



SILVERCREST
ASSET MANAGEMENT GROUP

ECONOMIC REVIEW AND INVESTMENT STRATEGY: 2005/IV

AN EMPEROR'S FAREWELL

"I guess I should warn you, if I turn out to be particularly clear, you've probably misunderstood what I've said."

Alan Greenspan, 2000

As Alan Greenspan prepares to bring to a close his distinguished service as Chairman of the Federal Reserve Board, it would be instructive to reflect on his contributions to monetary policy in a period of considerable change, as well as on his critical role in charting a relatively steady course for the U.S. economy.

Mr. Greenspan has been at the helm of the central bank for 18 years, the second longest tenure of any Chairman, succeeding Paul Volcker, who has become known as the fearless and decisive giant inflation killer. Both have proved to be men for their times, though with sharply different agendas and styles. Mr. Volcker faced an urgent predicament that threatened the foundation of the economy as hyperinflation was breaking out at a time when the U.S. industrial base was rapidly losing its competitive muscle. He did not have the advantages of time and patience to experiment with theoretical alternatives to remedy a problem seemingly reeling out of control. He met the task head on, accepting a deep recession as perhaps the most appropriate trade-off.

By the time Mr. Greenspan assumed leadership at the Fed in 1987, inflation had been tamed and economic growth was accelerating. Rapid changes, however, were already at work domestically and abroad. At home, untested approaches to financial engineering and the introduction of many complicated investment instruments were creating new risks that could not be accurately measured, let alone fully understood. Patient, thoughtful and rarely ruffled, he radiated confidence in the ultimate success of his approach, but without projecting power or arrogance. Such soothing demeanor allowed him to expand the influence of the central bank beyond its historically-defined responsibilities of price stability and full employment. As a consequence, he was able gently to influence policies that had been considered the domain of the Treasury and State Departments, two executive branches of government presumably separate and distinct from the politically-independent Fed. That he was able to become a key power broker beyond the central bank, assuming various roles without antagonizing other important players, is underscored by the very high regard in which he has been held irrespective of which political party held sway in Washington. His claim to modesty has often been verbalized in such assertions as: "There is much that we don't know about the economy."

Until Mr. Greenspan became its chairman, the Federal Reserve Board was perceived as an institution largely shrouded in mystery, which created a distorted view of its influence, particularly regarding what it can and cannot accomplish. His rapid move toward much greater transparency has created a better understanding of the Board's decision-making process and the thinking that anchors any policy action it takes. This important evolution has been achieved through the earlier release of the

minutes of the FOMC meetings, the more open access of the individual governors to speak out on the record, his testimonies before Congressional bodies, and the multitude of economy-related topics that he treats upon at various forums. Such efforts have largely succeeded in removing the element of surprise that in earlier instances had jolted the consensus view.

For nearly the entire existence of the Federal Reserve Board, its responsibilities were understood to be those of achieving relative price stability and full employment. However, in an increasingly globalized financial structure and massive cross-border movement of goods and capital, magnified by self-serving nationalist machinations, controlling inflation became only one of many related tasks that fell to him. In this connection, he has shunned rigid inflation targeting—in the style of the Bank of England—giving preference to achieving maximum sustainable economic growth consistent with relative stability. This subtle shift appears to flow from recognition of the significant impact of globalization, technology and productivity which he believes may be reining in inflation, perhaps for a long time. That the two recessions experienced during his tenure were the briefest and shallowest in more than one hundred years attest to his ability to chart and navigate a steady course. Mr. Greenspan made a smooth transition into this expanded role with a substantial understanding of the various levers that can be moved to keep the economy growing with as little volatility as possible. His early recognition that monetary policy requires the application of “risk management” has helped him deal successfully with many difficult and contentious crises, even by preemptive action when required. These included the confrontation with the Bundesbank precipitated by then-Treasury Secretary James Baker in 1987 that, some claim, contributed to that year’s stock market collapse; the savings and loan debacle; the Mexican default; the meltdown of Long Term Capital Management; and the Russian debt default in 1998, to list only the most obvious. His responses to these high-risk events will always stand out, providing examples to be emulated by his successors.

Some critics fault Greenspan for his failure to speak out firmly on some critical issues that called for more assertive voices. Among these are the stock market bubble of the late Nineties, which he accurately described as “irrational exuberance,” then turned silent on his timely warning; his studied indifference on tax and other questionable fiscal policy decisions in Washington; his weak guidance on how to address mushrooming trade deficits; and, most recently, his reluctance to raise the flag of caution on a housing boom apparently on the way to extremes. In his defense, he would be justified in claiming that a free enterprise system must be allowed to function unencumbered so long as it remains within reasonable parameters of risk. Again, this may be viewed as another aspect of his “risk management” approach.

Mr. Greenspan has been described as “being the greatest central banker who ever lived.” While it is difficult to accept such a lofty judgment of a mortal, it cannot be denied that his guidance, temperament and style greatly influenced monetary policy, and hence the course of the U.S. economy. He was notably successful in skirting major pitfalls that could have derailed a long period of prosperity not experienced anywhere else in the world. For that he will always be viewed as the quintessential central banker.

Mr. Greenspan’s successor at the Fed will be inheriting an institution with a considerable residue of goodwill, confidence and respect that were justly earned. The new chairman will be taking the helm just when a long series of interest rate hikes are either at, or close to, an end. Nonetheless, he will be promptly pressed to address many remaining problems which, if not treated with some urgency, can intensify economic volatility and impede growth. The list includes the deteriorating balance-of-payments deficit, low personal savings, elevated consumer debt, excesses in the housing market, and the integrity of

the dollar. How he approaches this agenda will likely define his style and the early reliability of his stewardship.

THE ECONOMY: CHALLENGED BUT NOT DAMAGED

With hurricanes Katrina and Rita now part of meteorological history, an assessment of the damage they wrought, untainted by emotions or politics, would be a particularly useful exercise as it relates to their near-term impact on the economy. In this connection, several tentative conclusions can be cited. First, their human cost and suffering are beyond measure, but should become catalysts for preparedness to deal with future disasters. Second, business activity, not only in the region that sustained the most damage but across the entire country, will be temporarily impeded as higher prices and various shortages ripple through the system, with a possible reduction of 0.5-1.0 percent in Gross Domestic Product spread out over the next 3-6 months. Third, such imbalances are almost certain to penalize profits, perhaps slicing by about one-half their previously expected gain of 10-12 percent over the next year. Fourth, the fiscal cost of rebuilding may well exceed \$150 billion, to be assumed mostly by the federal government, adding to the previously projected budget deficits with related consequences on interest rates and the dollar. Fifth, a whiff of inflation is already discernible as businesses attempt to capture increased costs, thus raising a warning flag on monetary policy. Finally, all of the foregoing will likely depress consumer sentiment, keeping personal consumption expenditures at bay for a few quarters.

Beyond the intermediate term restraints generated by the hurricanes, business conditions should resume a more normal growth pattern, perhaps as early as next spring or sooner. Providing support would be a solid increase in capital spending generated both by corporate outlays to protect profit margins in a competitive, technology-driven environment and by political pressure to rebuild damaged infrastructure. The former can be readily financed with the abundant liquidity in corporate balance sheets as well as strong cash flows, while the latter would be largely the responsibility of various levels of government. The estimate of more than \$150 billion cited above would contribute a total increase of about 1.5% to GDP, excluding any multiplier effect, over the time span required essentially to complete the necessary reconstruction.

While such efforts are underway, some changes in the sources of growth may well unfold. Key among them is a moderate slowdown in housing activity brought on by a rising inventory of unsold homes, particularly in key urban areas, higher mortgage rates and other carrying expenses, as well as an emerging shift in the trade-off between renting and owning which is tending toward the former.

Throughout the downturn of 2000-2001, the consumer barely wavered on the spending front, dipping into meager savings and using proceeds from home equity loans. With these sources nearly exhausted, and no evidence of remaining pent-up demand, personal consumption expenditures are not likely to be as accretive to normal economic growth as they had been early in the current expansion.

In addition to a robust capital spending sector, the economy may get a boost from a decline in the cost of energy once the industry's damaged infrastructure is largely repaired. In recent weeks, domestic as well as foreign sources with unused production capacity have raised their oil and gas output to satisfy pressing demand and to take advantage of record prices. At the same time, more conservation is being reported domestically and abroad that may well persist for an extended period. As lost production capacity is restored, sources that had stepped in to provide additional supplies may become reluctant to promptly reduce output, thus putting downward pressure on prices. The oil industry's pricing history over the past 25 years attests to such cycles in the demand/supply balance. China and India, often invoked as

buyers of first and last resort, cannot be relied upon to generate a level of demand sufficient to bring permanent equilibrium to a volatile energy market.

In the course of the past fifteen months, the Federal Reserve Board has conducted monetary policy with one overriding objective, namely to withdraw the abundant stimulus it had made available to contain the economic downturn of 2000-2001. While until recently inflation had remained tame, the economy has continued to expand at a solid clip requiring the removal of prior accommodation. Although some may argue that this task is now nearly complete following eleven successive hikes in interest rates, the threat posed by new inflationary pressures, even if temporary, should persuade the Fed to stay the course with additional hikes. Furthermore, many Fed governors, including Mr. Greenspan, have recently expressed concern over the persistent increase in housing prices, consumer debt and the consequences of a sharp escalation in the country's balance-of-payments deficit. Finally, with the additional borrowing needs in Washington, the dollar would require some support which, in the short-term, can only be provided by higher interest rates.

A concern that has surfaced of late is the threat of an inverted yield curve which in the past had often heralded an approaching recession. Without meaning to dismiss entirely such correlation, many conditions have intervened that may have weakened the historical connection. A flattening yield curve during the second half of the 1990s failed to suppress vigorous growth, perhaps because inflation remained relatively tame. Meanwhile, the rise in short-term interest rates ultimately pushed up the long-end, though to a lesser degree. Finally, the balance sheets of financial institutions, particularly those that can be at risk of disintermediation, are now in a far better shape than at any time in the past forty years when an inverted yield curve carried an implied warning.

In summary, we conclude that: (1) the U.S. economy may have entered a brief patch of slower growth, but it should return to its secular pace sometime during the first half of 2006 as additional spending provides incremental support and as energy prices recede; (2) inflation is about to show a temporary acceleration largely due to recent events; (3) monetary policy will likely continue on a restrictive path into the early part of next year; (4) housing demand and prices may be nearing a peak, as suggested by various data; (5) as damaged infrastructure in the Gulf Coast region is repaired, the resulting increase in oil supplies, together with some conservation, should cause the cost of energy to decline; (6) the dollar should remain in a broad trading range near current quotations as higher interest rates offset the impact of escalating deficits, and (7) in anticipation of an end to monetary restraint and the resumption of more normal economic growth, investors will look with favor on the U.S. stock market which has failed to reflect the full measure of the gains in business profits.

INVESTMENT STRATEGY: STAYING THE COURSE

For the past year, the U.S. stock market has been hostage to a number of factors that cannot be easily quantified. Topping the list is widespread social and political dissatisfaction with the nation's leadership, notably the lack of transparency in Washington's decision-making process. Whether this claim is entirely accurate, or is heavily tainted by political bias on intractable problems that have been brewing for a long time, is worthy of debate in a different forum. Nonetheless, it cannot be denied that such feeling of unease has contaminated investor sentiment and ignores the solid performance of the economy. Furthermore, this heavy fog of doubt and uncertainty is not likely to lift until a few favorable developments restore a measure of psychological balance, if not the outright optimism typical of the American psyche.

With the hurricane season essentially behind, and the magnitude of its damage better known and perhaps largely discounted, relief for the stock market may not be far off in the future. First, once the rebuilding of the damaged energy infrastructure begins, oil and gas quotes should anticipate increased supplies which will reduce prices by a significant amount. Second, it is quite likely that monetary restraint may come to an end with Mr. Greenspan's departure early next year. Third, earnings may well reaccelerate as the economy recovers from the recent damage, perhaps as early as the opening months of 2006. Fourth, Katrina and Rita have slightly dented but not meaningfully damaged corporate balance sheets or cash flows which remain near their best levels in more than four decades. Collectively, these developments should restore clarity and confidence in the valuation metrics that typically support any market forecast.

Successful investing relies on the art of anticipation. We are persuaded that profit growth in this cycle is not at an end, but the outsized contribution of some sectors, such as energy, may fade with the torch passed on to other groups. Over the past two years, energy has contributed far more than its pro rata share, and we suspect that further large gains are unlikely given the anticipated 1-2 percent secular increase in global consumption. On the other hand, the capital spending/producer durables sector should benefit from an extended cycle helped by rebuilding prospects. The financial sector, particularly intermediaries engaged in mortgage and consumer lending, appear to be in the early stages of a downturn as real estate, notably the housing market, finally succumb to peak prices and rising interest rates. Retailers and consumer staples seem to have entered a period characterized by sluggish growth in personal consumption, heightened competition and rising costs.

In general, we are inclined to nudge the structure of our portfolios toward investments with growth attributes where the gain in profits is perceived to be greater than the mid-single digits we forecast for the Standard & Poor's 500 Index. These would include selected technology companies, healthcare, life and health insurance carriers, and defense companies with exposure to surveillance and homeland security equipment and services. These favored candidates are in addition to the previously cited producer durables that may be treated as having a limited shelf life tied to the business cycle.

For the stock market as a whole, once the current period of heightened uncertainty comes to an end, it is more likely to trade closer to the level justified by fundamentals than be shaped by adverse psychology or politics. Nearly all of its relevant metrics point to valuations that suggest lower than normal risk and double-digit annual returns at least through 2006. As an asset class, equities are calculated by us to promise the best risk-adjusted rate of return compared to fixed income, real estate or commodities. Ranked by style, the disparity in valuations as between "value" versus "growth" and "large" versus "small" capitalization has rarely been as thin as it is at present which explains our inclination to lean cautiously toward companies with growth characteristics.

On the fixed income front, we remain quite cautious recognizing that some escalation in inflation, even if caused by short-term factors, and the desire to restore "normalcy" on the interest rate front would call for further restraint. Hence, emphasizing the short end of the yield curve would be a suitable strategy, in our opinion.

October 1, 2005

Stanley A. Nabi, CFA
Vice Chairman

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ECONOMIC FORECAST
(AS OF OCTOBER 1, 2005)

| | <u>2003</u> | <u>2004</u> | Estimated <u>2005</u> | Projected <u>2006</u> |
|---------------------------------------|-------------|-------------|---------------------------------|---------------------------------|
| Real GDP (Ann. % Change) | 2.7% | 4.2% | 3.6% | 3.0% |
| Real Consumption Expenditures | 2.9% | 3.9% | 3.7% | 2.9% |
| Business Fixed Investment | 1.3% | 9.4% | 8.3% | 6.2% |
| Inventory Investment (Billions) | \$15.5 | \$52.0 | \$15.5 | \$29.0 |
| Residential Construction (Billions) | \$509.4 | \$561.8 | \$595.0 | \$585.0 |
| Government Spending (Billions) (a) | \$1911.1 | \$1,952.1 | \$2010.0 | \$2050.0 |
| Trade Balance-Goods & Services | (\$494.8) | (\$617.6) | (\$695.0) | (\$775.0) |
| Federal Budget*: Unified (Billions) | (\$374.3) | (\$412.8) | (\$325.0) | (\$425.0) |
| GDP Deflator | 1.8% | 2.6% | 2.8% | 2.8% |
| Producer Price Index | 3.2% | 3.6% | 4.4% | 3.2% |
| Consumer Price Index | 2.3% | 2.7% | 3.6% | 3.5% |
| Industrial Production | 0.0% | 4.1% | 3.6% | 4.1% |
| Real Disposable Income | 1.9% | 3.4% | 2.3% | 3.2% |
| Hourly Compensation | 4.0% | 4.5% | 5.9% | 4.3% |
| Unit Labor Costs (Non-Farm) | 0.2% | 1.1% | 3.4% | 2.1% |
| Productivity Growth (% Change) | 3.8% | 3.4% | 2.4% | 2.2% |
| Personal Savings Rate (% DPI) | 2.1% | 1.7% | 0.2% | 0.4% |
| Capacity Utilization – Total Industry | 75.5% | 78.1% | 80.2% | 80.9% |
| Trade Weighted \$ Exchange Rate (b) | (12.2%) | (8.2%) | (2.0%) | (1.0%) |
| Vehicle Sales (Million Units) | 16.7 | 16.9 | 17.1 | 16.9 |
| Housing Starts (Million Units) | 1.854 | 1.950 | 2.000 | 1.840 |
| Civilian Employment (Millions) | 137.736 | 139.252 | 141.8 | 143.6 |
| Civilian Unemployment Rate | 6.0% | 5.5% | 5.1% | 4.8% |
| Corporate Profits - AT-NIPA | 28.2% | 11.8% | 29.0% | 6.5% |
| S&P-500 Earnings-Reported | \$48.74 | \$58.55 | \$66.50 | \$72.50 |
| S&P-500 Earnings-Operating | \$55.54 | \$67.09 | \$73.50 | \$77.00 |
| S&P-500 Dividends | \$17.60 | \$19.25 | \$21.00 | \$22.25 |
| 90 Day U.S. Treasuries-Yield (%) | 1.40-0.75 | 0.86-2.25 | 2.49-3.90 | 3.40-4.25 |
| 10-Year U.S. Treasuries-Yield (%) | 3.17-4.55 | 3.68-4.87 | 3.90-4.65 | 4.35-5.00 |

*Fiscal Year-end 9/30. (a) Federal, State, and Local; in 2000 dollars; (b) Fed Major Currency Exchange Rate.