Market Update

Evergreen Investments™

BY JOHN K. LYNCH, CHIEF MARKET ANALYST

November 17, 2008 | *An Investment Strategy Newsletter*

In This Issue:

- Market Performance
- TARP, GDP, GM
- Earnings Review

Market Performance

After the unprecedented volatility in October, the equity markets continued to experience volatile swings in the first two weeks of November. Indeed, the average daily swing from high to low has averaged more than 5.0% these past six weeks. The combination of grim economic news, weaker-than-expected corporate profits, and uncertainty about the global policy response has conspired to wreak havoc on investor sentiment. Consequently, the selling pressure has continued in the equity markets, pushing the major market indexes further into the red for 2008. A flight to quality has enabled U.S. Treasuries to gather strength, while extremely wide spreads in the markets for municipal and investment grade corporate bonds have attracted the attention of investors in recent weeks. Signs of global recession continue to pressure commodities, while gold and the U.S. dollar remain up in November. See Chart 1 for more details of Market Performance.

TARP, GDP, GM

Secretary Paulson announced last week that the U.S. Treasury would not purchase troubled assets as part of the original TARP (Troubled Asset Relief Program) legislation. Instead, Treasury would focus solely on bank recapitalizations, i.e. direct injections of liquidity into banks, as these recent efforts have already been successful in reducing inter-bank lending rates. Not surprisingly, this switch confused the financial markets and frustrated lawmakers on Capitol Hill. Yet Secretary Paulson indicated that market developments hindered the original plan and that this change should be more beneficial to taxpayers. In addition, it is becoming very clear that other areas such as auto loans, credit cards, and student-loans may also require additional relief. We do not believe this is the end of it, though, as remaining funds may also be used for non-bank financials such as life insurers and municipal bond insurers (monolines.)

Recessionary signals have escalated in recent weeks. While third quarter GDP contracted at an annual rate of -0.3%, we suspect this initial estimate will be revised downward as recent reports on consumption, auto sales and employment suggest the economy had been weakening prior to the mid-September bankruptcy of Lehman Brothers. The collateral damage from that event has been the complete seizure in the credit markets, resulting in a sudden and dramatic decline in economic activity. The unemployment rate jumped to 6.5% in October as payrolls fell by 240,000 jobs. Perhaps more distressing, figures for the prior two months were revised lower by 179,000 jobs and recent unemployment claims data suggest payrolls are on track to decline in excess of another 200,000 jobs for November. Weakness was also evident in the manufacturing and services sectors, as reports on activity in those areas plunged last month.

1. Market Performance as of 11/14/08

EQUITIES	11/14/08 LEVEL	MTD TOTAL RETURN	YTD TOTAL RETURN
Dow Jones Industrials	8,497.31	-8.6	-34.4
S&P 500	873.29	-9.7	-39.3
NASDAQ	1,516.85	-11.9	-42.8
Russell 2000	456.52	-15.0	-39.7
S&P MidCap	497.52	-12.3	-41.2
Russell 1000 Growth	356.56	-10.3	-41.1
Russell 1000 Value	468.84	-9.8	-39.5
MSCI EAFE	1,164.81	-5.8	-46.8
MSCI (Emerging Markets)	530.28	-7.0	-56.5
FIXED INCOME	**11/14/08 YIELD**	**MTD TOTAL RETURN**	**YTD TOTAL RETURN**
10-Year Treasury	3.75	2.6	6.3
Lehman Aggregate	5.37	1.7	-0.1
Lehman Municipal	4.57	1.8	-2.4
Lehman Corporate	8.52	3.1	-11.8
Lehman High Yield	19.56	-2.7	-26.4
Lehman Mortgage	5.40	2.2	4.8
Lehman Global ex. US	2.69	0.8	-0.9
COMMODITIES & CURRENCIES	**11/14/08 LEVEL**	**MTD TOTAL RETURN**	**YTD TOTAL RETURN**
CRB Index	247.58	-7.8	-31.0
Crude Oil - WTI	57.04	-15.9	-40.6
Gold	742.50	3.4	-11.1
Trade Weighted Dollar	86.79	0.5	13.1

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.

Finally, retail sales dropped a larger than expected -2.8% in October as the declines of the prior two months were larger than previously thought. Given these developments, we look for GDP in the current quarter to contract sharply, possibly by as much as -4.0%, and we continue to look for the economic malaise to persist through the bulk of 2009.

Congress is getting ready to move legislation this week authorizing $25 billion of TARP money for the automakers. Treasury remains opposed to using TARP funds for non-financial institutions, particularly since $25 billion has already been authorized for Detroit from the Department of Energy's plan approved last summer. Details of that package, though, centered more on efficiency and alternative fuels, rather than the industry's survival. Indeed, though bankruptcy is still on the table for GM, huge collateral damage may surface from this development. For example, labor contracts would have to be restructured or thrown out entirely, a situation that is anathema to the Democratic majority. Senate Republicans, though, appear to have the votes to prevent TARP funds from being used in 2008. Another problem is the already extended Pension Benefit Guaranty Corporation, which couldn't offer the retirement packages of the existing labor contracts for hundreds of thousands of workers. As a result, lawmakers will debate whether GM is a short term problem or a failed business model. It should make for unparalleled political theatre in the coming days.

Earnings Review

After our recession call earlier this year, we reduced corporate profit estimates several times, highlighted by our initial 2009 projection of $75.00, which at the time was more than $30.00 below the consensus forecast on Wall Street. Despite our cautious stance, the post-Lehman credit seizure and resulting drop-off in economic activity suggests that even our conservative projections for this year and next may prove too sanguine. Indeed, third quarter earnings fell by approximately -15.0% and the fourth quarter consensus estimate has been reduced from +50.0% to +20.0% in just the past six weeks! Considering the weakness in consumption and investment, along with historically wide corporate credit spreads (indicating a lack of available/affordable credit) we would be surprised if actual earnings growth exceed +5.0% for the current quarter. As a result, it now appears that 2008 operating earnings for the S&P 500 Index will decline by approximately -18.0%, from $82.50 in 2007 to $67.50 this year. Additionally, as the credit crisis morphs from the sole domain of financial services to the other sectors in the index, which had held up relatively well in 2008, we suspect earnings may fall by another -5.0% next year, to the $65 range. See Chart 2.

2. S&P 500 Sector $ Contribution to Aggregate EPS

	2008	2009	2009 Y/Y % Chg
Energy	17.59	16.82	-4.40%
Technology	11.12	10.37	-6.70%
Health Care	10.65	10.84	1.80%
Industrials	10.36	7.14	-31.10%
Staples	8.74	9.11	4.20%
Utilities	3.01	3.19	6.00%
Discretionary	3.01	2.34	-22.30%
Materials	3.01	2.39	-20.60%
Telecom	2.53	2.39	-5.50%
Financials	-2.44	0	N/A
S&P 500	**$67.57**	**$64.58**	**-4.40%**

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

Given our call for persistent domestic (and global) economic weakness through 2009, we believe that consensus expectations for corporate profitability next year ($89.00) remain too optimistic. New fiscal stimulus and falling gas prices may help the U.S. consumer, but until the markets are convinced that global policy makers won't keep changing the rules, we're hard pressed to see investor sentiment escalate from current levels. Also, the recent improvements in the inter-bank lending rates must translate into narrower spreads for mortgage and corporate credit before the economy is able to gain any traction. Consequently, we look for the equity market to remain volatile in the months and quarters ahead. We suspect investors may sense value in the market (as defined by the S&P 500 Index) near the 850 level while viewing stocks as somewhat expensive above the 1050 range through mid-year 2009. While it is possible that the lows of October, 2002 (775) may be tested, we do not expect those levels to be sustained given the huge amounts of cash ($500 billion in private equity, $3.5 trillion in money market funds, and $3 trillion in sovereign wealth funds) on the sidelines, searching for the start of the next cyclical bull market.

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.