

Monthly INSIGHTS

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August 2010

Converting to Fiscal Conservatism, But How Fast?

*"Grant me chastity and continence, but not yet."
– St. Augustine, Confessions, Book VIII, Chapter VII*

Summary

- The result of years of excess spending, the global debt problem, although manageable, will not be resolved overnight.
- Resolution will require credible debt-reduction plans spread across enough time to allow the economy to transition gradually.
- Debt-reduction plans should balance contractionary spending reductions and tax adjustments with offsetting monetary policy and currency devaluation.
- Governments need to more clearly and consistently outline their regulatory intentions and exhibit sufficient political will to execute such measures.
- Recent global government efforts remain incomplete, creating a road to resolution that is long and bumpy.
- Investors should employ market-neutral hedge funds, absolute-return managers, and options-based strategies to both protect against and benefit from the prolonged volatility.

Chastity and Fiscal Austerity

St. Augustine (354 – 430) was the Bishop of Hippo Regius, a Roman Africa province. In the Catholic Church and the Anglican Communion, he is a saint and pre-eminent Doctor of the Church, and the patron of the Augustinian religious order. A Latin-speaking philosopher and theologian, St. Augustine's writings were very influential in the development of Western Christianity. Many Protestants, especially Calvinists, consider him to be one of the theological fathers of the Reformation due to his teaching of salvation and divine grace.

In the years prior to his rise to sainthood, St. Augustine led a shockingly sinful and hedonistic lifestyle, including one affair and two concubines. However, in the summer of 386, having been inspired by an account of the life of Saint Anthony of the Desert, Augustine underwent a profound personal crisis that led him to convert to Christianity, abandon his career in rhetoric, forgo any ideas of marriage, quit his teaching position, and devote himself entirely to serving God and to the practices of priesthood, which obviously included celibacy.



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St. Augustine detailed his long spiritual journey in his famous *Confessions*, which became a classic of both Christian theology and world literature and is one of the earliest known Western autobiographies. His conversion to Christianity was no easy task; it took more than four years. Reflecting on the duration of his spiritual conversion, Augustine admits in his *Confessions* to having prayed, "da mihi castitatem et continentiam, sed noli modo" ("Grant me chastity and continence, but not yet").

Developed economies are presently undergoing an Augustine-like transformation toward fiscal conservatism. Today's economic sins of excess spending and rampant borrowing are hardly on the same level as Augustine's hedonism, although some economic enthusiasts may so claim. Nevertheless, similar to St. Augustine's transformation, the conversion to fiscal conservatism will occur over a prolonged period and will require consistency and determination from those seeking resolution. If fiscal austerity is implemented too quickly and without a sufficient offset from monetary policy or currency devaluation, the resulting economic weakness could overcome the cost savings of the austerity plan, leaving budget deficits in no better shape. On the other hand, if austerity measures are not implemented quickly enough or are not seen as credible, the markets will withhold financing, driving the cost of borrowing higher at exactly the wrong time.

European Austerity Measures – Too Much Too Fast?

European governments have announced significant budget reductions, including public job and wage cuts, benefit reductions, tax increases, and government program eliminations. Some sanctions, such as the reduction of government jobs and wages, will prove to be more of a drag than others on the European and global economies. If implemented as proposed without offsets or delays, the total amount of European austerity measures will amount to a 1.5% headwind to euroarea GDP growth. It will be important to monitor the economic impact of each nation's plan and the effect on government revenue (taxes). Economic headwinds caused by the austerity measures will reduce government tax revenues and may limit the austerity-driven budget gains.

Austerity Measures: A Headwind to Growth

Greece: Reducing Budget by €24 billion by 2013

- Public wage cuts, increased retirement age for benefits
- Increased Value Added Tax (VAT)

Spain: Reducing Budget by €65 billion by 2013

- Eliminated 13,000 public sector jobs
- Reduced State Employee Salaries by 5%

Britain: Reducing Budget by £135 billion by 2015

- Hiring freeze for civil service
- Eliminating 300,000 public services jobs

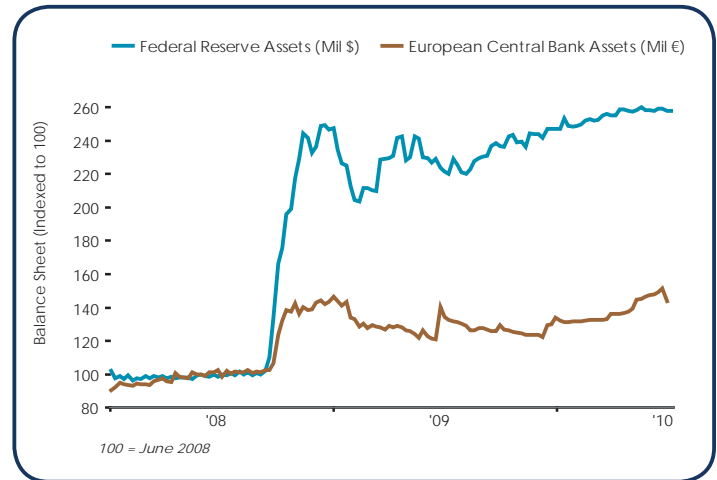
Germany: Reducing budget deficit to 0.5% by 2016

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A headwind of as much as 1.5% per year for multiple sequential years is enough to cripple most developed economies, which typically need above-2% growth in order to exhibit stable employment. Europe's economy would need to grow more than 3.5% before the austerity headwind in order to maintain stable employment. This may be a stretch for a group of nations that has barely exceeded 2% growth over the past 10 years. Most economists estimate 2010 eurozone real GDP growth at between 0% and 1.5%.

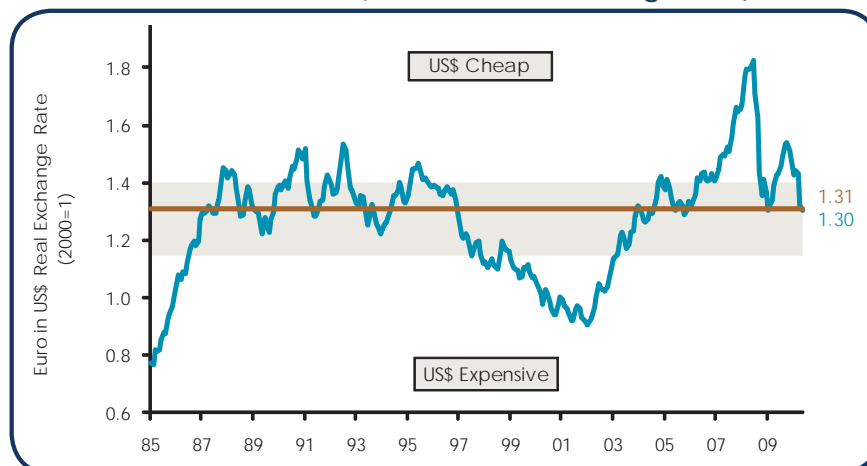
European nations need the support of meaningful offsets for the economy to stabilize and grow despite the austerity headwinds. The European Central Bank (ECB) could easily provide an offset to fiscal austerity by expanding its balance sheet and providing more monetary stimulus but has hesitated to do so for fear of undermining its independence from the region's politics. Another option could be the continued devaluation of the euro. The International Monetary Fund (IMF) typically prescribes currency devaluation, in combination with budget tightening as part of its approach to sovereign solvency issues. Such an approach should be as effective for a currency block of multiple nations as it is for a single nation, despite the political differences of the member nations. With the euro having declined from above \$1.40 to nearly \$1.30 today, it has already acted as a safety valve for economic pressures; further declines may be desired as an offset to fiscal austerity. Ultimately, either of these approaches would soften the blow of the austerity measures, in effect pushing a portion of the headwinds into future years.

European Central Bank Needs to Expand More



Data as of 7/16/10

US\$ versus Euro (Real Effective Exchange Rate)



Sources: Glenmede Investment Research & Haver Analytics (JP Morgan Broad Real Effective Exchange Rate Indices Base=2000, Synthetic Euro pre-1999) Data through 6/10

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European Union Stress Tests – Invoking the “Not Yet” Clause

European regulators may have finally realized the need to delay some of the pain of resolving the sovereign debt problems. The EU stress tests came and went on July 23 with barely a whimper of resolution. Amazingly, only seven of the 91 banks were deemed to have inadequate capital, and only €3.5 billion in capital injections was found to be needed to restore the banks from the brink of inadequacy.

The stress scenario assumed that eurozone real GDP would not grow in 2010 and would decline 0.4% in 2011, hardly a stressful economic environment; some economists are already using such assumptions as their baseline estimates for these years. Further, varying degrees of loss assumptions were applied to the values of all sovereign debt, but banking book exposures, those unrelated to trading activities, were not directly stressed. On the positive side, Spain's banks were deeply stressed with a cumulative loss assumption of 55% in commercial real estate and 23% in residential real estate. Perhaps most emblematic of the leniency of the tests, the possibility of a sovereign default was not tested, even in the case of Greece's sovereign debt. In fact, only a 23% discount to value was applied to Greece's debt.

Ultimately, the European stress tests failed to deliver the most beneficial outcome – a significant recapitalization of the banks. In contrast, the U.S. stress tests failed 10 out of 19 banks and forced the industry to restructure its balance sheets. The U.S. banking system received \$250 billion in TARP capital injections in advance of the stress tests and another \$75 billion afterward, raised common equity in the public markets, converted existing preferred equity into common equity, and underwent significant sector consolidation. The benefit of such an approach is that it pushes most economic losses permanently onto financial-industry equity holders and away from the government and taxpayers. Furthermore, it wipes the slate clean for the financial system, allowing banks to emerge from restructuring less like zombies than if still loaded with excess debt and unrecognized losses. While Europe's approach of whitewashing the stress test results relieves some of the near-term pain, it does not purge the economy of the imbedded, unrealized losses that will act as a longer-term economic drag.

Nevertheless, the stress tests were credible in that some banks, primarily those in Spain, were induced to seek ECB aid and raise capital. The tests also showed the economic impact, by bank, of a standardized set of assumed events that represented extra economic and asset-loss stresses. While the loss and economic assumptions used may not have been as severe as hoped, disclosure of the results provides lenders and investors with a way to understand each bank's economic exposure. This disclosure has lifted a cloud of uncertainty and fostered increased cross-bank lending. As a result, the rate of interest banks charge each other for short-term loans (LIBOR) has declined. Overall, we believe the European stress tests were only marginally successful and did not resolve the issue or fully remove longer-term uncertainty.

United States – Are We Doing Enough?

The United States is on the opposite end of the spectrum from Europe. At the G20 meeting in May/June, it was agreed to halve budget deficits by 2013 and to stabilize government debt by 2016. Aside from these commitments, the U.S. has yet to provide a detailed and credible plan for resolving its budget deficit and soaring debt burden. In fact, at the G20 meeting, President Obama fought for wording in the agreed-upon statement that deficit-reducing efforts would be made with "an eye" toward maintaining global economic growth. Perhaps, one day, world leaders will write confessions similar to St. Augustine's, including a modified version of the chastity-but-not-yet prayer.

We believe the U.S. government should develop and communicate a concrete deficit-reduction plan as soon as possible. Actions could be taken on both the indexation of Social Security for workers not yet near retirement, as well as defense spending, which is arguably at unsustainable long-term levels. Perhaps more significant, there is likely an abundant supply of spending excesses and government inefficiencies that could be eliminated with little cost to the overall economy. The Geddes Commission, established in Britain between World Wars I and II, successfully explored deficit reduction through improved efficiency and removal of unnecessary spending by benchmarking government operations to similar private-sector operations.

Anyone who has experienced jury duty, as I have recently, could easily identify unnecessary government expenses and inefficiencies. In my recent experience, I watched as the federal government paid more than 250 people to sit in an auditorium-sized room for two days for potential selection to one of six jury panels. This was not the trial itself, just the jury selection process. Each person was paid \$60/day, plus travel and parking expenses; many travelled farther than 50 miles and received hotel accommodations plus incidental expenses. Assuming that a modest 25% of the people required overnight lodging, that hotel and incidental expenses were \$250/night per person, and that travel/parking expenses were \$15/day per person, the total 2-day expense for 250 people would amount to \$68,750. If federal district courts see approximately 500,000 cases per year, this expense totals \$5.7 billion per year. Perhaps this is idealistic, but it is not hard to conceive some form of jury selection, perhaps via secure electronic communications, that could significantly reduce this expenditure.

Marginal steps toward budget sustainability, even with a mode of fiscal constraint, would be warmly welcomed by the financial markets. Corporations — particularly smaller businesses which account for approximately two-thirds of the nation's job growth — are worried about the direction of taxes and regulation. Capital appears to be on strike due to the simple fact that people are more comfortable making economic and business decisions when they know the rules by which they are playing. Large corporations are hoarding cash that could otherwise be used for any combination of hiring new workers, plant expansions, mergers and acquisitions, capital investments, increased dividends or share repurchases. Definitive progress toward budget resolution could unlock this capital.

Investment Strategy and the Long Road to Debt & Deficit Reduction

It is not easy to make the hard choices necessary to contain spending and reduce debt balances. It is even harder to make these choices within the political circles that our democracies operate. Families with only one or two decision-makers have a hard time trimming budgets; imagine 100 equal-vote voices with varying biases debating your household dining-out budget.

Credible plans are needed to satisfy government bond investors' need for confidence in respective nations' ability to return the principal upon maturity. Such plans need to have a true component of spending reduction, but also need to balance this imperative against its effect on economic growth and tax revenues. Finding the right speed of implementation of austerity measures is critical to the success of the developed world's debt-reduction efforts.

The financial markets appear to already reflect this slower growth, deleveraging economic environment. Equities in developed nations appear reasonable or modestly attractive on a valuation basis, trading near 13.5x smoothed 10-year earnings in the U.S. and as low as 12x smoothed earnings in Europe. Traditional developed-government fixed income, on the other hand, with yields as low as 3% on 10-year treasury bonds, offers very little in the way of future returns. As a result, we continue to become incrementally more positive on the outlook for equities vs. fixed income, particularly as more definitive plans for long-term budget reduction are set in motion.

This view is not without risk; many puzzle pieces, such as European bank balance sheet strengthening and a credible U.S. deficit-reduction plan, remain unplaced. Politics at the national and international levels are making it difficult for all of the pieces to come together in an orderly and simple manner. As a result, we do not think Greece will be the last of the volatility-spiking potholes in Europe's bumpy road to fiscal conservatism. While we may have an incrementally more positive long-term outlook for equities vs. fixed income, we continue to recommend that a significant portion of client portfolios be invested in a diversified basket of non-market correlated assets. This basket should consist of a combination of market-neutral hedge funds, absolute-return managers who hold cash when investment opportunities are limited, and options-based strategies that seek to capture excess volatility.

We continue to advocate that investors, while taking advantage of reasonable valuations in the equity markets, position themselves to protect against and benefit from what we expect will continue to be a volatile economic and market environment as the developed nations repent for previous fiscal sins.