

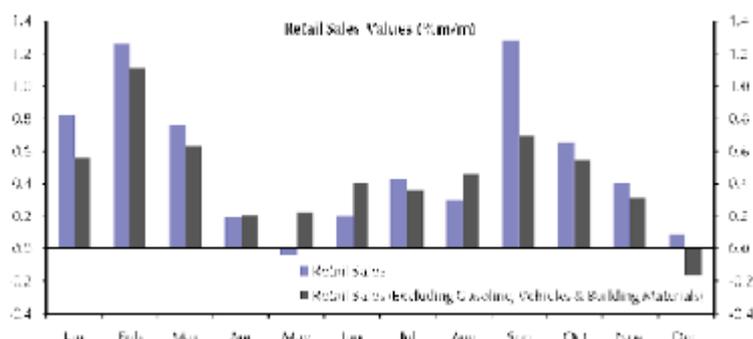
# February 3, 2012

"Given the scale of the problems faced by many of the eurozone countries, it is hard to believe they won't face further periods of extreme stress over the next couple of years."

- ARIF HUSSEIN, DIRECTOR OF ALLIANCE BERNSTEIN'S EUROPEAN FIXED INCOME RESEARCH

## POINTS TO PONDER

1. While most observers seem to believe the US economy is accelerating, the all-important measure of retail sales (given that consumer activity drives roughly 70% of America's GDP) is telling a very different story.



2. Numerous sources have noted that US consumer spending was boosted by a drawdown of savings in last year's second half. Gluskin Sheff's hyperkinetic head economist, David Rosenberg, states that absent this factor, and a 60 cent drop in gasoline prices (which amounted to a \$100 billion windfall in household disposable income), real consumer spending would have fallen 3%.

3. One of the best pieces of US economic news over the last few months is related to the long-struggling American job machine. According to the influential surveys conducted by the University of Michigan, employment conditions are improving at the best rate since 1983.

4. The US economy grew at its fastest pace of the year in the fourth quarter. Unfortunately, despite this pickup to a less than awe-inspiring 2.8% rate, for the year GDP expanded at a limp 1.6%.

GDP BY EXPENDITURE (%Q/Q ANN)									
	Personal Consumption Expenditure	Business Investment	Residential Investment	Government Consumption	Change in Private Inventories (\$bn)	Exports	Imports	GDP q/q ann	GDP y/y
Q1 11	2.1	2.1	-2.4	-5.9	49.1	7.9	8.3	0.4	2.2
Q2 11	0.7	10.3	4.2	-0.9	39.1	1.6	1.4	1.3	1.6
Q3 11	1.7	15.7	1.2	0.9	-2.0	4.7	1.2	1.8	1.5
Q4 11	2.0	1.7	10.9	-4.6	56.0	4.6	4.4	2.8	1.6

5. One of several drags affecting the American economy as 2012 begins is the reduction of the 100%

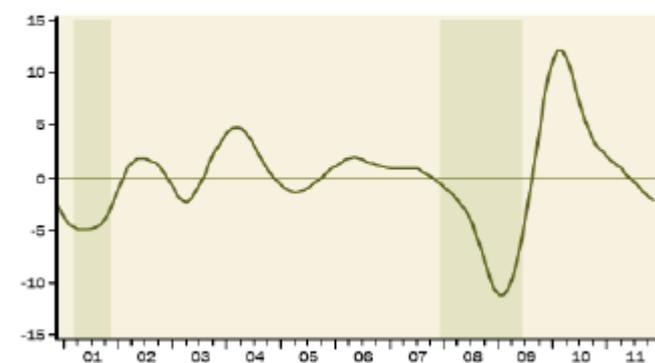
bonus depreciation allowance for businesses to 50%. Although this is a near-term impediment, given that corporate profits are at an all-time high but net capital investment as a percentage of GDP is back to where it was in 1975, an eventual spike in fixed-asset investing is virtually certain.

6. US stocks have recovered nearly all of their losses from last April's peak. Yet profits continue to look topy with the ratio of negative-to-positive earnings pre-announcements at 3.5:1, the worst reading since the fourth quarter of 2008 when the Great Recession was in full swing. Additionally, projected corporate tax receipts for 2011 are now \$194 billion, compared to an initial estimate of \$280 billion.

7. Last week's EVA noted that US leading economic indicators are revealing a much less robust picture than those that are concurrent or lagging. America is not alone in this regard, with cautionary advance indicators being the prevailing condition throughout the rich (OECD) world and, surprisingly, even in Asia.

**CHART 3: OECD LEADING INDICATORS CONTINUE TO FLAG THE FRAGILITY OF THIS 2½ YEAR GLOBAL RECOVERY**

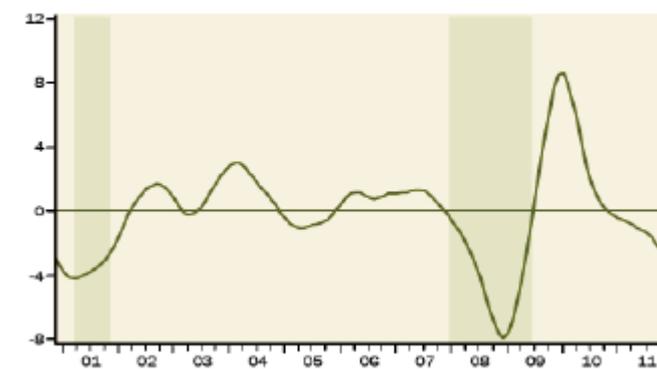
OECD: Total Leading Indicator  
(year-over-year percent change)



Shaded regions represent periods of U.S. recession

**CHART 5: IS ASIA HEADING INTO AN OUTRIGHT DOWNTURN?**

Major Five Asian Countries: Total Leading Indicator  
(year-over-year percent change)

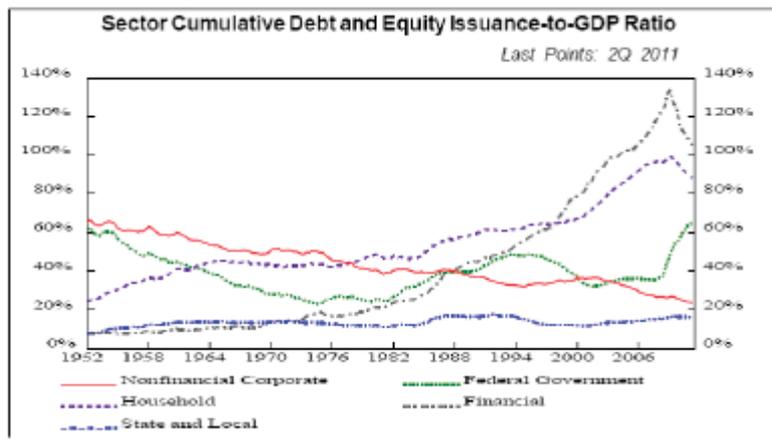


Shaded regions represent periods of U.S. recession

8. Experienced investors are skeptical of the overly upbeat earnings forecasts by Wall Street analysts and for good reason. Never once in 26 years have US (or European) "sell side" analysts forecast profit declines even though they have occurred one-third of the time.

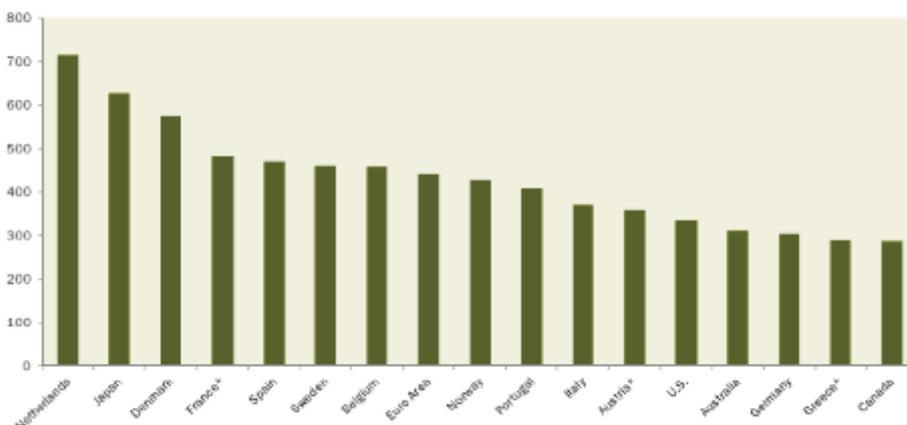
9. The venerable Dow Jones Industrial Average was the envy of global stock indexes last year, posting an 8% total return (i.e., including dividends) even as most world markets fell, many precipitously. Interestingly, 44% of the Dow's gains came from just one stock—IBM.

10. Over the last four years, the US private sector has reduced its leverage by 16% of GDP, roughly three times more than the 5% of GDP increase seen by the federal government. Consequently, overall debt levels in the US are among the lowest in the developed world, though all countries have disturbingly high levels of total liabilities.



**CHART 2: TOO MUCH DEBT AT ALL LEVELS**

**Domestic Debt Outstanding as a % of adjusted GDP (Q2 2011)**



\*Last available data point for France and Austria are as of Q3 2010 and Greece is as of Q1 2011

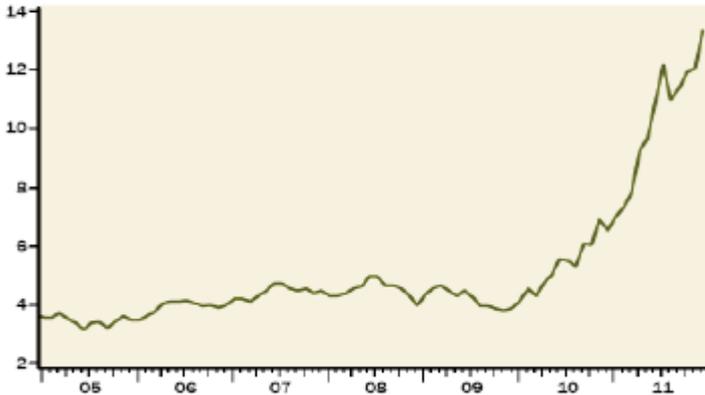
11. America continues to make impressive strides toward energy independence due to enhanced drilling techniques that are now turbo-charging oil production from shale formations just as they have with natural gas. As a result of these breakthroughs, North Dakota is now producing more oil from its Bakken Shale than Alaska is from Prudhoe Bay.

12. The ECB's unprecedented program to extend virtually unlimited financing to Europe's banks appears to have prevented a calamitous chain reaction of bank failures. A key reason for the fragility of the Continent's financial system, in addition to excessive holdings of questionable government debt, is the sheer size of its banking sector. Europe's \$41 trillion in total bank assets is 2.5 times greater than that of the US.

13. Almost all continues to be quiet on the European front of late. However, one area that remains under siege is Portugal, where 10-year government bond yields are becoming ever more reminiscent of those in Greece prior to its debt market totally imploding.

**CHART 3: THE NEXT GREECE?**

**Portugal: 10-year Government Bond Yield**  
(percent)



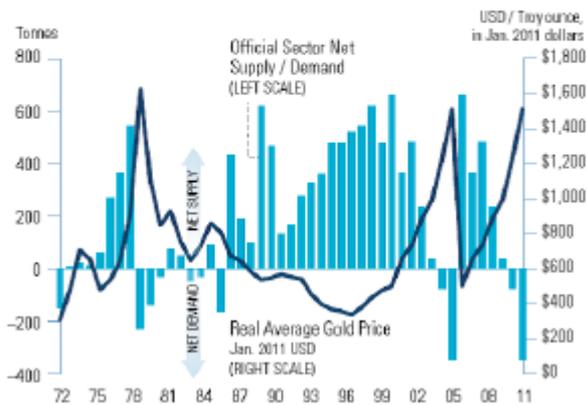
Source: Haver Analytics, Gluskin Sheff

14. Tax evasion in Greece has attained, quite appropriately, mythic status yet Italy is no slouch in this regard. Among Italian taxpayers, 66% say they earn less than \$26,000 US annually even though 518 own either jets or helicopters, 42,000 own luxury yachts, and 188,000 own Maseratis, Ferraris, or Porsches.

15. Gold weakened noticeably last year during the most intense phase of Europe’s bank funding crisis. This may have been due to central bank bullion-selling by the more financially squeezed countries.

**Exhibit 64: Net Purchases of Gold by the Official Sector**

Central Banks tend to be large net sellers of gold around market peaks.



**My take on the above points.** It’s that time of the year when my wife and I make our mid-winter escape to Hawaii. Through the years, I believe I’ve done some of my best long-term thinking over here (I realize a few of you probably feel that’s not saying much). The chance to downshift to "Island time" and catch up on my always voluminous stack of research reading (with hopefully a book snuck in as well) definitely allows me to do some deeper reflecting.

The last time I was in Hawaii was in August on the way back from visiting our new business partners, GaveKal Capital, in Hong Kong. I vividly remember creating an "on the fly" EVA discussing what was, at that point, a vaporizing stock market. Boy, have things changed in six months!

Capping a recent string of ebullient economic data was today's announcement that the unemployment rate fell to 8.3%, catalyzing another robust rally in the stock market, with the tech heavy NASDAQ hitting an 11-year high. A year ago, I had felt the jobless rate would be down around 8% by now so, if anything, I'm a bit surprised we haven't added even more jobs. But what gnaws at me the most is that I don't believe the employment picture is as hunky-dory as it seems superficially.

As I've noted before, much of the statistical gains are occurring due to jobseekers simply giving up. This isn't to say conditions aren't improving; unquestionably—and fortunately—they are. Yet like so many other aspects of US economic data, when you perform a deeper tissue analysis the results aren't as positive.

Whether it's US consumers drawing down savings to maintain spending, the drag on disposable incomes from \$100 oil prices, profit margins that appear to be peaking, or a mistaken belief that Europe has magically solved its existential problems, there are still some serious challenges staring us in the face. And although I realize bull markets climb walls of worry, I'm concerned we're in a lull between storms.

If my anxieties haven't been chased away by my time in paradise or by the profits that have been accruing in our portfolios lately (despite the hedges we have in place), maybe, just maybe, there's still a typhoon or two lurking out there beyond the beautiful horizon.



**David Hay** | Chief Investment Office  
Evergreen Capital Management, LLC

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