March 1, 2013

"When I find myself on the side of the majority, I know it's time to find a new place to side."
-MARK TWAIN

1. Post-financial crisis market rallies have tended to run out of steam when Market Vane's Bullish Consensus Stock Index has hit current levels. (*See Figure 1*)

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2. Although bonds have generated higher returns than stocks for more than 30 years, one of the longest stretches of stock performance inferiority ever seen, over the last 87 years, equities have clearly out-legged fixed income. Yet, on a risk-adjusted basis, the Sharpe ratio (which considers how much risk, or volatility, was incurred), bonds have actually excelled, even over nearly nine decades. (*See Figure 2*)

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*STNDEV – (Standard Deviation): measures the amount of variability or dispersion around an average; a measure of volatility.

3. One worrisome aspect of the stock market's recent attainment of its highest level since 2007 (aka a new recovery high) has been declining volume, continuing a long-term trend. Average trading volume on the NYSE fell 26% in 2012 compared to 2011, notwithstanding a 16% rise in share prices. Sub-par trading activity has continued into this year despite the ongoing rally. (*See Figure 3*)

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4. Although stock prices appear overbought currently, market skeptics can no longer cite the failure of the transportation average to confirm the advance. (*See Figure 4*)

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5. Past EVAs have noted that when the overall market's Shiller P/E (based on an inflation-adjusted average of the prior decade's profits) is 23, as it is today, returns have only averaged 1% in real terms over the next 10 years. Similarly, whenever it has been this elevated, stocks have typically underperformed T-bills by 30% or more over the next year.

6. There may be no free lunch in the financial markets but the present relative cheapness of high-quality stocks might be close. Per the *Financial Times*, since 1926, higher volatility issues (i.e., riskier) have produced roughly the same return as lower risk shares. And, since 1946, they have mostly underperformed. Thus, blue chip companies offer far superior risk-adjusted returns, especially when they are comparatively undervalued as they appear today.

7. Looking at a variety of economically sensitive measures, it is hard to discern signs of vitality. If anything, the patterns appear to be suggesting a slowdown if not an outright recession. (Evergreen continues to believe that sluggish growth, rather than an actual contraction, is most probable.) (*See Figures 5 through 9*)

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8. Few companies are a more accurate harbinger of the overall economy than UPS. And, the

company well known for its brown trucks recently released soft earnings and, more meaningfully, reduced its 2013 outlook.

9. Thanks to almost irresistibly low prices, natural gas now produces 30% of total US electricity, up from 18% a decade ago. Over this time frame, the portion generated from coal has tumbled from 50% to 37%.

10. In recent years, there has been a very tight linkage between the size of the Fed's balance sheet and gold prices. Based on its avowed plans to fabricate another $1 trillion this year in order to buy more government bonds and mortgages, gold may well have one more material up-move in its future. It has also closely tracked the Peoples' Bank of China's (PBoC's) balance sheet expansions. (*See Figure 10*)

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11. Another area in which Canada stacks up well relative to other countries is its ratio of workers to overall population. In 2010, it was second only to China in this regard. (*See Figure 11*
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12. While US economic activity continues to be mixed (though, in Evergreen's view, skewed to the weak side), the same is not true in Japan, Europe, and the UK. All three of those economies are back in recession, meaning that nearly 40% of the planet's GDP is once again in contraction mode.

13. The Spanish stock market has risen more than 30% from its lows last summer despite a recent correction. As is the case throughout most of the developed world, this is a dramatic divergence from what is occurring in its economy. (*See Figure 12*)

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14. Japanese stocks appeal to value investors given that they trade close to book value versus twice book in the US. Yet, American companies have a return on equity three times that of Japanese corporations. So, when adjusting for this, the US market is actually more attractively valued despite being pricey on a Shiller P/E basis.

15. Although China's recovery isn't being stoked by reckless and excess bank lending, the growth in non-traditional loan creation is concerning.   This is uncomfortably reminiscent of the surge in "shadow bank system" lending in the US prior to the Great Recession. (*See Figures 13 and 14*)

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~~Good~~ Bad as gold? It would be difficult, if not downright impossible, to imagine a set of circumstances more supportive of gold than today's conditions: Interest rates that are negative net of inflation; central banks worldwide conjuring up fake money by the trillions as they vie with each other to debauch their currencies; governments spewing red ink at rates never seen in peacetime; and, to top it all off, a profound and pervasive lack of trust in "the system."

Yet, in a world where almost every asset class seems to be riding the wave of the Great Levitation, gold is fading like the Seattle Seahawks defense protecting a late-game lead (yes, I'm still bitter over how they squandered one of the greatest comebacks in NFL playoff history). In the "what have you done for me in the last nanosecond" investment world we live in, gold has quickly become the Cleveland Browns of asset classes.

Of course, the "gurus" in the financial media are always willing to provide an after-the-fact rationale for why a given investment is rising or falling, even if they have no clue, which is usually the case. But, frankly, none of the scenarios they are putting forth makes much sense to me.

Accordingly, it was serendipitous that last week I had one of the brightest commentators on gold and gold mining stocks, Grant Williams, in town for Evergreen GaveKal's Annual Outlook event. Even more fortunate was that Grant and I headed down to Indian Wells, California, the next day to spend a weekend mingling and kibitzing with the leading lights of the precious metals investing world.

Among these celebrated bullion bulls were John Hathaway, manager of the Tocqueville Fund, John Mauldin, whose newsletter fame requires no elaboration, Simon Mikhailovich, distressed debt expert and now creator of one of the more intriguing gold vehicles I've come across, and Seattle's own Bill Fleckenstein. In the case of Bill, I've tracked his career for years and although, like me, his warnings have often been early, they've consistently been borne out by the passage of time (and the latest investment fad).

Before I attempt to summarize some of what I learned last weekend, I wanted to clarify, especially for newer readers, that I am far more comfortable with blue chip stocks and yield-oriented securities than I am with gold. In fact, for most of my career, I've argued against gold relative to other more productive investments. However, about five years ago, I came to believe it was an attractive hedge against what were becoming increasingly desperate governmental responses to the global financial crisis.

In reality, gold has done commendably well as measured from the end of 2007, before the world began to spin off its axis. Bullion is up 89% since then, while stocks, despite all the hysteria over their effervescence of late, are essentially flat. More strikingly, if you go back 13 years, to the March 2000 peak, stocks have produced about 1.8% per annum, including dividends, or around 15% compounded, while gold is up a truly glittering 454%. And even though it was perceived to have had a disappointing year in 2012, the yellow metal still rose 7%.

However, as chronicled in past EVAs, the miners have been a very different story. Since 2010, the gold miners ETF (exchanged-traded fund) has melted by 38% despite gold being up 11%. Thus, producers like Barrick and Newmont have been pounded even as gold was rising.

The damage has become so serious that many mining issues, including the two mentioned above, have broken three-year support (i.e., trading below their lowest levels of the last 36 months). As many of you know, Evergreen has a hard and fast sell rule to exit such situations. Yet, as congenital contrarians, we don't want to be out of this devastated sector. Thus, I was most interested to hear from the aforementioned precious metal experts about their favorite ideas in this space, hoping for a few names still holding above critical support. Fortunately, I wasn't disappointed.*

*For compliance reasons, I am not able to share company-specific recommendations (I know, I hate this rule, too!)

In Ben We Trust. In the past, I've attended events in the midst of a general or sector-specific bear market. Typically, the gloom was so deep that the participants seemed more intent on handing out business cards for their next career move than capitalizing on the panic. Perhaps it's because the folks I was hanging with in the desert have weathered so many prior storms that they were notably unruffled. They seemed to have no problem with the fact that they have gone from the toast of the town to just plain toast.

Their collective view is that prevailing sentiment has become so universally hostile toward gold, and gold shares, that a powerful rally in the next six months is a near certainty. As Grant pointed out, and the others confirmed, bullish positions on gold are at their lowest in five years. John Hathaway, who looks like a US senator straight out of central casting (sorry, John, I don't mean to sully your reputation by such a comparison), believes you can buy gold stocks without compunction, if you can hold them for at least six months, due to their extreme undervaluation.

They also felt it is extraordinary, almost inconceivable, that the gold extraction companies have underperformed the commodity price itself by 80% over the last few years. And even though I was mostly in listen-only mode, I did receive strong agreement with my thesis that the decade plus rally in gold has not yet produced the parabolic rise that characterizes the end of almost every mega-bull market. Grant had coincidentally created the chart shown below for his conference presentation, comparing the 2000–2013 bull run in bullion with that of the 1970s. As you can see, the current advance has been a thoroughly controlled and deliberate affair. Therefore, the most explosive stage of gold's ascent may well lie ahead.

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Of course, if you believe US policymakers have their arms around our myriad problems, with latter-day versions of Ronald Reagan and Paul Volcker waiting in the wings, gold is probably not your asset class of choice. But Simon Mikhailovich had one of the best sound bites when he told me: "The US government has the Midas touch. Everything it touches turns into a muffler."

He also made the point, with which I wholeheartedly concur, that trust was one of the primary casualties of the 2008 cataclysm. In his (and my) view, there's a very high probability that, once the artificial high from the central bank liquidity fixes wears off, global investors will express, and act on, deep reservations about paper assets. After all, the essential foundation of so-called fiat currencies is faith in the issuing government. You don't have to be a die-hard gold bug to realize that most of the developed world's sovereign entities are not exactly in the "building trust" behavior pattern.

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And, yet, for the time being, there has been a revival of trust that the grandees of central banking and government have the situation under control. In my mind, that's the main reason gold has been acting as feebly as the planet's most valuable tech company (which has had more than a few bites taken out of it lately).

The overarching question is whether the powers-that-be have got us back on the path to true stability and prosperity. If an investor is skeptical about the unfolding of that rosy scenario, given current US policies, then this may be the best opportunity to buy insurance, on the cheap, that he or she will get in a very long time.

David_Hay_Signature

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