

May 17, 2013

"The trouble with most people is that they think with their hopes or fears or wishes rather than their minds."

-WILL DURANT, author of *The Story of Civilization*

Thanks, Sunny Jim! One of the joys of approaching 60, and having led a fairly active life, is that body parts, such as joints and cartilage, begin to break down. In my case, it's a degenerative disc in my lower back. Consequently, my L5 and S1 vertebrae are becoming more intimate than God intended, impinging on the nerves between them and causing extreme stiffness whenever I sit for extended periods. To combat this, I do the usual exercise and physical therapy, but what provides the most relief is an inversion table (i.e., for five minutes daily, I hang upside down like a bat).

To occupy my mind whenever I do this first thing in the morning, I put on CNBC. Last week, I was in the inverted position while Jim Cramer was doing his usual hyperventilating. Actually, I had the privilege of listening to him on two different days as he was frothing away, and it dawned on me that hearing Cramer while inverted is quite appropriate given that so much of what he says is upside down.

First, he made the assertion that US stocks are hitting new highs because the US economy is accelerating, China's slowdown is over, and Europe is bottoming. The next day, he went on one of his inimitable rants, saying that the reason so many hedge fund superstars are dissing the market rally is because they are lagging.

Once I got done yelling at the TV (always a very mature reaction, particularly when you're hanging from your ankles), I realized he had just given me a great lead-in for our *EVA* series on the Mauldin/Altegris Strategic Investment Conference (SIC) attended by several Evergreen team members earlier this month. Some *EVA* readers may be questioning why this is such a big deal. I think the answer is that the folks we heard from down in Carlsbad are basically the anti-Cramers.

They have built their impressive reputations, and in many cases sizable fortunes, by resisting, and often betting against, the type of performance-chasing and emotion-driven investing personified by Jim Cramer. And what they said at the conference couldn't have been more at odds with what he was purveying to the public last week.

As you will soon read, some recurring themes came out of the SIC, but none of them involved anything resembling a normal global economy. The overarching message was one of a tremendous disconnect between persistently sub-optimal growth, despite unprecedented stimulus, and frothy financial markets. Of course, the solution to the paradox is the \$10 trillion of "pseudough" that central banks have created over the last five years.

And then, on Friday, in one of the most ironic developments I've come across in a very long time, the Great Enabler (aka Ben Bernanke) warned against excessive risk-taking in the financial markets. Wow! Think about that for a minute.

Besides coming down squarely on the side of savants like Bill Gross, Jeff Gundlach, and David Rosenberg—and against Jim Cramer—Mr. Bernanke is sounding like a saloon owner who gets his patrons sauced and then tells them to behave like good little Baptists. Maybe it's because he's starting to realize just how hammered his customers have become.

So, with much needed assistance from Mark Nicoletti, Jeff Eulberg, and Tyler Hay, let's get to what some of the most glittering of the investment glitterati are thinking now. (In the weeks ahead, we will elaborate on what we think are the more compelling concepts, but for now we would like to simply get the information out to our readers.)

Jeff Gundlach—Portfolio Manager of the Double Line Total Return Fund

David Hay

Barron's crowned Jeff Gundlach the "New King of Bonds" in a glowing February 2011 cover story. A former punk rock guitarist, and an innate math genius, Gundlach has used both his creative and quantitative skills to forge one of the finest track records in the fixed-income firmament.

His self-confidence borders on the arrogant, and he's never afraid to express controversial views. At the 2012 Mauldin event, he told the audience that in his own account he was shorting AAPL and buying natural gas. These were extremely contrarian calls, but both have proved out (with AAPL down 25% and natural gas up over 40%.)

This year, he was railing against the alleged Great Rotation of money moving from bonds into stocks. One reason for his view is that stock holdings in the US are far higher than in Europe and Japan. In addition, US households hold less cash than their counterparts in most developed countries.

Of course, he is a bond guy, but he was passionate and persuasive that the Fed is not going to turn off its magical money manufacturing machine anytime soon. Part of his rationale for this, which he delivered in his trademark snarky but highly entertaining style, was that almost all major countries are running budget deficits now. In more normal times, some countries are in surplus, allowing them to fund those with shortfalls. Since budget surpluses have gone the way of the dodo bird in recent years, this leaves central banks, and their trusty printing presses, as the primary funding source.

Gundlach believes the Fed won't halt its "From Here to QEternity" program until Bernanke sees negative consequences. But right now, Bubble Ben sees no evil (at least until last week when a few scales seemed to fall from his eyes). Gundlach, on the other hand, perceives many, with one being that vanishing interest rates force retired folks back into the workforce. This displaces young people and gives us the increasingly common phenomenon of the 65-year-old cashier at Wendy's. In his view, this is just another example of the intergenerational scam that is going on right now (for more on this topic, please see the Niall Ferguson section below).

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He feels we will ultimately see various forms of a wealth tax (a long-time contention of this author). One of the easiest to implement, in his opinion, will be a federal property tax on high-end homes. He also sees a tax on municipal bonds coming. In his opinion, only high net worth individuals and corporations have what he calls "retained surpluses" so they will be the ones targeted by the government's relentless revenue reach.

Further, he feels global growth is worse than perceived and deteriorating, in total contrast to Jim Cramer's sunny forecast. This is another reason he believes interest rates are going to remain suppressed for the foreseeable future and also why QEs will prove to have a very long shelf life.

The New King of Bonds also spoke at the Ira Sohn confab last week, which included a similar gathering of the most astute investment minds, and he caused quite a stir by telling audience members to take their money out of banks. While he doesn't see a Cyprus-like haircut coming for US bank depositors, he detests "return-free risk." He'd rather hold bonds, backed by healthy corporations, and improving mortgages.

To sum up his world outlook, he sees the present conditions of gushing central bank liquidity continuing for the next 6 to 18 months, maintaining asset price levitation, especially those that provide superior cash flow. However, he believes that by artificially suppressing normal market volatility, the central banks have created a highly combustible condition—when volatility does return it will do so with a vengeance. He calls this ultimate day of reckoning "the kaboom" (somehow, I think "boom" with a "ka" is more like a "kabust").

Oh, by the way, Jim Cramer, Jeff Gundlach hasn't been lagging.

David Rosenberg—Chief economist for Gluskin Sheff and former head US economist for Merrill Lynch

Veteran *EVA* readers are aware that "Rosie," as David Rosenberg is known to his readers and friends, is one of my favorite economic experts. He nailed the housing bubble, and his recommendation from almost 13 years ago to be long both gold and dependable income vehicles has dwarfed the returns from US stocks.

Rosie has built a reputation as one of the most resolute bond bulls over the last quarter-century; thus, as I've relayed over the last couple of months, his recent change of heart is particularly notable. He now believes the greatest bond bull market in history is nearing its terminal phase.

This was the first time I had a chance to hear him discuss his "epiphany" in person, and I found

his reasoning to be exceedingly convincing. And I say this realizing it contradicts the mind-set of Jeff Gundlach as just recapped above.

The reconciling factor in their big picture perspectives is timing. Rosenberg admits that the transition he foresees—from disinflation with falling interest rates to stagflation with rising rates—will be a very drawn out affair. Thus, it is likely to play out well beyond the 6 to 18-month time frame where Gundlach is focused.

Because I plan to devote a full *EVA* to Rosenberg's long-term stagflation vision, I'm going to merely provide a few of his concepts here with apologies for the necessary brevity. In essence, he believes the Fed is mis-calibrating how much slack there is in the US economy. He contends it's almost impossible for the US to have 2% inflation with a supposed "output gap" (a measure of excess capacity) of 6.5%. For example, Japan has deflation with a mere 2% output gap.

Additionally, he believes our cherished central bank is once again facilitating a boom-bust cycle while also letting the federal government off the hook by financing its profligacy. He further asserts that Fed policies are increasing uncertainty rather than mitigating it. Just to top things off, he (and several other presenters) commented that the rule book for Obamacare is 20,000 pages long and is another confidence killer for business owners.

As a result, the private sector has been under-investing in productive investments for years, with publicly traded corporations opting to use today's low borrowing costs to buy back stock or raise dividends. Concurrently, much of the unemployed labor pool may be unemployable due to job skill erosion; ergo, the new full employment might be nearer to a 7.5% jobless rate than 4.5%. If so, the economy is closer to hitting on all cylinders than is popularly believed, even if it's now a six-cylinder engine vs the old V8.

In summary, Rosie's view is anything but rose-colored, even regarding his long cherished bond market. When a raging bull quits raging, it really grabs my attention, and I think it should yours as well.

As you will read below, courtesy of my Evergreen colleagues, the views of Jeff Gundlach and David Rosenberg have much in common with the other presenters. These circumstances remind me so much of what I heard at the SIC back in 2006 when both home prices and stocks were bubbling along. It also brings back memories of how most people didn't want to hear the warnings at that time. After all, it was far more fun to listen to "Sunny Jim" then, just as it is now.

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Niall Ferguson—Harvard, Stanford, and Oxford affiliated economic historian and acclaimed author

Mark Nicoletti

Niall Ferguson is known for his provocative and contrarian views and, unlike most university scholars, he has been a vocal critic of President Obama. He authored *The Ascent of Money*, published in 2008, which examines the long history of money, credit, and banking. In it, he

predicted a financial crisis as a result of the world economy, and in particular the United States, using too much credit.

He commands the stage like few I've seen. Bombastic and obviously well practiced, he has remarkable conviction. It's like watching Michael Jordan play in the 1990s as a staunch Los Angeles Laker fan—an uncomfortable adoration.

His latest book, titled *The Great Degeneration*, was the basis of his SIC presentation. Both are centered on capitalism, the rule of law, and whether monetary stimulus is masking a greater structural economic problem.

He believes the key differentiator of the West from the East has always been the rule of law. The guarantee that there will be a path to justice is what allows countries to grow and is what separated Europe from China in the 1800s. Is that no longer the case?

The central question of the *The Great Degeneration* is whether our institutions, corporations, and governments are degenerating. He cites four symptoms of degeneration:

1. Breakdown of the Generational Contract. Each generation has an obligation to the next. We have violated the contract between our generation and the next. We are spending more, tax revenues are insufficient, and debt is surging to unthinkable levels.

2. Excess Regulation. He believes the recent financial crisis was the result of excess regulation and complexity. However, we've responded by adding new layers of regulation, making a complex system more complex and, as a consequence, more fragile.

3. Rule of Law vs Rule of Lawyers. The rule of law is supposed to be a fast and efficient path to justice. The US now has the highest legal costs of any nation in the world, and the legal system continues to become increasingly convoluted. The lawyers, not the law, are making the rules. Moreover, compliance and regulatory costs continue to sky rocket.

4. Decline of Civil Society. Americans have become reliant on government to solve problems. Decline in our civil society comes with a decline in economic output.

He submits, plainly, that the US is overspending, too reliant on government, and its legal system is no longer a path to justice.

(Woody Brock, another Evergreen research contributor, agrees with Ferguson and estimates that Obamacare will raise small business healthcare costs by 200%-400%. Metrics like these will give small businesses an incentive NOT to hire, crippling employment growth.)

On a positive note, Ferguson contends that despite flawed energy policies, the US is undergoing an energy revolution. He calls natural gas the new gold rush and concedes the US may have gotten "lucky again."

Ferguson believes that experimental monetary policies will not stimulate employment or economic growth, or solidify the rule of law. He believes the integrity and efficacy of private institutions is paramount and their decline cannot be bailed out by money spinning. The lawmakers in Washington are killing economic prosperity. We're neglecting the long run, and the vicious cycle of booms and busts is bound to continue.

Kyle Bass—Hedge fund manager and founder of Hayman Capital

Bass became a media darling after short-selling sub-prime mortgage debt before that market crashed. With frequent appearances on CNBC from his ranch in Texas, combined with his elite hedge fund manager cachet, he stood out as THE celebrity persona even among this celebrated assembly.

He is well known for his pessimistic views on the global economy, notably Japan and Greece, which he believes are doomed due to their high debt. He pulled no punches, pointing out that 11% annual US debt growth in the last 10 years is unsustainable long term.

First and foremost, he believes that because the largest central banks in the world have all moved to unlimited printing ideology, monetary policy is the "only game in town." He feels leading governments are failing miserably to introduce essential reforms.

Bass has long been a bear on Japan, a trade his investors have not enjoyed until recently. He believes Japan is running an enormous economic experiment as it has had 10 finance ministers in the last 10 years. He predicts a full-blown bond crisis in Japan in the next few years. He says he is not naive enough to think he can predict the end of a 70-year debt super-cycle (in Japan) with any kind of precision. However, he is adamant that objective quantitative analysis (in contrast to frantic quantitative easing) proves that country's bonds are insolvent.

Bass concedes that global investors are excited about Japan's recent implementation of "Abenomics" (named for Japan's latest prime minister). However, he feels this fresh round of government spending and drastic monetary easing, designed to end 15 years of deflation, is doomed to fail. He claims 28% of owned Japanese equities were purchased in the last two weeks (not exactly core holders). Bass believes a 2% inflation goal for Japan is too ambitious, but if investors begin to assume it can be attained the implications for Japan's bond market are dire.

He suggests that if Japanese interest rates soar, meaning prices plunge, due to higher inflation expectations, nominal (i.e., before inflation) US Treasury yields will go negative in a flight to quality. Gold will also move up and, if the Japanese bond situation becomes severe enough, fears of a similar disaster may spread to other important global financial markets.

Essentially, he is skeptical that over-indebted countries will be able to keep interest rates at negligible levels indefinitely. Meanwhile, their high debt levels leave them exceptionally vulnerable to rising borrowing costs.

Despite the fact that he gets attention for his shorts and negative views, et al., he maintains 90% (or more) of his clients' money in long positions: notably, US structured credit, US mortgages, and US stocks.

Overall, Bass' key insights are that his equities will continue to appreciate, but with the following caveat: Given how rapidly the monetary base is growing, you have to focus on inflation and the possibility that the real rate of return might be negative on both equities and bonds. He believes to protect yourself you need productive assets that give you exposure to different currencies. And, of course, he believes that Japan's sovereign bond market is on its last legs.

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A. Gary Shilling—President, A. Gary Shilling Co. Inc.

Jeff Eulberg

When you close your eyes and picture an economist, the way he talks, the way he looks, the hobbies he has, I'll bet you imagine something very close to A. Gary Shilling. Gary Shilling is a world-renowned macro-economist. He is a regular columnist for *Forbes* magazine and frequent contributor to many of the finest financial publications. He is also well known for founding the economics department at Merrill Lynch at just 29 years of age. Since 1978, he has run the A. Gary Shilling Co., one of the most highly regarded financial research firms, and he pens the widely distributed monthly *Insight* newsletter. If that weren't enough, Gary spends his free time raising bees as a beekeeper in New Jersey. Now that you have a solid mental image, and respect for what he has to say, here are his thoughts from the SIC.

Gary currently sees us living in a world with six fundamental realities:

1. Private sector deleveraging and public sector reaction
2. Rising protectionism
3. Markets disconnected from the economy
4. Aggressive chase for yield throughout the world
5. End of export-driven growth in developing countries
6. Vulnerable equities worldwide

As you can probably tell from the list, Gary doesn't believe the economy is on very firm footing. In fact, he believes the economy will continue to be in a deleveraging period for the next five years, as we are still in the throes of a very strong secular bear market.

The currency manipulation that we are seeing throughout the developed world is just the tip of the iceberg, according to Shilling. He postulates the countries that have been reliant on export-driven growth will find this environment very challenging in the coming years. Shilling also seems adamant in his belief that the manipulation will disrupt trade and lead to a stronger US dollar (a common theme throughout the SIC).

He also warned of another significant correction in the equity markets, citing a soaring Shiller (not to be confused with Shilling) price-to-earnings ratio (calculated using the S&P 500 price/average inflation-adjusted earnings for the trailing 10 years). Further, he mentioned that if this metric were to revert to its historic average, it would require a 27% price correction in the S&P 500. Additionally, Shilling is uncomfortable (as are we) with profit margins near all-time highs and believes these will revert to the mean—taking a significant bite out of corporate earnings. While Shilling does not expect a US recession, he is anticipating 2% US GDP growth for (as Mr. Bernanke would say) "an extended period of time."

Some of Gary Shilling's recommendations include being long US Treasuries, the US dollar, small luxuries, and staples, while holding short positions in commodities and global stocks.

Nouriel Roubini—Chairman, Roubini Global Economics

Nouriel Roubini, also called Dr. Doom, is known for being one of the first and loudest economists to warn about the US housing bubble. Roubini is a professor at NYU and runs the well-respected macroeconomic research firm that bears his name. Roubini has consistently warned about the harmful effects throughout the developed world of central bank manipulation. In the past, due to his dramatic and alarming concerns, his audience has often been driven to the closest tavern following his presentations. However, this time was a little different. He doesn't believe we are on the edge of a cliff, and although he was far from bullish, he did seem to be less concerned about major tail risks (i.e., big blow-ups).

Roubini still believes that Europe is the biggest risk to the global economy. Yet, for the time being anyway, he believes that a Eurozone breakup is unlikely, largely due to the ECB's outright monetary transactions (OMT) program and other steps taken to strengthen the political union. The bad news for Europe, however, is that growth is still very low (or even negative) in key countries and the Continent's aging population will not contribute to new growth. Furthermore, Europe has a credit crunch in the peripheral countries with high and unsustainable debt ratios. Roubini believes that Europe will continue to go through an internal devaluation (aka, falling wages) via very painful recessions. He believes the fundamental problems in Europe have not been solved because there is no solution. The countries that need a lower currency cannot achieve this and will continue to fall deeper into recession. Spain and Italy are too large to be bailed out and if these two countries cannot stand on their own, the risk of an EU breakup is off the table. They will continue to use buckets to throw water overboard in an effort keep the ship from going down.

Regarding the US economy, Roubini was somewhat more optimistic. He feels that the housing recovery is legitimate. He does believe that there will be a manufacturing revival in the US due to lower energy costs and that the shale gas boom will be a massive tailwind for the US for many years to come. All of these together will lead to solid employment growth and should continue to strengthen the US recovery.

However, Dr. Doom did find a few areas to be concerned about in the US. He feels that the US economy is fighting a huge fiscal drag. Our debt ratios are too high and the deleveraging that the US government is going to have to go through will be a major headwind. The most pressing US concern is the eventual exit of QE. He believes rates were normalized too slowly from 2004-2006, which amplified the housing crash. This time the US will exit very slowly and that process will likely take more than two years. Roubini doesn't anticipate any exit until 2014, at the earliest, and doesn't expect rates to normalize until after 2017.

Nouriel does believe that the emerging markets present some opportunities for sound investments, but mentioned that you should be very picky because only certain markets are attractive.

Roubini believes that there are four potential tail risks, but these risks are much lower than a year ago. The Eurozone is still the most likely area to be the epicenter for a potential correction. The next concerns, in no particular order, would be a slowdown in the US (created by fiscal drag and increased regulation), a Chinese slowdown (due to lack of internal consumption), and, finally, geopolitical risk from Iran, North Korea, or a myriad of other potential hot spots.

Dr. Doom was definitely concerned, but relative to his past musings, he seemed more like Dr.

Cautious.

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Mohamed El-Erian—CEO/co-CIO, Pimco

Tyler Hay

El-Erian says we are living in a new world—a world of unpredictability and confusion. He observed that an outsider with no investment knowledge could have listened to the different presentations at the conference and come to one certain conclusion: There is tremendous uncertainty.

El-Erian thinks the new world has one of three speeds: no growth, slow growth, and steady growth. Japan and Europe fall into the first category, the US the second, and emerging markets the last. At one point, he compared the state of the US economy to that of a hospital patient who has begun to recover and can take short walks through the halls but is not yet ready to check out (hardly consistent with the stock market's recent performance). He thinks it's a thoroughly unstable world; in fact, he calls it an "upside down world" and points to the unique circumstance of low Treasury yields combined with soaring stock prices.

El-Erian made an interesting observation about benchmarking. He thinks that trying to maintain pace with benchmarks brings excessive risk; instead, investors should be benchmark agnostics. Trying to keep up with the seemingly unstoppable market right now can force many money managers to be "all in"—at exactly the wrong time. Pimco is doing quite the opposite as it has been systematically de-risking portfolios. This means that it is willing to sacrifice near-term performance in order to have some protection for when the Fed's ocean of liquidity begins to ebb. If it's good enough for Pimco...

El-Erian suggests that investors "ride the wave" the central banks are creating. But he concedes that this behavior can't continue forever. The biggest question is whether central banks can facilitate a smooth transition from assisted growth to real growth. He clearly doesn't believe it can be done smoothly. In fact, he expanded his wave analogy by noting that they "always break" and the real question is whether investors "crash or walk off the board."

The last item I want to relay is his point about liquidity, which goes as follows: "...do not give up liquidity cheaply. The world today is very binary. It will either end well, or very badly, with no middle ground. Optionality and liquidity are the key to surviving and profiting from a binary world."

Louis Gave—CEO, GaveKal

Louis believes that for the last 10 years it was extremely easy to make money if you followed one axiom: Front-run the Chinese investor. When the Chinese bought real estate in Vancouver, investors who followed suit did very well. When the Chinese bought gold, again those who did the same saw handsome gains. When the Chinese bought expensive French wine...you get the point.

For the next 10 years, he believes there is another simple, but different paradigm for making money and that is for investors to front-run the Japanese. Japan's households have amassed a staggering amount of private sector wealth. To quantify this, the Japanese have \$10 trillion in cash versus the U.S., which has \$9 trillion in cash; however, Japan's economy is only a third the size.

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These cash reserves are losing value as the yen is intentionally devalued by the Bank of Japan. This leaves Japanese investors in search of a more stable currency as well as yield. Louis thinks U.S. high-income investments are a likely beneficiary. Also, Japanese exporters should experience a strong tailwind as the yen is devalued.

Louis further contends that China is at an interesting inflection point with respect to its allocation of resources. For the last 20 years, if you wanted something made cheaply, you made it in China. Today, China's economy is starting to mature, and it is seeing rising labor costs. As the standard of living in China increases, so does the demand for more complex foods as people substitute meats for grains. Domestic food production has long been considered essential from a national security perspective. The land needed for richer food output is in direct competition with China's energy resources. China's previous energy policy, reliant on coal, has become unsustainable because of the tremendous pollution it generates. The dilemma facing China is whether to deemphasize internal food production in order to aggressively develop its oil and gas reserves (China's natural gas resource base is actually larger than America's).

Louis' last point, and potentially most destabilizing to US investors, is the financial revolution that he thinks is beginning to take place in Asia. Hong Kong has a tremendously developed financial system in large part because of England's control, which was relinquished in 1997. In

some ways, China inherited a financial system far more mature than its economy. If China pursues status as a reserve currency for trade in Asia, it will certainly pose some serious challenges for the US dollar.

Charles Gave—Founding Partner/Economist, GaveKal

John Mauldin says he learned the hard way that the only way to be assured of a poor reception from an audience at an investment conference is to present right AFTER Charles Gave. So, at this event, John wisely chose to introduce him instead. Charles' ability to put complicated financial concepts into easily digestible context was on full display. Charles said the central banks remind him of Christopher Columbus. Like Columbus, they have no idea where they are going, no idea what to do when they get there, and they are doing it all with other people's money.

Charles, as with most French men, has a way of stating opinions that somehow seem like fact. As his partner, Anatole Kaletsky, has said: "Charles, I wish I were as sure about anything as you are about everything." He has said that debating where the euro will stand relative to other currencies is an irrelevant conversation because soon enough the euro won't exist. Charles has been a staunch critic of the euro for reasons we have cited ad nauseum in past EVAs. (As a reminder, a common currency with such uncoordinated fiscal policies is a recipe for failure.)

When asked what he imagines central bankers will do next, he conceded he has no idea. He said that central bankers have already broken so many rules he isn't capable of such imaginative thinking.

Charles believes that risk is being completely mischaracterized. The manipulation of securities that are historically lower risk (i.e., Treasuries) has forced investors to look elsewhere for returns and created an unnatural risk-reward profile for different asset classes.

He also has a major problem with the concept of GDP. On the surface, it's supposed to convey the total economic activity of a country. GDP growth means progress but, to Charles, this doesn't make sense. He has published an article (if you email us, we can provide it) that attacks the methodology behind GDP. In a nutshell, GDP includes government spending as an added value. But government spending isn't really a legitimate indication of growth. Instead, it's a measure of government expansion, something he considers an enemy of true economic development.

Charles, of all the presenters, was the most outspoken regarding the actions currently being taken by the central banks. Perhaps quieted by recent market strength, some speakers found it difficult to continue their attacks on central bankers, conveying a kind of "enjoy it while it lasts" sentiment. Others said that we are in uncharted waters and no one can predict how it ends. Charles was his usual self when asked what conclusions he drew when evaluating the current set of global monetary policies by saying, "I'll tell you how it ends: In tragedy."

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