SILVERCREST
ASSET MANAGEMENT GROUP

Economic Review & Investment Strategy: 2013/IV

Flying Blind

As we prepare these comments for distribution, Congressional leaders on both sides of the aisle are apparently unwilling to compromise. To claim that each party has a monopoly on sanity is to assert that politics is a rational, selfless game that separates winners from losers. Nothing is farther from the truth, if such assertion is measured against a dysfunctional world with a growing number of failed states and stumbling democracies.

At its roots, the current budget conflict in Washington is not the only one of its type on the global stage. Many developed countries are finding themselves fiscally strapped and in need of revising their fiscal outlooks.

In a nation such as the United States where democracy as a political order, personal initiative and the rule of law largely define social conduct and the form of government, philosophical differences tend to be either marginal or nearly impossible to detect. This condition has become more evident in recent years as both major political parties have moved to the center despite the popular perception otherwise. Each has tended to appropriate from the other positions that seem to attract wide support. As a result, traditional distinctions have become blurred even though labels still survive, causing debates and elections to be won or lost on the margin and the legislative process to stall and to become largely politicized. The current contentious debate on the budget is the latest in a series of confrontations that date back even prior to 1991, when the purse was held hostage to party warfare.

Politics, it has been said, is increasingly becoming the science of redistribution of wealth and incomes in a society. It is a process by which its practitioners, who perceive themselves as statesmen but are standard issue politicians, compete for power and assume authority using favors, fraud, force and fear, which they have come to view as the essence of government. To exercise their power to its utmost, politicians solicit taxes from the affluent and votes from the masses on the pretext of protecting one from the other. That the measure of their influence and authority has exceeded their prescribed role in a democratic process is evident in their attempt, increasingly successful in the post-war period, to spend far in excess of what they are able to wrest by legal means from those they govern. The budgetary deficits so created thus have become another tax, hidden and unauthorized, on current and future generations.

Perhaps the time has come for citizens to have a greater voice in how the nation's resources should be allocated. Frequent and direct referendums on major fiscal issues would appear to provide a more efficient and democratic process. Alternatively, candidates and those in high office should be called upon to provide voters with a series of position papers addressing in specific terms their views and proposals, rather than relying on vague sound bites with no substance. Without orderly debates that shed light rather than add to the confusion, the ugly side of politics will frequently prevail to the detriment of the governed.

The adverse impact of the government shutdown, now in its third day, is certain to intensify, if not ended quickly. Our forecast here is that sanity may prevail as an agreement could be reached within a few days. Given a firming economy on the domestic front and a measure of stability in the euro zone, our expectations are that the final quarter of 2013 may be the year's best. An extension of the shutdown beyond two weeks would require revisions in our forecast.

The Economy: Count Your Blessings

The U.S. economy has remained in a state of suspended animation in the latest quarter, neither gaining notable momentum nor lapsing into retreat. Considering the multitude of domestic and global headwinds to which it remains exposed, such an outcome should be accepted with a measure of equanimity.

There is much on which to pin a hopeful outlook. Employment is registering solid monthly gains, particularly as jobless claims continue to decline and wage increases exceed the inflation rate. Consumers' net worth has recovered swiftly, recently reaching record levels, aided by a rebound in home prices and recent record highs in domestic stock indices. Durable goods orders continue to climb, providing momentum to manufacturing. The federal deficit has been reduced by about one half since its peak four years ago and is on track to shrink further. Energy self-sufficiency, for long a quixotic dream and a source of geopolitical concern, has become a decidedly achievable objective with multiple favorable consequences. The U.S. dollar, often derided as a weakening currency, seems to be gaining support from improving fundamentals particularly on the trade front. Corporate America remains awash in record cash levels as business profits climb to new highs and cash flows continue to exceed capital spending; most important in this connection is an underlying rational assumption that the recent timid economic growth continues to fall short of satisfying pent-up demand in both the private and public sectors. Also worthy of emphasis is the vigorous rebound in productivity which is confirming solid progress in U.S. competitiveness.

Given the foregoing evidence, it seems difficult to make a case for a cyclical downturn within the next 12-18 months unless Washington precipitates one as a consequence of political conflict associated with the ongoing budget stand-off. In fact, the obvious lack of excesses in the production/consumption/private debt level that characterize current conditions, combined with the slow pace of the rebound partly caused by fiscal austerity, argue in favor of an extended business recovery that may rival in staying power, though perhaps not in amplitude, some of the longest expansions of the post-war period. An elevated unemployment level in both industrialized and developing economies, the lack of shortages in a broad range of commodities, timid fiscal policies intended to restrain deficits, combined with moderate but competitive wages, should keep domestic inflation in check and interest rates manageable. Such a quiescent climate should continue to provide support to the manufacturing and export sectors as has been amply demonstrated recently in the United States, Germany and the United Kingdom.

Although we remain cautious about economic prospects in the European Union, and more specifically in most of the euro zone countries, recent signs of relative stability may provide a respite to address some of the pressing problems. Nonetheless, a broad rebound may take time as remedial policies are likely to be resisted, particularly if the pervasive social safety nets are substantially modified. Furthermore, a firm euro (notably versus the U.S. dollar) presents a challenge on the trade front as long as superior U.S. productivity continues to generate a competitive advantage.

On the interest rate front, the Federal Reserve system has served notice that it is in no hurry to shrink its monetary stimulus (through a reduction in Quantitative Easing) even though evidence suggests that QE's favorable impact has been on the wane since its original adoption nearly two years ago. With the domestic financial system not short of liquidity, and the Federal budget deficit in decline, QE's elimination within the next 12-15 months is not likely to be a cause for concern for either investors or the economy at large. Moreover, while we expect interest rates to slowly creep up, their advance will likely be a response to improved business conditions rather than a reaction to pending inflationary pressures.

In summary, we conclude that: (1) the U.S. economy should continue to expand at a moderate pace; (2) interest rates will creep up erratically but will not threaten the expansion; (3) inflation will remain subdued while the global workforce is underemployed and wage gains are restrained; (4) the U.S. dollar will gain ground in the short-term on a trade-weighted basis; (5) corporate profits should continue to grow, but will trail current consensus forecasts; and (6) the U.S. market remains attractively valued, with the potential for double-digit returns within the next 12-15 months. This forecast is based on the assumption that the Government shutdown would not last more than a week or so.

Investment Strategy: Still Open For Business

Despite the U.S. stock market's recent retreat in response to the political drama on display courtesy of Washington's talking heads, the market has delivered solid returns over the past three years, reaching an all-time high in mid-September. Its advance has been quite broad, encompassing nearly all major sectors. Even after more than doubling since their cyclical troughs, individual stocks reflect no wide valuation dispersion that is often seen as a warning signal of risky excesses. Furthermore, judging by the pace of company repurchases of their own shares, it seems obvious that corporate managements feel comfortable enough with their business prospects that they are willing to pay rising prices. This is in addition to reinvigorated merger and acquisition activities that seem to extend to candidates whose prospects are in doubt.

At its closing level of 1,681.55 on September 30, 2013, the Standard & Poor's 500 was valued at 15.3-times our 2014 very conservative earnings estimate of $110 for the Index, which is well short of a consensus forecast of close to $116. Our "defensive" valuation is intended to recognize many uncertainties; those would include a possible peak in profit margins, a likely modest rise in interest rates as the recovery cycle ages, political turbulence in the Middle East and elsewhere, continued downward pressure on commodity prices, and the inability of the euro zone to put its fiscal house in order. Even taking into consideration some headwinds, our defensive posture translates into a P/E of 15.3X, or about 14.3X net of cash holdings. Given the current level of interest rates, it would not be excessive to derive a market multiple in a range of 17X-18X before meandering into the danger zone, implying a midpoint that allows a 15% appreciation plus dividends. Other supportive factors include: (1) further potential gains in corporate profits beyond 2014; (2) a more generous dividend policy that would deploy some of the excess cash; (3) the continued shrinkage in the number of companies listed on U.S. Exchanges (Exhibit I); (4) a decline in the total shares outstanding due to repurchases and/or merger and acquisition activities (Exhibit II); (5) following many years of substituting exotic investments, such as hedge funds, for traditional equities, their meager returns have not proven to be widely competitive; and (6) massive liquidity currently lodged in fixed income instruments may carry more risk than generally believed in an environment of rising interest rates, thus favoring equities.

Exhibit I

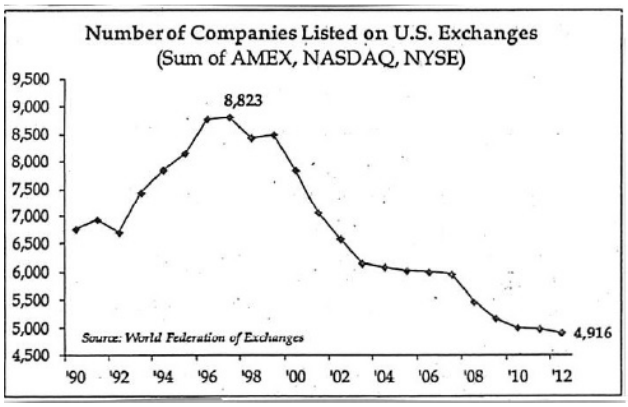
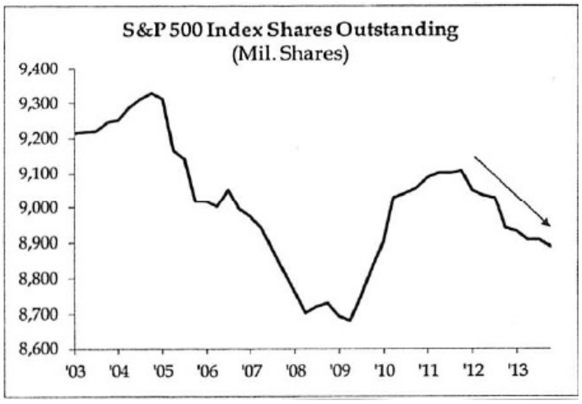


Exhibit II



We are persuaded by available evidence that U.S. stocks represent defensible value, risks considered. Aside from the dynamics listed above, there appears to be a measure of industrial revival in the U.S. triggered by reasonable wages, abundant capital accumulation, increased cooperation by state and local governments, and an inclination on the part of sovereign manufacturers to establish a foothold in the United States.

We find three sectors to be compelling in the short and intermediate-terms. These include financials which appear to have remained unjustly punished due to their meltdown during the banking crisis of 2008-9, capital equipment producers who should benefit from a manufacturing revival, and the broad energy sector which should reflect rising demand from developing economies.

Fixed income investments should be made on the assumption that interest rates are likely to rise due to a process of normalization, even if inflation remains relatively dormant. Capturing inefficiencies in this sector could provide short-term opportunities.

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Vice Chairman

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ECONOMIC FORECAST
(As of October 1, 2013)

			Estimated	Projected
	2011	2012	2013	2014
Real GDP (Y-O-Y)	2.0%	2.0%	2.0%	2.8%
Real Consumption Expenditures	2.5%	2.2%	1.9%	2.6%
Business Fixed Investment	7.6%	7.3%	3.2%	6.8%
Inventory Investment (Billions)	$33.6	$57.6	$42.0	$38.0
Residential Investment	0.5%	12.9%	13.7%	11.6%
Government Spending* (Billions) (a)	$2,992.4	$2,963.1	$2,889.0	$2,845.0
Trade Balance-Goods & Services (Bil.)	($559.9)	($576.0)	($520.0)	($475.0)
Federal Budget*: Unified (Billions)	($1,299.0)	($1,089.2)	($675.0)	($605.0)
Gross Federal Debt* (Billions)	$14,790.0	$16,066.0	$16,818.0	$17,424.0
Consumption Price Deflator	2.4%	1.8%	1.2%	2.0%
Producer Price Index (Finished Goods)	4.7%	1.4%	1.1%	1.5%
Consumer Price Index	3.0%	1.7%	1.1%	1.8%
Industrial Production	3.4%	3.6%	2.5%	3.2%
Real Disposable Income	2.4%	2.0%	0.8%	3.1%
Hourly Compensation	2.5%	2.6%	1.3%	2.6%
Unit Labor Cost (Non-Farm)	2.0%	0.7%	0.7%	1.3%
Productivity Growth (Non-Farm)	0.6%	0.7%	0.8%	0.8%
Personal Savings Rate (% DPI)	5.7%	5.6%	4.5%	5.0%
Capacity Utilization – Total Industry	76.8%	78.4%	79.6%	81.2%
Trade Weighted $ Exchange Rate (b)	(4.6%)	2.4%	3.0%	1.8%
Vehicle Sales (Million Units)	12.7	14.4	15.4	15.9
Housing Starts (Million Units)	0.612	0.783	0.960	1.140
Civilian Employment (Millions)	139.9	142.5	144.6	146.2
Civilian Unemployment Rate	9.0%	8.1%	7.4%	6.7%
Corporate Profits – After Tax – NIPA	0.6%	19.2%	3.8%	5.2%
S&P-500 Earnings-Operating	$98.73	$103.61	$107.00	$110.00
S&P-500 Dividends	$26.43	$31.25	$35.50	$38.00
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	1.55-3.10	2.85-3.65

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