



SILVERCREST  
ASSET MANAGEMENT GROUP

## ECONOMIC REVIEW AND INVESTMENT STRATEGY: 2007/IV

### PASSAGE TO SANITY

Business cycles, and more specifically the onset of recessions, are not preordained by some cosmic arrangement. They are typically the consequence of a build-up in excesses and imbalances over extended periods, or else the product of unforeseen developments mainly on the geopolitical front. To a considerable extent, downturns cannot be measured precisely as to length and amplitude because they are shaped by a wide range of variables, including some that flow from psychology and politics.

At present, observers of the economic scene in the United States are divided as to the direction of the business cycle. Those whose focus is predominantly on the impact of a deteriorating housing sector assert that the accelerating downturn in this industry will depress consumer spending which, combined with traumatized credit markets, is bound to trigger a domestic recession. Those with a more optimistic bent believe that, housing aside, other engines driving economic growth are sufficient to prevent a classic decline.

On our part, we currently subscribe to the latter school based on two self-evident assumptions: first, that the turmoil in the housing sector has become well-publicized and therefore largely discounted; and second, that the credit markets are in the process of a rapid adjustment aided by the prompt response of the Federal Reserve and other central banks, with further assist from Washington. More specifically, the adverse impact of the subprime mess will likely begin to fade soon as speculators who have invested in such currently compromised obligations take their lumps and as other financial intermediaries are pressed to acknowledge and/or quantify their losses. When this chain of events unfolds, a considerable measure of transparency, and thus confidence, should re-emerge.

Comparing the current credit crisis in housing with prior experiences ignores the sea change that has occurred in risk management and mortgage lending by financial institutions since the last major downturn in 1990-1991. In the past, lenders, largely banks and thrifts, retained the loans as long-term investments, exposing themselves to significant interest rate and other risks. However, as the business has evolved in recent years, these traditional mortgage issuers have turned increasingly into mere intermediaries who packaged and resold such loans as newly-created debt instruments. Hence, the implied risk in these obligations shifted to the new owners, represented by traders and hedge fund speculators who as a matter of policy are required to affirm their ability to shoulder the attendant risks.

While some of the subprime obligations may have found their way back into the investment portfolios of the traditional lenders, in the form of security for loans to leveraged hedge funds, the amounts involved in such transactions represent a small fraction of the

recently-created mortgage paper. What all of this implies is that, despite the obvious risks and the significant losses that no doubt will be sustained by holders of such debt instruments, the direct exposure of the banking system, and to a lesser extent the insurance industry, is not of a magnitude that would cause corrosive or destabilizing consequences.

There are other reasons to expect the U.S. economy to be able to offset the adverse impact of housing. Key among these is that global growth is generating its own momentum, contrary to the past when the U.S. was relied upon as the prime engine. Such a reversal of roles has triggered a chain reaction of immense importance, including the rapid deployment of an abundant labor force unleashed within emerging countries, with China and India in the forefront; this in turn appears to be keeping inflation in check, contributing to low interest rates and a flood of savings and financial liquidity around the world.

Within the U.S., some of these global blessings are providing their own rewards. Aside from generating solid growth in exports, corporate managements have adjusted quickly to the new competitive conditions, which have indirectly triggered the most rapid acceleration in profits and cash flows in decades; such abundance has compelled many public companies to become more generous with their shareholders.

Creeping globalization has had other consequences as well. Spending for plant and equipment within the U.S. in the current expansion has been proceeding at the slowest pace in the post-war period, no doubt because many companies have found it more profitable to build facilities elsewhere. This cautious approach has reduced one key source of cyclicity by keeping excess domestic capacity in check. In addition, except for housing, an obvious lack of shortages has resulted in lean inventories nearly across the board, leading to the lowest inventory-to-sales ratio on record.

In brief, with inflation unthreatening, interest rates moderate, corporate balance sheets strong and quite liquid, the nation's major financial institutions well-capitalized, and profits and margins not subject to significant risks, the most obvious requisites for a recession seem to be in short supply.

#### **THE ECONOMY: CRUISIN' OR BRUISIN'?**

Two related developments have dominated the economic landscape in recent months: a rapid deterioration in the housing sector with its fallout in the credit markets, and the Federal Reserve's aggressive response to prevent a possible slide into recession. There is concern that the drop in housing may cause a slowdown in consumption, by far the largest slice of the economy and the most reliable source of growth.

With only one month of preliminary data showing weakening employment, it is too soon to conclude that consumers are becoming so disheartened that they may soon cross into a negative spending pattern. Employment statistics are notoriously unreliable and subject to significant revisions. It is still likely that 1.3 million jobs would be added this year which,

combined with a nominal increase of about 4.5% in hourly wages, could be counted on to keep consumption in a growth mode. The other sectors of the economy, though smaller in their totality, appear to be positioned for solid gains. Government spending is still budgeted to increase about 2.5% in real terms, while outlays for plant and equipment, aided by strengthening exports, are projected to rise close to 5.5%. The weakening dollar, combined with continued vigor around the globe, also has had a favorable impact on exports where the rate of gain has consistently outpaced that of imports in recent months. The sum total of these trends implies that a frugal consumer alone is unlikely to drive the economy into a recession.

Consensus views on the housing sector appear to have regressed from caution to concern and, most recently, to seeming despair. While data on sales and starts show rapid declines, media hype, often laced with exaggerations and inaccuracies, has heightened the sense of pessimism that has gripped the industry. We surmise that a trough may be reached in coming months due to the rapid adoption of a wide range of remedial measures. These include a gradual decline in mortgage rates and lower home prices, both of which are beginning to improve the affordability ratio. In addition, a thaw among conventional mortgage lenders—who had recently turned extraordinarily cautious in their lending policies—and some liquidation of excessive home inventories at reduced prices should accelerate the process of adjustment and eventually bring it to a halt. In the meantime, the fixed income market seems to have regained some sanity and equilibrium, having in recent days returned to a more normal level of activity while making a rational distinction among the various levels of risk. This is currently being reflected in narrowing credit spreads and resumption of strong inflows into money market funds.

It has been calculated that demographics, immigration, replacement and other factors call for a secular annual addition of 1.7–1.8 million housing units. These requirements have been exceeded by a total of close to one million units over the course of 2003-2006, of which about 400,000 units typically would have been absorbed this year if a normal pace of sales were attained. Applying a moving average for demand, it should take approximately one additional year to bring inventories to a sustainable level. Adverse psychology has evidently contaminated this calculation which may alter the implied timetable, though perhaps not by much.

Cognizant that an uncertain timeframe for housing stability may carry too much risk for the economy at large, the Fed has embarked on what is being viewed as an aggressive course of monetary ease with a promise of additional help if needed. Such a clearly articulated policy, while therapeutic in several respects, is being viewed in some quarters as an acknowledgment that Bernanke & Co. are willing to compromise on both maintaining dollar stability and containing the very mild inflationary pressures currently in evidence. Whether this approach constitutes a hasty retreat or a studied strategy will only become evident in the future. However, the Fed's prompt and unequivocal actions clearly spell out its current priorities. For this and other reasons, we believe that additional help may be forthcoming in the months ahead, perhaps in more measured steps, until economic stability can be reasonably assured.

We remain persuaded that some key attributes will help the U.S. economy avoid a recession. These include relatively low real and nominal interest rates, moderate inflation, strong corporate balance sheets thanks mainly to abundant free cash flows, the most cost-

conscious management class in decades, and a highly liquid financial system even after taking into account charges that may have to be recognized on delinquent mortgages or loans on subprime debt. On the consumption side, employment should remain in a moderate uptrend at the same time that wages continue to rise at a respectable pace. Finally, export demand should remain robust, fueled by global growth and a declining dollar.

The boring circus being billed as a presidential campaign has had virtually no impact on the course of the economy so far. This lack of response may be due largely to the fact that the victorious party will not be in a position to put its stamp on economic policy until 2009 at the earliest. By then, it should become abundantly clear whether a business downturn was at hand or has been dodged. Nonetheless, a barrage of populist pronouncements by various presidential candidates may raise more questions than provide answers about the direction of the nation's fiscal policy in the future.

In summary, we are of the view that: (1) the stress in the housing sector alone will not trigger a recession; (2) the U.S. economy will continue to draw strength from government outlays, capital spending and exports; (3) the Fed will remain friendly at least until mid-2008; (4) the dollar will remain under intermittent but moderate downward pressure until the central bank signals a "balanced" monetary policy; (5) a moderately lower dollar will likely intensify competitive pressures in favor of the U.S., particularly relative to many of the Eurozone countries; (6) growth in profits may well decelerate as margins, now at a peak, enter a topping process, and (7) due to its low risk profile, as reflected in a wide range of valuation metrics, the stock market should continue to plod irregularly higher even in the face of sluggish growth in the economy.

#### **INVESTMENT STRATEGY: SINNERS & WINNERS**

For most of this year, investors have approached the stock market with caution, if not outright unease. While both the economic landscape and corporate fundamentals remained supportive, doubts and uncertainty have been in the forefront. As a result, gains in the broad stock indices have not carried stocks to excessive valuations. In fact, since the market's rebound from the recession of 2000-2001, its trajectory has almost tracked the growth in corporate profits, thereby avoiding the excessive enthusiasm that typically builds up as confidence returns and appreciation of risk wanes. To cast the foregoing within a mathematical framework, the Standard and Poor's 500 Index has gained about 90% since its cyclical trough in 2002 while operating profits for the same period have nearly doubled; however, unlike prior bull markets where investors succumbed to irresponsible enthusiasm, caution and a measure of self-doubt have kept stock prices anchored to tangible fundamentals.

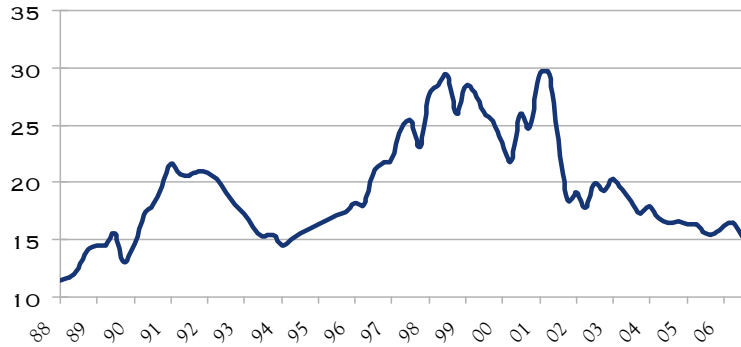
The caution and self-doubt alluded to above are clearly the outgrowth of the rapidly changing role of the United States on the global stage. On the economic front, the expanding influence of many developing countries, together with a reinvigorated industrial Europe, are making U.S. growth seem uninspiring and the country's "balance sheet" the subject of intense debate. On the geopolitical front, involvement in Iraq raises the issue of whether the United

States, or any other country for that matter, can any longer assume a dominant leadership role in a world afflicted by a multitude of conflicts fueled by rigid self-interest. For the U.S. stock market, the implications of such altered state is evident in its valuation metrics which no longer sport the historic “leadership premium” that has been its hallmark in the post-war period.

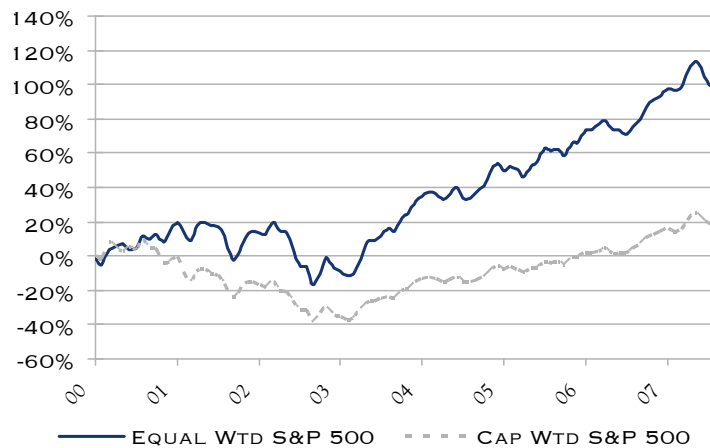
Interest rates considered, the Standard & Poor’s 500 is currently valued at the lowest price-to-operating earnings in more than 20 years (Chart I) which, combined with strong and liquid corporate balance sheets, cannot but reflect a low risk profile for domestic stocks. More important is that the distribution of value is not narrowly focused but is instead evident across a wide range of sectors and industries. Finally, the mega companies that constitute a pivotal anchor for the market continue to trail in the performance race even though they generally boast many defensive attributes including reliable growth, above-average dividends, significant global exposure and strong finances. Such disparity in valuations has become quite significant in recent years, with the mega caps currently priced at about a 15% discount to the broad index (Chart II).

Of equal relevance is that the growth sector of the market has underperformed value for several years, implying a multiple compression (Chart III). This near elimination of the valuation gap between the two disciplines has greatly expanded the shopping basket, improving the long-term return of diversified portfolios.

**CHART 1**  
**S&P 500 OPERATING P/E RATIO**  
Quarterly NTM Operating P/E 15.3\*



**CHART 2**  
**MEGACAPS UNDER-PERFORMANCE**



**CHART III**  
**GROWTH VS. VALUE**  
RELATIVE RETURN WITHIN RUSSELL 1000



The two sectors that provide investment attraction at present are technology and healthcare. Technology appears to be in the early stages of a new growth cycle which is encouraging accelerated consolidation in the industry. Healthcare has been beaten down by Washington's political posturing thus depressing their share prices, particularly those for pharmaceuticals, to their bare intrinsic value.

Financials, the market's largest weight, continue to trade under the cloud of weak housing and the subprime problem. While their depressed prices may already reflect a worst case scenario, it would be prudent to delay aggressive purchases pending greater clarity of their exposure to questionable loans. We suspect that the release of September quarter results will impart some measure of transparency.

In general, corporate earnings should be supportive for the balance of this year, aided by the decline in the dollar. However, profit growth in 2008 is likely to reflect the sluggish pace of the economy; as a consequence, a probable peak in margins may permit no more than a modest increase. This should be sufficient to generate an adequate return for stocks, aided by further monetary stimulus, a gift from the Fed.

On the fixed income front, dislocations from the subprime mortgage crisis continue to linger and we are taking advantage of some of the inefficiencies. Portfolio durations are currently slightly short of their benchmarks. We are looking for an opportunity to bring durations to neutral.

October 1, 2007

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Vice Chairman

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**ECONOMIC FORECAST**  
(AS OF OCTOBER 1, 2007)

	<u>2005</u>	<u>2006</u>	Estimated <u>2007</u>	Projected <u>2008</u>
Real GDP (Annual % Change)	3.1%	2.9%	2.1%	2.5%
Real Consumption Expenditures	3.2%	3.1%	2.9%	2.5%
Business Fixed Investment	7.1%	6.6%	04.1%	3.6%
Inventory Investment (Billions)	\$33.3	\$40.3	\$7.4	0.0%
Residential Construction (Billions)	\$597.1	\$569.5	\$475.0	\$460.0
Government Spending (Billions) (a)	\$1946.1	\$1981.3	\$2020.0	\$2063.0
Trade Balance-Goods & Services	(\$714.4)	(\$758.5)	(\$700.0)	(\$680.0)
Federal Budget*: Unified (Billions)	(\$318.5)	(\$248.2)	(\$150.0)	(\$225.0)
GDP Deflator	3.2%	3.2%	2.8%	2.4%
Producer Price Index (Finished Goods)	4.9%	2.9%	3.3%	2.7%
Consumer Price Index	3.4%	3.2%	2.7%	2.5%
Industrial Production	3.2%	4.0%	2.2%	3.1%
Real Disposable Income	1.7%	3.1%	3.2%	2.8%
Hourly Compensation	4.0%	3.9%	5.5%	5.0%
Unit Labor Costs (Non-Farm)	2.0%	2.9%	4.3%	2.9%
Productivity Growth (% Change)	2.0%	1.0%	1.2%	2.0%
Personal Savings Rate (% DPI)	0.5%	0.4%	0.7%	0.9%
Capacity Utilization – Total Industry	80.0%	81.7%	82.1%	81.3%
Trade Weighted \$ Exchange Rate (b)	(1.8%)	(1.4%)	(4.8%)	(5.0%)
Vehicle Sales (Million Units)	16.9	16.5	15.9	15.8
Housing Starts (Million Units)	2.073	1.812	1.410	1.450
Civilian Employment (Millions)	141.73	144.4	145.7	146.6
Civilian Unemployment Rate	5.1%	4.6%	4.6%	5.0%
Corporate Profits - AT-NIPA	32.3% (c)	13.9%	3.7%	3.5%
S&P-500 Earnings-Reported	\$69.93	\$81.51	\$87.00	\$90.00
S&P-500 Earnings-Operating	\$76.29	\$88.17	\$93.50	\$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	3.55-5.18	3.75-4.45
10-Year U.S. Treasuries-Yield (%)	3.89-4.66	4.33-5.25	4.25-5.00	4.00-5.00

\*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.