

April 12, 2013

"Inflation is a more fundamental danger than speculative investment. Some countries seem to be in the unusual situation where they are trying to create inflation. They will come to regret that."

-PAUL VOLCKER, FORMER FED CHAIRMAN, IN A RECENT INTERVIEW

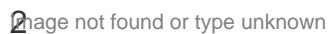
POINTS TO PONDER

1. One of last week's big news items was the stunning announcement that the Bank of Japan (BoJ) intends to double its monetary base. Yet even before this development, the BoJ's balance sheet was nearly 35% of Japan's GDP, rivaling the European Central Bank as the most bloated. By comparison, notwithstanding the Fed's \$1 trillion annual print rate, it is far behind its peers. (See Figure 1)

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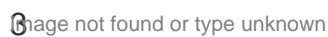
2. The other major news of late release was the disappointing US jobs number. Prior to that report, there was considerable enthusiasm over a slowly falling official unemployment rate. However, the percentage of the working age population that is employed is now lower than it was in June 2009, when the Great Recession was still raging. Had the labor participation rate remained constant last month, the actual unemployment rate would be 8.3%, not 7.7%, as 500,000 Americans gave up looking for jobs.

3. For those who have struggled to understand why the Fed's unparalleled liquidity blast has failed to revive the economy, the charts below tell the tale. (See Figure 2)

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4. Although the US economy remains lackluster, and may once again be losing what modest momentum it had as it moves into the second quarter, US automakers continue to be on a roll. For the first time in years, if not decades, the "Big Three" are picking up market share in the small car segment that tends to attract younger buyers. Detroit's slice of the small and midsize vehicle market is estimated to vault from 26% in 2009 to 33% next year.

5. After a spectacular profits implosion during the Great Recession, and an equally spectacular recovery since (despite an underachieving economy), S&P 500 earnings have flatlined over the last year. (See Figure 3)

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6. The 2015 scheduled completion of the Panama Canal expansion will allow very large vessels to pass through for the first time. As a result, it will only take specialized supertankers 18 days, versus 45 days now, to reach the Far East from the US Gulf Coast, further opening up Asian markets for US LNG and LPG (propane) exports.

7. Wall Street is projecting a 12% gain in 2013 for S&P 500 profits. While this is possible, given ongoing economic softness, plus drags like rising taxes and uncertainty over the looming Obamacare enactment, such an increase seems highly optimistic. To hit this 12% year-end target based on the sluggish first half for earnings, analysts are projecting an even less probable 26% explosion in fourth-quarter profits. Thus, the market's estimated P/E of 14 looks suspect.

8. Gold continues to struggle in an environment that should be very supportive, which raises legitimate concerns (including in the mind of this author). All is not bleak, though, based on the fact that speculators, who almost always get it wrong, are very bearish on bullion, as noted in the March 1st EVA. Conversely, large commercial institutions hold close to record bullish positions. In contrast to speculators, the "commercial" long-term track record has been exemplary. (See *Figure 4*)

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9. Thanks to a healthy economy—combined with sound fiscal, monetary, and tax policies—the fair value estimate of the Canadian dollar continues to rise, according to Toronto-based investment firm Gluskin Sheff. (See *Figure 5*)

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10. Mexico has recently announced it will allow foreign oil and gas companies to invest in its

long-underperforming energy sector. With the passing of thug-in-chief Hugo Chavez, Venezuela may eventually follow suit. Based on its dwindling production, despite repeated expropriations of foreign-owned oil resources, Venezuela certainly needs all the assistance it can get from multinational energy companies. (See *Figure 6*)

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11. It appears as if eurozone authorities have contained the Cyprus banking crisis—at least temporarily—but at a steep cost. Thanks to capital controls to prevent a mass exodus of Cypriot deposits, a euro in Cyprus is no longer equivalent to a euro in Germany. Thus, in a subtle yet significant way, the euro currency union is already fracturing.

12. Last summer's vow by European Central Bank boss Mario Draghi to do whatever it takes to save the euro has dramatically lowered borrowing costs for the Club Med governments. Perhaps more significant, though, is the harsh reality that the cost of capital for private borrowers continues to steadily rise, recently hitting all-time highs.

13. Nearly 60% of French GDP is related to government activities, and the public share of its economy has never contracted in the last 40 years. This means that France's small private sector bears the brunt of recessions, including the latest. Per the graph below, both its industrial production (black line) and business confidence (red line) are cratering. (See *Figure 7*)

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14. Although China's government finances are far healthier than those of most Western countries, and China it is sitting on \$3 trillion of foreign currency reserves, its total debt levels are soaring. As pointed out by the *Wall Street Journal*, the ratio of private credit to GDP has swollen by 50% to 180% of GDP. This is comparable to the debt ratios seen in the US and Japan prior to the bursting of our, and their, real estate bubbles.

15. Hong Kong-based GaveKal Research, which accurately anticipated China's recent economic reacceleration, is now concerned it may falter somewhat. GaveKal is observing manufacturing softness as well as concerns about undisciplined loan expansion by China's non-traditional financial entities (i.e., its "shadow banking system"). (See Figure 8)

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Fall forward, spring back. As regular EVA readers are aware, Seattle sports teams are one of my favorite piñatas. There is no question that part of the reason I pick on them so often is to excise some of the enormous frustration that has built up over the years from having my heart broken countless times.

Not far behind on my ridicule list, though, are the nattering nabobs of nothingness on CNBC. However, a huge exception to my Casino National Broadcasting Company disdain is a man who personifies class and reason in a world increasingly devoid of both, Art Cashin. Art is Director of Floor Operations on the NYSE for UBS and one of the most familiar faces on CNBC.

Last week, right after the shockingly weak employment numbers for March were released, Art was interviewed regarding his views on the economy and he said something I've heard from very few market experts. Essentially, he recapped the theory espoused by economic forecasting firm ECRI, often referred to in these pages, that the reason the US economy tends to look robust during the fourth quarter of the prior year moving into the first quarter of the new year relates to seasonal adjustments.

Art succinctly described the manner by which government statisticians compared the fourth quarters and first quarters of each of the last three years to the utter collapse in business activity at the end of 2008 and the start of 2009. This has created the illusion of an economy attaining "escape velocity" from the Great Recession at the beginning of the last three years. Yet, in each case, as we moved into the second and third quarters, the GDP numbers faded (much like one of our beloved local sports teams coming down the home stretch of pretty much any season).

Since this has been a recurring EVA theme, possibly to the irritation of some readers, my ears naturally perked up when I heard Art's comments. Interestingly, one of the few other individuals I have heard bring up this seasonal adjustment issue is none other than Ben Bernanke, who said he felt its influence was waning. However, the recent jobs report is evidence that would seem to validate Art's view rather than Ben's.

Perhaps more meaningful than just one jobs report, typically to be substantially revised, is a chart (on next page) located by Jeff Dicks, one of Evergreen's investment team members. As you can see, it clearly illustrates the pattern of early-year vitality, as reflected by a rising number of positive economic surprises (the green areas of the chart), followed by a pronounced drop-off. It also is obvious that once the economic data have rolled over in recent years, conditions have continued to deteriorate until the fourth quarter. And, as you will also notice, the same pattern is unfolding again this year. Because the stock market has roughly tracked this same cycle, it should be of more than academic interest to any EVA readers who also happen to be invested in stocks. (See *chart below*)

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But actually, it's what's happening outside the US that has us more on edge...

Going stag... Of all the leading financial newspapers I read, *Investor's Business Daily* is my least favorite as it lacks the deep bench of talented journalists that publications like the *Wall Street Journal* have on staff. However, I do diligently scan its "To the Point" section, right behind the front page, which is a nice summary of interesting happenings. Frankly, the April 2nd edition under "The Economy" caused me to almost spill my morning 1%, extra hot, one pump of sugar free vanilla, decaf, latte (hey, I'm from Seattle!)

Below are the lead-ins of *all* six of the sub-sections of that column:

- Indian factory orders weaken
- Turkey's economy expanded by 1.4% in Q4...slowing from Q3...and missing forecasts
- Russian manufacturing slows
- S. Korea exports remain weak
- Vehicles sales in Japan plunged
- Mexican factory growth softened for the third straight month

Realize, loyal reader, it wasn't long ago that the popular belief was that livelier foreign economies would offset the "new normal" US recovery. This was the term Pimco came up with several years ago to describe the deficient growth we were likely to see in the post-global financial crisis era. Pimco received a fair amount of criticism during those aforementioned first quarters of the last few years when it looked like the expansion was more normal than new. Yet, as time has gone by, its prediction has looked increasingly prescient. And obviously there was a bit of a flaw in the thesis that emerging markets could resist the drag from a deleveraging and crisis-prone developed world.

In fact, emerging country share prices are moving in a noticeably different direction from the seemingly unstoppable US stock market juggernaut. They are now down -6.7% YTD, continuing their habit of underperforming US shares over the last few years (in complete contradiction to what was a heavily consensus view back in 2010 that just the opposite would happen). Since these markets tend to be more leveraged to the global economy, this is another indication that the world may be closer to going "ex-growth" than is popularly believed.

Similarly, commodity prices are signaling that perhaps what happens in Europe won't stay in Europe. Of particular note is the stumbling behavior of copper, often known as the metal with a PhD in economics due to its historic tendency to discern economic trends well before the forecasting community does (which, admittedly, isn't saying much). Moreover, today's bloodbath across the precious and industrial metal complex indicates the risk of a planetary recession is indeed escalating. (*See chart below*)

Yet stocks, at least in the US, are manifestly unruffled by the spreading evidence of another

economic downturn. In fact, the prevailing attitude of "bad news is good news" perversely embraces weak data as it means it's unlikely the Fed will quit suckling this market anytime soon. Unless, that is, the Fed has miscalculated how much slack there is in the system.

As mentioned in the March 29th EVA, one of the biggest bond bulls on planet Earth, David Rosenberg, has experienced a change of heart. He has been issuing a steady stream of commentary that the risk of '70s-style stagflation is rising. David bases this on his analysis (and that of hedge fund legend Ray Dalio's firm) that there isn't as much excess capacity in either production facilities or employable people as the Fed believes.

Late last year, I ran a chart showing that capacity utilization was essentially back to where it peaked when the economy was firing on all of its debt-fueled cylinders in 2007. Now David is highlighting this as well and he concludes it is a function of the chronic under-investment in fixed assets (factories, infrastructure, technology, etc.) over the last decade.

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He's also made the valid point that since wages are turning up even with high unemployment, it must mean there really aren't as many employable workers as one would suspect--particularly with a jobless number that, adjusted for those who have dropped out of the workforce, is over 11%. The rapid rise in job openings combined with no real decline in the great mass of unemployed also indicates this may be true. (*See charts below*)

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Additionally, there are some signs that money velocity is accelerating, though my team and I believe it's premature to call a major turn in this crucial indicator. But if it does occur, and with growing odds that the Fed is leaving the monetary floodgates open too long, there could be a nasty surprise: inflation accelerating with the economy still growing below trend—in other words, that old 1970s show, stagflation. If so, the Fed may be forced to stop its magical money manufacturing machine sooner rather than later or let the inflation genie out of the bottle (trust me, this one won't look like Barbara Eden). And that would be bad news that is truly bad news.

Perhaps it's ironic that Margaret Thatcher, who along with Ronald Reagan and Paul Volcker, did so much to eradicate the toxic combination of low growth and high inflation, died this week. Well, at least Mr. Volcker is still around.

But even though he has attained the tender age of 85, Mr. Volcker would still get my vote to run the Fed again. Sadly, that's about as likely as the Seattle Mariners returning to the American League championship series while he's still on this side of the outfield grass.

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