SILVERCREST
ASSET MANAGEMENT GROUP

ECONOMIC REVIEW AND INVESTMENT STRATEGY: 2008/II

THE UNITED STATES VS. JAPAN: COMPARE, OR CONTRAST?!

Searching for similarities between current conditions in the United States and those in other times and in other countries, many commentators have invoked the example of Japan in the 1990s as a possible template for what is in store on our shores in coming years. The thrust of their observations is that Japan experienced real estate and stock market bubbles that painfully deflated over a very long time, inviting anemic growth and a market index that today trades at about one-third of its peak level, reached in 1989. They further assert that extremely low interest rates and other remedial actions failed to provide an adequate and timely cure for the ills that have kept the Japanese economy moving at low speed. From these elemental historical guideposts they leap to the conclusion that the U.S. is facing similar prospects, noting that monetary measures and very low interest rates have so far failed to prevent the proliferation of imbalances, let alone administer a remedy.

Invoking such largely superficial comparisons ignores a sea of stark differences that challenge a list of hasty conclusions. These range from historical and cultural to the policy measures adopted to address the root cause of Japan's economic malaise.

To begin with, despite its rapid economic success immediately following World War II, characterized by a very aggressive approach on the trade front, Japan has been and remains a closed society not welcoming of external influences. It resists immigration, encourages personal frugality, and is respectful of social contracts that are not easily altered even when revisions are urgently required. It is a country with an aging and shrinking population painfully aware of the burden that this imposes on future generations. Its labor force enjoys little mobility aside from being resistant to rapid changes. Most relevant to the country's governance is the powerful role that entrenched senior bureaucrats play, often exercising control by challenging or impeding policies proposed at the highest levels.

Partly due to Japan's substantial economic gains in the 1970s and 1980s, as well as the appreciation of its currency, escalating labor costs substantially reduced its competitive advantage as it approached the crest of its growth. This, together with massive savings, set the stage for investments outside the country, robbing domestic economic activity of the related benefits.

At the peak of Japan's stock market bubble in 1989, the Nikkei traded at close to 100-times earnings and generated a dividend yield of about 0.1%. Throughout this period of prosperity, corporate reports turned increasingly suspect, with the silent consent of authorities who sanctioned cross-ownership among companies to inflate earnings. In the meantime, the banking system was allowed to operate free from any transparency or prudent discipline as powerful bureaucrats

continued to turn a blind eye to widespread abuses extending over many decades. This led to extreme speculative excesses not only in the stock market but in real estate, art and other asset classes. At one stage late in the country's boom, it was estimated that the value of Tokyo's real estate alone exceeded that of the entire United States.

When the downturn began around 1990, many authorities in and outside Japan were firmly in a state of denial, claiming that the Japanese model was a new invention to be envied and emulated. As a result, the government was very slow to address a rapidly unraveling and highly leveraged financial system burdened by many industries in the manufacturing sector with vanishing profits. The most concrete action adopted by the government was a determined and precipitous reduction in interest rates not balanced by any meaningful fiscal measures. In fact, consumption and income taxes were frequently lifted during the 1990s to address budgetary problems.

In Japan, senior bureaucrats rather than those at the ministerial level hold sway over major policy decisions, often resisting or impeding any changes that challenge their authority or alter traditional practices. Hence many of the announced fiscal proposals designed to accelerate growth never moved past the planning stage, keeping the economy mired in stagnation. In addition, powerful special interests, particularly in farming and construction, rejected proposed changes that they believed would dilute their traditional political influence.

Faced with these and other impediments, the Japanese economy could not generate the momentum to participate fully in Asia's stunning revival of the last two decades. Judging by its recent performance, this state of affairs is not likely to change for the better any time soon.

How do conditions in the United States economy today compare or contrast with those outlined above? More important, can any meaningful conclusions be drawn from this exercise?

To begin with, the United States is arguably the most resilient country on earth. Partly because of its diversity, it suffers from no cultural or historical sclerosis. Its population has never stopped growing, and if all forms of immigration are considered, is not aging. It has been able to deal with rapid changes in the structure of its economy, replacing vanishing smokestack industries with advances in technology and the delivery of services. Most relevant is that the productivity of the labor force is near the top in the world. Following a period of excessive wage increases in the 1970s and 1980s, compensation is now generally consistent with that of other major countries. Despite occasional mishaps, its corporate governance is reliable and its financial system is transparent, as evident in the massive amount of information accompanying recent events. Without any attempt to downplay the housing/sub-prime problems widely covered by the media, the highest authorities in government (rather than bureaucrats) are joining together to seek solutions to difficult issues rather than pretending that they do not exist, thus reducing the chances of a very long period of recuperation.

Unlike the Japanese market at its peak, its U.S. counterpart is priced at a level eminently defensible on long-term fundamentals, with a rising dividend stream, and profits that are increasingly derived from global sources. In addition, exports are on the rise, partly a function of a declining dollar, but also a testimony to U.S. industrial excellence and its competitive advantage.

Although cyclical factors may cause the jobless rate to rise in coming months, long-term employment gains have rarely stumbled.

Glib comparisons with Japan of the 1990s may find support in temporary events, some of which are fashioned to fit preconceived conclusions. However, the contrasts seem more convincing and, we believe, supportive of a more favorable outcome for the United States.

THE ECONOMY: BEYOND THE EYE OF THE STORM

As 2008 came into view, the focus of debate on the direction of the U.S. economy revolved around whether the growing turbulence in the capital markets was severe enough to trigger a recession. Three months later, the guessing game seems to have shifted to the amplitude of the downturn, given the rapid deterioration in both business fundamentals and psychology. Fear of a serious meltdown has forced preemptive interventions by the Federal Reserve, the U.S. Treasury and Congress, with all three moving in unison to build a multi-sided firewall designed to keep the economy and the credit markets from falling into an abyss. While the measures adopted and announced thus far are less than ideal from a policy and precedence standpoint, they appear to have restored a sense of balance and a base of confidence that those in positions of responsibility are not underestimating the magnitude of the risks involved. In this regard, Congress has passed a huge fiscal stimulus package in the form of a giveaway to support consumption, even though its cost will add substantially to an already ballooning budget deficit. On the monetary front, the Federal Reserve Board lowered significantly critical interest rates and made credit more abundant and accessible to a variety of borrowers thereby expanding the money supply bubble already in place. Finally, the U.S. Treasury entered the fray by consenting to substantial guarantees to prevent the demise of Bear Stearns, an act that required an implied change in policy allowing non-banks to borrow directly from the Fed. The speed and sense of urgency implied in these massive measures appear to have delivered a much needed message that the ship may be passing through a patch of stormy weather but it is neither rudderless nor floundering.

The prime cause of the disarray in the financial system can be traced to a housing bubble spawned by artificially low interest rates, a sea of liquidity, irresponsible and unregulated speculation in exotic financial instruments, and a misguided sense of entitlement. The convergence of these and other factors have manifested themselves in loose lending standards and a re-pricing of risk, warning flags that are often ignored at the peak of euphoria. With the problems at hand no longer a mystery and the normal discounting mechanism clearly at work, the element of surprise has greatly diminished. In fact, the "rescue" of Bear Stearns may well prove to be a defining event not only in bringing the financial crisis to a climax, but in a growing perception that this action may be seen as setting a new policy approach that draws Washington into areas not commonly considered in its direct line of responsibility.

With a financial meltdown probably averted, the debate should now turn toward the shape of the business cycle going forward. In brief, we believe that a recession may be already in progress as housing continues to be a drag, lenders remain defensive, and consumers are restrained by pessimistic headlines in the media and by sluggish gains in employment and real incomes. While the downturn should be partially mitigated by the stimulus package already adopted, the other supports at work may not prove sufficient to fuel a rapid recovery; specifically, exports, capital outlays by business, and

government spending are not collectively large enough to generate the requisite momentum for a rapid reversal. Hence, the early stages of the anticipated recovery may not occur until consumers have an opportunity to repair their balance sheets and feel more secure in their jobs. Furthermore, it is not clear what impact Washington's largesse will have on business activity once it is exhausted. By one estimate, even if all the remittances flow into consumption—an unlikely event —they will merely add about 1% to economic growth in the two middle quarters of this year, or something barely approaching the ongoing drag from housing.

Positive but inconclusive recent data in the housing sector may be hinting at some support later this year. Although home prices continue to decline, and construction remains at an ebb, glimmers of hope are flickering. These include a steep upturn in the Housing Affordability Index, very low conventional mortgage rates, a recent improvement in existing house sales, and some shrinkage in the inventory of unsold units. A broadening in these measurements could set the stages for a trough in the industry later this year, thus reducing or eliminating the headwinds from this troubled slice of the economy. Mere stability would add about 1% to the current pace of growth.

Although the Federal Reserve has provided active support on the monetary front, with a series of aggressive reductions in both the fed funds and discount rates, such a highly stimulative approach will no doubt have a diminishing impact going forward, and may even be viewed in some quarters as inviting delayed inflationary consequences. Such concern was evidently reflected in the vote of two members of the FOMC who expressed a preference for smaller cuts. Hence, we believe that a more deliberate monetary policy may be pursued, in part fashioned to prevent another credit bubble from taking shape.

Within the current patch of pervasive gloom, a decidedly positive note can be sounded about U.S. corporations outside the financial sector. By most measures, these businesses remain mostly in good standing, supported by favorable operating trends, strong balance sheets and more than adequate cash flows. Judging by current estimate of operating results, they should be in a position to report solid growth in their profits at least through the current year and perhaps beyond.

In summary, we believe that: (1) the downturn in the U.S. economy will be shallow but will last longer than in recent cycles due to weak consumption and stretched personal balance sheets; (2) monetary and fiscal policy will remain stimulative, at least through 2008, to ensure against a financial relapse; (3) currently-elevated inflation will not become a serious threat due to a global easing in demand, competitive conditions and potentially lower commodity prices; (4) corporate profits will not return to their recent peak until a new expansion phase is well under way; (5) the domestic stock market will experience a plodding reversal that could erase recent losses in key indices by the end of 2008; and (6) markets outside the U.S. will likely experience a similar upturn.

INVESTMENT STRATEGY: THE SKY IS NOT FALLING

The global stock markets were seized by severe and frequent convulsions in the March quarter, taking their lead from the extreme turbulence in the credit markets. No financial intermediary was spared the penalty arising from bad loans, declining values of investment

portfolios, elevated leverage, and speculative excesses. In many instances, reassuring declarations by talking heads were either misleading or were rapidly overtaken by events. Stability became a notion to be aspired to but not easily achieved. In such a climate of fear, ugly rumors and outrageous claims, it has become a challenge to find a shelter of reason and comfort. It took an enormous dose of intervention from Washington to convince rabid pessimists that the powers charged with the task of keeping the wheel of the economy turning were hard at work trying to tame a wild beast. While the evidence is not yet conclusive, stability appears to have been restored, thanks to massive, coordinated and unprecedented intervention by many arms of government. That this will prove to be a costly undertaking cannot be denied or ignored.

It is quite fortunate that the wrenching events depicted above have occurred at a time when interest rates are quite low, and perhaps remaining so for a while. It is also fortuitous that valuations in the stock market are unthreatening and liquidity seeking a more permanent but secure home is abundant. More important is that other alternative investments may be far less attractive than equities, particularly those of stable industrialized economies. At present, real estate remains suspect aside from providing a very modest internal rate of return, quality fixed income instruments barely generate a yield that matches inflation, commodities are generally at a peak, and aggressive hedge funds and private equity funds are widely stretched and largely in disrepute. Hence, by a process of elimination, equities emerge as a logical choice, even if some patience may be required to harvest their full potential.

Admittedly, corporate profits may not sparkle in the short-term. For the Standard & Poor's 500, negative comparisons are almost pre-ordained on a macro basis for several quarters as financials, which in mid-2007 accounted for 23% of the index but generated nearly 40% of its profits, work through their massive charges and write-offs. With most other sectors continuing to forecast higher earnings, comparisons should turn favorable late this year. Our very conservative estimate for the S&P 500 of $81 for 2008, down from a 12-month peak of about $92, translates to a P/E of 16.2x, a reasonable ratio, interest rates considered. On the assumption that economic growth will resume by early next year, improvement in profits should follow.

Though mindful of the potholes on the road to an economic rebound and a market recovery, we are persuaded by historical and other evidence that stocks are likely to signal an upturn in business well before the end of this year. This forecast is based on the fact that the U.S. market typically embarks on a recovery near the midpoint of a recession, registering significant gains even before a full economic rebound is in place. Other signals can also be gleaned from the compression of P/Es among the largest companies in the S&P 500, as well as in the convergence of valuations for "growth" and "value" in both large and small capitalization shares. Finally, following a long period of net liquidations, insider activity is weighing in on the buy side.

Large-capitalization companies with significant multinational exposure are currently priced at or below the market multiple. With confidence in their earnings stream quite high, their dividends secure and in most instances subject to regular increases, they are deemed to offer a relatively safe shelter in times of uncertainty. Consumer staples, which tend to be subject to less cyclicality in their operations, have not succumbed to the market malaise but remain reasonably

valued. The retail sector, recently suspect due to concern over restrained consumer spending, should once again attract positive attention following its adjustment to lowered expectations.

Following several years of enthusiasm for the energy group, we believe that caution is in order. With oil prices having nearly doubled over the past 15 months, even while global demand has barely risen, the stage may be set for a downward adjustment in the sector. Similar trends can be projected for companies involved in various commodities whose prices have risen sharply over the past year or so.

Financials may well prove to be solid performers in the future. However, their reports for the March quarter are not likely to allay current fears, particularly where dividends are at risk or capital needs would call for dilutive measures. Finally, many of the players may have neither the capital nor be in a position to recapture their former earning power for a long time.

On the fixed income front, we continue to adhere to a conservative, low risk approach, focused on short maturities of the highest quality. For tax-sensitive portfolios, tax-free resets provide the most efficient approach in the current climate of uncertainty.

April 1, 2008

Stanley A. Nabi, CFA
Vice Chairman

This publication contains the personal opinions, as of the date set forth herein, about the securities, investments and/or economic subjects discussed by Mr. Nabi. No part of Mr. Nabi's compensation was, is or will be related to any specific views contained in these materials. This publication is intended for information purposes only and does not recommend or solicit the purchase or sale of specific securities or investment services. Readers should not infer or assume that any securities, sectors or markets described were or will be profitable or are appropriate to meet the objectives, situation or needs of a particular individual or family, as the implementation of any financial strategy should only be made after consultation with your attorney, tax advisor and investment advisor. All material presented is compiled from sources believed to be reliable, but accuracy or completeness cannot be guaranteed.

© Silvercrest Asset Management Group LLC

ECONOMIC FORECAST
(As of April 1, 2008)

	2005	2006	2007	Estimated 2008
Real GDP (Annual % Change)	3.1%	2.9%	2.2%	1.3%
Real Consumption Expenditures	3.2%	3.1%	2.9%	1.4%
Business Fixed Investment	7.1%	6.6%	4.8%	3.9%
Inventory Investment (Billions)	$33.2	$40.3	$6.6	($12.0)
Residential Construction (Billions)	$597.1	$569.5	$472.8	$375.0
Government Spending (Billions) (a)	$1946.1	$1981.3	$2022.0	$2070.0
Trade Balance-Goods & Services	($714.4)	($758.5)	($709.5)	($690.0)
Federal Budget*: Unified (Billions)	($318.5)	($248.2)	($162.8)	($400.0)
GDP Deflator	3.2%	3.2%	2.7%	2.8%
Producer Price Index (Finished Goods)	4.9%	2.9%	3.9%	5.6%
Consumer Price Index	3.4%	3.2%	2.9%	4.1%
Industrial Production	3.2%	4.0%	1.9%	1.6%
Real Disposable Income	1.7%	3.1%	3.0%	2.5%
Hourly Compensation	4.0%	3.9%	5.0%	4.3%
Unit Labor Costs (Non-Farm)	2.0%	2.9%	3.0%	2.0%
Productivity Growth (% Change)	2.0%	1.0%	1.8%	2.2%
Personal Savings Rate (% DPI)	0.5%	0.4%	0.4%	2.0%
Capacity Utilization – Total Industry	80.0%	81.7%	81.7%	80.5%
Trade Weighted $ Exchange Rate (b)	(1.8%)	(1.4%)	(5.8%)	(8.5%)
Vehicle Sales (Million Units)	16.9	16.5	16.1	14.8
Housing Starts (Million Units)	2.073	1.812	1.343	1.010
Civilian Employment (Millions)	141.73	144.4	145.8	146.3
Civilian Unemployment Rate	5.1%	4.6%	4.6%	5.3%
Corporate Profits - AT-NIPA	32.3% (c)	13.9%	3.2%	(3.0%)
S&P-500 Earnings-Reported	$69.93	$81.51	$75.20	$80.00
S&P-500 Earnings-Operating	$76.29	$88.17	$85.00	$81.00
S&P-500 Dividends	$22.08	$24.51	$26.20	$27.50
90 Day U.S. Treasuries-Yield (%)	2.25-4.03	4.08-5.15	2.87-5.19	1.25-2.50
10-Year U.S. Treasuries-Yield (%)	3.89-4.66	4.33-5.25	3.84-5.29	3.20-4.40

**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.*