



SILVERCREST  
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## JOCKEYING FOR POSITION: THE U.S. ECONOMY AND THE DOLLAR

Legitimate issues are being raised about how the U.S. will deal with the sharp rise in its deficit and escalating national debt. Pragmatically, there are no effective short-term remedies other than tax increases, on both income and consumption. However, such additional burdens at a time of high unemployment and a fragile economic recovery are neither practical nor politically feasible. In fact, there is almost growing resignation that increased income taxes on so-called high income earners would be enacted before the end of this year. Nonetheless, if all current proposals are adopted, the budgetary deficit will remain huge through at least 2011. This makes it likely that a broad consumption tax—similar to the VAT imposed by 23 of 28 OECD countries—may be actively pursued once the economic recovery is firmly in place. There are no reliable estimates of revenues a VAT would generate, since several areas of consumption (food, healthcare, etc.) might be exempted. A ballpark figure of a modified 6% VAT could produce an annual intake in a range of \$140 - \$200 billion.

For the U.S., there are several unfolding trends that may help alleviate the deficit problem. First, although the downturn has not caused consumption to collapse, as had generally been expected, personal debt is nonetheless being reduced at a rapid pace. Given the high level of unemployment, a return to a “borrow and spend” mindset may be several years in the future. Second, business taxes are recovering more rapidly than during prior rebounds, helped by the strong upturn in profit margins. Third, there appears to be a respectable revival in manufacturing, in part spawned by exports to the emerging countries; this should continue to reduce the trade deficit, as it has the past four years. Fourth, corporate America is accumulating cash at a record pace which may provide various benefits on the sovereign borrowing front.

The other issue in the debate concerns the stability of the credit markets and the status of the dollar, both as it pertains to the greenback’s value and its role as a reserve currency. This focus on the dollar’s shortcomings ignores two key considerations: (1) the absence of a viable substitute; and (2) the myriad currency and economic problems that other major players face.

At present, the Eurozone must deal with the survival of its currency in the face of severe fiscal crises in Greece, Spain, Ireland, Portugal and Italy, a problem aggravated by aggressive demands from organized labor in these countries. These pressures are likely to grant the U.S. a bit of a privileged position and provide the dollar with a measure of support, at least in the short and intermediate term.

Thus far, the viable members of the Eurozone have been silent about what measures, if any, they would propose to address the crisis, perhaps because aid provided one member in distress would have to be extended to others facing similar conditions. The International Monetary Fund

(IMF), often called upon to help when sovereign nations encounter financial distress, has also refrained from making comforting pronouncements.

Two currencies often cited as potential candidates to be part of a reserve “basket”, the yen and the yuan, have their own problems that disqualify their candidacy. Japan’s fiscal condition, together with its weak domestic economy and insular social policies, compromise its potential as a serious contender. China, which recently began to address its overheated economy, will not likely have a freely convertible currency for several years perhaps due to concern that this could expose the economy’s structural weaknesses, particularly pertaining to the viability of government-owned businesses operated to support employment rather than to generate true accounting profits.

All of the above aside, we believe that the U.S. stock market is reasonably valued even by conservative metrics. These include corporate balance sheets that are in the best shape in several decades, including record cash positions that have nearly doubled over the past six years; an apparent revival in manufacturing; robust and improving margins; timid organized labor; and low interest rates and inflation. Hence, it would be difficult to be pessimistic on prospects for profits and the stock market. An additional supporting consideration is that U.S. equities have become underowned both in the U.S. and abroad following a long period of liquidation.

Alternatives on the roster of investments do not appear so enticing. Non-U.S. equities are no cheaper than the domestic ones, if subjected to analytical purification. Fixed income does not provide enough return to protect against even mild inflation anywhere around the world. Real estate may take time to heal and, even then, investors may not be as willing to rely on historical returns as in the past, while lenders may be constrained by capital limitations.

Our conclusion is that the U.S. (and the dollar) may be emerging as the “least bad” of all major alternatives in the investment arena. This has been the case for a long time. The dollar’s value on a trade-weighted basis over an extended period confirms its resiliency, having recently encountered support at the same relative level as in mid-2009, late 2008, mid-2007, toward the close of 2004 and in late 1995. During most of this 15-year span it often traded much higher than at present.

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