Market Outlook

Evergreen Investments™

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Mid-Year Market Outlook

Market Performance

After maintaining a rapid pace in the first two months of the second quarter, the financial markets slowed down in June. In the equity markets, daily trading volume moderated as areas of leadership for the month included small caps, growth and technology. For the quarter, stocks rallied sharply from their lows reached in early March. International indexes soared for the quarter, as hopes for a "V-shaped" recovery surfaced, particularly in developing regions. In the fixed income markets, the yield on the benchmark 10-year Treasury climbed by approximately 100 basis points during the quarter, as fears escalated relative to government spending, the potential for pricing pressures and currency weakness. Signs of stability emerged in the corporate credit markets, though, as both issuance and performance improved despite the trajectory of the 10-year Treasury. The price of oil surged for the quarter, pulling most commodities higher, as gold gave back earlier gains and the dollar weakened. See Chart 1 for more details of Market Performance.

U.S. Economy

First quarter GDP was recently revised to a decline of -5.5% versus the steep decline of -6.3% during the fourth quarter. Though "less bad" than the original estimates, the data still point to the second weakest quarterly output in 27 years, as a downward revision to imports and a less severe contraction in business inventories largely accounted for the change. Indeed, the draw-down in inventories may prove additive to GDP over the next few quarters, as businesses rebuild their stockpiles. We look for the combination of inventory investment and federal spending to help lessen the blow to second quarter GDP (-2.0% est.) and possibly prove additive (+2.0% est.) during the third quarter. See Chart 2.

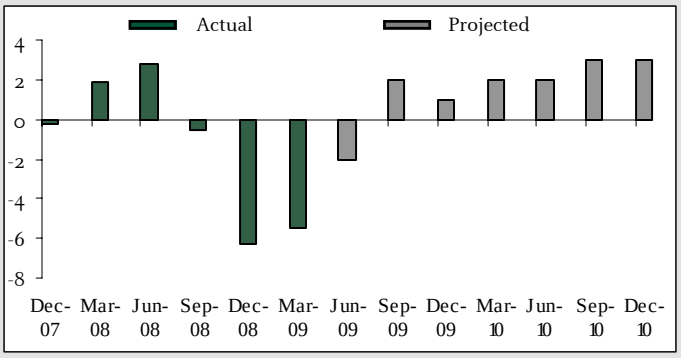
While recent data reflect an economy that is managing to climb from the depths of the past two quarters, we question whether or not the fundamentals are in place for sustainable growth. It appears that hopes for a rebound remain hinged on government spending and improved manufacturing activity based on depleted inventories. To the extent these developments could temporarily spur consumption and export growth, it is possible that gross domestic product (GDP) could see positive gains into 2010. Yet we would consider these gains to be transitory, since the deleveraging U.S. consumer (typically responsible for two-thirds of economic activity) remains an unlikely candidate to propel the economy higher. Until we see signs of stability in home prices and employment growth, we look for a "less spectacular" recovery than those experienced in past cycles.

1. Market Performance as of 6/30/09

EQUITIES	6/30/09 LEVEL	JUNE TR*	QTD TR*	YTD TR*
Dow Jones Industrials	8,447.00	-0.4	12.0	-2.0
S&P 500	919.32	0.2	15.9	3.2
NASDAQ	1,835.04	3.4	20.0	16.4
Russell 2000	508.28	1.5	20.7	2.6
S&P MidCap	578.14	0.6	18.7	8.5
Russell 1000 Growth	410.05	1.1	16.3	11.5
Russell 1000 Value	465.18	-0.7	16.7	-2.9
MSCI EAFE	1,307.16	-0.6	25.4	8.0
MSCI (Emerging Markets)	761.30	-1.3	34.7	36.0
FIXED INCOME	**6/30/09 LEVEL**	**JUNE TR***	**QTD TR***	**YTD TR***
10-Year Treasury	3.52	-0.2	-6.2	-8.7
Lehman Aggregate	4.14	0.6	1.8	1.9
Lehman Municipal	4.10	-0.9	2.1	6.4
Lehman Corporate	5.98	2.7	10.4	8.3
Lehman High Yield	12.79	2.9	23.1	30.4
Lehman Mortgage	4.34	0.1	0.7	2.9
Lehman Global ex. US	2.39	0.2	5.6	-0.6
COMMODITIES & CURRENCIES	**6/30/09 LEVEL**	**JUNE TR***	**QTD TR***	**YTD TR***
CRB Index	249.96	-1.2	13.4	8.9
Crude Oil - WTI	69.89	5.4	40.7	56.7
Gold	927.40	-5.4	0.3	4.9
Trade Weighted Dollar	80.43	1.3	-6.4	-2.1

Source: Factset, Bloomberg, Lehman Brothers, Evergreen Investments.
*Total Return (TR) includes price appreciation & dividend income for equities.
Past performance is not indicative of future results. It is not possible to invest directly in an index.

2. Real Gross Domestic Product (Qtr/Qtr)



Source: Baseline, Evergreen Investments

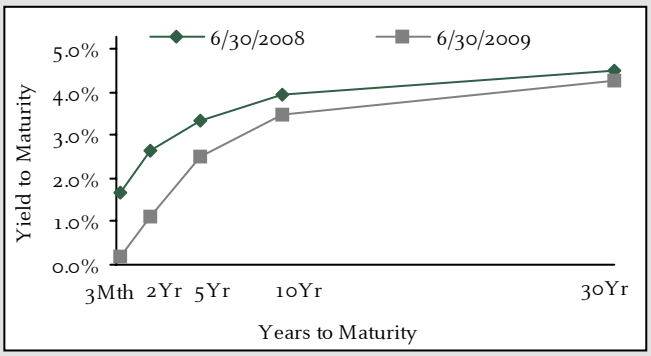
Due to these prospects for "below-trend" growth, we consider the growing inflation fears to be overdone. The economic school of monetarism (inflation is always and everywhere a monetary phenomenon!) suggests that the global surge in government spending will trigger pricing pressures and we would agree, but just not yet. Global growth is receding, oil prices remain 50% lower than last summer, and domestic home prices continue their descent. Rather, as massive global stimulus seeks areas that may hold their intrinsic value (hard assets such as gold) signs of "reflation" may continue. Yet with wages representing the largest costs for businesses and an unemployment rate headed toward 10%, it is improbable that true inflationary pressures are poised to develop until well into 2010.

Federal Reserve & Interest Rates

It appears that the Federal Reserve may agree with this assessment. At the conclusion of their most recent meeting on June 24th, monetary policy makers decided to leave their target for the benchmark federal funds rate near zero "for an extended period" as inflation is expected to remain "subdued for some time." In addition, the central bank reiterated its commitment to the asset purchase program announced in March, whereby policy makers pledged to purchase up to $300 billion in long-term U.S. Treasury bonds and up to $1.25 trillion in mortgage-backed securities. Thus far, the Fed has fulfilled slightly more than one-half of its Treasury pledge and approximately one-third of its mortgage commitment. The goal of this program is to drive prices up, and yields down, in order to lower the rates borrowers must pay on a variety of loans to help improve demand and economic activity.

These programs to combat the recession do not come without risks, however. Having the central bank purchase government bonds at a time when federal spending is accelerating has increased fears of debt monetization, where the Fed has been criticized by some as enabling the government's massive increase in spending. To be sure, concerns about deficit spending, debt issuance, inflation, and dollar weakness have forced Treasury yields higher over the past few months. Earlier this year when the yield on the 10-year Treasury was trading in the 2% range, we suspect investors were pricing in a doomsday scenario. At current levels (3.50%), we suspect market yields are simply attempting to normalize as credit conditions have improved. While the "bond vigilantes" have had their say, driving market yields higher, we look for the Fed to fulfill its commitment on the $300 billion Treasury purchase plan, placing a temporary lid on market interest rates as the year progresses. Furthermore, if mortgage rates don't acquiesce soon, it is entirely possible that more purchase programs may be considered by monetary officials, particularly given the current weakness (YOY CPI -1.3%) in pricing pressures.

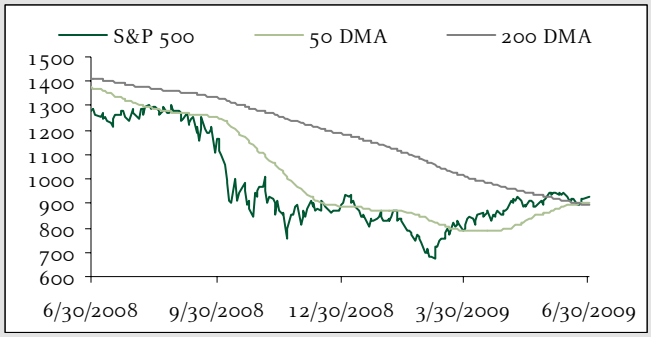
3. U.S. Treasury Yield Curve



Source: Baseline

In this environment, a diversified and actively managed portfolio is recommended for fixed income investors. Indeed, the Fed has attempted to combat the credit crisis with a credit-driven response, driving short-term rates as low as possible. The resulting steep yield curve (See Chart 3) should allow banks to do what it is that they do best – borrow short and lend long – in order to improve economic activity. We also believe that monetary policy tends to be binary, in that central banks don't mind surprising the markets with a cut in interest rates, but seem loathe to surprise with a tightening of credit. Therefore, watch for the phrase "for an extended period" to be removed from the Fed's policy statement over the next year – that could be a very bad day for Treasuries! In addition, we continue to see opportunities within diversified national municipal bond funds as well as investment grade corporate bonds. In both areas, the interest rate differential, or yield spread to comparable Treasury maturities, remains well above historical averages. Finally, though high yield bonds have generated significant gains for investors in 2009, we caution that default rates are poised to escalate as a result of the recession, potentially threatening some of the recent gains for this sector of the bond market.

4. S&P 500 vs. 50 & 200 Day Moving Average



Source: Baseline, Evergreen Investments

Equity Market

The S&P 500 Index has now rebounded by approximately 35% from the lows reached on March 9th. See Chart 4. Despite this rally, cash positions in institutional funds and money market asset levels remain high, suggesting investors may continue to chase this rally. Indeed, the market's strength was recently augmented by two historically powerful technical developments. First, the S&P 500's Index level recently crossed through its 200-day moving average (DMA), an event last experienced more than one year ago. If the market can sustain this action, a move above the 940-950 range could potentially trigger enough buying power to quickly propel the index above the 1000 level. Perhaps more important, the index's 50-day moving average just passed through its 200-DMA. This "Golden Cross" has noteworthy historical significance - since 1929, in nine of the previous twelve bear markets (75%) when this cross occurred, a new cycle low failed to materialize.

While this cyclical momentum is difficult to deny, we remind investors that it is largely based on excess cash levels and anticipation of an inventory re-build, which we would view as a transitory economic development. Market euphoria based on economic data that is simply "less bad" may prove to be short lived. Indeed, the market's historical corrective chart patterns often include a retracement of up to 50% from a rally's gain, indicating the possibility for a move back toward the 810-840 range. Since the solvency of the banking system is no longer in question and the mark-to-market accounting rules have been altered, we would consider it a very low probability that the doomsday scenarios priced into the market last March will return. In addition, a pullback to the low 800s for the S&P 500 would help establish a pattern of "higher lows" for stocks in this cycle, which history has shown to be a necessary stepping stone for sustainable market recoveries.

Looking at the fundamentals, market interest rates and inflation readings remain well below historical averages. In addition, cash levels in investment portfolios and corporate balance sheets are high. Yet it should be noted that we are on the cusp of another disappointing earnings season, with second quarter operating profits for companies in the S&P 500 Index expected to decline by approximately -35% from the same period last year. Since profits peaked in this cycle during the second quarter of 2007, we are now in the eighth consecutive quarter of profit declines totaling approximately -50% from their record-levels achieved two years ago. Moreover, we suspect the earnings-per-share (EPS) hit to continue in the third quarter, before profits jump on a YOY basis in the fourth quarter, leading to our projection of basically flat operating earnings growth, to $50.00, for the S&P 500 Index in 2009. See Chart 5.

5. S&P 500 Quarterly Earnings Per Share (EPS)

	2009		2010	
	EPS	% Chg	EPS	% Chg
Q1	$10.25	-38%	$14.50	41%
Q2	$11.25	-34%	$14.75	31%
Q3	$13.75	-14%	$15.25	11%
Q4	$14.75	N/A	$15.50	5%
Full Year	**$50.00**	**0%**	**$60.00**	**20%**

Source: S&P, Strategas RP, and Evergreen Investments

While the decrease in financial leverage has weighed heavily on corporate margins in 2009, operating leverage (through dramatic job/cost cutting) has improved prospects for margin growth next year. Moreover, monetary policy has helped reduce interest expenses and an expected uptick in economic growth should bolster prospects for revenue gains. The combination of these trends should enable more dollars to flow directly from the top line to the bottom line for many businesses. As a result, we are projecting earnings gains of +20%, to $60.00, for the S&P 500 in 2010.

The next question for investors relates to an appropriate market P/E ratio for these expected earnings. The last few economic recoveries were accompanied by falling market interest rates, low inflation, accommodative fiscal policies and an easing of regulatory standards. Of all these, perhaps the level of interest rates is the most important consideration. For example, the last great bull market began in August of 1982, when the federal funds (10%) rate, the prime (14%) rate, and the yield (13%) on the 10-year Treasury were all a full ten percentage points higher than they are currently! Unfortunately, at today's levels, none of these rates are poised to plunge, as they did 27 years ago, propelling stocks significantly higher on a multi-decade run. Furthermore, the political climate emanating from the dramatic policy response to the financial crisis suggests that neither fiscal nor regulatory

policy will provide sufficient tailwinds for the market in the coming years. Fortunately, though, inflation readings (as measured by the Consumer Price Index) after falling by approximately -1% in 2009 are expected to increase just +1% in 2010, likely providing some lift for P/E ratios. Considering these trends, we look for the market P/E multiple (which has averaged 16-17 times trailing twelve month earnings since WWII) to trade as high as 17-18 times our EPS projection of $60, suggesting the S&P 500 Index would be fairly valued within the 1050 range over the next twelve to eighteen months.

Given the uncertainties surrounding home prices, distressed assets on bank balance sheets, unemployment, federal spending, credit availability and auto bankruptcies, a volatile market environment is expected to continue and we look for the S&P 500 to trade within a sustainable range of 800-1000 for the balance of 2009. Investors are likely to have trouble digesting the ramifications of "less bad" economic data and portfolio managers will likely place more emphasis on historically mundane items such as balance sheet strength rather than income statements that are "less-levered" than in years past.

In this challenging environment, we continue to emphasize fully diversified strategies for long-term investors in order to participate in equity market gains while limiting the potential for losses. Periods of economic weakness have previously been accompanied by increases in market volatility, allowing for active managers to typically outperform passive strategies. Therefore, we encourage investors to have appropriate equity exposure relative to capitalization, investment style and region. In this deleveraging world where access to debt financing may be limited, we suspect the balance sheet strength of larger companies able to internally fund future growth opportunities may result in market leadership in the next recovery. Since we question the potential for significant multiple expansion, we look for growth companies to become dividend payers in an attempt to attract shareholder loyalty. As a result, we continue to recommend *slight* overweights for large caps over small caps and growth over value as this "less spectacular" recovery takes hold in the coming year

International

As always, we continue to recommend that exposure to international markets be a part of the asset allocation decision for diversified portfolios. While the sharp downturn that plagued the U.S. economy spread throughout the world over the past year, it appears that some areas, particularly in the developing world, may be poised to experience something closer to a "V-shaped" recovery as opposed to the "short, fat, lower-case U-shaped" recovery in the U.S. that we've previously suggested for 2009. Indeed, it appears that global GDP growth may decline by as much as -2.0% this year as weakness in credit markets and economic activity crossed all borders. Yet foreign central banks and global stimulus programs may have provided the necessary antidote as global GDP is projected to rebound by more than +2.0% in 2010.

There are several factors at work here. First, the Chinese stimulus was a much larger percentage of total output than any other program administered in the world, and is having a much faster impact to production. Secondly, many Asian economies were far less levered than their western counterparts, allowing for a smoother transition to recovery. Finally, central banks in Japan and Europe were much slower to combat the crisis than in the U.S., likely contributing to what we expect to be a sluggish recovery in those economies. Given these considerations and our belief that "reflation" will play a larger role than inflation in the coming year, investors may want exposure to areas such as energy, materials and gold. Resource-rich and export-driven emerging economies, along with their currencies, may also benefit more than their developed counterparts in this global reflationary environment.

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John is a Managing Director and Chief Market Analyst for Evergreen Investments. A member of the firm's Investment Strategy Committee, John uses a top-down, macro-economic approach in his analysis of the financial markets. He has been featured in various media outlets, including CNBC, BusinessWeek, CNN-Money, Bloomberg News and The Wall Street Journal.