A PERSPECTIVE ON RECENT EVENTS — Q1, 2016

Market Insights

Going Back to Normal

“I’m going back to Cali, Cali, Cali,
I’m going back to Cali ...hmm, I don’t think so.”
—LL Cool J

• The global markets and economies have recovered to relatively “normal” levels from the 2008 downturn.
• In concert, the Federal Reserve is removing stimulus, restraining near-term growth, but at a slow enough pace not to derail the expansion.
• Investors should reduce risk to neutral by investing abroad and remaining defensive domestically.
• Investors should also seek opportunities in out-of-favor assets such as select high-yield and active value approaches and in deepening private markets.

Going Back to Normal (again)

For those who came of age during MTV’s glory days, you either hate or fondly recall the disruptive scratching, wandering saxophone and firm backbeat of LL Cool J’s 1989 classic “Going Back to Cali.” Hailing from Kentucky, I didn’t connect with the hip-hop imagery, but I grew to appreciate the song’s meaning. The chorus expressed the emotional pull LL Cool J, aka James Todd Smith, felt to return to California, while the “I don’t think so” response expressed his reservations about leaving New York City. I experienced similar feelings, having moved from city to city over the course of my education and early career. While not emotional beings, the markets and economies seem compelled by a similar lure.

EXHIBIT 1: World Equity Markets Looks Relatively “Normal” (i.e. Close to Trend)

World Stock Index vs. Trend Growth

Source: Glenmede, MSCI, FactSet
* World stocks are represented by MSCI’s All Country World Total Return Index (ACWII).
Trend is based on a log-linear regression (-7% growth rate).
We believe global markets and economies are compelled to return to “normal” by their own repetitive calls and swanky backbeat. Not driven by any observable physical force, markets move lackadaisically, sometimes staying awhile before heading off in another direction. Still, they rarely drift far afield and eventually return to normal levels. In the six years following the 2008-2009 downturn, the markets and economy have since meandered back to “normal,” and Exhibit 1 shows that worldwide equities have arrived at their long-term-trend growth rate.

**The Near-Normal Economy**

While a market index and trend line provides a simplistic baseline, what constitutes “normal” should be explored further. Exhibit 2 compares a broad selection of economic data series over a 30-year period. We find that most of these diverse factors—consumer debt levels, government deficit, unemployment and inflation—are all quite close to historically normal levels.

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**EXHIBIT 2: What Does a “Normal” Environment Look Like?**

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2008-2010*</th>
<th>Normal**</th>
<th>Today</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer Debt % of Disposable Income</td>
<td>95%</td>
<td>133%</td>
<td>100%</td>
<td>104%</td>
</tr>
<tr>
<td>U.S. Budget Surplus or Deficit % of GDP</td>
<td>3.9%</td>
<td>-11.2%</td>
<td>-1.6%</td>
<td>-1.8%</td>
</tr>
<tr>
<td>U.S. Unemployment</td>
<td>3.9%</td>
<td>10.0%</td>
<td>6.1%</td>
<td>5.0%</td>
</tr>
<tr>
<td>U.S. Inflation***</td>
<td>2.6%</td>
<td>0.6%</td>
<td>2.7%</td>
<td>2.0%</td>
</tr>
<tr>
<td>10-Year U.S. Interest Rates</td>
<td>5.1%</td>
<td>2.1%</td>
<td>5.3%</td>
<td>2.2%</td>
</tr>
</tbody>
</table>

* 2008-2010 shows the peak or trough data point.
** Normal is the 30-year simple average for the respective data item.
*** U.S. Inflation is represented by year-over-year changes in Core CPI, which excludes food and energy.

However, there is an important outlier—interest rates are well below normal. While it should not be surprising that the Federal Reserve feels pressure to raise rates, we can’t assume rates will immediately surge higher. As shown in Exhibit 3 on the next page, while labor markets and price inflation seem to be roughly at the same level as the last tightening cycle in 2004, gross domestic production (GDP) growth, a broad measure of economic activity, is noticeably lower. There are a number of reasons for this, including ongoing household deleveraging as well as slower growth in the developed world’s working population. As a result, the Fed’s forthcoming normalization of interest rates will occur gradually, so as not to derail the slow-growth expansion.
There has been much hoopla surrounding the Fed’s December rate hike, but many pundits fail to mention the Fed has essentially been tightening monetary policy since 2014, when they began tapering their bond purchases. The graph below shows a theoretical “shadow rate” measure, popularized by the Federal Reserve Bank of Atlanta, to illustrate the effects of all monetary policy, including quantitative easing and other measures, by showing where short-term interest rates would have needed to be to produce a similar theoretical effect. The extraordinary impact of quantitative easing—the equivalent of reducing short-term rates to a negative 3.0 percent—cannot be understated. Perhaps more important is the reversal of that shadow rate since 2014, which we think has been a headwind to the markets and economy.

EXHIBIT 3: Key Economic Indicators Relative to the Previous Tightening Cycle

Source: Glenmede, U.S. Bureau of Economic Analysis, Conference Board, U.S. Department of Labor, FactSet
Inflation measured by Y/Y changes in Core CPI, which excludes food and energy. GDP growth rate measured by seasonally adjusted GDP 2009 chained prices Y/Y.

EXHIBIT 4: The Federal Reserve Has Essentially Been Tightening for the Past Year

Source: Glenmede, Federal Reserve Bank of Atlanta
* The Wu-Xia “shadow” federal funds rate is a theoretical short-term interest rate meant to provide a better measure of U.S. monetary policy than the Fed Funds rate alone, since it is not bounded by zero (investors can choose to hold physical cash at a 0% interest rate.) Interpolated from the Fed Funds futures market, it reflects the combined effect of all monetary policy actions (both interest rate reduction and other actions such as quantitative easing that were taken after rates were reduced to zero).
A partial offset to the U.S. Fed’s unwinding of stimulus programs has been the surge in monetary stimulus provided by the European Central Bank and the Bank of Japan. Exhibit 5 shows that each agency has initiated large-scale asset purchases and balance sheet expansions with similar stimulative effects. In addition to aiding their respective economies as intended, these initiatives have served to counterbalance the U.S. Fed’s more recent tightening. We suspect that domestic and international monetary policies will continue to diverge for the intermediate term as international developed economies remain below their respective normal levels of operation.

EXHIBIT 5: Global Central Banks are “Refilling the Punch Bowl” with Liquidity

Central Bank Asset Purchases (Billions of USD)

Investment Strategy: Neutral Risk and Selective Risk-Taking

Investors should look to shift their portfolios back to a more normal, neutral risk position. This adjustment equates to a modestly reduced equity allocation from our recent recommendation, but does not reflect an expectation of an impending, large downward market or recession. The move to neutral simply reflects the probability of a more balanced risk environment, where the economy and markets could very well continue to expand but where the risk of declines has risen back to normal levels.

EXHIBIT 6: Even Earnings Growth Appears Better Overseas
In this environment, some investments offer a greater likelihood of success than others. In particular, we find international developed markets provide better risk-reward prospects than those in the U.S. As shown in Exhibit 6 on the previous page, both Japan and Europe have better earnings trajectories than the U.S. over the past 12 months. Of particular note is the dramatic outperformance of Japanese corporations, which are benefitting from a potent combination of monetary stimulus, economic reform and a gradual improvement in corporate efficiency. We think these trends will continue into 2016, rather than suddenly reverse course.

At the same time, international markets continue to offer a discount and the potential for a valuation reversion versus U.S. equities (see Exhibit 7, above.) This has led us to maintain our overweight allocation to international equities and a more defensive and active position in U.S. equities. In fact, the divergence in performance among U.S. stocks has created a relatively wide gap in valuations (see Exhibit 8, below.) We believe this may provide an opportunity for talented active managers to purchase sound companies at meaningful discounts from the wreckage left by investors who threw in the towel.

**EXHIBIT 7: U.S. Stocks Now More Fully Valued, International Still at a Discount**

<table>
<thead>
<tr>
<th>Valuation Category</th>
<th>Overvalued</th>
<th>Fairly Valued</th>
<th>Undervalued</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>22%</td>
<td>-13%</td>
<td>-23%</td>
</tr>
<tr>
<td>Int’l Developed</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Emerging Markets</td>
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</tbody>
</table>

Source: Glenmede

Valuations are calculated using normalized price-to-earnings, price-to-book value, and dividends, as of 12/20/15.

**EXHIBIT 8: Valuation Dispersion* Provides Opportunity for Active Managers**

*Valuation dispersion shown as the spread between the top quintile and market average for the 800 largest U.S. corporations.

Source: Empirical Research Partners Analysis, National Bureau of Economic Research
Although Exhibit 8 on the previous page shows international emerging markets offering a larger discount than developed markets, we believe investors should take a more nuanced stance. Near-term momentum, economics and earnings have been relatively lackluster for broad emerging markets. The transition away from over-investment in infrastructure will continue to be painful for the cyclical businesses that were tied to that build-out. As a result, we have focused our investments on companies selling to the Asian emerging market consumer, a still-healthy demographic. Exhibit 9, below, illustrates the divergence between the new “consumer” and the old “industrial” China by looking at the relative performance of stocks in each of those sectors.

EXHIBIT 9: The New “Consumer” China vs. the Old “Industrial” China

Then There is Politics, Which May Never be Normal

We would be remiss to ignore the effect a presidential election year can have on U.S. markets. Beyond the expected hyperbole of election news cycles, rarely before have we been treated to such raucous commentary by and about presidential candidates. Despite this increased noise, there are nuggets of information that may be helpful to investors. From betting websites to state polls and economic-based prediction models, early projections suggest a slightly higher likelihood of former Secretary of State Hillary Clinton winning the general election and Congress remaining divided. If these predictions play out, history would suggest this scenario would be supportive of the markets—not due to a fondness for Clinton, but because markets have an inherent preference for gridlock over complete control by either party (see Exhibit 10, following page.)
EXHIBIT 10: Gridlock is Good (According to Market History)

The markets perform worst when one party dominates politics


*“At least one strong” means that one party controlled 60% or more of the votes. “Weak majorities” means that both Congress/Senate were controlled by one party with under 60% of the votes. “White House with no control” means there was an aligned Congress/Senate with a president from the other party.

Normal, Neutral and Beyond

Markets, like LL Cool J’s “Return to Cali,” are disrupted by scratchy turbulence from time to time. But the steady backbeat of normalcy eventually calls them home, although the path may wander like a jazzy sax riff. We believe that markets and economies are now quite close to normal, and our investment strategy and portfolio positioning should reflect this perspective. It is also important to note that the resulting neutral risk recommendation does not mean avoiding risk. We continue to believe investors should be rewarded for taking risk, but recognize the trade-off will be more balanced on the whole. Finally, Exhibit 11 shows our long-term projected returns for a variety of asset classes. There is a relatively normal upward bias to return potential for more risky investments, with some more attractive than others. Extended market assets—a handful of choices not often considered core positions in most investors’ portfolios—seem to exhibit this advantage. So, perhaps not all is normal yet, providing some opportunity to the aware investor.

EXHIBIT 11: Projected 10-Year Asset Class Returns

Source: Glenmede

Note: Information based on sources we believe to be reliable, but Glenmede does not guarantee its completeness or accuracy. Future results cannot be guaranteed.
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