

February 24, 2012

"This is about as serious and difficult an environment as I have experienced in my career...At times like this, it is more important to survive than to get rich."

-BILLIONAIRE INVESTOR GEORGE SOROS.

"I have never been as scared as I am now."

-DONALD TSANG, CHIEF EXECUTIVE OFFICER OF HONG KONG.

POINTS TO PONDER

Wasting away in Volatilityville... The world we live in today is a very strange one. You don't have to be the reincarnation of Milton Friedman to realize we are facing the most severe set of economic challenges since the 1930s. Yet, when the stock market is rising, all of those sobering considerations melt away. In sports, they say winning is a great deodorant and, when it comes to the financial markets, rising prices are an incredibly effective amnesiac.

Last year was a classic case in point. There were clearly a series of serious problems that were getting worse, not better. Yet, during the first few months of 2011 these seemed to escape the notice of all but a few cantankerous types, including your humble (especially when it comes to my golf game) EVA writer.

By the time last fall rolled around, it was a much different story. Recession forecasts for the US and Europe were ubiquitous, including from the prestigious Economic Cycle Research Institute (ECRI) which had accurately, unlike almost all other experts, called the prior three downturns. Most international stock markets had plunged 30% or more and the US market fell perilously close to the 20% decline level that demarcates an official bear market. There were legitimate concerns about a Lehman-type financial collapse in Europe with its entire banking system looking like, as John Mauldin is given to say, a bug in search of a windshield.

The worst possible course of action last year was to become increasingly exposed to stocks during the feel-good early months and then to bail out in the frightening second half. Unfortunately, based on the fact that funds flowed into stocks in the first half of 2011 and then came roaring out during the worst of the sell-off, that's apparently what a large number of investors did. (2010 also saw a remarkably similar pattern, with the timing just a bit different.)

While no two (or three) years are alike, 2012 could plausibly be somewhat similar. In 2010, the Fed "bulled" the market with its infamous QE2. Late last year, its European counterpart, the ECB, executed a more subtle version of "quantitative easing" which played a leading role in the recent rally. But have you noticed over the last few years, since the global financial crisis first went nuclear, that we've had a series of these rallies whenever the printing presses are unleashed? And have you also observed that, like a cocaine high, they don't last? In fact, the global financial system seems to be developing a resistance to the latest fix with reactions becoming progressively less euphoric.

Evergreen's overarching view is that stocks are a tale of two investor classes. On the one hand, you have the typical affluent individual who doesn't trust the market, the economy, or our political leaders (imagine that!). Then you have those that flip stocks in nanoseconds—all the pesky high-frequency traders, hedge funds, ETF re-balancers, and other hyperactive types causing most of the market's greatly increased volatility.

The former, due to their understandable concerns, have been persistent sellers of stocks for years and are holding vast sums of cash. The latter don't concern themselves with long-term "macro" issues. They just want to be in stocks when they are rising and out when they are falling.

That sounds good in theory. Why shouldn't "normal" investors play the same game?

...looking for my lost decade of return Another pattern that has evolved over the post-plunge years is that when the economy and the market look the healthiest, it's been time to sell—and vice versa. In both 2010 and 2011, it appeared as though the US economy was poised to have its typical post-recession growth spurt. Yet, in both instances, instead of spurting we got sputtering. This tendency is also evident in the all-important realm of unemployment, as you can see in the following chart.

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Once again, the jobs picture is looking brighter early on and this has been one of the positive forces propelling stocks higher. Yet, what is being overlooked is a very warm winter, at least up until recently, throwing off the usual seasonal adjustments. Additionally, as noted in prior EVAs, there is continuing erosion in the labor participation rate. This results in an unemployment rate appearing better than it truly is because it is computed by comparing the number of unemployed to the overall level of the workforce.

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As mentioned above, the stock market has had a tendency, in both 2010 and 2011, to rally early on before succumbing to the weaker economic data, and other concerns, during the summer months. Then, just when it looked like a replay of 2008's meltdown was in the offing, the market has roared to the upside, wrong footing all but the nimblest of traders.

This behavior has also bamboozled those who use technical analysis to discern the market's future moves. Even the venerable 200-day and 50-day moving average indicators appear to have gotten it wrong last year when they flashed clear bear market warnings (as did our Right Cycle Alternative signals).

The fact that the 50-day moving average is breaking above the 200-day, the so-called "golden cross," is receiving a fair amount of press right now. But no one I've read is bringing up the point that its downside break last year—the colorfully named "death cross"—was very much a false signal, at least so far. Over the last 80 years, the behavior of the 200-day and 50-day moving averages has given advance notice of the start of almost every bear market and the birth of nearly all bulls. It has also worked extremely well since the tech bubble popped back in 2000. If this reliable technical indicator is getting whipsawed, you know we are in a very tricky environment.

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It's interesting that the powerful outflows from stock-oriented mutual funds, which hit a crescendo during last year's plunge, are now moving back into positive territory. Thus, retail investors are once more running the risk of being victims of the turn-on-a-dime trading community.

Frankly, in a secular (aka long-term) bull market, real investors don't have to worry about whether stocks might be a bit topky and due for a shakeout. But in a secular bear market, it is essential. Buy-and-hold investors have nothing to show for their patience over the last 12 years. However, those who have moved counter to the trend and raised cash during periods of optimism, then bought during the plunges, have been able to create at least some positive return out of stocks. (They've done even better if they've used a contrarian approach to overweighting the unpopular market sectors and vice versa).

Therefore, it's my belief that one of the most important ways to make money again this year is not to get sucked in by the illusion of an upside breakout. Those high-frequency traders will be selling right around the time the general belief is that the Dow is headed to 20,000 (or at least 15,000 as Barron's recently proclaimed on its cover).

But that's more about not losing money—actually a pretty important tactic in an accident-prone investment world. Now let's talk about how to actually make money this year.

Be selective, be very selective. To answer that question, one that is paramount in most investors' minds, I think it's important to realize we're still in the clutches of a post-bubble deleveraging world. You might be sick of hearing it, but that doesn't make it less valid or critical. One consequence of this is that central banks like the Fed have created staggering sums of money and they continue to do so. They are also intent on keeping interest rates very low.

Grasping those key concepts helps answer the how-do-I-make-money question. One

consequence is that there is almost certain to be a strong bid under the price of gold (and China's central bank just announced it is adding to its bullion holdings). Yet with gold already at \$1700, it might be hard to make appreciable gains on it this year. Gold mining stocks, however, had a tough 2011 and the leading players are now priced around 10 times earnings. They can remain extremely profitable if gold hovers in the \$1400 to \$1800 range and even generate decent earnings should gold fall as much as 30% (unlikely, in my opinion, as long as the printing presses are working overtime).

Although there is a movement among the top miners to link their dividends to the gold price, it's unlikely you'll ever be able to support your lifestyle on what they pay out. Thus, for those who need income to live on, you've got to be creative or hire a manager with expertise in managing for yield. (I wonder who that could be?)

The interest rate collapse Mr. Bernanke and his cronies have engineered is making this about as easy as staying awake during the Oscars. Aggravating this situation is the aforementioned market frothiness that has pushed up the prices of our long-favored master limited partnerships as well as high-dividend stocks. You can still get decent yields with these but you are definitely at risk of seeing your capital erode during the next "risk off" phase, which could happen at any time.

Consequently, one of the few areas where 6% to 7% yields can still be generated with limited risk is what I have called high-grade high-yield or, as some might more paradoxically characterize it, good junk. This has been a consistent EVA recommendation for the last couple of years and it has performed admirably. BB-rated corporate bonds even held up well during last summer's convulsions.

Over the past few years, we have also consistently placed blue chip growth companies, such as Apple, in our favored category. The good news is that these have outperformed the overall market over the last five years and they beat almost all global stock sectors in 2011. They've also rallied nicely this year and therein lies the problem—they are no longer slam dunks. That's not to say they can't generate decent multi-year returns, exceeding the overall market. My team and I still believe that to be the case. But they won't be immune to another one of the market's sudden and vicious reality checks.

Conversely (or, perhaps, inversely), the advent of inverse ETFs has given investors the ability to make money when valuations are stretched and sentiment is too upbeat. Such vehicles allow investors to hedge their downside due to the fact that they rise when the market is falling. While these certainly have their drawbacks, they are one of our preferred paths to make money in what is likely to be another volatile and vexing year for the financial markets. Typically, those areas that have had the steepest ascent in recent years fall the hardest when the forces of gravity reassert themselves (real estate investment trusts continue to get my vote as most vulnerable).

Now, let's close this EVA with a wrap-up on why making a decent return this year requires some self-discipline--and listening to the right people.

Being fearful when others are greedy.....A wise man once said "patience is a position." That's been very true over the last few years and it is likely to be true in 2012. There is a big boom and a romping new bull market in our future, but I believe it will need to come off a lower level, most likely in the 900 to 1100 range on the S&P 500.

It's also probable that the major turn won't happen until we have a plan to resolve our twin terrors of dysfunctional fiscal and monetary policies in this country. Rising stock prices can make those fade into the background temporarily, but they aren't going away until they are rationally addressed. There will be a price to pay for multi-trillion dollar deficits and money fabrication. We are likely to experience at least part of the payback this year.

As far as Europe goes, the big news this week was the latest Greek bailout. Having read numerous articles on this, I'm convinced of a couple of things: It is unlikely to be the silver bullet for which the markets have been hoping and this time credit default swaps (CDSs) are going to be triggered, an event European policymakers have been desperately seeking to avoid. (The best sound bite on this came from the CEO of Germany's Commerzbank who said, referring to the allegedly "voluntary" nature of the massive losses taken by private investors: "It was as voluntary as a confession during the Spanish Inquisition.")

Triggering CDSs might not be cataclysmic when it comes to Greece, but there remains a danger that should Portugal, or God forbid, Spain or Italy, go down a similar path we could see a European replay of the AIG debacle (with some major financial institutions going down because of their exposure).

But, unquestionably, Europe is making halting progress as it is implementing some of the solutions we have long thought were inevitable, including debt write-downs, following in the Fed's money-printing footsteps, and recapitalizing its banks. Yet it's imperative to realize how far Europe has to go and how many things can still go sideways.

The problem for investors is that when markets are assuming the best, the potential for severe downward reactions is considerable. This is why my team and I are maintaining hedges for our clients even though they are losing money right now and holding back our performance somewhat. It's also why we have more cash on hand than usual.

Yes, I realize right now there is a steady stream of excited chatter on CNBC. But at times like this, I believe it's important to hear what the wiser folks are saying, such as those quoted at the beginning of this EVA.

In a similar vein, Prof. Kenneth Rogoff, one of the world's foremost experts on post-bubble economics and the co-author of the celebrated book,

This Time is Different, made the following comments this week in referring to Europe's most recent grand plan: "I don't want to be a Cassandra, but the idea that it's over is an illusion. I am amazed by the short-term psychology of the market. I don't think we're anywhere near the endgame."

Let's see—should you believe Jim Cramer or Ken Rogoff? My two cents, if you want to earn that two percent, is that it makes much more sense to listen to the man who realizes this time really is different.

David_Hay_Signature

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