

## June 1, 2012

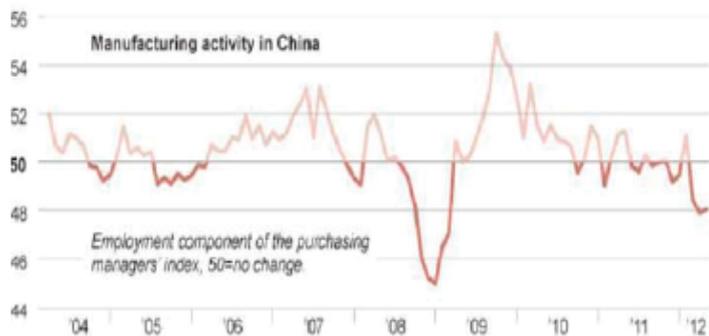
"When will market cycles be banished or made more muted? That'll happen when greed, human failings and herd behavior are eliminated. Or, in other words, never."

-HOWARD MARKS, CO-FOUNDER OF OAKTREE CAPITAL MANAGEMENT

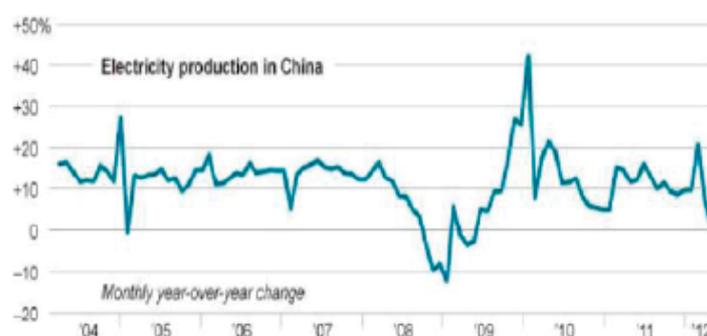
### POINTS TO PONDER

1. The euro currency's fight for its life continues to dominate headlines worldwide, obscuring what is becoming an intensifying economic slowdown in China. (See Figures 1 and 2)

**Figure 1: Manufacturing Activity in China**



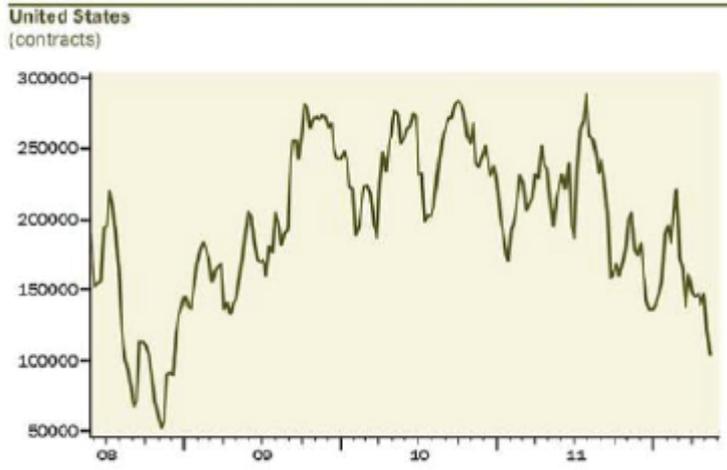
**Figure 2: Electricity Production in China**



2. As China's growth decelerates, calls are growing for another round of government-mandated hyper-spending. Such hopes may not be satisfied given that during the Great Recession stimulus spending amounted to 27.5% of GDP, (in the US, this would equate to over \$4 trillion), more than double the original goal of 12.5%.

3. A year ago, gold was literally a hot commodity. Now, the yellow metal is languishing in investment purgatory. However, hedge fund maestro Ray Dalio suggested in a recent Barron's interview that investors should have 10% of their assets in gold to hedge against central bank money creation run amok. Meanwhile, gold stocks are near three-year lows, with P/Es around 10 and, in the case of one blue chip miner, a 3% dividend yield. (See Figure 3)

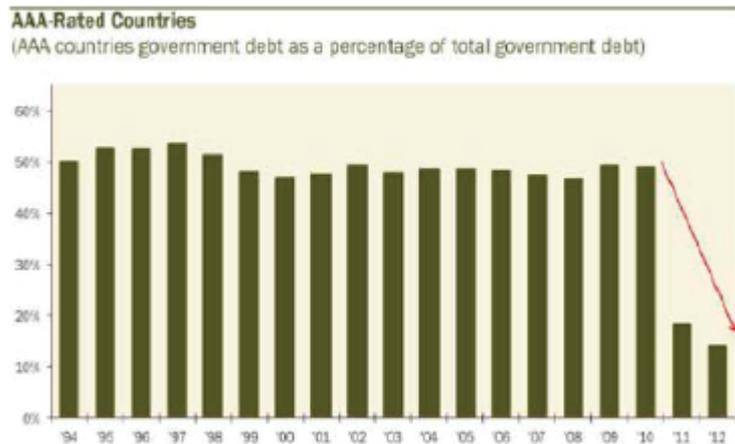
**Figure 3: Net Speculative Long Position in Gold (COMEX)**



Source: Haver Analytics, Gluskin Sheff

4. The trashing of government balance sheets around the world since the global financial crisis has created a dwindling supply of countries that still possess the highest credit rating, with just 10% retaining the coveted AAA status. (See Figure 4)

**Figure 4: Safe-Havens Dwindling in Number**



Source: Standard & Poor's, Bank for International Settlements, Gluskin Sheff

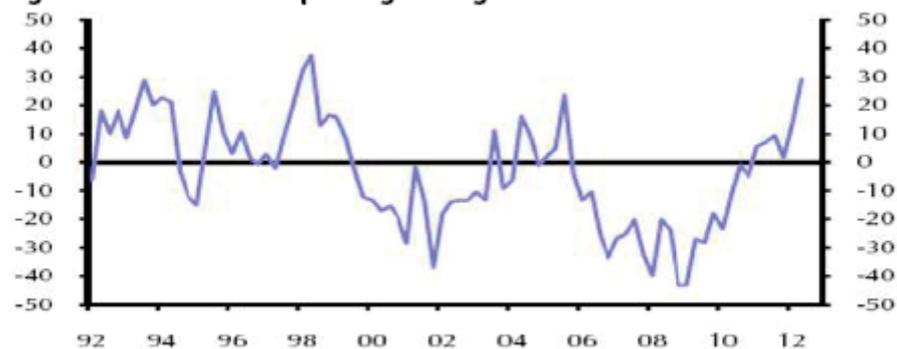
5. Brazil, India, China, and Russia are often collectively referred to by the famous acronym "BRIC." Lately, there have been some deep cracks apparent in their façade of economic superiority. In addition to the aforementioned Chinese growth hiccup, Brazil's currency and stock market have both tumbled 20%, reflecting a decided slowing of its economy. Share prices and business activity in India are also stumbling, as is the rupee.

6. It continues to be the prevailing view that the American economy is in comparatively robust condition even as Europe descends deeper into recession and the formerly dynamic BRICs hit a wall. However, US non-defense capital spending fell 1.9% in April following a 2.2% slump in March, representing the fourth contraction in the last six months, with the annualized rate of decline hitting

8%, the worst since the recession.

7. Although US economic data have begun to lean more to the soft side, there are some encouraging trends. Notably, the percentage of banks reporting increased demand for loans is at the highest level in roughly 15 years. (See Figure 5)

**Figure 5: % of Banks Reporting Stronger Demand for Loans**



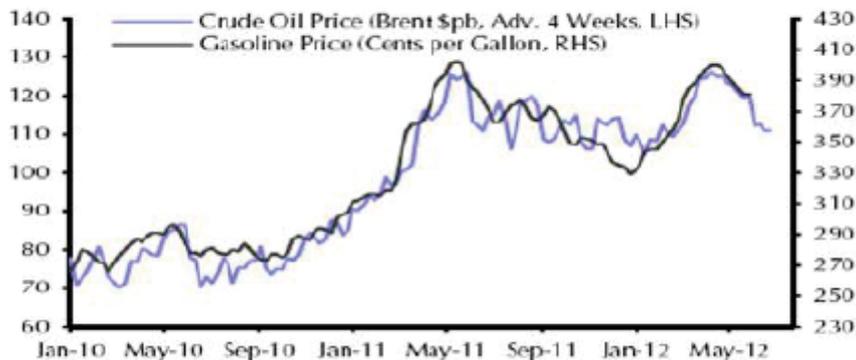
Source: Capital Economics

8. Although many financial gurus continue to warn of imminent inflation, or even hyper-inflation, government bond yields are collapsing worldwide implying deflation is a more immediate threat. German bund yields are now just 1.2% and in Denmark they are nearly 1% flat. In the UK, gilt yields just hit a 300 year low of 1.53%. Other countries with rates in the 1½% vicinity are Finland, Sweden, Canada and Holland.

9. As Gluskin Sheff's crack economist David Rosenberg pointed out in his May 28th Breakfast with Dave, if the parts of the US economy that benefited from the warmest winter since 1895 were pulled out, real GDP would have fallen by 1% in the first quarter.

10. Another source of strength for the US economy is coming from the sharp break in oil prices over the last two months. Pump prices have already fallen to \$3.80 per gallon from \$4 and based on the current Brent crude contract they may be headed to \$3.50. If so, this would amount to about a \$65 billion boost to US consumers. (See Figure 6)

**Figure 6: Oil & Gasoline Prices**



Source: Capital Economics

11. The Japanese government earlier this year reported a trade deficit for the first time since 1980. Some economists warn that if the present combination of an overvalued yen and weak global demand persists, Japan could run chronic trade shortfalls. In turn, this could exacerbate rising fears about its ability to service government debt-to-GDP levels that make Italy look fiscally sound.

12. Europe’s banking system needs more distress like France needs more taxes, but both are nearly a certainty. A *Wall Street Journal* article on May 15th noted that almost 18% of European commercial real estate mortgage-backed securities face possible restructuring (i.e., they’re in trouble). Although the US is in much better shape, the ratio here is still a troubling 13.4%.

13. Despite the pervasive perception that the euro is increasingly unpopular among Europe’s citizens, the latest polls show that a majority favors staying with the troubled currency. Surprisingly, Greeks are particularly euro positive notwithstanding the economic devastation retaining it has entailed. (See Figure 7)

14. Until lately, Germany has been able to resist the downward pull from its continent mates. However, German business activity in May contracted at the sharpest rate in nearly three years, with its closely followed Purchasing Managers Index (PMI) tumbling into negative territory. Meanwhile, France’s PMI hit the deep recession level of 44.7.

15. Pressure is mounting on Germany to agree to the issuance of bonds backed by all eurozone governments, the so-called Eurobond. While German taxpayers would clearly bear the brunt of the liabilities this would entail, according to a Jeffries study from earlier this year, it would be an affordable 2% of GDP. (See Figure 8)

**Figure 8: Cost of a Eurobond to Individual Euro Area Countries**

	2010 GDP (bn, euro)	Debt end 2010 (bn, euro)	Debt as % GDP	10y yield (%, latest)	Cost of a Eurobond relative to current borrowing rate (% pt)  [Assuming 4.7% Eurobond rate - current average 10y yield]	Annual cost of a Eurobond subsidy (bn, euro)  [Level of Outstanding Debt * Higher/Lower borrowing rate]	Annual Cost of a Eurobond as % GDP
Germany	2,476	2,062	83.2	2.3	2.4	49.0	2.0
France	1,933	1,591	82.3	3.5	1.2	18.7	1.0
Italy	1,596	1,849	116.4	7.2	-2.9	-46.2	-3.0
Spain	1,051	642	61.0	6.4	-1.7	-11.1	-1.1
Netherlands	588	370	63.0	2.7	3.0	7.3	1.3
Belgium	354	341	96.2	5.2	-0.5	-1.8	-0.5
Austria	285	206	71.8	3.5	1.2	2.4	0.8
Greece	227	329	144.9	29.2	-13.5	-77.5	-34.1
Finland	181	87	48.3	2.9	1.8	1.5	0.9
Portugal	173	161	93.3	12.0	-7.9	-12.8	-7.4
Ireland	158	148	94.9	9.1	-4.4	-6.6	-4.2
Slovakia	66	27	41.0	4.8	-0.1	0.0	-0.1
Luxembourg	80	7.7	15.1	2.5	2.2	0.2	0.4
Slovenia	35	13.7	38.8	7.3	-2.5	-0.4	-1.0
				[weighted average excluding Greece]		[excluding Greece]	
<b>Euro area</b>	<b>9,127</b>	<b>7,028</b>	<b>85.8</b>	<b>4.7</b>		<b>409.0</b>	

Source: Jefferies

**Here we go (down) again!** For the third year running, the dominant first quarter EVA theme has been caution. This certainly turned out to be reasonable advice in 2010 and 2011 but as the market marched ever higher in April of this year being defensive once again looked stodgy and out of synch.

A series of upbeat US economic releases during the first quarter gave the impression that our economy was, to use a most overused word, decoupling from the rest of the world, particularly Europe. Even the Continent's rapidly weakening vital signs were being inexplicably overlooked which struck us as extremely dangerous. As expected, the reality of the severity of Europe's crisis has made a most unwelcome intrusion upon euphoria. What was hoped to be a brief and mild recession is now increasingly looking like something much more sinister.

Today's latest disappointing US jobs report has also shocked those who were fooled by the seemingly healthy numbers released earlier this year, which were clearly heavily, and positively, influenced by the extraordinarily warm winter in North America. I'm sure readers grew weary of the numerous reminders of that in EVAs earlier this year, but it was simply a fact that the raging bulls were conveniently overlooking.

Certainly, there is still some encouraging news coming out of the US economy and we continue to believe we won't double dip. However, there is some risk of that as the "global cooling" repeatedly discussed in EVAs this year becomes more intense. In addition to worse than expected news on

China's growth rate, India just reported its weakest GDP numbers in nearly a decade.

Suddenly, holding large amounts of cash, as well as hedge securities that rise when the markets fall, doesn't look so imbecilic after all. As was the case during the mini-panics of the last two years, even dependable and high cash flow equity securities are under pressure. Thus, yields of 7% to 8% are once again available. But to be able to pounce on those it is necessary to have cash in reserve which, thankfully, we do.

For several years, another recurring EVA message has been to favor the US over foreign markets with Europe and its currency being a frequent piñata for this author. Now, however, prices have fallen down to levels that are, even on their finest companies, beginning to look like what we saw in the US in 1974 and 1982. My team and I are finding world class companies with free cash flow yields well into double digits and dividend yields in the high single digits.

The world is unquestionably facing problems on many fronts right now. The fear is palpable and it may well get worse before this latest gut check is over. But with "risk-free" interest rates on 10-year government bonds in safer countries plunging toward 1%, money will once again flow toward reliable corporate yield instruments once the fear subsides a bit. Another bedrock belief of ours is that it's better to be lending money to corporate America than government America even though that idea runs counter to the latest market fad.

Market downdrafts are no fun but they are the times when future profits are seeded. We expect to be doing some serious planting in the weeks ahead.



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

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