



### Green Shoots and Crabgrass

#### Summary

- Thanks to a substantial amount of government stimulus, there is evidence that the economy is bottoming out.
- This is normally the point in the cycle where we would be on the verge of investor “nirvana” thanks to a recovering economy, reasonable valuations, and a brighter outlook for corporate profits.
- We have two concerns. As we have previously written, the massive amount of debt that consumers accumulated will make it hard for the economy to grow at normal rates. Second, massive government stimulus probably comes with some nasty side effects: higher inflation and interest rates.
- Generally, it takes time for excessive stimulus to result in inflation and higher interest rates. In the interim, equities tend to do well.
- The size of government stimulus is, however, much larger than anything we have seen in the past. This makes us want to be cautious in our bullishness and to recommend a moderately defensive approach to investing.

#### Green Shoots and Crabgrass

I hate taking care of my lawn, especially this year. Our backyard shed and the pool (a.k.a. the house of pain and the money pit with chlorinated water) were both in danger of collapsing and sinking into the earth last year. In the case of the shed and a good portion of the back lawn, six-foot deep sink holes appeared thanks to a landscaper who had evidently used biodegradable matter, like tree stumps, as fill. As for the pool, natural aging had taken its toll. If, by chance, you and your family move to a new town with a slightly warmer climate and buy a house with a pool, remove all romantic notions from your mind of summer cookouts and gleeful children splashing about. Do yourself a favor and immediately fill in the pool. It could make an excellent

garden and prevent the pool company and their coven of maintenance people from installing a drain on your bank account. Unfortunately, we missed our opportunity.

The multitude of people assigned to accomplish the task of rejuvenating our backyard did not tread lightly on the lawn. This year, it is our job to spend our days moving the sprinkler around the dirt and mud bowl hoping that massive amounts of "stimulus" will result in some green shoots. I am from New England and suspicious that after all of this effort, the green shoots may be crabgrass.

A good case could be argued that the economy is recovering from the depths of the downturn and that we are seeing some "green shoots" in the form of some "less bad" data on retail sales and housing. In a free market, weak economies do tend to heal themselves after a period of consolidation. During this downturn, the economy has been given an extra hand with massive amounts of government stimulus. These measures should work, but they may come with some nasty side effects. These side effects – higher inflation, higher interest rates, and a devalued dollar – may take years to arise.

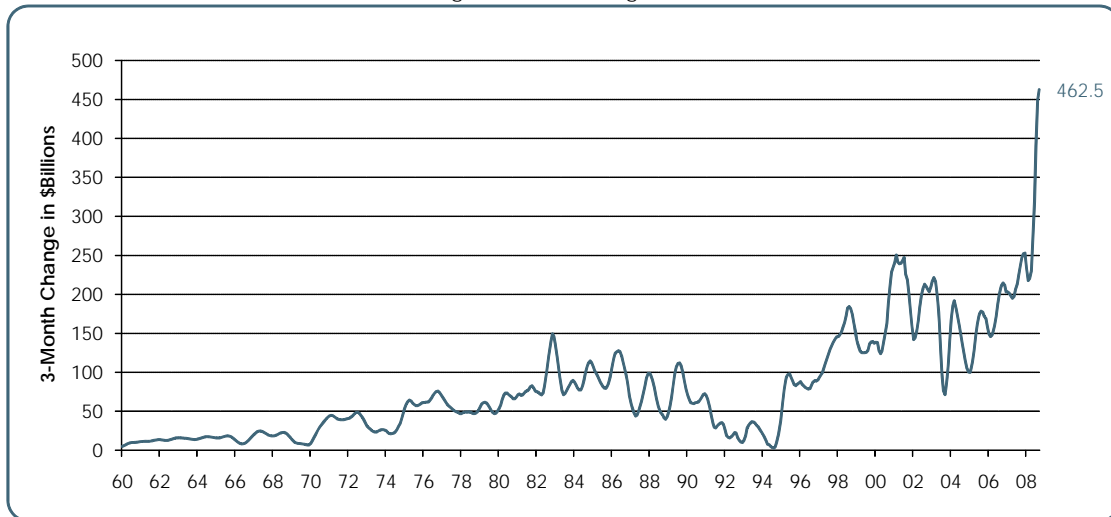
While recovering from a recession, the economy generally gets a grace period before stimulus results in higher inflation and interest rates. During this period, life is good, and markets tend to rise from low valuation levels to either fair or expensive levels. Hence, our concerns may be very premature. We do have an uncomfortable feeling, though, that some of these nasty side effects are already manifesting themselves and that our grace period may be shorter than normal.

### **Government Stimulus – the solution and the problem**

Stimulus can come in two forms, monetary and fiscal. The most powerful form of monetary stimulus occurs when the money supply is boosted. Money supply is created when the Federal Reserve buys securities from banks. The Fed, in essence, prints money when it buys securities from a bank. During the 1930s Depression, the Fed chose not to inject money into the system, and one bank after another failed. This dramatically reduced the availability of credit to both good and bad businesses, deepening and lengthening the economic downturn.

Fed Chairman Bernanke is a student of this era and acted swiftly last year to avoid repeating the mistakes of the past by creating a massive increase in the money supply.

**Money Supply (M2) Growth**  
Average 6-Month Change in \$Billions



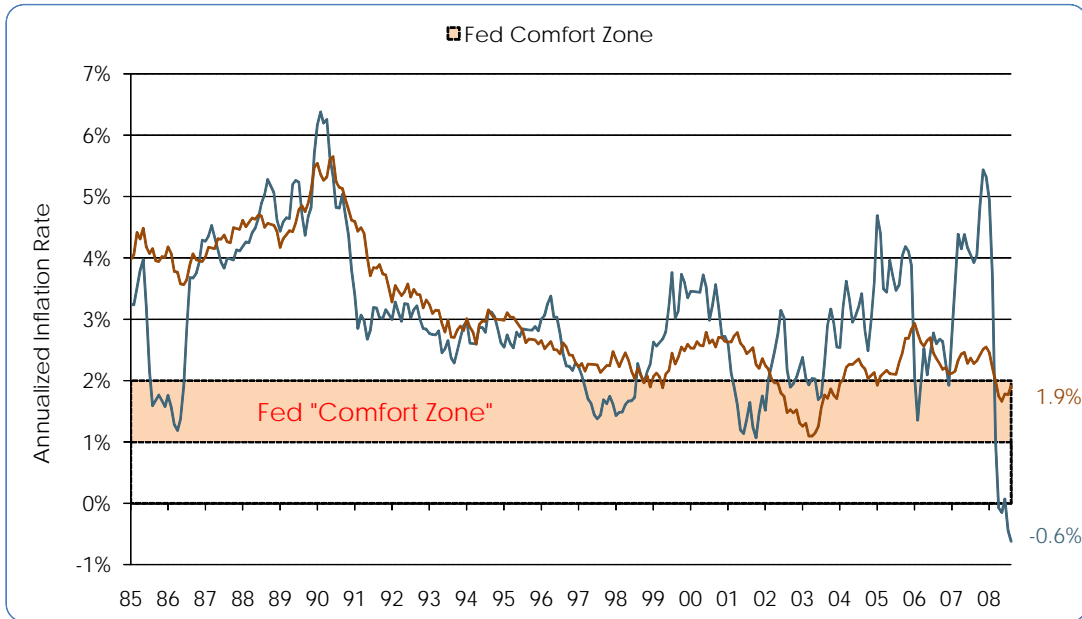
Sources: Glenmede Investment Research and Haver Analytics

Data through April 30, 2007

There is one problem with this technique. Injecting a lot of money into the system is, at first, not a problem. In a deep recession, banks and individuals are reluctant to spend money. Eventually though, there will be too much money chasing too few goods and that results in inflation. Once a recovery is started, the Fed is supposed to withdraw money by selling securities and thereby raising interest rates to keep inflation under control. This rarely comes, however, at a convenient time. It is never completely clear to anyone (except economists with 20/20 hindsight) when a recovery is really taking root. This recovery is going to be particularly hard to gauge.

There is more than a little risk that Chairman Bernanke or his successor will, in guessing when to withdraw money from the system, inadvertently favor more inflation in exchange for better economic growth. A case can be made that this is already happening. Inflation has fallen dramatically over the last few years. Year over year, prices are actually declining by -0.6%. Core inflation, excluding volatile oil and food prices, however, has remained close to 2%. At this point in the cycle, when businesses across the board are having problems selling their products, it would be nice to see a lower rate of growth in core inflation before recovery puts upward pressure on prices. In addition, oil prices, a source of the prior year's decline in overall inflation, are now on the rise. The strength of both of these measures of inflation is disturbing.

### U.S. Consumer Price Index - All Items and Core Through April 2009

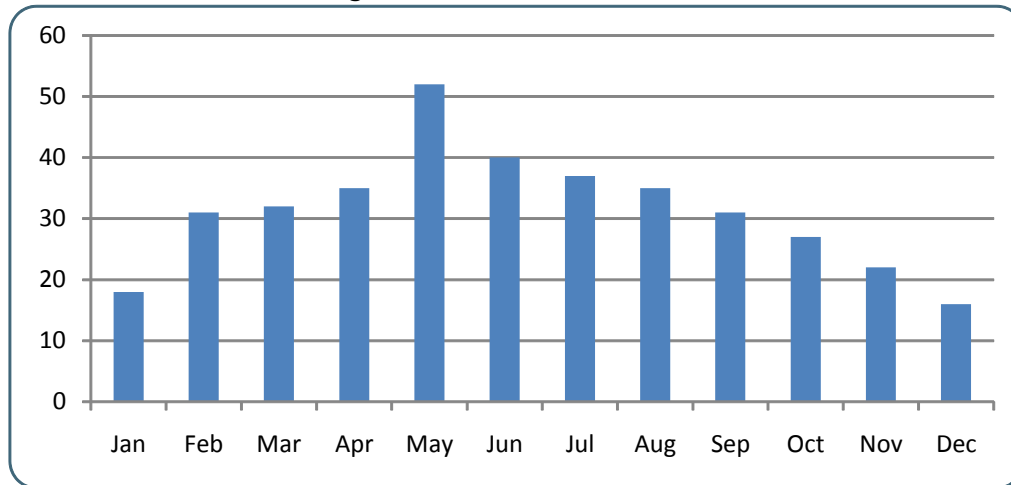


Sources: Glenmede Investment Research and Haver Analytics

### Fiscal Policy and Interest Rates

The other tool that the government can use is fiscal policy. The idea here is that government spending and/or tax cuts for people who have a high propensity to spend will offset the decline in spending by more risk adverse businesses and individuals who are hoarding cash. Over the next few months, a good portion of the stimulus that was approved earlier this year by Congress will be entering the system in the form of tax cuts and rebates.

**U.S. Fiscal Stimulus**  
Change in \$Billions - 2009 versus 2008



Source: Moody's

In the process of stimulating the economy, the government is going to create a lot of debt. By some estimates, federal debt as a percentage of GDP will increase from 37% to 68% from 2007 to 2011. This is on top of a great deal of debt that has already been created for the benefit of consumers and businesses. Non-financial debt as a percentage of GDP is about 235% right now.

The effect of an increase in debt is sometimes very hard to see. It does tend to increase economic growth and asset prices. Does it, though, increase interest rates and consumer prices? Certainly, during the 1980s, we saw huge increases in debt. Interest rates and inflation, however, either declined or stayed stable.

This is somewhat of a counterintuitive result. Eventually, if you issue too much debt, investors eventually want higher interest rates to compensate for the risk. Governments that have a hard time paying back their debt are also tempted to keep monetary policy loose by allowing for some inflation.

Have we reached the tipping point where interest rates and inflation are destined to go up because of too much debt? We are getting close. Government bond interest rates have risen over the last few months. This isn't completely a bad or surprising thing. Treasury securities were viewed as the ultimate safe asset at the beginning of the year. As people have become more comfortable that the financial system can be nursed back to health, they have sold Treasuries and bought higher risk assets like stocks and corporate bonds.

Still, when there is a hint that a Treasury auction has gone badly or when disconcerting news is received like British debt has been downgraded, interest rates have risen sharply.

In addition, our suspicion is that policy makers in Washington are going to take their chances and will get closer to issuing too much debt rather than too little. It seems that ambitious spending programs are meeting very little resistance, but taxation initiatives, such as limiting the deductibility of mortgage interest and charitable contributions and auctioning off carbon credits, are running into considerable headwinds. Washington may need (and subconsciously want) another financial crisis to inject some fiscal discipline.

### **Oh yes, one other uncomfortable feeling in the pit of my stomach**

Given the weakness in the world's economies, this would not be a great time for a round of protectionism. Unfortunately, we may be closer to that than many think. In some ways, it has already started. Governments are choosing to bail out failing local industries rather than let them succumb to global competition (e.g. autos, banks).

The enthusiasm for free trade has progressively waned particularly in the United States. Generally, the justification for protectionism is that it safeguards good domestic jobs. There are, however, several newer rationales (in this country) for protecting local markets. The first is that global trade keeps local economies from developing diverse and humane economies. This is a variation of the same sentiment that Walmart

encounters when it moves into a town. In essence, the benefit of lower prices is viewed as insufficient to offset the loss of local businesses on Main Street.<sup>1</sup>

The second rationale concerns the environment and global warming. If this country takes measures to control carbon emissions, it will, in the short run, put U.S. companies at a competitive disadvantage. It also does nothing to prompt overseas manufacturers in China and the rest of Asia to do the same thing. If China and others don't change their ways voluntarily, do the U.S. and Europe have the right and obligation to "carbon tax" imports from these locations?

Perhaps protectionist efforts to save jobs, preserve local economies, and reduce global warming are worth the costs. It is not for me to say. It is, however, probably unwise to underestimate their impacts and disregard the possibility of a more difficult trade environment. Once politicians start to fiddle with trade policy, finely tuned economic management can be replaced by a complex web of impediments to commerce.

### **And how would you invest in this environment?**

The last time we exited an economic downturn in 2003, we recommended an overweighting in equities. If history is a guide and if we return to a normal economic environment, the current valuation levels justify the same sort of policy. I have spent a tremendous amount of space citing all of the potential problems associated with the stimulus programs. History teaches us that the markets may rationalize many of our concerns for a while and confront daunting long-term problems (e.g., the housing crisis was discussed for years before it actually occurred).

Instead of focusing on these troublesome long-term issues, the markets could well focus on a number of very valid factors that support a bullish view for equities. These include: (a) high cash levels among investors, (b) very low earnings expectations, and (c) reasonable to attractive valuation levels.

Our best thinking at this point is that some, but not extreme, caution is warranted. We would hold equities below their normal weightings and favor assets that will give us some protection. One of the best forms of protection is to buy the cheapest asset, which by our measure is corporate credit. We would also keep bond portfolios somewhat short and invest in growth-oriented businesses that can weather a sustained downturn and even a rise in inflation. We would also continue to recommend a position in commodity-based assets. (Although after the most recent run up, we might be tempted to wait before adding to positions.)

Finally, we have mentioned in past commentaries that it is wise to revisit periodically your long-term asset allocation policy. Now that the market has recovered from its

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<sup>1</sup> As a "proprietor" of a mid-sized, privately owned investment and wealth management firm that competes against sometimes soulless, multi-national firms, I have to admit to a certain sympathy for this argument, although I am also not too scared of the competition. There is a huge advantage to staying focused on a well-defined line of business in the financial world.

lows and we are closer to fair value, it is worth asking whether you are at the right risk level given your long-term financial needs.

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