

November 15, 2013

*“The stock market is the story of cycles and of the human behavior that is responsible for overreactions in both directions.”*

-SETH KLARMAN, Legendary value Investor and long-time hedge fund manager

Thank you for your interest in the *Evergreen Virtual Advisor* (EVA). Evergreen GaveKal's e-letter, written by Chief Investment Officer David Hay, is delivered to clients and friends of the firm every Friday. Our continuous goal is to inform investors through thoughtful analysis of the economy, market trends, and the psychological influences that frequently drive asset prices.

Evergreen GaveKal is fundamentally focused and congenitally contrarian. Yet, in addition to a sharp focus on valuation, we also believe investors are well advised to be keenly aware of major economic cycles and the impact they may have on financial markets. Ignoring events such as the tech mania of the late 1990s and the real estate bubble of 2005-2007 proved exceedingly hazardous to investors' wealth.

Our EVA is delivered four times a month in one of three formats:

- **Points to Ponder:** Published twice monthly
- **Dave's in-depth overview:** Published once a month
- **Guest EVA:** Published monthly

Our e-writings started eight years ago and have offered readers advance warning of major problems since that time and also flagged those instances when the forces of fear have created extreme investment opportunities. By no means is our analysis perfect. At times, our rational approach has not seemed so rational, but our track record certainly suggests our good calls have handily outnumbered our less-than-stellar forecasts.

If you would like to learn more about our investment process, please [click here](#) or feel free to contact us directly at:  
425-467-4600.

Below are excerpts of our written observations over the years, which include a separate explanation of how they helped frame our investment views. The purpose of reviewing these is not to showcase our good market calls, but to provide readers with a sense of how our big picture views have helped shape our investment process. A more detailed overview is available on request. Included are two notable market bubbles David called out and helped clients avoid before our e-writings began.

### **Early 1990s**

David helps clients avoid the Japan's stock market bubble.

*Over 20 years later, Japanese stocks are far below their 1990 peak.*

### **Late 1990s**

David experiences one of the most difficult episodes in his career as he rightly refrains from joining investors in the late stages of the technology bubble, becomes increasingly defensive, and recognizes that income-oriented and value investments are being ignored.

*The tech bubble subsequently went down as the greatest stock market mania in US history.*

### **July 2003**

Evergreen warns that the aftershocks of the tech bubble, specifically low interest rates, could lead to future dislocations in the economy. Citing that popular thinking suggests a possible bubble in bonds, we counter that low interest rates are likely to persist, keeping bond prices elevated.

*Bonds would end up being a worthy asset class to include in portfolios for years to come.*

### **January 2004**

Evergreen worries that “consumers have been piling on massive debt, particularly treating their homes like inexhaustible ATMs.” We further state that “we think the good times can roll on for a while longer” and “we believe that the stock market is still in a bullish phase.” We finish by saying, “We do not believe the fundamental underpinnings for the kind of long-lasting expansion we saw throughout the 1990s are in place.”

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*The chance to buy high-grade corporate bonds and preferred stocks with double-digit returns, at a time when inflation and government bond yields were plummeting, would turn out to be the greatest buying opportunity for yield investments since the early 1980s.*

### **March 2009**

Evergreen addresses the issue that too many market “experts” continue to be negative on stocks, specifically pointing out a handful by name. We state that those pundits “who are urging folks to stay out of stocks, even when they hit their most depressed levels a couple of weeks ago...seem irresponsible.” We went on to say: “To be highly negative on stocks, even when they were down nearly 60%, defies both logic and historical precedent.”

*Unfortunately, many investors listened to the nattering nabobs of negativity back then that corporate bonds and common and preferred stocks could go much lower. In reality, March 2009 turned out to be one of the most important bottoms in both common stocks and corporate yield securities in the history of the financial markets.*

### **April 2009**

Referring to master limited partnerships (MLPs), a long-time investment favorite of Evergreen’s, we state that “usually ‘safe’ and ‘10%’ don’t go together but that was before last year’s indiscriminate mauling of equity income investments.” We go on to say: “So, for those of you still in the fetal position, it’s time to quit quibbling and do some nibbling.”

*MLPs proceed to generate exceptional returns over the next four years, even exceeding those of the S&P 500.*

### **January 2010**

EVA discusses concerns over Portugal, Italy, Greece, and Spain being caught between an overvalued euro and exploding debt levels. Evergreen also feels inflation is more of a concern abroad than it is “in the US and that the only bout of inflation we would have would be bouts of inflation paranoia” (at a time when inflation consumed the media). We later reiterated the same forecast that “subdued growth and exceedingly low inflation assure interest rates will stay suppressed much longer than most expect and should continue to support income investments.”

*Two years later, the 10-year Treasury would be below 2%. Unfortunately, many conservative investors were paralyzed during this period, unwilling to invest in either bonds or stocks.*

### **March 2011**

We warn that “with bearish sentiment on the dollar running extremely high, the developing world in full-blown anti-inflation mode, high commodity prices draining global consumer purchasing power, fiscal tightening in many leading countries (even in the US at the state and local level), and unresolved dysfunction in Europe, there is a distinct possibility of something snapping.”

*In the summer of 2011, the S&P 500 would experience a correction just shy of 20%.*

### **August 2011**

With a correction in the market underway, we become more positive on stocks, stating: “Over the last few weeks, the collateral damage from the eurozone, combined with the constant downgrades of economic growth in the US, has destroyed investor confidence, causing a stock sell-off of extraordinary intensity. This has left most large cap US stocks at stunningly cheap prices.”

*While many speculated that this may be the start of the financial crisis 2.0, the late summer of 2011 would indeed end up being an excellent entry point in the market.*

### **March 2012**

Regarding US recession forecasts by certain influential firms: “Among the numerous reasons Evergreen does not expect a recession this year, despite high profile sources predicting a downturn, is that private sector debt has been contracting and capital spending is extremely subdued. Both of these tend to peak when the economy is poised to roll over.”

*Over a year later, the US economy appears to have avoided another recession.*

### **March 2012**

“While acknowledging many positive long-term trends, such as the energy boom, industrial renaissance, and pent-up demand for corporate capital spending, we also worry stocks are overestimating economic strength and are vulnerable to another summer swoon. We are moving into the time of the year when the market struggles. ‘Sell in May and go away’ certainly doesn’t work every time but following that advice the last two years would have been highly rewarding, as it has been on balance going all the way back to the 1920s. I wouldn’t ignore its admonition this year, either.”

*The stock market did begin what became nearly a 10% correction shortly thereafter.*

### **April 2012**

Evergreen discusses partnership with GaveKal, one of the world’s elite macro (big picture) economic research firms; GaveKal has been quoted more than 600 times by major publications such as Barron’s, the Financial Times, and the Wall Street Journal.

### **June 2012**

With European markets in free-fall, we point out a plethora of bargains. “For several years, another recurring EVA message has been to favor the US over foreign markets with Europe and its currency being a frequent piñata for this author. Now, however, prices have fallen down to levels that are, even on their finest companies, beginning to look like what we saw in the US in

1974 and 1982. My team and I are finding world class companies with free cash flow yields well into double digits and dividend yields in the high single digits."

*European stocks have staged a powerful rally since the summer of 2012*

### **June 2012**

One of our official forecasts of 2012 was a dramatic weakening of the yen. "One of the more bizarre features of the current investment landscape is that the Japanese yen continues to trade at exceedingly overvalued levels. This is despite the fact that Japan has now been downgraded by Fitch to the same A-minus rating as Estonia and Malta. Just as inexplicable as the yen's safe haven status, bond investors still treat Japan as one of the world's elite credits."

*The yen would fall as much as 22.7% against the dollar over the next 12 months.*

### **November 2012:**

"A master strategy that has guided me so well and benefited my clients for so long is coming to the end of its useful life. Now, however, with the 10-year Treasury note rates at 1.6%, below even today's quiescent inflation rate, future returns look paltry at best, and certificate of confiscation-like at worst...Shakespeare once wrote that it is better to be three hours early than one minute late. When it comes to preparing for the demise of Paul Volcker's 30-year bull market in bonds, those centuries-old words are very much worth remembering."

*Seven months later, Treasury bonds suffer as the 10-year T-note yield experiences the largest surge on a percentage basis, during any other 200-day period, since 1953*

### **Off-the-Mark Calls**

In the interest of full disclosure, and in contrast to sources that only highlight their prescient predictions, we have listed below our worst calls. However, we continue to believe recommendations such as positioning for a steep decline in real estate investment trusts (REITs) and a rebound in the devastated gold mining stocks will be vindicated in the long run.

These mis-timed predictions include:

- Repeated negative views on REITS since they bottomed in late 2011
- Being bullish on gold stocks over the last two years
- Recent belief that small caps would underperform large cap stocks
- Underestimation of the positive market response to ECB President Mario Draghi's statement of determination to preserve the euro
- Expectation of a correction in the US stock market in 2013

Under the heading of the ever-elusive nature of perfection, [please click here to watch a clip from](#) one of the classic comedies of all-time, *Some Like It Hot*.

Thanks once again for your interest in the Evergreen Virtual Advisor.

**Correction:** Last week's EVA included a parenthetical comment that the multi-month average of US job creation had fallen from around 200,000, prior to the Fed's launch of its trillion dollar third round of quantitative easing, to approximately 150,000 currently. However, based on the upward revisions to August and September, along with over 200,000 new jobs created in October, the three-month moving average is now roughly equivalent to what it was prior to the inception of QE3. This still indicates a negligible benefit especially relative to the size of the

stimulus and the eventual risks when the Fed ultimately reverses course. Additionally, average hourly earnings were essentially flat in October, despite the superficial job creation strength last month, while the overall participation rate fell to a 30-year low of 62.8%. Therefore, the US employment picture remains far from robust. Fascinatingly, at her Senate Banking Committee confirmation hearing this week, Fed chair nominee Janet Yellen admitted the true unemployment rate was 10% or higher.



*David M. Hay*

David Hay | Chief Investment Officer

## IMPORTANT DISCLOSURES

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