

# Quarterly Insights

## *Economic and Market Views*

Quarter 2, 2011

### The Broken Places

“The world breaks us all. Afterward, some are stronger at the broken places.”  
— Ernest Hemingway, *A Farewell to Arms*

#### “Breaking Events”

Having started the year with a promising transition from recovery to expansion as real GDP exceeded previous peak levels, the global economy and financial markets have since encountered what Hemingway would likely have described as “breaking events.” Although a different context than his reference to the human experience, the sentiment seems applicable to countries and economies. The aftermath of a devastating earthquake and subsequent tsunami off the coast of Japan and the increased geopolitical tensions in the Middle East and North Africa (MENA) now threaten to derail the still young economic expansion. However, today’s events must be viewed holistically, both in regard to the near-term pain and disruption and the potential for rebuilding and strengthening.

#### The 2011 Tōhoku Earthquake and Tsunami

The March 11<sup>th</sup> 9.0 magnitude earthquake was the most powerful to ever hit Japan and was described by Japan’s Prime Minister as the nation’s most difficult crisis since World War II. More than 12,000 people lost their lives, over 125,000 buildings were damaged or destroyed and infrastructure such as roads, railways and electrical and water utilities sustained heavy damage, isolating some areas from transportation and other essentials. Perhaps most frightening has been the near-meltdown of the Fukushima nuclear power plant, which has sparked numerous potential health concerns and has impaired approximately 18 percent of Japan’s nuclear power and 6 percent of total electrical generation.

For those of us fortunate to be on safer ground, it has been extremely difficult to watch the pain and suffering of the Japanese people. While the personal loss from the disaster is unquantifiable, we can conclude that the magnitude of the economic impact is likely manageable for both Japan and the world. The region affected by the earthquake and tsunami account for roughly 6 to 8 percent of Japan’s total economy. The World Bank estimates the resulting damages will total between U.S. \$122 billion and \$235 billion, or approximately 2.5 to 4 percent of Japan’s GDP. Importantly, at 8.5 percent of the world economy, the estimated near-term 1 to 3 percent GDP impact from lost production and other disruptions in Japan will impact the global economy by less than 0.2 percent.

Economies are dynamic and reactive; people and businesses often prove surprisingly resourceful when faced with adversity. We should not discount the ability of Japanese companies to reallocate resources quickly to fix supply chain disruptions. Nor should we discount the determination of working people to migrate to other areas just as residents of New Orleans had following hurricane Katrina. Putting aside the potential for ongoing residual effects of the radiation leakage, and barring another natural catastrophe, the impact of the disaster is mostly behind Japan. As with other recent natural disasters, these events will be followed by a period of rebuilding that should lead to a near-term lift to economic growth. Some economists even suggest that such events can improve the

longer-term economy by expediting updates to older buildings, plants and equipment, roads and electrical and telecommunication infrastructure that were otherwise delayed. Japan could emerge stronger within these “broken places.”

### **Middle East and North Africa (MENA) Tensions**

For years, many MENA nations have resisted the global trend toward democracy and have instead rested on their ability to disperse geographic riches as a way to placate citizens and suppress opposition. A case could easily be made that this area is well due for a Hemingway-like breaking and strengthening. As discussed in last month's *Monthly Insights*, aside from the war in Iraq, the recent surge of politically-inspired uprisings is perhaps one of the most significant events to occur in years.

There are, however, distinct differences between the situation facing Japan and that facing the Middle East and North Africa. First, while it is essentially preordained that Japan will rebuild, the successful formation of a democracy following the downfall of an autocratic regime is far from certain. Second, and perhaps more importantly, it is unlikely that the MENA region has made it through all of the “breaking” points. Not only do the underlying political tensions remain unresolved, the effects of such a breaking process are arguably far more material to the world economy than the resulting disruption from the Tōhoku Earthquake and Tsunami.

Given their proximity to much of the world's oil reserves, tension in the MENA region causes global angst and consternation. Although contributing less than 5 percent to world GDP, regional instability has a disproportionate effect on worldwide oil prices, which acts as an immediate transfer mechanism of the region's problems to otherwise unrelated economies. For this reason we are closely monitoring these

events. We continue to believe that regional tensions will remain elevated, resulting in fear-induced, higher-than-normal oil prices and an associated near-term economic drag. While material (0.2 percent-0.5 percent of GDP), this headwind is not currently strong enough to halt the global economic expansion. This base case is hinged upon continued stability of Saudi Arabia, by far the largest oil producer in the region, and also by the expectation that the MENA nations are financially incentivized to protect domestic oil production.

### **Breaking Events, Broken Places, and Opportunistic Investments**

The events of the first quarter of 2011 have not derailed the economic expansion as much as they have raised investor awareness of the risks presented by unexpected events. It is in this context that we should discuss investment strategy. How can investors defend themselves from unexpected occurrences? How should investors react after such occurrences?

### **Non-traditional Strategies: An Intelligent Defense**

Due to continued below-average fixed-income yields, we have been advocating for investors to underweight what is typically the most risk-controlled portion of their portfolio. If investors were to implement this in a traditional stock-and-bond balanced portfolio, it would lead to a significant over-weighted allocation to equities and therefore, risk. We think this is not optimal given it marries the fixed-income investment weighting decision to the risk-management decision. Instead, we have advocated a smaller overweight to equities and the use of non-traditional investment strategies to reduce portfolio risk. In particular, we have employed absolute-return oriented strategies, such as hedge funds that are less intertwined with equity markets, and options-based techniques to reduce the risk of equity exposure. These strategies protect client

portfolios against some of the volatility without limiting future longer-term return potential as much as traditional fixed-income investments.

### **Opportunistic Investments in International Markets**

Unexpected and devastating events create fear, confusion and disruption, often resulting in the mispricing of financial assets. While all markets have suffered varying degrees of weakness due to the earthquake and MENA political tensions, international markets have fallen harder and, in particular, Japanese equities have fallen the hardest.

Previously, we had estimated Japanese equities were approximately 10 percent undervalued due to concerns for their nations' economic growth opportunities. At the trough, recent catastrophic events triggered an additional 17 percent drop, driving Japanese equities to a now 30 percent discount. More aggressive calculations suggest they are as much as 50 percent undervalued.

As a result, we have begun recommending that investors use recent equity market weakness to rebalance portfolios and lift international equity allocations. We have further suggested that investors prioritize shifting allocations toward international equity strategies with a higher allocation to Japan. To this end, we have introduced a Japanese equity-focused ETF to our approved investments list, and have recommended that investors who are able to tolerate risk consider a more focused allocation to the region.

As is the case with such contrarian, value-oriented investment decisions, it may take quite some time for the investment to pay off. However, we believe this patience will be rewarded.

### **GLENMEDE'S MARKET ANALYSIS TEAM**



**Gordon B. Fowler, Jr.**  
President & Chief Executive  
Officer; CIO

Mr. Fowler oversees all of the Company's investment activities and is responsible for Glenmede's investment process and policies.

**Vladimir de Vassal, CFA**  
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Mr. de Vassal is responsible for asset allocation, market-leading indicators, managing the quantitative-based equity portfolios, and stock valuation tools.

**Jason D. Pride, CFA**  
Director of Investment  
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Mr. Pride is responsible for formulating investment policy and strategy, and serves as a leading member of the Investment Policy Committee.

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# Economic & Market Outlook

## 2011 Outlook

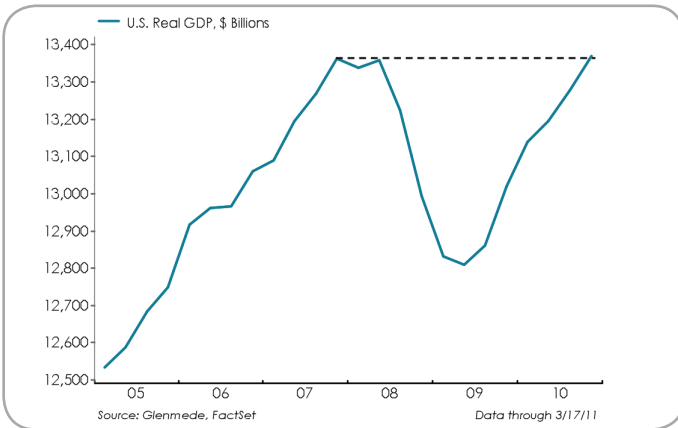
- The global economy has transitioned from recovery to expansion, providing a supportive backdrop for financial markets.
- However, the global economy still faces multiple headwinds (deleveraging, deficit reduction, etc.), inhibiting a more robust expansion.
- The economy has so far sustained itself through unexpected events, including an escalation of Middle East political tensions and the Tōhoku Earthquake and Tsunami.
- Reducing government spending is key to sustaining the expansion; however such reductions will inhibit a more robust economic expansion.
- Commodity inflation and developed market currency devaluation pressures continue as the result of Middle East & North Africa tensions and stimulative monetary policies.

## 2011 Investment Strategy Themes

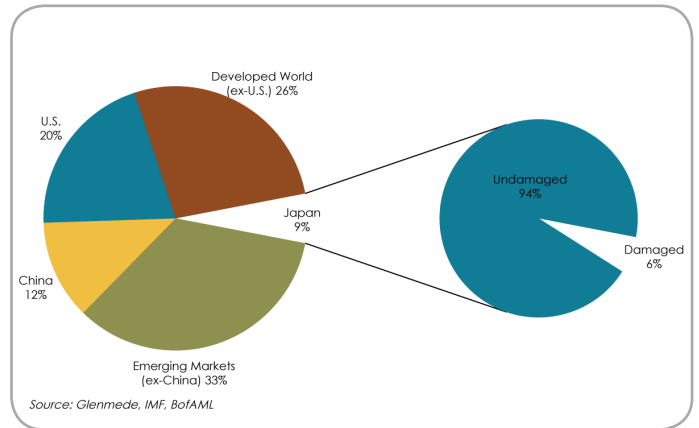
- Allocate to a diversified basket of risk assets
  - Underweight low-yielding investments such as cash and Treasuries
- Emphasize relative value opportunities within asset classes
  - Equities: U.S. growth and both European and Japanese multinationals
  - Fixed Income: Select municipal bonds and sovereign debt
- Position to benefit from growth in the emerging market middle-class
  - Direct emerging market investments
  - Multinationals selling into emerging markets
- Protect against developed currency devaluation
  - Emerging market currencies and a broad commodity basket
- Enhance/protect returns with non-traditional strategies
  - Hedge Funds and Secured Options Strategy

# Market Analysis in Brief

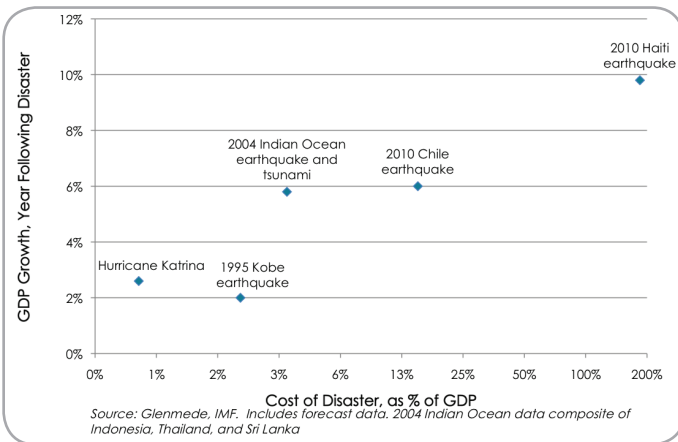
**Chart 1 Economy: Recovery to Expansion**



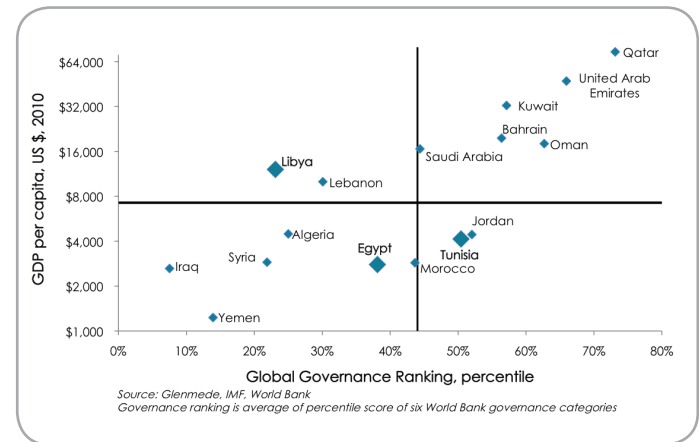
**Chart 2 Region Affected by the Tōhoku Earthquake and Tsunami**



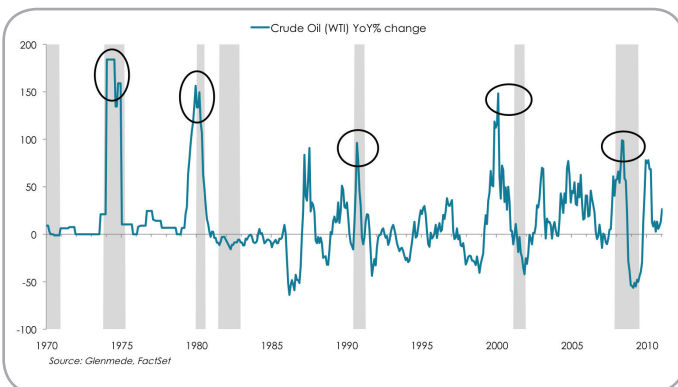
**Chart 3 Reconstruction Spending Stimulates Economic Growth**



**Chart 4 Social Unrest in Poorer Nations with More Repressive Governments**



**Chart 5 Oil Prices Rising by More than 100% in a Year is Often Recessionary**



**Chart 6 Impact of Recent Developments in the Economy**

|                                 | U.S.      | Global    |
|---------------------------------|-----------|-----------|
| GDP Growth Estimates pre-Events | 3.0%–3.5% | 4.0%–4.5% |
| Impact of higher oil prices*    | 0.2%–0.5% | 0.2%–0.5% |
| Impact of Japanese events†      | 0.2%      | 0.3%      |
| New GDP Growth Estimates        | 2.5%–3.0% | 3.5%–4.0% |

\* Based on "Aggregate Disturbances, Monetary Policy, and the Macroeconomy," Federal Reserve Bulletin, 1999. Assumes oil prices remain ~\$100/barrel.

† Based on disaster costing 3% of Japanese GDP, 6% U.S. revenue exposure to Japan, Japanese economy holding 8.5% share of world GDP. Excludes potential benefits from reconstruction.



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