

May 4, 2012

"Europe is headed for a depression if it doesn't figure out how to reform."

-JOHN MAULDIN, SPEAKING TODAY AT HIS ANNUAL STRATEGIC INVESTMENT CONFERENCE IN CARLSBAD, CALIFORNIA

POINTS TO PONDER

1. Recent EVAs have noted that growth in US after-inflation (real) disposable income is at recession-type levels. Looking back over a longer time frame shows a similarly discouraging pattern. (See Figure 1)

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2. Despite the stock market's recent rally back up to its highest level since 2008, the initial estimate of first quarter growth was a disappointingly meager 2.2%. While this could certainly be revised up in the future, the fact that the critical sub-component of real final sales was up an even weaker 1.6% is concerning.

3. Another indication that the US economy isn't as buoyant as some pundits have been loudly proclaiming (especially on CNBC) is that March durable goods orders shrank at the fastest clip in three years. In fact, two of the past three quarters have now been negative.

4. Although the US has done more deleveraging than most developed countries since the global financial crisis began, the amount of debt pay-down is far from impressive. (See Figure 2)

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5. EVAs from the spring of last year warned of a potential stock market correction in part due to a high level of insider selling. Consequently, it's worth considering that officers and directors are selling shares at the most intense rate since April 2011.

6. It's often assumed that a stock's price action just prior to an earnings announcement foretells the actual number. Proving that the market doesn't always know best, Apple's market cap fell by \$50 billion (more than Hewlett Packard's entire valuation) in the 11 days before it released another stunningly strong profit report.

7. As evidence mounts of global economic cooling, the US has reassumed its long relinquished role as the world's growth engine. Real consumption growth has been healthy despite the aforementioned flatlining by spendable earnings. The key question now is whether this is sustainable.

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8. Despite the fact that the US first quarter GDP rise was a letdown for those expecting a more dynamic reading, most European nations can only dream of such performance. Seven of the 17 countries that share the euro are now in recession, including the Netherlands, Ireland, the UK, and Spain, with the latter being the most heartbreaking as unemployment nears the depression-like level of 25%.

9. As with Apple, the law of large numbers is working against China. Based on a GDP of

around \$7 trillion, up from \$1 trillion a decade ago, the days of double-digit growth are over. What is a challenge for China, though, is a boon to the rest of the world. In 2001, the Chinese economy grew by 11%, amounting to some \$110 billion of increased activity. Yet an 8% expansion today equates to \$560 billion of added demand.

10. Excluding oil imports, the US is running a relatively modest trade deficit. As shifts occur to domestically produced natural gas for uses such as fleet transportation fuel (UPS, Fed Ex, etc.), as well as its displacement of oil for utility power generation, the outflow of dollars for energy is likely to continue shrinking. The rapid increase now underway in oil produced in North America should only magnify this beneficial trend. (See *Figure 5*)

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11. Germany, once known as the sick man of Europe, initiated a series of growth-enhancing reforms over the last decade, becoming the Continent's he-man in the process. Yet, even the supposedly muscular German economy is looking increasingly feeble of late.

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12. Not all is bleak in Europe, however. Back in the 1990s, years before Germany adopted similar measures, Sweden instituted a radical restructuring of its crippling welfare state. It also made its tax rates much less punitive, incentivizing the private sector. In 2011, Sweden was Europe's fastest growing economy, enabling it to balance its budget, in glaring contrast to most of its European peers and, of course, the US.

13. Illustrating how bloated the loan books have become for Chinese banks, China's "Big Four" now hold assets that are as large as the GDP of Germany, France, and the UK combined.

14. The so-called "China price" has deflated the cost of consumer goods over the past decade. Now, this same phenomenon appears to be happening with industrial products, many of which are heading to emerging countries. Given current trends, exports of capital equipment to developing nations should soon exceed shipments of consumer items to rich countries.

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15. Numerous past EVAs have been critical of the Fed's second round of money creation, popularly known as QE2. These days, though, it is not alone in its monetary munificence as both the European Central Bank and the Bank of England have also opened the floodgates. However, John Taylor, creator of the legendary Taylor Rule, has flatly stated that both QE1 and QE2 were "ineffective and potentially harmful."

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It's that time again. My usual brief synopsis on the above items will be even shorter than usual due to the fact that I am once again attending the Altergris/John Mauldin investment conference just north of San Diego. As many of you know, I have made the difficult pilgrimage to the harsh environs of the La Jolla area nearly every year since 2006. (If you had to pick one place to live year round, this would be it, although the state of California seems intent on imitating Europe's failing economic system to the bitter end.)

However, this week's Mauldin conference is a topic for an EVA later this month. For now, the subjects at hand are recent developments in the US, Europe, and China and how those might impact the financial markets.

As far as the US goes, the tone of economic data has shifted from largely upbeat to slightly skewed to the weak side. This is not to say the numbers are decisively punk; however, as David Rosenberg (one of the featured speakers here) points out, nearly two-thirds of the key releases over the last few months have been on the soft side. Today's flaccid jobs report further tips the scales the wrong way. It is the expectation of the Evergreen investment team that this eroding trend will continue in the upcoming months.

As far as Europe goes, Egan Jones, the rating agency that has been consistently and presciently out in front of the likes of Moody's and S&P, just lowered Spain to junk. Most alarming of all is that Spain lost about \$80 billion of bank deposits in March alone. Despite the European Central Bank's trillion euro credit line, depositors are voting with their feet, and they are definitely not happy feet these days.

Yet, the focus may be in the process of shifting away from what's happening on the debt and growth fronts, which is depressing enough, and toward what promises to be an explosive political season. Elections are looming in several countries and a prediction that I feel very confident about (unfortunately) is that we will see riots and violent protests going viral across the Continent this summer. Events are winding up to a crescendo worthy of a Wagnerian opera and extremist groups, some with a fascist bent, are already asserting themselves (Hitler was apparently a Wagner buff).

If our economy does begin to show signs of double dipping, as Europe most definitely is, the see-no-evil US stock market could actually experience a real correction, with the last few trading sessions indicating that isn't as improbable as it seemed just three days ago. And although the consensus view is that no matter how bad it gets in Europe the American market is insulated, my team and I have serious issues with such a blithe attitude. In fact, it is eerily reminiscent of the notion so popular a few years back that the developed nations could endure a major fissure without affecting the emerging markets, a view that proved to be seriously misguided.

On the encouraging side, I had a short cell phone chat this week with Louis Gave, who is back at home in Hong Kong. He told me that the tone of business and the financial markets is improving in Asia. He and his firm are becoming increasingly bullish on Chinese stocks, which were down 20% last year and have crashed 56% since the end of 2007.

Ok, it's time to get back to listen to the last few speakers. I'm already excited about summarizing for you what I've heard down here in the May 25th EVA.

David_Hay_Signature

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