SILVERCREST
ASSET MANAGEMENT GROUP

ECONOMIC REVIEW & INVESTMENT STRATEGY: 2015/IV

There's something happening here
What it is ain't exactly clear
There's a man with a gun over there
Telling me I got to beware

- Buffalo Springfield, "For What It's Worth" (1967)

Markets are unsettled. Investors look around and see a number of big changes in the global economy—a slowdown in China, sharp falls in the price of oil and other commodities, the Fed looking to raise interest rates—that appear threatening. They see a number of data points—disappointing earnings, job cuts, cancelled projects—that seem to confirm their fears that the world could be sliding back into recession. Their response is confusion and anxiety—and the worst quarter for stocks in the U.S., Europe, and Asia in four years.

There *is* something happening here, but there's a lot that, in our view, is unclear to the typical investor that they are getting wrong. The broad sell-off of recent months has been dominated by several misconceptions, notions that have contributed either to misplaced fears or to a failure to make crucial distinctions between who wins and who loses from the changes that are so evidently taking place.

WHAT MARKETS ARE MISSING

When markets misprice risk, they create opportunity. The following are nine misconceptions that we see leading the market astray, creating either opportunities for investors, or pitfalls they need to avoid:

1. Slower China growth means slower global growth.

It seems logical to assume that when the world's second-largest economy slows, that must be bad for everyone. But when Japan—the world's second-largest economy at the time—went from boom to stagnation in the 1990s, it didn't derail the global economy. That's because, for most of its trading partners, Japan's export-led economy was a growth deriver, not a growth driver. The same has been true for China.

Markets tend to assume that all growth is good growth, no matter where it takes place, or what it consists of. In fact, much of the "growth" China has seen in recent years has been bad growth: a binge of over-investment fueled by excessive credit. While it may have boosted certain industries, this bacchanalia sapped global growth by generating huge overcapacity and

contributing to the global glut of supply over demand. China faces a long and painful adjustment, but having produced more than it consumed for years, it can afford to support consumption, even as output falters.

While China's imports of raw materials like copper and coal have fallen sharply, the amount of food its households import is up +24% so far this year. The volume of imported soybeans, the top U.S. export to China, is up +10%. Caterpillar's sales of equipment to fuel China's faltering construction boom may be down this year, but Apple's iPhone sales in China are up +75% and Nike's sales have jumped +30%. Both the number of Chinese tourists traveling abroad (116 million in 2014) and the amount they spend ($200 billion this year) are expected to double by 2020. As the Chinese are forced to rein in the wrong kind of growth, redirect their energies in more productive directions, and draw on their collective savings to see their way through, they not only set China on a more sustainable growth path, but become what the global economy, including the U.S., most needs: a source of final demand.

2. Weaker commodity prices reflect a weaker global economy.

Back in the day, "Dr. Copper" was a reliable indicator of the health of the U.S. economy. With copper down -21% so far this year, to a 6 1/2-year low, that would have implied shrinking demand and slowing growth at home. That was then, this is now. Today, the price of copper, iron ore, and other industrial inputs reflects the pace of China's runaway investment boom, and their sharp drop spells relief for many economies, including the U.S.

China's investment binge bid up the price of inputs, but pushed down the price of many outputs by creating massive overcapacity. (The most vivid example was the solar sector, where Chinese manufacturers built so much capacity they first drove the Americans out of business, then drove the Europeans out of business, and finally drove themselves out of business). The end of China's investment binge is having the opposite effect: deflating the price of inputs, and eventually reflating the price of outputs. Rather than signaling broad deflationary pressure, as many fear, the drop in commodity prices signals a sea change in the prevailing terms of trade that certainly hurts some sectors of the global economy, but favors a great many others, and on balance is supportive of U.S. growth.

3. U.S. corporate earnings are falling.

In Q2, operating earnings per share (EPS) for the S&P 500 index was down -11% from the year before. This figure, however, disguises a number of trends. While EPS dropped in 4Q14 and 1Q15, it actually rose +1.3% in 2Q15 as the dollar stabilized and the U.S. economy rebounded, though not enough to make up lost ground. Meanwhile, unadjusted after-tax corporate profits for the economy as a whole rose +6.4% in Q2, up +8.5% from a year ago.

S&P 500 earnings were pulled down mainly by the energy sector (-104.3% from a year ago), along with materials (-15.6%) and industrials feeding into those sectors (-2.2%)—exactly what one would expect from the end of China's investment binge. Six out of 10 sectors in the S&P 500 actually had higher EPS than a year ago, including utilities (+12.5%), consumer

discretionary (+9.5%), and IT (+4.0%). The great disparity in earnings performance among sectors and among firms drives home the fact that while the bottom is *not* falling out of the U.S. economy, the days of passively riding the major indices are over, and we have entered a market that places a premium on wise selection of stocks.

4. QE is good for stocks.

Early this year, the "smart money" said European stocks would outperform because quantitative easing (QE) by the ECB would boost exports and earnings, as well as valuations. Even in Euro terms, growing doubts about QE's effectiveness in reviving growth have pulled both Germany's DAX and the Eurostoxx 50 down -1.5% year-to-date. Add currency depreciation, and for a U.S. investor, the DAX has lost -8.9% and Eurostoxx 50 -8.8%, compared to -6.7% for the S&P 500.

The idea, now losing steam, was that the Eurozone would replicate Japan's QE-driven stock market rally, with the Nikkei 225 nearly doubling since Abenomics was launched three years ago. But in dollar terms, even Japan's rally loses much of its shine, up +27.5% compared to +33.3% for the S&P 500 over the same 3-year period. Smart investors could have also shorted the Euro or the Yen, and many did, but their returns came from their currency bet, not equity out-performance in real terms. All of which reinforces our rather old-fashioned belief that fundamentals, not monetary head-fakes, are what have a lasting effect on markets.

5. Fed tightening will cut the legs out from under U.S. stocks.

There are some who argue that Fed QE was the prime mover behind the bull market in U.S. stocks, and the moment the Fed hikes rates, the party's over. QE undoubtedly nudged the stock market towards higher valuations, but it's worth noting that 85% of the money the Fed pumped into the banking system stayed there, as idle reserves, and never circulated, while the money that did was not constrained to flow into stocks, or even remain in the U.S. The 12-month trailing P/E ratio for the S&P 500, while pricey in recent days due to earnings disappointments, never strayed outside of its normal historical parameters, and the implied equity risk premium (ERP), at 6.6%, remains well above its historic average of 4.1%.

The Fed has clearly signaled, with its latest decision, that it is in no hurry to raise rates until it sees clear signs of sustainable economic momentum. At that point, a shrinking risk premium should help cushion equity valuations, as the higher cost of capital is offset by an improving growth outlook. Rising rates are not to be feared if they reflect growing confidence in the economy. Until then, we expect the Fed to remain patient in keeping rates low.

6. China selling U.S. Treasuries will cause interest rates to spike.

When China announced that its foreign exchange (FX) reserves fell by a record $94 billion in August, some analysts were thoroughly alarmed. They argued that China selling U.S. Treasuries could remove demand from the market, drive up interest rates, and sink the U.S. economy. Fortunately, that's not how it works.

The reason China draws on its FX reserves is to meet a demand for dollars. The dollars it receives for selling Treasuries don't disappear, they just change hands. They are used to pay for imports, or fund investments abroad—actions that help drive economic growth. In the process, the amount of dollars available to purchase Treasuries, among other things, is not reduced. And if their new recipients find more productive uses for those dollars than stashing them in Treasuries, causing interest rates to rise, that's all for the better.

Over the past year, China's FX reserves have fallen by nearly half a trillion dollars, much of that surely in Treasuries. Other emerging markets, hit by lower commodity prices, have been selling down reserves as well. Yet 10-year U.S. Treasury rates are actually 45 basis points lower than a year ago, falling from 2.49% to 2.04%. Even in August, as China's FX sell-off intensified, 10-year Treasury rates barely moved, from 2.18% to 2.22%. Clearly the dollars that China and others are using to make payments are making their way, for better or worse, right back into Treasuries.

7. The U.S. is bearing the brunt of lower oil prices.

After the Saudis refused to cut production to support oil prices, many concluded that their aim was to drive U.S. shale producers out of the market. If so, it hasn't worked out that way. The shale industry has proven remarkably resilient and adaptable. Some experts estimate that their average break-even cost of production has fallen from $80/barrel to $40-50. While the number of U.S. drill rigs has fallen dramatically, oil output kept rising until very recently, indicating that shale drillers have been making great strides in maximizing output per well.

The failure of U.S. shale producers to capitulate in the face of lower prices has shifted the burden of adjustment—or staying in the game at a loss—onto other higher-cost producers, like Norway's offshore fields and Canada's oil sands. Even if petro-states like Russia, Iran, and Venezuela keep pumping oil at lower prices, it means giving up much-needed revenue they were counting on. To be sure, U.S. producers haven't remained unscathed—witness the recent decision by Shell to scrap its offshore drilling plans in Alaska—but they aren't the "fall guys" many had expected.

It's important to keep in mind that, for the U.S., the "shale revolution" was always about cheap energy, not just a drilling boom. Most economist still estimate that, as the world's largest oil consumer, the U.S. gains about +0.5% in annual GDP growth from the recent fall in crude prices. It's not just cheaper gas at the pump, it's lower costs for transportation and farming. And when countries like Saudi Arabia turn to debt markets (as they have been) to maintain spending levels in the face of lower oil revenues, that reduces the global savings glut and adds to net demand, which—just like China's rebalancing—helps rather than hurts global growth.

8. Emerging Markets either are—or aren't—the place to be.

There isn't a day that goes by that we don't get asked whether investors should be "underweight" or "overweight" Emerging Markets (EMs). That question might have made sense prior to 2009, when most EMs tended to rise and fall in tandem, providing a potential counter-

story to more developed markets. Since then, however, EMs have really dispersed, driven in different directions by completely different dynamics.

Some EMs are commodity exporters, others are commodity importers. Some run trade surpluses, others run trade deficits that must be financed, which make them potentially vulnerable to future Fed rate hikes. Some are driven mainly by demand from China, others by Europe, and others by the U.S. Some are making progress on vital reforms, others have backtracked.

These dramatically different—and often opposing—trajectories are often ignored when "the herd" gets an idea in its head about "Emerging Markets", which means that entire countries often get lumped into the wrong crowd. It also means that a broad, passive strategy of allocating to "Emerging Markets" is virtually meaningless, unless it feeds into active strategies aimed at distinguishing winners from losers, and capitalizing on the failure of others to do the same.

9. The market is just too scary—it's time to go "risk off".

The term "risk off" offers the reassuring impression that it's possible to "take your money off the table" so that, even if you don't make much money, you won't lose much either. The risk-on/risk-off dichotomy is based on the idea (often true) that at different points in the business cycle, people pile into higher risk-assets (like stocks), leaving lower-risk assets (like bonds) attractively priced, or vice versa. If you anticipate the rotation, you can buy low and sell high.

In recent years, however, central banks have purposely bid up "risk-free" assets in order to push investors into taking more risk—making both risk-on and risk-off assets equally pricey. If stocks make you nervous at 18-times earnings (compared to a 60-year median of 16.4x), 10-year Treasuries at 2.0%—an implied P/E ratio of 50x, compared to a 60-year median of 17.8x—aren't exactly cheap. Even a modest increase in interest rates could translate into sizable losses. Putting your money in cash (zero-interest Treasury notes) also implies both an opportunity cost and a conviction that, despite a 4.5-fold increase in the monetary base, the dollar will retain its purchasing power against real assets and other currencies. That position may make sense, but it is a *position*. In this market, whether it's stocks versus bonds, paper versus real assets, or one currency versus another, there is no way to avoid risk entirely, only a careful choice of which risks make the most sense.

Misconceptions can be intensely frustrating to investors who see through them. As long as enough people believe them, they can move markets as though they were true. In the short-run, one approach is to rely more on market-neutral long/short strategies, which capitalize on the relative gap between winners and losers, even if broader sentiments push markets in the "wrong" direction. In the long-term, smart investing may mean having the patience to ride out volatility—or the endurance to swim against the current—in the conviction that you see something the market does not. One thing is for sure: you can't outperform the market by following in its footsteps.

STRESS, BUT NO FRACTURE

The market's recent sell-off has been dominated by multiple misconceptions about what is really taking place. But that doesn't mean there aren't weak spots in the U.S. economy, or areas of genuine concern. The seismic changes that are unfolding are creating both winners and losers, as well as some collateral damage, and certain sectors are coming under a substantial amount of stress. The latest economic data show this clearly.

Manufacturing, hit by a strong dollar and cutbacks in oil drilling, remains the weak link in the U.S. economy, and is getting worse. Factory orders fell -1.7% from July to August, down -6.5% from a year ago. New orders for mining and drilling equipment are down by more than half. Industrial production, which had been buoyed by a surge in auto manufacturing, fell -0.4% in August, up a mere +0.8% from the year before. The ISM Manufacturing Index fell to 50.2 in September, barely clinging to expansion territory. The new orders gauge fell to 50.1, suggesting little hope for a quick turnaround ahead. Backlog orders, at an extremely low 41.5, and new export orders, at 46.5, both endured their fourth straight month of contraction.

U.S. exports and the trade balance took a big hit at the start of Q1, from the stronger dollar. Both stabilized in Q2, but have yet to recover. Exports rose +0.4% in July, led by autos, but were still down -4.3% from a year ago. While the strong dollar has weighed on export prices down -7.0% from last August, it—along with improving terms of trade—has also slashed the price of imports, down -11.4%. Imports, down -3.3% from last July, fell -1.1% from June to July, dialing the trade deficit back slightly. Whatever happened to the benefits to the U.S. from global rebalancing? In the first half of the year, at least, competitive devaluation of the Euro, Yen, and other currencies siphoned off many though not all of them.

It's important to keep these negative numbers in context. U.S. GDP growth for Q2 was revised upwards from +3.7% to +3.9%, with every single major component—consumption, investment, government, and net exports—contributing positively to growth. The Wall Street consensus for Q3 is +2.5%, while the latest (and far more cautious) GDP forecast from the Atlanta Fed is +0.9%. Strong headwinds, yes. Impending recession, no.

While manufacturing and exports struggle, other sectors are showing more vigor—precisely the disparity in performance we spoke of earlier. Consumer spending rose +0.4% in August, up +3.2% from a year ago, supported by similar growth in real disposable income. Retail sales rose +0.2% in August, on top of a +0.7% gain in July, up +2.2% from a year ago. Auto sales surged +2.3% in September to an annual rate of 18.2 million, the strongest since July 2005—a key factor propping up otherwise lackluster industrial output. While the ISM Non-Manufacturing Index fell back somewhat from the extraordinary highs it reached this summer, the September reading remained in strong expansion territory at 56.9.

The housing market continues to be a bright spot for the economy, after a rough patch last year. Existing home sales retreated in August from their peak in July, but still came in +6.2% higher than a year ago. New home sales surged +5.7% in August, on top of +12.0% in July, +21.6% higher than a year ago. Volatile new housing starts have yet to catch up, falling -3.0% in

August, up +16.6% from a year ago. However, the housing rebound has helped boost construction spending, which rose +0.7% in August, up +13.7% from a year ago. In August, the National Association of Home Builders' housing market index rose to 62, its highest reading in 10 years.

The September employment report fell below expectations, despite the fact that new unemployment claims remain at near-record lows. The U.S. economy created 142,000 jobs last month (well below the average 238,000 for the past 12 months) and the prior two months were revised downward by 59,000. The slowdown in job creation is concerning because, in lieu of rising wages or consumer re-leveraging, the steadily rising number of job-holders has been a vital factor supporting consumption growth. Looking past the headline figures, one quickly sees the same pattern of strengths and weaknesses we have noted all along: manufacturing shed 18,000 jobs in August and 9,000 in September, while mining (including oil drilling) lost 22,000 jobs in August and 13,000 in September. In contrast, retail added 24,000 jobs in September and professional and business services added 31,000, while government, benefiting from improved fiscal conditions, added 24,000. Average hourly wages were flat, which together with the weak jobs numbers, gave the stock market a somewhat perverse boost by lowering expectations for a Fed rate hike in October.

The chance of a new budget standoff between Congress and the President, which could introduce a new source of market volatility, rose significantly this month. While the surprise resignation of Speaker Boehner helped secure a short-term funding bill, avoiding a federal government shutdown in October, the funding will run out again in mid-December, and Treasury Secretary Lew has warned that the debt ceiling will need to be raised by mid-November. The fierce jockeying among House Republicans to fill vacant leadership shoes is likely to fuel more, not less confrontational tactics in the months ahead. Meanwhile, politics intruded on markets in a different way after a proposal by Democratic presidential frontrunner Hillary Clinton to cap drug prices sparked a sharp sell-off in pharmaceutical shares. Expect more moments like this as we enter campaign season.

The news that the U.S. and 11 other Pacific Rim nations have reached a final deal on the Trans-Pacific Partnership (TPP) trade agreement may or may not move markets, but it's very positive news in the long run. Not only will it boost trade, especially in services and IP-sensitive sectors where the U.S. excels, but for many countries, such as Japan, it will serve as a vehicle for much-needed market-opening reforms. It also bolsters the prospects for reaching agreement on TTIP, a similar trade-enhancing initiative between the U.S. and Europe. There's a risk that TPP will find itself tied up in political gamesmanship until the 2016 election runs its course, but is almost sure to be approved after the election, regardless of who wins.

The changes sweeping the global economy are creating winners and losers, both abroad and within the U.S. economy. While certain negatives cannot be ignored, the positives that are evident both in the story we see, and in the data, should not be ignored either. We see little evidence that the U.S. economy is on the verge of the kind of broad downturn that would justify a continued decline in equity valuations. We believe earnings performance will continue to vary widely among sectors and companies, and that earnings, not volatile sentiment, will

ultimately drive returns. It's an environment that places a premium on smart stock and credit selection, and the patience and conviction to see those positions through.

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Patrick Chovanec
Managing Director, Chief Strategist

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ECONOMIC FORECAST

(As of October 7, 2015)

	2013	2014	Estimated 2015	Projected 2016
Real GDP (Y-O-Y)	2.2%	2.4%	2.4%	2.8%
Consumption Expenditures	1.7%	2.7%	2.7%	2.7%
Business Fixed Investment	3.0%	6.2%	2.9%	5.0%
Inventory Investment (Billions)	$61.4	$68.0	$113.0	$55.0
Residential Investment	9.5%	1.8%	9.7%	7.0%
Government Spending * (Billions) (a)	$2,854.9	$2,838.3	$2,855.2	$2,883.8
Trade Balance-Goods & Services (Bil.)	($478.4)	($508.3)	($531.6)	($500.0)
Federal Budget*: Unified (Billions)	($679.5)	($484.6)	($426.0)	($414.0)
Gross Federal Debt* (Billions)	$16,719	$17,795	$18,191	$19,056
Consumption Price Deflator	1.4%	1.4%	0.2%	2.2%
Producer Price Index (Finished Goods)	1.2%	1.9%	(2.9%)	1.6%
Consumer Price Index	1.5%	1.6%	0.1%	2.2%
Industrial Production	2.3%	4.6%	1.0%	4.0%
Real Disposable Income	(1.4%)	2.7%	3.0%	3.2%
Hourly Compensation	1.1%	2.7%	2.4%	2.5%
Unit Labor Cost (Non-Farm)	1.1%	2.0%	1.5%	2.5%
Productivity Growth (Non-Farm)	0.0%	0.7%	0.7%	1.5%
Personal Savings Rate (% DPI)	4.8%	4.8%	4.9%	4.8%
Capacity Utilization – Total Industry	76.7%	78.1%	78.0%	78.5%
Trade Weighted $ Exchange Rate (b)	3.3%	3.3%	15.6%	0.5%
Vehicle Sales (Million Units)	15.9	16.8	17.5	17.3
Housing Starts (Million Units)	0.925	1.003	1.114	1.320
Civilian Employment (Millions)	143.9	146.3	149.3	151.7
Civilian Unemployment Rate	7.4%	6.2%	5.2%	5.0%
Corporate Profits – After Tax	0.6%	0.1%	8.5%	4.0%
S&P-500 Earnings-Operating	$107.30	$113.01	$111.00	$118.00
S&P-500 Dividends	$34.99	$39.44	$42.94	$45.00
90 Day U.S. Treasuries-Yield (%)	0.02-0.12	0.01-0.08	(0.01)-0.50	0.30-2.50
10-Year U.S. Treasuries-Yield (%)	1.55-3.00	2.07-3.01	1.90-2.60	2.30-4.50

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

SILVERCREST ASSET MANAGEMENT GROUP LLC
1330 AVENUE OF THE AMERICAS, NEW YORK, NEW YORK 10019 • (212) 649-0600
WWW.SILVERCRESTGROUP.COM