

June 28, 2013

"Frankly, I view the present course of monetary policy as reckless—not because it threatens inflation (which I don't think it will for several years), but because it diverts scarce capital away from productive investment and toward speculative activities."

-JOHN HUSSMAN, highly regarded money manager.

Special Message: Due to the turbulent market conditions, particularly in yield instruments, we are interrupting our normal *EVA* cycle to run this special issue. Additionally, Evergreen clients should be aware that as a result of the sharp correction that has hit income investments, the transaction level in your account(s) will be higher than normal as we seek to capitalize on the turmoil caused by, in our view, over-leveraged investors. We strongly urge all clients to read this edition of the *Evergreen Virtual Adviser*.

Minsky Moment, Take II. The event in question is not, as many of you might assume, based on the 1960s hit film, *The Night They Raided Minsky's*. As far as I know, deceased economist Hyman Minsky never owned a burlesque hall, though his posthumous fame has been built on laying bare the follies of speculative excesses.

Prior to his passing in 1996, Mr. Minsky was a relatively obscure academic teacher at the University of St. Louis. Just two years after his death, his core thesis that "stability breeds instability" rocketed to notoriety, at least in financial circles. This was due to the attention it was given by Pimco's Paul McCulley, who coined the term "Minsky Moment" in the wake of the late-1990's Asian financial crisis. That debacle revealed how various Pacific Rim countries had used extensive short-term borrowings to maintain growth that was unsustainable based on fundamentals. Asset prices had been driven to absurd levels by cheap money until, suddenly, the Minsky Moment was at hand.

Americans rightly believe that we survived a brutal and unparalleled shellacking in housing prices as values fell 30% to 50%, from 2006 to 2011, depending on the region. But during the Minsky Moment in Asia fifteen years ago, home prices in Hong Kong cratered 70%!

Of course, our home-grown housing disaster was very much a product of Minsky's theory that stability leads to instability. Years of low interest rates and, even more enabling, an extended period of incredibly lax lending standards catalyzed our bubble's implosion. As one who began warning of housing's inflated status two years before the edifice began to crack, I vividly recall how hard it was to fight the euphoria. The relentless rise in property values made it appear as though they had achieved a "permanently higher plateau." Yet once again, the clock was about ready to strike the Minsky Moment.

One of the less well-known aspects of Mr. Minsky's thesis is what happens once a bubble runs into a sharp object. As asset prices begin to fall, the leverage employed to carry them becomes threatened and lenders do what Mark Twain said more than a century ago: they take away the umbrella they lent you when the sun was out as soon as it starts raining. Loans get called in, triggering the forced liquidation of—and this is the key nuance—*high-grade assets*.

The reason it's frequently the good stuff that gets sold off first is that, in the early stages of a Minsky Moment, these are often the only assets that can attract buyers. The truly speculative caca is virtually unmarketable.

If this is bringing back shades of 2008, and sounding faintly like what is going on right now, you are definitely paying attention.

Been there, suffered that. As noted in numerous past *EVA*s, the fall of 2008 was not only extremely traumatic for me, as it was for almost all investors, it was also embarrassing. Repeatedly throughout 2006 and 2007, I had warned of a coming reckoning for housing and, reluctantly by September 2007, of a US recession. In preparation for these related events, and the collapse in interest rates we believed would follow, we had positioned our clients' portfolios in high-quality bonds and preferred stocks. Unfortunately we overlooked the Minsky Moment nuance.

Once Lehman failed, a global margin call of the first order kicked in. Normally defensive and non-volatile securities were being liquidated simply because they could be. The dodgy sub-prime "CDOs" became so radioactive that no one would touch them, at least not at prices above 15 cents on the dollar. Accordingly, investment-grade corporate bonds and preferred stocks fell as much as 40% nearly overnight. Even more remarkably, this was occurring while the Fed was frantically cutting interest rates, a backdrop that would normally cause a powerful rally in yield instruments.

Unsurprisingly, Evergreen clients were less than thrilled with this turn of events. For me, getting the formula right but the answer wrong was, to say the least, rather humbling. However, it did have an enormous upside. What had once been very attractive opportunities to attain high yields plus appreciation morphed into the equivalent to buying stocks in 1974 and 1982. Specifically, a blue chip preferred stock that had been selling for 85% of face value yielding 8% was now selling at 60% of par, with a cash flow return of over 11%. And this was happening with inflation falling toward 1%, so that real yields were a staggering 10%.

Now, in a rational world, or an efficient market, such a scenario should be impossible. Buyers are supposed to immediately step in to gobble up such incredible bargains. Yet, prices for high-income securities actually kept falling for months with a few halfhearted rallies along the way. In reality, as I clearly recall, it was almost impossible to convince folks to bring out their checkbooks (fortunately, in our discretionary accounts, we were able to move without client approval). Fear had utterly paralyzed all but the most intrepid investors.

The reason for this brief history lesson is that we are seeing a "kinder, gentler" replay of this situation today. However, there is a slight difference. Instead of everything going down except cash and government bonds, as was the case in the fall of 2008, even Treasuries are getting thumped this go-around. This is one of the main reasons I'm convinced that we have another global margin call on our hands.

Certainly, it hasn't approached the apocalyptic dimensions of 2008, at least for now, and I seriously doubt it will. But there's no mistaking the whiff of panic in the air. Once again, conservative income vehicles are taking it on the chin. Investment-grade corporate bonds are now down 5% on the year, a fact of which I don't think most investors are aware. Even the very short-term and almost yield-free, Barclays Aggregate Bond Index is off over 4% at the halfway point in 2013.

Yet, it's the action in the Treasury market that is most curious.

Getting "interest"-ing. For months now, a recurring *EVA* theme has been the coming demise of the great bond bull market, of which I have been a proponent from its improbable birth in the inflation-ravaged early 1980s. But, I have also said that I didn't think it would be this year and, despite its recent stumbling, I still don't. In fact, we have recently warmed up to longer bonds as insurance against what our partner Charles Gave believes will be a deflationary shock of some kind (like either the Asian crisis or the Lehman collapse).

One of the reasons Charles is worried about such an outcome is that real, or inflation-adjusted interest rates, are rising, as you can see from the following chart. Based on the continued yield surge from when this chart was created in mid-June, this situation has become more acute. In his view, this is particularly problematic when global growth is sluggish at best and recessionary at worst, as is the case today.

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The 10-year Treasury note, which traded at 1.6% as recently as May, hit 2.66% at one point this week before backing off slightly. Even though this is coming off a low base, it is still a mammoth increase. A bond market reality is that when Treasuries catch a cold, the rest of the yield world contracts pneumonia. And government bonds have come down with one heck of a cold lately. Thus, we are seeing extreme respiratory distress in areas like leveraged closed-end municipal bond funds, mortgage REITs, and even utility stocks (equity REITs have corrected as well but remain highly valued).

Two specific examples might drive this home. First is a mortgage REIT, which primarily buys

government-backed loans. We previously sold it out of our clients' portfolios at over \$17 not long ago. Now, it is trading under \$13, selling at a 15% discount from book value and yielding 11%. Reduced refinancing activity due to higher rates, much wider spreads (based on their unchanged borrowing costs, with short-term rates still anchored as far as the eye can see), and far higher mortgage yields have improved its prospects even as the share price has melted.

Another illustration is a leading utility whose stock has tumbled by 14%, raising its yield to 5.7%, despite a materially improved regulatory outlook. Additionally, the company is committed to regularly raising its dividend over the next few years.

(On a related note, our long-favored master limited partnerships, or MLPS, have held up amazingly well; at least I am amazed. But I suspect this resiliency is due to a flurry of newly issued closed-end MLP funds providing near-term buying support. This is unlikely to continue as we are trimming back on our MLP's.)

Consequently, being inveterate contrarians, Team Evergreen is actually more excited about the world of yield investments than we've been since the summer of 2011 (which turned out to be a most lucrative time to buy high-income issues). But, based on the string of angst-ridden emails and phone calls that are streaming in, from both clients and other investment pros, it's clear that fear has quickly replaced greed.

Beyond our anecdotal observations, the fact that redemptions out of bond funds are breaking records is *prima facie* evidence that we've got at least a mini-panic on our hands in bond land. It appears that the chickens the Fed has been raising, as in all the normally fearful investors it has goaded into taking more risk, are coming home to roost.

A little chatter, a big disaster. As a result of feedback I've heard both directly and indirectly, I realize many *EVA* readers and Evergreen clients feel I've been too negative recently, similar to perceptions six years ago about my housing and recession calls. Unquestionably, the most dominant *EVA* message of the last two years is that the Fed was printing itself into a very tight corner.

Frankly, I don't see how a rational person can look at the market action around the world over these last few weeks, ever since our dear Fed chairman obliquely hinted at "tapering," and not recognize how tenuous the situation is presently. Imagine if he actually announced that the Fed was tapering (apparently, a word the Fed hates even though it was created by its own wordsmiths) and not just talking about it at some indefinite point in the future. Or, God help us, that it was actually turning off the fire hose. Or, almost inconceivable in its ominous portents, that the Fed was preparing to become a seller of its massive trove of government and government-backed obligations.

A market truism, or at least tendency, is that bonds lead stocks. In other words, what happens in bonds doesn't remain quarantined there, but gradually infects stocks. In my experience, a little bond weakness can be shrugged off by the stock market. However, when extreme stress afflicts the fixed-income universe, equities eventually begin to wilt.

One reason I believe this will be the case once again, particularly if rates move much higher, is that we are moving away from what I've called the LBO market, as in Least Bad Option. When you can get 6% to 8% with upside potential, as is becoming increasingly prevalent, stocks have some serious competition.

One point we've been making of late is that this market is significantly more expensive than in

October of 1987, right before you know what (if you don't know what, you might want to do some reading up on the subject). Yes, interest rates were much higher but the economy was growing far faster.

Of course, a repeat of 1987, with all of those computers running wild, could never happen again, right? Certainly not in this stable world, with trillions of dollars of derivatives still floating around, and high-frequency trading making up close to 50% of total trading volume.

3 is the new 10. Because I lived through the crash of 1987, though it was almost a near-death experience, I'm very aware that it took 10-year Treasury yields vaulting from 8% to over 10% to set off that terrible chain reaction. Obviously, those kinds of rates aren't in the cards anytime soon.

Yet, in this fragile world we live in, I don't believe it will take much more than 3% on the 10-year Treasury to create some severe dislocations in the US stock market. Per the table below, you can see that numerous other world markets have come off much more than the puny 4% hit the US market has incurred. Part of the reason for this global sell-off, I believe, is that rates are rising almost everywhere, in some cases significantly.

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In addition to the previously mentioned competition that higher rates pose for stocks, they also inhibit the sector that is supposed to be the shining star of our otherwise dull recovery: housing. But that's not the only drag the economy is facing.

One of the reasons Charles Gave has become more concerned about some type of deflationary bust is the continuing collapse in money velocity. He believes the various QEternity programs around the world are failing, other than to temporarily inflate asset prices, because they are driving money velocity through the floor. When you look at the facts, it's hard to argue with him.

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Another distressing aspect of this is that we are seeing inflation contracting as rates rise. Across the developed world, what economists wonks call the OECD, inflation has fallen below its Great Recession lows. This, good readers, is not the way the financial textbooks say it's supposed to work. Yet it is just another example that conditions are currently light years from normal. (See chart.)

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Rising real yields tend to be a razor to the jugular of weaker borrowers. This is likely a leading reason emerging markets have been reeling, even though they are in much better shape than they were 15 years ago when the big kaboom hit Asia. For instance, one of Brazil's biggest industrial empires, whose founder was reportedly worth nearly \$40 billion a few years ago, is on the brink of collapse.

Yield spikes also tend to panic the very investors who should welcome them, as evidenced by the mad dash for the exits now that bond prices have swooned. This is the behavior pattern decried by countless past *EVAs*, and it happens with all asset classes (witness the frantic

exodus out of gold right now). It is classic "wrong cycle investing," the antithesis of what we try to practice at Evergreen.

We can't urge you strongly enough to understand what is going on before you impulsively react to falling prices or losses on your monthly statement. The fact that you can now lock in a 7% yield on high-quality income investments for years to come, often with the prospect of rising cash flow and price recovery potential, should be viewed positively not negatively. As I wrote back in early 2009, don't let fear be the mind-blocker in these kinds of markets.

Regular *EVA* readers know this is precisely the kind of scenario we have been warning about for well over a year, except that US stocks have skirted most of the damage. It's why we have held cash and hedges despite a fair amount of criticism for both. We had also shifted from longer term bonds to much shorter maturities over the last 9-12 months in preparation for the day when investors, who had been lured by a wily Fed into taking on more risk than they are comfortable with, hit the panic button.

Despite all of our defensive maneuvers, we are still taking some hits. Even a bond that falls just 2% wipes out all the income it produced this year. But, we are extremely well positioned to capitalize on the bargains being coughed up, putting it politely, by over-leveraged or fear-stricken investors.

We realize it's very possible this "great unwind" of the carry trade described last week will continue to worsen, rendering income investments acquired today even cheaper in the weeks ahead. That is why we will move gradually and methodically. But if the Minsky Moment unfolds as it usually does, it won't be much longer until high-quality yield investments become money magnets.

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