SILVERCREST
ASSET MANAGEMENT GROUP

ECONOMIC REVIEW AND INVESTMENT STRATEGY: 2005/III

BLAME IT ON THE MAGNA CARTA

One of the notable curiosities in the current global economic scene relates to the persistent divergence in growth between the English-speaking countries (the so-called Anglo-Saxon crowd) and other industrialized nations. Except for a period immediately following the Second World War, when a demolished Europe was rebuilding itself, the former group has managed to make greater economic strides than the latter. The reasons for this disparity may be debated on social and political grounds, but nearly all are rooted in the fundamental laws that set forth the obligations of the government and the rights and responsibilities of the governed.

The English-speaking countries to which reference is being made are the United Kingdom, the United States, Ireland, Australia, Canada and New Zealand. The constitutional foundation of these countries has enjoyed a constancy that harks back eight centuries, to 1215 AD, when the *Magna Carta* became the law of the land in England, having been imposed on King John in response to his disastrous foreign policy and aggressive financial administration. Interestingly, the Founding Fathers of the United States, who were charged with drafting the Declaration of Independence 560 years later, are widely believed by historians to have consulted the *Magna Carta* for precedent.

The constancy of the rights and privileges set forth in the *Magna Carta*, mainly in the form of stipulations, has been pivotal in imparting relative political and economic stability to the nations that adopted its core principles. These included a list of personal freedoms, and a legal system that affirmed property rights and recognized the sanctity of contracts.

Nearly all the industrial countries that today are afflicted with severe economic malaise and sluggish growth lack the comfort and safety of such constancy. Few of the nations in Continental Europe have managed to escape the constitutional upheavals of the twentieth century, and in particular France, Germany, and Italy which today presume to speak for the proposed European Union. The eastern part of the continent suffered even greater instability since it was forced to adopt an alien and untested political and legal structure within the Soviet orbit. Whether because of wars, social distress or the misguided policies imposed on them, it was mainly political expediency instead of the unwavering principles that charted the direction they have pursued. For those countries which escaped the rigid tyranny of Soviet communism, socialism of various intensities became an accepted form of economic life as nationalization and privatization of key industries frequently alternated to accommodate political winds. Rapid changes in business regulations, tax laws, property rights and the security of contracts created an unstable climate that paralyzed or impeded investment decisions and discouraged creative economic pursuits. Such absence of relative consistency was contrary to the practices in English-speaking countries where a more investment-friendly approach prevailed and where risk-taking was allowed to generate its own rewards.

Most of the industrialized countries currently experiencing sluggish growth and difficult economic conditions hide behind their touted devotion to cradle-to-grave safety nets whose cost they often underestimate and clearly can ill-afford. To support such expensive social welfare programs, they have promulgated a tax structure that accepts the notion of compensation without contribution over one that provides fair rewards to those who are willing to assume financial and other risks. In 2004, this unequal trade-off reduced U.S. direct investment in France by half and caused a net withdrawal of $39 billion from Germany, according to data recently released by the OECD.

The economic progress of the United States, and to a somewhat lesser degree of the United Kingdom and others in the English-speaking realm, is now well-documented, and can be attributed to the resiliency in their sociopolitical structure that has successfully managed many of the necessary changes. In the course of the past fifty years, the United States has moved from substantial reliance on smokestack industries to the dynamism of information technology and bioscience, with the next stage perhaps holding equally exciting surprises, as the vitality and creativity of venture capital investing has repeatedly demonstrated. For the United Kingdom, the most important transition came with the initially-reluctant acceptance of Thatcherism which recognized the failure of the post-war welfare structure. In both countries, as well as others in the English-speaking world, constancy and confidence in the sanctity of economic rights, combined with a high degree of personal self-reliance, have contributed greatly to social stability and progress as reflected in a constant inflow of investments and low unemployment.

Perhaps the squabbling members of the European Union should replace the proposed constitution with their own version of the *Magna Carta*. It may well become an inspirational guide to a more prosperous economy and pave the way to peaceful coexistence with their neighbors.

THE ECONOMY: STRANGE INTERLUDE

While the U.S. economy appears to have lost some momentum in recent months, its growth remains solid with no apparent threat of a downturn. This conclusion is supported by the absence of meaningful imbalances that typically foreshadow a slide into recession. The increase in industrial capacity over the past two years has been moderate, obsolescence considered, corporate balance sheets are flush with cash, the financial system is healthy and interest rates are far from burdensome. While hiring has remained cautious, mainly reflecting greater operating discipline, it has nonetheless allowed disposable personal income to expand in line with its historical trend line. Meanwhile, profits and margins have reached record levels aided by respectable gains in productivity. The mild upward pressure on inflation that has crept into this placid scene is mainly attributable to the increase in the price of commodities, notably energy, although many of them appear to be retreating.

The two major sectors that may be in the early stages of deceleration are housing and capital spending. The former, while still enjoying close to peak demand, is exhibiting some characteristics of a topping process; however, it should not suffer from a substantial drop as long as mortgage rates do not surprise on the upside. The apparent slowing in outlays for plant and equipment merely hints at a more sustainable pace following its steep exit from recession. This sector should remain robust for another two years or longer as businesses focus on protecting their profits and margins through greater efficiency, and as aerospace spending (military and civilian) moves through a new cycle. In all, we view the current modest slowdown in general business activity as a typical mid-cycle respite that should exhaust itself no later than the early part of 2006.

While comparisons of business cycles can be instructive, the current expansion is blessed by a number of attributes rarely found in prior recoveries. These include very low real interest rates, a financial system which is both sound and liquid, businesses that continue to generate abundant cash flow and mild inflationary pressures that have so far digested the increase in commodity prices without unleashing disturbing consequences.

The intense focus on domestic monetary policy not only flows from fear of potentially higher interest rates but also from an inability to explain the seeming breakdown of the historical relationship that has traditionally been key to the shape of the yield curve. Mr. Greenspan, usually a master of creative ambiguity in his declarations, has confessed to a lack of adequate enlightenment on the subject. It seems possible, however, that the global credit markets may have become so homogeneous that one nation's approach, fashioned to work within its borders, can greatly influence decisions made elsewhere. As an example, the broadest measure of money growth in the U.S., the so-called MZM, has barely shown any growth so far this year, which traditionally raises a warning flag of a forthcoming economic downturn. That such has not been the case can be explained by the "globalization" of monetary aggregates which are estimated to have grown at a robust 7.4%. In addition, the weakened role of the euro as a result of the seeming disarray and open hostilities among key members of the European Union may have diverted additional global savings to the United States.

The recent rebound in the dollar, particularly relative to the euro, has many causes, none mysterious. First, the U.S. continues to generate much higher growth than many major industrialized countries. Second, the Federal Reserve Board remains in a tightening mode that should carry interest rates a bit higher in coming months even while the European Central Bank and the Bank of England are under pressure to ease. Third, dissension within the European Union has escalated into hostile confrontations that do not lend themselves to rapid compromises. Finally, with the decline in the dollar in 2003 and 2004, all of the current euro zone members have become decidedly uncompetitive. These considerations persuade us that the greenback will very likely experience further meaningful appreciation in coming months. As for the dollar's relationship to the yen, the Japanese economy's sluggish and erratic growth, and its very low interest rates, conspire against any meaningful resurgence in its currency.

Nonetheless, an appreciating dollar should not be treated as a singular blessing. Its recent rebound will likely detract from the earnings of most U. S. multinationals in addition to making many exporters somewhat less competitive. The continued impact of these factors causes us to scale back modestly our earlier forecast regarding the gains in corporate profits in coming quarters.

In summary, we conclude that: (1) growth in the U.S. economy will show some moderation during the next twelve months, but would still exceed those of nearly all other industrialized countries; (2) inflation may be close to its cyclical peak as more stable demand begins to put downward pressure on the price of important commodities; (3) the Federal Reserve Board will henceforth allow domestic economic conditions rather than "neutrality" to guide monetary policy; (4) the dollar will rise further, particularly relative to the euro, as the current members of the European Union struggle to reach mutually acceptable compromises on a multitude of difficult issues; (5) gains in business profits will become more difficult to achieve as margins peak and as dollar appreciation detracts from foreign earnings; and (6) the U.S. stock market will treat a combination of a potential end to monetary tightening, cresting inflation and a firm dollar as a "comfort zone" that justifies higher prices for equities.

INVESTMENT STRATEGY: TROTTING ON A TREADMILL

Judging by the stock market's inability to make much progress over the past six months, one would be inclined to assume that the U.S. economy will soon be in retreat, perhaps accompanied by a meltdown in profits. Such is not the case, in our view. Corporate profit gains exceeding 30% over the past 18 months have generated returns of well under 10% in the various stock indices during this period, most of which can be credited to the energy sector. This anemic performance, in the face of very low interest rates, strong corporate fundamentals and defensible stock valuations, smacks of severe pessimism not justified by the evidence at hand.

"Guilty until proven innocent" has become the mantra of most professional investors and traders. No longer satisfied with earnings reports consistent with consensus forecasts, they have raised the bar to levels that defy rational expectations. With profit margins at their highest level in almost five decades, corporate managements can no longer be accused of a lack of operating discipline or of not acting to reward shareholders. Dividends are being raised at the fastest pace in more than a decade, share repurchases have become a widely practiced strategy, and acquisitions are being approached with discipline including more rational prices paid and clearer business objectives. That some unpredictable disaster is lurking around an unsuspected corner challenges our predictive powers.

What stocks may be suffering from is a typical mid-cycle syndrome similar to that experienced in 1985 and 1995, in addition to some compression in valuations wherein "value" and "growth," "small" and "large" are not far apart, as well as a new refrain that investors may be more drawn to real estate than to equities. Sluggish trading volume combined with a shrinking cadre of momentum players, such as hedge funds, have also weighed in.

We remain optimistic about U.S. equities and continue to forecast a second half upturn in the market. Our upbeat conclusions derive from what we perceive as largely prudent stock valuations that, we believe, discount a mid-cycle deceleration in economic growth, moderating earnings gains, further monetary restraint when appropriate, and a more prudent fiscal approach in Washington. On the global front, unresolved issues in the euro zone will likely make the region's currency less attractive as an alternative safe haven thereby diverting some liquidity to U.S. stocks. Finally, as has become evident once again, sovereign investors are finding value in acquisitions within the U.S., where they can establish a beachhead in a market with more dynamic attributes than exist in countries with more rigid industrial policies.

Among the sectors that we consider to be potentially rewarding, are healthcare, notably pharmaceuticals, and consumer staples with well-entrenched franchises. While concern over a future lift in interest rates would impair mortgage lenders, and has as a result cause many banks and insurance stocks to stall, we are inclined to be selective buyers of companies in this group with a diversified book of business. Banks, in particular, have been able to manage a rapidly flattening yield curve through good commercial loan growth, higher fee income and stable credit conditions. We also favor life insurance companies which typically have little or no exposure to the real estate market. Finally, we view companies in defense and aerospace with rising multiyear backlogs as having a reliable profit stream and a relatively low risk profile.

With oil near record prices, we have tempered our enthusiasm for the energy sector following more than two years of strong performance. The advertised demand/supply imbalance in oil can no longer be attributed entirely to the production side of the equation but to other factors that may soon fade, including refining and transportation bottlenecks. In addition, we detect the involvement of hedge funds in the most recent spike, based on a recent estimate of $50 billion committed by such opportunistic traders to various commodities, primarily oil. Finally, slowing growth in Europe should reduce demand for energy at the same time that producers gear up to take advantage of record prices. Nonetheless, our more cautious investment posture on the sector is merely a detour that will likely last only until a better opportunity develops. This could occur when a moderate decline in energy prices precipitates an exaggerated correction in valuations, as often occurs.

The longer end of the fixed income market has surprised by its lack of response to the cyclical rebound in the economy. However, this does not alter the fact that the longer maturities now carry more risk than reward simply because their nominal returns barely offset the secular rate of inflation. Because dividend yields on many conservative stocks with defensive characteristics are currently above 3%, the pendulum favors selected equities.

July 1, 2005

Stanley A. Nabi, CFA
Vice Chairman

ECONOMIC FORECAST
(AS OF JULY 1, 2005)

	2003	2004	Estimated 2005	Projected 2006
Real GDP (Ann. % of Change)	3.0%	4.4%	3.6%	2.9%
Real Consumption Expenditures	3.3%	3.8%	3.6%	3.0%
Business Fixed Investment	3.3%	10.6%	8.5%	5.5%
Inventory Investment (Billions)	($0.7)	$45.7	$48.0	$50.0
Residential Fixed Investment (Billions)	$511.2	$560.7	$584.0	$570.0
Government Spending (Billions) (a)	$1909.5	$1,946.5	$1971.0	$2006.0
Trade Balance-Goods & Services	($494.8)	($617.6)	($635.0)	($640.0)
Federal Budget*: Unified (Billions)	($374.3)	($412.8)	($360.0)	($380.0)
GDP Deflator	1.8%	2.2%	2.7%	2.4%
Producer Price Index	3.2%	3.6%	3.9%	2.2%
Consumer Price Index	2.3%	2.7%	3.0%	2.6%
Industrial Production	0.0%	4.1%	3.4%	3.5%
Real Disposable Income	1.8%	3.7%	3.4%	3.3%
Hourly Compensation	4.0%	4.8%	5.5%	4.2%
Unit Labor Cost (Non-Farm)	(0.2%)	0.7%	3.8%	1.8%
Productivity Growth (% Change)	4.3%	4.0%	2.5%	2.3%
Personal Savings Rate (% DPI)	1.3%	1.3%	0.8%	1.1%
Capacity Utilization – Total Industry	75.5%	78.1%	79.6%	80.2%
Trade Weighted $ Exchange Rate (b)	(12.2%)	(8.2%)	1.0%	(1.0%)
Vehicle Sales (Million Units)	16.6	16.8	16.7	16.4
Housing Starts (Million Units)	1.854	1.950	1.996	1.840
Civilian Employment (Millions)	137.736	139.252	141.4	143.4
Civilian Unemployment Rate	6.0%	5.5%	5.1%	5.0%
Corporate Profits - AT-NIPA	11.4%	12.0%	13.8%	3.1%
S&P-500 Earnings-Reported	$48.74	$59.46	$66.50	$72.00
S&P-500 Earnings-Operating	$55.54	$67.09	$73.50 (c)	$77.50 (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	3.90-4.75	4.15-5.10

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