



SILVERCREST  
ASSET MANAGEMENT GROUP

## ECONOMIC REVIEW & INVESTMENT STRATEGY: 2012/I

### BEWITCHED, BOTHERED AND BEWILDERED

The year 2011 was conceived in turmoil, born in despair, nurtured in serial disappointments and has ended in frustration and uncertainty. As it is, the crowded events of the past year have evolved into a blur of financial and geopolitical crises almost indistinguishable from each other but nonetheless demanding urgent long-term solutions. Instead, policymakers have opted for policy paralysis and political machinations, causing most observers to question whether leaders of the nations at the eye of the storm truly appreciate the magnitude of the risks ahead. Although a repeat of the Great Depression seems unlikely, the potential for social upheaval on at least three continents could tarnish or reverse a great deal of the progress made in recent decades.

Adrift in a sea of fiscal distress and indecision, the euro zone countries seem incapable of forging a workable, fiscally responsible arrangement that would reasonably integrate the various economies involved. The rapid escalation in the financial requirements to backstop the debt of the countries on the brink of default, combined with the unwillingness of other members of the European Community, such as Britain and Switzerland, to fully participate in the rescue effort, have pushed the entire exercise toward exhaustion. More relevant is that the intensity of the fiscal discipline being demanded of those countries facing the greatest fiscal distress would likely plunge them into an economic abyss and social instability not experienced in recent history. Such a turn may ultimately compel many members of the union to exit the system and seek redemption in the devaluation of newly adopted national currencies. In the meantime, the longer the current drama continues the more likely the possibility of a significant recession on the European continent that would adversely impact already decelerating global growth. As a by-product, a slimmed down euro zone would no doubt subject its currency to downward pressure for three obvious reasons: (1) to make it more competitive on the trade front and thereby to revive the region's economy; (2) to compensate for residual doubt that a restructured euro zone may not be a viable arrangement; and (3) to alleviate persistent reluctance to move towards greater political integration, a policy that should have been adopted at inception.

As the industrialized nations began to experience economic and financial stress in recent years, many of the emerging countries managed to capture an increased share of global growth. China, India, Brazil and other developing participants in Southeast Asia and Latin America were at the forefront of this race. With China recently opting for a measure of restraint to douse inflationary pressures, India afflicted by deep budget and balance-of-payment deficits, and several others facing a substantial rise in wages, the policy of growth at any cost is being reconsidered, causing their superior performance in recent years to slow to a more moderate

pace. At the same time, countries such as Australia and Canada, whose abundant natural resources have commanded elevated prices, may now find some buyers, notably China, less eager to raise inventories. To this should be added recent attempts by Chinese policymakers to deflate a real estate bubble, further restraining growth in 2012 and perhaps beyond.

While the current focus is on economic and financial issues, developments in the Middle East and North Africa (MENA) have shifted rather rapidly from the optimism associated with the so-called Arab Spring to a state of extreme turbulence. Impatient citizens, apparently dissatisfied with the pace of political progress, are demanding immediate results on the misguided notion that there is a magical formula that can redress centuries of failed governance, economic neglect and deeply-held sectarian enmities.

What is emerging in MENA are two very disturbing trends, neither of which conducive to lasting peace or regional stability. The first is a turn toward movements with strong theocratic roots, as is the case in Tunisia, Egypt and, less obviously, Turkey. The second is the hostile splintering of several countries along ethnic or sectarian fault lines, with each group demanding either substantial control or total autonomy. At present, Iraq is emerging as the poster child of such an implosion as the country seems to be cursed by both of these sources of conflict. The warring factions in Iraq were so impatient that they would not wait for the departing American troops to reach home before terrorist acts and ethnic hostilities reemerged, with each faction seeking an early advantage as the country splinters into three hostile camps: Sunni, Shi'a and Kurdish. Such a break-up would no doubt compel Saudi Arabia and many of the surrounding emirates to choose sides in this intensifying conflict. Adding to such confusion is the ongoing disintegration of neighboring Syria, an unstable Libya lacking a defined governing infrastructure, and a Lebanon obviously hostage to a variety of internal and external pressures. This muddled picture is further complicated by the never-ending Palestinian-Israeli conflict and the persistent provocations by Iran to burnish its regional influence.

Given the various sources of instability outlined above, one would be justified to conclude that sociopolitical considerations on the global stage may trump economic concerns in 2012. Domestically, presidential election year paralysis will likely stand in the way of timely policy decisions from Washington, once again deferring any constructive action on the budget deficit, or in mounting a critically needed new foreign policy approach now that our efforts at nation-building have turned into failed adventures.

#### **THE U.S. ECONOMY: BETTER THAN ADVERTISED**

Although the U.S. economy ended 2011 on a firm note, many doubts are being raised regarding the sustainability of its recent strength. To be clear, some of the latest vigor appears largely to be supported by improving fundamentals at home. Housing activity is emitting signals of a bottoming process and an early, though modest, upturn. Automobile sales are recovering, mainly due to nearly a decade-long increase in the average age of vehicles in use. Employment data continue to provide evidence of a revival as the 12-month rate of job gains is now in excess of 1.5 million. Spending on plant and equipment by businesses remains on a solid upward trajectory as managements continue to substitute machines for manpower further bolstering productivity. Exports are in a rebound, seemingly not damaged by events in the euro zone.

Finally, consumers do not appear to be intimidated by the pervasive pessimism being repeatedly, and often emphatically, verbalized by the media at large. Hence, the critical question confronting forecasters is whether unresolved issues and new challenges can be addressed in a more timely, rational and orderly manner than has been the case in recent periods.

There are, of course, lingering doubts concerning the longevity of the current expansion in the U.S. Pessimists assert that employment and wages are not rising nearly enough to provide the requisite momentum to achieve solid gains in consumption, particularly since government spending at all levels is likely to begin feeling the impact of fiscal austerity. In addition, it is being argued that external influences, including a possible recession in Europe and deceleration in emerging countries, may generate enough of a drag to impede or derail the ongoing global expansion.

On our part, we feel more hopeful than the doubters. To begin with, we believe that the U.S. economy has in some measure delinked from global trends, mainly because trade is not a major contributor to U.S. growth. Second, recent reports suggest that a repatriation of some manufacturing is in progress, perhaps gaining momentum due to stable wages and sharp gains in productivity at home and escalating operating costs abroad. Third, the U.S. dollar seems to be attracting support because of a pragmatic recognition of its relatively improved purchasing power and its safe haven attributes. Fourth, most multinational companies have accumulated an unhealthy pool of liquidity abroad that may be amplifying currency risks. Fifth, despite many claims to the contrary, the fiscal crisis in the U.S. is well past the point of maximum impact as Washington seems reluctant to aggressively apply the fiscal brakes and thus to derail the ongoing recovery. Sixth, much of the reduction in employment at the state and local levels seems to have been essentially completed, thus essentially eliminating the negative drag from downsizing. Finally, the moderate improvement in business activity appears to have generated increased tax revenues, thus likely reducing the fiscal deficits at all levels of government.

For most of 2011, many observers of the domestic economic scene felt persuaded that a so-called double-dip recession was in prospect. As growth accelerated, however, opinion shifted to a short economic cycle theme. That evidence is lacking to support such forecasts continues to be ignored. For a classical downturn to take roots, either a major external shock will have to be sustained or else an accumulation of excesses would need to be liquidated. While the former possibility cannot be dismissed, particularly within a clearly combustible world, recent tremors have been absorbed with limited consequences. In the latter case, excesses would typically include punitive interest rates, high inflation, excessive inventories, unreasonable wage increases, declining productivity, and a domestic financial system short of resources or lending capacity. None of these impediments is currently on the radar screen.

In the interest of a balanced view, we should note that some of the recent gains in consumption may have been the result of a reduced personal savings rate and a rebound in consumer debt ratios, both of which are not sustainable for long. Should the recovery in employment continue, as we suspect, our caution on consumption may not matter much as higher personal income would compensate. A second source of concern is the extreme disparity that now exists between record high corporate profits and margins on one side and record low

wages as a ratio of corporate GDP on the other. The wide gulf between the two appears to be unsustainable in a healthy economic structure importantly reliant on personal consumption.

In summary, we believe that in 2012: (1) the U.S. economy will continue to grow, albeit at a moderate pace; (2) fiscal policy, paralyzed by election year politics, will not depart much from a middle course; (3) the Fed, obviously fearful of an economic or financial relapse, will essentially remain on hold through 2012 or perhaps beyond; (4) business profits and margins should remain robust, although we suspect that they may be approaching an unsustainable peak; (5) inflationary pressures should continue to ease as prices of industrial commodities retreat due to lower demand from emerging economies and persistently elevated unemployment keep wages at bay; (6) the dollar should experience some firming as the U.S. gains traction as a safe haven and a profitable investment destination; (7) the U.S. stock market is likely to deliver respectable returns, but would continue to adhere to its currently defensive characteristics; and (8) domestic fixed income investments will likely lag equities as investors begin to question the negative real return generated by quality debt instruments.

#### **INVESTMENT STRATEGY: COUNT YOUR BLESSINGS**

By any reasonable measure, U.S. stocks are inexpensive, even after taking into account the various risks to which most of the global economies are exposed. Valuations have been in an erratic but a downward course for nearly 11 years, having attained an unjustifiable record high level at their peak. Part of the decline may be attributed to globalization and the advent or expansion of new markets, the proliferation of new investment vehicles, such as ETFs, and the rapid movement of capital across borders. Most important in support of current valuations, however, has been the role of technology in reducing the capital required to expand production capacity. This is evident in the huge accumulation of extra cash on corporate balance sheets, and the substantial cash generation from operations in excess of normal capital spending needs. By the latest count, seven of the ten largest corporations in the Standard & Poor's 500 Index carry no net debt and require less than their cash flow from operations to finance normal capital projects. What is notable about these companies and many others is that their shares generally trade at less than the market's P/E ratio. Their seeming lack of attraction as investment vehicles may well stem from a suspicion that the excess capital available cannot be deployed to generate a return consistent with recent historical norms. That such liquidity is, in fact, an implied insurance policy and a countervailing balance to a national fiscal policy greatly reliant on debt financing should justify a more favorable interpretation.

Other fundamentals are equally supportive of U.S. stocks. Foremost is a trailing P/E ratio of less than 13X for the S&P 500 which, if adjusted for net cash on balance sheets, would decline to 12X. While the index's dividend yield remains a modest 2.1%, it should be noted that more than 270 of the index's 500 companies have raised their dividends in the past 12 months (a few more than once), and there appears to be some acceleration in both the pace and the size of such increases. Added to this vote of confidence is the accelerated pace of share repurchases as it becomes clear that the interest being earned on cash is far lower than the dividend being paid on the reacquired shares. In a similar vein, our calculations indicate that

the dividend yield on some of the highest-rated companies exceeds the real or implied yield on their long-term debt.

An unusual development in recent years has been the consistent liquidation of equities held in institutional pools, including retirement programs and mutual funds. This trend can be partly attributed to rising interest in non-U.S. markets where higher growth rates are presumed but not recently achieved. While such assumptions may have some validity, they ignore greater implied risks that include a relative shortage of political safety, a lack of market depth, and currency volatility, among others. The implosion of several markets over the past decade and the badly lagging performance in 2011 of both seasoned and developing markets stand as a reminder that sovereign diversification may have lost one of its primary objectives.

Many of the factors discussed above merely support our view that the U.S. stock market remains the cheapest major asset available, risks considered. This is particularly true at present since valuations have become quite compressed, making no distinction as between value and growth.

Proceeding on the assumption that the current expansion in the U.S. has further longevity, we are inclined to remain well-represented in producer durables, many of which experienced a significant pullback in the early fall from which they have not fully recovered. In addition, given the instability in the Middle East, notably among some of the important oil-producing countries, we favor an overweight position in the energy sector. Finally, health care in general, and pharmaceuticals in particular, continue to possess attraction as the relentless political hostility of recent years appears to be easing.

Businesses with significant exposure to the euro zone will likely encounter profit pressures on two fronts: weakening demand as the local economies teeter on recession and negative currency adjustment on a decline in the euro and other currencies versus the dollar.

In the fixed income sector, the Fed's implied affirmation of an extended period of monetary accommodation and low interest rates provides comfort against rising interest rates in the short- to intermediate-term, although potential capital gains appear limited. Longer-term, we consider the risks to be significant as interest rates in general revert to a normal yield curve based substantially on inflation expectations.

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Stanley A. Nabi, CFA  
Vice Chairman

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**ECONOMIC FORECAST**  
(As of January 1, 2012)

	<u>2010</u>	Estimated <u>2011</u>	Projected <u>2012</u>	Projected <u>2013</u>
Real GDP (Y-O-Y)	3.1%	1.8%	2.6%	2.5%
Real Consumption Expenditures	2.0%	2.2%	2.1%	2.3%
Business Fixed Investment	4.4%	9.0%	8.3%	6.0%
Inventory Investment (Billions)	\$58.8	\$22.5	\$14.0	\$19.0
Residential Investment	(4.3%)	(1.6%)	4.5%	5.6%
Government Spending* (Billions) (a)	\$2,562.9	\$2,516.4	\$2,535.0	\$2,536.0
Trade Balance-Goods & Services (Mil.)	(\$421.8)	(\$411.8)	(\$406.0)	(\$400.0)
Federal Budget*: Unified (Billions)	(\$1,294.2)	(\$1,301.0)	(\$1,175.0)	(\$962.0)
Gross Federal Debt* (Billions)	\$13,167	\$14,724	\$16,139	\$17,461
Consumption Price Deflator	1.8%	2.5%	2.3%	2.4%
Producer Price Index (Finished Goods)	3.8%	5.3%	3.6%	3.5%
Consumer Price Index	1.6%	3.3%	3.0%	2.6%
Industrial Production	5.3%	4.2%	4.5%	3.4%
Real Disposable Income	1.8%	1.2%	2.3%	3.0%
Hourly Compensation	2.2%	2.4%	3.0%	3.2%
Unit Labor Cost (Non-Farm)	(2.0%)	2.1%	1.8%	1.0%
Productivity Growth (Non-Farm)	4.0%	2.2%	1.0%	0.5%
Personal Savings Rate (% DPI)	5.3%	4.4%	4.2%	4.6%
Capacity Utilization – Total Industry	74.5%	77.0%	78.3%	79.4%
Trade Weighted \$ Exchange Rate (b)	(3.0%)	(4.7%)	(1.8%)	1.0%
Vehicle Sales (Million Units)	11.5	12.7	13.2	13.7
Housing Starts (Million Units)	0.585	0.606	0.705	0.860
Civilian Employment (Millions)	139.1	139.8	141.4	143.2
Civilian Unemployment Rate	9.6%	8.9%	8.6%	8.3%
Corporate Profits – After Tax – NIPA	19.0%	5.4%	11.0%	9.0%
S&P-500 Earnings-Operating	\$86.73	\$98.50	\$101.00	\$100.00
S&P-500 Dividends	\$24.50	\$26.25	\$28.50	\$29.50
90 Day U.S. Treasuries-Yield (%)	0.03-0.18	0.00-0.20	0.05-0.50	0.45-1.50
10-Year U.S. Treasuries-Yield (%)	2.39-3.99	1.70-3.74	1.75-2.60	2.50-3.00

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