



## REVIEW AND OUTLOOK

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### THE POLLYANNA REPORT

#### Summary

- By anyone's standards, the economic data is fairly bleak. The world's economies have slowed down dramatically, and jobs are being lost at an unhealthy clip.
- Against this backdrop, the stock market is trading at fairly attractive long-term valuations. Levels of investor fear portend a substantial equity rebound.
- Values will not be realized, and fear will not be overcome until investors can see some data indicating that we will pull out of a worsening situation.
- Very faint but positive evidence exists that conditions in the economy are, at least, getting less bad.
- In some very small ways, housing and credit markets are in a better place now than they were a year ago. Corporate earnings expectations have also retreated from wildly optimistic levels and now reflect a level of reality.
- Last week, the market rallied on hope that the various economic programs going through Congress would lift the economy out of the downturn. A more lasting impact would come if the private economy showed signs of healing by itself.

#### If Pollyanna Were a Strategist

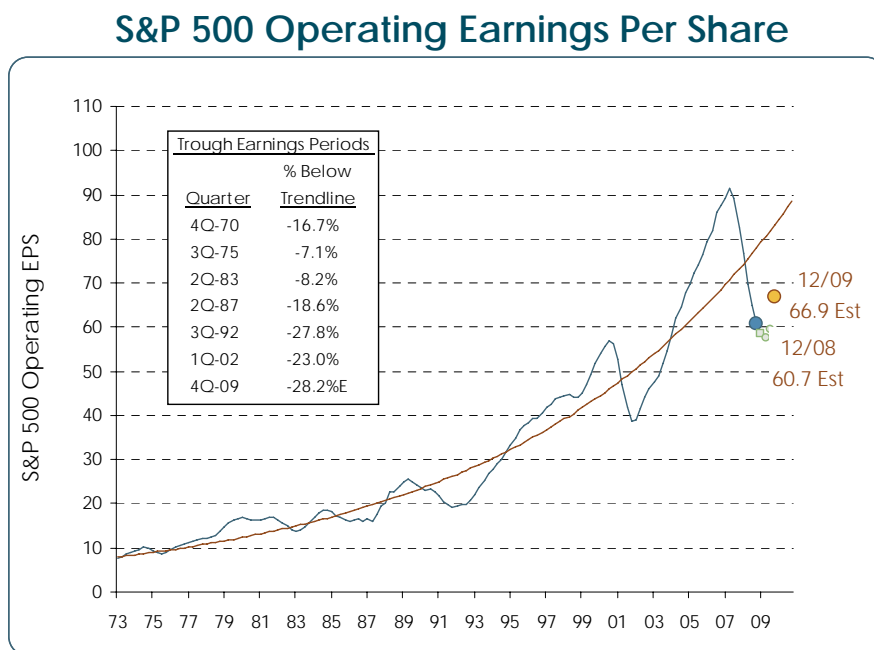
Pollyanna is a character from a novel written in 1913 about a poor orphan girl who learned from her father how to play something called "The Glad Game." The Glad Game is the ability to look at a miserable situation and see some good in it. This strikes me as a pretty apt description of the job of a strategist who is trying to find some information that might give investors a reason to hope for an eventual turnaround in the economy and the capital markets.

The economic picture, to be sure, is fairly bleak. We are experiencing the worst downturn in post World War II history. The credit markets are not fully functioning.

Employment continues to deteriorate. In Washington, debate rages between two polar extremes on fiscal policy –either we are spending too much or too little.

Yet, little shoots are emerging from the ground, and some signs of spring are showing in the economy. We have been following four areas that could tell us to become more positive about the equity markets: economic factors, market sentiment, earnings, and valuation. Sentiment and valuation indicate that equities are worth buying. Investors are scared, and the markets are cheap, usually making it a good time to buy. The other two factors have been more mixed to date, but they are also getting close to a point where a turnaround is at least conceivable.

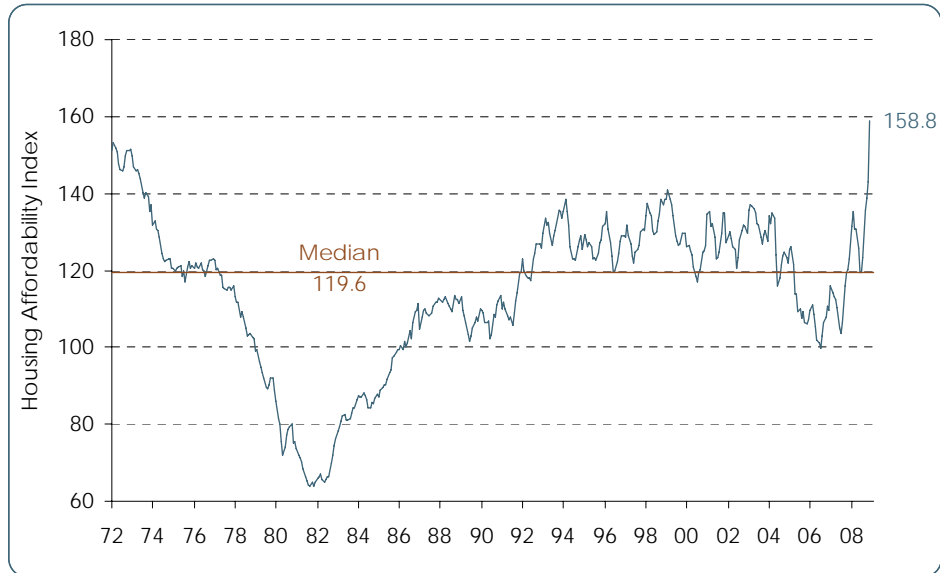
There is less to say about earnings and the economy. Earnings have steadily ratcheted downward. They are, as shown in the graph below, close to 28% below normal trendline levels. Based on historical cycles, this is very close to a bottom. We are inclined to think, however, that this cycle will be worse and that we will experience further declines. Nevertheless, it is comforting to know that we have already completed an expected and steep decline in earnings.



Sources: Glenmede Investment Research and FactSet (Bottom up First Call Forecasts for 2008 and 2009)

The news on the economy is a little more interesting. We have been focusing on two areas: credit and the state of the housing markets. In both cases, things are bad, but they appear to be getting less bad. Housing prices, for example, are getting close to the point where they could be deemed attractive. The National Association of Realtors Index of Affordability is now at its highest level since the creation of the index in 1971, indicating that housing is very affordable. (Affordability is measured by dividing the mortgage payment on the most recent median house price by the median income of the average American family.) Based on current housing prices and low interest rates, a mortgage payment is fairly low relative to median income.

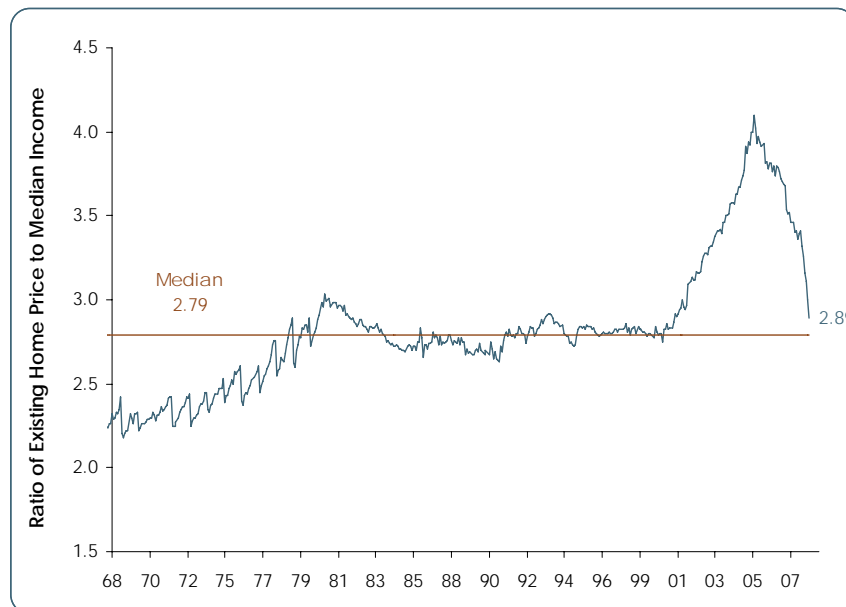
## Housing Affordability Index



Sources: Glenmede Investment Research and Haver Analytics

A similar measure of affordability, which does not take interest rates into account, shows that home prices are within 3-5% of fair value. The following graph shows the ratio of median home price to median income. This ratio rose as high as 4.1 in comparison to a 2.8 long-term median, indicating that the median home price was nearly 50% above long-term trends. The ratio now stands at 2.9. Assuming that we see an overreaction, this means that home prices would only have to go down another 10% before they hit modern lows versus median income.

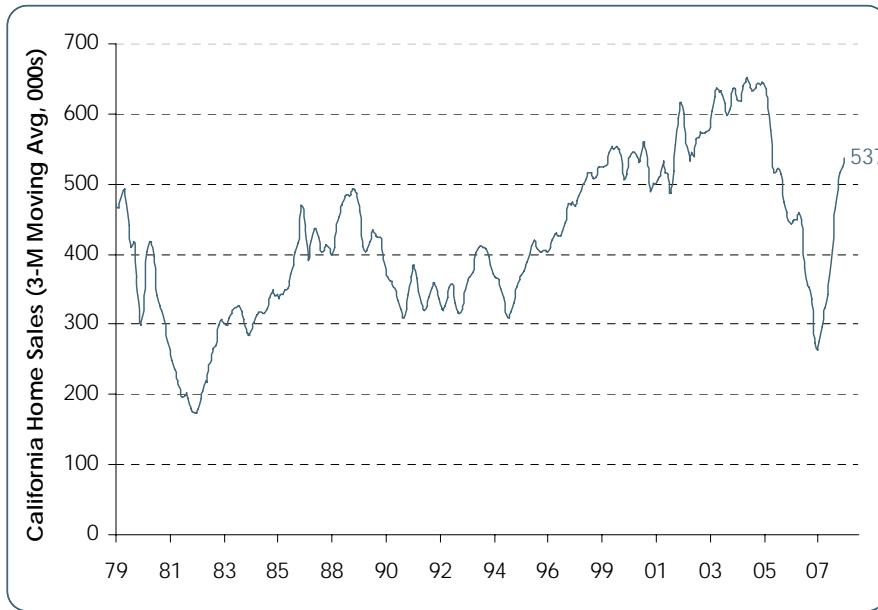
## Ratio of Median Home Price to Income



Sources: Glenmede Investment Research and ISI

We are only just beginning to see some meaningful declines in home prices in places like New York City and Boston where job losses, associated with the decline in the financial markets, will be steep. It is also true, though, that housing sales have begun to pick up in places where the hit to the market has been the hardest. California sales are up nearly 100% over the trailing three months. Many of these sales are associated with foreclosures, but a sale is a sale and thus helps to establish a floor price.

### California Home Sales

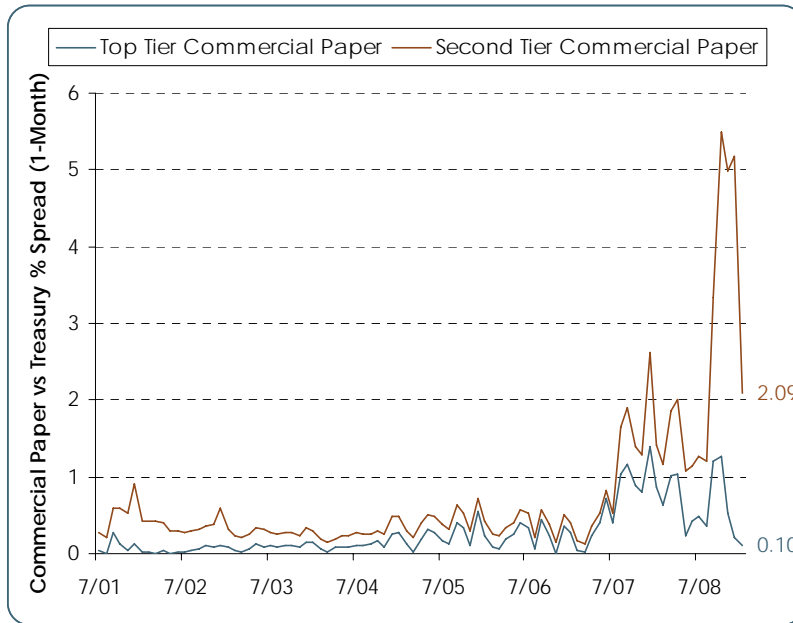


Sources: Glenmede Investment Research and ISI

The housing market is not, by any means, out of the woods just yet. As shown in the graph below, a lot of unsold inventory remains. Until we see a more meaningful decline in inventory, we won't know for sure whether housing prices have hit market clearing levels (market clearing = the point where buyers and sellers agree on a price).

A more stable housing market can eventually contribute to a steadier credit market. Here too, there is some good news. It appears that one of the effects from all of the government programs instituted over the past six months is that the credit markets have begun to thaw a bit. At the very least, things have not gotten worse. High-quality firms can once again issue Commercial Paper – in essence, short-term loans used to fund inventory and other immediate needs. Credit spreads are no longer widening; in some cases they are contracting.

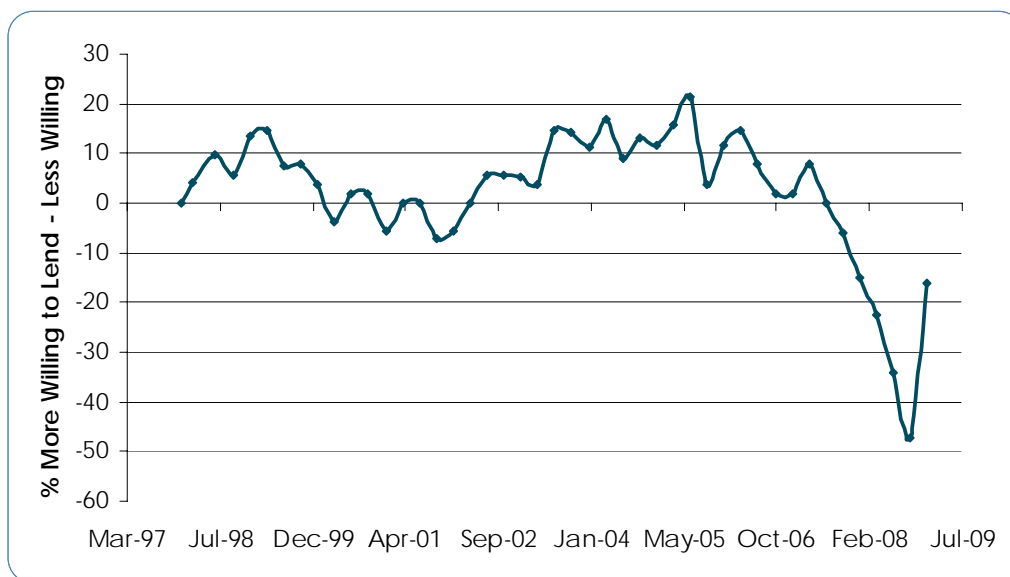
## Commercial Paper Tier One and Tier Two Overnight Rates Since July 2001



Sources: Glenmede Investment Research and Bloomberg

Finally, recent Federal Reserve data shows that banks are becoming “less unwilling” to lend. The Fed asks lending officers if they are more or less willing to make loans to consumers. They calculate the difference between those who are more willing to lend versus those who are less willing to lend. While the difference is still quite negative, just over the past month, it has become less negative.

## Bank Lending Willingness Survey



Source: ISI

It is not time to open the champagne and get out the party hats just yet. The U.S. still has a secular problem associated with too much leverage/debt in the system. The consumer will need time to unwind their overextended positions. This could quite possibly keep economic growth relatively low for some time. It is not clear whether increased deficit spending hurts or helps. One camp argues quite forcefully that more spending and tax cuts (and hence more government debt) are needed to reverse the effects of consumer credit contraction and deflation. Another camp believes that while some government help is needed to keep the economy from going into a downward spiral, it will begin to heal by itself. Some of the most recent data would support the idea that the healing has begun. Pollyanna would probably go out and buy some equities.

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