



SILVERCREST  
ASSET MANAGEMENT GROUP

## ECONOMIC REVIEW AND INVESTMENT STRATEGY: 2005/I

### TAMING THE TIGER AND OTHER TALES

The U.S. dollar has seized center stage in the global financial press where it is being treated as if it were a toxic substance. The greenback's weakness has provoked sermons on fiscal rectitude, criticism of the profligate American consumer, lectures on the anemic savings rate, and finger-pointing by self-righteous politicians at home and abroad. Not surprisingly, few participants in this blame game seem inclined to take an inward look or to assess the multinational relationships that are depressing the dollar and threatening undesirable economic and social consequences.

That the dollar has become materially undervalued on the basis of purchasing power parity, and therefore quite competitive relative to the currencies of other advanced industrial nations, is no longer in dispute. Whether its decline is sufficient to overcome other fundamental, psychological and political hurdles it faces is a subject that calls for dispassionate discussion.

It is undeniable that the United States is guilty of living beyond its means and that a continuation of its current budget and trade deficits is unsustainable and fraught with risk. However, given that the U.S. is the world's largest importer, its contribution to global growth is both significant and critical. Therefore, the dollar's retreat cannot be helpful to a global economy moving toward a more liberal open architecture that requires the rapid easing or elimination of trade and other barriers. This is particularly relevant at a time when most countries are attempting to forge a new economic order that spreads prosperity, stimulates growth and reins in extreme fluctuations. Recent efforts to strengthen and expand the European Union, China's rush to industrialize and create jobs, Japan's struggle to address its perennially meager growth, and the desire of many countries in Southeast Asia to be included in this worthy exercise are all meritorious undertakings that could be thwarted or impeded by unnecessary jealousies and hostilities. Hence, making the dollar an instrument of political gamesmanship should be recognized as a destructive approach that will benefit none of those on either side of the seesaw.

Viewed through a panoramic prism, the budget deficit of the United States is no greater relative to GDP than those being incurred by Japan or nearly each of the Eurozone countries. Of more urgent concern, however, is the trade deficit which is being financed almost entirely by external borrowings. While most lenders have been vocal in their criticism of the size of the shortfall in the trade balance, they seem reluctant to concede that their economic interests are best served by their continued accommodation. Specifically, most creditor nations can only maintain their exports to the United States if they are willing to recycle some of the dollars they receive for their goods since failure to do so would understandably reduce their domestic growth. The lending side of the equation is being undertaken voluntarily in a free market environment calibrated by the changing value of the dollar and interest rates. Finally, it is evident that such lenders are unable to invest their excess liquidity at home or to deploy it elsewhere as safely and efficiently as they can in the United States.

The United States currently imports more than \$1.8 trillion in goods and services annually, accounting for about 6.3% of global gross product, and incurs a trade deficit of more than \$600 billion. To achieve a meaningful reduction in this imbalance, a reduction in the shortfall by about one-half, or

\$300 billion, would be necessary. Such major surgery, if not performed with caution and over time, could unleash a shock to the global economy that could reduce growth by more than one percent, excluding any multiplier effect. While the damage would be sustained broadly, many countries and regions can ill-afford such a deleterious outcome. As it is, the decline in the dollar has rendered the Eurozone uncompetitive, contributing to the recent deceleration in its growth rate, and has also caused Japan's economy to sputter, with negative consequences for many of its trading partners in Asia.

The rising chorus for intervention in the currency markets is misguided for two reasons: first, such intervention has never provided a lasting remedy, and second, it merely delays the hard decisions that ultimately have to be made. Only a multinational, multifaceted approach can administer the necessary cure. At present, the U.S. is in no position to deal unilaterally with the problems of the dollar if others act largely in their own self-interest. Nevertheless, the U.S. should raise interest rates more aggressively, restrain government spending, and encourage savings by marginally penalizing consumption through fiscal measures. Other players, such as the Eurozone countries and Japan, which are afflicted by sluggish growth, would benefit from some lowering of their interest rates, the adoption of measures that would stimulate domestic consumption, and the implementation of rapid changes in their costly and rigid regulatory and industrial structures and their labor markets.

China, perhaps the greatest beneficiary of U.S. imports, has used its currency's peg to the dollar to maximum advantage and continues to be adamant in its refusal to make the necessary adjustments. This is in addition to violating many terms of its World Trade Organization's agreement, notably the protection of intellectual property, and its weak enforcement against rampant counterfeiting of a wide range of branded consumer and industrial products. Although it seems to be managing successfully its migration to a hybrid system mixing capitalism and socialism, China must be made to understand that participation in the big league of global trade requires it to adhere to a set of rules and conventions that call for a more resilient currency consistent with its newly-found competitive advantage.

A view rarely articulated because of its sensitivity in diplomatic circles is whether some of the damage sustained by the dollar may be attributable to a rise in anti-American sentiment, which became more pronounced as a result of the conflict over Iraq. From a timing standpoint, the dollar has been in decline for two years, which almost coincides with the confrontation at the United Nations and the decision by the U.S. to act unilaterally. Such suspicions may have gained further confirmation by the accelerating retreat of the dollar since President Bush's re-election to a second term, an outcome generally not viewed with favor outside the United States.

Whatever decisions are made to deal with the problems of the dollar, they need to be politically dispassionate, unbiased and unthreatening, recognizing the critical and growing interdependence of the major economies of the world. This is adequately reflected in the sharply rising contribution to global output of multinational trade, which the latest available data estimates at more than 26% of the world's GDP, up from 12% in 1970. Evidently, prosperity and stability benefit all.

#### THE ECONOMY: MOVING AHEAD, AND DAMN THE POTHoles !!

The U.S. economy appears to be slowly shifting gears from a post-recession rebound to a mid-cycle cruising pace. While growth in personal consumption is losing some momentum, and efforts are being made to control government spending, capital outlays by business continue to rise at a vigorous clip, bolstered by solid cash flows, strong balance sheets, anticipated benefits from repatriation of foreign earnings, residual advantages from "bonus depreciation," and widespread efforts to contain operating costs. Although employment remains a laggard compared to prior expansions, the addition of about two million jobs in the past year, and perhaps the same number in 2005, should contribute a respectable

increment to Disposable Personal Income and keep the consumer engaged. In all, we forecast economic growth to be in a range of 3.0%-3.5% in the coming year.

While our expectations are comforting, life is rarely so placid and free of complications. Monetary policy is almost certain to be less accommodative in 2005 as the Federal Reserve Bank continues to raise interest rates, and the dollar flounders. In addition, Iraq remains a dark tunnel, and global hostility toward the United States has become increasingly fashionable. These impediments have become fit topics to justify a wave of pessimism not entirely supported by the sum total of the economic fundamentals currently in evidence.

With the central bank having advertised its intention to become less accommodative, the credit markets seem to have responded with indifference and a paucity of concern, keeping long-term interest rates no higher than they were a year ago. This lack of fear may be due to abundant liquidity in the system, subdued inflationary pressures (recently somewhat alleviated by the retreat in the price of most commodities) and the willingness of foreign lenders to continue financing our twin deficits without insisting on higher returns. These factors should continue to be in play in coming months, permitting Mr. Greenspan and his monetary monks to be cautious and deliberate, thus accomplishing the Fed's stated objectives without impairing economic growth. This task is likely to become even more achievable if the federal budget continues to shrink, as it has been in recent months, and if the slide in the dollar begins to ameliorate the U.S. trade balance, which it should.

Concern is being widely expressed about what is being described as a "bubble" in real estate. This vital industry is not homogeneous and should be viewed within the context of its various components. Specifically, commercial and industrial properties have not experienced the same degree of appreciation as the residential variety, and even the latter should be separated by location into coastal/metropolitan and rural varieties for a better understanding of the dynamics at play. In such a stratified classification, only the residential/metropolitan segment has been driven to what might be deemed as excessive valuations. As such, a significant and broad retreat in all real estate prices is unlikely without a crippling rise in interest rates, which is not part of our forecast for the foreseeable future.

In summary, we are of the view that in 2005: (1) the U.S. economy will continue to expand at a respectable pace; (2) inflation will remain relatively tame as commodity prices stabilize, and in some instances retreat; (3) monetary policy will adhere to a deliberate and unthreatening path, with interest rates rising moderately during the year's first half, then managed to accommodate the course of business activity; (4) the dollar will gradually find support as the twin deficits moderate and proper recognition is accorded to cross-border differentials in economic growth; (5) profits will continue to increase but at a more moderate pace, reflecting a peak in margins, moderating productivity, and some inability to pass on increased costs, and (6) the stock market will generate a return nearly in line with the growth in profits, implying no meaningful expansion in valuation.

#### **INVESTMENT STRATEGY: WRESTLING WITH A TAME BULL**

The stock market's performance in 2004 deserves applause. The respectable returns achieved by the broad indices, despite widespread anxieties and numerous headwinds, have once again affirmed the resiliency and vigor that characterize the U.S. economy. Gains were fueled by record margins and profits, strong corporate balance sheets, abundant cash flows, optimistic consumers, and the benefits of a cyclical, and still youthful, upturn in capital spending. With the increase in corporate earnings far outpacing the appreciation in stocks, valuation metrics cannot be said to have breached the boundaries of their safety zone.

The same basic attributes that drove the economy and the market in the past year are still at work as we enter 2005, although the outcome may be shaped by changing cyclical guideposts, how some unfinished tasks are approached, and how the political landscape unfolds. For our part, we find adequate reasons to remain upbeat.

While economic growth and increased profits will support market fundamentals, a few restraints on momentum are apparent. These include: (1) interest rates that will continue to drift higher, both as a partial remedy for an embattled dollar and as a protection against inflation; (2) deceleration in the pace of earnings gains as already elevated margins reach a cyclical crest, and (3) a measure of fiscal restraint as Washington is forced to adopt some spending discipline. Historically, such conditions introduced a sense of caution among investors which manifested itself in conservative valuations for stocks. Currently, this is reflected in the fact that in 2004 the Standard & Poor's 500 Index gained about 9%, or much less than the increase of 20% or so in its operating earnings.

Our assumptions and estimates lead to the conclusion that the market is undervalued by more than 10%, after applying a peak interest rate forecast within the next twelve months of 5.15% for the 10-year U.S. Treasury obligations and S&P 500 earnings of \$70.50. The latter recognizes the impact of expensing stock options at a cost of \$1.50-\$2.00.

If there is a major departure from our forecast, it is likely to be on the upside. This is largely due to rising corporate activity on the merger and acquisition front, the recent inclination to initiate or raise dividends, and a greater willingness on the part of many companies to repurchase their own shares as another approach to bolstering returns to shareholders.

For the past four years the performance of small capitalization stocks trumped the returns of their larger siblings, mainly because of their significant undervaluation. However, small cap's relatively strong showing since the trough of the market cycle in 2001 leveled the field. We look for the anticipated wave of mergers and acquisitions to favor medium- and small-capitalization companies which persuades us to remain committed to this slice of the market.

We continue to favor the producer durables sector, including defense contractors, mainly because of abundant cash flows that will be greatly supplemented by repatriated foreign earnings, and strong growth in capital spending following many years of underinvestment in plant and equipment. With competition limiting pricing power, corporate managements will attempt to offset rising costs by relying on greater efficiencies.

As 2004 came to a close, the energy sector was in moderate retreat as oil and gas inventories appeared to be adequate and OPEC reversed course and advertised the possibility of reducing production, if conditions warrant. We would consider raising exposure to exploration and production companies that can be purchased at a significant discount to their net asset values, particularly if their hydrocarbon reserves are mainly domestic or located in politically secure areas.

The financial sector has largely been moving sideways for several months reflecting concern over the upward creep of interest rates. Although not overvalued by traditional yardsticks, financial stocks are likely to remain locked into a trading range until more favorable conditions emerge.

The pharmaceutical industry, which in the course of the past two years has migrated from a reliable, non-cyclical investment to one fraught with uncertainties, could be approaching a trough as it now appears that its widely-advertised problems are discounted and perhaps exaggerated. The sector's depressed valuation should permit investors with a long-term horizon to derive maximum benefits.

In the fixed income area, we believe caution is justified, preferring to confine investments to the near end of the yield curve. Risk-considered, the best returns may be obtained from short-term floating rate notes, a strategy that essentially eliminates interest rate risk.

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**ECONOMIC FORECAST**  
(As of January 1, 2005)

	<u>2002</u>	<u>2003</u>	Estimated <u>2004</u>	Projected <u>2005</u>
Real GDP (Ann. % of Change)	1.9%	3.0%	4.4%	3.3%
Real Consumption Expenditures	3.1%	3.3%	3.7%	3.2%
Business Fixed Investment	(8.9%)	3.3%	10.3%	8.3%
Inventory Investment (Billions)	\$11.8	(\$0.7)	\$46.0	\$40.0
Residential Construction (Billions)	\$470.1	\$511.2	\$559.0	\$565.0
Government Spending (Billions) (a)	\$1,858.0	\$1909.5	\$1,948.0	\$1,985.0
Trade Balance-Goods & Services	(\$421.7)	(\$496.5)	(\$600.0)	(\$607.0)
Federal Budget*: Unified (Billions)	(\$157.8)	(\$374.3)	(\$412.3)	(\$367.0)
GDP Deflator	1.7%	1.8%	2.2%	2.2%
Producer Price Index	(1.3%)	3.2%	3.6%	3.5%
Consumer Price Index	1.6%	2.3%	2.7%	2.8%
Industrial Production	(0.6%)	0.3%	4.5%	4.2%
Real Disposable Income	3.8%	1.8%	3.0%	3.1%
Hourly Compensation	3.3%	4.1%	4.2%	4.1%
Unit Labor Cost (Non-Farm)	(1.1%)	(0.4%)	0.1%	1.6%
Productivity Growth (% Change)	4.4%	4.4%	3.9%	2.4%
Personal Savings Rate (% DPI)	2.3%	1.3%	0.8%	0.8%
Capacity Utilization - Total	75.6%	74.8%	77.0%	78.3%
Trade Weighted \$ Exchange Rate	(0.4%)	(6.7%)	(7.3%)	(6.5%)
Vehicle Sales (Million Units)	16.7	16.6	16.6	17.0
Housing Starts (Million Units)	1.711	1.850	1.957	1.780
Civilian Employment (Millions)	136.485	137.736	139.4	141.0
Civilian Unemployment Rate	5.8%	6.0%	5.5%	5.2%
Corporate Profits - AT-NIPA	11.0%	16.3%	11.6%	7.0%
S&P-500 Earnings-Reported	\$27.59	\$48.74	\$59.00	\$65.25
S&P-500 Earnings-Operating	\$48.09	\$55.54	\$66.00	\$70.50
S&P-500 Dividends	\$15.67	\$17.60	\$19.25	\$21.00
90 Day U.S. Treasuries-Yield (%)	1.40-2.35	1.40-0.75	0.86-2.25	2.10-3.35
10-Year U.S. Treasuries-Yield (%)	3.59-5.20	3.17-4.55	3.68-4.87	4.20-5.15

\*Fiscal Year-end 9/30. (a) Federal, State, and Local; in 2000 dollars