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The month of August has proven to be a period of extreme turbulence, not only in the global stock markets but in the broader financial system as well. How it is approached by the various authorities should provide a window on how financial crises of a global magnitude will be dealt with in the future. Thus far the evidence is comforting. Not only have key central banks responded promptly and in proper order, but they have done so without heightening the fears that have gripped capital markets. In the U.S., the Federal Reserve Board has made several moves to alleviate capital market risks by: (1) reducing the Discount Rate; (2) allowing Reserve Bank lending of up to 30 days instead of the usual 24 hours; (3) making such loans renewable by the borrower; (4) accepting mortgage-backed securities instead of Treasuries as security; (5) continuing the injection of liquidity as needed; and (6) relaxing the cap on bank lending to affiliates. These are not half-hearted measures but rather provide an unmistakable signal of a determined effort to contain damage to the financial systems.

We are not persuaded that a lowering of the Fed Funds rate in September is desirable or necessary at this time since it would cast doubt on the Fed's inflation fighting credentials, particularly as Chairman Bernanke may still be in the process of burnishing his credibility. Nonetheless, the central bank should take it upon itself to be more forthcoming in its assessment of conditions in the credit markets at its next meeting. Meanwhile, fear of an upturn in interest rates is no longer an imminent danger.

The key question at present is whether the measures already announced will be sufficient to keep the global economy on a growth trajectory. Our guess is that any impact from the credit crisis will be limited in both magnitude and timing, although the media may keep it front-and-center for longer than necessary. This conclusion is derived from the following observations: (1) central banks have been prompt in their intervention, notably by acting before the fallout from the credit problems moved into the danger zone; (2) The global financial system remains awash in liquidity, and hence is in a position to provide the resources to temper some of the exaggerated concerns; (3) While the crisis has broadened somewhat in recent weeks, from hedge funds and mortgage lenders to a longer list of players, it does not appear to have had an adverse impact on basic economic activity as defined in the production/consumption equation; (4) It has now become questionable whether those central banks that have been in the camp of "tightening" would act hastily, at least in the short-term; (5) Recent events in the capital markets have delivered a warning against unsound speculative practices, hence peeling off a layer of risk; (6) Financial institutions that have sustained serious damage will be pressed to acknowledge and quantify their exposure, thus eliminating the guessing game that has afflicted the financial sector.

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Although second-quarter growth for the U.S. economy has been revised upward, the evidence for the second half of this year calls for a more tepid, though still positive, performance. Consumers have turned less aggressive at the same time that the other sources of business activity are merely moving apace rather than taking up the slack. Nonetheless, worthy of mention are the recent strength in U.S. exports, rising industrial production and a very firm backlog for producer durables. In all, we do not judge the current imbalances in the economy to be of sufficient magnitude to spark a recession within the next 12 months, despite the adverse consequences of the subprime mess.

While forecasts for U.S. growth are being tempered, corporate fundamentals should be subject to less uncertainty. Corporate balance sheets remain in excellent shape, with cash balances the highest in 20 years. Profit margins appear to be giving little ground, thanks to a new generation of managers keenly aware of global competition and the need for cost containment. Inflation remains unthreatening and likely headed downward in the short term. With corporate profits for the second quarter having been reported above expectations, mean estimates for the remainder of the year do not appear at serious risk. Finally, the current correction in the stock market, aside from possibly discounting the much publicized subprime problem, has further depressed previously reasonable valuations thereby removing another layer of risk. Of critical note is that, interest rates considered, a bear market has not developed from current valuation levels in more than 40 years.

With confidence shaken, investors may lean toward a more conservative approach that would favor companies not caught up in the LBO/private equity/financial engineering frenzy. This should add attraction to a long-neglected but diversified slice of the market with defensive fundamental attributes, demonstrated long-term growth, and significant exposure to global growth.

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