

July 27, 2012

"Clearly, things are weaker than we thought when we made plans for this year."

-UPS CFO KURT KUEHN

POINTS TO PONDER

1. Retail sales have now fallen for three straight months. This has occurred just 2% of the time since WWII and in all instances except one (late 2000) the US was already in recession. Even in the exception case of 2000, a downturn started within months thereafter. It is possible, however, that the warmest winter in 100 years is at least partially skewing the data (too strong in the winter, too weak in the spring). (See Figure 1)

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2. In a similar vein as retail sales, the Philadelphia Fed survey has hit its present low level without a recession ensuing just once in the last 50 years. (See Figure 2)

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3. REITs have a reputation for being comparatively safe harbors relative to common stocks. However, over the last five years, the standard deviation (a measure of volatility) of the Vanguard REIT ETF is 73% higher than the S&P 500. Going back to 1978, when the REIT index started, volatility has been lower, though still roughly in line with the market. Unquestionably, average annual returns of 14% have been outstanding - perhaps too outstanding.

4. Showing that the US isn't immune to faltering overseas economies, America's manufacturing sector recorded negative growth in June for the first time since the Great Recession ended three years ago. The most alarming feature of the report may have been the collapse in new orders. These fell at the fastest rate in more than a decade. (See Figure 3)

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5. Pressure appears to be growing on the Fed to launch another burst of money fabrication. Besides spreading evidence of economic fragility, the National Association for Business Economic Survey showed that business pricing has plunged to a record low. Such reports tend to cause intense deflation worries at the Fed.

6. Oil prices have been on a wild ride in recent months. After plunging 29% from their February highs, they have spiked back up 14% over the last few weeks. Crude's resilience may be a function of the lowest inventories in several years. Unfortunately, higher oil prices take away one of the few ballasts for consumer spending.

7. Among the factors indicating that US stocks have not fully corrected the excesses of the 1982-2000 mega bull market is the overall P/E ratio. Based on the famous "Shiller P/E," using an average of the prior decade's earnings, valuations continue far above the trough seen at the end of other major bear markets. (See Figures 4 and 5)

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8. According to a June Barclay's poll of institutional investors, only 20% of respondents felt a growth slowdown is the main risk to stock prices. Consequently, should the US join Europe in recession the reaction may be severe. Additionally, thus far, S&P 500 companies are reporting revenue growth of just 1%, the weakest since Q3 2009.

9. When the Great Recession was at its worst, the vaunted Taylor Rule indicated the Fed should maintain negative interest rates. Since this is nearly impossible (though the Swiss Central Bank is trying right now), the Fed instead created massive sums of excess reserves (aka money printing). Now, though, the Taylor Rule implies that the fed funds rate should be closer to 2% rather than the prevailing 0.25%. (*See Figure 6*)

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10. One of the long-term investment themes of Evergreen's partner firm, Hong Kong-based GaveKal Research and Capital, is that the US dollar may be in the early stages of a durable bull market. Although GaveKal believes certain Asian currencies remain undervalued versus the greenback, it feels America's increasing energy independence and resurgent industrial base will cause a reversal of its 30-year bear market. (*See Figure 7*)

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11. While emerging markets have struggled for the last few years, since 1970 they have been a spectacular investment. (*See Figure 8*)

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12. China's economy appears to be touching down for a smooth landing according to official statistics, but based on the analysis of less biased sources the deceleration is more abrupt. (*See Figure 9*)

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13. Illustrating how yield-starved the world has become, the Czech Republic, rated A1, was able to sell 10-year bonds at the miniscule rate of 2.5%. Meanwhile, Dutch government bonds are selling at their lowest yields in nearly 500 years.

14. With Spanish unemployment set to exceed 25%, it's perhaps illuminating to consider that in 1933, the year in which one quarter of Americans were jobless, US stocks produced their highest return on record. Thus, should Spain take radical measures to rekindle growth, say by exiting the euro, its market may produce spectacular profits.

15. Save for a valiant but lonely Mario Draghi, head of the European Central Bank, Europe continues to look rudderless during its typical summer-long holiday (nothing seems to interfere with what is nearly a continent-wide vacation). Yet there is at least some faint hope among the relentless gloom-the battered economy of Spain has moved back into a trade surplus while Germany's once Himalayan surplus has receded. Such "rebalancing" is a key part of resolving the crisis. (See *Figure 10*)

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Better than expected, but not necessarily strong. After a turbulent month of May for the markets, and a strong recovery in June, investors around the world have recently focused on corporate earnings announcements to dictate investment decisions. With poor economic news consuming recent headlines, the markets seemed prepared for negative announcements from the world's multinationals. However, as the market loves to do, bears were left scratching their heads after better than expected earnings were reported, prompting a multi-day market rally. Many investors rushed in their buy orders based on the headline releases with blatant disregard for detail. And, as we all know, the devil is in the details.

Alcoa, one of the world's largest aluminum manufacturers, kicked off earnings season on July 9th with an expectation-beating \$.06 per share in earnings (analysts expected \$.05). The market relished the news from Alcoa as aluminum is used in so many of the world's products, from Coke cans to automobiles. This was a good quarter for Alcoa if you base its performance solely on current analyst expectations. If we take a step back and compare Alcoa's year-over-year earnings, we find that earnings have declined 81%. Furthermore, expectations for Alcoa's Q2 earnings on May 1st were \$.12 per share. By the time Alcoa reported results on July 9th, analysts had lowered expectations all the way down to \$.05. Lately, similar downward adjustments of analyst expectations have been a common trend for many of the S&P 500 companies. Thus, the better than expected projections should be taken with a grain of salt.

The next few headline-grabbing companies were the big banks here in the US. JP Morgan was the first bank to report expectation-beating results, followed by Wells Fargo, Bank of America, and Citigroup. The market accepted this positive news with open arms and the rally was propelled. However, for our team at Evergreen to feel confident about the validity of the rally, we needed to take a closer look at the results. What we discovered was that the pretty headline numbers didn't tell the whole story. The top five banks reported the worst start to the year since 2008 (JPM, BofA, C, GS, and MS). The banks combined first-half revenue in 2012 was \$161 billion, down 4.5% from 2011. This represents the lowest level since 2008 (in the middle of the Great Recession) when the same banks recorded revenue of \$135 billion. Low interest rates, a drop in trading fees, limited merger and acquisition transactions, and poor conditions in Europe were among the culprits blamed for the poor results. So the question I pose: Is this really the type of news that should trigger a 5% market rally?

Overall, S&P 500 revenues for the current quarter are expected to grow less than 1% year-over-

year, while earnings are expected to grow at a tepid pace of just over 2%. Many of the companies' announcements have beaten on the bottom line, reporting stronger than expected earnings. However, top-line revenue has been coming in rather light. Intel, for example, grew year-over-year earnings by 3.6%, but sales came in flat. Cost-cutting has helped keep company margins low, but is not a sustainable driver for an economy desperately in need of growth. Companies have also started announcing significant layoffs. To name a few, Hewlett Packard will be cutting 30,000 jobs, Cisco plans to eliminate 1,300 jobs, and Goldman Sachs recently announced a workforce reduction of 1,000. This is a negative trend for an economy that desperately needs job growth, not contraction!

Even though earnings have been the focal point over the last few weeks, negative economic news continues to roll out. As mentioned above, retail sales are signaling a significant slowdown for the US consumer. As pointed out by Gluskin Sheff's esteemed economist David Rosenberg, if you total all the recent economic announcements, 75% of the results are negative. While US housing has been the lone bright spot for the economy, if layoffs continue and the economy cools, expect its resilience to be short-lived.

As our team at Evergreen extracts the facts from the details, we don't see any reason to change our defensive stance. Going into the year, we anticipated a tremendous amount of volatility stemming from the unresolved troubles in Europe. We didn't anticipate a US recession in 2012 and we haven't wavered from this stance. However, as economic results continue to be anemic, our investment committee has had an increasing number of debates regarding the possibility of another US downturn. Here's to hoping for a better second half for the global economy and corporate earnings, regardless of what the headline numbers say.

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