

The Nine Most Terrifying Words in the English Language*

**Except, of course, for when you're really, really terrified to begin with. Then... not so much*

We've all no doubt become so familiar with the above quip by Ronald Reagan that we can complete the punch line from memory: All together now, "I'm from the government and I'm here to help." It was classic Reagan; a finely-crafted, often humorous comment neatly packaging a broader, deeper message. In fact, it's probably not too much of a stretch to think of his little bon mot as a reasonable representation of that era. Yet recently, as the nation became gripped by the worst financial crisis since The Great Depression, "government" has been cast in an entirely different light. The irony is almost palpable. That the view of government has flip-flopped so completely from problem to solution tells us a great deal about how converging cyclical forces will shape our economic and financial future. But we're getting ahead of ourselves. Let's take a look at how the heck we got here in the first place.

The National Bureau of Economic Research, the group that provides the official start and end dates for recessions in the United States, set the start of today's model as December 2007. Even after experiencing a variety of emotional spasms in the first eight months of 2008 – like the Bear Stearns deal, for instance – most policymakers and market participants still viewed this economic downturn as nothing more than of the normal cyclical variety. But the decision in September to allow Lehman Bros. to fail changed all that, and it led to unintended consequence number one. We'll leave for another time the debate about the wisdom of the move, but the result was that the flow of global capital literally dried up.

As prices for risk assets began to plummet, policymakers realized that we could potentially be on the precipice of something far greater than a normal cyclical recession, something unseen since the 1930s. Then-Treasury Secretary Henry Paulson and Fed Chairman Ben Bernanke believed a coordinated effort between the Fed, the Administration and Congress was needed to stem the tide, which led to unintended consequence number

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Figure 1. S&P 500 Index
June 30, 2008 - June 30, 2009



Source: Bloomberg

two. Realizing that we were now in the midst of something more than a garden variety recession, Paulson and Bernanke were convinced that a full-frontal coordinated fiscal and monetary counter-attack was necessary, and that the only way to herd the cats in Congress to act was to scare the bejeezus out of them. So the dynamic duo, in essence, screamed fire in a crowded movie theater. Unfortunately, the sight of our economic and political leaders freaking out caused all hell to break loose. A full-fledged panic ensued, which began feeding on itself as we entered the first quarter of 2009.

Financial markets are nothing if not the ultimate manifestation of human emotion. The self-feeding frenzy reached its zenith in March [see figure 1] and sharply abated in the second quarter when policymaker's efforts were deemed strong enough to prevent the end of the world. If the unintended consequence-led panic produced an overshoot in the first quarter, then perhaps the best way to view the second quarter is as unwinding the overshoot. Unfortunately, this is also the time when a virtual cottage industry sprung up, where everyone and their brother began frantically searching for "green shoots." So what are these green shoots and what do they have to do with another popular notion, the V-shaped economic recovery? And can they really be considered green shoots when they're arising as a result of

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Armageddon-level comparisons? We believe that the answer to these questions depends importantly on understanding what exactly is being unwound.

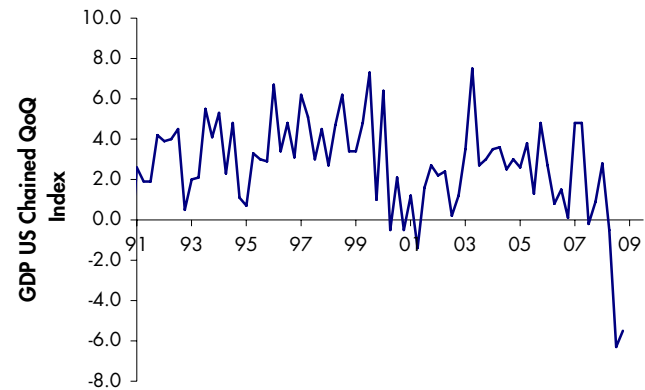
The phrase green shoots was coined by Federal Chairman Bernanke on 60 Minutes. Leave aside for the moment the question of whether it was appropriate for a sitting Chairman of the Fed to do such an up-close-and-personal on network television. The point is that he never referred to the green shoots in the economy that everyone is so desperately searching for; he was referring to green shoots in different markets. That everyone is so eager to expand his meaning beyond what he meant tells us a great deal about where we really are in the healing process. Hope is a thin economic reed.

Green shoot or thin reed, you have to hand it to Bernanke; the phrase is artful. It's calming. Green shoots suggest this is all simply part of the kind of normal seasonal transition that you see every year. Hey, what could be more natural than a winter thaw nourishing green shoots in the spring? You know; rebirth and all that. Nevertheless, we believe the phrase is dangerously misleading in that we aren't dealing with anything remotely resembling a normal, seasonal cycle. Readers of SCM's Market Commentary will recall that we believe something more secular in nature is unfolding and that the process is going to take longer than the phrase green shoots implies.

As we've chronicled in past Market Commentaries, the United States is in the process of correcting three highly-interconnected cycles of different timeframes. The first is the approximately 60 year cycle of demographically-charged debt accumulation. The second is the 25 year regulatory cycle best illustrated by the explosive growth and subsequent collapse of the shadow banking system. The third covers the last 10 years, where myriad monetary and fiscal policy errors needlessly pushed the global economy into the first coordinated financial crisis since the Great Depression. The second cycle fed upon and energized the first, while the third cycle fed upon and further supercharged the previous two. You could fill a book with details about each, but further elaboration is beyond the scope of this piece.

The clearly unsustainable nature of these three cycles laid the groundwork for the financial crisis, which in turn led to a mind-blowing amount of government stimulus to counteract it. Professor Friedman, meet Lord Keynes. How far and how fast these cycles correct remain to be seen. While most observers are finally beginning to get their arms around the cyclic issues that led us into the crisis, many remain in the dark about the financial and economic impact of the financial crisis. The widely-distributed paper by Reinhart and Rogoff, studying past financial crises, provides a sobering benchmark for how the crisis will continue to unfold. In a nutshell, it concludes more time and a more muted recovery than implied by green shoots, a conclusion also reached by San Francisco Fed President Janet Yellen in a recent speech. Add the sheer cost of the countercyclical stimulus efforts and the picture becomes positively surreal.

Figure 2. U.S. Gross Domestic Product
June 30, 1991 - March 31, 2009*



Source: Bloomberg

* Most recent data available as of press time

As we've often explained, we don't expect the type of demand follow-through implied by a V-shaped recovery [see figure 2]. Yes, it is likely that we could see a positive domestic GDP number before the end of the year, thanks to a rebuilding of depleted inventories along with improvement in net exports. (Remember that much of the emerging world only has to work its way through cyclic excesses, while we in developed countries will continue to struggle with secular excesses.) But a sustainable consumer-led domestic recovery is probably not in the cards. So far, the unprecedented stimulus may have eased some of the financial stress, but it has not meaningfully impacted domestic demand. And that gets to the very financial nature of the downturn.

This is a very different beast from anything that has been seen for decades. The financial headwinds are daunting. Deleveraging by both consumers as well as the financial system itself – the literal weaning off the steroidal juice that drove the economy for too long – will continue for years. The wealth destruction from cratering home prices and asset portfolios, when coupled with the damage inflicted to the financial infrastructure, will leave consumers wary in a once-bitten-twice-shy sort of way for a long time. The jobs situation promises to stay ugly well past the peak in the unemployment rate, which we don't expect until well into 2010 at a level approaching 11% [see figure 3]. Wages and salaries, hours worked, the duration of unemployment and the level of underemployed will weigh on consumers for an extended time thereafter, and will help mute demand.

A recent series of economic data, released late in the second quarter, tells you all you need to know about the current situation. Personal Income rose 1.4% in May, while Personal Spending rose only 0.3%, which in turn lifted the savings rate to a 16 year high of 6.9%. Scratching the surface a bit, you find that the wages and salaries component has fallen the most

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Figure 3. U.S. Unemployment Index

US Unemployment Rate Total in Labor Force Seasonably Adjusted
July 31, 1989 - June 30, 2009



Source: Bloomberg

in the 50 year history of the series, and that the only reason income rose at all was because fully 18% of it was composed of government transfers and the stimulus efforts. So think about it; the government increased its debt in an effort to get the consumer to spend, but all that was actually accomplished was for consumers to take the money and save it. In effect, the government traded private debt for public debt.

This is called a liquidity trap, folks. Policymakers throw money at a problem to spur activity and it does not get used for the intended purpose. The same thing is happening with the monetary side, as the Fed has literally drenched the system with liquidity only to find that it has ended up sitting in the form of excess reserves, not lent. As for the inflationary impacts of Quantitative Easing... just ask Japan.

The government is effectively underwriting the financial system. Don't get us wrong, monetary and fiscal stimulus is exactly the correct remedy. Without it the financial crisis would have been even more of a catastrophe and the global recession would have been deeper and longer. It's just that we caution against letting expectations about the economy get too rosy now that it appears the worst of the financial crisis may be behind us. Complacency can be dangerous.

The challenges for the domestic economy will be formidable. As outlined above, we are now entering a period where the economy – already burdened by a high degree of economic slack – will face significant headwinds from financial restructuring. When you layer on a greater level of government intervention in the form of increased regulation, health care reform and higher taxes, it's hard to see where anything more than tepid economic growth is likely. While this should help place a lid on earnings and profit margins, it isn't necessarily a disaster for financial assets. As we've described before, inflation should

not be an issue over the foreseeable future, despite the hue and cry to the contrary, and we believe monetary and fiscal policy will remain stimulative longer than is currently built into market expectations.

There has been increasing chatter of late about the difficulty surrounding the removal of the government stimulus, the so-called "exit strategy." No doubt the timing will be tricky, but the lessons of history are clear. Policy errors in both the Great Depression and 1990s Japan should be seared into policymaker's minds. The urge to declare victory and move back to more "normal" policies will be strong, but a sudden fit of fiscal austerity would be a mistake. Even though it won't be easy, that urge needs to be resisted. Yes, the sheer size and cost of running deficits may eventually pressure the long end of the yield curve as well as the dollar. And hopefully, our economy and the financial system will be repaired enough to handle it at that time. But it's not today's problem. Much of the stimulus at the federal level is being offset at the state and local level. For right now, we believe it's entirely premature to be concerned. Other issues predominate.

So we've entered an era where the image of government has evolved from problem to solution. But markets and economies are always evolving, always adapting. In fact, it's helpful to think of them as complex, adaptive systems. We're going to have to live with, and adapt to the consequences – intended or otherwise – of correcting numerous cyclic excesses at the same time that we also have to deal with the effects a serious financial crisis and its attendant unprecedented countermeasures. Complex it is.

Some have taken to calling this The New Normal. Could be, but at the very least, it should be abundantly clear that we are not simply emerging from the normal type of winter implied by the phrase green shoots. Oscar Wilde once said "Life imitates art far more than art imitates life." It's our fervent hope that government-as-the-solution doesn't create a kind of unintended extended nuclear winter, where today's green shoots grow into disfigured Salvador Dali-like surrealist mutations. But however it turns out, whether it's uncertainty over green shoots, or alphabet-shaped recoveries, liquidity traps or exit strategies, we at SCM are certain about one thing: 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.

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

Fueled by signs of economic stability, equity markets rallied substantially in the second quarter of 2009. The broader market returns were the largest in almost ten years and were based on hopes of a trough in economic activity. Bulls were supported by encouraging reads such as the ISM Manufacturing Index (five months of consecutive increases), stronger than expected Durable Goods orders, an increase in the Conference Board Leading Economic Index and signs of stability within the housing market. Investors responded by ratcheting up their risk tolerance with each above consensus data point. Given prevailing market levels and poor sentiment, the impact on equity market returns was significant. To be fair, most of the gains came early. The market lost momentum late in the quarter as the Consumer Confidence Index ebbed and unemployment rates ticked higher. While data points remain volatile, it is clear the economy made progress towards stabilization this quarter. Broadly speaking, risk assets performed exceptionally well, with equities significantly outperforming bonds, emerging markets significantly outperforming developed markets, and small caps significantly outperforming large caps.

Equity COMMENTARY

We wrote last quarter that forecasting profit levels given the current environment is, at best, a formidable challenge. Unfortunately, not much has changed on that front as visibility remains limited. As growth stock investors we seek to find levels of profitability not fully recognized by the market in either scale or sustainability. We find it encouraging, at least, that profit (earnings) revisions have turned positive for the first time in well over a year. Consensus estimates for both

2009 and 2010 have risen in recent weeks. Positive revisions have been greater in the growthier segments of the market, adding credence to the significant outperformance of 'growth' over 'value' stocks. We are well aware that these more optimistic forecasts may be a function of previously overly pessimistic assumptions or unsustainable dynamics (i.e. inventory builds) coming out of the nuclear winter of economic activity preceding this quarter, but the trend is promising. Equally encouraging was the continuation of some market characteristics we highlighted last quarter: correlations amongst asset classes and between equity sectors continued to fall and valuation disparities continued to widen. A more discerning market is a welcome sign.

Market Outlook

The effect of the largest global policy stimulus package ever continues to work its way through the market. Only a few short months ago we were discussing the potential of a complete systemic failure of our financial system. Progress has certainly been made. This alone justifies the current rally, but equity investors should not count on outsized gains based solely on a slowing rate of decline. A sustained market recovery will require a move beyond the current stabilization phase and into a growth phase. Undoubtedly, this will take time. It is one thing for the recession to end, quite another to return to a more normalized level of growth.

Moving from the later stages of contraction to the early stages of growth is typically accompanied by messy and uneven equity returns. Our current transition should be no different. The improvements we have witnessed recently are warranted, but shouldn't be uniform. Profit growth will be elusive and at a premium, thus we expect our growth-biased approach to continue to outpace the broader market. While we continue to feel we have seen the worst of the cycle, the market backdrop remains highly volatile and uncertain. We are intensely focused on the effectiveness of the global stimulus packages not only stabilizing world economies, but facilitating a sustained recovery in output.

Investors in risk assets will have to factor into their forecasts several secular concerns (tighter credit, higher savings rates, increased regulation, etc.) We believe efficiently navigating these concerns, while taking advantage of cyclic opportunities, will be the key to generating returns in the equity markets in the near term. The investment professionals here at SCM 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 with you in greater detail and welcome any questions and comments you may have.

Getting to Know SCM Advisors : Meet Doug Couden, Director of Equity



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.

Doug Couden is one SCM's longest tenured employees, having been with the firm for over 12 years. Doug has been an integral part of the maturation of SCM over the years and is currently a member of the firm's Executive Committee and head of its Equity division. Doug has been quoted in several publications and news services and maintains a visible presence in the financial community.

Prior to joining SCM, Doug worked as a Business Analyst with Paine Webber in New York. Doug received his B.A. from Southern Methodist University and holds the Chartered Financial Analyst designation.

Doug is married with two daughters and resides in the Bay Area.