EVERGREEN VIRTUAL ADVISOR (EVA) NOVEMBER 14, 2008

"We have never in history seen the margins of risk that companies have to pay."

Diane Vazza, head of Standard & Poor's fixed-income research, referring to the current corporate bond market

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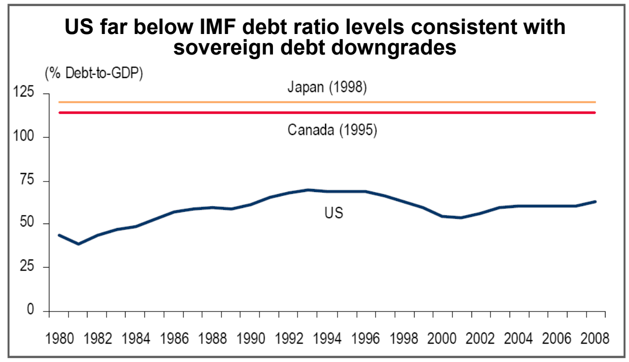
In This Issue:

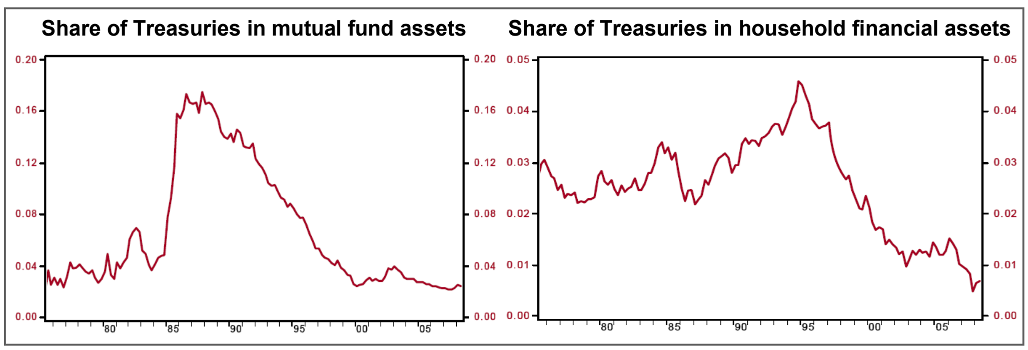
American households are now paying down debt for the first time in nearly 20 years

Points to Ponder

1. The demands on the US government's financing needs are increasing on a daily basis. Many investors are concerned that our debt levels will soon reach a point where foreign buyers will balk. However, America's total debt-to-GDP is far below that hit by Japan and Canada when they lost their AAA ratings back in the 1990s.

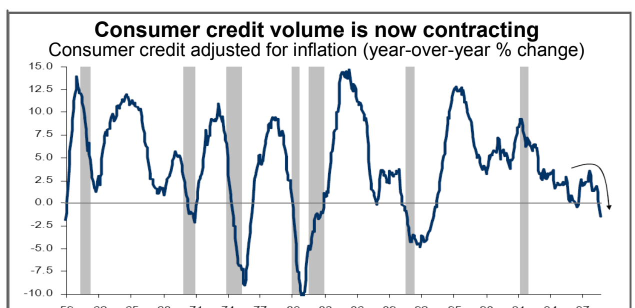


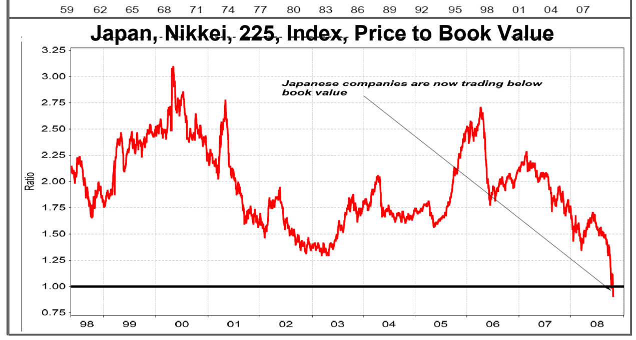
2. Beyond the fact that much of the government's new debt is being invested and is likely to be repaid (bank capital infusions, AIG bailout, Fannie and Freddie funding), Treasury holdings by both individuals and institutions are extremely low, implying significant potential demand.



3. The onslaught of negative news recently drove the S&P 500 down 30% in just 30 days. This has not happened in the last 50 years and at this point 2008 is on track to be the worst year for the stock market since 1931.

4. US consumers are feeling battered from all sides, with some $11 trillion of paper wealth having evaporated between the collapses in housing and stock prices. Consequently, American households are now paying down debt for the first time in nearly 20 years. This trend is likely to continue and even accelerate.





5. As a leading exporter to the US, Japan is also suffering mightily. Its stock market recently fell to its lowest point since 1982 ,with share prices now trading below book value.

Special note: *This EVA is another in a series on the extraordinary condition involving private-sector interest rates. My investment career began in 1979 and I've never seen an environment where rates have risen for consumers and businesses in the midst of a recession. In fact, as you will read, this has not happened in the last 100 years. Yet, I continue to be amazed about how little media attention this is receiving, though now a few heavyweights appear to be moving into my corner.*

"If something can't go on forever, it will stop"

While this astonishing aberration is a gilt-edged opportunity for yield-oriented investors, it remains an extreme threat to both the US and global economy. Though I can't tell you why or when this will change, I do know it cannot continue much longer. As the late, famed economist Herb Stein (Ben's father) once quipped with his usual dry humor: "If something can't go on forever, it will stop."

EVAluating the Environment

Fed Chairman Bernanke, student of the Great Depression, fully comprehends the gravity of the current systemic risks

So much money, so little to show for it. As mentioned in past EVAs, Fed Chairman Ben Bernanke is a student of the Great Depression. His fascination with that awful era, coupled with his extensive research on how to avoid a repeat, may be one of the few fortuitous breaks we've had of late. Certainly, his tireless creation of new lending programs to undergird the financial system is indicative of someone who fully comprehends the gravity of the systemic risks. He has even expanded his efforts to include other countries that have found themselves in a liquidity pickle (ironically, due to a rapidly rising dollar). In fact, for the first time he has offered so-called dollar swaps to emerging countries such as Mexico and Brazil (Hugo Chavez, however, shouldn't be expecting the Fed check to be in the mail). Yet, the economic gales seem to be building in intensity by the day.

There has *never* been an economic recovery when real rates on BBB-rated corporate bonds were above 5%... Today they are 6.5%

Toxic rates. Despite Mr. Bernanke's Herculean efforts, the real economy continues to deteriorate and interest rates remain exorbitant for consumers and businesses alike. This is not just a US phenomenon as you can see in the chart below; interest rates in the emerging countries have also gone ballistic, with many of them paying 14% on their sovereign debt. Here at home, we continue to struggle with private-sector interest rates that are making a bad situation worse. With investment-grade companies still being forced to pay 9% or 10% to borrow longer term, the real interest rate (i.e., adjusted for inflation) is punishingly high. My good friends at GaveKal research have pointed out that there has *never* been an economic recovery when real rates on BBB-rated corporate bonds were above 5%. Today they are 6.5% and that's rising daily as inflation melts away. Thus, we've got a situation today that is nearly unprecedented.

Faulty transmission. Back in 2002, we also had a credit crisis on our hands (though by comparison with our current near-death experience, that event now

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seems like a mere fainting spell). At that time, deflation also reared its repulsive head and Mr. Bernanke gave a series of speeches on how the Fed could avoid it. In one of those he facetiously mentioned throwing dollar bills from the sky if necessary, earning him the nickname "Helicopter Ben." I've gone back and read his main techniques for combating deflation (and, implicitly, anything resembling a modern-day depression). Of his five key tactics, three of them involve the Fed buying private securities; thus, he is philosophically open to something like the direct purchase of corporate debt. However, his other comments at the time indicated a belief that if yields on government bonds are forced down by the Fed, corporate rates will follow. Washington, we have problem—just the opposite is occurring.

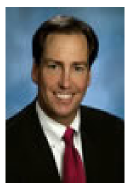
Theory vs. reality. The current situation where Treasury yields are near 50-year lows while corporate borrowing costs are dramatically rising should be causing some intense soul-searching at the Fed. After all, it's what consumers and businesses have to pay that really drives the economy (or puts it in reverse). Have you checked out the yields on US automakers' bonds? Would you believe over 40%? Even their ability to package up car loans and sell them to investors, usually a much lower cost funding mechanism, is now far more expensive. Until Detroit has access to reasonable financing, it's hard to see how it survives. Consumer interest rates haven't risen as rapidly as they have for corporations but access to credit is now significantly harder. From every angle, debt has become costlier and harder to procure. That's why I keep harping on the idea that the Fed needs to get even more imaginative to force rates lower. As it turns out, I'm not alone.

A growing chorus. Over the last few weeks, I've read op-ed pieces from three very big kahunas in the world of finance: Pimco's Bill Gross, Wharton's Jeremy Siegel, and former Fed Chairman Paul Volcker (who is also a top economic adviser to President-elect Obama). All three were basically saying the same thing: Sometimes the capital markets need help and this is one of those times. Mr. Volcker wrote: "Recent US legislation has provided authority for large-scale direct intervention by the Treasury in the mortgage and other troubled markets." It's hard to imagine a market more challenged right now than the one for corporate debt where, according to Merrill Lynch, junk bonds are now anticipating a 40% default rate. For corporate bonds in general, yield differentials versus Treasuries are at 100-year highs. As indicated by the chart on page 2, this is a global dilemma for the world's central bankers, possibly even the most serious one they face. Fortunately, there seems to be an increasing awareness of this.

Where are the buyers? Referring to international monetary authorities, the *Financial* Times' Gillian Tett recently wrote: "No wonder some senior policymakers argue in private that one of the biggest problems dogging the financial system is a dire shortage of investors with enough courage to buy assets now trading at distressed levels." One key reason for this is that the major banks and insurance companies use a model called "Value at Risk" (VAR). When the volatility or risk component explodes as it has done lately, this VAR model tells these institutions that normally defensive things like bonds are actually far riskier. This makes them more inclined to sell, even though yields are unbelievably attractive. Consequently, we have another example of computer models wreaking havoc—during one of the greatest buying opportunities in the history of the bond market, the computer says sell! But, I remain convinced that either the market will heal itself (a slower, more painful process) or the government will get out its checkbook and accelerate the recovery. What is certain is that private-sector interest rates will come down, those brave investors buying them now will be hugely rewarded, and the end of the world will once again be avoided. But don't tell a leading British magazine…

Negativity dominating the headlines likely indicates that investors are over-discounting the problems and ignoring their eventual solution

Have they done it again? A few months back, when oil prices were surging toward $150, I poked a little fun at the *Economist's* habit of running "Wrong Way Corrigan" cover stories—the financial press equivalent of the *Sports Illustrated* jinx. Sure enough, the *Economist's* ominous article about oil prices almost perfectly coincided with the peak. Therefore, I was greatly encouraged to see a recent cover story entitled "Capitalism at Bay" with the image of a mortally wounded animal implicitly representing the current state of free market economics. It was also highly reminiscent of the famous *Business Week* cover story on the "Death of Equities" that appeared not long before the uber-bull market began in 1982. When such negativity is dominating the headlines, it's likely that investors are over-discounting the problems and ignoring their eventual solution. I'm certainly not attempting to minimize the difficulties up ahead. However, I'm convinced that once interest rates come down it will set off a chain reaction of positive events; in other words, the polar opposite of what we've been through lately where adverse developments have been self-reinforcing. Let's hope the *Economist* has not lost its touch.



David Hay
Chief Investment Officer
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What We Like and What We Don't Like

We Like:

- Intermediate & long-term municipal bonds with strong credit ratings
- Large Cap Growth
- Mid Cap Growth
- Small Cap Growth
- Large Cap Value
- High quality preferred stocks yielding 9% to 12%
- Intermediate-term high grade bonds
- International developed markets
- Numerous publicly traded pipeline partnerships yielding 10% to 14%
- Emerging stock & bond markets

We're Neutral On:

- Small Cap Value
- Mid Cap Value
- Intermediate & longer-term Treasury notes/bonds
- Most cyclical stocks in resource-based industries
- REITs
- Three to five year FDIC CDs

We Don't Like:

- Cash

For information regarding sources referred to and used in this article, please contact Kim Harlan at kharlan@evergreencapital.net