

January 27, 2012

“When all the experts and forecasts agree, something else is going happen.”

-ACCLAIMED MARKET TECHNICIAN, BOB FARRELL

Where have all the risks gone? In the far distant past, like around last Thanksgiving, the world’s sundry problems were weighing heavily on investors’ minds. Now, some two months later, all seems forgiven if not quite forgotten. For many, it’s hard to forget a most unforgiving year, especially when less than thrilling return reports for 2011 have only recently arrived. In fact, I suspect the number of investors who lost money last year exceeded those who were in the black, save for those with the foresight, or sheer luck, to be totally in bonds and high-dividend US stocks.

One of the bigger disappointments of 2011 was hedge funds. Collectively, they were down almost 9%. Considering their high fees, low transparency, complex strategies, and limited liquidity, expectations are that, even in years much worse than 2011, these alternative vehicles are supposed to produce profits. Obviously, as is so often the case with “alternative” investment vehicles, expectations did not coincide with reality.

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A probable cause for hedge funds’ overall deficient performance was the extraordinarily “whippy” market seen in 2011. Whenever stocks appeared to have some upside momentum, they proceeded to reverse course; similarly, when it looked as though a repeat of the 2008/early 2009 obliteration was unfolding, the market rallied. (In fairness, Evergreen’s alternative strategy also was hurt by the bipolar conditions.)

Based on this performance shortfall by hedge funds, it’s quite possible that the rally we’ve seen since Thanksgiving, which has carried into the start of the new year, is a function of hedge funds, and other trading-oriented players, frantically playing catch-up. Thus, short positions are being covered and leverage increased.

Conspicuously absent so far is the old-fashioned, real-money, volatility-scarred (and scared) traditional investor—you know, the kind of folks who are reading these words right now. In fact, I believe it is somewhat stating the obvious to say that the market’s violent up- and downswings only leave the typical non-institutional market participants [\[O1\]](#) ever more confused and cynical. In other words, even less inclined to put their personal treasure into stocks.

But I’m getting ahead of myself. This is the EVA issue in which I outline Evergreen Capital’s forecasts for 2012. As you will soon read, I’m once again diverging from the current trend of the financial markets, at least as far as stocks are concerned. However, I’m not alone. There is another market, and one that often does a better job of discounting the future, which also is begging to differ with the recent ebullience in US stocks.

Forecast 1. Stocks—single-digit losses.

Given how strong share prices are right now, this call seems downright foolhardy (but that's never stopped me in the past). Beyond performance chasing by lagging hedge funds, it's fair to note that, fortunately, US economic data have improved (in a bit we'll see how likely that is to continue).

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.

It would be wise for me to stop there, but I'm going to make my usual mistake of further saying I believe a major correction looms in the first half of the year. But prices could certainly move higher early on, as they did last year, before some of the other trends we see developing begin to bite.

As alluded to above, there is a battle of the market titans going on right now. Ten-year US Treasury notes have been moving down in yield even as stock prices have been rising. Their current yield is below 2%, implying a risk-averse, quasi-recessionary environment. Clearly, one of these markets is wrong and I don't think it's bonds.

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Forecast 2: Bonds: not so great expectations. Bonds have delivered outstanding returns over the last profit-challenged (for almost everything else) five years. In fact, they've been fabulous for most of the past three decades. At this point, it's prudent to be happy with their basic yield and not expect appreciation as well.

However, corporate bonds, as they did last year, may do better than their face interest rate. With spreads over Treasuries at their widest in the last decade, save during the worst of the Great Recession, they might produce a bit of capital gain in addition to their coupon.

Forecast 3: The economy: the spurting becomes sputtering. As previously mentioned, US stocks have unquestionably been lifted by better than expected economic data. But there are

four problems that call the sustainability of this into question.

First, past growth spurts have had a tendency to reverse course around this level. Second, forward-looking economic indicators are not validating the recent acceleration. Third, consumer incomes after inflation remain pressured and savings have been drawn down to drive spending. Fourth, oil prices at or over \$100 are an albatross around the economy's neck.

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Consequently, we see some disappointing GDP numbers in the first half of 2012. It's possible the whole year will be sub-par but we are hopeful a break in oil prices, and a perception that US government policies will change for the better, will lead to a pickup in the last two quarters. However, forecast 5, if right, may keep oil prices artificially elevated.

Forecast 4: Real estate investment trusts—year of reckoning. This has been a negative theme of mine for more than a year and frankly it hasn't worked yet. While we did take profits on the anti-REIT positions we have for our clients during last year's near-bear market, we were early on building those back up. REITs have tracked the market rally and are likely to stay strong until stocks correct. This hedging strategy was definitely a bit of a drag on our returns last year.

Eventually, the reality that this sector is exceptionally pricey relative to the overall stock market, as you can see by the chart below, will lead to the inevitable mean reversion (i.e., they'll be taken to the woodshed). The fact of the matter is REITs never been so expensive versus the

S&P 500 in the last 40 years based on comparative yield. Other valuation metrics tell much the same story.

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Forecast 5: The Fed—more printing on the way. In addition to slack growth telegraphed by Treasury bonds, another factor running contrary to the belief that the US economy is accelerating is the Fed. Numerous Fed watchers are picking up on smoke signals wafting from Ben Bernanke's tribe that the Fed is preparing to do another round of "quantitative easing." The Fed's announcement this week that it will keep rates at subatomic levels for as far as the eye can see (at least as far as my aging eyes can see) is indicative Bernanke and Co is also suspicious of the recent bounce's sustainability.

Based on recent improvements in jobs and the overall economy, "QE3" is unlikely to be launched right away. But should the four negative forces I outlined above lower GDP growth back down to "stall speed," the Fed is likely to respond with another boat (or ship) load of manufactured money.

This is not something I'm looking forward to or endorse. In fact, it might work against a second-half bounce-back by driving up oil and other commodity prices (as it did in late 2010 and early 2011), thereby hurting US consumers' purchasing power.

As for any rate increases by the Fed, "fugget about it."

Forecast 6: Higher risk investments (commodities, emerging markets, the riskiest slices of junk bonds, et al.)—another wild year.

Last year, I thought riskier vehicles were clearly an area to avoid. In 2012, I'm not so sure though, despite their strong start thus far, I believe the first six months will be challenging. This is predicated on my belief that halting US economic growth, continuing European shock waves, and a difficult attempt at a soft landing in China will all, at various points, serve to diminish risk appetites.

Assuming I'm right that there is trouble over the next few months and prices fall hard from their recent rally levels, that, combined with a decelerating domestic economy, will likely cause the Fed to print yet again. This should trigger a brief but intense surge in high-risk asset classes. As a side note, it is revealing that the Fed seems to be getting less bang for its manufactured buck with each new iteration of quantitative easing.

As for an up or down forecast, I'm torn. My best guess is that commodities will be somewhat negative while the riskiest bonds and emerging markets will finish flat to slightly up. Don't bet much on that viewpoint, however, as my conviction level is low.

Forecast 7: Inflation—a non-issue in the first half but an anxiety resurgence before year-end.

One of my favorite “cinemascope” (i.e., big picture) economic sources is longtime Forbes columnist Gary Shilling. Few economists cum strategists have nailed the overall environment as well as Gary has over the last five years. In fact, he's been pretty darn accurate for the last three decades.

He continues to believe that we are in a deflating, deleveraging cycle that has many years to run. His reasoning makes sense to me; therefore, I continue to feel that any burst of inflation will peter out as quickly as Tebow mania (my personal authority on the NFL, as in my wife, predicts that's just a lull until next season).

Yet that's not to say we can't have some periodic flare-ups in price pressures, especially commodity related, and particularly when the Fed decides once again that somehow fabricating more money will work better in the future than it has in the past. As Einstein was reported to have said, Insanity is when you keep doing the same things expecting different results. Perhaps we'd be better off if Dr. Bernanke had spent more time studying physics and less time on that dismal science—aka economics.

Forecast 8: Currencies—the year of the setting yen.

For the last three years or so, one of our main thoughts on the subject of currencies was that the rumors of the dollar's demise as the world's primary means of exchange were greatly exaggerated. It's extremely illuminating that, just as during the darkest days of the credit cataclysm, Europe is once more in dire need of dollar loans from our Federal Reserve.

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Additionally, we also felt the euro was the truly flawed currency, even when it was trading at 1.60 to the buck, precipitating the usual hysteria to replace the dollar as the world's reserve currency (notice how that has all died down recently?). Our view was that when rappers and supermodels wanted to be paid in euros rather than dollars, as was the case when the euro hit 1.60, a top in the Continent's currency was close at hand (and it was).

These days there is tremendous negativity against the euro which, depending on the path Europe chooses this year, could prove right. But we are getting increasingly concerned there could be a big rally, particularly if the weaker countries are given the heave-ho, resulting in a more Germanic currency. Admittedly, it could go either way, but the odds of the euro slipping precipitously with such a massive short interest have definitely fallen.

The yen, on the other hand, looks much like the euro did at its zenith in early 2008. Similarly, fundamentals look questionable given enormous and ever growing government borrowings, a trade surplus gone missing, a sharply eroding savings rate, and a rapidly aging population. We've had a small negative bet against the yen for the last year or so, but most of our attention was focused on our anti-euro stance. We now feel the yen is the more vulnerable of the two.

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Forecast 9: US fiscal policy—another year, another trillion (in debt).

There was a long-held belief on Wall Street that government gridlock was actually a good thing as it kept the knuckleheads from doing serious damage. But these days, we need action and, in my opinion, a new social contract. The old policies of both the right and the left have been shown to be woefully deficient to deal with the unprecedented problems we have today.

Unfortunately, I see little progress on this front this year. Again, I hope I am wrong, but in an election year the odds of fiscal reform legislation along the lines of Bowles Simpson, or something even better, are right up there with the Mariners leading the American League in hitting.

Forecast 10: Europe—break out the lifeboats!

For years now, we've been hearing a string of reassurances from Europe's "leaders" that they've got its crisis under control. Yet, in reality, they have consistently and greatly underestimated the severity of the situation. As a result of this complacency and the belated response, far more damage has been incurred than would have been if they had moved swiftly and decisively.

Rather than reading more of my ramblings on this topic, I thought I'd share one image that coincidentally—and tragically—symbolizes what those at the helm of Europe have let happen.

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Much like Europe's leaders, the captain of the Costa Concordia was in denial about the extreme danger into which he had piloted his ship. Incredibly, passengers were allowed to go to dinner even as water was gushing through the ruptured hull. Like arrogant European policymakers, he also felt he could blithely ignore the rules--in his case, the usual safe routes and in the case of the Euro elite, the rules of budgetary discipline (which even Germany flouted when it was in its national interest). What should have been a safe and uneventful voyage ended in disaster.

As is the case with the Italian Coast Guard and this tragedy, valiant efforts are belatedly being made to prevent Europe from going down or at least breaking up on the shoals of a currency experiment gone bad. And Italy is likely to be where the reef meets the hull.

As Churchill said 70 years ago, and is still true today, Italy is the soft underbelly of Europe.

Two very special messages. First of all, it is my great pleasure to announce that GaveKal Capital and Evergreen Capital have officially formed a strategic alliance. Over the years, GaveKal's charts, economic research, and, occasionally, full essays have frequently enlivened the pages of the Evergreen Virtual Adviser. Hopefully, this has given EVA readers a sense of the global perspective of the firm along with the very high quality of its work and insights.

GaveKal has offices in Hong Kong, Beijing, Denver, and . In addition, it has a staff of , including analysts and portfolio managers. Therefore, it's no exaggeration to say this is a firm with a very impressive set of capabilities.

While once primarily known as a research provider to many of the world's premier money managers, over the years GaveKal has built up an enviable investment track record of its own, as shown in the table below.

Moreover, as noted in a prior EVA, it also scored a major coup for its clients (and itself) with a vehicle that benefited immensely from the turmoil in European bond markets. In essence, GaveKal showed the same kind of recognition of massive mispricing of debt as those who made a fortune shorting sub-prime mortgages did back in 2006 and 2007.

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Beyond the business aspect, the principals of GaveKal, including my very good friend Louis Gave, are simply outstanding human beings in terms of both their intellectual prowess and their integrity. Louis has a second home in Whistler, B.C., and plans to be spending an increasing amount of his future time in the Northwest. We plan to host an event for our clients and potential clients with Louis as the featured speaker sometime in the next few months.

GaveKal is a world-class investment and research firm. Our primary goal in entering into this collaborative venture is to bring an unparalleled level of investment expertise directly into the construction of our client's portfolios. Over time, it is our intent to expand these into direct participation in various investment opportunities GaveKal uncovers, particularly those that are

typically difficult for US investors to access. Based on GaveKal's real-world track record, as well as the deep resources it brings to Evergreen, we believe very few regional money management firms can offer their clients this level of global investment expertise.

Secondly, and almost simultaneously, Evergreen earlier this week broke above the semi-magical \$1 billion mark in assets under management. As I admitted to the many who attended our annual forecast event last night, this amount is a mere rounding error to the behemoths like Fidelity and Vanguard. But in the world of independent registered advisers it is a most cherished milestone. My team and I both want to thank all of our clients who are reading this for their unyielding loyalty even when the good ship ECM has had to navigate some very treacherous waters. You can rest assured we will continue looking for the safest route for our clients and their precious assets.

David_Hay_Signature

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