

Quarterly Insights

Economic and Market Views

Quarter 1, 2012

2012 Outlook: The Mendoza Line

“They were giving George Brett a hard time because he had a slow start...they told him, ‘Hey, man, you’re going to sink down below the Mendoza Line if you’re not careful.’”
– Mario Mendoza, 2010, recounting locker-room banter

The Mendoza Line

The Mendoza Line is a baseball expression used to define a player’s threshold of incompetence or lack of performance. It was named for Mario Mendoza, a former shortstop of the Pittsburgh Pirates, Seattle Mariners and Texas Rangers, who was known as a sub-.200 hitter. Today, when a position player’s batting average falls below .200, the player is said to fall below the Mendoza Line — the unfortunate point when, regardless of field abilities, his presence in Major League Baseball is questioned.

Due to investors’ perception of the economy transitioning from a cyclical recovery to one of ongoing debt deleveraging, 2011 was a year of below-Mendoza-line returns for most asset classes. Most assets, particularly riskier ones, performed well below historical levels while the most protective delivered near record returns. This disparity is largely a reflection of the sub-par economic growth experienced both recently and periodically over the past decade. Since 2000, the global economy has delivered an average real-GDP growth rate (economic growth over and above inflation) of 1.5 percent, significantly below the average historical level of 3.5 percent prior to 2000. If a batting average is good over .300 and poor under .200, GDP growth of 3 to 3.5 percent or higher should be considered good and 1.5 to 2 percent or lower sub-par.

Of course, not all economies are experiencing the same degree of weakness. Emerging markets are

growing well above the rates experienced during the 2001 to 2003¹ and 2009 global recessions. Although projections for the U.S. are presently weak, they remain above any previously-reached lows². Europe, on the other hand, continues to be mired by ongoing national debt problems, painful austerity measures and a slowdown in bank lending propagated by European Union leader demands for stricter bank capitalization targets.

2011: Curveballs and Missed Pitches

As is the case with economic and financial markets, unexpected events are a reality — 2011 experienced two significant curveballs. The first was the Tohoku earthquake and tsunami. The second was the Arab Spring, which caused energy costs to rise, further squeezing consumer spending when many were already compromised by earlier financial blows. Neither event in isolation would normally have shaken the global economy, but with slower-than-normal growth, there was greater vulnerability to disruption.

Not all of the 2011 sub-par economic growth can be attributed to exogenous events and deleveraging. Similar to a batter who fails to swing at a pitch in the strike zone, government leaders have missed numerous opportunities to affect change and instead waited for the perfect pitch — one which still may never come. The failure of the U.S. to legislate a \$3.5 to \$4 trillion budget deficit deal was the most obvious of political shortfalls. Despite numerous

¹ Source for emerging market GDP estimates: International Monetary Fund (IMF) Semi-Annual Outlook, July 2011

² Source for U.S. and European GDP estimates: Organization for Economic Co-operation and Development (OECD), October 2011

detailed proposals to rein in the deficit, Congress' extreme polarization precluded a completed resolution and prompted Standard & Poor's to downgrade its U.S. debt ratings and other rating agencies to issue cautious or negative outlooks. Likewise, European national governments put forth significant austerity plans, but time and time again it was too little, too late.

2012: The Seventh Inning Stretch and a Run Deficit

While both crises will likely restrain growth in even the best scenario, each can still be remedied. A hypothetical \$4 trillion U.S. budget deficit deal, as recommended by both the Deficit Commission and by Standard & Poor's, should produce a manageable drag of somewhere around 0.5 percent of GDP growth over the next 10 years. As witnessed with Greece and other peripheral nations, timely implementation of a spread-out multi-year plan is integral to producing a manageable effect. While the cost of repairing the U.S. balance sheet remains economically bearable, the longer we wait the more debt will accumulate and the more costly and sudden the ultimate reckoning. Unfortunately, our need for clear and decisive budgetary action comes at a time when our political system is more fractured than any time since the Reconstruction Era, according to an analysis of U.S. congressional vote records.

As far as Europe is concerned, movement toward fiscal unity could resolve many problems. In aggregate, European net-debt-to-GDP and deficit-to-GDP ratios are lower than those of the U.S. Yet, until the Eurozone becomes a true fiscal union, it remains vulnerable to the politics of negotiating fiscal transfers and budget restrictions. On either continent, the impacts of a contentious political environment are critical and uncertainty of the outcomes is high.

2012: Batting Coaching and Line-Up Changes

We continue to believe elected officials, on average, have good intentions and when pressed, will make the appropriate decisions to stave off a further downward spiral. Both in the U.S. and in

Europe, the incentive and firepower to resolve the debt crisis are present. However, the path to resolution remains difficult given the complexity of the problems. Whereas austerity proposals are difficult to impose (e.g., altering retirement ages and other entitlements, spending cuts and higher taxes), budget reconciliation is an economic reality that must occur. When these "tough love" programs will succeed in delivering debt sustainability, no one clearly knows.

If we assume history repeats itself, we know that government action must be decisive and significant if to halt the bloodletting. This could potentially occur in two ways. One possibility, which has been the case so far, is a gradual progression of a solution(s) that accumulates to a critical enough mass to sufficiently alter the overall direction of the crisis. The other possibility is that a contingency of political leaders reach a tipping point and propose a solution that leap-frogs the state of the crisis.

Perhaps Europe and the U.S. will learn from each other. As evident by Tim Geithner's prodding of European leaders, the U.S. is a strong proponent of significant government intervention in the banking system. Alternatively, the U.S. would be well-served to act upon the need for immediate and concise budget discipline. In both cases, line-up changes may be necessary. Interestingly, seven of the G20 nations (representing more than 30 percent of world GDP) will hold presidential or equivalent elections in 2012, including the U.S. This will provide ample opportunity for voter input to force some modicum of change.

Europe, after a few line-up changes, may finally be showing signs of political progression. The combined leadership of Mario Draghi (ECB), Christine LaGarde (IMF), Mario Monti (Italy) and Lucas Papademos (Greece), coordinated with a more open-minded Angela Merkel (Germany) and Nicolas Sarkozy (France), could finally break the log-jam. The ECB's preference for price over economic stability will likely cause further economic weakness due to regional austerity measures, but effort toward fiscal

unity appears to be gaining steam and the ECB now seems committed to serving as a backstop for the financial system in the case of more adverse events.

Investment Strategy: Focusing on the Strike Zone / Moving to the Middle

Struggling to stay above the Mendoza Line, the world economy is producing below-normal growth. The financial markets reflect this uncertainty with continued above-average volatility and significant valuation discrepancies between protective and riskier assets. These disparities exist across the risk spectrum, some in greater magnitude than others. Generally, U.S. government bonds and Treasuries appear most expensive, while assets with any risk are more fairly or even attractively valued. International developed equities offer the best valuation discount but are also at the epicenter of the disruption. Emerging market equities provide attractive valuations and reasonable growth prospects but could be significantly impacted depending on how events unravel.

This leads to our final baseball analogy: focus on the strike zone. With protective securities highly overvalued and risk at heightened levels, it is justifiable, for different reasons, for investors to focus on the middle instead of either extreme. Long-term returns should not be forfeited outright to portfolio protection. Investments in the middle of the

spectrum should pose less risk than equities. They have not seen the flight-to-quality and resulting overvaluations as more protective assets and are more likely to produce the best prospective risk-adjusted returns. Included in the middle are higher quality (lower-risk) equities, high-yield corporate bonds (BB-rated, higher risk than investment grade debt, but lower risk than equities), global bonds, options-based strategies and absolute return strategies (our preferred name for the category that includes hedge funds). We believe the middle of the risk spectrum is also optimal for the current sub-par economic growth environment since riskier investments typically depend more on strong economic growth, and more protective assets are starting at such a disadvantaged valuation.

At the same time, we believe investors should remain responsive to changes in the economic, political and market environment. In previous writings we have identified three possible triggers that would prompt us to assume more risk: a significant and proactive European debt deal with a banking recapitalization, and perhaps including ECB participation; an expansion of the U.S. deficit deal to a \$4 trillion reduction over 10 years or an upward turn in our primary economic leading indicators. Of course, market valuations must also be considered to determine the appropriateness of any changes at a given point in time.

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Economic & Market Outlook

2012 Outlook

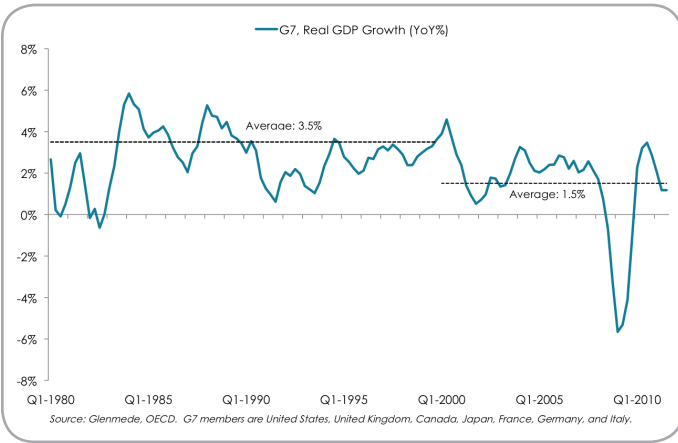
- **The global economy is growing but continues to struggle to produce trend-line growth** as consumers and governments attempt to repair their balance sheets.
- **Economic growth remains polarized** with emerging economies outpacing developed economies, Europe close to a recession and wide performance dispersion between small and large businesses.
- **Politicians in the U.S. and Europe have not met reasonable expectations** of compromise and budgetary discipline, resulting in heightened systemic risk, low confidence and an additional drag on economic growth.
- **However, with confidence and systemic risk concerns such prominent factors** affecting the global economy and markets, asset class performance in 2012 is largely dependent on political outcomes.
- **Meanwhile, inflation and developed currency devaluation pressures continue to build**, as easy monetary policies are used to offset fiscal austerity and facilitate gradual deleveraging.

2012 Investment Strategy Themes

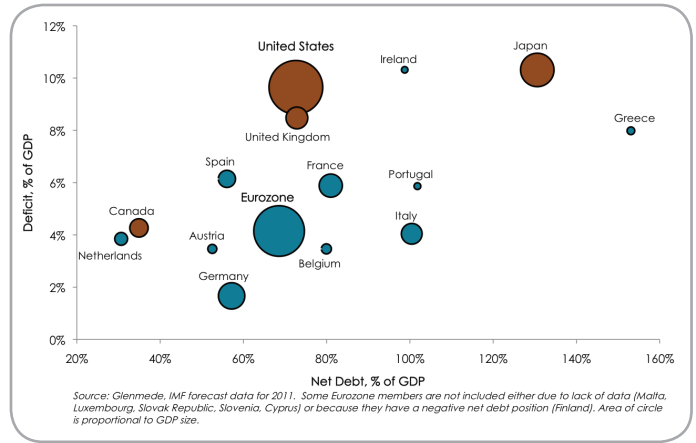
- **Move to the middle:** Investors should focus portfolios in the middle of the investment risk spectrum, where the most attractive risk-reward opportunities lie.
 - Seek protection in equities: high quality and/or dividend growth
 - Substitute some equity risk with credit risk: high yield, long-term municipal credit, and global bonds
 - Underweight low-yielding safety: cash and Treasuries
 - Utilize alternative risk control: secured options and absolute return strategies
- **Position to benefit from the growth of the emerging market consumer**
 - Direct emerging market investments
 - Multinationals selling into emerging markets
- **Protect against future inflation and developed currency devaluation pressures:**
 - Global fixed income and broad/active commodity basket

Market Analysis in Brief

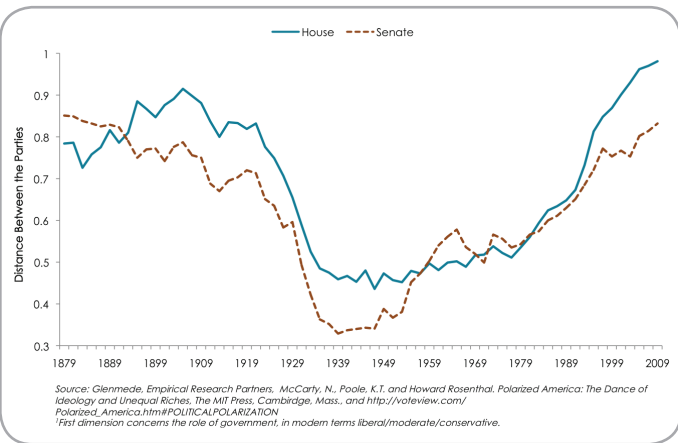
Working off Excesses: Slower Growth Since 2000



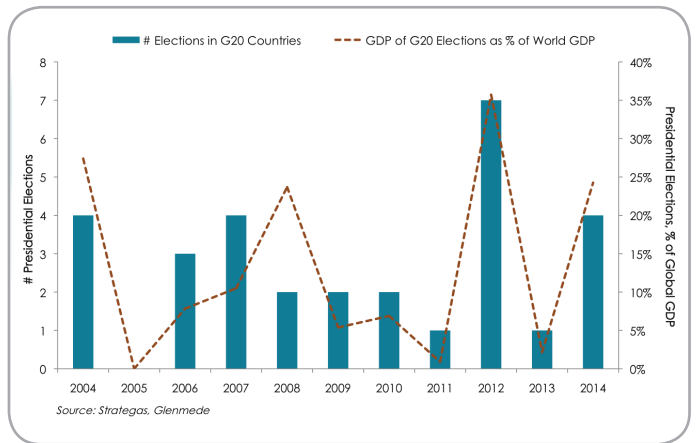
Europe: Fiscal Unity Could Heal Many Wounds



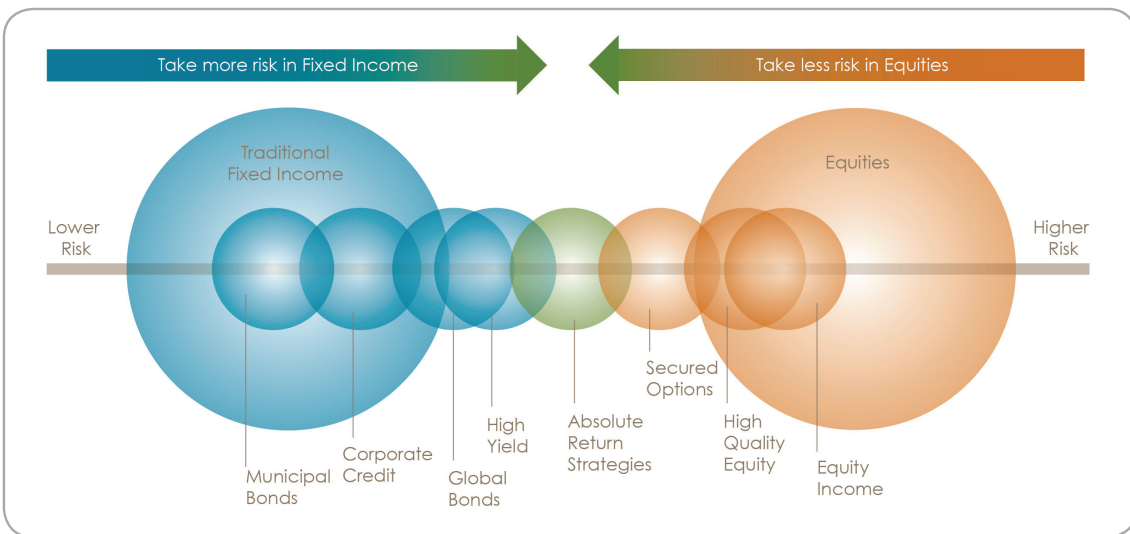
Partisan Politics: The Main Obstacle to a Solution



Elections in Many G20 Nations This Year



Investment Strategy: Move to the Middle





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