

August 24, 2012

"We live in a technological golden age but in a monetary and fiscal dark age. While physicists discover the so-called God particle, governments print and borrow by the trillions. Science and technology may hurtle forward, but money and banking race backward."

-JAMES GRANT, AUTHOR OF GRANT'S INTEREST RATE OBSERVER.

POINTS TO PONDER


1. Despite lower tax rates over the last 30 plus years, the top 20% of Americans earn 51% of all income and pay 68% of aggregate income taxes. In 1979, the top 20% generated 45% of total earnings and paid 55% of aggregate taxes. Middle-income taxpayers, conversely, paid 13.6% of the tax burden in 1979; in 2009, this amount was 9.4%. (See Figure 1)

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2. Tax rates on the wealthiest taxpayers fell sharply during the Bush administration (though not overall tax liability). However, many, especially on the left, might be surprised that they declined even more steeply during the Clinton years.

3. The fact that roughly half of all Americans are not paying income tax has received a fair amount of attention lately. While there is no doubt the US tax base needs to be broadened given the current social demands on the federal government's shoulders, in 1940 just 3% of Americans paid any income tax.

4. As feeble as America's recovery from the Great Recession has been, the US economy has fared far better than most of Europe's economies, with Germany being a pronounced exception. (See Figure 2)

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5. Financial markets have recently been caught up in a mild flurry of optimism about the global growth outlook. Yet two of the most economically sensitive raw materials—iron ore and coking coal (key ingredients in steel production)—are down 17% and 22% in price since mid-June and mid-July, respectively.

6. Another sobering economic marker is that US non-farm payroll growth has fallen below 1.4% year-over-year. This has occurred nine times since the early 1950s, and in each instance a recession has ensued. It is possible, though, that the limp job growth during this recovery is making this indicator look worse than it truly is. (See Figure 3)

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7. An increasing amount of attention is being focused on the lackluster returns collectively produced by hedge funds, despite the stellar records boasted by a select few. Past performance results for these alternative investment vehicles would be even less impressive if closed funds, which tend to have the worst track records, were included. (See Figure 4)

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8. In another take on the mediocre-at-best aggregate performance of hedge funds, the

Bloomberg hedge fund index, tracking 2,697 funds, fell 2.2% annually for the five years ended June 30, 2012. Meanwhile, the Vanguard Balanced Index Fund (roughly 60% stocks and 40% bonds) returned 3.5% per annum. The same Vanguard fund has also beaten the HFRX Global Hedge Fund Index (which has a longer record) every year since 2003.

9. One probable reason for the summer rally in US stocks is that nearly 70% of S&P 500 companies are exceeding estimates. However, analysts had previously reduced projections, lowering the bar and rendering the "beats" less impressive. Additionally, twice as many big firms are reducing forward guidance than are raising their outlooks.

10. Large cap growth stocks, heavily weighted toward tech issues, have been out-legging the overall market for the last five years. This is despite the fact that tech valuations have consistently become more attractive versus the S&P 500. (See *Figure 5*)

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11. Although there has been considerable encouraging news about housing this year, deadheads lurk just below the surface. One of the most treacherous is home equity debt. Because borrowers only need to pay interest in the early years, such credit lines are initially affordable, especially with the collapse in rates. But 60% of all home equity loans require payment of both interest and principal between 2014 and 2017.

12. A few years back there was widespread teeth gnashing (though not in EVAs) about "imported inflation." The theory was that the combination of spiking commodity prices and rising wages in developing countries, especially China, would elevate the US CPI. Lately, import prices have actually been declining.

13. The US shale gas boom is one of the most remarkable developments in the history of the energy industry. Yet, many other countries actually possess potential "unconventional" reserves that dwarf our own, China being a notable example. However, China lacks both America's abundant water resources (key for this type of production) and our extensive infrastructures of pipelines, storage terminals, and processing plants. (See *Figure 6*)

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14. Many China watchers are fretting about the flatlining of electricity production in that nation. It is widely believed this is a better measure of economic growth than notoriously erroneous official GDP reports. However, it's possible that the accelerating shift toward a more service-based economy is distorting this indicator as heavy industry consumes 60% of electricity but amounts to just 20% of GDP.

15. The math and science skills of American students are continually—and unflatteringly—compared to those of students from Asian countries. However, despite dramatic improvements over the last 30 years, roughly 75% of China's workforce has less than a high school education. (See *Figure 7*)

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Reflections from "Smoke" Valley. Thanks to some heroic efforts by Team Evergreen, your primary EVA scribe has been able to unplug from a few of his normal responsibilities this summer. This has allowed my wife and I to escape for a few weeks to what is normally pristine Sun Valley. As bad luck would have it, this month has brought some of the worst wildfires locals have ever seen. The smoke has been so intense that most of the time it's been like being in LA during a record-breaking smog alert.

Nonetheless, it's been a much needed regeneration time. It has also allowed me to do some reading beyond what I normally have time for (I'm also trying to improve my "quant" or math skills which are, to put it charitably, a bit rusty). One of the books that I've read during my semi-break is *Tax Reform: Why We Need It and What It Will Take* by Bruce Bartlett. As many of you are aware, this is a topic near and dear to my heart. Moreover, with Paul Ryan now tapped as the GOP vice presidential candidate, this is likely to be a subject of intense focus as we move toward November.

One of the few points that politicians on both sides of the aisle agree upon is that our current Tax Code is a pretzel palace of complexity and inefficiency. One of the many fascinating factoids in this book, underscoring just how inept our present tax structure has become, is that in 1990 the gap between adjusted gross income and the related tax due was about 10.3%, or \$400 billion. By 2005, this "leakage" had widened to 14.8%, or \$1.3 trillion. It's likely this has worsened even further since then as tough economic times tend to worsen tax compliance.

The Tax Code has become increasingly unfair to those on both ends of the economic scale. For example, due to the phase-out of the earned income credit (EIC), low-income families can wind up in the 31% marginal tax bracket. Conversely, in addition to the fact that roughly half of Americans pay no income tax, 23% are also refunded, via credits, all of their payroll taxes.

Although Mr. Bartlett participated in a number of the sweeping GOP tax reforms and cuts of the last quarter century, including Reagan's largely successful 1986 package, he is no right-wing shill. In fact, he is highly critical of the Republican mantra of tax cuts as a perpetual panacea. He notes that both conservative and liberal economists agree that tax reductions only recoup about 1/3 of the revenue loss through faster growth. This obviously flies in the face of traditional supply-side/Laffer curve economic theory.

For me, the key takeaway from Mr. Bartlett's book is that eventually the US will need to implement a value-added tax (VAT). He notes that we are the only developed country that is VAT-free. In reality, one of the prime factors in Canada's extraordinary fiscal turnaround since the mid-1990s was an expanded and rationalized VAT (called a GST up north).

It goes without saying that slapping a VAT on the US economy without lowering personal and corporate tax rates would be economically devastating. However, combining a VAT with a much simpler income tax structure—such as three brackets of 8%, 15%, and 23% with virtually no deductions—would likely be a key step toward getting us back on the flight path to faster growth and restored fiscal health. Of course, numerous other changes need to occur as well, like restraining runaway entitlement expenditures.

There is no shortage of reasonable plans, whether it's Bowles Simpson, the Ryan road map, "Brockonomics" (profiled in the August 3rd and August 10th EVAs), or Bruce Bartlett's tax reform recommendations. But there is a shocking deficiency of political courage. So let's break out the rosary beads and do some serious praying that rationality and leadership will soon triumph over attack ads and political posturing. If not, the stock market's recent gravity-defying tricks will end most disastrously.

Speaking of the stock market...

PS: Mind the P/S, not the P/E, ratio. A frequent source quoted in these pages is money manager and market strategist extraordinaire John Hussman. Despite the superlatives I've just lavished on him, anyone checking out the recent performance of his flagship Hussman Strategic Growth Fund would question whether it qualifies as even ordinary.

However, his long-term track record is superb. Additionally, having followed his results for years, I've noticed that the times his numbers have looked the worst—typically, when the market is late in an uptrend—is about when he's ready to be proven very right. Which leads me to a paragraph from one of his *Weekly Market Comments* that struck me as particularly timely...

In his July 30th issue John wrote: "So what do I worry about? I worry that investors forget how devastating a deep investment loss can be on a portfolio. I worry that the constant hope for central bank action has given investors a false sense of security that recessions and deep market downturns can be made obsolete. I worry that the depth of the recessions and downturns—when they occur—will be much deeper precisely because of the speculation, moral hazard, and misallocation of resources that monetary authorities have encouraged. I worry that both a global recession and severe market downturn are closer at hand than investors assume, partly despite, and partly because, they have so fully embraced the illusory salvation of monetary intervention."

Clearly, John has more than a handful of profound concerns and, in my opinion, he's not being a Nervous Nellie. Stock markets in both the US and Europe have rebounded admirably from their early summer weakness, surprising the Evergreen investment team and yours truly. (European share prices have risen for 11 straight weeks!) Some of the bounce has been driven by thin strands of better economic data. However, the main catalyst appears to be related to blind faith that central banking money printing and debt buying of increasingly busted governments will save the day.

Among market bulls who are less smitten with the over-reliance on central bank profligacy, this recent rally's rallying cry is that stocks are cheap based on P/E ratios in the low- to mid-teens. Yet, as I've frequently pointed out, and John mentions almost every week, earnings are inflated by profit margins that are at record levels. In another recent commentary, John also ran a statistic that jumped out at me: On a price-to-sales basis, the stock market is higher than it has been at any time other than during the giddiest days of the tech bubble.

Because revenues are much less prone to distortion than earnings, as they are not impacted by fluctuating profit margins, the price-to-sales ratio is one of Evergreen's favorite valuation metrics. While even most market pros focus on P/E ratios, it's our belief (and John's) that such a simplistic measure is dangerous at this advanced stage of the economic cycle. With the price-to-sales ratio extremely elevated, a wise investor's defensive instincts should be as well—particularly when our own Fed is so blatantly trying to encourage throwing caution to the wind. For those who blithely ignore the ample warning signs, a lot of net worth might end up literally gone with the wind.

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