SILVERCREST
ASSET MANAGEMENT GROUP

ECONOMIC REVIEW & INVESTMENT STRATEGY: 2018/I

The terrorist attacks of 9/11 taught all of us that the unthinkable *can* happen. For investors, the 2008 financial crisis reinforced that lesson, that the ground beneath our feet can be less solid than we assume. Perhaps that's why, with the stock market and economy both humming along nicely right now, the conversation keeps coming back to what catastrophe could be lurking around the corner. It may also explain why the year's top-performing investment isn't the S&P 500, the Nasdaq, or the Dow (which have all done strikingly well) but a cryptologically encoded "virtual currency" called Bitcoin that its advocates say will turn everything else upside down.

Are we Bitcoin converts? No. But we do think it's worth trying to understand what Bitcoin's volatile rise says about the moment that we're in. Bitcoin asks some of the right questions, even if the answers it gives fall short of the mark. While the policies that contained the last crisis and shaped the recovery—going on nine years now—seem to have worked, they've also put us in uncharted territory as that recovery reaches new heights. The same growth momentum that we believe will continue to propel markets upward, for now, could end up posing new challenges, such as inflation, that investors would be wise to begin thinking about.

UNCHARTED TERRITORY

Under Ben Bernanke, the Federal Reserve responded to the 2008 financial crisis by unleashing a flood of money, first to ensure adequate liquidity, and later with the express goal of boosting asset prices, in order to revive confidence and spending. Rather than just lowering interest rates, the Fed purchased billions each month in Treasury bonds, in exchange for new cash, an approach dubbed Quantitative Easing (QE), which expanded its balance sheet from less than $1 trillion pre-crisis to $4.5 trillion by December 2014. Early fears that such a huge monetary injection would trigger inflation proved unfounded, allowing Bernanke's successor, Janet Yellen, to ease back the throttle gently, while prompting Japan and Europe to embark on their own—in some ways more aggressive—versions of QE, in order to combat deflation and spur growth.

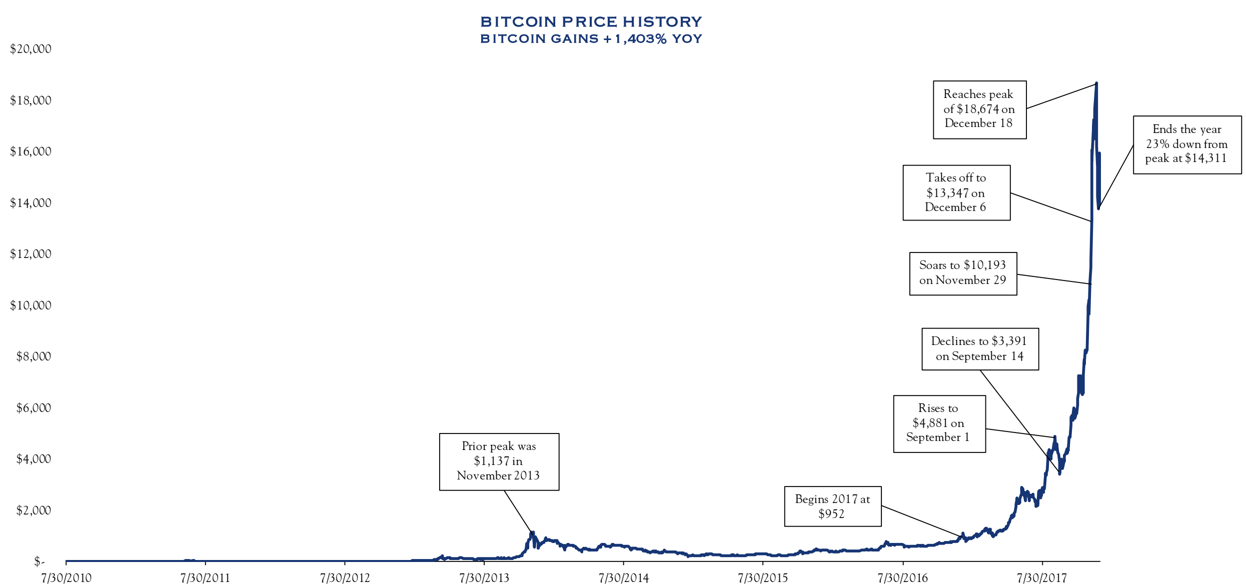
One of the reasons QE didn't spark inflation in the U.S. is that roughly 3/4 of the money it "created" went into excess bank reserves, and stayed there, rather than being lent out. For better or worse, from the point of view of the U.S. economy, it's as though that money never existed. This giant pool of available funds—now $2.2 trillion, up from nearly zero before the crisis—does matter, however, when the Fed wants to raise interest rates. In the past, by selling bonds and reducing the limited amount of cash reserves in the system, the Fed could constrain the amount banks had available to lend, thus bidding up rates. Now, with so many excess reserves on hand, banks face no such constraint, unless all of QE were unwound. Instead, the way the Fed has been gradually raising rates is by increasing the interest rate it pays on those huge cash reserves—in effect, paying banks not to lend. So far, it's worked, raising the effective Fed funds rate from barely above zero to a range of 1.25–1.50%, a quarter percentage point at a time over two years. We think it becomes a great deal more problematic—politically, as well as mechanically—if the Fed starts paying banks a growing fortune to hike interest rates to 5.25% (as it did last cycle) or 6.5% (the cycle before that) in order to cool an overheating economy.

That's not a problem, of course, as long as inflation remains under control. But we're approaching the point in the business cycle where inflation typically starts becoming a concern. The unemployment rate is 4.1% and falling, and even if the official rate understates the amount of hidden slack in the labor market due to discouraged workers who have temporarily stopped looking, their supply—and the ability to reintegrate them smoothly—still has its limits. While the nation's industrial capacity (at a utilization rate of 77%, compared to 80% or higher for a typical cycle peak) is far from overstretched, the Congressional Budget Office (CBO) estimates that total economic output in Q3 nevertheless ran slightly above maximum sustainable output, for the first time in over a decade. Improving growth momentum in Europe and Japan, along with China's efforts to reduce its own industrial overcapacity, could also remove some of the global downward pressures that have kept prices from rising.

The tax cut just enacted by Congress is poised to add fuel to that flame. While its impact on each company and individual will vary, the net impact on the economy will likely be to add upwards of $1 trillion in more deficit spending over the next 10 years. Provisions allowing the immediate expensing of capital equipment purchases, and removing tax barriers to bringing profits back from overseas, could give a boost to investment. The real key, as Yellen told Congress a year ago, isn't how much immediate kick tax cuts can give to an economy already nearing full employment, but whether those cuts and reforms can unlock productivity gains that increase the rate the economy can grow without causing inflation. Advocates argue that they will, and we're hoping they're right, because without that, any fiscal stimulus only hastens the day when inflation becomes as a concern, and the Fed is forced to respond.

As Yellen reaches the end of her term as Fed Chair, observers have given her good marks for gradually raising rates while avoiding any disruptive moves that could derail the recovery. So far, so good. As the recovery continues, however, monetary and fiscal policies aimed at tackling one set of now-familiar problems (unemployment, risk-adversity, deflation) may complicate our ability to respond to a new set of challenges (resource constraints, overconfidence, inflation). The Fed has just started unwinding QE by letting its holdings of Treasuries draw down as they mature, but draining away the huge monetary overhang in the banking system could take the better part of a decade. What happens if the economy overheats before then? What happens if, after gunning the engine and picking up unwanted speed, we press the brake pedal and nothing happens? That's precisely the kind of worry driving the curious to think about Bitcoin.

THE EXCITING BIT



Bitcoin began 2017 at $952, having struggled to regain lost ground after dropping to $183, following a rally that peaked at $1,137 in November 2013. That was a far sight above its first real-world transaction price, in May 2010, when a woman from Florida bought two pizzas for 10,000 Bitcoin. After a volatile January, Bitcoin passed its previous high in February, and rose steadily to $4,881 in September, before crashing below $3,400 following a trading crackdown in China. Then it really took off, shooting to $6,377 by the end of October, and climbing almost vertically from just below $10,000 to over $16,000 in the first five trading days of December. The frenzy peaked just above $18,600 on December 18 before falling by nearly a quarter to end the year at $14,311. It's been a wild ride, with an annual gain this year of 1,403%. Those two pizzas, purchased in 2010, would now cost almost $72 million each.

Before we go any further, now may be a good time to stop and ask what this magical substance could be and how it works. Bitcoin was introduced in October 2008 in a paper published by Satoshi Nakamoto, a mysterious figure who may or may not actually exist. It is a digital currency that can be transferred from one virtual "wallet" to another by using a password known only to the owner of that wallet. A record of all transactions—who owns what—is kept in a public distributed ledger, called the "blockchain", rather than by a central authority such as a bank, and so-called "miners" are rewarded for using their computers to help verify and update this ledger (every 10 minutes) by receiving new Bitcoins. As the blockchain record of transactions grows, more and more computing power is required to verify it and "mine" a gradually diminishing number of new Bitcoins. About 16 million Bitcoins have been created so far, and the total number is capped at 21 million, which is expected to be reached by the year 2140.

One of the questions we're frequently asked is whether we think Bitcoin is really a currency. We take an existential view: money is what money does. What can you buy with it? Does it preserve its value or earn interest if you save it? Over 100,000 merchants, including Microsoft and Expedia, now accept Bitcoin as payment, but they normally exchange it for dollars they can use. Bitcoin's rapidly rising value might make it attractive to hold, but makes it less attractive for buyers to spend, not knowing how much value they could be giving up. In principle, anything—bits of metal, bits of paper, seashells, cigarettes—can function as a currency, though some are better suited than others. Bitcoin is an ingenious idea that brings some much talked-about advantages to the task, as well as some less talked-about disadvantages.

Of course, some of the interest in Bitcoin is purely speculative: people ready to jump aboard anything that seems to be going up. The most absurd example, in recent days, was when a local beverage maker called Long Island Iced Tea suddenly changed its name to Long Blockchain Corp., only to see its share price skyrocket 275% in a single day. But advocates argue that unlike Dutch tulips and Beanie Babies, Bitcoin is a transformative technology that offers a lot more than just hype. It's no accident that Bitcoin came into being right after Wall Street's big meltdown, just as the Fed was pumping out money to prop up markets. The entire project is rooted in a deep skepticism towards banks and government printing presses, and a kind of techno-libertarian conviction that technology can produce an "honest coin" free from their manipulations. The solution is, on the face of it, an elegant one, and even many who dismiss the prospect of Bitcoin replacing existing currencies believe that the collaborative blockchain approach can radically replace our clunky bank-centric systems for processing payments and have broader applications as well. Several leading Silicon Valley venture capitalists are particularly keen on the idea, as is China, whose central bank has set up a digital currency research group.

The idea that blockchain technology can eliminate the need for financial intermediaries and their processing fees is true only to a point. As long as it's used as cash for direct payments, Bitcoin is self-sufficient, like a more versatile version of paper money or gold. But money is more than cash; it's also credit. As soon as you want to use Bitcoin to do any of the more interesting and important things we do with money—lend it, borrow it, or exchange it for a different kind of currency—you're right back to relying on intermediaries. In Bitcoin's case, these marketplaces have proven alarmingly vulnerable to fraud, hacking, and other illegal activities. Once Bitcoin's mining cap has been reached, even the comparatively straightforward work of verifying cash transfers will have to be compensated by charging transaction fees, rather than mining new Bitcoin.

In fact, the real cost of verifying those transfers is already presenting growing challenges. As the blockchain lengthens, the amount of computer power—and electricity needed to run it—has grown astronomically. Already, one estimate figures that Bitcoin consumes as much energy in a year as the entire country of Ireland. The Dutch bank ING calculates that the electricity required for a single Bitcoin trade could power a home for a whole month (200 kilowatt-hours, compared to 0.01 for a typical Visa transaction). Even if these estimates err on the high side, as its advocates claim, Bitcoin's hungry resource demands could prove a serious practical disadvantage.

Since only a finite amount can be "mined", Bitcoin is often compared to gold as a potential hedge against a looming monetary crisis, caused by irresponsible central banks printing money *ad infinitum*, or some other catastrophe that causes government-backed currencies to collapse. This comparison obscures one very important difference: Bitcoin, unlike gold, depends on a highly sophisticated and potentially fragile electronic infrastructure to function. If a hacking attack or power outage takes the internet down, you can't send or receive Bitcoin or even access your wallet, if you keep it remotely. If North Korea explodes an electromagnetic pulse (EMP) weapon over the U.S., the gold coins you buried in your backyard will still be there, but any Bitcoin on your hard drive will be fried, along with your devices for reaching the internet (a big chunk of which will be fried as well). The point isn't that these events are likely but that most doomsday scenarios capable of seriously disrupting life as we know it would hardly leave Bitcoin safe and sound.

Whatever your concerns are about inflation, QE, and the stability of the financial system, there are two main reasons why stocking up on Bitcoin probably isn't the answer. The first is that there are better alternatives—and we're not talking about that gold buried in your backyard. The place to invest in a time of high inflation is in real assets—commodities, property, and productive facilities—not in a new, experimental currency. For most Americans, the most basic way to do this is owning their own home. Inflation can be harmful to equity returns, but some companies—those with sizeable holdings of real assets or strong pricing power in their markets—are positioned to fare better than others. Even at the peak of hyperinflation in Weimar Germany in 1923, farmers who owned land and crops did fine, while entrepreneurs who borrowed to buy factories and machinery walked away with fortunes, as their money-denominated debts dwindled away to nearly nothing. Real resources, real goods and services, and the real ability to produce them retain their value, whether the world uses Reichsmark, dollars, or Bitcoin to price them.

AHEAD OF THE STORY

The second reason not to flee to Bitcoin, or other air raid bunkers, is that investors need to be careful about getting too far ahead of the story. Thinking about the potential implications of rising inflation, down the road, is prudent, but it's important to remember that so far, inflation is still scarcely to be seen. The Fed's preferred inflation gauge, the PCE index, stood at +1.8% in November, below the Fed's target of +2%. Consumer prices (CPI) were up +2.2% from a year ago, but core CPI (excluding volatile energy and food prices) was up just +1.7%. Export and import prices are exerting some modest upward pressure (+3.1%) due to a weaker dollar, but wage pressure—which topped +4% at the peak of the last two cycles—remains in low-gear at +2.5%. For now, the Fed is under no pressure to raise interest rates any faster than it wants to, and the new incoming Fed Chair, Jerome Powell, is a long-time Yellen ally who is expected to stay the same patient course she has. The flattening Treasury yield curve over the past year wouldn't appear to indicate that the bond market expects a big ramp-up in rates, to combat inflation, anytime soon.

Meanwhile, unchecked by these constraints, the U.S. economy keeps moving forward, and corporate earnings look healthy. The Atlanta Fed currently projects GDP growth of +2.7% for Q4, while the New York Fed estimates a more vigorous +4.0%. Industrial production, rebounding from a nearly 2-year slump, is up a healthy +3.4% from a year ago. New orders for durable goods in November were up an impressive +8.2% from a year before, while orders for core capital goods—a key indicator of business investment—was up +8.1%. Meanwhile, the inventory-to-sales ratio has fallen to 1.35, its lowest level since December 2014, which suggests robust demand is more than keeping pace with supply. The ISM Manufacturing Index rose +1.5 points in December, based on surging new orders, but the prices gauge for both the manufacturing and non-manufacturing surveys—in contrast to the headline inflation numbers—are blinking a warning light that price pressure could be building.

The U.S. economy created 2.1 million new jobs in 2017. This is a slightly slower pace than previous years, but still the seventh straight year over 2 million, bringing the unemployment rate down to a 17-year low (4.1%). Consumer confidence cooled a bit in December, from the 17-year highs it hit the previous two months, but remains strong. Only 15.2% of consumers surveyed say jobs are hard to find, down from 16.8% in November, which means they are willing to spend. Retail sales surged +0.8% in November, up a striking +5.8% from a year ago. Auto sales have rebounded from their slump earlier this year and housing sales are back in positive territory again, year-on-year, after their summer slowdown. The NAHB Housing Market Index surged +5 points in December to 74, a new high for this business cycle.

There are two trends we've observed that should strike a note of caution. First, the personal savings rate has fallen steady, from 6.1% two years before to just 2.9% in November, its lowest level of the cycle. While consumers' incomes are up a healthy +3.8% from a year ago, they've dug deep in their pockets to spend even more, up +4.5% from a year ago. That's good for growth right now, but it also makes the economy more vulnerable to shocks.

Second, the Equity Risk Premium (ERP)—the amount of additional return investors can expect from taking equity risk, based on trailing cash flow—has also fallen steadily, from 6.3% just before the November 2016 election to 4.7% at the beginning of last month. That's still above the long-term historical average of 4.1%, but the gap that once existed and which strongly favored equities has narrowed considerably.

The fact that equities are more fairly priced relative to fixed income doesn't mean that share prices won't advance further as earnings grow. A year ago, we argued that our initial earnings per share (EPS) projection of $117 for the S&P 500 in 2017 was reason enough to stay in the market. We now expect 2017 EPS to outperform that by a sizeable margin and reach $124, up +17% from 2016. That would keep the S&P 500's trailing P/E ratio relatively steady at 21.6x operating earnings, up only modestly from 21.1x a year ago, driving home the point that earnings growth, not skyrocketing valuations, are what supported the market's strong upward trajectory through 2017. We believe that will continue to be the case, and have raised our EPS projection for 2018 to $136.40, in part due to lower taxes on corporate income, though our expectations remain conservative compared to the consensus ($145).

The +21.8% total return (including dividends) to the S&P 500 investors earned in 2017 was the reward for patience and calm in a year many feared could be filled with turmoil. Double-digit returns to overseas equity markets—especially when the dollar's −7% decline this past year is factored in—show that growth momentum wasn't limited to the U.S. Based on the data we're seeing, the economy and equity markets could still have some room to run in 2018. But at some point, it's possible that they will face new challenges, ones they might even be ill-prepared to face. When that point does come, investors who stick to disciplined, tried-and-true strategies, rather than speculative gambles, will come out ahead. Until then, we keep our ears to the ground, our eyes on the data and try to not get too far either ahead—or behind—the story as it unfolds.

January 8, 2018

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ECONOMIC FORECAST

(As of January 4, 2018)

	2015	2016	Estimated 2017	Projected 2018
Real GDP (Y-O-Y)	2.9%	1.5%	2.3%	2.5%
Consumption Expenditures	3.6%	2.7%	2.7%	2.5%
Business Fixed Investment	2.3%	-0.6%	4.5%	3.5%
Inventory Investment (Billions)	$100.5	$33.4	$18.8	$20.0
Residential Investment	10.2%	5.5%	1.1%	2.0%
Government Spending * (Billions) (a)	$2,878.5	$2,900.2	$2,900.0	$2,914.7
Trade Balance-Goods & Services (Bil.)	-$500.4	-$504.8	-$555.4	-$560.0
Federal Budget*: Unified (Billions)	-$438.4	-$584.7	-$693.2	-$698.4
Gross Federal Debt* (Billions)	$18,120	$19,539	$20,188	$21,356
Consumption Price Deflator	0.3%	1.2%	1.7%	2.0%
Producer Price Index	-7.3%	-2.6%	4.4%	5.1%
Consumer Price Index	0.1%	1.3%	2.1%	2.3%
Industrial Production	-0.7%	-1.2%	1.9%	2.5%
Real Disposable Income	4.2%	1.4%	1.2%	2.2%
Average Hourly Earnings	2.2%	2.6%	2.6%	3.0%
Unit Labor Cost (Non-Farm)	1.9%	1.1%	-0.3%	1.0%
Productivity Growth (Non-Farm)	1.3%	-0.1%	1.5%	1.7%
Personal Savings Rate (% DPI)	6.1%	4.9%	3.5%	3.0%
Capacity Utilization – Total Industry	76.8%	75.7%	76.4%	77.3%
Trade Weighted $ Exchange Rate (b)	16.1%	0.6%	-0.4%	1.0%
Vehicle Sales (Million Units)	17.8	17.9	17.6	17.4
Housing Starts (Million Units)	1.112	1.174	1.215	1.250
Civilian Employment (Millions)	148.8	151.4	153.3	155.0
Civilian Unemployment Rate	5.3%	4.9%	4.4%	4.0%
Corporate Profits – After Tax	-5.3%	2.2%	9.5%	4.0%
S&P-500 Earnings-Operating	$100.45	$106.26	$124.00	$136.40
S&P-500 Dividends	$43.39	$45.70	$48.93	$52.00
90 Day U.S. Treasuries-Yield (%)	(0.02)-0.29	0.18-0.54	0.49-1.45	1.25-2.50
10-Year U.S. Treasuries-Yield (%)	1.68-2.50	1.37-2.60	2.05-2.62	2.00-3.50

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