



SILVERCREST
ASSET MANAGEMENT GROUP

ECONOMIC REVIEW AND INVESTMENT STRATEGY: 2007/III

SPEAKING TRUTH TO THE POWERLESS

Once again, the United States is in the grip of a quadrennial spectacle called a presidential campaign. Candidates of self-proclaimed distinction are coming forward in increasing numbers to anoint themselves as suitable prospects to lead the nation and influence the course of world events. They will hold forth on numerous issues they barely comprehend on the assumption that the mere mention of a topic would promptly burnish their credentials as experts. To hear their elocution, one would conclude that they have at their command ready solutions to complicated social, economic and geopolitical problems.

What differentiates the current campaign from prior ones is that it started early, has drawn more aspirants than any of the prior races, is being financed by an obscene amount of money, and is being managed by tribes of handlers and troublemakers who are committed to the personal destruction of the opposition rather than to rational debate. Sound bites fashioned by such suspects are treated as worthy substitutes for a detailed analysis of problems crying out for solutions, an assessment of the costs and sacrifices required to address them, explaining who would shoulder the attendant burdens, and setting forth a proper order of priorities. While most candidates promise Utopia if elected, they are well aware that they are hawking impossible dreams.

The list of social programs that are often cited as requiring prompt attention is almost endless. Front and center are the funding of Social Security, healthcare and welfare, improving a deteriorating education system, cleaning up the environment, legislating a rational minimum wage, financing viable defense and security programs, improving the nation's transportation network and reducing the budget and trade deficits before they further debase the dollar. To hear the rhetoric being spouted by each of the aspirants, one is asked to believe that the associated costs are manageable, requiring no special efforts, sacrifices or discipline. A reality check would reveal that addressing only the most pressing of the problems would call for the near confiscation of the personal incomes earned by all tax-paying citizens. That no candidate has the courage or requisite integrity to reveal the obvious sends a misleading message that mere "social re-engineering" is a sure remedy for all of the nation's domestic ills. Such posturing has fed a misguided sense of entitlement based on the principle of "compensation without contribution."

When pressed for answers on how to meet the needed expenditures, the candidates gingerly dance around the subject of taxation, but they are quick to lend it respectability in the name of fairness, order, and moral rectitude. That this represents their devious route to the politics of envy is rarely lost on those eager to blame society's ills on economic circumstances.

While we as a nation are empowered through our representatives to define the specifics of our socioeconomic system, we seem to have assumed authority to dictate to other countries what they can or cannot do domestically. Our frequent efforts to impose on foreign exporters working conditions acceptable to us fails to recognize the thrust of history. As an example, our repeated objections to the employment of under-age labor ignores the fact that nearly every country, including our own, that has reached an

advanced level of industrialization has passed through stages of development that included making use of such workers. It is estimated that 100 years ago more than 15 percent of the labor force in the United States was under 14 years of age. While child labor is not necessary today, our desire to dictate Western-style labor and social policies for developing countries may have the unintended consequence of hindering their progress and depriving those eager to earn an income of the satisfaction and pride of being self-supporting. Underdeveloped nations can ill-afford social policies which have driven even wealthy industrialized nations, such as France and Germany, to sustained underemployment, excessive deficits, expansive governments and oppressive tax policies. The same can be said of our insistence on environmental standards that would mirror our own but retard their drive toward self-sufficiency.

The presidential candidates who could attract the greatest following and achieve the highest possibility of success will be those willing to level with the electorate by telling them what is achievable within our nation's means and the attendant sacrifices that would be required. As a society with steadily rising expectations, whose citizens are seemingly unwilling to extend the commensurate extra effort, we are in danger of losing the hard-earned gains contributed by generations past. No nation can thrive for long if its social order is hostage to a web of lofty entitlement programs.

THE ECONOMY: NET POSITIVE

The U.S. economy is currently navigating through a typical mid-cycle transition prone to a wide range of forecasts and opinions. Each datum point released is invariably accorded undeserved attention even though, standing by itself, it sheds little light on the future course of business activity. Such is the case at present when key sectors of the economy are moving at varying speeds.

The slowdown experienced in late 2006 and early this year is now judged as a brief adjustment caused by a decline in housing activity, the liquidation of inventories, deterioration in trade balances and sluggish capital spending. The impact of the downturn in housing has additionally raised doubts about the ability and willingness of consumers to remain upbeat. Thus far, such concerns have proven to be exaggerated or unfounded. While the weak housing sector remains a drag, its adverse consequences are being alleviated by vigor in commercial, industrial and municipal activity which has kept the total value of construction near a steady pace. In addition, aside from the housing sector, inventories have declined to a level that requires prompt replenishment, as reflected by a near-record low inventory/sales ratio. More recently, reported gains in retail sales are challenging the notion that the sharp increase in gasoline prices is adversely affecting store shopping by consumers. In the meantime, the deterioration in trade balances appears to have been stemmed in recent months by a rise in exports stimulated by continuing strong global growth. On the capital spending front, corporate managements appear to have concluded that an elevated capacity utilization level, abundant cash flows and intense pressures to protect margins and remain competitive would require a further increase in capital outlays. While each of these factors is incremental in stimulating growth, the sum total of their impact is adding to the economy's momentum which is likely to last for several quarters, or perhaps until the housing sector reaches a trough.

The Federal Reserve Board's essentially neutral monetary policy seems destined to last longer than many now are willing to acknowledge even though other central banks have been far more inclined toward restraint. The difference in approach appears justified by the significant disparity in growth rates, with the United States at the lower end of the scale, and the need to keep U.S. mortgage rates from climbing to disruptive heights. While inflation is modestly above the Fed's comfort zone, it has shown no tendency to

accelerate as Unit Labor Costs and industrial commodity prices remain generally where they were a year ago.

The dollar may be entering a period of relative stability even in the face of currency appreciation mainly among developing countries. Improved domestic growth, the attraction of U.S. businesses to foreign buyers, escalating operating costs across many emerging economies, the continued slide of the yen, and the recent improvement in U.S. trade balances due to export gains are among sources of support. For the present, interest rate differentials on short maturities favor the dollar, although the inclination of major central banks to lift rates may shrink this advantage. Nonetheless, undervaluation on a purchasing parity (PPP) basis, relative political stability and a highly liquid fixed income market provide obvious advantages.

In summary, we believe that: (1) the U.S. economy has entered a period of moderate acceleration that should last a year or longer; (2) inflation is likely to recede incrementally in coming months; (3) the Fed does not seem pressed to move in the direction of either ease or restraint, perhaps for the balance of this year; (4) corporate profits should continue to grow, probably at a slowing pace, though margins may be at a peak for this cycle; (5) the dollar may be approaching temporary stability compared to the currencies of the industrialized countries, but it remains at risk relative to those of the developing economies, and (6) the U.S. stock market holds attraction as a relatively low-risk investment destination in an overheated global framework.

INVESTMENT STRATEGY: A DETOUR WITH OPPORTUNITIES

As the June quarter came to a close, the most critical issue bedeviling investors has become the potential impact of the subprime mortgage debt held by hedge funds and other financial intermediaries. Fear of the unknown often trumps logic or reality in the short-term. Media headlines, repeating and embroidering on what had already been amply expounded, take on a life of their own though they rarely provide an informed assessment of the potential risks. In the current situation, concerns have been heightened by a rapid spike in interest rates that has shaken the sense of complacency which had implied, perhaps mistakenly, a Fed ease in short order.

While the problems in the subprime debt space are real, they are not likely to have long-lasting or debilitating consequences on the stock market. Despite the excessive leverage assumed by some hedge funds, there are underlying real assets supporting at least a portion of their investments. This is unlike the technology/telecom meltdown that spawned the recession of 2000-2001 and erased nearly \$3 trillion in stock market value; even that event failed to cripple the economy for long. In addition, the financial system remains quite liquid, imparting considerable resiliency in dealing with any fallout. Throughout the 1990s a variety of financial crises had been dealt with successfully, with the decade having opened with the near-collapse of the savings and loan industry, which was promptly followed by the Mexican currency crisis, the Long Term Capital Management implosion, Russia's default and scattered financial problems in Southeast Asia. Finally, it would be a surprise if the Fed and the U.S. Treasury Department are not already hard at work drawing up emergency plans to deal with the most relevant contingencies that may arise.

The stock market is driven by psychology and fundamentals, with the former often transitory and the latter much more reliable and longer lasting. Most recently, sentiment has assumed the upper hand which explains the recent increase in market volatility. At the same time, we believe that both economic and corporate attributes are nowhere near the danger zone.

Despite weak housing, business conditions remain supportive, with growth accelerating from the anemic pace registered in the March quarter. The seeming breadth of this improvement, encompassing consumption, business spending and exports, should generate incremental gains in profits combined with relatively stable margins near peak levels. The combination of aggressive share repurchase programs, solid increases in dividends, and a stream of M&A and private equity transactions add further substance to a stock market with superior attributes as an asset class. In support of this conclusion, we point out that the Standard & Poor's 500, at 16-times our conservative estimate of \$92.50 in earnings for 2007, is trading at the lowest valuation in nearly 20 years, interest rates considered. However, given the many headwinds currently on the radar screen, gains are likely to be plodding and measured, charting an erratic upward course similar to that traveled since the beginning of this year.

We continue to favor the megacap companies because they: (1) generally trade at a 10-15 percent valuation discount to that of the Standard & Poor's 500, (2) are subject to less volatility in earnings, (3) have a more reliable stream of dividend increases, (4) derive a significant, and generally rising, portion of their earnings from foreign sources, and (5) enjoy greater operating flexibility, management reliability and accounting efficacy. In dissecting the market by capitalization size, style and approach, "value" has outperformed "growth" since the bear market trough of 2000-2002. As a result, the valuation gap that had separated these two investment styles has largely vanished blurring the boundaries that for many years had differentiated them, making it less challenging to mix-and-match in portfolio construction.

With capital spending exhibiting a measure of revival, and global growth stimulating exports, durable goods manufacturers should continue to outperform. In addition, geopolitical considerations argue against being underweight in the energy sector. Technology and telecom appear to be entering a new cycle of innovation, although in this case disciplined selectivity is called for. Healthcare equities, particularly pharmaceuticals, remain inexpensive, but their outperformance may await resolution of reimbursement and other regulatory impediments.

The financial sector, which has recently been placed in the "penalty box" due to the rise in interest rates and the emergence of credit quality questions, will likely remain suspect until a clearer assessment can be made of the magnitude of subprime problems. However, given stronger balance sheets and much improved controls than in past cycles, the ultimate upturn may not be too far in the future.

With the credit markets seized by uncertainty, and the Fed's intentions remaining unclear, our fixed income strategy favors emphasis on the short-end of the yield curve which would achieve the objective of capturing close to the maximum yield. Better opportunities should open up to extend maturities as some of the current impediments begin to fade.

July 1, 2007

Stanley A. Nabi, CFA
Vice Chairman

This piece contains no recommendations to buy or sell securities or a solicitation of an offer to buy or sell securities or investment services or adopt any investment position. This piece is not intended to constitute investment advice. Market and economic views are subject to change without notice and may be untimely when presented here. Readers are advised not to infer or assume that any securities, sectors or markets described were or will be profitable. All material presented is compiled from sources believed to be reliable, but accuracy cannot be guaranteed.

ECONOMIC FORECAST
(AS OF JULY 1, 2007)

	<u>2005</u>	<u>2006</u>	Estimated <u>2007</u>	Projected <u>2008</u>
Real GDP (Y-O-Y % Change)	3.2%	3.3%	2.3%	2.8%
Real Consumption Expenditures	3.5%	3.2%	3.3%	2.7%
Business Fixed Investment	6.8%	7.2%	3.7%	4.5%
Inventory Investment (Billions)	\$19.6	\$43.2	\$8.0	\$18.0
Residential Construction (Billions)	\$608.0	\$582.3	\$500.0	\$510.0
Government Spending (Billions) (a)	\$1957.9	\$1998.4	\$2042.0	\$2088.0
Trade Balance-Goods & Services	(\$714.4)	(\$758.5)	(\$730.0)	(\$785.0)
Federal Budget*: Unified (Billions)	(\$318.5)	(\$248.2)	(\$180.0)	(\$220.0)
GDP Deflator	3.0%	2.9%	2.8%	2.5%
Producer Price Index (Finished Goods)	4.9%	2.9%	3.4%	2.9%
Consumer Price Index	3.4%	3.2%	2.9%	2.6%
Industrial Production	3.2%	4.0%	1.9%	2.8%
Real Disposable Income	1.2%	2.6%	4.0%	3.5%
Hourly Compensation	4.1%	5.0%	4.7%	5.0%
Unit Labor Costs (Non-Farm)	2.0%	3.3%	3.2%	3.0%
Productivity Growth (% Change)	2.1%	1.6%	1.5%	1.9%
Personal Savings Rate (% DPI)	(0.4%)	(1.0%)	(0.3%)	0.7%
Capacity Utilization – Total Industry	80.0%	81.8%	81.3%	81.5%
Trade Weighted \$ Exchange Rate (b)	(1.8%)	(1.4%)	(3.3%)	(2.5%)
Vehicle Sales (Million Units)	16.9	16.5	16.3	16.0
Housing Starts (Million Units)	2.073	1.812	1.485	1.575
Civilian Employment (Millions)	141.73	144.4	145.9	147.3
Civilian Unemployment Rate	5.1%	4.6%	4.6%	4.7%
Corporate Profits - AT-NIPA	32.6% (c)	19.4%	3.8%	2.5%
S&P-500 Earnings-Reported	\$69.93	\$81.51	\$88.00	\$93.00
S&P-500 Earnings-Operating	\$76.29	\$88.17	\$93.00	\$97.00
S&P-500 Dividends	\$22.08	\$24.51	\$26.80	\$29.00
90 Day U.S. Treasuries-Yield (%)	2.25-4.03	4.08-5.15	4.53-5.18	4.70-5.25
10-Year U.S. Treasuries-Yield (%)	3.89-4.66	4.33-5.25	4.49-5.60	5.10-5.75

*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.