

September 7, 2012

*"The shale/tight oil boom in the United States is not a temporary bubble, but the most important revolution in the oil sector in decades."*

-FROM OIL: THE NEXT REVOLUTION, BY THE BELFER CENTER AT HARVARD'S KENNEDY SCHOOL

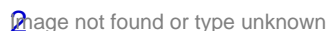
## POINTS TO PONDER

1. Fed Chairman Ben Bernanke continues to strongly imply he will launch a third round of massive money creation (QE3) in the near future. Yet a key reason his two prior experiments in monetary manipulation have minimally impacted the real economy is that money velocity has collapsed. Remarkably, it remains lower today than it was during the worst of the Great Recession. (See *Figure 1*)

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2. US stocks have risen a husky 16% including dividends this year, perhaps indicating an abiding faith in the Fed's ability to prop up the market. One warning, though, that stocks may be vulnerable is that essentially all of the S&P's increase has occurred on low-volume days. Conversely, it has fallen 5% on those days when volume has been high.

3. The double-digit rise in the S&P has wrong-footed many experts (including this author) who were concerned about the mounting risk of a global recession. While the reasons for this frothiness are debatable, sales and profits certainly have not been the catalysts. (See *Figures 2 and 3*)

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4. Oil prices are now back up to the levels of 2008 and 2011 when their draining impact on consumer spending retarded economic growth. Every one cent increase in pump prices shaves about \$1.3 billion off of household disposable income. With gasoline up 40 cents per gallon over the summer, this equates to roughly a \$53 billion drain, equivalent to a major tax hike. (See *Figure 4*)

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5. There are many disheartening statistics about the true returns to investors from hedge funds. However, the most shocking may be from a new book called *The Hedge Fund Mirage* by Simon Lack in which he calculates that hedge fund managers have taken 84% of all profits generated since 1998. Nonetheless, hedge fund assets recently hit an all-time high.

6. GDP growth is usually reported on a simple percentage basis. Although the present expansion looks frail enough on that basis, the per capita calculation is even worse. Adjusting for population growth of 3.7%, per person GDP is actually still 1.9% below its 2007 peak.

7. Companies reduced inventories frantically during the Great Recession. This set up a powerful re-stocking response, one of the few dynamic drivers of the otherwise squishy recovery. Now, however, inventories appear dangerously bloated. (See *Figure 5*)

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8. US companies are not alone in struggling on the earnings front. Bloomberg News reports that a record number of Hong Kong companies are forecasting profit declines ahead. Reflecting the softening conditions throughout Asia, the Shanghai stock index just hit its lowest level since March 2009 late last month.

9. The Economist's famous "Big Mac Index", comparing the cost of McDonald's iconic burger across countries, makes a strong case for buying bonds from emerging markets. Based on this measure, the majority of developing countries' currencies are undervalued by around 30% versus the US dollar. By contrast, most "rich" nations' currencies are overvalued by about 30% vis a vis the greenback.

10. Despite the rally in financial markets over the summer, economic data continue to weaken. China's latest Purchasing Managers Index (PMI) fell to its lowest level since March 2009, when the world was still in a deep recession. South Korean exports, which tend to closely track global economic activity, swooned 6.2% last month versus August 2011. (See *Figure 6*)

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11. European Central Bank (ECB) Chief Mario Draghi's announcement this week to ramp up bond purchases to save the euro has caused interest rates in Italy and Spain to dramatically retreat. However, long-term borrowing costs remain in the 5 to 6% range, respectively, even after this week's big rally. With deflation emerging in those countries, this means that the real, or after inflation, borrowing costs are actually increasing.

12. Italy is considered the strongest of the "Club Med" countries. However, its southern half is rife with a bloated bureaucracy after decades of political patronage. Sicily's regional government alone employs 1,800, more than the British Cabinet office. It also has 26,000 auxiliary forest rangers, despite meager timberlands, compared to just 1,800 responsible for the immense forests of British Columbia.

13. Among Europe's seemingly endless challenges, one of the most critical, at least on a long-term basis, is demographics. Eleven of the 15 eurozone member countries reported falling birth rates in 2011, aggravating what was already one of the world's worst population stability situations. (See *Figure 7*)

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14. In a delightfully ironic development, Venezuela is now relying on the US for 36% of its refined products supply (i.e., gasoline, jet fuel, etc.). This further spotlights the appalling economic mismanagement by the ultra-socialist Chavez regime and is particularly absurd given that Venezuela possesses the planet's most abundant proven oil reserves.

15. Not all the global economic news is downbeat. GaveKal Research's advance measure of developed country (OECD) indicators has recently turned positive. Similarly, the prestigious economic forecasting firm, ECRI, reported that its leading indicators improved for the fourth straight week, hitting nearly a four-month high. (See *Figure 8*)

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**What kind of fool am I?** The late, great Sammy Davis, Jr., whom my wife and I had the privilege of seeing live several times, immortalized these words in his classic song from 1962. Lately, I've been asking myself pretty much the same question. The reason for my soul searching has been the disconnect between

the generally accurate economic forecast I made earlier this year and the effervescent behavior of most of the world's stock markets.

As 2012 opened, my team and I felt the US economy, which looked like it was accelerating, would disappoint once again as the year matured, similar to what transpired in 2010 and 2011. It wasn't a popular view at the time but it has turned out to be correct.

We also felt Europe was not only heading into a recession but that it would be more acute than what all but the most pessimistic forecasters were projecting. Again, events seem to be unfolding consistent with this outlook (unfortunately, for the 17 million unemployed eurozone workers whose ranks continue to swell on a daily basis).

Moreover, growth in Asia has been even weaker than we thought it would be eight months ago. China, in particular, seems to be decelerating more abruptly than we envisioned. FedEx's latest earnings downgrade this week caused analysts to speculate that there is more softness than previously believed in what is typically the planet's most dynamic region.

And, yet, stock markets, with a few exceptions, are producing decent, if not downright nifty, returns so far this year (even the main European index is up 13%!). As I've reflected on this divergence, it's occurred to me that I haven't seen anything quite like this in my nearly 34-year career.

Certainly, as the old Wall Street saying goes, stocks can climb walls of worry. They also are well known for looking past current conditions and discounting what is likely to happen six to nine months out. But 2013 isn't looking all that great in the US and it appears even more challenged overseas.

Of course, the markets have grown to love debt monetization (i.e., central banks buying their own government's debt) and the ECB has pledged to do plenty of that. Meanwhile, our own Fed seems inclined to print up a few hundred billion more dollars despite the highly questionable success of its second round of "large scale asset purchases." (Doesn't that sound so much better than money printing?)

However, things can change most rapidly in the equity markets, particularly given the extreme dominance by flash traders, hedge funds, and other "investment" vehicles that have the attention span of an MSNBC reporter at the GOP convention. Further, the technical underpinnings—based on breadth, volume, and the chronic lag by economically sensitive stocks—are far from impressive.

It's impossible to know, of course, how long monetary incontinence will continue to prop up stock prices. But when the infatuation ends, the reaction is likely to make Usain Bolt look sluggish.

**Big energy in the Big Apple.** Despite the fact that our near-term economic and market views are guarded, we do see some very positive long-term trends. As discussed in a number of past EVAs, one of the most notable of those relates to the US energy situation.

For the first time in several years, I was able to break free this week to head to the annual Barclay's energy conference. In fact, I am writing this EVA from New York City as I try to squeeze in some time between a flurry of meetings with senior management from integrated energy companies like Chevron and Shell. It's also a chance to chat with the CEOs of many of

the master limited partnerships (MLPs) we own, or are considering, for clients.

In the past, I've gotten some valuable insights at this event, relative to both new and existing investments. This year has been no exception. The presentation I heard on Wednesday about one of the MLPs we own was especially encouraging.

We recently added significantly to this holding on price weakness that was strictly related to a secondary offering. These additional units were issued to fund a series of high-return and low-risk capital investments. My experience is that these temporary price drops caused by the additional supply are rewarding buying opportunities. Based on what I heard, this should be another chance to pick up a 6% yield with material capital gain potential.

But beyond specific issues, the resounding message from this conference was the enviable energy supply condition the US finds itself in these days. It's such a refreshing change from decades of feeling like we had the fingers of the lovely folks at OPEC wrapped around our collective throats.

However, it's not unalloyed good news for energy producers, particularly those that are mostly natural gas oriented. One of my key "takeaways" from this confab is that natural gas prices are likely to stay depressed for two to three more years. However, they are likely bouncing around bottom, with not much additional downside given the massive shift underway from coal to gas in the power generation field. Another dominant theme was that almost every energy producer is shifting from exploring for natural gas to oil. Given the rapidly rising tide of demand for natural gas, this supply reduction should eventually trigger a healthy rally in the long-depressed price for gas.

Also, there are a number of huge plants being built that will use ethane, a prime gas byproduct, to produce ethylene. Ethylene is an essential building block for plastics and other industrial products and making it with ethane is much cheaper than with oil-based naphtha. This means that US chemical producers will continue to have an enduring and significant cost advantage, particularly against European and Asian competitors (who must either use oil or natural gas, that sells at five to six times US prices, as a feedstock.)

Consequently, despite the risks of a broad correction after this summer's rally, we believe the long-term outlook of the energy sector offers considerable potential for superior rewards. In a world where central banks have been diligently squeezing out high returns by collapsing interest rates, being able to attain a 6% cash flow with an excellent shot at a 20 or 30% capital gain over the next couple of years, is nothing to sneeze at—unless you are allergic to double digit returns!

David\_Hay\_Signature

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