



More Questions and Answers: The Cyclical and the Secular

Question: Have you changed your view on the economy and the markets?

Massive amounts of government stimulus and the economy's own natural healing powers may well be in the process of creating a bottom for the recession. The issue for investors going forward, however, is not just whether the economy will start to grow at some point but whether the quality of growth will live up to market expectations. Given the real risks that the economic growth will be sub-par for a sustained period of time, we have retained an investment posture that is tilted more toward opportunities in the credit markets than the equity markets.

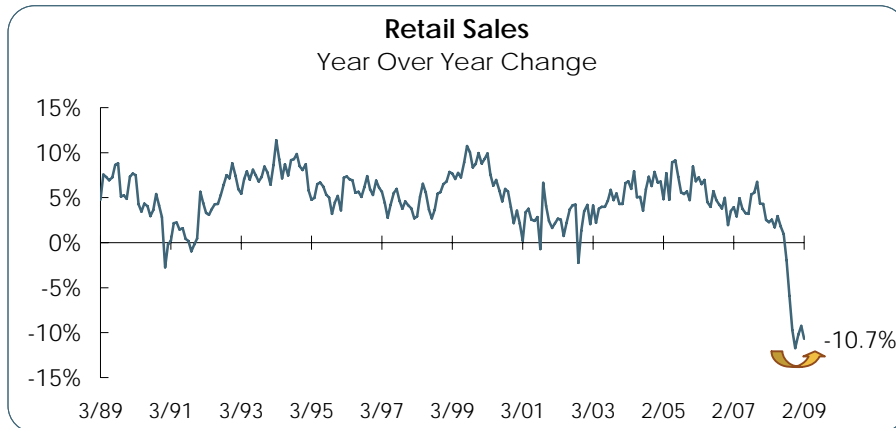
Question: Has the economy turned the corner?

During the month of March, the stock market rebounded sharply from a low of 666 on the S&P 500. The source of this rebound can be attributed to three factors:

- 1) The market was "oversold."
- 2) Treasury Secretary Geithner's second attempt at a plan to remove toxic assets from bank balance sheets went over much better than his first proposal.
- 3) The economic data showed signs of getting "less bad." ("Less bad" does not necessarily mean that the economy is actually improving. Instead, imagine the economy is a car, skidding out of control. "Less bad" means the car's anti-lock brakes appear to be slowing the skid.)

In recent months, retail sales have fallen at a slower annual rate, building permits and housing sales have begun to stabilize at lower levels, and the Institute for Supply Management's expectations for manufacturing activity have stopped getting worse. As a result, it is possible to make a case that the economy could be ready to turn in a positive direction

Retail Sales May Signal A Bottoming Of The Economy



Sources: Glenmede Investment Research and Haver Analytics

Question: Has the latest version of Secretary Geithner's plan helped the markets?

Secretary Geithner's plan may begin to have some positive effects. From at least one perspective, it does seem to be succeeding. Large institutional investors are showing interest in some of the securities that the government is creating to help free up the credit markets. TALF partnerships, leveraged pools of asset-backed securities, appear to be viewed quite favorably by large investors.

The second part of Geithner's program, the PPIP (Public-Private Investment Program), is intended to remove bad credits from bank's balance sheets. The fate of this program is a lot less clear at this point. Banks who wish to participate in this program need to be prepared to sell their "bad" assets at substantial losses. Banks that have already written down the assets don't have huge incentives to sell. In addition, banks that have not taken the losses could potentially put their capital positions in jeopardy. At the end of the day, PPIP may be used principally by banks that the government forces into a program due to their precarious financial state.

Question: If there is chance that the market has bottomed, does that mean we are about to return to normal, long-term economic growth.

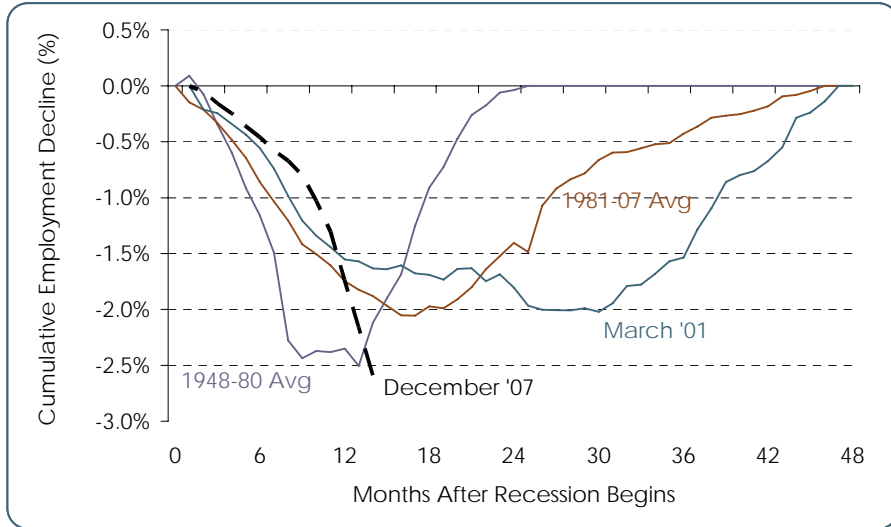
Fixing the credit markets (and then finding the economic bottom) is only part of the problem. There is a larger question: how strong will growth be once we begin to emerge from the recession? Several factors could cause growth to be relatively slow for a sustained period of time:

- 1) Since the U.S. became more of a service-oriented economy, over the last 20 years, economic recoveries have been much slower to unfold.
- 2) The American consumer is very overleveraged and unable to take on more debt.
- 3) A change in the behavior of the American consumer has big implications for the economies of the rest of the world.

Economic downturns from 1945 to 1980 used to result in relatively sudden drops in employment followed by rapid rehiring cycles. In contrast, over the last two and a half decades, firms have laid off workers at a slower pace and reemployed people at an even more gradual rate when the economy begins to recover.

Economic Recoveries Are Taking Longer

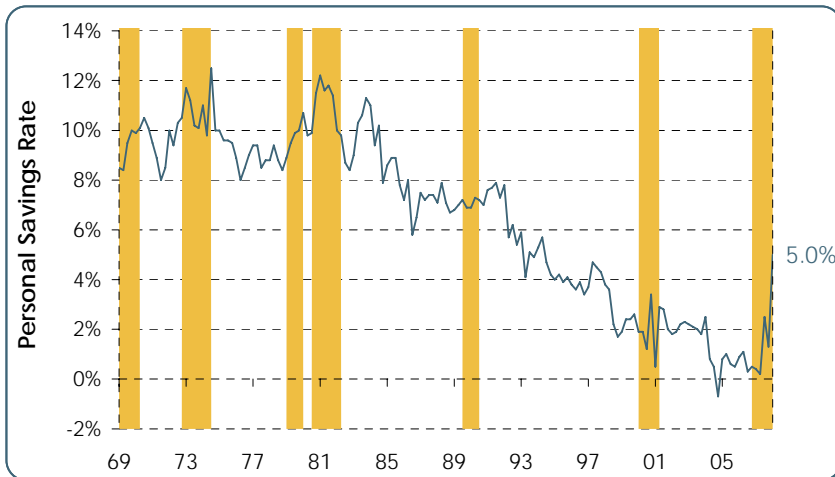
Cumulative Employment Decline Following The Start OF A Recession



Sources: Glenmede Investment Research, J.P. Morgan and Haver Analytics

The second issue is more germane to the current cycle. An increase in consumer borrowing has been an important part of post-World War II recoveries. In contrast, American consumers, particularly the soon-to-retire baby boomers, need to repair their balance sheets. Baby boomers, who saved for their retirement through their 401(k) and the equity in their homes, have now seen substantial depreciation in their assets and must consume less and save more.

Personal Saving Rate Had Been On A Long-Term Decline



Sources: Glenmede Investment Research and Haver Analytics

Question: How does deleveraging affect the rest of the world?

If Americans made the mistake of over-consuming, the rest of the world erred by building their economies around exporting to us. A rebalancing must occur where the traditionally thrifty countries in Asia and Europe refocus their economies on consumption rather than exports. While free enterprise economies can adapt with remarkable speed, this sort of economic adjustment will take time for other economies.

Question: Is there a chance that the economy briefly revives and then slows down again? The “W” shaped recovery.

Parts of this scenario are a real possibility. It could happen if the economy responds positively to the massive amounts of stimulus now being inserted into the economy and, then, slows back down when the programs expire. In other words, the recovery may be neither robust nor sustained. This could leave policy makers in a very uncomfortable position. With a fair amount of government debt in the system, further fiscal stimulus will be difficult for the markets to absorb. With short-term interest rates already close to zero, monetary policy may also be difficult to implement. Quantitative easing, where the Federal Reserve tries to inject money into the system by buying government and corporate debt securities, is an untested remedy. We don't really understand the side effects. In addition, higher taxes, greater regulation, and a creeping level of protectionism seem to be on the horizon.

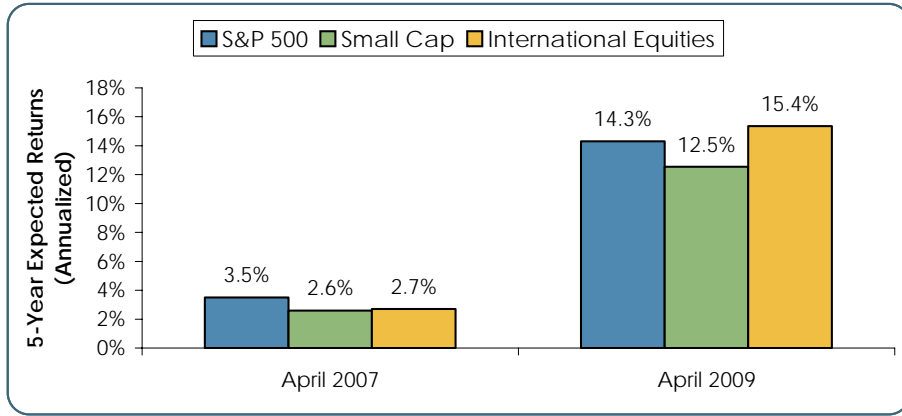
Question: This sounds grim. Are we heading back into the abyss?

It's hard to envision the exact sequence of events over the next few years. It is important not to underestimate the ability of an economy to get back on its feet by itself. Eventually, people choose to buy houses when the prices get low enough. Cars need to be replaced. New ideas are developed, and businesses get created. All of the factors mentioned in the prior paragraph, though, would seem to create some real headwinds for a natural recovery process and translate into a sustained period of slow growth for the U.S. and international businesses.

Question: How do we invest in this environment?

From our perspective and even after the recent rebound, the good news is that the equity markets continue to represent good, long-term values. Our five-year expected return for stocks is 14%. Stocks should be held as a long-term investment, and they are currently priced to return a significant premium over bonds in the long term. The only problem with valuation models is that they can take a long time to work. Stocks in the 1970s and 1930s were very attractive from a valuation perspective. It took considerable time, however, before those values were realized.

Current Expected Returns For Stocks Versus Two Years Ago

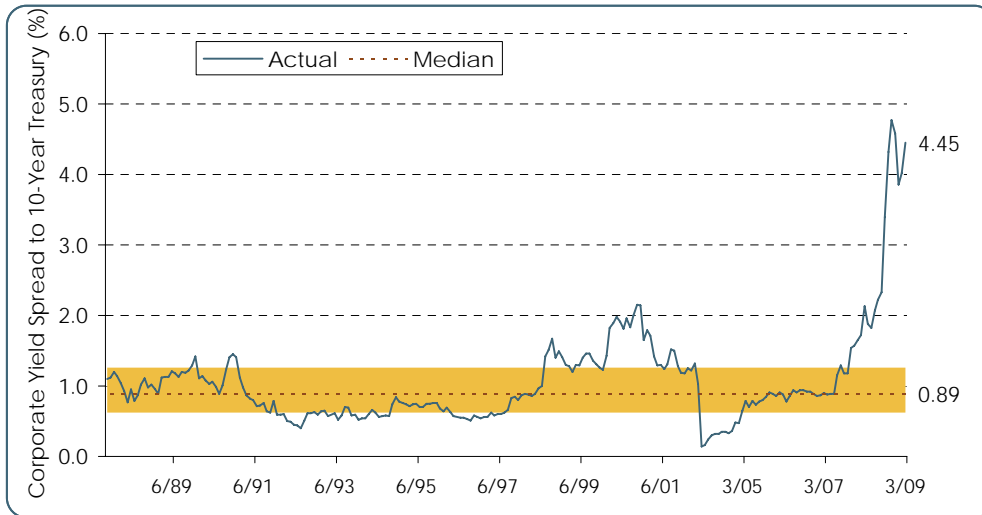


Source: Glenmede Investment Research and Factset

Currently, credit seems to be priced at even more attractive levels than stocks. This asset class provides a better risk / reward tradeoff than equities in the near term. As a result we would overweight corporate credits in portfolios. High-yield, and convertible bonds would also appear very under-priced. If the economy recovers smartly, they will participate in the rally. If, however, the economy is only able to achieve weak growth, these assets have the ability to hold more of their value than equities.

Corporate High Grade Bonds Are Attractive

Corporate Investment Grade Spread to 10-Year Treasury Yield



Sources: Glenmede Investment Research and FactSet (US Treasury Note 10-Year and Lehman US Aggregate Credit Yields)

Questions: Isn't there a risk that all of the stimulus that is being pumped into global markets will lead to inflation?

Inflation is a risk down the road. Right now, a little bit of inflation would be welcome if it was associated with a recovery. The Fed and many other central banks may be thinking the same way. We recommend making an allocation to commodity-based equities in part for this reason, with half of the recommended allocation going to precious metals.

We are inclined to think that a commodities/precious metals exposure can win in a variety of ways. If the economy does recover smartly, we would expect that growth would continue in Asia where commodities are in demand. If inflation gets out of control, commodities have some valuable, inflation-hedging properties. Conversely, if the economy deflates badly, we suspect that investors will flee the dollar and invest in precious metals. The worst scenario for precious metals – peace, stability, and good growth – is probably the best scenario for the rest of the assets in a typical portfolio.

Question: Precious metals have appreciated in price. Does it make sense to invest now?

Let me note a few things. First, gold has gone up significantly in price. It is not, however, as high as it was in 1979 on an inflation-adjusted basis. For it to rise further, we must see somewhat dire events in the economy. Most other investments, however, will probably depreciate if those dire events were to occur. Hence, it is nice to have a risk diversifier in the portfolio. Second, we are recommending investing in gold mining stocks, which are not purely dependent on the price of gold. This builds a bit of cushion into our recommendation.

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