

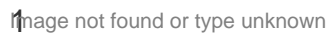
January 18, 2013

"Anyone who isn't confused really doesn't understand the situation."

-EDWARD R. MURROW, JOURNALIST

POINTS TO PONDER

1. Until recently, it appeared as though the very sub-par expansion in the wake of the Great Recession was coming to an inglorious end. Over the last couple of months, however, industrial production and employment have both rebounded sharply. Continuing the trend of conflicting and confusing data, this revival is at odds with what looks to be a weak official fourth quarter GDP release. (See Figure 1)

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2. Financial stocks have been on a tear of late amid expectations that they are a prime beneficiary of the Fed's seemingly limitless liquidity creation. Thus, it seems strange—in the face of such euphoria—that Amex would announce the termination of 8.5% of its workforce. It does appear that most of the cuts will fall upon its travel division.

3. Some observers have been waxing euphoric over the spike in disposable personal income (DPI) at the end of last year. The odds are high, however, that most of this improvement was due to the acceleration of income to avoid the arrival of the highest marginal tax rates in 27 years. A little known feature of the new tax structure is the Pease Amendment, phasing out itemized deductions for higher earners and effectively creating a top marginal tax rate of 46.3%.

4. According to House Speaker John Boehner, the president repeatedly told him during the "fiscal cliff" negotiations that the US doesn't have a spending problem. However, even a cursory review of the facts indicates otherwise. (See Figure 2)

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5. The boom in US natural gas output has led to cheap prices that have, in turn, caused American utilities to retire 8% of their coal-based facilities, replacing those with mostly gas-fired generation. Despite this trend, pollutant-rich coal remains the fastest growing fuel on the planet. In 2011, its usage increased seven-fold versus wind and solar, and even three times faster than natural gas.

6. The combination of a mending economy and significant tax increases has enabled the beleaguered state of California to project a balanced budget over the next four years. It remains to be seen what will happen should its punitive tax structure accelerate the flight of its dwindling number of high earners. The next recession will also pose a huge challenge to state revenues, which will now be even more strongly tied to the business cycle. (See Figure 3)

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7. Americans have an intrinsic faith that by investing more in education the natural result is higher test scores. Yet, since 1970, US spending on education has tripled in real terms with no discernible improvement in aptitude levels.

8. The Boston Consulting Group projects that the Fed will own 60% of all outstanding US

Treasury debt by the end of 2015 if it maintains its current rate of accumulation. On a positive note, it estimates the present value of the Fed's "seignorage" (the profits earned from creating zero cost base money like currency and reserves) at \$1.8 trillion.

9. Vividly illustrating how much more responsible Canadian monetary policies have been than the Fed's, the latter's balance sheet is now 40 times greater than the Bank of Canada's. The normal ratio has been 12 to 1. The ratio of currency in circulation in Canada versus the US tells much the same story. (See *Figure 4*)

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10. Sentiment has improved immensely toward Europe since last summer, leading to growing perceptions that the Continent has resolved its most vexing problems. However, according to JP Morgan Asset Management, wages need to decline, or productivity needs to improve (or a combination thereof), by 30% in France and Spain to restore competitive equilibrium with Germany.

11. Despite the deepest recession since WWII, fewer than 30 companies in 10,000 (i.e., below 0.3%) have failed in Greece, Spain, and Italy. As noted by the Financial Times, this is one of the unintended and negative consequences of the European Central Bank's policies. The ultra-easy monetary environment being fostered by the ECB is sustaining so-called "zombie" companies—those barely able to service their debts and unable to invest for the future.

12. Revealing how difficult it is for a central bank to resist the global movement toward massive liquidity creation, the once staid Swiss central bank has become one of the most aggressive money manufacturers. The Swiss National Bank has now bought assets equivalent to Switzerland's entire GDP, all with synthetic funds. Even the binge-printing US Fed has limited its asset accumulation (thus far) to 20% of America's economy. (See *Figure 5*)

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13. The *Financial Times* ran an article on January 6th warning of the risks of a triple-dip UK recession. A few days before, it had even more alarmingly raised the specter of a downturn in Singapore's typically dynamic economy. These reports stand in stark contrast to an increasingly pervasive belief that global growth is improving.

14. China is attempting to help its private companies to better compete with its bloated and corrupt state-owned enterprises (SOEs). While it is making progress in this regard, with private firms now producing two-thirds of GDP, the reality is that the non-government-sponsored portion of the economy only receives one-third of overall bank loans.

15. With its labor costs rapidly escalating, China is aggressively moving to install industrial robots. As indicated by the chart below, it has a very long way to go. (See *Figure 6*)

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That old echo feeling. When you write a newsletter, there's always a risk of sounding like you've got all, or at least a majority of, the answers to the most vexing questions about the economy and the financial markets. As many EVA readers know, I just scored myself last week on my forecasts for 2012 and, while the results were decent, it was an exercise in humility. This was particularly true for my call that the US stock market would fall last year, which it most certainly and fortuitously, didn't.

As veteran EVA readers are aware, last year was the first time I've called for a down market since the beginning of 2008, which means it's been a long while since I've been off the mark on stocks. In fact, I predicted up years in 2006 and 2007,* which is how they turned out. Then I

anticipated a down year in 2008 and, boy, was it ever. Then I stuck my neck out like Marie Antoinette on a market rally in 2009, causing many readers at the time to think I truly had lost my head. In reality, it turned out to be one of the best market years ever.

In both 2010 and 2011, I called for stocks to rise and the market cooperated. So, last year was my first truly bad forecast on the direction of share prices (though I didn't always get the magnitude right in prior years). Thus, I had to smile when one of our young team members informed me that some financial consultants, at a firm to remain anonymous, are viewing me as a perma-bear.

If anyone doubts my willingness to say "buy" when almost everyone else is screaming "sell," I'd suggest going to our website where we have our EVAs all the way back to 2005 archived. The repeated message in late 2008 and early 2009 was that it was the buying opportunity of several lifetimes, particularly with investment-grade corporate bonds, preferred stocks, master limited partnerships (MLPs), and even junk bonds. I also felt that you could make a lot of money in the stock market by simply throwing a dart—if you had the courage to throw it. Not many did, unfortunately.

On the other hand, there were some very bright people who, like us, accurately called the housing bubble, the recession, and the bear market prior to the meltdown. Most of them, however, overstayed their bearish positions. They never said enough, was enough, as they kept calling for ever lower prices, even when the market was down nearly 60%.

Consequently, I think it's fair to say I'm far from a perma-bear. However, it has recently occurred to me that pretty much the same cohort of pundits who were warning about the precarious nature of the financial markets in 2007 are once again stridently sounding the alarm bells. And, essentially the same bunch of experts who were telling us six years ago to ignore the "worry warts" are trumpeting that message just as loudly today. This includes almost every strategist at the big Wall Street firms, who almost to a man (and woman) completely missed the 2008 cataclysm.

Jeremy Grantham was one of the few former bears who actually made the shift over to the bullish side during the bleakest days of the global financial crisis. In fact, I vividly remember the title of the letter he wrote in early 2009 when the market seemed to have no bottom: *Reinvesting While Terrified*. It was a great and perfectly apt description of what a smart investor needed to do during those truly terrifying times.

The reason I'm bringing this up is that today's conditions are increasingly reminding me of what the landscape was like back in 2007. Markets were frothy, spreads between government bonds and riskier debt were very tight, debt creation had been frantic for several years, profit margins were at an all-time high, and countless institutions were borrowing heavily in the short-term debt markets to invest in longer term securities (aka the carry trade, as discussed in last week's EVA—[click here to read](#)).

Of course there are numerous differences, particularly that retail investors have been pulling money out of the US stock market for years. Additionally, the explosion in debt creation is happening at the government level rather than in real estate lending. And, pursuant to my opening comment, I will admit that I am more befuddled than I can ever remember by the starkly divergent economic data I am seeing. Nevertheless, there are enough similarities with 2007 to make me uncomfortable.

One of those echoes is how much better the riskiest parts of the bond markets did last year—and, in fact, how spectacularly they have performed since early 2009. (See chart to the right.) As was the case in 2007, junk bonds have gone from hated to adored in four short years. When all the world seems to want to be in junk debt, and the issuers can once again put out stuff that allows interest to be paid in more debt, and lending covenants become as skimpy as the bikinis at Cannes, then you know the clock is nearing midnight. (It's perhaps noteworthy that Jeremy Grantham is once more very much in a bunker state of mind.)

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Maybe it really is as easy as the planet's central banks are making it look right now. Maybe the Fed just needs to whip up three, or four, or five trillion dollars out of its magic money manufacturing machine and all will be well with the world. Or maybe, as was the case back in 2007, those who smelled out that disaster are picking up the scent of another stinker.

David_Hay_Signature

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