

## ECONOMIC REVIEW AND INVESTMENT STRATEGY: 2008/III

### THE MYTHOLOGY OF CHANGE

More than any other people, Americans crave change. From its early formation, the United States has climbed to the pinnacle of economic and political power through a process of timely and well-modulated transformation rather than through the jarring destruction of established social institutions. Extreme positions that required departure from a centrist course have been rejected consistently because the nation's diverse forces always sought common grounds that serve the best interests of a "community" rather than the narrow preferences of special groups. This historical pattern largely explains the dominance and durability of a two-party political system with only modest philosophical differences; it also sheds considerable light on the reasons that other parties with rigid views and less inclusive platforms have remained marginal even in periods of distress, such as the Great Depression, the Vietnam conflict, and the constitutional crisis provoked by Watergate.

As the current presidential campaign progresses toward the final elections, the presumptive nominees of the two major parties continue to cling to their theme of change without actually dressing it with any substance lest it is unmasked as a hollow concept. However, their message is carefully crafted to inflame passions, intensify widely-held anxieties and convince the most insecure amongst us that they have been ignored by our government and hence relegated to an uncertain future.

In the current presidential contest, both major political parties are preaching a similar sermon of hope and promise, but without explaining how such a worthy destination can be reached. Both sides claim to be committed to the long-term viability of the Social Security System, affordable health care coverage for all, a world-class education structure, a defense network suited for a turbulent world, energy self-sufficiency, greater attention to the environment, and the rapid rebuilding of the nation's long-neglected infrastructure. However, neither side has come forth with an estimate of the ultimate cost of such an expansive wish list out of concern that it would reveal itself to be unmanageable, even within a fiscal framework of a confiscatory tax system.

An honest debate outlining what would be reasonably achievable and what is beyond the nation's means would, in itself, represent change, particularly if it is combined with emphatic declarations that the essence of a successful social order is an honest partnership between the government and the governed.

The most economically advanced societies have been slow to recognize that the safety nets they have committed to provide their citizens are far beyond their abilities to deliver. Japan is struggling with the burdensome requirements of an aging population; France continues to meet public resistance in its attempt to contain its various social protections, while many other countries on the European continent are similarly burdened. As global competition continues to intensify, the issue of compensation without contribution is likely to be recognized as a source of social conflict and acknowledged as a growing impediment to fiscal sanity and economic progress.

As the presidential contest in the U.S begins in earnest, the volume of political rhetoric will rise, unachievable promises will proliferate, and rigid positions will be championed, all in the name of change. To assume that candidates can make all of their wishes come true is a denial of campaign history. The ship of state reaches its destination safely and undisturbed only if it is kept on a course far from the eye of the storm and away from uncharted waters. Republicans, Democrats and spoilers who attempt to seduce voters by preaching change for its own sake should recognize the risks in their provocative sermons. Their carefully tailored circumlocutions are certain to provoke anxieties, intensify insecurities and escalate class envy without achieving anything constructive.

#### **THE U.S. ECONOMY: CHALLENGED, BUT NOT BROKEN**

For more than a year, the U.S. economy has been sliding slowly into a state of structural dissonance. A rapidly expanding housing bubble, hugely inflated by irresponsible lending and borrowing, has damaged seriously a financial system that has traditionally anchored the global credit markets. Consumers, increasingly gripped by a quixotic sense of entitlement, have continued to add to an already unmanageable debt burden. As economic growth recently entered a period of rapid deceleration, Washington responded by engineering a giveaway program that has raised sharply the budget deficit, with potentially deleterious consequences on inflation, interest rates and the dollar. All of the foregoing has occurred at a time when geopolitical stress remains intense and the outside world is becoming increasingly vocal in its questioning of U.S. leadership and fiscal health. A presidential campaign devoid of fresh ideas on how to deal with the massive issues facing the nation and the world contributes little clarity to this confusing tale.

Comparing business cycles may be historically instructive, but it rarely yields potent remedies when urgently needed. The financial stress spawned by the real estate downturn in 1990-91 was far more contained in magnitude and consequences than the current slide in the housing sector. The proliferation of financial instruments in recent years, combined with a lack of appreciation of the related risks, has rendered any repair efforts inconclusive at best and certainly quite costly. More important is that a process of contamination has afflicted other countries, compromising their housing and financial markets as well. Hence, the urgent task of deleveraging, currently in progress, is very likely to last longer than generally assumed; even then, most of the surviving intermediaries will emerge from the crisis with shrunken balance sheets and short of resources to play the expansive role they had assumed in the past. This anemic state should continue to retard economic growth until additional capital is raised or accumulated, which may take several years. Responding to the critical conditions at hand, Washington policymakers have signaled their willingness to remain diligent and are adopting measures, largely of the non-conventional variety, to keep the financial system afloat and functioning.

While the distress in housing will continue to weigh down on economic activity, some tentative signs of approaching stability in the sector can be detected. These include an apparent peak in existing houses for sale, a steady decline in the number of new homes on the market, and a sharp rebound in the Housing Affordability Index. However, until the slide in home prices comes to an end, the adverse impact of the sector on consumer sentiment and spending will continue to compromise economic growth.

Offsetting the adverse impact of housing has been a steady acceleration in exports, reflecting both the decline in the dollar and the related increase in spending on infrastructure projects by

developing countries. Added help is being derived from stable non-residential construction activity domestically; very lean inventories, and temporary benefits from the hastily contrived tax rebates. Exports, the most important of these sources of support, should continue only as long as the global economy does not succumb to the same symptoms afflicting the U.S.

While inflation remains a threat, given the sharp rise in the price of oil and other commodities, it still has not developed deep roots. With labor mindful of the impact of outsourcing and job security, wage increases have so far been kept quite moderate and are being largely offset by respectable gains in productivity. At the same time, corporate managements, keenly aware of global competition, are limiting price increases to protect market share.

With oil having taken center stage as the primary source of economic and geopolitical importance, it is no longer being treated as a commodity subject to the vicissitude of demand and supply. Its almost sudden elevation to a mystical role seems to ignore some historical verities. In rapid succession, oil has moved from a cyclical commodity to an asset class and then to a store of value, finally emerging most recently as a currency-correlated substitute largely dictating the value of the dollar. Some observers have even raised the possibility that it may ultimately replace gold in the latter's long-standing role as the ultimate inflation hedge. However, such hyperbole must, in due course, pass the test of time, having on several occasions in the past proved to be a failed prophesy. That the price of oil has recently risen to more than \$143 per barrel, from \$56 in January 2007, absent wars or other disasters, challenges rational analysis. Contained global consumption in response to this spike in price, reduced subsidies to consumers by many developing countries, planned increases in production, and threatened control over speculative trading cannot help but break the upward cycle, perhaps sooner than even some bears are prepared to venture. While major producers, notably OPEC, have learned to be more disciplined than in the past, they will be severely challenged to defend lofty prices, particularly when market or cyclical forces intervene.

For the U.S. economy at large, our timeline assumes that it will continue to operate below potential, with unemployment creeping up gradually to about 6% from the recently-reported 5.5%. As the supportive impact of tax refunds fades by late summer, personal consumption may weaken further, possibly exposing the economy to a brief period of negative growth and a further decline in business profits. The rebound that will likely follow, perhaps in the latter half of 2009, will derive from stability in housing, continued gains in exports, and a measure of improvement in the debt burden and the saving rate of consumers as some mortgage obligations are written off. Nonetheless, we expect this period of recuperation to be less vigorous than was the case in prior economic recoveries.

In summary, we conclude that: (1) the U.S. economy will remain mired in recessionary conditions or anemic growth for an extended period, perhaps lasting well into 2009; (2) inflation will be reflective of the trend in commodities, but should remain moderate as long as wage increases are largely offset by productivity gains; (3) monetary policy will be more responsive to the pace of economic growth than to price pressures in the short-term; (4) current consensus estimates of corporate profits will be scaled back as this year progresses, but we forecast no collapse; (5) the dollar will reflect a measure of stability as other countries develop many of the same symptoms afflicting the U.S. economy, particularly in housing and on the inflation front; (6) U.S. assets will attract increasing sovereign interest as abundant liquidity seeks a fairly-priced, politically secure and productive venue; (7) with share prices not notably elevated relative to earnings and asset values, and U.S. stocks having already experienced a significant correction, a market trough may not be much below current levels.

## **INVESTMENT STRATEGY: STRANGE HAPPENINGS**

Since the U.S. stock market climbed to a peak in October 2007, investors have had to deal with a climate characterized by sharp divergences in sector performance. At the same time that financials seemed to descend into an abyss, energy stocks were mostly on a bullish rampage, while the rest of the list either marked time or, in the case of megacaps, eroded slowly. In all instances, sentiment played as much of a role in this performance as fundamentals, causing most traditional investors to feel disconnected from reality. This sense of frustration is being heightened by conflicting signals emanating from the economy, the Federal Reserve and other key central banks, Washington policymakers and the corporate elite.

Simply stated, the market is acting as if the U.S. is in, or is rapidly moving into, a recession. Although data thus far have failed to confirm the downturn, many key indicators - such as employment, industrial production and consumer sentiment - have been in negative territory for several months. The Fed, on its part, has been in a recession-fighting mode for nearly a year, but recently has been called upon to serve three masters with contradictory requirements: an economy in need of support in the form of a more stimulative monetary policy, inflationary pressures that call for restraint and a U.S. dollar buffeted by real or imaginary storms. The best that Washington has been able to muster in this intensely stressful climate are measures with marginal benefits for a housing debacle in urgent need of substantial relief. The cumulative impact of such feeble response has left investors with little visibility and an uncertain sense of direction.

On our part, we view the release of June quarter corporate results as something approaching a defining event. Given early warnings from the financial sector, its report card is not likely to be comforting, although it may reveal the extent of the additional damage that needs to be discounted. While the energy group is certain to contribute robust profits, its gain may fall well short of filling the gaping hole created by the shortfall from the financial intermediaries. The rest of the list will do well to hold its own, leaving overall earnings significantly below consensus expectations, and perhaps setting the stage for “capitulation” and the formation of a final support level for the market. As it is, investor psychology is clearly in bear territory, with some opportunists beginning to look for an entry point.

Working in favor of domestic equities are favorable long-term valuation metrics, a depressed dollar that makes U.S. assets among the most attractively priced globally, huge liquidity around the world seeking productive deployment, and a shortage of other investment options with similar potential. With interest rates likely to be raised almost everywhere, real estate under pressure and not ready for a rebound, commodities near a parabolic peak just as global growth is tapering off, a process of elimination should cause U.S. stocks to be recognized as perhaps the most attractive asset class on the roster of investment alternatives.

For reasons detailed elsewhere in this report, we believe that the energy sector should be approached with caution, but geopolitical considerations prevent us from reducing positions to a below-market weight. Financials remain suspect until greater transparency restores confidence, although the insurance segment may have been excessively punished in the current environment, and may thus be deserving of attention. Companies involved in global infrastructure are likely to

remain in demand as developing countries deploy some of their huge savings to accommodate their growing importance on the global stage.

The most intriguing aspect of the current market is the compression in valuations that has developed in the past few years. Across all capitalization levels, P/E ratios have fallen into a narrow band that make “value” and “growth” almost indistinguishable, thus giving investors an opportunity to choose from a large collection of suitable candidates. A broad list of high-profile technology stocks, with solid balance sheets, abundant cash flows, and growth rates at least twice nominal GDP, are currently available at prices well below their estimated intrinsic value. Similarly, many successful biotech companies have become engulfed by the pessimism that has afflicted traditional pharmaceuticals.

On the fixed income front, we are mindful of the possibility that global interest rates may be headed higher as key central banks attempt to restrain inflationary impulses. Accordingly, we remain relatively short on the maturity end, while at the same time favoring highly rated obligations.

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Stanley A. Nabi, CFA  
Vice Chairman

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**ECONOMIC FORECAST**  
(AS OF JULY 1, 2008)

	<u>2006</u>	<u>2007</u>	Estimated <u>2008</u>	Projected <u>2009</u>
Real GDP (Annual % Change)	2.9%	2.2%	1.0%	1.4%
Real Consumption Expenditures	3.1%	2.9%	1.8%	1.3%
Business Fixed Investment	6.6%	4.7%	2.7%	(0.8%)
Inventory Investment (Billions)	\$40.3	\$4.6	(\$12.0)	(\$15.0)
Residential Construction (Billions)	\$569.5	\$472.8	\$370.0	\$370.0
Government Spending (Billions) (a)	\$1981.3	\$2022.0	\$2065.0	\$2090.00
Trade Balance-Goods & Services	(\$758.5)	(\$709.5)	(\$690.0)	(\$675.0)
Federal Budget*: Unified (Billions)	(\$248.2)	(\$162.8)	(\$445.0)	(\$510.0)
GDP Deflator	3.2%	2.7%	2.8%	2.5%
Producer Price Index (Finished Goods)	2.9%	3.9%	6.3%	3.5%
Consumer Price Index	3.2%	2.9%	4.1%	3.3%
Industrial Production	4.0%	1.7%	0.9%	1.3%
Real Disposable Income	3.1%	3.1%	2.8%	2.6%
Hourly Compensation	3.9%	5.0%	3.8%	4.1%
Unit Labor Costs (Non-Farm)	2.9%	3.2%	1.6%	2.1%
Productivity Growth (% Change)	1.0%	1.8%	2.2%	2.1%
Personal Savings Rate (% DPI)	0.4%	0.5%	1.6%	2.4%
Capacity Utilization – Total Industry	81.7%	81.0%	79.5%	79.0%
Trade Weighted \$ Exchange Rate (b)	(1.4%)	(5.8%)	(8.5%)	(1.5%)
Vehicle Sales (Million Units)	16.5	16.1	14.4	14.5
Housing Starts (Million Units)	1.812	1.343	0.965	1.120
Civilian Employment (Millions)	144.4	145.8	145.8	146.1
Civilian Unemployment Rate	4.6%	4.6%	5.5%	6.0%
Corporate Profits - AT-NIPA	13.9%	4.3%	(4.0%)	4.3%
S&P-500 Earnings-Reported	\$81.51	\$75.20	\$80.00	\$83.00
S&P-500 Earnings-Operating	\$88.17	\$85.85	\$81.00	\$85.00
S&P-500 Dividends	\$24.51	\$25.25	\$26.00	\$26.65
90 Day U.S. Treasuries-Yield (%)	4.08-5.15	2.87-5.19	0.57-4.00	3.80-4.50
10-Year U.S. Treasuries-Yield (%)	4.33-5.25	3.84-5.29	3.31-5.00	4.75-5.50

\*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.