

May 25, 2012

"Better an end with horror, than a horror without end."

-AN OLD GERMAN PROVERB

POINTS TO PONDER

When titans, and their egos, collide. Just a few miles up the hill from the race track where, as Bing Crosby used to croon, "the surf meets the turf at Old Del Mar," the annual gathering of many of the most glittering minds in the investment firmament recently convened. Though simplistic, it would be reasonable to refer to this confab as where the bulls meet the bears by Old Del Mar.

Yet it's probably more accurate to say that these yearly events hosted by newsletter maven John Mauldin and hedge fund purveyor Altegris Financial have evolved into a showdown between the "Apocaleptics" and the "Solutionists." The days of investment pros extolling ways to make fat returns have been replaced by an existential debate as to whether the rich world's economic systems are totally doomed or "merely" in need of a complete overhaul. Basically, do you invest as if the Mayans were right about 2012 or do you act as if human ingenuity and rationality will eventually triumph?

Veteran EVA readers know that I've gone to this conference for many years and that the insights I've attained have helped clarify and reinforce some of my "big picture" views. With apologies to those who've seen this before, it was at the 2006 Mauldin gathering that I became convinced we had huge problems headed our way from housing. This illumination was unquestionably a factor in the defensive, income-focused portfolios we crafted for our clients prior to the Great Recession.

Unfortunately, these days, the proper course of action is much less obvious. One of my primary takeaways from this year's Mauldin conference is how perplexed even the best and the brightest are, although, given the size of some of the egos, they don't actually act that way. A few of these guys can swagger like Jamie Dimon (prior to the harpooning of J.P. Morgan's whale, that is). But all of them admit that the world's never been through anything like this before so there is really no precedent to follow, a point conceded by Pimco CEO Mohammed El-Erian in his talk.

Mr. El-Erian had one of the better metaphors of the event when he stated that the global economies are like the knight in the old Monty Python film who gets one arm cut off, then another, and eventually both legs, but keeps bravely declaring: "It's only a flesh wound!"

While there was a huge division among the presenters as far as how events will play out, the one point on which they all agreed is that we're dealing with something a bit more serious than a flesh wound.

The Big Four. In trying to summarize the dominant themes conveyed at this year's opinion-fest, I've come up with this quartet:

Inflation vs deflation

The Keynesians vs the "Austerians"

Europe

The clash of generations

Starting with the inflation/deflation debate, which has such profound implications for investment portfolios, there was close to an even split between ardent advocates on both sides. Long-time Barron's Roundtable member Marc Faber feels inflation is already running 5% to 10% and he sees the kind of price explosion coming to the US that Latin America experienced through the 1970s and 1980s. (He neglected to mention that he had previously called for hyperinflation to erupt in America back in 2009.)

But he wasn't alone. Jeff Gundlach, the man who has been anointed by some as the new King of Bonds (somehow, I don't think the old King, Bill Gross, is ready to relinquish his crown), was largely of the same view. He thinks inflation will creep up to 4% to 5% driven by the Fed's Control+Print monetary policies. He feels these escalate the cost of essentials while producing mini-bubbles in a constantly changing array of asset classes, an appraisal I have expressed in the past.

On the other side of the inflation debate were luminaries like David Rosenberg (macro economist extraordinaire), Niall Ferguson (arguably the most popular historian/economist in the world today), and Lacy Hunt (principal at the Hoisington Investments, one of the best performing US bond managers).

Some EVA readers may recall that at last year's Mauldin conference, when commodities were sizzling (silver had just hit \$50), and most of the attendees were clearly betting heavily on their continued uptrend, David Rosenberg slammed them back to reality. He made an impassioned argument that the deflationary forces unleashed by the bursting of the real estate and debt bubbles would overwhelm any temporary flare-up in prices for commodities and even for consumer goods. He also shocked those in attendance by telling them they should be buying bonds not silver. Just weeks later, he was proven absolutely right.

Lacy Hunt has made a fortune for his clients by resolutely sticking with a long bond position for many years and, unsurprisingly, he doesn't see the 30-year bull market in fixed income coming to an end just yet. His view is that we are in a debt disequilibrium and we are foolishly trying to solve it with more debt (an observation that all the pundits agreed on save one). He noted that Europe's total indebtedness is 450% of GDP, Japan's is 500%, and the US's, while better, is still a towering 350%.

He further commented, as did a few others, that the debt multiplier has gone negative, meaning that for every dollar of additional IOUs the US government incurs it produces less than \$1 of increased economic activity (i.e., GDP growth). Dr. Hunt also asserts that what economists call the output gap (basically, the excess supply of productive capacity and people) is actually increasing. This is at odds with some (even in the Fed) who maintain the US is not that far away from bumping up against its full output potential, meaning that we are close to a point where inflation will heat up.

However, like all wise men of money, both Mssrs. Rosenberg and Hunt were mindful that the superannuated bull market in bonds will inevitably expire. And they also had a suggestion on how to be out in front of its eventual demise.

Follow the money...multiplier. One of the biggest questions we wrestle with at Evergreen, especially considering the half a billion or more of income investments we manage for clients, is when interest rates and inflation will spike. Unlike Faber and Gundlach, we don't believe inflation is running higher than officially reported though we do concede the latter's point that whenever the Fed's printing press cranks up it inflates commodity prices. This in turn puts pressure on the cost of daily living, such as at the gas pump.

However, we also feel that in such a chronically weak economy, where there is a huge surplus of workers and the COLA has gone the way of the typewriter, the net effect is actually contractionary, at least for the economy if not inflation. Less money available due to \$4 gas means reduced spending at WalMart.

The essential Ferguson/Rosenberg/Hunt view is that the forces of deleveraging are swamping the impact of normally inflationary behavior by central banks such as the Fed. One direct example of this, as noted in many past EVAs, is the unparalleled collapse (at least since the 1930s) in the velocity of money. We have all witnessed this through the indifference your friendly (or maybe not as friendly) banker has toward getting you to make a big deposit or take out a hefty loan. Money just isn't multiplying like it used to in the good old days. (See *Figures 1 and 2*)

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You're probably not surprised to read that I continue to agree with this view. Moreover, I also

concur with both David Rosenberg and Lacy Hunt when they say that if you want to know when inflation and interest rates are going to turn, keep a very close eye on money velocity. With nearly \$2 trillion of the Fed's "funny money" floating around, if velocity turns up and the Fed doesn't drain excess reserves like the sluice operators at Grand Coulee dam during spring runoff, look out below. It will be time to bust out the bell bottoms and Bee Gees albums: The 1970s will be back—if not worse.

This topic naturally flows into the next major debate between those advocating a return to fiscal rectitude, whom I've dubbed the Austerians, and the true believers that government spending and Fed printing can solve all our problems, the Keynesians. In the case of this conference, it was a most lopsided contest. There were in reality just two pundits defending the latter approach, most notably the former vice chairman of Pimco, Paul McCulley.

Appropriately enough, he totally looked the part.

Are we all Europeans now? Mr. McCulley, once rumored to be on the short list to become a Fed governor, retired from Pimco a couple of years ago and since then let's just say he's gotten back in touch with his inner hippie. Actually, he looked very Buffett-like, but it was definitely Jimmy not Warren. Thus, it was thoroughly appropriate that he was defending the kinds of policies that started in the 1960s and hit their inflationary crescendo in the 1970s.

In fairness to Paul, who gave some of the best speeches I heard back in 2006 and 2007, brimming with clarion warnings about the housing bubble, things are very different now than when polyester and leisure suits reigned supreme. These days he is cautioning against the "paradox of thrift," which means that it's ok for some consumers, and even some countries, to cut spending and increase savings. But when everyone tries to do it at the same time, bad things happen—like deep recessions and modern-day depressions. (Geek note: It's also called the "paradox of aggregation.")

Consequently, when the private sector is deleveraging, the public sector must leverage up to avoid what we saw in the early 1930s. Additionally, central banks need to print like crazy to offset the related collapse in money velocity.

Despite these plausible arguments, and the fact that the US has avoided Great Depression, The Sequel, at least partially because we have largely followed the McCulley prescription, he attracted a lot of flak from his peers. It was the general consensus, with which I'm in accord, that while such extreme measures were necessary during the worst of the crisis, a continuation down our present path inexorably leads us to where Europe is today. And, as we're all fully aware, that's a most unpleasant destination.

Naturally, Europe's increasing anguish was a hot subject at this event even though it was held before global stock markets once again turned their frightened gaze on the Continent's latest paroxysms. As with your humble EVA scribe, there was intense concern about the recent course of eurozone events, and what has happened since then certainly justifies said anxiety.

To greatly condense hours of discussion on this issue, the great thinkers believe Europe is now at its moment of truth, much like a mortally wounded bull facing his unyielding matador. Either Germany agrees to a fiscal union or the grand euro experiment is toast (note I'm referring to the paralyzing straightjacket of the currency not Europe itself).

There was, of course, fierce debate on which outcome would be better in the long run, but no

one doubted that, given the twin terrors of catastrophic unemployment and accelerating bank runs, the great reckoning is close at hand. As in the 1960s, it's likely to be the young people who precipitate a tectonic shift.

The Road to Europdom—and how to get off it. The final issue, the clash of generations, is relevant not only to Europe but to America, Japan, and China as well. All four regions are either rapidly aging or soon will be (with China's one child policy seriously impacting its demographics in another decade or so). Niall Ferguson and one other speaker, who I will focus on shortly, both highlighted this as one of the dominant themes and threats of our times, a view I absolutely share. (See *Figure 3*)

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The generations behind baby boomers like me are being left a massive bill with little hope of paying it, and the reality is they won't. One of the reasons that the situation is coming to a head so fast in Europe is because some countries, including crucial Spain, have 50% youth unemployment. A key cause of that is inflexible labor laws which make companies very reluctant to hire. The European baby boomer also tends to have a generous pay package and ironclad employment protection. It's a recipe for extreme social dissension and several of the presenters believe, as do I, that the situation is becoming increasingly unstable. This will be a very long, hot, and violent European summer.

It's not just Europe. America and Japan have also built social models that are predicated on the younger generations paying for the tsunami of retiring boomers. The former pyramid of lots of workers paying for a few retirees is being flipped upside down and it doesn't take a self-professed math genius like Jeff Gundlach to realize the numbers no longer compute. The inverted pyramid is destined to tip over and crash barring an entirely new economic construct.

And this leads me to the speaker I referred to at the opening of this section. His name is Woody Brock, and in my view he was this conference's equivalent of the Rosetta Stone. A recurring thought I had as I listened to the Austerians and the Keynesians (pretty much just Paul McCulley and an Irish economist, David McWilliams) was that neither side has an effective solution to offer. Further, their views are so polarized that any kind of reconciliation seems impossible, an observation that I feel also applies to the current stalemate in US politics.

John Mauldin devoted two issues and 34 pages of his Outside the Box newsletter to provide Woody Brock a forum to summarize his new book *American Gridlock: Why the Left and Right are Both Wrong*.

Having just read this, I was particularly interested in his presentation.

Suffice it to say I wasn't disappointed by his rapier-like mind and his impassioned delivery. Basically, he gets it more than anyone else I've heard or read. Woody advocates a new economic operating system designed for what we face today, not a leftover vestige of the 1970s or 1980s. There isn't time to get into his solution set in detail in this EVA; rather, I will do an issue fully devoted to his truly grand plan this summer. But to give you a sense of his views, just with regard to the Austerians and the Keynesians, he believes they are both right and both wrong. The government does need to borrow massive sums for now, but the excess debt should be invested not spent.

His overarching point is that government accounting is flawed which then leads to misguided spending. One of his solutions is to empower (a key word) commissions of private experts to allocate the roughly one trillion of extra spending that is occurring now in the US, to avoid a recession cum depression, into "certifiably productive" investments. These would be scored based on return on investment not political patronage.

Yes, I realize, it almost strains credulity to imagine such a process, but actually the Roosevelt administration used a similar approach in WWII to achieve the most remarkable industrial surge in history (with no apologies to China's recent experience). My favorite tangible example of how this could work would be for the US Post Office, one of America's largest consumers of motor fuel, to retrofit its immense fleet of trucks to run on compressed natural gas. This would require a substantial upfront investment, thereby creating jobs. It additionally would have huge and enduring long-term benefits such as reducing our outflow of dollars to OPEC. Of course, it would help to produce even more domestic energy jobs, one of the few bright spots in our dismal employment picture.

He also has fascinating and thoroughly rational views of what needs to be done to reform our healthcare system, almost inarguably the greatest challenge our country faces. In his book, he notes that the supply of general practitioners and surgeons is already down 26% and that the Affordable Healthcare Act will aggravate this despite its noble intentions. What will result is a disastrous combination of further supply contraction and an explosion in demand. Again, he proposes a series of reforms that are broader and more logical than any I've seen (hopefully, you're getting excited to read the "Brockonomics" EVA).

Now, let's close this EVA with a brief summary...

Why we're "apped" to succeed. For the first time, I was joined by an Evergreen client at the Mauldin conference and he asked me a very good question as we said goodbye at its conclusion. He wondered if anything I had heard changed my mind about how Evergreen should manage client portfolios.

After thinking about that for a few moments, I said no. My reasoning was that what I heard confirmed no one knows how these crazy times will play out. While that's always somewhat true, it's much more the case today. The normal post-recession road map has been ripped up. Nobody has ever seen the extraordinary confluence of events we are dealing with now.

One of the few original thoughts I've had that I've expressed in prior EVAs, which was reinforced at this conference, is the fact that all four members of the world's major economic bloc—the US, Europe, Japan, and China—need to create new operating systems. I'm convinced this will happen and in our case I think it will be something along the lines of "Brockonomics." But it's going to be anything but a smooth transition. This is why my team and I feel it's essential to be

actively contrarian: taking profits when the optimists get carried away and putting money to work when panic is in the air.

And because no one knows how this will all play out, being hedged, holding more cash than normal, and being willing to leave some near-term performance on the table to be defensive are also vital. As Jeff Gundlach said, in this investment environment, it's better to be three hours early than one minute late. But there will be a time to be an aggressive buyer and this summer might be it.

The months ahead are likely to be both traumatic and pivotal. Western societies are being forced to make some very tough decisions. In the vernacular of Niall Ferguson, the "first world" needs some new killer apps—such as radical reforms of our many failing policies--if it wants to avoid becoming "third world." He's right about that, but I'm convinced mankind's greatest apps lie ahead. In other words, don't bet on the Mayans—heck, they haven't written a good app in at least a few centuries!

David_Hay_Signature

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