SILVERCREST
ASSET MANAGEMENT GROUP

MARKET COMMENTARY CALL TRANSCRIPT
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Corporate Speakers:

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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 strategy group. Gentlemen, please begin.

Robert Teeter: As I look here at the calendar, it's August which typically would be the summer doldrums. Although, I think Patrick and I would both agree that this is one of the most interesting boring times that we've seen in recent memory. There's certainly a lot of noise, but yet there's been very little volatility. Those are some of the topics that we explore today. One scenario that I think of is if an investor were on vacation, sitting in a hammock reading the news, but not having access to market data, they might assume that something quite different was going on as to what's actually been happening.

Maybe we'll start first with exploring some of that noisy news, and one of the topics that's certainly in the news quite a bit these days are the developments going on in Asia, particularly in North Korea. Patrick has had the experience of having traveled to North Korea on multiple occasions. So, I thought maybe we'd start there to get your take on some of the developments in North Korea and as it might relate to developments in China as well.

Patrick Chovanec: Sure. I want to begin by stressing what you did is that the good news here is actually that the U.S. economy is kind of boring. Every week, I come in and talk, we have a weekly meeting and I say pretty much the same thing in terms of the economic statistics that are looking reasonably positive. The market valuations—we'll get into the details of that, but I want to frame that first before we get to the really exciting tumultuous stuff because that really is the baseline that we're operating under.

And the key questions that we ask ourselves is if the economy is plugging along and if the markets are steadily rising based on that, what could throw that off? And not that we think it's likely to throw it off, but we have to think through what are the possibilities [down] there that could cause surprise even if we think that they're unlikely. And obviously, the thing that's been in the news in the North Korea and I do have kind of interesting perspective on that having been there a couple times. I'm torn in some ways between on the one hand saying that this is not something that new. We've lived with the ever-present danger of the Korean peninsula blowing up at some point for a very long time, for a generation or more.

And I remember being a young officer in the Army in the early 90's when Kim Il-sung died and there was a crisis. And it looked very unstable, and I was in officer basic camp and was told when this is over, you may not go back home, you may be sent to Korea. So this is not the first Korean crisis, however, what is different here is that for decades really, the idea of North Korean developing a nuclear bomb and the ability to deliver it to the mainland of the United States which it looks like they may either be able to or be on the cusp of doing so, but that for decades has been a redline.

Whether you ratchet the rhetoric up or you ratchet it down, that's not just going to blow over, and it going to have to be resolved some way, and it doesn't even matter who the president is. Obviously, it matters in terms of what they do but it doesn't matter in terms of the dilemma that they face.

I hear that when President elect Trump went to visit President Obama in the White House that President Obama told him that the biggest topic, the most difficult problem you have on your plate right now is going to be North Korea. And so, no matter who won the election, it would have been a very difficult situation to resolve. And so, we're going to be living with. Now, one interesting this is how this ties to China.

I know that's what you were just about to ask me. I'm going to head that off and say that obviously China, being the second largest economy, looms very large in any kind of economic outlook. And one of the things that—when we think about what could disrupt the current trajectory of the economy or current trajectory of markets a trade war with China, or other countries as well, would be one of those things. And so just in the past week we saw the Trump administration throw out the idea—it wasn't very specific, but throw out the idea that they were thinking of a whole host of trade sanctions against China that then could provoke a Chinese response.

Now, it wasn't clear what they—there were a range of different things that they were talking about and the Chinese response would depend a great deal on which of those things the Trump administration proceeded—decided to proceed with. But—and then that was [pulled]. He was actually supposed to have a press conference about that or some kind of announcement about that on Friday and then there was disagreement at the UN for imposing sanctions and China voted for the sanctions on North Korea.

It looks like there was some kind of linkage. And in fact, President Trump had said previously that if China helps out with North Korea, that the U.S. would kind of go easier when it came to trade disputes. And so maybe that's part of it, maybe that's part of the leverage that was used, but that raises a very interesting question, which is, during the campaign, President Trump made actions against China on trade a centerpiece of his economic agenda, saying that that was essential for US prosperity.

And you can debate whether things that he was thinking about would be good things or bad things but it was certainly a priority and it wasn't—it was a priority for what he saw as the economic future of the United States. Is it that? Is it really a priority or is it a bargaining chip on North Korea? And it kind of—so the use of it as a bargaining chip or the talk about it as a bargaining chip and the fact that maybe they decided not to proceed because there was some agreement on North Korea does raise the question, so where does that leave the rest of the president's trade agenda?

And where—will we see follow-through on some of the trade threats that have gotten people's attention? And it's not, of course—that's not just China, it's also NAFTA, it's also steel tariffs, which then Europe said that that would constitute a trade war against them. And so there's been this rhetoric out there that's seemingly very core to the president's economic agenda of very strong, tough trade action, and then a gap between that and the follow-through.

Because the only follow-through that we've actually seen has been concrete has been quitting TPP initially, but that's something that—that wasn't a negative so much as the lack of a potential positive. And then—and then really, trade tariff on lumber from Canada, which while it may have an impact on the housing market, at least that's what some people are talking about, it fits within very conventional, traditional definitions of trade disputes.

I mean, that was an existing dispute and the way that they went about it was a fairly conventional approach. And I could have easily seen another administration doing the same thing. So the gap between what promised to be a radical break with US trade policy and what we've seen so far is quite significant. Does that mean that we're in the calm before the storm? Or does that mean that actually the administration's a lot more pragmatic than its rhetoric would suggest? We're going to have to watch that.

Robert Teeter: Interesting, very interesting. Maybe sticking on the macro side for a bit but transitioning back to the domestic front, I know a couple of issues that you've talked about that you're paying close attention to, one being the debt ceiling and the other being what are the prospects and timing around potential tax reform?

Maybe you could give us an update on what you're seeing and hearing in those two areas.

Patrick Chovanec: So, the debt ceiling is another issue where it's not likely to become a problem but it's on our radar screen as something that could become serious if it's not dealt with. Every—not every year but every once in a while, the debt ceiling needs to be raised or else Treasury warns that, if you don't raise the debt ceiling in Congress, we are—at some point—we can play games for a little while but we're ultimately going to run out of rope and we'll start missing payments.

And that would constitute essentially a default which would have serious ramifications in terms of US credit. Congress needs to raise the debt ceiling, the time given is September 29th by the Treasury. But the problem is, nobody really wants to bring this front and center so Congress would rather not, Republicans in Congress see this as, at least optically, a bad thing.

They're talking about tying various conditions on it, the Trump administration doesn't particularly like those conditions. But it's not—pressing Congress on it is not necessarily at the top of the Trump administration's priority list either. And so what happened was, during the Summer, Congress said that they wanted to raise the debt ceiling by the end of August so that they could move on and deal with other things. Well, they got bogged down in healthcare and that didn't happen, so they missed their own deadline.

When they come back at the end of August, they will have a month to fix it. They don't have a plan to fix it yet and it won't fix itself. Now, if you go back in history and say "Well, Okay, usually they fix it." And sometimes they fix it at the 11th hour and it's not pretty and people get a little nervous and then it's fixed. But the point is it won't fix itself.

And it has to be, at some point, brought to the front burner. And the longer—this is an important point, is that even if they do fix it, the longer they take trying to resolve it, is the less time that they have to work on the more substantive aspects of their agenda like tax reform, that I think they would rather be doing, right? And so, Congress—Republicans in Congress right now, I think, are feeling a lot of pressure to deliver on something.

And they're going to want to pass something to do with taxes. The trick is, what will that be? And how much time will they have to cobble that together? Because tax reform—comprehensive tax reform is going to be tricky, it's going to involve a lot of tradeoffs. It's not going to be any easier than healthcare. There are a lot of ideas that are thrown out there and here's the caution to investors reading the news, is that you're going to hear a lot of ideas about tax reform and tax cuts and, how's tax codes going to change?

You're going to hear a lot of ideas thrown out over the next couple of months. And a lot of those are never going to make it into a bill, assuming that there is a bill that's passed. Because they all involve tradeoffs and so there's going to be a lot of horse trading. And at the end, we may have a bill that maybe a majority of Republicans will be happy with, I don't know.

But it will be challenge—a challenging process. So, the longer time that they spend on trying to fix the debt ceiling—and also, by the way, keeping government open, because they have to pass another debt—another budget bill to just keep the government from shutting down. That—the time that they spend doing that is going to be time that's eaten away at the more constructive parts of their agenda.

Robert Teeter: Right. It's a great reminder and I know you've written about it before but I think it's helpful for people to have that, the commentary that you just offered.

Patrick Chovanec: And one thing that I have written about as well, and it was in—we sent out—

Robert Teeter: Economic and market insights.

Patrick Chovanec: Exactly. And one thing that I wrote there was about budget reconciliation process and how that also constrains Congress in terms of what it can pass and how it can pass it without encountering a Senate filibuster. So, there are a lot of things that constrain them is going to make it challenging this Fall to produce what they want to produce.

Robert Teeter: Right. Now, well it—and what's—an interesting takeaway, I think, is sort of coming back to where we started, which is that there's a lot of complexity and a lot of noise going on in the world. But as you've often pointed out, despite all of this, the underlying fundamentals of the economy seem to remain sound and on-track. So perhaps you could update everyone on your thoughts there.

Patrick Chovanec: Well, so this is the interesting thing; so, after the election, there was what was called the Trump Trade. The idea that, Okay, Trump would come in, he would pass—there would be tax cuts, that there would be infrastructure spending, there'd be defense spending. A lot of people—there'd be deregulation. A lot of people interpreted those things as being very positive for the economy and we saw a rally in stocks.

The expectation that a lot of those things will come about easily has receded. And so, the initial spike that we saw in the dollar for instance in reaction to that, in the expectation that the Fed might push back against inflationary growth has now—the dollar's fallen back from its 14-year high that it reached at the end of last year.

And so, what happens when the Trump Train goes away? Well you have the economy that you had before. Which wasn't bad, wasn't stellar, was chugging along not on all cylinders but growth has been sluggish but positive. And so, what's interesting when we look at the economic data is how little things have changed from when we were writing about the economy before the election. That the pace of job growth is essentially the same.

The pace of economic growth is up and down but not that much of a break from the past. The—there are some things that are better than they were last year. For instance, last year there was a big manufacturing slump brought on by the strong dollar that has recovered. And so, manufacturing and non-manufacturing are both in expansion mode right now. And the new order number seems to suggest that will continue for the near future.

Another thing that was a concern was inventory levels were very high last year and that's the kind of thing that can trigger a recession. They've come down. They're still a little elevated but they've come down from the heights that they were at. And so those are positive. There are a couple things that have come along that are new. The auto market. The auto market's cooled off. It was really strong last year.

One of the reasons it was strong is because there was a lot of subprime auto lending. Now, there's been growing concern about that and the pullback. And, that's a sector that has a ripple effect throughout the rest of the economy. And, another one that has a big multiplier effect for the rest of the economy is housing.

And if you look at the second quarter data, the GDP data, the one negative thing was residential investment. And, that's not so much that the housing sector is pulling down the rest of the economy, it's just that it's not taking off. You'll see housing rev up for a quarter or two and then it'll fall back.

So, the question—the issue is not so much housing pulling down the rest of the economy or that there's been this excessive build up, it's why with relatively small inventories, relatively tight inventories in the housing sector why aren't we seeing more construction, why are we seeing this take off in a more consistent way and holds more weight than it is.

So, the concerns about the US economy wax and wane but overall if you look at the market and if you look at the economy earnings are—earnings have supported the market. And, right now in the second quarter with about 85% of the S&P 500 having reported it looks like we're on track for a year on year earnings per share increase, operating earnings of 21%.

Now, a lot of that is recovery from energy because when you have the oil market collapse early—at the end of 2015 early 2016 it took the energy sector down into negative earnings and it pulled the average down into basically an earnings recession last year. That has rebounded.

And so, that's a kind of a one-off story to get that kind of a balance. But, if you look at quarter on quarter earnings per share that's up—or at least we think—it looks like it's on track to be up around 7% from last—from the first quarter to the second quarter. And that's much broader.

In fact, energy looks like it'll be down a little bit. The other sectors, that's what's really pulling that—those numbers up and what that means is that the valuations in the market at least at an average level remain at a price per earnings or P/E ratio of about 21.5.

That has not changed for the past year. So, as the market has gone up, earnings have either recovered or grown to support that on average. Twenty-one times earnings is high. It's historically on the high side. It's more typical of and of the more mature stages of the market than the beginning stages.

Having said that though, compared to the very low interest rates that are the alternative it's still fairly attractive to be in equities. We talked about the equity risk premium, the amount that you're paid in addition to take equity risk on top of what you would earn in a risk-free Treasury bond.

And, historically the average has been 4.1% over the past 50 years. Right now, it's at 5%. Now that is significantly lower than it was, it was at 6.3% before the election. So—and that is before the election we were being paid a great deal to take equity risks. That gap has narrowed but it's still there and it still tends to favor equities. It's still technically—it's not the stocks are cheap it's that seeking a safe harbor is very extensive.

Robert Teeter: Great. Well thank you for that very comprehensive update and insight in terms of where things sit. And being mindful of time we'll maybe turn over the line for questions and then we've received a few questions by e-mail, as well.

We'll turn it back over to the moderator now for questions.

Operator: (Operator Instructions) Martin Leimdorfer, your line is now open.

Martin Leimdorfer: I happen to be in Europe right now and I'm certainly influenced my mind by the very, very strong reaction to the dollar valuation and my question is how do you feel that it will move versus let's say the euro over the next 12 months?

Patrick Chovanec: Thank you. The big driver of the dollar and especially relative to the euro is the gap in expectations between what the Fed will do and what the ECB will do. So, if over the past couple years, the expectation was that he Fed, with the US economy growing, the Fed would be in tightening mode and at different points the expectation was well the Fed will raise rates four times this year.

And that's been a recurring theme. The Fed will raise the rates four times this year. Never quite amounts to that but that kind of expectation attracts capital flows from Europe where, at least in the past the belief was well the economy isn't doing that well. There is disinflation and the ECB has been in full easing mode.

And that has changed in the past year. After the election, actually it was compounded because the belief was that the Trump administration engaged in all kinds of stimulus efforts and that the Fed would actually push back. And that would even attract more capital to the United States and that boosted the dollar to a 14 year high on a trade weighted basis by the end of the year.

Ever since then, that expectation has receded. And, as it's receded it's also a complimented by the fact that Europe's been in a cyclical rebound and the ECB has been talking about stopping QE and maybe even some day tightening. So, the gap between where the Fed is and where the ECB is has narrowed quite a bit. And with that, there's been downward pressure on the dollar, particularly relative to the euro.

I think that will continue as long as those trends remain in place. So as long as we're continuing to see that typical rebound in Europe, which we'll see for a little bit longer, and as long as sort of Trump's more inflationary agenda remains bogged down.

One thing that could change it would be—would be potentially the US—the Congress passing a tax bill. And the larger the tax bill, the more it would change the equation because that would start to bring back that story of US inflation and the Fed having to push back against it. That might cause the dollar to revive a bit. But I think that right now we're on a track of continued modest downward pressure on the dollar relative to the euro.

And the effect of course is—there's two effects. There's the effect on investors, which is that a weaker dollar tends to—it doesn't affect returns in dollar terms, but it certainly affects foreign currency returns and gives them a bit of a buff in US dollar terms. Like just over the past month, markets in Europe were—and in Japan were basically flat, but if you translate it into dollar terms, they were slightly positive because of the—because of the declining dollar.

The other effect that it has is on the US economy, which is it relieves some of the headwinds from a stronger dollar. So, it actually it makes imports a bit more expensive, helps the domestic pricing power of US companies. It means that US exports are more competitive aboard. It also means that the dollar value of foreign earnings for US multinational companies is worth more in their reporting terms, which is US dollars.

And we've started—we've started to see at least the first couple of things I mentioned be reflected in the stabilization of the US trade gap this year. In contrast to what happened in the fourth quarter, which is there was a big blow out in the trade gap because of the strong dollar, and it actually shaved about 1.1 points of GDP throughout the fourth quarter.

So, what a strong or a weak dollar gives with one hand, it takes away with another. I mean, just I think we'll continue to see some downward pressure on the dollar and we need to be conscious of kind of what the—what the tradeoffs involved in that are.

Robert Teeter: Do we have any other questions on the line?

Operator: I'm showing no further questions at the moment.

Robert Teeter: We do have one other question we received in advance by e-mail, and it's really regarding the strong returns we've seen in international and emerging markets this year. I'll maybe open up with just a brief comment on that from kind of a bottom up standpoint, and let Patrick talk about the top down view.

I had the benefit recently of traveling quite a bit as well, nowhere as interesting as North Korea or some of the places that's Patrick's been, but meeting with a number of our investment managers in both Europe and Asia. And one of the things that really stood out was that there does seem to be a very interesting opportunity for stock selection in some of these markets. And I think we've seen that starting to play out here in the US as well this year with active managers doing a bit better job than they have in the past.

But I want to come back to the question specifically, and in particular get your views on the emerging markets, Patrick, and just kind of the top down sense. We've seen markets explode there. I'm just curious to see what your macro outlook is there.

Patrick Chovanec: We do get out and about, and we don't sit here in New York. While you were in Asia, I was in Latin America and in the Middle East and in Eastern Europe;

and kind of getting an impression of where—of where things are going. This year it's very eye catching. The MSCI Emerging Markets Index is up 25% this year. And that's in dollar terms. And part of that is the dollar. So part of that is simply the fact that the dollar boosts non-dollar—declining dollar boosts non-dollar returns.

The other thing that you need to keep in mind is that some of that is a rebound from after the—immediately after the election in November and December of last year, emerging markets took a big tumble because there was a concern as part of this contemplation narrative that there would be dollar tightening and that that would very negatively affect emerging markets. And so, as that Trump inflation narrative receded, it's also led to a rebound in emerging markets.

But that is not the only thing going on. The other thing is that you have—last year a lot of people were concerned about China. I think for very good reasons. The debt that we see piling up there is very problematic, but China poured on the stimulus. And it stabilized the growth numbers for now, I think in a very bad way. I think in a way that reinforces the imbalances of the Chinese economy. But it produced better numbers and so a lot of people are very positive.

Now what's interesting is, though, if you look at Hong Kong as a foreign-listed Chinese shares are [out]. But if you look at the Chinese domestic markets, they're either flat or down. And so, it's a very mixed picture there in terms of what's really happening. But I think maybe at a distance it looks prettier than the reality up close.

In India, there's been a renewal of confidence in reform, that some of the reforms are going to start bearing fruit.

And the same thing is true of Brazil. Brazil's seen some ups and downs because they're going through a big anti-corruption campaign, which is negative in the short run because a lot of big companies are running into trouble and aren't able to get government contracts because of previous bribes and things. A lot of big politicians have gone down.

But in the long run, cleaning that up is very positive, not just for corporate governance and the way the economy functions but also getting necessary reforms passed and on track. And so, we saw—just this year Brazil kind of—it was strongly up last year, it took a tumble when there was a political scandal and then it's back again. And so that process of working through those reforms has supported a positive outlook.

The one that's down this year, really the one market at all that's down this year, is Russia, which is down a little bit over 10%. And that's because of its disproportionate exposure to oil. And also, its exposure to international sanctions. So that's the one emerging market that's sort of pulling things down.

On the whole, my belief—and I've expressed this before—is that you can't throw all emerging markets into a bucket and they're behaving in different ways for different reasons. And some of them are commodity exporters and some commodity importers. Some are helped by high oil price, some are hurt by it. Some are helped by a weak oil price, like India. Some have the reforms on track, others don't. And so, it's a very disparate picture.

And so, it's an argument for active management. You want to have a manager in—you want to be exposed to emerging markets, but you want to have a manager who's able to see those different trends going on and adjust accordingly as opposed to simply treating it like an escalator you ride up or down.

Robert Teeter: Well, thank you, Patrick. And thanks especially to everyone who dialed in to listen today. We'll be producing a transcript of the call and that will be available on our website. Thanks again, everyone, and have a wonderful day.

Operator: Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program. You may now disconnect. Everyone have a great day.