

March 15, 2013

"You are neither right nor wrong because the crowd disagrees with you. You are right because your data and reasoning are right."

-BEN GRAHAM, WARREN BUFFET'S STOCK MARKET MENTOR

In this latest issue of *Points to Ponder*, we are altering our usual format a bit to include one of the more interesting items I've come across lately. This piece is courtesy of my friend and fellow newsletter scribe, Simon Hunt*. It is particularly timely given that last week the Dow Jones exceeded its 2007 high. As you will read, the contrast between the strength of the US economy now versus then, not to mention federal government finances, is, to say the least, an eye-opener.

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* Cargo and shipping specialist, Charles de Trenck, who works closely with GaveKal Research, brought this to Simon's attention.

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Au, contrarian. For those EVA readers who harbored any doubts, let me be high-definition clear: Evergreen GaveKal is a congenitally contrarian firm. Of course, as chief investment officer, I set the tone for this mind-set but I have plenty of company on the investment committee.

My personal contrarian streak runs back at least as far as the Japanese stock market mania of the late 1980s, when I said the Nikkei was absurd at 20,000. It then proceeded to double but, nearly a quarter century later, it remains 38% below the level at which I believed mass greed had overtaken rational investment analysis.

The next example of my "prescience" was when I said the NASDAQ, in 1998, was approaching bubble terrain. It, too, went on to double in short order, leaving me with about as much credibility as the Seattle Mariners' front office. (Obviously, I have a God-given ability to underestimate bubbles by a mere 100%!) Yet, within a few years, it had plunged to around 1200 or roughly half the level I had felt was extreme overvaluation.

Then there was my personal jihad waged on the housing frenzy, which I began in earnest in 2005. However, home prices continued to sprint higher for another two years, once again causing many to question my judgment, sanity, intelligence, or all of the above. Enough said on how that one turned out...

On the bullishly contrarian side of the ledger was my strident advocacy of high-grade corporate

bonds, preferred stocks, and MLPs (master limited partnerships) in late 2007. My team and I believed a recession was probable in 2008 due to the puncturing of the real estate and lending bubbles. We saw interest rates coming down hard and we wanted to lock in juicy yields before they dried up, as well as to position for capital gains.

Unfortunately, even as interest rates did a veritable bungee jump (without the recoil) in 2008, our conservative income investments behaved in anything but a defensive manner. For a short time, many high-grade bonds and preferred issues fell by 30% to 40%.

However, as longtime Evergreen clients know, this additional instance of being a tad premature worked out just fine despite some serious heartburn along the way. Fortunately, we had cash and cash equivalents on hand to press our mistimed bet on income vehicles. In fact, as I've often told Evergreen clients, we would have made substantially less if there hadn't been the post-Lehman panic that crushed almost everything that was not government guaranteed.

Yet, even though high cash flow investments were the main object of our affection back then, we were also manifestly bullish on equities--a stance that was about as popular then as being cautious is today.

Thanks for the Memorex. One of the continual battles we fought in the wake of the meltdown was against the argument that it would be many years before investors trusted the market again. But even before the Great Recession ended, stocks were rallying furiously, showing once again how short memories are once a bull market gets rolling.

By early 2010, however, with the market up 80% from the bottom, we began to be less sanguine about stocks, believing that corporate yield securities continued to offer the potential for better risk-adjusted returns (a view that subsequent price action bore out, at least until this year). Then, in the first quarter of 2011, we started to perceive a pattern of economic activity and stock prices peaking in the late winter and early spring, followed by a decided drop-off in both during the summer and fall.

Consequently, EVAs for the last few years have correctly warned of excessive optimism on both the market and the economy in the early months of 2010, 2011, and 2012. What we didn't do as well at was becoming more aggressive after the various corrections we foresaw played out. While we did offer some encouragement to buy into the weakness, and did a reasonable amount of buying for our clients (especially of MLPs), in hindsight we should have become fully invested during those mini-panics.

A major reason for our timidity during the air-pocket events of the last few years was our discomfort with the synthetic nature of the economic and market recovery. Those of you who are as old as this author recall the old commercials where a glass would be shattered by one of singer Ella Fitzgerald's high notes, followed by the famous voiceover question: "Is it live or is it Memorex?" In our view, most of what has been propelling US stocks and business activity falls under the Memorex category.

Of course, the glass in the commercial was broken regardless of the source and the recovery of the last few years has nonetheless produced real profits (unless, of course, you benchmark them against a non-printable asset like gold, in which case stocks and corporate earnings are far below their 2007 peaks).

Therefore, the question investors should be asking themselves right now is whether this Memorex market can keep on singing—and surging? And, related to that query, is this year really different?

Same time, this year? As I've written at least once before, there's an old Wall Street saying that the most dangerous words when it comes to investing are: "This time is different." Yet, based on stock indices breaking out to new highs (or on the verge of doing so in the case of the S&P 500), that does seem to be the collective wisdom. Implicitly, investors are voting with their money that the pattern of the last few years won't repeat. In fact, I am reading an increasing number of comments about the booming US economy.

However, the brainiacs at a very important entity disagree, and inveterate contrarians might want to hear them out. The Economic Cycle Research Institute, popularly known as ECRI, isn't your typical me-too economic think tank. For one thing (and a most important thing it is), ECRI correctly forecasted the last three recessions. The rest of the economic soothsaying community at large has, embarrassingly, somehow managed to miss all three (though certain renegades such as David Rosenberg have been exceptions to that sorry rule).

Despite this commendable track record, ECRI of late has been the object of withering criticism, even derision. This is due to its now infamous call in late 2011 that the US economy was either in recession or soon would be. Because it *appears* that no recession developed last year, the prevailing Wall Street view is that ECRI has lost the plot.

Thus, it was with great interest that I read its March 2013 missive written by ECRI co-founder and COO, Lakshman Achuthan (warning: don't try pronouncing his name to impress your friends after a couple of adult beverages). It was truly one of the clearest and most concise overviews I have seen of our current economic rhythm.

ECRI has a term for what we are going through right now: the Yo-Yo Years. When you reflect on the chart from the previous page (courtesy of another powerhouse econometric firm, ISI), it's hard to argue with the Yo-Yo description. But it begs the question as to why this has been the case, which might also shed some light on whether the pattern will continue this year. Or, could it be that this up-then-down cycle is simply a coincidence?

It's been my experience that one should be highly skeptical of coincidences, especially as they pertain to the financial markets and the economy. Yet, they do occur and it's possible that's all it has been. Mr. Achuthan, however, believes there is a logical explanation and that it is directly related to the cliff dive in global business activity in late 2008 and early 2009.

Here's why: The government's computer programs, which make seasonal adjustments to real-time economic data, have apparently incorporated the unprecedented plunge of '08-'09 as "a lasting change in the seasonal pattern itself, rather than being an isolated event." He goes on to note: "So, in recent years, the seasonal factors for the fall and winter months have effectively been expecting the data to be so weak that they are being adjusted upward in a way that makes them fairly strong."

Of course, this could be a classic case of torturing the data until they tell you what you want to hear but, in my mind, Mr. Achuthan's analysis is thoroughly credible. The next pressing question is: Does he see the pattern being broken this year?

Some cynics have accused ECRI of rationalizing its missed call. However, its view is that recessions are never contemporaneously recognized; rather, their actual start isn't identified for several quarters after they're underway. Thus, ECRI believes the summer of 2012 may well be the official start of the next downturn.

Lending considerable credence to its contention, the following chart shows the rate of change in nominal GDP (this is a measure of total economic activity, including inflation, versus the more typical real GDP). As you can see, and as Mr. Achuthan points out, since 1981 the economy has gone into recession each time nominal GDP has fallen below 3.7%, which it recently just did.

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It's fair to observe that four prior examples isn't exactly a deep sample set but, regardless, the above chart does make it clear that the US economy is far from en fuego. Given that we've got the lagged impact of a \$60 billion hit to consumer spending power, due to higher gasoline prices, combined with a potential drag of almost 2% on GDP from tax hikes and the sequester looming up ahead, the probability appears high to me that the Yo-Yo Years are not behind us.

Additionally, Steve Vanelli, who runs our partner GaveKal's US equity operations in Denver, is picking up on the same vibes. (By the way, Steve is the proud owner of an exceptional long-term stock market-thrashing track record.) In the following chart, he notes that P/E ratios have peaked early each of the last three years and appear to be doing so again in 2013.

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Consequently, he is reducing risk at a time when less sophisticated and/or less seasoned investors are doing the opposite. And, as noted in recent EVAs, insider selling is running at one of its most intense levels of the last few years.

It's certainly possible that ECRI, Steve Vanelli, and those in-the-know in corporate America are wrong, while the same group of investors that has been emboldened in the first quarter of each of the last few years is right. But do you really want to bet that way?

On a lighter but related note, Will Rogers told audiences back in the 1930s that he didn't make jokes—he just watched Congress and reported the facts. As many veteran EVA readers are aware, for years Seattle sports teams have been my version of Congress: a never ending source of tragicomic material. Looking ahead at the on-paper potential of both the UW Huskies and Seattle Seahawk football teams, 2013 may be the year I need to show Seattle sports teams some respect (excluding, of course, the Mariners). But I'm not sure I'd want to bet that way, either.

David_Hay_Signature

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