



**SILVERCREST**  
ASSET MANAGEMENT GROUP

**ECONOMIC REVIEW & INVESTMENT STRATEGY: 2017/III**

There has been no lack of dramatic headlines lately—political battles in Washington, tumultuous elections in Europe, a tense regional standoff between rival U.S. allies in the Persian Gulf—yet markets have mostly shrugged them all aside, like water off a duck’s back. Is this a sign of complacency, or well-founded confidence?

In our past few notes, we focused on some of the political dynamics—tax reform, Brexit, trade wars—that could impact markets in the months ahead. But sometimes the wall-to-wall political debate can distract attention from other developments that could throw markets for a loop, or change their direction entirely. In particular, we see two factors—China and oil prices—that could rattle markets in the short-run, and two more—inflation and productivity—that could challenge the outlook for longer-term growth.

When we look at these concerns closely, however, we come away convinced that investors should be conscious of, but not intimidated by, the risks they pose. We see the market’s strength, for the most part, as reflecting that.

**CHINA SYNDROME**

China can move markets. The last two big stock market sell-offs—in August 2015 and January 2016—were triggered by fears that a slowing China would pull the rest of the world economy into recession. When that didn’t happen, most assumed it had all been a false alarm, and China drifted off their radar screens. This was reinforced by heavy government intervention to stabilize China’s falling stock market, and a new round of fiscal and credit stimulus that boosted China’s industrial output, along with global commodity prices. Now concerns about China have begun to resurface.

The problem is that China’s latest spending binge solved nothing, only adding to its mounting pile of dubious debts and overcapacity. Stimulus is running out of gas, just as China’s rulers prepare to enter a major Communist Party Congress that is supposed to solidify President Xi Jinping’s hold on power. Economic reforms described as “urgent” and “past due” four years ago keep getting bumped back as too sensitive or risky, as a crackdown on anything outside the Party’s control continues. The latest target: business tycoons, whose tangled financial affairs, if unsettled, could trigger unseen risks to the country’s broader financial stability.

Such surprises could well rattle global markets, as they have before, but only because many outside of China haven’t been paying close enough attention. We have long held the view that China faces a painful economic correction, but that an end to China’s over-investment boom—while damaging for some—will not derail the U.S. economy, and may in some ways be welcome. We have also argued against the view that China must or should sharply devalue its currency to evade such a correction, though we recognize it may be tempted to do so, nonetheless. So far, China has avoided this path, which would have damaging consequences for the U.S. and other economies, through a combination of heavy-handed capital controls and blowing asset bubbles, without solving the underlying problems. China’s

troubles are real, but not contagious (beyond China-driven commodity markets), unless it attempts to export them by devaluing its currency.

## **OIL CHANGE**

The oil market, worth \$1.7 trillion a year, is the world's largest commodity market by far, and the price roller-coaster it's been on recently has had a tangible effect on share prices and economic growth worldwide. The rising supply glut that led to a collapse in oil prices, from a stable \$110/barrel before June 2014, to less than \$30/barrel in January 2016, gave a helpful boost to net energy importers like Europe and India, while pushing many oil producers into recession and, for some, serious financial difficulty. In the U.S., where in the past cheaper oil might have been an unalloyed boon to consumers, the shale boom made it a mixed blessing, or even a net negative. Investment in oil drilling equipment was slashed, and energy sector earnings took a dive, pulling average S&P 500 operating earnings per share down by -11% in 2015. The sense of not knowing where the bottom might be alarmed markets more broadly, and for a while, daily U.S. stock market performance closely tracked the rise and fall of the oil prices, hoping for a sign of stability.

The recovery of oil prices to the \$40-60 range has provided relief, but not much certainty. An effort by OPEC and Russia to boost prices by cutting back production instead triggered a rebound in U.S. shale output, which sparked worries of a new glut, and helped push crude prices down by -14% in the first half of this year. U.S. frackers have replaced the Saudis as the world's swing producers, but instead of a single decision-maker holding the tap, there are now a host of smaller drillers, which tends to cause the industry to overshoot when adjusting supply, in either direction.

The real problem is that, even if they could accurately anticipate global demand, nobody really knows what the oil supply curve looks like anymore, since the break-even price for fracking varies enormously by geography and is constantly changing, due to improvements in technique. The fact that highly scalable but faster-depleting shale wells are undercutting investment in larger, longer-term projects raises the further prospect that near-term plenty could possibly give way, at some point, to an acute shortage.

For now, we expect the U.S. shale spigot to keep global oil prices bound within their current, relatively affordable range. The longer-term outlook could be a lot more volatile, depending on how the fracking industry (not to mention the development of renewable alternatives) evolves. And that could translate into disruptive impacts on corporate earnings and economic growth, much as it has before.

## **INFLATED CONCERNS**

It's been a while since investors have had to think very much about inflation. Since the 2008 crisis, the worry for most economies has been the prospect of deflation (falling prices), and the strenuous efforts of central banks to prevent it. In the U.S., the Fed's preferred PCE price index spent much of 2015 near zero (due to a strengthening dollar and collapsing oil prices), and has since recovered to +1.4%. Core PCE (excluding more volatile energy and food prices) has hovered around +1.5%, well shy of the Fed's 2% inflation target.

We're now at the point in the business cycle, however, where inflation normally picks up and becomes a concern. The U.S. unemployment rate has fallen to 4.4%, below the Fed's "full employment" estimate of 4.6%, while new jobless claims are at a 43-year low, suggesting a tight labor market where employers should be bidding up wages which—if not accompanied by productivity gains—could start pushing through to higher prices. Instead, average hourly wages are up a tepid +2.5% from a year ago, and even appear to be cooling off in recent months, indicating there could still be a lot of hidden slack in the labor

market, from discouraged workers who dropped out of the workforce. We know that the labor participation rate has fallen to its lowest level in four decades, and that the decline has been particularly evident among working-age men. But how many of these people can rejoin the workforce, or are permanently out of it, is a much-debated question.

Some argue that deflation is the inevitable result of an aging population, across nearly all of the developed world. But this assumes that lifetime spending patterns will remain constant, as more people live longer. In our view, the more immediate causes of downward pressure on prices are over capacity and weak demand, arising from persistent global imbalances. As a result, when the U.S. sees relatively stronger growth, that has boosted the value of the dollar, driving import prices down as much as -11% in recent years (aided, of course, by the collapse in oil), keeping both inflation and U.S. growth momentum in check. This year's decline in the dollar, from a 14-year peak, should help restore some pricing power, but the entrenched gap between global supply and demand remains a driving issue.

We don't expect a sudden surge in inflation, but are keenly aware that any real uptick could complicate market assumptions a great deal. Having barely begun to unwind its QE-bloated \$4.5 trillion balance sheet, the Fed would have to rely on unconventional and untested methods to raise rates a good deal more aggressively than they have so far, if faced with real inflation. If the Fed's response is effective, higher interest rates could reduce equity valuations by choking off growth; if it's ineffective, untreated inflation could lower those valuations by diminishing the real value of future earnings. For now, we're in sort of a sweet spot, in which disruptive price pressures are largely absent—a situation the market hopes will continue indefinitely, without necessarily questioning how or why.

## **PRODUCTIVE THOUGHTS**

Rising productivity is the key to sustaining stronger growth without inflation. Yet last year, U.S. labor productivity rose a meager +0.2%, and in the first quarter of 2017 it was flat. The average annual gain over the past 10 years was +1.2%, compared to +2.8% in both the 1950s and 1960s. These figures have set off alarm bells among observers who warn that slowing productivity gains bode poorly for future prosperity—including returns on investment.

People offer several reasons for this apparent slowdown, each with very different implications. Some well-regarded economists argue that the data is flawed; measurements originally devised in the 1930s for a mainly industrial economy aren't capturing the full extent of value creation in today's more tech and service economy. Others, most notably Robert Gordon in *The Rise and Fall of American Growth*, contend that recent innovations, as ingenious as they may be, are simply not generating the wide-ranging productivity gains the cotton gin, railroad, electricity, and internal combustion engine once did—and may never again.

In our 3Q 2015 letter, we discussed how the business cycle can distort perceptions of productivity growth, with output/worker surging when less productive workers are let go in a recession, and appearing to slow when they are rehired again as the economy picks back up. Others have pointed out how a shift in the mix of economic activity, away from capital-intensive sectors like manufacturing towards more labor-intensive sectors such as services, can require more workers for that new mix of output, reducing average productivity statistics, despite improving efficiencies. Both of these, we think, offer partial explanations, but as the economy reaches full employment, the finite supply of more workers still implies real limits on economic growth, unless average productivity rises.

Then there are political explanations. Republicans argue that burdensome regulation stifles productivity-enhancing innovation, and point to a noticeably slower rate of new business creation in recent years.

Democrats argue that workers are more productive with higher wages, such as they enjoyed in the 1950s and '60s, when unions were stronger, minimum wages higher (in real terms), and tax rates more steeply progressive. Even if they disagree about the size and scope of government, the two parties might both acknowledge that the complexion of spending has changed, in ways that potentially impact productivity. In the 1960s, the federal government spent \$3 on productivity-boosting public investments (in infrastructure or scientific research) for every \$1 on more consumption-oriented entitlements. Today, that ratio has flipped to \$1 in investments for every \$3 on entitlements.

None of these explanations necessarily excludes the others; most likely, the truth involves a mix of several, to varying degrees. What should be clear is that there are few quick fixes, only actions—or omissions—that reverberate far down the road. The good news is that the trend is not a straight downward line. After riding high in the 1950s and '60s, productivity dipped to +1.5% in the 1980s, before bouncing back to +2.5% in the first decade of the new millennium. The outlook is not so invariably bleak as sometimes portrayed. Just as the bull markets of the 1980s and '90s anticipated productivity gains that were only realized later, today's valuations should be forward-looking, reflecting the seeds of future growth that have been—or may still be—planted.

## **PLUGGING AWAY**

When we shift our attention from these longer-term questions to the data that's right in front of us, what's most striking is the continuity. So far the U.S. economy is recognizably the same one we described in our 4Q16 letter, before the election, in which different elements are waxing and waning out of sync with one another, giving rise to neither a sustained boom, nor a bust. Aside from a post-election bump in consumer confidence, most of the trends we observe now can be traced to the patterns we observed then. It remains, in other words, the sluggish recovery, and anxious bull market, that we've come to know quite well.

The strongest argument in favor of continued growth comes from the ISM survey indices, Manufacturing and Non-Manufacturing, which both advanced further into solid expansion territory in June. They were boosted by even stronger readings for new orders, which suggests that momentum will continue. Actual factory orders stumbled by -0.8% in May, mainly due to volatile aircraft sales, but were still up +4.2% from a year before. Orders for core capital goods rose +0.2% in May, up +5.5% from a year ago, reflecting the rebound in business investment from last year's slump. Nevertheless, businesses appear reluctant to add too much to their inventories of unsold goods.

One reason, perhaps, for that reluctance is the ambivalence of U.S. consumers. Consumer confidence has cooled somewhat from its post-election peak, but remains higher than it was before the November election. Retail sales have stumbled lately, falling -0.1% in May and -0.2% in June, though they were still up +3.9% for the first half of the year, compared to a year before. Auto sales continue to slide, and housing is a mixed bag. While sales of new and existing homes rose in May, new housing starts fell -5.5%, down -2.4% from a year ago, leaving construction spending flat.

The Atlanta Fed currently projects GDP growth for Q2 at +2.4%, while the New York Fed projects +1.9%. A strong employment report showed the U.S. economy adding 222,000 jobs in June. Along with upward revisions to prior months, that puts the average pace of job creation so far this year at 180,000 per month, nearly apace with last year's rate of 187,000, a healthy gain that should continue to fuel consumption growth. Low inflation will give a boost to real wage gains, and means the Fed faces little immediate pressure to raise interest rates.

The U.S. dollar continues to decline, as expectations for tax cuts and spending stimulus recede, and growth stirs abroad. It has fallen -5.2% so far this year, on a broad trade-weighted basis, and now stands lower than it was before its post-election bounce. While weakening the relative performance of U.S.-denominated assets, at least in dollar terms, the cheaper greenback spells relief for the external trade balance and its impact on GDP growth.

The S&P 500 plateaued in June, rising just +0.5%, as earnings play catch-up with the recent rally. While the index has delivered total returns (including dividends) of +9.3% in the first half of the year, the recovery in energy sector earnings, in particular, has kept average earnings per share at pace with the market. If Q2 earnings come in at consensus, the 12-month trailing P/E ratio should remain stable at 21x. The equity risk premium has continued to narrow to 5.1% (down from 6.3% before the November election) but remains well above its long-term historical average of 4.1%, which means investors are still paying a high price for avoiding equity risk.

Returns year-to-date indicate that U.S. shares are underperforming non-U.S., and that small caps in particular are lagging behind. It's important to realize that this is, in large part, a timing issue. Following the U.S. election last November, markets first adjusted to the new "Trump reflation" storyline, then readjusted as doubts began to creep in. Exchange rates did the same. If you look at a variety of key equity indices from the end of October last year—especially adjusted for currency movements—you'll notice that most of them ended up around the same place, but took different paths to get there, and that the U.S., in fact, largely outperformed. The fact that the year closed about 1/3 of the way through this unfolding process gives us a lop-sided impression of how markets have performed throughout.

	4Q2016	2017 YTD	Since 10/31/16
S&P 500	+5.3%	+8.2%	+14.0%
Dow Jones Industrial Avg	+8.9%	+8.0%	+17.7%
Nasdaq	+3.7%	+14.1%	+18.3%
Russell 2000	+13.9%	+4.3%	+18.8%
FTSE (in USD)	+4.0%	+7.9%	+12.2%
Nikkei 225 (in USD)	-1.7%	+9.4%	+7.6%
MSCI Eurozone	+1.3%	+16.5%	+18.1%
MSCI Emerging Markets	-5.7%	+18.3%	+11.5%
MSCI World	+2.8%	+9.9%	+12.9%

Conviction is not complacency, but its opposite. It thinks through the risks, questions the assumptions, asks what could surprise—and then adopts a view that balances what we know with what we can't. We will continue asking ourselves hard questions, but for now, we believe the market will continue to reward investors who keep their fears in perspective.

July 17, 2017

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 July 17, 2017)

	<u>2015</u>	<u>2016</u>	Projected <u>2017</u>	Projected <u>2018</u>
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	\$118.00	\$124.00
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.