



SILVERCREST
ASSET MANAGEMENT GROUP

ECONOMIC REVIEW AND INVESTMENT STRATEGY: 2007/II

THE FUTURE IS NOW

Since the collapse of the Soviet Union more than 15 years ago which brought to an end superpower confrontations, the global economy has undergone an extreme makeover that, somewhat erratically, has perhaps placed it on a course of rapid development. While sociopolitical conflicts remain—and may even have intensified in many regions as long suppressed internal and external hostilities floated to the surface—a new economic order is expanding opportunities and forging new relationships. This new environment, while mostly constructive, will require difficult adjustments as each important player will have to adapt to a new role and accept compromises.

For the United States, whose economy has enjoyed nearly unchallenged dominance for close to a century, sharing the spotlight will be accepted but will present a psychological challenge. With the global growth rate now significantly higher than that of the U.S., the combined weight of several industrialized and emerging countries will very likely allow them to exercise greater influence than the U.S. is able to achieve by itself; this will unfold even as the U.S. remains the largest player on the stage. The significance of such realignment is that it renders the business cycle more diffuse and, if properly managed, could have a moderating influence on economic fluctuations with favorable consequences on industry and finance around the world.

Globalization has rapidly set in motion cross-border consolidation of pivotal capital-intensive industries. For instance, no longer can it be safe to assume that, in the absence of overt protectionism, such industries as steel, autos and a wide variety of consumer products are sheltered from competitive forces and the variable factors that set their cost of production. While such evolving structure may initially spawn trade frictions, it should, in due course, help create a more level field.

Global capital markets have been integrating quite rapidly. Witness the shrinking disparity in interest rates among the major countries as well as the compression of the inflation level around the world. Such conditions are conducive to long-term lending and borrowing with limited concern for currency volatility.

Although it may take decades, employment and wages are certain to shrink the wide gap that has encouraged outsourcing and the transplanting of factories to take advantage of labor cost and availability. The global supply of labor has expanded tremendously as developing countries made manufacturing jobs more accessible to their citizens. It has been estimated that the integration of China, India and the former Soviet Union countries into the global economy has nearly doubled the labor force. This should continue to have a favorable impact on the living standards of the countries involved as well as the level of inflation of the importing nations.

The foregoing may be viewed as blessings without a downside. Unfortunately, such is not the case. The intrusion of politics often contaminates what could be wide-ranging benefits across a large swatch of the world and its population. With the United States incurring huge trade deficits, and borrowing to finance them, it is placing its fiscal health at risk and giving its lenders at least some say in its foreign policy. Conversely, should the United States face a recession, or it attempts to remedy its fiscal shortfall by restraining consumption and encouraging savings, such measures would impose a heavy burden on those exporting countries with the most to lose. More damaging would be a move toward greater protectionism in favor of national industries, as is currently the case with agricultural and dairy products, a source of conflict still unresolved among several Eurozone countries. Finally, protection of intellectual property rights remains a contentious issue that is treated gently and sporadically because it is difficult to address or enforce.

Globalization offers wide-ranging benefits, but it must be approached delicately and with fairness. In times of prosperity, it is viewed as a blessing. However, it can quickly turn into a source of conflict if any participant feels that his interests are being compromised. The real measure of globalization's success or failure will only become evident when the world economy enters a period of meaningful deceleration or outright recession and each country takes refuge in its own economic bunker for safety.

THE ECONOMY: MISREADING THE TEA LEAVES

The media's intensive focus on the downturn in the housing sector, and more specifically its impact on the subprime mortgage debt market, has driven some observers to predict the demise of the current expansion. To support their forecast, they invoke the historical record which reveals that the housing declines of the current magnitude have nearly always tipped the economy into recession. Such a conclusion seems hasty since it ignores many differences with the past which are almost certain to provide safeguards and mitigate some of the much-feared risks. To begin with, cyclical fluctuations have become less severe as the U.S. economy, like those of other developed countries, becomes increasingly anchored to the more stable service sector. Second, globalization has reduced the inward focus of most major economies; as an example, in dollar terms U.S. exports currently dwarf the domestic new housing sector. Third, earlier downturns had been either caused or were aggravated by a steep rise in interest rates, a condition not currently in evidence. Finally, the treatment of mortgage debt by lenders and other financial institutions has undergone significant changes; specifically, the original issuers of mortgages nearly always gather such loans and rapidly resell them without recourse. In these transactions, such obligations quickly find their way into the hands of higher risk investors, mainly hedge funds and other speculators. As a result, the financial institutions that originated the loans, such as banks and major credit companies (read General Electric Credit, etc.) typically end up with limited exposure to the implied risks. The upside in this process is that the major institutions that anchor the country's financial system are able to avoid serious damage.

The foregoing comments do not imply that the recent trends in housing are not placing downward pressure on the economy. By our estimate, growth has so far been reduced by about one percentage point and will continue to lag its long-term trend at least through 2007. However, we expect this subpar performance to be followed by a rebound as some of the current impediments fade or vanish. To place the housing problem in perspective, it is difficult to see how its most

pessimistic downside could surpass the estimated \$3 trillion loss associated with the bursting of the technology bubble of the late 1990s.

With housing starts currently running nearly 250,000 units below secular needs, excess inventories should be expected to shrink rapidly to more normal levels. This process would be stimulated by the continuing increase in rent, thus establishing a favorable trade-off with home ownership. In the meantime low mortgage rates should provide some support on the Affordability Index front. Finally, many holders of adjustable rate mortgages (ARMs) may opt to switch to conventional mortgages at much lower rates when they are faced with a reset trigger.

The housing sector aside, the U.S. economy has been in a sluggish mode for the past two quarters as capital spending waned, retail sales lost momentum partly due to weather, and consumer sentiment meandered around a neutral path. Orders for plant and equipment, which in the current expansion have trailed the gains of most prior recoveries, may have been restrained by the impact of weak residential construction, caution on the part of corporate managers concerned about global competition, and a less than comforting geopolitical scene.

The current period of hesitation seems likely to be followed by a reacceleration fueled by strong export demand and a domestically elevated capacity utilization level that in the past sparked additional investment. Furthermore, consumption should find support in the continued gains in employment, at an annual rate of about 1.2-1.4 million new jobs, together with a respectable gain in wages. In brief, the conditions that typically drive an economy into recession—a steep rise in interest rates, excessive inventories, aggressive additions to industrial capacity, stretched corporate balance sheets, etc.—are largely absent in number and intensity.

Despite its efforts to articulate anew the basis of its monetary policy, the Federal Reserve Board seems to be stuck on a steady course of no change. Although inflation remains somewhat above the central bank's comfort level, lifting interest rates at this time would not be an appropriate policy move if it would intensify the downward pressure on the housing market. On the other side of the equation, growth is not so anemic as to require a hasty move in the direction of ease as this would trigger a sense of alarm; it would also undermine the dollar at a time when other central banks are either raising their interest rates or are poised to do so.

In summary, we conclude that in 2007: (1) the U.S. economy will likely continue to operate below its long-term trend followed by a moderate acceleration in 2008; (2) inflation will remain elevated for a longer period than is currently assumed; (3) interest rates will continue to move within a narrow range as the Fed struggles to find an appropriate balance; (4) the dollar may come under modest pressure as other central banks raise their interest rates and as U.S. growth remains below that of other industrialized countries; (5) corporate profits should remain essentially unchanged compared to 2006 as margins peak and a few industries disappoint; and (6) the U.S. stock market should deliver a respectable return of about 10% as investors begin to anticipate a rebound in growth next year.

INVESTMENT STRATEGY: RESPITE, NOT REVERSAL

The stock market's retreat in recent weeks, essentially erasing most of this year's early gains, should prove to be nothing more than a modest correction in a bullish trend. Whether the slide has been triggered by volatility in emerging markets, aggravated by concern over the downturn in the domestic housing sector, or the consequence of profit-taking following several years of solid gains may be worthy of debate, though no one is truly in possession of the ultimate answer. However, perhaps it is more useful to review the key factors that will chart the market's future direction.

As is often the case in the middle of a long expansion, not all signals point in the same direction or with similar intensity. At present, the economy is operating somewhat below its long-term pace, with its growth tempered by weak housing, a slowdown in capital spending and a cautious consumer. In addition, gains in productivity have been sliding slowly for nearly a year, with no indication that a reacceleration is close at hand. Employment costs are also creeping up due to a firm labor market at the same time that prices of industrial commodities, with oil in the forefront, remain elevated. As a consequence, profit margins appear to have reached a peak during last year's September quarter and have been eroding ever since, albeit at a slow pace. Hence, reported earnings may fail to notch another noteworthy gain this year, as they have since 2003.

A leap of superficial logic would suggest that flat or moderately lower corporate profits would be a rational justification for a weak stock market. However, the historical record fails to support such a conclusion. Available data clearly reveals an absence of any meaningful correlation between the direction of earnings and stock prices in the short and intermediate-term. The mid-cycle decelerations experienced in the two prior long expansions of the 1980s and 1990s were essentially ignored by investors as stocks continued to advance in anticipation of a resumption in economic growth.

Far more critical to the market's health has been the course and level of interest rates and the apparent confidence in the central bank's declared willingness to be both vigilant and flexible. Investors seem quite comfortable with the Fed's position that somewhat elevated inflation, while it bears watching, is no cause for alarm and requires no intrusive action at this time. With the real fed funds rate below 3%, the central bank and investors can take comfort from the fact that it is below the 5% rate that preceded the last two recessions (2000 and 1990-91). Furthermore, the "inverted yield curve" dilemma has recently corrected itself and should no longer be invoked as a warning flag.

Aside from investor sentiment, which cannot be empirically measured, the most important yardstick that provides a guide to the market's intrinsic value combines earnings and interest rates with cash flow thrown in for additional enlightenment. In this regard, while earnings and margins may be under mild pressure, cash flow remains robust at the same time that interest rates provide valuation support. With the Standard & Poor's 500 priced at about 16-times our below-consensus forecast of \$88.50 in earnings for both 2006 and 2007, the index reflects a four-year compression in its price/earnings ratio. That it has not responded more favorably to some \$420 billion in leveraged buyouts, \$360 billion in share repurchases in 2006 and the prospect of even greater flows still available, estimated at up to \$2 trillion, merely hints at the magnitude of the pent-up demand for U.S. stocks. Add to these factors multinational transactions as well as the accelerating increase in the dividend payout ratio and it would not be difficult to conclude that U.S. equities represent a superior asset class for long-term investors.

Although the megacap slice of the U.S. market has continued to trail, its laggard performance is largely attributable to a lack of interest rather than poor operating results or inferior prospects. Hedge Fund and LBO players seek either smaller or more volatile targets rather than steady, moderate growers which they have relegated to a fate of benign neglect. However, as valuation disparities widen, investors can be expected to return to these reliable candidates with defensive attributes.

More specifically, several sectors hold promise. Many financial intermediaries have been laggards due to a perception that they are heavily exposed to mortgage loans. Years of diversification and restructuring, combined with a growing practice of rapidly reselling such debt, have greatly reduced the risks of exposure to subprime mortgages. The aerospace industry, long reliant on U.S. purchases, is benefiting from the emergence of sovereign buyers interested in establishing a footprint on the global stage. The much maligned and politically unpopular health care sector has not only lost its long-standing valuation premium but in many instances has descended to a significant discount even though all proposed policies call for expanded access to its services. Finally, the prospects of reacceleration in capital spending should stimulate additional demand for technology.

On the fixed income side, our strategy is to emphasize relatively short maturities since we detect no meaningful movement on the interest rate front for an extended period.

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ECONOMIC FORECAST
(AS OF APRIL 1, 2007)

	<u>2004</u>	<u>2005</u>	<u>2006</u>	Estimated <u>2007</u>
Real GDP (Y-O-Y % Change)	3.9%	3.1%	3.1%	2.4%
Real Consumption Expenditures	3.9%	3.5%	3.2%	3.0%
Business Fixed Investment	5.9%	6.8%	7.3%	2.6%
Inventory Investment (Billions)	\$53.4	\$19.6	\$41.9	\$45.0
Residential Construction (Billions)	\$559.9	\$608.0	\$582.5	\$510.0
Government Spending (Billions) (a)	\$1,940.5	\$1957.9	\$1998.2	\$2046.0
Trade Balance-Goods & Services	(\$611.3)	(\$716.7)	(\$763.6)	(\$723.6)
Federal Budget*: Unified (Billions)	(\$412.8)	(\$318.5)	(\$247.0)	(\$190.0)
GDP Deflator	2.8%	3.0%	2.9%	2.7%
Producer Price Index (Finished Goods)	3.6%	4.9%	2.9%	2.2%
Consumer Price Index	2.7%	3.4%	3.2%	2.2%
Industrial Production	4.1%	3.2%	4.0%	2.3%
Real Disposable Income	3.6%	1.2%	2.6%	3.3%
Hourly Compensation	3.6%	4.4%	5.2%	4.6%
Unit Labor Costs (Non-Farm)	0.6%	2.0%	3.2%	2.8%
Productivity Growth (% Change)	3.0%	2.1%	1.6%	1.8%
Personal Savings Rate (% DPI)	2.0%	(0.4%)	(1.1%)	(0.4%)
Capacity Utilization – Total Industry	78.6%	80.0%	81.8%	81.3%
Trade Weighted \$ Exchange Rate (b)	(8.2%)	(1.8%)	(1.4%)	(3.0%)
Vehicle Sales (Million Units)	16.9	16.9	16.5	16.4
Housing Starts (Million Units)	1.949	2.073	1.818	1.525
Civilian Employment (Millions)	139.252	141.73	144.4	145.8
Civilian Unemployment Rate	5.5%	5.1%	4.6%	4.6%
Corporate Profits - AT-NIPA	27.0%	32.6% (c)	19.5%	4.0%
S&P-500 Earnings-Reported	\$58.55	\$69.93	\$80.75	\$82.00
S&P-500 Earnings-Operating	\$66.99	\$76.29	\$88.50	\$88.50
S&P-500 Dividends	\$19.25	\$22.08	\$24.51	\$26.50
90 Day U.S. Treasuries-Yield (%)	0.86-2.25	2.25-4.03	4.08-5.15	4.50-5.50
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.