

March 16, 2012

"We live in what most business commentators call a volatile world. I would argue that when the environment is continuously unstable, it is no longer volatile. Rather, we have entered into a new economic era. It could remain this way for a long time."

-GE CEO, JEFF IMMELT

POINTS TO PONDER

1. It's common knowledge that the long and vicious bear market in housing has created exceptional affordability. However, looking at a chart of how cheap homes have actually become relative to interest rates and income levels is nonetheless arresting. Additionally, prices excluding distressed sales appear to be bottoming and the supply of new homes on the market has returned to its long run average.


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2. While pain and suffering have been a chronic state for the single-family housing market for years, the multi-family sector has been increasingly euphoric of late. Rental vacancies have recently fallen below their long-term trend line while rents have been steadily rising. The good times, though, are creating a supply response with apartment starts up 56% in 2011, albeit from a low base.

3. In its latest statement on economic conditions, the Fed did slightly alter its outlook by becoming somewhat less guarded. Should the economy accelerate further, it will almost certainly require the Fed to begin offloading its massive holdings of treasury and mortgage debt, likely beginning the long process to normalizing interest rates. While this is essential to restoring healthy lending markets, it is likely to cause some turbulence.

4. Unlike large cap tech stocks, big oil issues have lost some \$1.5 trillion of market value since 2007 despite a 53% increase in the price of Brent crude in that time span. The biggest losers among the mega energy producers have been state-owned oil companies such as Petrobras and Petrochina. These goliaths have seen their market capitalizations chopped by 44%, far worse than the 22% shrinkage by super-majors like Exxon.

5. Technology stocks have long been favored by this newsletter and the NASDAQ has now managed to recover its entire market loss from the 2007 peak. Meanwhile, the S&P 500 is still well below that level. Despite this robust recovery, tech stocks remain at surprisingly low P/E ratios. Part of that, however, is due to profit margins which are elevated to an unprecedented degree, partially due to Apple.

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6. Speaking of the largest companies, despite recent outperformance, the largest 100 companies in the S&P have lost 0.4% per year since March 2000 versus an annual gain of 4.2% for small cap stocks and 7.2% for mid-cap issues. The top 100 also sell at just 12 times forward earnings estimates versus 15.4 times small caps.

7. Increased consumer borrowing has been cited as another example of an improving economy. However, much of this is related to rising student loan balances. In January, overall consumer credit actually contracted by \$13 billion, the sharpest decline since March, excluding a \$28 billion surge in student loans outstanding.

8. The February jobs report once again was viewed as a major positive. The fact that the six month cumulative rise in nonfarm payrolls totaled 1.2 million, the highest half-yearly increase since 2006, certainly justifies a degree of optimism. Yet, according to Gluskin Sheff's David Rosenberg, mild February weather accounted for 60% of that month's job gain.

9. Among the numerous reasons Evergreen does not expect a recession this year, despite high profile sources predicting a downturn, is that private sector debt has been contracting and capital spending is extremely subdued. Both of these tend to peak when the economy is poised to roll over.

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10. Unfortunately, it appears that any resurgence in corporate fixed asset expenditures is not happening quite yet. Capital goods orders fell 4.5% in January, the most in a year and have now declined in three out of the last four months.

11. As has been the case for several years, US real (after inflation) wages remain very depressed. Encouragingly, though, the trend is clearly up, a plus for both workers and future consumer spending. The loser in this, however, is corporate profit margins; rising wages and unit labor costs also have negative implications for inflation.

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12. Corruption and China are virtually synonymous but the scale is nonetheless astounding. The People's Bank of China estimates that between the mid-1990s and 2008, roughly 17,000 officials at state-owned enterprises have siphoned off \$123 billion.

13. The US is not the only country where labor is at long last gaining a greater share of the economic pie. Chinese workers are achieving 20% wage increases in many cases, leading to a marked jump in the cost of imports from China. As with increasing US unit labor costs, this is likely to place upward pressure on our CPI.

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14. In a development that should be sending a shiver up the spines of European policymakers, one of the original architects of the Greek debt default, Duke University's Mitu Gulati, is

advocating that other peripheral eurozone countries should do the same.

15. A recent EVA prediction was that the latest Greek debt reduction cram down would finally trigger Credit Default Swaps (CDSs). That has turned out to be the case but the impact should be muted unless countries like Portugal follow suit. However, another forecast is that this won't be the last pound of flesh extracted from Greek lenders as even in the best case scenario Greece's debt burden remains a towering 160% of GDP. Tellingly, new Greek government bonds are trading at just 25 cents on the dollar.

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