



SILVERCREST  
ASSET MANAGEMENT GROUP

## ECONOMIC REVIEW AND INVESTMENT STRATEGY: 2007/I

### HOW TO TAME A PAPER TIGER

The intensive preoccupation with Iran and the erratic behavior of its government and leaders seem to be leaving the impression that the country is a pivotal player on the global stage, and hence its views and actions should be deserving of the most serious attention. By falling into this trap, the world is confirming Iran's inflated assessment of its own importance and, in the process, encouraging an escalation in its devious and destructive activities. A more passive form of engagement may well serve to deliver the message that its errant conduct would ultimately leave it isolated and in danger.

Iran's main claim to fame is that it sits on substantial oil reserves which it has managed to use amply as a political and economic tool. If not properly managed, this natural wealth can have its downside as seems likely in its case. At a time of high prices and strong demand, Iran's oil industry appears to be going backwards. Production has been in decline due to years of underinvestment and failure to take advantage of new technologies in the example of Saudi Arabia. In fact, Iran now finds it necessary to import refined products to meet its domestic requirements. Confirmation of this inability to maintain production is evident in its frequent advocacy to reduce OPEC output quotas even though the country is burdened by a significant fiscal deficit. Abundant oil revenues in recent years have been wasted on fomenting political disturbances and support for terrorist activities in the region and elsewhere, as has become widely evident in Lebanon, Iraq, Afghanistan and the Palestinian territories. Iran is quite aware of its weak and dysfunctional armed forces which lack a meaningful air force or naval power, and whose failure became quite evident in its inability to prevail against Iraq's primitive and disorderly military during their eight-year war in the 1980s. Therefore, for Iran, supplying insurgents with offensive weapons has become a timid substitute for dispatching troops.

Iran's misdirected spending has undercut support for creating an industrially-diversified economic base. As a result, inflation and unemployment remain quite high, encouraging the trained and educated class to leave the country, with many of those remaining seething in their discontent and quietly opposed to their government.

Iran faces even more insurmountable problems in the Muslim world. Of its population of nearly 70 million, almost 90 percent espouse the Shi'a branch of Islam. Its current design to bond with Iraq's majority of 15 million Shi'as, together with a large representation in Lebanon, have provoked both concern and suspicion among the Sunni countries in the Middle East, notably Saudi Arabia and Egypt, which have made it abundantly clear that they would not tolerate a dominant Iran in the region. It is now an open secret that the Saudis have alerted the United States of their concerns and have even discussed strategic options to deal with Iran's ambitions. As a consequence, Iran's aspirations to seize the mantle of leadership in the region may be thwarted if it persists in its designs.

In the current upheaval in the Middle East there are widely disseminated pretensions that Islam is a monolithic religion with nearly 1.4 billion adherents. This presumptuous mindset is contradicted by

the ongoing sectarian bloodbath in Iraq, pitting Shi'as against Sunnis with many in both of these camps engaged in a form of ethnic cleansing against the minorities in their midst.

Domestically, Iran's turn toward extremely rigid social policies sanctioned by an unforgiving theocracy is helping to encourage a silent opposition that in the past had frequently precipitated unstoppable revolutions elsewhere. With more than two-thirds of the population under 30 years of age, an increasing number, including women, persistent in their attempts to climb the education ladder, and an intensifying inclination toward more liberal thought, the unelected religious leadership at the helm may soon find themselves under siege. The current president, Mahmoud Ahmadinejad, serves at the pleasure of the clergy and hence may be at the forefront of those who may be sacrificed to redress early signs of open revolt. Nonetheless, it would be a mistake to equate Iran's sociopolitical deficiencies with those of Iraq. With an overwhelming majority of the population professing the Shi'a branch of Islam, religious and ethnic frictions are quite limited as is tribalism. In addition, Iran has a long history as a nation, unlike Iraq which is a synthetic entity formed following World War I to satisfy the designs of the victorious allies upon the disintegration of the Ottoman Empire. As a consequence, Iran can rightly claim a cohesion not evident in most of the countries in the Middle East.

The imbroglio surrounding Iran's nuclear aspirations is an exercise designed to burnish pretensions for regional leadership. Its recent invitation to its Arab neighbors to become part of a combined nuclear effort is a move in that direction. Efforts by western countries, under the umbrella of the United Nations, to reach an acceptable resolution is little more than an exercise in futility. Iran's main objective is to flex its muscle for show, since any settlement acceptable to the West would contradict its cherished rallying cry. Hence, passive engagement may prove to be a worthy strategy as a substitute for the verbal escalation that is often mistaken for diplomacy.

The economic and geopolitical consequences of Iran's intransigence fall well short of those widely presumed. Due to many countervailing forces, a nuclear Iran several years out would present no greater threat than a nuclear Pakistan does currently. Its importance as an oil producer is being rapidly diluted by its fading output on one side and growth in non-OPEC production on the other. Its involvement in conflicts in the region is alarming a Sunni majority around the world, and its aspiration of a détente with Iraq's Shi'as seems misplaced due to long-standing sectarian frictions. Most important, however, domestic tranquility is at stake as religious extremists tighten their grip and rapidly intensify their estrangement from a growing portion of the country's citizen. In short, time does not appear to be on Iran's side.

#### THE ECONOMY: NOT A STRANGE INTERLUDE

Although headwinds were visible and in abundance throughout 2006, the U.S. economy managed to deliver respectable growth in a climate of unthreatening inflation and moderate interest rates. Consumers continued to spend despite ugly press dispatches from Iraq and other trouble spots around the world. Corporate managements were successful in insulating their capital spending plans from geopolitical concerns, focusing instead on meeting growing demand at home and from abroad. Federal and state governments, encouraged by a flood of revenues that far exceeded earlier projections, continued to spend freely, almost unrestrained by any fiscal discipline. Job creation, though lagging historical gains at the current stage of the business cycle, still achieved full employment without sparking an upward spiral in wages. Finally, as corporate revenues, margins and profits climbed to record levels, free cash flow turned into an embarrassment of riches prompting the rapid repayment of

corporate debt, generous increases in dividends, massive repurchases of shares and the almost unbridled pursuit of mergers, acquisitions and leveraged buyouts.

On the surface, the snapshot depicted above would suggest a cyclical peak in business activity with a slow journey into the expansion's sunset. In our opinion, such is not the case at present. In fact, we perceive the recent deceleration as nothing more than a respite reminiscent of those previously experienced in the middle of the two prior cycles of the 1980s and 1990s. This conclusion is based on a number of considerations: First, the excesses that typically set the stage for a downturn—such as a rapid increase in industrial capacity, rising inflation, an unwelcome spike in interest rates, strained corporate balance sheets, etc.—are now nowhere in sight. Second, the U.S. economy is benefiting from, and responding to, a synchronized global boom rather than acting as its primary engine. Third, a rolling readjustment is reducing the risks inherent in overextended sectors, such as the much publicized decline in housing. Finally, the Fed appears to be in a comfortable position, with broad latitude to pursue a flexible monetary policy suitable for almost any condition that may surface in the foreseeable future.

Our forecast suggests that the sluggish growth that unfolded during the latter half of 2006 is largely the consequence of a downturn in housing which reduced GDP by almost one percent. This deceleration should persist for a few more months, allowing the industry's excess inventories to be reduced and the national affordability index to turn more positive. With conventional mortgage rates not far above their lows of the past 40 years, employment and personal income on the rise, builders rapidly reducing their output, and house prices down in many regions, incoming data are signaling an approaching trough. As the housing drag on business activity eases, growth should return to its long-term pace, perhaps by the middle of 2007. Meanwhile, gains in orders for plant and equipment, while understandably below their peak, should remain firm, supported by tight capacity and high operating rates, solid export demand, and spending measures to protect some of the recent gains in productivity.

Meanwhile, the forces of inflation appear to have eased recently. Industrial commodities have retreated from their peaks, global competition is keeping prices of finished goods at bay, and employment costs seem contained by the well-publicized efforts of several troubled industries demanding give-backs. Hence, the Fed will be hard put to justify an early change in policy. We are inclined to the view that a modest reduction in interest rates will not occur until mid-2007 at the earliest.

With the U.S. budget deficit for the past fiscal year having been reported well-below earlier forecasts, and the rate of growth in exports now exceeding that of imports, the downward pressure on the dollar seems ill-conceived. Of course, it can be explained on geopolitical grounds, particularly the confusion surrounding a "new" strategy on Iraq, as well as the potential for further tightening moves by a number of key central banks. Nonetheless, we remain persuaded that, relative to the euro, the dollar will continue to trade in the broad range established over the past three years. However, superior growth in large developing economies in Asia should continue to raise the relative value of their currencies until gross imbalances compromise their long-lasting expansions.

On the profit front, gains since the trough of the 2001-2002 recession are clearly unsustainable. Domestic margins have reached the highest level in nearly 50 years, garnering a record portion of GDP. While some of this bounty can be explained by the rapidly rising income of American companies earned outside the U.S., appreciating foreign currencies, more disciplined corporate managements and

low interest expense, it nonetheless must be taken as a possible signal of a pending slowdown in profit growth. With energy having contributed an outsized portion of the gains in both 2005 and 2006, and some cyclical sectors no longer able to maintain earlier increases in revenues, a downshift in the operating earnings of the Standard & Poor's 500 is almost certain, from a gain of about 16% in 2006 to a range of 7%-8% in the coming year.

In summary, we conclude that: (1) 2007 will be another year of moderate growth, with the first half below the historical trendline, but accelerating as the drag from housing begins to dissipate; (2) employment should continue to absorb new entrants into the workforce, with increases in wages and salaries modestly exceeding inflation; (3) consumers will remain engaged, providing reliable support for the economy; (4) inflation will remain tame as global competition and adequate capacity restrain prices; (5) interest rates will remain unthreatening due to abundant global liquidity and a patient approach on the part of the Fed and other central banks; (6) the increase in U.S. exports will accelerate as other economies speed toward greater industrialization; and (7) the dollar will continue to trade within the range established in the past three years relative to key European currencies but will lose some ground in key Asian markets.

#### INVESTMENT STRATEGY: "YOU HAVE TO BE IN IT TO WIN IT"

Although the leading stock market indices delivered a solid return in 2006, their gains fell moderately short of the reported increase in operating profits, as measured on the Standard & Poor's 500. The disparity, while not very large, clearly suggests that U.S. stocks remain fairly valued with no excessive escalation in their risk profile. The prior peak in reported earnings, reached in 2000, though inflated through subsequently revealed accounting fraud, have since been exceeded by 54%, rising to about \$87 in 2006 from \$56.38. The laggard relative performance of the market has its reasons, of course. Price/earnings ratios do decline as recessionary profits are left behind. In addition, geopolitical confrontations have been corrosive as the United States was blamed for the mismanagement of many of these conflicts. A derivative of this latter issue is the growing perception, both at home and abroad, that the U.S. stock market no longer justifies the "leadership premium" that it had commanded for nearly 50 years following the Second World War. Those who subscribe to this view cite the superior growth being generated by the large developing countries which are rapidly raising their share of the global economic pie and whose markets are attracting heightened notice. Finally, while the dollar remains the premier safe-haven currency in an increasingly turbulent world, it has become somewhat suspect in the eyes of those with excess liquidity as they wrestle with Washington's continued reluctance to remedy the country's fiscal problems.

While some of the issues cited above have a measure of validity, it remains a fact that U.S. stocks have clearly lagged their underlying economic and corporate fundamentals, and hence may be largely discounting the implied risks. On the opposite side of the scale is the questionable notion that the developing countries that are now attracting both attention and investments can be relied upon to manage their transition into a new economic model without encountering the frequent turbulence and extremes that typically afflict newly-industrialized nations and compromise their progress.

Until the issues invoked as impediments begin to fade, the U.S. stock market is likely to remain range-bound in its valuation, which would track to its most basic fundamentals, mainly earnings and interest rates. Except for those speculators and traders engaged in hedge funds and private equity activities, investors appear to lack the venturesome spirit that often carries stock prices to speculative

heights and set the stage for major bear markets. These assumptions lead us to a P/E range of 14.5x to 17.5x for 2007, equivalent to about 1350-1650 on the Standard & Poor's 500, implying a decidedly favorable reward/risk ratio of more than 3-to-1.

Generally speaking, the megacap slice of the market remains attractive despite its moderate outperformance in recent weeks. While earnings growth may be less robust than for smaller companies, its valuation is largely at or below that of the market while its dividend yield is more generous.

The sectors that we deem to possess superior potential are financials, healthcare providers with particular emphasis on pharmaceuticals, and technology. We favor financials, particularly banks and a variety of insurance companies, because they have succeeded in keeping their balance sheets in good shape, seem able to generate respectable earnings growth in the face of limited increases in rates on the insurance side, and on valuations which are pricing their shares at or near their traditional discounts to industrials.

The pharmaceutical group has been a clear laggard for nearly three years as managements attempted to deal with numerous problems, including regulatory threats and penalties, patent expirations, product recalls, weak product pipelines and poor control over costs. While these issues have not been resolved in their entirety, some of them have been tackled successfully. In the meantime, free cash generation has remained abundant, share repurchases are frequent, dividends are being increased, and stock prices are down significantly; at the same time, the prospects for rejuvenated product pipelines have turned hopeful.

The technology bubble of recent years has spawned a long period of disappointment that drove many of the sector's high-profile stocks well below their intrinsic value. With highly liquid balance sheets, and a rapid flow of new products or services, the risks in the group seem limited, particularly if the sector is approached as a substitute for deeper cyclicals.

We have not highlighted energy as representing a particularly enticing space at present because increased consumption and higher prices would be required to drive the sector to significantly higher levels. These requisite trends are not in evidence for the short-term. However, given the geopolitical risks and the instability of many oil-producing countries, it would seem imprudent to be underweighted in the sector. A clear buy signal would require a 10%-15% retreat in the industry's shares, to a valuation level somewhat below their historical mean, as measured either on cash flow or asset value.

We remain uncomfortable in taking significant maturity risks in fixed income. Although we expect the Fed to stay the course for at least six months, a temporary spike in inflation could either ignite fear of, or set the stage for, higher interest rates adversely impacting returns.

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**ECONOMIC FORECAST**  
(AS OF OCTOBER 1, 2006)

	<u>2004</u>	<u>2005</u>	Estimated <u>2006</u>	Projected <u>2007</u>
Real GDP (Ann. % Change)	3.9%	3.2%	3.3%	2.5%
Real Consumption Expenditures	3.9%	3.5%	3.1%	2.8%
Business Fixed Investment	5.9%	6.8%	7.5%	5.6%
Inventory Investment (Billions)	\$53.4	\$19.6	\$52.9	\$57.0
Residential Construction (Billions)	\$559.9	\$608.0	\$582.0	\$534.0
Government Spending (Billions) (a)	\$1,940.5	\$1957.9	\$1998.0	\$2040.0
Trade Balance-Goods & Services	(\$611.3)	(\$716.7)	(\$785.0)	(\$801.0)
Federal Budget*: Unified (Billions)	(\$412.8)	(\$318.5)	(\$247.0)	(\$340.0)
GDP Deflator	2.8%	3.0%	2.9%	2.4%
Producer Price Index (Finished Goods)	3.6%	4.9%	2.7%	0.7%
Consumer Price Index	2.7%	3.4%	3.2%	2.0%
Industrial Production	4.1%	3.2%	4.3%	3.2%
Real Disposable Income	3.6%	1.2%	2.7%	3.6%
Hourly Compensation	3.6%	4.4%	5.2%	4.2%
Unit Labor Costs (Non-Farm)	0.6%	2.0%	3.1%	2.5%
Productivity Growth (% Change)	3.0%	2.3%	2.2%	2.0%
Personal Savings Rate (% DPI)	2.0%	(0.4%)	(0.8%)	0.2%
Capacity Utilization – Total Industry	78.6%	80.0%	81.4%	81.9%
Trade Weighted \$ Exchange Rate (b)	(8.2%)	(1.8%)	(1.4%)	(3.8%)
Vehicle Sales (Million Units)	16.9	16.9	16.5	16.2
Housing Starts (Million Units)	1.949	2.073	1.807	1.595
Civilian Employment (Millions)	139.252	141.73	143.30	144.7
Civilian Unemployment Rate	5.5%	5.1%	4.6%	4.7%
Corporate Profits - AT-NIPA	27%	32.6% (c)	19.6%	5.2%
S&P-500 Earnings-Reported	\$58.55	\$69.93	\$80.00	\$87.00
S&P-500 Earnings-Operating	\$66.99	\$76.29	\$87.00	\$93.50
S&P-500 Dividends	\$19.25	\$22.22	\$24.75	\$26.60
90 Day U.S. Treasuries-Yield (%)	0.86-2.25	2.25-4.03	4.08-5.15	4.25-5.00
10-Year U.S. Treasuries-Yield (%)	3.68-4.87	3.89-4.66	4.33-5.25	4.25-5.25

\*Fiscal Year-end 9/30. (a) Federal, State, and Local; in 2000 dollars; (b) Fed Major Currency Exchange Rate;  
(c) Artificially boosted due to tax changes.