

October 19, 2012

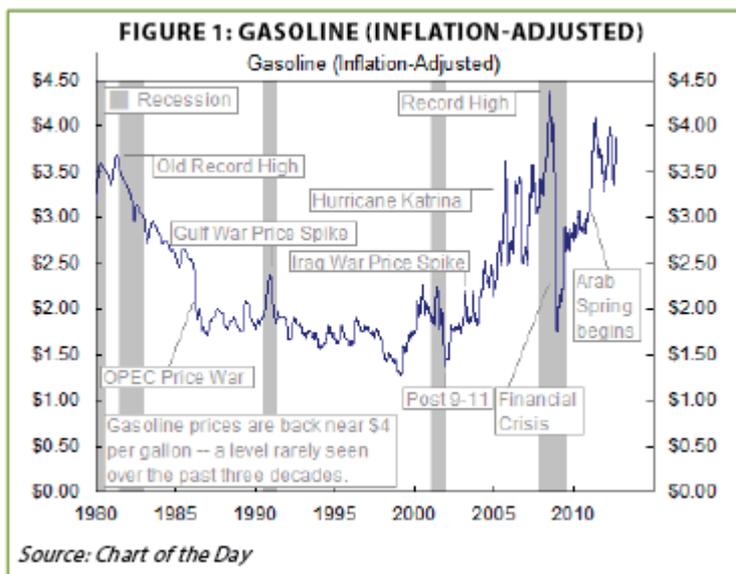
"Those who are too smart to engage in politics are punished by being governed by those who are dumber." - PLATO

"A good president is one who gets elected." - ADOLPH MENJOU, IN THE 1948 FILM STATE OF THE UNION

"The world needs honest men more than it needs presidents." - SPENCER TRACY IN STATE OF THE UNION

POINTS TO PONDER

1. Enthusiasm for the Fed's latest frantic (or desperate) effort to kick-start growth overlooks the drag from \$4 gasoline. Past Fed quantitative easings have inflated crude and historically pump prices this high have been a major headwind for the economy. (See Figure 1)



2. Most sectors of the US economy have seen flat-to-falling shares of the overall employment pie over the past 50 years. However, education and healthcare are glaring exceptions. This might explain why they are the only areas where it takes more labor hours to pay for these services than was the case in the 1950s. (See Figure 2)

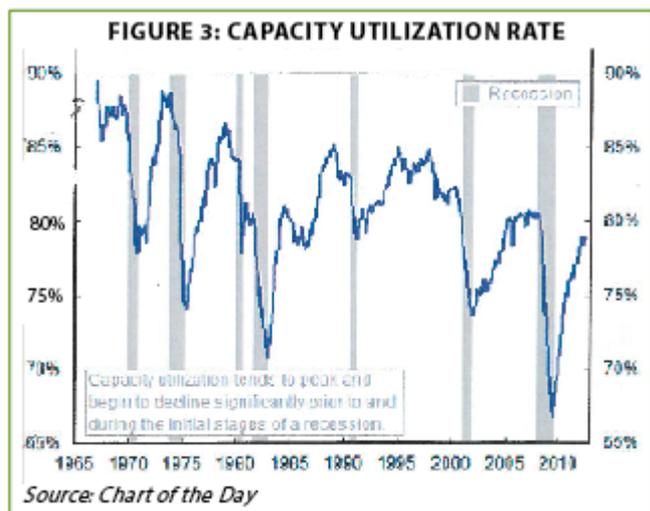
FIGURE 2: NON-FARM EMPLOYMENT (AS A % OF TOTAL)

	1960s	1980s	2000s	Dec 11
Construction	5.3	4.8	5.1	4.2
Manufacturing	27.4	18.5	10.6	8.9
Transport & Wholesale	20.0	20.7	19.4	19.1
Retail	10.2	11.9	11.3	11.1
Information	3.0	2.5	2.3	2.0
Finance & Real Estate	4.7	5.9	6.0	5.8
Education & Health	5.9	8.8	13.3	15.3
Leisure	6.5	8.0	9.6	10.1
Government	16.7	17.2	16.5	16.7

Source: BLS

3. The Fed now owns \$2.8 trillion of government bonds and mortgages with an average duration of 7.3 years. This means that a 1% rise in interest rates would cost the Fed about \$200 billion and a 2% jump would wipe out about \$400 billion of its portfolio value. The Fed’s entire capital base is \$55 billion.

4. There is intense focus on the unemployment rate for obvious reasons. However, the other measure of the economy’s slack (or lack thereof during boom times) is capacity utilization—basically, how much of the nation’s production capabilities are engaged. As indicated in the chart below. US factories continue to operate at a sub-par level. However, this measure is not appreciably below where it was when the economy was hitting on all cylinders in 2007. (See Figure 3)



5. There continues to be a loud chorus of economic conspiracy theorists who believe inflation is running much higher than government statistics. Yet, even in services, typically more resistant to price declines than manufactured goods, deflation has resumed. When viewed together, the message is of falling prices. Ironically, the rising cost of oil tends to act as a consumer tax, putting downward pressure on other prices. (See Figures 4 and 5)

FIGURE 4: DEFLATION IN SERVICES

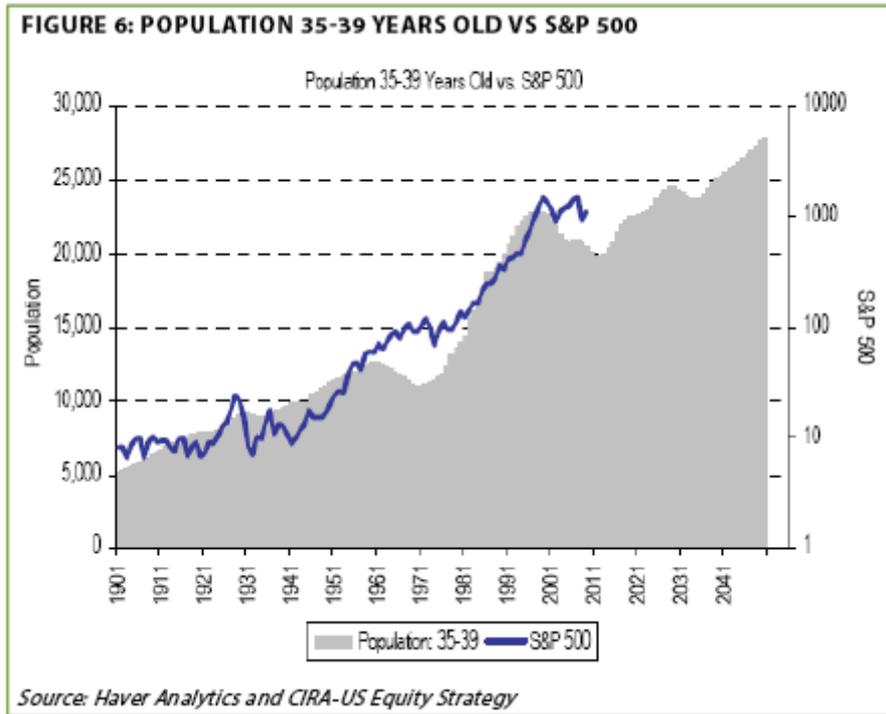


FIGURE 5: DEFLATION IN GOODS



6. US retail sales in September surprised on the upside, increasing about 1%. However, this continues a pattern of savings drawdown seen for most of the last year. For example, had consumer savings stayed flat in July, overall spending actually would have contracted.

7. The September 28th EVA showcased demographic expert Harry Dent's view that the "geriatrification" of America will hamper future stock returns. However, there does appear to be a clear correlation between the trend in the 35- to 39-year-old age group as a percentage of the population and stock prices. The good news is that this age cohort is projected to begin increasing its share of the overall demographic pie in the next few years. (See Figure 6)

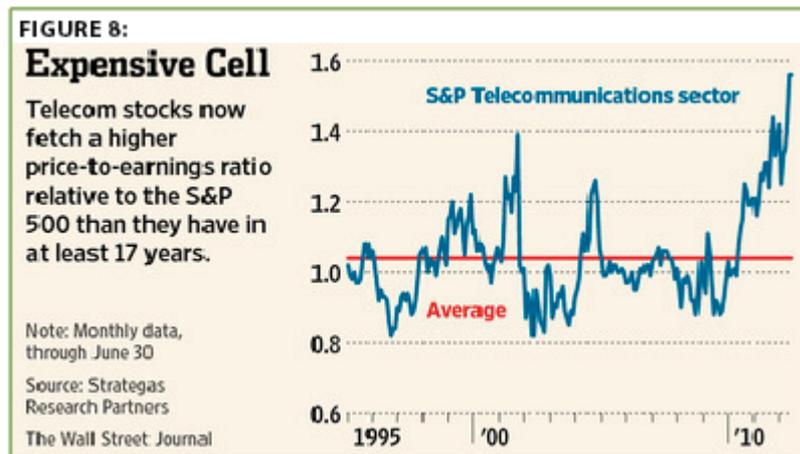


8. While the bond market is likely to be hyper-sensitive to either an inflation flare-up or economic acceleration, it's tough to produce either when the labor force is showing zero earnings improvement. (See Figure 7)



9. According to a recent Pimco essay, if the planet's entire base of physical and electronic currency reserves were backed by gold, bullion would be valued at \$2500 per ounce. While this is materially higher than its current price, it is not as dramatic at many "gold bugs" seem to believe.

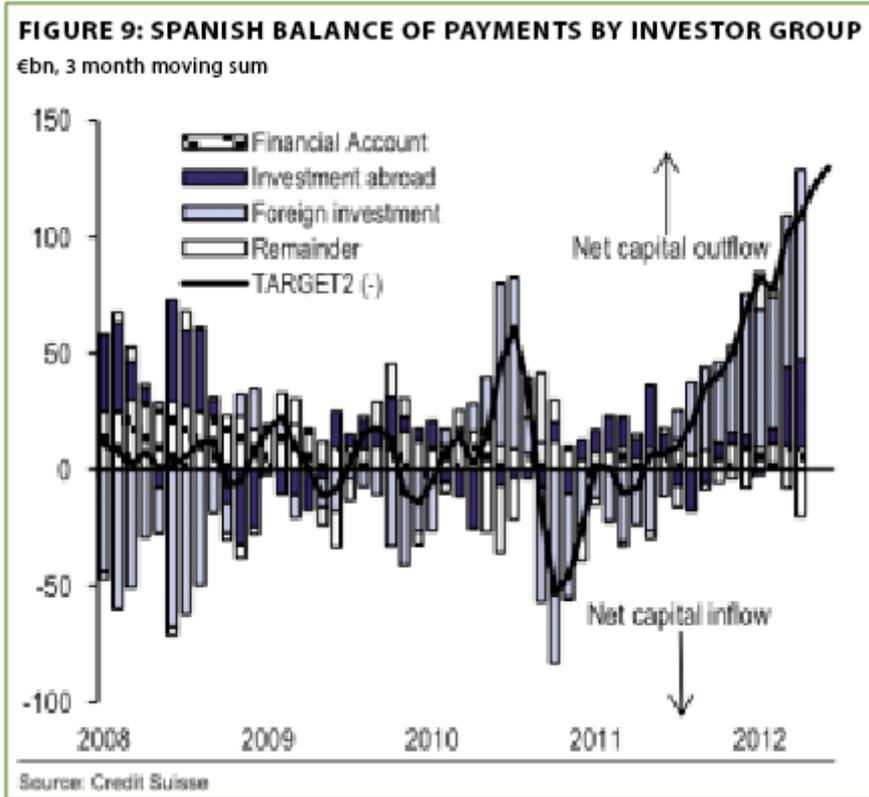
10. REITs are not the only stock market sector trading at a lofty valuation. Telecom and utility shares have also been bid up sharply so that, as in the case of REITs, dividend yields are no longer much above most blue chip stocks with better growth profiles. Additionally, they are also selling at high P/E ratios relative to the overall market. (See Figure 8)



11. Europe’s economic distress is well known but the more surprising news is that China’s manufacturing sector has contracted for 11 straight months.

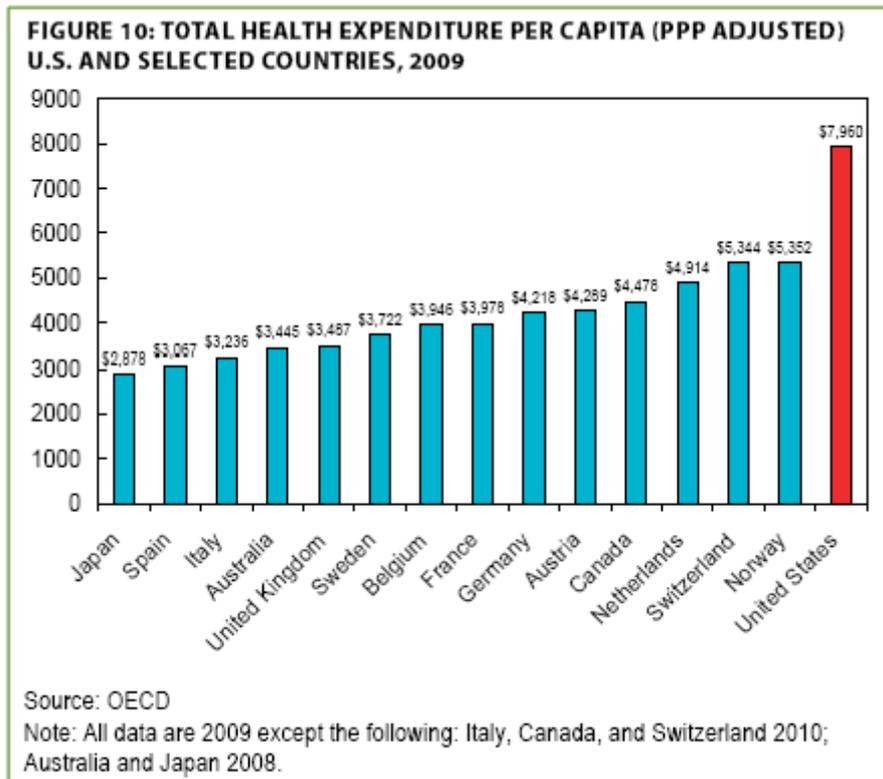
12. France appears to be the next eurozone country poised to come under siege. Government spending in France equals nearly 60% of GDP. It also diverts 38% of gross salaries paid by businesses to social charges such as healthcare and retirement benefits. This compares to just 17% for German companies. Also, greatly hindering competitiveness, only 40% of French workers between the ages of 55 and 64 are still on the job versus 57% and 58% in the UK and Germany, respectively.

13. Underscoring the extreme danger of Spain’s crisis of confidence, Credit Suisse estimates that capital outflows from that country are now running at a rate of almost 50% of GDP. If this were occurring in the US it would amount to roughly \$8 trillion. (See Figure 9)



14. Based on the current run-rate of gambling revenues in Macau thus far this year, its take is now about five times that of Las Vegas.

15. Although the US has far superior access to medical care services, at least for now, compared to most other developed countries, this comes at a serious cost. Accordingly, there is little doubt that significant changes to our healthcare system are essential. (See Figure 10)



State of the Union—still crazy after all these years. Let's be honest. Very few of you have ever watched the Christmas film, *It's a Wonderful Life*, starring Jimmy Stewart and Donna Reed, without shedding more than a few tears. Probably even fewer of you know that this Yuletide classic was produced and directed by Frank Capra.

Back in the 1930s and 1940s, Capra was among Hollywood's most celebrated directors. His *It Happened One Night* won all five major Academy Awards, a feat that was not equaled until 1975 when *One Flew Over the Cuckoo's Nest* swept them as well. Mr. Capra was one of a handful of directors to have his name shown above his movies' titles on theater marquees and in the opening credits. Appropriately enough, his autobiography was called "The Name Above the Title." It's a book I vividly remember as it inspired me to go into cinema studies and attempt to become a filmmaker.

In the summer of 1976, I had the extraordinary good fortune of interviewing Mr. Capra at his mountain retreat in the high Sierras. Somewhere around our house, I think I still have a recording of our time together when he regaled me with stories of Clark Gable, Barbara Stanwyck, Frank Sinatra, Errol Flynn, and even Ernest Hemingway (who was apparently known for proving his machismo by beating up drunks).

As things turned out, I only made it half way in my pursuit of a film career. Despite a very kind and overly flattering letter of recommendation from Mr. Capra, I wasn't accepted into UCLA's graduate film school (somehow I managed to apply too late). After a couple of years of futile attempts to enter the industry, I decided to try my luck at my other passion: the stock market. Undoubtedly, there have been some times when a few Evergreen clients wished I had stuck with my cinematic aspirations.

Last week's EVA was a relatively intense look at the investment implications of the upcoming presidential election. Since then we've had another debate between the candidates and the feathers were really flying. As I'm sure you've noticed as well, the ultimate victim in these verbal versions of hand-to-hand combat is an often inconvenient element, at least for the campaigners, commonly known as the truth. However, I must admit I find the intensity of these events to be captivating and they do drive home just what a nasty business politics truly is. Which brings me back to Frank Capra...

Two years after Mr. Capra directed his holiday tour-de-force, he made another film, *State of the Union*, starring Hollywood's most iconic screen couple of all time, Spencer Tracy and Katherine Hepburn.

Earlier this year, I re-watched *State of the Union* after a hiatus of many years, if not decades, and I was amazed at how relevant and entertaining it remains.

Spencer Tracy plays a multimillionaire aircraft manufacturer from Seattle (obviously, at least loosely based on Bill Boeing) who is conscripted to run for president, initially against his will. Without giving away the plot (which is one of my pet peeves about most movie reviews), let's just say he goes through a change of heart—and a change of just about everything else, too.

But my point is that this is a fantastic film to watch during a presidential election year. It makes you realize that the brutal and, at times, repugnant presidential election process we are witnessing right now isn't a new phenomenon. While I can't guarantee you will be pleased with the outcome of this year's election, I can assure you that you will enjoy this movie. *State of the Union* is available on Netflix--and keep your eye out for other films that have the name Frank Capra above the title.



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