



SILVERCREST
ASSET MANAGEMENT GROUP

ECONOMIC REVIEW & INVESTMENT STRATEGY: 2015/II

These are the days of miracle and wonder
Don't cry baby, don't cry don't cry.

– Paul Simon, “The Boy in the Bubble” (1986)

When you follow markets from day to day, week to week, month to month, it’s easy to lose sight of the big picture. The immediate preoccupations driving market sentiment are important, no doubt, but often not as important as we like to imagine. The fact is, five years from now, no one will be talking about whether the Fed raised interest rates in June or in September.

Interest rates, exchange rates, inflation—these are the play’s scenery, not its plot. They set the mood, not deliver the action. The “lead players” are the new ideas and new technologies that create new fortunes and destroy old ones, even as the scenes change. For the long-term investor, who would like to be richer in 2020 than today, there is one question that overshadows all others: where is value being created in the economy?

The search for value-creation isn’t about jumping onto the hottest new tech stock, or cashing in on the latest gee-whiz product. Technological change creates ripple effects whose most profound (and rewarding) impact is often felt in industries we don’t usually consider “high tech”. Walmart didn’t invent the bar code scanner—which was an off-the-shelf technology available to anyone—but it used scanning to cut inventory costs while keeping its shelves fully stocked, trouncing the competition. Sometimes ground-breaking innovation doesn’t have to be based on new technology. The humble 20-foot shipping container—basically just a corrugated metal box—is hardly a space-age marvel, but its adoption, starting in the 1950s, made global supply chains possible. If you could go back in time, and see these patterns taking shape, you could make millions—*regardless of the business cycle*.

What are the truly transformative innovations that will unlock opportunity in the years ahead? Here are ten trends that we think will have outsized importance:

1) **Computing power is fast turning from a product into a utility.** There are two ways of selling people electricity: one is to sell everyone their own generator, the other is to build a huge power plant and charge people for plugging into your (much more efficient) network. Not so long ago, the information technology (IT) industry made its money by selling everyone their own computers, and the software to run them. Today, using the mobile internet, people are able to use less powerful, more user-friendly devices to access virtually unlimited computing power and resources at huge data processing centers (aka, “The Cloud”). The winners are savvy device

makers and “app” developers, able to connect consumers to technology, and large-scale data crunchers (like Google and Amazon) who are using that scale to deliver cheap computing power to anyone who “plugs in”. The potential losers are the giants of IT who thrived on the old industry model, and are now struggling to adapt.

2) Everything will be connected—whether we like it or not. One promising new direction for traditional IT providers is what they call “the internet of things”: the idea that all devices, even your toaster, will become “smart” devices, embedded with chips capable of receiving remote instructions and sending back location and diagnostic data. In fact, this is fast becoming a reality, and the upside—in terms of energy efficiency, maintenance, safety, and convenience—is immense. But the ability to track, store, and even sell data about your movements, transactions, and even health condition raise profound privacy concerns. Furthermore, anything that is connected online can be hacked: your toaster ...or an aircraft engine, or a power plant. The risk from cyber attack is not just compromised data, but possibly deadly malfunction. In this new, always-connected world, providing cyber-security will be a growth industry.

3) Data is the product. We recently were told about a company in China that performs thousands of medical check-ups a day, cranking them through an assembly line. An interesting low-margin, high-volume service model, we thought. But no, the company doesn’t make its money charging for check-ups, but by selling (legally, we presume) the valuable personal data it gathers in the process. For most companies, gathering and processing data is a cost that must be incurred to deliver something else that people want and are willing to pay for. Increasingly, entrepreneurs are turning this model on its head, offering goods and services at cost, or even for free, in order to capture data. For many companies, the data they gather from customers, not the sales they generate, will become their primary value proposition.

4) Digitization is making pricing a lot more difficult. For physical products, each unit costs something to make and distribute. Selling a million record albums costs a lot more than selling a thousand, and—while there are benefits to scale—the price tends to reflect the incremental costs that all sellers have roughly in common. When you sell a song (or a book, or movie) in digital form online, though, the marginal cost is close to zero. Some futurists believe this will lead to an economy where the sharing of free goods replaces market transactions. This ignores the fact that songs, books, and other digital “content” require a large up-front investment to create in the first place. Digital replication widens the gap between superstars, who can sell infinite units at almost pure profit, even at pennies a sale, and also-rans, whose more modest sales could easily fail to cover the same fixed costs. The problem of pricing goods that are costly to create but costless to reproduce looms like a cloud over the otherwise promising media and entertainment industry.

5) Moving things around will become more, not less, important. All this talk about data, digitization, and wireless connectivity might lead you to conclude that in tomorrow’s economy, the physical world will be less important. To the contrary, throughout history, communications and transportation have advanced in tandem. The telegraph and the railroad literally developed alongside one another. The telephone and the automobile facilitated a shift from centralized, linear connections to greater dispersion and mobility. Real-time global communications via satellites and computers made global supply chains and just-in-time inventory management

possible. The corollary to buying goods by mobile wireless internet is delivering them, wherever the customer happens to be, by wireless-enabled technologies like driverless vans and pilotless drones. In the meantime, it's no coincidence that Amazon hired the U.S. post office to stay open on Sundays. Real-life logistics is more important than ever.

6) Intelligent machines will do more and more of the things people now do. Barely a few years ago, researchers despaired of ever getting computers to perform some of the most routine tasks that humans do, such as driving a car or translating two languages. They were too subtle for binary brains to grasp. Today, computers are overcoming their lack of subtlety through sheer number-crunching brute force. Computers are now able to recognize photos and diagnose diseases—often better than people can. They are already writing many of the news articles you read (we just received a call the other day from a company that has computers write investment notes for clients, which sounded pretty tempting). The big losers, of course, are the people whose skills are rendered obsolete by machines. The big winners are the manufacturers of “smart” machines and their components, such as the sensors they use to interact with their environment, as well as the people who put those machines to creative use.

7) 3D printing will unleash a creative revolution. Genius is 1% inspiration and 99% perspiration. But what if you could lower the barrier between an idea and its realization? 3D printing promises to do that. The overlooked key to the original Industrial Revolution was machine tools—machines to make other machines. But they were expensive and restricted to factories. 3D printers aren't cheap—yet—but they are more flexible. Chefs can use them to “print” elaborate custom-designed pastries. Children can use them to “print” their own toys. Inventors can use them to “print” prototypes, reducing the time from concept to full production, as well as the need for costly design changes. It's no exaggeration to say these machines could lay the ground for a Second Industrial Revolution.

8) Climate change cannot be stopped, only managed. Put the politicized debate aside. Whether climate change is man-made or not, whether it's an age-old process or something strikingly new, the Earth's climate is changing. And if humans burning fossil fuels is the reason, that's not going to stop anytime soon. Even if the political will existed in developed countries, emerging economies such as China and India are on track to consume more energy, not less. Green technologies might help, but they offer no silver bullets. Nobody wants to say it, but we are going to have to adapt. That means large-scale investments to protect our existing investments from rising sea levels and extreme weather events. Droughts, like the current one in California, will turn water from being a “free” public resource into an ever more market-based commodity. Climate change will create new opportunities as well as challenges, by opening up new trade routes and new crop regions. Ultimately, advances in geo-engineering may give us the ability to control climate to our wishes. Meanwhile, in Stephen Hawking's words, “Intelligence is the ability to adapt to change.”

9) Genomics will extend the human lifespan, perhaps indefinitely. How would you like to live forever? That's what some venture capitalists are pouring money into: gene therapies that promise to halt aging, perhaps even reverse it. Even if this ambitious goal eludes them, new gene-based treatments for cancer, heart disease, and Alzheimer's are likely to add years or even

decades to our active lifespans. The impact on demographics, and hence the economy, could be profound. People will have to save for longer retirements, or work longer. Older people will spend more, on longer and more active lifestyles. The transition from childhood to adulthood will be pushed back even later, with young people living with their parents longer and devoting more years to education. The result will be lower rates of household formation and childbirth—key drivers for some sectors of economy, like housing. So enjoy your longer life—but keep in mind the impact it will have on where and how to invest.

10) Company lifespans, on the other hand, will grow shorter and shorter. The traditional model of valuing stocks assumes that companies, after an initial period of high growth, eventually settle down to a long and comfortable tenure as a “going concern.” In the past, this was probably realistic: even firms that went out of business, like RCA and PanAm, enjoyed several decades of prosperity before succumbing to competition. Today, we wouldn’t count on it: more and more companies like Blockbuster Video soar, flame out, and crash in the course of a single decade. Some firms are able to negotiate the rapids by regularly re-inventing their business models. But it’s fair to say that, in fast-changing sectors, even dominant players are often just one bad decision—or indecision—away from going the way of the dinosaurs. In this environment, maybe it makes more sense to value some companies as projects of a few years’ duration, with zero terminal value, or perhaps some option value on its continued existence. In any event, our past assumptions are due for re-evaluation.

While Silvercrest is not a “thematic” investor, awareness and insight into these trends informs our bottom-up analysis of how companies are positioned to create value in the future. It also bolsters our confidence that, whichever way the economic winds blow, real investment value is out there waiting to be found.

Market Headwinds

Turning our eyes back to the immediate present, we see the U.S. economy and U.S. markets facing some strong—but likely temporary—headwinds. The strong Dollar is having a negative effect on U.S. exports and corporate earnings abroad. Lower oil prices are forcing U.S. producers to slash investment in new drilling and equipment. And so far, U.S. consumers have tended to save rather than spend the windfall from lower fuel prices.

Add some difficult weather and a major port strike, and the Atlanta Fed projects that U.S. GDP growth for Q1 will be 0%. In its March statement, the FOMC tempered its earlier conviction that the economy is “strong,” noting that growth “has moderated somewhat.” The ISM Manufacturing index has cooled steadily from 57.6 in November to 51.5 in March (>50 signifies expansion). Durable goods orders fell -1.4% in February, up barely +0.5% from a year ago. Retail sales fell for the third straight month in February, by -0.6%, up +1.4% from the year before. However, auto sales, which also declined in February, rebounded to a healthy annual rate of 17.5 million units in March (up +4.2% from a year ago). The housing market, which had been a weak spot, is also showing a strong rebound, with new home sales in February up +7.8% from

January, to their highest level in seven years, up +24.8% from a year ago. (Existing home sales also showed more modest improvement, up +1.2% from January, up +4.7% from a year ago).

Signs of softness in the U.S. economy have reduced expectations for Fed tightening and relieved some of the pressure pushing up the U.S. Dollar, which fell -1.4% (on a trade-weighted basis) from its peak in mid-March. Nevertheless, the strong Dollar has had a clear impact. Although the U.S. trade deficit narrowed in February, due to cheaper oil imports, exports fell by -1.6%, to their lowest level since October 2012. Even as U.S. non-financial corporate profits in Q4 rose +1.4% from Q3 and +7.8% from the year before, profits from overseas fell -8.8% from Q3 and -11.6% from a year ago. The S&P 500, which earns about 40% of their profits overseas, took a number of write-downs in Q4 that brought 12-year trailing earnings growth down from +12.0% year-on-year to +5.4%. That disappointing earnings performance pushed the index's P/E ratio up to 18.4x at the end of March, which may explain why share prices have had difficulty sustaining advances.

In the face of these headwinds, we counsel patience. We do not think that the U.S. economy will tip into recession, or that the bull market is over. But it has entered a new, more mature stage. In the early stage, rising expectations boosted valuations across the board, like a rising tide lifting all boats. Now, share gains depend on real earnings performance, and that performance is highly uneven. It's an environment that, for the first time in a while, favors small-cap stocks, which are less exposed to currency movements and should benefit from increased M&A activity in recent months. Indeed, the Russell 2000 has outperformed, rising +4.0% so far this year. But even more importantly, it's an environment that favors active, intelligent stock-picking over riding the index. This is not a market where investors can afford to be passive.

April 9, 2015

Patrick Chovanec
Managing Director, Chief Strategist

This communication contains the personal opinions, as of the date set forth herein, about the securities, investments and/or economic subjects discussed by Mr. Chovanec. No part of Mr. Chovanec's compensation was, is or will be related to any specific views contained in these materials. This communication is intended for information purposes only and does not recommend or solicit the purchase or sale of specific securities or investment services. Readers 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, as the implementation of any financial strategy should only be made after consultation with your attorney, tax advisor and investment advisor. All material presented is compiled from sources believed to be reliable, but accuracy or completeness cannot be guaranteed. © Silvercrest Asset Management Group LLC



SILVERCREST
ASSET MANAGEMENT GROUP

ECONOMIC FORECAST
(As of April 9, 2015)

	<u>2012</u>	<u>2013</u>	Estimated <u>2014</u>	Projected <u>2015</u>
Real GDP (Y-O-Y)	2.3%	2.2%	2.4%	2.5%
Consumption Expenditures	1.8%	2.4%	2.5%	2.5%
Business Fixed Investment	7.2%	3.0%	6.3%	4.8%
Inventory Investment (Billions)	\$57.0	\$63.5	\$65.2	\$55.0
Residential Investment	13.5%	11.9%	1.6%	5.0%
Government Spending * (Billions) (a)	\$2,953.9	\$2,894.5	\$2,889.7	\$2,900.0
Trade Balance-Goods & Services (Bil.)	(\$537.6)	(\$476.4)	(\$504.7)	(\$500.0)
Federal Budget*: Unified (Billions)	(\$1,087.0)	(\$679.5)	(\$483.4)	(\$467.5)
Gross Federal Debt* (Billions)	\$16,050	\$16,719	\$17,792	\$18,472
Consumption Price Deflator	1.8%	1.2%	1.3%	1.5%
Producer Price Index (Finished Goods)	1.9%	1.2%	1.9%	1.6%
Consumer Price Index	2.1%	1.5%	1.6%	1.5%
Industrial Production	3.8%	2.9%	4.2%	4.0%
Real Disposable Income	3.0%	(0.2%)	2.5%	2.9%
Hourly Compensation	2.7%	1.1%	2.5%	2.7%
Unit Labor Cost (Non-Farm)	1.7%	0.3%	1.7%	1.0%
Productivity Growth (Non-Farm)	1.0%	0.9%	0.7%	0.6%
Personal Savings Rate (% DPI)	7.2%	4.9%	4.8%	5.6%
Capacity Utilization – Total Industry	77.3%	78.0%	79.1%	80.0%
Trade Weighted \$ Exchange Rate (b)	3.7%	3.3%	3.3%	5.0%
Vehicle Sales (Million Units)	14.8	15.9	16.8	17.0
Housing Starts (Million Units)	0.781	0.925	1.003	1.150
Civilian Employment (Millions)	142.5	143.9	146.3	148.7
Civilian Unemployment Rate	8.1%	7.4%	6.2%	5.4%
Corporate Profits – After Tax – NIPA	17.8%	4.7%	3.8%	4.0%
S&P-500 Earnings-Operating	\$104.29	\$107.30	\$113.02	\$115.00
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	1.68-3.00

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