SILVERCREST
ASSET MANAGEMENT GROUP

Economic Review & Investment Strategy: 2015/I

Question Time

"Stocks Slide on Oil, Economic Fears". That's the newspaper headline staring up at me as I sit down to write this note. There's a palpable anxiety as the arrival of a new year shifts people's thoughts from "so far so good" to "what happens next?" The day's headline neatly encapsulates the three question marks we see looming in investors' minds right now:

1) After a six-year winning streak, is the bull market in U.S. stocks too good to last?
2) Will the sharp plunge in the price of oil help or hurt the U.S. economy?
3) Will slowing growth in Europe and China derail the U.S. recovery?

Here, taking them in reverse order, are our answers to these questions, which help explain why we remain optimistic about 2015.

Less Is More

The world economy is flying on one engine right now. Europe is slowing, China is slowing, with prices in both regions stagnant or falling, but the U.S. economy keeps powering right on. However, many are convinced that the downward pull of global "deflation" will eventually, inevitably, drag the U.S. economy down with it. That is why, they argue, we should all be selling our more risk-exposed (and growth-contingent) investments like stocks and taking refuge in safe (but very low-yielding) assets such as U.S. Treasuries and German Bunds.

That straight-line conclusion rests on the unspoken assumption that all growth is good growth, no matter where it takes place or what it consists of. To the contrary, we would argue that much of the investment- and export-led "growth" that is slowing in countries like Germany and China is based on unsustainable imbalances that actually have held back global economic growth, and U.S. growth in particular. A shift to a more balanced growth model is to be welcomed, not feared, and ultimately benefits the U.S. economy.

Take China. In the wake of the global financial crisis, faced with falling demand for its exports, China propped up GDP growth by unleashing the mother of all credit booms. In five shorts years, Chinese banks added $14 trillion—the size of the entire U.S. commercial banking sector—to their balance sheets. This money went mainly into capacity expansion, not end-user demand. As a result, the stimulus was inflationary for commodities like iron ore, but deflationary for many produced goods, like solar panels, where excess supply drove down prices and eviscerated competitors worldwide.

All that overcapacity created a mountain of bad debt, and now China's investment boom is buckling under its own weight. The resulting slowdown in China's capacity build-out has turned the tables, deflating prices for commodities like iron ore (down -47% in 2014), copper (-18%), thermal coal (-25%), and coking coal (-16%)—not to mention the sharp downturn (-50%) in oil. But shutting off the credit valve fueling the supply glut from China will eventually be reflationary for a host of other hard-pressed industries. Meanwhile, China's $4 trillion in foreign currency reserves gives Chinese consumers the ability to keep spending, even if domestic output falters. Together, these translate into lower costs and improved markets for many of the goods and services that drive the U.S. economy.

Faltering growth in Europe isn't good for the U.S. economy, but it isn't as relevant as many imagine. Since 2011, when Europe began to "recover", virtually all Eurozone GDP growth has come from net exports, including a widening trade surplus with the United States. Far from helping U.S. growth, domestic European demand has been stagnant. It's a problem, but it's not a new problem, and propping up export growth with a weaker Euro—siphoning off even more demand from the U.S. —is hardly the answer. What Europe needs is for Germans to save less and spend more, even if, by reducing German trade surpluses, it "subtracts" from GDP. The most effective way to do this would be to split the Euro into at least two currencies. However it's done, rebalancing the growth dynamic within Europe is far better for global growth than supporting the wrong kind of GDP.

Oil Slick

The kind of rebalancing we're talking about—whether in Europe or China—is good for global economic growth, and for the U.S. economy. But it's not good for everyone. Whenever change happens, there are winners and losers. Being on the right side of change is critical for any investor. Nowhere is this more evident than in the precipitous drop in the price of crude oil in recent months.

Most commentary on oil's collapse—from $115 per barrel in June to $58 by the end of the year, and even lower since—has focused on the "supply glut" created by the refusal of Saudi Arabia to cut production in the face of the surge in U.S. output from shale fracking. Yet U.S. production had been rising, and imports falling, for several years without pushing the (Brent) price below a $100 floor. That's because the oil displaced by falling U.S. imports was absorbed by a voraciously energy-hungry China. From 2003 to 2013, Chinese oil consumption grew at an average annual rate of 6.2%, accounting for 45% of the entire increase in global demand; imports nearly tripled. When China's investment boom faltered, that growth fell off sharply, to just 1.4% in 2013. Many thought that number would rebound in 2014. By summer it became clear this would not happen, and the price of oil—like iron ore, copper, and coal—began to fall.

For the U.S. economy, cheaper oil prices are a decidedly double-edged sword. The shale revolution has propelled the U.S., as of 2014, past Saudi Arabia to become the top oil producer in the world. Although most drillers hedge selling prices for several months out, any sustained drop in prices will hit the earnings of U.S.-listed oil producers, large and small. If the domestic price (now at $48) falls below the cost of production (which varies widely by region, from $25 to $80, and averages $34), companies will cut back the number of new wells they drill, cutting jobs and investment. Even if they can make a profit, oil producers might have trouble borrowing enough money, cheaply enough, to keep up the pace of production. The oil and gas sector accounts for just over 10% of U.S. business investment, up from about 4% a decade ago. Oil and gas-related jobs (broadly defined) make up just 0.6% of total U.S. employment, but account for 4% of all new jobs created in the past five years. Perhaps more importantly, they pay up to double the average wage. Banks that lent to more vulnerable oil producers could suffer losses. Energy company debt now accounts for over 15% of the U.S. high-yield bond market, compared with less than 5% in 2006. Fears of default—the cost of insuring energy bonds has tripled since June—could widen spreads and punish high-yield bond prices in other sectors as well.

Still, we agree with most economists—including those at the Fed—who calculate that cheaper oil prices will have net positive effect on U.S. growth. Lower prices at the gas pump could put as much as $125 billion back into consumer wallets to spend, which might explain why retail sales saw a big jump in November. They also translate into cheaper food prices (modern farming is very fuel-intensive) and lower shipping costs for virtually every product imaginable. The physical volume of oil shipped via U.S. pipelines and railroads may not necessarily shrink; it could even grow. Meanwhile, cheaper fuel should boost airline profits, as well as toll road and airport bonds. The key for investors is to identify the likely winners and losers, and invest accordingly. For the shrewdest investors, that includes identifying stocks and other assets that have been mistakenly lumped in with the "losers" and oversold. Silvercrest's bottom-up, fundamental analysis focused on value should benefit investors in such an environment.

The Texas oil bust of the 1980s may be a useful reference point to keep in mind. At the time, the oil and gas sector accounted for roughly the same share of that state's economic output as it does today. Thousands of jobs were lost, the regional property market tanked, and hundreds of local banks failed—helping to trigger the infamous Savings & Loan crisis. But the national economy kept growing quite strongly, aided—in part—by cheaper energy prices. And the U.S. stock market saw one of its strongest bull markets in history.

The promise of the shale revolution was never merely the drilling boom it unleashed, but the cheaper energy prices that would follow. It's worth remembering that the domestic U.S. price for natural gas collapsed years ago, putting immense pressure on gas-oriented drillers. Ultra-low gas prices brought on a boom in building new gas-fired electrical plants, as well as new petrochemical facilities (relocated from Europe and Asia). They also opened up export opportunities yet to be tapped. With the steep drop in oil prices, the shale revolution is entering a new, more mature phase. The "gold rush" is over; U.S. drillers must now find a more sustainable footing in a global market awash in the bounty they themselves have created.

One thing that should help them is technology. We often talk about "fracking" as though it were a one-time advance, which now lies in the past. In fact, the shale revolution arose from a whole set of inventive pathways—some reaching back to the 1860s—that converged and achieved critical mass only recently, and are still seeing continuous improvement and innovation. The drop in oil prices will likely have two effects. First, it will slow the spread of fracking to exploit shale reserves outside the United States. Second, it will push U.S. oil producers to innovate all the more, in order to reduce costs and improve the productive output of each well they drill. Ironically, the combined effect may be to solidify America's already formidable competitive edge in low-cost energy, which will aid consumers, manufacturers, and domestic oil producers alike.

Aging Bull

Five times in 2014, the market experienced fits of anxiety that sent U.S. shares sharply lower. Each time, the fears were rooted in developments abroad, and how they might affect the U.S. economy, rather than disappointing U.S. data. Each time, the U.S. stock market rebounded just as sharply to achieve new highs, when the data showed the U.S. economy remained on track.

Bull markets don't die from worrying, and they don't die from old age. (The bull market that followed the 1987 crash ran for more than 12 years, and saw the S&P 500 go up seven-fold). Two things bring bull markets to an end: a recession, or the Federal Reserve raising interest rates.

Neither the Conference Board's nor the Philadelphia Fed's index of leading indicators suggest any impending slowdown in the U.S. economy. GDP growth in Q3 registered an eye-catching 5.0%, with every major component—consumption, business investment, housing, government spending, and net exports—making a positive contribution. Employers added an average of 289,000 jobs per month in Q4, reducing the unemployment rate to 5.6% (from 6.7% a year ago), and making 2014 the best year for job creation since 1999—although wage growth remained weak. It was also the biggest year for new U.S. stock listings (IPOs) since 2000—a trend strongly linked to job growth. Despite a strong dollar, the U.S. trade deficit fell to an 11-month low in November, as the country's reliance on imported oil fell to its lowest point in 20 years. In December, the ISM Manufacturing Index eased off the frantic highs it hit in previous months, but remained in strong expansion territory at 55.5 overall and 57.3 for new orders. Its companion, the non-manufacturing Business Activity Index, was also solid at 57.2.

The Federal Reserve is likely to raise interest rates sometime in 2015. When it does, the Equity Risk Premium (ERP) should provide a cushion for U.S. share prices. ERP measures the "extra" return investors must earn to be willing to hold stocks instead of "risk-free" U.S. Treasuries. In 1999, when dot-coms had everyone bubbling over with confidence, the premium fell to 2.1%; in early 2009, when everyone expected the world to end, it shot up to 7.7%. Today, ERP has come down a bit to 5.8%, still well above its (50-year) historical average of 4.1%. The Fed has made it very clear that it will only raise interest rates if the economy continues to improve. If that happens, the risk premium should fall as rates rise, absorbing the effect on share prices. Alternatively, if the economy doesn't inspire greater confidence, the Fed has no cause to raise rates. Either scenario is supportive of current equity valuations.

There is a lot of trepidation right now as companies begin to report their year-end earnings. Earnings estimates for Q4 have fallen dramatically, from 8% year-on-year growth to 2%, dragged down by energy and related sectors. Nevertheless, even if Q4 does see the setback people fear, the S&P 500 Index will have ended the year with its 12-month trailing P/E ratio at 17.9, only a modest increase from 17.2 a year ago. Most of the S&P 500's gains in 2014 were based on improved earnings, not rising multiples. We expect the same to hold true this year. Given that the energy sector weighs more heavily on the S&P 500 than on the overall economy, we project that EPS will grow at a more moderate rate of 5% in 2015, with the index gaining in tandem, and non-energy sectors delivering better-than-average returns. That said, energy-related sectors may present value opportunities as they become oversold.

Throughout his career, Warren Buffett often responded to worried investors who wrote to him about all the uncertainty they were seeing in the economy and world affairs, asking whether they shouldn't pull their money out of the market and put it on the sidelines until the storm clouds moved on and the future looked more certain. "The future is never clear," he told them. "You pay a very high price in the stock market for a cheery consensus. Uncertainty is the friend of the buyer of long-term values." The storm clouds NEVER go away. If you wait for them to clear, you will be waiting forever, and will miss the reward as well as the risk—as many investors did following the financial crisis. That's not an argument for blindly making investments. It's a case for making educated choices about which risks are worth taking.

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ECONOMIC FORECAST
(As of January 12, 2015)

	2012	2013	Estimated 2014	Projected 2015
Real GDP (Y-O-Y)	2.3%	2.2%	2.5%	3.0%
Consumption Expenditures	1.8%	2.4%	2.4%	2.8%
Business Fixed Investment	7.2%	3.0%	6.7%	6.5%
Inventory Investment (Billions)	$57.0	$63.5	$67.0	$55.0
Residential Investment	13.5%	11.9%	2.2%	6.5%
Government Spending * (Billions) (a)	$2,953.9	$2,894.5	$2,890.0	$2,890.0
Trade Balance-Goods & Services (Bil.)	($537.6)	($476.4)	($500.0)	($480.0)
Federal Budget*: Unified (Billions)	($1,087.0)	($679.5)	($483.4)	($469.0)
Gross Federal Debt* (Billions)	$16,050	$16,719	$17,804	$18,426
Consumption Price Deflator	1.8%	1.2%	1.5%	2.3%
Producer Price Index (Finished Goods)	1.9%	1.2%	1.0%	1.6%
Consumer Price Index	2.1%	1.5%	2.0%	2.4%
Industrial Production	3.3%	3.3%	5.2%	4.5%
Real Disposable Income	3.0%	(0.2%)	2.2%	2.9%
Hourly Compensation	2.7%	1.1%	2.4%	2.7%
Unit Labor Cost (Non-Farm)	1.7%	0.3%	1.4%	1.0%
Productivity Growth (Non-Farm)	1.0%	0.9%	0.9%	0.6%
Personal Savings Rate (% DPI)	7.2%	4.9%	4.8%	5.6%
Capacity Utilization – Total Industry	77.3%	78.0%	79.2%	80.4%
Trade Weighted $ Exchange Rate (b)	3.8%	3.3%	3.3%	1.5%
Vehicle Sales (Million Units)	14.4	15.5	16.4	17.0
Housing Starts (Million Units)	0.781	0.925	0.993	1.180
Civilian Employment (Millions)	142.5	143.9	146.3	148.5
Civilian Unemployment Rate	8.1%	7.4%	6.2%	5.4%
Corporate Profits – After Tax – NIPA	17.8%	4.7%	4.3%	4.0%
S&P-500 Earnings-Operating	$104.29	$107.30	$115.00	$120.75
S&P-500 Dividends	$31.25	$34.99	$39.44	$43.00
90 Day U.S. Treasuries-Yield (%)	0.01-0.11	0.02-0.12	0.01-0.08	0.02-0.30
10-Year U.S. Treasuries-Yield (%)	1.39-2.38	1.55-3.00	2.07-3.01	1.90-3.40

**Fiscal Year-end 9/30. (a) Federal, State, and Local; in 2009 dollars; (b) Fed Major Currency Exchange Rate.*

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