lifeblood.

There can be little doubt that the events of this summer will take a toll on the economy. We had expected the economic recovery to take a V-shape after a weak 0.6% GDP level in the first quarter of 2007, with output approaching its 2.75% potential by the first quarter of 2008. It now appears that the recovery will take on more of a U-shape. Domestic GDP has been growing at a below-potential 2.0% rate over the last five quarters, and we don't expect much improvement from those levels over the next several quarters. The U.S. economy clearly faces some challenges, and the risk of recession has no doubt risen, but we still don't think it's the most likely scenario. We remain in the soft-landing camp.

We believe that one of the positive results of an extended period of sub-potential economic growth is a further lessening of inflation pressures. The economic impact of this summer's credit crisis comes at a time when trends for both core and headline inflation are clearly pointing down, and with the FOMC-favored core PCE measure *[See figure 2]* showing three straight months inside the Fed's "comfort zone." Despite this evidence, we find it stunning that inflation is being widely touted as a major risk resulting from the Fed's 50 basis point cut.

Figure 2. U.S. Personal Consumption Expenditure Core Price Index

January 1, 2000 to August 31, 2007*



Source: Bloomberg

** most recent data available at press time*

In what only can be considered another of an increasingly long line of urban market legends, media and market pundits are knee-jerking to the conclusion that a Fed ease is necessarily inflationary. A housing recession and seizure in the credit markets are unquestionably deflationary events. Adding these events to a slowing economy and a falling inflation rate just doesn't tally up to higher inflation in our eyes. While reflationary monetary policy might be problematic if the economy were re-accelerating and approaching full-potential GDP, we don't foresee such an outcome for at least a few quarters. In the meantime, we think today's inflation fears are unwarranted, and continue to believe that inflation surprises will be more to the downside going forward. In fact, we wouldn't be surprised if deflation were to become the market's fear-du-jour around year-end.

There's also been much ado about the notion that a cut in the fund's rate is akin to bailing out unworthy parties who've been damaged by the recent market turmoil. Some call it moral hazard; others have taken to calling it the "Fed Put." While this argument might win you some points in a first-year college morality seminar taught by an overly-zealous graduate assistant, we're talking monetary policy here, folks. Get over it. Look, the Fed is not deaf to the issue of moral hazard, but could not afford to fiddle while the credit markets – and the economy – burned.

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The markets are currently priced for another 75 basis points of Fed rate cuts over the next 9 – 12 months, which seems reasonable to us; it will depend on the health of the economy and the credit markets. In our last commentary we expected the recent 4.5% to 5.0% trading range for 10-year Treasurys to shift wider by 25 to 30 basis points, thanks to increased volatility.

As we end the third quarter, we see no reason to alter the trading range concept except to acknowledge that as post-crisis economic data get released there is scope for spasms toward lower yields, perhaps as low as 4.0%. Nevertheless, we will retain our trading range outlook over the intermediate term.

10-year Treasury yields hit 4.30% prior to the Fed's rate cut and rebounded as high as 4.70% after *[See figure 3]*. Even though most were attributing the higher rates to the inflation fears mentioned above, we believed it to be another example of the market trying to cram a square fundamental peg into a round technical hole. We view the pop in rates as more of a snapback from this summer's credit mess. As the flight-to-quality began to partially unwind, so too did risk spreads stop widening and start to tighten when investors slowly dipped their toes back into the water. Well positioned for this summer's events, we will continue to structure portfolios for further steepening in the yield curve, and will seek to take advantage of periodic widening of risk spreads to add to our underweight positions.

Many are claiming that this decade's great liquidity boom has dried up. We take issue with that, and point to over 10% growth in global money supply, over 20% growth in global forex reserves, and skyrocketing bank lending as evidence. Massive cash balances sitting on corporate balance sheets, petrodollar profits and other Sovereign Wealth Funds looking to be diversified, and ever-growing "2-and-20" money itching to be invested, all suggest that liquidity did not dry up. It is simply waiting – and incented – to be put to use when things inevitably settle down.

The seizure in the credit markets is slowly beginning to ease, although serious issues remain in the commercial paper arena. We continue to expect periodic bouts of emotion to return to the marketplace, as sentiment bounces between obsessing about a recession, and fearing a serious upturn in inflation. The bond market has basically been held hostage to action in other markets over the last couple of months. Concerns about volatility in stocks, $80 oil, financial engineering, a falling dollar *[See figure 4]*, the on-going housing recession, and the ever-present specter of terrorism, will keep the bond market in a technical reactive mode as we move into the fall. The shiny object of economic fundamentals will eventually, however, attract the market's attention. The already-begun easing process will help the credit market find rational clearing prices. It will not always be smooth, but this healing process is necessary.

Figure 3. 10-Year Treasury Yields
January 1, 2001 to September 30, 2007

Source: Bloomberg

Figure 4. U.S. Dollar Index
January 1, 1990 to September 30, 2007

Source: Bloomberg

We will look back on this transition as yet another where lessons were re-learned, products re-tooled, and risk re-priced. We look forward to such a transition not only because of our confidence that the credit markets will come back stronger, but also 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. 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 of our clients to the dynamics of an ever-changing marketplace.

Stocks Post Positive Quarter After Wild Ride

Quarterly Review

The stock market muscled through a plethora of potentially derailing news during the third quarter of 2007 as the broader markets posted their fourth straight quarter of positive returns. The credit markets took center stage as the fallout from the subprime mortgage mess worked its way through the financial system. Not surprisingly volatility in the equity markets increased as bond spreads widened, M&A activity slowed, and liquidity started to dry up. Continued weakness in the housing market (June housing starts were down 20% year-over-year) and more signs of a slowing economy (retail sales weaker than expected) were enough to cause a brief pullback in the equity markets early in the quarter. The sell-off proved short lived. As the quarter progressed it became clear that GDP growth would decelerate in the intermediate term and inflation concerns waned. The mid-cycle slowdown we have referred to in previous quarterly reviews has firmly taken hold, now with an added credit driven twist. The Fed took all of this into account as it cut interest rates late in the quarter, helping to fuel the equity rally. Technology and global industrials led while financials and consumer discretionary stocks lagged.

Equity COMMENTARY

Broadly speaking, Growth stocks continued their recent outperformance relative to their Value brethren across all market cap segments. We view this trend as sustainable given a multitude of factors, including: more attractive growth-adjusted valuations, better Growth stock performance during periods of slower earnings growth, and broader global exposure. Generally, Large Caps outperformed Small Caps during the quarter. We were encouraged to see valuation dispersions across the landscape widening as investors distinguished between high and low quality investment opportunities. Reversing a trend from the first half of the year, valuation spreads between 'good' and 'bad' companies have widened, a result of increased uncertainty and rising volatility. We see this dynamic continuing. Disciplined portfolio managers were given ample opportunity to enhance returns courtesy of the pervasive volatility throughout the quarter. Across our equity products, we took advantage of the volatility to upgrade our holdings base and take advantage of perceived price dislocations.

Market Outlook

We remain optimistic regarding further gains in the stock market. At the same time, we doubt the volatility we became accustomed to last quarter has ended. A slowing economy, housing related problems, record oil prices, and a falling dollar simply won't allow it. In the near term growth will be harder to come by as the economy chugs along at an uninspiring rate, but inflation concerns will ebb with the slowdown. The global economy remains quite strong, global inflation pressures are easing, liquidity is slowly returning to the market, and the housing meltdown has yet to pull the domestic economy into a recession. Productivity is increasing, balance sheets are healthy, and valuations are supportive of further equity gains. Even with the recent turmoil, corporate profits should continue to come in ahead of expectations. Mid-cycle slowdowns are generally good for Growth stocks and we continue to see that dynamic holding true. We are forecasting further market multiple expansion and see better opportunities in higher quality Growth stocks over Value stocks, particularly when relative valuations and growth projections are considered.

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 Team Update: Third Quarter 2007

October 1, 2007 marks the two-year anniversary of Doug S. Couden, CFA assuming leadership of SCM's equity portfolio management team. The team has maintained its long-standing high quality growth investment philosophy while making several enhancements to its research process. The end result has been a revitalization of portfolio performance.

After seven years, equity market dynamics have squarely shifted in favor of growth styles and we believe SCM's profit growth focus will continue to benefit from this trend. Our team is a strong and vital part of our growth efforts here at SCM, which also include our Fixed Income and Structured Product franchises.

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