



REVIEW AND OUTLOOK

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A MATTER OF SECONDARY IMPORTANCE

Summary

- The fate of the economy depends, to a large degree, on whether we will see an orderly or disorderly decline in consumer credit.
- Over the past few months, the credit market has backed off somewhat from some of its extremes, as spreads in the mortgage and corporate markets have contracted.
- Concern exists that banks are not taking full advantage of government assistance and failing to make loans.
- Banks are indeed increasing credit at a relatively healthy clip. Banks are limited as to how much they can do to mitigate capital shortages.
- Strong credit creation requires a strong secondary market where securitized packages of loans can trade. Unfortunately, the securitization process for credit is barely functioning.
- Glenmede's expectations for the economy have become more pessimistic since we made our last report.
- Our client survey of expectations for the economy and stock markets shows optimism and pessimism fairly balanced.

Speed of a Slippery Slope

As a result of the rapid decline in economic growth, the creation of consumer credit that accompanied the last growth spurt is quickly reversing. A reduction in consumer leverage is, in part, a desirable event. Similar to the way corporations overleveraged Internet assets in the late 1990s, the consumer took on too much debt over this last cycle. An extremely rapid decline in credit (or "increase in virtue") has the potential to create a very deep hole from which the economy must climb.

Not surprisingly, the Federal Reserve and Treasury Departments have been concerned about the speed of de-leveraging, and a good number of the programs that have

been rolled out over the last five months have been squarely aimed at propping up the debt markets. The most notable attempt has been the TARP program, in which the Treasury invested billions of dollars in American banks in order to preserve their ability to make loans.

Even though all of this money has been allocated, considerable angst remains that credit still seems to be tight. Are those people on Wall Street hoarding all of the lucre or surreptitiously allocating funds to the purchase of new spats and top hats sported most notably by the little fellow in Monopoly?

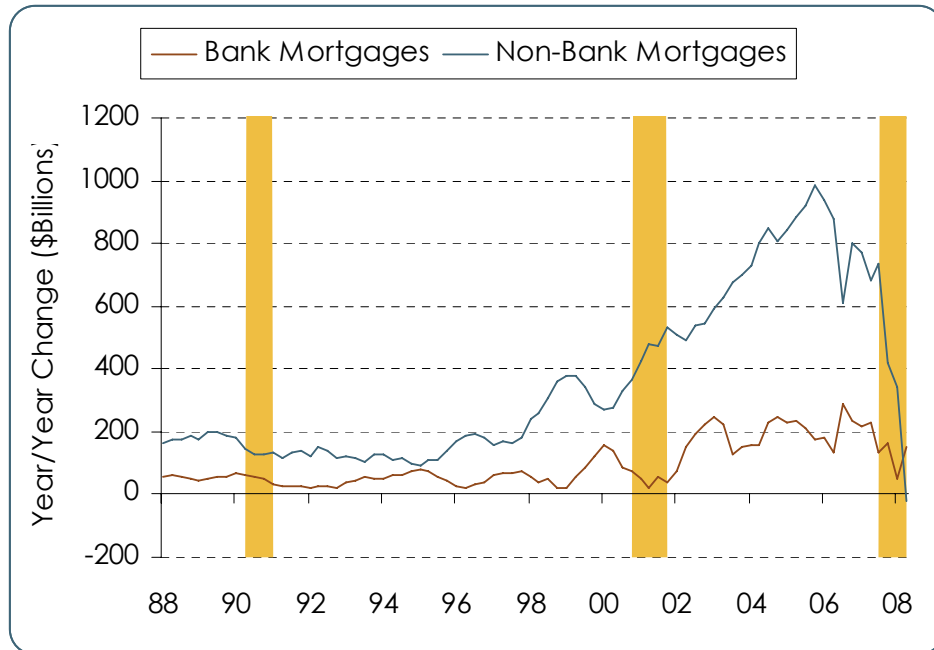
Banks have actually been doing their intended duty and are indeed increasing credit at a non-recessionary clip. In the twelve months ending December 31, 2008, total bank loans to corporations and consumers increased by 5.7%. So if banks are lending, what's the problem with the credit markets?

The problem is that the banks are a relatively small source of debt capital. Back in the 1930s, sick banks resulted in a sick economy. Since then, the size of the secondary debt market has grown and now surpasses banks, but they remain related. Banks are limited as to how much they can lend. They must have a certain amount of equity or capital reserved for the loans that they make. By some peoples' measures, the banks have already used up all of the additional capital that they have received from the government to make loans.¹ In order to make new loans, they have to package existing loans and sell them to institutional and individual investors.

As shown in the chart below, the secondary market utilized by the non-banks became a much larger source of funds than the banks. The secondary market has had an advantage over the bank market. Banks hold loans on their balance sheets and fund these loans with a fair amount of debt and deposits. If a bank makes too many bad loans that they subsequently write off, their equity cushion is rapidly depleted. Institutional and individual investors are usually not operating with that much leverage. If some of their loans go sour, it is unfortunate but not life threatening. They will probably still have the capacity to keep on investing in the secondary market.

¹ "The Loan Lenders?" Robert B. Albertson & Cather Xiao, Sandler O'Niel and Partners.

Home Mortgages: Bank versus Non-Bank



Sources: Glenmede Investment Research and Haver Analytics

Data through 3Q08

Banks, by contrast, have been the source of much of the instability in the credit markets in past recessions. The S&L crisis and the collapse of numerous money center banks in the 1980s and 1990s characterized most of the downturns in these periods.

Something different has happened this time around. Not only have the banks had trouble but the secondary market has also fallen into tremendous disrepair. Part of this is due to the problems with Fannie and Freddie, the prime packagers of mortgage debt. Problems also arose because the secondary market became far more leveraged. Pension funds and endowments that might have once purchased debt without borrowed funds instead invested in hedge funds who bought the debt in part with borrowed money. CDOs and SIVs were, in essence, another form of leverage.

Hence, when the housing market began to crumble in 2007, it not only took down the usual suspects (i.e. the banks), but it also severely damaged the historically stable secondary market. Repairing the credit markets now means not only getting banks to lend again – they are already doing that – but it also means getting the secondary market functioning again.

Can this problem with secondary markets be fixed? Indirectly, the government has tried to boost secondary markets through its purchases of commercial paper and auction rate securities. But in order for the economy to heal, private secondary securities

markets are going to need to return to more stable conditions. This may take some time.

Glenmede's View

Since our last report, we have updated the probabilities that we have assigned to our five different economic scenarios. Unfortunately, the news is not good. When we originally made our estimates, we had a slightly rosy view for the economy. We assigned a 55% probability to the thought that the economy would either begin its recovery by mid-year 2009 (15%), or it would endure a manageable recession that would begin to return to normal growth levels in early 2010 (40%). Both of these forecasts translated into fairly positive outcomes for the equity markets.

When we redid our estimates in late December, the weights assigned to the sunnier outlook (manageable recession with improvement in 2010) had dropped to a 30% probability. The scenario with the highest weighting (40% probability) is now the prolonged recession where we see multiple years of slow or no growth. The scenarios where the equity market probably produces a positive return in 2009 now total 40% (Scenarios 1 and 3), while the economic scenarios that result in a more problematic outcome for equities now total 60% (Scenarios 2, 4 and 5).

Five Possible Economic Scenarios

1. Manageable recession: Economy emerges from a deeper than normal recession at the end of 2009 and shows signs that it is capable of return to moderate real GDP growth (2 - 3%)
2. Prolonged recession: Economy endures deeper than normal recession but appears at the end of 2009 to be capable of growing at a very reduced rate of growth (0 - 1%)
3. A quick rebound: Economy begins to rebound in the middle of 2009 thanks to massive government stimulus and action by the Federal Reserve.
4. Depression: Global economy endures a massive credit contraction leading to a multi year loss of GDP. Extensive defaults and double digit unemployment.
5. Reflation: Economy recovers but reflate. Inflation rises to 5 to 6% due to excessive injections of stimulus causing interest rates to rise to high single digits.

Investment Policy Committee Survey Results

1.	Manageable recession:	30%
2.	Prolonged period of slow/no growth:	40%
3.	A quick rebound:	10%
4.	Depression:	10%
5.	Reflation:	<u>10%</u>
		100%
	Positive Equity Market Outcomes by the end of 2009 (1 & 3)	40%
	Problematic Outcome by the end of 2009 (2, 4 & 5)	60%

This reinforces our thought that it makes sense to overweight fixed income and cash for now. In our analysis, equities still provide the higher expected return, but corporate fixed income provides a better risk-adjusted return. Underlying part of our thinking is that government policy is aimed, first and foremost, at fixing the credit markets. While equity holders will get rewarded eventually, corporate fixed income holders are likely to be rewarded first.

Client View

A few weeks ago, we surveyed a sample of our clients and their advisors by email to learn about their expectations for the economy and the markets. We were curious to know how our clients viewed the future. Generally, the results were fairly mixed with a noticeable tilt towards the bearish/pessimistic side when it comes to expectations about the economy. Given the choice of the same five economic scenarios, 57% of the respondents chose a prolonged recession lasting well into 2010 as the most likely economic scenario. Neither of the two alarming scenarios, depression and deflation, showed up in many people's surveys as a first choice. If you had to contrast the Glenmede internal and Glenmede client view, you would say there is a fair degree of similarity, although the client view attaches a little bit more certainty to the prolonged period of slow/no growth scenario.

**Client Survey Results
Most Likely Economic Scenario**

1. Manageable recession:	29%
2. Prolonged period of slow/no growth:	57%
3. A quick rebound:	4%
4. Depression:	7%
5. Reflation:	<u>3%</u>
	100%

When we asked people for their forecasts for the equity market, they were somewhat more optimistic than their economic forecasts might imply. A total of 55% of people believed that the market would rise in 2009. The most popular forecast was that the market would rise moderately, 0% to 15%, in 2009. Glenmede's opinion might not be too different from this distribution. Given a fairly significant chance of a loss in equities and the significant under-valuation of corporate fixed income, we like the idea of overweighting corporate fixed income. Convertible bond strategies carry more risk than high grade fixed income but offer similarly attractive valuations.

**Client Survey Results
2009 Stock Market Returns**

1. Rise in value by more than 15%:	10%
2. Rise in value by less than 15%:	45%
3. Fall in value by less than 10% :	25%
4. Fall in value by more than 10%:	<u>10%</u>
	100%

Finally, we asked our clients, where 30-year mortgage rates would be by the end of 2009. Roughly two-thirds of them believed that mortgage rates would be 5% or less. Many in the government think that rates need to fall to 4.5% to give some life to the housing market. There are 55% of you who believe that is possible. We would concur with this thought.

**Client Survey Results
30 Yr Mortgage Rate by the end of 2009**

1. 4.0% or less:	11%
2. 4.5%:	28%
3. 5.0%:	26%
4. 5.5%:	18%
5. Greater than 6.0%:	<u>17%</u>
	100%

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