

DECEMBER 23, 2015

"Money is too much a serious matter to be left to central bankers."

- Milton Friedman

SUMMARY

- *Last week's fed funds rate hike may be the first in nine years, but the Federal Reserve has effectively tightened US monetary conditions over the last 18 months by roughly 325 basis points. It's already more than the Fed tightened during the 1990s.*
- *Considering how much the Fed has already tightened, and how the US economy seems to be losing momentum on several fronts, we may be much closer to the next recession than most investors believe.*
- *In the event of a 2016 recession, the Fed has only three options at its disposal: (1) cut interest rates, (2) guide market expectations, or (3) launch QE4.*
- *While the Fed may be able to dampen the effects of the next recession with hot air, negative interest rates, and massive QE, overvalued US equity markets may be in for a rude awakening between now and then.*
- *Investors will have the opportunity to rotate into more aggressive, equity-heavy portfolios with attractive yields and compelling valuations. Until then, my colleagues at Evergreen GaveKal and I prefer defensive, equity-light portfolio allocations with large cash reserves and modest collections of beaten-up, high-yielding assets that are already priced for bad outcomes.*

TAPERING IS TIGHTENING & QE4 IS INEVITABLE

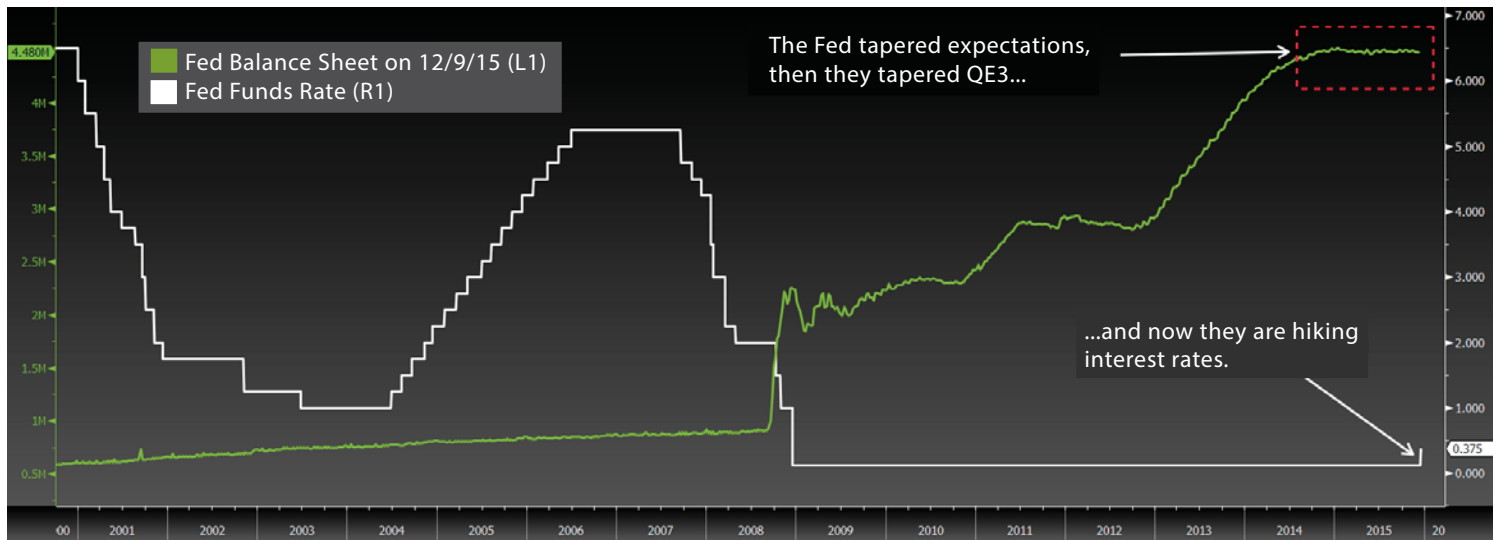
By Worth Wray, Chief Economist

Tapering is Tightening. Forget what you've seen on CNBC or read in the *Wall Street Journal* about last week's rate hike heard 'round the world.



Since the summer of 2013, the Federal Reserve has curtailed the markets' once open-ended stimulus expectations, it's tapered its QE3 asset purchases down to zero (green line in chart at the top of the next page), and now it's hiking interest rates (white line in chart at the top of the next page).

FEDERAL RESERVE BALANCE SHEET & MEDIAN FED FUNDS RATE



Source: Evergreen GaveKal, Bloomberg

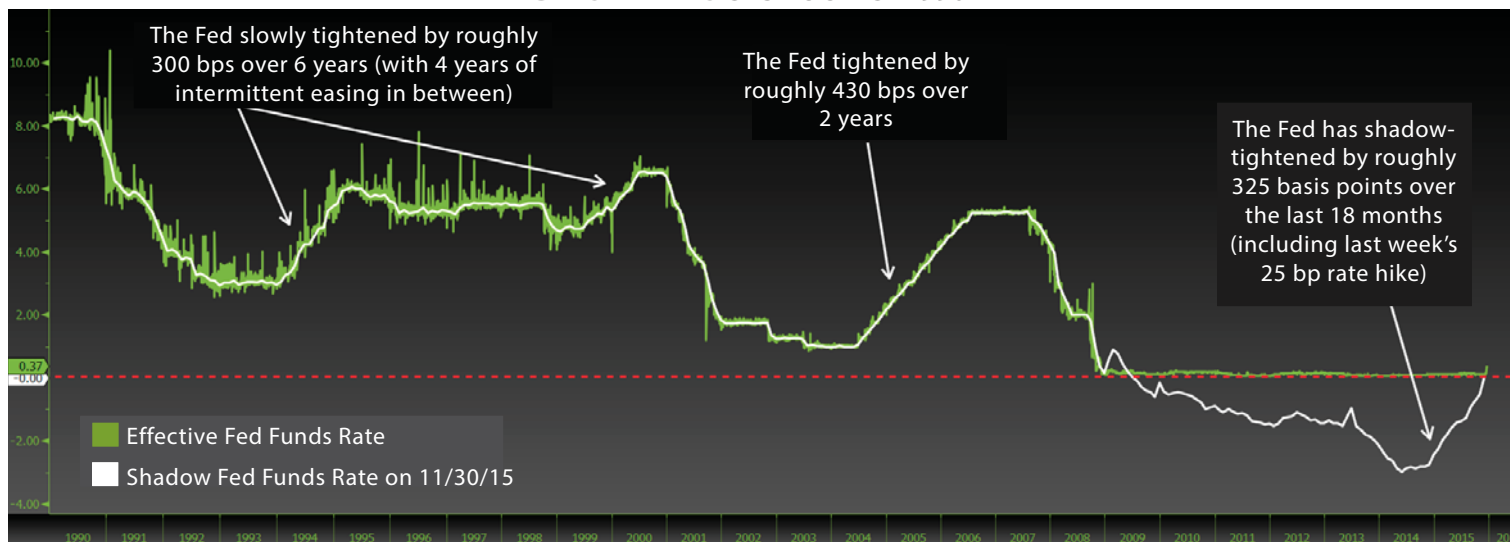
Last week's Fed hike may have been the first in nine years (with obvious parallels to the central bank's premature tightening in 1937), but – as the [Atlanta Fed's Shadow Fed Funds Rate](#) suggests – the central bank actually started tightening more than eighteen months ago.

While common knowledge tells us to worry about the last hike instead of the first one, this time truly is different than every other initial rate hike in US history.

In the chart below, the federal funds rate (green line) gave investors and policymakers a clear view on how easy or tight Fed policy was in the years before 2008; but when the Fed dropped its fed funds target to the 0% to 0.25% range in December 2008, it failed to reflect any subsequent changes. Monetary conditions varied substantially over that period, and yet the Fed's rate target remained the same.

That's where the shadow fed funds rate (white line) comes in. As you can see in the chart below, it gives us a much clearer look at Fed policy below the zero bound by showing how unconventional policies like QE1, QE2, Operation Twist, and QE3 effectively eased monetary conditions and how shrinking and/or ending those programs has effectively tightened monetary conditions... despite the fact that – until just last week – the fed funds rate has remained at zero for the past seven years.

FED TIGHTENING CYCLES SINCE 1990

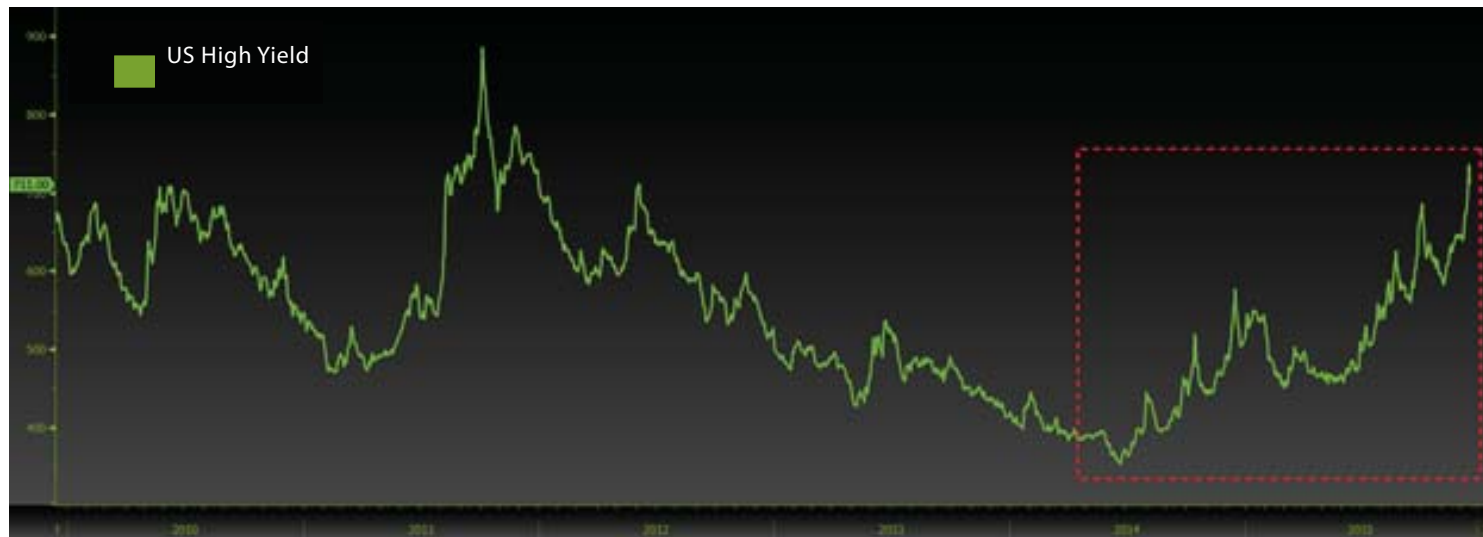


Source: Evergreen GaveKal, Bloomberg

As you can clearly see, *tapering is tightening* and the Fed has been tightening for quite a while. Look no further than the foreign exchange and bond markets if you have any doubt.

As you can see in the charts below, the widening of credit spreads*...

HIGH YIELD SPREAD OVER 10 YEAR US TREASURIES



Source: Evergreen GaveKal, Bloomberg

... the rise in the US dollar (white line below), and the deterioration of US financial conditions (green line below) has perfectly coincided with the tapering-off of QE3.

US FINANCIAL CONDITIONS & THE TRADE-WEIGHTED DOLLAR



Source: Evergreen GaveKal, Bloomberg

That means that combined with last week's 25 basis point (0.25%) fed funds hike, the Federal Reserve has already effectively tightened by 325 basis points (for the lay reader, that's 3.25%) since mid-2014. We're talking about 25 basis points more than the Fed tightened throughout the entire 1990s and roughly 75% of the entire tightening move from 2004 to 2006. From this perspective, either the Fed is in the middle of one of the greatest tightening efforts in modern history, or it is almost tapped-out with short-term rates barely above zero.

Stick with me, because this has enormous implications for the US economy, global financial markets, and your personal portfolio. Almost a third of the world's active investors are too young to have experienced a Fed rate hike, but no one has ever seen

* The difference between corporate bond yields and the yield on US Treasuries of comparable maturities.

anything quite like this. While the majority of investors are operating as if the Fed is just beginning to tighten, we may be a lot closer to the next recession than the Fed admits or the general public realizes.

The Smell of Bankruptcy. While the Fed sees continued improvement in the US labor market – with unemployment (white line below) now arguably at or below its target level despite elevated underemployment (gray line below) – as cause to signal further tightening in 2016...

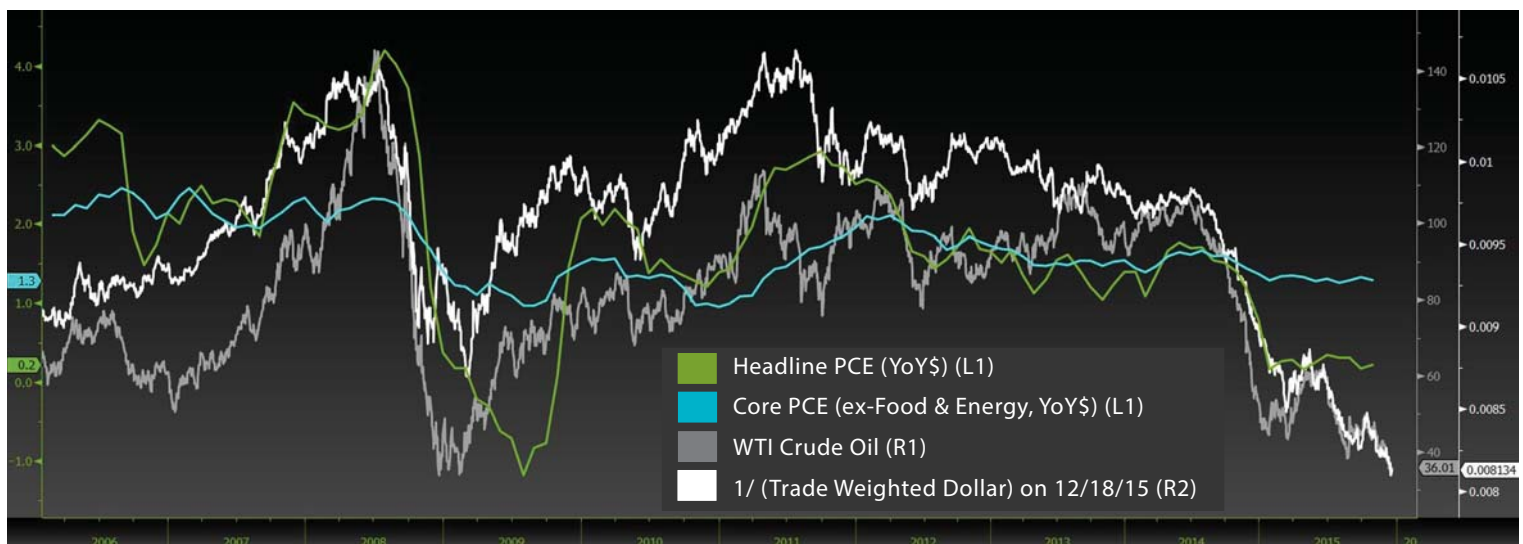
UNEMPLOYMENT, UNDEREMPLOYMENT & JOBLESS CLAIMS



Source: Evergreen GaveKal, Bloomberg

...and sees weak inflation readings as the temporary product of low oil prices (gray line below) and a strong trade weighted dollar (white line, inverted to show its impact on inflation and oil prices)...

INFLATION, OIL PRICES & THE TRADE-WEIGHTED DOLLAR (INVERTED)



Source: Evergreen GaveKal, Bloomberg

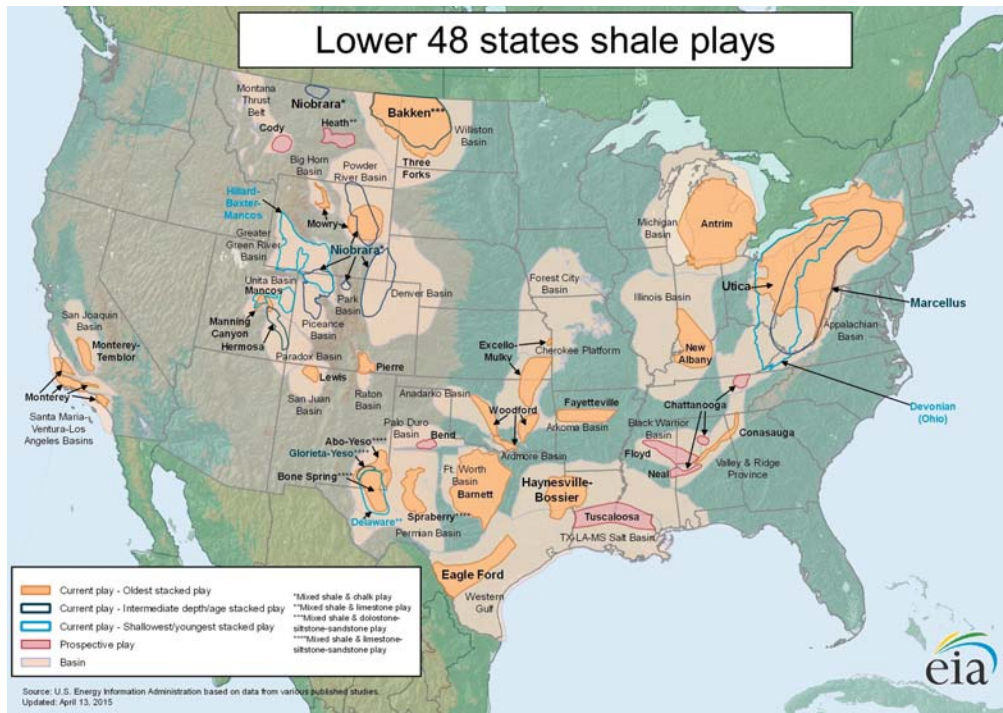
...it's worth considering if the Fed is actually *too late* in hiking interest rates after the most aggressive easing cycle in modern US history (830 bps from 2007 to 2014, as we discuss a little later).

Yes, unemployment is low, but it may be *too low* considering the logical impact of the global financial crisis, the retirement of Baby Boomers now in their mid-to-late-60s, and the labor-displacing effect of rapid technological change. If that's true – if the

natural level of unemployment is now closer to 6% or 7% as opposed to 5% – then it's very possible the Fed has over-stimulated the economy once again.

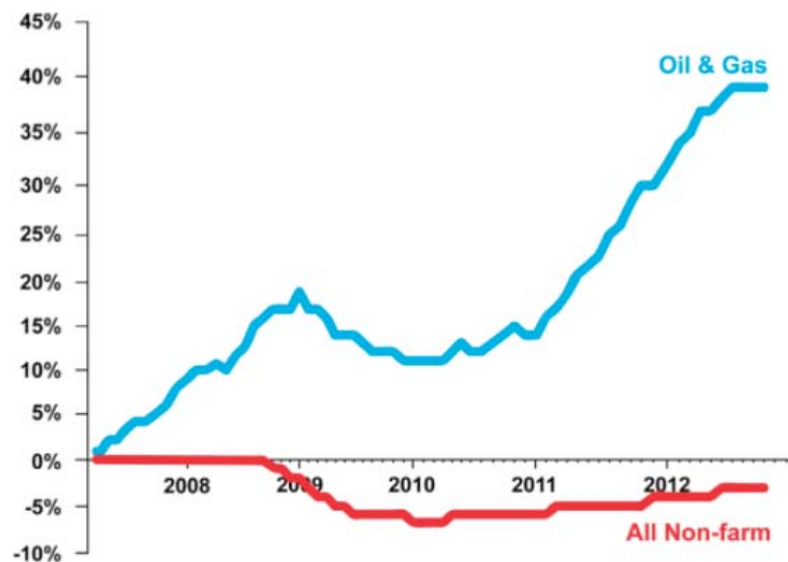
QE1 and QE2 were necessary evils in saving the country from a Great-er Depression scenario, but the decision to use emergency tools and open-ended forward guidance in an attempt to fine-tune economic growth with QE3 may prove to be the biggest policy error in decades.

Just consider where all (or at least a lot of) those construction workers from Greenspan's housing bubble went after the global financial crisis. Many of them went to work in shale fields in places like Texas and North Dakota...



...which accounted for the vast majority of US employment growth during that period.

GROWTH IN OIL & GAS EMPLOYMENT OUTPACED THE REST OF THE US ECONOMY



Source: US Chamber of Commerce, Federal Reserve Bank of St. Louis

It may not be immediately obvious, but easy Fed policy played a big role in pulling the shale boom forward by supporting the price of oil with a weak dollar and holding the cost of capital near zero with unnaturally low interest rates, unnaturally tight credit spreads, and unnaturally rising equity markets for so many years.

Of course, the spectacular advances in horizontal drilling and hydraulic fracking technology would have eventually led to rising US oil production; but the Fed played a major role in turning a technologically-driven boom into a credit-driven bonanza.

As many of you know, I lived in Houston – the energy capital of the world – for most of the last decade and experienced the shale boom firsthand. The October 2013 cover of *Texas Monthly* magazine captures exactly the way it felt during the go-go years of 2011, 2012, and 2013.



What this image doesn't show is how the shale boom indirectly affected non-energy sectors like housing, hospitality, finance, and retail in places like Houston, Dallas, and Midland, Texas as modern day shale barons like the oil-drenched man on the cover proceeded to throw money at one another for several years. As my close friend and *National Interest* contributor, [Sam Rines](#), explains, it's why Texas accounted for the majority of US job gains and a disproportionate share of US economic growth during the boom years.

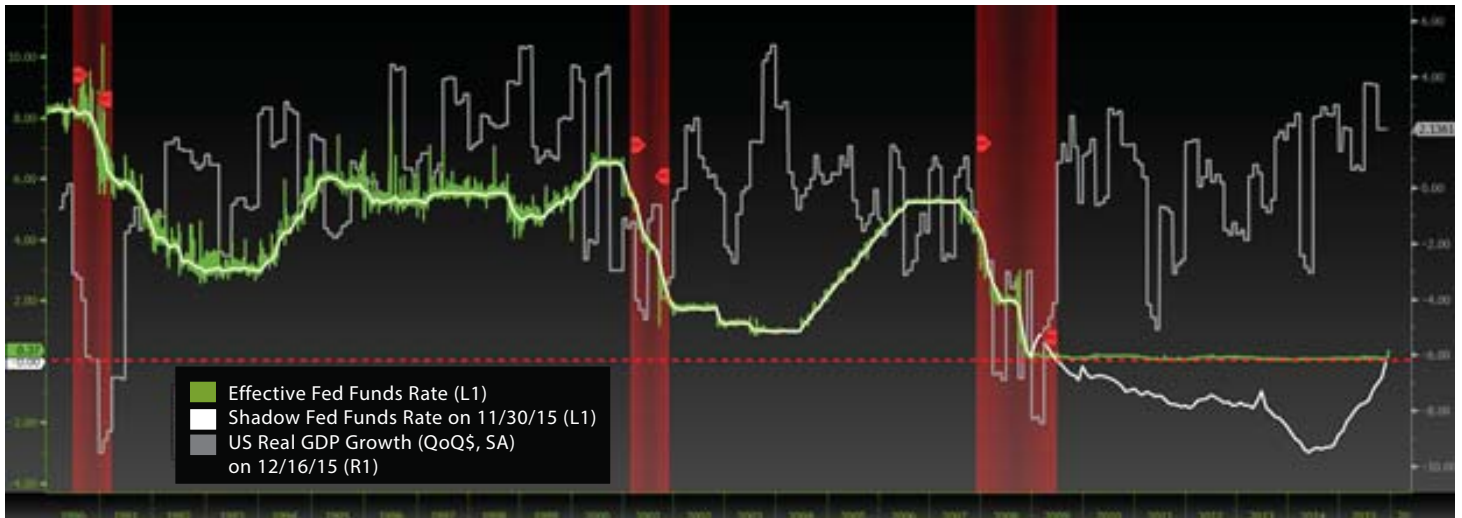
Unfortunately, credit-fueled "miracles" always come to abrupt ends. Now that the shale boom has given way to an outright bust with oil and gas prices falling back to late-1990s levels (a direct consequence of the rising dollar and tightening financial conditions, in addition to other supply-side issues in the global energy market) the layoffs are just beginning as energy firms slash overhead, disassemble rigs, and abandon planned investments.

The sweet smell of money is slowly giving way to the foul stench of bankruptcy.

Hiking Into a Recession? Janet Yellen and her colleagues at the Federal Reserve did not miss their window to hike interest rates last week (as a number of my peers predicted), but that window may close a lot faster than most investors realize as widespread production cuts and bankruptcies in American oil and gas fields lead to a turn for the worse on the jobs front and a recessionary decline in consumer demand.

As I noted earlier, the Fed has been steadily tightening for the last 18 months; but as you can see in the following chart it takes a while (economists call it an "implementation lag") for tighter monetary policy to curtail employment, investment, and demand. And since we're further along in that process than most observers realize, we may be a lot closer to the breaking-point as well.

TIGHTENING CYCLES & RECESSIONS

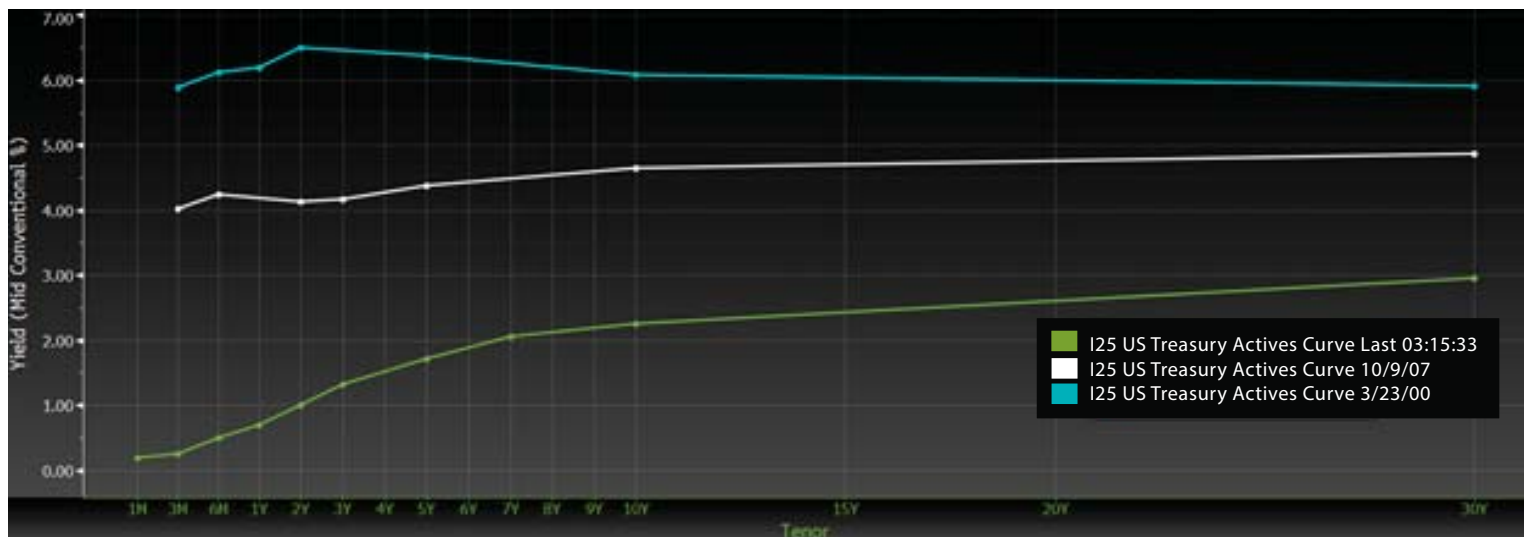


Source: Evergreen GaveKal, Bloomberg

From that perspective, maybe weak inflation readings, widening credit spreads, the strong dollar, and beaten-down oil prices are telling us something more important about the state of US economic growth.

Normally, we would look to the yield curve for confirmation of pre-recession conditions. But funny things happen at the zero bound. With short-term rates still anchored just above zero after 325 basis points of unconventional tightening, the current curve (green line below) is not inverting (i.e. short-term rates are not rising above long-term rates) as we saw at the 2000 peak (blue line below) or at the 2007 peak (white line below).

US TREASURY YIELD CURVE, TODAY VS. THE 2000 & 2007 STOCK MARKET PEAKS



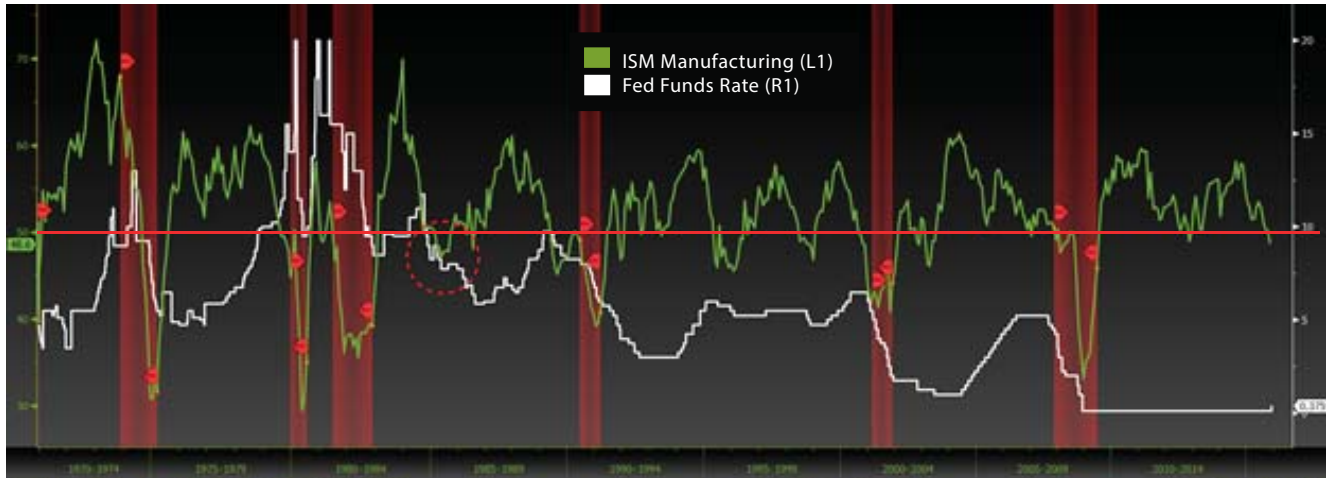
Source: Evergreen GaveKal, Bloomberg

Instead, we're just seeing a modest flattening across the curve.

While I do see the potential for long-term Treasury rates to fall substantially, the market rate on the 30-year bond would have to drop from 300 basis points today to below 25 basis points for the curve to invert in the absence of further Fed hikes. And since that scenario is extremely unlikely even in the case of a nasty recession, we have to conclude that there is no guarantee the yield curve will ever invert again as long as the Fed keeps short-term interest rates at very low levels.

Other business cycle indicators, however, are already flashing red.

FED FUNDS RATE & THE ISM MANUFACTURING INDEX



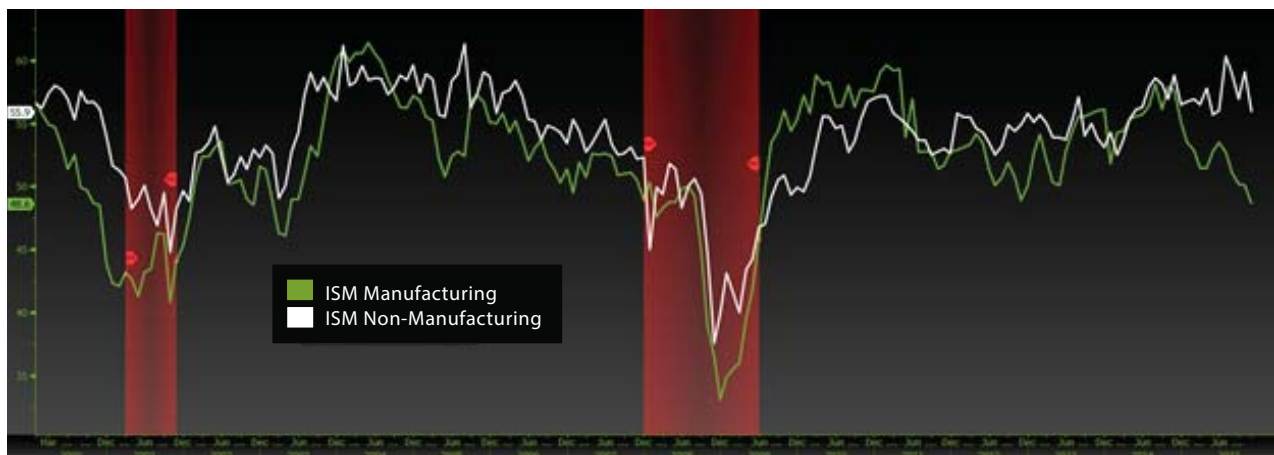
Source: Evergreen GaveKal, Bloomberg

While it's worth noting that manufacturing accounts for a smaller share of the overall economy than it did a couple decades ago, it's hard to dismiss the fact that sub-50 ISM Manufacturing Index (green line above) readings have signaled recessions 65% of the time since 1948. [In case you missed it, my friend, [Raoul Pal](#) of [The Global Macro Investor](#) and [Real Vision TV](#) fame, has been [hammering this point](#) all over the web since the survey hit 48.6 at the end of November.]

What's even more interesting is what this likely means for Fed policy as Jones Trading's Mike O'Rourke pointed out in a recent note. If you look at the circled area in the ISM chart above, you'll see that the last time the Fed hiked interest rates (white line) with ISM below 50 was in 1985 and 1986. And in both cases, the Fed was forced to return to easing within six months.

Yes, it's true that, for now, other indicators like household spending, auto sales, and residential investment tell a more optimistic story. But falling industrial activity should still give us serious pause, especially since the ISM Non-Manufacturing Index (white line below) seems to be in the process of decelerating and catching-down, similar to before the last two recessions.

ISM MANUFACTURING INDEX VS. ISM NON-MANUFACTURING INDEX



Source: Evergreen GaveKal, Bloomberg

So why does the Fed continue to posture as if the economy is strong enough to sustain another 200 bps in rate hikes when it appears to be losing momentum under the weight of substantial shadow tightening? Because shooting straight would undermine confidence.

Admitting that the economy is losing momentum with short-term interest rates barely above zero and the risk of a recession on the horizon would be tantamount to admitting what we've feared all along: ZIRP (the Fed's zero interest rate policy) and QE are the monetary equivalents of Hotel California. You can check out anytime you like, but you can never leave.

QE4 is Inevitable. All this prompts an important question. What happens if the US economy *does* show more signs of slipping toward recession over the next few quarters?

Conveniently for us, Federal Reserve Chairwoman Janet Yellen just answered that question in [her testimony before the Joint Economic Committee](#) on December 3, 2015.

As she explained, the Fed basically has three options:

(1) It can cut interest rates.

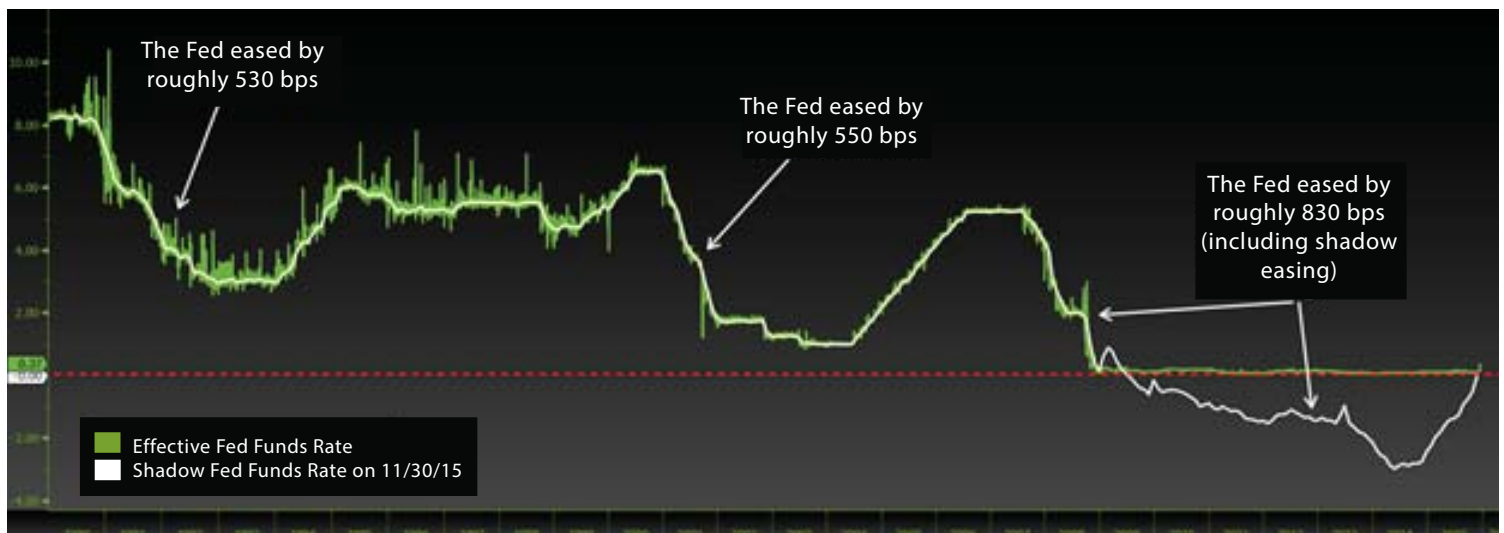
The trouble with cutting interest rates is that the federal funds rate is currently being set at a 0.25% to 0.50% range. That doesn't leave much policy room for easing in the event of a 2016 recession, as Yellen herself admits: *"If we had raised rates, we would have the possibility of lowering rates."*

Of course, the Fed could always try to drop nominal interest rates mildly below zero as we've seen in Europe since June 2014. It's hard to predict exactly what it would mean for investor sentiment; but aside from its symbolic impact, you have to wonder how much stimulus the Fed can really deliver by dropping its target rate from a +0.25% to +0.50% range to a -0.25% to -0.50% range.

The Fed may pretend that nominal rates can drop all the way to -5%, but in practice, it's unlikely to fall even as far as -1%.

Take a quick look at the Fed's last few easing cycles and tell me if 125 basis points (or 1.25%) of easing will be enough to mitigate the impact of a recession. Sorry, but that's a big, fat NO. As the next chart shows, the Fed dropped rates by almost 530 basis points in the early 1990s; it eased by roughly 550 basis points in the early 2000s; and it eased by a mind-blowing 830 basis points in the aftermath of the Great Recession.

EASING CYCLES SINCE 1990



Source: Evergreen Gavekal, Bloomberg

I'm not saying that the next recession has to be as deep or as intense as the 2007 to 2009 experience, but it's unlikely that 125 basis points of easing will be enough to stabilize the economy in such an event.

(2) It can guide market expectations.

There's no question the Fed has been able to amplify the impact of its policy moves in recent years by guiding the markets' expectations about future policy action.

"For a number of years after rates had hit zero, we discussed the reasons why it would be appropriate to keep rates at low levels... [and] as the market absorbed the notion that they will stay low for a long time, longer-term yields came down," Yellen explained.

If and when hard-pressed, the Fed can always lie about the effectiveness of its policies – like negative interest rates – and hope for the best. It's not exactly comforting if you consider how fragile trust and confidence would be if and when the Fed goes into a recession with rates just above zero.

It is possible that a move to negative interest rates and a firm promise of subsequent cuts could result in the strongest surge in investor sentiment since QE3, but all that rests on the Fed's shaky credibility.

Should the markets call Ms. Yellen's bluff, that only leaves one more option.

(3) It can launch QE4.

"Of course, we can do asset purchases," she explains. "We undertook substantial asset purchases in order to stimulate the economy. I think those purchases were successful as well in conjunction with forward guidance in bringing down longer term rates. And those tools are still available."

At the end of the day, as Ms. Yellen's comments imply, QE is really just a forward guidance tool. It works because the Fed says it works and investors respond accordingly. By appearing to pump liquidity into the system, the Fed has been able to boost sentiment, force investors to take more risk, and lower long-term yields in the process... which has, in turn, resulted in a lot of under-funded investors taking more risk than they can afford in asset classes they do not understand. It explains why QE3, thus far, has had such an impact on income-oriented asset markets and also why the unwind has been so brutal.

The trouble here is that QE becomes less effective every time, which means that more and more (not to mention, more creative) asset purchases are needed to restore a sense of calm each time.

Considering the Fed's limited room for policy easing, I don't think it's a stretch to say that QE4 is inevitable... and not just another round of asset purchases, but the biggest expansion of the Fed's balance sheet to date. The United States has never gone into a completely unmitigated recession in modern history, and certainly not with as much debt as we've stored up over the last thirty years. Thus, if the Fed allows itself to get behind the curve – as it may be doing at this very moment – we're talking about trillions more dollars in QE, massive fiscal stimulus, and a wild rise for asset prices until the markets get the necessary ingredients for a recovery.

Selling in a panic. So, you ask, what does this mean for my portfolio?

It means this is an opportune time for a gut-check. As 2016 approaches, ask yourself, am I taking too much risk? Am I too heavily exposed to a frothy equity market? Am I reaching for yield in places I do not understand?

As the Fed's shadow tightening over the last 18 months has led to a rise in the US dollar, a collapse in oversupplied energy markets, and a widening of credit spreads, markets have presented value-hungry and yield-starved investors with a more workable set of options.

- (1) We can **embrace beaten-up assets** like midstream (i.e, pipeline-type) master limited partnerships (MLPs) – and, at some point, high yield bonds – to significantly boost our overall portfolio yields, improve our long-term return prospects, and make it easier to commit to otherwise defensively-positioned portfolios.
- (2) We can **chase returns** in overvalued asset classes like US equities, which, in many cases, could have more than 50% to fall whenever complacency gives way to fear, panic, and indiscriminate selling.
- (3) Or we can sit in **cash**, waiting for valuations to improve in a more comfortable corner of the global financial markets while continuing to lose purchasing power and suffer the frustration of missed opportunities.

The good news is that it's now possible to buy deeply-discounted assets with attractive yields. The bad news is that these assets – like MLPs and high yield bonds – can fall even further in the event that emotional selling and indiscriminate ETF liquidations continue.

We've seen this dynamic at play several times in 2015 within equities (very briefly), MLPs (repeatedly), and most recently in high yield bonds (which will likely intensify if recession risks continue to build).

What you have to understand is that public securities markets have changed dramatically over the past decade with the decline of market makers, the shift toward passive investment structures like ETFs, and the rise of high-frequency, computerized trading (check out my August EVA ["Rage Against the Machine"](#) for more information).

Liquidity is not always available in this brave new world. And just because you can sell out of things like high yield bond ETFs in a panic doesn't mean you should. Selling in a panic is a surefire way to lose a lot of purchasing power in a market that can gap down 20% in a flash.

The good news is that there is a way to capitalize on the opportunities created by indiscriminate selling. That is, you can take your emotions out of the equation, think for yourself, and take a longer-term view. Don't run wild with the herd or the machines. Position your portfolios ahead of time to take advantage of them.

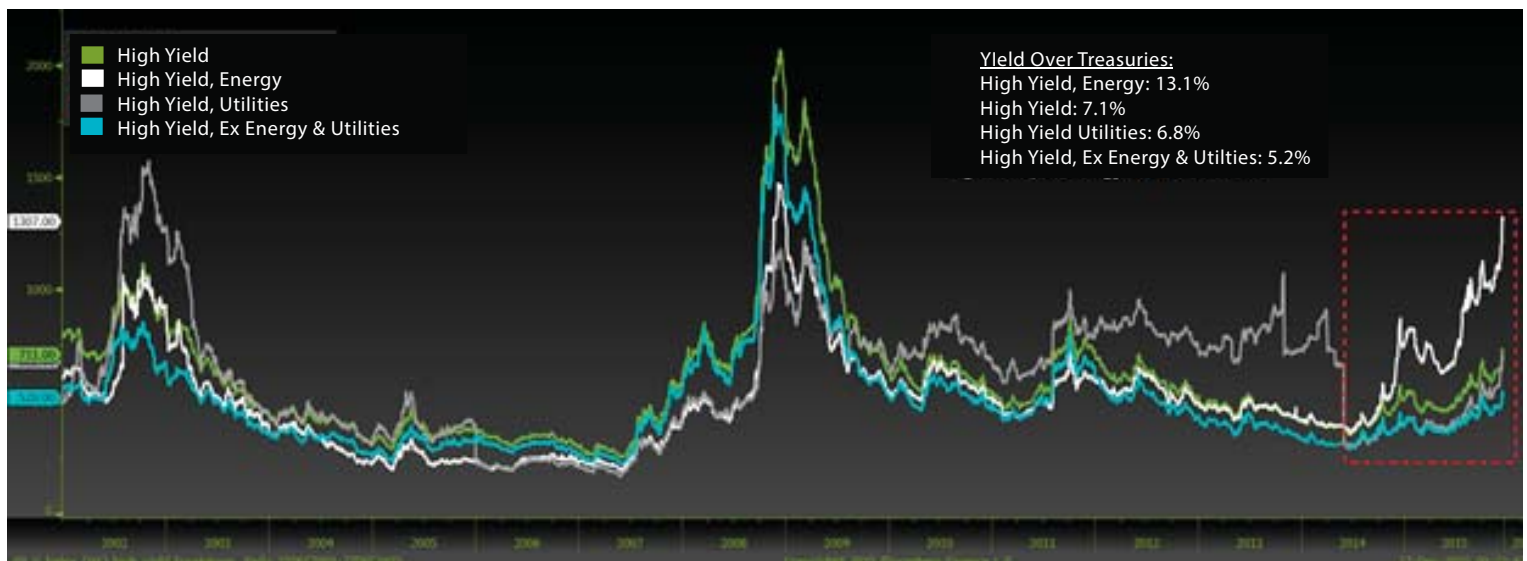
"Computers do not think," notes the ever-brilliant Charles Gave. "They simply calculate at light speed, which allows them to react to short term movements in market prices as they were programmed to do.... The result is some big short-term market moves. In essence, these computers act as machines that allow market participants to stop thinking."

Keep that in mind if the Fed continues to tighten, foreign central banks continue to ease (thereby driving up the US dollar), and more recession indicators begin to flash red.

While most of the major sell-offs and disorderly trading so far has taken place within commodity and income-oriented assets like MLPs and junk bonds, equities are ripe for a major correction.

Whenever corporate bonds and the equity market reflect dramatically different views on risk, credit often proves to be correct. But while even non-energy and non-utility credit spreads have blown out quite sharply in recent weeks...

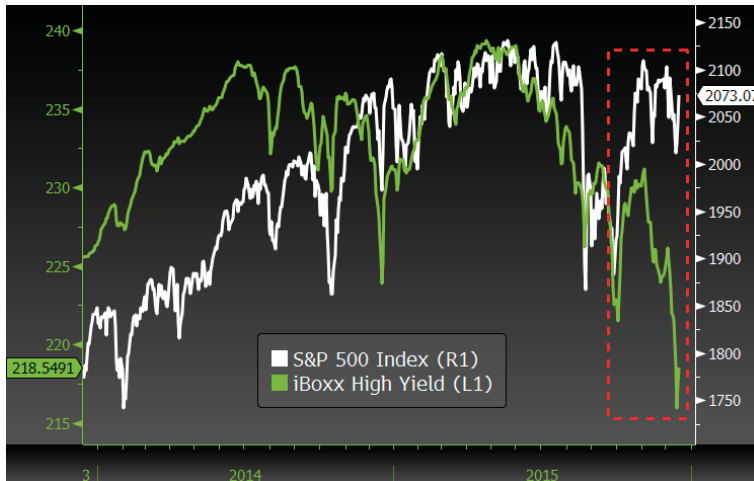
HIGH YIELD CREDIT SPREADS



Source: Evergreen GaveKal, Bloomberg

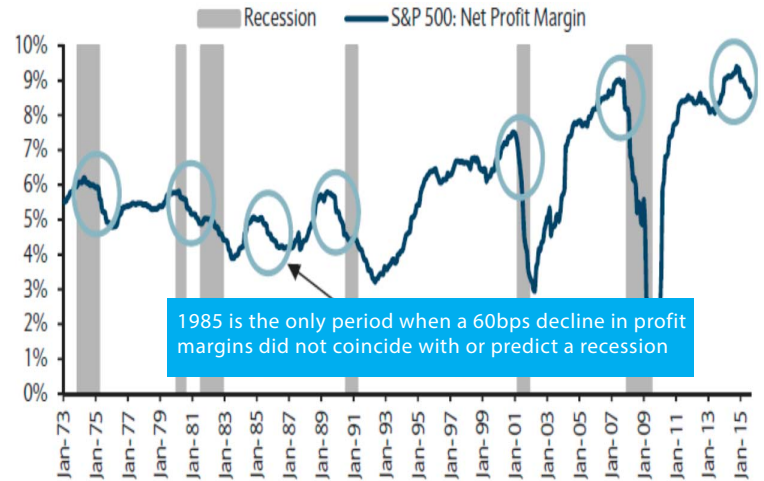
... the richly-valued S&P 500 (white line below) has proved remarkably resilient, even in the face of eroding profit margins. [As a side note, I should also point out that 1985 is the only period in modern history when a 60 basis point (0.60%) decline in profit margins did NOT coincide with or predict a recession.]

US STOCKS VS. US HIGH YIELD BOND PRICES



Source: Evergreen GaveKal, Bloomberg

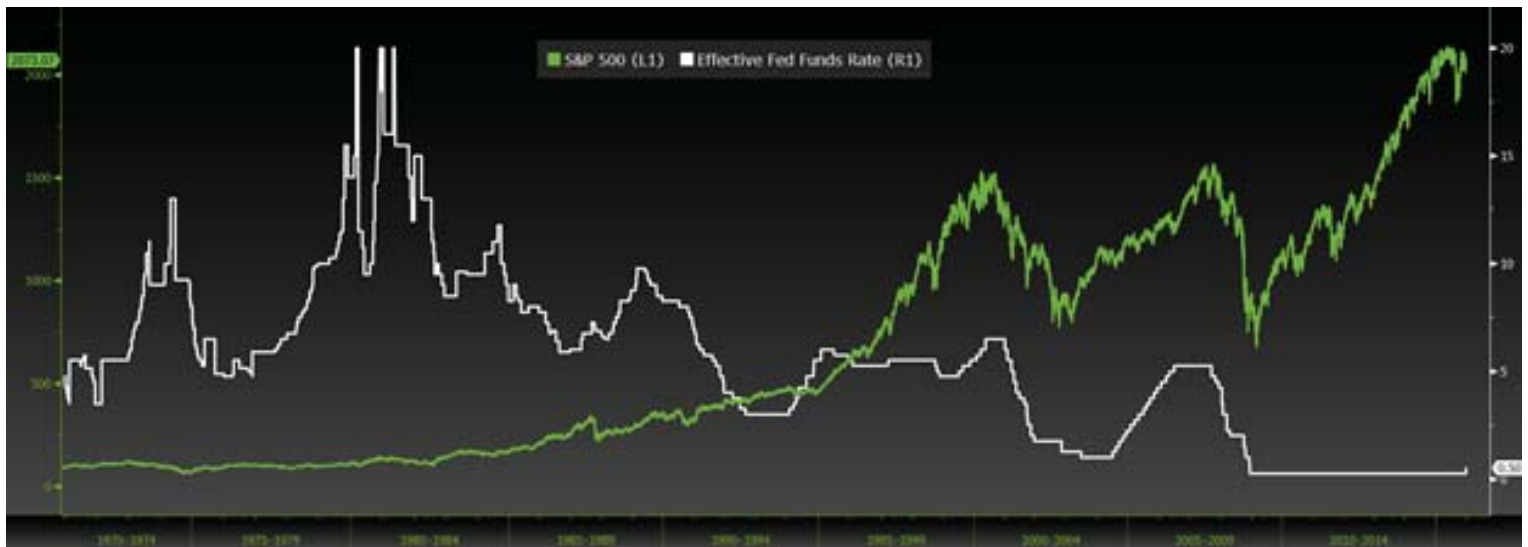
ERODING S&P 500 PROFIT MARGINS



Source: Barclays, Thompson Reuters

While it's possible the equity market can continue to run like a wounded bull a while longer, we're about to see what happens when equities have to trade on their own merit in an economy that is already losing momentum.

ZIRP SUPPORTED A MASSIVE S&P 500 RALLY...WHAT NOW?



Source: Evergreen GaveKal, Bloomberg

For what it's worth, tapering is tightening and QE4 is inevitable. But in the meantime, overvalued assets like US equities are in for a rude awakening.

If I am even remotely right, investors will have the opportunity to rotate into more aggressive, equity-heavy portfolios in the coming years with attractive yields and at compelling valuations. But for now, my colleagues and I on the Evergreen GaveKal investment committee would rather sit in defensive, equity-light portfolios with large cash reserves and modest collections of beaten-up, high-yielding assets that are already priced for something like worst-case-scenarios.

If you have any doubts about your own portfolio going into 2016, this is a good time to get defensive.

OUR CURRENT LIKES & DISLIKES

No changes this week.

WE LIKE

- Large-cap growth (on a deeper pull back)
- International developed markets (on a deeper pull back)
- Canadian REITs
- Intermediate Treasury notes
- BB-rated corporate bonds (i.e., high-quality, high yield)
- Cash
- Publicly-traded pipeline partnerships yielding 7%-12% (MLPs)
- Intermediate-term investment grade corporate bonds, yielding approximately 4%
- Gold-mining stocks
- Gold
- Intermediate municipal bonds with strong credit ratings
- Long-term municipal bonds
- The Indian stock market
- Long-term Treasury bonds
- Blue chip oil stocks (on a pull-back after the recent rally)
- Emerging bond markets (dollar-based or hedged)

WE'RE NEUTRAL ON

- Most cyclical resource-based stocks
- Large-cap value
- Short-term investment grade corporate bonds
- High-quality preferred stocks yielding 6%
- Long-term investment grade corporate bonds
- Short yen ETF
- Emerging market bonds (local currency)
- Short euro ETF
- Bonds denominated in renminbi trading in Hong Kong (dim sum bonds)
- Canadian dollar-denominated bonds

WE DON'T LIKE

- Real Estate Investment Trusts (REITs)*
- Small-cap value
- Mid-cap value
- Small-cap growth
- Mid-cap growth
- Floating-rate bank debt (junk)
- Lower-rated junk bonds
- Emerging stock markets

*However, some small and mid-cap issues look attractive (and are becoming even more so)

the Evergreen
**VIRTUAL
ADVISOR**

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