SILVERCREST
ASSET MANAGEMENT GROUP

MARKET COMMENTARY CALL TRANSCRIPT
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Corporate Speakers:

- Robert Teeter; Silvercrest Asset Management Group Inc., Managing Director and Chairman of Investment Policy and Strategy Group
- Patrick Chovanec, Silvercrest Asset Management Group Inc., Managing Director and Chief Strategist

Operator: Welcome to the Silvercrest Asset Management Group Market Commentary Call.

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I would now like to introduce your host for today's call, Patrick Chovanec, Managing Director and Chief Strategist; and Robert Teeter, Managing Director and Chairman of Investment Policy and Strategy Group. Gentlemen, please begin.

Robert Teeter: One of the things that we've noticed as we look back and I'm sure you all know this as well, it was quite a rocky road for markets in the fourth quarter, actually nearly touching a 20% decline.

When we think back to that period of time, there were no shortage of issues that were on the forefront of discussion as to what was the purported cause for the decline in stocks. One of these seemed to be that the recession was entering the dialog or concerns of a recession. And while the case for a recession seemed to be at least a bit weak as reported in the popular press, it sets the backdrop for Patrick's quarterly letter where he spent a lot of time conducting a deep dive into a variety of different recession indicators and spending a lot of time assessing whether or not this actually works and what they are telling us today.

Now, markets have since recovered about half or more of that decline, but this topic is still a very worthwhile one. We are certainly in the later years of the economic recovery, and while many pieces of research point to the fact that when you go through a significant contraction or recession as we did in the financial crisis, but the recovery tends to be longer lived, there's certainly no reason why we shouldn't be paying close attention to the economy and to any signs of recession and whether or not they are perking up.

The other reason this topic is really timely and very interesting is that a key component of our base case all along has been that absent recession or inflation, stocks ought to track earnings and dividends higher. And that tends to be the case historically, it tended to be the case recently, and so we've got our eyes pretty closely tuned to whether or not there are any developments that would increase the probability for us of a recession.

So, with that, we'll turn into some of the topics that Patrick addressed in his quarterly with regard to a number of different indicators. And his work was along the lines of seeing whether these indicators were, in fact, indicative of pending or upcoming recession, but also to assess where these indicators are today to give us some sense of where we are in the cycle.

But before we dive into the meatier topic, I thought I'd first just ask Patrick a quick question. In the technology industry, there's a concept of an Easter egg or sort of a hidden message and it seems to me that there is a bit of a hidden message in your letter that I thought you might want to share with those who dialed in today.

Patrick Chovanec: Oh, no, I just—the first line, a specter is haunting markets, the specter of recession, if that sounds familiar to people at all from their college days, that's actually the opening line of the Communist Manifesto, which is, "A specter is haunting Europe—the specter of communism." So, yes, it is a little bit of an Easter egg for those paying attention.

But it's also seemed accurate in terms of what was happening in December that there was this shadow that was hanging over market that we wanted to kind of get to the bottom of what was really casting that shadowing.

They say that markets—bull markets climbed a wall of worry, and that's true, there have been worries all along throughout this recovery, but we also don't want to dismiss worries that when they have real merit, and there has been no lack of headlines recently of things to worry about, whether it'd be Brexit or a government shutdown lasting however long it might last or trade negotiations in the prospect of a trade war with China or slowing China or slowing Europe.

So, so many of these things have been in the headlines and sort of contributed to this narrative that was taking place at the end the year. I heard so many people—and I'm not just talking about talking heads but people who I listen to, who I respect, who I think are thoughtful people saying: I kind of feel like it's the end of the cycle.

And as much as I respect intuition and intuition can be useful sometimes, I thought that what we really need to do given all those kinds of gut feels was go and say: Okay, so objectively, what

are the signs that usually signal upcoming recession in the end of the cycle, and how many of them are we seeing?

And I entered on the project really without a preconception of saying: It's nothing to worry about, or Yes, we will see that all these things are happening. But the result was, when I looked at them, that except for a handful that might look like they were things to watch, most of them were saying no, most of them were saying that the things that we normally see going into recession are not happening.

Robert Teeter: Great. Well, that's a fantastic backdrop to just dive right in, I think. And as I looked through a number of the indicators in your quarterly letter and I mentioned this to you earlier, it seemed to me that there were four or five that I think are very popularly talked about and perhaps some misconceptions about how they're interpreted and how they're used.

So, why don't we start with the first one that you listed first, the yield curve, which is certainly talked about a lot and I think you came across some interesting findings both in terms of its efficacy but also in terms of things that happened between the period of time when the yield curve inversed and when a recession might be starting.

Patrick Chovanec: So, if you hadn't heard about the yield curve before December, you probably did, because there was all the talk about the prospects of the yield curve inverting or a partial inversion in the yield curve and that is a very reliable recession indicator.

It is true that an inverted yield curve is when short-term rates rise higher than long-term rates, longer term rates fall lower than short-term rates and you get a negative slope to the yield curve. That is actually a very reliable predictor of a recession coming at some point. And the reason why it's—logically, you think it through is basically what the bond market is saying is that they expect the Fed to go into rate cutting mode at some point, which would be a reflection of a recession taking place.

But the important thing is this; that first of all, we don't have a fully inverted yield curve yet, that's the first thing to recognize, and for all the talk about it, it didn't happen. And I'll talk about a little bit about what the partially inverted yield curve might mean. But we did not see a fully inverted yield curve as would typically indicate upcoming recession. But even then, there is often a long lead time, as long as two years until between the time when the yield curve inverts and then the recession takes place.

And so, it's not an indicator of, okay, everybody out of the pool because the cycle is over. It is—it's significant, but even if it were to happen tomorrow, that would mean, on average, that we'd be looking at a recession sometime in the latter half of 2020. It could happen sooner, but that on average, would be the case.

And then what happens in the meantime is interesting because you would presume that, okay, everybody sees that, well, there's a clear indicator of a recession coming, so markets are going to anticipate that and you're going to have a bear market before that.

Not at all the case that in many instances, not all, but in many instances, you actually see double-digit gains after the yield curve inverts up to the point before the recession hits or the market peaks before the recession.

So, it is not—it's not something where you can just look at the yield curve and say: Okay, our market outlook can be based on what the yield curve is telling us, because it's a very early indicator and a lot can happen between the point where the yield curve inverts and you might miss a significant chunk of the bull market if you just take that as an indicator to, okay, it's time to get out, right?

Robert Teeter: And maybe just loopback to the second, you touched on it briefly, but just to walk through the—their partial—

Patrick Chovanec: Yes, so, what happened was the one-year yield climbed up higher than the two- and three-year and I think, at one point, maybe to five-year yield. The 10-year never went below. So, there was always overall a positive slope to the yield curve. But there was kind of this kink to the curve.

But there was kind of this kink to the curve where it went up and then it went down and it went—and what that indicated to me—I get a lot of thought, like: Okay, what is this implying? What it seems to be implying was that the Fed—the market believed that the Fed was going to make a mistake, that the Fed was going to raise rates one to many times this year—this year and that that would—then they would turn around and have to undo that very soon afterwards, which suggests that the Fed is going to make a mistake and it's going to kick us into a recession.

But then the Fed came out in December and a number of different people from the Fed basically said: We're patient. We're under no pressure from inflation to rush ahead and raise rates and we may well just—we're going to be data-driven. We're not on any kind of a schedule for raising rates.

And what we've seen since then is that the yield curve hasn't completely unkinked, but a lot of that has been removed. And so, the bet that the market was making that the Fed is going to make a mistake, policy mistaking drives the economy into recession, that has eased off a lot given what the Fed has said.

Robert Teeter: Great. Well, why don't we shift maybe from interest rates in the Fed to the consumer, which as you highlight and it's an important factor for people to keep in mind that household spending accounts for 69% of the U.S. economy. The consumer confidence would seemingly play a really important role in the economy in any indications of pending recessions though. If you could walk through what you found there, that would be helpful.

Patrick Chovanec: So, what I found was that it was actually a very good indicator, that I always knew it was kind of listed as a leading indicator, but in the deep dive, it was one of the most reliable, which is one of the reasons why I had it upfront, that you do see significant declines in

consumer confidence in the immediate, which is a six-month period before a recession, which is in contrast to where consumer confidence has been, which is it's been very strong and near the top of its game for the cycle through December.

Now, we had a reading in January from University of Michigan that was a significant drop and put us back to I think—I can't remember—I mean it was—it was—it was like an eight- or nine-point drop and it was—and it was—it put us back to at least the lowest in a year or two.

A lot of that has to be due to the government shutdown. And how short-live that will be, whether that's a hiccup or whether that's a new trend, that's pretty important because if the government shutdown continues indefinitely and that continues to gnaw at consumer confidence then you could see—that's normally I advise as—when this shutdown began, I said, normally shutdowns don't have a big economic impact or if they do have an economic impact, it tends to be transient and you get a slowdown in consumption and you get a bump in consumption when everybody gets paid what they were owed.

But the longer it goes on, the more serious of a shock to consumer confidence that it implies. And so, we see today even indications that maybe they might be heading towards a deal, they could solve it maybe, I don't know what that would look like. Nobody really—nobody in Washington knows what that will look like. But I think that there's a growing realization that—where—this is like—we're into the 30s, 32 days, 33 days, whatever.

Robert Teeter: Yes.

Patrick Chovanec: And that the economic consequences are becoming more serious and more real and therefore there's more pressure to put an end to it. And so, we'll be looking very closely at whether consumer confidence then recovers.

Robert Teeter: Yes, I think that it's worthwhile to keep a close eye on both as you know it for whether and how the shutdown is resolved.

Patrick Chovanec: Because it has been extremely strong.

Robert Teeter: Yes.

Patrick Chovanec: And showing none of the typical signs that you would see before a recession of a falloff.

Robert Teeter: And you'll probably also get some movement in it based on the fact that stocks have been down and quite a bit more recovered somewhat, so keep a close eye on that one. I don't want to jump around too much, and I want to be aware of time and Q&A and things.

But another indicator that you looked at that I think would be great to dive into a little bit is the inventory to sales ratio. Historically, the boom/bust cycle has been one that's been a cause

of a recession and so I think it's noteworthy that you took a look at that and be worthwhile to talk to your findings.

Patrick Chovanec: It's not something that always precedes a recession, but it can cause a recession in the sense that you had too much inventory buildup and then there's a pullback. That was something that I was quite concerned about two years ago and it's—actually, it's a good opportunity to talk about.

Two years ago, I wrote a quarterly note at the beginning of the year that talked about the prospect of a recession in 2016. And rather than say, well, I guess you're wrong, it's interesting in retrospect how rightly we're to be concerned about certain things that we were seeing, that there were many more of these nine-recession indicators for flashing at least yellow—

Robert Teeter: Right.

Patrick Chovanec: —at that time than are right now. And inventory to sales was one of them, that there was a big inventory to sales buildup, and it reached kind of concerning levels. It's fallen back since then.

It has kicked up a bit in recent months, but not anywhere close to where it was. So, it's something we continue to watch and a little bit elevated compared to historical trends, but it's something which is actually gotten better rather than getting worse over the past two years.

Robert Teeter: Right, interesting. I know that in prior monthly letters and quarterlies, and also again here in the recession indicators with both ISM surveys, and I think there's some interesting things to probe there both in terms of the number and its relevance for a recession, but also just some regard to some of the comments that have been coming through in the comments section that you've been passing along.

Patrick Chovanec: So, the ISM surveys are soft data in a sense that they reflect just a survey of what people are thinking, in this case, purchasing managers. And there are two different surveys, manufacturing and non-manufacturing and they have some subcomponents, which give an indication, particularly, new order gives sort of a leading indication of where things might be heading.

Two years ago, the ISM Manufacturing number went into contraction for several months and there was talk around that time that this is a—is this an indication of a recession. And it was actually an indication of a manufacturing recession, perhaps, and earnings recession because we did see earnings go down in 2016, but not an overall economic recession.

Economic recessions tend to be—so manufacturing is only a relatively small part of the economy although a significant one. And a much broader indicator—much broader survey is the ISM Non-Manufacturing, which covers a much larger portion of the economy but has a much shorter history, so it's harder to make sort of broad historical lessons from what's happened.

But what has happened in the last two recessions has been that both of them have gone down. There are a lot of times when the manufacturing index goes below 50, which is contraction without actually causing a recession. But when they both go into contraction, both looked like they're trending towards contraction, that's when you probably need to be alarmed. Now, what it looked like, they both did really strong until December.

Nowhere close to what would be a recession indicator, quite the contrary, up around 60, which is really strong expansion territory. Manufacturing came in surprisingly low in December and also new orders really showed a significant pullback, which got a lot of people's attention and should, but it still is above the sort of typical danger zone that would signify a recession.

But it's something to watch. If that continues to weaken, if we see more indications—and there's also in these surveys qualitative responses that are given. And for a while now, they said: Really strong economic growth, really strong demand, but we're worried about tariffs. That's what they said for like the last half year.

In December, they started to say: We're starting to see a slowdown in demand. That continues that something which we need to keep an eye on. But so far, we're not anywhere close in the overall readings to what would signal a coming recession.

We also saw a bit of a weakening in non-manufacturing as well, but interestingly, no weakening in new orders, which remained very strong. So, new orders tell you a little bit about what to expect from those numbers a couple months out. And again, unless we see continued weakening in those numbers, I'm not too worried, but it is something to keep an eye on because they have been really strong, and they showed up much weaker in December.

Robert Teeter: Right, okay. Any other items of big indicators either that you talked about or things that perhaps you looked at and decided not to comment on because they were not as relevant as you might have deemed or any other findings from your research that would be worthwhile to know?

Patrick Chovanec: Well, one thing that a lot of people talk about is commodity prices. And there's the old expression, Dr. Copper tells you what diagnoses the economy. And what I found was that, that really may have been true in the early 20th century or the 19th century, but it doesn't really—now that the United States has become largely a service economy, it tells you something but it probably tells you more about China than it tells you about the United States.

And, of course, China is a valid concern, the second largest economy in the world, but I have a little bit different take than most people about what a slowing China means for the U.S. economy. I don't think that there is a direct translation between slowing Chinese economy and slowing U.S. economy because a lot of what has driven Chinese economic growth has been expansion in capacity investment, and I would argue overinvestment, which has really flooded the world with competitive goods and been a deflationary force for outputs and inflationary for input like oil or like copper, but deflationary for a lot of our own industries, right? It makes it hard for us to have pricing power globally.

And the result of the slowdown or an end of China's overinvestment boom is actually to relieve a lot of pressure on a lot of U.S. industries. So, just like—and people—and I think it's hard for people to kind of wrap their minds around the idea of, well, if the second and largest economy in the world slows, isn't it bad for the rest of the world economy? Well, it depends on whether that growth was—what kind of growth that growth was feeding in the rest of the world?

Robert Teeter: Right.

Patrick Chovanec: If it was just simply feeding commodities which we're flowing into overinvestment and then creating overcapacity in the global economy, that wasn't good for the rest of the world. It was actually negative for the rest of the world. And it wasn't really driving demand, the kind of demand that we need to see sustainable end-user demand.

In the 1990s, Japan, which was another surplus country, another country which was creating a lot of capacity, exporting a lot of capacity, they went from being one of the fastest growing economies in the world and one of the slowest growing economies in the world. It did not derail the rest of the global economy because they were not driving the rest of the world's economic growth.

Robert Teeter: Right.

Patrick Chovanec: So, I think the same is true of China, and in many ways, we should welcome a slowdown in China in terms of its output. One of the things that's true about China is that China has produced more than it's consumed for many years. It can afford to consume more than it produces.

So, as output growth slows in China, they're going to see the need to prop up standards of living in their country, and that is actually going to translate into net demand globally. So, I'm not—I'm not trying to paint a too rosy of a picture of what a slowdown in China means, but it's an economic adjustment that needs to take place and will actually be healthy for the rest of the global economy.

So, when people point to things like oil or they point to copper as an indicator of future economic growth, you've got to ask, what kind of economic growth and where is it actually giving an indication of.

Robert Teeter: Right. Great. Well, one of the things that I think is fantastic about that point and indeed the entire letter is that it really highlights two concepts. One is that nothing is as easier and simple as it seems in this job that we and others have as investors.

And the second is that both data and sentiment are important, but it's important to separate the two and recognize what you're looking at. And I think when you went through the exercise of looking at these indicators and really trying to take a very clear-eyed look at what they meant

and what they didn't mean, I think that was a really helpful guidepost that we all take into consideration when we're setting our asset allocation and other things like that.

So, with that and mindful of the time and knowing that we'd like to keep a fairly crisp call here on the quarterlies, we'd like to turn it back to the moderator for any questions that might be on the line.

QUESTIONS AND ANSWERS

Operator: Perfect. Our first question comes from Caller 1. Your line is now open.

Patrick Chovanec: Hello.

Caller 1: Hi, sorry. Patrick?

Patrick Chovanec: Hi.

Caller 1: What is the—what is the downside on this Brexit fiasco? What should—what should—indicator should we look for in all of this?

Patrick Chovanec: Well, Europe is already slowing, so that's—I mean that is an area of real concern. It's quite possible. Germany had negative GDP growth in the third quarter. Given some very disappointing industrial output numbers from Germany in December, it's quite possible that we'll have a fourth—negative fourth quarter in Germany, which would mean Germany is in recession.

So, the weakness in Europe is something to take seriously. Brexit has the potential to aggravate that. I don't think—that without looking at other indicators, I wouldn't necessarily say: Okay, well, that translates into a recession for the United States.

I think one thing that maybe we didn't really fully articulate in previous conversations is that the U.S. economy is slowing, and I think that's part of what the growth is slowing, the rate of growth is slowing, whether it's for GDP growth that's anticipated for 2019 or whether it's the earnings growth.

We had phenomenal earnings growth last year on the back of the corporate tax cut and on the back of a lot of corporate buybacks. So, earnings per share was up quite a bit. We're not going to see a repetition of that. But that doesn't then translate into a recession or negative growth, whether it's in GDP growth or whether it's in—whether it's in earnings.

And so, I would say that Brexit, I don't have any more—I don't think anybody—again, just like this government shutdown, I don't think anybody in London or Brussels has a clue what's going to happen. If I had a bet, if I had—if I had—forced to bet, I would say, they're going to delay it and they're going to kick it down the road about six months and they're going to say: We hold out hope of an agreement and that it's not a hard Brexit, but we're still sticking to Brexit. Maybe we'll have another referendum [made], who knows? And who knows what the result of that would be?

But it's going to get kicked on the road. I would be very surprised if we get to March 29th and we're just facing a hard Brexit and that's what happens. And maybe some the weakness that we see in Europe also lends itself to a willingness to do that as well.

Operator: Thank you. And the next question comes from Caller 2, private investor. Your line is now open.

Caller 2: Hi. I was wondering if you could comment on your view on equity valuations, kind of both domestic and overseas. And if you feel comfortable doing so, comment on how you incorporate kind of cyclically adjusted Shiller PE valuation numbers into your calculus.

Robert Teeter: Yes, sure. Hi, Caller 2, it's Rob. I'll address that and let Patrick fill in some—

Patrick Chovanec: Okay.

Robert Teeter: —gaps if he see fit as well. With regard to U.S. equity valuation, I think we and others for some time have been aware that valuations were in the upper deciles and quartiles and whatever ranking mechanisms you'd like to use versus history. Although I think we had a slightly different view, in that if you take a longer-term historical perspective, you realize that a lot of those valuations that go into the averages were in an environment of much higher inflation and much higher interest rate.

And so, you rewind the clock maybe six months or so, I think we perhaps—valuations were perhaps a bit elevated but supported by those factors. If you jump forward to today, what we've seen is valuations have come down quite a bit. And while earnings growth next year may not be quite as robust and certainly won't be quite as robust as it has been in the past year, earnings have grown quite soundly, and with stocks being off their highs a bit, valuations have come in considerably. And so, I think that's the stage for a fairly constructive outlook going forward.

At sort of the near the bottom for stocks, when they were at their lows a few weeks back, there were some maps put out there which I happen to generally agree with by JPMorgan, which talks about the change in valuations, set the stage for an extra 3% or so for a year of returns on top of whatever your expectations were otherwise, and I think that's fairly reasonable.

I'll touch on the Shiller point for a sec. One thing that's interesting about those numbers, and I think it will be important for us and others to pay attention going forward in the next couple of quarters is that I believe those are based on a 10-year look-back and we tried to model forward

what happens as you roll off some of the recession numbers. And I think—I think those metrics improved a little bit as well.

And so, anyway, boiling that all down I would say that we come to sort of the same point we were before, which is that you could say that the valuations are a bit higher than long-term averages. At one point, during the decline here a few weeks ago, they actually dropped below historical averages. So, I think they're not as much of a concern as they were a month or two ago. But even then, again, supported by decent earnings outlook, stable economy and not a real risk of inflation at that point in time.

The last part of your question, and I'll let Patrick add anything that I may have missed was on U.S. versus international. And there too, I think a lot of folks have been pounding the table that international is quite a bit cheaper. I think as Patrick noted there in his comments, maybe for—potentially for good reason in some segments of Europe with the softening economy and other issues.

But when you look at those numbers, again, you again have to look at them as historical context. And I think if you—if you go back across a pretty broad swath of time, the valuations outside the U.S. typically do average between 65% and 75% of U.S. valuations, which is around where they are now. So, there is a dispersion there.

But one that tends to be in place and sometimes for good reasons, I think there are some complexities involved in investing abroad. There are situations in terms of whether or not shareholders are treated well in macro perspective and things like that.

So, no doubt, there is a valuation gap. Maybe selectively, there is some opportunity. We certainly invest globally. We invest with managers. They were putting some money to work overseas and why we think great companies are good valuations. So, I do think there's some opportunity there, but not just based on a simple valuation argument.

Patrick Chovanec: Yes. I'll add to that and say that I think it's—I think it's a common mistake that people make to compare a P/E ratio in one market with the P/E ratio in another and say: Well, okay, one is cheaper than the other, because there are lots of differences that need to be taken into account, some of them having to do with accounting in some cases, some of them having to do with risk premium that may or may not really be appropriate that Rob mentioned, also, just a mix of industries.

If you—if you look at—certain industries will have a high P/E ratio and others will have a low. And if you have an economy with a very different mix of industries, you should have a different P/E ratio.

Caller 2: Right.

Patrick Chovanec: So, it's actually useful—more useful to compare each market with this historic—own historical benchmarks and then say: Okay, what do we think?

Caller 2: Right.

Patrick Chovanec: What do we think about what's happening in an economy and what—does this valuation make sense as opposed to simply saying: Oh, one is a 20 and another is a 17, and obviously, buy the 17 because that's cheaper?

Speaking of risk premium, I'll also add something that is in my quarterly, so I won't—I won't try to summarize it in full, but basically, when we look at valuations, it's also relative to what, what's your—what's your alternative. And the fact that you have very, very low interest rates around the world, it has to be weighed against what the value—what equity valuation should be. And it's something that may look expensive in one situation, it doesn't quite look as expensive in another.

So, one thing that we've been talking about over the course of those past couple of years has been the equity risk premium, and I mentioned it in this note. And given the downturn in the market over the past couple of months, the equity risk premium has popped back up to 6% at the end of December. That is well above its historical average of 4.2%.

And what that implies is that a lot of risk adversity is being priced into this market. And if you go back historically, as I did, and say: Okay, whether equity risk was about 5%, what were the—what were typically the five-year annual returns over the next five years versus when the equity risk premium was at or below 4-point—I think it was—I think it's at 3.4%? And the differences between 11% when you had a high equity risk premium versus 3% when you had a low equity risk premium.

So, the equity risk premium won't tell you whether the market will be down or up next year, okay? But it—but it might tell you or it certainly has told you over the past years or so that when you have a high equity risk premium, when you have a lot of fear being priced into the market, at some point over the next five years, usually, that fear—if something happens, maybe it's the end of the cycle and the beginning of a new cycle, that fear gets priced out and you could actually end up with above-average returns no matter where you started.

So, whether or not there's going to be a recession next year or not, so much fear of a recession is being priced into the market relative to interest rates, that equities are still relatively attractively priced for a long-term investor as long as that long-term investor can afford—with the fear that's being priced in, which is fear of volatility, fear of going through the end of the cycle. But if you can afford that—you don't have to worry about where your—what your portfolio looks like at the end of the year, you only worry about what it looks like five years from now, to the extent that that's true, the equity risk premium suggests that equities are attractively priced.

Robert Teeter: No, you're quite welcome, happy to—happy to chat with you further too as well. Thanks for calling in.

Operator: Thank you. And I'm not showing any further questions in the queue.

Robert Teeter: Great. Well, thank you, everyone, for dialing in this afternoon and we look forward to hosting you again next quarter.

Operator: Ladies and gentlemen, thank you for participating in today's conference. This does conclude today's program and you may all disconnect. Everyone, have a great day.