Market Update

Evergreen Investments™

BY JOHN K. LYNCH, CHIEF MARKET ANALYST

September 4, 2009 | *An Investment Strategy Newsletter*

In This Issue:

Market Performance

The equity markets continued to generate gains last month, as the Dow Jones Industrial Average enjoyed its best August in nine years and the S&P 500 Index rose for the sixth consecutive month. From an index perspective, the gains were broad based, with leadership coming from the midcap and value areas. In a potentially troubling development, though, some large gains were had in highly speculative consumer and financial names, often involving stocks priced in the low single-digits during a month where volume trends were weak. Developed markets performed well for international investors, yet a major pullback in China weighed heavily on emerging markets in August. Despite significant debt issuance from the U.S. Treasury, the 10-year bond rose +1.0% for the month. Demand for municipal and corporate debt also remained high. Commodities excluding oil were weak as the U.S. dollar continued to struggle. See Chart 1 for more details of Market Performance.

As we've written in previous editions of Market Update this summer, the "technicals" for the equity market (as defined by the S&P 500 Index) remain strong, as a new "higher low" of 880 was set in July. In addition, the market's moving averages are strengthening while an estimated $3.5 trillion sits in money market funds, earning next-to-nothing. We suspect another move above 1015 for the S&P 500 could begin a push toward to 1050-1100 level over the next few months as cash enters the equity markets from money markets and shorter-term Treasuries. Yet given our conservative projections for the economy and corporate profits, we question whether the market will be able to sustainably hold onto these levels. Consequently, as the "technicals" appear stronger than the "fundamentals," we continue to look for the S&P 500 Index to trade within a volatile range (880-1080?) until prospects improve for housing, employment, consumption and investment.

U.S. Economy

Recent economic reports continue to display data that is simply "less bad" than the previous depths of the recession. Employment trends, however, remain troublesome.

- Personal incomes were flat in July after the stimulus-induced jump in May was followed by June's difficult comparison. Spending rose +0.2% for the month as the Cash for Clunkers program spurred demand, potentially reducing consumption growth in the months ahead.

- The Institute for Supply Management's (ISM) manufacturing index surged to 52.9 in August from 48.9 in July, suggesting the manufacturing sector (representing approximately 20% of

1. Market Performance as of 8/31/09

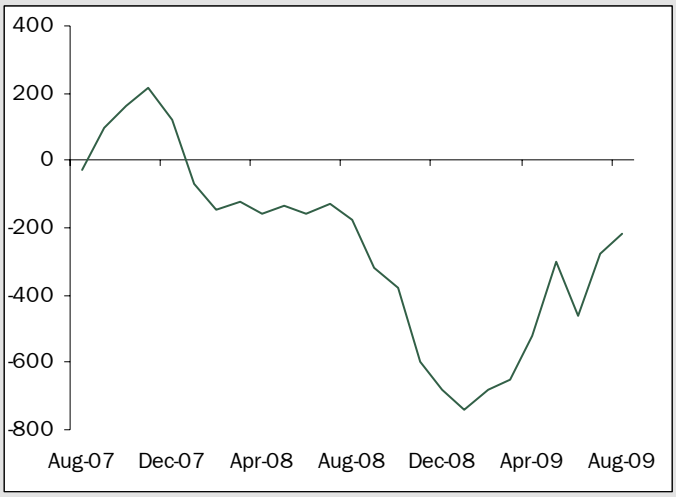
EQUITIES	8/31/09 LEVEL	AUGUST TOTAL RETURN	YTD TOTAL RETURN
Dow Jones Industrials	9,496.28	4.0	10.8
S&P 500	1,020.62	3.6	15.0
NASDAQ	2,009.06	1.5	27.4
Russell 2000	572.07	2.9	15.8
S&P MidCap	654.54	4.4	23.1
Russell 1000 Growth	446.97	2.1	21.9
Russell 1000 Value	527.29	5.2	10.6
MSCI EAFE	1,498.97	5.4	24.2
MSCI (Emerging Markets)	839.46	-0.4	50.8
FIXED INCOME	**8/31/09 LEVEL**	**AUGUST TOTAL RETURN**	**YTD TOTAL RETURN**
10-Year Treasury	3.40	1.0	-7.4
Barclays Aggregate	3.75	1.0	4.6
Barclays Municipal	3.78	1.7	10.1
Barclays Corporate	5.04	1.8	15.1
Barclays High Yield	11.37	1.9	41.0
Barclays Mortgage	4.13	0.7	4.4
Barclays Global ex. US	2.25	2.2	3.7
COMMODITIES & CURRENCIES	**8/31/09 LEVEL**	**AUGUST TOTAL RETURN**	**YTD TOTAL RETURN**
CRB Index	253.68	-1.5	10.5
Crude Oil - WTI	69.96	0.7	56.9
Gold	953.50	-0.2	7.8
Trade Weighted Dollar	78.22	-0.3	-4.8

Source: Factset, Bloomberg, Barclays, Evergreen Investments.
*Total Return 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.

economic output) is recovering as auto makers resume production and businesses add to inventories. The much larger services sector, though, remains sluggish, as measured by last month's 48.4 reading in the ISM's non-manufacturing report.

- The unemployment rate rose to 9.7% in August as the economy lost 216,000 jobs, bringing the total recession-induced employment contraction to 7.4 million. See Chart 2.

2. Monthly Non-Farm Payrolls



Source: Bloomberg

While this "less bad" data may point toward economic growth in excess of +3.0% for the current quarter, we remind investors that the bulk of gains in economic output are derived from government spending and exports, areas that we would consider as cushions for growth. Until we see stabilization in homes prices and employment, it is unlikely that personal consumption and business investment (catalysts for growth) will be capable to propel the economy beyond anything other than "below potential" over the next several quarters.

Federal Reserve

Although the central bank has not held a meeting since August 12th, monetary policy has been front and center for investors in recent weeks. President Obama re-nominated Ben Bernanke as Chairman of the Federal Reserve, removing a big uncertainty for the market. While still facing what is expected to be a heated confirmation process later this fall, we expect congressional approval to follow. We believe it is important for the architect of the financial system's backstop to have the opportunity to unwind the significant measures (near zero interest rates, expansion of the Fed's balance sheet, etc) put into place during the crisis. Additionally, we suspect this development will help restore confidence on the part of global investors regarding the Fed's independence, which has come into question during the financial crisis amidst accusation of subsidizing federal spending, otherwise described as debt monetization.

But we must be careful for what we wish. Chairman Bernanke still faces a very challenging environment. If he raises rates too soon, he risks stalling the recovery; but if he waits too long before raising interest rates, the Fed risks inflation. As a result, we look for the Fed to gradually prepare the market in the first half of 2010 for higher interest rates, using speeches and text changes in its policy statements, as well as transparent shifts in strategies for managing its balance sheet. Since we believe policymakers remain loathe to surprise the markets with a rate increase, these not-so-subtle moves should allow market interest rates to move higher during the first half of next year, well before the Fed begins to adjust its target for the benchmark federal funds rate.

ABOUT THE AUTHOR

John K. Lynch
Chief Market Analyst
Evergreen Investments

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.