



SILVERCREST
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ECONOMIC REVIEW AND INVESTMENT STRATEGY: 2006/IV

THE FAILURES OF ECONOMICS

Judging by the massive flood of commentaries that are spewed daily on the human condition domestically and abroad, apparently nearly everyone has become a self-appointed economist. It matters little that economics has been aptly described as “the dismal science” and that opinions and conclusions on any specific topic can differ widely with identical information in hand. What for decades had been viewed as a flexible discipline has turned into a game whose rules have become largely improvised and subject to political winds, and nearly always tainted by self-interest.

In reality, such a transformation is neither surprising nor of recent origin. For most of the 20th Century, economics was not a stand-alone subject matter in academic circles outside the United States. Except for the United Kingdom, universities in Europe offered courses mainly in political-economy, recognizing that political decisions either sway or dictate economic policy. No better example of this approach can be found than the pervasive adoption of “socialism-lite” by Western European countries following World War II, a hybrid structure which they now recognize as out of touch with current fiscal needs and which they now find nearly impossible to reform.

For a period in the middle of the last century, efforts were made to cast economics into relatively rigid mathematical relationships. The discipline was called Econometrics, and it was intended to generate more effective and more accurate forecasting techniques by empirically testing statistical research for better policy planning. However, the vanity of this approach was quickly deflated because of two shortcomings: the application of unreliable data and an assumption of a static universe in a fast changing world.

Economic forecasting relies heavily on a daily stream of statistics each of which is accorded reverential treatment when released, but only until a new series is announced and finely parsed. Such compulsive preoccupation ignores the fact that such data are often derived from faulty, unreliable or tentative sampling techniques or estimates and are subject to frequent and significant revisions, some as long as ten years later. As the global economy continues to integrate and expand, and the U.S. becomes a smaller portion of the whole, it will no longer be possible to keep the focus of attention on domestic activity. Over the course of the past ten years, for instance, cross-border transactions have expanded at nearly three times global growth. This, however, will add another dimension of uncertainty since many countries are known to provide questionable and self-serving statistics, and even then with long delays. No better example can be cited than the budget deficit estimates provided by a European country that was successful in seeking entry into the Eurozone with what was later conceded as knowingly false data. More recently, Hungary’s government became embroiled in scandal when the prime

minister admitted to providing false information about the economy during the election campaign in April of this year.

Politicians are no less guilty of the type of misrepresentation that distorts reality. The impact of changes in tax policy can generally be measured with some accuracy, but politicians of different persuasions trumpet diametrically opposed conclusions, with each side asserting that its position represents sound economic reality.

Even in hallowed academic circles, economists no longer provide objective and impartial guidance based on disciplined research. As practitioners, they are now entering government service in increasing numbers, or are becoming journalists or consultants, in the process assuming clear political identities that, at a minimum, contaminate their views and compromise their intellectual integrities.

Changes in public sentiment and political winds often bring to the fore debates on economic policy as the public becomes indoctrinated to demand changes that are not always in its best interest or those of the country at large. Worn out refrains, such as the redistribution of wealth and income, the protection of the environment without regard to cost or global competition, and prohibiting the search for oil and gas in some locations, have become political tools disguised as socioeconomic issues.

Given the massive number of variables that impact economic decisions and the discipline's own serious shortcomings, is economics still relevant as a tool of social policy, and can it add incremental knowledge? The answer is positive, but provisional. In that spirit, no single data series should be treated as a decisive piece of information. The sum total of available evidence, gathered from a variety of sources, can provide a sense of direction but not necessarily the pace at which events or trends are proceeding. As an example, the current focus on the housing sector as a most critical element can lead to dire forecasts, but looking at it as a part of a larger puzzle would probably prove more enlightening and less scary, as will be explained more fully later in this discussion. Finally, while anecdotal evidence cannot be measured empirically, it is frequently an early warning of important changes in progress.

In the next pages, we set forth our views on the economy and the stock market, with conclusions based on our assumptions of the probable response of investors, consumers, government officials, and business managers. We claim no sure vision, but hope that we can integrate a wide range of information into coherent and objective views that would serve to spark enlightened debate.

THE ECONOMY: BACK TO PURGATORY

The sense of frustration and uncertainty that dominated 2005 has continued into this year. Nearly all the geopolitical issues that had bedeviled the outlook remain unresolved, with several more added to the roster. On the economic front, the expansion has actuarially reached middle age with its typical requisite adjustments. How such a transition unfolds will likely chart the course of business activity for the remainder of this business cycle.

Consumers remain the pivotal engine of growth, though their contribution may become attenuated by modest gains in real income as well as by concerns related to the ongoing slide in housing values and their impact on the so-called “wealth effect.” Business spending on capital projects, though decelerating modestly, is being supported by abundant corporate liquidity, rising capacity utilization, and efforts to squeeze greater efficiency in an increasingly competitive global climate. Government outlays continue to grow somewhat in excess of inflation, with any attempt at restraint masked by strong revenues that have caused the budget deficit to drop well below earlier projections.

The pivotal factors that are likely to chart the course of the economy through 2007 are: inflation and its impact on monetary policy, the magnitude of deterioration in the housing market, global growth and geopolitical tensions.

Since Ben Bernanke assumed the chairmanship of the Fed, the central bank’s main focus has been on an accurate reading of the course of inflation. The early summer spike in the price of energy, an outsized lift in the Employment Cost Index and flattening productivity trends have caused obvious concern within the Fed, though the alarm bells seem to have been muted by the knowledge that data at hand are backward-looking and frequently subject to significant revisions. With spot commodity prices, including energy, having apparently peaked, as suggested by the year-to-year decline in the Goldman Sachs Spot Commodity Index, many businesses are likely to feel under less pressure to raise prices. As a result, the recent acceleration in inflation may reverse itself, allowing the Fed more time to consider its next move.

The slide in the housing sector also has become a consideration in charting monetary policy. With a significant decline in sales and a sharp increase in excess homes available on the market, prudence dictates that mortgage rates become part of the solution rather than aggravate the problem. In addition, lower home prices should restrain a recent spike in rents, with salutary consequences on inflation. These considerations should persuade the Fed to remain on hold for an extended period with no pre-conceived timetable on the next move or its direction. A quick reversal into ease, if it occurs soon, would be seen as a signal of desperation, casting doubt on the central bank’s competence in reading the economic tea leaves.

While the risks of a rapid downturn in housing are real, they should not be overstated. Recent data indicate that the gains in non-residential construction activity have so far more than offset the decline in housing. Although such a favorable trade-off may not persist, given the pace of deterioration in the residential sector, it is likely to blunt the negative impact. In any case, the magnitude of the drop in housing starts should rapidly remove excess inventories and perhaps bring about stability as early as mid-2007. Giving support to this conclusion is the fact that the national Affordability Index should generally remain in positive territory, particularly in the absence of a decline in real personal incomes. Perhaps equally relevant is that the much-feared potential meltdown in Adjusted Rate Mortgages (ARM) may fade with limited damage as it becomes clear that manageable mortgage rates would allow holders of ARMs to switch to conventional long-term mortgages at flat or lower financial costs.

On balance, the dollar’s response to the shifting gears in the economy should be uneventful as the various influences balance each other out. On one end, the probable slowdown in inflation, the potential drop in the trade deficit arising from the lower cost of

imported commodities and continued firm exports should be supportive. On the other side is the threat of increased interest rates outside the United States, particularly by the Bank of England and the European Central Bank.

Although substantive evidence is lacking, this is not preventing some pessimists from claiming to feel the winds of recession. We believe such a hasty conclusion borders on the irresponsible as some of the most telling imbalances that lead to a downturn are nowhere on the horizon. These often include punitive interest rates, restrained liquidity in the financial system, excessive expansion of industrial capacity, a serious deterioration in corporate balance sheets, vigorous growth in employment that sparks a wage spiral, and an elevated inventory/sales ratio. We detect none of these warning signs in the current environment.

In summary, we are of the view that within the next 12-18 months (1) the U.S. economy will continue to expand, albeit at a slower pace than its long-term trend; (2) recent inflationary pressures will moderate, helped by lower commodity and house prices; (3) domestic monetary policy will not soon be the object of significant changes; (4) business profits and margins, while remaining robust, may soon be entering a cresting period; (5) the U.S. dollar will continue to trade within the broad range established over the past two years relative to most major currencies; (6) global growth, in general, will likely lose some momentum but should remain respectable; and (7) the U.S. stock market will continue to generate moderate, though halting, gains.

INVESTMENT STRATEGY: OUT OF THE BOX

Restrained by an apparent lack of conviction as well as a continuing shift of interest into other markets and non-traditional investments, U.S. stocks have struggled so far this year to register moderate gains. Corporate fundamentals have remained supportive, with profits during the first half exceeding earlier forecasts. Despite the central bank's determination to continue on a path of restraint, market interest rates have moved in the opposite direction thereby improving valuation metrics for equities.

Although most of the key stock indices, including the Standard & Poor's 500 and the Dow Jones Industrials, recently attained their highest levels in more than five years, the strong gains in earnings since the trough of the recession, estimated by us at more than 70%, have kept valuations at unthreatening levels. In the past, bull markets nearly always spawned speculative bubbles that compromised the market's balance, a condition not currently in evidence. Whatever excesses do exist appear to be almost entirely outside organized and regulated trading, primarily tied to hedge funds and commodities. This pivotal difference lends a measure of confidence that whatever instability may develop would be transitory and easily manageable.

The impediments cited to explain the market's sluggish progress include a maturing expansion, a possible peak in profits and margins, and the impact of a rapidly deteriorating housing sector on consumer sentiment and spending. Long-lasting business cycles, such as those of the 1980s and 1990s, tend to develop a mid-term period of hesitation, typically characterized by slower growth, as the economy shifts gears and new sectors take the lead.

On the profit front, the outsized gains of recent years will not likely continue without doing harm to the country's well-being, as such distribution of income would favor investment over consumption. In any case, stocks have so far failed to reflect the full extent of recent gains in profits and may have some catching up to do.

In our view, the response of homeowners to the decline in housing values may not reach the extremes that the media is depicting because mortgage rates remain quite manageable, the slide in energy prices has quickly improved consumer sentiment, and continued gains in employment and incomes should keep consumption—and hence general economic activity—on a moderate uptrend. These considerations argue in favor of a positive market outlook, with a probable repeat of the experience of 1980s and 1990s when stocks delivered solid gains despite slowing economic activity.

A generous list of high-profile megacap companies remains distinctly undervalued. Trading on average below a market P/E, they generally grow at a faster pace than GDP, provide a modestly higher dividend yield, are supported by solid financial metrics, and offer broad diversification. These candidates have been clear laggards over the past several years as traders and speculators ignored them in favor of more volatile investments. Moreover, as the business cycle continues to mature, a more defensive posture would underscore anew the strong attributes and long-term reliability of such megacaps.

We also remain enthusiastic on two major sectors, energy and healthcare, though we expect them to perform on different schedules. In the case of energy, further downward pressure is likely to persist as oil and gas prices continue to trend lower due to technical and fundamental factors and as speculators close out positions in the commodities. As with all trends, this process will likely carry to extremes which would be reflected on the sector's valuation front. While a significant portion of the correction may have occurred already, there is still the risk of disappointment as companies lower their earnings and cash flow forecasts to reflect the recent decline in energy prices. Our long-term optimism on the sector is based on various considerations, including escalating exploration and production costs, the scarcity of new discoveries, rising demand from the developing economies, persistent geopolitical risks and the reluctance of major players to make the huge investments needed to develop reserves located in politically unstable regions. New commitments should be considered when "normalized" cash flow approaches the midpoint of its historical range.

The healthcare sector has experienced a long period of underperformance, with the pharmaceuticals in recent years having lost their traditional premium valuations. Product problems, which had garnered extensive headlines, have apparently been discounted, we believe in many instances to excess. In addition, operating costs have been adjusted to reflect new realities, product pipelines are being gradually replenished, and consumption is rising once again due to new regulations. As a result, the industry appears to be regaining traction. Its defensive characteristics, potential for merger and acquisition activity, and attractive valuations are now clearly part of our investment thesis.

The financial sector should begin to generate above-average returns, taking its lead from what is likely to be unthreatening monetary policy. Although operating results of some mortgage lenders may disappoint, the nation's banking system remains in excellent shape.

Multi-line insurance companies are similarly positioned to deliver respectable growth even in the face of some competitive pressures.

The aerospace and defense group is benefiting from persistent geopolitical instability. With domestic military spending rarely reduced, and many other countries such as Japan seeking to build their own deterrent capabilities, growth in this sector should exceed nominal GDP for many years.

On the fixed income front, the recent rapid decline in interest rates reduces the justification to take above average maturity risk in the short-term.

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ECONOMIC FORECAST
(AS OF OCTOBER 1, 2006)

	<u>2004</u>	<u>2005</u>	Estimated <u>2006</u>	Projected <u>2007</u>
Real GDP (Ann. % Change)	4.2%	3.5%	3.4%	2.7%
Real Consumption Expenditures	3.9%	3.5%	3.2%	3.0%
Business Fixed Investment	5.9%	6.8%	7.2%	5.6%
Inventory Investment (Billions)	\$52.0	\$19.6	\$52.8	\$45.0
Residential Construction (Billions)	\$559.9	\$608.0	\$586.0	\$540.0
Government Spending (Billions) (a)	\$1,940.5	\$1957.9	\$2002.0	\$2044.0
Trade Balance-Goods & Services	(\$611.3)	(\$716.7)	(\$780.0)	(\$840.0)
Federal Budget*: Unified (Billions)	(\$412.8)	(\$318.5)	(\$265.0)	(\$340.0)
GDP Deflator	2.8%	3.0%	3.1%	2.6%
Producer Price Index (Finished Goods)	3.6%	4.9%	3.7%	3.1%
Consumer Price Index	2.7%	3.4%	3.7%	3.2%
Industrial Production	4.1%	3.2%	4.5%	4.1%
Real Disposable Income	3.6%	1.3%	2.9%	3.3%
Hourly Compensation	3.6%	4.4%	7.1%	5.2%
Unit Labor Costs (Non-Farm)	0.6%	2.0%	4.5%	2.9%
Productivity Growth (% Change)	3.0%	2.3%	2.6%	2.3%
Personal Savings Rate (% DPI)	2.0%	(0.4%)	(0.6%)	(0.1%)
Capacity Utilization – Total Industry	78.6%	80.0%	81.6%	82.2%
Trade Weighted \$ Exchange Rate (b)	(8.2%)	(1.8%)	(1.3%)	(3.5%)
Vehicle Sales (Million Units)	16.9	16.9	16.5	16.4
Housing Starts (Million Units)	1.949	2.073	1.834	1.625
Civilian Employment (Millions)	139.252	141.73	143.40	144.8
Civilian Unemployment Rate	5.5%	5.1%	4.7%	4.8%
Corporate Profits - AT-NIPA	27%	32.6% (c)	20.0%	5.2%
S&P-500 Earnings-Reported	\$58.55	\$69.93	\$79.50	\$86.00
S&P-500 Earnings-Operating	\$66.99	\$76.29	\$84.50	\$92.00
S&P-500 Dividends	\$19.25	\$21.75	\$24.25	\$26.10
90 Day U.S. Treasuries-Yield (%)	0.86-2.25	2.25-4.03	4.08-5.10	4.25-5.25
10-Year U.S. Treasuries-Yield (%)	3.68-4.87	3.89-4.66	4.33-5.15	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.