

January 11, 2013

"The future price tag of printing six trillion dollars' worth of checks comes in the form of inflation and devaluation of currencies either relative to each other, or to commodities in less limitless supply such as oil or gold."

-PIMCO'S BILL GROSS

2012: Triumph of the Central Banks. Wow! Didn't I just do one of these? By that, I mean our annual outlook newsletter. Maybe it's just that years with positive returns go by a lot faster than the clinkers. On that topic, I need to face head on one of my worst forecasts for 2012, namely, that the US stock market would produce mildly negative returns. As we all happily realize, last year was the fourth up year in a row, with the S&P 500 rising a remarkable 16%.

The reason I feel the word "remarkable" applies is that the market is alleged to be a "discounting mechanism." This means, in English, that it is supposed to anticipate what will transpire six to twelve months hence. Generally, then, stocks should weaken well in advance of a deteriorating economy. Given that the global economic news mostly degraded through 2012, the strength in stocks was perplexing, save for one very important factor—the action of the world's most powerful central banks.

 Image not found or type unknown

Actually, I got quite a bit right in my overall take on the backdrop for last year when I wrote, in the 2012 annual forecast EVA (with stocks already off to a very buoyant start): "Despite the recent euphoria, my worry list hasn't changed much from two months ago: Europe is still a monster mess, deleveraging remains the order of the day, US corporate earnings and profit margins appear to be peaking, and sentiment is very bullish, at least among the traders who push the market around these days."

Moreover, I even acknowledged the market might keep running a bit further before the problems mentioned above started to bite and actually that's pretty much what happened. The European crisis became far more intense and Wall Street came around to our view that the US economy was indeed losing momentum. It also came to realize that profits and profit margins were indeed in the process of rolling over. Thus, a full-blown correction did clip the US stock market, right after the first quarter ended. Meanwhile, in Europe, markets were hit much harder. By June, the main European index had plunged 20% from its early-year highs.

It was also my expectation that the combination of weakening stock prices and worsening economic data would lead the Fed to launch another round of what it antiseptically refers to as quantitative easing. Most of the rest of us would simply call it what it is: printing money. Of course, this is exactly what happened.

Therefore, I feel a bit like I did back in college when I got the calculus formula right but somehow whiffed on the answer. My mistake was in underestimating how much the combined firepower of the Fed, the European Central Bank, the Bank of England, and, now, the Bank of Japan would overwhelm the fundamental realities.

Yet, as I admitted at our annual outlook event last January, I really did want to have the wrong answer. After all, Evergreen clients own hundreds of millions of dollars of stocks, plus an equivalent amount of income investments that tend to at least loosely track the equity market.

Accordingly, my team and I are thrilled with how 2012 turned out even if we do believe the returns were almost totally a function of what we call the Fed's Great Levitation. But before we get into what that exercise in unprecedented monetary legerdemain means for 2013, let me provide a summary of my calls for 2012. As you will see, my overall score wasn't all that shabby.

2

Image not found or type unknown

Based on half scores for the partially right calls, I think a fair overall grade is around 70%, about what I realistically shoot for, but with a little explanation needed. For example, one could argue there wasn't much of a revival in inflation expectations as the Fed not only unveiled QE 3 but made it sound more like QE infinity. Yet, Treasury inflation-protected (TIPS) yields indicate that the most sophisticated inflation-judging machine in the world is expecting higher prices. It was also my contention that any inflation spurt caused by QE 3 would be a non-issue in 2012 which was the case.

3

Image not found or type unknown

If that score was slightly charitable, leaning the other direction was #10 above. A year ago, I was primarily talking about the economic situation in Europe continuing to worsen, which definitely happened. However, the financial markets went the other direction, rallying a most surprising 21.6%. Yet, I did concede there was a lot of bad news priced into European stocks, especially by the summer after they had been severely spanked. This extraordinary turnaround was triggered by an assertive central banker's vow to do whatever is necessary to save the euro (even if that does seem to be nailing much of southern Europe's populace to the cross of an overvalued currency).

Ok, enough on what was—let's focus on what might be heading our way this year.

Forecast 1: US Stocks—essentially flat (up 5% to down 5%)

If that call seems a bit ambivalent, it's because that's precisely how I feel. Frankly, if it weren't for the Fed's "a trillion dollars here, a trillion dollars there" Pavlovian response to any market weakness, I would be much more worried about a steep dive at some point during the year. Yet, the "Bernanke Put" is very much a reality and far more potent than I thought a year ago.

Thus, for now, there is a floor under the market, though a 10% type correction, such as we saw last year, is to be expected. And, although the overall market may not make much progress, there is likely to be some serious rotation among sectors. For the last few years, the market has been led by companies that benefit from easy money. Telecom stocks, high-dividend consumer staple issues, master limited partnerships (MLPs), and real estate investment trusts (REITs) have been the stars, validating one of our themes from a couple of years ago that stocks with bond-like characteristics were unusually attractive. (We exempted REITs from our positive views, due to their lofty valuations, but that was a mistake.)

More economically sensitive stocks have been noticeable laggards, until lately. In fact, there does seem to be a gradual shift occurring in recent months. Utilities have struggled, MLPs corrected hard, and even REITs seem to have hit a ceiling. The rally since the post-election lows has been led primarily by a snapback in the cyclical market sectors.

4

Image not found or type unknown

Because the Fed and other central banks appear determined to keep creating trillions of dollars until the economy gains traction, we are likely to see the market led by tech, energy, and industrial issues. These also tend to benefit from the Fed's relentless dollar depreciation efforts.

Of course, there will be times when the more defensive, income-oriented names outperform, but in general most of these appear to have seen their high-tide moment. MLPs, given their connection to the energy boom, should be an exception to this, particularly with their preferential tax status looking more secure in the wake of the fiscal cliff "deal."

Forecast 2: Bonds—small losses on Treasuries, small gains on high-grade corporate bonds. While we're not expecting a bloodbath (yet) in the bond market, our long-running enthusiasm for this important asset class is significantly diminished by the double whammy of low yields and a print-happy Fed. As many EVA readers know, we feel it's increasingly vital to be moving income-oriented and risk-averse funds into bond markets where the relevant central bank is not dead set on crushing the currency. Canada is a classic case in point, but we also think emerging market debt offers decent value.

In the US, we plan to focus on adjustable rates and issues with shorter maturities. We have enjoyed solid returns from our long-standing recommendation on the oxymoronic "high-grade junk" (the better-rated tier of the less-than-investment-grade market). We continue to think this slice of the bond world looks OK, but the juicy returns of the last few years are very unlikely to be repeated.

An important point to make about bonds is that given the Fed's avowed intent to buy up nearly all of the Treasury's debt issuance, there isn't a ton of merchandise left for the rest of the planet to acquire. As a result, even though a 10-year Treasury note yield of 1.9%, below the expected long-term inflation rate, represents an appalling value, the Fed is also undergirding this market. Someday, that floor will give way in a thunderous implosion, but it's unlikely to collapse in 2013.

Forecast 3: The economy—at stall speed. Frankly, I have been on the edge of reprising our recession call of late 2007, which turned out to be accurate, a couple of times over the last few months. However, I've held off on that primarily due to the intensity of the Fed's money manufacturing mania. The good news is that I don't see anything remotely as severe as what occurred in 2008, and I even think we might miss an official recession designation.

The Fed's hyperactive printing presses are one reason why I think cyclical stocks could do comparatively well in 2013 despite the continuation of a flaccid economy as they begin to discount, rightly or wrongly, better times next year.

However, I do worry tremendously about the Fed's exit strategy. The more liquidity it jams into the system, the more it will have to pull out at some point to avoid a massive inflation problem once money begins to multiply again. Interestingly, our partners at GaveKal Research in Hong Kong are seeing some evidence of that, as shown below.

Image not found or type unknown

Therefore, both the economy and the financial markets have a Sword of Damocles hanging over their heads, which is why we plan to maintain an underweight stance on stocks. It's also why we intend to hold considerable assets in what we view as the new safe harbors of Canadian dollar-denominated debt, plus bonds issued in Hong Kong in China's currency, and the aforementioned emerging market bond markets.

Forecast 4: The Fed—It won't stop the presses. Lately, there's been some news leaking out of our dear central bank that another trillion dollars of fabricated money during 2013 will be enough. Because this implies that unemployment will be down to 6.5% by the end of this year, the level at which the Fed says it will halt its printathon, I have to challenge that notion.

As noted in various EVAs, the minor improvement in the US unemployment rate has been almost totally driven by job seekers withdrawing from the labor force. Looking at the participation rate, which is far more comprehensive, shows how little progress has been made, even from the depths of the Great Recession.

Image not found or type unknown

Additionally, the Fed is likely to feel compelled to offset the contractionary nature of the fiscal cliff compromise, particularly once the spending cuts kick in. It appears that the US will be coping with around 1.25% of "fiscal drag," which, given an economy that has been expanding at just 2%, is far from negligible. (However, a reviving housing sector should offset at least some of

that headwind.)

Consequently, I see the Fed continuing to force-feed money into the banks that are likely to continue mostly sitting on the excess reserves. This ocean of stagnant money is actually a global phenomenon. Until we start to see that stir, a bond market rout is unlikely. Yet, the velocity pick up GaveKal is observing is definitely the proverbial straw in the wind. Even assuming that warning is premature, the Fed's predicament of how it will ultimately extricate itself from a trap of its own making is likely to become even more daunting as it prints itself into an ever deeper hole.

7

Image not found or type unknown

Forecast 5: US Fiscal Policy—the denial continues. One of the many unhappy side effects of the Fed's campaign to crush interest rates down to subatomic levels is that it removes most of the pressure on Congress to reform fiscal policies. Having just re-read the Report of the National Commission on Fiscal Responsibility and Reform, aka, the Simpson-Bowles plan, I was again struck by its comprehensiveness and realism. It is light years removed from the kind of nonsense that comes out of Congress itself. Yet, Simpson-Bowles has once again been relegated to political purgatory.

With no other "grand plan" anywhere on the horizon, I reluctantly have to agree with those who feel our government will continue to administer Sudafed when what is required is a heavy dose of super antibiotics. Basically, I don't see Congress adequately addressing our monstrous budget problems until a crisis of the first order explodes again. It will rely on the Fed to continue financing trillion dollar deficits and anesthetizing the financial markets. The Evergreen Investment team continues to believe this will end very badly—but probably not in 2013.

Forecast 6: Inflation—no upside breakout in sight. For years, we've argued with those who have felt the Fed's multi-trillion dollar monetary incontinence would lead to inflation. Our logic centered on the collapse in money velocity as the banking sector has largely sat on the dough. Time has vindicated this view and we don't see it changing this year (but we are on heightened alert based on the aforementioned velocity readings from GaveKal).

However, this doesn't mean that currencies backed by sound money central banks, and historic stores of value like gold, won't rise sharply against the US dollar. In fact, although gold is experiencing a shake-out right now, with sentiment having transmuted from euphoria to apathy to disdain, I believe it could surprise on the upside this year. The catalyst is likely to be a realization of just how much money the Fed, the ECB, and the Bank of Japan are willing to fabricate.

Forecast 7: Real Estate Investment Trusts—finally, a break.

The error I've made is focusing on valuation as opposed to catalyst. While there's no doubt REITs have gone from pricey to overvalued to priced-for-perfection, they have been a big beneficiary of the great yield starvation. However, if bonds are likely to trade with an upward rate bias, especially should money velocity

accelerate, REITs are almost certain to feel some heat.

Regardless of timing, they have enjoyed twelve years of exceptional returns despite so-so fundamentals and being in the eye of the credit bubble hurricane. After all, they're called REITs because they own real estate and the underlying assets went through a bear market unlike any previously seen. Yet, REITs are trading at all-time highs. There are also a number of not very REIT-like businesses converting to that status, meaning increased supply. Should prices begin to drop, the selling is likely to feed on itself, as it has so many times in the past with REITs. They look invulnerable now—and I look foolish—but no market sector can defy gravity indefinitely. Thus, I'm REITerating my bearish view of REITs.

Image not found or type unknown

Forecast 8: Higher risk investments, like commodities and "junky" junk bonds—a mixed bag. Commodity prices are likely to be caught in a tug of war between a weak global economy and central bank money alchemy. The net result is probably another "rocking chair" year: Lots of motion but not much progress.

The riskiest tiers of the junk bond market are likely to have a tougher time. They provided investors with munificent returns again last year, but a softer overall bond market, a challenging economy, and record low yields are likely to make this another time when the riskiest junk lives down to its name, as Buffett once famously predicted.

Forecast 9: Europe—the fix is not in. One of the most amazing events of 2012 was how much relief came from seven little words. When ECB boss Mario Draghi punctuated his vow to do whatever necessary to save the euro he added: "And believe me, it will be enough." Frankly, I didn't, but it was—at least for the time being.

Yet, I can't help but look at Europe, America, and Japan and think that the central banks have merely bought time for their feckless politicians. They really haven't—and can't—solve anything. In fact, as mentioned above in the context of US fiscal policies, the Fed's Herculean triage efforts are actually enabling the politicians, undercutting any reform urgency.

Europe is in even more desperate need of radical restructuring than the US because it is much

further down the road to welfare serfdom, with a private sector that has been throttled by bureaucracy and its related regulatory overreach. Labor markets are notoriously inflexible and uncompetitive, including in the crucially important country of France. As a result, unemployment remains disastrously elevated and rising.

Further, the European banking system continues to be hugely exposed to the sovereign debt of the underlying countries. Thus, Italy's banks are overloaded with Italian government debt that likely needs to be written down at some point.

Basically, Europe has not resolved its fundamental problems any more than we have. Governments have once again lost the will to restructure as financial markets have been bamboozled by Draghi's high-testosterone rhetoric. Yet another reckoning seems inevitable, at least to this observer (as well as the ultra-astute Charles Gave).

Forecast 10: Currencies—the most important thing. Regular EVA readers know that we've been quite vocal over the last couple of months that currencies are becoming a very big deal. Simply looking at returns from an asset class have been, and are likely to be, misleading. For example, last year, the Japanese stock market returned 25.5% in yen. But, in dollars, it was up just 12%, less than the S&P 500.

Actually, the underlying currency is less of an issue with equities than with bond-type investments. This is because, as was the case with Japan last year, a lower currency can cause a vigorous market rally. But with bond investors, a weak currency is an unmitigated negative (and a rising currency is an unalloyed blessing). At a minimum, it means you can purchase fewer imported goods with your depreciated currency than you could before. That's why we believe it is essential for income investors to be highly cognizant of the probable trend of the currency in which they've placed their yield money.

Rather than get depressed and/or paralyzed by Mr. Bernanke's unconstrained desire to flood the financial system with dollars, view it as an opportunity to be ahead of the crowd and move into those countries that are eschewing this reckless behavior. Admittedly, there aren't many major nations that are acting responsibly in that regard right now but they are out there, as I've noted above and in prior EVAs.

One last thing. A key reason the 2008 bear market was so brutal in almost everything, everywhere, had to do with an investment tactic called "the carry trade." This is a situation in which professional investors, usually hedge funds, leverage up by borrowing at low short-term rates to invest at higher long-term rates. It's a fabulous way to print money (though not quite as easy as what central banks do), at least until one or both of two events occur: Short-term interest rates rise or the longer duration assets begin to fall in price.

Clearly, rising rates weren't the culprit in 2008 as the Fed was feverishly cutting borrowing costs but vaporizing asset prices did more than enough damage. These triggered an avalanche of margin calls that hit even safe securities like high-grade corporate bonds (much to our chagrin at the time). Of course, that was then and there is much less leverage in the system now, right? Well, yes and no.

For sure, the Lehman's of the world are no longer around to fund carry trades and even the surviving brokers are much more circumspect. However, the Fed and the world's other leading central banks have filled the void. Bill Gross has noted how massive carry trades are once again, with investors worldwide using nearly free short-term money to buy higher yielding, but riskier, assets like junk bonds. All carry trades come to an end and when they do, it's never a pleasant experience. Given how long this one has been running—and the trillions of dollars

involved—its unwinding promises to be a doozy.

Therefore, my overarching suggestion for 2013 is to be willing to leave some return on the table in order to be protected when those playing the latest carry trade get carried out—once again—on stretchers.

David_Hay_Signature

Image not found or type unknown

IMPORTANT DISCLOSURES

This report is for informational purposes only and does not constitute a solicitation or an offer to buy or sell any securities mentioned herein. This material has been prepared or is distributed solely for informational purposes only and is not a solicitation or an offer to buy any security or instrument or to participate in any trading strategy. All of the recommendations and assumptions included in this presentation are based upon current market conditions as of the date of this presentation and are subject to change. Past performance is no guarantee of future results. All investments involve risk including the loss of principal. All material presented is compiled from sources believed to be reliable, but accuracy cannot be guaranteed. Information contained in this report has been obtained from sources believed to be reliable, Evergreen Capital Management LLC makes no representation as to its accuracy or completeness, except with respect to the Disclosure Section of the report. Any opinions expressed herein reflect our judgment as of the date of the materials and are subject to change without notice. The securities discussed in this report may not be suitable for all investors and are not intended as recommendations of particular securities, financial instruments or strategies to particular clients. Investors must make their own investment decisions based on their financial situations and investment objectives.