



**SILVERCREST**  
ASSET MANAGEMENT GROUP

## THE U.S. ECONOMY & STOCK MARKET: LIFTING CLOUDS

Judging by the preliminary data issued by the U.S. Department of Commerce, economic growth in the September quarter, estimated at 3.8%, has remained solid, exceeding expectations on many fronts. Final sales increased 4.4%, exports rose and imports declined modestly. Inventories registered a significant drop which, if excluded, would raise growth to 4.2%. In all, final sales advanced 4.4%, helped by a gain of 3.9% in consumer outlays, 6.2% in business investment and 7.7% in federal government spending. As measured by the GDP Deflator, inflation crept up to a 3.1% annual rate, which seems manageable considering the various price pressures experienced recently. There are indications that some easing on the inflation front may be in progress, reflected in a relatively small rise in the Employment Cost Index and the modest advance of 1.3% (annualized) in the price components of Personal Consumption Expenditures. Meanwhile, employment data remain robust when adjusted for the impact of the hurricanes, suggesting average monthly additions of 175,000-200,000 jobs.

The clearly comforting picture depicted by the data seems inconsistent with the negative sentiment that has gripped many forecasters and investors throughout this year. Such pessimism was, of course, provoked by many headwinds, including the persistent tightening by the central bank, the spike in the price of energy (which now appears to be reversing course), the added cost of the recovery plan following the hurricanes, rumors about the ultimate survival of General Motors, and the seemingly never-ending morass in Iraq. These sources of concern are being further aggravated by the debate on Social Security and Medicare, as well as political frictions in Washington. These conditions have aroused public dissatisfaction and unease, clouding an otherwise encouraging economic picture. While psychology cannot be entirely divorced from fundamentals, its impact is often fleeting and subject to rapid reversal.

Although Ben Bernanke, Mr. Greenspan's anointed successor, is being painted as an independent thinker whose approach to inflation is of a more rigid variety, he is likely to initially use the same map as Mr. Greenspan in charting the course of monetary policy. If the recent vigor in business activity continues into the first half of next year, as we believe, he may well remain on course to implement further increases in interest rates. This would constitute a signal of his determination to smother budding inflationary pressures and to introduce a greater margin of safety. Hence, we forecast at least two additional hikes in the Fed Funds rate in the early months of his leadership. Such an approach would serve to cement his credentials as an inflation hawk, restrain the real estate market by gradually deflating the housing sector (short of sparking severe consequences), and in essence setting a less volatile course for the economy.

With growth generally above expectations, interest rates moving upward at the same time that inflationary pressures are being contained or reduced, and the trade deficit shrinking as a result of lower oil prices and declining imports, the dollar should be subject to adequate support, even perhaps generating an extension of its year-long rally.

The U.S. stock market, whose return so far this year has lagged those of the bourses of most other industrial countries, should be viewed within the context of several observations. First, its underperformance has not been the consequence of timid or negative economic growth, nor of anemic operating earnings or margins; in fact, profits should be up at least 15% this year on top of almost 21% in 2004, for a total return of more than 40% in the two-year period. This is barely reflected in the Standard & Poor's 500 which gained a mere 8.5% since the opening bell in 2004. Such disparity has brought the market valuation on forward 12-month earnings to a level not seen since 1993 when interest rates were higher than at present. Second, corporate balance sheets are in their best shape in more than 45 years, cash flow is quite robust, dividends are being hiked, share repurchases are accelerating and M&A activity is on the rise. These attributes argue against either a bear market developing in the near future or a lack of positive response should earnings continue to grow next year, as we expect. Third, sector valuations in the market, whether divided into styles or capitalization size, have become severely compressed, a condition that often occurs near the trough of a market cycle. Finally, a comparison of the attractiveness of various asset classes (stocks, fixed income, real estate, art, venture capital, etc.) strongly suggests that equities are the most undervalued among the various categories.

At a minimum, the U.S. stock market should deliver a solid return within the next twelve months with little or no expansion in its P/E ratio. The reward/risk balance seems clearly in favor of the former.

November 1, 2005

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**ECONOMIC FORECAST**  
As of November 1, 2005

|                                       | <u>2003</u> | <u>2004</u> | Estimated<br><u>2005</u> | Projected<br><u>2006</u> |
|---------------------------------------|-------------|-------------|--------------------------|--------------------------|
| Real GDP (Ann. % Change)              | 2.7%        | 4.2%        | 3.5%                     | 3.0%                     |
| Real Consumption Expenditures         | 2.9%        | 3.9%        | 3.2%                     | 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   | \$2005.0                 | \$2045.0                 |
| Trade Balance-Goods & Services        | (\$494.8)   | (\$617.6)   | (\$700.0)                | (\$775.0)                |
| Federal Budget*: Unified (Billions)   | (\$374.3)   | (\$412.8)   | (\$316.8)                | (\$435.0)                |
| GDP Deflator                          | 1.8%        | 2.6%        | 2.8%                     | 2.8%                     |
| Producer Price Index                  | 3.2%        | 3.6%        | 4.9%                     | 4.2%                     |
| Consumer Price Index                  | 2.3%        | 2.7%        | 3.6%                     | 3.7%                     |
| Industrial Production                 | 0.0%        | 4.1%        | 2.9%                     | 3.0%                     |
| Real Disposable Income                | 1.9%        | 3.4%        | 1.5%                     | 2.5%                     |
| Hourly Compensation                   | 4.0%        | 4.5%        | 5.9%                     | 4.3%                     |
| Unit Labor Costs (Non-Farm)           | 0.2%        | 1.1%        | 3.4%                     | 2.3%                     |
| Productivity Growth (% Change)        | 3.8%        | 3.4%        | 2.4%                     | 2.2%                     |
| Personal Savings Rate (% DPI)         | 2.1%        | 1.8%        | -0-                      | -0-                      |
| Capacity Utilization – Total Industry | 75.5%       | 78.1%       | 79.8%                    | 80.2%                    |
| Trade Weighted \$ Exchange Rate (b)   | (12.2%)     | (8.2%)      | (2.0%)                   | (0.8%)                   |
| Vehicle Sales (Million Units)         | 16.7        | 16.9        | 16.9                     | 16.7                     |
| 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%       | 30.5%                    | 7.0%                     |
| S&P-500 Earnings-Reported             | \$48.74     | \$58.55     | \$67.50                  | \$73.00                  |
| S&P-500 Earnings-Operating            | \$55.54     | \$67.09     | \$76.50                  | \$79.00                  |
| 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   | 2.49-4.45                | 4.40-5.10                |
| 10-Year U.S. Treasuries-Yield (%)     | 3.17-4.55   | 3.68-4.87   | 3.90-4.80                | 4.50-5.50                |

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