EVERGREEN GAVEKAL

Monthly Chartbook

MARCH 2015

Monthly Chartbook

BY DAVID HAY

Welcome to this month's *EVA Chartbook*! As you will soon read, much of this issue is focused on coping strategies for investors desperately seeking yield in an environment where interest rates have been put on the endangered species list by our enlightened monetary policy-makers. Without spoiling the show up front, I can say that anyone striving for more than a miserly yield will need to put on his or her contrarian goggles to spot those few remaining pockets of respectable cash flow.

Hyperventilating hype. A report from a reliable source recently came across my desk that really got my adrenaline flowing. The reason for my "fur up" reaction is that it is one of the most biased analyses I've ever seen. If you think I'm being too harsh, consider that the title was "Even Bigger Than the Big Short." Hyperbole sells, but isn't that just a bit over the top?

However, despite its flaws, this piece (notice, I didn't say piece of what!) motivated me to devote my section of this month's *EVA Chartbook* to telling the other side of the story, especially since I suspect many EVA readers received a copy of the BS report (that would be "Big Short" report, but you can use your imagination).

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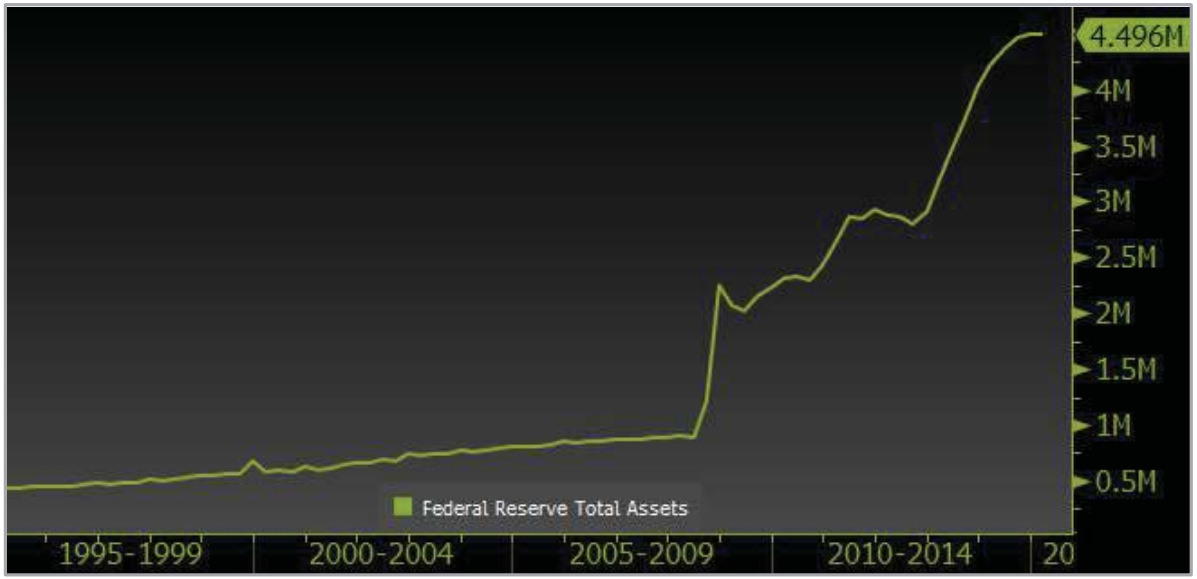
The main theme of this "research report" was to predict a housing disaster in Canada worse than what happened in the US—one that would torpedo the Canadian economy. A companion essay, published a few weeks earlier, also predicted that this would cause the Bank of Canada to resort to extreme quantitative easing (QE) measures, driving down the Canadian currency (popularly known up north as the loonie) from its already depressed level of 78 cents to the dollar, to around 65 cents.

Therefore, let's take a look at some charts that seek to balance the scales a bit, while acknowledging that Canada definitely has some problems (I'm still looking for a country that doesn't!).

BY DAVID HAY

FEDERAL RESERVE BALANCE SHEET

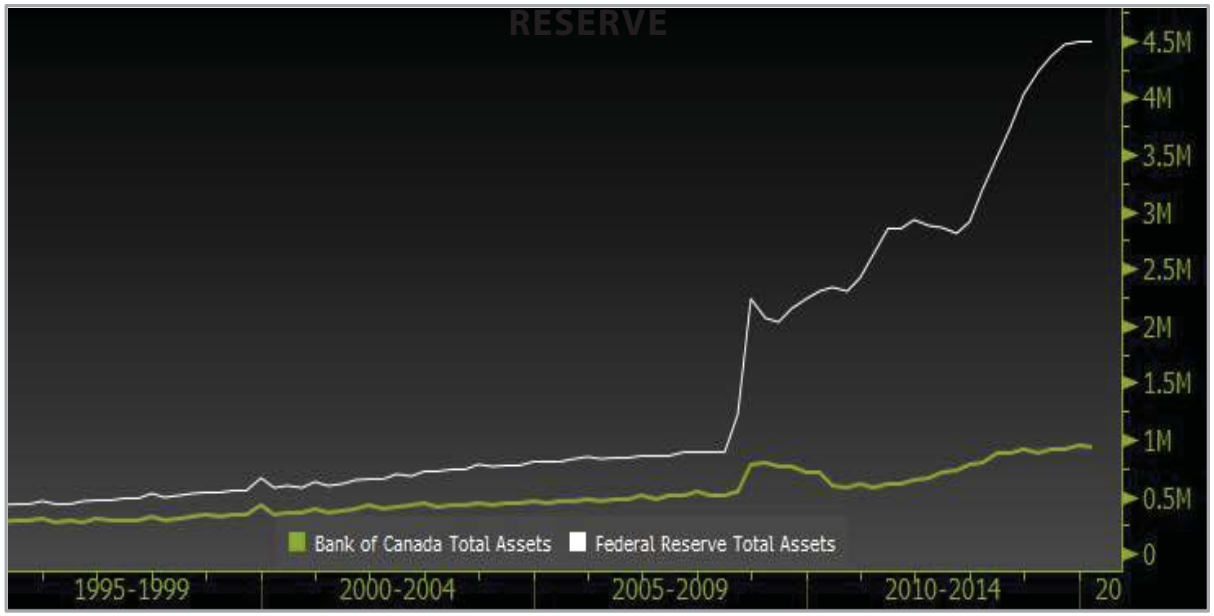


Source: Evergreen GaveKal, Bloomberg

A lot of catching up to do. First, let's look at how much the Fed has inflated its balance sheet by creating reserves out of thin air to buy government bonds. This is, of course, the notorious QE process.

BY DAVID HAY

BANK OF CANADA TOTAL ASSETS COMPARED TO FEDERAL RESERVE

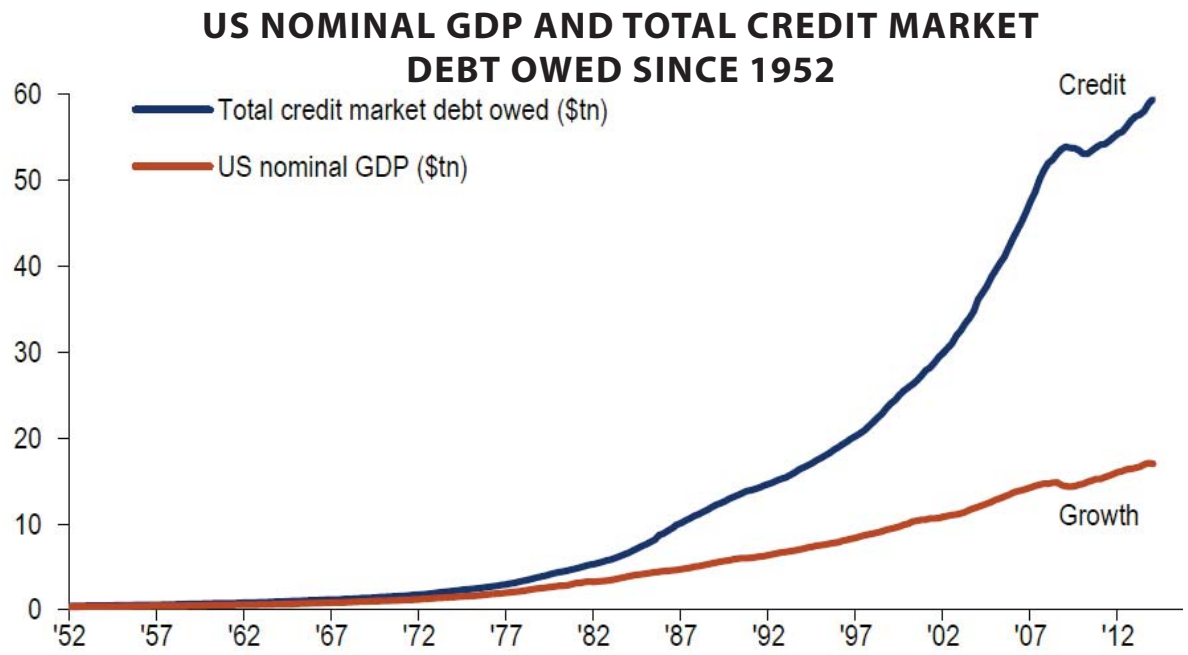


Source: Bloomberg, Evergreen GaveKal

Now, let's check out what the Bank of Canada has done—or hasn't done—to its balance sheet.

One could reasonably wonder why Canada has resisted the allure of QE when America, Europe, and Japan have gone all-in. Further, commodity prices have been in a three-year bear market, and if the Canadian economy was as overly dependent on resource prices as folks like this author contend, you'd think QE would already be running full-tilt up north.

BY DAVID HAY

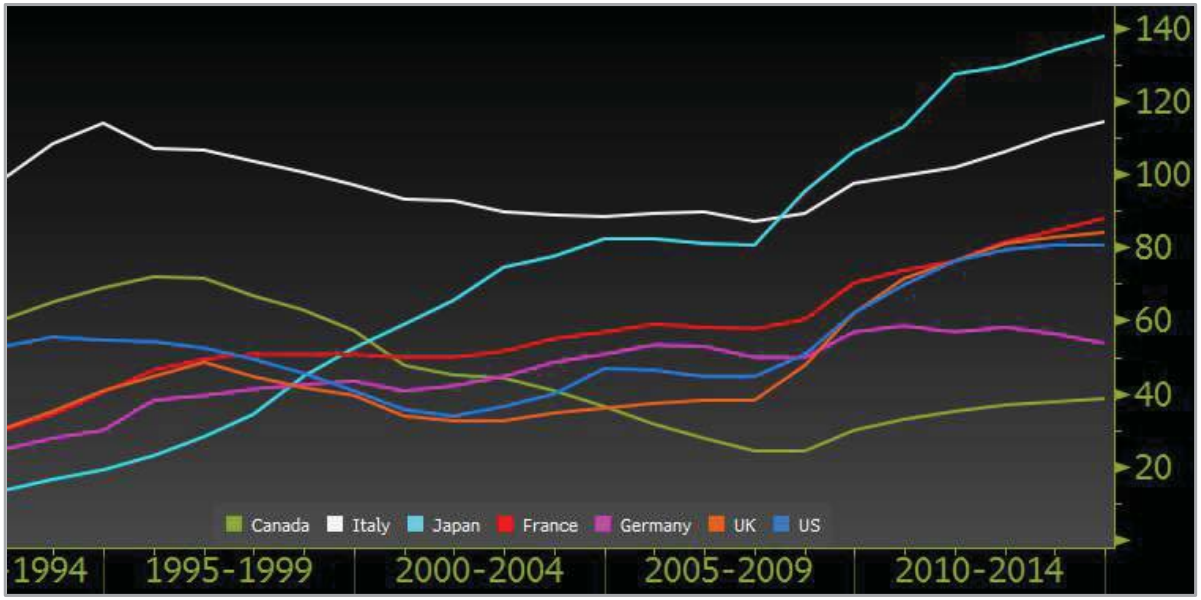


Source: BofA Merrill Lynch Global Investment Strategy, Federal Reserve Bank, DataStream

Who's swimming in debt? Another point of the aforementioned slam-fest against Canada was that the country is drowning in debt. Since the author's point was that the US was in much better shape debt-wise and, therefore, the US dollar should rise even further against the loonie, let's check out some charts on comparative indebtedness as well.

BY DAVID HAY

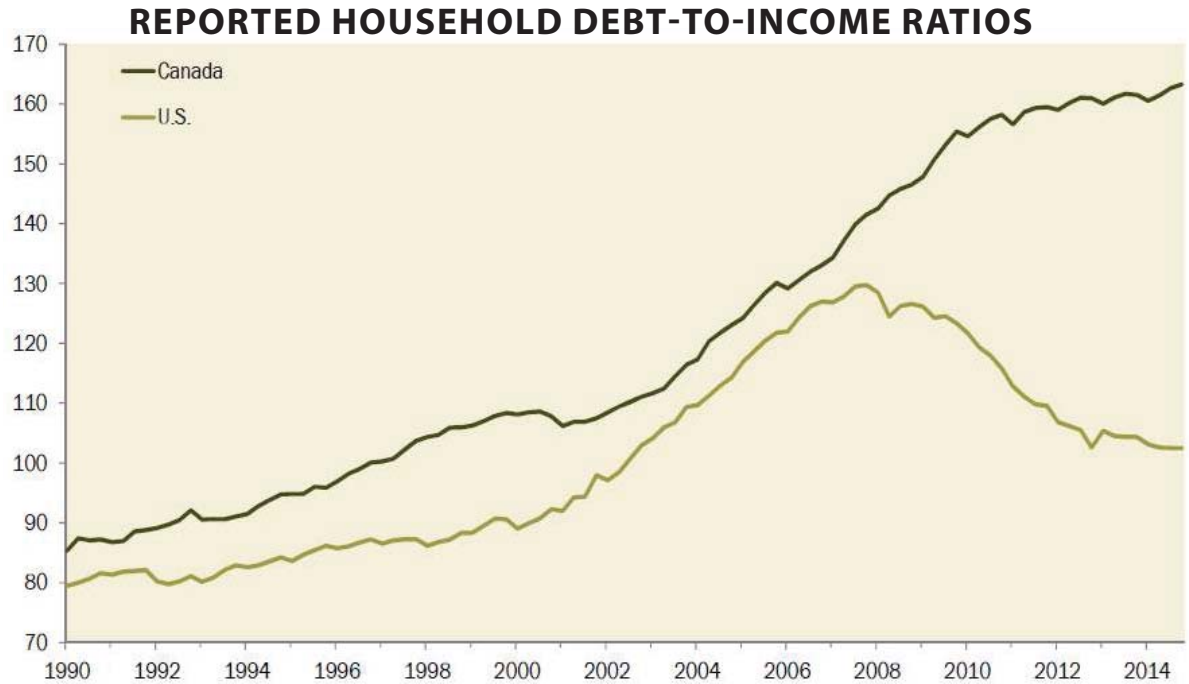
G-7 NET GOVERNMENT DEBT AS A SHARE OF GDP



Source: Evergreen GaveKal

And when it comes to government debt relative to the size of economic output, Canada is in an enviable position, vis a vis all leading countries, not just the US.

BY DAVID HAY

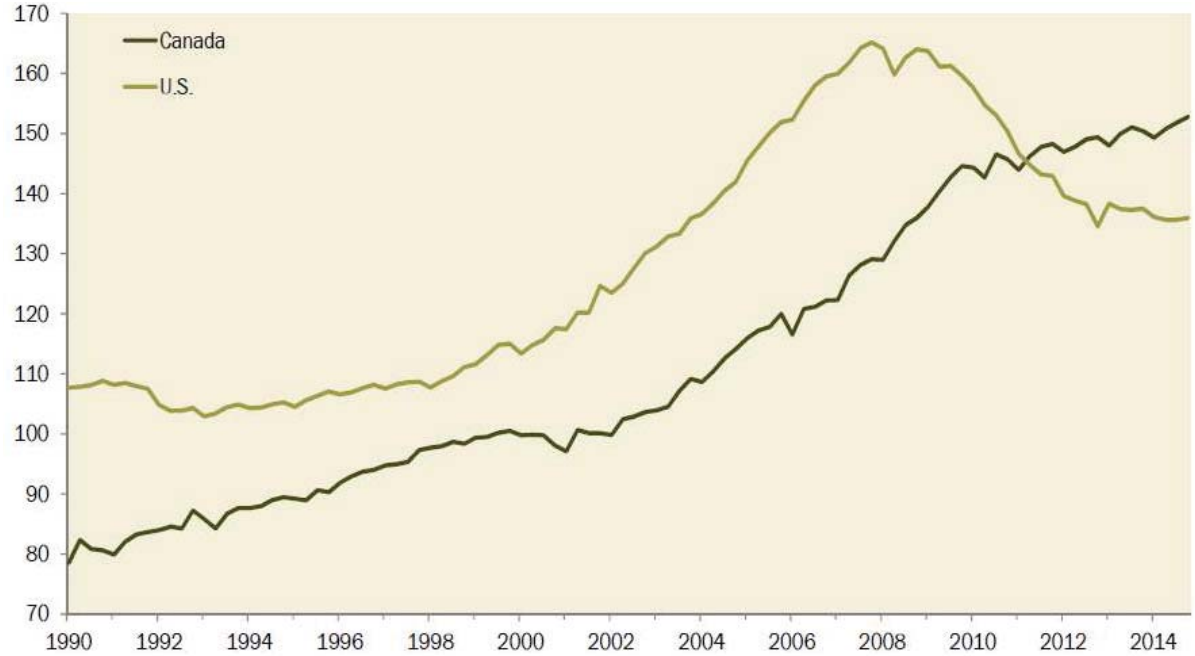


Source: Statistics Canada, Federal Reserve Board, Gluskin Sheff

Apples-to-apples. The author of the "Even Bigger Than the Big Short" report also made a big deal about this chart, his contention being that consumer debt levels are far worse north of the 49th parallel than in the US.

BY DAVID HAY

COMPARABLE HOUSEHOLD DEBT-TO-INCOME RATIOS

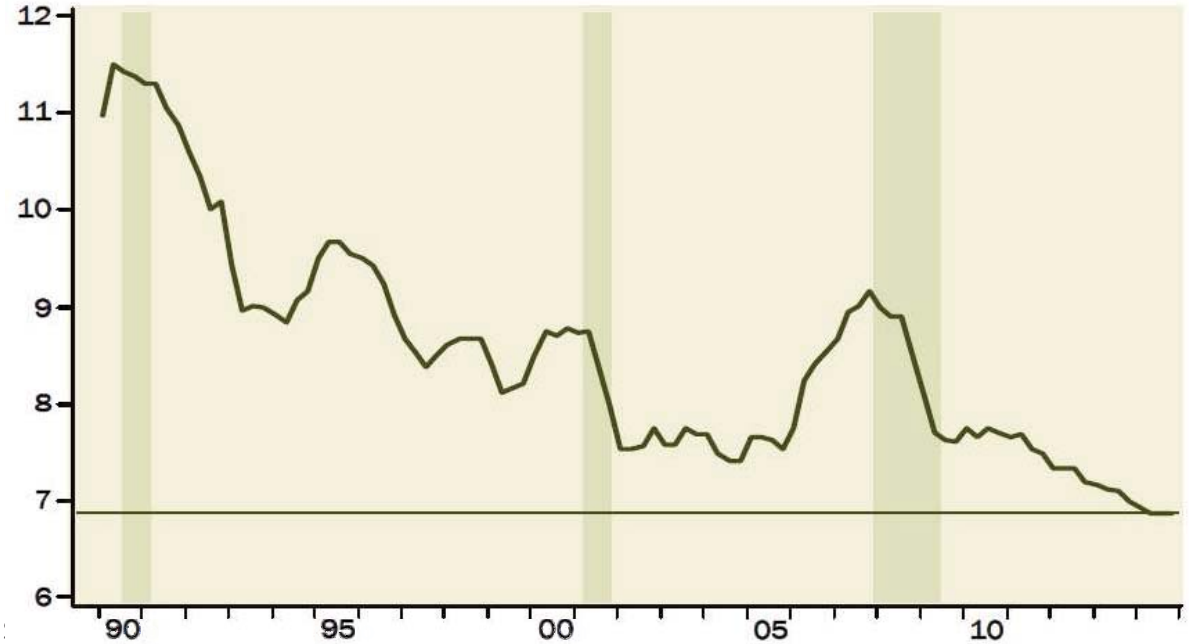


Source: Statistics Canada, Federal Reserve Board, Gluskin Sheff

However, per David Rosenberg, who is arguably Canada's top economist, when you adjust for accounting differences, the gap is relatively minor.

BY DAVID HAY

CANADA: MORTGAGE AND NONMORTGAGE INTEREST PAYMENTS AS A SHARE OF INCOME

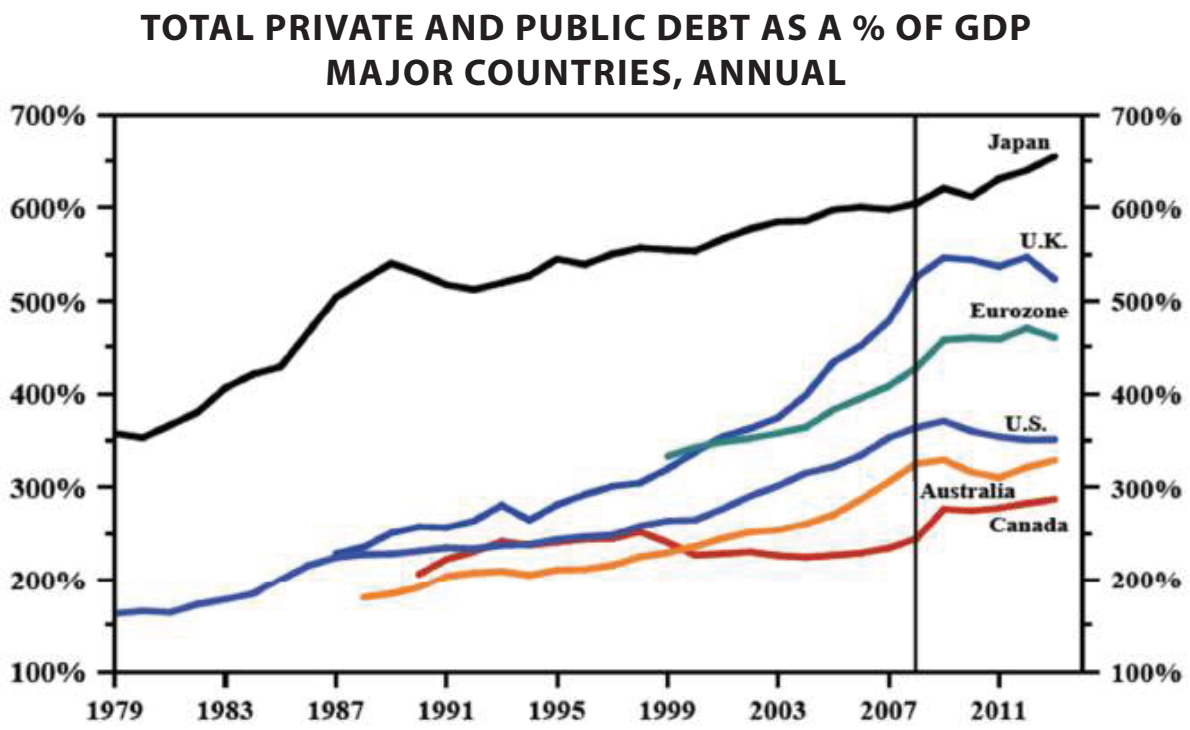


Source: Statistics Canada, Gluskin Sheff

Is this the stuff of "The Big Short"? Another glaring omission on the part of the "Canada Slam" author was that he totally ignored the currently low level of debt service Canadian households are enjoying presently (the same is also true in the US, of course).

It's exceedingly hard to see how this situation poses a dire threat to Canada's economy barring a sudden upward bolt by interest rates. That's always possible but, given current inflation and interest rate trends, there is little likelihood of that anytime soon. Moreover, much of the debt carried by Canadian consumers is in the form of fixed-rate mortgages.

BY DAVID HAY



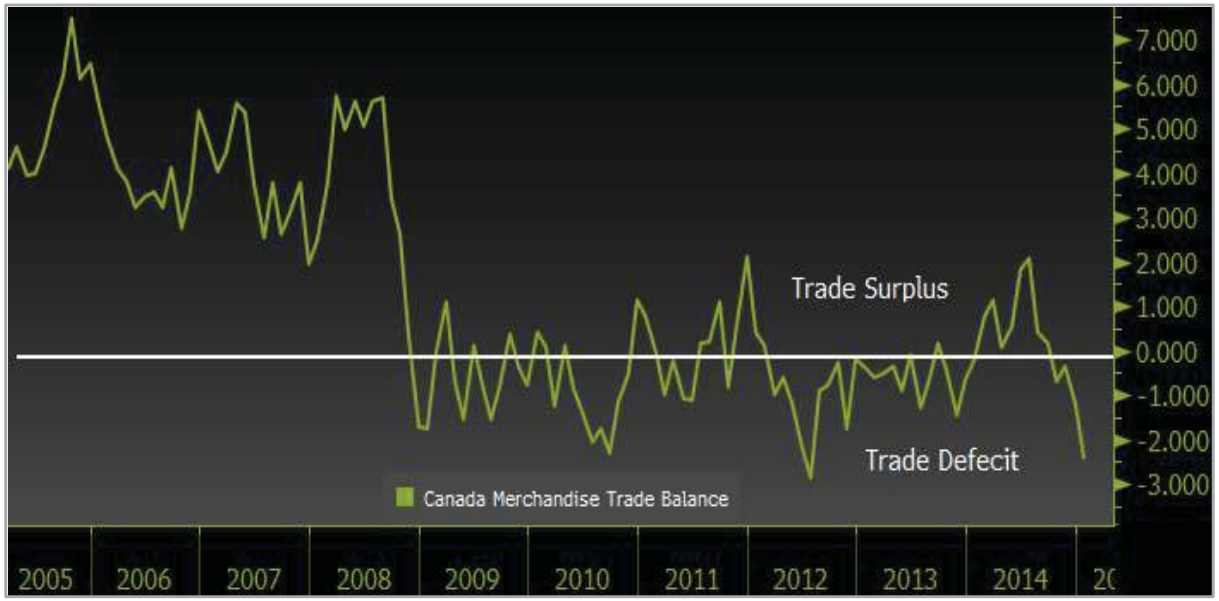
Source: Mauldin Economics, Lacy Hunt, Bank of Japan, Cabinet Office, Statistics Canada, Federal Reserve, Bureau of Economic Analysis, Office for National Statistics for UK, Statistical Office of the European Communities, Reserve Bank of Australia, Haver Analytics, through 2013

Then, there is the Big Picture... In keeping with the utterly skewed tone of this report, the writer neglected not only to compare Canada's government debt-to-GDP to its peers (per page 6), he also failed to run this graphic.

As you can see, when total private and public sector liabilities are considered, Canada ranks far below the US, and is in much better shape than almost every other advanced economy.

BY DAVID HAY

CANADA'S MERCHANDISE TRADE BALANCE



Source: Bloomberg, Evergreen GaveKal

On the downside... As noted at the outset, Canada does have some serious challenges. Despite being a predominantly consumer-oriented economy, exports are a much bigger share of its economy than in the US. Problematically, oil exports represent around 20% of total merchandise exports. However, offsetting this, oil in Canada is traded in dollars and, since the greenback has soared, it's softened the blow of the oil price's implosion. Most of Canada's energy sector's costs are, of course, in Canadian dollars.

The aforementioned long-running bear market in commodities is undoubtedly the main driver behind the recent pronounced weakening in Canada's balance of trade. However, as you can see, it has tended to fluctuate quite a bit over the years, but has averaged just below the breakeven point. This is in contrast to the US, which has consistently had a deeply negative balance of trade status.

BY DAVID HAY

AVERAGE HOUSING PRICES IN MAJOR CANADIAN CITIES
C$1=US$0.912

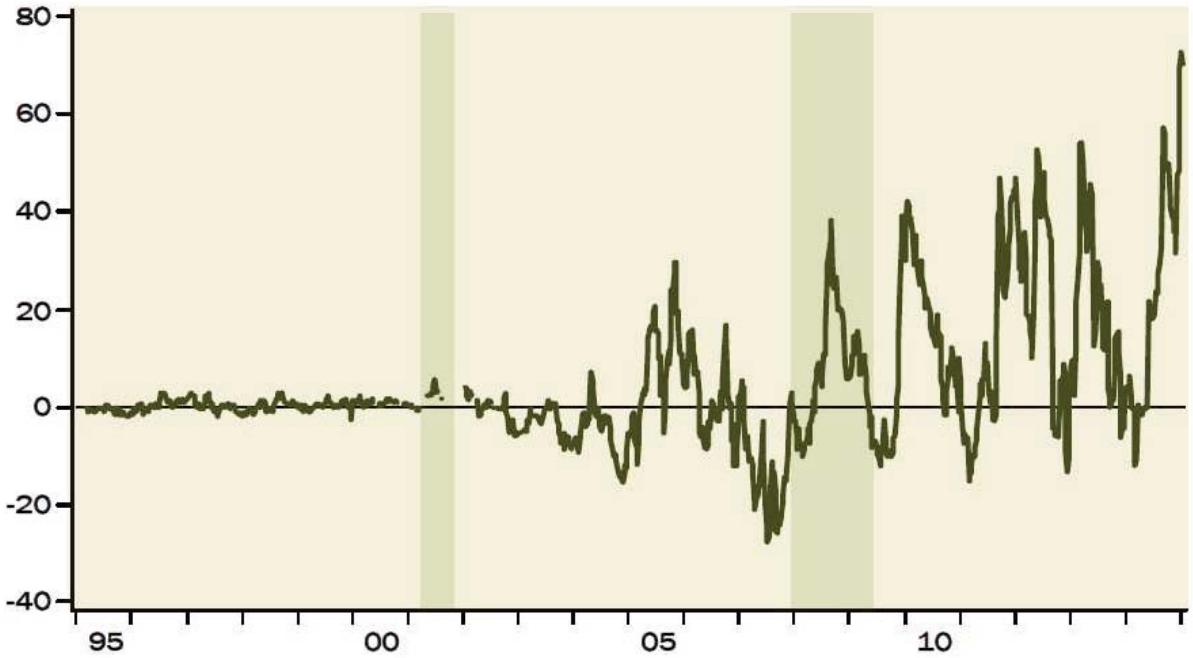
Source: Canadian Real Estate Association

Another legitimate beef. The main negative theme of this "Woe, Canada" missive was centered on its inflated housing market. This is a valid point and one we've conceded in the past. However, he implies a 40% overvaluation for the country as a whole, not just the long-bubbly Vancouver and, to a lesser extent, Toronto residential property markets. This seems much too negative, in our view.

Despite his dismissal of the notion that Canadian property values outside of Vancouver and Toronto aren't excessive, the *Wall Street Journal* table to the left indicates otherwise. An average home price of around $375,000 in the capital city of Ottawa just doesn't strike me as over-the-top (particularly by Seattle standards where a million doesn't buy you much house these days). Also, with the loonie at 78, versus 100 when this table was published, home values up north just got a lot more affordable for US and, most relevantly, Chinese buyers (China's currency largely tracks the US dollar).

BY DAVID HAY

NET SPECULATIVE LONG POSITION ON THE US DOLLAR

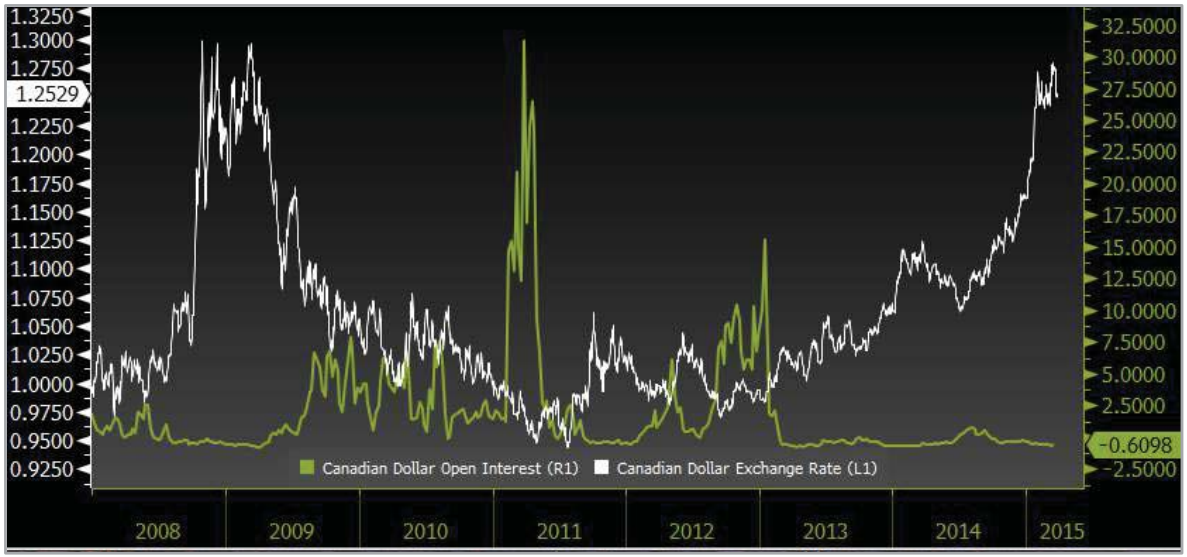


Shaded regions represent period of US recession
Source: Haver Analytics, Gluskin Sheff

Are dollar bulls feeling their oats a bit too much? It's rare to find a research report these days that isn't ragingly bullish on the US dollar—a stark contrast to a few years ago. This enthusiasm is reflected in the unprecedented net-speculative long interest in US dollar futures contracts.

BY DAVID HAY

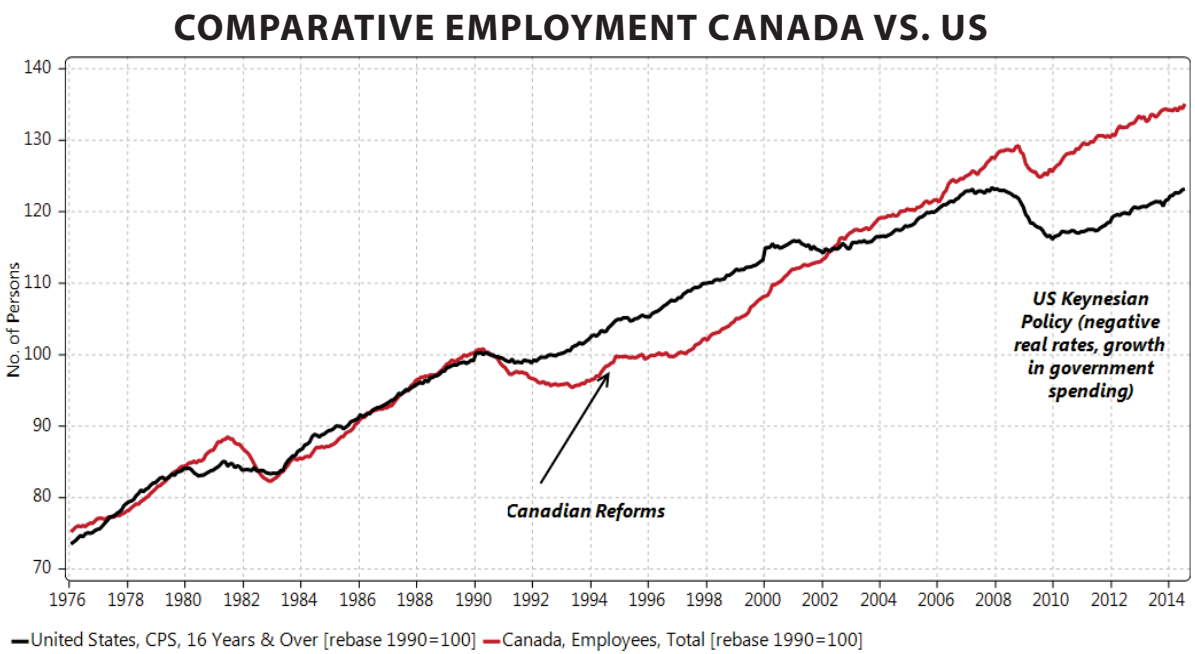
CANADIAN DOLLAR AND SPECULATIVE OPEN INTEREST



Source: Evergreen GaveKal, Bloomberg

180 degrees in the opposite direction, is the attitude of speculators toward the loonie. As noted in myriad past EVAs, when sentiment is this skewed, the majority is usually disappointed.

BY DAVID HAY



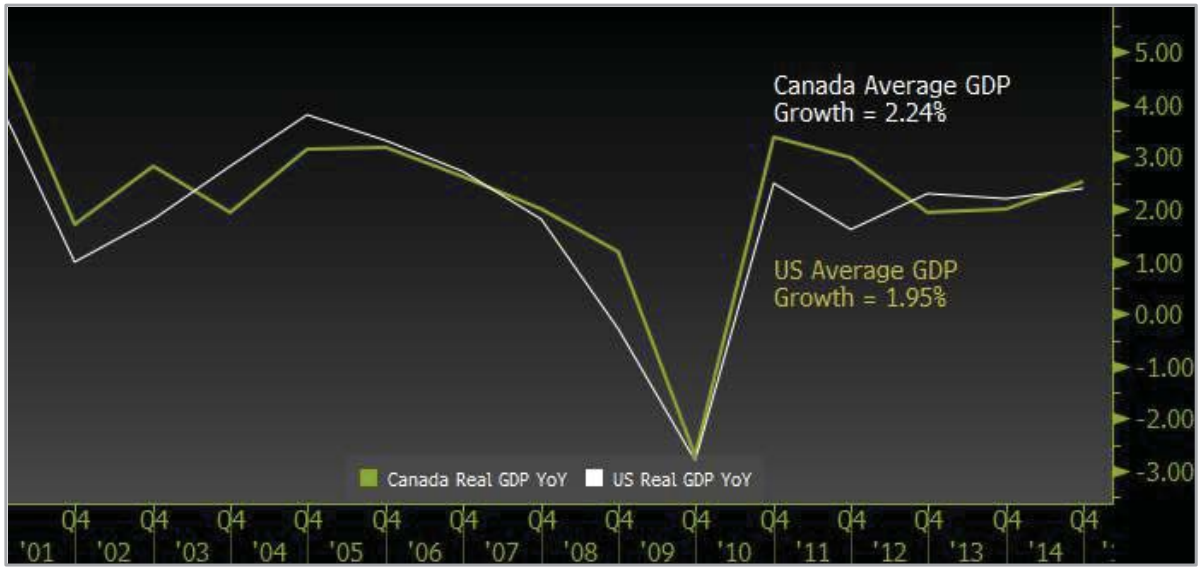
Source: GaveKal Data powered by Macrobond

The Great Turnaround. Related to the above disparity in attitudes toward the US and Canadian dollars is the widespread belief that the US economy is much more dynamic than Canada's. However, starting in the mid-1990s, when Canada was being referred to in some quarters as "the banana republic to the north"—and the loonie as "the northern peso"—stunningly turned its back on welfare-state policies.

As you can see here, since that time, employment expansion in Canada has been much healthier than in the US. This trend originated about 15 years ago when America began to heavily rely on deficit spending and ultra-easy monetary policies (save for a few years from 2005 to 2007).

BY DAVID HAY

REAL GDP GROWTH IN THE US AND CANADA

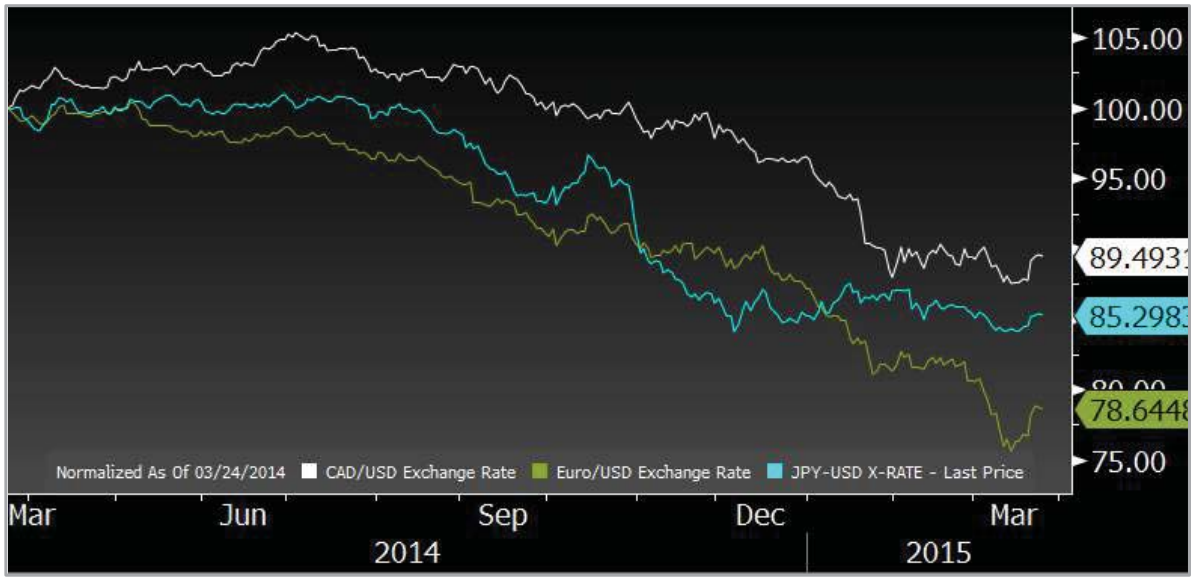


Source: Bloomberg, Evergreen GaveKal

And the winner is… One would expect with better policies and a superior employment picture that economic growth would reflect this—and one would be right! In fact, per the chart to the left, Canada has indeed grown faster than the US, despite mostly lacking America's vibrant tech sector (clearly, a tremendous competitive advantage for our country not only vis a vis Canada, but almost every other country on the planet).

BY DAVID HAY

CANADIAN DOLLAR, EURO, AND YEN VS. THE USD



Source: Bloomberg, Evergreen GaveKal

No loonie tune. There seems to be a belief among Americans, who follow the loonie's up and downs more closely than other currencies, likely due to Canada's proximity, that it has been uniquely weak. However, as you can see, that's not the case.

The Canadian dollar has actually outperformed both the yen and euro over the last year. It has done even better versus Mexico (home of the southern peso) and most other currencies in the western hemisphere.

Wrap up. To conclude my section of this month's *EVA Chartbook*, let me concede that the above referenced author may end up being right about the loonie heading to around 65 cents to the US dollar. But I seriously doubt it will be for the reasons he's given.

Should the present global trends toward deflation intensify and devolve into a true deflationary bust, accompanied by the financial market panic that implies, the Canadian dollar is almost certainly heading lower. It's possible it will retrace all the way back to its "northern peso" lows. At that point, however, it would likely be one of the best currency values in many years, pulling in substantial US-based capital to take advantage of the opportunity to buy financial and tangible assets at fire-sale prices.

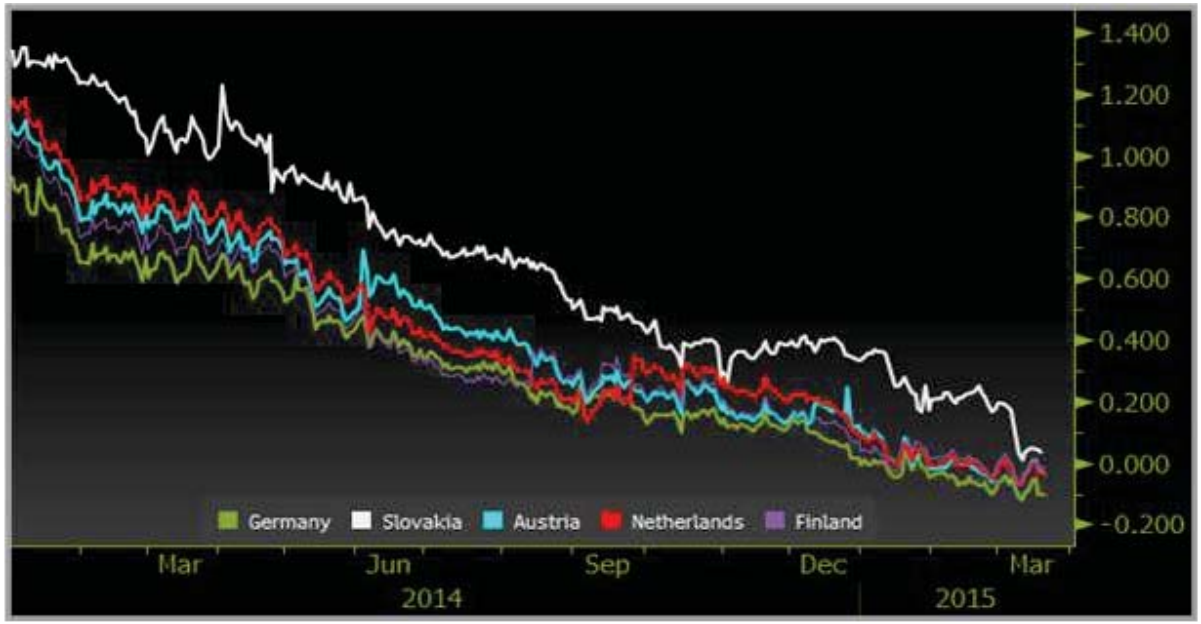
With 75% of Canadian exports US-bound, such an undervaluation relative to the buck would be a hurricane-force tail-wind to its exporters—from industries such as autos to forest products (both of which are substantial in Canada). Additionally, oil prices will eventually recover from today's unsustainably low level where producers are typically receiving $10 per barrel below the already depressed "headline" quote.

Consequently, Evergreen believes US investors should continue to gradually add to their Canadian exposure, with REITs up north—and their 7%-plus yields—appearing particularly enticing, as Jeff Eulberg and Jeff Dicks convey in their section of this issue. And feel free to give short shrift to over-hyped stories that Canada is the second coming of the Big Short.

Now, to the two Jeff's…

BY JEFF DICKS & JEFF EULBERG

5-YEAR GOVERNMENT BOND YIELDS IN EUROPE



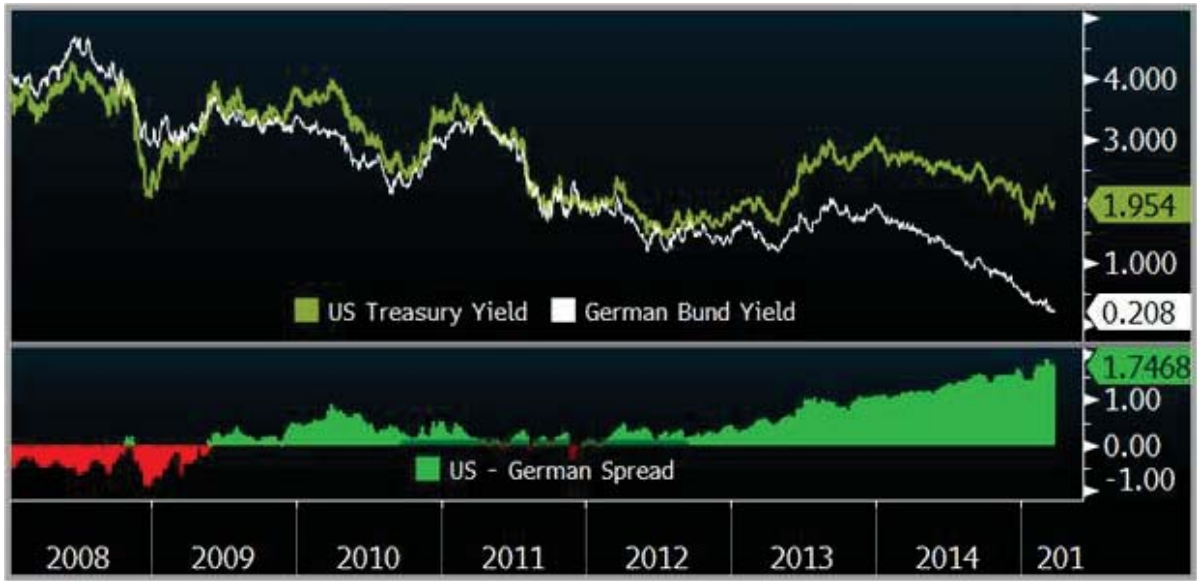
Source: Bloomberg, Evergreen GaveKal

Negative-Interest Rate Policy? Well, zero interest rate policy just got a whole lot worse. For investors who thought 1-2% yields were tough to live on, bond investors in the Eurozone are now facing a much bigger challenge: negative yields. Currently, 30% of the bonds issued in Europe pay less than 0.0%. That's right, you actually have to *pay the government to hold your money*—and this extends out to six years! For some of the larger financial institutions, this could make some sense, given the European Central Bank charges banks 20bps (0.2%) for holding excess reserves. However, for the average Joe (or Giuseppe)—who lives on the income from their investment portfolio—times are certainly tight. So, as yield securities continue to collapse at record pace, we think it's essential to lock-in yield in the US while you still can. In this section of the *EVA Chartbook*, we are going to do a little "show and tell" of where you can still find livable income in today's low interest rate environment.

The Point Of No Return

BY JEFF DICKS & JEFF EULBERG

10-YEAR US TREASURY YIELD, 10-YEAR GERMAN BOND YIELD, AND US/GERMAN SPREAD

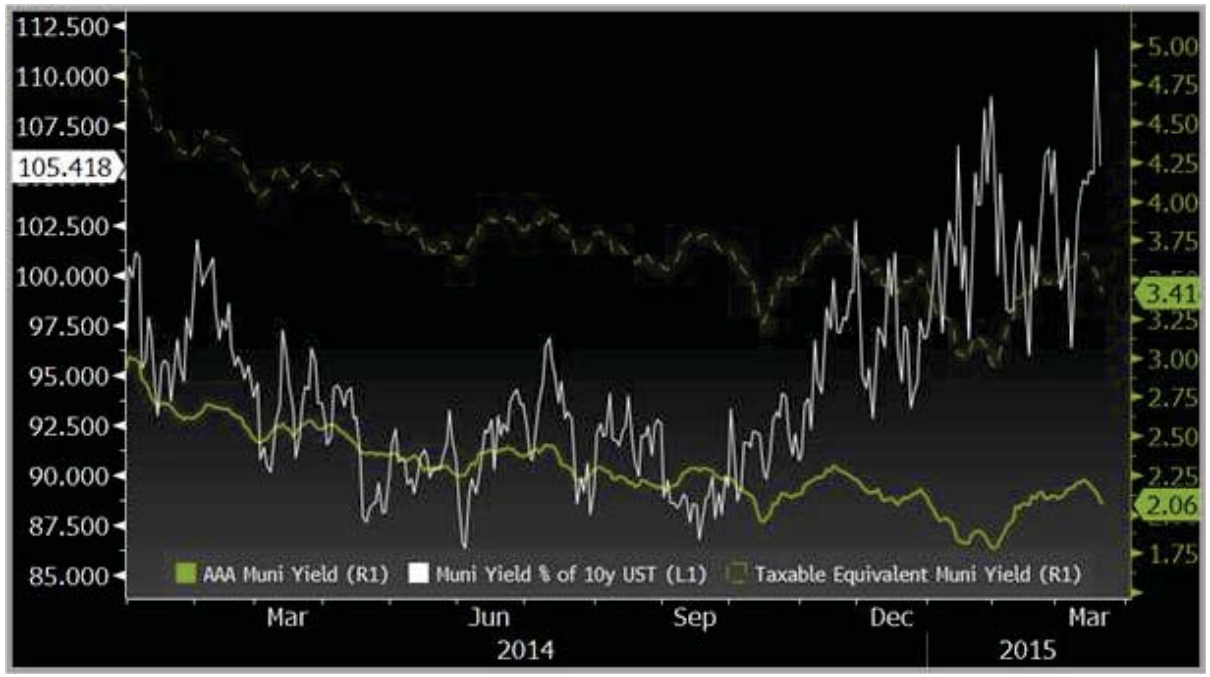


Source: Bloomberg, Evergreen GaveKal

Today, US Treasuries (UST) currently yield under 2.0%, which we'll admit isn't a great long-term investment. However, when you compare US government bonds to their German counterparts, USTs are relatively attractive. As the chart on the left shows, the spread between US and German debt is now at 174 bps (1.74%). This recently hit the largest government debt premium the US has had over Germany since the late 1980's. With high-quality government yields non-existent across the world, we think there could be a bid on the relatively attractive US Treasuries. We also believe this will be particularly true for international investors who live in a region with rapidly depreciating currencies, such as Japan and Europe. For near-term investment purposes, we think the 10-year could test or even break through its 2012 low of 1.39%.

BY JEFF DICKS & JEFF EULBERG

AAA RATED MUNI YIELDS, % OF 10-YEAR UST, AND TAXABLE EQUIVALENT YIELD

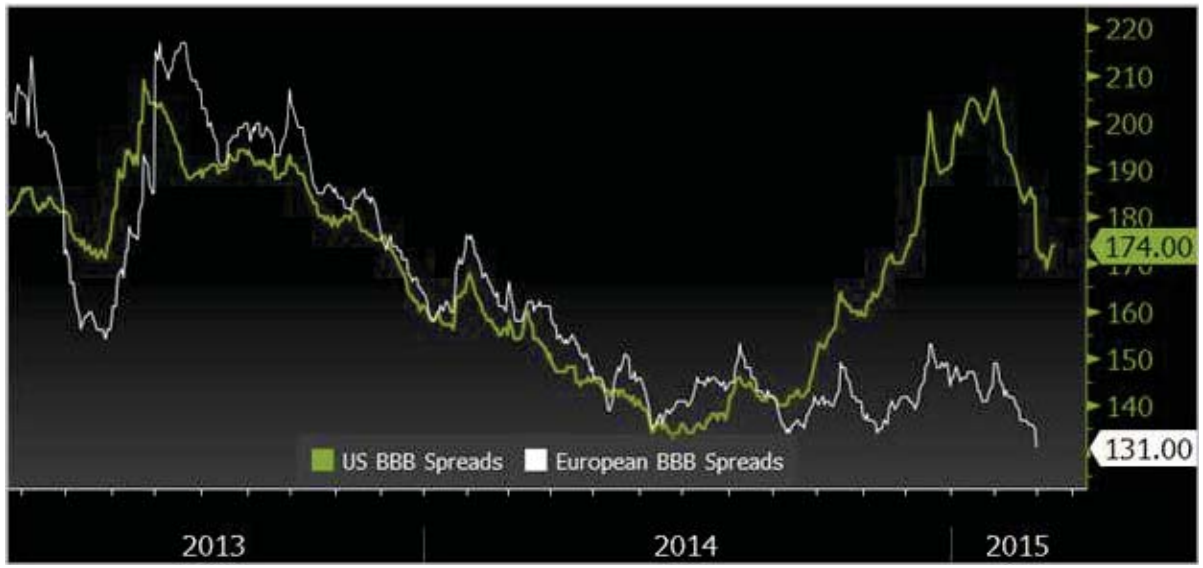


Source: Bloomberg, Evergreen GaveKal

To expand on the last topic, we also like high-quality munis for taxable accounts. This chart shows that AAA-rate munis are trading at a 2.06% yield. Again, this is not great by historical standards but, in today's world, a 2% tax-free yield isn't bad. The dash line on the chart illustrates the taxable-equivalent yield for the highest tax bracket (39.6%), which equates to a 3.4% yield. Said another way, the 10-year US Treasury would need to yield 3.4% for an investor in the 39.6% tax bracket to earn the same income. And, relative to treasuries, the yield ratio is the most attractive, at over 100%, than it's been in nearly two years.

BY JEFF DICKS & JEFF EULBERG

BBB-RATED CREDIT SPREADS FOR EUROPE AND THE US



Source: Bloomberg, Evergreen GaveKal

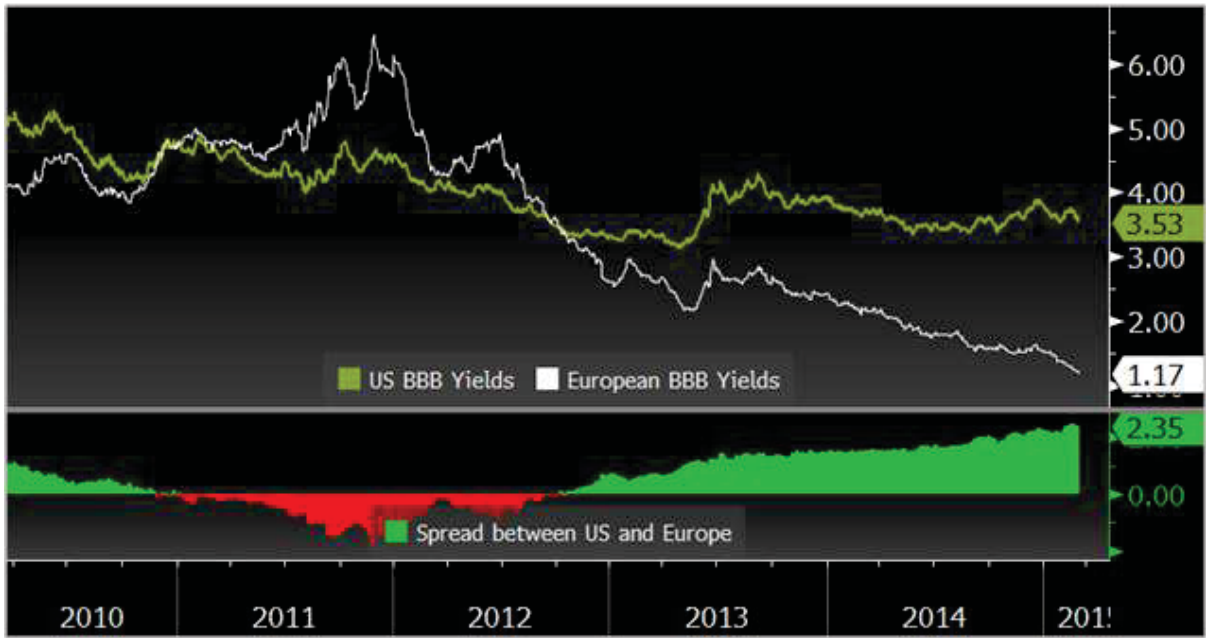
Shifting gears back to the US versus Europe discussion, we believe corporate debt is much more attractive stateside. The chart on the left shows both American and European BBB-rated credit spreads*, and the difference between the two. As you can see, US corporate bonds are perceived as being 40bps riskier than comparable eurozone corporate debt. We would argue that US corporates should trade on a tighter spread than Europe given a much healthier economic situation.

*The difference between the interest rate on corporate and government bonds

The Point Of No Return

BY JEFF DICKS & JEFF EULBERG

BBB-RATED YIELDS FOR EUROPE AND US



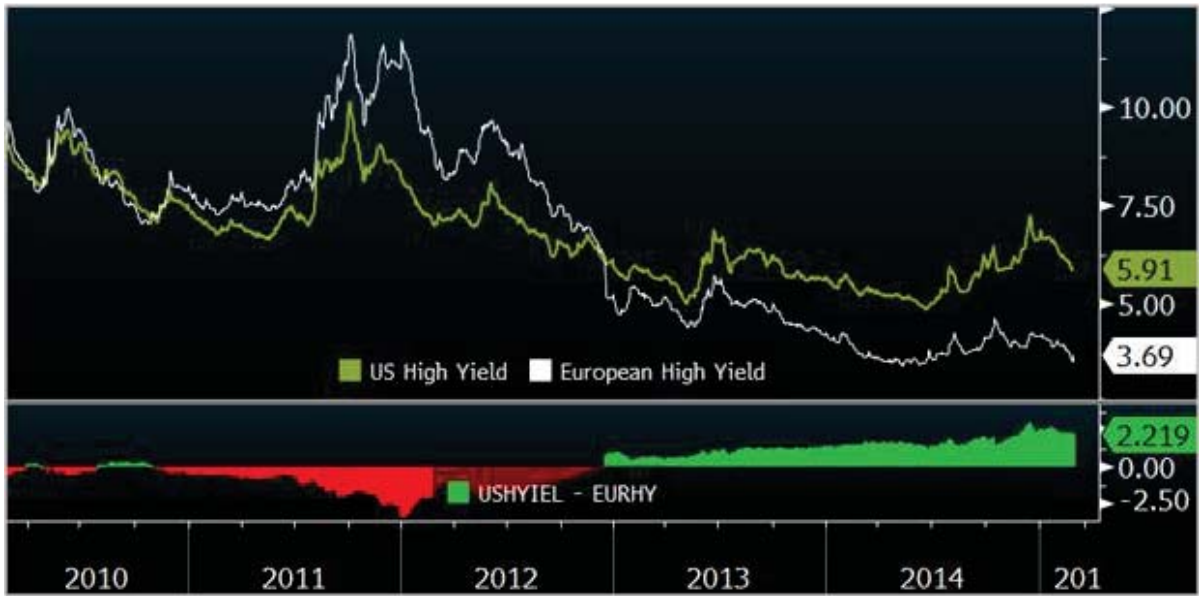
Source: Bloomberg, Evergreen GaveKal

Expanding on the last chart, when you take into account the risk-free rate, the total yield is much more appealing in the US. In fact, with negative yields for the benchmark index, a bit of an anomaly has occurred. Specifically, five-year corporate yields are now less than the credit spread itself. Said differently, BBB-rated corporate bonds in Europe trade at a spread of +131, but since the benchmark is negative, they only yield 1.17%!

The Point Of No Return

BY JEFF DICKS & JEFF EULBERG

JUNK RATED BOND YIELDS IN EUROPE AND THE US



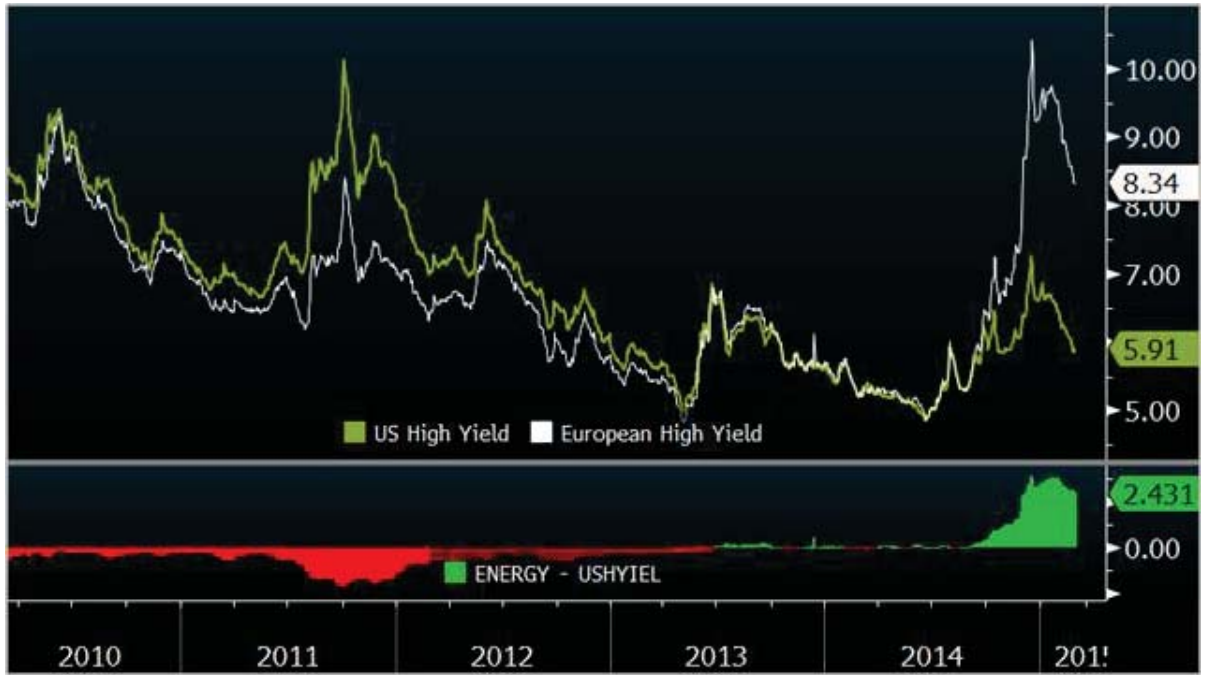
Source: Bloomberg, Evergreen GaveKal

Looking at high-yield bonds, we believe the same relationship holds. These securities yield almost 6% in the US, compared to just 3.7% for Europe. The differential between the two has shifted by nearly 5% over the last two years. In today's world of low interest rates, we believe that buying a BB-rated bond at a 5-6% value beats the alternatives. (Fun fact: Less than 1% of BB-rated bonds default per year.)

The Point Of No Return

BY JEFF DICKS & JEFF EULBERG

JUNK RATED BOND YIELDS IN ENERGY SECTOR VS. US

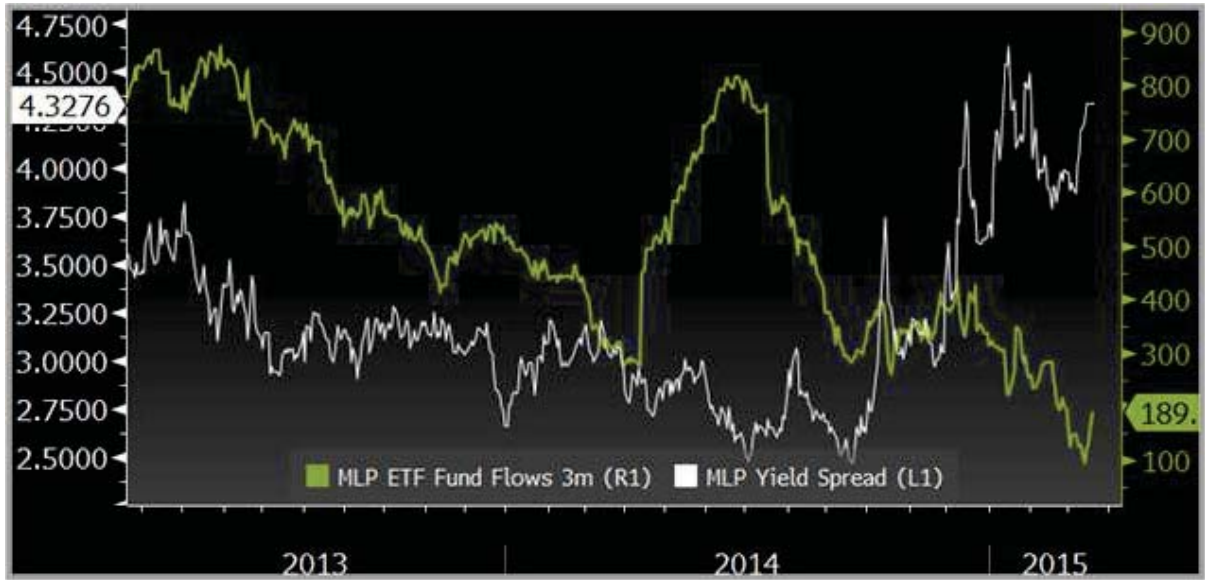


Source: Bloomberg, Evergreen GaveKal

We're also of the belief that there's value to be found in the high-yield energy market. As you can see in the chart, bonds in this space yield well over 2%, compared to similar-rated non-energy bonds. From 2010 through 2013, they primarily traded at a premium. In the energy sector, we like companies with some insulation from energy prices, such as Master Limited Partnerships (MLPs). Additionally, we're seeking out companies with strong balance sheets and liquidity profiles that can withstand an extended downturn. At the same time, we are avoiding companies rated single-B and below, and ones with excessive leverage. Since we think energy-related defaults will spike over the next year or two, it's extremely important to perform a financial background check before investing in this area.

BY JEFF DICKS & JEFF EULBERG

MLP YIELD SPREAD AND MLP ETF FUND FLOWS

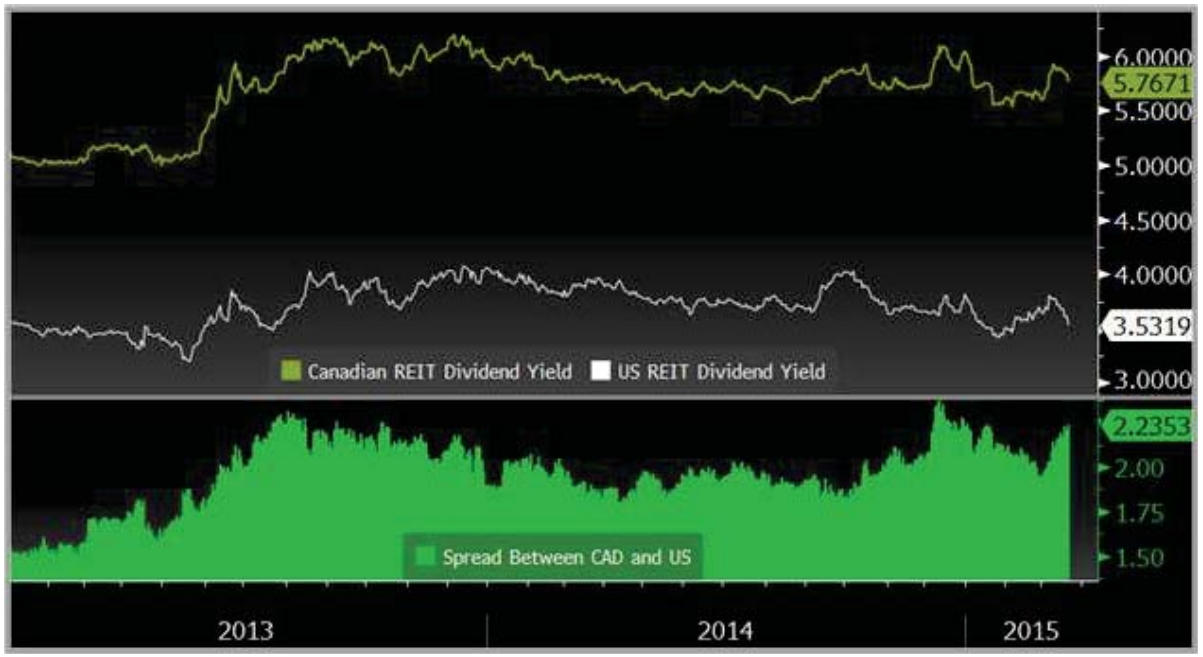


Source: Bloomberg, Evergreen GaveKal

While we're on the topic of energy, we should probably point out that we'd also advise gradually increasing weightings in MLP-related equity. As the chart on the left shows, the yield differential between MLPs and US Treasuries has increased by 60% over the last several months. With MLPs yielding over 6%, and distributions growing 3-5% per year, we think future returns are bright. Fund flows into the space are also well below the historical average. Prior to the recent sell-off, you can see there were massive inflows, which tend to be a good time to reduce exposure to almost any asset class. On the flip side, when fund flows are depressed, it's often a good indicator to buy.

BY JEFF DICKS & JEFF EULBERG

CANADIAN AND US REIT DIVIDEND YIELDS



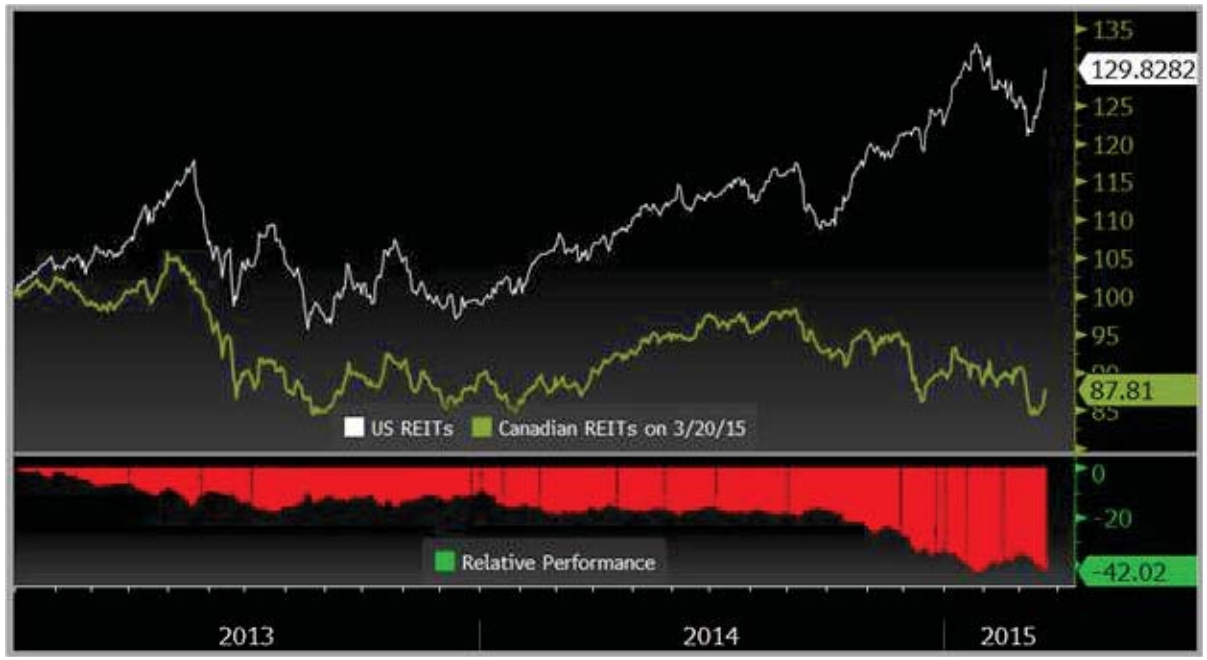
Source: Bloomberg, Evergreen GaveKal

Also, in the equity income space, we think Canadian REITs offer exceptional value. We have discussed these securities at length in past EVAs but, as a reminder, the yield pickup between the US and Canada in the REIT space is significant at over 220bps (2.2%). It's also worth noting that REITs trade at a substantial discount on a price-to-cash flow basis in Canada, compared to the US.

The Point Of No Return

BY JEFF DICKS & JEFF EULBERG

PERFORMANCE US REITS VS. CANADIAN REIT NORMALIZED 12/31/12 AT 100 IN USD

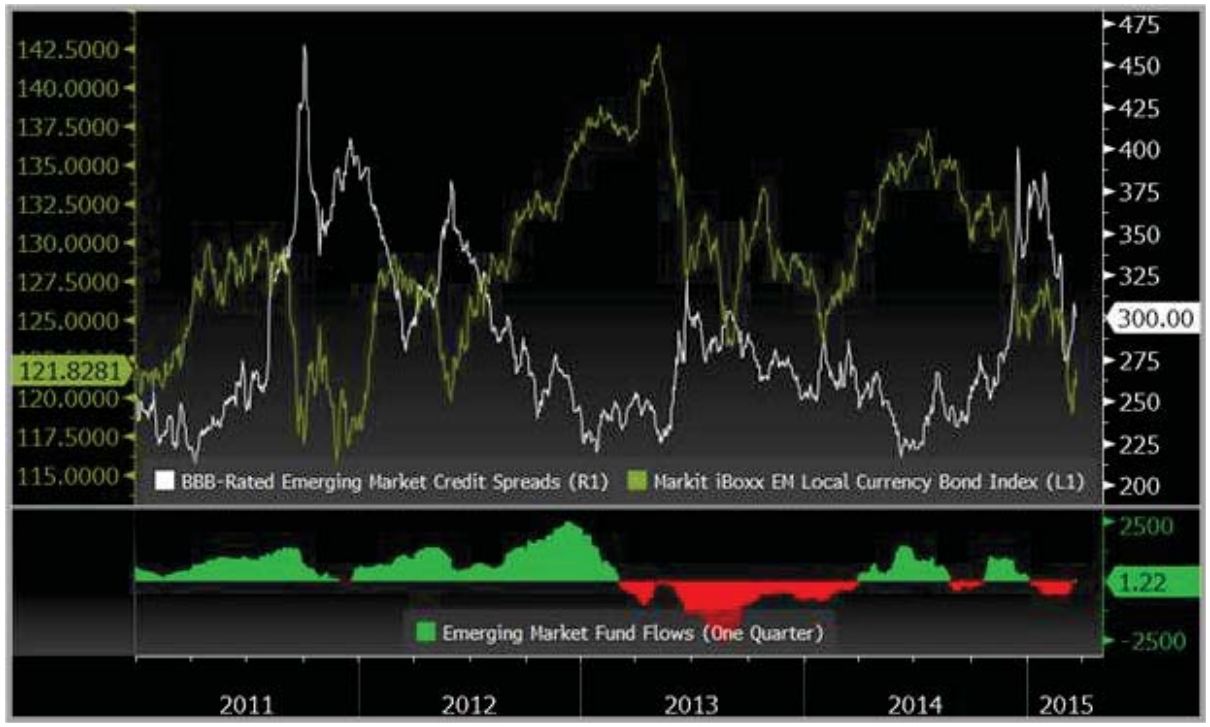


Source: Bloomberg, Evergreen GaveKal

Canadian REITs have also significantly underperformed in USD compared to US REITs. As the chart to the left shows, US REITs have outperformed CAD REITs by over 42% since 12/31/2012. This is due to the combination of a falling Canadian dollar and outperformance of US REITs. Overall, we think high current income, a depressed currency, and depressed share prices (in local terms) will boost long-term returns.

BY JEFF DICKS & JEFF EULBERG

IBOXX EM LOCAL CURRENCY INDEX, EM CREDIT SPREADS, AND CUMULATIVE ONE QUARTER FUND FLOWS

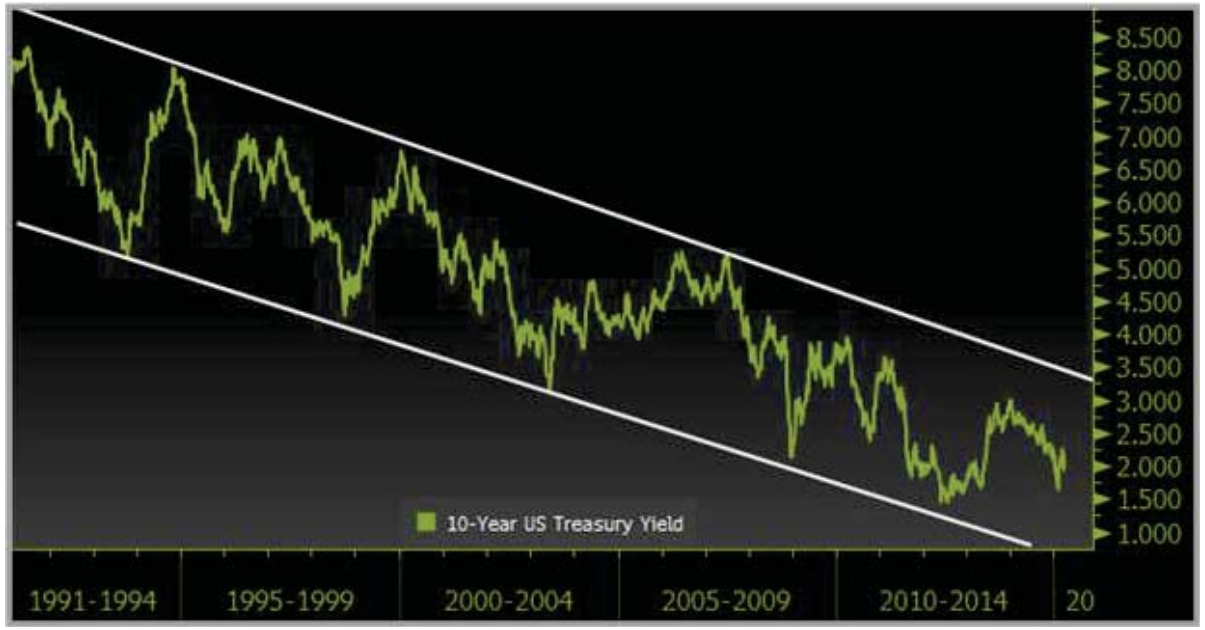


Source: Bloomberg, Evergreen GaveKal

The next chart illustrates an emerging market (EM) local currency price index, EM local currency fund flows and credit spreads for the space. As you can see, this area of the market has experienced serial outflows over the last two and a half years. Additionally, prices have fallen by more than 15% over the last two years and are flat over the last four-year period. As a result, they've massively underperformed other income investments over this time-frame. Credit spreads, on the other hand, are right around their historical average and currency momentum has been extremely weak. While we are taking a cautiously optimistic approach in this space, given material weakness, we think this asset class offers a very compelling risk/reward proposition.

BY JEFF DICKS & JEFF EULBERG

LONG-TERM BOND BULL MARKET STILL INTACT



Source: Bloomberg, Evergreen GaveKal

Finally, we have a long-term chart of the 10-year Treasury yield. Over the last 30 years, we have certainly witnessed a bond bull market of epic proportions. And while we know it won't last forever, we believe it still has room to run. Looking closer at the chart, the long-term trend is still intact, and we've still yet to see the 10-year Treasury break above its long-term downtrend. In the current global environment of evaporating yields we think it's critical to take advantage of sell-offs and divergences in the space. We do believe this is a time where US yields are much more attractive than those overseas. Additionally, corporate bonds, MLPs, and Canadian REITs also offer relatively attractive entry points. Ultimately, we believe that—when looking back in a few years—locking in today's yields in the 5-7% range will have been a wise choice.