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## STORMS, POTHoles, & SPEED BUMPS

Initially frustrated by the inability and unwillingness of congressional factions to reach a compromise on raising the limit on the national debt, the stock market has sustained a follow-up shock with the surprise downward revision of key U.S. economic data. The significant reductions, indicating that the recovery has been much more timid than initially reported, raised once again the threat of a double-dip recession in the near future. If this comes to pass, it would be the first time since the Second World War that the economy relapsed without first making a full recovery and entering an expansion phase.

Economic downturns are nearly always triggered by excesses and imbalances, most of which typically reflected a decline on the consumption/production end. This was the case with the last recession (2008-9), with the culprits being a housing bubble, elevated debt, and distressed financial institutions. While some problems remain in each of these areas, they have experienced considerable healing and may now be on a path to recovery. Nonetheless, the public sector, with unmanageable debt and record deficits, continues as a threat to fiscal probity, and will likely limit the upward elasticity of both the U.S. economy and the stock market.

In the whirlwind of pressing domestic and global events, some important considerations seem to be ignored. The sense of urgency and almost surgical precision with which the financial crisis was approached speak to the ability of the U.S. to find acceptable solutions and compromises when pressed. Contrast this approach to the protracted debates, negotiations, and distressingly complicated plans being proposed by the eurozone to deal with a much smaller debt crisis, and it becomes clear that the U.S. reputation for creative management is well-deserved. This view holds true even in the face of Washington's seemingly interminable political jockeying on the national debt in recent weeks.

The views expressed above are reinforced by many considerations that challenge some of the dire forecasts of pessimists:

- (1) There are currently very few imbalances in the demand/supply chain that typically provide the basis for a downturn. Inventories are in relatively good balance. Manufacturing capacity, having lagged in the prior expansion, is not excessive. Managements are moving cautiously and acting prudently on nearly all fronts. Finally, wages remain steady, allowing businesses to improve their profitability.
- (2) Despite a temporary spike in inflation earlier this year, as commodity prices escalated, a significant retracement is in progress. This, together with sluggish employment data, reduces the pressure on the Federal Reserve Board to raise interest rates or to embark on monetary restraint. The most recent downward revision in GDP growth likely delays any future action to late 2012 or beyond.

- (3) Congressional action on the national debt represents a merciful compromise by limiting somewhat the growth of government but not excessively reducing spending at a time when the economy needs the benefits from spending support. The legislation, as approved, may compel Washington to reset priorities, notably reducing defense outlays and costly foreign interventions and curbing inefficiencies. While the legislation that emerged is far from ideal, it is still a small step in the right direction.
- (4) There is growing evidence that some manufacturing activity is being repatriated for a variety of reasons. On the U.S. end, moderate wages, transparency in regulations, hospitable arrangements with local governments, quality control, timely delivery, etc. are being cited as some of the reasons for this change in policy. Major companies such as Texas Instrument and Intel, as well as auto parts manufacturers, have in recent months announced the establishment of new production facilities in the U.S., their first in a decade or longer.
- (5) Corporate America is awash in cash. Most recent data shows nearly \$1.5 trillion on balance sheets, although more than 60% is sheltered from taxes outside the U.S. Pressure is growing on Washington to allow repatriation at a low top rate of perhaps 6%-7%. These funds are not needed for capital projects as ongoing cash flow is sufficient to meet capital spending needs. It seems likely that a portion of these funds would be deployed for acquisitions, stock repurchases, dividends, etc., all of which can be supportive of the stock market.
- (6) More than a decade-long liquidation of U.S. stocks by a wide range of investors (individuals, foreign, institutions, retirement plans, etc.) have left them underweight in the world's most liquid market, with record profits, strong finances, and global presence. With alternative investments having proven not to possess the claimed superiority of returns or risk containment, and fixed income arguably exposed to a greater potential downside than equities, some return to U.S. stocks is likely to occur in short order.
- (7) Measured by any reasonable yardstick, the U.S. stock market is arguably the cheapest major asset, risks considered. We are currently projecting S&P earnings of \$94 for 2011 and \$102 for 2012, for a P/E ratio of 13.2x and 12.2x, respectively. Adjusting for net cash on the balance sheets, these ratios decline to 12.2x and 11.2x compared to more than 15x for a long-term average. These calculations do not factor in the Fed model equation that incorporates interest rates and that would almost double the imputed P/E ratio even after recognizing a risk premium of 500bp.
- (8) While concern over the status of the U.S. dollar is justified, it is likely to remain the reserve currency of choice given the near-failure of the euro, the artificial status of the yen and the difficulty in creating a viable basket of currencies as a substitute. Both the yen and the yuan will likely encounter difficulties in due course as the former must deal with fiscal problems far more pressing than ours and the latter with the consequences of aggressively rising expectations in China.

Partly based on the foregoing, we assign a very high probability to a forecast of below trendline growth for the next 12-18 months, mainly supported by modest gains in personal consumption, firm capital spending, continued sluggish recovery in employment, reduced government outlays with defense as a prime victim, and a slight improvement in net trade. (See attached detailed forecast).

Can the U.S. lapse into a recession in coming months? It would be irresponsible to entirely dismiss the possibility in the face of what appears to be severely adverse public sentiment, but we attach a probability of less than 20% to such an outcome. Should it occur, it is likely to be brief and shallow and be viewed, at least by some academics, as an extension of the 2008-2009 downturn.

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## Economic Forecast

(As of August 4, 2011)

	<u>2009</u>	<u>2010</u>	Estimated <u>2011</u>	Projected <u>2012</u>
Real GDP (Y-O-Y)	(2.6%)	3.0%	1.9%	2.6%
Real Consumption Expenditures	(1.2%)	2.0%	2.1%	2.4%
Business Fixed Investment	(17.1%)	4.4%	7.0%	7.0%
Inventory Investment (Billions)	(\$113.1)	\$58.8	\$53.0	\$45.0
Residential Investment	(4.3%)	(1.6%)	4.4%	5.6%
Government Spending* (Billions) (a)	\$2,546.4	\$2,562.9	\$2,516.4	\$2,526.0
Trade Balance-Goods & Services (Mil.)	(\$363.0)	(\$421.8)	(\$405.0)	(\$400.0)
Federal Budget*: Unified (Billions)	(\$1,413.8)	(\$1,294.2)	(\$1,300.0)	(\$1,065.0)
Gross Federal Debt* (Billions)	\$11,910	\$13,167	\$14,467	\$15,617
Consumption Price Deflator	0.2%	1.8%	2.8%	2.6%
Producer Price Index (Finished Goods)	(2.6%)	4.2%	5.7%	4.2%
Consumer Price Index	(0.3%)	1.6%	3.3%	2.8%
Industrial Production	(11.2%)	5.3%	3.9%	4.2%
Real Disposable Income	0.6%	1.8%	1.8%	2.8%
Hourly Compensation	2.0%	2.2%	2.1%	2.8%
Unit Labor Cost (Non-Farm)	(1.6%)	(1.6%)	0.6%	1.0%
Productivity Growth (% Change)	3.7%	3.8%	2.8%	1.4%
Personal Savings Rate (% DPI)	5.9%	5.3%	5.5%	5.6%
Capacity Utilization – Total Industry	69.2%	74.5%	77.0%	79.0%
Trade Weighted \$ Exchange Rate (b)	4.7%	(3.0%)	(7.8%)	2.0%
Vehicle Sales (Million Units)	10.3	11.5	12.4	12.8
Housing Starts (Million Units)	0.554	0.585	0.592	0.725
Civilian Employment (Millions)	139.9	139.1	139.8	141.6
Civilian Unemployment Rate	9.3%	9.6%	9.1%	8.6%
Corporate Profits – After Tax – NIPA	3.6%	19.0%	10.1%	11.0%
S&P-500 Earnings-Operating	\$65.26	\$86.73	\$94.00	\$102.00
S&P-500 Dividends	\$24.20	\$24.50	\$26.25	\$28.00
90 Day U.S. Treasuries-Yield (%)	0.01-0.32	0.03-0.18	0.05-0.80	0.50-1.30
10-Year U.S. Treasuries-Yield (%)	2.20-3.95	2.39-3.99	2.60-3.40	3.35-4.20

*\*Fiscal Year-end 9/30. (a) Federal, State, and Local; in 2005 dollars; (b) Fed Major Currency Exchange Rate.*