ECONOMIC REVIEW & INVESTMENT STRATEGY: 2017/IV

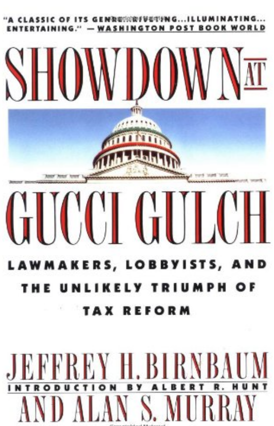
"Steady as she goes." That's been the byword for the economy, and markets, throughout this year, despite a constant diet of headlines promising tumult and change. That apparent disconnect has caused many investors no end of anxiety, but the best response, in our view, has been to take things a step at a time, not get too far ahead of the story, and stay grounded in the facts we know. And for now, those facts show an economy that has continued growth momentum, which should continue to provide support to share prices.

One way to stay grounded, amid all the noise, is studying history. Clients often ask what books are helpful in understanding the current investing environment. Good, and sometimes overlooked, history books always top the list. Hidden behind everything, there is a story. Knowing that story sheds unexpected light on the present, and offers hints of what the future may hold.

Here are four books that offer valuable historical perspective on key questions about today's economy, and today's markets. The first offers some useful insights into the outlook for tax reform, while the second explores the sources of innovation that are so critical to sustained economic growth. The third sheds light on the dollar's role in the global economy, and the fourth spotlights the secrets to one great investor's success in preserving and growing wealth in uncertain times.

The historical perspective from these and other books helps to reinforce the benefit of staying grounded in the facts.

TAXING SITUATION



One of the biggest questions this Fall is whether Congress can pass tax reform, and what it could end up looking like. We may not have a better crystal ball than anyone else, but *Showdown at Gucci Gulch: Lawmakers, Lobbyists, and the Unlikely Triumph of Tax Reform*, by Jeffrey H. Birnbaum, may be the next-best thing: the rollicking, warts-and-all story of how Congress succeeded in passing the last big round of tax reform, in 1986. Readers will notice some clear parallels to today's effort, as well as some important differences, both of which provide plenty of good food for thought.

The key to passing tax reform in 1986 was making it revenue neutral. The Democrats controlled the House, so if the Reagan White House wanted to achieve anything, it would have to be a bipartisan effort. While both parties agreed that the tax code had grown too complicated, and needed to be fixed, they passionately disagreed—much as they do today—about what the size and scope of government should be, as well as on spending priorities. Only by pushing these issues to the side, and focusing solely on finding a simpler, fairer way to raise the same amount of revenue, could a bill get the Democratic and Republican votes it needed.

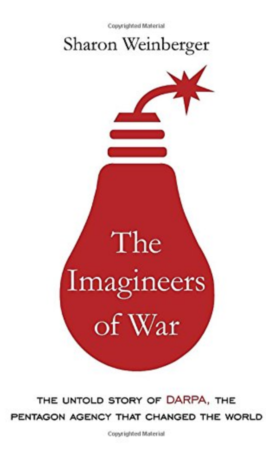
This time around, Republicans control both chambers, giving them the votes to pursue other fiscal priorities besides fixing the tax code, assuming they can agree on what they are. To the extent they want to cut tax rates without adding to the deficit, Congress will have to struggle to deliver the same sorts of offsets they did in 1986. One of the main offsets that's been put forward this year, eliminating the deductibility of state and local taxes, was also proposed last time—only to be shot down early in the process by the concerted opposition of representatives from high-tax states like California, New York, and New Jersey. Since today these are mostly "blue" states that voted against Trump, it's possible that Republicans will simply override their objections this time around. If so, it could sharpen the partisan divide over any bill that emerges. If not, however, the impact of proposed tax rate cuts on the deficit could be much larger than desired.

Very early in the 1986 process, the Reagan White House reconciled itself to the idea that to achieve rate cuts for individuals, it would have to accept a substantially higher tax burden on corporations—a shift that Democrats welcomed, and favored the pocketbooks of voters. This time, a key goal of Republicans is to reduce the corporate tax rate, while many of the offsets they are considering (such as eliminating the deductibility of state and local taxes) could fall on individual taxpayers. Whatever the arguments for this, in terms of economic policy, it could make this year's tax changes a tougher sell, politically, than in 1986.

Regardless of the shape any new tax bill takes, one thing that won't change is the sheer hard work and complexity of making major changes to the tax code. It took nearly two years to pass tax reform in 1986, from the time the White House started serious work designing a package, to when a bill finally arrived on the president's desk to sign. Every change they proposed raised a host of unanticipated issues and a myriad of details to be ironed out, while the taxpayers and industries affected were determined to weigh in or push back. This time, Congress is hoping to plow through this process in 3-4 months. Can they do it? Anything is possible, but they have their work cut out for them. Already, complex issues such as how to tax pass-through business entities like partnerships at lower corporate tax rates are cropping up and causing heartburn.

To dig even deeper, and gain even broader perspective, on the tax reform debate, we also recommend another book, *The Great Tax War*s, by Steven R. Weisman, about the fiery debates that led to the introduction of the income tax in 1913. It tells how the income tax, by reducing the federal government's reliance on tariffs and excise taxes, opened the door to much freer international trade—a story made even more timely and interesting by recent proposals, such as the border adjustment tax, that would move the U.S. tax system back in the other direction.

STATE OF INNOVATION



Low productivity growth over the past few years has given rise to widespread worries that the "innovation engine" of the American economy is broken. We're far from convinced that this is the case, but the sources of innovation are a critical topic for any economy, and can hardly be taken for granted. Many recent commentators have focused attention on what they see as the government's important role in fostering innovation, and their arguments usually give the Defense Advanced Research Projects Agency (DARPA)—"the agency that invented the Internet"—a prominent place. In her brand new book, *The Imagineers of War: The Untold Story of DARPA, the Pentagon Agency That Changed the World*, author Sharon Weinberger takes an in-depth look at DARPA's real track record: including the good, the bad, and plenty of things that probably wouldn't make it into a PR brochure.

The entire book is dominated by a tension, one that runs through its origins as a response to Russia's launch of Sputnik, the jungles of Vietnam, Reagan's vision for a "Star Wars" missile defense shield, to the groundbreaking military technologies that won the first Gulf War and hunted down al-Qaeda. It's the tension between DARPA as a far-sighted sponsor of creative and open-ended technology with unpredictable potential, and DARPA as a hard-headed customer for technology that has clear and useful military applications.

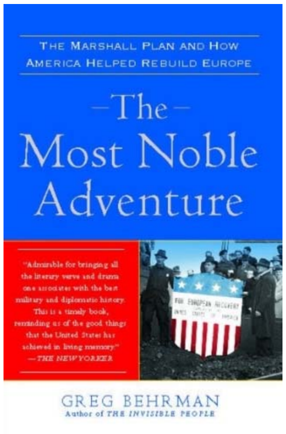
It quickly becomes apparent that DARPA's more visionary impulses have given birth to a host of wild and cockamamie ideas, projects whose abysmal failures not only flushed millions of dollars down the toilet, but embarrassed the agency and at times even threatened its very survival. The litany makes fun, if dark, reading, but over time, it becomes equally apparent that many of these "catastrophes" paved the way—sometimes quite directly—for some of its most stunning accomplishments. The same fascination with the "soft sciences" that had DARPA researchers studying the sexual frustrations of Vietcong insurgents encouraged it to fund similarly far-fetched investigations into "human-machine interaction" that produced the Internet, the touch screen, and the mouse. Its flaky flirtation with parapsychology (mental telepathy and spoon-bending, all the rage in the 1970s) gave rise to ground-breaking progress in using the brain's electrical signals to communicate directly with devices like prosthetic limbs. DARPA's dismal experiments with primitive flying drones in Vietnam prepared it to sponsor a far more viable design, the Predator, when it came along. In many ways, DARPA's willingness to think big and fail, sometimes ludicrously, opened the door to really meaningful success.

That said, DARPA's success rate has been highest when it kept sight of its core mission: developing viable technologies the U.S. military could use. Perhaps nowhere did it quietly shine so bright, in this respect, than in its development computer combat simulations that reduced the cost of training while improving its effectiveness. The risk in defining its mandate too narrowly, however, is that DARPA has sometimes found itself of the verge of pulling the plug on major innovations—like the stealth fighter—because there was no existing demand from the military for technologies that could change the nature of warfare as they knew it. To succeed, DARPA has to think outside that box.

So what is the key to innovation, and what is DARPA's role in it? It is tempting to point to successful government-funded innovations and assume that if the government only funded more such efforts, there'd be more innovation. Our takeaway, though, is that the government's real strength lies on the demand side, not the supply side. DARPA's most enduring and valuable—if not necessarily most lauded—contributions come when it acts as a deep-pocketed, far-sighted, yet demanding *customer* for viable (but visionary) military solutions, rather than a *source of subsidies* for interesting ideas that might have broader impact.

The question of what drives major strides in technology also animates another book, *The Idea Factory: Bell Labs and the Great Age of American Innovation* by Jon Gertner, this time from the perspective of the corporate world. We often associate innovation with small, nimble start-ups, but large companies like Google or Amazon—or Bell Labs, in its day—can bring huge resources to bear, sometimes working with partners like DARPA. As the book shows, they face a similar tension too: between the patience needed to nurture creative ideas and the discipline needed to produce tangible results. The impression we get, from both authors, is that innovation is unpredictable, but rewards persistence and focus; it is a discipline, rather than a bolt of inspiration, whose results must be measured over decades, not quarters.

DOLLAR DIPLOMACY



The ups and downs of the U.S. dollar over the past year—spiking to a 14-year high in December, followed by a steady decline in 2017, especially against the Euro—have had an impact on economic growth and investment returns. At the same time, there's constant buzz about China's yuan possibly someday replacing the dollar as the world's leading reserve currency, maybe sooner than anyone expects. If this all sounds a bit mystifying, it might be worth taking a look back at the one event that—though many don't' realize it—served as the critical moment in establishing the U.S. dollar as the world's dominant currency. *The Most Noble Adventure: That Marshall Plan and How America Helped Rebuild Europe*, by Greg Behrman, tells that often underappreciated story.

History books usually frame the Marshall Plan as a far-sighted act of political generosity, in which the U.S.—having learned the cost of isolationism in World War II—helped rebuild Europe, winning friends and allies in the process. In fact, it was a response to a serious financial crisis, one caused in part by the failure of the U.S. to understand the implications of its own currency policies. In 1944, at the Bretton Woods Conference, most of the world agreed to peg their currencies to the U.S. dollar. At U.S. insistence, those fixed exchange rates tended to undervalue the dollar, to give U.S. exports a leg up. The result was that much of Europe, which needed dollars to pay for equipment and raw materials to rebuild after the war, had almost no way of earning them, leaving their economies teetering on the edge of collapse. By providing dollars, in the form of aid and credit, the Marshall Plan solved the shortage and—along with a few discreet currency devaluations—got the wheels of trade turning again.

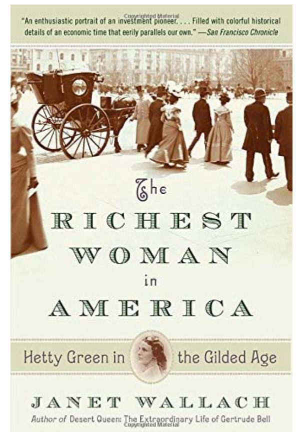
The tale highlights a critical point: the global role of a nation's currency hinges not only on economic "might" or political influence, but on the balance of payments. The dollar (or the yuan) cannot function as a reserve currency unless the U.S. (or China) exports its currency, either by running recurring trade deficits or sending a great deal of capital abroad. In the immediate aftermath of World War II, the world was eager to buy American-made goods, and the U.S. wanted to supply them, but it could only do that by financing global development. Today, China clearly sees itself pursuing the same path, through projects like "One Belt One Road" and the Asian Infrastructure Investment Bank (AIIB). But as its recent clampdown on capital outflows suggests, it's far from clear that China has fully reconciled itself with what this would mean for its own economy. Perhaps even more important, the world has changed: instead of craving U.S. capital, it is now awash in capital, and overcapacity seeking demand. What the world needs from China isn't a new Marshall Plan, but well-off consumers ready and able to spend.

Another key point the book raises is the role public opinion played in at first resisting, then eventually supporting, the Marshall Plan. In 1947, few Americans had any interest in rebuilding Europe. Not unlike today, they were tired of spending blood and treasure abroad, fixing what they saw as other people's problems, and wanted to get back to their own. Political leaders who understood what was at stake had to go out and make the case, persuade Americans why the Marshall Plan was really in their own interests. Once engaged, they stayed engaged, laying the seeds for NATO (1949) and the precursors of the European Union (1952). Whatever the merits of these far-sighted commitments, the point—and it's a very timely one—is that the popular support that made them possible could not be taken as a given.

The Marshall Plan is a story we think we know, but really don't, and what we don't know has a lot of bearing on today's issues. For those interested in learning more about the wartime conference that set the stage for Europe's post-war dollar shortage—but also gave birth to the International Monetary Fund

(IMF), World Bank, and eventually the World Trade Organization (WTO)—look no further than *The Battle of Bretton Woods: John Maynard Keynes, Harry Dexter White, and the Making of a New World Order*, by Benn Steil. We also hear that Benn has his own book on the Marshall Plan coming out next year.

UNCOMMON FORTUNE



Before Warren Buffett, there was Hetty Green. While hordes of investors carefully study the method and mindset of "The Oracle of Omaha," only a handful know anything about the most successful female investment tycoon of America's Gilded Age. Hetty went head-to-head with the Morgans, Vanderbilts, and other "robber barons" of her time, winning their respect—and as often as not, their money too. When she died, in 1916, she left a fortune that today would be worth $1.6 billion. The story of how she built that fortune is told by Janet Wallach in *The Richest Woman in America: Hetty Green in the Gilded Age*.

Hetty Robinson was born in 1834 to a Quaker family whose shipping and banking activities were a mainstay of New Bedford's booming whaling industry. When his only son and heir died in infancy, her father transferred his hopes to Hetty, who he brought along to the wharves and warehouses to teach her the practical ways of business. She hoped to win his trust, but it was not to be; when he died, along with an equally rich aunt soon after, the family fortune passed to Hetty, but only on the condition that male trustees manage it for her. The only money she actually controlled was the stream of dividends they gave her. It was by reinvesting these dividends that Hetty built her own fortune, many times greater than the one she inherited.

The key to her success was information. She invested mainly in railroads—the hot stocks of that time—and real estate, but only after she studied each one carefully and learned everything she could to determine its true value. "Before deciding on an investment," Hetty advised, "seek out every kind of information about it." Later in life, she regularly staked out a desk in the lobby of Chemical Bank, on Wall Street, where she spent the day gathering rumors and analyzing numbers. She constantly travelled across the country to get a first-hand look at railroads and properties that might have promise. In contrast, Hetty's adventurous husband, Edward Green, liked to gamble on the stock market, and his fortunes rose and fell accordingly. Several times, she had to bail him out when his "luck" fell through, from her own more prudently invested funds.

That doesn't mean Hetty avoided risk. We tend to look at the late 19th century as a boom time for America, but as Wallach's book reminds us, it was filled with risks and uncertainties, and punctuated by frequent financial crises. Hetty was bold: "I am always buying when everybody wants to sell," she said, "and selling when everyone wants to buy." She could do this because she understood—unlike her husband—how much risk she could afford to take, and could ride out her paper losses while seizing on the bargains panic had created. Buy low, sell high sounds like obvious advice, but it was Hetty's discipline as an investor that made it possible.

Hetty was also extremely frugal. "Watch your pennies and the dollars will take care of themselves" was one of her favorite expressions. It won her no admirers among the public, who preferred greater flamboyance and generosity from their "betters". They derided her plain clothes as "shabby", her haggling as "mean". Disputes over her inheritance, and how it was managed, left Hetty bitter and suspicious, and she was constantly filing lawsuits against her enemies, real and imagined. Hetty may have gone to extremes, but she never lived beyond her means, which led to the demise of so many great fortunes.

Readers intrigued by Hetty's story can also check out a second biography, *Hetty: The Genius and Madness of America's First Female Tycoon*, by Charles Slack, which offers more details of her business dealings, and her epic rivalries. While Hetty's story may have been an uncommon one, for her time, she firmly believed that her success as an investor was rooted in straightforward common sense. A key part of that common sense was her conviction that "it is the duty of every woman to learn to take care of her own business affairs." People at the time said that was impossible, or crazy. She certainly taught them a thing or two.

STEADY AS SHE GOES

Hetty Green's career is more than just an inspiring story; it's a timely reminder of how steady nerves, founded on an informed view of risk and return, pay off over the long run. Right now, we are in the mature stages of a bull market. U.S. stocks have climbed a wall of worry for eight years, and investors are—understandably—looking over their shoulders asking how long their good fortune can hold. But bull markets don't die of old age, they end when the fundamentals deteriorate. And for now, those fundamentals are holding firm.

It's true that the multiple hurricanes that hit the U.S. these past two months will likely put a temporary dent in Q3 economic growth. Industrial production fell −0.9% in August, due mainly to a −5.5% drop in utilities because of hurricane-related power outages. Retail sales also slipped −0.2% in August, and July's +0.6% surge was revised downward to +0.3%. Recent weeks have seen a sharp spike in initial jobless claims from hurricane-affected areas, and the U.S. economy lost −33,000 jobs in September, the first monthly job loss in seven years.

Yet these effects are expected to be short-lived, and the economy is already showing signs of bouncing back strongly. Consumer confidence remains buoyantly close to cycle highs, and despite August's decline, retail sales are still up a decent +3.2% from a year ago. The housing market has been in the doldrums for a couple months now, but auto sales—which have been a source of worry this year—saw a startling comeback in September, from a 3-year low in August to their strongest pace of the recovery (18.6 million vehicles per year). As long as job growth recovers, as expected, consumers seem set to continue spending.

On the supply side, the picture looks even stronger. Durable goods orders leapt +2.0% in August, up an impressive +5.5% from a year ago. Even more striking, both the ISM producer survey indices shot up to new cycle highs in September. Manufacturing rose +2.0 points to 60.8, its highest level since May 2004, while new orders surged +4.3 points to a 4-year high. Backlogs surged to a 6-1/2 year high, as might be expected due to bad weather, but current production also ramped up, to an eye-catching 62.2. Non-Manufacturing leapt +4.5 points to 59.8, its strongest level since August 2005, while new orders jumped +5.9 points to a sizzling 63.0. These are remarkably strong numbers, suggesting solid demand momentum and business confidence going forward, across the economy.

One aspect of the latest ISM indices that caught our attention were the price gauges, which shot up sky high in September. Survey responses suggest that most of this surge in inflationary pressure may be related to hurricane-related shortages and bottlenecks, but it's worth keeping an eye on, especially as rebuilding efforts ramp up. Despite September's job losses, rising wages ticked up to +2.9% from a year ago. The PCE price index, the Fed's preferred inflation barometer, remains at +1.4%, well below its 2%

target, though consumer prices (CPI) have inched up to +1.9%. It's too early to ring any alarm bells over inflation, which saw a similar rise in Q1 only to go completely flat in Q2, but it's something we'll be watching closely.

The renewed prospect of stimulus from tax cuts caused the U.S. dollar to perk up a bit in September, after an 8-month slide to its lowest point in two years. Treasury rates also recovered (with the 10-year rising +21 bps in September), though longer-term rates remain below where they were at the start of the year. As we've noted, the outlook for tax cuts this year remains highly uncertain, and these modest and highly cautious "rebounds" in interest and exchange rates reflect that. A similarly modest rebound in oil prices, in September, is less a cause for concern than a sign of healthy adjustment and stabilization in that market.

One potential source of uncertainty for markets arises from the Fed's gradual unwinding of its $4.5 trillion QE balance sheet, starting this month, as it no longer purchases Treasury bonds to replace those that mature. If you believe, as some do, that the Fed's QE intervention was the key driver of this bull market, then you might understandably think that reversing it could have an equally profound effect. We don't buy into either proposition. Low longer-term interest rates, at this point, have shown themselves to be as much a product of economic expectations as of Fed intervention, and we do not anticipate that the Fed's gradual wind-down will have a major disruptive effect on the economy, or on equity valuations.

After a more jittery August, growing confidence and positive data gave the S&P 500 a +1.9% boost in September, bringing total returns (including dividends) for the year so far to +14.2%. Those gains have been mostly due to improved earnings, with the trailing P/E multiple holding steady at roughly 21x operating earnings for over a year. Such valuations, as we have noted for some time, are highly elevated, closer to the typical apex of a market cycle than its beginnings. But given historically low interest rates, the equity risk premium, at 5.0%, still remains almost a full percentage point above its long-term historical average, implying a reasonable reward for accepting the ups and downs of the market, to the extent one can afford it.

Positive performance has by no means been limited to U.S. shares. As measured by their respective ETF, the MSCI World Index is up +15.2% this year, with Emerging Markets (+28.0%) and the Eurozone (+25.2%) showing particularly strong gains, in part due to dollar weakness. It's worth remembering the panicky cries raised in January 2016, when alarms over China sent the market lurching and caused many to predict an imminent recession, and an end to the current bull market. Had we given into those fears, rather than staying grounded in the more assuring story the economic data was telling us, we'd have missed two years' worth of positive double-digit returns. While a new worry—the impact of the recent hurricanes—has caused the Atlanta Fed to downgrade its projection for Q3 GDP growth to +2.5%, and the New York Fed to a (more conservative) +1.5%, the fact that these numbers remain positive suggests that, tax cut or no tax cut, this economy still has some fairly robust growth momentum. Our view is that staying invested in that growth makes sense.

The greatest lesson of history, perhaps, is patience: the willingness to stick with a reasonable conviction despite all the noise. People who change their minds—and their plans—with every passing moment, rather than orient themselves towards the long haul, will miss the reward that only the steadier hand can realize. Now's not the time to blink.

October 10, 2017

Patrick Chovanec
Managing Director, Chief Strategist

SILVERCREST
ASSET MANAGEMENT GROUP

ECONOMIC FORECAST
(As of October 10, 2017)

	2015	2016	Projected 2017	Projected 2018
Real GDP (Y-O-Y)	2.6%	1.6%	2.2%	2.2%
Consumption Expenditures	3.2%	2.7%	1.6%	2.1%
Business Fixed Investment	2.1%	-0.5%	6.0%	3.0%
Inventory Investment (Billions)	$84.0	$22.0	$20.0	$20.0
Residential Investment	11.7%	4.9%	2.0%	2.0%
Government Spending * (Billions) (a)	$2,883.7	$2,907.0	$2,951.0	$2,995.0
Trade Balance-Goods & Services (Bil.)	-$500.4	-$504.8	-$515.0	-$515.0
Federal Budget*: Unified (Billions)	-$438.4	-$584.7	-$693.2	-$563.7
Gross Federal Debt* (Billions)	$18,120	$19,539	$20,188	$21,221
Consumption Price Deflator	0.3%	1.1%	1.5%	2.0%
Producer Price Index	-7.3%	-2.6%	3.0%	2.5%
Consumer Price Index	0.1%	1.3%	1.8%	2.0%
Industrial Production	-0.7%	-1.2%	2.0%	1.0%
Real Disposable Income	3.5%	2.6%	2.5%	2.5%
Average Hourly Earnings	2.2%	2.6%	2.7%	3.0%
Unit Labor Cost (Non-Farm)	2.0%	2.6%	2.5%	3.0%
Productivity Growth (Non-Farm)	0.9%	0.2%	1.0%	1.0%
Personal Savings Rate (% DPI)	5.8%	5.7%	5.4%	5.5%
Capacity Utilization – Total Industry	76.8%	75.8%	76.5%	77.8%
Trade Weighted $ Exchange Rate (b)	16.1%	0.7%	2.0%	2.5%
Vehicle Sales (Million Units)	17.8	17.9	17.0	17.2
Housing Starts (Million Units)	1.112	1.174	1.200	1.220
Civilian Employment (Millions)	148.8	151.4	153.5	155.0
Civilian Unemployment Rate	5.3%	4.9%	4.4%	4.4%
Corporate Profits – After Tax	-8.5%	4.3%	4.0%	4.0%
S&P-500 Earnings-Operating	$100.45	$106.26	$120.50	$125.00
S&P-500 Dividends	$43.39	$45.70	$49.00	$52.00
90 Day U.S. Treasuries-Yield (%)	(0.02)-0.29	0.18-0.54	0.49-1.50	1.00-2.50
10-Year U.S. Treasuries-Yield (%)	1.68-2.50	1.37-2.60	2.00-3.50	2.00-4.00

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