



SILVERCREST
ASSET MANAGEMENT GROUP

ECONOMIC REVIEW & INVESTMENT STRATEGY: 2011/IV

CLASH OF THE TITANS

Economic thought over the course of the 20th Century came to view fiscal and monetary policy as key levers by which the pace and direction of a nation's economic growth could be influenced, if not totally controlled. Monetary policy helps determine both the supply and cost of funds which, in turn, stimulate or discourage consumption and investment. Fiscal policy derives its importance from government's taxing authority, the allocation of revenues thus generated, and the additional borrowing power granted by law. In theory, monetary and fiscal policies are intended to be complementary and to work in harmony to reinforce each other, but harmony does not always prevail. Politics and other considerations frequently intervene which cause the two to conflict in timing and consequences.

Because changes in fiscal policy require a long legislative process often fraught with political machinations, controversies and compromises, they tend to have a delayed impact, nearly always missing their targeted timeline by a wide margin. Monetary action produces rapid, more timely results because it can be implemented almost at will, moves through the system more quickly, and wields a psychological force which is hard to measure but which nonetheless is quite relevant.

In its early development as a social science, economics was true to its Greek definition, *ta Oikonomicka*, or the discipline of household management. Its function was largely confined to measuring a nation's input and output and providing some understanding of the social conduct associated therewith. Its early thinkers, including Adam Smith, never presumed or aspired to play a role in charting or influencing social policy but advocated a *laissez-faire* approach wherein the state's primary function in the economic life of a nation was to enforce a set of rules that would ensure optimal production. The exalted function of social engineering was not assumed by the practitioners of economics until the early part of the 20th Century when governments began to lay claim to a growing portion of output and acquired the authority for reallocating such resources. Emboldened by their powers over the purse, those elected or appointed to administer the affairs of a nation made increasing use of fiscal and monetary policy to achieve social and political aims rather than merely to maximize the potential of the economy and to keep it from reaching extremes of boom or bust. This change in the direction of greater activism expanded the implied role and obligations of government and caused it to embark on deficit spending and huge borrowings to meet its new agenda. It also generated a new conflict between policies needed to implement business cycle stabilization and the massive requirements of social programs.

By the late 1980s, when public finance threatened to crowd the private sector out of the capital markets, an extreme was reached by most industrialized nations, including the United States, that threatened to overwhelm the global financial system. The collapse of communism, though often blamed for exposing the gravity of this financial crisis but not credited for some of the reforms that followed, merely revealed what had long been overlooked or denied. In brief, the use (or abuse) of fiscal and monetary policy had been carried to such extremes that they seemed to lose a great deal of their efficacy in helping maintain a semblance of economic order.

While the risks in such a transition was recognized in some quarters, a successful effort was nonetheless made to eliminate the protections of the Glass-Steagall Act, a regulatory firewall adopted during the Great Depression intended to curb speculation and to limit the risks from collusive activities in the financial system. Over the past few years such severe concern became a reality as many major financial institutions were able to by-pass the regulatory disciplines that had for many years served the world of finance with considerable efficiency. Glass-Steagall was ultimately repealed and laid to rest in 1999 paving the way to irresponsible speculation in ambiguous, mysterious or dangerous financial instruments.

Aside from the fading discipline in the financial arena, the weakened link between fiscal and monetary policy has greatly compromised the role of governments in guiding their nations' economies. As may be clearly noted in the current situation, both in the United States and in the euro zone, monetary policy has recently turned impotent, a fact clearly telegraphed by Fed Chairman Bernanke in his most recent testimony before Congress when he urged the legislative body to assume a more active role in stimulating economic activity through fiscal intervention. With the U.S. central bank having brought down interest rates to levels not seen in many decades, and with the system having been flooded with liquidity, monetary policy can no longer be counted on to be a key driver of an economic rebound in this cycle.

THE ECONOMY: A HIGH WIRE ACT

Thus far in 2011, events in the euro zone have influenced perceptions in the U.S. far more than soft domestic trends in the economy. While growth during the first half of this year was at a near standstill, and the threat of a double-dip recession grabbed many headlines, the real focus has remained on whether such a downturn would lead a parade of other euro zone countries down a slippery slope into a pit of financial and economic disasters. Negotiations to forestall such an event are continuing with no concrete measures either adopted or implemented. While brave words continue to flow on how to prop up a system too compromised to survive as it exists today, observers and commentators removed from the negotiating circle are privately convinced that the best outcome that can be achieved is a mere deferral of the inevitable. In the meantime, the euro zone, and perhaps the European community at large, may already have lapsed into recession, as Germany's latest data seem to suggest. With Europe a significant trading partner of the U.S., such weakness cannot help but clip whatever growth the U.S. is able to muster.

Domestically, modest improvements are becoming visible on many fronts. Employment is gaining, aided by upward revisions of prior data. Average hourly earnings and weekly hours worked are in an uptrend, supporting Disposable Personal Income and, by extension, consumption. Auto sales have been firm, hinting at solid year-over-year gains. Retail sales continue to advance, suggesting potentially favorable holiday sales. Manufacturing continues to reflect robust corporate spending and exports. Even the housing sector, long considered a lost cause, has held flat for several months with an increasing number of regions exhibiting improvement and the inventory of new houses reaching a new record low. While none of these sectors is in a vigorous upward trend, collectively they hint that growth in the second half should well exceed the anemic trajectory recorded in the early part of this year.

Recessions can have many causes, not all of which initially the result of shrinking final demand. At present, public sentiment ranges between uninspiring and cautious, but a number of considerations argue against an imminent downturn. Usual culprits, such as tight monetary conditions, excessive accumulation of inventories, overbuilding of industrial capacity or compromised corporate balance sheets have often been primary causes of recessions. None of these conditions is currently in evidence or on the short-term horizon.

In brief, we believe that: (1) the U.S. economy will likely deliver timid rather than robust growth in coming quarters; (2) neither inflation nor monetary restraint is in prospect; (3) while domestic profit margins appear to have peaked, further gains in revenue should keep earnings firm or in a slight uptrend; (4) capital spending by businesses should remain robust as companies cautiously raise their outlays for plant and equipment; (5) the dollar will likely remain firm, particularly versus the euro, and may score further gains if the threat of a euro zone implosion persists; (6) while growth in the developing economies may moderate somewhat, it is likely to remain substantial; and (7) having undergone a significant downward adjustment, global stock markets should remain sensitive to developments in the euro zone but are not likely to implode.

INVESTMENT STRATEGY: THE RACE BELONGS TO THE BRAVE

Global markets have been in a turbulent state since responding in full force to a long list of failures, uncertainties, and frustrations. These included the euro zone's continued inability to fashion plans that would bring a measure of lasting stability to countries in the throes of severe financial strain and facing a rising risk of recession. Further complicating this picture is Washington's inability to find political harmony, to resolve differences between the two major political parties or to keep the budget deficit from rising. These sources of stress have made any sense of optimism easy to challenge, exacting a large discount factor on such favorable indicators as the stellar results of corporate America and the tenacity of consumers to keep their expenditures on a mildly upward trajectory. Among the considerations cited by the doubters are an apparent peak in profit margins, the consequences of a possible disintegration of the euro zone, slowing growth among the emerging economies, and the probability of the Arab Spring regressing into uncontrollable social upheaval. These concerns have caused investors to focus largely on the attendant downside risks of the major world markets.

While a snapshot of the global economy justifies a cautious approach, it should be recognized that the threat to market stability currently emanates mainly from the financial arena rather than from the production/consumption side of the economy. Hence, any restoration of confidence could unleash robust final demand particularly in the developing economies.

In sync with other global bourses, the major U.S. stock market indices have so far declined 20% or more from this year's recovery high and are now nearly 30% below the peak registered in 2007-2008. This retreat has occurred in the face of a strong rebound in profits, sharply improved corporate balance sheets, an upsurge in productivity, and widespread increases in dividends. When September quarter earnings are reported, they are likely to show that American corporations now hold about \$1.7 trillion in cash, while their ongoing cash flow from operations exceeds spending for plants and equipment. With interest rates close to record lows, additional restructuring of balance sheets is further reducing debt service expenses in addition to encouraging managements to prudently continue the repurchases of their shares on the assumption that such action represents an efficient use of excess capital.

At its close on September 30th, the Standard & Poor's 500 was valued at 12-times 2011 earnings of about \$94, but at close to 11-times if adjusted for excess cash. Such conservative valuations appear to discount a very sluggish economy and recognize no further growth in profits in the near term. More notable is that the S&P 500 now provides a dividend yield of 2.2% which is well above the interest rate of 1.85% on 10-year U.S. Treasury obligations.

The assets that U.S. businesses represent should be valued primarily on the basis of discounted future cash flows net of excess liquidity. Applying such measurement would suggest that U.S. equities are arguably the cheapest major asset available, sociopolitical risks considered. In brief, we believe that the race belongs to those patient investors who are willing to wait out the current period of turbulence.

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Vice Chairman

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ECONOMIC FORECAST

(As of October 1, 2011)

	<u>2009</u>	<u>2010</u>	Estimated <u>2011</u>	Projected <u>2012</u>
Real GDP (Y-O-Y)	(2.6%)	3.1%	1.8%	2.8%
Real Consumption Expenditures	(1.2%)	2.1%	2.3%	2.5%
Business Fixed Investment	(17.1%)	4.4%	7.8%	7.0%
Inventory Investment (Billions)	(\$113.1)	\$58.8	\$49.0	\$45.0
Residential Investment	(4.3%)	(4.3%)	(1.6%)	4.5%
Government Spending* (Billions) (a)	\$2,546.4	\$2,562.9	\$2,520.0	\$2,545.0
Trade Balance-Goods & Services (Mil.)	(\$363.0)	(\$421.8)	(\$415.0)	(\$390.0)
Federal Budget*: Unified (Billions)	(\$1,413.8)	(\$1,294.2)	(\$1,271.0)	(\$1,150.0)
Gross Federal Debt* (Billions)	\$11,910	\$13,167	\$14,725	\$16,130
Consumption Price Deflator	0.2%	1.8%	2.8%	2.6%
Producer Price Index (Finished Goods)	4.3%	3.8%	5.2%	4.0%
Consumer Price Index	(0.3%)	1.6%	3.3%	3.0%
Industrial Production	(11.2%)	5.3%	4.1%	4.4%
Real Disposable Income	0.6%	1.8%	1.8%	2.8%
Hourly Compensation	2.0%	2.2%	2.4%	3.0%
Unit Labor Cost (Non-Farm)	(0.7%)	(2.0%)	4.4%	2.0%
Productivity Growth (% Change)	2.4%	4.1%	(1.6%)	(1.4%)
Personal Savings Rate (% DPI)	5.9%	5.3%	5.3%	5.6%
Capacity Utilization – Total Industry	69.2%	74.5%	77.0%	78.5%
Trade Weighted \$ Exchange Rate (b)	4.7%	(3.0%)	(6.4%)	(2.0%)
Vehicle Sales (Million Units)	10.3	11.5	12.4	12.8
Housing Starts (Million Units)	0.554	0.585	0.593	0.780
Civilian Employment (Millions)	139.9	139.1	139.8	141.4
Civilian Unemployment Rate	9.3%	9.6%	9.1%	8.7%
Corporate Profits – After Tax – NIPA	3.6%	19.0%	7.8%	11.0%
S&P-500 Earnings-Operating	\$65.26	\$86.73	\$94.00	\$98.00
S&P-500 Dividends	\$24.20	\$24.50	\$26.25	\$28.50
90 Day U.S. Treasuries-Yield (%)	0.01-0.32	0.03-0.18	0.00-0.20	0.05-0.50
10-Year U.S. Treasuries-Yield (%)	2.20-3.95	2.39-3.99	1.70-3.74	1.75-2.50

**Fiscal Year-end 9/30. (a) Federal, State, and Local; in 2005 dollars; (b) Fed Major Currency Exchange Rate.*