

GLENMEDE

Review & Outlook

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Getting in Touch with my Baby Boomer Biases

Summary

- The consensus among many economists is that the current business cycle will follow familiar patterns and thus, a more virulent level of inflation will re-emerge over the next few years.
- Fear that inflation could rage wildly may stem from the generational biases of the current crop of baby boomer economists and investors.
- On the other side of the equation, it is quite possible that deflation and very slow growth represent a greater risk.
- We believe inflation will stay under control and our recommended portfolio biases reflect this assumption.
- However, we believe a portfolio should be constructed to protect against both inflationary and deflationary risks when "protection" can be affordably purchased.

Talkin 'Bout my Generation

Based on my birth date, I am a baby boomer. Popular belief suggests that my generation has been profoundly changed by Woodstock. This isn't true in my case. Woodstock went on well past my 8:00 p.m. bedtime. As well, baby boomers were known for conducting "sit-ins" at university administration buildings. By the time I got to college, the only "sit-ins" I staged were the numerous job interviews I lined-up during the worst job environment since the 1930s. Choice of dress made a statement about your outlook on life. My father wore a white buttoned down shirt to work every day of his career. Older baby boomers viewed my father's choice in dress as representative of a generational divide between a conformist corporate mentality and the new generation of free-thinkers. Growing up during two decades of societal chaos, I looked upon my father's dress as a reassuring symbol of the stability he maintained for our family. His conformist dress, which failed to keep up with current trends, masked a non-conformist mindset and a willingness to defy the intellectual fads of the day.

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This gap between the experiences of younger and older baby boomers is not uncommon. There is, however, one experience that unites both: the fear of inflation. Two thoughts come to mind. The first is of my father taping a graph-paper drawing to the refrigerator door with the stunning trend in our monthly energy bill during the 1970s. In our house, *Darkness at Noon* was not just a book by Arthur Koestler, it was also a best practice for electric usage. In addition, "55 saves lives" was a phrase that was applied not only to driving, but to the thermostat in winter.

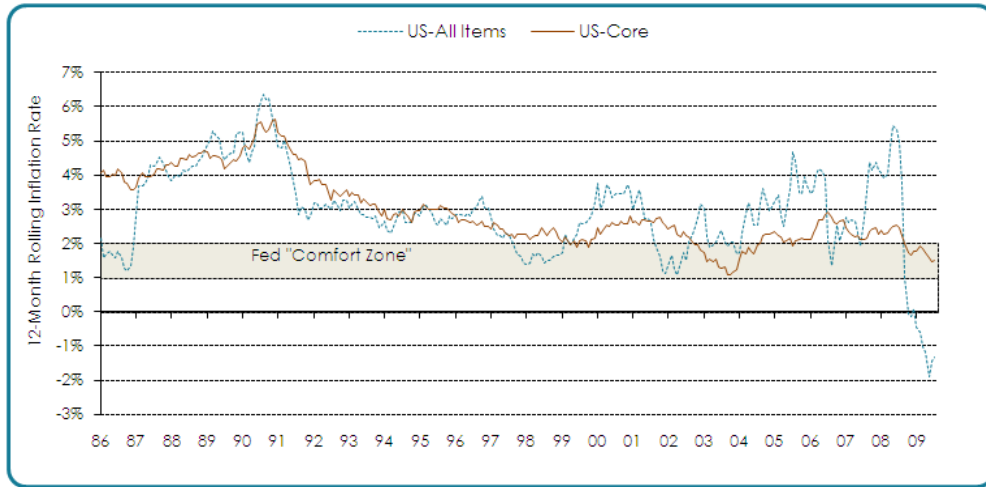
Second, I also remember how much pride I associated with my savings account passbook. I loved the concept that I could put money aside, collect interest and see my savings build. Though, this soon became overwhelmed by the unpleasant reality that those incremental interest payments were small in relationship to the increasing costs of essential goods and services such as our home energy usage and a complete set of yearly Boston Red Sox baseball cards.

Economists and investors raised during the inflationary 70s and wrenching economic policies of the 80s, often reference this point in time as the seminal economic event in their life. The re-emergence of inflation is one of this generation's greatest concerns. Since the beginning of the 1980s, we have had several inflation scares, but never to the extent of the prior decade. This is partly due to the fact the Federal Reserve would eventually raise short-term interest rates. Perhaps just as important, the bond market would begin to anticipate Fed tightening and would raise intermediate and long-term interest rates in anticipation of a Fed rate hike.

This generation of inflation hawks replaced an earlier generation of economists and investors who were badly scarred by the unemployment levels of the Great Depression. For this group, high unemployment represented the biggest risk to the economy and the primary concern for policy makers. In fact, it was perhaps this hyper-vigilance which led to the inflation of the 70s. When unemployment began to perk up as the economy slowed in the 50s and 60s, the Federal Reserve would step on the gas and ease monetary policy. The process of boosting the money supply and keeping interest rates at very low levels kept unemployment in check. However, inflation levels and expectations crept up throughout the 1960s. Eventually, these boosts had little positive effect on the economy and merely resulted in more inflation (you can fool some of the people some of the time, but not all of the people all of the time).

It is worth questioning whether we are in the midst of another cycle where the Fed and markets will respond a little too late to the inflationary pressures implicit with the recent massive monetary stimulus. Or, perhaps we are in the midst of a cycle where the economy will behave differently from our longstanding expectations. Currently, as illustrated in the chart following, consumer prices have fallen and inflation is low.

U.S. Consumer Price Index - All Items and Core Through October 2009

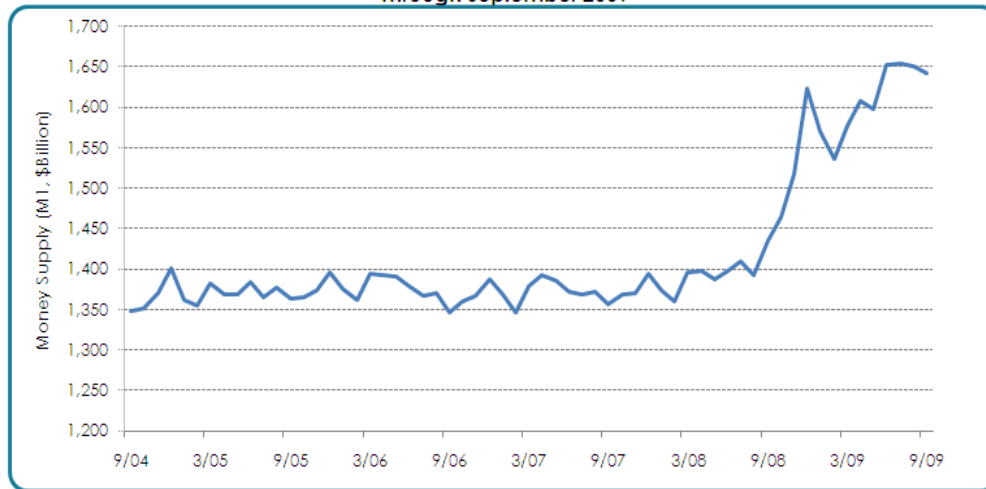


Sources: Glenmede Investment Research and Haver Analytics (Bureau of Labor Statistics)

The Case for Inflation

Let's consider both scenarios. The case for inflation is fairly simple. The Federal Reserve has been stepping on the gas pedal for quite some time and injecting easier money into the economy. First, short-term interest rates were slashed to zero and subsequently, in a less conventional way, treasury and mortgage debt was bought. The chart below shows the rapid growth in the money supply over the past year.

U.S. Money Supply (M1) Through September 2009



Sources: Glenmede Investment Research and Haver Analytics (Federal Reserve Board: Money Stock, M1)

On top of this trend, loose monetary policy has led to a weaker dollar and in turn raised import prices on overseas goods and services. At some point, higher import prices could very well pass through the rest of the economy. This is the economic scenario we Baby Boomers fear.

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Unfamiliar Ground: Deflation

Countries with high debt levels and weak asset markets have, however, undergone the less familiar scenario of persistent deflation. The United States experienced this during the 1930s and Japan has been going through this for close to twenty years.

In this scenario, the stimulus injected into the economy is muted or overwhelmed by a slow and steady reduction in asset prices and an unsteady credit market. In order to get an economy going after a downturn, consumers and businesses need to get a "little crazy." For both parties this means borrowing against their assets or future income streams. This can be difficult in an economy where asset prices are in retreat or weakened, debt levels are already high, and future income streams appear uncertain. As a result, the economy fails to operate at full capacity; businesses are unable to raise prices and wages remain stagnant.

Does the United States now face these conditions? To a degree, the answer is yes. The real estate market, a significant part of the asset base for consumers and businesses, has fallen considerably but has not yet, by historical standards, reached cheap levels. Both consumers and businesses may need to restructure their debt loads relative to their real estate holdings. Business sentiment has certainly improved from earlier levels, but it is hard to say there is excitement for the economy. The prospect of higher tax levels on investment and business income (to fund the enormous budget deficits and social spending) could well restrain the willingness of businesses to take risks.

Government spending should positively impact economic growth, but it is not clear the "multiplier effect" is all that great. The multiplier effect is the follow-on impact of a dollar spent. For instance, spending a dollar to repaint commuter train stations will likely have a multiplier effect. The painter will likely spend a good portion of his wages on goods and services that will in turn be spent by the sellers of the painter's goods. The multiplier effect, let's say, of a new highway could be greater if it allows freight to move faster and more efficiently. For a variety of reasons – some of which are quite good - the multiplier effect on government investments tends to be lower than on private investments.¹

Inflation or Deflation?

So are we on the verge of a great inflation where prices skyrocket, or a sustained deflation where prices collapse? Both extremes are quite possible. However, the most logical bet is that for the next few years it will be challenging to get consumers and businesses to bid-up prices and wages. This scenario will keep inflation somewhat in check.

¹ Public investments can be as productive and stimulative as private investments if the people making the public allocations focus on the "return" on investment in a disciplined manner. Think of the positive impact on growth from a lower crime rate that may come from more spending on the local police force or educational programs for children in crime-ridden neighborhoods. Public investment decisions, though, can have a nasty way of getting allocated based on political might and expediency rather than rational return on investment criteria. Public investments can also be purposely-directed toward quality of life investments with no real return on investment. I would have no problem if someone would indeed do some remodeling of the Bryn Mawr commuter rail station, for example.

How do you invest in this environment? Since our most likely scenario is a slow growth environment with limited inflation, we would overweight high-quality growth stocks. These companies should not only prosper in this environment, but they are also relatively cheap. Likewise, we continue to like corporate high-yield debt as spreads may still narrow. Both of these assets will also perform well in an economy that is growing stronger than expected.

A good portfolio is also prepared for the unanticipated. As a result, we would include commodity-like investments to hedge against a rise in dramatic inflation expectations. This exposure serves double duty as commodities tend to act as a proxy for growth in the emerging markets.

Similarly, we would have sizable holdings in high-quality tax-exempt and taxable fixed income to protect against an unpleasant deflationary scenario. If we really thought sustained and deep deflation was the most likely scenario, we would move from an underweighting to an overweighting in stable assets.

The case for sustained deflation is not the consensus viewpoint and there is good reason to dismiss it. It is, however, worth thinking through the possibilities. At any rate, perhaps I am just being a bit contrary. I am after all wearing a white button down shirt today.