

It's Complicated

With The Great Reflation Experiment, policymakers hope to prod private sector demand by attempting to rekindle inert animal spirits

In last quarter's *Market Commentary* we poked some fun at the increasing polarization of views about the lab experiment we're all living through. We described how the growing intensity of those views was a little hard for us to swallow given the scale and scope of the uncertainties that make up this particular experimental brew. Yet, as we roll into 2010, the polarization and intensity of views seem to have been cranked to new extremes. Sure, 2009's financial and economic X Games were tailor-made for wildly volatile and divergent views [See *Figure 1*]. But now seems hardly the time to be furiously pounding the table, as so many have recently, about how The Great Reflation Experiment will turn out.

We believe that a high degree of uncertainty remains on a number of key secular and cyclical issues, creating a far wider-than-normal range of possible outcomes. Like the popular movie, it is indeed complicated. So in the spirit of keeping our fists off the table and hands folded calmly in our collective laps, please consider this edition of our *Market Commentary* to be our exploration of those key issues and their possible outcomes.

As we've written about (some say all too) often, the United States is in the process of correcting three highly-interconnected cycles of compressing timeframes. The first is an approximately 60 year cycle of demographically-charged debt accumulation. The second is a 25 year cycle of bank disintermediation and socialization of risk best illustrated by the explosive growth and subsequent collapse of the shadow banking system.

Left to its own devices, this so-called Debt Supercycle would likely have reached a more natural and ultimately less damaging peak in the late 90s. But it was extended further by a third cycle, where myriad monetary and fiscal policy errors combined with regulatory ineptitude to artificially drive the debt binge to stratospheric levels and needlessly push the global economy into the first coordinated financial crisis since the

We expect economic growth in the U.S. to be volatile and very uneven in 2010

Figure 1. S&P 500 Index
December 31, 2006 - December 31, 2009



Source: Bloomberg

Great Depression. Much like the old story about a frog being slowly boiled alive, each cycle gradually increased the leverage heat from the one before it – with the subsequent cycles actually being energized by, and then feeding upon, the previous one – until the unsustainably toxic combination reached its explosive boiling point in 2007.

We believe that the process of correcting such a long and explosive confluence of cycles is *A Very Big Deal*, with precious few historical analogues. Over the last 18 months, we've trotted out a number of folks whose work we feel best captures how periods like this differ meaningfully from the more frequent and common types of economic downturns seen since the Great Depression; names like Fisher, Friedman, Shiller, Reinhart, Rogoff, Koo. And as we've attempted to explain, one of the key unifying themes among these economic thinkers is that when you have a massive debt deflation created by a financial crisis, the private sector is in for a long, hard slog, and that it's the public sector that must do much of the economic heavy lifting in the interim.

While initially slow to clue-in to how the confluence of cycles could metastasize into *A Very Big Deal*, with significantly broader economic and social manifestations, policymakers responded with a very big deal of their own; coordinated monetary and fiscal stimulus on a never-before-seen scale. We've taken to calling it The Great Reflation Experiment, the goals of which are pretty straightforward. The first goal was

(cont. on page 2)

It's Complicated... (cont. from page 1)

to avoid what surely would have been a full-on depression at least on the scale of the 1930s, which appears to have been successfully accomplished.

Interestingly, the success has not been a *direct* result of the stimulus efforts. The Fed has literally drenched the system with liquidity only to find that it has ended up sitting in the form of excess reserves on bank balance sheets, not lent as intended. On the fiscal side, the government has massively increased its debt in an effort to get the consumer to spend, but all that has actually been accomplished is for consumers to increase savings or to reduce indebtedness. We've often made reference to the notion of a liquidity trap in describing why these stimulus efforts have not been used for the intended purpose.

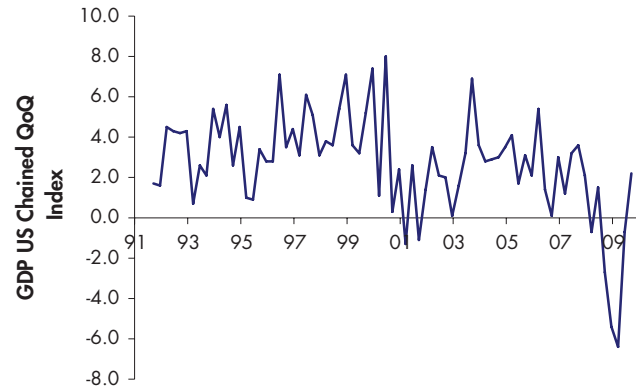
What *has* happened, however, has been for a healthy portion of that stimulus to find its way into the capital markets, where it began to unclog the frozen financial system and provide the source for a liquidity-driven rally in the prices of risk assets. Since the more direct stimulus methods aren't yet having the desired effect, policymakers hope that by helping to partially repair badly damaged balance sheets via higher asset prices, they can at least *indirectly* prod private sector demand to pick up by trying to rekindle inert animal spirits. But make no mistake about it; trying to stem the reversal of a 60-plus year balance sheet expansion is a Herculean task.

Goal number two of The Great Reflation Experiment is for the government to eventually hand the economic reins back to the private sector once the coast is clear. Here's where things get a little dicey, and where most of polarization and intensity of views we mentioned earlier originate. What makes this reflationary campaign so experimental is not just its scale, but given the interconnected nature of the global financial crisis, how coordinated the stimulus efforts must be. This coordination has had to occur at a number of levels: between monetary and fiscal policymakers within a particular country or region, between policymakers around the globe, and also between those global policymakers and some of their key private sector financial institutions. While this coordination has led to a variety of tin foil hat conspiracy theories, it's also greatly complicated the experiment.

This brings us to the question of when policymakers can actually feel comfortable that the economy is healthy enough to hand back to the private sector, a job made especially tough due to the artificial nature of current economic fundamentals. Domestically, no one knows what the underlying economic conditions are really like today, much less 6-12 months from now. What we do know is that all of Q3 GDP [See Figure 2] growth came as a result of government stimulus and it looks like a big portion of Q4's growth will be the result of inventory restocking... hardly the stuff of a table-pounding certainty about pick-up in demand.

We expect economic growth in the U.S. to be volatile and very uneven in 2010 and believe that any forecast of economic activity this year is in large part an implicit bet on the success

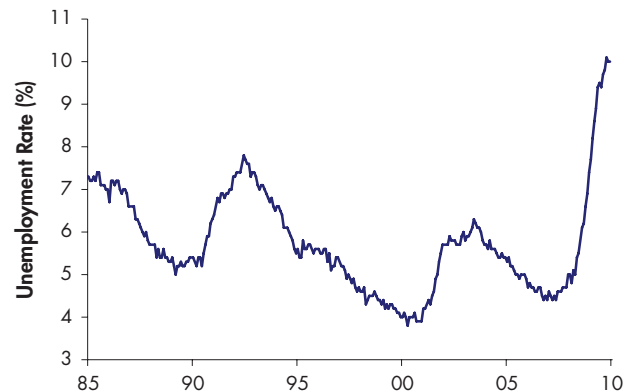
Figure 2. U.S. Gross Domestic Product
September 30, 1991 - September 30, 2009*



Source: Bloomberg

* Most recent data available as of press time

Figure 3. Unemployment Rate
As a percent of the labor force - seasonally-adjusted
December 31, 1984 - December 31, 2009



Source: Bloomberg

of further stimulus. While we look for the yearly number to average a below-potential 2.0% for the year, that number will likely end up being less meaningful because we see risk that a couple statistically impressive quarters could be off-set by a negative one as policymakers struggle to get the balance of the monetary and fiscal porridge just right... which they probably won't. Our below-potential forecast is due to something we've referred to in the past as the *drip-drip-drip of demand disappointment* that comes from continued de-leveraging, increased savings, stubbornly high unemployment [See Figure 3], and low-to-negative real wage growth. A banking system facing continued loan deterioration and increased regulation, a moribund securitization market, and badly damaged real estate sector don't help matters either.

(cont. on page 3)

It's Complicated... (cont. from page 2)

Our forecast for a volatile and uneven economy should add ample fuel for the burgeoning inflation-deflation debate. For many, the knee-jerk reaction is that the massive stimulus must necessarily produce inflation, to which we reply; well, you'd better hope so, because the alternative wouldn't be pretty. But given significant post-crisis economic slack, and our forecast for little reduction of that slack due to below-potential growth, if inflation is to eventually become a worry – and that's a hopeful "if" – we don't think it's likely to be a 2010 concern. While we do give a nod to the notion that inflation is less a tangible concept than it is a psychological one – like the crisis reminded everyone about how to think about liquidity – for the near-term we remain more concerned about the overwhelming deflationary impacts of correcting the 60-plus year balance sheet expansion and the more immediate headwinds mentioned in the paragraph above.

Even though 10-year Treasury yields are close to the upper end of their seven-month trading range, much of the recent sell-off reflects overly aggressive expectations for the Fed to tighten policy. The minutes from the December FOMC meeting revealed a wide variety of views, but as we explained in detail last quarter however, we would not be surprised for the Fed funds rate to remain unchanged at exceptionally low levels until deep into 2010 or even into 2011. The more important question, for now, will be when the FOMC decides to remove the "extended period" language from its statements, which could get ugly for the markets.

If the economic data is as volatile as we expect, we'll need to keep a close eye on important leading indicators of monetary traction such as the money multiplier (M2/the monetary base) and velocity (GDP/M2), which both remain in significant downtrends. But ultimately, just as any forecast on economic activity is essentially a bet on the success of stimulus, so too do we feel the forecast of Fed tightening is a bet on the success of fiscal policy. And given how little de-leveraging has occurred so far, and the amount of anger that "government" stimulus has already engendered, it makes us wonder if policymakers will have the political courage to keep the fiscal pedal to the metal during this growing wave of populist discontent. Nevertheless, even though the slope of the Treasury yield curve has been grinding wider of late, we look for it to be flatter a year from now.

What was coordinated going in will be far less coordinated coming out

As we mentioned earlier, one of the most impressive things to come from the financial crisis was the well-coordinated timing of the massive global stimulus. Unfortunately, what was coordinated going in will be far less coordinated coming out due to vastly different economic and political conditions around the globe. Since we believe the U.S. issues to be more secular in nature relative to many parts of the world, it's likely the U.S. will be one of the last to unwind its stimulus efforts, which should

keep pressure on the beleaguered greenback. As the year ended, however, the dollar rallied almost six percent, attracting all manner of commentary on its future. Bulls and bears alike have trotted out their ideologically-driven advocates, who run the gamut from the strong dollar table-pounders to the grassy knoll types who swear the dollar's role as the world's reserve currency is about to end. Our view is that with the exception of an occasional mini-flight-to-quality panic that might pop up thanks to additional de-leveraging pressures, we would expect the decade-long slide in the dollar to continue, albeit on an orderly basis. And rather than wringing one's hands about the dollar's demise, we suggest that it might be more helpful to view the decline as a natural consequence of government stepping in for a retrenching private sector, effectively trading private debt for public debt in an effort to create yet another artificial extension of the Debt Supercycle at the same time that more prudent multi-currency portfolio management strategies are being implemented on a global basis.

We continue to scratch our heads not only at misguided attempts to compare this period to those of more typical post-war economic downturns, but also by the assurance (and decibel levels) many have on the outcome of The Great Reflation Experiment. What this means for the continuation of the liquidity-fed reflation trade – the bet that a good chunk of the stimulus efforts will continue to find its way into stocks and commodities – has also been the subject of much high-decibel debate. For our part, we respect the trends in place since March but continue to believe the rally in these assets is cyclical in nature. Ironically, how much further the cycle has to run is, in our opinion, inversely related to the economy successfully transitioning into a self-reinforcing recovery and becoming less dependent on government stimulus. We remain concerned about how the markets will respond when the artificial liquidity-spigot gets tightened.

We believe that the scope of secular and cyclical uncertainties for the coming year have rarely been broader, which we think suggests an extremely wide range of possible outcomes... not to mention a healthy dose of caution. But for 2010, we believe superior investment performance will be driven less by the broader macro calls that characterized 2009, and more by separating winners and losers at the individual security level. Of course, how it all plays out can never be certain; like the movie, *It's Complicated*. But we can be certain of one thing: this is an environment that will provide plenty of opportunity for active 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. Our firm'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.

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.

Quarterly Review

Stocks continued to help drive a recovery and posted a third consecutive quarter of gains. Spurred on by a robust earnings reporting season and showing signs the recovery was picking up momentum, stocks closed 2009 near the year's high and well off the bottom set earlier in the year. A few short quarters ago a global recession was raging, profit forecasts were slashed, and confidence was nonexistent. While the depth and speed of the downturn surprised many, so has the robustness of the recovery. The index of economic leading indicators has improved every month since March, GDP growth has resumed, structural problems (credit, housing, unemployment, etc.) all have shown signs of recovery, and, most important to us, corporate profit growth has turned decisively positive. Our growth cyclical and reflation positioning within the portfolios again contributed to performance this quarter.

Equity COMMENTARY

Subtle market leadership and technical changes took place this quarter, and a few are worth highlighting. Early expansion and highly economically sensitive sectors (consumer discretionary, technology, etc.), the leaders since the March '09 lows, were joined by traditionally later cycle sectors (materials, industrials, etc.). This broader participation was instrumental in the push to year end highs and reflective of the evolving expansion. Some of the better performing factors in the

fourth quarter were quality biased (high ROE, high profit margins, earners vs. non-earners, large caps over small caps, etc.), a notable change from the previous two quarters. These dynamics typically exist in more mature phases of expansions and reflect a heightened sense of valuation discernment. The negative correlation between the dollar and the stock market began to weaken late in the quarter as the debate regarding the Fed's ability to tighten up its monetary policy began. Finally, as the rally progressed, correlations amongst securities subsided, resulting in a narrow but more discerning market.

Market Outlook

A domestic and global economic recovery is underway. There is no denying the recovery is underpinned by historically accommodative policy and significant doses of fiscal stimulus. There exists a feeling of codependency between recent stock market gains and policy actions over the past year. To many, it feels tenuous and fragile, and while the mood has definitively shifted away from the outright pessimism witnessed earlier this year, we think the recovery remains skeptical to many. At the macro level, we believe sustained gains this year will be most influenced by the degree to which global economies can demonstrate their ability to stand on their own and advance to a self-reinforcing stage. We think the economy will continue to recover in the first half of 2010 and give the Fed a chance to talk "exit strategies" (monetary, fiscal, and regulatory). This will most likely test the foothold, or codependence, of the stock market and set the stage for the second half of the year. Structural problems remain, but as 2009 demonstrated, opportunities for stock gains will be ever present.

At the micro level, we continue to focus on several factors to gauge risk appetites and adjust portfolios accordingly. We are growth equity investors focused on profit acceleration, thus the profit cycle itself is something we monitor closely. The positive revisions of late are encouraging but largely margin (cost cutting) based. Going forward, we see the market focusing more on those companies that can continue to report strong bottom-lines, fueled by top-line (revenue) strength. Factors driving stock returns should evolve in 2010 as the recovery matures. We expect momentum and risk (leading 2009 factors) will trail sustainable growth and valuation factors. We will continue to focus on well capitalized market share leaders with strong profit outlooks. In regards to sector positioning, as noted above, there are subtle changes in market leadership taking place. While we suspect the economic-sensitive sectors will continue to perform well again in 2010, they will be more balanced in their return profile. Finally, watch for lower correlations as stock returns should be driven more by company fundamentals and less by the global economic landscape. As correlations fall, so should the contributions of active management.

The investment professionals here are an experienced, stress tested group that always has our clients' best interest at heart. We will continue to work hard and 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 in greater detail and welcome any questions and comments you may have. We wish you all a happy, healthy and prosperous 2010.

Getting to Know SCM Advisors : Meet Kaushik Saha, Portfolio Manager MBS/ABS



Given the 20-year history of SCM Advisors, "Getting to Know SCM Advisors" is a periodic series designed to introduce you to some of the key individuals of the firm.

Kaushik Saha is SCM Advisors' Portfolio Manager of mortgage and asset-backed securities. Utilizing 18 years of investment experience, Kaushik researches and develops a firm-wide Securitized Investments strategy as well as determining ideal allocations of MBS and ABS within a variety of the firm's fixed income strategies.

Prior to joining SCM Advisors in 2008, Kaushik was a Portfolio Manager of Securitized Credit Investments at Barclays Global Investors and Director of Mortgage Valuation and Strategy for Freddie Mac. Kaushik received his MBA in finance from Johns Hopkins University and holds an MS in computer engineering from the University of South Carolina.