Market Commentary
Fourth Quarter 2007

SCM ADVISORS

SCM ADVISORS LLC

The Times They Are A-Changin'

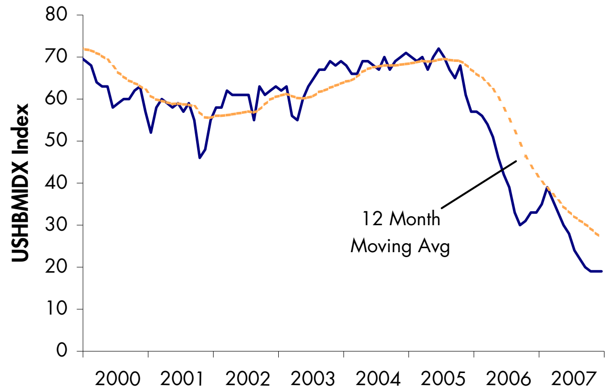
As the business of borrowing and lending is being re-thought, the global capital markets are being tossed around in the wash phase of the credit cycle

Props to Bob Dylan, for when it comes to the current condition of the credit markets, no truer words have ever been spoken… or sung, for that matter. For most of this decade, the process of creating credit – lending, if you prefer – had increasingly been shifting away from the traditional highly regulated banks we all grew up with, to other less regulated entities. As a group, these acronym-laden entities have been dubbed the Shadow Banking System (SBS – to add another to the list). The shift from regulated to seemingly unregulated lending – known as disintermediation in market jargon – has come to an abrupt halt of late as the SBS has been all but shut down. Worse yet, the ugliest of the loans packaged and sold by the SBS have been finding their way back onto the balance sheets of traditional banks with disturbing regularity. This re-intermediation roiled global capital markets in the second half of 2007, and will have significant economic, political, and market implications as we move into 2008. These are uncharted waters and no one can really be sure how the changes will unfold. This edition of SCM's quarterly commentary attempts to set forth our best guess, but one thing is for certain: A brave new world of credit creation awaits.

Ground Zero of the whole mess is the U.S. housing market *[see figure 1]*. What began as an isolated problem in the subprime mortgage sector spread like a virus all over the financial system, infecting an ever-growing array of borrowers, lenders and financial institutions. And as is usual in most credit crises, whenever reckless leverage and over-the-top risk-taking are uncovered, banks somehow find their way to the middle of it.

What makes this version especially troubling is that this was precisely the type of problem their new strategy was supposed to avoid. Most banks had successfully made the transition from mortgage lenders to originators, effectively moving from the traditional credit-driven spread business to volume-driven fee-generation. Risk was supposedly being re-distributed to others as the loans were sold. But to find these loans (and risks) back on their balance sheets simply as a result of banks stretching to earn a few measly extra pennies by providing back-up lines of credit to various SBS institutions, speaks volumes about exactly the type of excess that needs to be cleansed during this cycle.

Figure 1. NAHB Housing Market Index
National Association of Home Builders Index - Seasonally Adjusted
December 31, 1999 - December 31, 2007



Source: Bloomberg

And so we start the New Year with global capital markets being tossed around in the wash phase of the credit cycle. Assets of all types are being sold indiscriminately, leverage is being reduced, longer-term funding is being sought, and capital is being injected onto bank balance sheets. Capital is moving from weak hands to strong hands – slowly, but surely – and as we enter 2008, everyone is scrambling to figure out how the business of borrowing and lending will be re-jiggered for the start of the next credit cycle.

We find it increasingly unlikely that the catalyst of the current turmoil – namely, the housing market – will find a bottom in 2008, and should remain an economic headwind. Inventories continue to swell despite huge price cuts and every incentive known to mankind. Further, any lender left standing seems unwilling to lend until they get their arms (no pun intended) around their own issues. Given the importance of housing to both individuals and the economy as a whole, we expect significant fiscal and monetary stimulus to help soften the negative economic impacts of what may end up being one of the worst housing corrections in decades.

While none of the fiscal proposals that have been tossed out recently amount to much individually, in aggregate they could begin to mean something; in a situation like this, every little bit helps. And after re-convening a meeting of the Plunge Protection Team (Treasury Secretary Paulson and Fed Chair Bernanke) in early January, many now expect President Bush to announce a comprehensive plan, including tax cuts, during

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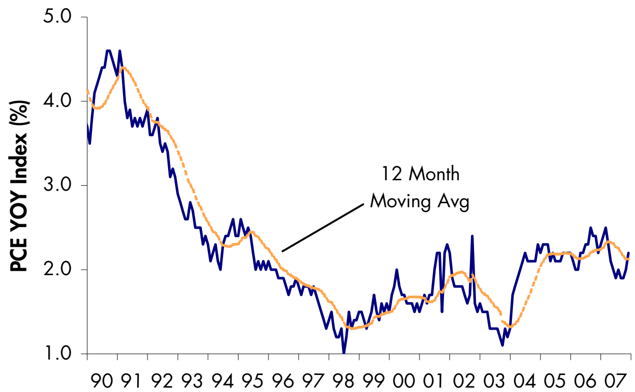
his State of the Union speech in the last week of January. Perhaps of more importance, that's also when the FOMC next meets.

The Fed, unfortunately, seems increasingly prone to shooting itself in the foot. There can be little doubt that housing deflation and the dysfunctional credit market have impacted an already slowing economy. We expect fourth quarter GDP to come in between 1.5% and 2.0% after averaging 3.1% in the first three quarters of 2007, and we look for economic growth in the first two quarters of 2008 to fall below 1.0% before turning up in the second half of the year. How far below 1.0% depends on the Fed's response. It becomes a bit like game theory. The longer the hawkish wing of the FOMC continues to wring their hands about backward-looking inflation data and remain slow to get the joke about the obvious economic risks, the greater the odds of a recession, and the more easing needed to combat it. Employment remains key and it's important for the unemployment rate to stay under 5.5%. But even if a recession is avoided, the economic outlook is nothing to write home about and will continue to cause market jitters.

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

January 1, 2000 to November 30, 2007*



Source: Bloomberg

** most recent data available at press time*

We believe the Fed has been too timid to date in its response to economic weakness. But our real problem with policymakers has been how poorly they've communicated that response. After a full year of reviewing how they could improve their communication efforts, they followed the October release of their improvements with an onslaught of speeches that proved to be virtually unrelated to the policy actions taken in December. It's as if their speeches have become a series psychiatric free association sessions for the various FOMC members. And the bungled announcement of the globally coordinated Term Auction Facility in December only added to the severe clog in the credit markets. We can almost buy the idea that it was important for the Fed to attempt to get into the new year and gauge how much of the credit market problems were truly due to year-end weirdness. It certainly worked for the European Central Bank. But to add to the already severe clogging by ham-handed timing cost the Fed some much-needed credibility, and gave the markets yet another jolt of unneeded volatility.

The main reason being trotted out for the Fed's timidity so far has been the recent blip up in various inflation data *[see figure 2]*. Unlike the inflation hawks on the FOMC, we believe that this blip was caused largely by the temporary pop in economic growth that occurred in the middle of 2007. Since inflation data are notoriously lagging indicators, we expect the current economic weakness will be reflected in the inflation data that are released as we move into the second quarter of 2008. While FOMC member's angst about inflation no doubt comes with their central banker handbook, it clearly doesn't line up with the market's inflation expectations, which – as measured by TIPS break-even spreads – have actually fallen recently. Eventually, policymakers' fears will prove misplaced, but it will take weaker economic data, and some improvement in the actual inflation numbers.

Approaching mid-year, we wouldn't be surprised if the re-opening of the output gap, when combined with the housing recession, the credit crunch and a weakened employment outlook, re-introduces deflation back near the top of the market's "List of Things to Freak Out About." We believe that this will give the Fed ample scope to cut target rates at least another 100 bps by mid-year, on top of the 100 its already cut, taking the funds rate to 3.25% or lower… and the sooner the better. The most important thing for the Fed to do right now is to make sure a potentially self-reinforcing feedback loop does not develop. Further tightening in credit could be very damaging since it would come at a time when the economy is fragile. Credit is the grease that makes the economic gears work, and if the gears remain clogged up, the economy will continue to falter… only to require much more grease later.

Despite economic weakness and expectations of further easing by the Fed, the dollar has begun to stabilize after falling steadily for most of 2007. The dollar's drop helped net trade become a source of this summer's economic strength. While further dollar weakness is possible, the story is beginning to change. We believe the dollar is starting to bottom out against major developed currencies. Since the Fed was the first central bank to begin easing in response to economic weakness, and that weakness is only now beginning to be felt in other developed countries, we expect the U.S. economy to be the first to benefit from the stimulus. Additionally, sentiment against the dollar had reached

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extreme levels as we approached year-end, and had gotten cheap from a textbook purchasing power parity standpoint. We still expect the dollar to weaken further against developing currencies, as those countries are not as likely to be impacted by the slowdown in the developed world.

We also believe Treasury yields are in the process of bottoming out. While there is clearly scope for lower yields over the near-term as credit-related and economic surprises could periodically spook an already skittish market, we expect most of the action to be in the front end of the Treasury curve. From an intermediate-term viewpoint, however, we believe that most of the downside for long Treasury yields has been achieved, although a run at 3.50% can not be ruled out. 10-year Treasury yields below 4.0% offer little value, but if the Fed remains slow to respond, yields could stay at overvalued levels for some time.

The yield curve *[see figure 3]* – as measured by the difference in yields between 2-year and 10-year Treasurys – steepened in 2007 from a low of negative 16 bps in February to about +100 bps at year-end. We expect the positively sloped yield curve to exceed 175 bps in 2008, which will benefit the beleaguered banking system by boosting bank profitability, making them more willing to lend.

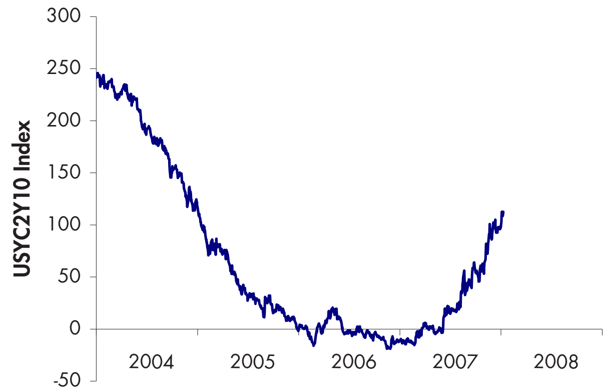
Demand for longer-dated Treasurys should fall as global central banks employ reflationary policies to deal with the economic slowdown, and as Sovereign Wealth Funds continue rebalancing their portfolios out of lower risk, lower yielding debt into other higher risk assets, as seen by the recent equity infusions made to U.S. financial institutions. Additionally, and coming full circle back to the mortgage meltdown, it is expected that prepayments on mortgage related securities will slow precipitously as lenders become less keen, or perhaps less able, to make new loans to those who might want to refinance existing loans. In effect, this lengthens the duration of mortgage securities of even the highest quality, which might cause fixed income portfolio managers to need to shed some duration, in the form of longer-term Treasurys, during coming months.

It should come as no surprise during periods such as these, where significant change is afoot and uncertainty is growing, that markets tend to become increasingly jittery and volatile. Indeed, bond market volatility – as measured by Merrill Lynch's MOVE index *[see figure 4]* – recently hit levels reached only five other times in its almost 20-year history. Each one marked the type of extreme that gives astute portfolio managers something to lean against, especially as it relates to securities that have what's known as embedded options. For instance, recent levels of volatility have offered opportunities in the highest quality generic FHLMC and FNMA pass-throughs, where the price has been hammered not only by the extreme volatility, but also by being thrown out with the mortgage credit bath water.

Clearly, there are risks to our outlook. Whether it's still higher volatility, or another acronym blowing up, or more bank re-intermediation, or continued housing woes, or yield curve weirdness, or a weaker dollar, or even FOMC reticence, there is one thing we know for sure: Opportunities will abound. 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.

Figure 3. 10-Year Treasury Yield, 2-Year Treasury Yield Spread

January 1, 2004 to January 9, 2008*



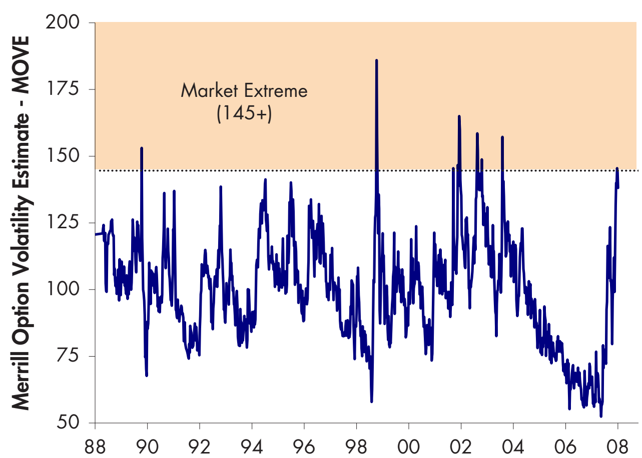
Source: Bloomberg

USYC2Y10 Index is the 10-Year US Treasury Yield minus the 2-Year US Treasury Yield

** most recent data available at press time*

Figure 4. Merrill Option Volatility Estimate

January 1, 1988 to January 4, 2008*



Source: Bloomberg

** most recent data available at press time*

Volatility Anyone?

Quarterly Review

After a strong showing in October, major indices posted their worst monthly return in five years in November, and December added to those losses. The net result was a down quarter for all the major averages. Liquidity concerns, write-offs, quant fund implosions, and soft economic reports reached a fever pitch at mid-quarter. There were 27 days of 100-point moves in the DJIA this quarter, and the CBOE Volatility index jumped 25% from September to December. Fears of a US economic recession and concerns over the strength of consumers and corporations (particularly financials) intensified as we moved through the quarter. The market became increasingly narrow with the number of new highs relative to new lows declining as we progressed throughout the quarter. It became evident that certain parts of the US economy were already in a recession, highlighted by the collapse in the housing market. While the broad indices ended only slightly down for the quarter, they posted their first fourth quarter loss in seven years.

Equity
COMMENTARY

Growth stocks again outperformed value stocks and large caps trumped small caps this quarter. For the year, growth outperformed value by a large margin. We have been champions of growth stocks throughout 2007 due to their ability to sustain profitability in a slowing economy. Above average profit growth rates and momentum factors were two of the most rewarding characteristics during the quarter and the year. We see this trend continuing as business risk is substantial given the macro backdrop.

Market Outlook

We feel the economic slowdown will be felt most acutely in the first half of 2008. Although we continue to believe we are in the midst of a midcycle slowdown, the continued housing fallout and its effect on the consumer highlight the risks to this forecast. We are closely monitoring unemployment rates, manufacturing activity, capex budgets, and higher energy prices. All of these concerns raise the odds of a domestic recession, but current policy measures should eventually cushion the blow. Fiscal stimulus, money flows, and attractive relative valuations will ultimately overcome a glut of concerns for equity investors. Once the full effect of the decelerating economy is reflected in profit forecasts, it is our belief that the equity market should rebound generating decent returns in 2008.

Regardless, profit growth will be harder to come by as we move into 2008. We will remain consistent with our investment philosophy and continue to isolate those higher quality companies that can sustain profit levels above their peer groups. As investors shun business risk and focus on growth potential, we are confident the Growth stock rotation will continue and our portfolios will participate in this better relative performance. Volatility will no doubt remain as investors re-price risky assets. We plan to use times of extreme volatility to our advantage as we capitalize on perceived oversold situations and trim back securities with stretched valuations.

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.

Happy New Year

All of us at SCM Advisors wish our clients and friends a wonderful new year with continued prosperity and success in 2008.

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.

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