

There's something happening here...

What it is ain't exactly clear - Stephen Stills of Buffalo Springfield

What we're unwinding are not just the excesses from the most recent credit cycle, but from multiple credit cycles going as far back as 1980.

As years go, 2008 was surely one for the ages. Whether referring to the markets, the economy or even the social psyche of our nation, there's no getting around the fact that, yes Mr. Stills, something did indeed happen in 2008. Unfortunately, that something turned out to feel a whole lot like a two-by-four across the collective brow, a blow that left many staggering into 2009 with only the vaguest sense of what the heck just hit them. And while our title's lyrics might be an excellent starting point in trying to describe the current state of things, please consider this edition of SCM's Market Commentary our humble attempt to help clear the collective head. Think of it as a round of written smelling salts, if you will, trying to add a little more clarity to what, admittedly, ain't exactly clear to anyone.

Given the sheer scale of events, we feel it's necessary to step back and present an even broader macro view than we typically do in our commentaries. This is due to the fact that the most significant bear market for financial assets in decades has morphed into what will likely become the deepest global economic slowdown since World War II, as multiple negative feedback loops have been allowed to become fully entrenched. Forced asset sales – as banks, mutual and hedge funds, and individuals de-lever – have led to falling asset prices, which in turn has led to further forced selling.

Banks and other lending institutions have effectively shut down the credit creation processes that businesses and consumers have become so addicted to over not only this economic cycle, but going back multiple economic cycles. This has led the U.S. economy into recession, and will likely push developed countries globally in to the first joint recession in post-war years.

These tectonic events have brought with them a profound shift in social mood. The political and socio-economic pendulum has clearly swung left as fair weather capitalists scramble to abandon ship. This has led to a collective reevaluation of consumer's spending and savings patterns and to massive and unprecedented coordinated government policy responses.

2008 was the year when the cyclical morphed into the secular. Make no mistake about it; what we're unwinding are not just the excesses from the most recent credit cycle, but from multiple credit cycles going as far back as 1980. In fact, as we've written about often, in many ways we may be entering an almost mirror image of the late '70s/early '80s period. Long-time readers are amply aware that we at SCM didn't believe it was necessary to get to this point, but have ended up here through a myriad of policy errors and tardy responses.

The period since 1980 can be thought of as The Era of Leverage, and was kicked off when then Fed Chairman Paul Volcker was fighting the excesses generated by the previous secular credit cycle. He crushed inflation through a series of rate hikes that led to back-to-back recessions, and set the stage for one of the greatest bull markets for financial assets in history. The period since the early '80s was characterized by falling inflation, falling interest rates [see figures 1 and 2], and falling risk premium – a golden era for the financial sector. It was also marked by a remarkable decrease in economic volatility – and importantly – by some significant financial disruptions that produced little-to-no real economic damage. As a result, the post-1980 period even earned its own nickname from Fed officials patting themselves on the back; The Great Moderation. (Note to file: when central bankers start taking credit for economic performance – and even giving it a name – it's probably best to get a little wary. Another note to file: Isn't it ironic that Paul Volcker is hanging around again, thereby effectively bookending The Great Moderation? While he's currently revered, memory holds that he wasn't all that popular when he created the double-dip recession to fend off inflation. Be careful what you ask for, he's a real take-your-medicine kind of guy).

Shifting our focus a bit from the secular to the cyclic, the recent economic roundtrip, which began earlier this decade, clearly wasn't all that impressive even in light of the greatest explosion of credit in history. As we've written about often, despite an almost unfathomable amount of leverage that was ginned up, it could only spit out a rather measly average of around 2.5% GDP growth for the cycle, one of the lowest averages in recent history. In fact, taking out the effects of Mortgage Equity

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20th Anniversary

This year SCM Advisors will celebrate its 20th year of investment advisory. A special thanks to all of you that made it possible.

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Withdrawal (MEW), there was essentially no real economic growth over this cycle. We've described in past commentaries the reasons, but suffice it to say that the leverage was plowed into stuff with questionable economic value, and there was massive leakage throughout the credit system.

Another way to view the tepid economic performance of this cycle is to look at the amount of leverage needed to produce output. By the time we reached 2007, it took \$6 to \$7 in added leverage to produce \$1 in GDP, while it took only \$1 to \$2 in the early 1980s, clearly indicating that the secular trip from 1980 was producing exhaustion.

So if we might be unwinding something more than just the most recent credit cycle's excesses, where does that leave us? We've found it helpful to pull out our old text books and revisit the Fisher/Von Mises/Friedman concept of the Quantity Theory of Money...

MV = PQ

...where M = money, V = velocity (or how much that money turns over), P = price, and Q = quantity. PQ can be re-written as nominal output (or GDP), which can be further re-written as inflation plus real GDP, leaving us with...

MV = Inflation + Real GDP

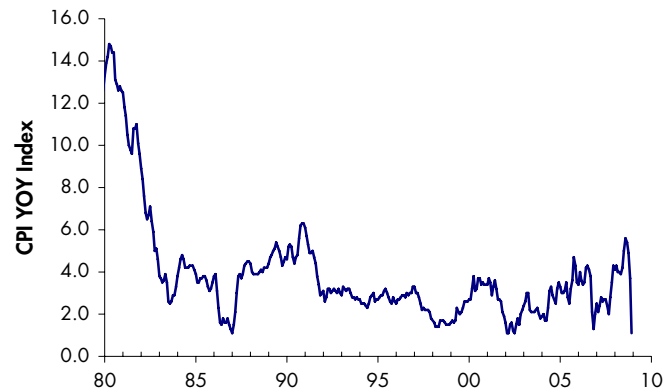
Now let's look at each of the variables a little closer. Inflation is falling on a month-to-month basis and will likely fall on the more closely watched year-to-year basis as we move further into 2009. Real GDP is negative and promises to get worse. We know that narrow money, like M1, is simply skyrocketing by any historic standard. So if money supply is up big, yet both parts of the right side of the equation are down, we know that the velocity of money must be utterly collapsing and, indeed, that is what is occurring. The money multiplier is working in reverse as the private sector credit creation process is locked up. Giving it a name, let's call it The Great Unwind.

That leaves the government to essentially take over the entire of the left side of the equation from the private sector in order to produce economic output. What was already a pretty bad situation before Lehman was allowed to go under in September, turned markedly worse in the following weeks. The destruction of wealth has been almost incomprehensible, and it's too late to prevent a deep recession. The question now is how to contain it, and the government is trying – in classic Keynesian fashion – to pick up the slack from the retrenching private sector by attacking both M and V. The government is doing everything it can to re-start the credit cycle, but the essential problem is that there is still too much credit outstanding.

Increased government spending can help fill some of the void created by private sector retrenchment, but it isn't clear it will be enough to build real, sustainable growth in 2009. For some perspective, for every 1% that the private sector cuts back on spending, the government has to increase its

Figure 1. Consumer Price Index

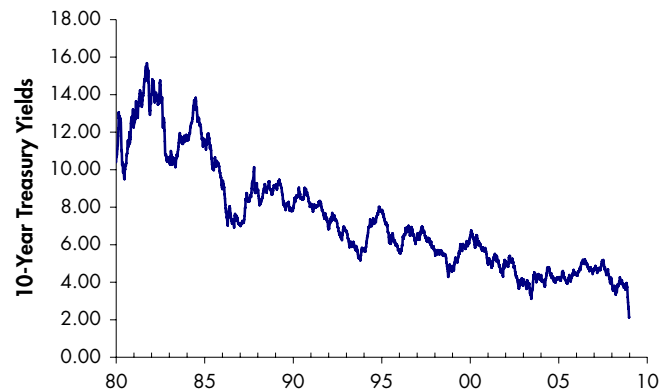
December 31, 1979 to January 2, 2009



Source: Bloomberg
CPI Year-over-year for urban consumers

Figure 2. 10-Year Treasury Yields

December 31, 1979 to November 30, 2008*



Source: Bloomberg
* Most recent data available as of press time

spending by 10%. And for every 1% that the private sector de-levers its balance sheet, the government has to lever up by 5%. Clearly they have their work cut out for them. It's important to emphasize that the various monetary and fiscal stimulus schemes are merely pieces of a puzzle that has yet to really take form, but no one program – in and of itself – will make it clearer.

The Fed is doing its part by starting down the road to Quantitative Easing following the Lehman failure and by instituting what we've taken to calling N-ZIRP – near zero interest rate policy – at its October meeting. Thus far, the massive increase in money has remained trapped in bank reserves. The Fed and other global central bankers will have

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to continue to pursue unorthodox and extreme measures until the adjustments in bank balance sheets is advanced and the monetary transmission mechanism begins functioning again, in whatever new form that may be.

The implications of a secular unwind of credit excesses – as opposed to a cyclic unwind – are profound. First off, we are not going back to where we were before the crunch began 1½ to 2 years ago. Things will never be quite the same again. We're heading to a very different place that is only now beginning to take vague shape. Markets, the economy and social mood are changing in a once in a generation kind of way, and trying to view it in a cyclical fashion is problematic.

We're currently struggling through the first part of the transition, where much of the burden of the left side of the equation (MV) shifts from the private sector to the public sector. And then comes the second part of the transition; weaning the economic patient from the government stimulus as the private sector cautiously returns. And therein lies the next great debate. If the government is too slow to wean the economic patient from its temporary stimulus, the argument goes, you risk inflation. Do it too fast and you risk a double-dip recession. We lean toward the former, utilizing the LLO model (they were Late-In, and it wouldn't surprise us if they were Late-Out). Either way, we don't expect it to be a 2009 issue, as the economy is facing significant headwinds in the years ahead.

The consumer is under attack on multiple fronts. Unemployment is rising quickly and we expect it to peak between 8% and 9% in early 2010. Real incomes will continue to fall. Home prices have fallen 10% to 20% depending on where you live, and we expect at least another 5% to 10% decline. Financial assets have fallen even more than home prices. As a result, consumer spending will fall significantly in 2009 and savings rates will rise, sometimes referred to as The Paradox of Thrift, each taking a significant chunk out of an already muted economic recovery.

From the lending side, credit growth remains stagnant as banks are reluctant to lend back out the money provided by the Fed and, at the same time, borrower demand has fallen off a cliff. Forced selling of troubled assets at banks will continue for many quarters, and capital raises will be used in large part to plug holes created from write-downs of existing assets and from future losses stemming from the global economic slowdown. The lack of both the supply and the demand of credit have already created substantial holes, and this process still has a way to go before it's over.

With both consumers and lenders constrained, we look for an extended period – at least two to three years – of below-potential GDP growth following a few quarters of negative growth. Sure, the economic collapse will be slower than without the stimulus, but it won't prevent further significant weakness. We expect Q4 2008 GDP to contract by about 6%, with Q1 and Q2 of 2009 contracting between 2½% and 3½%. Trying to forecast much beyond that becomes a function of the speed and size of the monetary and fiscal stimulus efforts, both here and abroad. It depends largely on how effectively the now-entrenched negative psychology can be broken, and by how much remaining forced selling there will be. On the inflation front, we expect year-over-

year headline inflation to turn negative by spring and for core measures to fall comfortably within the Fed's 1% to 2% target range. Deflation will be a bigger threat than inflation for at least the next couple of years.

As for the financial markets, there's obviously much we don't know, but there are a few things we do know. We know, for instance, that the relationship between the financial markets and the real economy has not been fully understood by policymakers, regulators and investors. We know that the interaction between the lending bubble – we've long refused to call it a housing bubble – and the economy has been underestimated every step of the way. And we also know that every seemingly significant event over the last year or so has led to a scramble to mark it as the bottom (what are we up to now, 8 or 10 bottoms in the last year?). At the heart of the matter is a fear of missing the big move that helps recoup losses, which is more of a lingering bull market psychology.

Stepping back a bit, we believe the market needs to work through the process of marking down economic expectations, and marking up risk premiums, and doing so in a very constrained, increasingly regulated environment. We stress that this is a process that involves both price and time, and while we may already have approached some higher probability price extremes in certain markets, secular turns can be very different animals. Basing forecasting decisions in a secular sea change on more familiar cyclical criteria sets one up for underestimation. For instance, cyclical bottoms do most of their psychological damage utilizing price, creating the types of V-bottoms seen in the stock market in 1987 and 1998. Secular bottoms, on the other hand, often use time to do their cleansing; think 1929-41 and 1968-80.

We believe it's prudent to consider the possibility that the current process of working through the excesses of multiple credit cycles will command more of a function of time than of price from today's levels. 2009 will likely be a very iterative, volatile period, with the potential for more false starts ahead of us. Borrowing again from our investment consultant Stephen Stills, "Paranoia strikes deep, into your life it will creep; it starts when you're always afraid." But let us be clear: we believe that this too shall pass. Monetary and fiscal stimulus will eventually stabilize the economic patient, albeit with the attendant unintended consequences. And as we work through the necessary secular cleansing process, there will be plenty of opportunity for active portfolio 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. 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 to the dynamics of an ever-changing marketplace.

Quarterly Review

The fourth quarter put the wraps on one of the most difficult investing time periods ever recorded. Equity assets across the landscape suffered significant losses as many troublesome records were broken. The largest monthly decline, the greatest number of high volatility days, the widest corporate spreads, and the largest earnings cuts ever recorded to name a few. The dramatic and comprehensive effects of deleveraging combined with softening economic data outweighed attractive valuations and a stream of government ordered stimulus. The end of 2008 brought the worst decade of stock investing on record to an inauspicious close.

Equity COMMENTARY

The multitude of afflictions facing the stock market like housing, unemployment, credit and slowing world economies, are well documented, but its impact on trading patterns within the equity market are less so. We have found this difficult time period to be notable in two inter-related ways. First, the market confounded conventional wisdom regarding diversification with almost all asset classes and sectors posting significant declines while correlations reached all time highs. Secondly, sovereign decoupling arguments broke down as emerging and developed economies suffered similar fates. While it is clear to us that there are segments of the market deeply entrenched in secular decline, others will prove to be more cyclical in nature and thus present opportunity. This dramatic time period has summoned an equally impressive policy response, the effectiveness of which will have a substantial impact on returns going forward.

Market Outlook

The stock market is a leading indicator and has the proven ability to trough several months prior to any real economic growth. We suspect the government programs enacted to date, as well as the stimulative policies that will likely be enacted early in the new administration, should begin to gain

traction as we move through 2009. While the effects are lagged, we suspect the prospects for growth will improve and sentiment can begin to rebound from our current depressed state. Equity investors have paid a dear price for living at the low end of the capital structure as the world delevers. While policy actions gain traction, negative earnings momentum should slow, credit spreads narrow, bond yields improve, and forced selling slow. In this environment equity investors will be rewarded for delineating between "good" and "bad" stocks. This has not been the case over the past year as stocks were generally guilty by association and often times sold unremittingly. We are forecasting a more discerning 2009 for equity investors.

It is easy to be apprehensive in this environment. We are still seeing two negative feedback loops impacting stocks: credit downgrades that result in price drops which produce capital raises (forced selling), and consumer sentiment feeding off depressed economics, that generate further negative sentiment. These loops will break as economic activity stabilizes. We view the recent rally off the lows in stocks as overdue. Some securities are discounting the most dire outcomes, which we don't see happening. A sustainable, broad based market recovery will benefit from the record amount of cash currently on the sidelines as stimulus efforts gain traction. Valuations are generally supportive, and valuations specific to the growth equity space are the cheapest they have ever been. Additionally, growth-biased investing styles tend to perform best coming out of recessions and bear markets.

The world looks much different than it did only three months ago. We will be more vigilant than ever as the economic and political drama unfolds. As always, we 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.

Organizational Update: Fourth Quarter 2008

We are pleased to announce that on December 31st, 2008, Virtus Investment Partners became an independent publicly traded company. As we have previously communicated, a decision to spin-off Virtus Investment Partners from the Phoenix Companies was announced in the first quarter of 2008. Virtus provides investment products and services to individual and institutional clients through its affiliated managers. Each management firm, including SCM Advisors LLC, has a distinct investment style and autonomous investment process. On January 5, 2009, George R. Aylward, president and chief investment officer of Virtus, rang the opening bell at the NASDAQ stock exchange and stated "We are excited about the opportunity to begin 2009 as an independent publicly traded company and are particularly honored that Virtus is the first newly public company to open

the NASDAQ stock market in the new year." He went on to say "We believe our company's core strengths of solid investment management capabilities, active product management and development and broad distribution will position us well to navigate this difficult economic environment."

At SCM Advisors, market conditions in 2008 provided us the opportunity to refocus our business back to our roots as a traditional fixed income and growth equity manager. In the fourth quarter, Warren Goodrich, CFA, was appointed Portfolio Manager of our High Yield fixed income strategy replacing Al Alaimo, who left SCM in December. Warren has been with SCM Advisors since 2001 as an analyst and Director of Research and has previously worked at Barclays Global Investors and Banc of America Securities.

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