

November 2, 2012

"Let's be honest with ourselves. The US economy is not on the path of a sustainable and healthy recovery from a Great Recession that began almost four years ago."

-DAN DIMICCO, CEO OF STEEL GIANT, NUCOR.

POINTS TO PONDER

1. Although the long-term picture looks radiant for US manufacturing, even this resurgent part of our economy is struggling due to present conditions. This renders growth even more reliant on US consumers who have been drawing down savings to maintain spending. (See Figures 1 and 2)

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2. Third quarter US GDP growth came out at a better than anticipated, though still deficient, 2%. Yet, this unimpressive reading likely overstated actual activity. Backing out a 9.7% jump in defense spending, hardly an area to rely on for future robustness, the economy would have expanded by roughly 1.4%.

3. A flurry of downbeat earnings reports for Q3 is indicative of an economy fighting to avoid another recession. Numerous blue chip and economically sensitive stocks, such as Dupont, United Technologies, and 3M, have released poor results. More ominously, mass layoff announcements are occurring for the first time since the Great Recession ended. Freight giant UPS showed a 3.7% drop in its international package revenue, indicating the global nature of the slowdown.

4. One of Evergreen's better forecasts for 2012 (far better than our stock market call) was that this year would mark the bottom in the long and grueling bear market in housing. (See Figure 3)

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5. Although housing is clearly showing signs of resuscitation, not all the news is glowing. Mortgage applications for new home purchases remain exceedingly subdued, despite the Fed's extreme efforts to collapse borrowing costs. (See Figure 4)

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6. Thanks largely to the fracking extraction process moving beyond natural gas production and into oil fields, the US is expected to halve its dependence on Middle East crude by the end of the decade. According to the US Energy Information Administration, by 2035 oil exports from the Middle East to North America "could almost be nonexistent." Some industry experts predict that North America might be energy self-sufficient as early as 2020.

7. One of the most alarming technical features of present US stock market conditions is the narrowing breadth. The yawning gap between the S&P 500's price trend (the red line below) and its cumulative advance/decline ratio (the blue line below) reflects a market that is being driven by a shrinking number of rising issues. (See Figure 5)

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8. The price action of REITs implies strong operating fundamentals. Yet, retail and office vacancy rates look far from tight. Even in the multi-family space, where high demand for rentals has persisted since the housing bust, vacancies are increasing and rent increases are ebbing. (*See Figures 6 and 7*)

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9. Contrary to the expectations of most market pundits, US stocks have been rising as a share of the global market in recent years. As a result, the US comprises 48% of the planet's overall market value, despite accounting for just 22% of total economic output. (*See Figure 8*)

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10. Although US bank exposure to the peripheral eurozone (aka Club Med) countries has been nearly cut in half since 2009, it remains substantial. In fact, it is roughly one-third higher than in 2005.

11. A key reason US bond investors might want to have some participation in Asian debt markets is the vastly superior fiscal status of Pacific Rim governments. (See *Figure 9*)

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12. According to the Institute of International Finance, a worldwide recession next year is a "non-negligible risk." Additionally, the prestigious forecasting firm, Capital Economics, is calling for Europe's recession to intensify next year, making the rise this year by the Continent's main stock index even more perplexing.

13. If China sincerely desires to narrow its trade surplus with the US, it might want to invest the tens of billions needed to develop its enormous shale gas resources with American oil and gas service companies. These firms have demonstrated their exceptional skill at producing energy from unconventional formations, a capability China clearly needs to access as quickly as possible to reduce its dependence on highly polluting coal. (See *Figure 10*)

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14. Lending some credence to the theory that China is amassing gold reserves in order to make its currency at least partially convertible into bullion, state-owned China National Gold is buying Barrick's African gold-mining subsidiary. China also imported 459 tons of bullion in September, four times the year-earlier amount.

15. Not long ago, it was unthinkable that Italy and Spain would be considered bailout candidates. Thus, it's not unreasonable to wonder if France might also come under intense scrutiny given its widening trade deficit, its labor cost disadvantage, and its high debt levels. With government spending representing 56% of overall economic activity, economic stagnation and an eventual financial crisis seem probable in the not too distant future. (See *Figures 11 and 12*)

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The storm of the century—and a quarter. It takes a lot to bring the stock market down. This isn't to say price declines happen infrequently but rather an actual shutdown of the New York Stock Exchange occurs about as often as the US runs a balanced budget (ok, they're not quite that rare!). But this week saw trading halted on the NYSE for two consecutive days for the first time since the Great Blizzard of 1888. You read that right—the first two-day NYSE time-out in 124 years!

Perhaps I'm reading too much into a natural phenomenon but there's a part of me that wonders if Hurricane Sandy wasn't a sneak preview of what might hit share prices in the months ahead. Past EVAs have noted the strange disconnect between economic skies that have darkened considerably over the course of the year and stock market price action. Even more amazing than the fact that the S&P has vaulted 13% this year is that the main European index, the STOXX 600, with dividends included, is up nearly as much.

In the late spring, when eurozone stocks had been punished as severely as Penn State's football program, I thought there was some rebound potential. Now, after a 15% run off the bottom, Continental shares look as vulnerable to a return-to-reality experience as does our own stock market.

The Evergreen investment team was concerned the month just ended might have been like some of the vicious market experiences of Octobers past. Fortunately, we avoided anything like October 19, 1987, (which I vividly and painfully remember). However, it was the first negative return month for the market since May. What unsettles us more is the sub-surface deterioration that is becoming increasingly apparent. This is particularly highlighted by the ugly cumulative advance-decline ratio, as mentioned in Points to Ponder #7.

We actually believe a post-election rally is quite plausible. After that, however, 2013 is likely to turn out about as fortuitous as befits a year ending in thirteen. A 20% or 30% haircut—more like buzzcut—wouldn't shock us. We are very aware of the bullish argument that P/E ratios, relative to almost sub-atomic interest rates, are actually quite attractive. Which brings up an interesting point...

Based on this logic, 1982 was one of the worst times you could have bought stocks. That's because interest rates were in the mid-teens for even high-grade bonds. One of my vivid memories as a young stock broker was trying to answer the question: "Why should I buy stocks when I can get 13% on tax-free bonds?"

In retrospect, interest rates up in the ionosphere were in reality a key reason to be bullish on stocks back then. Paul Volcker was in the process of crushing inflation and rates had nowhere to go but down. This unparalleled rate collapse was going to provide a tailwind to stocks that lasted for five years and then, after a counter-trend spike in the late 1980s, into the mid-1990s.

Now, as 2012 draws to a close, we've got the opposite situation. Rates are at rock bottom and are poised to scream higher once "animal spirits"—aka the desire for businesses and individuals to borrow and invest—return in full force. Of course, the multi-trillion dollar question (literally) is: When will that happen? Many ultra-bright folks I respect believe this will take a very, very long time and they could be right. But there's a definite risk it could happen sooner if the markets begin to discount a departure by the print-happy Ben Bernanke.

In addition to the distinct possibility of the global economy being even weaker in 2013 than it was in 2012, the sobering history of the first year of a new presidential term for stocks, and the potential for rates to spike should there be anticipation of a new Fed chairman, there is another threat to consider. In fact, in next week's EVA I plan to run a guest edition written by veteran market technician, Walter Deemer. He has done an intriguing study of what happens in the case of "Bull Market Extensions"—essentially, those situations where the typical four-year up-market cycle extends into a fifth year.

You'll want to check out that issue of EVA to find out why Hurricane Sandy might not be the only perfect storm with a bead on Wall Street.

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