Market Update

Evergreen Investments™

BY JOHN K. LYNCH, CHIEF MARKET ANALYST

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In This Issue:

Market Performance

The financial markets have struggled mightily these past few weeks as the crises in the credit and housing markets have escalated. See Chart 1 for more details of Market Performance.

Financial Market Frenzy

Over the past several days, the frenzy in the financial markets has accelerated dramatically, resulting in perhaps the biggest transformational week in the history of Wall Street. The financial crisis that began in August 2007 has quickly moved into uncharted territory, as excessive leverage and counter-party risks continue to weigh on the confidence of the nation's leading financial institutions.

To summarize the recent mayhem:

- On Monday, September 8th, the Federal Housing Finance Agency placed the Fannie Mae and Freddie Mac into its conservatorship, essentially a government takeover of the GSEs. Treasury also took aggressive steps, including a senior preferred stock purchase agreement, a $200 billion credit facility, and authorization for the purchase of mortgage-backed securities (MBS).
- On Monday, September 15th, the 158-year old investment banking giant Lehman Brothers filed for bankruptcy after weekend negotiations for a merger/bailout failed. Treasury refused to back any deal, which scared off BAC and Barclays.
- This led to the sudden and stunning sale of Merrill Lynch to Bank of America. The "leverage domino effect" identified Merrill as being next in line relative to the escalating concerns of counter-party risk. As a result, BAC announced it would purchase MER for $29 a share, for a total of almost $45 billion, a 70% premium to the prior day's closing price.
- Perhaps the biggest development, though, was the Fed's $85 billion emergency loan to AIG. Given Washington's unwillingness to once again put taxpayer money at significant risk, the plan included several steps to protect taxpayers. The lending facility is collateralized by all the assets at AIG and will allow it to sell assets in an orderly fashion over a two-year period at an attractive rate of Libor + 850 basis points…OUCH! For its efforts, the government will receive up to an 80% equity stake in AIG and can prevent dividend payments to other shareholders.

1. Market Performance

EQUITIES	9/17/08 LEVEL	MTD TOTAL RETURN	YTD TOTAL RETURN
Dow Jones Industrials	10,609.66	-8.0	-18.5
S&P 500	1,156.39	-9.7	-20.0
NASDAQ	2,098.85	-11.3	-20.9
Russell 2000	676.38	-8.5	-10.9
S&P MidCap	736.25	-9.7	-13.3
Russell 1000 Growth	489.47	-10.5	-19.3
Russell 1000 Value	617.48	-9.6	-20.8
MSCI EAFE	1,592.77	-12.5	-27.6
MSCI (Emerging Markets)	768.92	-19.4	-37.0
FIXED INCOME	**9/1708 YIELD**	**MTD TOTAL RETURN**	**YTD TOTAL RETURN**
10-Year Treasury	3.41	3.6	8.0
Lehman Aggregate	4.80	0.8	2.8
Lehman Municipal	4.16	-0.9	0.6
Lehman Corporate	6.88	-3.2	-4.1
Lehman High Yield	12.53	-2.8	-5.0
Lehman Mortgage	5.10	1.9	5.0
Lehman Global ex. US	3.18	-0.4	2.2
COMMODITIES & CURRENCIES	**9/17/08 LEVEL**	**MTD TOTAL RETURN**	**YTD TOTAL RETURN**
CRB Index	341.17	-12.9	-4.9
Crude Oil - WTI	96.96	-16.0	1.0
Gold	846.60	2.1	1.4
Trade Weighted Dollar	78.79	1.7	2.7

Source: Factset, Bloomberg, Lehman Brothers, 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.

Why did the Fed help AIG and not Lehman? Perhaps the answer lies in the very different definitions of the words "insurance" and "investment." Another possibility is that AIG, as an insurer, did not have access to the Fed's discount window. Additionally, the sheer size of AIG and the complexities of its exposure to distressed mortgage related investments and its dealings with leading businesses and governments throughout the globe likely placed it in the "too big to fail" category. Indeed, at $1 trillion, AIG's balance sheet is larger than that of the Federal Reserve's!

Despite the most comprehensive policy response to a financial crisis in history, the markets continue to struggle. Indeed, equities have climbed deeper into bear market territory as financial stocks continued to be pummeled, particularly by short-sellers. At 1150, the S&P 500 is approaching the typical bear market (-30%) pullback, led particularly by weakness in the financial sector. The decision by the SEC (Wednesday, September 17th) to prohibit naked-short selling was a good first step to limit this damage, but the commission's refusal to re-instate the Uptick Rule has dramatically exacerbated the stock market's turmoil, in our opinion.

In addition to equity market weakness, the nation's credit markets have also failed to function normally. Unfortunately, the Fed's innovative lending facilities have thus far failed to inspire confidence, which remains a necessary component for liquidity. Indeed, credit default swap spreads have widened significantly for both financial and non-financial organizations. Moreover, a variety of indicators suggest stress in the fixed income markets, particularly spreads for mortgages and Libor, highlighting the unwillingness of banks to extend credit in the current environment.

What will it take to resolve this crisis? In addition to the many of the dramatic and innovative steps taken by the Treasury and the Fed, we believe the following areas must be successfully addressed to allow the economy, and the financial markets, to emerge from this unprecedented crisis.

- Federal Reserve - Today's coordinated $180 billion liquidity infusion by the Federal Reserve and other foreign central banks should go a long way in improving the flow of credit. While plenty of cash exists ($3.5 trillion in money markets, $500 billion in private equity) we consider confidence as a necessary component of liquidity. Once the former improves, the latter will flow.
- Securities and Exchange Commission – The SEC took two actions yesterday, eliminating naked short selling and requiring transparency for short positions. We still maintain that a return of the Uptick Rule, which requires a positive bid before each short sale, would result in less manipulative downside volatility.
- Congress – We suspect that regulatory reform will be front and center when the next Congress takes over early next year. In the meanwhile, bi-partisan support is building for a structure similar to the Resolution Trust Corporation to deal with distressed mortgage-related securities and the associated counter-party risks.
- U.S. Treasury - As part of Treasury's recent GSE actions, Secretary Paulson was given the authority to purchase up to $5 billion in MBS before the end of the month. We suspect this amount will be increased significantly over the next few weeks to help support the mortgage market.
- Credit Default Swap Regulations – An idea being discussed in Washington is to limit the authority to purchase credit default swaps to the owners of bonds. The belief is that the CDS market is the first sign of a company's health and some manipulative investors may be piling in to create the perception of a company in distress, which is then followed by a shorting of the stock.
- FASB 157 – The Financial Accounting Standards Board Rule # 157 requires that illiquid assets must be "marked to market" and in our opinion has exacerbated the free-fall in the financial markets over the past year. Since this would be a major policy reversal, we are not holding our breath for this one.
- Private Equity Investment in Banks – Since this group has approximately $500 billion sitting on the sidelines, we believe this could be very effective in helping to re-capitalize the banking industry. Though current rules limit ownership to 24.9%, both Bernanke and Paulson have expressed support to move this cash into the markets and spur new investment.

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.