

July 19, 2013

"Those classes of investments considered 'best' change from period, to period. The pathetic fallacy is what are thought to be the best are in truth only the most popular—the most active, the most talked of, the most boosted, and consequently, the highest in price at that time."

-FRED SCHWED, Author of "Where are the Customer's Yachts?"

POINTS TO PONDER

1. One of the more surprising aspects of the recent bond bloodbath is that it occurred as money velocity has continued to fall. It is also unusual that inflation has been receding as well. Both of these factors lend credence to the theory that bonds and other yield instruments have been the victims of selling by leveraged investors who have been spooked by the Fed's taper talk. (See *Figure 1*)

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2. As is almost always the case when prices suddenly decline, investors are frantically bailing out of muni funds. It is now possible to get tax-exempt returns in the 3.5% to 4% range from intermediate-term issues. Yet, investors are exiting munis at the fastest rate since early 2011 when Meredith Whitney's strident (and ultimately misguided) warnings of widespread defaults created an extraordinary buying opportunity. (See *Figure 2*)

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3. Stock market cheerleaders frequently assert that rock bottom interest rates (until recently) mean that P/Es should be higher than normal. Yet, as pointed out by leading strategist and economist David Rosenberg, when 10-year Treasury notes have yielded between 2% and 2.5%, the P/E based on the past 12 months' earnings has been just 13. Presently, the trailing PE based on reported (not operating) earnings is nearly 19 and is based on record profit margins.

4. Over the past 13 years, the Fed has kept short-term interest rates largely in negative territory. This led to the housing bubble, chronically sluggish growth, and an overreliance on debt to stimulate the economy. In fact, debt accumulation has exceeded GDP expansion every single quarter over the last five years. (See *Figure 3*)

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5. Despite the dramatic recovery in housing in cities such as Seattle, on a national basis prices remain 28% below their 2006 peak.

6. There have been growing signs that the lessons of the lax lending debacle of the past decade have been unlearned. Among those is that auto loans recently hit a six-year high with sub-prime loans having rocketed 30% in the past year. Additionally, the once infamous CLOs (collateralized loan obligations) are being churned out as fast as they were in 2007.

7. Despite a wide array of indicators reflecting a squishy US economy, renowned forecasting firm ISI perceives that the US economy is stabilizing at a fairly high level of activity. It now believes the US will avoid a repeat of the growth problem that has occurred mid-way through each of the past three years. (See *Figure 4*)

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8. Regardless of ISI's upbeat view, the trend in exports and imports is sending a very different message. It's possible the traditional leading economic indicators that firms like ISI focus on are providing a misleading view of the US economy's vitality. By backing out those factors being directly or indirectly impacted by the Fed, the economy appears to be noticeably downshifting, reinforced by the downbeat outlook this week from freight giant UPS. (*See Figures 5 and 6*)

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9. Although the US economic picture is mixed and confusing, there is no question that it is far superior to what is happening in Europe. According to Cornerstone Macro, Italian industrial production has slid all the way back to where it was in 1987.

10. Portugal is enduring its third- straight year of economic contraction, making it four out of the last five that have seen negative growth. Additionally, interest rates on its 10-year government debt surged to 8% lately, before receding somewhat. Yet, per The Economist, 70% of Portugal's citizens are in favor of staying with the euro, similar to surveys from other economically- devastated "Club Med" countries.

11. Notwithstanding the above realities, optimism is building (again) that Europe's economy has bottomed. Yet, the trend is definitely not the Continent's friend. (See *Figure 7*)

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12. The magnitude of government debt in Japan is astounding, approximately 220% of GDP on a gross basis. Also shocking is that government outlays are 43% of GDP. (See *Figure 8*)

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13. Chinese overnight lending rates have receded dramatically, of late, as the Bank of China has provided liquidity relief. Inter-bank borrowings have crashed from a brief peak at 25%, to 4.2%.

14. Because economic data in China remain unreliable, many observers focus on electricity production. This measure appears to corroborate concerns about a growth rate materially lower than the official 7.5%. (See *Figure 9*)

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15. One reason for China's flattening growth might lie in the fact that Europe is China's largest trading partner. The massive depreciation in the yen, making Japan's exports much more competitive with China's, can't be helping its struggling industrial sector. (See *Figure 10*)

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Maybe it's May? Mayday! Mayday! Mayday Not to be confused with the first day of May, when the workers of the world unite to march down boulevards with TV cameras rolling, before they themselves roll into a nearby pub, the "mayday" I'm talking about is the legendary distress signal.

In case you think I was annoyingly redundant (even more than usual) with my opening threepeat, that's the way it is done—at least if it's done right. The triple iteration is to make sure this broadcast of a life-threatening crisis is not confused with random noise—like the kind our beloved Fed seems to specialize in lately.

Moreover, if you wondered why the most cherished day of Bolsheviks everywhere came to represent the ultimate SOS, it's because it evolved from the French term "venez m'aider," or "come help me." (Given the current state of France's economy and government finances, you can rest assured that President Francois Hollande will soon be yelling "Venez m'aider!" at the top of his lungs.)

It's been a very long time since the US government bond market needed to issue its own mayday call. In fact, it was nine years ago, back in May 2004, when the yield on Treasuries zoomed to a level that seemed almost inconceivable just a few weeks earlier. Admittedly, the

bond bloodbath in 2004 started in April, but it gained momentum in the first two weeks of May before essentially peaking out at just under 5%, up a shocking 100 basis points (1%) from where it was trading on April Fool's Day of that year. (See *Figures 11 and 12*)

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Of course, as Mark Twain was wont to say, history doesn't repeat itself but it does rhyme; thus, this year has not been an exact clone of 2004. However, there's been a lot of rhyming happening based on the fact that nearly the entire run-up in Treasury yields that would happen over the full Fed tightening cycle from June of 2004 until December of 2006 was achieved by mid-May of that year.

To be precise, even though the Fed would soon embark on a tightening campaign that would last for two and a half years, during which it raised its overnight rate 17 times by a total of 400 basis points (4%), almost the entire increase in longer term Treasury yields was over by the second week in May of 2004! And, as you can see in Figure 12 on the previous page, this was before the Fed even raised rates once, a move it didn't make until late June of that year.

Although it's true that the 10-year Treasury note did poke its head above a 5% yield numerous times over the next few years, the reality is that the bulk of the rate rise occurred before then Fed-head Alan Greenspan ever lifted his finger (or overnight rate). Remarkably, in early 2007--despite rising inflation, surging commodity prices, and a credit-fueled housing and consumer spending boom--the yield on the 10-year treasury note was right where it was in mid-May of 2004: 4.8%.

By contrast, 10 years earlier, in 1994, the bond market pasting--which bankrupted Orange County, California--coincided with actual Fed hikes and played out over a much longer time frame, as you can see below. (See *Figures 13 and 14*)

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Unquestionably, rates also rose much more, from 5.5% to 8%, before the economy cooled and stocks buckled. Yet, that's also a point I'd like to convey. In 1981, it took Treasury yields of 16% to induce a recession and vanquish double-digit inflation. In 1984, the breaking point was at 14%. By 1987, 10% was the number (the chart below shows monthly closing yields; thus, it doesn't capture the spike to 10% in mid-October of that year). In 1990, it was 9% and, as just noted, in 1994 it was 8%. In 2000, Treasury yields at 7% did the trick and, of course, in 2007 the yield was just north of 5%. Do you detect a pattern? (See *Figure 15*)

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Gentlemen prefer bonds. Returning to the here and now, it's been my belief that once our present bond market got an inkling of Fed tightening, it would react much the same way it did in 2004. In other words, most of the damage would be incurred as soon as there was a whiff of a change in Fed policy. My reasoning was based on the hair-trigger nature of markets these days and also the highly leveraged status of so many institutional bond investors (two sides of the same coin, I realize). The carnage in yield instruments we've seen since May, before any actual Fed action, certainly rhymes with the spring of 2004.

Naturally, it remains to be seen how much further rates have to rise before they pose a problem for the economy. But based on what's happening with inflation and money velocity, as highlighted in today's first Point to Ponder, as well as with housing affordability, it's not unreasonable to assume that the level at which higher rates bite is quite a bit lower than it was in 2007. My best guess is that the 10-year T-note will occasionally, and briefly, trade above 3% (it hit 2.7% early this month) but not much more due to the dislocations that produces in an already frail economy. (See *Figures 16 and 17*)

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A growing number of economists is cutting their forecast for US GDP growth for the second quarter, on top of the downward revisions to just 1.8% for Q1. Most notably, Moody's chief economist, Mark Zandi, said on CNBC last week that he thinks the American economy will actually contract in the quarter just ended. But, as is the normal refrain from most gurus, he opined that he was bullish on the outlook for next year. Based on the market's snapback rally after last month's indigestion, stocks clearly agree with him, continuing the extraordinary disconnect between share prices and the economy. (See *Figure 18*)

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This optimistic view could certainly be right but how often have we heard that over the last few years? "Escape velocity" to a normal recovery pace has allegedly loomed right around the corner according to the consensus narrative. Yet, considering that the recession ended four years ago, it must be one gargantuan corner. Consequently, I think it's reasonable to consider the thesis of those who believe that the endless QEs are inhibiting, rather than stimulating, the economy. (Prominent Democrat and Boston Properties CEO Mort Zuckerman penned a

scathing critique this week in the *Wall Street Journal* of our job-challenged and Fed-fabricated recovery, highlighting that since it began three times as many individuals have left the workforce than have founded employment.)

If QE is truly backfiring, the fact that Ben Bernanke has lately gone out of his way to assure humanity that his printathon won't end anytime soon may well mean the US economy will continue to be relegated to the Rod Serling zone, trapped somewhere between daylight and darkness. And, should that be the case, the ability to secure *after-inflation* yields in the 5% to 6% range, as we have been able to do since bonds fell out of bed, may turn out to be a fleeting opportunity that most investors miss, either due to either excessive leverage or exaggerated fears of falling prices.

Accordingly, it appears that the income world is much further along in discounting a removal of the eternal part of "QE-ternity" than is the US stock market. As noted in recent EVAs, the strength in American share prices is particularly remarkable given the weakness in almost everything else on the planet. But, per last week's guest EVA from Louis and Charles Gave, this could be similar to the classic warning sign at the end of a bull market when just a handful of issues continue rising. In other words, narrowing "breadth," or upside participation, among international asset classes might be a tsunami siren going off.

As we have all heard ad nauseum, the Fed's large-scale asset purchases, popularly known as QE, was intended to increase stock and home prices. This in turn was supposed to lead to higher spending and job growth that justified all of the "unwind" risks.

But with so many asset prices under pressure, and even the supposedly stellar US economy still limping after all these years, the odds of a policy shift are growing. Based on the president's comments to Charlie Rose recently, making it sound like he's decided to help Ben Bernanke return to academia, by early next year we should see a new Fed chairman (or chairwoman).

While it's possible the Fed will keep the printing presses humming, there's a distinct chance that this person, who almost certainly will have to execute the exit strategy, will want to do so sooner rather than later. Ultimately, that should be a good thing for our economy but, as we saw in June, just the hint of QE's demise creates enormous shock waves and I believe they will be felt much more acutely by high-flying equities than already pummeled income investments.

On the other hand, if you believe the Fed's got the situation under control, then maybe we're headed to Dow 20,000. If so, please keep reading...

The Great Taper Caper. To wrap up this week's EVA, I want to comment briefly on the Fed's oft-stated desire to improve transparency in its "messaging". The message from Mr. Bernanke in May and June was that the economy was looking better and, thus, should continue, tapering would follow. Financial markets proceeded to come unhinged around the world, causing Mr. Bernanke to back-pedal as fast as a defensive back covering Calvin "Megatron" Johnson.

Yesterday's headline in the *Financial Times* read: "Bernanke vows no retreat from easy money policy", followed by the first sentence of the article: "Ben Bernanke said the US Federal Reserve would support a weak economy for the foreseeable future."

In other comments before Congress on Wednesday, which was the subject of the *Financial Times* article, he also said: "Our general broad outline is that we expect the economy to pick up, probably later this year...Our asset purchases are strengthening the overall economy...I

don't think the Fed can get interest rates up very much, because the economy is weak...If we were to tighten it would tank the economy."

There's more: "The reason I think that markets are improved so much since 2009 is because Fed policy and other policies have succeeded in providing a stronger economy." But before he could take any bows he got some chin music from Rep. Mick Mulvaney: "If the economy is growing at such a strong rate as to support some fairly dramatic increases in the stock markets that we've seen, then why are you continuing your easy money policies?" (Thanks, Mick, I've desperately wanted to ask him that same question but I would have said "incredibly easy money policies".)

To which the Chairman replied: "Because we haven't—well, profits are actually ahead of jobs. That's one of the problems. So we continue to provide easy money in order to get the job situation back to where we need it and also because inflation is below our target."

After reading the above, do you get the same vivid impression I do, that the Fed is utterly confused? It's my belief that is why their attempt at transparency is backfiring, much like QE-ternity. The messages are so mixed and muddled that they amount to a disinformation campaign that would make the CIA proud. Thus, markets are becoming increasingly perplexed, save, as usual, for the US stock market which seems to have an unshakeable faith in the Fed's ability to create a happy ending—and an immaculate exit.

Maybe we all just need a remedial lesson in Fed-speak. Along those lines, perhaps it would also be a good idea, as suggested by my close friend Grant Williams, to pick up that new bestseller, *Tapering for Dummies*, to help us mere mortals better comprehend what the money wizards have up their monogrammed sleeves.

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In my case, I'm going to wait for another question from Congressman Mulvaney like: "Mr. Chairman, after years of supposed recovery, trillion dollar deficits, and \$3 trillion in Fed money printing, how come the number of Americans on food stamps has doubled to 48 million?"

Undoubtedly, the answer would be: "we just need to print more". Gosh, any dummy should be able to figure that out!

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