SILVERCREST
ASSET MANAGEMENT GROUP

Economic Review & Investment Strategy: 2014/I

When Tomorrow Is History

Business cycles are often viewed as the consequence of contemporaneous events when in reality they are importantly influenced by decisions made long before. Although politics and psychology are important components of the equation, they are rarely given their proper weight in economic analysis. Historians may reflect on the politics and psychology of past periods but their efforts do little to control the present, guide the future or define the outcome. The past is nearly always an imperfect guide because no two cycles can be relied upon to be identical in causes, consequences or magnitude even though observers frequently attempt to make comparisons with, or draw conclusions from, prior experiences. In his public pronouncements during the recent financial crisis, Federal Reserve Board chairman Ben Bernanke has acknowledged the unusual characteristics of the events that spawned the distress and wisely moved to adopt previously untested measures to remedy the situation. That his plans brought about considerable stability without undermining the country's socio-political foundation is an accomplishment worthy of praise. It is further notable that other countries facing similar financial and economic problems, in particular the euro zone, continue to stumble in the search for suitable solutions.

It is fortunate that the financial crisis surfaced in the United States at a time when not all economic cylinders were in distress. To begin with, corporate America remained fiscally healthy, with abundant liquidity, despite a significant but temporary decline in profits, thus avoiding an industrial collapse. Consumption, which accounts for more than 70% of GDP, succumbed to a marginal retreat which was reversed rapidly. Massive reduction in government spending, importantly aided by the departure from Iraq and reduced military presence in Afghanistan, cut the federal deficit by more than one-half, thus alleviating a source of tension in the credit markets. Rarely noted, furthermore, is the expense of servicing the sharply escalating national debt which has remained essentially unchanged at around $225 billion for the past 18 years even though the debt total has tripled in the interim to about $17 trillion. This fiscal miracle, spawned almost entirely by a substantial decline in interest rates and a reduction in the maturity schedule, has prevented deleterious consequences in the credit markets.

The supportive events cited above pale when compared with what is emerging as an industrial revival in the U.S. Importantly, the recent upturn in manufacturing jobs following nearly two decades of losses, combined with the steady repatriation of various industrial activities, continue to confirm the regeneration of competitive muscles and the continued upgrade in productivity. In this connection, domestic manufacturing employment is exhibiting the most significant gain in nearly 30 years as wage raises remain modest. Conversely, the threat

from low-wage countries is fading rapidly as double-digit increases are granted under pressure. The most recent reported data indicate that manufacturing wages in China are being lifted at an average annual rate of about 13%, with more to come.

As each of the past three years came into view, prognosticators hurried to raise the flag of caution, invoking unresolved issues domestically and abroad. Quite often pessimism is marketed as a substitute for wisdom. Given that there remains substantial pools of liquidity available to be deployed, which is further reinforced by the continued decline in the federal and state deficits, a financial/economic crisis should not be considered as a candidate for the front burner. Perhaps cautious optimism should take its place as a substitute.

The Economy: Count Your Blessings

As the calendar turns to 2014, the U.S. economy remains in ascendency as it continues to gain traction. It is creating jobs at an annual count of more than two million which leads to peak employment by midyear. Wage gains are exceeding inflation and invigorating consumption, as recently confirmed by solid increases in retail and auto sales. While the housing sector seems to have stalled temporarily as mortgage rates track the rise in interest rates, the latest data are nonetheless confirming resumption in the rebound of housing starts due to elevated pent-up demand. Meanwhile, corporate America is delivering record earnings and cash flows that far exceed capital spending needs. Such abundance is persuading many managements to raise dividends at a faster pace than the increase in their profits even as they embark on, or accelerate, already robust share repurchase programs.

With tax revenues, both at the federal and local levels, exceeding forecasts and deficits in significant decline, attention should soon turn to improving the country's deficient infrastructure. As it is, this fiscal year's federal deficit may well decline to 4% of GDP or lower, from 10.5% as recently as four years ago. Such improvement, if it continues, should provoke demands for additional public spending, thereby lengthening the lifespan of the current expansion.

Many forecasters tend to measure the sustainability of a business cycle by comparing it to historical averages. This approach misleads as each cycle is largely responsive to a wide range of economic and political influences that are neither identical nor similar in magnitude. With the current recovery/expansion already well past its fourth anniversary, it is actuarially middle-aged in duration but still youthful in amplitude, having so far progressed weakly and in fits and starts. Importantly, however, it does not appear as yet to have satisfied pervasive pent-up demand as the economy moves into a secular (vs. cyclical) growth phase. This sets forth the prime reason for our belief that the current expansion may prove to be one of the longest of the post-war period. Other considerations that support our upbeat forecast include Washington's fiscal roadmap that hints at migration from contractionary policies in the past three years to near neutral in FY2014 and then to an expansionary mode the following year.

The combination of a private sector enjoying a deeply rooted rebound, reduced fiscal risks, rapidly approaching energy self-sufficiency, and an undervalued U.S. dollar that has so far failed to respond fully to the broadening revival in the economy, should impart long-term support to sustainable gains. Other attributes, such as relatively stable wages, solid gains in

employment and healthy corporate balance sheets seem certain to remain key drivers for near-term acceleration in growth. Meanwhile, the monetary gatekeepers appear in no rush to rapidly reverse their stimulus, particularly while global conditions remain uncertain.

Any concern that political and economic turbulence outside the U.S. might undercut smooth domestic growth fails to consider modest domestic reliance on global trade, continued gains in productivity, and accumulating evidence of a manufacturing renaissance. These favorable trends, tied to such competitive advantages as rapid technological innovations and labor peace, have recently raised weekly manufacturing employment to a record post-war high.

In brief, we are of the view that in the coming year: (1) the U.S. economy will continue in an expansion mode, with some further acceleration; (2) interest rates will creep up but should not threaten the recovery; (3) employment will increase by more than two million jobs, finally exceeding the previous peak, perhaps prior to midyear; (4) business profits will reach another record high although margins will not attain the heady levels currently anticipated by the consensus; (5) elsewhere, the global economy will remain sluggish but will experience greater stability than in recent periods; (6) the U.S. stock market will outperform most major bourses as it attracts excess liquidity and accelerating outflow from fixed income investments.

Investment Strategy: Bulls, Bears & Bum Steers

A determined bull has been in a raging form on Wall Street for nearly three years, overcoming many real and some imaginary hurdles. It has successfully challenged conventional wisdom that for a long period has counseled severe caution or outright pessimism. To be sure, there are enough imbalances and social distress around the globe to provoke serious concerns, although surrender has been far from a winning strategy.

As we see events unfolding, the United States appears to have been the first among major countries to face its financial problems head-on and emerge victorious. A combination of unconventional and untested strategies was promptly adopted to stem the decline, taking advantage of social stability, a corporate structure with abundant liquidity, and a fiscal approach that challenged conventional wisdom by reducing sharply runaway deficits. With an assist from the monetary gatekeepers, interest rates have been brought down to a level that raised profit margins and triggered a new capital spending cycle. Perhaps reading between the lines, and encouraged by rising employment and real incomes reaching a new high, consumer spending, which accounts for more than 71% of GDP, is once again assuming the role of the main driver of domestic growth.

The foregoing depicts an economic system on the mend, not quite in perfect harmony, but functioning to advantage and moving forward. This conclusion is supported by a steady recovery in employment, businesses raising their capital outlays, and consumers once again willing to borrow and spend. Set against a global economy with erratic momentum and many unattended problems, the U.S. clearly emerges as a unique machine whose handlers can repair it quickly and successfully when it malfunctions.

The U.S. stock market, which has more than doubled since its last cyclical trough, is now moderately undervalued, in our opinion, despite its recent gains. Our optimism is derived from three broad considerations: (1) valuations remain defensible, given still relatively low interest rates; (2) there are no alternative investment vehicles with the requisite liquidity and size to recycle the enormous cash pools waiting to be deployed; (3) the U.S. dollar's modest strength over the past year has so far failed to reflect the economy's revival, particularly mounting evidence of reindustrialization.

Although we deem current consensus forecasts for Standard & Poor's 500 earnings of $115-$116 to be excessive for 2014, given current peak profit margins, a more modest $111 seems attainable with some help from share repurchases. This is equivalent to a P/E of 16.6X, or a P/E of 15.5X if adjusted for net cash holdings. In addition, despite the recent spike in interest rates, debt instruments offer no protection from a downturn, particularly if it were assumed that the business recovery has further to run. Finally, a rush into U.S. assets may develop in due course as it becomes more evident that many of the developing economies that are being touted as tomorrow's giants (such as China, India, Brazil, etc.) may encounter a list of difficulties, both social and economic, that are impeding their growth. Thus, our roadmap for U.S. stocks in 2014 envisions double-digit returns without a significant elevation in the market's risk profile. Pervasive dividend increases as well as expansion of share repurchases should provide support.

We remain intrigued by the financial sector which, despite its strong performance in the past year, is being valued at a deep discount to industrials. Energy stocks, having recently consolidated, should attract renewed attention. Mainstream technology companies, a laggard subsector, may also attract interest as a defensive medium that has failed to participate fully in the market's outsized gains.

While the fixed income area lacks compelling prospects, portfolios can be positioned to take into consideration rising interest rates in an economy growing at a moderate pace. Monetary policy will likely remain stimulative for an extensive period even assuming the ultimate expiration of QE (Quantitative Easing) in all forms.

January 6, 2014

Stanley A. Nabi, CFA
Vice Chairman

This publication contains the personal opinions, as of the date set forth herein, about the securities, investments and/or economic subjects discussed by Mr. Nabi. No part of Mr. Nabi's compensation was, is or will be related to any specific views contained in these materials. This publication 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

ECONOMIC FORECAST

(As of December 30, 2013)

	2011	2012	Estimated 2013	Projected 2014
Real GDP (Y-O-Y)	2.0%	2.0%	2.0%	2.6%
Real Consumption Expenditures	2.5%	2.2%	1.9%	2.5%
Business Fixed Investment	7.6%	7.3%	2.6%	6.6%
Inventory Investment (Billions)	$33.6	$57.6	$68.0	$40.0
Residential Investment	0.5%	12.9%	13.6%	11.6%
Government Spending* (Billions) (a)	$2,992.4	$2,963.1	$2,899.4	$2,860.3
Trade Balance-Goods & Services (Bil.)	($445.9)	($430.8)	($423.5)	($425.2)
Federal Budget*: Unified (Billions)	($1,299.0)	($1,089.2)	($679.0)	($607.4)
Gross Federal Debt* (Billions)	$14,790	$16,066	$16,738	$17,794
Consumption Price Deflator	2.4%	1.8%	1.2%	1.9%
Producer Price Index (Finished Goods)	4.7%	1.4%	1.0%	1.2%
Consumer Price Index	3.1%	2.1%	1.5%	1.9%
Industrial Production	3.4%	3.6%	2.5%	3.2%
Real Disposable Income	2.4%	2.0%	1.0%	3.2%
Hourly Compensation	2.5%	2.6%	1.4%	2.4%
Unit Labor Cost (Non-Farm)	2.0%	1.2%	0.7%	1.3%
Productivity Growth (Non-Farm)	0.5%	1.5%	1.2%	1.0%
Personal Savings Rate (% DPI)	5.7%	5.6%	4.7%	5.3%
Capacity Utilization – Total Industry	76.5%	77.6%	78.0%	79.1%
Trade Weighted $ Exchange Rate (b)	(4.6%)	2.3%	3.5%	1.6%
Vehicle Sales (Million Units)	12.7	14.4	15.5	15.9
Housing Starts (Million Units)	0.612	0.783	0.933	1.140
Civilian Employment (Millions)	139.9	142.5	143.7	145.8
Civilian Unemployment Rate	9.0%	8.1%	7.4%	6.6%
Corporate Profits – After Tax – NIPA	0.6%	19.2%	4.9%	5.2%
S&P-500 Earnings-Operating	$98.73	$103.61	$106.50	$110.00
S&P-500 Dividends	$26.43	$31.25	$35.75	$37.50
90 Day U.S. Treasuries-Yield (%)	0.00-0.20	0.01-0.11	0.02-0.12	0.10-0.50
10-Year U.S. Treasuries-Yield (%)	1.70-3.74	1.39-2.38	1.55-3.00	2.70-3.65

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