

March 23, 2012

"Reality is that which, when you stop believing in it, doesn't go away."

-PHILIP K. DICK, AMERICAN NOVELIST (BLADE RUNNER, TOTAL RECALL, MINORITY REPORT)

POINTS TO PONDER

Send your checks or money orders now. Stocks are not alone in climbing lofty peaks lately. Last week, I spent a couple of days skiing with one of Evergreen's best clients, who is also a close friend, at his spectacular home high in the mountains of Utah. Similar to the market, the conditions were beyond balmy with temperatures that felt more like summer than the tail end of winter. (Of course, as my ski luck would have it, as soon as I left, the area was pounded with a massive winter storm leaving in its wake multiple feet of the fluffy powder skiers dream about.)

At one point, as we were whisked up the mountain on a high-speed chair, I remarked to our very market savvy client, only partly in jest, that the world should be paying me a royalty to keep predicting that a serious correction is imminent. Somehow, though, I don't think any funds will be showing up in the Evergreen mailbox.

By sheer coincidence two other friends, who also happen to be, like yours truly, chief investment officers at money management firms, were visiting Park City at the same time. This charming couple joined us for dinner one night and, as to be expected (or feared) given our occupations, the conversation soon turned to the market's relentless rally.

Let me warn you that when you get three CIOs together, the last thing you should expect is a consensus. As we walked out of the restaurant, our client remarked that it's amazing how three supposedly smart people (come to think about it, he put a lot of emphasis on supposedly) could have such radically different views of what lies ahead.

It's probably no surprise to any EVA reader that of this CIO trio I was the least optimistic, at least on a near-term basis. The most bullish among us made an articulate case for why stocks are in a new bull phase. High on his list of reasons why was the fact that so many investors share my anxiety. His "significant other" (imagine having two investment gurus under one roof!) was noticeably more restrained but she agreed that stocks are headed higher.

My client actually did a better job than I did of making the counter argument, pointing out that Europe is still a total mess. He noted that Greece's debt deal was a farce and that "new and improved" Greek bonds are trading at just 25 cents on the dollar. He also cited that nearly a quarter of the Spanish populace is unemployed.

The friendly debate carried onto the ski slopes the next day and perhaps it was the fresh mountain air (or possibly the waning influence of adult beverages) but my friends were a bit more cautious. While still asserting that the trend is up, they both conceded a sharp correction was to be expected. One of their best long-term bull points was that US investors had been selling out stocks for years, a point that I've repeatedly made in these pages. As I've noted in the past, when this changes it will be a huge booster rocket under the market.

 Image not found or type unknown

The question is: Are we on the verge of seeing money flow into, rather than out of, stocks on a

sustainable basis or is this just another whippy rally without legs? Maybe the answer lies in that old sound bite from the early Bill Clinton campaign...

It's still the economy, stupid. Over the last few months, I've often referred to the Economic Cycles Research Institute (ECRI) and its forecast that the US was on the cusp of another downturn. Naturally, there are a slew of entities predicting an endless array of outcomes, but the ECRI deserves special attention because, unlike its peers, it has called the last three contractions.

This time, however, it is looking a bit fallible as it was contending last fall that the US was either already in a recession or soon would be. You may remember at the time that Evergreen was respectfully, albeit hesitantly, disagreeing.

The question now is whether the ECRI was truly wrong or just early. Notably, it continues to stick with its forecast. In this regard, my client stated that a firm he's dealt with for years, which oversees managers like Evergreen and in which he has considerable confidence, is adamant that a US recession is just months away.

When you consider these views, and also the recession warnings from Bloomberg economist Rich Yamarone, as well as John Hussman, whom I've often quoted in past EVAs, I have to concede there are some very smart people residing in the recession camp. And they're not just poking their fingers in the wind; their views are based on comprehensive and independent sets of leading indicators (in the case of the ECRI, these are such a closely guarded secret that a cottage industry has sprung up trying to "reverse engineer" them). Additionally, ECRI's coincident indicator is at a 21-month low. Over the last 50 years, whenever it's been down at this level a recession has been in the offing.

2

Image not found or type unknown

Yet, despite my current "bear" label, I continue to believe the US will not actually incur an economic contraction, principally because I don't see the kind of excesses that have preceded every past recession. It's my view, however, that we will continue to experience the kind of on-again, off-again growth pattern that has characterized the post-global financial crisis years.

However, given the degree of optimism in the markets lately—as evidenced by such facts as utility stocks being in the red this year while the riskiest issues soar and that 15% of all mutual fund inflows are now going into junk bond funds—even a mild growth scare is likely to upset the

Apple cart. In other words, even the most valuable stock in the world might soon have a few bites taken out of it. (A side note: We continue to like Apple but its latest run is magnifying an already serious law-of-large-numbers problem.)

What might cause a more sober view of US growth prospects? Based on the run of good economic news we've had lately, and the fact that outfits like the ECRI are sticking to their recession guns, it's reasonable to expect that some disappointing data lurk ahead, in no small part due to the thermometer.

There's little doubt in my mind, corroborated by both economic soothsayers like David Rosenberg and common sense, that the weather this "winter" is upwardly skewing the government's typical seasonal adjustments. When the mercury is pushing 80 on Saint Paddy's Day in the Windy City, that's about as normal as the Chicago River staying green all year long. About the only thing predictable about the weather is that it isn't, but the seasons are. Realistically, the seasonal adjustments tailwind is almost certainly over.

And then there is that old bugaboo from the Old World...

Germany tries to call in its marker. In spending some serious reading time catching up after my two days of ski hooky, I'm more convinced than ever that Europe is still the crisis that will just keep on giving. What concerns me is that it has become fashionable among the investment community, as I heard in Utah, to believe that its problems are "fully price in." That complacency worries me and it reminds me of a similar attitude toward housing in the first half of 2008 (and even regarding Europe numerous times over the last few years.)

Two of the more compelling pieces I've read lately come from one of my old standbys, John Mauldin, while the other is from a much less well known source, at least in the States, Simon Hunt. Since it's my plan to run one of these in the next guest EVA, I won't leak too much of the content but I think John nails it when he writes: "But let's make no mistake. The sovereign debt crisis is not over. Not in Europe, not in Japan, and not in the US. It is in a lull period."

If he's right, and I think he is, this tranquility between the tempests is a gift for those willing to be accused of premature ejection syndrome, aka taking some profits on the way up. It's my view that one of the best strategies an investor can follow these days is to be a seller of "risk assets," like stocks, when the markets are relaxed about Europe and to be a buyer once reality bites yet again.

Despite my belief that nothing has really been solved in Greece, and that until it pulls out of the euro it is relegated to years of economic stagnation, even more really bad news from there is unlikely to be the source of the next destabilizing surprise. Lately, though, I've come across an issue that might qualify.

Simon Hunt is one of the few sources I've seen (along with some scattered articles in the *Financial Times*) talking about the Target 2 balance. If you've never heard of it, don't feel bad—neither had I until a couple of weeks ago. But basically it is, to be quite simplistic, a rather large account receivable tabulated by the Bundesbank—like about \$650 billion. This represents the amount owed to Germany from the rest of Europe (mostly southern) due to the massive accumulated trade surpluses of the former versus the latter over the past decade.

Per Simon, the "Bubba's" president, Jens Weidmann, now considers this IOU to be "an unacceptable risk" and is demanding that collateral in the form of Greek and Spanish real assets

be posted. As one *Financial Times* journalist recently wrote, this is about as politically correct—and feasible—as sending in the Luftwaffe to collect the dough.

Simon further points out that resentment between Germany and its debtors, such as Greece, is reaching a fever pitch. Cartoons appear on a regular basis in the Greek press showing German President Angela Merkel dressed as a Nazi. German papers are just as pejorative and some are now calling for Greece to be given the boot (fortunately, I haven't heard any mention of giving them the jackboot).

More importantly, there is little doubt Europe is in recession. Even the optimists admit this, but their view is that it will be shallow and brief. That would be nice if it were true but when I see that Spanish unemployment jumped 2.4% in February alone, and as my client noted, is now pushing 25%, I question such rosy attitudes.

Of course, the dwindling number of Euro skeptics could be the ones who are wrong. However, with numerous elections looming across Europe in the next few months, new austerity programs taking hold, and youth unemployment in several countries around 50%, the potential for political and social upheaval is significant. Now with Germany waking up to how much of its national balance sheet is at risk of not being repaid, the odds of something snapping seem very high to me.

Regardless of the cause, and realistically the next euro-quake is likely to be an event unforeseen by either the markets or moi, it's just one of the numerous risks still lurking out there. Unfortunately, all the trouble in the here and now is obscuring a future that is shaping up to be increasingly promising.

To lock in or not to lock in. As I assess the long-term outlook, I see a growing number of positives beginning to fall into place. These include America's emerging independence, the accelerating trend to relocate production back to our shores, consumer debt pay-down, pent-up corporate capital spending, the greatly underestimated pace of our national savings and wealth creation, and the immense productivity enhancements due to the "cloud", as well as from 3D printing and advanced robotics. Then there is nanotechnology which is almost certain to play key role in the next growth boom. There are even whiffs of bipartisan support for desperately needed Medicare/Medicaid reform. (Stay tuned for more on these trends in future EVAs.)

Somewhat humorously, when I bring up such heartening factoids during times when the market is plunging, people look at me like I'm predicting the UW men's basketball team could win the Pac 12 and still not be invited to the NCAA tournament. (Wait a second—that's exactly what did happen, another example of Seattle's star-crossed sports karma.).

Therefore, it's not that I don't have a lot of confidence in the future of our country; in fact, I am an unrepentant long-term bull on America. However, at the risk of being called a gelding bull (ouch!), it's the near-term that worries me.

In that regard, our political circus is likely to become even more absurd as we get closer to November. Markets abhor uncertainty but that promises to be in abundant supply in the months ahead. Should our government continue to wallow in partisan paralysis, we will be looking at, as Fed head Ben Bernanke recently warned, "a massive fiscal cliff." Specifically, taxes are scheduled to rise and expenditures are set to be cut to the combined tune of 3.5% of GDP, or more than \$500 billion.

Then there is the issue of gasoline prices. Based on the run-up since January 1, this amounts

to almost an \$80 billion drag. Fortunately, however, getting back to the weather, the winter that wasn't and a glut of natural gas has shaved some \$30 billion off consumer heating bills. But as we move into summer, that benefit will fade and the peak driving season will collide with pump prices that might be in the \$4.50 range.

Yet most daunting of all is that four of the world's most important economic blocs—the US, Europe, Japan, and China—are all undergoing wrenching transitions. It's been at least 30 years, if not 80, since the planet's dominant economies needed to undergo such extreme structural reforms. And they need to do so concurrently, moving away from economic models that obviously are malfunctioning (bloated welfare states in the West and overreliance on exports in the East).

Consequently, I believe it won't be long before the investment community decides being up 11%, roughly how much the market has risen already this year, might be close to as good as it gets. Unquestionably, prices can keep rising even further but valuations, especially adjusting for peak profit margins, no longer justify any table pounding. In fact, given the manifold threats floating around, they look downright full.

There are also some signs of market fraying such as the declining number of stocks making new highs, small cap underperformance, the lagging transportation average, and, the chronic problem with this rally, a resounding lack of volume (pardon the pun). Additionally, the S&P 500 is now two standard deviations above its 50-day moving average, indicating an extremely overbought condition, while profit warnings are exceeding positive forecasts by a three-to-one margin.

A year ago, we said our target return was in the 6% to 8% range and most Evergreen clients appear to be annualizing at the high end of that range over the last 15 months. There's an old saying in the investment game that bulls and bears make money but pigs get slaughtered. We don't know for sure what happened to the little piggy that went to market but something tells me he had a close encounter of the butcher kind—especially if the market in question involved stocks.

David_Hay_Signature

Image not found or type unknown

IMPORTANT DISCLOSURES

This report is for informational purposes only and does not constitute a solicitation or an offer to buy or sell any securities mentioned herein. This material has been prepared or is distributed solely for informational purposes only and is not a solicitation or an offer to buy any security or instrument or to participate in any trading strategy. All of the recommendations and assumptions included in this presentation are based upon current market conditions as of the date of this presentation and are subject to change. Past performance is no guarantee of future results. All investments involve risk including the loss of principal. All material presented is compiled from sources believed to be reliable, but accuracy cannot be guaranteed. Information contained in this report has been obtained from sources believed to be reliable, Evergreen Capital

Management LLC makes no representation as to its accuracy or completeness, except with respect to the Disclosure Section of the report. Any opinions expressed herein reflect our judgment as of the date of the materials and are subject to change without notice. The securities discussed in this report may not be suitable for all investors and are not intended as recommendations of particular securities, financial instruments or strategies to particular clients. Investors must make their own investment decisions based on their financial situations and investment objectives.