SILVERCREST
ASSET MANAGEMENT GROUP

MARKET COMMENTARY CALL TRANSCRIPT
APRIL 11, 2017

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: Good day, ladies and gentlemen, and welcome to the Silvercrest Asset Management Group Market Commentary Call.

(Operator Instructions)

As a reminder, this conference is being recorded.

This discussion contains personal opinions as of the date set forth herein about the securities investments and/or economic subjects discussed by Mr. Patrick Chovanec and Mr. Robert Teeter. No part of Mr. Chovanec or Mr. Teeter's compensation was, is or will be related to any specific views discussed in this call.

This discussion is intended for information purposes only and does not recommend or solicit the purchase or sale of specific securities or investment services. Listeners should not infer or assume that any securities, sectors or markets described were or will be profitable or are appropriate to meet the objectives, situation or needs of a particular individual or family.

The implementation of any financial strategy should only be made after consultation with your attorney, tax advisor and investment advisor. All material discussed is compiled from sources believed to be reliable, but accuracy or completeness cannot be guaranteed.

I would now like to introduce your hosts 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: Thank you and thanks, everyone for joining us today, this is Rob Teeter of the Investment Policy and Strategy Group and I'm joined by our strategist Patrick Chovanec and we're pleased that all of you can join us today for our quarterly investment call. We expect this will be about a 30-minute call and we welcome questions and answers at the end.

So to start off, despite a relatively flat month in March, the S&P finished with a very strong quarter. First quarter was up about 6.1% total return and was led by growth, large caps, technology, consumer and healthcare, so it seemed like a very positive quarter.

However, there seems to be perhaps a disconnect brewing in some sense between the markets and the political environment. In fact, depending on which newspaper I read and when I read it, it might seem like we've it’s either a great environment or a terrible time to invest.

So, Patrick, how do you sort through this seeming paradox?

Patrick Chovanec: Yes, it's the best of times and the worst of times in a sense of what kind of headlines you read. There are a lot of headlines that would make you very confident about investing and others that would make you very worried about investing. And the question that we often get given the rally that has taken place in U.S. equities is, is this a bubble or is it a new bull market?

And my answer to that question is, is it's neither. It's the old bull market. It's the market that we've known for many years now and the economy that we've known for many years now. The market has climbed the wall of worry all along. Some of those were even now new and different, others have receded, but by and large, the economy continues to chug along.

If you actually look through the headlines and look at the underlying economic data, the economy is in moderate expansion mode, new orders which are a leading indicator suggest that that expansion will continue for at least the immediate future. Some of the things that we, were worrying signs last year like the run-up in inventory levels relative to sales has fallen off a bit, which is good news.

And so we're always looking around for what will derail this old bull market, this mature bull market. And at this point, we don't see something that would imminently derail it. And within that context, it makes sense to look at valuation and say, okay, so where are we?

Right now if earnings come in, let's say, in the first quarter the same as they did in the last quarter, we expect it will rise, but let's just say they come in at the same, that would be a market that was valued, S&P 500 at a little bit over 21 times earnings. That's a rich valuation historically, more typical of the later stages of a bull market, certainly the early stages. But relative to the alternative which is to seek a safe harbor, equities are still reasonably priced.

The equity risk premium which is how much do you have to -- how much do investors have to be paid to take equity risk? It was before November 6.3%, that's come down to 5.6% because of the rally and because of somewhat higher interest rate, but even so, at 5.4%, but even so, that is well above the 4.1% 50 year historical average, which, it doesn't mean that equities are cheap.

What it does mean is that to sort of seek a safe harbor away from equity risk is very expensive, that you're giving up a lot of potential return and sure, if you get the market timing exactly right, that's one thing, but if we think back a year ago, there were a lot of people who were saying, who were worried that there was a recession right around the corner.

They were legitimate worries about the possibility of recession, and yet if they had gone to ground as it were, they would have given up a significant return for the year. So if you do that year after year, you're giving up quite a bit and that's what that equity risk premium tells us. Not that it's a safe environment. Not the equities are expensively priced, but simply that the alternative is also quite expensive.

Robert Teeter: Okay. So sticking within the U.S. for the time being, I think last quarter we talked some about the political environment and the agenda out of Washington, D.C., what's evolved over the last quarter? Has anything gotten incrementally more positive or negative? Anything encouraging to you or things you see on the horizon?

Patrick Chovanec: Well, so there have been some stumbles out of the gate for the Trump administration and I don't think that's a partisan evaluation. I think Republicans and Democrats would both agree that that's the case. And the most notable one of course being the failure to pass repeal and replace of Obama Care which was a top agenda priority for the Trump Administration.

There were a number of mistakes that were made. And the issue going forward is really whether the Trump administration and the Republicans in Congress learn from that or not. If they do, then there's a great likelihood that they will recover from that and pass other elements of their agenda. If they do not, then it will be Ground Hog Day over and over again and they will continue to run with the same problem.

So it really is up to them to figure out whether, what went wrong and how to overcome that. It's not unusual at all. There was an impression right after the election that with a friendly Congress that President Trump would simply pass his entire agenda very easily, very smoothly, very quickly.

And that translated into a lot of the market excitement about at least some of the things that the market thought was going to be positive, you know, tax cuts, repatriation of earnings from abroad, other things, infrastructure and defense spending, things that the market kind of, they kind of conveniently said well, we don't really think that the

(Inaudible – microphone inaccessible) destructive trade agenda or immigration agenda will necessarily be the priority. We think these things will be the priority.

That was an unrealistic expectation, that things would just sort of skate through. It is equally unrealistic to then say because there's been a setback or because a new president has made mistakes that therefore his entire agenda is dead in the water. It is likely that they will figure out ways to pass elements of his agenda. But I think what it does highlight is that he came with a very broad agenda, there was an expectation in the market that while it will all skate through or at least the good parts will skate through, most presidents really only pass two or three major pieces of legislation because of constraints of time and political capital.

And so they are going to have to choose. There is not going to be time and effort and energy for everything, particularly complex issues like tax reform are going to take significant investments of time and energy to work out. And so the question really is, what do they prioritize?

As we've seen, even in areas where there is general agreement like repealing and replacing Obama Care among Republicans, there are specific disagreements and very different sets of priorities in working out the differences. And the same is true for tax reform and even for tax cuts.

They're going to have to prioritize what they're going to spend their time and energy on, and that's something that we're going to be watching very carefully, because not only do they learn the lessons or not from the healthcare -- their failed attempt to pass the healthcare bill, but what will they focus on given that they don't have time and energy to focus on everything.

Robert Teeter: Okay. So maybe moving overseas for a bit, I know there are a number of issues that investors are paying attention to that are perhaps causing some uncertainties and some of these are just starting to develop, such as the Brexit process and others that are sort of in the works such as the potential outcome of the French elections.

And really we were just in two trips to Europe, one to Albania and one to Brussels, so maybe you could share your thinking on what's the latest from on the ground in Europe.

Patrick Chovanec: Both of those strips offered an interesting perspective because the Brussels trip was to an annual forum in Brussels attended by what one might call the Transatlantic policy elite. A lot of officials, a lot of senior officials from EU countries had some very useful conversations with people involved in the Brexit negotiations going forward, and also people who had some very useful perspectives on the French elections and the German elections going forward.

The trip to Albania was actually for a Pan-European conference held by -- there's a bloc in the European Parliament that is what I would call the moderate euro-skeptic block, not the ethnic nationalists, but the moderate euro-skeptics, and obviously they have a very different take on things that are going on, and so it was very useful to hear that as well.

My impression from both of them is that particularly regarding Brexit, that there's been a shift in attitude both among the Brits and the Europeans. The British side, initially there was right after the Brexit there was a great hope, at least among some that they could engineer a soft Brexit, but that Britain would not leave the common market or the customs union and that disruptions would be minimized. That looks very unlikely now, actually almost certainly not, it won't happen. And so the question becomes, how hard is a hard Brexit?

We have two years now that the clock is ticking, Article 50 was invoked at the end of March. So they have two years to either work out an agreement with EU or not. They could exit without an agreement.

One of the big obstacles to working out any kind of agreement whatsoever is that the European Union believes that Britain owes the EU GBP60 billion to cover commitments that were made when Britain was a member. And British voters by and large feel that they don't owe a cent, and that will be a political issue domestically in Britain, and so that will be potentially an obstacle.

But because there has been no immediate negative impact from Brexit as many people worried there would be, the view in Britain is very much that well, there's been no negative impact, so we could probably weather a hard Brexit. And so there's a confidence, one might say a cockiness that Britain can sort of stare down a hard Brexit.

On the EU side, initially the view was that Britain must be punished, that Britain must be made an example of. There were very vocal voices, very prominent voices that Britain really must be made an example of so that others will not follow in Britain's footsteps. And that view has also shifted. I think the thing that really changed that was the election of President Trump and some of the things that he said.

There was, at the conference in Brussels, there was a Pew poll that I don't think has been publicly released yet, but they shared it with us and they asked if Russia -- they asked Transatlantic, it was people in the United States and people in Europe, policy elites, if Russia got into a conflict with the European countries, would the United States honor its NATO commitment and defend that country? 49% said yes, 48% said no. That actually is an amazingly tepid response.

And whether it's true or not, obviously the opinion is divided, but whether it's true or not it has really cast a shadow of the thinking in Europe. And the thinking in Europe has now become much more pragmatic. The view is our relationship with the U.S. is at least potentially in question and we're going to need all the friends that we can get. So we need as positive a relationship with Britain post Brexit as possible.

And I think that's led a greater pragmatism and maybe a greater flexibility on the EU side. So we've seen shifts in thinking on both sides, one of which makes an agreement a little bit more difficult, the other which makes the agreement perhaps a little bit more plausible. And we are going to have to see exactly what the shape of this agreement may be.

So far, the business community in Britain has been relatively quiet about their concerns, but there is deep concern in Britain about what the impact of a hard Brexit will be, especially if there is no agreement on the terms of leaving.

Robert Teeter: So, maybe let's come back to the domestic front here for a little while.

Patrick Chovanec: Well, you know, one thing I should add is that there's going to be additional twists here because there's going to be a French election and a German election. The French election, Marine Le Pen is given only a 25% chance of winning, but if she won, you know, she has pledged to essentially take France out of the euro and potentially out of the EU, and a lot of people believe that it would be the end of the European Union.

That's a pretty significant historical development if that took place although there still is only about a 25% likelihood at least in betting markets' minds that that will happen. But she's running against some candidates who have their own weaknesses and who is to say given the political surprises that we've encountered what might unfold?

In Germany, Merkel is running against a much more conventional candidate, wouldn't represent a significant break in German policy. But Merkel has been such a steadfast figure on the European scene and in every European crisis over the past several years that even if German policy didn't change, her absence would be felt on whether or not it's on Greece or on Brexit or other things, so some potential curve balls coming down the road.

I think, though, the one thing that the past year has taught us is that we should not underestimate the chance of political disruption, but we shouldn't overestimate the market impact of that disruption.

And the market so far has basically said, okay, there are some potentially very disruptive events whether in the United States or in Europe, but show us the negative consequences before we're going to start factoring it in and seeing it negative, especially given the fact that the economic data continues to be relatively positive.

Robert Teeter: Yes, well that's a good transition to what we were about to talk about which is that politics might be capturing the headlines particularly here in the U.S., at least on a day-to-day basis. But fundamentals really carry the long term and we're long-term investors around here and we talked some about the favorable backdrop of the U.S. economy in your opening remarks.

But I thought maybe we could get into one issue that people have been paying some attention to which is inflation and whether or not there's a risk of inflation. I know you've talked some about the dampening mechanism of the dollar. I thought it would be interesting for people to hear about your views on inflation and the dollar.

Patrick Chovanec: So prices have been moving up slightly. Inflation in February, the headline CPI number reached 2.8% which is well above the Fed's target of 2%. If you look at core inflation though, it's much closer to the target. And if you look at the Fed's preferred measure which is PCE, the PCE price index, that is also closer to 2%.

But nevertheless, prices have been gradually inching up and what to make of that? The thing that really leads to inflation in the United States is labor shortage or tightness in the labor market. That's usually the main constraint. Other countries have different constraints.

The United States, it's usually labor and so far although we've continued to see job growth and the unemployment rate is below 5% which usually suggests a reasonably tight labor market, we have not seen significant wage growth and certainly nothing that would push inflation. So there's that.

There's also, as you mentioned, the dollar. After the election, one of the reasons why interest rates went up and one of the reasons why the dollar went up was the expectation that President Trump would push a number of policies that would essentially be reflationary, the would boost demand in the U.S. economy whether through defense buildup or infrastructure spending or tax cuts, all of them would potentially boost demand. And so there was this reflation story.

But what happens is that in anticipation of that, the dollar responded. People expect then the Fed to push back and in fact Janet Yellen herself said if there are measures that actually increase productivity, that's fine.

But if there're measures that simply boost demand, well, the Fed might, she implied, push back against it. And when markets see that, they start to anticipate Fed tightening, the dollar goes up, and the stronger dollar starts to dampen growth in the United States and so it actually pushes down the growth that might potentially generate inflation.

And so the dollar here has been a regulator. And it regulates in the other way. What we've seen over the past couple of months has been as people have lost confidence that that reflationary agenda would necessarily barrel through, that the dollar has eased somewhat, it's come down.

It hasn't lost all of the bump that it got after the election, but it's fallen off about 3% since the beginning of the year, and that that has relaxed the negative downward pressure on growth that a stronger dollar creates.

And so the dollar sort of acts as a governor to keep both U.S. growth in line, but also kind of implicitly head off inflation. Of course there could be spikes, there could be different things, a trade policy that imposed tariffs for instance could lead to inflationary spike, but what we're seeing in the economy right now is not some kind of takeoff point of inflation.

We're seeing price rises that are moderate but not the kind of thing that's going to cause really the things that we would be concerned about, right, which would be derailing the consumer economy or consumer confidence or causing the Fed to massively raise rates which then would potentially end the cycle.

Robert Teeter: Great. Thanks, Patrick. But I think we want to be mindful of the time here, I've received a couple of questions in advance, but I thought first we'd turn it to the moderator and see if there are any questions from anyone who has dialed in today.

QUESTIONS AND ANSWERS

Operator: (Operator Instructions)

I'm showing no questions over the phone.

Robert Teeter: Okay. Well, I'll maybe just take one question, one of the questions that I've received in advance which is, Patrick, you have a long history of being a well-documented China follower. It seems as though the markets there at least as measured by the MSCI Index have been pretty strong this year. Has anything changed fundamentally in China that we should be paying attention to?

Patrick Chovanec: So, observers from outside of China have, you know, we talk about business cycles, people have emotional cycles about China and right now we're kind of riding an optimistic wave. But really what has happened in China has been that there has been another round of credit and fiscal stimulus that has indeed boosted the economy, but only at the expense of much greater debt.

And so China continues to be locked into the problems that have been present all along. We have not really seen an economic adjustment in China that would put it on a more sustainable path. What we've seen is a doubling down on the kind of growth which isn't necessarily good growth which ultimately leads to more overcapacity, not just in China, but on a global basis.

So, in the meantime we've seen greater optimism about China. Maybe China changed, turned a corner and that's been reflected in commodity prices, so iron ore prices, copper prices have all reflected that because China is the main consumer of those. And we've also seen the concern that weighed over global markets about a China recession. That was one of the things that caused some correction, some jitters in the market last year. We've seen those recede.

But I would really say that that has only receded for a while, because what we've seen in the meantime is the debt levels in China continue to rise. Now, those don't work out. So why do we never see a collapse?

Well because China is not really a market economy particularly in its financial system, and when you have a contained financial system in which many of the actors are actually state owned and state directed and others rely implicitly on the idea of state backing and the state preventing defaults or preventing financial uncertainty, then you can still have the same problems. They just work themselves out differently.

In order to have a market meltdown, you need to have a market. And if you don't have a market, you just have greater and greater inefficiencies piling up. And so we're really seeing the latter.

We're not seeing a crisis that would necessarily unfold like a crisis in a western country, but you are seeing greater and greater weight, greater and greater burden placed on the Chinese economy of debt that is ultimately unsustainable and will again come to haunt the Chinese economy.

So I think that we should be prepared at some point for a renewal, I mean not tomorrow, not the next day, but at some point, people waking up one day and realizing that things in China are still problematic, and then that could cause market jitters again.

Robert Teeter: Great. Well maybe one other quick question that I've heard from a few folks and given that it's April, it might be on people's minds, which is have you heard anything new in regards to tax reform or what types of signals are you looking for out of Washington that might indicate that something might be being accomplished this year?

Patrick Chovanec: So we are in very early stages of talking about what a tax package would look like. And the people who I've talked to I think who are reliable, giving a realistic view are saying only by the end of the year at best would we see a tax package, which then raises the question of whether it would apply to 2017 or not.

There was a lot of talk after the defeat of the healthcare bill that – well, healthcare was hard, so we'll switch gears and we'll move to something easier which is tax cuts. Tax cuts or more meaningfully tax reform is not easier. Obviously the Republicans would like to cut taxes, but how and how you accommodate it, they have very different sets of priorities.

You could accommodate it by getting rid -- you could lower rates on corporate taxes and personal taxes by, one option would be getting rid of different deductions or exclusions or tax credits, but all of those are popular and some of those affect people in very significant ways depending on who you are.

If you're in a high tax state and they get rid of the state and local tax deduction, that might wipe out all the benefit that you get from a lower federal tax rate. The other option would be cutting spending. Well, another option would be the border adjustment tax which could deliver $1 trillion worth of revenue, but that's highly controversial and the effects on industries like retail or anybody who imports are uncertain, unknown, and that leads to a lot of controversy and a lot of push back against it.

And then you could cut spending, but President Trump has promised to A, increase defense spending, B, increase infrastructure spending, and C, not touch entitlements which leaves a couple of discretionary programs which I guess could be gutted, but it's problematic. And then you could just have deficit spending, but there are a lot of people in the Republican Party fiscal talks who -- that would not sit well with them.

So that's all going to have to be hashed out. Now I'm not saying that there isn't a way to hash it out, but it may take time and political capital and energy, and if that's what they decide to focus on, then they could get it done.

But it's worth remembering that the last major tax reform which took place in 1986 took about two years to put together, and there were a lot of things that were in the original package which didn't end up in the package that was finally passed.

So, the advice that I would give investors would be this, there are going to be a lot of ideas that percolate in the process of this legislative discussion and some of them might seem very consequential and there would be all kinds of questions, "Well I heard that they might do this or I heard they might do that."

We need to think about and be aware of all the things that they're considering, but just because something is being talked about doesn't mean it's going to make its way through a final package because it's got to be weighed against a whole host of other things to make a package that basically satisfies even all the Republicans much less anybody else.

That's the mindset that I'm going to approach this with and I would urge anybody else to approach it with as an observer.

Robert Teeter: Great. Well, that's a great insight. Thanks, Patrick and thank you very much to everyone who joined us today.

Operator: Ladies and gentlemen, thank you for your participation in today's conference. You may all disconnect. Everyone have a great day.