



SILVERCREST
ASSET MANAGEMENT GROUP

ECONOMIC REVIEW AND INVESTMENT STRATEGY: 2004/II

IN SEARCH OF A BRIDGE OVER TROUBLED WATERS

Terrorism is arguably the most pressing and dangerous challenge facing the civilized world today. Its violence has profoundly altered the geopolitical landscape for a long period into the future, if not forever. Its human cost, captured daily in headlines around the globe, is wrenching. Its economic cost, though difficult to measure, is no doubt enormous. The seeming inability to eradicate it or, at a minimum, to contain it is a problem rarely encountered by the civilized community of nations. Hence, despite all the valiant talk about winning the “war on terrorism,” which may be comforting on the surface, final victory is not assured.

The challenges in facing down terrorism are daunting. Its perpetrators, who are not given to self-reflection, claim to commit their bloody acts in the name of religious dogma which, they assert, transcends the established laws of civilized societies. Their battlefield is not confined to a specific country or region but covers the entire world. Their causes and demands are neither specific nor apparently negotiable. Simply stated, today’s terrorism is a brutal movement that lacks a vision of a new and peaceful social order but seeks nothing less than to impose its cultural and religious values on the nations of the world. This is ethnic cleansing at its most extreme.

Terrorism is largely sponsored or encouraged by insecure national leaders intent on diverting attention from their corrupt and brutal regimes, shadowy pretenders to leadership in the name of religious dogma as they interpret it, or disaffected individuals or groups who are resolute in blaming their frustrations and failures on anyone but themselves. With no one apparently in charge or in command, competing cells of perpetrators try to outdo each other in causing the greatest harm to organized societies.

Unwittingly or not, the terrorists have already won a victory. They have managed to degrade the relationships of old allies, have heightened corrosive political tensions in many countries, have imposed huge expenses for establishing homeland or cross-border security, and have impaired the effective functioning of the United Nations. Given these and other damages, a more intensive, coordinated and wide-ranging approach is urgently called for to deal with their destructive designs.

Today, there are about 1.3 billion Muslims in the world, or close to one-fifth of its population. They occupy nearly contiguous land extending from the northwest of Africa to the farthest eastern part of the Asian land mass. They are also becoming a growing, vocal presence in many Western countries. While many of them are not committed to religious orthodoxy, they are, nonetheless, quite supportive of their coreligionists. Hence, while they claim that the basis of their hostility is neither religious nor cultural, they are prompt in invoking a perversion of Islamic dogma in support of their cause. This is in contradiction of the true faith of Islam, as articulated in the Qur’an, which is rich in the virtues of brotherhood, equality, generosity and charity.

Recent experiences in planting western-style democracy or embarking on nation-building have pushed America’s peacetime armed forces to their limits, though they have so far delivered questionable results. Intervention in Somalia was an embarrassing failure, Afghanistan continues to be ruled by warlords, and Iraq’s future, despite our intervention, is almost certain to be as bleak as its past. Accordingly, it would not be unreasonable to conclude that current policies and approaches are inadequate aside from being costly and wasteful. This is in addition to the very long time horizon, perhaps measured in decades, that would be needed to alter the poisonous mindset that feeds terrorism.

While it may not guarantee rapid success, a multi-faceted economic development program would eventually create a climate less fraught with hostile aggression. A vague outline is already in place in the form of three developed industrial blocs with firm roots—in the Americas, Europe, and Asia—where a considerable measure of prosperity is in evidence. While differences in trade and tax policies have slowed progress, these can be resolved if it is acknowledged that globalization has become a fact of economic life and that it should be encouraged rather than impeded through barriers or frictions. Recent history confirms that prosperity is a potent antidote to aggression as China's, India's and Russia's integration into the industrial world has demonstrated in the past decade, and as Taiwan's massive flow of investments into China's mainland confirms. The growing interaction among these three zones of stability would no doubt benefit laggard countries in their regions, setting the stage for greater political harmony.

For years, economic assistance to various countries has been squandered, looted or misappropriated, ultimately delivering no benefits to the recipient countries. Growing prosperity should encourage the adoption of aid programs fashioned after the Marshall Plan, with grants specifically targeted to projects of social urgency under the specific control of the benefactors. This approach would differ from those of such traditional intermediaries as the International Monetary Fund and the World Bank whose lending has often found its way into the pockets of the governing elite. The prosperity and other social benefits that would flow from such a plan would likely attract the attention of those who are either sympathetic to, or sponsor, terrorism. The response may well manifest itself in spontaneous social combustion in Muslim lands akin to that which liberated Eastern Europe from Soviet tyranny.

A quixotic plan? Perhaps. However, given the human toll, the destruction and the cost that has been and may still be sustained, and the seeming inadequacy of other measures implemented so far to fight terrorism, a new approach with socially and politically redeeming features may find adequate sympathetic support to reverse a growing tragedy.

THE ECONOMY: NOT FAR FROM HARMONIC CONVERGENCE

The U.S. economy is in far better shape than the popular media would seem to imply. Political hyperbole in a presidential election year, and press headlines that reach for relevance in sound bites, have tended to exaggerate or distort some of the issues that often surface when structural changes with unclear consequences are in progress.

At present, all key indicators suggest that both the production and consumption sides of the economic equation are healthy; meanwhile, whatever imbalances and excesses exist appear manageable. While growth has clearly decelerated from its unsustainable pace of last year's second half, it is likely to remain above its secular trendline in 2004 and perhaps beyond. A new capital spending cycle is on track, reversing the steep decline that precipitated the last recession. Consumption continues to register solid gains as lower tax rates and refunds add to real disposable income. Despite some restraint at the federal level, government outlays should continue to rise, aided by a confirmed post-recession resurgence in state and local revenue. Exports remain in an uptrend, mainly in response to a lower dollar and a synchronized global recovery. Finally, inventories, now at the lowest level on record relative to sales, may soon become accretive if vigorous growth persists. All of these blessings are supported by a relatively healthy financial system awash in liquidity and an articulated monetary policy clearly reluctant to interfere with a winning approach.

The economic issues that have attracted the greatest attention are a sluggish rebound in employment, a steep rise in the federal budget deficit, a persistent deterioration in the trade balance and a weak dollar. While this litany may sound daunting, particularly when repeated and exaggerated in a national election campaign, it is not likely to immediately impair growth, though it could turn corrosive if ignored.

The debate on employment will persist as long as data is suspected of being less than reliable and subject to significant revisions many years following its initial release. There is no doubt that major innovations in technology have generated substantial gains in productivity. This, and a highly price-sensitive environment, have restrained new hirings as corporate managers seek to raise profitability in an intensely competitive global market with excess capacity in manufacturing and labor. Adding to suspicions is an apparent disconnect between the solid increase in real disposable income and the

reported modest gains in employment. Furthermore, the jobless rate, both currently and at the trough of the latest recession, are below those reached at this stage of most of the prior downturns. Finally, the impact of a wide range of structural changes that cannot be readily measured should be recognized in order to reach a reasonably accurate assessment of the employment picture. Aside from the statistical deficiencies, distortions created by the underground economy, working but not counted illegal aliens, and a very sharp increase in the number of workers who leave their jobs under a disability arrangement but are listed as unemployed, could alter the data to a meaningful degree. Hence, it seems likely that when a comfort level is reached that the expansion is alive and well, new hiring should quickly reduce the jobless rate to about five percent, a level that only ten years ago was deemed to constitute full employment.

The compulsive preoccupation with outsourcing as a prime cause of weak domestic employment fails to pass the test of accuracy. *BusinessWeek* calculates that less than 10% of recent job losses can be attributed to outsourcing, with the remainder the result of productivity gains. The flipside of this issue is that inflation, and by extension interest rates, would not be as low as they are without the competitive impact of globalization, including outsourcing.

Since the end of World War II, the U.S. economy has navigated successfully through several shocks and shifts. Throughout each period of change, dire consequences were predicted but never materialized. For nearly thirty years it was asserted that the gradual loss of some of our basic industries to low-wage countries constituted a surrender of our manufacturing heritage. It is now evident that we have been able to substitute new and more profitable industries in technology, healthcare, and various services without being overwhelmed by these structural changes. Resiliency, described in economic parlance as “creative destruction,” has always been a mark of success. While globalization may cause temporary dislocations, it is almost certain to spawn much greater long-term opportunities in addition to retarding inflation.

Similarly, the sharp increase in the budget deficit should be viewed within the context of the times rather than invoked as a damning political refrain. During the past three years, the onset of a recession, the critical needs of national security following 9/11, and the foray into Afghanistan and Iraq have greatly added to the shortfall which so far has been financed without much difficulty. Pressure on Washington to limit spending, as well as gains in revenue generated by the economic expansion, should limit the growth of the deficit. Clearly, the critical problem is not the size of the deficit (which is below the record high relative to GDP reached in the mid-1980s) but whether sovereign lenders would be willing to continue lending to a country whose currency is at risk of depreciation. For the present, excess savings by other countries seeking a safe haven for their liquidity should continue to provide the required financial resources. However, with the deficit having been recognized as an economic and political liability, it is likely to be addressed without much damage to growth.

While the decline in the value of the dollar has been of concern to many countries that rely on exports, it seems to have been treated with benign neglect in Washington. Though not without risk, this approach may be attributed to two considerations: first, the orderly drop in the dollar has not unleashed inflationary forces, as textbooks tend to inform, and, second, it improved U.S. competitiveness on the export front. The central issue is whether countries on the losing side of trade may soon be forced into adopting measures that would reverse the dollar’s slide to protect their markets. Canada has recently lowered its interest rates as did China, and the European Central Bank is under pressure to do the same. Japan has undertaken two successive, but failed, interventions, and many countries are considering other options including retaliatory trade restrictions. In any case, we believe the dollar has become undervalued and may well stabilize around current levels as strong U.S. growth begins to attract investments.

The current business cycle is, in many respects, typical in its progression but is distinctive on several fronts. For example, strong growth has not intensified inflationary pressures nor has it provoked inappropriate wage demands. The dollar’s decline has had few of the typical consequences, such as capital outflows. While productivity appears to be waning, as it often does at this stage of the cycle, it should remain robust and continue to aid margins and profits. The consumer, often intimidated by a weak job market, does not seem inclined to alter his optimistic spending pattern. Most important is that the current expansion appears to be exposed to very few impediments for the balance of this year, and perhaps beyond, largely because of these differences.

The smooth functioning of the various engines of the economy should remain free of any significant imbalances until the output gap is eliminated by growth that surpasses the historical trend. By

our estimate, this would require real GDP gains in excess of five percent for two years or longer, and would first manifest itself in a strong increase in employment followed by a significant rise in capacity utilization culminating in various signs of inflationary pressures. Such chain of events typically calls the Federal Reserve into action. Given currently placid conditions, Mr. Greenspan seems comfortable remaining on the sidelines for at least several more months, and even then would probably be inclined to move cautiously. This conclusion is consistent with his past practice of managing monetary policy in pursuit of longer-term stability rather than in response to pressures arising from perceptions commonly held in the marketplace.

In summary, we conclude that in 2004: (1) growth in the U.S. will remain above its secular trendline; (2) inflation will slowly escalate, due to higher commodity prices and some revival in pricing power, but will not justify a turn toward a restrictive monetary policy; (3) the Federal Reserve should be expected to move with caution in adopting restraint, recognizing the sensitivity of any such action in an election year and in an economy still operating below optimal capacity; (4) business profits will continue to surge at a double-digit pace, aided by further widening in margins, with some deceleration likely as the year progresses and comparisons become more difficult; (5) the dollar may have attained a measure of stability around current levels; and (6) the major economies of the world will continue to grow, providing support to U.S. exports and perhaps containing the deterioration in the trade deficit.

INVESTMENT STRATEGY: RANDOM THOUGHTS ON A MOVING TARGET

Investors ushered in 2004 with considerable hope and nearly unbridled optimism. Economic growth is clearly on a roll, business profits are robust and rising, inflation is tame and a synchronized global expansion, the first in almost twenty years, is subject to daily confirmation. Even following a period of substantial appreciation, U.S. stocks remain reasonably valued, discounting some but not all of the gains in corporate earnings conservatively forecast for the current year. This sunny environment persuaded some excessively cheerful observers to assume that the heady upward pace of the market since its upturn in March 2003 would be sustainable despite a list of concerns not entirely related to economic activity.

Until its recent period of consolidation, the market's advance had been notable on many fronts, such as the suspect quality of the initial leadership, the persistent vigor of the rebound, the reluctance of many investors, both institutional and individual, to participate, and the prevalence of doubt that the advance possessed staying power in the face of the traumatic decline that preceded it. Such misgivings are not unusual under the circumstances. What differentiated the almost explosive upturn from its prior siblings are the conditions that spawned it, particularly the rapid operational and financial restructuring, the continued strength of the banking system, courtesy of an aggressively stimulative monetary policy, Washington's quick adoption of individual and corporate tax relief, and the immense improvement in the quality of corporate earnings. While in the past such remedial measures had been slow in unfolding, their rapid implementation imparted both comfort and confidence. Their impact has been equally rapid, generating a sharp recovery in profits to the highest level on record. Stock markets derive their valuations from the quality and quantity of earnings as well as their rate of growth, and from interest rates as a proxy for inflation. Both have been, and remain, supportive to an extent not experienced in more than forty years.

While the speculative brew that initially sparked last year's rebound was not comforting, as it cast doubts on the fundamentals fueling the advance, it ultimately broadened to include a wide range of industries. In addition, upward revisions in profits for the March quarter and the year, in combination with declines of 5-10 percent in the various indices in recent weeks, have provided the valuation adjustments that, we believe, have opened up new investment opportunities.

Our calculations suggest that the market is nearly 15 percent undervalued. Our assumptions include a material increase in interest rates over the next twelve months, possibly to a yield of about 5.0% on 10-year U.S. Treasury obligations, and profits rising about 13 percent this year, to \$62.50 for the Standard & Poor's 500. These estimates have been cast within a conservative mold as they do not incorporate further potential gains in earnings or the possibility that, given global competition, the Fed may not feel pressed to raise interest rates to the level indicated.

Other dynamics that provide support for stocks include abundant liquidity and hugely underfunded retirement plans that would benefit the demand side of the equation, foreign buyers becoming more aggressive on any hint of stability in the dollar, and an ongoing trend toward higher dividend payments that could persuade income-seeking investors to raise their exposure to equities.

While our optimism is based on a reading of business and market fundamentals, it is tempered by various uncertainties, some of which challenge our predictive abilities. These include: (1) a potential but a natural deceleration in the unsustainable pace of profit growth; (2) restraints on fiscal policy to contain the budget deficit; (3) some moderation in productivity as the expansion matures; (4) the persistent threat of terrorism at home and abroad with its corrosive impact on the global economy, and (5) the ugly fallout from a polarizing presidential election campaign that paints a most unflattering picture of our country's leadership as well as those who aspire to replace it. While stock markets over the long term typically reflect economic and corporate fundamentals, they are nevertheless influenced by shorter-term events and perceptions, particularly the passions generated in the heat of the moment. Such is the case at present.

We suspect that the market's consolidation over the past two months represents both a response to some of the geopolitical events that have dominated media reporting, as well as a correction of the excesses that carried stocks of some high risk industries, such as technology/telecom and biotechs, to unreasonable heights. At the same time, this consolidation may also be signaling a shift into "old economy" sectors that are likely to be favored by various institutional and other investors who have been reluctant to commit their liquidity to industries with questionable fundamental support.

We currently favor four sectors that we view as timely. Energy stocks remain undervalued because of what we regard as the questionable assumption that oil and gas prices are bound to return to their levels of a decade ago once full production is restored in Iraq. Pharmaceuticals have been among the worst performers for more than a year mainly due to concern over government intervention in pricing and the growing prospects of importation. Manufacturers of producer durables are now in the sweet spot of their cycle but do not as yet reflect fully the potential contribution of productivity to their bottom line or the growing industrialization of many developing countries. Defense stocks have retreated due to an erroneous perception that budgetary issues might limit new orders. In each of the four instances, we believe that the most extreme negative scenario has been discounted leaving adequate upside potential for related stocks.

On the fixed income front, we counsel remaining at the shortest end of maturities consistent with needs. The current climate continues to argue against lower interest rates at a time when economic growth continues above trendline, the budget deficit remains a problem and a hot political issue and dollar stability is in question.

April 1, 2004

Stanley A. Nabi, CFA
Vice Chairman

ECONOMIC FORECAST

(As of April 1, 2004)

	ACTUAL	PRELIMINARY	PROJECTED
	<u>2002</u>	<u>2003</u>	<u>2004</u>
Real GDP	2.8%	4.3%	4.2%
Real Consumption Expenditures	3.4%	3.1%	3.6%
Business Fixed Investment	(7.2%)	3.0%	10.3%
Inventory Investment (Billions)	\$5.7	\$2.7	\$28.0
Residential Construction (Billions)	\$470.3	\$505.6	\$535.0
Government Spending (Billions) (a)	\$1,837.1	\$1,900.0	\$1,936.0
Trade Balance-Goods & Services	(\$418.0)	(\$487.6)	(\$512.0)
Federal Budget*: Unified (Billions)	(\$157.8)	(\$374.2)	(\$465.0)
GDP Deflator	1.5%	1.7%	1.9%
Producer Price Index	(1.3%)	3.2%	2.6%
Consumer Price Index	1.6%	2.3%	2.1%
Industrial Production	(0.6%)	0.3%	5.3%
Real Disposable Income	3.8%	2.5%	3.8%
Hourly Compensation	2.3%	3.2%	3.2%
Unit Labor Cost (Non-Farm)	(2.5%)	(1.1%)	(0.9%)
Productivity Growth (% Change)	5.0%	4.4%	3.8%
Personal Savings Rate (% DPI)	2.3%	2.0%	2.2%
Capacity Utilization - Total	75.6%	74.8%	77.0%
Trade Weighted \$ Exchange Rate	(0.4%)	(6.7%)	(6.0%)
Vehicle Sales (Million Units)	16.7	16.6	17.1
Housing Starts (Million Units)	1.711	1.848	1.850
Civilian Employment (Millions)	136.485	137.9	139.5
Civilian Unemployment Rate	5.8%	6.0%	5.5%
Corporate Profits - AT-NIPA	11.0%	12.4%	9.8%
S&P-500 Earnings-Reported	\$27.59	\$47.61	\$56.00
S&P-500 Earnings-Operating	\$48.09	\$55.50	\$62.50
S&P-500 Dividends	\$15.67	\$16.90	\$18.20
90 Day U.S. Treasuries-Yield (%)	1.40-2.35	1.40-0.75	0.87-1.80
10-Year U.S. Treasuries-Yield (%)	5.20-3.59	4.55-3.17	5.00-3.65
*Fiscal Year-end 9/30. dollars			
(a) Federal, State, and Local; in 2000			