Market Outlook

Evergreen Investments™

BY JOHN K. LYNCH, CHIEF MARKET ANALYST

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Quarterly Market Outlook

Executive Summary

- The unprecedented economic and financial crisis has been met with an unprecedented policy response as the Federal Reserve, Treasury, FDIC and FHA have allocated more than $11 trillion to combat this crisis. Perhaps most important, the Public-Private Investment Program (PPIP) is designed to help rid banks of toxic assets from their balance sheets
- The U.S. economy remains mired in a severe recession, as GDP is poised to contract by approximately -6.0% for the second consecutive quarter. The immediate goal of the federal action is to spur demand, resulting in what we expect to be economic data in the next two quarters that is simply "less bad" than in the previous two quarters. As the lagged-effects of the massive policy response take hold, we look for pent-up consumer demand to combine with government spending to help push GDP back into positive territory by the fourth quarter.
- The fixed income markets continue to worry about deflation, as evidenced by investor willingness to accept virtually nothing for short-term loans to the government. Concerns about federal spending have also increased, with yields climbing for longer-term U.S. Treasuries during the quarter.
- Equities, as measured by the S&P 500 Index, have attempted to find a bottom near the 670 level. Fundamentals suggest to us that operating profits for the index could weaken further in 2009, to the $50.00 level. As a result, we suspect the market will remain volatile over the next several months, likely trading within a range of 650-850 for the S&P 500. We recommend slight "overweights" for growth over value and large caps over small caps.
- The global economy is now expected to weaken by approximately -1.0% in 2009. As the "reflation trade" develops, we look for emerging economies, largely resource based and export driven, to outperform their developed counterparts.

Market Performance

After two dismal months, the equity markets rallied strongly off their lows reached in early March. These gains, though, were insufficient to save the quarter, which experienced broad-based losses in all the major stock indexes. Investors continued to be rattled by weakening economic data, poor profit reports, and uncertainty about the effectiveness of the government's response to the economic and financial crisis. As such, equity market leadership was once again reduced to "relative" numbers, with emerging markets, Nasdaq, and growth indexes displaying less weakness than other segments of the market. Bonds also rallied in March, as the Federal Reserve's plans to purchase longer-term Treasuries trumped concerns about increased issuance to fund the recovery. Commodities weakened for the quarter, yet oil, gold and the dollar gained. See **Chart 1** for more details of Market Performance.

1. Market Performance as of 3/31/09

EQUITIES	3/31/09 LEVEL	March TR*	QTD TR*	2008 TR*
Dow Jones Industrials	7,608.92	7.9	-12.5	-31.9
S&P 500	797.87	8.8	-11.0	-37.0
NASDAQ	1,528.59	10.9	-3.1	-40.5
Russell 2000	422.75	8.9	-15.0	-33.8
S&P MidCap	489.00	9.0	-8.7	-36.2
Russell 1000 Growth	354.15	8.9	-4.1	-38.4
Russell 1000 Value	401.55	8.6	-16.8	-36.8
MSCI EAFE	1,056.23	6.3	-13.9	-43.4
MSCI (Emerging Markets)	569.97	14.4	0.9	-53.3
FIXED INCOME	**3/31/09 YIELD**	**March TR***	**QTD TR***	**2008 TR***
10-Year Treasury	2.69	3.3	-2.7	20.1
Barclays Aggregate	4.11	1.4	0.1	5.2
Barclays Municipal	4.12	0.0	4.2	-2.5
Barclays Corporate	7.76	-0.4	-1.9	-4.9
Barclays High Yield	18.13	3.2	6.0	-26.2
Barclays Mortgage	3.71	1.4	2.2	8.3
Barclays Global ex. US	2.30	2.7	-5.9	9.4
COMMODITIES & CURRENCIES	**3/31/09 LEVEL**	**March TR***	**QTD TR***	**2008 TR***
CRB Index	220.40	4.2	-4.0	-40.0
Crude Oil - WTI	49.66	10.9	11.3	-53.5
Gold	925.00	-1.9	4.6	5.9
Trade Weighted Dollar	85.90	-2.6	4.6	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.

Policy Response

The unprecedented economic and financial crisis has been met with an unprecedented policy response from Washington. Indeed, the allocations from the Federal Reserve, the U.S. Treasury Department, the Federal Deposit Insurance Corporation (FDIC) and the Federal Housing Administration (FHA) now total more than $11 trillion. It should be noted that approximately one-third of this amount has been "spent" and that these allocations reflect a combination of hard dollar loans & investments, debt financing, and guarantees/ backstops against potential losses. **See Chart 2.**

2. Federal Policy Response

	Allocated Amt ($Trillion)	Size	Notes:
Federal Reserve	7.21	63%	Increased Lending Facilities
FDIC	1.79	16%	Liquidity & Loan Guarantees
Treasury/FHA	2.43	21%	TARP, Stimulus, GSEs
	11.42	**100%**	

Source: Strategas Research Partners

The innovative and adaptive steps taken by policy makers have been staggering as leadership in Washington (and on Wall Street) attempts to avoid the mistakes made domestically in the 1930s and in Japan during the 1990s in fighting those financial crises. In addition to lowering the federal funds rate by more than 500 basis points (5.0%) over the past 18 months to fight deflationary pressures, the Federal Reserve has also significantly expanded the size of its balance sheet to improve the flow of credit throughout the economy. Growing from approximately $900 billion to more than $2 trillion in the past six months alone, the central bank has shifted its holdings in short-term U.S. government securities from more than 70% to less than 30%, as it has taken on a variety of holdings in commercial paper, mortgages and asset-backed securities. Since the benchmark federal funds rate is already close to its terminal level (between 0.0% and 0.25%) monetary policymakers most recently announced a further expansion of their activities, including the potential purchase of an additional $1.25 trillion in mortgages ($750 billion), agencies ($200 billion) and for the first time ever, longer-dated U.S. Treasury securities ($300 billion).

While the Fed's actions have been intended to grease the wheels of the credit markets, the actions of Treasury, the FDIC and the FHA have largely been directed toward rebuilding confidence (and demand) in the economy. Congress passed and President Obama signed the $780 billion Recovery and Reinvestment Act in February and the mortgage foreclosure relief plan totaled $300 billion. The $700 billion Troubled Asset Relief Program (TARP), which has received some media coverage in recent months, has quickly evolved from a distressed asset purchase plan into a bank recapitalization plan and back into a distressed asset purchase plan.

Perhaps the most important step taken, however, was the Public-Private Investment Program (PPIP) recently introduced by Treasury Secretary Timothy Geithner. To be sure, the measures taken to address this crisis have merely treated the symptoms, but the announcement of this program finally gets to the root cause of this crisis, i.e., the distressed assets on (and off) bank balance sheets. The PPIP is designed to use government subsidies to attract private purchases of currently illiquid mortgage related loans and securities held by banks. As a market returns for these assets, banks will be positioned to improve capital ratios, increase lending activity, and potentially buy their way out of the increasingly restrictive TARP. We believe that the successful implementation of this program is critical for a sustainable expansion to ensue.

U.S. Economy

The U.S. economy remains mired in a severe recession, as the nation's gross domestic product (GDP) is poised to contract by approximately -6.0% for the second consecutive quarter. The credit seizure in the aftermath of the failure of Lehman Brothers has altered what would likely have been a normal cyclical correction into a deep contraction, with economic activity at its weakest levels in decades. As the recession enters its sixth quarter, the process of balance sheet deleveraging has spread from banks to virtually all sectors of the economy, especially the consumer, where the combination of declining home values and stock prices reduced household net worth by almost 20% last year. Though recent housing data has been somewhat encouraging, much of these sales gains have been foreclosure-related, further pressuring average home prices. Moreover, the unemployment rate continues to climb, eclipsing the 8.0% level last month. Further layoffs are expected in the months ahead, as initial claims for unemployment benefits remain elevated and businesses show no inclination to increase investment anytime soon.

Consequently, the government's share of GDP is poised to escalate from an historical average of approximately 20% to almost 30% in the current fiscal year. The aforementioned spending programs enacted to lift the economy out of its doldrums will likely result in a federal deficit as a percentage of GDP in the range of 14%, levels not seen in 60 years. While longer-term ramifications may ultimately surface, the immediate goal of this federal spending is to spur demand, resulting in what we expect to be economic data in the next two quarters that is simply "less bad" than in the previous two

quarters. As the lagged-effects of monetary policy and Treasury/FDIC activity gradually take hold, we look for the early signs of a floor in housing and a ceiling on the unemployment rate to begin to develop by the fourth quarter, where pent-up consumer demand may finally combine with government spending to help push GDP back into positive territory. **See Chart 3**.

3. Economic Forecast

	Q109	Q209	Q309	Q409
Real GDP	-6.0%	-2.0%	-0.5%	1.0%
CPI	-0.5%	-1.0%	-1.5%	0.5%
Unemployment	8.0%	8.5%	9.0%	9.5%

Source: Wachovia Economics Group, Evergreen Investments

While in ordinary times the combination of low interest rates and an expansion of the Fed's balance sheet would ignite rampant inflation, these are not ordinary times. Receding global economies, rising unemployment, oil prices that have fallen by more than $100 per barrel in the last eight months, and declining home values are all likely to serve as disinflationary trends that enable policy makers to "print" money in 2009 without creating inflation. Moreover, since wages are the largest costs for businesses, we do not see the classic "wage-price spiral" developing this year. Rather, all this money being created will eventually need to find a home, and we suspect the resulting "reflation trade" will be most evident in areas such as gold, basic materials, energy and emerging economies by the middle of 2010.

Fixed Income

"Return of capital" continues to be the dominant theme for investors in the Treasury market, as uncertainty prevails with monetary policymakers battling the threat of deflation. Consequently, investors have been willing to accept virtually nothing in return for holding short-term U.S. government securities. Indeed, as policy is geared toward fighting deflation and renewing demand, the Treasury yield curve remains steep. Yet as the Federal Reserve fights deflation, Treasury investors have grown concerned about the longer-term ramifications about the higher levels of government spending enacted to spur growth, resulting in the yield on the 10-year Treasury backing up by some 75 basis points during the first quarter. At these levels, we continue to question the wisdom of lending to the government over a 10-year period, with reflation and increased Treasury issuance looming in the years ahead.

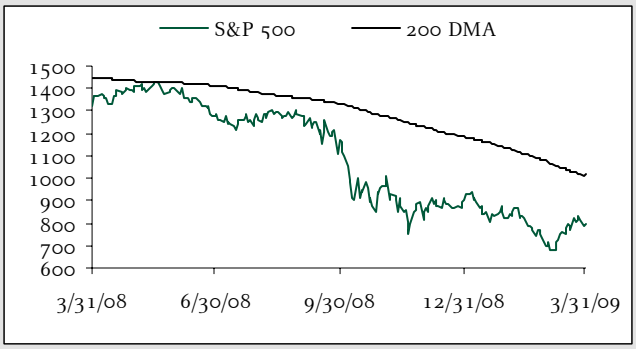
Given that we are already in the depths of recession, it may also seem tempting for investors to overweight high yield bonds within their fixed income portfolios. Indeed, this classic "early-cycle recovery" strategy has proved successful in many previous cycles, yet considering our outlook for persistent economic malaise in 2009, we suspect it may still be too soon to heavily tilt portfolios in this direction. Instead, we continue to 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 rapid deterioration in economic activity, both domestic and global, resulted in a stunning drop in corporate profitability, bringing EPS down -33% for 2008. Consequently, as we work off this dramatically lower base, and factor in continued economic weakness in the coming months, we recently reduced our S&P 500 operating earnings estimate to $50.00 for 2009. Moreover, we suspect the entire earnings model for the index will be dramatically altered as the Financial Sector now comprises a much smaller portion of the index's capitalization. As a result, the S&P 500 is changing from leveraged financial leadership to non-leveraged, non-financial leadership. In addition, given the global scope of the crisis, corporate profits are likely to remain under pressure in the coming year as once favorable currency translations and international demand levels turn negative. Equity market weakness will also likely trigger higher pension costs, and declines in share buybacks/dividend payouts may also weigh heavily on the bottom line for stocks in 2009.

Unfortunately, these fundamental issues have collided/coincided with a volatile technical trading range. **See Chart 4**. To be sure, another major technical breakdown occurred in the S&P 500, which closed near our 670 downside support target on March 9th (a level last achieved in August, 1996.) A healthy, "cyclical bull rally" ensued, similar to the two other rallies/pullbacks experienced since last September. We suspect this volatility may continue over the next six months or so as the market contends with alternating bouts of euphoria/mania as the "less bad" economic data is digested. Assuming another shock to the economy (autos, banks, politics) it is possible a recessionary/deflationary market P/E multiple of 12x-13x our $50 estimate for 2009 could bring 600-650 into play, as the market attempts to find a bottom. It should be noted, though, that trough earnings and trough multiples rarely coincide, particularly during periods of exceptionally

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



Source: Baseline, Evergreen Investments

low interest rates and low/no inflation. Therefore, from our perspective, it is critical that the market re-tests and successfully holds the 670 level in order to solidify the foundation for the next expansion. As the lagged effects of the massive policy response take hold, investors may 'bid-up" prospects for recovery later this year and into 2010. Improved demand and early signs of pricing power may result in a market willing to pay as much as 16x-17x earnings, suggesting an upper end of a sustainable trading range within the 800-850 range over the next couple of quarters.

It is important to remember that plenty of cash remains on the "sidelines" with a market that is willing to pay 33x to earn less than 3% on 10-year Treasuries, $4 trillion is sitting in money markets (more than 40% of equity market capitalization), and up to $500 billion in private equity is waiting to take advantage of red-tag sales with 50% discounts on Price to Sales, Price to Book Value and Price to Cash Flow. In addition, history has shown that any time the economy has contracted by four percentage points or more, the S&P 500 Index has climbed by 25%, on average, twelve months after the nadir in output, supplying the historical justification for a move in the S&P 500 toward 1000 by early 2010.

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 believe 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 a similar distribution 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 returns.

International

The global economy is also expected to remain weak in 2009, declining by approximately –1.0%. 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. Given the massive sell-offs in many emerging stock markets over the past year, along with their potential to benefit from reflation, we look for them to offer slightly better return opportunities than their developed counterparts over the next 12-18 months.

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.