EVERGREEN VIRTUAL ADVISOR OCTOBER 2007

"When will market cycles be banished or made more muted? That'll happen when greed, human failings and herd behavior are eliminated. Or, in other words, never."

-Howard Marks, manager of the Oaktree Funds [1]

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"Recessions are not the end of the world."

"You can't believe in capitalism without acknowledging that recessions happen."

Tropical musings…

Before beginning the normal EVA text, I thought I would attempt to pull together the varied and, in many ways, contradictory forces that are impacting the financial markets today.

Obviously, we've been through some pretty wild times lately. Fortunately, after an incredibly volatile and disconcerting August, things stabilized in September, with the Federal Reserve (Fed) reducing its key rate by 0.5% and stocks rallying back close to their highs.

Seeing some return to normalcy was also a happy development from a personal standpoint, as my wife and I recently celebrated our thirtieth wedding anniversary. After having our plans for an extended twenty-fifth anniversary trip scuttled by the market meltdown in the summer of 2002, I was having a very uncomfortable deja vu experience over these past few months.

As a result of the market's "great exhale" recently, we were able to head off with a sigh of relief on a wonderfully rejuvenating three-week getaway to Hawaii. Instead of working half the time, as I normally do on vacations, I was able to downshift to only about one-quarter time, thanks to my very capable team at Evergreen Capital.

It was an extremely beneficial experience for our marriage and it allowed me considerable away-from-it-all reading and reflection time. Thus, I was able to formulate my "big picture" view of where things seem to be headed for both the economy and the financial markets.

Essentially, as you will read in the main EVA, I'm concerned that the likelihood of both a U.S. and a global recession has increased. This is not the outcome we want to see at Evergreen; we have been hopeful that the widely expected soft landing would play out. However, in my view, the weight of evidence is leaning the other way. (It's important to note there is some controversy on this internally, with the younger members of our team being more optimistic and the old man—meaning me—decidedly less upbeat.)

But before running out to buy the Costco survival kit (yes, they really do sell them), let me reiterate something I've said many times before: Recessions are not the end of the world. In fact, they are a normal and inevitable part of the capitalistic system, which, to paraphrase Winston Churchill, is incredibly flawed but the very best economic process humanity has yet devised to increase overall prosperity.[2]

Now, I realize CNBC's Larry Kudlow would disagree vehemently with my contention. He says he doesn't even have the word "recession" in his vocabulary.[3] Rather, he's a believer in the marvelous wonder that is capitalism. Alas, I think his logic is flawed: You can't believe in capitalism without acknowledging that recessions happen (though they clearly have become less frequent). They are simply part of the business cycle, and they tend to occur when there has been too much speculation in a certain part (or parts) of the investment world and too much debt accumulated to fund the frothiness. Sound familiar?

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"…if we do have a recession, I think it will be relatively mild…"

"…I continue to worry about the many millions who have spent beyond their means"

"…DON'T PANIC. We certainly aren't"

As I've written before in these pages, there is opportunity during downturns. For one thing, interest rates and inflation almost always decline. This tends to be highly positive for conservative, income-producing securities. The residual shock waves of this summer's credit crunch left many high-quality corporate bonds and preferred stocks yielding between 6% and 8%. For example, we recently bought a preferred stock for many of our income-oriented clients from a very healthy utility yielding nearly 7.5%.

Additionally, the best blue chip companies, both here and abroad, continue to look undervalued to us. Their price-to-earnings (P/E) ratios should be sustainable, as should their profit margins, especially for those that are less linked to the economy's ups and downs. Consequently, we have skewed our client's portfolio toward those companies that have historically experienced a high degree of earnings consistency.

We are also in the process of reducing our overall stock exposure somewhat. This does not mean we are getting out of stocks, and we are certainly not advising anyone else to do that. In fact, we believe most U.S. investors are underinvested in stocks, particularly those blue chip "dependables," as described above. Furthermore, one of our key predictions going forward is that oil prices will come down hard. If that happens along with falling interest rates, stocks could have a fun run even if the economy is slowing. It may be a close horse race between the benefit of lower oil prices and interest rates and the negative pull of what could become an outright contraction.

If I had to handicap the odds of a recession, I'd say they are somewhere around 60%, maybe a bit higher. But even if I'm right, and the odds really are that high, it means there is still a very good chance that negative growth can be avoided. And if we do have a recession, I think it will be relatively mild, primarily because most companies are in excellent financial shape (at least those the private equity folks haven't overleveraged). Also, severe recessions are usually caused by major consumer price index (CPI) flare-ups, forcing the Fed to really crank on its anti-inflation controls. Fortunately, this is not the situation we have today.

The consumer is a different matter. The wealthiest segment is in fine fettle, with their assets up nicely over the last decade. But I continue to worry about the many millions who have spent beyond their means and have used too much debt to do so. The trite but true saying is that markets are made at the margin, and I envision many more marginal sellers of things, particularly real estate, than buyers. Eventually, that will reverse, but it may well take longer than the Larry Kudlows of the world want to believe right now.

The good news is that there should be decent profits to be made in certain sectors over the next couple of years, just as in the early part of the decade, despite the recession we had then. The losers are likely to be different this time around with Large Cap Growth stocks being largely insulated versus being the center of the storm back in 2001/2002.

In other words, DON'T PANIC. We certainly aren't. Rather, we are positioning our clients to capitalize on the present environment. In my experience, the biggest profits are made when there is uncertainty and turmoil. However, courage, discipline, and a long-term focus are essential; otherwise, the business cycle will be your enemy instead of your ally.

"The Nasdaq rose 14% in one day back in 2001!"

"Parts of Europe may have a worse housing bubble than the U.S. did"

"Debt levels have soared in the U.S."

Points to Ponder: A Brief Rundown on Interesting Items I've Run Across

1. Approximately 40% of stocks in the S&P are down this year, despite the overall index being up 9.1%.[4]

2. Foreign-derived profits now comprise about 20% of total U.S. corporate profits; in the last quarter, they comprised 75% of overall earnings growth.[5]

3. China will likely be responsible for a larger share of global gross domestic product (GDP) growth than the U.S. in 2007; this is an unprecedented event.[6]

4. If you think the Dow's 300-point rise after the Fed's recent rate reduction was spectacular, consider that when the Fed began its last rate cut campaign in January 2001, the Nasdaq rose 14% in one day![7] (But this didn't halt its long slide to a devastating 76% collapse when it finally bottomed in July 2002.)

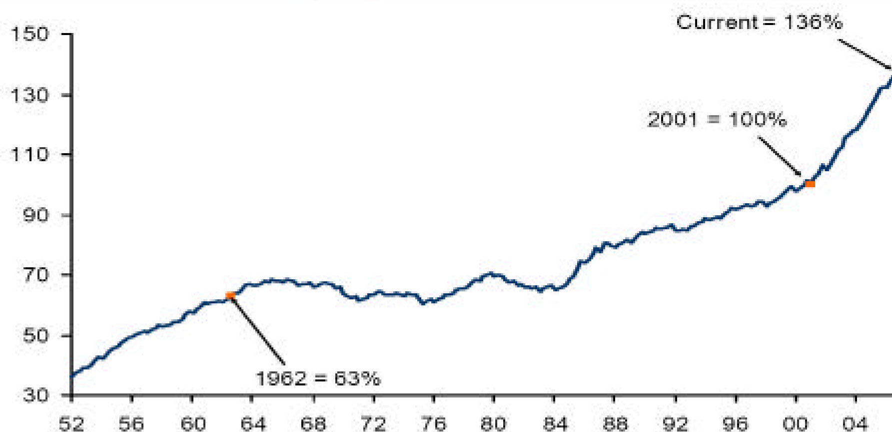
5. The Wall Street consensus is for profit margins to rise in 2008; however, over the last 30 years, margins have fallen by an average of 1% (i.e., from 8.5% to 7.5%) whenever GDP growth recedes below 2%[8] (highly probable in our view).

6. The third and fourth years of a presidential term tend to be positive for stocks[9] (which is perhaps one reason why 2007 has seen a decent return thus far despite a serious credit crunch). But, this is the first time in 80 years that the neither the sitting president nor vice president is up for election.

7. While the bursting bubble in the U.S. housing and mortgage markets has gotten most of the press, it may be worse in Europe: In Spain, home values represent 18% of gross domestic product (GDP)[10] (versus 6% in the U.S. at the peak). In the UK, mortgage debt now represents more than 80% of GDP, with the median home price 11 times average income.[11]

8. The Federal Deposit Insurance Corporation (FDIC) estimates some 1.5 million American households will not be able to meet their mortgage payments as their adjustable-rate mortgages (ARMs) reset.[12]

9. The U.S. debt-to-income ratio increased as much in the last 5 years as it did in the previous 39 years,[13] with mortgage debt up 85% just since 2001![14]



[15]

“…U.S. pension assets amounted to $12.3 trillion … This compares to $17.9 trillion for all industrialized economies”

“…the Saudis have a massive new field coming on line in the 4th quarter”

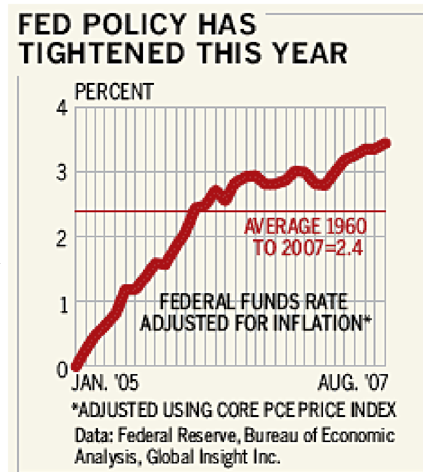
“Super Cut. The Fed finally did what pretty much the whole world expected it to do”

10. Had the employment participation rate remained where it was as of year-end 2006, the unemployment rate would now be around 5.4%,[16] up a full percentage point from its trough. U.S. recessions have consistently occurred when the jobless rate rises by just one-half a percent.

11. Even though the American populace is considered to be genetically savings-averse, U.S. pension assets amounted to $12.3 trillion at year-end 2005 (and presumably would be higher today). This compares to $17.9 trillion for all industrialized economies.[17] It also is likely indicative of the under-reporting of U.S. savings as well as the sharp divide between the savers and non-savers in our country.

12. Saudi Arabia has been forced to reduce its output by one million barrels a day due to the growth in non-OPEC production; additionally, the Saudis have a massive new field coming on line in the fourth quarter.[18]

13. On an after-inflation basis, the Fed funds rate is still higher than it was a year ago, despite the recent cut. Additionally, many other rates, such as on prime jumbo loans and junk bonds, have risen over the last few months. (See Chart to Right)[19]



October EVA Core Content

Super cut. The Fed finally did what pretty much the whole world expected it to do by reducing its crucial overnight rate on September 18. The only aspect that was somewhat surprising (although not to us) was that the Fed cut by 50 basis points (one-half a percent). As EVA readers know, a Fed easing has been one of our key forecasts for 2007.[20] We were feeling very lonely on this call as recently as June, but our view was that things were reaching a fever pitch in the debt creation world and that it would soon end in tears, as it always does. The alacrity with which it all unwound has clearly wrong-footed the formerly tough-talking central bankers, who are now almost universally easing in some way, shape, or form. Yet this hasn’t taken much heat off the Fed head…

Bashing Ben. Proving that you really can’t please all the people all the time, Fed Chairman Ben Bernanke has been both exalted and pilloried since the rate reduction was announced. But from the tone and quantity of the articles we’ve seen, it seems as though he has triggered more criticism than praise. Some wags are using terms like “Bubble Ben” or “Bailout Ben”[21] and well-known banking analyst Dick Bove has characterized the cut as a “disaster.”[22] Bove recently wrote: “The fact is that the Fed has stimulated a full-blown financial crisis. It did so because 2008 is a presidential election year and there is a need for Mr. Bernanke to pay back his handlers. He must now start to think about the country. The Fed must protect the currency.” Boy, talk about a tough crowd!

What’s a Fed to do? Assertions that Mr. Bernanke is playing politics and/or not placing the national interest first are both wrong-headed and irresponsible in our view.

"…employment reports vary tremendously month-to-month"

"Japan's GDP actually shrank by 1.2% in the second quarter"

"...in my view recessions odds are now roughly 60%"

The reality is he was, and is, coping with an extremely intense mortgage and banking crisis that threatens the foundation of the global financial infrastructure. He also is looking at the same economic data we are and lately that information has been more bust than robust. The exceedingly weak jobs report on September 7th[23] gave the Fed ample reason, beyond bailing out Wall Street speculators, to reduce their rate. But these employment reports vary tremendously month-to-month and can definitely produce some serious head fakes.

Are you dizzy yet? First, there was that really bad jobs number in early September. Then, today, it was revised materially higher and the most recent month's data was decent. Consequently, the stock and bond markets are being whipsawed by apparently conflicting data. We don't think this is at all unusual at turning points in the economy; think back to all the angst in 2003 that due to outsourcing, off-shoring, etc. employment just wasn't recovering. Now it's the opposite issue: the contemporaneous jobs numbers are probably being overstated by the government's estimation process known as the birth/death model. So before assuming all is well on the job front, you might want to wait until next month.

The BED and the Fed. The Business and Economic Development survey (BED) is due out October 8th. This has the potential to be an explosive release as it "trues-up" the earlier job estimates and aligns them with reality. The problem with reports such as the one that comes out at the beginning of each month is that the birth/death model, which assumes business formations are liquidations, tends to be inaccurate when the economy is either in the midst of turning up or down. When a recovery is in its early stages, it underestimates job growth. When the economy is decelerating, it overstates employment gains. Incidentally, we're no longer the Lone Ranger on this call: Goldman Sachs is now forecasting the unemployment rate will peak at 5.2% next year.[24] Some other major economies are also looking wobbly...

Synchronized sinking? We have watched with growing alarm as the economic reports coming out of Japan and Europe are increasingly bleak. Japan looks particularly feeble as the land of the rising sun is also the land of the setting economy. In fact, Japan's GDP actually shrank by 1.2% in the second quarter[25] (though the most recent economic releases ticked up). While Europe has been far more buoyant, it is now throwing off clear signals that it too is downshifting. The extreme strength of the euro against both the yen and the dollar is an enormous business handicap for a continent that is highly export driven. Yet, the European Central Bank (ECB) has continued to rage against subdued inflation.[26] Where does that leave us?

Chindia can't carry all the mail. With the first (Eurozone.), second (U.S.), and third (Japan) largest economies on the planet looking either weaker or downright recessionary, it's almost inconceivable that China, India, and the rest of the emerging economies can maintain global growth. In fact, we think they are very much at risk of catching the slowdown virus. Consequently, we have to unhappily confess that we think the likelihood is that we will see a recession in most of the world. We're not up to Merrill Lynch's David Rosenberg's odds of a 70% chance of recession[27] (at least in the U.S.), but roughly 60% is probably realistic. We're also concerned about the extreme popularity and risk-adjusted valuation of stocks in the developing world.

Emerging to submerging? Thanks to an incredible multi-year run, stock markets in the developing world now trade in aggregate at virtual parity with those in the wealthier countries. The positive argument is that they grow faster but they are also

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"…non-OPEC supply has been increasing while global demand has turned out weaker than expected"

"…oil prices headed to the $45 to $50 level"

clearly more volatile. And one thing we haven't read anywhere is how much higher inflation and/or interest rates are in countries like Brazil and Russia. For example, in Brazil, short-term rates are 11%, and in Russia, inflation is around 7%.[28] Higher interest and inflation rates usually translate into lower valuations, even if risk levels are comparable, which they obviously aren't. Therefore, though these markets continue to rock and roll we see a material correction coming. Then there's another asset class we see weakening in a big way…

It was a global bubble. Forbes recently ran a cover headline declaring: "Sub-prime Mess: Way Overblown."[29] From our vantage point, Forbes is right, but the implication is wrong. If it were just sub-prime, then so much turmoil from one sector would seem excessive. But the toxicity of lunatic lending has literally known no bounds—or boundaries. The Spanish and Irish property markets may have been even crazier than the U.S. market at its worst.[30] Furthermore, it's widely known that homeowners in Eastern Europe have borrowed in Swiss francs and euros[31] to access much lower rates but simultaneously exposing themselves to huge currency risk.[32] Now the stress is showing up in various property markets in Europe, which are beginning to crack. Then there is the oil market…

Oil slick ahead? Mike Rothman is a senior managing director of the prestigious economic forecasting and investment strategy firm ISI. Barron's described him as a premier energy analyst and featured his thoughts in a fascinating interview in the September 17 issue.[33] The gist of his view is that the oil market is far from tight; to prove this he said that the Saudis have cut production by one million barrels a day over the last year to keep a glut from forming. His view is that non-OPEC supply has been increasing while global demand has turned out weaker than expected. Furthermore, the Saudis have a massive oil field coming on line in the fourth quarter. He also noted a much higher speculative interest in crude than in the past. That hot money can turn cold in a hurry.

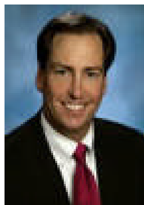
A very contrary call. Of course, his outlook, which we share, is extremely against consensus. But he makes some compelling points, to wit: "The rate of global oil-demand growth has slowed pretty dramatically since '04…A chart of the OECD (our note: the industrialized economies) countries shows *demand growth has been negative* (our emphasis), with the exception of a small gain in the second quarter… That's the worst showing since the '80-'82 recession."[34] As far as booming demand from Chindia, he points out that in 2004 it was an aberrantly high 15% but that, for China, he has revised his demand numbers down for the last three years with consumption growth running closer to 5%. What will happen if we have a global recession?

Collision course. The combination of high supplies, a slowdown if not outright recession in the leading economies, excessive bullish speculation, and extremely extended prices leads us to conclude there is a serious correction coming to the oil complex. Mike Rothman told Barron's he sees oil prices headed to the $45 to $50 level, and that makes sense to us.[35] Such a decline would be a shock to most investors, but the financial markets tend to do that with fiendish regularity. But falling oil prices, especially if coupled with declining interest rates, could certainly buoy the economy and cheer investors—much as they did last year. If you don't think that's possible, consider that ethanol prices have crashed some 30% in just a few months.[36] Other things might land sunny-side up as well.

"…even if the negatives win out it will be a temporary event… creating a wonderful opportunity to gain even greater exposure to the world's finest companies"

What could go right. As mentioned earlier, my recession handicapping could be too bleak. Factors that could override the powerful downdrafts caused by housing and worsening unemployment are numerous. They include the continued strength in Asia, the possibility that the Fed didn't over-tighten as much as it has in the past, the potential for a sharp drop in oil prices, and the stimulative impact of a weaker dollar, among others. As mentioned at the outset, the combination of falling interest rates and oil prices could lead to a sharp stock market rally. It's likely going to be quite a tussle between the upside and downside drivers. However, even if the negatives win out it will be a temporary event. And it will create a wonderful opportunity to gain even greater exposure to the world's finest companies, which remain unloved and undervalued. So, as I said in the last EVA, you may want to rachet down your risk level but, just like on the golf course, stay out of the bunker– especially when it comes to mentality!

David M. Hay



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Did you miss last month's EVA?
You can always find it in the archive at www.evergreencapital.net

What we like and what we don't like

We Like:	We're Neutral On:	We Don't Like:
· High quality steady growth stocks	· Large Cap Value	· REIT's
· Three to five year FDIC-insured CD's	· Large Cap Growth	· Small Cap Value
· High quality preferred stocks 6.5% - 7%	· Mid Cap Growth	· Mid Cap Value
· Intermediate-term high-grade bonds	· International developed markets	· Most Cyclical stocks
	· Intermediate treasury bonds (with a bias to bullish if they move up in yield to 4.75%)	· Emerging markets

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