

The Tyranny of Cycles

2010 was when policymakers decided that The Great Reflation Experiment needed a reboot

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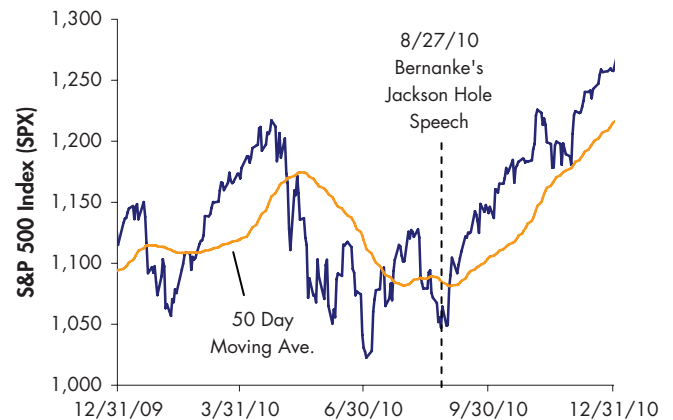
Well, it's that time of year again. The time in the calendar's cycle when you get the pleasure of being bombarded with all manner of annual reviews, market forecasts, lists of surprises, and other such pontifications. While we would much prefer to analyze current financial and economic trends without time parameters derived solely from the earth's relative position to the sun, we as card-carrying strategists have sworn an oath to carry out this ritual.

2010 was a year when economic and political ideologues staked out highly polarized positions and stridently fanned the flames of discontent with sound bites pulled from shopworn pet theories. It was a year where emotion-addled attention spans shrank, causing consensus expectations to vibrate wildly around the stretched elastic band of reality. And 2010 was when policymakers decided that *The Great Reflation Experiment* needed a reboot, only to find that policy was better communicated by internet cartoons and satirical TV news shows than by policymakers themselves. But mostly, 2010 was a stark reminder of the role that cycles play in our lives.

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Last year began with the near-universal belief that the cyclical economic tailwinds generated by policymakers' massive reflationary efforts had successfully muted the impact of the secular headwinds that resulted from unwinding decades-in-the-making credit excesses. Consensus opinion at the time was that the private sector had recovered enough from the financial crisis to take back from the public sector the responsibility for being the main driver of economic growth. We at SCM weren't as confident. An echo of the financial

Figure 1. S&P 500 Index
December 31, 2009 - December 31, 2010



Source: Bloomberg

crisis reverberated through Europe during the spring, and by mid-year it had become clear that the domestic economy had, in fact, *not* recovered enough to function without government stimulus. Fears of a double-dip recession sent markets falling like birds from an Arkansas sky and left policymakers "...staggering around with their Chief Brody face on, realizing that a bigger (stimulus) boat may indeed be needed." *

That boat set sail in late August when Fed Chairman Bernanke laid out the monetary piece of the reflationary reboot, since dubbed QE2, during his speech in Jackson Hole. In it he introduced the concept of the *portfolio balance channel*, which the market immediately read as the Fed possibly, just possibly, targeting higher stock prices as a monetary policy objective. On cue, risk assets began to rally [See Figure 1]. And then on November 4th, one day after the FOMC made QE2 official, Bernanke published an Op-Ed piece in the *Washington Post* that became the defining event of 2010. In this stunning article he basically admitted that the Fed was indeed targeting higher stock prices in setting policy.

Our jaws hit the floor; we'd never seen anything like it. It had long been a kind of dirty little secret that the stock market played at least *some* role in the monetary policy mosaic, but no self-respecting central banker would ever admit it. Now we had the Chairman of the Federal Reserve doing so... and in a very public forum. Even though the Fed's intentions had

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* Quote from SCM Advisors' 2q10 Market Commentary

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been very clearly telegraphed in the ten weeks since the August 27 Jackson Hole speech, the *Post* article kicked-off a high-decibel maelstrom of anti-QE2 screeching. All manner of naysayer – from monetary officials here and abroad, to mama grizzlies – jumped on their favorite ideological soapboxes to pedantically beat Bernanke about the head and shoulders concerning the Fed's all-too-well communicated strategy.

But as it turned out, the Bernanke-bashing combined with another brief European monetary-union-without-fiscal-union spasm to cause only a brief hiccup in the risk markets before the post-Jackson Hole rally resumed. Adding to the optimism was the growing realization that the Tea Party-led election shellacking would produce the second piece of the reflationary reboot, which turned out to be the Obama tax-cut package, and the upward momentum carried through to year's end.

What's most interesting to us about 2010 – and especially the fourth quarter – was not so much the need to extend the reflationary cycle, or the seeming success of that additional stimulus. Rather, it was the broader context of the intensity of the emotional outbursts. Our sense is that the type of anger and vitriol manifested by such things as the post-announcement onslaught on QE2, the groundswell and influence of the Tea Party, and even the righteous indignation about airport pat-downs, is that they are really natural outgrowths of the type of Reinhart/Rogoff-style secular debt deflation we've written about so often. The types of tensions and frustrations seen in 2010 reflect something more than the kind of disappointment typically felt after temporary financial setbacks.

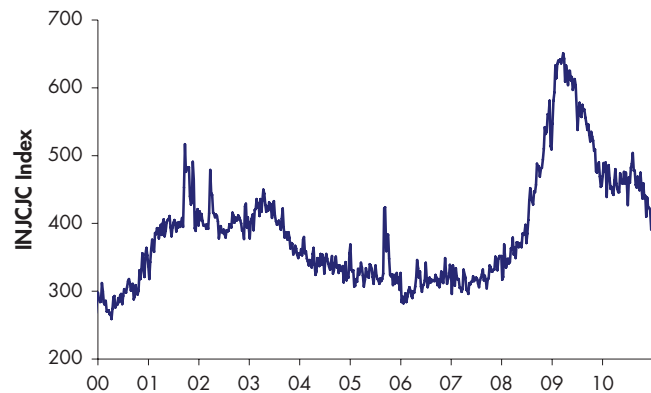
This kind of lashing out is a sign of something deeper. Our nation is struggling through the first meaningful detour in the upward arc of our standard of living in decades, and these collective responses reflect the fear that something core to our way of life may have changed. They are the visceral manifestations of the secular headwinds we've written about, and we expect them to be around for awhile.

It's important to keep in mind that we just went through a once-in-a-lifetime financial crisis that pushed the world to the brink of another depression. The subsequent policy response, which we refer to as *The Great Reflation Experiment*, is just that; an experiment. And yes, those cyclical reflationary

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Figure 2. U.S. Initial Jobless Claims

January 7, 2000 to December 31, 2010



Source: Bloomberg

efforts appear to be working. But the jury is still out on how it will all end. While we continue to believe the reflation cycle has some life left in it as we head into 2011, we also retain a healthy uncertainty and apprehension about how long it will last given the lessons of history.

Economic Forecasts

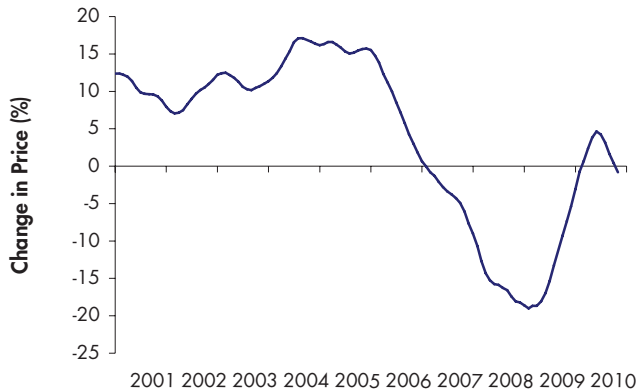
The U.S. economy picked up steam in the second half of 2010, after the fears of a double dip recession this summer forced monetary and fiscal policymakers into their reflationary reboot. Domestic GDP fell to a below-potential 1.7% in the second quarter, before rebounding to 2.6% in the third quarter. It looks like fourth quarter growth, which will be announced on January 28, could come in above 3.0%. Real consumer spending rose at an annual rate of 2½% in the third quarter and recent data suggest that it likely expanded at a somewhat faster pace in the fourth quarter. Business investment in new equipment and software has grown robustly, albeit from fairly low levels.

We've grown cautiously optimistic about the economy over the near-term and look for the economic momentum in place at the end of the year to continue well into the first part of the year. We now expect domestic GDP to average between 3.0% – 3.5% in the first half of 2011. Nevertheless, given our belief that the cyclical economic and market recoveries that have developed to date have largely been the result of the unprecedented monetary and fiscal stimulus, we are less optimistic and not as confident in our forecast about the second half of the year as the impact of that stimulus begins to wane. Domestic growth could ratchet down to 2.0% – 2.5% by second half of 2011.

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Figure 3. S&P / Case-Shiller Home Prices Composite
January 31, 2001 to October 31, 2010



Source: Bloomberg
Most recent data available as of publication date

Figure 4. Core PCE Inflation
January 31, 1990 to November 30, 2010



Source: Bloomberg
Most recent available data as of publication date

Our biggest concern is that while aggressive policy actions have stemmed the unraveling of the financial system and contributed to an impressive rally in risk assets, they so far have failed to jump-start the money and credit cycle necessary for a self-sustaining economic recovery. The essence of the problem is that consumers and businesses remain reluctant to borrow and banks don't seem to be in any hurry to lend. While there is some evidence in improvement in the shorter-term growth rates of the key monetary aggregates, the normal monetary transmission mechanisms remain clogged.

We're also concerned about the labor markets. After the loss of nearly 8½ million jobs in 2008 and 2009, private payrolls expanded at an average of only about 100,000 per month in 2010. This is not enough to accommodate the normal increase in the labor force, much less make much of a dent in the unemployment rate. Recent data suggest that

the situation is improving, as a number of indicators of job openings and hiring plans have turned up, and initial claims for unemployment insurance have declined [See Figure 2]. A recent Fed staff research paper estimates that QE2 will add roughly 700,000 jobs. But it will take considerable time before the labor markets return to anything resembling normal levels, and we'd be surprised if the unemployment rate fell much below 9.0% by the end of 2011. This headwind will dampen household income and confidence for many years.

On the housing front, the good news is that we expect the housing market to finally find a bottom in 2011. The bad news is that even though the economic data have generally improved over the last few months, housing has clearly lagged and appears to have turned down once again [See Figure 3] once artificial government support was withdrawn. A massive overhang of unsold homes remains on the market, not to mention a potentially large shadow inventory of foreclosed and soon-to-be-foreclosed properties waiting in the wings. A price decline of another 5.0% cannot be ruled out. Nevertheless, we believe that much of the negative news has been disseminated and we are encouraged by the improvement in affordability measures, even with the recent pop in mortgage rates.

As with our forecast for housing, we also expect inflation to mark a bottom in 2011. Inflation has trended downward over the last few years and is largely the result of low rates of resource utilization and the build-up of the output gap, which we currently estimate to be over 5½%. Wage growth has slowed along with inflation and recent data show consumer prices in the aggregate continuing to trend downward. For the 12 months ending in November, prices for personal consumption expenditures rose 1.0%, with core prices – the Fed's favored metric – up only 0.8% [See Figure 4]. We expect that core PCE inflation will bottom in the second quarter and move back toward the Fed's 1.7% - 2.0% target range by year end.

As we explained in last quarter's *Market Commentary*, another way to view QE2 is as a way to boost inflation – and more important, inflation expectations – at a time when a deflationary mindset was beginning to gain traction. Policymakers have clearly stated that since measured inflation is below their target, they prefer to rekindle animal spirits a bit and loosen up the still-constipated banking system by heading off the potentially self-fulfilling expectations of falling prices. The introduction of QE2, when combined with hints that M2 may be showing signs of life, gives us confidence that the Fed will be successful in moving inflation back toward its target. We believe the Fed will use all of the announced \$600 billion of QE2 by the expected June completion date, and that the funds rate will stay basically locked near zero for all of 2011.

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Fiscally, things get a little murkier. On the positive side, the Obama tax-cut package was bigger and broader than we expected and marked a much-needed swing of the political pendulum back toward the center. It definitely gave both the economy and markets added momentum going into the first half of 2011. But we remain skeptical about any meaningful progress this year on the longer-term budget issues that hang like the sword of Damocles over the United States as well as the dollar. P.J. O'Rourke neatly summed-up our thoughts on the outlook for Washington recently, "Democrats are the party that says government can make you richer, smarter, taller, and get the chickweed out of your lawn. Republicans complain that the government doesn't work, then get elected and prove it."

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Stocks and Bonds

Looking to the markets, risk assets faltered last spring when it appeared that stimulus might be removed, only to rebound sharply when it became clear that the reflation cycle was going to be extended. The S&P 500 – still a great proxy for our risk-on/risk-off world – gained over 20% from Bernanke's August 27 Jackson Hole speech to the end of the year. We think the index has scope to approach 1400 during the first half of the year, given that the Fed has only used about a quarter of its proposed \$600 billion. The second half of the year may prove more challenging. If the reflationary reboot is enough to overcome the secular headwinds and trigger a self-sustaining economic expansion, then no further stimulus will be needed. We're not convinced the stock market can continue its cyclical rally if the primary catalyst for the rally is withdrawn. And if the economy fails to reach that "escape velocity," then the hawkish additions to the FOMC and Congress (think Ron Paul) could make further stimulus problematic.

Treasury yields fell during the first nine months of 2010 as the economy weakened, approaching levels last seen during the flight-to-safety panic lows of the financial crisis. After it became clear that the Fed was intent on fighting deflation and the economy was gaining momentum, yields spiked in the fourth quarter. Benchmark 10yr Treasury yields jumped from below 2.40% in October to close the year around 3.30%. We believe the path of least resistance for yields remains higher and look for the 10yr to trade within a broad 3.0% - 4.0% range for

2011. Investment grade and high yield bonds remain attractive, and we find particular value in the bank loan market.

The markets, economy, and financial system continue to be buffeted by cyclical tailwinds and secular headwinds. Those tailwinds, generated by stimulus of almost incomprehensible scale, have clearly stiffened. There can be little argument that the reflationary efforts have helped us heal from the worst financial crisis in generations. The U.S. economy

is preparing to move from the recovery stage into expansion, modest though it may be. It looks as if housing and jobs may begin to improve this year. The credit system is starting to loosen up. Markets have turned, with some showing remarkable resilience. Things *are* getting better.

But secular headwinds remain, and they are relentless. The private sector has yet to resume its rightful place as the driver of economic growth. Balance sheets are still in need of repair. Jobs must be found. Savings have to be rebuilt. State and local budgets are a mess. The psychological water torture – the drip-drip-drip of debt deflation – has begun to take its toll. Citizens have looked to their leaders and are left wanting, resulting in a political pendulum that has whipsawed violently in only two short years. And people have had it up to here with the Federal Open Mouth Committee. 2010 was marked by the type of anger and frustration found when long-held hopes and dreams get challenged, or worse yet, shattered. Yes these are indeed highly uncertain and volatile times. 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.

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