Market Outlook

Evergreen Investments

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# 2009 Market Outlook

## Executive Summary

- The U.S. economy is expected to remain mired in a deep recession through at least the first half of the year. Inflationary pressures are likely to remain quiescent while the unemployment rate is expected to climb above 8.0% in 2009.
- We look for the Federal Reserve to keep interest rates low for the balance of the year, in an attempt to support economic growth. Innovative lending facilities and a further expansion of the Fed's balance sheet are expected, as well as coordinated efforts with the Treasury Department to minimize damage from the credit crisis.
- The fixed income markets have gone from worrying about inflation to deflation, as evidenced by investor willingness to accept virtually nothing for short-term loans to the government. U.S. Treasuries appear expensive, while investment grade corporates and municipal securities look more attractively priced at current levels.
- Equities, as measured by the S&P 500 Index, have attempted to find a bottom near the 750 level. Since technicals have weakened in 2008, these lows could be re-tested, or even breached. Fundamentals suggest to us that operating profits for the index could weaken further in 2009, to the $55.00 to $60.00 range. As a result, we suspect the market will remain volatile, sensing value below the 800 level while appearing expensive as the index exceeds the 1000 level.
- Given our projection for persistent economic malaise in 2009, we suspect it is still too soon to overweight traditional "early cycle recovery plays." Therefore, we encourage long-term equity investors to slightly overweight large caps relative to small caps, while equally balancing the growth and value components of their portfolios.
- The global economy is also experiencing recession, with global GDP expected to rise within the +1.0% range in 2009. The dramatic sell-offs in many emerging stock markets over the past year, along with their superior long-term growth prospects, may enable them to offer slightly better opportunities than their developed counterparts in 2009.

## Market Performance

The financial markets experienced one of the worst years in history during 2008, as the housing and credit crises quickly escalated from concern to catastrophic. The economy held up relatively well in the first three quarters, supported largely by exports and a fiscal stimulus package. Yet weakness in housing and employment prevailed throughout the year and the economy was officially declared in recession in early December. History will likely treat the failure of Lehman Brothers as a policy mistake, as inter-bank lending rates

### 1. Market Performance as of 12/31/08

| EQUITIES | 12/31/08 LEVEL | DEC TR* | QTD TR* | YTD TR* |
|---|---|---|---|---|
| Dow Jones Industrials | 8,776.39 | 0.8 | -18.4 | -31.9 |
| S&P 500 | 903.25 | 1.1 | -21.9 | -37.0 |
| NASDAQ | 1,577.03 | 2.7 | -24.6 | -40.5 |
| Russell 2000 | 499.45 | 5.8 | -26.1 | -33.8 |
| S&P MidCap | 538.28 | 4.8 | -25.6 | -36.2 |
| Russell 1000 Growth | 371.18 | 1.8 | -22.8 | -38.4 |
| Russell 1000 Value | 487.05 | 1.4 | -22.2 | -36.8 |
| MSCI EAFE | 1,237.42 | 6.0 | -20.0 | -43.4 |
| MSCI (Emerging Markets) | 567.04 | 7.8 | -27.6 | -53.3 |
| **FIXED INCOME** | **12/31/08 YIELD** | **DEC TR*** | **QTD TR*** | **YTD TR*** |
| 10-Year Treasury | 2.25 | 6.3 | 15.0 | 20.1 |
| Lehman Aggregate | 4.04 | 3.7 | 4.6 | 5.2 |
| Lehman Municipal | 4.50 | 1.5 | 0.7 | -2.5 |
| Lehman Corporate | 7.57 | 6.8 | 4.0 | -4.9 |
| Lehman High Yield | 19.50 | 7.7 | -17.9 | -26.2 |
| Lehman Mortgage | 3.63 | 1.7 | 4.3 | 8.3 |
| Lehman Global ex. US | 2.31 | 8.2 | 8.6 | 9.4 |
| **COMMODITIES & CURRENCIES** | **12/31/08 LEVEL** | **DEC TR*** | **QTD TR*** | **YTD TR*** |
| CRB Index | 215.21 | -12.1 | -37.3 | -40.0 |
| Crude Oil - WTI | 44.60 | -18.1 | -55.7 | -53.5 |
| Gold | 884.30 | 8.0 | 0.4 | 5.9 |
| Trade Weighted Dollar | 82.15 | -5.3 | 3.5 | 7.1 |

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.

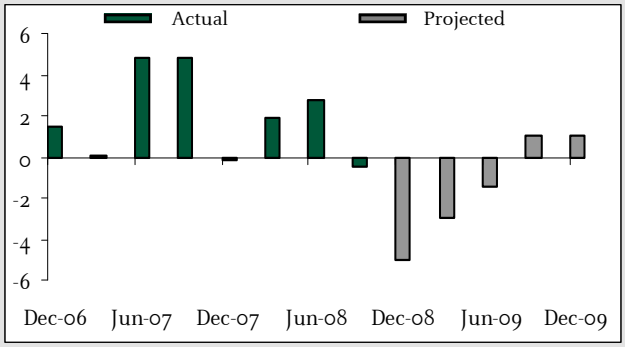
quickly soared and the credit markets froze. Consequently, economic activity and corporate profitability plunged during the fourth quarter. No sector, style, nor capitalization was spared in the equity markets, as all the major market indexes declined significantly for the full year. Yields plunged for U.S. Treasuries in a flight to quality, providing one of the few bright spots for investors. Oil dropped by more than $100 per barrel from their summer-highs, leading commodity prices drastically lower as the year progressed. Gold and the dollar experienced wide swings before finishing the year with mild gains. See Chart 1 for more details of Market Performance.

## U.S. Economy

The U.S. economy is expected to remain mired in a deep recession through at least the first half of the year. We look for the persistent weakness in housing and credit availability to continue to negatively impact activity in both the manufacturing and services sectors. Personal consumption patterns are poised to deteriorate further and business investment will likely remain limited as household and corporate deleveraging continues in 2009. Volatility in the dollar and slowing global demand may combine to diminish the positive contributions from exports to GDP over the past year as overall output becomes increasingly dependent on government spending. To be sure, the costs incurred by the Federal Reserve and the Treasury Department to rescue the financial system are likely to result in a federal budget deficit in excess of $1 trillion in fiscal 2009 (period ending in September). A huge stimulus package ($750 billion?) consisting largely of longer-term infrastructure spending plans, is expected to pass in late-January, and may provide a boost to confidence as the year progresses. However, the key to a sustainable recovery, in our opinion, will be evident as housing prices stabilize, inventories of existing homes for sale decrease, and lending activity normalizes. As a result of all these considerations, we look for GDP to remain very weak in the fourth quarter of 2008 and in the first quarter of 2009, followed by periods of less dire, but persistent, malaise as the economy contracts by up to -2.0% for the full year. See Chart 2.

Inflationary pressures are likely to remain quiescent for the majority of 2009. The combination of global economic weakness, falling home prices, rising unemployment and plunging oil prices are expected to serve as a powerful offset to the potential inflationary build-up resulting from the massive global policy response to the financial crisis. Indeed, fears of deflation are likely to persist in the months ahead due to weak demand, as evidenced by investor willingness to accept virtually nothing for short-term loans to the U.S. government. Yet as demand stabilizes, and begins to re-accelerate by 2010, we suspect a powerful rebound in global pricing pressures will emerge. In the meanwhile, though, we look for domestic consumer prices to climb by just +1.0% in 2009.

**2. Real Gross Domestic Product (Qtr/Qtr)**




Source: Baseline, Evergreen Investments

The unemployment rate is projected to rise from the current 6.7% to above 8.0% over the next year. While previous deep-recessions have experienced periods of double-digit unemployment rates, we suspect the current experience may not be as severe. This is because the last recession in 2000-2001 was business-led, as opposed to consumer-driven, resulting in what appears to have been more caution on the hiring front in this most recent cycle. Businesses spent more on productivity-enhancing technology (chips and software don't require benefits) in an attempt to limit costs and expand margins during this cycle. Almost two million jobs, though, have already been lost in 2008 and this amount is likely to increase in the months and quarters ahead, particularly given the uncertainty in the automobile and financial services industries. Eight percent unemployment with record levels of consumer debt, though, will likely support our projection for persistent economic malaise in 2009.

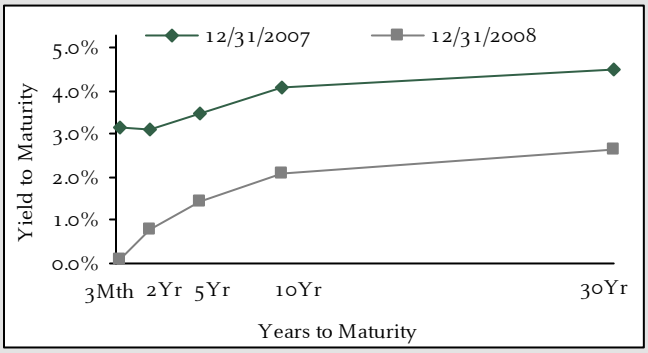
## Federal Reserve

At the conclusion of their most recent meeting in mid-December, monetary policymakers reduced their target for the federal funds rate from 1.0% to a range between 0% and 0.25%, essentially matching where the market had been trading. The Fed also said it expected interest rates to remain exceptionally low for some time. Finally, the central bank reiterated its commitment to employ a variety of lending facilities to help lift the U.S. from recession.

As we've written throughout the past year, monetary policy makers have been extraordinarily innovative in their response to the financial crisis. In addition to aggressively reducing its target for the federal funds rate, the Fed has created a variety of lending facilities in an attempt to provide increased liquidity for the credit markets. As a result, the Fed has almost tripled the size of its balance sheet in the second half of 2008 (from less than $900 billion to almost $2.5 trillion) while simultaneously reducing its percentage of Treasury holdings from approximately 70% to less than 30%. We

suspect policymakers at the Fed and Treasury will further attempt to keep the yield curve steep, providing the necessary incentive for banks to start lending (borrow short-lend long) again to help the economy emerge from this crisis. See Chart 3.

**3. U.S. Treasury Yield Curve**




Source: Baseline

## Fixed Income

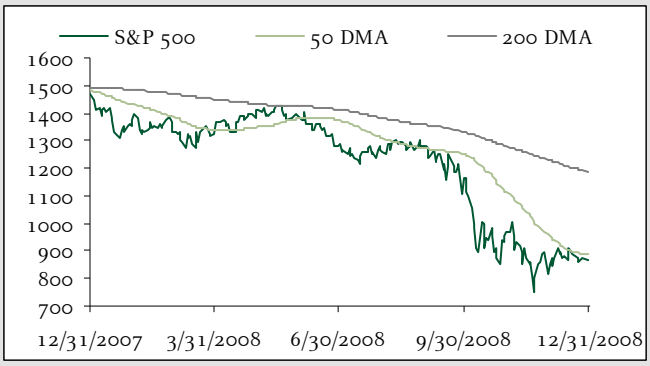
Prices for U.S. Treasuries continued to climb in the second half of 2008 as investors factored in the likelihood of continued economic weakness along with growing fears of deflation. Indeed, short-term U.S. Treasuries are now paying yields of next- to-nothing as investors seek return of capital as opposed to return on capital. While these deflationary fears persist, the yield for the benchmark 10-year Treasury hovers slightly above 2.0%. At these record-low levels, we question the wisdom of lending to the government over a 10-year period, particularly in an environment where the massive global policy response may result in a similarly massive "reflationary build-up" over the next few years.

Given that we are already in the depths of recession, it may also seem tempting for investors to overweight high yield bonds within their fixed income portfolios. Indeed, this classic "early-cycle recovery" strategy has proved successful in many previous cycles, yet considering our outlook for persistent economic malaise in 2009, we suspect it may still be too soon to heavily tilt portfolios in this direction. Instead, we would recommend that investors attempt to take advantage of the extremely wide spreads in the investment grade corporate bond market, where many companies with sound balance sheets appear to offer exceptional value with lower potential for defaults. Other areas in the fixed income markets, particularly municipal securities, appear to have already priced in the worst-case economic scenarios, suggesting improved total return possibilities for diversified long-term portfolios.

## Equities

The stock market posted one of its worst years in history as the economic recession and credit crisis combined to pummel both investor sentiment and the outlook for corporate profitability. Given the precipitous drop in equity prices, it would appear that market technicals have accurately priced in the negative effects of the economic and financial crises. See Chart 4. Indeed, the technicals suggest the market (S&P 500 Index) has tried to establish a bottom near the 750 level, a 50% drop from its peak in October 2007. Though conviction in this range is necessary for the recovery to fully take hold, we caution that another catastrophic event, such as terrorism or the failure of GM, could temporarily bring 670 into play, a level of support last achieved in the summer of 1996.

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




Source: Baseline, Evergreen Investments

Though equities remain in a deep bear market, we believe consensus estimates for corporate profits in 2009 are still too high. Fundamentally, we look for operating earnings in the S&P 500 to decline within the range of $55.00 to $60.00 in 2009, which represents a drop of approximately 30% from the cycle's peak in profitability achieved in mid-2007. Our estimated profit range compares to the current consensus industry analyst forecast of almost $80.00 for the index next year. To be sure, our projections have been well-below the consensus forecast throughout this financial crisis, yet even these conservative estimates have proven too sanguine as the credit crisis deteriorated further. While earnings ex-Financials were positive for the S&P 500 in 2008, we look for several sectors (Consumer Discretionary, Energy, Industrials, Materials, Technology and Telecom) to contribute less to the index's total profitability in 2009 than last year. See Chart 5.

Considering the combination of large cash positions, mild inflation readings and exceptionally low market interest rates, along with the positive vibes that are likely to accompany the new stimulus package, it is entirely possible that the equity

markets may experience bouts of euphoria in 2009, with the S&P 500 Index, on occasion, exceeding the 1000 level. Assuming an average market multiple over the past 50 years, a P/E of 16.5 to 17.0 times our earnings estimate of $60.00 would likely provide sufficient justification for fair value near the 1000 level. Yet as investors receive further disappointment on the earnings front, as we suspect, stocks may experience bouts of depression, once again testing the recent November low of 750. Furthermore, investors must not lose sight of the long-term costs for the recent bailouts. Though it remains to be seen whether or not these efforts will result in a surge in growth, history does provide clues that periods of huge liquidity build-ups often result in higher inflation. Assuming "TARP-induced" inflation begins to surface by the middle of 2010, the markets will likely factor in this development by the end of 2009, potentially resulting in rising market interest rates and falling market P/E multiples. At that point, we believe projected earnings for 2010 would need to climb near $70.00 (with a P/E of just 15x) to justify the 1000 level.

**5. S&P 500 Sector $ Contribution to Aggregate EPS**

| | 2008e | 2008 Y/Y % Chg | 2009e | 2009 Y/Y % Chg |
|---|---|---|---|---|
| Energy | 17.59 | 23% | 11.67 | -34% |
| Technology | 11.12 | 7% | 9.33 | -16% |
| Health Care | 10.65 | 6% | 10.84 | 2% |
| Industrials | 10.36 | 2% | 7.5 | -28% |
| Staples | 8.74 | 12% | 9.11 | 4% |
| Utilities | 3.01 | 0% | 3.19 | 6% |
| Discretionary | 3.01 | -54% | 2.11 | -30% |
| Materials | 3.01 | 1% | 2.00 | -34% |
| Telecom | 2.53 | -4% | 2.39 | -6% |
| Financials | -2.44 | -117% | 0.00 | N/A |
| **S&P 500** | **$67.50** | **-18%** | **$58.25** | **-14%** |

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

In this challenging environment, we continue to emphasize fully diversified strategies for long-term investors in order to participate in 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. Since we suspect the recession's duration may surprise the markets, we suspect it is still too soon for early cycle recovery plays, and we continue to recommend a slight overweight for large caps over small caps and encourage an equal balance between the growth and value styles. Quality companies with sound balance sheets, large cash positions and a history/ability to pay dividends are likely to outperform the market in 2009, and we expect a longer-term trend to develop with income becoming a larger portion of total return going forward. Finally, if you think we've been too gloomy, it should be noted that during periods when the economy has contracted by -4.0% or more, the equity market has climbed by an average of +25.0% twelve months after the economy's nadir.

## International

The global economy is also expected to remain weak in 2009. The financial crisis and the domestic recession have spread, affecting both developed and emerging economies. Most advanced economies have already slipped into recession and while countries like China and India are expected to experience growth at a mid-single digit pace, it will seem like recession given their previously strong growth rates. Other emerging economies, often heavily dependent on export growth, will also struggle as global growth moderates to approximately +1.0% in the coming year. While decoupling has been debunked, we suspect the massive sell-offs in many emerging stock markets over the past year, along with their superior long-term growth prospects, may enable them to offer slightly better return opportunities than their developed counterparts in 2009.

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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.