SILVERCREST
ASSET MANAGEMENT GROUP

ECONOMIC REVIEW AND INVESTMENT STRATEGY: 2006/I

Predictable surprises

With the current economic expansion in the United States approaching middle age on the actuarial table, questions are being raised about its longevity and vigor, most notably the timing of the next downturn. The debate is being framed as if business cycles are pre-ordained by some immutable celestial order, rather than shaped by events with often unpredictable and unquantifiable consequences. That the history of business expansions and contractions has departed from any rigid timetable in recent decades seems to be lost in a maze of incoherent babble packaged as received wisdom. As the record confirms, recessions have become shorter and shallower while expansions have grown longer and more robust.

It would be dangerous, of course, to declare that business cycles have been repealed. However, there is growing and convincing evidence that fluctuations have become less severe due to sweeping changes that are rapidly redefining the traditional relationships among the various economic forces within nations and among them. Some understanding of such a transformation should alleviate many of the concerns vehemently espoused by the pessimists.

Globalization is arguably the trend with the most far-reaching consequences. While it has been unfolding gradually for many decades, it has gained considerable momentum since the collapse of the Soviet Union as many countries sought to rapidly integrate into the global economy. Such aspirations have provoked competitive pressures to improve and excel on many fronts, from the reshaping of socio-political institutions in Eastern Europe to industrial restructuring almost everywhere, with favorable and, so far, visible benefits to living standards and on the inflation front. More important has been a rapid expansion in the consumer class, not only in the liberated regions of Europe but across a larger swath of Asia, notably in China and India.

Globalization has, of course, clearly ordained a more open architecture on many levels. It has facilitated the flow of capital across borders as a result of which interest rates have settled in a lower and tighter range. It has also caused the pricing of goods and services to have less variability among various markets. More relevant, capacity in any specific industry is no longer measured locally for planning purposes, but is rather viewed globally for more efficient control.

Technology has been an important ingredient in globalization by reducing cyclical volatility, having become easily transportable and more readily replicated than old smokestack facilities. Technology's benefits can be captured rapidly which has attracted a new generation of innovative and eager adherents. By many measures, it has compounded geometrically the pace of efficiency in a wide range of businesses, from the factory floor to administrative functions. The rapid evolution in telecommunications and data transmission, for instance, has all but demolished most national borders in the exchange and processing of information. A by-product of this revolution has been the effective elimination of the much-feared inventory cycle which in the past had either triggered or deepened downturns.

With heavy manufacturing continuing to lose ground to services, and consumption capturing a growing portion of economic activity even within developing countries, large swings in the supply/demand balance, a primary cause of recessions, have all but disappeared. In addition, the growing importance of government spending to meet commitments under various social contracts and for defense purposes has added another source of stability. In many of the developed countries, government expenditures currently total 30% or more of Gross Domestic Product.

No less significant has been the changing approach of business managers worldwide, particularly their awareness of global competition and the need to keep costs under control. This has resulted in less volatility on the employment front, as suggested by the record of the current expansion in the U.S. which has generated less of a rebound in manufacturing job creation than at a similar stage in prior economic upturns. Such discipline has extended to the addition of new production capacity which, so far, has trailed behind prior recoveries.

The combination of globalization, technology, and a more disciplined approach by managements, along with the declining importance of cyclical manufacturing and the expansion of a new consumer class, has been instrumental in creating an economic climate characterized by greater stability than at any other time in modern history. It has kept inflation under good control and can thus be credited with holding interest rates within a manageable range. Collectively, these benefits have helped businesses raise profits without making full use of their pricing power and strengthened corporate balance sheets which are now in the best shape in more than 40 years in the United States, with other countries not far behind. Even with all of these favorable attributes, managements seem reluctant to raise the risk profile of their businesses, preferring to protect their profit margins through cost-containment rather than through higher prices or other unreliable measures.

It has been almost 15 years since the United Kingdom, Canada and Australia have experienced a recession, and it would be logical to attribute such good fortune to the linkage among these three English-speaking countries. This list should grow longer in due course as global integration continues through more fluid cross-border transactions in goods, capital and the exchange of knowledge, creating a more level field that would contain inflation and interest rates, two key causes of economic volatility.

Recessions are the product of excesses and imbalances that undermine the foundation of an already compromised economy. We see none of the preludes of a downturn lurking in the background. Exogenous accidents do happen, but recent experiences suggest that they merely provoke a passing reaction rather than a long-lasting, debilitating response. During the decade of the 1990s, events such as the Mexican currency crisis, the Russian meltdown, and the Long-Term Capital Management collapse, made quick headlines that quickly turned into mere historical footnotes.

THE ECONOMY: STRANGE INTERLUDE

The U.S. economy overcame a mountain of gloom and many potholes in 2005 to come through victorious. Growth far exceeded early projections, profits and margins challenged the pessimists, the dollar damned the doubters and long-term interest rates bedeviled nearly all forecasters. Whether a repeat of this performance is possible in the coming year depends on how some important trends continue to evolve and what non-economic events unfold.

Two key pillars are likely to keep business activity on a reliable growth trajectory well into 2006: outlays for plants and equipment and government spending. These two engines, which together generate nearly 40% of the GDP in the U.S., have been particularly robust and promise to continue their above-trend contributions. Business spending, in particular, has been slow in making up ground lost in the last recession and remains well behind the average pace of past recoveries relative to its lifespan and magnitude. However, rapid obsolescence, particularly on the technology front, and a desire to protect profit margins by substituting more efficient machines for labor, have finally persuaded corporate managements to cautiously deploy a mounting cash horde on their balance sheets for new production facilities. Meanwhile, the slow pace of the rebound compared with the past almost guarantees a stretched demand cycle for capital goods.

The elevated level of government spending is dictated by conditions that cannot be readily reversed. These include the cost of addressing the conflict in Iraq, the rebuilding of large areas demolished by the hurricanes, and the swelling expenses arising from Medicare and other entitlement programs. On the state and local levels, generally improved fiscal conditions are making it politically challenging to ignore deteriorating infrastructures.

In combination, these two sources of economic activity are growing at seven percent or more and should provide an offset to personal consumption, which may become less vigorous due to a waning housing sector, and a less eager consumer who is repeatedly admonished about anemic savings and warned of a possible reversal of recent appreciation in home prices.

Despite continued favorable data on housing starts, there is reason to be less optimistic about the residential real estate sector. We see a slow, moderate retreat rather than a rapid collapse for several obvious reasons. First, mortgage rates are not likely to reach punitive levels because of abundant liquidity in the financial system. Second, demographics support about 1.7-1.8 million annual housing starts, a level above that attained during the general boom of the 1990s. Third, proposed new guidelines on mortgages are intended to reduce the excessive risk recently allowed by lenders; their impact should be limited to marginal borrowers. Finally, the home construction industry has consolidated in recent years and is now in a much better financial shape to deal with an orderly but moderate downturn.

Interest rates are unlikely to provide any surprises. With inflationary pressures easing following a sudden jump provoked by the spike in energy costs, the Federal Reserve Board may not feel under pressure to be particularly aggressive in its restraint out of concern that growth remains above its long-term pace. Chairman-elect Bernanke may wish to burnish his credibility as a disciplined central banker and an inflation hawk by lifting rates a bit more early in his term, but such action will incur no significant damage given the abundant liquidity in the financial system and the steady stream of private foreign capital seeking a home in the United States.

The recent inversion of the yield curve, with the yield on two-year U.S. Treasury obligations rising slightly above that of the 10-year, has attracted attention because it is presumed to provide historical evidence in support of a forthcoming economic downturn. We disagree with such a knee-jerk conclusion, noting that recessions occur because of a linkage among many factors not now on the radar screen. First, Fed action over the past 18 months has raised only short-term rates, with absolutely no response on the long end; in fact, rates on the 10-year notes are lower today than they were when the Fed embarked on its "return to neutrality" process. Second, the central bank did not act primarily to contain inflation but to reverse the aggressive stimulus (not fully warranted, in our opinion) that it provided during the recession and to reload its cannons in case it needs to ease in the future. Third, long-term rates have remained relatively low because the private sector is awash in liquidity and because foreign lenders have been eager buyers of U.S. debt. Fourth, real yields in the U.S. are higher than elsewhere even though productivity growth remains robust for this stage of the cycle, with favorable implications for inflation. Finally, there have been several instances over the past 20 years of a flat or slightly inverted yield curve that did not end up precipitating a downturn or a meaningful slowdown.

For more than a year, the dollar has held firm or has risen against nearly all relevant currencies, and we suspect that it is not likely to come under pressure until many of its current supports reverse or crumble. With growth in the U.S. far superior to that of other industrialized countries, with interest rates higher, and with most policymakers elsewhere pursuing various strategies to keep their currencies at relatively low levels to gain trade advantages, the outlook for the greenback is for continued stability or further moderate appreciation in the foreseeable future. This, however, does not remove the long-term danger in not addressing the imbalances that have carried the trade deficit to unreasonable heights.

In summary, we conclude that in 2006: (1) the U.S. economy will continue to grow at a solid pace; (2) inflation will retreat moderately as some of the spike in the cost of energy fades; (3) interest rates will creep up, mainly on the short end of the yield curve; (4) corporate profits will continue to rise but at a slowing pace; (5) the dollar will remain stable or improve marginally on a trade-weighted basis; and (6) investors will shed their jaundiced view of U.S. stocks as they recognize their favorable reward/risk profile.

Investment Strategy: The Case of the Sedated Bull

The key domestic stock averages struggled throughout 2005 to achieve very modest gains. Their unremarkable returns, for a second consecutive year, ignored robust economic growth, strong gains in profits, contained inflationary pressures despite a sharp increase in energy prices, solid productivity, unthreatening interest rates and a recovery in the dollar. During the past two years, corporate earnings have risen by 40%, easily eclipsing a total advance of 12.3% in the Standard & Poor's 500, 2.5% in the Dow Jones Industrial Average and 10% in the NASDAQ. This sluggish performance has caused a steep decline in absolute valuations, to a level not seen in nearly 10 years. At about 15-times estimated next 12-month earnings, the Standard & Poor's 500 last traded at this ratio in 1993-95 when interest rates on 10-year U.S. Treasury Notes were more than two percentage points higher than they are at present. The obvious conclusion that may be drawn from such disparity is that investors have been reluctant to recognize the full measure of the economic expansion and instead seem to be focusing on some transitory factors making headlines in the popular press, particularly those pregnant with political passion.

A key consequence of the state of mind noted above is that a great deal of risk has been taken out of domestic stocks. Bear markets rarely develop from valuation levels that are defensible on a fundamental basis. Each of the major declines of the past 60 years (2000-2001, 1991, 1987, 1973-74) was triggered mainly by unsupportable valuations aggravated by other deleterious events. Such is not the case at present, in our opinion.

In 2006, the U.S. stock market should be driven by moderately higher business profits early in the year, and a probable end to Fed tightening by midyear. Reduced deployment of troops in Iraq should also alleviate the tensions provoked by this unhappy adventure. Finally, a possible absence of severe hurricanes, a measure of conservation, and the resumption of normal production in the Gulf of Mexico may well contain or possibly reduce energy prices, with favorable consequences for inflation and corporate profits. With most global stock markets up strongly in the past year or longer, and foreign investors seriously under-invested in the U.S., it would be consistent with past experiences for a shift in global sentiment in favor of American stocks. Early evidence from fund flows in recent weeks supports this conclusion. In brief, we find ample reasons for optimism in the coming year with most surprises likely favoring the upside.

Many of the sectors that delivered superior returns in 2005 are not likely to be candidates for a repeat performance in the coming year. In particular, additions to the energy group and other industrial commodities should be deferred. Utilities and transportation, which have recorded two consecutive years of stellar gains that have driven them close to full valuation, should be scaled back. While financials are not notably overpriced, they are likely to remain rangebound out of fear of rising interest rates in coming months.

As we enter 2006, market leadership should favor the health care group, mainly large pharmaceutical companies whose prospects have recently stabilized. In addition, mid- and large-cap technology companies, which are no longer trading at premium valuations, should attract attention as they benefit from a rejuvenated spending cycle. With backlogs mounting at a hefty clip, the aerospace sector remains attractive despite warnings of cutbacks on the defense spending. Finally, a laggard group of diversified mega-cap companies, whose shares have trailed the broad indices despite solid operating results, may well be rediscovered as a safe haven with superior prospects.

As the year unfolds, new opportunities will no doubt come to the fore. A hint that the Fed may be approaching the end of tightening should spark renewed interest in a variety of financial intermediaries, while a material drop in energy prices may well be misread as a reversal, presenting a new entry point.

With the U.S. economy continuing to generate solid growth, and the Fed apparently not prepared to concede that it has achieved "neutrality," additional hikes in short-term interest rates cannot be avoided. As a result, we remain cautious in our fixed income strategy, preferring investments with shorter maturities and superior quality. On the corporate side, we continue to favor high-grade instruments since spreads on the lower end do not appear to justify the added risk.

January 1, 2006

Stanley A. Nabi, CFA
Vice Chairman

ECONOMIC FORECAST
(As of January 1, 2006)

	2003	2004	Estimated 2005	Projected 2006
Real GDP (Ann. % Change)	2.7%	4.2%	3.6%	3.2%
Real Consumption Expenditures	2.9%	3.9%	3.5%	2.9%
Business Fixed Investment	1.3%	9.4%	8.7%	7.0%
Inventory Investment (Billions)	$15.5	$52.0	$18.5	$29.0
Residential Construction (Billions)	$509.4	$561.8	$602.0	$590.0
Government Spending (Billions) (a)	$1911.1	$1,952.1	$1998.0	$2055.0
Trade Balance-Goods & Services	($494.8)	($617.6)	($710.0)	($775.0)
Federal Budget*: Unified (Billions)	($374.3)	($412.8)	($318.5)	($435.0)
GDP Deflator	2.0%	2.6%	2.8%	3.0%
Producer Price Index (Fished Goods)	3.2%	3.6%	4.7%	4.0%
Consumer Price Index	2.3%	2.7%	3.4%	3.3%
Industrial Production	0.6%	4.1%	3.1%	3.4%
Real Disposable Income	1.9%	3.4%	1.5%	2.9%
Hourly Compensation	4.0%	4.5%	5.1%	4.9%
Unit Labor Costs (Non-Farm)	0.2%	1.1%	2.2%	2.2%
Productivity Growth (% Change)	3.8%	3.4%	2.9%	2.7%
Personal Savings Rate (% DPI)	2.1%	1.7%	(0.4%)	0.0%
Capacity Utilization – Total Industry	75.5%	78.1%	79.8%	80.9%
Trade Weighted $ Exchange Rate (b)	(12.2%)	(8.2%)	(1.0%)	1.0%
Vehicle Sales (Million Units)	16.7	16.9	16.7	16.5
Housing Starts (Million Units)	1.854	1.950	2.040	1.900
Civilian Employment (Millions)	137.736	139.252	141.5	143.3
Civilian Unemployment Rate	6.0%	5.5%	5.1%	4.8%
Corporate Profits - AT-NIPA	28.2%	11.8%	31.8%	6.3%
S&P-500 Earnings-Reported	$48.80	$58.45	$67.25	$73.50
S&P-500 Earnings-Operating	$55.55	$66.99	$75.40	$81.50
S&P-500 Dividends	$17.60	$19.25	$21.00	$22.25
90 Day U.S. Treasuries-Yield (%)	1.40-0.75	0.86-2.25	2.25-4.03	3.80-4.80
10-Year U.S. Treasuries-Yield (%)	3.17-4.55	3.68-4.87	3.89-4.66	4.25-5.00

**Fiscal Year-end 9/30. (a) Federal, State, and Local; in 2000 dollars; (b) Fed Major Currency Exchange Rate.*