



SILVERCREST
ASSET MANAGEMENT GROUP

ASSESSING KATRINA'S CURSE

Views on the U.S. economy and stock market have apparently diverged for nearly two years. While gains in business activity have largely exceeded forecasts for most of that period, with corporate profits up about 35 percent over the past two years, investors have elected to keep the stock market at bay with a far more modest advance of about 8 percent since the opening bell in 2004. Part of this disparity, of course, can be explained by the ageing of the business cycle, specifically the probable deceleration in the rate of growth in profits, but it does not provide an adequate justification for the wide difference, particularly since valuations in the market currently appear defensible.

There is no doubt that blemishes are evident in the economic landscape, most notably the potential impact of the steep rise in the price of energy not only on operating costs but also on personal consumption expenditures. In addition, there is early evidence of a topping out in the housing market, although we see no major disaster there as long as interest rates remain within a reasonable range. Finally, incentives and discounts offered on large ticket items, such as autos and appliances, are likely to lose their stimulus, or may be terminated for tactical reasons, setting the stage for lower sales. While collectively these potential impediments could cause growth to moderate, perhaps by mid-2006, they are not of a magnitude that would spark a recession due to a list of offsetting strengths. The latter include robust spending for plant and equipment and efforts by state and local governments to use their mounting budgetary surpluses for urgently needed public projects.

The economic consequences of hurricane Katrina can no longer be deemed negligible. The destruction left in its wake will certainly have a substantial impact not only on the cost of energy, and hence on inflation and profits, but also on government spending, both federal and local. While it is too early to quantify accurately the damage to the economy, we estimate that GDP growth will be reduced by 0.4%-0.5% (annualized) during the second half of this year with an increase of 0.3% in inflation (CPI). On the profit front, the combination of higher costs and lost business may well wipe out one-half or more of the previously anticipated gains in the September and December quarters. The insurance industry alone estimates claims at \$26 billion, but others assess the damage as close to \$50 billion. Fortunately, these downward adjustments merely take us back to our base forecast issued on July 1, 2005 which we were about to revise to the upside. Whether Katrina's curse will persuade monetary authorities to alter their policy in coming months is an open question. However, at a minimum it should raise the possibility that Mr. Greenspan may defer further restraint until the damage can be more accurately assessed. In the past, any indication of a less

determined monetary tightening has been a signal for the market to move up, particularly when the economy remained on a steady course.

In the meantime, the mystery on the monetary front remains unsolved. Despite the persistence of the Fed in its efforts to raise short-term rates to a more “normal” level, mainly as a hedge against budding inflationary pressures, the long end of the yield curve refuses to respond according to textbook expectations. Several factors explain this curious turn of events. First, there is a justifiable assumption that inflation can remain muted due to respectable gains in productivity, the impact of technology, global competition, adequate industrial capacity and the weakened position of organized labor. Second, corporate cash flow has been quite abundant which reduces the need to borrow. Third, global savings are at record levels, a sizeable portion of which has been flowing into the United States. Finally, repatriation of some tax-advantaged foreign earnings of American multinationals has added to liquidity, at least for this year. Without a reversal in these favorable conditions, interest rates were likely to remain manageable even without Katrina’s intrusion.

The combination of moderate interest rates, continued gains in business profits, further growth in employment, an accelerating wave of mergers and acquisitions, persistent share repurchases, a greater willingness to raise dividends and an improving fiscal profile on the budgetary front are all major sources of support for the U.S. stock market. But the most important anchor is that of valuations, which at current levels appear to exaggerate risk and underestimate reward. In summary, at a minimum we expect stocks to track gains in profits in coming months.

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