Market Update

Evergreen Investments

BY JOHN K. LYNCH, CHIEF MARKET ANALYST

September 19, 2008 | *An Investment Strategy Newsletter*

Massive Policy Response to Financial Crisis

Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke presented a sweeping plan to members of Congress aimed at restoring confidence in the U.S. economy and the financial markets. Indeed, the government now appears fully engaged in its attempts to solve the problem of illiquid assets that has plagued consumer net-worth and the financial markets over the past year.

1) The Treasury and the Fed are moving toward an "RTC-like" plan to systematically remove illiquid assets from the balance sheets of financial institutions. While there are a few differences from the original Resolution Trust Corporation, set up to help move past the Savings and Loan crisis, the intent of the entity is very similar: address the capital inadequacy of financial institutions. Early estimates suggest it will be much larger than the original RTC and the costs of the proposals could exceed $750 billion. Items still being worked out with members of Congress include: who can sell into it, what can be bought by it, and asset valuation. Since the political pressure is on this election season, we expect the plan to be passed within the next two weeks.

2) The Treasury also unveiled a new guaranty program for the $3.5 trillion invested in money market funds, which has been hit by a wave of redemptions these past few days. The Exchange Stabilization Fund will be financed with up to $50 billion to insure both individual and institutional investors in all publicly traded money market funds.

3) The Securities and Exchange Commission has banned short selling in 799 financial companies for a period of 10 days, which can be extended to 30 days if conditions warrant. The New York Attorney General also began an investigation into market manipulation by short sellers.

In addition to these actions, the Treasury has significantly increased issuance these past few days and the Fed's discount window has seen borrowing surge as commercial and investment banks sought additional liquidity. Moreover, several foreign governments also took action to address recent market activity: The Financial Services Authority in the U.K. banned short selling of financial stocks for 3 months, Russia introduced a $20 billion stimulus package including corporate and capital gains taxes and China moved to reduce the tax on stock purchases.

We believe the RTC-like structure will help thaw activity within the credit markets, but it may come with a great cost. Consequently, equity prices soared on the news and the prices for U.S. Treasuries, particularly at the short end of the yield curve, declined dramatically. Unlike the original RTC, which simply disposed of assets, the new entity must first purchase illiquid assets and then attempt to sell them. Therefore, the entity must balance benefits and risks to both the financial institution and the U.S. taxpayer. An obvious concern in the bond market is that the federal budget deficit, already on pace to reach $500 billion by early next year, could double or even triple as these plans are put into action. Given all the liquidity being pumped into the financial system, inflationary concerns are also expected to build going forward.

The other actions outlined in the plan are also expected to improve confidence in the financial markets. Treasury and the Fed have been very proactive in recent weeks, and we are pleased to see the SEC take up the fight against short sellers. Longer-term, though, we would still prefer to see changes to the mark-to-market accounting rules, (FASB #157) as well as restoration of the Uptick Rule. The increased activity of policy makers around the globe is also encouraging, indicative of an improved appreciation for the challenges ahead as we all attempt to emerge from this crisis.

While these plans should help limit the damage to the economy, we do not expect them to eliminate the economic damage from the crises in housing and credit. As a result, we maintain our projection that the risk to the economy remains with the duration, rather than the magnitude, of economic weakness. Tailwinds in 2008 (monetary and fiscal policy) are expected to become headwinds as the economy finally contracts by early 2009. We continue to expect flat profit growth in 2008 and our projection for 2009 remains well below consensus estimates. Considering our expectations for profits, interest rates, and inflation, we still look for the S&P 500 to experience a sustainable trading range of 1225-1350 through the first half of next year.

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.

Investments in stocks, bonds, variable annuities and mutual funds:

NOT FDIC INSURED	NOT BANK GUARANTEED	MAY LOSE VALUE

Important Disclosure: The information and statistics in this report have been obtained from sources we believe to be reliable but are not guaranteed by us to be accurate or complete. Any and all earnings, projections, and estimates assume certain conditions and industry developments which are subject to change. Evergreen Investments, its officers, directors, research analysts, and other employees may hold or take significant long or short positions which are the subject of this report, and such positions may be inconsistent with the information given herein. The opinions stated are John Lynch's, Chief Market Analyst for Evergreen Investments and are not intended to be used as investment advice. Past performance is not indicative of future results.