

April 13, 2012

*"Risk is most dangerous when it is least apparent and least dangerous when it is most apparent."*

-FINANCIAL NEWSLETTER WRITER EXTRAORDINAIRE, JAMES GRANT

## POINTS TO PONDER

1. Many pundits believe stocks are on the cusp of a new bull market. However, the liftoff point for the last two times when stock prices roughly doubled (2003 and 2009) coincided with high cash levels relative to overall market value. Looking at the low level of money funds today versus total market capitalization, it's hard to envision that type of extreme appreciation.

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2. Recent weakness in the US Treasury bond market, caused by perceptions of rising inflation and strong economic growth, triggered a sharp run-up in yields and a related break in prices. Consequently, the net speculative short position on the 10-year Treasury surged to its highest level since last May, just prior to a powerful rally. Coincidentally (or not), since the latest leap in bearish sentiment, Treasuries have rebounded smartly.

3. Notwithstanding a smattering of heartening news on US housing, the new-home market remains exceptionally weak. A prime reason for this is that the average new home is 30% more expensive than its pre-owned equivalent, twice the historical spread.

4. Last week's US jobs report disappointed those who were assuming an accelerating economy. The mixed nature of that release is consistent with the contrasting signals coming from the generally more timely Household survey, indicating robust employment trends, and other much less encouraging reports. For example, a recent Gallup poll of 30,000 US households actually revealed a surge in job losses.

5. One of the less alarming explanations for chronically swollen unemployment numbers this deep into a recovery is that aging baby boomers are voluntarily leaving the work force. Given the shaky status of the average boomer's finances, however, a large number of them may soon be changing their minds.

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6. House Budget Committee Chairman Paul Ryan's recently unveiled long-term budget reform plan has drawn withering criticism from both extremes of the political spectrum, likely indicating its intrinsic soundness. Encouragingly, another credible plan was produced by Republican Representative Steven LaTourette and Democratic Representative Jim Cooper, drawing the support of the bipartisan chairmen of the Bowles-Simpson commission.

7. Could it be that America's smallest state is its biggest hope? Rhode Island Governor Gina Romando, a Democrat, has revived a state that was on track to fiscal ruin, spending one-third of all tax revenues on public employee pensions. Gov. Romando has extended retirement ages and reduced generous cost-of-living adjustments. The state has also enacted Medicaid reforms, causing related spending to come in \$1.1 billion under budget.

8. There is mounting anxiety that the \$1.6 trillion the Fed has manufactured over the last three years will trigger an inflation contagion. However, with almost all of the excess liquidity still stuck as excess reserves in the banking system, such fears are likely still premature.

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9. When oil broke above \$100 for the first time four years ago, US auto sales crashed along with the economy. Today, however, triple-digit prices appear to be spurring Americans to replace their cars, now at an antiquated average age of 10 years, with newer, more fuel efficient models.

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10. The key Brent crude contract, which drives prices at US gas stations, continues to trade around \$125. Beyond softening demand due to the European recession, slowing Chinese growth, and contracting total miles driven in the US, actions by Saudi Arabia should push prices lower. Its oil minister, Ali Naimi, has pledged to ramp up output asserting that his country has ample additional production capacity and that its storage is 100% full.

11. Investors who were bullish on emerging markets prior to the global financial crisis believed that those countries would experience faster economic growth. While this turned out to be true, their stock markets have not kept pace, actually trailing the US since the end of 2007. This validates a London School of Economics study indicating that there is minimal correlation between rapid GDP increases and stock outperformance.

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12. There is little doubt the world is in the grips of a deleveraging cycle unseen since the 1930s. Yet, all the progress has occurred in the private sector (with the US making the most dramatic improvement) where \$1.5 trillion of debt has been eliminated since 2008. On the other hand, governments in the 10 largest economies have actually increased their leverage by \$7.8 trillion.

13. While market jitters have recently focused on Spain, Italy remains very vulnerable as well. Essential labor reforms have been seriously diluted while Italian banks remain overloaded with their government's bonds. Italy's sovereign debt is now 120% of GDP, typically the threshold where the IMF has intervened to force radical restructuring. Reflecting its fragility and new European tremors, Italian stocks fell 5% on Tuesday.

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14. In addition to Byzantine labor laws and towering government debt, Italy also has seen zero economic growth for more than 10 years. On the plus side, however, it remains a very wealthy country with a net worth per household approaching \$500,000. Moreover, as of 2010, Italy's overall liabilities, including those of its government, were just 9% of gross assets.

15. Although China's industrial machine remains heavily reliant on coal, its demand for natural gas is increasing dramatically, causing gas imports to also soar. This may be a factor behind

Alaska's decision, along with leading energy companies, to build a natural gas pipeline that will run from the North Slope down to a liquefaction facility on the state's southern coast, from which LNG can be exported to Asia.

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**A true turn or a head-fake?** Pretty much non-stop since Thanksgiving, global stocks, and other higher risk asset classes, have been on a tear. Then, suddenly, a week ago, the streak came to a screeching halt. The main culprit seemed to be last Friday's US jobs numbers, but the fact of the matter is that few data points are as volatile, and as subject to revision, as the US unemployment report.

Moreover, after a powerful rally on Thursday and a partial giveback on Friday, the S&P 500 is down a mere 3%, not even qualifying as a mild correction. Therefore, concluding that we are definitively moving into another one of the violent "risk-off" episodes that have characterized the last few years is a tad hasty. However, as noted in last week's EVA, it is a topic worth considering.

It is interesting to me, if not somewhat humorous, how quickly the phrase "double dip" resurfaces in the financial media when there is some less than scintillating economic news. At this point, it's merely a trickle but the fact that it's popping up at all when just a couple of weeks ago the constant chatter was about the virility of the US economy is indicative of the present fickleness of confidence.

It has been Evergreen's continuing view that our economy is mending, but at a subdued clip reflective of a post-credit bubble environment. When the investment community at large, due to a run of positive news, becomes overly ebullient we believe it's time to raise some cash. When there is a disappointing string of releases and prices sell off, which they tend to do much more quickly than they rise, it's likely time to be on the buy side.

This has also been our stance regarding Europe, as mentioned in prior EVAs. During those tranquil interludes when the markets actually believe the soothing sayings emanating from the lips of disingenuous Eurocrats, it's best to be a seller. Then, once the latest commitments to labor and/or budget reforms begin to flag, causing another market seizure, the buying window re-opens. When it comes to Europe, the most alarming recent developments are the backing off by Italy's new "technocratic" (hey, it's better than bureaucratic) government on labor law rationalization and the spike in Spanish bond yields. Regarding the former, labor unions are once again flexing their economically paralyzing muscles; thus, the realization is sinking in that

the honeymoon is over for the new Italian Prime Minister, Mario Monti. Sadly, it lasted about as long as Kim Kardashian's snippet of marital bliss. In Spain, bond yields are back up knocking on the door of 6%, far above their 4.8% trough seen when denial was all the rage a couple of months ago.

For those who are wondering if this is dip to buy, I'd offer a few observations. First, the fact that the backdrop seems to be deteriorating as we move into the oft-dangerous spring and summer months does argue for some restraint. Second, with US stocks looking fully valued, adjusting for record high profit margins that appear to be eroding, it's hard to say shares are pricing in much in the way of disappointment. Third, bonds don't look especially appealing either other than those with special defensive characteristics.

Therefore, having a fair amount of cash in reserve to capitalize on deeper declines seems appropriate. Based on the history of the last few years, however, investors should be poised to move quickly when fear strikes back.

*David\_Hay\_Signature*

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