

MARCH 11, 2016

"We really can't forecast all that well, and yet we pretend that we can, but we really can't."

- Alan Greenspan

SUMMARY

BULLISH SUMMARY

- The latest growth scare is over, and the US economy is set to accelerate.
- The risks that drove the latest panic in global markets (US growth, oil oversupply, and a Chinese currency devaluation) were overblown and have begun to recede.
- Credit spreads (the gap between what corporate and government bonds yield) peaked in February and have narrowed considerably in recent weeks. Given their extreme importance to the economy and financial markets, this is great news.
- This environment is more like the 2011 correction than the 2008 with a lot of upside left to come.

BEARISH SUMMARY

- While sentiment has improved with the global market melt-up, economic and earnings fundamentals have not changed.
- Risks are rising in the US economy and around the world as the Fed tightens after years of misallocation and foreign central banks scramble to address their own growth problems via competitive easing.
- The ability of central banks to exert a "shock and awe" influence on stock markets is clearly fading.
- This environment is more like the run-up to the 2008 crisis (but, hopefully, without the risk of a financial system collapse) than the 2011 correction.

The following commentary is from the Evergreen Investment Team:

THE BULL CASE

Goodbye, growth scare; hello, growth spurt!

While global markets sold-off violently in January and February, on growing fears of a weakening US economy, a flood of new Middle Eastern oil production, and a Chinese currency devaluation such concerns now appear to be overblown.

For starters, US economic growth and inflation are reaccelerating with the Atlanta Fed's "GDP Now" forecast for Q1 economic growth nearly doubling to 2.2% over the course of the last month and the core consumer price index (which excludes food and energy) currently running well above the Fed's 2% target.

With unemployment now below 5%, auto sales near their highest levels since 2005, and nationwide home price indices back to their strongest levels since 2007, we are seeing few signs of an imminent recession.

Yes, the strong US dollar has clearly weighed on manufacturing and mining (including oil production), but the rest of the US economy – which is heavily dominated by services – has continued to expand even in the face of rising corporate borrowing costs.

Moreover, those headwinds may be fading now that the Federal Reserve is reassuring that any future rate hikes will be cautious and gradual. This has led to clear reversals in both corporate credit spreads (how much more corporations have to pay to borrow money in the bond market than does the US government) and the trade-weighted US dollar.

If these emerging trends persist, it could breathe new life into cyclical US stocks, stem the tide of China's troubling capital outflows, and support a continued reflation in major commodity markets... particularly oil, which has been one of the biggest drivers of the recent panic.

The “lower for longer” outlook for global energy markets has worked its way into the consensus over the past six months with fears that a price war between Saudi Arabia and Iran would leave the world awash with oil. However, we’re already seeing a number of signs that non-OPEC production is falling amid ongoing depletion, substantial cuts in planned investments by major energy companies, and a steady decline in active oil rigs across the United States (the US rig count is now down 75% from its 2014 peak).

The 2 million barrel per day (bpd) production glut may sound like a huge number, but the fact of the matter is that it’s only about half the annual depletion rate of roughly 4 million bpd. Therefore, all we need to see is a modest fall in daily production rates for global supply to start coming back in line with global demand, which may accelerate if the US dollar continues to weaken.

It’s a slow process to be sure, but something the markets may already be anticipating with WTI crude oil up more than 45% since the \$26 per barrel bottom in mid-February as the strong US dollar has started to roll over. Today’s announcement by the International Energy Agency (IEA) that non-OPEC crude output is falling faster than expected is an indication the oil market may be coming into balance sooner rather than later.

With the sharp snap-back in everything from the S&P 500 and junk bonds to emerging market currencies and commodities, global financial markets are now telling us that the intense pessimism at the beginning of the year was overblown. Rather than resembling 2008 for the global economy and financial markets, the latest panic looks more like 2011 where markets struggled after the end of QE2. Even yesterday’s market fizzle in response to the European Central Bank’s latest extreme stimulation measures is being reversed today.

Instead of falling into a US equity bear market, we’ve just been working through a normal correction, or as Gavekal’s Anatole Kaletsky offered earlier this year, “a pause that refreshes.” And if these trends (weakening US dollar, falling corporate credit spreads, reflating commodities) persist, it won’t be long until depressed pockets of the US equity market take off as earnings bounce back.

THE BEAR CASE

Despite the powerful short-covering rally we’ve seen since mid-February, not much has changed in terms of the underlying economic and/or earnings fundamentals.

Here in the US, we’re still living in a stop-and-go economy as the Federal Reserve’s ever-changing guidance on interest rates fuels big swings in the trade-weighted US dollar and corporate credit borrowing costs. A hard “stop” could very well mean outright recession in 2016 or 2017, but even the “go” periods aren’t very exciting as our rising debt burden (now 350% of GDP) keeps real GDP growth capped at roughly 2%.

Yes, economic growth appears to be strong and durable enough with low and falling unemployment, strong auto sales, and cycle highs in home prices, but these are the same classic lagging indicators that characterized the late stages of the last business cycle in 2007.

A deeper dive into the economic data suggests the consumer is still quite weak with a large portion of new job creation coming from lower-quality, part-time gigs. For sure, low gasoline prices have helped to offset the rising costs of healthcare and education. But, the net effect is still negligible as the balance sheet effects from the commodity crash create headwinds for employment as more US energy firms suspend some or all of their operations. In the process, these reeling oil and gas producers are eliminating many of the best paying jobs created during this expansion.

Years of ultra-low interest rates and aggressive money printing have made the rich richer by fueling asset price bubbles around the world. Meanwhile, the American middle class is under siege as a result of the downward wage pressures from globalization (e.g. offshoring of manufacturing jobs) and automation (e.g. software and robots replacing human workers).

In fact, recent data shows that 46 million Americans are now on food stamps (compared to the long-term average of 2.9 million). Considering that the labor force participation rate is now back to levels not seen since the late 1970s, it’s clear that there are a growing number of “riders” versus “rowers” in our economy, which is intuitively creating a huge drag on GDP.

With that in mind, it shouldn’t be a huge surprise that populist movements are redefining US politics with the Presidential election season now in full swing. (By the way, the same is true in Europe where a lengthy list of nationalistic and anti-

immigration politicians are riding ascending waves of popularity.) If clear extremists like Donald Trump or Bernie Sanders somehow find their way into the White House later this year, it could usher in a wave of trade protectionism unlike anything we have seen since the 1930s.

In a world where enormous excess capacity, high debts, aging workforces, technological innovation, and competitive currency devaluation are already creating profound deflationary pressures, the last thing the global economy needs is for the world's largest consumer economy to shun trade with the rest of the world. But, as in the 1930s, it may be exactly what we get in the coming year.

Debt is an even greater concern beyond our borders as China, Europe, Japan, and a number of clearly-overextended emerging markets struggle to cope with insolvent banking systems, fragile government bond markets, and double digit declines in global trade. Anything that pushes one or all of these regions into crisis (like competitive monetary easing or an outright Chinese currency devaluation) could be enough to send powerful economic and financial shocks back to the United States, which is simply not strong enough to keep growing as global growth continues to crumble.

That said, we're already seeing a number of signs that the US business cycle may be turning on its own.

While credit spreads have come down in recent weeks, corporate borrowing costs are still clearly in an uptrend as signs of distress keep popping up in sectors that once appeared immune to problems in the energy and mining sectors. What we are seeing, quite simply, goes beyond the commodity crash. It's broad-based weakness with junk bond defaults appearing to accelerate instead of cresting with the recent bounce in sentiment.

This kind of corporate distress – together with the worst earnings recession since the global financial crisis – suggest the odds of a recession in 2016 or 2017 is much higher than most investors now realize. It also could mean that a bear market in US equities is already underway.

Since 2009, buoyant US equity prices have largely been a function of excess liquidity. Markets rallied as the Fed purchased mortgage-backed securities and US Treasuries on the open market and went sideways at best whenever the taps turned off. But not only did the Fed end its QE3 asset purchases in October 2014, it also has been steadily tightening financial conditions ever since. Additionally, with the recent pullback in the US dollar and tightening in corporate credit spreads, it raises the odds for future rate hikes by the FOMC in 2016. This would presumably breathe new life into the dollar and widen credit spreads once more.

It may be tempting to view the latest bounce in global financial markets as a sign that risks have somehow receded and that the latest growth scare is over, but sentiment is always fickle in bear markets. The inescapable truth is that economic growth is driven by demographics and productivity, and both are remarkably weak at a moment when the Fed is steadily draining US dollar liquidity from the global financial system.

From that perspective, the current macro environment looks a lot more like the set up to a 2008-style crisis—sans the near collapse of the US banking system—than the overblown panic-attack of 2011. Similar to 2008, we are late into an up-cycle for stocks after years of aggressive Fed easing that sowed the seeds of malinvestment and wealth destruction all around the world.

For now—and until stock prices fall much more than they have—that easy money has come to an end, at least in the US. Once the latest round of short-covering runs out of steam, investors will find plenty of reasons for worry (or at least caution) as fundamentals continue to deteriorate—especially considering this bull market just became the third longest in history. Such a long up-trend, combined with one of the highest valuations of all-time, seems totally at odds with a world that appears increasingly out of control.

Closing comment. One of the dangers of examining both sides of an important topic—like the future direction of US stock prices—is that readers come away confused as to what to believe. That's a risk but, to add a Yogi Berraism to Alan Greenspan's opening admission, "it's always hard to make predictions, especially about the future." Nowhere is that more true than with the stock market.

Evergreen is a total believer, however, that in the long run, valuations are the ultimate determiner of future returns. In other words, when stock prices are high, gains from stocks over the ensuing decade are ALWAYS low. In the short-run, they can keep

overachieving but history tells us this only leads to even more inferior results in subsequent years. Despite the best (worst?) efforts of the planet's "monetary mandarins", as Jim Grant calls central bankers, reversion to the mean still rules.

Based on the reality that this remains one of the most expensive stock markets ever seen—and that the main driver in recent years, the Fed's magical money machine, has been deactivated—Evergreen remains cautious. However, we are hedging our bets by having overweight positions in some of the shattered, but now aggressively recovering, sectors like energy, mining, and Canadian REITs. Despite this resurgence, all three continue to strike us as significantly undervalued, in vivid contrast to most areas of the American equity market.

OUR CURRENT LIKES & DISLIKES

Changes are noted in bold.

WE LIKE

- Large-cap growth (on a deeper pull back)
- International developed markets (on a deeper pull back)
- Canadian REITs (**on a pull back**)
- BB-rated corporate bonds (i.e., high-quality, high yield)
- Cash
- Publicly-traded pipeline partnerships yielding 8%-13% (MLPs)
- Intermediate-term investment grade corporate bonds, yielding approximately 4%
- Gold-mining stocks (**on a pull back**)
- Gold (**on a pull back**)
- Intermediate municipal bonds with strong credit ratings
- Long-term municipal bonds
- The Indian stock market
- Long-term Treasury bonds
- Select blue chip oil stocks
- 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
- Intermediate Treasury notes

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

the Evergreen
VIRTUAL
ADVISOR

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