

EVERGREEN  GAVEKAL



Monthly Chartbook

JANUARY 2015

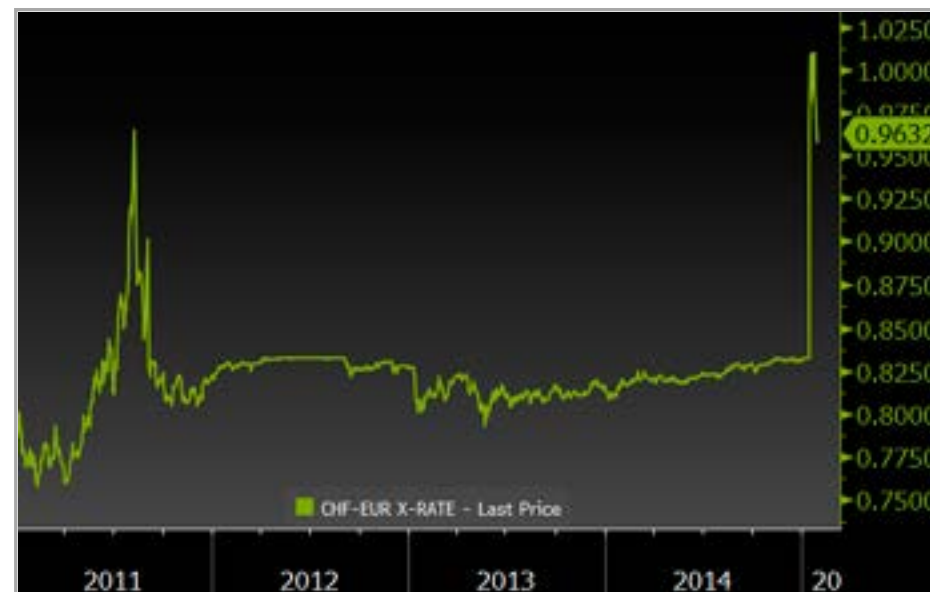
BY DAVID HAY

Exhibit A. One would have to be a most sporadic reader of the *Evergreen Virtual Advisor* (EVA) not to realize we are passionate in our conviction that extended periods of artificially repressed volatility ultimately cause explosive price swings. Frankly, though, there haven't been many tangible examples of this phenomenon in recent years. This is almost certainly due to the fact that the global monetary maestros—aka, the planet's central banks—have been so successful in the volatility-suppression game. Until lately, that is...

We've noted that the Swiss National Bank's (SNB) recent decision to quit spending staggering sums as a percentage of the tiny country's GDP to link its currency to the euro was a pivotal event. It ended a campaign the SNB had waged since 2011 to prevent the Swiss franc from finding its natural level. It is now safe to say that would have been far above where it traded over the last three plus years.

The wages of this pseudo valuation structure became shockingly apparent on January 15th when the SNB threw in the towel and let the Swiss franc's price be set by market forces. The result was a 39% super-surge in the first few minutes of unconstrained trading before the "Swissie" settled at "just" a 16% one-day rocket in value. Now, that's some serious hyper-volatility after years of contrived flat-lining.

SWISS FRANC VERSUS EURO



Source: Bloomberg, Evergreen GaveKal

This little experiment in trying to deny the inexorable equilibrium of supply and demand cost the SNB a cool \$70 billion, give or take, amounting to around 10% of GDP and a nauseating loss of approximately \$9000 per Swiss citizen. This would be like the Fed blowing \$1.7 trillion (then again, there's still time for the Fed to play catch up!).

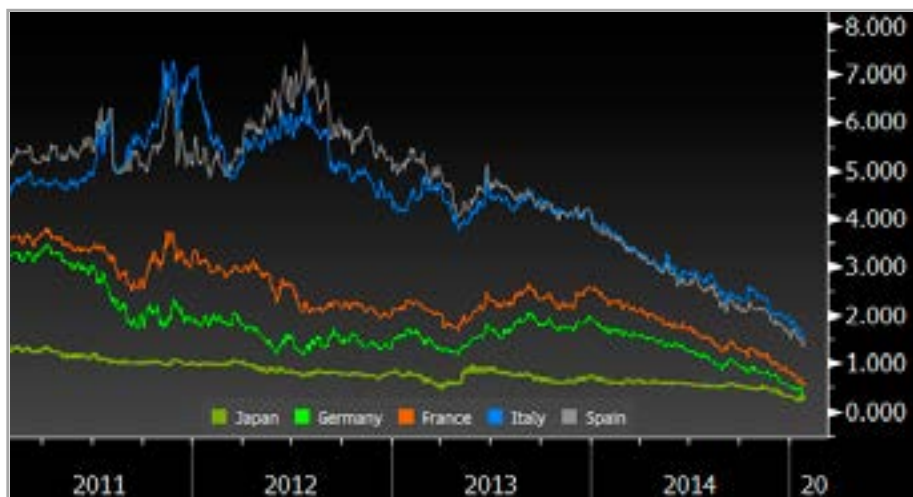
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MONTHLY CHARTBOOK EVA / JANUARY 30, 2015

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Exhibit B. Of course, this is but one of many instances where central banks have intervened to deny reality. Let's consider what may be the epic distortion of our time: government bond yields in Japan and the eurozone. As you can see below, the march toward zero interest rates—incredibly, even on 10-year maturities—continues apace.

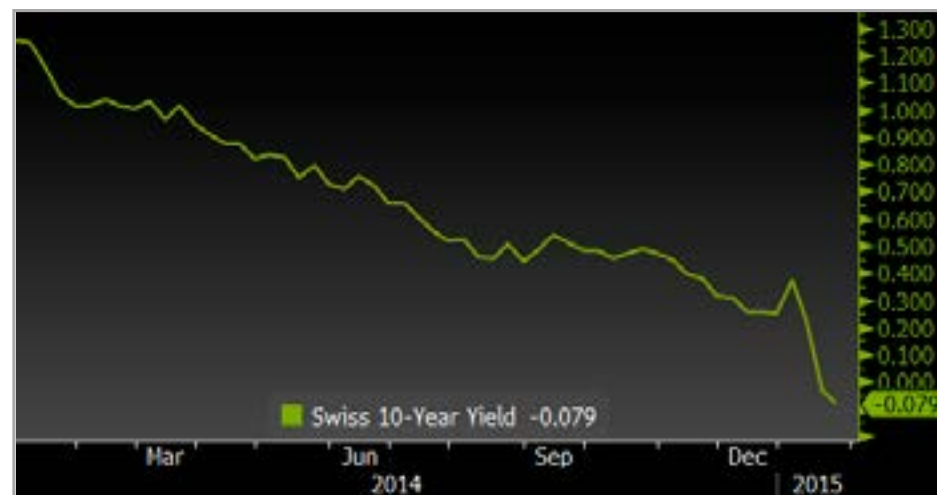
10-YEAR GOVERNMENT BOND YIELDS



Source: Bloomberg, Evergreen GaveKal

In fact, German sovereign bond yields are negative out to seven years. In Switzerland, they are sub-zero even at a 10-year maturity. Thus, investors are paying the Swiss government to hold their money for ten years.

SWITZERLAND 10-YEAR BOND YIELDS



Source: Bloomberg, Evergreen GaveKal

It's interesting that Switzerland is not attempting to force yields down, unlike the European Central Bank (ECB). Rather, it is the specter of a severe recession and enduring deflation—caused by the traumatic spike in the Swiss franc and the hurt that puts on its many multinational corporations—that has produced this almost incomprehensible negative yield status.

Okay, but what does that have to do with the only asset class US investors care about these days—the S&P 500?

Monthly Chartbook

MONTHLY CHARTBOOK EVA / JANUARY 30, 2015

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Exhibit C. Never in the history of our fair country has the Fed overtly sought to drive stock prices to lofty levels—and keep them there. Consequently, the S&P 500 has gently, but relentlessly, worked its way up to one of its most expensive valuations ever. The correlation between the increase in the Fed's balance sheet (i.e., the bogus bucks created through QEs I, II, and III) has been uncanny.

S&P 500 AND FED BALANCE SHEET



Source: Bloomberg, Evergreen GaveKal

For sure, I thought that once QE 3.0 ended, stocks would have come under more pressure than they did. Additionally,

the strength of the year-end rally caught me off-guard (again!). But it's noteworthy that the S&P 500 has essentially gone sideways since last August. Prior to this, stocks hadn't treaded water throughout a six month interval over the last three years. Naturally, the US market could pop nicely in the next 30 days, keeping the streak alive, but the wind does feel like it is shifting.

S&P 500 SIX MONTH PRICE CHANGE



Source: Bloomberg, Evergreen GaveKal

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MONTHLY CHARTBOOK EVA / JANUARY 30, 2015

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The Spread's the Thing. Moving away from those areas where manipulation has been overt, there are a few critical markets that have been indirectly impacted, even if counter-intuitively. The first is the Commodity Research Bureau (CRB) metals index. Certainly, it was never an express goal of the world's monetary mandarins to inflate, or even support, commodity prices. However, many pundits assumed that hard assets would be beneficiaries of the creation of trillions of ersatz money. Instead, metals are down nearly 30% since global QEs went into hyperdrive.

THE CRB METALS INDEX

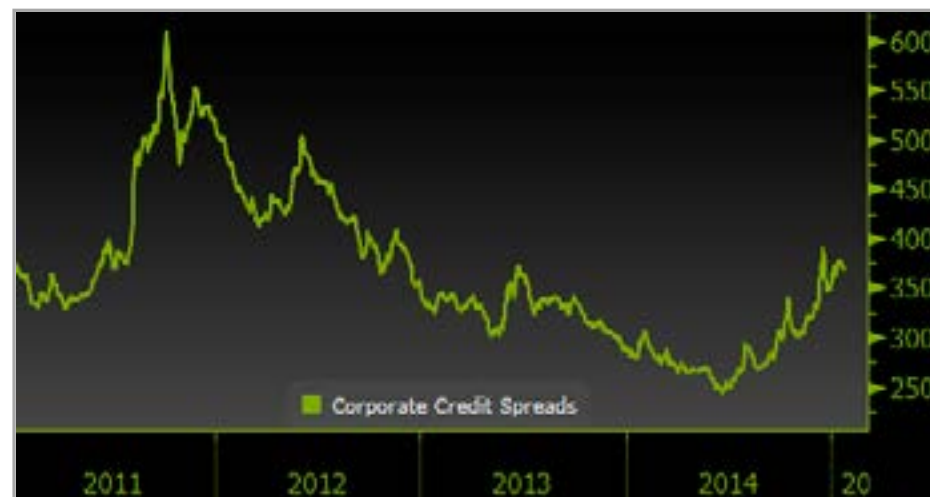


Source: Bloomberg, Evergreen GaveKal

Frankly, I hadn't previously noticed the inverse correlation between credit spreads* and commodity prices. But as

you can see from the chart below, the first pummeling of commodities happened in mid-2011 when corporate spreads went postal. Then, as they eased substantially, bottoming out last summer, commodity prices stabilized and even rallied somewhat.

CORPORATE CREDIT SPREADS



Source: Bloomberg, Evergreen GaveKal

Of course, as repeatedly mentioned in EVAs since then, spreads began to break their multi-year downtrend and reverse decidedly higher about seven months ago. *(This section continues on the next page.)*

*The yield differential between government and corporate/non-Federally guaranteed bonds and mortgage-backed securities.

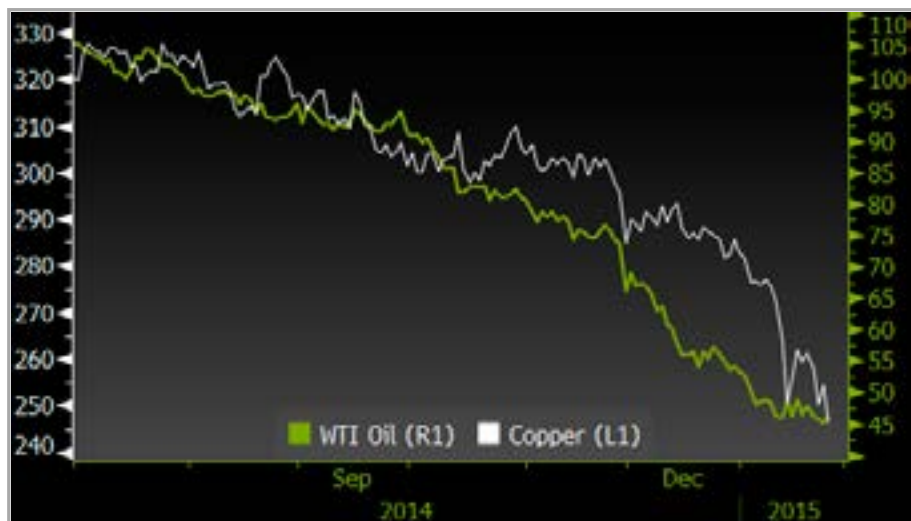
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This has coincided with another crack in metals, including copper, which is regarded as one of the most telling when it comes to the strength—or weakness—of the global economy. And, of course, oil has been slaughtered in this timeframe. This commodity implosion is definitely a most unexpected consequence of the “From Here to QEternity” era.

PRICE OF OIL AND COPPER

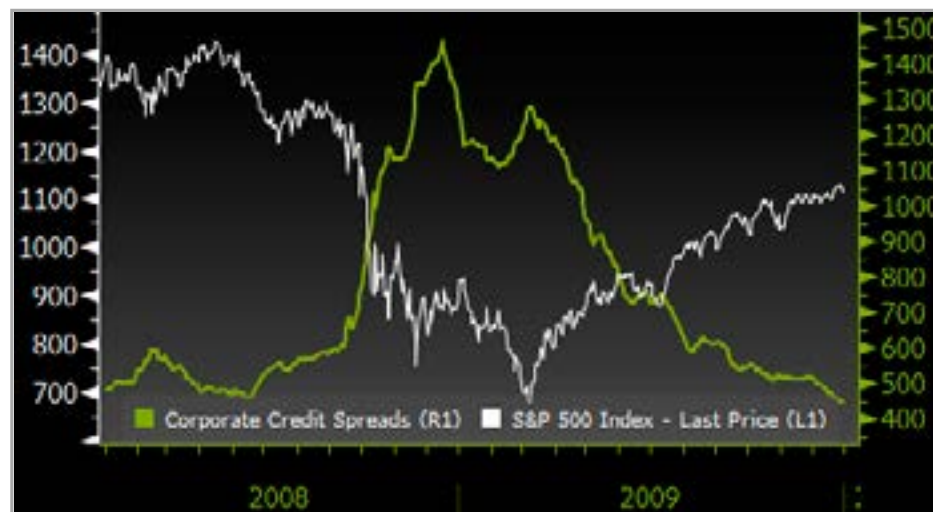


Source: Bloomberg, Evergreen GaveKal

The steady decline in credit spreads since the tumultuous summer of 2011 was arguably one of the most important drivers of the big stock rally since then. Certainly, the

historic increase by spreads in 2008 was a key cause of that horrific market environment. Further, when spreads began to come off those record-breaking levels in March of 2009, it coincided with the lift-off phase of what has become one of the longest running bulls of all time.

CORPORATE CREDIT SPREADS AND THE S&P 500



Source: Bloomberg, Evergreen GaveKal

Of course, this could all be just a coincidence, especially since the fairly material expansion in credit spreads since has not taken the spring out of the stock market's step—at least until this month. Perhaps it's a case of post-traumatic spread widening syndrome...

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Good news/bad news. Markets typically don't like dramatic spread widening events, but US retail investors should—if they are not excessively exposed to stocks. This is because, as noted above, there is not a more endangered species on the planet than a decent interest rate on lent capital. But thanks to the also aforementioned spread surge in the US, investors have the ability to secure yields ranging from 5% to 7%. Inexplicably, this has not been the case in Europe, despite its lengthy list of economic challenges.

SPREADS HAVE WIDENED IN THE US, BUT NOT IN THE EUROZONE—MAKE SENSE?



Source: GaveKal Data/Macrobond

Frankly, most investors I talk to don't seem too impressed by this situation, but I think they are making a huge mistake. Once the stock market finally hits the wall (and there does appear to be a close-encounter-of-the-brick-kind occurring lately), the realization of how return-deficient the investment landscape has become will hit home like—sorry—a ton of bricks. We do realize spreads could widen out further which is why we are keeping a higher level of cash on hand than normal for the income side of our clients' portfolios. Yet, we believe it's essential to be accumulating corporate yield securities in case we are close to the peak in spreads and yields.

Monthly Chartbook

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And emerging good news. Few asset classes have been as victimized by spread widening as emerging market debt. Between the dollar's ascent, concerns about some \$9 trillion in US dollar-denominated borrowings by the developing world, and the worrisome path of global growth, emerging market debt and currencies are deep in the penalty box. In fact, a basket of developing country currencies are essentially at 15-year lows.

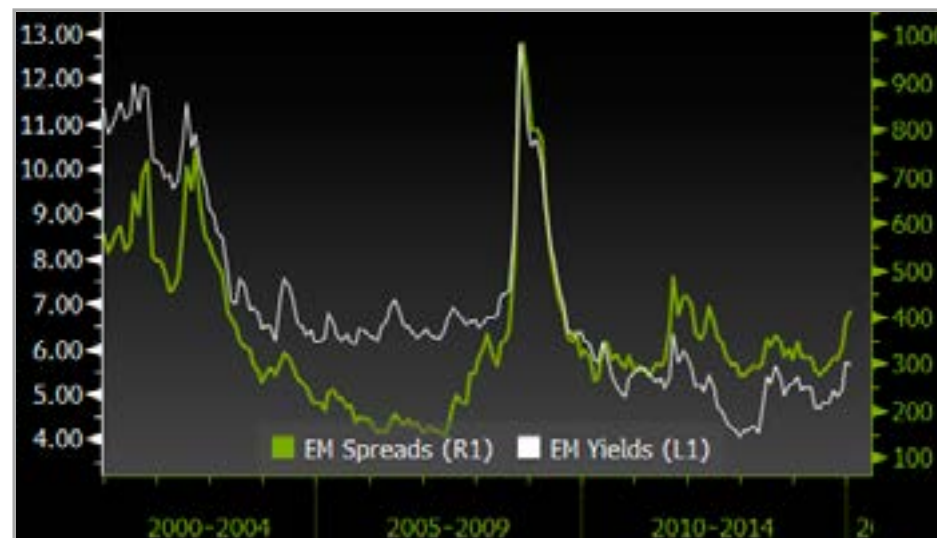
EMERGING CURRENCIES BACK TO 2003/2009 LOWS: GLOBAL VIEW



Source: JPM Index of Emerging Currencies

Yields, as well as spreads relative to US treasuries, though, are not quite up to where they topped out in 2011 and way below their peaks in 2008. Accordingly, it may be premature to be too aggressive in buying emerging market debt, especially in local currencies (versus dollar-denominated). Sometime this year, however, it may be time to ramp up exposure and capture some truly exceptional yields.

BANK OF AMERICA EMERGING MARKETS DEBT INDEX



Source: Bloomberg, Evergreen GaveKal

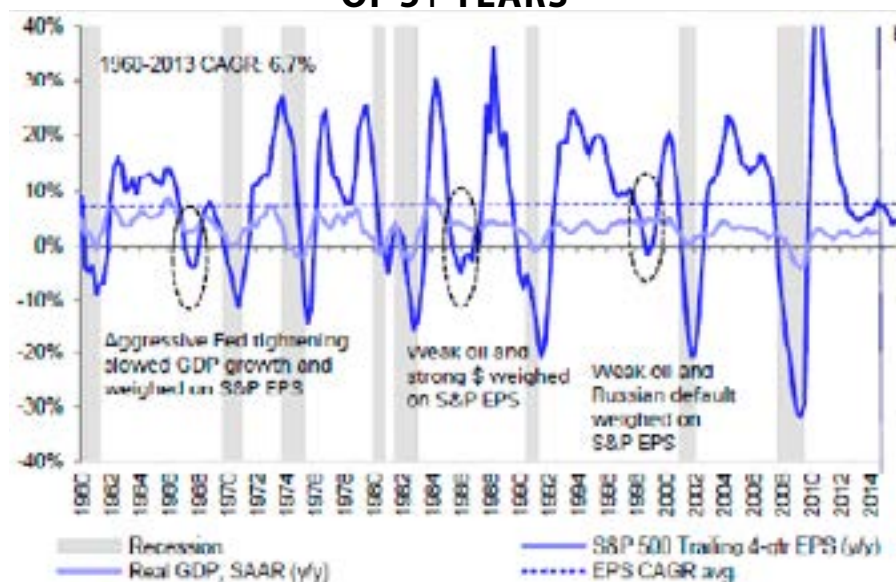
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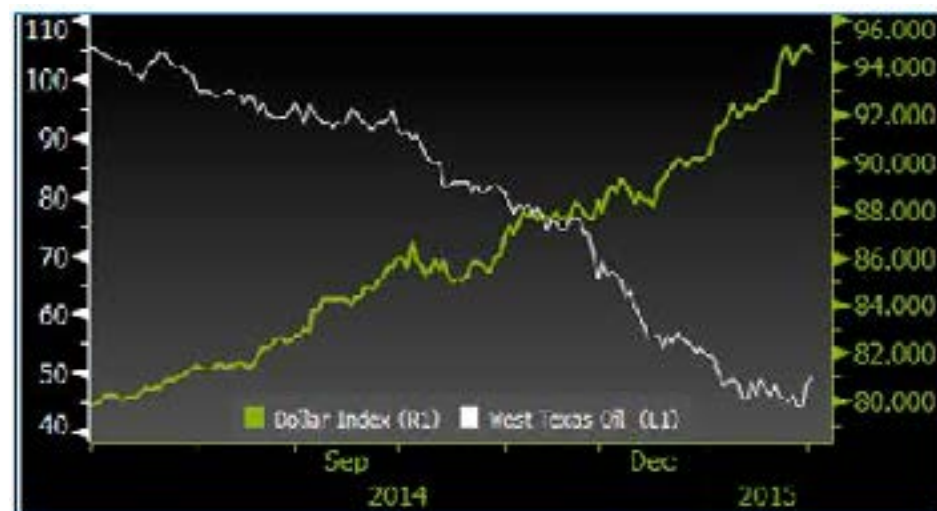
Then some so-so news. Despite America's limp recovery, we are the envy of most of the world, where recessionary and deflationary forces are intensifying. On the positive side, we don't see an actual recession engulfing the US anytime soon. On the other hand, a "profits recession" strikes us as much more likely. These are defined as two consecutive quarters of falling earnings by the S&P 500. Interestingly, these happen fairly often in long-lasting expansions such as we are in currently.

PROFIT RECESSIONS ARE RARE OUT OF RECESSIONS, BUT IT HAPPENED IN 3 OUT OF 4 US EXPANSIONS OF 5+ YEARS



Source: S&P, I/B/E/S, Deutsche Bank

A FURTHER SLIDE IN OIL PRICE WILL RAISE THE RISK OF PROFIT RECESSION IN 2015



Source: Bloomberg, Evergreen GaveKal

Such events have been caused in the past by a combination of a rising dollar and falling oil prices. In case you've been on an extended trek in Katmandu, this is exactly what has been happening of late. Both of these factors also are clearly affecting earnings reports coming out this month even (especially?) among America's multinational titans. Maybe the risk of a profits recession and the delayed recognition of the drag from significantly wider credit spreads is the reason this very elderly bull is finally feeling its age.

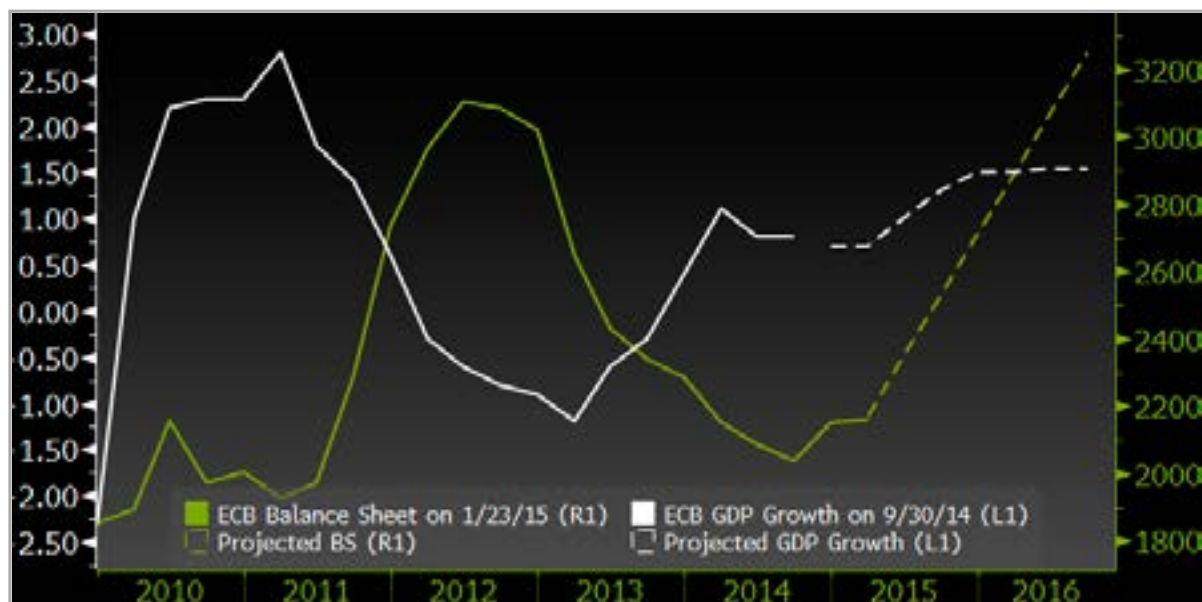
Now let's see what the two Jeff's have to say...

European Quantitative Easing Program

MONTHLY CHARTBOOK EVA / JANUARY 30, 2015

BY JEFF DICKS & JEFF EULBERG

ACTUAL AND PROJECTED ECB BALANCE SHEET AND REAL GDP GROWTH



Source: Bloomberg, Evergreen GaveKal

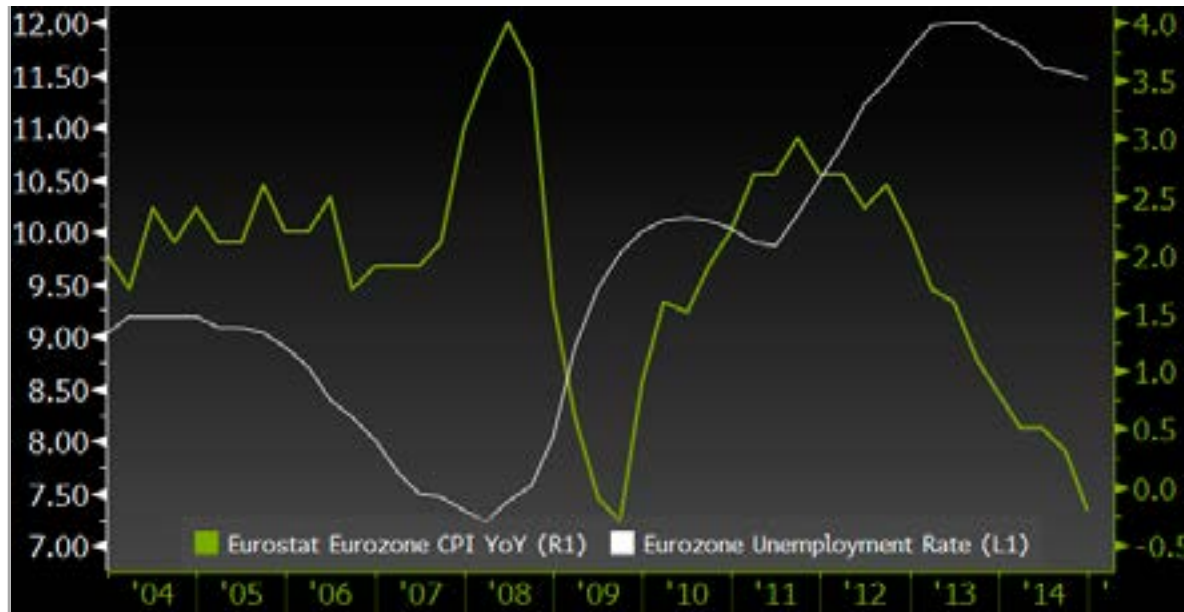
Last week, the European Central Bank (ECB) announced a new quantitative easing program (QE), which calls for €60 billion of monthly bond buying by the central banks from March 2015, to September of 2016. As you can see on the left, this will increase the ECB's balance sheet by over €1.1 trillion. Interestingly, over the last five years, the ECB's balance sheet appears to actually have a negative correlation to growth in the region. In this section of the chart book, we will analyze why the ECB is launching QE, how these programs have correlated with real growth in the past, the major issues facing Europe, and other alternatives to quantitative easing.

European Quantitative Easing Program

MONTHLY CHARTBOOK EVA / JANUARY 30, 2015

BY JEFF DICKS & JEFF EULBERG

EUROZONE INFLATION AND CONSUMER PRICES



Source: Bloomberg, Evergreen Gavekal

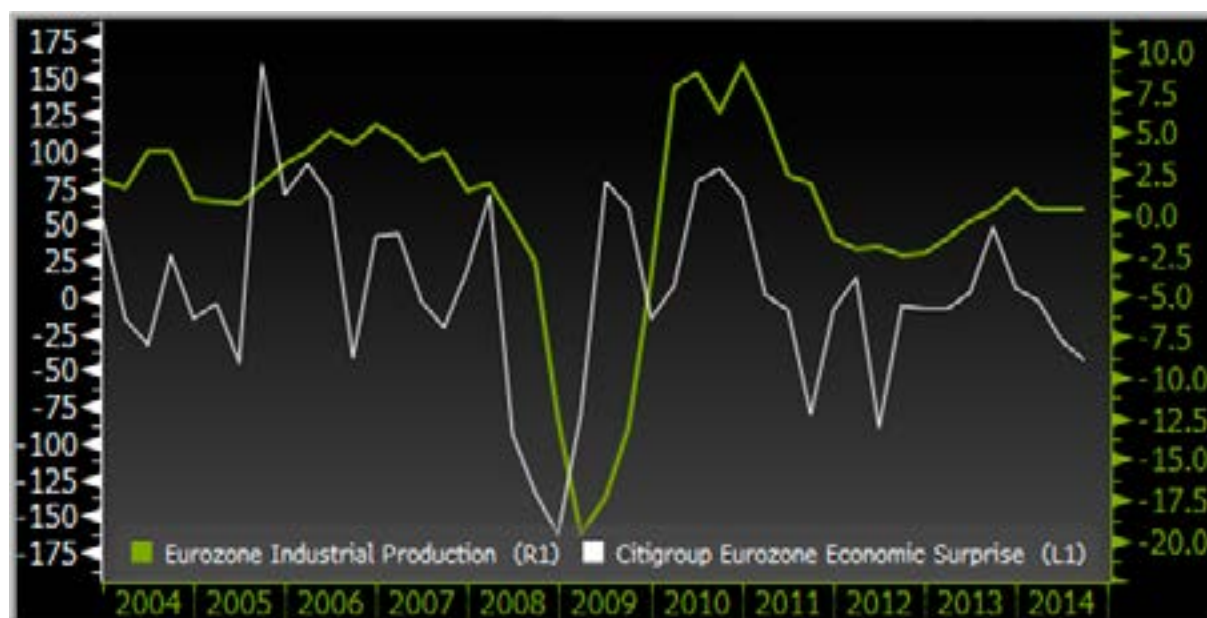
So why does the ECB feel the need to initiate a new QE program? First, the eurozone has been battling deflationary forces for several months. In fact, in December, year-over-year (YoY) consumer prices actually fell -0.2%, which marked the first YoY negative print since 2009. Deflation typically corresponds with falling wages, lower corporate profitability, and worsening debt burdens as liabilities become a bigger slice of the pie. As a result, you get slower growth as businesses scale back costs to maintain profitability. This factor is a large reason why we have seen eurozone (EZ) unemployment jump from 7.5% to over 11% today. The chart on the left depicts the dangerous combination of falling prices and rising unemployment over the last several years.

European Quantitative Easing Program

MONTHLY CHARTBOOK / JANUARY 30, 2015

BY JEFF DICKS & JEFF EULBERG

CITIGROUP EUROZONE ECONOMIC SURPRISE INDEX AND EUROZONE INDUSTRIAL PRODUCTION



Source: Bloomberg, Evergreen Gavekal

This devastating duo has led to volatile economic data, bouncing the eurozone in and out of recessions over the last several years. As the chart on this page shows, industrial production growth has been mostly negative in the eurozone and recently we've seen general deterioration interspersed with a few positive surprises. The white line represents a Citigroup index, tracking EZ economic releases. It is adjusted based on whether they exceed or disappoint expectations. As you can see, this index has been in deep negative territory and declining further over the last several months. This was a major catalyst for the ECB announcing a QE program to stem the tide.

Quantitative Easing Effects in the Past

MONTHLY CHARTBOOK / JANUARY 30, 2015

BY JEFF DICKS & JEFF EULBERG

JAPAN BALANCE SHEET EXPANSION, GDP GROWTH AND WAGE GROWTH



Source: Bloomberg, Evergreen GaveKal

But has quantitative easing actually helped stimulate economic growth in the past? To answer this question, we analyzed other countries that have implemented quantitative easing and the effect it had on GDP growth. The chart on the left shows the Bank of Japan's (BoJ) balance sheet, the country's real GDP and Japanese wage growth. As you can see, the massive growth in the BoJ balance sheet has, if anything, had a negative relationship to economic growth over the past few years. Additionally, wages have been in free fall over this timeframe, which points out that the additional yen pumped into the system have yet to reach the working class.

Quantitative Easing Effects in the Past

MONTHLY CHARTBOOK / JANUARY 30, 2015

BY JEFF DICKS & JEFF EULBERG

FEDERAL RESERVE BALANCE SHEET AND US REAL GDP GROWTH



Source: Bloomberg, Evergreen GaveKal

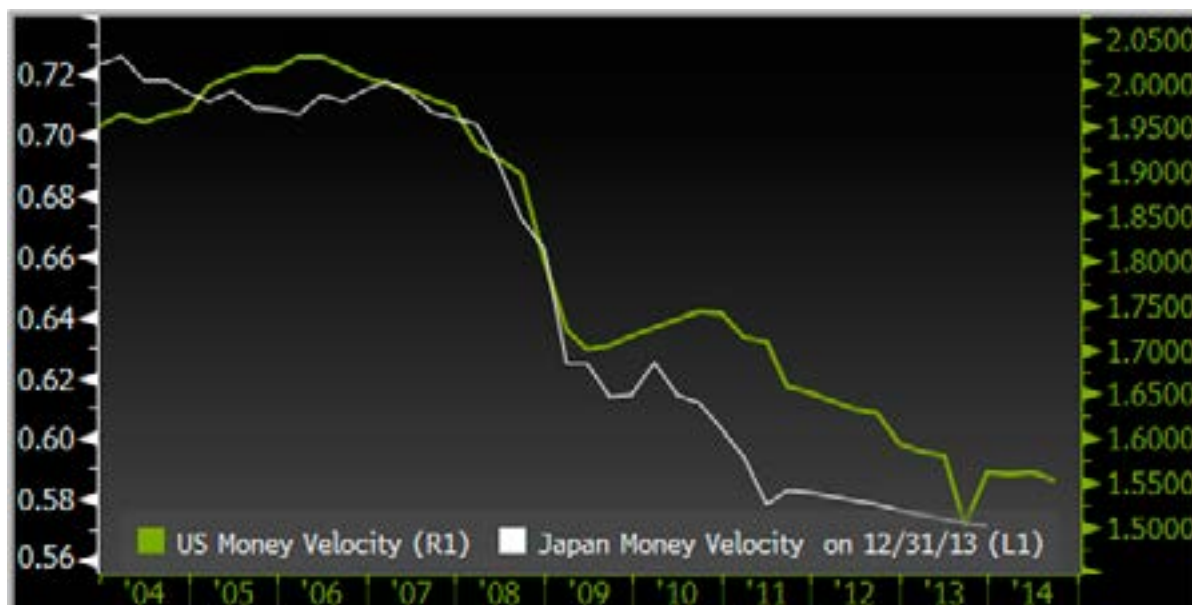
Next, let's take a look at the United States. The US just completed its third round of quantitative easing with the Fed's balance sheet growing from \$1 trillion to \$4.5 trillion over the last six years. In this case, we can see after the Great Recession of 2008, QE apparently helped the economy rebound fairly meaningfully. At the time, in the throes of a vicious recession, the Fed stepped in to stabilize the market, and growth followed suit. However, despite continued rounds of QE during 2011 and 2013, there was little impact on GDP growth. In fact, the economy has averaged just 2.2% GDP growth since 2009, which is the weakest recovery on record.

Quantitative Easing Effects in the Past

MONTHLY CHARTBOOK / JANUARY 30, 2015

BY JEFF DICKS & JEFF EULBERG

JAPAN AND US MONEY VELOCITY



Source: Bloomberg, Evergreen GaveKal

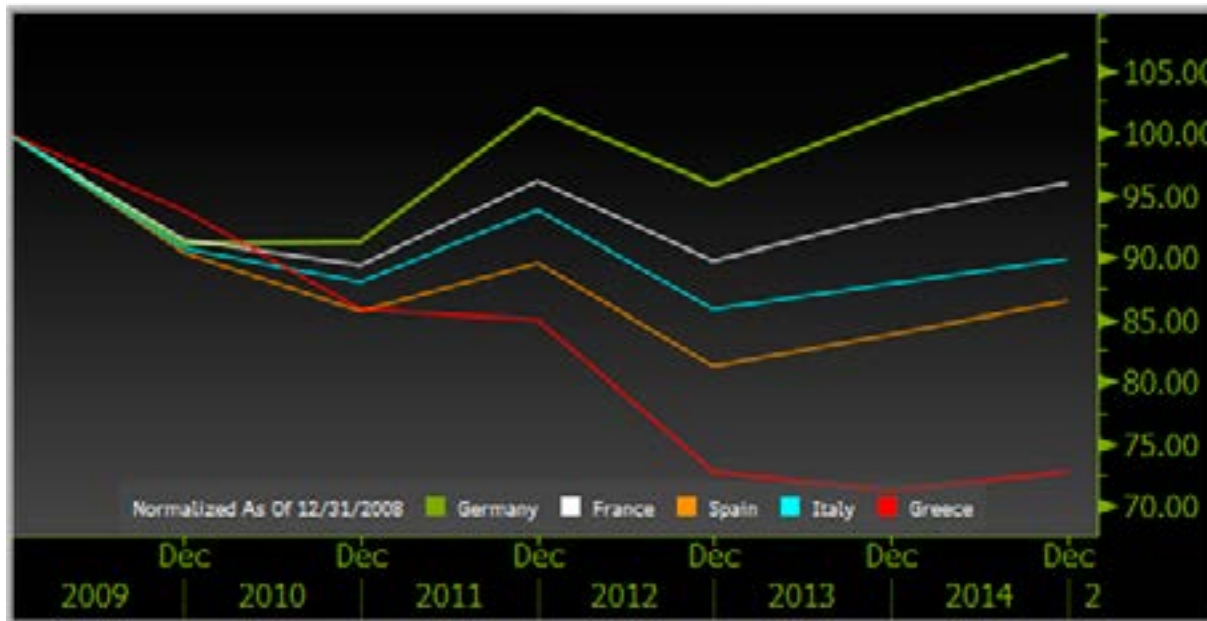
Additionally, in Japan and the US, bank lending has often contracted during periods of balance sheet expansion. One metric we use to measure this activity is money velocity, which tracks nominal GDP divided by money in circulation. Basically, this calculation determines how quickly a dollar (or yen) moves from one transaction to the next. The more times a dollar changes hands, the higher the money velocity, and the faster the economy grows. The chart on the left shows that even with all of the cash the Fed and BoJ have pumped into their respective economies, it has yet to increase lending, or real growth.

The Real Problems Facing the Eurozone

MONTHLY CHARTBOOK / JANUARY 30, 2015

BY JEFF DICKS & JEFF EULBERG

REAL GDP PER CAPITA GERMANY, FRANCE, SPAIN, ITALY, AND GREECE



Source: Bloomberg, Evergreen GaveKal

We believe the real problems facing the eurozone stem from the euro itself. This chart shows real GDP per capita in Germany, France, Italy, Spain, and Greece. As you'll notice, there has been a stark divide between Germany and the rest of the eurozone, causing unemployment to spike and quality of life to deteriorate in the periphery.

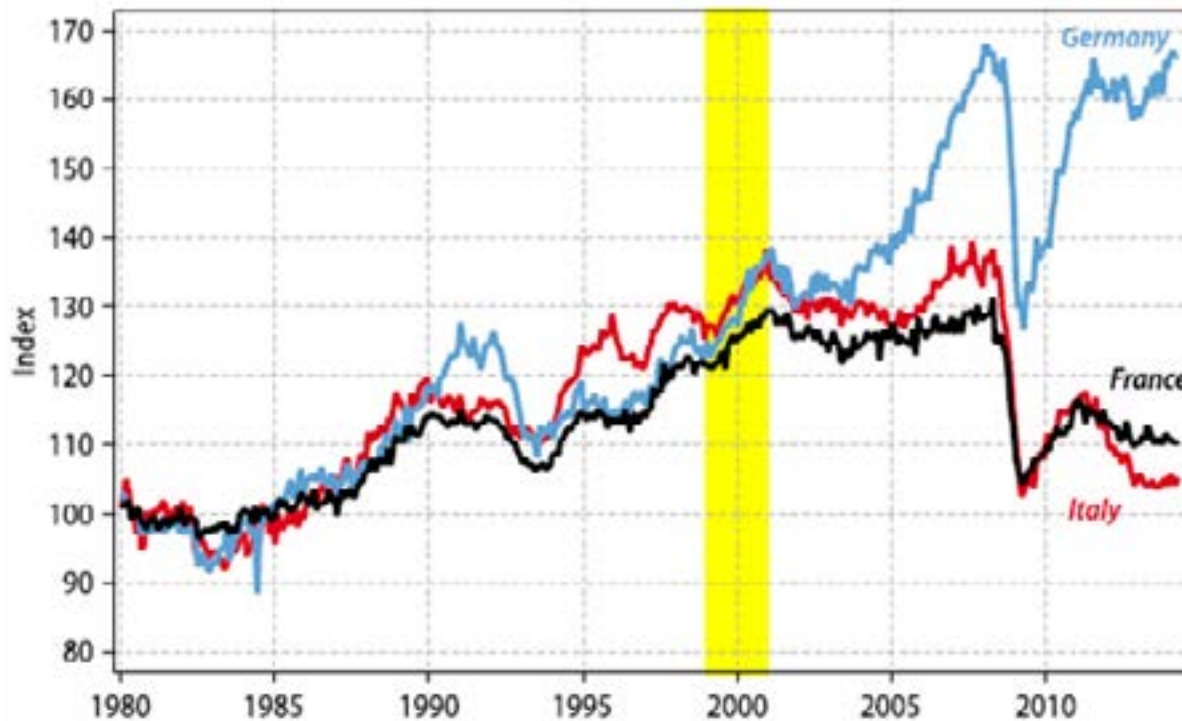
The Real Problems Facing the Eurozone

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BY JEFF DICKS & JEFF EULBERG

INDUSTRIAL PRODUCTION (IP) IN GERMANY, FRANCE AND ITALY BEFORE AND AFTER THE EURO

Yellow shaded area = euro inception



Source: GaveKal Data/Macrobond

Our colleagues at GaveKal have also pointed out that since the Euro was inception in 2000 there's been a major disparity between industrial production in Germany, compared to France and Italy. We believe the latter countries have become less competitive because of both their inability to weaken their currency versus Germany and by failing to implement structural reforms. The chart to the left does a great job depicting the trouble France and Italy have been in since the euro was introduced.

BY JEFF DICKS & JEFF EULBERG

SWEDEN'S 1992 DEVALUATION WORKED

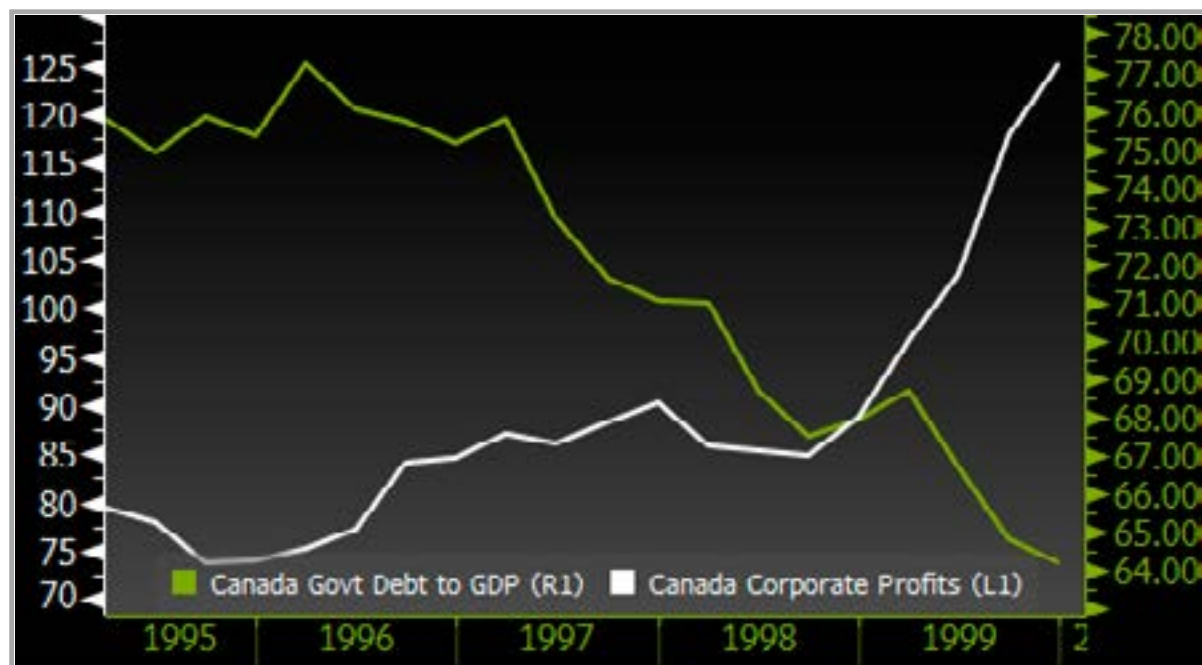


Source: GaveKal Data, Macrobond

Now that we've reviewed the main issues confronting the eurozone, we thought we'd look at policies that have worked in getting countries either more competitive or fiscally sound. First, we will look at Sweden in the early 1990s, when it successfully devalued its currency by approximately 30%. Since then, Swedish exports—as a percentage of GDP—grew from 27% to over 50%. And, as shown by our colleagues at GaveKal, this helped Sweden gain ground on their largest competitor, Germany. As the chart shows, the ratio of Swedish exports to German exports skyrocketed, leading to outperformance in Sweden's stock market. We believe that if Italy or Spain had their own currency to devalue, it would help immensely in terms of their competitive position versus Germany and the rest of the world. Of course, this would need to be combined with sweeping overhauls of the growth-retarding labor laws and other harmful policies in Europe's periphery to produce truly lasting prosperity.

BY JEFF DICKS & JEFF EULBERG

CANADA GOVT DEBT-TO-GDP AND CANADIAN CORPORATE PROFITS



Source: Bloomberg, Evergreen GaveKal

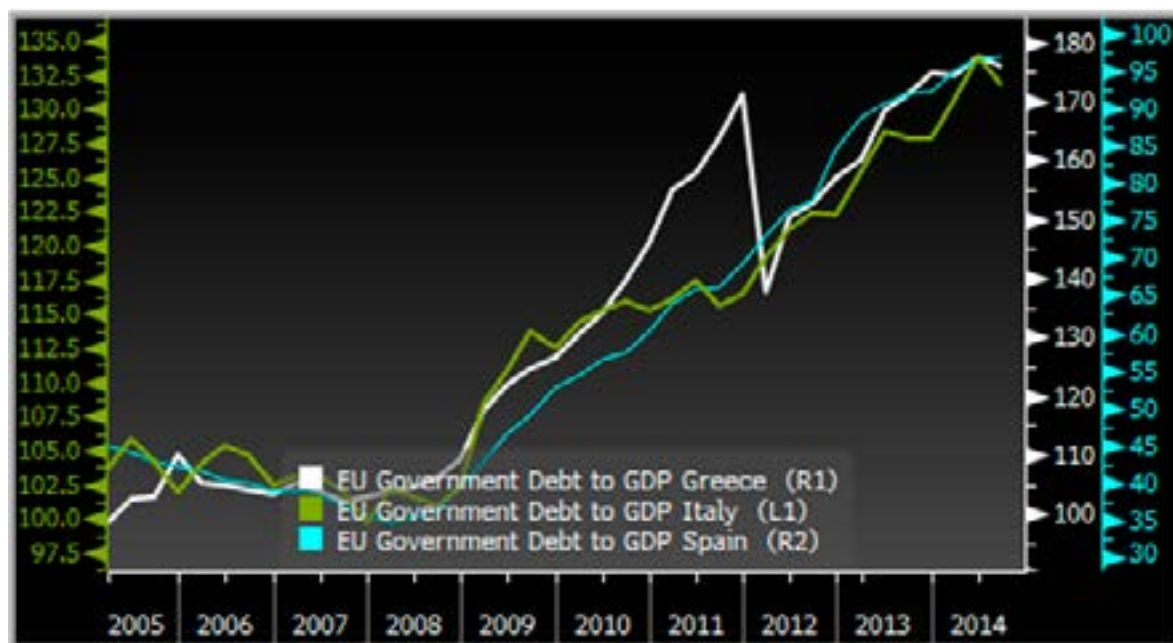
Next, let's turn our attention north for an example of a country that previously implemented tough structural reforms. Specifically, Canada made the hard decision of dramatically cutting government spending. Before doing so, Canada saw its government debt-to-GDP rise from 60% to nearly 80% by the mid-90s. During this period of excessive debt, the Canadian economy grew less than 1.05% per annum. Facing a debt crisis, Canada shrunk their government workforce, eliminated subsidies to corporations, and tackled entitlement reform. Over the next 13 years, Canada's GDP expanded by an annual growth rate of 3.4%! The chart to the left shows the effect on government debt-to-GDP, which shrunk from 77% to 64%. These structural changes ultimately led to a surge in corporate profits, as there was less spending and a lower tax burden. In the end, the ratio of spending cuts to tax increases was roughly 7 to 1.

QE Alternatives That Have Worked

MONTHLY CHARTBOOK / JANUARY 30, 2015

BY JEFF DICKS & JEFF EULBERG

GREECE, ITALY, AND SPAIN DEBT-TO-GDP



Source: Bloomberg, Evergreen GaveKal

Finally, our last chart shows the explosion of debt-to-GDP in the periphery of Europe. We can see Italy, Spain, and Greece all have debt burdens approaching, or exceeding, 100% of GDP. We don't believe central bank buying of these newly issued bonds will spark growth. Instead, we think these countries either need to go back to individual currencies to try and gain a competitive edge versus Germany or take the Canadian route. This would entail enacting structural reforms, reducing the size of government, deregulating industries, and making tough budgetary decisions to slowly reduce the debt burden. At the end of the day, we don't think QE is the answer for rejuvenating growth in the eurozone, and will only add to the debt burden and competitive disparity we see today.

We thought we'd close this EVA with a quote from a central banker who has learned the hard and costly way that you can only deny reality for so long: "Surely, you cannot solve all problems of this world with monetary policy." Thomas Jordan, president of the Swiss National Bank.

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Our Current Likes and Dislikes

There were no changes to our likes and dislikes this week.

WE LIKE

- Large-cap growth (on a pull back)
- Canadian dollar-denominated bonds
- Emerging stock markets (**in select countries**)
- International developed markets (on a pull back)
- Canadian REITs
- Intermediate Treasury notes
- BB-rated corporate bonds (i.e., high quality, high yield)
- Cash
- Publicly-traded pipeline partnerships yielding 7%-9% (especially those pounded in the recent mass selling of all things energy-related)
- Intermediate-term investment grade corporate bonds, yielding approximately 4%
- Gold-mining stocks (initiate a partial position to take advantage of crushed valuations and year-end tax-loss selling—buy, but buy slowly!)

WE'RE NEUTRAL ON

- Most cyclical resource-based stocks
- Large-cap value
- Short-term investment grade corporate bonds
- High-quality preferred stocks yielding 6-7%
- Long-term investment grade corporate bonds
- Short yen ETF
- Intermediate municipal bonds with strong credit ratings
- Long-term Treasury bonds
- Long-term municipal bonds
- Emerging market bonds (local currency)
- Short euro ETF
- Bonds denominated in renminbi trading in Hong Kong (dim sum bonds)
- Gold
- **Blue chip oil stocks**

WE'RE 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

*However, some small and mid-cap issues look fairly valued

the Evergreen
**VIRTUAL
ADVISOR**

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