

June 21, 2013

"You can always count on Americans to do the right thing—once they've tried everything else."
-WINSTON CHURCHILL

Special message: Several past EVAs have described the investment process popularly known as the "carry trade." As a refresher, this involves hedge funds, propriety trading desks of large financial institutions, and even closed-end mutual funds, borrowing short-term in order to buy, or carry, longer-term securities. The difference between the short-term financing costs and the yield on the long duration investments is the profit, otherwise known as the positive carry.

Thanks to the unprecedented generosity of global central banks over the last few years, carry trades of all types have been exceedingly lucrative. Due to this, and the fact that money has been heap for such a long time, these have also become exceedingly pervasive.

The assets used in carry trades range from treasury and high grade corporate bonds to emerging market and less than investment grade (aka, junk) debt. Other securities often include real estate investment trusts (REITs), master limited partnerships (MLPS), and utility stocks.

Almost all investors have benefited from the bidding-up effect of carry trade players. The problem comes, however, when the values of these longer-term assets begin to fall for whatever reason. This is what has transpired since mid-May, ever since Fed chairman Bernanke made a series of relatively mild comments about eventual "tapering" before Congress. Since then, and particularly this week, income securities have been under downward pressure. Until recently, the US stock market shrugged this off. But, as is often the case, once the erosion becomes serious enough, stocks begin to suffer collateral damage.

Because I am on the road today visiting clients, I won't address this important development fully until next week. Suffice to say, the situation is getting chaotic enough that Evergreen's bargain hunting process is kicking in. It's never fun to see values drop, but we are definitely in a position to take advantage of the carnage. Chaos is where real money is made.

The unwinding of carry trades, such as in 2008, are messy events, and prices have a nasty tendency to overshoot on the downside. Consequently, while we believe it makes sense to buy into this plunge in high cash flow securities, we also feel it's prudent to do so gradually. More to follow next week...

POINTS TO PONDER

1. Many market optimists have argued that stock prices should keep rising due to lingering bearishness. Yet, based on the Credit Suisse chart below, animal spirits are nearing the danger zone. The good news is that the recent shakeout in many investment sectors is likely dampening the ebullience. (See *Figure 1*)

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2. In another sign that the US bull market, now in its 5th year, is entering the frothy stage, the latest up-move has been propelled by "junk" stocks. This category is defined as those that are heavily shorted, are generally small cap, and/or have the worst analyst and credit ratings.

3. It may be obsolete to focus on corporate earnings in a world where stock markets are drenched with fabricated central bank money. However, Wall Street analysts, who tend to be on the overly optimistic side, are projecting 12% and 17% profit growth in the third and fourth quarters, respectively. Based on the tepid US (and global) economy, these numbers are highly likely to be cut, most probably by a considerable amount.

4. One of the many threads of instability in current financial markets is the size of mutual fund bond assets versus dealer inventories. Banks and brokers have reduced their market-making functions to free-up capital and reduce risk in recent years. Accordingly, the depth and liquidity of many fixed-income markets have shrunk. This may be a prime factor behind the high volatility in bonds lately (along with the unwind of the so-called "carry trade"). (See Figure 2)

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5. Just a few years ago, the Marcellus shale formation, extending from New York to Tennessee, and centered in Pennsylvania and West Virginia, was an interesting but unproven energy play. Now, it produces 10 billion cubic feet a day of natural gas, roughly 15% of total US output.

6. The recent gaping divergence between the Fed's monetary incontinence and the gold price is even more dramatic than it was during the 2008 financial panic. That episode turned out to be an extremely rewarding time to accumulate bullion.

7. Thanks to rebounding home values and stock prices, US households have now recouped all of the wealth lost during the global financial crisis. It does remain to be seen how much giveback there will be once the Fed begins to drain liquidity rather than force-feed trillions into the system. The stock market's recent action, despite relatively benign comments from Fed chairman Bernanke, is not encouraging in this regard. (See Figure 3)

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8. Validating an *EVA* forecast from late last year, US economic releases have been much more on the weak than the strong side in the first five months of 2013. However, based on the pattern

of the past few years, an upturn may not be too far off. As can be seen below, stock prices have already "decoupled" from economic trends, similar to last year. (See *Figure 4*)

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9. Besides a fiscal budget that is nearly in balance and a prudent central bank that has avoided binge-printing (unlike most of its developed country counterparts), the Canadian dollar should also be supported by a near-record short position. The last time speculators were this bearish on the "loonie," in 2007, it proceeded to rally by 7% in the next 90 days. (See *Figure 5*)

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10. Hopes have been running high that this would be the year the European economy revived. Unfortunately, the downturn seems to be worsening with Denmark cutting its growth forecast in half to a stall-speed rate of 0.5%. More troubling is that the IMF has pared mighty Germany's GDP outlook to an even feebler 0.3%.

11. Not long ago, Ireland was viewed as a shining example of a post-financial crisis revival. But lately, mortgage delinquencies have continued rising while loans to the private sector have maintained their downtrend. Both are reflections of a banking system that remains exceedingly fragile.

12. Economic bright spots in Europe are as rare as .300 hitters on the Seattle Mariners. The

UK, though, is looking like a slugger, at least by comparison to its still slumping Continental peers. (See *Figures 6-8*)

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13. One of the goals of Japan's aggressive currency depreciation was to kick-start exports. However, the weaker yen has immediately raised the cost of imports, causing its trade balance to continue deteriorating. (See *Figure 9*)

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14. Illustrating that lax lending standards have made a global comeback, one-third of the Asian credit market (ex-Japan) is now made up of junk. A year ago, it was just 12%.

15. Another headwind for the world economy may be blowing soon. Credit expansion in China has become excessive and the government is reportedly preparing to rein it in. Already, there are indications of a cash crunch in the Chinese banking system with overnight borrowing rates having recently erupted. (See *Figures 10 and 11*)

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The Kerry Doctrine. "In America you have a right to be stupid—if you want to be." John Kerry, our nation's current Secretary of State, spoke those stirring words to a group of students after a speech last February in Berlin (obviously, striving to maintain America's high standing abroad).

Remarkably, sometimes even politicians manage to tell the truth and, in my opinion, that's precisely what John Kerry did even if it was an off-the-cuff remark (those are always more interesting than their usual scripted blather.) While his observation doesn't quite elicit the same sense of national pride as does reading the opening words of the Declaration of Independence, or reflecting on the superhuman sacrifices by the Greatest Generation during World War II, or simply hearing the strains of the *Star Spangled Banner* during a July 4th celebration, it is, nevertheless, undeniably true.

We Americans have a God-given right to be imbeciles and no segment of our population excels at that quite to the degree as our elected representatives. That's not to say that many of the rest of us don't give it our best shot but, let's face it, it's very hard to keep up with the ~~chumps~~ champs in Washington, D.C.

In addition to John Kerry's comment in this regard, what motivated me to focus on this issue in this week's *EVA* was a recent article I read in the *Wall Street Journal* by best-selling economist and historian Niall Ferguson. Some of you may have seen him this week on CNBC, where he was a featured guest, discussing his new book *The Great Degeneration*. Many of you likely recall the write-up Evergreen team member Mark Nicoletti did of his speech at John Mauldin's Strategic Investment conference last month.

His overarching theme is that the key political, educational, regulatory, and legal institutions in the west are in decline. At one time, they were a source of enormous societal strength but as they have evolved—or devolved—they have turned into growth inhibitors and wealth concentrators.

Let me give you just one telling example from his *Wall Street Journal* essay. He highlights a recent class action settlement between Southwest Airlines and a plaintiff group over, get ready, unused drink coupons! As often happens with these suits, SW decided to settle out of court. Flyers will be thrilled to know they will receive "Replacement Drink Vouchers," which will no doubt ease any sense of social injustice. Lawyers for the class are coming out just a bit better: the attorneys' fees will be \$3 million (down from the \$7 million originally requested).

Of course, this is just one minor instance of the kind of tort abuse that occurs daily throughout our unfair land. Frankly, I think we've all become numb to this type of legally sanctioned larceny. As Dr. Ferguson concisely sums it up, we have moved from the Rule of Law to the Rule of Lawyers. But whether we are numb, or just plain dumb, Americans keep turning a blind eye to these types of abuses. Individually, they matter little. Collectively, they are lethal to our health, wealth, and even, our liberty.

Ok, other than the tort attorneys among us, we all buy that our legal system is a joke but what does that have to do with financial markets?

The ultimate good war. Let me answer a question with another in true Socratic style. When was the last time you heard about Simpson-Bowles? As you can see below, Google searches on this subject have crashed like the silver market (remember, we did say it was a bubble back in the spring of 2011).

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Another question—where is the public outrage for regulatory reform? We have foolishly allowed our bureaucrats, elected and appointed, to create a system that is so complex that you have to be wealthy or well-connected, or both, to navigate it. As Dr. Ferguson points out, it's only the deep pocketed, individual and corporate, who can afford to hire their own teams of attorneys to cope with the pretzel palace of rules and regulations created by other attorneys.

It's no wonder small businesses aren't hiring. They face, the British-born Ferguson observes, "a jungle of red tape," making it easier, in his words, to start a business in Old England than New England (apparently, he has just done the latter, much to his chagrin). Dr. Ferguson estimates the cost of this overregulation to our country at \$1.8 trillion. For small businesses, the burden of this regulatory overkill is 36% higher per employee than for large firms.

Whether it's our legal, tax, financial, regulatory, healthcare, or political system, it's all far too complex. One infuriating example is that the tax code is now approaching 10 million words. As a result, and thoroughly relevant to the financial world, it's also highly vulnerable. Complex devices are notoriously prone to failures and unless they have multiple redundancies (say, like the Dreamliner—oops, bad example), fail they will, usually catastrophically. Certainly, there's nothing more complex than the financial system, which is in the process of becoming much

more so thanks to Dodd-Frank.

Another brainiac, Nassim Taleb, published his book *The Black Swan*, in 2007, warning investors about how unexpected events were likely to shake the financial markets. Obviously, his timing was impeccable as 2008 brought a series of "Black Swans" that even Taleb (and yours truly, despite my many apprehensions back in 2007) didn't fully appreciate. Now, he has authored a book called *Antifragile*, in which he contends that policymakers, like the Fed, in seeking to artificially repress volatility (at least of the downside variety) are rendering the system increasingly fragile—essentially, anti-*Antifragile*.

Dr. Taleb's apt analogy in this regard is that it's like a forest floor where flammable material is allowed to accumulate. Small fires that would purge the woods of the combustible items are prevented. Thus, when a blaze does erupt, it is of epic proportions. As he writes, with regard to the Fed's suppression of normal volatility: "Stifling natural fluctuations masks real problems, causing the explosions to be both delayed and more intense when they do take place."

We've had plenty of wars in our nation's comparatively short history: A war of independence, a war between the states, world wars, a war on poverty, and, most recently, a war on terror. But, in my opinion, what we need now is a war on complexity. And, I think, that's exactly what we'll get—eventually. (The tax code would be a great place to launch the initial campaign.)

The good news is that despite all the handicaps the federal government has placed on our economy, it is still managing to grow. Actually, when adjusted for the much-needed (but still too modest) shrinkage in the public sector, it's not all that bad, especially compared to what's happening in much of the rest of the world.

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We are so resolutely exercising our right to be stupid right now--like by relying on the Fed to fix the economy and consistently avoiding making the changes to our system that are so obviously needed-- imagine how good it could be if we collectively decide enough is enough. That's been the history of America. We wise up and then we reinvent ourselves. When we do that again, Dr. Ferguson can write a new book called *The Great Regeneration*. Until then, invest accordingly—as in carefully.

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