



SILVERCREST
ASSET MANAGEMENT GROUP

ECONOMIC REVIEW AND INVESTMENT STRATEGY: 2008/I

DOUBLING DOWN WITH OTHER PEOPLE'S MONEY

Investors and other observers of the economic scene appear to be going through a recurring exercise of self-examination as they attempt to understand the most recent set of excesses, currently dubbed the sub-prime crisis. While no one is likely to come forth to accept responsibility for creating or propagating the problems at hand, there is enough blame to tar everyone involved in this insidious adventure. The culprits would include the homebuyers who could ill-afford the properties they purchased and the debts they incurred; the lenders who knowingly granted them excessive mortgages, often at usurious rates; the financial institutions that engineered the structuring, consolidation and marketing of misrepresented debt; the regulators who turned a blind eye to a dangerously expanding bubble; and the media who have taken a belated but compulsive interest in the whole matter, casting the problem as a vast conspiracy. This collection of apparently confused or misguided participants, recently joined by a few responsible parties, is now advocating intervention by various arms of government to mitigate risks willingly taken but ill-measured. In pleading to be saved from the consequences of their speculative follies, those exposed to significant losses have been joined by high profile sources in the public sector to propose compromising one of the most cherished foundations of our free-enterprise system, namely the violation of the legal sanctity of binding contracts forged willingly and freely between and among private parties. Underlining this mindset, one leading U.S. presidential candidate has gone so far as to recommend a plan calling for a moratorium on foreclosures and a five-year freeze on mortgage payments by borrowers.

Nearly all of the remedial plans advanced thus far are certain to set unwelcome precedents in the relatively orderly world of business. In particular, they would grant governments the implied authority to alter unilaterally the terms of any agreement entered into freely, mainly to ease the financial pain of those who gambled and lost. Carried to a more dangerous level, such conduct, if made acceptable even in extreme circumstances, would encourage dangerous risk-taking which would paradoxically create a less stable business environment.

The implications of unilaterally altering the terms of debt obligations traded globally and increasingly owned by financial institutions everywhere can lead to serious consequences. Changes made to the disadvantage of debt holders can be correctly viewed as adding to the perceived investment risk, thus requiring an increase in the implied returns which would translate into higher interest rates. This would lift the cost of borrowing across a wide swath of the debt market with a deleterious impact on spending, capital formation and economic activity at large. Equally important is the distinct possibility that foreign buyers may become much less inclined to invest in debt instruments of U.S. issuers even of slightly questionable merits.

As a result of recent instability in the mortgage market, it will likely take a long time before housing activity can return to a more traditional form of lending and borrowing and for capital markets to approach the housing industry's debt with confidence. However, massive government intervention to alleviate the current crisis would be a signal that the judgment of the marketplace no longer rules. Free enterprise carries a wide range of risks, imposes responsibilities and grants rewards, but the sum total of the exercise remains a roll of the dice. If we declare our devotion to a market economy, we should not be quick to violate our vows. It would be an egregious mistake to permit the strong arm of government, preached by Karl Marx, to replace the "invisible hand" espoused by Adam Smith.

THE ECONOMY: CLOSE TO THE EDGE, BUT NOT OVER IT

While at its inception 2007 did not promise to be recorded as a year of unbridled success on either the political or economic front, little progress can now be claimed for all the frustration and anguish that was its hallmark. Iraq remains an unsolved puzzle, while Pakistan and Afghanistan are less stable today than they were a year ago. Domestically, the U.S. economy has been rocked by a housing crisis not seen in more than a generation, and a broad range of financial intermediaries has been revealed to be reeling from the weight of a mountain of debt created or assumed to propagate a wild feast. The ultimate cost of such questionable conduct, and its impact on the nation's economic well-being, cannot be accurately measured perhaps for a long time, although they must be acknowledged to be significant.

So far, economic activity on the domestic front appears to be surviving the financial carnage. While the contribution of housing to growth has turned decidedly negative, the shortfall has been offset by rising exports stimulated by a declining dollar and a robust global economy. Furthermore, a tenacious consumer class, encouraged by a steady increase in employment and incomes, has become only slightly intimidated by scary media headlines repeatedly heralding the imminent onset of a recession. Meanwhile, the Federal Reserve Board, unwilling to put an aging expansion at risk, has embarked on a course of action that includes various forms of monetary accommodation as well as access to liquidity for financial institutions in need of short-term relief. The Fed also has been rapidly joined by other key central banks in these efforts, with the latter reversing course from hints of potential tightening a few months ago to an indicated willingness to ease. Finally, Washington has proposed various measures designed to alleviate the crisis and shore up confidence. Such cooperation on a global scale is quite rare, but it can now be attributed to a new phase in the process of globalization wherein common interests are both recognized and encouraged.

The remedial policies announced so far, and others that may follow, will no doubt be of some help, but they still leave the current U.S. expansion at some risk at a time when many of its supports do not appear to be as sturdy as they typically are when the cycle is young. Specifically, should gains in employment wane or global growth weaken, monetary measures alone could prove inadequate while fiscal intervention would take time to provide urgently needed help.

While the Fed has promised to intervene as conditions warrant, it currently finds itself in a delicate position. Recent escalation in the cost of oil and other commodities, both industrial and

agricultural, together with China's rising export prices due to the appreciation of its currency, are collectively intensifying inflationary pressures. This is in addition to the extraordinary flood of liquidity that nearly always moves through price pipelines with a lag. The Fed may soon find itself pressed to choose between two urgent but contradictory sets of policies: stimulating growth or fighting inflation. Given current conditions, further monetary easing in the first half of 2008 may be deemed the more pressing choice, although a reversal may loom in the not-too-distant future.

Other contributors to business activity remain supportive. Capital spending by business continues to gain, though with a diminished impact on growth if the contribution of exports is excluded. Government spending is rising at a solid pace, estimated to increase 7% or more in the current fiscal year. Of additional note is the serious attention being paid by corporate management to costs even as profit margins are close to a record high.

Although the adverse impact of the downturn in housing is now widely advertised and perhaps largely discounted, a number of imponderables render any forecast beyond 2008 quite tentative. With the current expansion actuarially advanced, a whiff of inflation in the air, a national election that promises to forge significant changes in taxing and spending, and a global economy losing some momentum, it may be too soon to make concrete predictions about the shape of 2009. Nonetheless, we remain in the camp that sees more positive than negative forces shaping the next two years, including strong exports, abundant corporate liquidity, and the attractiveness of the United States as an investment destination for countries with excessive savings.

In summary, we conclude that: (1) the U.S. economy will grow at a modest pace through mid-2008, with some acceleration later in the year; (2) inflation will remain elevated, though it may not reach threatening heights; (3) the Fed will continue to pursue a stimulative monetary policy intended to ease difficult conditions in the credit markets and to alleviate the threat of recessionary impulses; (4) domestic profits and margins will likely stagnate under the weight of higher costs and competitive pricing; (5) the U.S. dollar will stage a moderate recovery against major developed country currencies but will continue to decline relative to the currencies of emerging economies, notably China; (6) foreign economies, particularly those of industrial Europe, will likely turn sluggish, though less so than that of the United States; and (7) the stock market will move upward once the threat of recession diminishes and the housing problem is largely discounted.

INVESTMENT STRATEGY: DEFENSIVE IS BEST

Despite the widespread uncertainty that appears to have gripped the current economic landscape, investors appear unwilling to capitulate. For all of 2007, the leading stock market indices have managed to generate respectable returns not much below long-term trends. Meanwhile, valuations have remained largely unchanged, ignoring the favorable impact of declining interest rates while keeping risk at bay. If this unthreatening snapshot is at odds with scary media headlines, it is because the issues surrounding the sub-prime mess are exaggerated, misunderstood, or both. Greater transparency and substantive resolution of the most urgent aspects of the problem may be many months away, but the process has clearly begun. To place the ultimate monetary damage in historical perspective, its magnitude, adjusted for inflation, may ultimately fall short of that

sustained in the 1990-92 real estate bust when the Resolution Trust Corporation was created to seize the assets of failed thrifts in an effort to protect their depositors.

The opening weeks of 2008 should prove to be a test case for both reality and perception. Reality will come first, imposed in the form of audited corporate results for the prior year, which may include acknowledgements of additional write-offs and a revised assessment of future expectations. Such an exercise should be particularly revealing in the financial sector whose “confessions” have so far been viewed as a guessing game. The perception portion of the equation would flow mainly from the willingness of both investors and mere interested observers to buy into forecasts made largely by sources with obvious self-interest. Most important, however, will be whether confidence shall be restored in capital markets recently gripped by fear and uncertainty. Early signs seem encouraging as the flow of transactions has resumed, recharged by the coordinated efforts of key central banks and by measures discussed or adopted by both the private sector and government sources.

Investors’ response to information garnered from corporate releases in early 2008 should set the course for the stock market for several months. In particular, should the financial sector respond favorably following its recent battering, its action would deliver a comforting message that the housing/sub-prime crisis may be easing, even if home prices continue to retreat for a while longer. In this connection, historical evidence suggests that the shares of financial intermediaries frequently embark on a major upturn on any sign of tempered risk and an operational trough.

Concern over trends in employment and incomes, the rising cost of energy and the declining value of homes have caused a broad slice of the market, represented mainly by the consumer sector, to be approached with diminished enthusiasm. As a result, many stocks in this broad but defensive group are now trading at attractive valuations. Typically, they are viewed as late cycle “safe havens” with above-average dividend yield.

While we acknowledge that profits and margins may have entered a mature phase in the current economic cycle, valuations have not even come close to being excessive, given low and generally declining interest rates. Hence, absent a significant downturn in the economy, which would require a major drop in global growth, the chances of a bear market, defined as a decline of 20% or more, appears modest. The fact that the financial sector, the largest in the Standard & Poor’s 500, has already experienced a major correction further reduces that possibility. More important, there is likely to develop some expansion in the market’s P/E ratio for three obvious reasons: declining interest rates, historical precedents wherein laggard markets frequently advance even in the absence of rising earnings and margins, and huge global savings in search of investments. In our opinion, despite its advertised risks, the U.S. stock market today represents the cheapest major asset class in a political safe-haven, with easy access and abundant liquidity, but without the extreme volatility that often grips the markets of developing countries.

Since the bursting of the technology bubble several years ago, a relentless compression in valuations has essentially eliminated the large disparity that separated “growth” from “value.” As a consequence, there is currently an ample list of companies with growth attributes whose shares trade at value metrics, with both technology and healthcare among the most obvious candidates.

An extension of this profile would include a wide range of megacap companies that have underperformed throughout most of the past year despite a respectable growth in earnings.

The energy sector presents an investment dichotomy. While oil demand has only increased marginally this year, technical and political factors have carried prices to a record high. Despite continued global growth, forecasts suggest a modest increase in consumption in the near-term. It would not be prudent, however, to draw hasty conclusions from such a benign supply/demand relationship due to the geopolitical sensitivity of oil prices in a turbulent world. As a consequence, we would suggest at least a market weight in the energy sector.

Going forward, it would seem prudent to reduce exposure to companies with a pronounced cyclical bias, particularly those trading at valuations well above their historical ranges. With indications that costs may continue to creep up in the immediate future, record margins recently achieved may be past their peak. A similar strategy is advised for industrial commodities which have a history of rapid retreat.

On the fixed income front, we continue to keep our average maturity near neutral out of concern that the Federal Reserve Board and the other central banks may opt to rapidly reverse course in response to latent inflationary pressures once the sub-prime problems abate. In taxable accounts, we remain favorably inclined toward the highest quality tax-exempt obligations which currently capture more than 85% of the coupon of taxable debt.

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Vice Chairman

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ECONOMIC FORECAST
(AS OF JANUARY 1, 2007)

	<u>2005</u>	<u>2006</u>	Estimated <u>2007</u>	Projected <u>2008</u>
Real GDP (Annual % Change)	2.9%	2.6%	2.3%	1.8%
Real Consumption Expenditures	3.2%	3.1%	2.7%	2.1%
Business Fixed Investment	7.1%	6.6%	4.7%	3.7%
Inventory Investment (Billions)	\$33.2	\$40.3	\$15.3	\$4.0
Residential Construction (Billions)	\$597.1	\$569.5	\$465.0	\$390.0
Government Spending (Billions) (a)	\$1946.1	\$1981.3	\$2020.0	\$2065.0
Trade Balance-Goods & Services	(\$714.4)	(\$758.5)	(\$685.0)	(\$645.0)
Federal Budget*: Unified (Billions)	(\$318.5)	(\$248.2)	(\$162.8)	(\$235.0)
GDP Deflator	3.2%	3.2%	2.7%	2.5%
Producer Price Index (Finished Goods)	4.9%	2.9%	3.8%	4.9%
Consumer Price Index	3.4%	3.2%	3.1%	3.4%
Industrial Production	3.2%	4.0%	2.0%	1.8%
Real Disposable Income	1.7%	3.1%	3.3%	2.8%
Hourly Compensation	4.0%	3.9%	5.2%	4.8%
Unit Labor Costs (Non-Farm)	2.0%	2.9%	3.1%	2.4%
Productivity Growth (% Change)	2.0%	1.0%	2.2%	2.0%
Personal Savings Rate (% DPI)	0.5%	0.4%	0.7%	1.2%
Capacity Utilization – Total Industry	80.0%	81.7%	81.7%	80.5%
Trade Weighted \$ Exchange Rate (b)	(1.8%)	(1.4%)	(5.4%)	(6.8%)
Vehicle Sales (Million Units)	16.9	16.5	15.9	15.6
Housing Starts (Million Units)	2.073	1.812	1.335	1.150
Civilian Employment (Millions)	141.73	144.4	145.8	146.7
Civilian Unemployment Rate	5.1%	4.6%	4.7%	5.3%
Corporate Profits - AT-NIPA	32.3% (c)	13.9%	2.5%	3.6%
S&P-500 Earnings-Reported	\$69.93	\$81.51	\$77.50	\$82.00
S&P-500 Earnings-Operating	\$76.29	\$88.17	\$89.00	\$88.00
S&P-500 Dividends	\$22.08	\$24.51	\$26.40	\$28.00
90 Day U.S. Treasuries-Yield (%)	2.25-4.03	4.08-5.15	2.86-5.18	2.75-4.00
10-Year U.S. Treasuries-Yield (%)	3.89-4.66	4.33-5.25	3.84-5.29	3.70-5.00

*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.