

INSIGHTS

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Economic Slowdown or Double-Dip Recession?

“IT DOES NOT MATTER HOW SLOWLY YOU GO SO LONG AS YOU DO NOT STOP” – CONFUCIUS

Investor sentiment has swung from amazement over the strength of the global economic recovery to concern about a double-dip recession. This reversal of attitude is the result of three primary factors: tightening monetary policy in China, sustained high levels of unemployment in the United States, and European austerity measures. As each of these factors came to light during the second quarter, investor optimism quickly waned. Financial markets reacted accordingly, bringing equity valuations back to attractive levels while sending treasury yields to their lowest point since the beginning of 2009.

As Confucius observed more than 2,500 years ago, there is a significant difference between moving slowly and coming to a full stop. The economy, which is often likened to an ocean liner, has difficulty changing its course due to the positive and negative feedback loops that create self-reinforcing economic momentum. In a positive economic feedback loop, higher sales drive production and corporate profits, which drive capital spending, employment and wages, which in turn drive further sales and perhaps even inflation. Often these feedback loops continue until a formidable enough external force emerges and overcomes the economy's momentum, as was the case with last year's government interventions. Keeping this context in mind, we contemplate the three primary factors behind current economic concerns.

First, let's look at China, where throughout 2010 there has been a clear course of monetary tightening (chart 1), including nationwide restrictions on lending, increases in the required reserve ratio, and most recently, a decision to gradually revalue the yuan upwards. While it is reasonable that Chinese officials want to safely deflate their real-estate bubble and avert pending inflation, it is questionable whether the global economy should be toppled in the process. Modest reductions in growth would

sufficiently contain China's inflation, especially when combined with a gradually rising yuan and an already slowing real estate market. Still, China's tightening is hardly the adequate force required to induce a second global recession.

Next, let's examine employment in the United States. In reality, employment is not an external force that changes the direction of the economy; rather, it is an essential part of the feedback loop. While government spending often fuels the initial stage of an economic recovery, longer-term economic expansion requires growing employment. Consumers, who account for approximately two-thirds of the nation's economy, need to earn more in order to spend more. With corporate profits up 246% over the past year, U.S. businesses appear well positioned to increase employment levels, but so far these gains have been slow to materialize. Recent employment reports indicate that although job growth is positive, it remains relatively light for this stage of a recovery (chart 2). The positive feedback cycle is occurring but economic momentum is quite weak, making the overall economy more vulnerable to external shocks. Employment growth remains a key ingredient of a sustainable economic expansion due to its role in the feedback loop, but is not itself a trigger for economic contraction. Nevertheless, we continue to watch this number closely for evidence of sustainable economic growth.

Lastly, let's consider the recent European austerity plans and the extreme debt levels held by many of these nations. In sharp contrast to the economic stimulus plans employed during the previous year, many nations are now combating burgeoning budget deficits and debt balances by implementing austerity measures. Austerity is a euphemism for increasing taxes and eliminating numerous government programs. In addition, European banks, which are loaded with investments in sovereign debt and are considerably more leveraged than

their U.S. counterparts, face significant pressure. For these reasons, we must recognize that, among the list of primary concerns, this one has a realistic potential to undermine the economic recovery.

We have been noting for some time that, with sovereign and private debt at unsustainable levels, there would be a gradual belt tightening or an ultimate reckoning, either of which would restrain economic growth. Over the next few years, economic growth will be heavily influenced by the timing and implementation of these austerity measures, as well as whether they are offset by monetary and foreign-exchange policies. Fiscal restraint must be implemented gradually, so as not to weigh down the respective economies too soon. In addition, where possible, monetary policy needs to remain stimulative and currencies need to be devalued. The European Central Bank, which has been stubborn to act (chart 3), will likely be forced to take more dramatic actions. As Confucius would have contended, it is extremely important for the world economy to move ahead, even if at a sub-par pace. Policy makers should follow this advice and not undermine the economic recovery.

We continue to believe the global economy will successfully transition from recovery to expansion, recognizing that this shift is contingent upon world leaders making the right decisions regarding the timing of budget reductions and monetary policy. We do not, however, expect this process to be smooth. The economy remains vulnerable to downside risks, and the politics surrounding budget

decisions and the development of economic policy are complicated. Even with a successful transition to expansion, continued deleveraging should cause sub-par global economic growth for the next 5-10 years. As a result, we foresee continued above-average volatility and subdued returns for most asset classes.

We recommend that investors maintain a neutral exposure to market-related risks and rebalance in order to take advantage of price swings and extreme valuation disparities. Recent market weakness provides opportunities, particularly in Europe where valuations have reached an extreme level of 10x earnings, a nearly 30% discount to U.S. markets (chart 4). Recent market weakness also provides an excellent opportunity to increase exposure to emerging Asia, where secular economic growth is more robust (chart 5) and sovereign debt is essentially a non-issue (chart 6).

Finally, we continue to recommend a meaningful allocation to absolute-return strategies, most specifically hedge funds. Today's environment of higher volatility and sub-par market returns should result in increased performance differentiation by these opportunistic and nimble investors. Hedge funds have the unique ability to exploit market inefficiencies in a manner that provides steadier returns and limited exposure to financial market swings. In a sideways, volatile market, investing through such strategies will be the key to enhanced risk-adjusted performance.

GLENMEDE'S MARKET ANALYSIS TEAM



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Economic & Market Outlook

Key Economic and Market Viewpoints

- **The global economy continues to grow, albeit at a slower pace** due to numerous headwinds.
- **The global debt crisis is far from over.** The large debt burden of many developed nations leaves the global economy vulnerable to disruption.
- **Europe is being forced to deal with its sovereign debt burden first,** resulting in near-term volatility and declining economic growth.
- **The removal of fiscal and monetary stimulus (China) and changes in regulation (U.S.) are also likely to be headwinds** to economic growth during the next 24 months.
- Despite the global headwinds, **the U.S. and emerging economies appear to be transitioning towards a sustainable expansion.** Europe remains an area of weakness.
- **Global markets are most likely to remain in a sideways, volatile trend** due to the uncertainty surrounding the global debt crisis and slower global growth.

Investment Strategy Recommendations

- **Opportunistically rebalance to a neutral market-risk position.** The current environment affords this opportunity; likely triggers include lower valuations or increased stability.
- **Shift portfolio allocations toward undervalued assets.** We currently see valuation opportunities in U.S. quality growth and European equities.
- **Take a defensive posture towards the euro** in recognition that the global debt problem is most pronounced in Europe.
- **Maintain exposure to secular growth in emerging Asia,** through international investment strategies, multinational equities, Asian real estate, and commodities.
- **Anticipate appreciation in attractively priced income-producing assets,** high-yield debt and utilities, as retiring baby boomers invest for income.
- **Allocate to absolute-return strategies,** which are less correlated to the broad markets and can help reduce overall return volatility.

Market Analysis in Brief

Chart 1
China Monetary Policy Reacts Quickly to Inflation

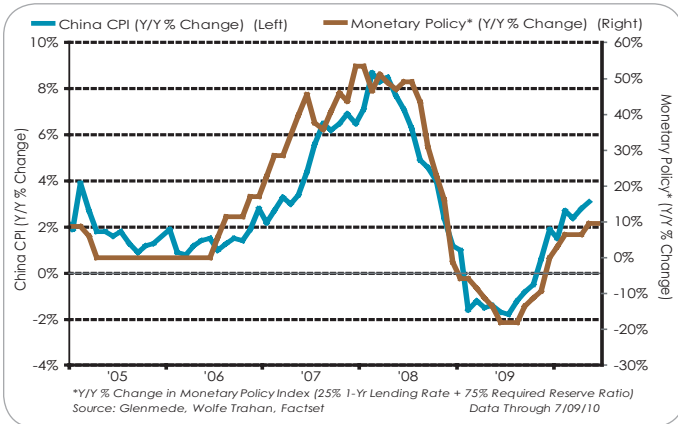


Chart 2
Employment Gains Are Slow Coming

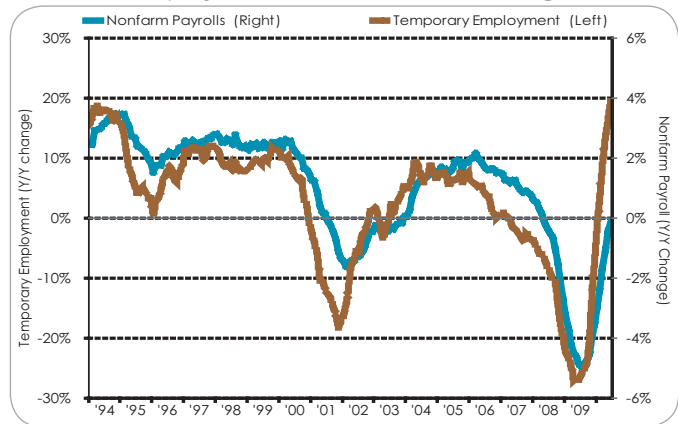


Chart 3
The ECB Needs to Catch Up with the Federal Reserve

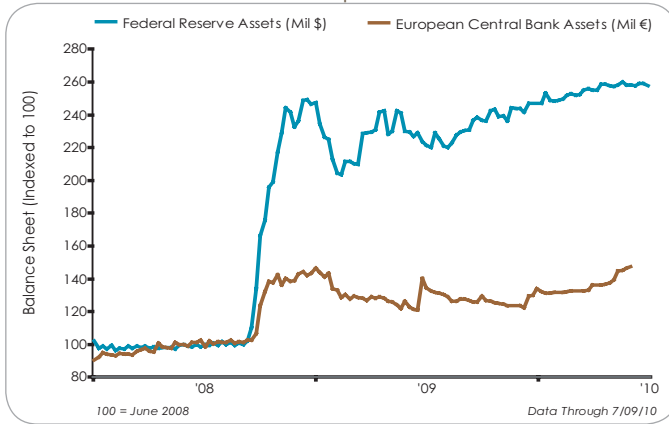


Chart 4
European Valuations Look Attractive

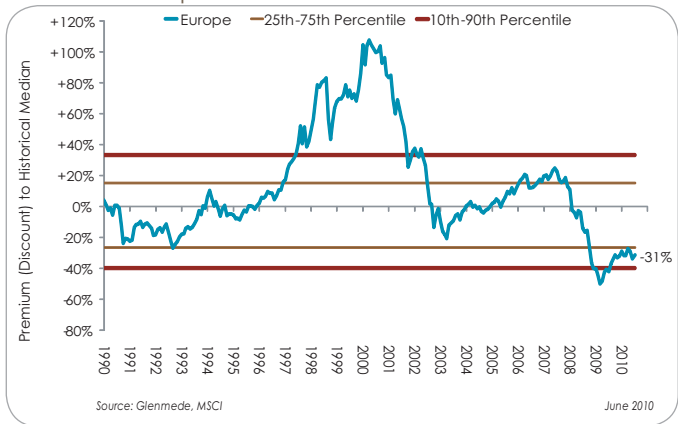


Chart 5
Developing Countries Continue to Lead Growth

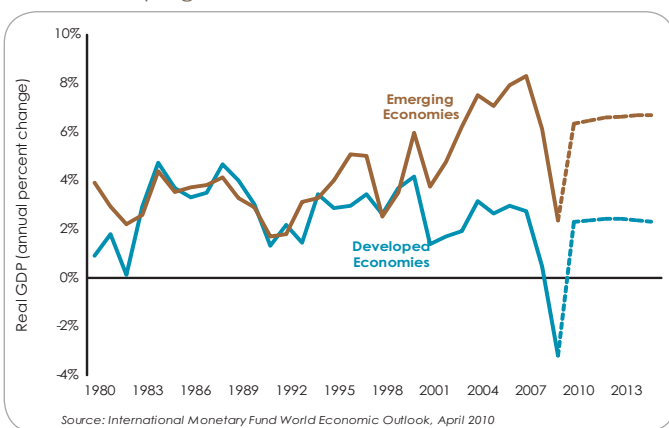
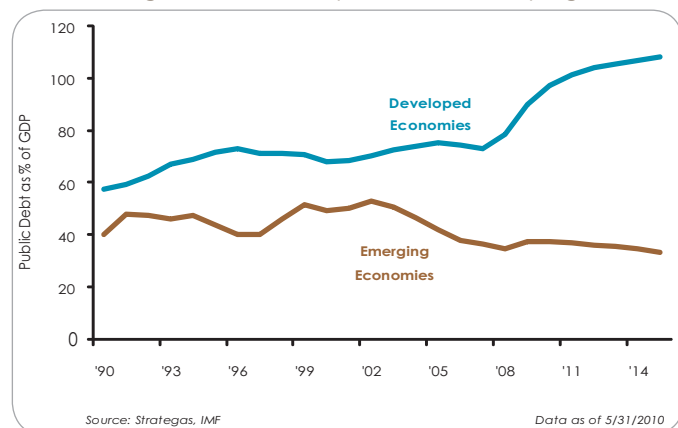


Chart 6
Debt Divergence in Developed and Developing Worlds



CLEVELAND

MORRISTOWN

NEW YORK

PHILADELPHIA

PRINCETON

WILMINGTON