

March 2, 2012

"Investing when something is undervalued and waiting for a return to normal valuation is called investment. Waiting to move from fairly valued to overvalued is called speculation."

- CHARLES GAVE

POINTS TO PONDER

1. The February 3rd EVA noted the persistent drop in US retail sales over the last three months of 2011. In January, however, this measure improved significantly. It remains to be seen how much of this was a function of unseasonably mild weather.

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2. Notwithstanding the popular view that the US economy is out of the woods, the renowned Economic Cycle Research Institute (ECRI) is reiterating its view that the US will soon enter a recession.

3. US tax reformers might want to consider Great Britain's recent experience with raising marginal rates. Last year, the UK boosted the highest tax bracket (which kicks in at roughly \$225,000) to 50% from 40%. Yet, based on preliminary numbers, it appears this has reduced revenue from top earners by 5%.

4. In another indication that the labor market remains exceptionally weak, the unemployment gap, tracking the spread between the official jobless rate and a more comprehensive measure including the marginally employed, has just hit an all-time high.

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5. The really Big Apple these days is a stock not a city, with 10% of this year's broad market gains attributable to Apple alone. Moreover, without the Cupertino colossus the S&P 500's year-over-year fourth quarter profit increase would have been a mere 2.9% rather than the reported 6.7%, and overall profit margins would have actually contracted. (Interestingly, AIG accounted for an even greater share of Q4 2011 earnings growth.)

6. The government bailout of AIG was front-page news back in 2008 as federal funds were being used to prevent the insurance giant's collapse. As these have been repaid, however, you have to dig deep to find articles on this topic. A recent *Wall Street Journal* article on page C4 noted that the Fed has sold another block of mortgages acquired from AIG, netting a gain of \$2.8 billion.

7. As noted in prior EVAs, a troubling aspect of the market's recent powerful rally is that it has occurred on very light volume. Additionally, the typically leading-edge transportation sector has been underperforming of late. Yet, indicating there could be further upside, the overall rise from the March 2009 low is still below average in terms of both longevity and total return.

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8. Financial markets are remarkably placid in the face of Brent oil prices nearing \$130 per barrel, but consumers are starting to feel the pinch. The 29 cent per gallon rise in pump prices over just the last month, with more likely to come, represents a \$38 billion drain on household

disposable income. Ironically, crude oil stranded in Canada due to a lack of pipeline takeaway capacity is trading at just \$63 per barrel.

9. Natural gas prices in the US continue to trade at just \$2.60 (per mBtu), roughly 1/40th of oil versus the normal 1-to-10 ratio. In contrast, natural gas in Japan trades at \$16, suggesting that the US has both significant export opportunities and competitive advantages, with companies such as Dow Chemical enjoying a major cost edge versus their international peers.

10. Even though the incessant advice spewed out to investors to place heavy bets on the BRIC (Brazil, Russia, India, China) countries was misguided, over the last three years export growth has been far greater than in developed markets. Compared to its mature peers, however, the US has been a relative outperformer.

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11. Mushrooming government debt in southern Europe has received most of the press, but in the crucial country of Spain private sector indebtedness is just as worrisome. Overall non-financial Spanish corporate debt is 12 times pre-tax cash flow. Normally, a ratio of 10 times pre-tax cash flow is considered to represent a junk credit.

12. According to *The Economist*, iPads alone account for \$4 billion of America's trade deficit with China due to the fact that the entire \$275 production cost is considered to be a function of Chinese inputs. However, the actual value of work performed in China is a mere \$10. Consequently, the World Trade Organization (WTO) estimates that adjusting for actual domestic content, America's trade deficit with China would be cut in half.

13 During last year's emerging market (EM) bloodbath, investors did not show much loyalty to this asset class, as they were, on balance, significant sellers when prices were down. Now, with these markets experiencing a vigorous recovery, investors are once again plowing money into EM funds.

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14. When the Shanghai Composite peaked back in November 2007, it was trading at a higher price to book value than either the Nikkei in 1989 or the Nasdaq in 2000. Since then, it has plunged by 58%. But with Chinese regulators forcibly deflating its follow-on bubble in property prices, stocks might be beneficiaries given that China's households have more in bank deposits than the combined GDP of Brazil, India, and Russia.

15. In a recent feature article in *Barron's*, legendary money manager Jeremy Grantham projects that the overall US stock market will produce just a 5% return over the next seven years (though he sees the largest companies doing better). Coincidentally, this is almost precisely the return anticipated by another crack investor, John Hussman, based on the linkage between valuations and future stock returns over the last 70 years.

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Kind of ironic. For a guy who was one of the few saying to buy almost everything besides government bonds in late 2008 and early 2009, I find it a bit amusing to hear some refer to me now as bearish or, the ultimate slam to an innate optimist, a bear. Additionally, while I was concerned we were entering into a new bear market last fall, I also said I felt stocks could bottom as soon as October. Little did I know it would be early October and that if it was an actual bear market it was among the briefest on record (right up—or down—there with October, 1987).

Yet, there is no denying that I have been anticipating a correction for the last couple of months and I was—and am--doubtful that this is the beginning of a new bull market. However, I do agree with my astute colleague on Evergreen's investment team, Jeff Eulberg, who makes the

point that the devilish low of 666 on March, 9, 2009 is almost certain to mark the ultimate bear market trough. Thus, one could reasonably argue that is when the secular bull market began.

The problem with this reasoning, even though it is almost certainly true, is that it implies we have broken out of the 12 year trading range we've been in since early 2000 and that we are entering into a phase like 1982 with many years of mostly double digit returns up ahead. And while I believe a time like that is coming, it's not here yet. In my mind, we're in a phase similar to what happened between 1974 and 1982. The market bottomed in the year of President Nixon's humiliating resignation but it didn't break out decisively to the upside until half way through President Reagan's first term.

Hopefully, we won't have to wait eight years, from 2009 to 2017, until we finally do see a powerful and conclusive shattering of the 1550 ceiling on the S&P 500 that was first achieved in March of 2000 (and which also turned out to be the effective peak of the credit bubble-driven market in 2007). But the reason I ran the chart from John Hussman as Point to Ponder 15, even though it was somewhat out of context, is that I think it's extremely significant on this topic. The fact that one of the great return forecasters of all-time, Jeremy Grantham, agrees with him should also grab your attention.

Additionally, I wanted to explain the Hussman chart as I know it can be confusing. The basic idea is that the blue line represents what stocks should have returned over the next 10 years based on their valuation at any past point in time (lower values leading to higher future returns and vice versa) while the red line illustrates what they actually produced. For example, when the market was very depressed in the mid-1970s, it implied unusually high future returns and that's precisely what happened. Of course, this approach is logical--almost axiomatic--but the linkage is remarkable with one main exception: the late 1980s.

Based on prevailing valuation metrics at that time, the market should have produced good returns but not the 20% per year results typically only seen coming out of vicious bear markets. But, as we know, the reason for this "miss" was that stocks would enter into a speculative mania episode in the late 1990s (at least in tech which was where almost all investment funds were flowing) only rivaled by 1929. Then, of course, there has been the aforementioned dozen years of return-free risk. Thus, it's fair to say you can't have excessive gains without some subsequent pain. (Also, note how accurately this predicted the poor returns of the past decade; Dr. Hussman was running this chart back in 2000 though few paid much attention.)

My point is that even though there has undeniably been a nice string of surprisingly good news recently--including bond yields in Europe falling sharply, upwardly revised consumer income numbers, better US employment and consumer confidence readings--the reality is it's hard to make a case stocks are poised to deliver superior long-term returns. In fact, the odds are they will be sub-par, though Jeremy Grantham, like Evergreen, believes the long out-of-favor ultra blue chips should produce 7% type pre-inflation average annual gains. Not bad, given alternatives, and, as noted in prior EVAs, the steady growth big blues have been leading the market over recent years (and far exceeding returns from international stocks).

In closing, to be clear, we're not expecting a melt-down. But if present buoyant conditions--heavily reliant on enormous sums of synthetic money--should deteriorate in the weeks and months ahead, be prepared for a very sudden, very sharp reversal of fortune. Accordingly, to preserve your own fortune, you might want to play just a little defense.

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