

September 21, 2012

"What we need is a central bank that has the humility not to do what it cannot do. And the Fed cannot do what others have failed to do, namely to plan an economy from a central desk in the capital city."

-JIM GRANT, FOUNDER OF GRANT'S INTEREST RATE OBSERVER.

POINTS TO PONDER

1. The continuation of unbridled money creation by the Fed and the European Central Bank (ECB) has caused the Volatility Index (the VIX) to recede to levels indicating extreme complacency. While the central banks have been able to briefly prop up financial markets, they have shown little ability to impact economic results. Meanwhile, the trend in US corporate earnings continues to move contrary to stock prices. (See *Figures 1 and 2*)

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2. Daniel Yergin, whose book *The Prize* won the ultimate author's prize—the Pulitzer—stated in a *Wall Street Journal* interview that shale gas was just 2% of US production in 2000. Today, it amounts to 42%. He further sees the Western Hemisphere becoming energy independent by the end of this decade.

3. Graphically illustrating Amazon's online retailing dominance, its \$48 billion of internet-based sales are slightly larger than its next 10 competitors combined.

4. The Fed's latest round of quantitative easing (QE3) is focusing on the mortgage market. With the Fed no longer an indiscriminate buyer of long-term Treasury bonds, their yields have suddenly spiked, although they remain exceedingly subdued relative to recent history. Looking back to the 1930s is revealing as to what might happen next. Based on that experience, the last time the US private sector was deleveraging, treasury yields may not fall much more but corporate bond rates could grind down even further. (See *Figure 3*)

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5. The US stock market's surprising 18% advance this year has deservedly received considerable press. However, scant attention has been paid to the fact that preferred stocks, a frequently favored EVA investment theme, have returned almost as much. Importantly, they have done so with a higher cash flow and less volatility than common stocks.

6. While it's no surprise that US exports to Europe have substantially decelerated, the same is also true with regard to China. (See *Figures 4 and 5*)

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7. Despite the distortions caused by the Fed's latest money fabrication, stocks are ultimately driven by earnings and available investor cash. On the latter score, institutional cash holdings (as reflected in the AAll-American Association of Individual Investors- survey) are presently consistent with levels that have coincided with past market peaks. (See *Figure 6*)

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8. Despite the most favorable dividend tax structure since before WWII, the payout ratio is at an all-time low. Nevertheless, overall dividend income has risen rapidly in recent years due to record profits, offsetting much of the pain for investors due to the Fed's zero interest rate policy. (See *Figures 7 and 8*)

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9. Luxury retailers have been on a roll over the last three years. However, the British brand icon, Burberry, just issued a profit warning. This announcement, combined with weakness at Tiffany's, indicates that even the affluent are feeling the effects of global economic cooling.

10. There aren't many ways that France is in better shape than the US. However, when it comes to healthcare costs, America's economy carries an immense burden even relative to France's free-spending welfare state. (See *Figure 9*)

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11. The pattern of the euro crisis over the last few years has been a series of dramatic announcements followed by inadequate actual remedies. ECB chief Mario Draghi's vow to do

whatever it takes to save the currency union, backed by his bond-buying pledge (implicitly for Spain and Italy), is the boldest move to date. Time is not on his side, however, as foreign ownership of Italian sovereign debt has swooned from 52% to 36% in just two years.

12. Showing the world's unparalleled addiction to central bank monetary incontinence, over the last three years the Fed, the Bank of England, the Bank of Japan, and the ECB have collectively fabricated a staggering \$4 trillion. Most of this has gone into bond purchases from their own governments, representing a degree of debt monetization unseen since WWII.

13. Rapidly receding inflation in developing countries was viewed as a much needed offset to slowing growth. Cooling prices gave emerging central banks the leeway to cut interest rates. Thus, the recent eruption in some key food commodities is worrisome. Food costs are a much larger share of consumer budgets in these nations versus the developed world, making agricultural inflation far more problematic. (See *Figure 10*)

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14. Back in 2009, India proclaimed, to considerable skepticism, that it would produce 20,000 megawatts of solar energy by 2020, enough to power 20 million US homes. Yet, plunging prices for solar panels are causing cynics to concede India's objective is now plausible.

15. A big difference today versus 70 years ago is how much of the Treasury bond market is now owned by foreigners. In 1945, just 1% of US government debt was held overseas. Today that number is 44%. By contrast, American financial institutions and households now own just 27% of Treasury debt versus nearly 80% when WWII ended. (See *Figure 11*)

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The Great Levitation. Prior to the thunderous bursting of the housing bubble—the pop heard ‘round the world—the world’s central banks had supposedly achieved what was known as "The Great Moderation." Under this idyllic scenario, recessions were almost non-existent, inflation was under control, and its chief architect, Alan Greenspan, was adoringly referred to as the "Maestro."

These days, though inflation remains (for now) quiescent, no one would refer to what the world has experienced over the last five years as anything remotely akin to moderate. And, alas, it’s been forever since I heard anyone use the M word in reference to Mr. Greenspan (though many other less than flattering words have been hurled his way in recent years).

Yet, this is not to say the role of global central banks has been diminished. On the contrary—never before have the world’s financial markets and economies been as utterly dependent on the machinations of folks like Ben Bernanke and his new soul mate, Mario Draghi of the ECB. Their creativity at continually propping up asset prices rivals David Copperfield and his famous levitation trick, the flying illusion.

Recently, stocks worldwide have been in a celebratory mood given the ECB’s determination to suppress interest rates in the "Olive Belt" countries. Not to be outdone by such spectacular feats of legerdemain, our beloved Fed last week unveiled what some have dubbed "QE Forever." This new program literally knows no bounds when it comes to the amount or the duration of money manufacturing.

You’ve got to give copious credit to our bubblemeister-in-chief, Ben Bernanke; he managed to positively surprise a market that was already primed for another fix of monetary amphetamines. His unlimited largesse has caused the US stock market to surge to its highest level since before the aforementioned housing (and lending) bubble implosion.

In addition to fellow helium merchant, Mario Draghi, Bubble Ben’s levitation trick has been aided

by some able assistants. China recently announced its usual Pavlovian response whenever growth threatens to ebb too much—another infrastructure splurge (unlike in the US, such spending is of questionable necessity). To top off the string of heartening news, Germany's highest court has allowed that nation to continue to be the underwriter-in-chief of the Great Euro Experiment.

Therefore, isn't it time to break out the bubbly and simply let the good times roll?

Prosperity-less profits. Due to the fact that Evergreen clients are decidedly "long" investments that benefit from rising markets, notwithstanding our many defensive holdings, I guess I should feel encouraged, if not borderline elated. After all, we've made much more in less than nine months than we anticipated for the full year. But I have to admit the uncomfortable feeling in the pit of my stomach won't go away—despite the gluten-light diet I've been on for the last few months.

Reading the editorial page from the September 11th *Wall Street Journal* reinforced my dyspepsia. The article was entitled *The Hidden Cost of Monetary Easing*, written by Phil Gramm, former chairman of the Senate Banking Committee (as well as co-sponsor of the deficit-slaying Gramm-Rudman legislation), and John Taylor. EVA readers might recall that Mr. Taylor is the inventor of the Taylor Rule. In the good old days this served as the guiding light for central bankers in setting short-term interest rates.

Suffice it to say Mssrs. Graham and Taylor are not exactly smitten with the Fed's relentless desire to create money out of thin air. Here's one excerpt that I think sums up the article's main thrust: "When the Fed must, in Chairman Ben Bernanke's words begin 'removing liquidity' by selling bonds, the external debt of the federal government will rise and the Treasury will then have to pay interest on that debt to the public. Selling a trillion dollars of Treasury bonds on the market—at the same time the government is running trillion dollar annual deficits—will drive up interest rates, crowd out private-sector borrowing and impede the recovery. Debt service costs to the Treasury will spiral as every 1% increase in federal borrowing costs add \$100 billion to the annual deficit."

Lately, I admit, I've been feeling a bit curmudgeon-like, similar to how I felt back in 2006 and 2007 when the housing mania was in full swing and I was repeatedly warning of trouble ahead. But reality is reality and I think anyone who has studied economics and financial market history knows that there is a payback for the kind of synthetic prosperity the central banks are creating currently. Printing up a few trillion dollars is simply no substitute for the sweeping fiscal and economic reforms the US, Europe, Japan, and even China need to implement.

Which leads me, as my ramblings often do, to the stock market...

Double trouble—higher rates and higher taxes? In past EVAs I've made the case that stocks aren't as cheap as they seem if you adjust for record-high profit margins. As you can see from the chart below, there's no doubt that we are in rarefied territory. Further, gravity does seem to be exerting itself of late as margins appear to be heading back to terra firma. (See *Figure 12*)

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But I would also make the point—one of the few I haven't merely borrowed from someone else—that a market this reliant on central bank munificence deserves a lower multiple (or P/E). After all, stock prices discount a stream of future earnings over many years. Given the inevitability of a major liquidity drain by the Fed, at some point interest rates are almost certain to rise.

Higher rates automatically increase the discount rate of those earnings, exerting downward pressure on stocks. And if rates rise significantly, the odds are pretty high that earnings themselves will be clipped, perhaps materially if rates go vertical thereby triggering a recession.

Then there is the little issue of taxes and specifically what could be a massive hike in how much Uncle Sam will suck up out of the dividend stream. There is a distinct possibility that the top tax rate on corporate payouts could rise from 15% to around 44%. And although last week's EVA cited a comprehensive study that concluded high-dividend stocks haven't been impacted by prior tax law changes, I'm not at all sure past will be prologue.

As Tyler wrote a week ago, we've never before been the lucky recipients of a tax hike of this magnitude. Moreover, as he pointed out in the last EVA, corporate dividend policies look to be much more closely linked with the economy and the trend in profit margins. If outfits like ECRI (Economic Cycle Research Institute), which called the last three recessions, are right and the US is already contracting, or soon will be, that doesn't bode well for dividend payouts.

Of course, the November election is very much up for grabs and its outcome will have a huge impact on what happens to dividend tax policy. Thus, it's premature to dump high-dividend stocks due to a potential change in the law, but it is a risk that needs to be considered. Consequently, Evergreen has been doing some precautionary trimming of high-income stocks, particularly those that appear to be on the rich side.

But whether it's dividend taxes or the other negative impacts from the fiscal cliff, this isn't a time for a devil-may-care attitude. Those piling into stocks right now may soon find out the devil cares very much; being hooked on central bank fixes will end as badly as every other addiction the diabolical one has created since the dawn of man.

David_Hay_Signature

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Special note: Our partners at GaveKal Research have written extensively on Europe's latest hail-Mary scheme to save the euro. In a nutshell, they are underwhelmed. They believe the ECB's conditionality on bond purchases from the weaker countries (meaning the ongoing need to inject additional austerity into already crumbling economies) will be self-defeating. (For an excellent overview of this topic from one of GaveKal's founders, Anatole Kaletsky, please click [here](#).)

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