

November 9, 2012

"Government is not reason; it is not eloquent; it is force. Like fire, it is a dangerous servant and fearful master."

-GEORGE WASHINGTON

Morning in America or America in mourning? Undoubtedly, how you are feeling, as this pivotal week comes to an end, is heavily dependent on your political inclinations. My suspicion is that most EVA readers are surveying the next four years with even more apprehension than they did prior to Tuesday's election.

Before I get into some brief commentary regarding the investment implications of the election, let me apologize for deviating from my usual EVA pattern. Normally, this would be when I run a full-length edition but, as indicated in the last issue, I was already planning to run a "guest" EVA this week. This is due to the fact that I knew in advance this would be an unusually busy week at Evergreen with Grant Williams and his colleagues in town on Tuesday and Wednesday. To top things off, the legendary Charles Gave, one of my true heroes, graced our offices with his presence today.

Past EVAs have relayed a few of Grant's incisive appraisals of the state of the investment world. It continues to be my belief that he is among the most talented financial observers and writers I have come across in my career. Grant visited us in September on his own but this time he came back with three of his key associates, including the founder of his current firm, Stephen Diggle. Stephen formerly started a Singapore-domiciled hedge fund, Artradis, which almost incomprehensibly grew from \$4 million in assets in 2002 to nearly \$5 billion by 2009. Most incredibly, the Artradis fund produced a profit windfall of \$2.6 billion for its investors during the darkest days of the 2008 financial market apocalypse, while most of its competitors were bleeding copious amounts of red ink.

On Tuesday night, over some adult beverages, Stephen's crew and I, along with a few Evergreen colleagues, watched the election unfold. As the waves of votes slowly rolled in, we swapped views of what the result meant for both the US and the world. After roughly four hours of listening to their analysis, with the Romney-Ryan ticket going down in flames in the background, it's no exaggeration to say they are as smart as their track record indicates.

While there's not enough space in this issue to relay all of their insights, the cut-to-the-chase summary is that they feel current US policies, now likely to stay in place for several more years, are almost certain to end very badly. Therefore, they feel it is essential to hedge traditional US-based investments with liberal--sorry, make that generous--amounts of international assets. They have also established two vehicles which will offer inflation-protected cash flow (the most intriguing in my mind being a conservatively hedged German real estate fund yielding 9%-10%).

As this EVA goes to print, it's too early to convey Charles Gave's view of the post-election US landscape. But, from reading some of his internal communications (one of the privileges of being partners with his globally connected firm, GaveKal Research), his views appear to be in line with those of Grant and Stephen. Yet at the risk of being accused of unfounded optimism, the future might not be as bleak as they fear.

In the October 12th EVA that discussed the possible outcomes of the presidential election, I made the point that if President Obama won a close race and still faces a divided Congress, he

might belatedly decide to adopt more moderate economic policies. Specifically, the Simpson-Bowles deficit reduction plan continues to be the legislative equivalent of Lazarus. Should Mr. Obama decide to finally get behind this construct of his own bipartisan commission, the outlook for our country would take a decided turn for the better.

Of course, this is mere speculation at this point and I have to admit that past history is not encouraging. Consequently, my investment team and I believe it is essential to protect our client's portfolios against a highly divergent range of outcomes: From a quasi-deflationary environment, on one extreme, to an inflationary cycle (a la the 1970s, or worse) on the other.

Next week, when things at Evergreen calm down a bit, I will delve further into the investment implications of the election. In the meantime, I want to fulfill my commitment to run the interesting and relevant essay by Walter Deemer I referred to in last week's EVA. Walter is one of the senior statesmen of the technical analysis field and I've studied his work for years in one of my daily must-reads, Horsesmouth.

Walter's article in point, "Bull Market Extensions," goes back to 1949 to illustrate that bull markets tend to hit the wall at about the four-year mark. In the case of our present up-cycle, it turns into a four-year-old in March of next year. However, as Walter notes, occasionally bulls can run for five years but with sobering consequences. (The 1990s were, in our view, an exception to the rule as the 1994 sell-off was comparatively mild.)

We thought we would put our talented in-house data cruncher, Jeff Dicks, on this and look back even further to the most important market low of modern times, 1932. Because there are a number of economic parallels with the 1930s (and, some would say, with our current president and FDR), it's an interesting decade to consider.

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As you can see, the market made a climactic bottom in 1932 and rose dramatically until around the presidential election of 1936. However, there were several 20% plus declines along the way that could be considered mini-bear markets. Yet, stocks basically trended up until late 1936 before a follow-on recession, at least partially triggered by big tax hikes (hmmm...), in 1937 triggered a wrenching 45% plunge that year. (It's also interesting to note that the summers of both 2010 and 2011 saw deep corrections similar to the sell-offs that occurred between 1932 and 1936.)

Jeff, also took a look at various other aging bull markets that coincided with the first year of a presidential term and he found that the average correction in these circumstances was 11%.

Again, the 1990s were the exception to the rule as that mega-bull market managed to defy almost all historical precedents not to mention the laws of gravity. Backing the 1990s out of the study, the average stock market swoon during the first year of a presidential term when the market had been generally rising for the prior three years was 26%.

Of course, the market is a wild beast that loves to maul those who think it will act in a predictable way. With this as a caveat, let's check out what Walter has to say on this very important topic for investors - at least for those who care about what might happen to their money next year.

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BULL MARKET EXTENSIONS

By Walter Deemer, Hoursesmouth

It is starting to become more likely that we now have a fourth bull market extension on our hands, since it is more unlikely that the stock market will be able to stage a bear market and make a Four-Year Cycle low on schedule.

The Four-Year Cycle tells us that the stock market should make its next major low sometime in the first half of next year. Since this is starting to look like an unrealistic expectation, though, the time has come to look at what implications this possible failure has for the long-term outlook. In order to look forward, however, we first need to look back.

Since 1949, the stock market has made major lows every four years pretty much like clockwork: 1949, 1953, 1957, 1962 (which was an exception), 1966, 1970, 1974, 1978, 1982, 1987 (a second exception), 1990 (eight years after the 1982 low, so not an exception), 1994, 1998, 2002, and 2008 (a third exception). I first started writing about these exceptions in 2007, when we were dealing with another one. At that time I called the two previous exceptions to the four-year major low rule that we experienced in 1957-1962 and 1982-1987 "bull market extensions," because the scheduled major low was pushed forward in both cases. I warned at the time that the two prior bull market extensions did not end at all well—and as it turned out, the bull market extension of 2007 was distressingly similar to its two predecessors.

It is starting to become more and more likely that we now have a fourth bull market extension on our hands, since it is becoming more and more unlikely that the stock market will be able to stage a bear market and make a Four-Year Cycle low on schedule by the first half of next year, or approximately four years after the March 2009 low. Given this, the time has come for us to look back at the past three bull market extensions to see what lessons they may hold for us in the current situation. Our review begins shortly—but if you want to cut to the chase, all three of the previous bull market extensions were followed by a much more severe than usual bear market.

Bull Market Extension No. 1 was in 1961. The stock market made a rather emotional major low in October 1957 (the "Sputnik low," when Russia unexpectedly launched an Earth satellite before we did and thereby cast grave doubts on our nation's scientific leadership). This meant that the next Four-Year Cycle low was due in late 1961, but the market staged a very speculative rally in early 1961 led by bowling, vending, and electronics stocks, and the blue chips were able to keep going until December of that year. As

a result, the Dow Jones industrial made a top in late 1961 rather than the scheduled bottom. Afterward, it plummeted 29.3% to its June 1962 low in what became known as the Crash of 1962.

Bull Market Extension No. 2 was in 1987. The stock market made a major low in August 1982, so the next Four-Year Cycle low was due in the third quarter of 1986. The market, however, staged a high-level consolidation during the second and third quarters of 1986 and then embarked on an ever-giddier advance to the Dow's August 1987 high of 2746. Less than two months later, though, it traded at 1616—a 41% plunge known forever after as the Crash of 1987.

Finally, there was Bull Market Extension No. 3 in 2006 and 2007. The Four-Year Cycle low had been made in October 2002, so the next one was due in late 2006. The market, however, completely ignored this and peaked a full year later, in October of 2007. It then staged the most severe decline since the Great Depression—58%—which led to the Four-Year Cycle low in March of 2009.

The Four-Year Cycle, it must be remembered in all this, is a behavioral cycle, not an economic one; the bull and bear markets that occur within it serve to correct (and usually overcorrect) the excesses of the preceding bull or bear market. With those behavioral roots in mind, the fact that the bear markets that followed the three bull market extensions were—without exception—more severe than average (29%, 41%, and 58%) can, I think, be attributed to the fact that the extensions gave the excesses of the preceding bull market more time to build up—which meant that there were more of them to be corrected by the subsequent bear market. Whatever the case, I don't think the fact that all three bull market extensions were followed by more severe-than-usual bear markets can be dismissed as a statistical fluke.

How long could the bull market extension last? The one in 1961 peaked at the time the next Four-Year Cycle low was scheduled to occur. The ones in 1987 and 2007, though, saw the market continue higher for a year after the Four-Year Cycle low was due. Based on this and this alone, the market could—could—continue to go up until the first half of 2014. Bull market extensions are exceptions to the rule, though, so I wouldn't place a whole lot of confidence in that first-half-of-2014 possibility. And why did the bull market extensions occur in the first place? Frankly, I don't have the answer to that one; excessive speculative activity in the stock market played a major role in the 1961 advance and, to a lesser extent, in the 1987 advance, but it was not really a factor in 2007. For what it's worth, though, I suspect that when the history of this bull market extension is finally written, the Fed's quantitative easings will be seen as one of the biggest reasons why it came to be.

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