

## Rules? In a Knife Fight?

*What can we learn about today's investment environment from Butch Cassidy?*

As it did for many, the recent passing of Paul Newman gave rise at SCM Advisors to reflection on a life well-lived, and fond reminiscence of his myriad movie roles. Given the events of the third quarter of 2008 (culminating in what will surely be a "September to Remember" in the world's capital markets), we choose to honor Mr. Newman by borrowing the title of this quarter's commentary from one of our favorite of his movies, Butch Cassidy and the Sundance Kid. As you might remember, the title phrases were uttered by Harry Logan moments before he was rendered incapacitated by Butch in a rather painful and wholly effective manner... we still cringe to this day. But if you stretch your imagination just a bit, the scene can also serve as a parable for where today's investors find themselves. Like Butch and Harry, many in the financial arena today are fighting for their very lives. There are those who must surely feel a little like Butch did when he gazed at the imposing figure of Harry, wondering how the heck he was ever going to get out of this predicament. And like Harry, there are probably those who wonder how you can have rules in what was supposed to be the capital market's version of a knife fight. But what we're left with is a financial landscape that is changing at breathless speed before our very eyes, where many have been incapacitated by a capitalistic kick to the crotch.

So how did we get here, with the world's financial system seemingly doubled over, gasping for air? Well, as it usually does, the story starts and ends with credit. You know, good old fashioned borrowing and lending. You've no doubt read countless times over the last few weeks that credit is the lifeblood of a capitalistic economy. As we described in our first quarter commentary, the ebbs and flows of borrowing and lending are as natural as the tides, with credit busts following booms as surely as night follows day. These cycles exist for one simple reason; humans are involved. Fear and greed each take their turns on the dance floor. Animal spirits swing wildly during these economic mating dances, as borrowers and lenders inevitably let their emotions get the better of them. At the top of the cycle, when credit is expanding, people seem oblivious to risk and dance like no one is watching. At the bottom of the cycle, when credit is contracting, they become obsessed with risk and hide self-consciously in the corner. Oh, and if you hadn't noticed, we're currently going through risk-obsessed phase... thank you Mr. Obvious.

Longtime readers will surely recall us going on and on over the last few years about how the domestic economy has had a seemingly preternatural "jones" – or addiction – to credit during this particular cycle. What made this cycle so unique was the incredible amount of credit that was actually created, and how levered the entire system became. We have also described in detail how much of this lending largesse originated from the unregulated portion of this decade's juiced-up credit creation process. Dubbed the shadow banking system, these entities used previously unheard of levels of both actual and embedded leverage, which is currently being unwound at a frightening pace. It is this shrinking of the financial system and the attendant disappearance of overly levered entities that is the heart of the matter. In fact, the very notion of borrowing short and lending/investing in another, longer time horizon or in riskier securities is undergoing a global re-think.

Now that we've completed a full economic cycle since the last recession earlier in the decade, it has become painfully clear that despite the almost unimaginable amount of leverage used, domestic GDP only averaged a meager 2.5% for the cycle – one of the weakest average economic output levels on record. At first glance that seems hard to square. How could the unprecedented amount of stimulus injected into the economy produce such historically tepid output? The answers go a long way to understanding the situation we find ourselves in today.

*Consumer spending is set to shrink for the first time in 17 years... thrift will become the new black.*

First of all, much of this leverage was funneled into ventures with little-to-no economic value. People got loans who had no business getting them. In far too many cases the ultimate lenders were unclear of the risks they were taking on and thus, were not properly compensated for bearing them. Risk became grossly underpriced. Why and how this came about, as well as who is to blame, have been (and will continue to be) all-to-well documented, so we'll spare you. But for now, let's simply say that the end-users of that leverage were not paid for the "real" risks they took. As a result, much of the decade's excess economic growth hormone is currently being flushed down capitalism's toilet.

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Another answer as to why all this leverage produced such painfully low economic output has to do with leakage in the transmission mechanism from input to output. As loans were originated, packaged together, sold to another party, repackaged and resold numerous times over, fees and bonuses were extracted at every step of the process. Motivations have changed. Back in the day, if you wanted a loan, your local banker would analyze your financial wherewithal, present your loan request to his credit committee, only to have a state or federal bank examiner regularly check in to make sure the homework was done properly. In the originate-to-distribute model of lending in vogue this decade, all parties' interests become aligned; they were only paid if transactions were done. What we've seen over this credit cycle has been the collapse of skin in the game.

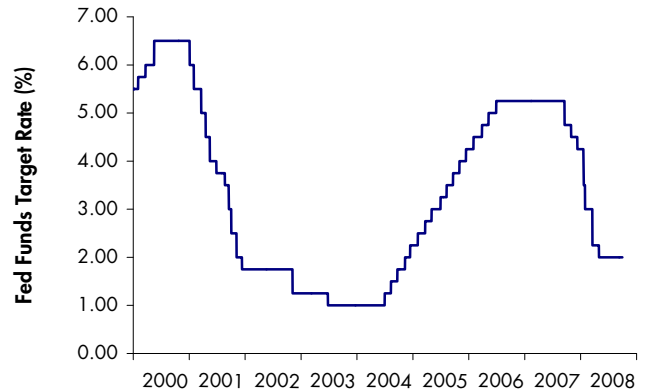
So what we're left with is not your father's typical credit contraction. To make matters uglier, the Fed's worst nightmare is starting to play out. A negative feedback loop has taken hold. As leverage continues to be withdrawn from the financial system, the economy naturally begins to weaken. But now the process is starting to feed on itself with the weakening economy negatively impacting the shrinking financial system, which is further weakening the economy. Most ominously, the psychology is becoming entrenched.

This did not have to happen. As we've chronicled extensively since the credit crunch began, monetary and fiscal policymakers have been a day late and a dollar short. They've effectively ended up playing "Whack-a-Mole" with the problems that have arisen from the massive leverage unwind. On the monetary side, we have written early and often (some said too often) over the past year, trying to debunk the so-called reasons behind their tardiness. The blame begins with the hawkish wing of the FOMC simply not understanding the relationship between today's financial system and the economy, and way overreacting to the risks of inflation sneaking into the domestic economy.

We've long felt that before this cycle ended it would be deflation that would emerge as the primary concern, not the knee-jerk, fighting-the-demons-from-another-era kind of inflation these economic Neanderthals were concerned about. The result was that their incessant yapping slowed the response by a new Fed Chairman who was hell-bent on building consensus and opening up communication at the FOMC. The silver lining through the whole debacle, we suppose, may be that we don't have to hear from the inflation crowd for a while. As a result, we can only hope that Bernanke will be less inclined toward fiddling while Rome burns. With the hawks effectively gagged for now, we expect the Fed to cut targeted rates by at least 75 basis points in the fourth quarter, most likely in coordination with other central banks [see Figure 1].

**Figure 1. Federal Funds Target Rate**

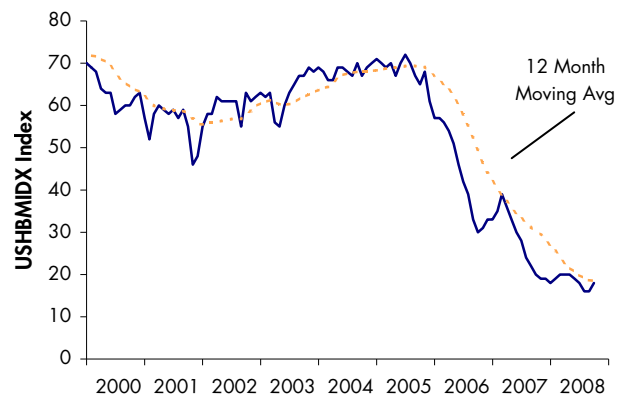
January 3, 2000 to September 30, 2008



Source: Bloomberg

**Figure 2. NAHB Housing Market Index**

National Association of Home Builders Index - Seasonally Adjusted  
January 3, 2000 to September 30, 2008



Source: Bloomberg

On the fiscal front, we wrote in our first quarter commentary about the need for an RTC-like solution. Not that it was an act of towering prescience or anything, history is very clear that in times of financial crisis; governments always step in... it's what they do. Treasury Secretary Paulson's moves may have been slow and clumsy over the last few months, and included a couple of monumental miscalculations, but they were absolutely necessary for the financial system. In fact, more coordinated action is needed on both the monetary and fiscal side.

The decline in home prices is not over [see Figure 2], either in terms of price or time. It would not surprise us if prices fell by another 10% over the next six to twelve months. As for the credit contraction, we expect that the deleveraging of the financial system will continue for years. Yes, the policy

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measures implemented as of this publication will eventually begin to slowly unclog the credit markets, but that only takes us to the next phase in the process; significant consumer retrenchment.

The consumer-led economic slowdown is only in its early stages and will be with us for quite some time. The massive monetary and fiscal stimulus to date, while tardy, will keep this from turning into a sharp and deep economic contraction. Nevertheless, consumer spending is set to shrink for the first time in 17 years, could last well into 2009, and will likely be nothing to write home about thereafter. Thrift will become the new black.

Net exports had been the primary driver of economic growth for the past year or so, but should fade as a source of economic strength over the near-term as the global economy slows. Further, the impending regulatory backlash and tax increases will unambiguously serve as economic headwinds as they get rolled out over the next few years. As a result, we expect negative signs in front of the fourth quarter 2008 and first quarter 2009 domestic GDP numbers, with a relatively muted 1% average for the remainder of next year and into 2010.

We look for headline inflation to begin to move back towards the core rate by the end of this year, as we detailed in last quarter's commentary, and for both measures to moderate next year. Oil and other commodity prices have collapsed as expectations of a significant global economic slowdown have become entrenched [see Figure 3]. The gravitational pull of deflation is slowly but surely becoming recognized by the markets, as the world is still producing more goods and services (and houses) than it consumes. Add into the mix a further forced deleveraging of distressed assets in a still-too-levered world, and you're left with a dangerous brew that will give global monetary policymakers ample cover to ease aggressively.

We prefer to view accommodative monetary policy as cushioning these deflationary forces rather than view them as inflationary, which is the way the now-discredited inflationistas will no doubt see it. When the credit markets unclog, house prices stop falling, bank write-downs slow enough for recapitalization of their balance sheets to occur, maybe we will then begin to alter our view. But with the economic slowdown accelerating, the output gap getting wider, unemployment ratcheting up in chunks, and capacity utilization cratering, now is not that time. There will be a number of headline-grabbing failures of banks and hedge funds that will weigh on investor psychology as the credit cycle finishes its economic cleansing.

Looking out over the next 18 to 24 months, we think economic prospects can best be described as "blah." Relatively low real (ex-inflation) growth, combined with our low intermediate-term inflation forecast, leaves nominal economic growth in the 3 to 3½% area. And if the economy is going to grow at what historically has been considered the equivalent of stall-speed, it's hard to see company earnings growing significantly faster in aggregate, especially in a de-leveraging environment. As such, we expect historically muted returns from financial assets.

**Figure 3. Commodity Prices Have Collapsed**

January 3, 2005 to October 1, 2008



Source: Bloomberg, Reuters/Jefferies

An arithmetic average of commodity futures with monthly rebalancing

Future returns are obviously impossible to know, but we suggest a good starting point for discussing expected returns over the next few years might be to take the historic averages and cut them in half. Given the fundamental economic background we envision, along with the relatively high valuations currently in place, this would not be a bad place from which to begin creating an active investment portfolio strategy.

The financial landscape is changing as we write. Even just a few years ago, who could have imagined the staggering amount of money that is currently being managed by government created entities, along with the attendant mind-boggling implications? Global central bank reserves, Sovereign Wealth Funds, and now TARP and its various Fed and Treasury acronym-based cousins, are all being managed for something other than pure economic motivations. And how about all of the rule changes, which are seemingly being re-written right smack in the middle of the game? Those who are looking the other way as the secular pendulum shifts surely risk being left doubled over in agony like the aforementioned Harry Logan. And even those investors who avoided capitalism's low blow to date must at least feel like they've brought a knife to a gun fight. Yes, monumental change is afoot. But what this incredible period we're living through really represents is opportunity. 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 of our clients to the dynamics of an ever-changing marketplace.

## Quarterly Review

The market maelstrom this quarter presented equity investors with one of the most difficult backdrops in history. The unprecedented de-leveraging of assets and re-pricing of risk across the market landscape led to record volatility. Liquidity concerns were real and, together with the pre-existing drags on the economy, drove decidedly negative results across all major equity indices. In the last month alone we nationalized our largest mortgage insurers, wiped out the investment banking industry as we know it, and watched as several major depository institutions went insolvent. As the quarter progressed, dislocations in the credit markets were manifested with significant selling pressure in equities. Concerns over the impact of any congressional response and its effects did little to calm the markets by quarter end.

### Equity COMMENTARY

Not surprisingly, the equity markets proxy for sentiment and volatility, the VIX, set new highs this quarter. Quite simply, investors were fearful, and risk aversion was abundant.

Underscoring the volatility has been the rapid rotation amongst sectors. Previous outperforming sectors (Energy, Materials, Technology) quickly became laggards. Given the uncertain macro backdrop, historically defensive sectors (Consumer Staples, Health Care) fared much better. The global growth trade unwound quickly as commodities eased and growth assumptions in emerging economies came into question. Stocks with significant foreign exposure suffered far worse than those with domestic focused businesses as the market began to digest the fact that the financial crisis is a global event. The sell-off in global cyclical had major ramifications for several hedge funds and resulted in exacerbated liquidation-unwind trades. Somewhat surprisingly, small caps managed to outperform large caps as the strengthening dollar and concerns about global growth hurt larger companies more. Value outperformed growth across the capitalization spectrum.

## Market Outlook

Clearly, the economy faces a tough year ahead, with the prospects of a serious consumer retrenchment a distinct possibility. Our job, of course, is to recognize how much of these well-documented concerns are reflected in valuations while considering expected future profit growth. The market is currently dominated by fear and the risk / reward profile has shifted sufficiently enough to warrant a rally. While falling risk premia is rarely good for equity investors, it typically foreshadows a change in sentiment, and sentiment can't be much worse. The government's proposed programs, while not a panacea, will help reduce systemic risk, aid capital markets, and go a long way to prevent worst case scenarios. With so many assets discounting a dire outcome, any economic stability will feel like a big improvement. While we project little growth in the next 12 months, it is not a precondition that earnings recover in order for equities to rebound.

With negative sentiment now approaching extremes, positive news will have a considerable impact on risk appetites. In many cases, unprecedented volatility has caused wide differentials between the underlying fundamentals of stocks and their market values. We believe this to be unsustainable. There are a lot of people waiting to get involved and take advantage of these dislocations. Investors have responded to worsening liquidity conditions by raising cash balances, reflected in the record \$3.5 trillion in money market mutual funds which sits at 30% of the Wilshire 5000 market cap (last seen in March 2003 at the prior market low).

A sustained rally in stocks will be beholden to stabilization within the credit markets and the broader economy. While we expect near term volatility to continue, we are optimistic regarding the near term prospects for stocks and view our tactically constructive stance as appropriate. We remain consistent in our investment philosophy of isolating those higher quality companies that can sustain profit levels above their peer groups.

## Organizational Update: Third Quarter 2008

SCM Advisors is pleased to announce that our parent company, Phoenix Investment Partners, Ltd., became Virtus Investment Partners, Inc. on October 1, 2008.

The name change was implemented in anticipation of the spin-off of Phoenix Investment Partners, Ltd. from Phoenix Insurance Companies and the creation of a pure asset management company. The completion of the spin-off remains subject to the review by the regulatory authorities (namely the SEC) and the timing of this review process is yet to be determined. Nonetheless, the official name change is an exciting milestone in the process. SCM Advisors retains its own name and identity and the spin-off will not affect the day-to-day operations of the firm.

We'd also like to take this opportunity to welcome Kaushik Saha to our fixed income team. He joined us in July in the capacity of Securitized Portfolio Manager and has 15 years of experience in the mortgage and asset-backed arena. Prior to his joining SCM Advisors, Kaushik was with Barclays Global Investors for five years and ten years with the Federal Home Loan Mortgage Corp. (Freddie Mac).

*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.*

SCM Advisors LLC 909 Montgomery Street, Suite 500, San Francisco, CA 94133  
(415) 486-6500 (800) 828-1212 www.scmadv.com

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