



**SILVERCREST**  
ASSET MANAGEMENT GROUP

**MARKET COMMENTARY CALL TRANSCRIPT**  
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**Corporate Speakers:**

- Robert Teeter; Silvercrest Asset Management Group Inc., Managing Director and Chairman of Investment Policy and Strategy Group
- Patrick Chovanec, Silvercrest Asset Management Group Inc., Managing Director and Chief Strategist

**Operator:** Welcome to the Silvercrest Asset Management Group Market Commentary Call.

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I would now like to introduce your host for today's call, Patrick Chovanec, Managing Director and Chief Strategist; and Robert Teeter, Managing Director and Chairman of Investment Policy and Strategy Group. Gentlemen, please begin.

**Robert Teeter:** So, every year is interesting. This year has been particularly interesting as we've transitioned from what was last year, a very tranquil market environment, to one this year, that seems quite a bit more volatile. Although, as we pointed out on numerous occasions, it's actually more of a return to normalcy on the volatility front.

We certainly saw markets rally quite a bit in January and then sell off in February and March, and so we continue to bounce around here in April as earnings season gets underway. However, what we really wanted to focus on today is a topic that Patrick touched on in his letter and elsewhere, and it's certainly worthy of a call and questions in Q&A. And these are the key fundamental economic issues of the budget deficit and the trade deficit.

And so, what we're going to do is go one by one and sort of talk about each of those, but then Patrick is going to walk us through some ways in which they're linked and why they really matter to markets and to economic policy here. So just to get underway, Patrick, maybe it would be helpful if you could just sort of briefly define the budget deficit and tell us what it is and why it matters?

**Patrick Chovanec:** So the budget deficit, we usually mean the federal budget deficit—that is how much more the federal government spends than it takes in from tax revenues and other revenues. And then the trade deficit is how much the U.S. sells versus buys in the world. And I think most people are aware that both have been salient features of the U.S. economy, negative deficits in both areas. They've been salient features of the U.S. economy since maybe the late 70s or the 80s, but they have definitely been with us off and on, waxing and waning since then as regular features.

But why talk about them now? I think it's useful to ask why to bring them up now. And it's because if you look at the reasons over the past couple of months that it pushed down stock prices, they are tied actually fairly directly to concerns over these two deficits. The first reason—the two reasons why there's a big sell-off in January, the thing that kicked that off was concerns about inflation and rising interest rates. If you remember, the year began very strongly on excitement about the tax cuts and what they would mean to corporate bottom lines and how they might stimulate the economy. And then all these second thoughts kicked in and say, well, what if the economy is overstimulated, what if the economy grows too fast and you start to get inflation, especially with unemployment at a very low rate.

And if that's the case, long interest rates have to start rising to hit off that inflation. And that's what really—in fact, it was one number that came out on January 26, I think, which was the wage numbers that came out, that at least if it didn't kick it off. It certainly solidified concern that maybe inflation might be taking off.

And then the other concern, which then subsequently took over, particularly over March, was concerns about trade war. And the conviction of President Trump that the trade deficit is a very serious impediment to U.S. growth and therefore requires potentially very confrontational strategy, even at the risk of disrupting existing trade patterns, particularly in trade relations. So we try to fix that. And so, what could be the implication of that attempt to fix this issue?

So both of that pushed share prices down, and it's worth kind of taking a step back and asking what do these deficits mean, how significant are they, how concerned should we be about them, and then how important are our efforts to address them. And I think all of those kind of feed in to, maybe, a longer-term view on some of the things that have been [royalty] markets recently.

**Robert Teeter:** And I guess in terms of framing both of those questions before you start getting into some of the linkages between the two of them, I guess it's fair to say that both the budget deficit and the trade deficit—neither are sort of new issues. And I think you mapped something out in your letter in terms of the graphs that are pointing out the impact of the tax cuts from the budget deficits.

**Patrick Chovanec:** In fact, in some ways, there's a history to them that is, I want to say, so old. I mean it's within living memory, but it's not recent enough that we tend to forget it. And that's actually, maybe, part of what I tried to do in my letter was to talk a little bit about the history of things we've seen and where we've been with both of these deficits to reveal some of the linkages between them.

**Robert Teeter:** Great. So maybe one thing that might be interesting is to start talking about how the two are linked in fact and why it may not be such an obvious issue.

**Patrick Chovanec:** Well, I think the place to start here is this concern that you even saw yesterday in the markets. I know there were sell-offs yesterday, and why did they happen? It happened because a number of companies, even though they met their earnings or even exceeded their earnings target, talked about price pressure. They talked—they said we're seeing price pressure, and this then—the market then focused on this and said, aha, you see. We're seeing inflation and we're seeing—and potentially that's going to raise interest rates.

And there is this concern out there that not only might—the additional stimulus from the tax cuts at this stage in the business cycle might start competing for capital, for labor, and pushing those prices up. And it also...

**Robert Teeter:** I think that's an important point. I just want to certainly expand on it maybe a little bit for the listeners. Because I think you walked through in your letter how, at different points in time, the budget deficit can have a different impact depending on where we are, and it's like, oh I think you just touched on that briefly there. It would be helpful to explain that a little bit.

**Patrick Chovanec:** Right. So, if you got a lot of slack in your economy, there's an argument which goes back to John Maynard Keynes during the Great Depression that governments could run budget deficits to private fund; that is, get some of those idle resources moving and get money flowing through the economy again. But there's a problem if you do that at a stage where there aren't—there isn't a lot of slack in the economy. You will end up competing for resources and basically getting prices up, and that's what happened in the 1960s when the U.S. started to run what today are actually fairly modest budget deficits. But it's credited with kicking off the inflation that plagued the 1970s.

But what's interesting though is that, that is not necessarily the way it has to play out. You know, one concern that we heard in recent days is that in addition to perhaps overstimulating economy and kicking off inflation, the Fed has to step in and raise rates to contain inflation. But also, the debt that you're—the government is issuing more debt at a time when the Fed is stepping back from purchasing that debt, that the Fed was very active in buying Treasury bonds as part of QE. It's now drawing down those holdings. And so, you've got more debt that has to be funded, and there's a concern that could raise interest rates.

However, if you look at what happened in the 1980s, the U.S. did run much larger budget deficits, but instead of it pushing up interest rates by competing for domestic funds, what ended up happening was it attracted funding from abroad. So, capital flowed into the country. Now that means that you don't necessarily have the crowding out effect that you had during the 1960s, for instance.

But the corresponding effect of capital inflows was outflow payment in the form of a trade deficit. So, in the 1980s, you saw a larger budget deficit that didn't result in higher interest rates. In fact, higher interest rates went down during that period. What it translated into was a larger trade deficit and enabled to a stronger dollar at that time. And that's why they became and were called the twin deficits. And it's no coincidence that while they don't—they don't move in lock step together, there are other factors that affect both of them. But fundamentally, over the past 50 years, we've seen the trade deficit, the budget deficit and the trade deficit in the United States rise together as features of the economy, and that's why.

**Robert Teeter:** Great. So, I think in your letter, too, it was interesting that you pointed out some of the underlying structural issues behind the budget deficit and noted how—while the tax cut is certainly contributing to it, they're not the main driving force behind the deficits. So, I think it would be helpful to walk through that a bit.

**Patrick Chovanec:** So, I think the first thing I say, and I said it in the letter, is something that's seen as very counterintuitive, which is that trade and balances don't arise because of competitiveness. They arise because of savings and whether you're lending or you're borrowing. And it is very counterintuitive because we think, well, I mean if you're better at making things, then people want to buy your exports and you'll run a trade surplus. But, in fact, if you're better at making things, that means that you have more income, but it doesn't mean that you can't spend that income. You could just spend it on a higher standard of living; you just spend it on more investment.

It's a choice by an economy collectively to lend that money abroad, and then by lending that money abroad, you actually enable somebody else to run a trade deficit because the only way you can run a trade deficit is if somebody lends you the money to do it because you're consuming an excess of what you're producing. So, it's really savings and differences in savings among economies that drive trade deficits. And this is, again, how budget deficits are connected because budget deficits are a form of the savings. You are—the nation is saving less and the result is that, that has to be funded somehow.

**Robert Teeter:** Right.

**Patrick Chovanec:** Now, the question, of course, is: is it better to be a lender or a borrower, or neither? And the answer really depends on where the investment returns are. If you are a company, often it makes sense to borrow money to invest in some business line that will actually generate higher returns. If you're a student thinking of going to get a higher degree, depending on what the higher degree is, it might be a good investment, it might be a bad investment.

So, the question is how—if the United States is borrowing both in terms of public debt and also it's being funded from abroad via a trade deficit, is that laying a good foundation where that money will be invested wisely and generate economic growth that will enable us to pay it back? Or is it going in directions which actually dig a deeper hole.

One of the things I—one of the concerns that I expressed was that back in the 19<sup>th</sup> century, the United States ran regular trade deficits with Britain. But it was the time of great economic development, and that money was invested and very well spent. It was a good deal for them because they got the returns from developing the new world, in the U.S. economy, and participating in that. And it was good for us because it enabled us to do a lot faster than we otherwise wouldn't have been able to. That's an example of good investment.

Germany, the time that the euro was introduced, Germany started running huge trade surpluses with Greece. Greece was running huge trade deficits. They were, in fact, borrowing money from German savers. That's a bad deal for both of them because it didn't result in that kind of productivity gain. And they ended up with a lot of debt that they couldn't pay back, and that's not good for the borrower or the lender.

So, the concern that I have going forward is that there's this big political debate in the United States over how does—how we should manage our fiscal priorities. And the Republicans will kind of say, well, we could cut taxes and that will incentivize productivity gains. And Democrats would say—tend to say, well, we could invest in a number of social resources, education, the environment, a whole host of the infrastructure. And there's some overlap between them, but they disagree about the priorities.

Well, it's great to have that debate, we should have that debate, and arguably some mix would create real productivity gains. And if we run budget deficits because of that, because we're investing in the right things, that's not a problem. The problem is that increasingly, that debate is being shunted to the side because more and more of the budget is being spent—is locked up in paying for entitlement.

Now those entitlements are things that we want, right? I mean, we want healthcare, we want Social Security, we want all these things. But that's consumption, it's not investment. And so, it's a problem when you are borrowing to consume as opposed to borrowing to invest. And that is, I think, the worry that I have about the structural trade surplus and—I'm sorry, the structural budget deficit and the structural trade deficit that we have is that it's not necessarily—it's really a sign of overconsumption rather than undersavings.

And to be fair, that is reflected also—it's mirrored in other countries, which have the opposite imbalance, where they're really saving too much and they're consuming too little. And that's really the underlying issue that needs to be addressed. And that's where I've started talking about some of the trade tensions that we've seen recently to the degree that their—addressed that intuitive notion of, well, there's unfair trade practices, and that means that we're less competitive than others, and we should impose sanctions and then maybe we'll be more competitive.

That is hammering on the wrong nail. It's important for us to be competitive, it's very important for us to be competitive, and it doesn't help when countries engage in policies that maybe suppress consumption abroad.

But, really, it's an issue of the patten of consumption, investment, and savings in the United States and other countries, and striking a better balance there. That's what will actually address some of these concerns about these twin deficits and the potential dangers they pose down the road to the U.S. economy.

**Robert Teeter:** Great. So maybe one more question before we jump into the Q&A, and kind of transitioning back to current economic environment. I think it might be helpful if you walked us through what you're seeing, what's in the steps now. It seems that there is some good momentum. It would be interesting to hear how you see things.

**Patrick Chovanec:** So, bringing it back down to earth, right, what is the takeaway from these kind of big thoughts about twin deficits, and it's what should investors be concerned about right now. This idea that debt issuance is going to lead to high interest rates, I don't think that's primarily how it's going to play out. I think we may see a wider trade deficit that may create headwinds to U.S. growth. But I think some of the concerns that's out there about rising interest rates is a bit premature, a bit overwrought.

The inflation is a time when we should be thinking about inflation clearly, but—and we do hear. We hear anecdotes about companies seeing price pressure. We see it reflected in purchasing manager survey. But we don't see it reflected yet in the hard numbers. Inflation has crept up a little bit from a very modest beginning. Consumer price inflation is at or below 2%, which is the Fed's target. Will it continue to creep up? More probably. Could that eventually become a problem? Possibly. But it's not going to change overnight. We're not going to wake up tomorrow and it's going to be 5% inflation. The Fed is going to have to immediately kick in.

So, it's something that we're going to continue to watch. But I think there's a little bit of an overreaction. And I think also it's tended to crowd out some of the good news that we've seen in the economy, which is that consumer confidence is very high. That's not really a good leading indicator of where the economy is going, but it does tell you that consumers are willing to spend right now, largely because they're confident of job growth.

They—consumer spending is up more than 4% year-on-year. It's reflected in full order books when we look at the purchasing manager surveys for both manufacturing and non-manufacturing, both are in very clear expansion territory. And one of the strongest items in them is new orders. And so, that suggests that, at least for the next several months, that we should continue to see the kind of demand that has caused companies both to run their production lines but also to think about adding more. And orders for core capital goods, that is what business is investing in new machinery and new product lines, those are up more than 7% year-on-year, which is quite a strong number.

So, that economic data looks pretty solid. The other thing is that—and I think really the unheralded story has been the story of corporate earnings. Corporate earnings rose—the earnings per share for the S&P 500 rose about 17% last year. The market rose about 19%. So, most of the rise in the market came from earnings growth. Now, part of that is earnings per share; so, part of that is a shrinkage in shares buybacks, and obviously that's a thing that we want to keep an eye on, especially as interest rates rise. But if earnings come in this quarter as they're expected at this late date, they will be up about 5% quarter-on-quarter and it will be up about 22%, 23% year-on-year.

And together with that earnings growth, the drop that we've seen in share prices now means that the valuation for S&P 500 Index is at its lowest point in nearly three years. They began the year at 21.5x earnings trailing. It went up when the shares rallied at the beginning of January up to 23x. That's where we started to get a little bit concerned that maybe things are getting—market was getting ahead of itself. But now it's gone down to 20. And that is, like I say, below where it's been for over two years, and that suggest—well, if you think that the economy is about to fall off a cliff, if you think that inflation is about to take off and the Fed is going to be forced to ramp up interest rates really fast, maybe that's—then that's the warning sign that things are going to go down from here. But I don't see either of those things immediately reflected in the data. There are concerns, there are issues, there are risks like trade work, and obviously the trade tensions could boil over and things could go in a wrong direction there, but that's not our base case. We always have concerns and there are issues, things that could go wrong, but then we bring it back to base case and say what are we seeing, and what we're seeing is some rooms to run.

**Robert Teeter:** Great. Well, we covered a lot of ground there. And in the interest of time, I think we want to allow for questions, if there are any. So, with that, thank you, Patrick, and we'll turn it back over to the moderator to see if there are any questions on the line.

## QUESTIONS AND ANSWERS

**Operator:** (Operator Instructions) And our first question comes Caller 1. Your line is now open.

**Caller 1:** The question I had is it really relates to deficit, and this may be more of an economic question. If I heard correctly, the forecast that you all had done quarterly were showing probably going back as far as 2017, maybe 2016, the beginning of 2018, that we would start—that the budget deficit would start increasing, have exceed billion dollars.

And so—and that's before—obviously, there's been any income tax revisions. At the same time, the Fed is starting to increase interest rates, and the Fed is starting to unwind. So if you look at the effect of the growing budget deficit just on an as is basis before the income tax changes, the increasing interest expense, which has to be funded, and the unwinding of the Fed balance

sheet, if you quantify what the effect of that could be on, collectively on the deficit on a going forward basis, and then further out as you mentioned, then you have the entitlement expense.

**Patrick Chovanec:** Right.

**Caller 1:** And I remember—lastly, I think that the last thing was—I think that the forecast based on what the effect of the tax bill was going to be, which may be cumulative, about \$1.2 trillion incremental deficit over a 10-year period. So, I don't—I'm a deficit [hawk] but...

**Patrick Chovanec:** Right.

**Caller 1:** ...I don't want to throw out—there's a lot of stuff going on here, even before the budget deficit, before the tax bill even came through. So, if you quantify each component and then further out looking at the—as you point out, the—an entitlement issue, it's to me is kind of scary or it is scary. But I just—I don't want people to overreact to what's going on. And the tax bill is one thing, but there's a lot of stuff going on that precedes the tax bill relative to the budget deficit. Thank you.

**Patrick Chovanec:** Yes, so your question, as I understand it, is related to really the structural budget deficit. The fact, with or without tax cuts, that the budget deficit was already projected to go out to 5.2% of GDP by, I think, it's 2027 and the potential issues that, that poses. And I think that's part of what I was trying to highlight.

It doesn't—it didn't tell us when this cycle will end, right? So, it's a different question, there's a question of what are the implications for this cycle and then what are the implications for the U.S. economy 10, 20 years from now, right? And I think that the implications for the U.S. economy 10, 20 years from now are that unless we address this ability more productively and whether we borrow or not, right, to employ those proceeds in a more productive way, and have that meaningful political debate about how to do that, then we will—we'll be on increasingly thin ice. And in fact, the IMF just came out with something that showed that the U.S. is the only country out of all the developed countries in the world that is expected to increase its debt to GDP, its sovereign debt to GDP ratio as opposed to have it fall over the next decade or so.

I'm a little skeptical about some of that optimism about some of these other countries, particularly a place like China, where I think a lot of the sovereign debt gets hidden in other places. But that said, that's a concern for the U.S. to be even arguably an outlier in that way. And the short-term question, though, is what are the implications for this cycle, right? What are the implications for the immediate investment outlook?

And that's where I would say that I think that one way, of course, the need to fund more debt can be met is through rising interest rates. But more likely, it will be met through a more modest rise in the interest rates, maybe even none, and that money—that funding will come from abroad instead of—instead of being reallocated within the U.S. economy. And that the result will be a wider trade deficit regardless of all the trade negotiations that you can have, that the need to borrow more in order to fund these larger budget deficits will translate into a trade—a

larger trade deficit, and that will continue to raise all the issues that people are concerned about, about the effects of the chronic trade deficit on U.S. productivity.

So—but what that means, though, is that some of these immediate concerns about rising interest rates may be based on assumptions that actually won't hold, but it will get resolved in a different way that raise different issues for investors.

**Robert Teeter:** Thank you for the question. Moderator, do we have any other questions on the line?

**Operator:** I'm seeing no further questions.

**Robert Teeter:** OK, great. Well, thank you, everyone, for dialing in this afternoon. Always a pleasure, and we look forward to having another call next quarter.

**Operator:** Ladies and gentlemen, thank you for participating in today's conference. This concludes today's program and you may all disconnect. Everyone have a great day.