

May 3, 2013

"Be patient and wait for markets to come to you. Patience is a position, too."

-JOHN MAULDIN , one of America's most popular financial newsletter authors

Will the "Curse of the Cover Story" strike again? Sometimes a magazine cover is worth a thousand words—and hundreds of thousands in wealth preservation. In fact, for some *EVA* readers, the savings might run into the millions if they pay heed to this frequently-accurate contrary indicator.

Past EVAs have noted the persistent tendency for major publications to come up with some embarrassingly bad cover stories over the years. The 1979 feature on the front of *Business Week* announcing "the death of equities" is arguably the most famous example, but the years have produced a plethora of similarly misguided feature stories. (My friend David Rosenberg has compiled an extensive library of this "hall of shame," which I may run at a later date with his permission.)

This week's guest EVA is a retransmission of a recent newsletter from one my favorite sources, John Hussman. As you will soon see, his first chart is remarkably simple, yet arresting. It shows the two prior peaks in the stock market over the last 15 years, along with *Barron's* cover stories celebrating the zeniths and calling for higher highs. More relevantly, it also shows *Barron's* April 22nd edition which ought to give all those rampaging bulls out there cause for pause.

In addition to the aforementioned chart, John also has some compelling data on the degree of professional investor bullishness, as well as the present level of margin debt. In my opinion, John makes a strong case for why investors should be getting increasingly defensive the longer this market soars while the real economy sours.

Because this is one of his shorter missives, I've also included a portion of a recent John Mauldin letter in which he runs his own guest edition. In this issue, John published the work of Sheraz Mian, director of research for Zacks Investment Research. The firm was founded by Len Zacks in 1978, and over the years it has been heavily relied upon by institutional investors worldwide.

As John Mauldin points out, Zacks innovated the concept of consensus earnings expectations. If you've ever wondered what a company's profits announcement is compared against to determine if it was better, or worse, than expected, it's typically the Zacks Consensus Estimate model. Sheraz Mian's insightful essay makes a nice companion piece to John Hussman's as it also makes clear that corporate profit expectations are, much like the professional investment community, excessively optimistic.

As mentioned in the April 26th *EVA*, I am down in Carlsbad, California, this week along with several Evergreen GaveKal team members (including GaveKal's founder Louis Gave and his iconic father, Charles) for John Mauldin's renowned Strategic Investment Conference. And as conveyed last week, Louis and Charles will be presenting alongside Pimco's CEO Mohamed El-Erian, celebrity historian Niall Ferguson, the man *Barron's* has crowned the new King of Bonds, Jeff Gundlach (the reigning regent, Bill Gross, might take issue with that)* and one of my personal favorites, Merrill Lynch's former chief North American economist, David Rosenberg.

It was gratifying to see our partners, Louis and Charles, plus co-founder Anatole Kaletsky, share the conference limelight with the above mega-stars (not to mention Kyle Bass, one of the heroes

of *The Big Short*). Moreover, GaveKal was introduced today by John Mauldin as being one of the premier research firms in the world, an assessment with which we emphatically agree.

Long-time *EVA* readers may recall that it was during my first years attending the Strategic Investment Conference that I became convinced that both housing and lending were entering classic "bubble" terrain back in 2006 and 2007. That belief was critical in correctly positioning our clients' portfolios to protect them from the devastating shock waves that emanated from the twin collapses of those related manias.

Appropriately, I've got that déjà-vu-all-over-again sensation these days. My flashback feeling now is due to the fact I'm constantly hearing and reading that it's OK, even necessary, for our economy to be relying on the Fed's "pseudough" (i.e., its multi-trillion production of money from nothing). This seems eerily similar to the attitude that it was no problemo for US consumers to be addicted to the house-as-an-ATM seven years ago, the common thread being that we can sustain prosperity through fake wealth creation.

In the weeks ahead, my team and I will be sharing with you the most meaningful information we have assimilated at this year's Mauldin confab. Until then, I hope you appreciate the message from these two sober voices in an ever more inebriated investment world.

**As a late-entry footnote, almost live from the Mauldin conference yesterday, I just heard Jeff Gundlach's presentation. Every time I hear him talk, I find myself wondering if his intellect or his ego is larger. There's little doubt in my mind he would eagerly paraphrase Winston Churchill by saying that he has much to be not humble about and, after listening to him again, I would agree. He truly is breathtakingly brilliant and his track record is commensurate with that description. Very much on point with this week's EVA, he also doesn't give praise freely to other money managers. In fact, I've never heard him do so, yet, he went out of his way to complement John Hussman in his remarks. He even ran one of John's profit margin charts showing the exceptionally elevated current level of US corporate earnings, and further pointed out this is bearish for stocks (but bullish for bonds) as they have only one way to go—as in south.*

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THE ENDGAME IS FORECED LIQUIDATION

John P. Hussman, Ph.D, Hussman Funds

"The stock market isn't the only thing that has set records this spring. *Barron's* semiannual Big Money poll of professional investors also is setting a record -- for bullishness, that is. In our latest survey, 74% of money managers identify themselves as bullish or very bullish about the prospects for U.S. stocks -- an all-time high for Big Money, going back more than 20 years."

"Dow 16000!" – *Barron's Magazine* Big Money Poll 4/20/2013

A few reminders...

"Still Bullish! (Dow 13000)" – *Barron's Magazine* Big Money Poll, May 1, 2000

The May 2000 Big Money Poll was published with the Dow Jones Industrial Average at 10733.91. The Dow had already peaked nearly a thousand points higher in January of 2000, and would go on to lose about 40% of its value in the 2000-2002 bear market, with the S&P 500 and Nasdaq faring far worse.

"Dow 14000?" – *Barron's Magazine* Big Money Poll, May 2, 2007

The May 2007 Big Money Poll was published with the Dow at 13264.62. The Dow did advance another 6% to reach 14000 by October 2007. By November (the poll is semi-annual), bulls were outnumbering bears by 2-to-1, and the headline ran "The Party's Not Over." In fact, the market had already peaked, and proceeded to lose over half its value in the 2007-2009 bear market.

The *Barron's* Big Money Poll is typically bullish, on balance. This is Wall Street, after all. But variations in the tone and extent of that bullishness can be informative, especially when the consensus is extremely optimistic at new highs of mature bull markets, and defensive at new lows of mature bear markets. I can't really throw stones about 2009, as I had my own concerns at the time (relating to the need to stress-test against Depression era outcomes, despite our favorable views of valuation). But it's worth noting that the 2009 Big Money Poll questioned the advance from the March lows, noting "good reason not to jump in with both feet yet." The 2003 Big Money Poll – already well into a new bull market – was bullish on balance, and up from just 43% bulls in an October 2002 poll near the market lows. Still, the 2003 poll noted "the bulls' views have been tempered by the market's losses in recent years. Consequently their expectations for the Dow, the Standard & Poor's 500 stock index, and the Nasdaq Composite have been ratcheted down from past surveys."

This certainly isn't a criticism of *Barron's* itself. I grew up on *Barron's Magazine*, and will remain a devoted reader at least as long as Alan Abelson provides a worthy counterbalance to the more short-sighted views of Wall Street and the Market Lab section remains in print. Still, the Big Money Poll is most useful as a contrary indicator.

Rule o' Thumb: When the cover of a major financial magazine features a cartoon of a bull leaping through the air on a pogo stick, it's probably about time to cash in the chips.

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While the attention of investors is focused on the short-run market outlook in what is already a mature bull market advance, it's crucial to understand the endgame to this overvalued, overbought, overbullish, overleveraged episode of market history. That endgame will be forced liquidation, as declining prices force leveraged investors to sell – voluntarily or otherwise. I noted back in January that margin debt had surged above 2% of GDP for the fourth time in history (the other three being 2000, 2007, and February 2011 - less severe, but still followed by an 18% market correction). In February, NYSE margin debt (the amount that investors have borrowed to purchase NYSE-traded stocks on margin) reached \$366 billion, and there's a fair chance that given the continuation of that advance in the subsequent weeks, more recent margin debt will have accumulated to a total that eclipses the July 2007 record of \$381 billion.

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Clearly, the dollar value of margin debt has experienced a secular increase over time, so the levels aren't as important as the cyclical variations. In particular, note that rapid and nearly parabolic increases in leverage tend to appear as the market approaches major peaks and bullishness feeds on itself. There are a number of series that can be used to normalize the long-term uptrend and to put the amount of margin debt in context. Notice that one would not want to normalize using the market value of stocks themselves. The reason is that margin debt surges near market peaks and collapses at market troughs, so to divide by the level of prices at those points would actually destroy much of the information content of margin debt (though you still typically observe debt rising much faster than prices as the market peaks).

Below, margin debt is presented as a percentage of GDP. Presently, margin debt is more than 2.3% of GDP, the highest level in history with the exception of the approaches to the 2000 and 2007 market peaks. Clearly, there have been changes in market structure over time, such as the emergence of hedge funds, long-short strategies and the like. So the long-term increase in margin debt certainly has some "structural" features to it. Again, however, the important feature to observe is not so much the absolute level, but the cyclical tendency for spikes in margin debt to accompany overvalued, overbought, overbullish market peaks. The subsequent market collapses are typically worsened by the inability of investors to simultaneously exit overleveraged positions that were all based on the same investment thesis.

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There is no question that objective, careful, historically-informed analysis has had enormous challenges in the context of monetary interventions and fiscal deficits that have suppressed yields, temporarily boosted profit margins, and encouraged speculative leverage. Unfortunately, however effective these interventions have been in achieving speculative outcomes and kicking cans beyond their normal resting places, the endgame is still the same. Again, the endgame of overvalued, overbought, overbullish, overleveraged markets is forced liquidation.

Margin debt is soaring, valuations are now elevated even on the assumption that profit margins 70% above their historical norms will be sustained indefinitely, yields are compressed on nearly every asset class, and there is increasing evidence that Fed "stimulus" is incapable of exerting meaningful effects on the real economy and is exerting only speculative effects on an already

overspeculative market. With a record 74% of Wall Street strategists now bullish, who is left to embrace further speculation, and how deep will the required losses be to induce the conservative 26% to absorb the overleveraged exposure of the exuberant 74% when forced liquidation becomes necessary?

On the temptation to disregard proven indicators

As a side-note, it's important for investors to be wary of "structural" arguments intended to discard indicators that have very reliable cyclical records. For example, hardly a day goes by that we don't see an attempt to harness some long-term structural factor, such as increasing globalization of trade, to explain away the spike in profit margins over the past few years – in the hope of proving that these margins will be permanent this time. Some of these arguments are discussed in recent weekly comments. But these factors don't explain the cyclical fluctuations in profit margins at all, and can't be used to discard the accounting relationships and decades of evidence that corporate profits have a strong secular and tight cyclical mirror-image relationship with the combined total of government and household savings.

Investors get themselves in trouble when they embrace "new economy" theories not because those new theories can be demonstrated in the data; not because existing approaches fail to fully explain the subsequent historical outcomes; but solely because time-tested approaches suggest uncomfortable outcomes in the present instance.

The same sort of structural second-guessing is evident in the gold market here – a good example of what forced liquidation looks like, as my impression is that leveraged longs have been forced into a fire-sale in recent weeks, creating good values for longer-term investors, but with continued near-term risks. If we look at the ratio of gold prices to the Philadelphia gold index (XAU), we do believe there are structural factors that affect that ratio (primarily the increasing cost of extracting gold over time). But these don't explain away or eliminate the strong cyclical relationship between the gold/XAU ratio and subsequent returns on the XAU over the following 3-4 year periods. So while we don't believe that the record high gold/XAU ratio can be taken entirely at face value, there's no question that it is elevated even on a cyclical basis (that is, even allowing for a gradual structural increase over time), and there's no question in the data that cyclically elevated gold/XAU ratios have been associated with strong subsequent gains in the XAU index over a 3-4 year period on average, though certainly not without risk or volatility.

As a final example, some analysts (such as the Dow 36,000 authors) have argued that the proper risk premium on stocks, relative to Treasury securities, should be zero. This line of argument was used in 2000 to suggest that stocks were still cheap despite high apparent valuations. But this "secular" argument for high valuations ultimately did not weaken the long-term evidence and tight cyclical relationship between valuations and subsequent market returns. Despite all the new economy arguments about productivity growth, the internet, globalization, the great moderation, and the outdated relevance of risk premiums, stocks still went on to lose half their value over the next two years, and to produce negative returns over the decade that followed.

The bottom line is that it becomes very tempting – both in speculative markets and fearful ones – to discard well-proven indicators as meaningless by arguing that some "structural" change in the market or the economy makes things different this time. True, those arguments can sometimes be used to explain very long-term changes in the level of an indicator. But even then, new economy arguments are typically ineffective at explaining away the informative cyclical

variations in good indicators. Be particularly hesitant about ignoring indicators whose cyclical variations have been effective even in recent data, as is true of the ability of time-tested valuation approaches to explain subsequent 10-year market returns even during the period since the late-1990's, and the ability of government and household savings to tightly explain cyclical swings in profit margins and subsequent profit growth, even in the most recent economic cycle.

EVALUATING EXPECTATIONS FOR THE COMING QUARTERS

Sheraz Mian, Zacks Investment Research

Earnings estimates from analysts are heavily influenced by guidance from management teams, particularly on the earnings calls. And while the tone of guidance in Q4 was somewhat less negative relative to what we heard from management teams in Q3, it was nevertheless predominantly weak and tentative. This prompted analysts to cut their estimates for the coming quarters, and particularly Q1.

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To provide a context for the consensus growth expectations for the coming quarters, the next two tables show the absolute dollar levels of total quarterly and annual earnings (as against the Year-over-Year growth rates shown above).

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What we see from looking at the last few quarters is that total quarterly earnings have yet to get back to the 2012 Q1 peak of \$248 billion. Total earnings have basically been trending down over the last three quarters, but consensus expectations are looking for earnings to start trending back up from 2013 Q1 onwards, with the growth pace materially picking up from Q2 onwards.

Another way to look at this data is by comparing the consensus expectations for the first half of 2013 with the actual results for the same period in 2012. Expectations are for flat earnings growth in the first half of the year, but a ramp-up in the back half of the year to a growth pace of +9.5%. This growth momentum is expected to carry into 2014, giving us earnings growth of +11.7% that year, after the +6.8% gain in 2013 and the +3.8% growth in 2012.

In absolute dollar terms, consensus expectations are for companies in the S&P 500 to earn \$1.03 trillion (yes that is a trillion) in 2013 and \$1.15 trillion in 2014. In terms of earnings per share, this approximates to \$109.88 per "share" of the S&P 500 index in 2013 and \$122.72 in 2014.

How Realistic Are These Expectations?

In my professional opinion, they are not realistic. I don't think these expectations will pan out, and here is why. Earnings increase through two ways: revenue growth and/or margin expansion (margins are basically earnings as a percentage of sales). The outlook on both fronts is problematic.

Margins have peaked already and at best can be expected to stabilize around current levels. And you can't have significant revenue growth in the current growth-constrained environment.

Another avenue for growth, particularly at the individual company level, is through mergers and acquisitions. While many M&A deals don't end up creating value for the acquiring company's shareholders and don't generate growth at the aggregate level, they do produce growth at the company level. The historical track record of corporate deal making, in terms of aggregate growth and returns, is spotty at best. But management teams are ever ready for a deal, particularly when elevated equity markets provide them with an easy-to-use currency and the credit markets are willing to fund anything, as is the case at present.

The expected strong earnings growth in the second half of 2013 and next year reflect a combination of revenue growth and margin gains. Revenue growth has a very strong correlation with (nominal or non-inflation-adjusted) global GDP growth. But economic growth has been very anemic lately, with the rich world's slow-motion deleveraging process casting a dark shadow over the faster-growing emerging world.

The US economy is actually in better shape relative to the recession in Europe and Japan's nascent efforts to inflate away its problems. But that's only in relative terms – the reality is that the US economy is at best on a sub-2% growth trajectory. Even that growth pace may be at risk from unfolding fiscal austerity efforts such as the budget sequester and Fiscal Cliff-related tax hikes.

But consensus expectations are looking for a second-half 2013 GDP growth ramp-up that pushes the growth pace close to +3%, and even higher next year. With the US economy barely producing any growth in 2012 Q4, it is hard to envision the growth outlook improving to that extent. But current revenue-growth expectations reflect these optimistic assumptions.

As the chart below shows, margin gains play a big part in projected earnings growth in the coming quarters.

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Margins have already travelled quite some distance from the 2009 bottom and are essentially in line with the prior cyclical peak. One could argue that margins should move past the prior peak like the stock market; but before we buy into that argument, let's not forget what gave us the 2006/2007 peak in the first place. Without even getting into the details of how the housing bubble back then pumped up everything, one could say with a lot of confidence that those were unusual times and cannot be expected to repeat. Total earnings, on the other hand, are already above the 2007 peak.

Margins follow a cyclical pattern. They expand as the economy comes out of a recession and companies use existing resources in labor and capital to drive business. But eventually capacity constraints kick in, forcing companies to spend more for incremental business. At that stage, margins start to contract again. Given the extent of unemployment and under-employment in the US economy, one could reasonably say that we haven't reached those levels. That said, it is hard to envisage companies doing more with less forever.

So What Gives?

Not only are margins already at record levels, but corporate earnings as a share of GDP are also at multi-decade highs. Just as trees don't grow to the skies, margins and the ratio of earnings to GDP don't expand forever, either.

What all of this boils down to is that current earnings estimates are too high and they need to come down – and come down quite a bit. One could reasonably draw a scenario where earnings growth turns negative this year. But the most likely path appears to be for earnings growth to flatten out – with the absolute level earnings this year and next not much different from what we got in 2012.

Granted, negative earnings revisions would not be a new phenomenon, as estimates have been coming down for more than a year now. But the market has essentially shrugged off this weakening picture in the hope of an improving earnings outlook for the coming quarters. Importantly, investors have been heartened by the improving outlook for China, a less worrisome European picture, and resolution of some of the domestic macro issues.

But the level of calm in the market is bordering on complacency. After all, Europe remains in a recession; and recent Chinese data about PMI, industrial production, retail sales, and inflation show that we can't take a rebound in that country for granted. Importantly, recent talk of changes to the Fed's QE program from within the FOMC are offsetting its effectiveness, Bernanke's assurances notwithstanding.

With global tailwinds dissipating, the earnings outlook question becomes far more significant for the market. Unless the domestic and international growth backdrop materially improves from current levels, it is hard to imagine current earnings growth expectations holding up. And as investors wake up to the significantly weaker corporate earnings backdrop over the coming months, it will become harder to justify the market's recent gains, potentially leading to a broad-based pullback.

Investing in a Low Earnings Growth Environment

The bottom line is that actual earnings growth will be substantially lower than what is currently built into stock prices. This view is contrary to current consensus expectations and could potentially serve as a major headwind for the market once investors begin to share it in coming months.

The way to invest in such an environment is to look for stocks that don't reflect aggressive growth expectations and that enjoy company-specific growth drivers not tied to broader macro trends. Companies that generate plenty of cash flows beyond their immediate capital needs and have track records of sharing excess cash with shareholders through dividends and buybacks are particularly well suited for a period of sub-par earnings growth.

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