

March 29, 2012

*"The time to repair the roof is when the sun is shining."*

-JOHN F. KENNEDY

*Special message: In the March 15th EVA, I emphasized that insider selling was running at an extreme rate. While this is true, the day after that edition went out, the Wall Street Journal ran an article quoting an insider trading expert who believes the present high reading is distorted by the new definition of insiders that includes large institutional shareholders. In his view, there have been several large sales by this category that is not privy to non-public corporate information. The article concluded that insider selling is essentially neutral. However, the Evergreen investment team believes that the majority of measures of short-term market vulnerability are still in place, particularly an overly bullish and risk-complacent attitude by most investors.*

## POINTS TO PONDER

1. It's possible that rising wages, along with some early signs of improving money velocity, may cause the Fed to end its multi-trillion dollar money manufacturing extravaganza earlier than anticipated. The erosion in bank cash balances may indicate that idle funds are beginning to circulate through the economy. (See Figures 1 and 2)

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2. Once again challenging the beliefs of those who think the US economy is booming, industrial and manufacturing production remain below their 2007 peaks, 44 months after the Great Recession's end. This has not happened since the days of that other "Great"—as in, Depression.

3. Based on the fact that roughly 40% of the planet has fallen back into recession, it's not surprising that economically sensitive companies like FedEx and Caterpillar have reported disappointing results of late. But steady-Eddy software titan Oracle also came up well short of expectations. The question is whether this is company-specific or related to economic weakness hitting even more resilient sectors.

4. Investors looking to hedge against a deep market correction might want to bet against small cap stocks. These volatile and riskier issues are trading at significant premiums to their blue chip cousins. Moreover, they have been out-legging high-quality shares for almost 14 years, the longest period of superior performance ever. (See Figure 3)

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5. Examining all bull markets since WWII, none has produced so much return accompanied by so little economic growth. (See Figure 4)

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6. The Fed was created 100 years ago to contain financial panics. Its mission has evolved into a dual mandate to maintain both low inflation and high employment (two goals that are often in conflict). Given that from 1800 to 1913, overall price levels (equivalent to a CPI measure) rose by 176% and since the Fed was formed they have risen by 448%, it hasn't exactly excelled at its

first mandate. And with unemployment just under 8%, a passing grade on that front is debatable as well.

7. The US economy is already facing several headwinds but the biggest may be ObamaCare's rapidly escalating societal costs. Note that the chart below is from the non-partisan and highly respected Congressional Budget Office. It will be interesting to see how employers' hiring and firing decisions are impacted by these soaring expenses. (See *Figure 5*)

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8. Speculator sentiment on gold has morphed from brazenly bullish to decidedly despondent over the last two years. Thus, for contrarians with a longer term focus, this could be a rewarding time to buy bullion. (See *Figure 6*)

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9. Although Canada's economy is growing anemically, similar to nearly all developed countries, it just leapt from 11th to 6th in the Conference Board's productivity ranking. Many economists believe that productivity is among the most vital measures of an economy's health.

10. Although the financial crisis in Cyprus has the potential to trigger a bank run in other peripheral European Union (EU) countries, markets have been remarkably placid. Bond yields

in Spain and Italy, for example, have remained largely stable. The Cyprus situation may be distracting attention away from the escalating recession in France and what appears to be a bursting housing bubble in Holland, two crucial core countries

11. Validating an against-the-grain EVA forecast from a year ago, Europe's economy contracted in last year's fourth quarter at the fastest rate since the depths of the Great Recession. Most worrisome is that the Continent's two dominant economies, Germany and France, reported sharply lower GDP numbers in last year's final quarter. The most recent data indicate a further worsening thus far in 2013, although the manufacturing sector has bounced a bit. (See *Figure 7*)

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12. Illustrating how stressed Italy's economy is at present, the *New York Times* reports that half of its small businesses are behind in paying employees. Financing for smaller enterprises has also become exceedingly challenging, if not impossible.

13. One of the criticisms of official Chinese economic releases was that they have shown higher growth than the more reliable electricity production statistics. Lately, though, the latter have revealed a clear uptrend, lending credence to the belief that China attained the elusive "soft-landing." (See *Figure 8*)

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14. Although China appears to have avoided a recession—in vivid contrast to Europe, Japan, and the UK—its industrial overcapacity condition remains concerning. Despite booming car sales, its domestic auto industry is running at just 60% of potential output (similar to most other Chinese heavy industry sectors). To put that in perspective, even at the worst of the Great Recession, as GM was being nationalized, the Big Three US automakers' capacity utilization never fell below 66%. (See *Figure 9*)

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15. The Federal Reserve isn't the only central bank propping up a debt-riddled government. Thanks to aggressive purchases of Japanese sovereign bonds by the Bank of Japan (equivalent to the Fed), yields on its 10-year debt have fallen to a mere 0.56%. This is notwithstanding the fact that Japan is endeavoring to force inflation up to 2%, producing a deeply negative return for bondholders. If successful, such a move would likely trigger an eventual bond market rout, making an already brutal fiscal situation almost insoluble.

**Return-free risk.** It's a proud papa moment when you can honestly say that your son's writings caused you to do some serious introspection—especially when one of the items in your job description says "newsletter author."

Last week's EVA written by Tyler Hay, aided and abetted by 40-year market veteran Charles Gave, did truly get my mental tachometer revving. Accordingly, I want to offer some reflections on Tyler's essay from last week with more planned for the next full-length EVA a fortnight hence (sometimes my old Shakespearean studies do surface).

First of all, I think Tyler's view, and that of his encourager, the aforementioned Charles Gave, is persuasive. However, as one who knows all too well what it is like to make a long-range forecast and then be judged by near-term market action, I think some time line clarification is in order.

As a refresher, for those who don't recall the precise details, or a fill-in for EVA readers who missed it entirely (you've got a second chance—[click here](#)), let me briefly recap the basic point. Tyler and Charles correctly noted that one of the cornerstones of investment theory is the so-called Efficient Frontier. Very simplistically, this means that the most conservative investments also have the lowest rates of return and the most aggressive have the highest potential—low risk/low return, high risk/high return. That seems utterly unassailable, right?

But, as Tyler and Charles pointed out last week, some serious assailing is actually in order. Due to the fact that the planet's most powerful central banks have been giddily whipping up money out of nothing, save for a few computer keystrokes, risk-free investments may well be a misnomer. While there is no question they are return-free (just check out your latest money market statement), the risk aspect is a different matter. As pointed out last week, short-term Treasuries and other cash equivalents have eroded a couple percent per year over the last four years simply due to inflation. And relative to gold, they have been crushed.

Then there is the rather pregnant (with quintuplets) question of what happens when the central banks need to become sellers of their immense holdings rather than buyers. Despite the professed calm folks like Ben Bernanke exude when they discuss this publicly, it's reasonable to expect that such an event won't resemble the tranquility of a Sotheby's auction once the long-dormant bond vigilantes smell central banker blood in the water.

Thus, the conclusion of Tyler and Charles was that stocks have less risk than bonds, the latter having been so dramatically inflated by all the central bank money manufacturing and related debt purchases. And, I agree—with a few qualifications...

**The Big Easy--the next Big Short?** Clients who have been with me a long time, and I'm happy to report there are quite a few, remember how skeptical I was of the tech mania in the late 1990s. Even though it was exceedingly unpopular at the time, I was willing to call it out for what it was: the biggest stock market bubble since 1929.

Today, however, even though I believe stocks are on the expensive side, I don't feel they are the object of a bubble (though sub-sectors like REITs and small caps are dancing on the edge). Yet, there is a bubble out there and I do agree with those who feel it is on the Fed's balance sheet. Thus, I am in full accord with Tyler and Charles that the Efficient Frontier should probably have an "In" at the beginning.

However, I also don't think that distortion will unwind in the near future, meaning that US

Treasuries may levitate longer than they should—at least until the Fed needs to reverse course. As mentioned in prior EVAs, I doubt such an event will occur this year. (However, taking precautionary steps right now against the "Great Unwind" is prudent.)

Actually, given the escalating banking crisis in Europe, US Treasuries could become a money magnet for a spell despite their totally unappealing long-term prospects, as Tyler noted last week. And, if we're right that there is another growth scare coming, as has been the case for each of the last three years starting in the spring, that would also tend to keep the Fed merrily printing and rates artificially suppressed.

There is additionally a possibility of a money tsunami hitting our shores from Japan. Its households are sitting on nearly \$9 trillion of cash earning "rei" (that would be zero in Japanese, and not to be confused with the Seattle outdoor gear store). They also are stuck with a currency that is eroding almost as rapidly as the bank deposit base in Cyprus. Further, there appears to be growing awareness among its savers that their country's government seems intent on committing fiscal hari kari. Hedge fund star, Kyle Bass, who nailed the "Big Short" in sub-prime mortgages, is predicting that affluent Japanese investors will soon be fleeing en masse for perceived safer environs. If so, the US would almost certainly be toward the top of their ports-in-the-storm list.

These considerations are why we currently have a neutral rather than negative view of Treasuries in our rating section at the end of each EVA. However, we are on high alert for signs that the Fed will need to abandon its "a trillion here, a trillion there" approach to what can only charitably be called "monetary policy."

Indeed, long-time bond bull David Rosenberg recently experienced a self-admitted epiphany. He now sees much less slack in the economy than he believed just a short time ago. David also worries that the Fed will do what it does so often: overstay its welcome in the Big Easy. Then, when it realizes the error of its wayward ways, it will also do what it does so regularly—slam on the brakes, sending the financial markets hurtling into the windshield.

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Let's hope Ben Bernanke's airbags work as well as he says they will. If not, Tyler and Charles' fears that the usual safe parking places, like bonds and preferred stocks, are about as secure as leaving your car unlocked in the Bronx, may be realized sooner rather than later. And, if so, even the Ferrari known as the stock market might come to a screeching halt.

David\_Hay\_Signature

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