SILVERCREST
ASSET MANAGEMENT GROUP

ECONOMIC REVIEW & INVESTMENT STRATEGY: 2018/IV

The U.S. economy keeps chugging along, with corporate earnings growth buoyant and inflation moderate. Overseas, the picture is less encouraging. While the S&P 500 delivered total returns of +10.6% in the first nine months of this year, China is in a bear market, and MSCI indices for Europe and Emerging Markets are both in negative territory. This divergence in global markets poses potential risks and opportunities for investors.

An essential part of my job is to get out from behind my desk and understand what's happening in the world, visiting companies, meeting with policy makers, and just getting a ground-level view of what the real economy is like. "Better to see something once," the proverb goes, "than hear about it a thousand times." My recent experiences abroad have driven home at least five key observations that help inform our outlook as investors: 1) the necessity of going against sentiment, when the facts say it's wrong; 2) the potential and pitfalls of investment for unlocking growth; 3) the stresses that mass migration is placing on the global economy; 4) the return of geopolitical conflict as a central investor concern; and 5) the value of seeking out diversified risk.

SENTIMENT

Forget about making your flight. Angry protestors have blocked the highway to the airport with barricades of burning tires, backing up traffic all the way to the gridlocked center of Buenos Aires. Every school in the country is on strike, and earlier this week, demonstrators were hurling Molotov cocktails at the Casa Rosada, the country's presidential palace. They're determined to stop the same market reforms that have attracted so much attention and enthusiasm among foreign investors, dead in their tracks. Welcome to Argentina.

In March 2017, investors were coming back to Argentina, hopeful that the financially troubled country had finally turned the corner. After defaulting on its debt in 2001, the country's populist president imposed capital controls, and MSCI dropped it entirely from its benchmark Emerging Markets stock index. Now Argentina had elected a new president with a pro-market reform agenda, come to terms with its bondholders, and successfully issued new bonds. In the previous 12 months, its stock market had soared +45%.

On the ground, however, it was clear there was far from smooth sailing ahead. The same was true for neighboring Brazil, where stocks had bounced back strongly after the populist (but deeply unpopular) President Dilma Rousseff was ousted in August 2016, following a massive corruption scandal. The same crackdown that brought down "Dilma", however, barred all of Brazil's largest construction companies from working on public works contracts—at a time when the country desperately needed to invest in developing infrastructure. The collapse in global oil prices also undercut Brazil's plans to tap newly-discovered offshore oil reserves—the anticipated revenues of which, in large part, it had already spent. On closer examination, the road ahead for both Brazil and Argentina was going to be uncertain and difficult—but for the moment, markets didn't want to hear that. Optimism was riding high.

Whether it's Abe in Japan, Modi in India, Renzi in Italy, or Macron in France, the election of a new reform-minded leader—or simply the prospect of a fresh start—can cause markets to soar in anticipation of better times ahead. Policies that sound impressive in a speech can be harder to implement in reality; until that reality becomes evident for all to see, enthusiasm prevails. In Argentina's case, share prices rose a further

+86% in the following 10 months, before plunging −29% this year, on fears the country could face a renewed currency crisis. They have since rebounded on news that MSCI will add Argentina back to its Emerging Markets index next year, a move bound to attract a host of new investors, though the risk of a financial meltdown has far from receded.

We frequently advise investors to ignore fickle sentiment, reflected in the short-term ups and downs of markets. But the tendency of entire countries to fall in and out of investment fashion, for extended periods of time, can pose a deeply frustrating dilemma for investors. Putting your insights aside and merely betting on which way the herd will go, is little better than gambling in a casino. Missing out on what looks like a hot market, or holding onto a position that nobody seems to appreciate, can be really painful. The long-term rewards of conviction and insight can be easily missed if we judge them on a quarter-by-quarter basis, though we might like to. They require patience and discipline—and a willingness to be "wrong" until you are proven right.

INVESTMENT

Crossing the Gambia River, in west Africa, on either of the two available ferries is not for the faint of heart. The "queue" is a maelstrom of honking and jostling, with dented-up trucks belching exhaust fumes and vendors hawking everything from flower bouquets to tins of corned beef to busloads of waiting passengers. You could wait hours or even days, unless you bribe someone to let you skip to the front of the line—and finding the right person to bribe is a task in itself.

Why don't they just build a bridge? They have been building one—for the past 16 years. The concrete pylons are readily visible at the upstream ferry crossing, but there's little evidence of further activity. Nobody wants drivers whizzing over a bridge without stopping—not the ferrymen taking bribes, not the shops and vendors servicing stranded travelers—except for the travelers themselves, and they don't count.

For every country, there's typically one project, that if it ever got off the ground, would make me give that country a new look. With Russia, it would be a multi-lane highway between St. Petersburg and Moscow, instead of the pot-holed country road that currently connects the land's two largest cities. In the Philippines, a new Manila airport, or at least a second runway for when the wind blows in the wrong direction, delaying flights in and out of the nation's capital for hours on end. In India, a water supply that flows 24 hours a day, at least in the most modern cities. In Colombia, winding a cargo-laden truck across mountain roads from the main port of Cartagena to the capital of Bogota takes at least 20 backbreaking hours—assuming you don't get robbed or kidnapped along the way. Cutting that in half, and making it safe, would unlock significant growth potential for the economy.

Some countries are making these visions a reality, with China's help. In Senegal, Gambia's next-door neighbor, Chinese funding, equipment, and expertise are building a modern new airport and connecting it by high-speed rail with downtown Dakar. In between, they're building a whole new city, and above each construction site flutters a red Chinese flag. That's why so many countries—and not just in Africa—are so excited about China's "One Belt One Road" and other multibillion-dollar investment initiatives.

Big Chinese checkbooks aren't always the blessing they might seem, however. In a rural corner of Nicaragua, a $50 billion canal project, sponsored by an obscure Chinese tycoon, is supposedly going to transform the country into a global transportation hub. A bumpy gravel road there gives way to a rutted forest path, and cows graze unworriedly on a field where the groundbreaking ceremony had taken place a year before. The only evidence of a worksite are two napping guards next to a wooden barricade. The lack of progress lends support to arguments that the project simply isn't viable, especially in light of the huge $5 billion expansion of the existing Panama Canal, with new locks capable of allowing much wider ships to pass Nicaragua illustrates the exact opposite lesson as The Gambia: that too many dreams can be just as big a drawback as too few, especially if they aren't well-grounded in reality.

MIGRATION

Why are they pulling me over? The border between Germany and Denmark lies within the "Schengen Area", 26 countries in Europe that have abolished passport and other controls at their common borders, making it no different than crossing from Ohio to Indiana. Normally, you don't even notice you've crossed a national boundary, except for your cell phone buzzing as it picks up a new carrier. But here, north of Flensburg, police are waving cars over and asking to see documents. They're looking for illegal migrants.

We've all seen images and articles about the refugee crisis caused by Syria's civil war, but the scale of it is hard to comprehend, until one visits what is now Jordan's fourth largest city: a camp of tents as far as the eye can see, containing half a million displaced people. Sometimes you can hear the crump of artillery or screech of a Russian fighter jet just over the horizon, but mostly it's a life of soul-crushing boredom, with no control over their lives or way to make a living. Those who can join the flow of people from other troubled countries—as many as 26 million refugees and 139 million voluntary migrants—seeking better opportunities in more stable, wealthier lands.

Anxiety over "uncontrolled" migration, into these richer countries, is sending tremors through their political systems. It played a key role in electing Donald Trump and persuading British voters to leave the European Union—despite the economic risks—and has come within inches of toppling German Chancellor Angela Merkel, who for over a decade has been *the* key power-broker and bulwark of stability on the European scene. European leaders tell us, with immense frustration, that discussions on all other issues—including the hugely consequential Brexit talks—have become politically hostage to migration and the intense feelings surrounding it.

The U.S. and Mexico may squabble over building a border wall, but conflicts over migration strike at the very heart of the idea of a unified Europe, free of internal boundaries. Front-line states like Bulgaria, Greece, and Italy complain that they bear the major burden of policing Europe's borders with the Middle East and Africa, and caring for unwanted arrivals, on behalf of far richer countries that are the migrants' real destination. When they lack the resources or determination to succeed, those wealthier neighbors threaten to re-impose their own border controls. Meanwhile, voters in western and northern Europe grouse about all the Poles, Romanians, and Bulgarians moving in and pushing wages down, even as their countries of origin worry about "brain drain" leaving behind an aging and less dynamic population, dependent on social security. The same mutual resentments are reflected in the Western Hemisphere, where President Trump grumbles about dirt-poor Haitian refugees coming to the U.S., while people I talked with on a recent trip to Haiti expressed irritation that the U.S. takes all its most talented citizens, who send nothing back but remittances.

Most migrants would be happy to go home, if that were a viable option. One Syrian refugee selling slushy drinks on the street in Aqaba, Jordan, dreams of rebuilding his house, which was bombed by Russian planes. And some who do return bring back valuable skills and experiences that can help make their home country a more attractive place for people to stay. One gas station owner in Tunisia, for instance, worked for several years in Germany, Italy, and France before bringing home the money he saved to start his own business. "I have work, so I am happy," he grins—but he also creates work for local employees, in a country where widespread joblessness regularly sparks riots. The real answer for developed countries that find themselves a magnet for desperate migrants can't be just keeping them out. It can only be replacing the downward spiral of spreading instability with a virtuous cycle that spreads stability and prosperity to the countries so painfully in need of them.

CONFLICT

War museums are usually about the past, but the one in Dnipro, Ukraine, is devoted to a war still being fought just an hour away. The shot-up windshields and mournful photos of the hallowed dead on display come from firefights taking place every day just down the road, since 2014, between the Ukrainian army and local militia on one side, and Russian-speaking separatists not-so-secretly backed by the Russian army on the other. The unit of fresh-faced Ukrainian soldiers touring the exhibit might well be on their way to the front lines.

We're a long way from 1992, when scholar Francis Fukuyama's book "The End of History" argued that with the end of the Cold War, and the universal acceptance of liberal democracy, there was nothing left to fight over anymore. These days, the prospect of great power conflict appears all too real again, on multiple fronts.

When I still lived in China, I traveled to North Korea, twice, to gain some on-the-ground insight into the pariah regime that's now positioned to threaten the U.S. with nuclear intercontinental missiles. It's a surreal powder keg sitting right in the middle of one of the world's most economically developed regions, and depending on which way diplomacy goes, could take a sharp turn toward frightful conflict or peaceful resolution in the days ahead. Saudi Arabia is engaged in at least three battles with its regional rival Iran, two hot—in Syria and Yemen—and one cold: its economic blockade of Qatar. But the most alarming battle lines being drawn, with the greatest potential impact for years to come, are with Russia and China.

That's what brought me to Kaliningrad, an enclave of Russian territory cut off when the Soviet Union dissolved, which straddles the vulnerable intersection between two NATO allies, Poland and Lithuania, and the Baltic Sea, and serves as a base for short-range nuclear missiles. In the border region surrounding it, as well as Estonia's border with Russia, one frequently runs across deployments of U.S. troops training for possible conflict. But even more than Russian tanks rolling across the border, the Baltic states—all three of which are now E.U. members and have adopted the Euro—fear the possible turmoil that could be caused by a Russian cyberattack. Estonia was hit by a limited one in 2007, which set off alarm bells in the defense community, and Putin's war with Georgia in 2008 and invasion of Crimea in 2014 drove home the potential threat even further.

Rising tensions with China carry even more complex risks, and more immediate consequences for investors. Last week, Vice President Pence outlined a series of concerns—including Chinese military expansion in the South China Sea, theft of U.S. technology, and efforts to influence U.S. public opinion—that have caused attitudes in Washington to harden significantly towards viewing Beijing as more of a threat than a potential partner. Tit-for-tat tariffs between the two countries have steadily piled up, with implications for both economies. And while some Trump officials discuss the prospect of banning all Chinese students from U.S. universities, U.S. trade negotiators quietly slipped a provision into the revised NAFTA agreement with Canada and Mexico, aimed at blocking them and other U.S. trading partners from signing new trade pacts with China. The Vice President even boasted in his speech of how U.S. pressure helped push China's stock market down −25% so far this year. A deal on trade is no doubt possible, but the two countries—with the world's two largest economies—seem to be on course for a much broader clash of interests.

There's no such thing as investing for Armageddon, but as investors, it's worth understanding the dynamics of these potential conflicts to know what the real risks and red flags are, and also avoid false alarms. When President Trump was threatening war with North Korea, some months ago, we weren't rattled because we knew what to look for and didn't see any concrete preparations taking place for a U.S. attack. But we're also aware that we're living in a world where more and more battle lines are being drawn—and one may, someday, be crossed.

RISK

Checking into a resort-hotel at Sousse, on the coast of Tunisia, is like entering a military base. At the first checkpoint, two armed guards examine in and under the car for explosives. At a second barricade, they do it again. You go through an airport-style security scan at the front door, and at the registration desk, they place a blue wristband on your arm, which you must wear at all times. There is a reason for these precautions. In 2015, a terrorist gunman entered a similar hotel at Sousse, posed as a guest, and killed 38 tourists staying there. Ever since, the local hotels have been on lockdown, to protect the few customers they have left.

The Middle East (and by extension, the broader Arab world including North Africa) is seen as a risky place, and in some ways, it undoubtedly is. Whether eyeing the itchy trigger finger of a Christian militiaman guarding a First Communion ceremony in central Beirut, or standing next to a bus stop bomb shelter in an Israeli suburb within rocket range of Gaza, it's a region that never quite lets you forget its intense rivalries and hatreds.

Much of the region also depends, to a rather lopsided degree, on a single commodity: oil. It's one thing to realize, mentally, that Kuwait is a major oil producer. It's another to arrive and have it tangibly dawn on you: *there's almost nothing else going on here besides oil*. It's just one big oil field—there isn't even any tourist industry to speak of. When the price of oil drops by more than half, as it did in late 2014, Kuwait's exports and public revenues drop by over half. Even countries that don't produce oil, like Jordan, depend heavily on neighboring markets that do.

Saudi Arabia, inspired by Dubai, has embarked on a radical transformation to reduce that dependency and create a modern, knowledge-based economy. There are both immense potential, and immense challenges, involved in this shift. Oil uniquely allowed the Saudi kingdom to retrain its feudal structure, and pre-industrial ways, while becoming the 19th largest economy in the world—larger than Switzerland. The division of the sexes is most striking. It's not just a matter of women not driving (until this year), but living in entirely separate spheres, which are supposed to never intersect with non-related men. This, the country's rulers have come to realize, is hopelessly incompatible with a diversified, participatory modern economy. Asked what people thought of the changes being introduced, a local guide hesitated: "They realize things cannot stay the same, but they feel they are losing their religion." In many ways, the Saudis are trying to pack all the social changes experienced in the West over the past 300 years into the next decade. That's a scary thought.

While the risks posed by the Middle East may seem daunting to an investor, however, there's one attractive quality that they have: they're uncorrelated. The downsides related to terrorism, revolution, or even volatile oil prices aren't necessarily tied to whether the Fed raises interest rates or the U.S. goes into recession and offer valuable diversification. Lebanon, for instance, may be half-ruled by a pro-Iranian militia prone to blowing up rival prime ministers, but its economy sailed through the Global Financial Crisis without even noticing, growing +10.3% in 2009. Israel may have enemies and desert all around, but it has turned those two negatives into a venture capital-funded dominance in cybersecurity and water-saving technology. Threats that pose a downside risk for other economies, like hacking attacks and climate change, generate upside opportunities for these Israeli entrepreneurs.

Far from being a dangerous gamble, seeking out uncorrelated risks around the world (the Middle East just offers some thought-provoking examples) can help insulate an investor from exposure to any given risk. That's an important thing to remember when non-U.S. markets are down (like now), and why no investment allocation should be judged solely on how it appears to be performing at the moment, but on how it contributes to the balance of risk and return in the total portfolio.

BRINGING IT HOME

Compared with some of my recent travels, the immediate outlook for the U.S. economy looks positively serene. In last quarter's letter, we laid out in detail the positive momentum we were seeing, along with the warning signs we'd be keeping our eyes out for. Not much has changed. Consumers remain confident, retail sales are strong (up +6.6% from a year ago), new factory orders are firm (up +10.0%), hiring remains positive—particularly for blue collar jobs—and the ISM business surveys show both the manufacturing and non-manufacturing sectors in solid expansion territory. The Atlanta Fed is currently projecting +4.2% GDP growth for Q3, while the New York Fed is projecting +2.3%—in either case, undoubtedly positive.

Inflation and interest rates have both inched up, but not beyond expectations, and not to any level that should set off alarm bells. The yield curve has not inverted (which could signal a coming recession). Companies in the ISM survey are worried about new tariffs and their impact on input prices, export sales, and future capital investment, but are otherwise upbeat. While markets cheered the agreement between the U.S., Canada, and Mexico on a revised trade deal, with only modest changes to NAFTA, other trade conflicts remain up in the air.

Earnings per share for large-cap U.S. companies have seen a big boost this year, aided by tax cuts and a surge in stock buybacks. If expectations for Q3 are met, quarterly operating EPS for the S&P 500 will be up a striking +28% from a year ago. It's worth noting that quarter-on-quarter earnings growth has likely slowed, to +3.8%, and that six out of the index's 11 sectors expect to see earnings decline from the record peaks achieved in Q2. But even so, this would still put the 12-month trailing P/E ratio at 19.6x, down almost two multiples from a year ago, despite a +9.0% rise in shares prices so far this year. The equity risk premium remains elevated at 5.4%, well above its long-term historical average of 4.1%, which suggests that share valuations have room to absorb higher interest rates, so long as they rise due to a growing economy, not a spike in inflation.

With numbers like these, it's tempting to stay home and sit pretty. But the global economy poses challenges—like great power conflict and mass migration—that no investor would be wise to ignore. It also presents opportunities—like diversification of risk and transformative investments that unlock growth—that investors would be wise to capitalize on, so long as they understand that the true rewards take patience and discipline.

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ECONOMIC FORECAST
(As of October 15, 2018)

	2016	2017	Projected 2018	Projected 2019
Real GDP (Y-O-Y)	1.5%	2.3%	3.0%	2.6%
Consumption Expenditures	2.7%	2.8%	2.6%	2.7%
Business Fixed Investment	-0.6%	4.7%	6.6%	5.0%
Inventory Investment (Billions)	$33.4	$15.2	$20.0	$20.0
Residential Investment	5.5%	1.8%	1.2%	2.4%
Government Spending * (Billions) (a)	$2,900.2	$2,903.3	$2,935.0	$2,945.0
Trade Balance - Goods & Services (Bil.)	-$502.0	-$552.3	-$580.0	-$590.0
Federal Budget*: Unified (Billions)	-$584.7	-$665.4	-$804.2	-$980.6
Gross Federal Debt* (Billions)	$19,539	$20,206	$21,375	$22,546
Consumption Price Deflator	1.2%	1.7%	2.2%	2.8%
Producer Price Index (Final Demand)	0.4%	2.3%	2.9%	3.5%
Consumer Price Index	1.3%	2.1%	2.6%	3.2%
Industrial Production	-1.9%	1.6%	3.5%	2.0%
Real Disposable Income	1.4%	1.2%	2.0%	2.0%
Average Hourly Earnings	2.6%	2.5%	2.7%	3.2%
Unit Labor Cost (Non-Farm)	1.1%	0.4%	2.5%	2.0%
Productivity Growth (Non-Farm)	0.0%	1.3%	1.2%	1.0%
Personal Savings Rate (% DPI)	4.9%	13.4%	3.1%	3.5%
Capacity Utilization – Total Industry	75.3%	76.1%	77.8%	79.4%
Trade Weighted $ Exchange Rate (b)	0.6%	-0.5%	0.0%	5.0%
Vehicle Sales (Million Units)	17.9	17.6	17.5	17.4
Housing Starts (Million Units)	1.174	1.203	1.250	1.294
Civilian Employment (Millions)	151.4	153.3	155.6	157.5
Civilian Unemployment Rate	4.9%	4.4%	4.0%	4.0%
Corporate Profits – After Tax	2.2%	5.5%	5.0%	4.0%
S&P-500 Earnings-Operating	$106.26	$124.51	$156.00	$163.00
S&P-500 Dividends	$45.70	$48.93	$52.50	$55.00
90 Day U.S. Treasuries-Yield (%)	0.18-0.54	0.49-1.45	1.37-2.75	2.00-3.75
10-Year U.S. Treasuries-Yield (%)	1.37-2.60	2.05-2.62	2.40-3.50	2.75-4.50

**Fiscal Year-end 9/30. (a) Federal, State, and Local; in 2005 dollars; (b) Fed Major Currency Exchange Rate.*