SILVERCREST
ASSET MANAGEMENT GROUP

MARKET UPDATE

The weekend financial press was, as to be expected, dominated by discussion of the market weakness in February following a strong January start to the year. Lots of finger pointing, and we tend to agree with the general consensus that the higher-than-expected wage growth number posted on February 1st precipitated a move higher in the ten-year bond and kindled some concerns over inflation, prompting profit taking. Derivative trading and trend following likely exacerbated the move down. We have been cautioning that we thought volatility was likely to increase with the popularity of ETFs, and while the low VIX may have suggested the market as a whole was less volatile, under the covers we felt there was a fair amount of volatility at the company and industry level, which finally showed up at the broad market level. So, while painful, and the rapidity of the decline and intra-day volatility is nerve wracking, we do not believe the action heralds the end of the bull market, but represents a long overdue correction to wash out some complacency.

We did not find the market particularly overvalued before February 1st, due to the strong fourth quarter earnings season we have witnessed, low by historical standards interest rates, and benign inflation. Elevated perhaps, but not overvalued. Post the 10% decline, moderated a bit by the advance on Friday, we see the market more reasonably valued and still operating within an environment of strong earnings growth, low interest rates, and moderate inflation. We had opined in our fourth quarter letters that we might need to "be careful what we wish for" regarding tax reform, as the economy had been improving, and maybe didn't need a big jolt of stimulus. Coupled with increasing concerns over a potentially ballooning deficit, higher interest rates appear likely.

What we do think this wake-up call does, perhaps, is limit the upside. We find it hard to argue for much P/E multiple expansion should we get higher interest rates and faster inflation. Cognizant now that the market can indeed go down, data points will be scrutinized and maybe more "loaded for bear" with a bias towards a more negative spin. We expect more volatility, but don't see much more downside for now than what we have already witnessed. Should the market mark time, or decline, we think that should benefit active managers as ETFs unwind, favor small caps for similar reasons, and in a higher interest rate environment, help financials, and continue to pressure the bond surrogates, Utilities and REITs. Without multiple expansion, we would expect the market to move with corporate earnings, and constructive use of the tax reform windfall. On that point, notice that most companies are talking employee bonuses to share tax reform dollars, as opposed to wage increases, potentially keeping wage inflation in check.

In general, our portfolios disappointingly participated fully in the decline, as the selling was pretty indiscriminate. This generally happens in the early stages of a sharp downturn, but over time, we would expect our companies' financial strength to be rewarded and return to our historic positive relative performance.

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