

Economic Uncertainty and the Current Market Environment

1. Why are the markets falling dramatically?

The markets are falling in reaction to two primary concerns:

1. Fear that slow U.S. growth will lead to another recession.
2. Concern European banks will experience a liquidity crisis similar to that experienced in 2008 by the U.S. banking system.

2. What is the likelihood of another recession?

Growth is definitely coming in slower than normal. Recent economic growth appears to be running at a 1-2 percent annualized rate, well short of both the average 3-3.5 percent and even our 2.5 percent estimate for the next couple years. Much of this, however, is due to near-term factors such as higher oil prices, disruptions triggered by the Japanese earthquake and flooding in regions of the U.S. Ultimately, we believe many of these factors will reverse, providing a lift to growth and pulling us away from recession.

Corporate earnings remain robust with estimates continuing to be revised upward; employment figures recently have shown a surprising amount of resiliency, but other data remains rather mixed. Most importantly, our leading indicators have yet to turn upward and indicate a true reversal.

As a result, our base case is that the U.S. will eke out positive growth and avoid recession. We see several factors which inhibited growth in the first half of this year gradually dissipating. This conclusion assumes European banks will not experience a liquidity crisis.

3. What is the risk of a European liquidity crisis?

From our perspective, this is the bigger of the two risks that we and the market are monitoring. The European Union (EU) has the economic resources to avoid a liquidity crisis. The critical question is whether there exists the political will to put those resources to use. The EU does not, at this point, have the appropriate government institutions and facilities in place, primarily because member nations have yet to establish the European-equivalent of the U.S. Treasury. However, the July 22, 2011, EU summit began to move in this direction, showing the resolve of EU leaders to manage the crisis at hand. The agreement reached would empower the European Financial Stability Facility (EFSF) to act much like the U.S. Treasury and Federal Reserve. This would mean the EFSF could buy bonds outright, recapitalize banks and provide liquidity lines. While this is the right solution, it must pass the parliaments of each member nation and the EFSF would arguably need more funding than currently granted. While we believe this reform will ultimately succeed, risks remain until the agreement is ratified and funding to the EFSF is increased. The European Central Bank remains the primary back-stop, and a reluctant one at that, thus further unnerving markets.

There is justifiable concern the debt markets may not wait for Europe to establish the needed infrastructure. We are closely watching European fixed income markets and in particular, lending between banks for signs of contagion. Interbank lending markets, as of Friday morning (August 5, 2011), were stabilizing.

4. Has Glenmede's strategy been positioned to protect portfolios in this environment and will this strategy change?

We continually monitor and alter our strategy in reaction to the economic environment, maintaining a consistent bias toward higher quality stocks and risk-managed strategies. For instance, as the market peaked a few months ago, our leading economic indicator (LEI) framework identified problems with economic growth, leading us to reduce our recommended portfolio exposures to market-related risks. This strategy has served us reasonably well, although in hindsight there is always an argument such moves could have been even larger. Glenmede's recommended moderate risk portfolio, as a result, has been reasonably protected in this downdraft.

As far as what to do now, there is evidence that in 12 months the market will be higher. Market volatility measures (i.e. the "VIX") have spiked to very high levels. When these measures have hit such levels in the past, a high percentage of the time the market has been oversold and rallied to higher prices. Furthermore, valuations on equities are again attractive with European valuations having fallen to the bottom deciles of historic observations.

Selling after a downdraft is a risky proposition, particularly given current valuation and sentiment levels. With a reasonably risk-managed stance, our bias is to maintain our current positioning. Ideally, we are looking to our LEI framework to identify a turn in the economic outlook, providing an attractive buying point. This means not rebalancing our portfolios immediately after the downdraft, which would lead to a purchase of equities.

We continue to monitor the European situation quite closely. At this time we are assuming the gradual and successful strengthening of the European financial stabilization infrastructure in the months ahead. However, a dramatic deterioration in the European debt markets could prompt us to take more money off the table. Specifically, we are monitoring overnight deposit rates (Euribor) between banks for signs that would demonstrate that the banks have become unwilling to lend to one another. This is the sort of event that could trigger a significant downturn.

As always, we will reevaluate our positions and views as events and facts change. Please do not hesitate to call me, Gordon Fowler, Chief Investment Officer, or your relationship manager with further questions. Finally, please join me and Gordon, along with Laura LaRosa and Peter Zuleba, for an ***Economic Volatility and the Outlook for Global Markets*** teleconference at 11:00 a.m., ET, on Tuesday, August 9, 2011.

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