



SILVERCREST  
ASSET MANAGEMENT GROUP

## ECONOMIC REVIEW AND INVESTMENT STRATEGY: 2005/II

### CHINA: THE DYNAMIC DELINQUENT

China has emerged in recent years as a pivotal player on the global economic scene, and it is there to stay. Depending on one's point of view, it has become either a prime engine of growth or a threat to the world's delicate economic balance, and there is ample evidence to support either extreme.

Those who are inclined to view China as a threat to the developed economies invoke abundant labor, low wages, a materially undervalued currency, an opaque and perhaps unstable financial structure, flouting of intellectual property rights, and a system that ignores environmental and health concerns -- all of which grant it unfair competitive advantages. Supporters argue that a country such as China, which is in the early stages of industrial development, and only a few years removed from the most rigid form of socialism, lacks the institutions, laws and infrastructure to comply fully with the rules, business practices and conventions of the more advanced nations. As a consequence, they claim, it should be allowed some slack to ease its transformation into a democracy with a free-enterprise system that would encourage it to play a constructive role on the world stage. Some of these more vocal adherents go so far as to assert that its growing importance could rapidly create a counterweight to the hegemony of the United States, particularly in Asia where a leadership vacuum has developed in recent years. By virtue of size, history and cultural reach, these protagonists aver that China should be viewed as an ideal candidate to assume that role.

While it is nearly impossible to reconcile the views of these opposing camps, reliance on mostly superficial historical guideposts ignores some relevant differences. As an example, attempting to compare China's economic ascendancy with that of post-war Japan fails to consider the latter's military defeat and humiliation, its renunciation of militarism, its adoption of a constitution largely "suggested" by the United States and its rapid focus on industrialization as a form of redemption. In addition, Japan's insularity and compulsive attention to a culture of saving have served to enrich the country early on, although this eventually turned into an impediment to its economy as reflected in its meager growth over the past 15 years. In fact, its wealth today is being importantly derived from a high personal savings rate and the role it plays as a middleman deploying capital outside its boundaries and generating exports from businesses mostly owned in developing countries. Combined with a misguided fiscal approach that favors elevated taxes, its policymakers have been engaged in a futile effort to contain the appreciation in the yen in the hope of driving the economy out of its perennial deflationary funk.

While China's historical backdrop is notably different from that of Japan, particularly its obvious aspiration to become the most important political player in its region, it appears to be repeating some of Japan's mistakes as it pursues rigid policies that rely on exports rather than domestic development and consumption. This is evident in the oversized spending being directed toward boosting industrial capacity -- with such outlays recently approaching 50% of GDP compared with about 17% for the United States. Furthermore, its insistence on keeping its currency materially undervalued encourages continued reliance on exports, further adding to its vast trade surplus. Such concentration of global savings in the hands of a country not yet at full economic maturity, and supported by an untested financial system, is a roadmap to eventual instability.

As China climbs the industrial ladder, it is almost certain to encounter a rapid increase in its employment cost as workers become better trained and demand higher wages and improved living standards. Furthermore, many businesses that continue to derive benefits from such a semi-regulated structure are destined to lose some of its advantages and safeguards. This is in addition to the symbiotic relationship that these businesses have enjoyed in dealing with a government-controlled banking system which may begin to vanish once the economy moves to a new level of sophistication. Finally, the almost certain revaluation of the currency will undoubtedly add another notch to the country's export prices. All of the foregoing will likely play out in two directions: they will make China less competitive, and will also remove some of the pressure on the dollar by reducing the U.S. trade deficit.

There are obvious risks in China's unwillingness to address such issues and excesses. Most obvious is its resistance to mounting pressures to revalue the yuan by removing or modifying its peg to the dollar. When this occurs, perhaps sooner rather than later, it would also force other dollar-pegged countries in the region to do the same, causing the flow of exports to decline and unmasking significant excess capacity. This, in turn, can precipitate an unwelcome recession with adverse consequences for both China and its trading partners in the area. Given the country's opaque and unstable financial and banking system, a ripple effect would almost certainly be felt at least in Southeast Asia and perhaps elsewhere.

China would no doubt serve its best interests by doing more than paying lip service to the imbalances now evident in its economic performance. While adjusting the value of the yuan would be a priority, greater attention to stimulating domestic consumption is equally desirable as a means of utilizing excess capacity and in the process reducing the chances and severity of any economic downturn. Such measures would also allow the financial system to mature and adjust as it develops better controls and greater transparency. Another critical issue relates to China's refusal to promptly deal with egregious trade conflicts that recently have brought it into open violation of the terms of its membership in the World Trade Organization, and which may provoke retaliation from those being most injured by this conduct. By addressing these issues in a timely manner, China would gain diplomatic goodwill by signaling that it is prepared to become a trusted team player, and would be of help in erasing its past reputation as a spoiler with self-serving designs.

## THE ECONOMY: STILL GOING

Despite headwinds and a collection of well-advertised uncertainties, the U.S. economy has been able to deliver a sturdy performance during the March quarter, with growth perhaps having exceeded four percent. As we noted in prior commentaries, the main driver recently has been business investment which is being easily financed by record corporate liquidity and robust cash flow rather than by a new layer of debt. More notable is that current outlays for plant and equipment are in response to actual demand and shrinking excess capacity, unlike the excessive spending on technology of the late 1990s, which ultimately proved to have been driven by faulty assumptions and inflated perceptions of need. Another notable feature in the current expansion is that the sectors garnering attention are those that had been short-changed when the high-tech feast was at its most exuberant. Specifically, industrial machinery and other heavy equipment, which are critical tools for building and maintaining infrastructure, appear to have entered a new and extended demand cycle both at home and abroad.

Personal consumption, the mainstay of the domestic economy, is merely carrying its weight, and should continue to do so, as disposable personal income registers respectable gains. Income growth has been aided by rising employment, a modest increase in real wages and relatively manageable interest rates. Four sources of constraint, however, place a lid on the growth in consumer spending going

forward: an elevated debt level, lack of pent-up demand, rising energy costs, and the upward trend in interest rates brought on by a measure of inflation and gradual monetary restraint.

The two other contributors to economic activity are government spending and trade. The former is subject to intense debate in Washington on measures to contain it, although success in such endeavors is far from assured and ultimately requires difficult compromises. On the trade front, the decline in the dollar has helped boost exports to record levels, but not enough to reduce the growing imbalances, particularly in the face of the steep increase in the cost of imported oil. Textbook economic theory informs that currency depreciation nearly always sets the stage for a rise in exports, but the foundation of such assumptions may need to be tested anew. The rapid change in global economic architecture, wherein sources of supply are multiplying, competition is intensifying, and the learning curve in both manufacturing and services throughout developing countries is steepening, seems to be working to the detriment of high cost advanced economies.

With the U.S. economy signaling moderate deceleration as 2005 progresses, the Federal Reserve Bank is facing a dilemma, specifically how quickly and forcefully to apply the monetary brakes and whether to treat stirrings on the inflation front as a passing phase which may be partly oil-induced. While evidence of a potential slowdown is scarce, it is not limited to the drag from energy, and now includes the potential effect of rising interest rates, an ongoing contraction in monetary aggregates and efforts to enforce some fiscal discipline in Washington.

In setting monetary policy, Chairman Greenspan is known to be a gradualist who only acts with a heavy hand when facing a crisis. While he has paid lip service to the risk of a declining dollar, thus far he has treated it as an issue of secondary urgency. He continues to lean toward the view that the recent modest uptick in inflation may be a temporary cyclical phenomenon that calls for vigilance rather than an aggressive response. Nonetheless, his "conundrum" calls for walking a fine line that avoids placing the current expansion at risk, keeping the cost of government borrowing relatively manageable, and preventing the dollar from succumbing to a destabilizing sharp retreat. Greenspan appears to have concluded that, despite huge borrowings by the United States, global interest rates are likely to remain subdued because of a global savings glut and the critical need of many exporting countries to continue their sales to the U.S. However, this does not alter the central bank's plans of removing prior accommodation, which points to additional rate hikes at each of the next three meetings at a minimum. If our expectations of moderately slower growth in this year's second half come to pass, the Fed should then suspend further action and await more concrete evidence of the economy's direction and speed. In short, monetary policy requires more active vigilance to fulfill its objectives of keeping the economy growing at a reasonable but non-inflationary pace, providing some support to the dollar and telegraphing an aura of confidence that the ship is being positioned to move at an unthreatening speed. With the dollar currently trading near where it was six months ago relative to the euro and the yen, and lenders willing to accommodate U.S. borrowing, despite their frequent sermons on fiscal discipline, the chances of a significant relapse in business activity or a currency crisis remain modest.

In summary, we conclude that; (1) the U.S. economy will continue to grow at a respectable pace for an extended period, but with some deceleration in this year's second half; (2) moderate inflationary pressures will continue for several more months, but will not cross into dangerous territory; (3) monetary restraint will persist for at least three more FOMC meetings, but will not be allowed to threaten the expansion; (4) business profits will continue to increase at least through the remainder of 2005, but at a moderating pace as operating margins peak; (5) the dollar may have reached temporary stability within the range established over the past six months, and (6) investors will treat a probable slowdown later this year as a repeat of prior experiences in 1985 and 1995 when a midcycle slowdown triggered a substantial upturn in stocks.

## INVESTMENT STRATEGY: FEAR NOT THE GENTLE BABY BEAR

For nearly a year, investors in the U.S. stock market have faced a frustrating dilemma in their efforts to rationalize a stock market supported by strong business fundamentals but burdened with other issues that defy quantitative assessment. The result has been a stand-off that has largely ignored a 20 percent increase in profits in 2004 and, by our estimates, an additional 8 percent or so this year. This delicate balancing act has caused an erosion in the market's P/E valuation to a level that seems eminently defensible on an historical basis. At about 16.5-times this year's projected earnings, the Standard & Poor's 500 has essentially purged nearly all of the excesses of the late 1990s and pushed many stocks down to a range that largely reflects their intrinsic value.

The concerns invoked to explain the market's laggard performance relate to perceptions of inflationary pressures (mainly arising from the spike in the cost of oil and other commodities), a recent revival in pricing power, the degree of monetary restraint that will be needed to contain these emerging trends, and how all of this will play out in the real world. In addition, the dollar's slide at a time of record trade and budget deficits has become a prominent cause for complaint both domestically and abroad. These issues, taken separately or presented as a litany, can seem overwhelming when viewed within a broader framework contaminated by adverse psychology and hostile politics.

Starting with an economy in the midst of a solid expansion, with a growth rate that exceeds those of all the major industrial countries, it would be unusual not to experience a whiff of inflation as the cycle matures. Thus far, the lift in prices, while obscured by the recent jump in oil, has been muted and gives no indication of becoming virulent. Adequate capacity, global competition, continued gains in productivity, and more disciplined corporate managements appear to be providing a solid line of defense. Oil's impact on economic activity is actually calculated to have decreased significantly over the past 30 years, which explains its limited pressure on the general price level. Finally, Greenspan's Fed has so far avoided surprises, moving cautiously on a path of gradual restraint with a clear intent not to undermine the ongoing expansion. The central bank is keenly aware that an economic downturn at this time, precipitated by a sharp increase in interest rates, would further raise the government's borrowing cost in addition to reducing its revenues. As it is, the credit markets are all but resigned to a Fed fund rate of about 4% and a 10-year U.S. Treasury yield a bit more than 5% within the next twelve months or less. Nonetheless, our reading of these projections does not provide a basis for a bear market but does warn of some deceleration in economic growth as the year progresses.

If the past is prologue, there is ample historical evidence to support a reinvigorated stock market as investors treat the onset of such a midcycle slowdown as foreshadowing diminishing inflationary pressures and perhaps a respite in monetary restraint. Such was the case in 1985 and 1995 when the Fed engineered an economic slowdown which was quickly followed by a significant advance in the market.

In the near-term, earnings reports for the March quarter, to be released soon, should be instructive. The relatively small number of negative preannouncements suggests that total profits should meet or exceed consensus forecasts. Nonetheless, the data would require thorough analysis to ascertain whether the reported gains are a function of higher prices and non-operating events or were achieved through greater efficiency and organic growth. The distinction is of particular relevance as it can provide a roadmap to the level and quality of future profits. Given respectable gains in productivity, a well-behaved employment cost index, cautious hiring and modest corporate borrowing, we are optimistic that a positive outcome may be in store.

A shift appears to be in progress in anointing leaders and laggards among sectors and industries. Specifically, groups sensitive to interest rates are likely to languish until either valuations become more compelling or the Fed signals less aggressive restraint; such groups would include banks, mortgage

lenders, insurance and other financial intermediaries. In addition, consumer staples, with extensive exposure to the escalating cost of commodities, appear to be at a disadvantage. Finally, producers and processors of industrial materials, such as metals and wood products, whose stock prices already discount their normalized earnings stream, may have recently crossed into a high risk zone relative to additional rewards.

Despite our cautionary comments on industrial commodities, we remain optimistic on the capital spending sector because of capacity shortages that should extend their normal cycle and because of strong demand from developing countries. We also remain hopeful that a trough may be close at hand in the pharmaceutical sector following almost two years of dismal performance; the industry's stellar finances and strong cash flow, even in the face of depressed profitability, provide fair measures of safety and support. While the energy sector has delivered an excellent performance, we continue to favor an overweighted position therein for the long-term, but would temporarily defer additional purchases until fresh opportunities develop following a pullback.

A more general approach in our strategy calls for the introduction of a measure of "growth" into the investment basket, with emphasis on carefully selected technology shares that have succumbed to benign neglect. Since we view the current expansion as possibly having nearly the same longevity as the prior two cycles (9 years and 10 years) with a similar mid-life crisis, there is still ample time for such laggards to benefit from a gradual recovery in demand for their products and a more efficient utilization of their excess capacity.

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**ECONOMIC FORECAST**  
(AS OF APRIL 1, 2005)

|                                       | <u>2003</u> | <u>2004</u> | Estimated<br><u>2005</u> | Projected<br><u>2006</u> |
|---------------------------------------|-------------|-------------|--------------------------|--------------------------|
| Real GDP (Ann. % of Change)           | 3.0%        | 4.4%        | 3.7%                     | 3.0%                     |
| Real Consumption Expenditures         | 3.3%        | 3.8%        | 3.3%                     | 2.8%                     |
| Business Fixed Investment             | 3.3%        | 10.6%       | 9.8%                     | 5.0%                     |
| Inventory Investment (Billions)       | (\$0.7)     | \$46.6      | \$46.0                   | \$38.0                   |
| Residential Construction (Billions)   | \$511.2     | \$560.2     | \$576.0                  | \$570.0                  |
| Government Spending (Billions) (a)    | \$1909.5    | \$1,946.8   | \$1975.0                 | \$2013.0                 |
| Trade Balance-Goods & Services        | (\$496.5)   | (\$617.1)   | (\$650.0)                | (\$610.0)                |
| Federal Budget*: Unified (Billions)   | (\$374.3)   | (\$412.8)   | (\$409.0)                | (\$415.0)                |
| GDP Deflator                          | 1.8%        | 2.2%        | 2.2%                     | 2.3%                     |
| Producer Price Index                  | 3.2%        | 3.6%        | 3.5%                     | 2.2%                     |
| Consumer Price Index                  | 2.3%        | 2.7%        | 2.8%                     | 2.6%                     |
| Industrial Production                 | 0.0%        | 4.1%        | 4.2%                     | 3.8%                     |
| Real Disposable Income                | 1.8%        | 3.5%        | 3.6%                     | 3.5%                     |
| Hourly Compensation                   | 4.0%        | 4.4%        | 4.4%                     | 4.2%                     |
| Unit Labor Cost (Non-Farm)            | (0.4%)      | 0.3%        | 2.2%                     | 2.0%                     |
| Productivity Growth (% Change)        | 4.4%        | 4.0%        | 2.2%                     | 2.0%                     |
| Personal Savings Rate (% DPI)         | 1.3%        | 1.2%        | 1.2%                     | 1.8%                     |
| Capacity Utilization – Total Industry | 75.5%       | 78.0%       | 79.5%                    | 80.2%                    |
| Trade Weighted \$ Exchange Rate (b)   | (12.2%)     | (8.2%)      | (8.9%)                   | (4.6%)                   |
| Vehicle Sales (Million Units)         | 16.6        | 16.8        | 16.4                     | 16.4                     |
| Housing Starts (Million Units)        | 1.852       | 1.952       | 1.830                    | 1.760                    |
| Civilian Employment (Millions)        | 137.736     | 139.3       | 141.5                    | 143.6                    |
| Civilian Unemployment Rate            | 6.0%        | 5.5%        | 5.2%                     | 5.0%                     |
| Corporate Profits - AT-NIPA           | 16.3%       | 11.2%       | 8.6%                     | 4.8%                     |
| S&P-500 Earnings-Reported             | \$48.74     | \$59.46     | \$66.50                  | \$72.00                  |
| S&P-500 Earnings-Operating            | \$55.54     | \$67.09     | \$73.00 (c)              | \$77.00 (c)              |
| 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   | 2.49-3.50                | 3.40-4.50                |
| 10-Year U.S. Treasuries-Yield (%)     | 3.17-4.55   | 3.68-4.87   | 3.99-5.15                | 4.80-5.60                |

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