



SILVERCREST
ASSET MANAGEMENT GROUP

ECONOMIC REVIEW AND INVESTMENT STRATEGY: 2004/III

A CONTINENT IN SEARCH OF ITS DESTINY

Europe spent the first half of the Twentieth Century embroiled in two ugly wars and their aftermath, and most of the second half divided against itself and in the direct path of nuclear superpower confrontation. Even after the collapse of the Soviet Union, it had to deal with the historically impossible mission of forging a more harmonious continent from distinct national identities and differing ideologies while at the same time bridging past rivalries and jealousies. That the history of the region did not encourage optimism was briefly overcome by a sense of relief that the world was moving away from the path of self-destruction.

Industrial Europe—consisting mainly of those countries to the west that had not fallen into the Soviet orbit—faced a daunting task in the aftermath of the Second World War. Aside from having to rebuild war-shattered economies, it felt pressed to deal with the destabilizing radiation of a hostile socioeconomic system on its border while at the same time tending to the needs of a citizenry tired of wars, political conflict and the deprivation of the Great Depression. To undertake this daunting task, it not only had to forge a strong alliance with the United States, and thereby come under the protective umbrella of its military might, but also to adopt very expensive social welfare programs, the latter in part to keep a dissatisfied and restless public from being seduced by communist socialism.

While the collapse of the Soviet Union liberated Europe from fear of superpower confrontation, it brought to the fore latent tensions and a range of economic and other social ills that were not approached with the requisite urgency. For a period following the fall of the Berlin Wall, it was presumed, perhaps with a measure of optimism not unjustified by history, that a more cohesive Europe might become a powerful political and economic force that would counter the hegemony of the United States. But in a world undergoing rapid change, this goal has fallen far short of realization. The integration process, whether through the formation of a European Union or the evolution of a eurozone, has exposed acute differences in policy and approach among the participants that cannot be easily overcome. Efforts to draw up a constitution for the European Union that would be acceptable to all the players have so far produced begrudging compromises that may well contribute to a failure of ratification by many of the nations involved. Some estimate that it may take another ten years or so before the outcome can be determined.

A more critical issue relates to the relative vigor of the continent's economy. Burdened by costly and almost inviolate social programs that stand in the way of meaningful fiscal stimulus, and with consumption impaired by declining and aging populations and perennially high unemployment, growth has disappointed. Europe's economy will likely continue to trail the vigorous gains generated in the United States to the west and the developing economies of Central and Southeast Asia to the east. This competitive squeeze has not gone unnoticed and has arguably provoked a measure of defensive jealousy and envy.

Another source of concern, now confined to a handful of countries but rapidly spreading to others, is the flood of immigrants with alien social and cultural values who are attracted by the political freedom and the extensive material benefits made promptly available to them. Such an open-door policy has awakened ugly latent nationalism and raw resentments with potentially disturbing consequences. Many of these immigrant minorities have found a voice in Islamic fundamentalism and are beginning to demand political recognition far beyond their proportional numbers.

The issues discussed above are not lost on Europe's leaders. In fact, they open a window on the psychological factors that may have shaped the response of many important countries to recent U.S. policies on the global stage. American unilateralism, they argue, even in pursuit of virtuous principles, is nothing short of arrogant militarism that needs to be contained; otherwise it devolves into a threat against the interests and, by extension, the sovereignty of other nations. Whatever validity such a claim may possess, Europe must take care that it does not foster negativism toward the United States as a means of burnishing its own image. Nor should it seek to amplify its role through hostile pandering to gain the support or allegiance of other countries with more sinister agendas, particularly if the ultimate objective is to secure effective veto power over American foreign policy decisions. Despite the end of superpower confrontation, the world has become a more dangerous place where foes can be anywhere and opportunists can masquerade as friends.

Iraq has proven to be a wrenching experience on all fronts. It demonstrated that military power does not guarantee final victory, nor does it quickly impart social stability. Those who insist that the acquiescence of the United Nations would have assured success ignore the world organization's many prior failures and the many examples of its impotence. Furthermore, until its platform is converted into one of civility and a venue for enlightened debate and compromise, it will remain suspect in the eyes of many who have been victimized by the partisan self-interest that often dominates its deliberations.

Despite the wide disparity in their economic and military weights, Europe and the United States share many principles and objectives that have become obscured by recent conflicts. With Europe lacking the means to bring order to a dysfunctional world, the U.S. somewhat traumatized by its recent experiences in trying to bring democracy to Iraq, and the United Nations lacking any enforcement power, the world may be facing uncontrollable risks. This is evident in the absence of any coordinated program to fight terrorism or any apparent effort to forge a plan of action, should it be required to protect those societies in harm's way.

With the United States having begrudgingly acknowledged that the invasion of Iraq may have fallen short of its initial objectives, and perhaps lacking domestic support to be involved in future humanitarian missions, an opportunity may be at hand for a reassessment of the role that each of the major players on the global stage can play to bring about a resolution to other conflicts. The global economy, now in a synchronized period of growth, can ill afford to sacrifice a chance to spread prosperity on the altar of power politics.

THE ECONOMY: MORE ANSWERS THAN QUESTIONS

The U.S. economy appears to be cruising smoothly above the clouds with no signs of near-term danger on the radar screen. The twin concerns of "deflation" and "jobless recovery" that were the mantra of a few months ago have been conveniently replaced by a fear of inflation and its consequent impact on monetary policy. In the meantime, with the nominal transfer of governance in Iraq to local authorities, and an exit plan apparently in progress, a chapter loaded with painful lessons will obviously influence

future response to rogue regimes. On the domestic front, the public seems to be approaching the presidential election contest with partisan passion but little enlightenment.

Stripped of all the noise that passes for informed debate, there appears to be almost no justification to view the current expansion as being anything other than part of a normal business cycle. Recoveries from recessions gather momentum and invite increased capital outlays. Employment rebounds, suppressed wages begin to move up, incomes rise providing the financial resources for additional consumption, depleted inventories are replenished, prices climb to reflect improved demand, dormant inflation stirs and the monetary gatekeepers respond. This sequence of events is virtually immutable, but the strength of each of its links, and the response of the involved players, often determine whether the flight is successful and the landing is safe.

At this stage of the cycle the threat of unsettling economic turbulence in the foreseeable future seems negligible. This hopeful conclusion in no way suggests that the expansion is a song without end; rather, it implies that the requisite excesses and imbalances that invite recessions are not in evidence. In addition, the engines driving growth are rooted in sound fundamentals. Most relevant, of course, is that the financial system is healthy and flush with liquidity. Second, productivity and other efficiency measures have affirmed to corporate managers the benefits of vigilance. Third, an increasingly open and competitive global architecture should reduce the risk of inflation. Fourth, claims that American consumers are overburdened with debt are contradicted by the vast improvement in their balance sheets. Fifth, the heightened reliance on technology has shortened the capital spending cycle due to more rapid obsolescence. Sixth, it would take a huge increase in borrowing costs to halt the expansion, given the health of corporate financials and the abundance of operating cash flows. Finally, the awakening over the past decade of many dormant or lagging economies with huge pent-up demand, as well as their aspirations to move up the industrial ladder, almost guarantee added opportunities for the United States.

Currently, most of the above seem somewhat obscured by the debate on inflation and the potential impact of rising interest rates. Several years of depressed commodity prices, timid labor demands, liquidation of inventories and the benefits of strong gains in productivity have, until recently, kept prices at bay. Therefore, it would seem natural for businesses to pass on increased costs in the form of higher prices to protect margins. The addition of the “China factor” to this brew, especially the massive purchases of commodities, set the stage for some revival of inflationary pressures. However, with growth in China decelerating, commodity prices including oil recently in decline, and inventory pipelines close to being replenished, the recent spike should begin to fade, as it has in recent weeks. This sequence may become evident in coming months, with the process perhaps somewhat accelerated by a less liberal monetary policy.

Significant changes in the structure of the U.S. economy argue against a replay of prior inflationary spirals. Since the 1970s, reliance on so-called smokestack industries has declined significantly, and with it the impact of rising commodity prices, including energy. Furthermore, organized labor has lost a great deal of power, mainly because of shrinking membership and also out of fear of global competition. In addition, trade and tax policies have since facilitated the rapid transfer of various manufacturing and some service operations to lower-cost countries. Finally, the current absence of pent-up inflation is at odds with the consequence of guns-and-butter approach associated with the Vietnam conflict and the subsequent adoption of ill-conceived wage and price controls.

Perhaps partly in recognition of this bit of recent history, Greenspan’s monetary monks may feel in no hurry to take precipitous action. Their most immediate task is likely to be a withdrawal of the excess stimulus supplied when they perceived a risk of an aborted recovery. Hence, the early steps that

will be taken should be viewed as a return to normalcy rather than the prelude for overt, aggressive restraint; this posture has been amply telegraphed by the Fed's decision to raise the fed funds rate by a modest 0.25 percent, and by the comforting statement that accompanied this action. A more aggressive approach is not in the cards at this time even if, as expected, additional tightening is implemented in coming months. For these reasons, we conclude that Alan Greenspan will continue to act as the deliberate monitor he is known to be, preferring to err on the side of relative ease. Therefore, concern that the Fed's response may fall behind the curve is nothing more than an academic exercise of limited value in the real world.

In summary, we believe that over the next twelve months or longer (1) the U.S. economy will continue to grow at a solid, but not an excessive, pace; (2) inflation will continue to creep up but will not reach a threatening level; (3) interest rates will rise at a measured pace but will not inflict meaningful damage on business activity; (4) growth in corporate profits will begin to decelerate soon but comparisons will remain positive at least through 2005; (5) continued economic vigor and higher interest rates will provide support and relative stability to the dollar; and (6) most of the global economies should continue to prosper with the help of greater interdependence.

INVESTMENT STRATEGY: FEAR OF FLYING

It is not unusual for stock markets to become detached from reality. Unbridled optimism and deep pessimism are not alien to investors, as these extremes seem to alternate in every cycle with reliable regularity. Having recently experienced the euphoria and subsequent pain of a burst bubble, investors now appear to be seeking salvation for their past sins behind a veil of deliberate caution. Otherwise it would be difficult to explain the almost irrational rejection of a long list of positive supports, evident in economic performance and valuation metrics, currently at play on the investment scene.

Granted, a whiff of inflation is in the air which seems certain to propel interest rates to higher levels over the next year or so, and Iraq remains a messy adventure. However, these impediments have been amply advertised and largely compensated for by economic growth that has exceeded most forecasts, by gains in profits that would have been considered unimaginable only six months ago, and by financial performance in the private sector that should provide the fuel for an extended period of solid growth. All of these blessings are neatly reflected in massive liquidity that should easily push stocks to a higher plateau before the current market cycle reaches its end. With the Standard & Poor's 500 nearly 35 percent below its all-time record and the NASDAQ almost 80% short of its peak, and with sharply rising earnings, it would be reasonable to argue that there is room for further gains.

Of course, interest rates are part of the equation that establishes the market's theoretical fair valuation; the other elements are profits and their anticipated rate of growth, and a "risk premium" that compensates for perceived uncertainties. Static analysis, incorporating current interest rates and consensus earnings estimates would suggest that stocks are nearly 25 percent undervalued. Advancing the timetable by a year or longer, and assuming a substantial increase in interest rates to 6% on 10-year U.S. Treasury bonds, with only a moderate increase in profits for 2005, would still leave the key averages about 15% below fair value, in our view.

What we conclude from the foregoing is that the market's current valuation has developed a defensive cushion that allows for some disappointments on almost any front without causing major or lasting damage. This is in sharp contrast to the peak of the previous cycle when stocks were priced at a premium well beyond perfection.

Investing is a process through which a reasonable risk-adjusted rate of return is obtained over an extended period. With stocks seemingly undervalued, as measured by traditional yardsticks, a considerable portion of the “risk factor” appears to be discounted, thus tipping the balance in favor of reward. Under the circumstances, time is an investor’s friend and impatience an enemy.

With the market over the past six months in a state of suspended animation characterized by declining volume, listless rotation, and a lack of enthusiastic response to a massive flow of positive corporate pronouncements, we believe that a favorable resolution to this standoff is not far into the future. A combination of very strong earnings releases for the second quarter coupled with affirmation of rising expectations, less equivocal policy statements by the Fed replacing its verbal dances of recent months, and additional steps in the transfer of governance to local authorities in Iraq would likely break the logjam that has impeded the market’s advance. In addition, the deployment of massive free cash flow generated by the business sector would likely reinvigorate share repurchase programs, accelerate activity on the acquisition front, and/or press corporate managers to otherwise return to shareholders some of the mounting hordes of liquidity in the form of cash dividends. The contribution of dividends to total investment returns should soon attract increased notice. Specifically, a recent study revealed that since the enactment of tax relief on dividends in 2003, nearly 150 firms have initiated payments adding more than \$1.5 billion in aggregate quarterly distributions.

Our optimism does not ignore some headwinds that could keep the market’s valuation at bay. These include rising interest rates, deceleration in the pace of earnings growth, a cyclical slowdown in productivity, higher wages and cresting profit margins. We view these impediments as largely reflecting the natural progression of the business cycle rather than signaling an end to the current expansion. Nonetheless, market gains are likely to be driven more by profit gains than by more liberal valuation metrics.

In our opinion, the three sectors that justify favorable consideration at present are producer durables, healthcare and energy. We favor the first because we are persuaded that the current recovery in capital spending will persist for an extended period as businesses attempt to protect margins through more efficient production facilities. Healthcare, notably pharmaceuticals, has underperformed for nearly two years as political pressure, maturing pipelines and company-specific events tarnished the industry’s long-term luster. In the meantime, valuations on a wide range of stocks in this group has declined to defensible, or perhaps even compelling, levels. The energy sector, long subject to benign neglect, is finally gaining deserved respect for its strong cash-flow generation, some secular acceleration in global demand as developing economies raise their requirements, and as sociopolitical instability compromises the reliability of some supply sources.

With interest rates in the very early stages of an upward reversal that we believe may last for longer than a year, fixed income investments should be positioned near the bottom of the list of preferences, with maturities at the shortest end consistent with needs. While the current interest rate cycle is very likely to be less unkind to financial stocks than in the past, it will no doubt reduce their attractiveness in the short and intermediate term.

July 1, 2004

Stanley A. Nabi, CFA
Vice Chairman

ECONOMIC FORECAST
(As of July 1, 2004)

	<u>2002</u>	<u>2003</u>	Estimated <u>2004</u>	Projected <u>2005</u>
Real GDP	2.8%	4.3%	4.0%	3.5%
Real Consumption Expenditures	3.4%	3.1%	3.8%	3.4%
Business Fixed Investment	(7.2%)	3.0%	9.5%	7.8%
Inventory Investment (Billions)	\$5.7	(\$0.8)	\$34.0	\$31.0
Residential Construction (Billions)	\$470.3	\$505.4	\$535.0	\$530.0
Government Spending (Billions) (a)	\$1,837.1	\$1898.9	\$1,936.0	\$1,980.0
Trade Balance-Goods & Services	(\$421.7)	(\$496.5)	(\$556.0)	(\$540.0)
Federal Budget*: Unified (Billions)	(\$157.8)	(\$374.2)	(\$417.7)	(\$366.0)
GDP Deflator	1.5%	1.7%	2.1%	2.3%
Producer Price Index	(1.3%)	3.2%	3.7%	3.0%
Consumer Price Index	1.6%	2.3%	2.6%	2.8%
Industrial Production	(0.6%)	0.3%	5.5%	5.2%
Real Disposable Income	3.8%	2.7%	3.9%	3.4%
Hourly Compensation	2.3%	3.5%	4.2%	3.8%
Unit Labor Cost (Non-Farm)	(2.5%)	(0.9%)	0.3%	1.2%
Productivity Growth (% Change)	4.9%	4.4%	3.8%	2.5%
Personal Savings Rate (% DPI)	2.3%	2.1%	2.3%	2.5%
Capacity Utilization - Total	75.6%	74.8%	77.5%	79.0%
Trade Weighted \$ Exchange Rate	(0.4%)	(6.7%)	(4.0%)	1.5%
Vehicle Sales (Million Units)	16.7	16.6	16.8	17.0
Housing Starts (Million Units)	1.711	1.850	1.920	1.765
Civilian Employment (Millions)	136.485	137.9	140.1	142.0
Civilian Unemployment Rate	5.8%	6.0%	5.4%	5.0%
Corporate Profits - AT-NIPA	11.0%	14.8%	10.3%	9.5%
S&P-500 Earnings-Reported	\$27.59	\$48.74	\$58.10	\$68.00
S&P-500 Earnings-Operating	\$48.09	\$55.54	\$66.50	\$72.00
S&P-500 Dividends	\$15.67	\$17.60	\$19.00	\$20.75
90 Day U.S. Treasuries-Yield (%)	1.40-2.35	1.40-0.75	0.87-2.25	2.00-3.25
10-Year U.S. Treasuries-Yield (%)	5.20-3.59	4.55-3.17	3.65-5.50	5.50-6.25

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