



## *A "Less Bad" Economy and "Less Good" Risk Premiums*

I can tell the economy is getting "less bad." Outside of work, fewer people ask me for my opinion. There was a brief moment when people who normally prefer talking about baseball, books, travel and art would seek out my views on all things related to the economy and the markets. I will admit that while I love my work, when I socialize I too like to talk about baseball, books, travel and art; so, I am happy to return to these topics. While the economy is "less bad," we are not out of the woods. There are still some important questions worth answering.

**Let us begin by trying to answer the two big questions:**

### **Question 1: What is Glenmede's current read on the economy?**

If I was to compare the economy to the performance of a car, I would say that while the brakes are working, it's unclear if the accelerator will kick-in when attempting to merge on the highway. The massive amount of fiscal and monetary stimulus injected since the end of last year seems to have kept the economy from running off the road. However, sustainable growth may be harder to realize.

### **Question 2: How would you recommend investing in this environment?**

While the economic situation is less bad, risk premiums are less attractive. Hence, we would be more selective and careful about the risks we take versus two or three months ago. We would increase our bet on quality growth-companies, keep fixed-income at an overweight (with an emphasis on corporate, high-quality bonds and a segment of high-yield credits), and reduce exposure to commodity companies and emerging markets. We continue to see very interesting opportunities in private equity.

*And now, let's dive into the details...*

### **The Economy**

#### **Once an economy starts to turn around, does good growth almost always follow?**

Yes, it does - for a bit. Businesses that had cut their inventories to the bone and consumers that limited their spending to include only the necessities do return. Inventory restocking usually provides a good, swift kick to growth.

#### **And what happens after that?**

Clearly, some businesses will use this period of dislocation to opportunistically expand. Likewise, some sectors of the economy like energy, healthcare and technology, which hoarded cash, are in a position to spend more liberally going forward. In contrast, weaker corporations will be supplanted.

**If things are improving, why do you remain so serious about slow growth?**

In the past, consumers drove the economy away from recession by leveraging their balance sheets. Now, consumers have incurred too much debt and the banks and credit markets are less inclined to lend. As a result, the national savings rate has gone from negative numbers to a level of 6.9% as of the last monthly reading.

**Is more savings a bad thing?**

Saving more and reducing debt is an inevitable outcome for American consumers. How quickly this happens is yet to be seen. If the Fed and Treasury had, over the last six months, allowed the market to administer "shock therapy," more debt would have been wiped away and inversely, saving levels would have increased more rapidly.

**In this scenario, what would have happened to relatively healthy businesses and to employment levels?**

We probably would have had a fairly massive depression.

**So, have our economic problems gone or are we just involved in a slower recovery?**

We are probably looking at the slow work-out scenario where consumers take years to pay off household and personal debts. Still, there are probably more shoes to drop. Insurance companies haven't recognized all of their bad assets, toxic assets remain on the balance sheets of many banks, and the real estate market continues to see price declines.

**If consumer balance sheets improve over time, what happens to the government's balance sheet?**

Deficit spending is one of the things that kept the economy from falling into an abyss. But it is more than possible we will replace an over-indebted consumer with an over-indebted government. Ideally, government should carefully control deficit spending to provide just enough "gas" to sustain the economy and to enable consumers to repay their debts, but not so much that the government runs out of borrowing capacity.

**Is deficit spending inflationary?**

Not directly. It will lead to inflation if the Federal Reserve, to keep interest rates down, ends up buying too much debt with money it has created or "printed." This process increases the money supply, creating the potential for too much money chasing too few goods.

**Does this mean inflation is right around the corner?**

We will probably not encounter inflation immediately. In fact, if the Fed does a good job, we might not experience much inflation at all. Right now there is plenty of "capacity" or excess supply of goods and labor so that buyers have the upper hand in pricing discussions. Eventually, the Federal Reserve must withdraw reserves at just the right time and allow interest rates to rise in order to block inflation.

**Does the Fed have either the ability to know when to make that switch from loose to tight, or the political will to execute in a timely fashion?**

The answer to both questions is probably, no. My guess is that the stock and bond markets will need to react with some poor results and "insist" that the Fed take action.

**In other words, the markets need to fall at some point to inject discipline into the process?**

Yes, but in the case of the stock market it could come at higher levels. Likewise, parts of the bond market with a steep yield-curve are already pricing in, to a certain degree, a higher interest-rate environment.

**So are we faced with the same need to turn off the Fiscal Policy tap at just the right time?**

Yes. Once again, closing the budget deficit all at once will probably be a mistake. Closing it slowly, over time would be the best policy. This, of course, should happen without introducing tax rates that discourage work and productive investment. In addition, investments in infrastructure projects should be sensible and come with substantial multiplier effects rather than to merely reflect the desires of the best represented political constituencies. The government would also, in the process, fund solutions that reverse global warming, reform the healthcare system and bring about world peace.

**Oh, come now. Are we looking to a period of slower growth, higher inflation and higher interest rates?**

That's a fair but perhaps overly pessimistic assessment. The free-market is an undisciplined beast that frequently makes massive mistakes (*i.e.*, over-investing in areas such as the internet and housing). It is, however, a relatively robust creature that does not generally stay beaten down for long. The market is made up of individuals who in the final analysis adapt, survive and prosper under harsh conditions.

Bravado aside, the slow-growth, higher interest rate and higher inflation scenario sits as one of the two pillars of our investment strategy.

**O.K. Let's move on and talk about investments.**

**Investment Strategy**

**So, what are the "two pillars" underlying your investment strategy? That sounds very grand by the way. Are they Marble or Sand? Is this the best your marketing group could do?**

We are quite proud of our marketing group, actually. I'll divert for a moment to suggest that if you haven't already reviewed our new website, Glenmede.com, you should take a look and of course, share it with your closest and most influential friends.

**You are stalling. Let's get back to the "two pillars."**

Our investment strategy rests on 1) a clear view on the global economic environment and, perhaps more importantly, 2) valuation levels.

**Do risk premiums have something to do with valuation levels?**

Yes. A risk premium is a means of measuring the cheapness or expensiveness of an asset. In the case of equities, we can measure valuations and risk premiums by looking at Price/Earnings, Price/Sales, Price/Book and Price/Cash Earnings ratios. Fixed income asset valuations are measured by their yields.

Generally, shopping for assets is similar to shopping for anything else. You want to buy goods that are inexpensive. There is an important caveat. Just as with shopping, you want to make an adjustment for quality and safety. A Mercedes will (almost) always cost more than a Chevy. The best buy will be the car that sells at the greatest discount to its fair value. Investors, like shoppers, tend to place too high a premium on popular brands and thus overpay for these assets.

**What is undervalued now?**

Once the markets concluded the world was not coming to an end, highly cyclical stocks with low-quality earnings were bid up quite a bit. As a result, high-quality stocks underperformed. These quality stocks look cheap on both an absolute and relative basis. This is true both in this country and outside of the United States.

### **Anything else?**

Although the credit markets have recovered to some extent, many sectors are still relatively cheap. High-grade corporate credits still offer a yield of 5.5 to 6.0% and high-yield bonds have rallied substantially (the lowest rated securities, C and B rated bonds, may not offer enough yield to justify the risk / the BB-rated part of the market still looks quite attractive). In fact, at this point, we would overweight credit and underweight equities. In general, the equity market is close to fairly valued while credit markets are still relatively inexpensive. If at some point, the market gets more nervous about the effectiveness of stimulus and the size of the deficit, the credit market will provide more downside protection than the equity market.

### **How about commodities? (Glenmede recommended them a few months ago as a hedge against inflation and since then commodity stocks have rallied sharply.)**

If you have a small position of commodity stocks in your portfolio, we wouldn't recommend doing anything. If you are overweight commodity stocks, we recommend taking some profits. Commodity-related stocks have rallied sharply with diminished concerns about the world's economies. Their valuations have gotten quite expensive. They are the right assets to own for a more inflation-prone environment, but we think it's wise to heed valuation levels and take profits when a trend becomes overdone.

### **Overvalued assets?**

Emerging market stocks have gotten fairly expensive. They flew upwards particularly in Asia due to the belief the Asian economies would escape the ill-effects of the American economy. We are a little wary of that conclusion. If the U.S. has to restructure its financial system to compensate towards less consumption, it's going to take a while for Asian markets to become oriented towards their own domestic consumption.

### **Other areas of interest?**

The private equity market is very interesting now and we like it for clients with sufficient liquidity and size. Over the past few years many asset pools over-invested in illiquid assets and now have to sell private equity investments at steep discounts. What is bad for them is good for investors with the ability to be offensive consumers.

### **In summary, you would:**

- 1) Overweight Credit and Underweight Equities.
- 2) Buy High-Quality Credit and "Higher-Quality" High-Yield.
- 3) Keep Bond maturities for most fixed-income at short to intermediate levels.
- 4) Invest in High-Quality Growth Stocks.
- 5) Take profits in Emerging Markets and Commodity related stocks.

### **Underwater**

#### **We know you like talking about baseball, books, travel and the arts but last time you wrote about your lawn and pool; would you care to provide an update on these subjects?**

Grrrrr! The lawn is fine. In fact it's doing so well it has moved into the flower beds. The pool is a different story. The water level started the month by dropping by about a foot a week. Our pool repairman, who incidentally rehabilitated our pool last year, has approached the problem with considerable imagination ("Oh yeah, Mrs. Fowler, you should just fill it up again. That water loss is all due to evaporation."). He has also sought to relate to me in ways I might understand by providing frequent forecasts ("Don't worry, Mr. Fowler, it will be fixed by the end of the week. Of course we will get it done before your children go off to camp for the summer."). The day after the children left for camp, the pool was fixed.

**So you, Mrs. Fowler, and the dogs get to swim in the pool this summer?**

Greyhounds don't swim.

**Not even the dog paddle?**

They sink like a stone. The adventurous, semi-suicidal one, Elbira, will jump into the pool if she thinks she is missing something fun. My spouse did buy her a life vest.

**So life is now good - you and the dogs can jump in the pool. Likewise, should we jump into the markets?**

Yes, you might jump in if that means maintaining a moderate weight in equities. Just like the dogs, however, don't forget your life vest and invest selectively.

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