



**SILVERCREST**  
ASSET MANAGEMENT GROUP

**ECONOMIC REVIEW AND INVESTMENT STRATEGY: 2004/IV**

**TRADE: ECONOMICS OR POLITICS?**

Since the collapse of the Soviet Union in 1989, trade has emerged as a pivotal issue of immense importance to the health and prosperity of the global economy. Perhaps it was the end of the Cold War that shifted the focus of many nations and their leaders from political gamesmanship to economic security, or it may have been the recognition that prosperity is the quickest and least painful path to freedom and democracy. In any case, rare is the country which does not seek to be a full participant in the trade game.

The following statistics underscore the importance of trade. In 1970, trade accounted for less than 12 percent of global output; today it is close to 26 percent and rising. For the United States alone, exports have climbed from 7 percent of GDP as recently as 1985 to about 10 percent last year, and these figures do not include the activities of American corporate affiliates domiciled outside the country. Hence, despite many restrictions and impediments, the United States is not being deprived of its share of global trade.

The global economies have clearly become divided into two camps: those that are mature, such as the G-7 nations, and those that are only now entering a period of vigorous growth. Small or no gains in population, combined with relatively high wages and other employment costs, are likely to contain the long-term growth of mature economies, thus permitting only a modest improvement in their standards of living in coming years. Emerging countries, on the other hand, are capable of growing much more rapidly, aided by cheap labor, significant pent-up domestic demand, a solid increase in population, and the eagerness to rapidly improve their living standards. In fact, over the past 25 years the latter have become a highly competitive force that cannot, and should not, be restrained.

Trade should be viewed as an economic force for good before it is treated as a weapon in a nation's foreign policy arsenal. Among its benefits is downward pressure on inflation as the lowest cost producers place at risk those that are less efficient. There is now convincing evidence that, since the collapse of the Soviet Union, trade not only has captured a greater portion of global GDP but has also been instrumental in lowering both inflation and interest rates. These benefits, however, require a relatively more open global economic architecture to produce the desired consequences. Unfortunately, political static has intervened to contaminate what should be a simple and straightforward process, that of reducing trade barriers.

The current confrontational policies on trade being pursued by the United States seem to be flawed and confused because they are predicated on two misguided notions. The first is an unwillingness to recognize that each nation's political evolution and economic development can only proceed at a pace compatible with its social institutions and the temperament of its people. The second is a misreading of the history and objectives of the Most Favored Nation (MFN) clause. In practice, MFN has always been intended to reduce impediments to trade, to facilitate commerce, and to grant certain reciprocal privileges to those nations that refrain from erecting discriminatory barriers in their trade

relations. At no time was MFN designed to exert leverage to achieve other foreign policy objectives, such as dictating or influencing the relationships of a country's government with its own people.

For the United States in particular, the deterioration of its trade balance to an annual deficit of more than \$600 billion is of notable concern. This shortfall has placed the dollar at risk of further decline, has given our sovereign lenders unhealthy political leverage, and has raised the specter of undesirable protectionism. While the blame game for this deficit has turned into a political issue, it needs to be recognized that the imbalance is largely due to a sharp increase in imports, mainly of consumer goods, rather than to overtly aggressive policies on the part of our trading partners. Being a free nation, we cannot control consumer preferences or conduct. The only viable remedies would be policies that encourage savings, investments, and innovation. Our success in replacing our impaired and shrunken smokestack industries with very high technology products and services demonstrates that this is not an impossible task. Furthermore, it would be self-defeating to talk down the dollar so as to place other exporters at a disadvantage. If a nation does not respect and protect the integrity of its currency, no one else will, or should.

Free of political designs, trade spawns prosperity which cultivates peace. One need not go too far back into modern history to recognize that recently successful and orderly political entities—such as Taiwan, Singapore and South Korea—managed to lift themselves to a position of economic prosperity and relative social stability as a result of their rising participation in multilateral trade. Nor can it be denied that Vietnam, and more recently China, have toned down their hostility toward the West as they sought new markets for their goods and new sources to meet their need for equipment and technology. That these countries have had authoritarian regimes does not diminish their growing willingness to interface with other economic systems whose institutional approach to democracy is different from theirs. Such current uneasy tolerance may well evolve into acceptance and peaceful coexistence.

Trade can be either a path to global peace and prosperity, or it can regress toward protectionism or whatever other label may be placed on it. Whoever prevails in the current presidential election owes a responsibility to the nation and the world to adopt trade policies suitable for our times rather than continue on the currently confusing course that ignores the constructive economic realignment taking place.

#### **THE ECONOMY: MIXED SIGNALS, BUT MOVING FORWARD**

While the U.S. economy remains healthy, growing as it is at a respectable and sustainable pace, it is being talked down by uncertainties that are largely outside the boundaries of fundamentals. Terrorism, Iraq and an ugly presidential campaign continue to provoke partisan passions which are being exacerbated by media reporting not entirely free of hyperbole. As a consequence, the public is being bombarded by a steady stream of fear, doubt and concern not balanced by the less interesting recitation of the gains and progress being made on many fronts.

Following a strong burst of activity coming out of the recession, the economy has settled into a more normal trajectory consistent with its long-term growth. So far, the expansion has failed to generate threatening excesses that would undermine its sustainability. While inflation escalated modestly for a brief period, largely in response to a spike in the price of commodities—particularly oil—it has recently retreated to a level below its historical trendline. In response, the threat of a rapid rise in interest rates has greatly diminished, allowing the yield on long-term U.S. Treasury obligations to return to the lowest level in more than a year. Capital spending remains robust as companies strive to safeguard their profit margins in an intensely competitive environment and are able to finance their projects almost entirely from internally generated cash flows. In the meantime, consumers are exhibiting some prudence in their

spending, although this may be a temporary respite caused by unusual weather conditions and the questionable but often repeated mantras of weak employment and excessive debt burdens. Finally, government spending is unlikely to shrink since domestic social demands and critical defense requirements continue to escalate, although the budget deficit will shrink as tax revenues continue to climb.

The employment picture, one of the most contentious issues in the election campaign, deserves more than a partisan focus. Weekly jobless claims have recently declined to a number below the average reported over the past thirty years even in the face of a 30% increase in the labor force. In addition, current unemployment, at 5.4%, is below the mean recorded during the decade of the Nineties, with further improvement anticipated as the current expansion continues. There are indications that the labor force is closer to full employment than raw data would seem to suggest because of pervasive miscalculations on many fronts, including the size and composition of the population and the unexplained disparity between household and establishment surveys. Finally, there has been an almost steady decline in jobs per real unit of GDP, which has accelerated since 1999, as the impact of technology on productivity became more pronounced. What all of the foregoing reveals is that the measured rebound in employment has not been the consequence of misguided or faulty policies but of a natural resetting of the economic engine.

Concern over the perceived risk associated with the heavy burden of consumer debt is contradicted by the weight of evidence. To begin with, the portion of disposable personal income required to service this debt has remained within its historical range, while the assets supporting it have improved in quality due to the rise in mortgages related to debt. In fact, the net worth of the consumer has risen nearly 80 percent since 1995, compounding at an annual rate of 7%, and exceeding the 6% increase in spending. Furthermore, personal income is now growing at a solid 6% rate, greatly outpacing inflation.

On the monetary front, a benign interest rate environment should remain supportive of the economy, though it will present a challenge to the central bank. Since midyear, when the Federal Reserve Board opted to begin withdrawing the stimulus it had provided during the recession, it has been assumed that such restraint would cause interest rates to creep up, but with some flattening in the yield curve. This, however, has not been the case. Productivity gains, global competition, a sharp recovery in profits and abundant liquidity have combined to keep long-term interest rates in check—and more recently in a downward trend—even in the face of greater commercial and industrial loan demand. The Fed, therefore, is faced with a dilemma as it attempts to reconcile the seemingly contradictory objectives of timely and necessary monetary restraint with an economy in a moderate uptrend and free of imbalances. The task is delicate but less risky than other alternative scenarios, such as having to deal with vigorous inflationary pressures or a weakening economy not responsive to monetary stimulus.

The presidential election campaign has generated much rhetorical fire but little light. It would be misguided to assume that over the short term a victory by either candidate would materially alter the course of business activity or the direction of the stock market. Major policy changes must be debated, enacted and implemented before their impact can be assessed from a rear-view perspective. This is often a multi-year process that cannot, and should not, be discounted in the span of a few months.

In summary, we are of the opinion that: (1) the U.S. economy will continue to grow close to its long-term pace; (2) inflation will remain subdued despite the occasional threat of a spike in the price of commodities, including oil; (3) the Fed will persist in its tightening mode until its overnight rate nearly equals the inflation rate, following which it would pursue a measured approach consistent with perceived need; (4) gains in business profits will likely decelerate though they will continue to improve at least through 2005; (5) the stock market will generate positive returns in the foreseeable future nearly

consistent with its historical trendline; (6) the U.S. dollar will remain within its current range in coming months provided that economic growth in the U.S. exceeds that of most other industrialized countries.

#### INVESTMENT STRATEGY: NOT TO WORRY

The major market indices ended the September quarter near where they had been at the start of the year. This lack of progress has occurred even though the economy continued to grow at a respectable clip, inflation remained relatively tame, interest rates failed to provoke concern, the dollar found a measure of stability, and both corporate profits and cash flow registered robust gains to record highs. These last two metrics served to drive valuations on key stock averages to their lowest levels in nearly eight years.

Clearly, there appears to be no lack of fundamental support for stocks. However, what emerges from any rational inquiry is the probability that investors have become infected by a crisis of confidence brought on by exogenous factors, such as geopolitics or the stream of ugly claims being traded in the domestic election campaign.

Pessimism, if it persists, can become a destructive force, feeding upon itself and undermining sound foundations. In the human condition such pessimism frequently turns into a sense of frustration or even despair. Such is the danger at present.

This psychological logjam is likely to begin clearing as Election Day approaches. By then third-quarter corporate earnings, which have been subject to more downward revisions than at any time in the prior twelve months, should help in resetting expectations for this year as well as for 2005. Given the intense attention being paid by corporate managers to profit margins, reflected in their cautious hiring, the outcome is not likely to disappoint.

Nearly all the current doubts about the stock market revolve around a “what if” scenario typically reserved for those who approach every discussion with a “devil’s advocate” position, ignoring the fact that their views lack the requisite anchors. The pessimism that has contaminated most investors in recent months appears to have as its root the faulty assumption that every challenge facing the economy and the market will succumb to its least desirable outcome.

Over the long-term, stock markets tend to reflect economic and corporate realities. Based strictly on the standard metrics of profits, interest rates and an assumed risk premium, the stock market, as represented by the Standard & Poor’s 500, appears to be at least 15% undervalued. This conclusion derives from conservative assumptions that include a meaningful deceleration in profit gains, to about 8% in 2005 from an estimated 18% this year, a gentle rise in interest rates to about 5.5% on the 10-year U.S. Treasury bonds, and a risk premium of 2.5%. Providing secondary support to this view is a new trend toward higher dividend payouts, significantly improved earnings quality and abundant liquidity.

While the key indices have remained essentially unchanged this year, the market has undergone several structural changes. Most important has been a compression in price/earnings ratios, with many sectors heretofore tagged with a “growth” label sliding to mainstream valuations. In addition, companies paying relatively high dividends, or the ability or promise to do so, have managed to generate significant outperformance in recent months. Finally, there has been widespread capitulation on companies with well-advertised legal or accounting problems which, in many instances, have pushed their stock prices below their intrinsic values.

Industries we favor include energy, pharmaceuticals, producer durables and selected technology. We are less favorably inclined toward consumer staples whose margins are being squeezed by the rise in the cost of commodities and the absence of pricing power. While the financial sector seems fairly valued, with a diversity of potential winners, it will remain under suspicion as long as interest rates are perceived to be on the rise.

Our optimism about the energy sector derives from a widely articulated misconception in the marketplace that the recent spike in oil prices is a temporary phenomenon. On the contrary, long-term demand/supply conditions argue for continued elevated prices. Important to our view is that the shares of many of the exploration and production companies are still being quoted at a deep discount to the underlying value of their assets. Add to this the rapid accumulation of abundant cash flows, and the attractiveness of the group becomes obvious even without introducing geopolitical uncertainties into the equation.

The pharmaceutical sector has underperformed for well over a year because of widely advertised problems, ranging from the threat of political intrusion into the pricing mechanism to maturing product pipelines and accounting issues. In our opinion, these impediments have been largely recognized and discounted in the sharp decline of their price/earnings ratios. Demographics argue for a continuing rise in demand for drugs under almost any conceivable scenario. In most instances the companies boast robust financials. A Republican victory in November would enhance the industry's prospects.

Producer durables are largely deep cyclicals tied to spending for plants and equipment. This segment of the economy is currently expanding at a rapid pace, and should continue to do so at least through 2005, as corporate managements seek greater productivity in the competitive race. While the shares of such companies typically peak well before their earnings cycle, many still possess considerable upside.

On the fixed income front, long-term interest rates have managed to confound the experts. However, with the Federal Reserve Board determined to remove the risk of future inflation, a continued drive toward restraint should prevail at least through 2005. Despite the short-term reversal of recent months, we believe higher interest rates with a flattening yield curve are in prospect.

October 1, 2004

Stanley A. Nabi, CFA  
Vice Chairman

This piece contains no recommendations to buy or sell securities or a solicitation of an offer to buy or sell securities or investment services or adopt any investment position. This piece is not intended to constitute investment advice. Market and economic views are subject to change without notice and may be untimely when presented here. Readers are advised not to infer or assume that any securities, sectors or markets described were or will be profitable. All material presented is compiled from sources believed to be reliable, but accuracy cannot be guaranteed.

## ECONOMIC FORECAST

(As of October 1, 2004)

	<u>2002</u>	<u>2003</u>	Estimated <u>2004</u>	Projected <u>2005</u>
Real GDP (year-over-year)	2.3%	4.4%	3.7%	3.3%
Real Consumption Expenditures	3.1%	3.3%	3.6%	3.2%
Business Fixed Investment	(8.9%)	3.3%	9.7%	7.4%
Inventory Investment (Billions)	\$11.8	(\$0.7)	\$46.6	\$32.3
Residential Construction (Billions)	\$470.1	\$511.2	\$557.0	\$561.0
Government Spending (Billions) (a)	\$1,858.0	\$1909.5	\$1,951.0	\$1,998.0
Trade Balance-Goods & Services	(\$421.7)	(\$496.5)	(\$608.0)	(\$605.0)
Federal Budget*: Unified (Billions)	(\$157.8)	(\$374.2)	(\$452.0)	(\$366.0)
GDP Deflator	1.7%	1.8%	2.2%	2.2%
Producer Price Index	(1.3%)	3.2%	3.3%	2.3%
Consumer Price Index	1.6%	2.3%	2.6%	2.3%
Industrial Production	(0.6%)	0.3%	4.5%	4.4%
Real Disposable Income	3.8%	1.8%	3.1%	3.3%
Hourly Compensation	3.3%	4.1%	4.0%	4.0%
Unit Labor Cost (Non-Farm)	(1.1%)	(0.4%)	0.1%	1.5%
Productivity Growth (% Change)	4.4%	4.4%	3.9%	2.3%
Personal Savings Rate (% DPI)	2.3%	1.3%	1.2%	1.0%
Capacity Utilization - Total	75.6%	74.8%	76.8%	78.5%
Trade Weighted \$ Exchange Rate	(0.4%)	(6.7%)	(4.3%)	0.0%
Vehicle Sales (Million Units)	16.7	16.6	16.8	17.0
Housing Starts (Million Units)	1.711	1.850	1.920	1.780
Civilian Employment (Millions)	136.485	137.9	139.8	141.5
Civilian Unemployment Rate	5.8%	6.0%	5.4%	5.1%
Corporate Profits - AT-NIPA	11.0%	16.3%	10.8%	7.5%
S&P-500 Earnings-Reported	\$27.59	\$48.74	\$59.9	\$67.00
S&P-500 Earnings-Operating	\$48.09	\$55.54	\$66.50	\$72.00
S&P-500 Dividends	\$15.67	\$17.60	\$19.10	\$20.75
90 Day U.S. Treasuries-Yield (%)	1.40-2.35	1.40-0.75	0.87-2.10	2.10-3.25
10-Year U.S. Treasuries-Yield (%)	3.59-5.20	3.17-4.55	3.68-4.87	4.25-5.25

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