SILVERCREST
ASSET MANAGEMENT GROUP

MARKET COMMENTARY CALL TRANSCRIPT
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Corporate Speakers:

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- 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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It is now my pleasure to hand the call to Mr. Robert Teeter and Mr. Patrick Chovanec. You may begin.

Robert Teeter: Thank you and thank you to everyone who dialed in this afternoon. Today we're going to be discussing the backdrop of some of the positive fundamental economic and corporate news that we've been seeing against some of the potential concerns that may be brewing. Both of things are things that Patrick discussed somewhat in his quarterly and we'll take a little bit deeper dive today as well as a Q&A at the end of the call—intend the call to be about 30 minutes.

So first of all, let's start off with just a very brief backdrop of a number of positive factors that have been unfolding throughout the course of the year. We have just seen a very strong and positive GDP report. Earnings have been quite strong. I think by most measures, in fact, a little bit stronger than they were even at the beginning of the year. Business confidence seems to be high.

The employment market seems to be quite strong and so the first question I wanted to pose to you, Patrick, is with regard to outlook for the economy and for economic momentum. I was wondering whether some of the recent strengths is merely a sugar rush from some of the stimulus that's been poured into the economy or whether it really provided a catalyst and might provide some true and lasting change.

I guess the first question is what's your outlook in terms of growth and will some of this growth persist?

Patrick Chovanec: We're entering the ninth year of a recovery. It's a mature phase of the business cycle. It's a mature phase of the market cycle and there's been a combination of very strong short-term data including forward-looking data, looking out in the next couple of months, things like new orders that should indicate continued momentum going forward combined with some things that we take very seriously.

The prospect of inflation, the prospect of trade wars, some slowdown in some economies overseas—and so the trick this year has been to not lose sight of either of those two things. Keep our eyes in both directions to not get wrapped up in the things that could go wrong and forget about the things that are going right, but then not get so enthusiastic about the things that are going right to forget about the things that can also go wrong, especially like I say, at a very mature phase of the business cycle.

You asked an interesting question about how much of the growth that we're seeing right now is a sugar rush from stimulus and what I would say is engaging the effective stimulus, in this case tax cuts on the U.S. economies, it's a lot easier when you have a spending stimulus to directly say, okay, this is how much that additional spending is adding to economic growth.

And then we can sort of debate about what the second order effects are, but at least you have a very clear indication right there in the GDP report on how much more money the government's spending. When you have a tax cut, what you're doing is you're leaving money in the hands of individuals, households—you're leaving money in the hands of corporations and then the question is what are they going to do with it?

Are they going to spend it? Are they going to save it? Are they going to invest it in building new factories? Are they going to buy back shares? Are they going to—even if you're a consumer, are you going to buy domestic products, which are going to add to the GDP, or are you going to buy more imports? And so, the point here is that when you have a tax cut stimulus, it really—it's not a separate question, is it organic growth versus is it stimulus?

It's how does the stimulus play into the things that are organically happening in the economy? And so, right now we have a very positive consumer, very confident consumer. They're willing to spend money. We have a rebound over the past year or so in business investment, so we're probably getting a bit of a bump from the availability of more funds.

But its really playing into underlying strengths that already existed. Now the question going forward, which I began with, is how fragile are these underlying strengths? How sustainable are they? And I think that we've got reason to think that they're sustainable for the immediate future, the next several months, the next quarter, maybe quarter after that.

But we really keep our eye on a number of things that could start to indicate that the business to market cycle is entering a new phase and facing new challenges.

Robert Teeter: Great. So maybe just a quick follow up on that, on an issue that I think you've talked about a number of times before with regard to the ebb and flow of different contributors to economic growth and how it's been sort of an asynchronous recovery in a lot of ways. Is that a trend that you expect to continue here?

Patrick Chovanec: I haven't seen that change. Let me give an example.

In the first quarter of the year, consumer spending slowed to its lowest growth rate in, I believe, four or five years. And of course, you look at that and you say, "Okay, is this a trend? Did they overspend at some point and now they feel the need to save because they're worried about X, Y, or Z? Or is this a blip?"

It turned out, it seemed to be a blip. And the overall consumer confidence rebounded. The overall consumer confidence remained high, but the actual behavior of consumers rebounded—we had very, very strong retail sales growth that was reflected in a solid 4% consumption growth in the second quarter.

You still see a lot of variation from quarter to quarter, and sometimes the economy hits on all cylinders and you get a high growth rate. Sometimes the economy doesn't; misses on a couple cylinders and you get a lower growth rate. Which, by the way, this is why we shouldn't read too much in to one quarter's growth, whether it could be good or bad.

Because this has been a very volatile recovery in terms of GDP growth, and especially with the politics surrounding it, there's a tendency to seize on either a good or a bad quarter and say, "Oh, this is indicative of the overall trend." There were several points before President Trump took office, under President Obama, where for a quarter, the economy exceeded 3%, 4%, even at [1.5, 0.1] growth it hit, but it wasn't followed up.

And because that didn't reflect an underlying and sustainable trend, we haven't yet seen 3% growth for an annual number in this entire recovery. And so, it's important to remember when we see a good quarter, and we see a bad quarter, there are a lot of things that are in flux that we don't want to read too much into that number as being the new trend.

Robert Teeter: We'll maybe transition to some of the things that we want to be mindful of or aware of here. I think three of the most common myths that we hear are one, being valuation, the second being interest rates and inflation, and the third being trade.

I think we'll focus primarily on the second two, partly because I think some the valuation issue is related to where interest rates are, and second because I think some of it has been starting to resolve itself in that valuations are lower now than they were at the beginning of the year as earnings growth is far exceeding stock performance this year. So—

Patrick Chovanec: Yes, let me just emphasize that because it is an important point for investors, that especially for large caps, we've seen a fairly sluggish share market this year. It's picked up in the past month, but at the same time we've seen really strong earnings growth and when you get that combination, valuations go down. And they're down to—for the S&P 500, 12-month trailing P/E ratio is down to 19 now, and it was up at 19x operating earnings and it was up to 23 at the beginning of the year.

To come down four multiples, unless you think that that means that, "Okay, market cycle's over," that is actually a point in which you want to begin looking for opportunities.

Robert Teeter: Right, yes. I agree, and I think the other reason that makes sense to focus on the rates and inflation part of the equation is part of the support for valuation all along has been low rates and inflation.

Patrick Chovanec: Right.

Robert Teeter: That's one of the reasons why I think we and others keep looking to see if inflation is rearing its ugly head or not, and I know it's a topic that you spoke about in your quarterly and so we'd love to get your latest thoughts on inflation and outlook for it.

Patrick Chovanec: The challenge with inflation going forward is that there are multiple layers to this onion that we need to peel. And the first layer is that there are long-term structural trends in the global economy that tend to be deflationary.

Demographics, delayed family formation among young people, a lot of older people retiring or populations aging—not just in the United States but in Europe, Japan. And technology, including automation of a lot of workplaces, puts downward pressure on particularly unskilled labor. And you also have a lot of over-capacity in China—particularly in China—which tends to bid up of inputs and push down the price of outputs.

And we haven't seen the kind of rebalancing in China that would resolve that. There are some long-term trends that tend to put global pressure on prices that's downward globally. You also though, despite that, had some cyclical issues. We're entering a point where—in the cycle where, particularly the U.S. economy but even globally, you're starting to bump in to some resource constraints.

One of them that we've seen has been energy prices. One of the reasons why inflation has been steadily increasing, or headline inflation, is because of the recovery of the price of oil. And my view is that the reason why oil has been marching upwards, and I think looks set to continue to march upwards at a fairly steady pace—no big spikes—it's not because of a lot of headlines that we see.

The headlines that we see in OPEC's cutting, OPEC's turning on the taps, U.S. is slapping sanctions on Iran, chaos in Venezuela, these things move the oil market on a daily basis, but what's really moving it upwards over time is the fact that in 2014 when the price of oil collapsed and it went down from $110 down to about $30, a lot of high fixed cost investments in discovering and developing conventional reserves were cancelled because nobody knew what the oil price was going to be and if they did, a lot of those weren't going to be profitable at $30 oil.

Now, what's made up the difference as demand for oil has continued to grow is the shale oil surge in the United States. It's very responsive, it's very low scale, but also these wells tend to deplete rather quickly.

And so, it doesn't create that huge pool of reserves that these larger projects would. And these larger products have large lead time. So, the fact that maybe now it makes sense to restart them, okay, but that oil is not going to come online for another two or three years.

And so that's why you start to see that upward pressure. That's global, by the way. It's not something that is unique to the United States. In fact, in many ways the United States is probably in a better position than a lot of purely energy consuming economies, like Europe or India, that have benefited a lot from cheap oil prices but now face some higher prices.

The other thing is the ongoing question of when we're going to enter a tight labor market, a truly tight labor market. People talk about this difficulty in finding qualified workers. But wage growth has been pretty modest, below 3% year on year. It's barely outpacing and, in many ways, is not outpacing inflation at this point. So, at what point do we get actual wage pressure from what looks like a tight labor market if you look at 4% employment and it was down to 3.9%, which was like the lowest in 15 years, so why isn't the labor market tighter?

And the reason that most people give is because, well that unemployment rate doesn't tell you about a lot of hidden unemployment, that there are people who left the labor market, they weren't looking for jobs; that's why you've had a lower labor participation rate and one of the lowest.

It's been hard to get to the bottom of that because we also have a lower labor participation rate because more people are retiring, or larger cohorts of people are retiring, and also a lot of younger people are staying in college longer. So, the way to narrow that down is to look at prime working age population, age 25 to 54. And in that case, the employment to population ratio has been steadily increasing and it's only about 1% away from its peak in the last cycle, only about 2.5% away from its all time peak. And those were tight labor markets; particularly around 2000 was a very tight labor market. So, we're not there but we're probably getting there to full employment. And we may begin to see more inflationary pressure from that.

And then the last thing that I brought up was the last kind of layer of the onion—is can the Fed raise rates? If we have inflation that begins to pick up, the Fed has been using very unconventional means to raise rates up to this point. Because there's this huge pool of liquidity out there of access reserves, they can't drain that, and they can't restrict the amount of liquidity that banks have to lend and create a constraint.

They have to create an artificial constraint paying banks not to lend. They pay them on their reserves that they have with the central bank. They pay them more so that there's a higher hurdle for them to be willing to lend. Well that, when you're paying banks less than 2% to do that, there's no human outcry. Typically, the Fed funds rate goes up to 5% or 6% in a typical cycle.

When you start paying banks $100 billion a year not to lend, I'm not sure that that's going to be a mechanism that people find acceptable. And yet, it's the only mechanism that the Fed has to raise rates at this point.

Taking a step back, there are lots of deflationary trends that are taking place. There are some inflationary trends that are starting to pick up that are cyclical. And then there's this additional concern about, well, if they really pick up, could the Fed keep them under control? Looking at the last quarter because—okay, so we have our eyes on this, we know what the things to look for are—what do we see in the second quarter?

What we saw was consumer prices actually decelerated, so we didn't see inflation accelerating, at least consumer inflation accelerating in the second quarter. It decelerated from, I think it was 2.7% in the fourth quarter, 2.5% in the first quarter of the year, and down to 1.8%, I believe, in the second quarter. Well that's the opposite of what we're worried about happening.

On the other hand, though, the GDP deflator, which measures prices more broadly in the economy, not just for consumers but also for producers, accelerated. And that went up from 2% in the first quarter up to 3.2% in the second quarter.

And what that might suggest, if that trend continues, is a squeeze on profits. That there's cost pressure that we hear from companies, and they're complaining about, but they don't have the ability, because of these broader deflationary pressures in the global economy, to pass that on to consumers.

And that means that these record profits that we've seen as a percentage of GDP might get the squeeze, and that obviously has an implication for corporate earnings outlooks.

Robert Teeter: Great, well, that was a pretty in-depth overview. Thank you for that.

Patrick Chovanec: But the reason it's worth being in-depth about it is because it is one of the key things—

Robert Teeter: Yes.

Patrick Chovanec: —that could determine how sustainable the growth that we're seeing right now really is.

Robert Teeter: Right.

Well, let's transition to, I guess, the third potential concern and talk a little bit about trade. There's certainly a wide range of possibilities there.

Maybe give us your outlook for trade, overall, and then if there are specific areas you want to touch on, whether it's Europe or NAFTA or China, that would be interesting as well.

Patrick Chovanec: So, the tricky thing about discussing the outlook for trade is that it depends, in large part, on human decision making. And human decision making, it's human. And so, you could think what should happen, and yet, what does happen might be somewhat different.

Our approach all along has been to try to cross each bridge as we come to it. And instead of getting wrapped up in rhetoric, either positive or negative, there's a huge trade deal one day, then there's a catastrophic trade war around the corner the next—has been to look at what actually seems to be taking place, or could reasonably be expected to take place.

What is the actual process? When the president tweets that they're going to put 25% tariffs on all imports from China, that's a different thing than if the Commerce Department has specific schedule of tariffs lined up to go and there's a deadline by next week.

Robert Teeter: Right.

Patrick Chovanec: We've, I think, done well by trying to stay focused on what is actually likely about to happen. And what has happened so far has been that there have been some tariffs. They have been highly concentrated on certain parts of the economy—obviously on steel and aluminum, inbound.

And then outbound, there have been retaliation mainly aimed at agriculture and some very high-profile manufacturing companies, like Harley Davidson. Because right now, it's about political signaling. And it's about political punishment. And so that's what's taken place so far.

There is the potential for a lot more expansive tariffs, a lot more disruptive trade actions; it's important to take that seriously.

NAFTA is a good case of how you don't want to get too ahead of the story, because yes, the president said on numerous occasions, I'm about to quit NAFTA, I might do it tomorrow. And yet, for a year, I think really a year and a half, we've seen ongoing negotiations. They haven't gone anywhere, they haven't led to an agreement, and yet they haven't led to the breakdown of NAFTA either. And so, life goes on.

Something that isn't getting a lot of attention, that I am more concerned about, is what's happening at WTO—that there's a lot of skepticism in the administration about WTO and whether it serves U.S. interests. There is particularly concern that some of these tariffs on steel and aluminum, and also prospectively on automobile imports, have been justified based on national security grounds.

And I'm only aware of one country that has actually filed a challenge, South Korea, on the steel and aluminum tariffs. But a lot have talked about doing that—filing a challenge at WTO. And quite frankly, it's likely that WTO would rule in their favor.

As a result of this, the United States has been refusing to confirm new judges for the WTO dispute board. And by September, it will be down to the bare minimum of three judges. And then after that, at some point, they'll have two judges and they won't be able to make any decisions at all.

That, I think, already is one of the reasons why you don't hear countries talking about going to WTO; you hear them talking about retaliating. And I think that bodes poorly for both the immediate prospect of instead of taking it WTO and resolving these issues, actually having a trade war and tit-for-tat tariffs.

But, longer term, looking past the cycle, what brings the cycle to an end, but going forward 10 years, how are those rules that—imperfect as they might be—have opened up a lot of opportunities for companies, both at home and abroad; are they going to be in place, or are they going to be severely compromised.

And that's something that I'm watching, is what happens at WTO, what if this really goes off the rails? Because that would have some serious implications both for how these trade disputes get resolved now but also what the platform is for resolving trade issues for the foreseeable future.

Robert Teeter: Thank you.

I have a few other questions, but I think what we want to do here is turn it over to the moderator and open up the lines for questions, just being aware of everyone's time. With that, we'll turn it over to you, moderator, and see if there are any questions on the line.

QUESTIONS AND ANSWERS

Operator: (Operator Instructions) And at this current time, I'm showing no questions in queue.

Robert Teeter: That'll give me a chance to ask one quick last question of Patrick, and then we'll conclude the call for today. Just wondering if you had any thoughts you'd like to share on the election cycle and how that's shaping up for the fall?

Patrick Chovanec: Oh, you gave me a real easy one—

Robert Teeter: —just a quick 30 second answer**—**

Patrick Chovanec: Gosh, conventionally, you would expect that a president, normally, in the midterm elections loses seats. This year, the election map tends to favor republicans keeping control of the Senate; it's a lot more iffy when it comes to the House.

And it really depends on sentiment about a whole host of things, some of which are economic. They have 4.1% GDP growth in the second quarter. Whether that's really reflective of 4% sustainable growth or not's another story, but it's a great headline.

And there's an old expression going to back to Clinton, it's the economy, stupid, and most people aren't constantly checking to see what the president tweeted. They're just thinking, hey, I've got a job, and things seem to be going well, and inflation is low. But there are a host of other news items out there that could spoil that, that normal recipe for success.

I think that it's likely that, even if democrats win the house, what you'll see for the next two years is, then, posturing for 2020. You won't see legislation passed, or if it is passed, it'll be vetoed, or it won't make it through the Senate, right. So, I think the likelihood of more legislation over the next two years, is pretty low.

And whether that be immigration or whether that be infrastructure, there's always talk about, going to be an infrastructure plan—I haven't seen any indication that that's coming together.

And one thing that I went back and looked at was that the president's lot of stuff going on, obviously. And whether you compare it substantively to Watergate or not, the whole controversy takes on that dimension. And yet, I went back and I looked at when President Nixon was elected, in 1972 by a landslide, the quarter in which he was elected had 6.8% GDP growth. The quarter in which he resigned, two years later, had negative 3.6% GDP growth, I believe, and had 11% inflation. Inflation had really ticked up.

Now I don't mean to say that he would've not been removed from office if the economy hadn't stumbled, but you've got to imagine that with an economy that stumbles, that erodes a lot of support that a president might normally have when they encounter problems. And it's the lens through which people view the seriousness of whatever—they're generally happy, "well, it's kind of a circus, you don't have to pay attention to it." And generally, looking for somebody to blame for their problems is a whole different story.

And so, I would say that the economy, and I'm looking at polls that suggest that people might be unhappy with President Trump for a whole host of things, he still has a plurality of favorables when it comes to the economy. And so that is going to be something that's politically supportive of him.

And at the moment, it’s very unlike the situation that Nixon faced when the economy was going into recession, and people were, therefore, viewing the various scandals and controversies with a much more critical eye than they might now.

But from an investor's point of view, I think the main takeaway is, it’s fun to talk about politics, it’s fun to talk about what's going to happen, but at the end of day, from an investor's point of view, the issue is, how is this going to affect policy? And I would say there’s very little prospect for significant legislative change going forward in the next two years.

There is an issue about how much latitude the president has on trade, because the law gives the president a lot of leeway on trade to make decisions. And Congress could take that back, and there’s even been talk among republicans who are unhappy with the president’s trade strategy, of taking that back, but it hasn’t gotten the attraction.

If you see a swing in November towards the democrats, you could see an effort to try to rein in the president’s discretionary authority over trade. And that would have implications for investors.

Robert Teeter: Great. Well, thank you. I thought we’d get out in front of that, since our next call will probably be some time in October, and we’ll be right here to pick up that discussion.

Thank you to everyone who dialed in on this lovely summer afternoon, and we look forward to speaking with you again next quarter.

Operator: Ladies and gentlemen, thank you for participating in today’s conference. This concludes the program, and you may all disconnect.