EVERGREEN GAVEKAL

Evergreen Chartbook

NOVEMBER 2016

Introduction

BY JEFF DICKS, JONATHAN FULCHER, DAVID HAY

We would like to take this opportunity to wish our clients and readers a very happy Thanksgiving weekend! We feel extremely fortunate to have such a loyal client base, as well as a growing readership of the Evergreen Virtual Advisor (EVA).

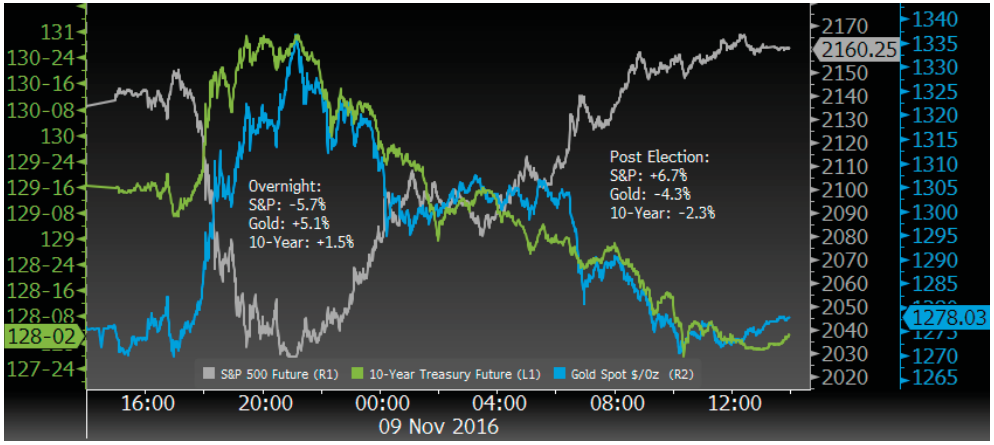
This week, we are bringing back the Chartbook version of our EVA. We feel it's an opportune time to run a series of charts considering the significant amount of market fluctuations we have witnessed since Donald Trump was elected the 45th president of the United States.

Perhaps the most remarkable shift post-election has been investor sentiment towards a Trump presidency. Heading into the vote, professional investors at large, including us, viewed a Trump victory as largely negative for risk assets, at least on a short-term basis. The idea was that policy uncertainty, protectionism, and trade policies would cause a sharp selloff in risk assets along with a flight-to-quality into assets such as gold and US Treasuries. On the night of Tuesday November, 8th, as Trump took swing-state after swing-state, that belief played out as stocks began to freefall. As the chart to the right indicates, by roughly 10:00pm pacific standard time the S&P 500 futures were down well over 100 points, or -5.7%. Additionally, futures on safe assets such as gold and treasuries rallied hard. Accordingly, at that point the market reaction was as expected.

At around 10:30pm, we saw a sharp reversal in just about every asset class. As you can see in the chart on the right, the initial fear turned into complete euphoria. The S&P 500 staged a massive comeback while gold and treasuries tanked. Investors began to focus on the potential benefits from deregulation and tax cuts, as well as infrastructure spending, and seemingly dismissed protectionism, anti-trade policy, and "The Donald" commanding our nuclear firepower.

Post-election, this newly found stock-market fervor has largely continued, particularly for areas seen as benefiting from a Trump win such as financials (deregulation) and industrials (infrastructure spending). In addition, we have seen a surge in inflation expectations, which has caused an epic bond market rout over the last two weeks. This has also led to significant divergence within key currency and commodity markets. We hope to visually illustrate these trends along with some key commentary throughout this week's chartbook.

S&P 500, GOLD, AND US TREASURIES

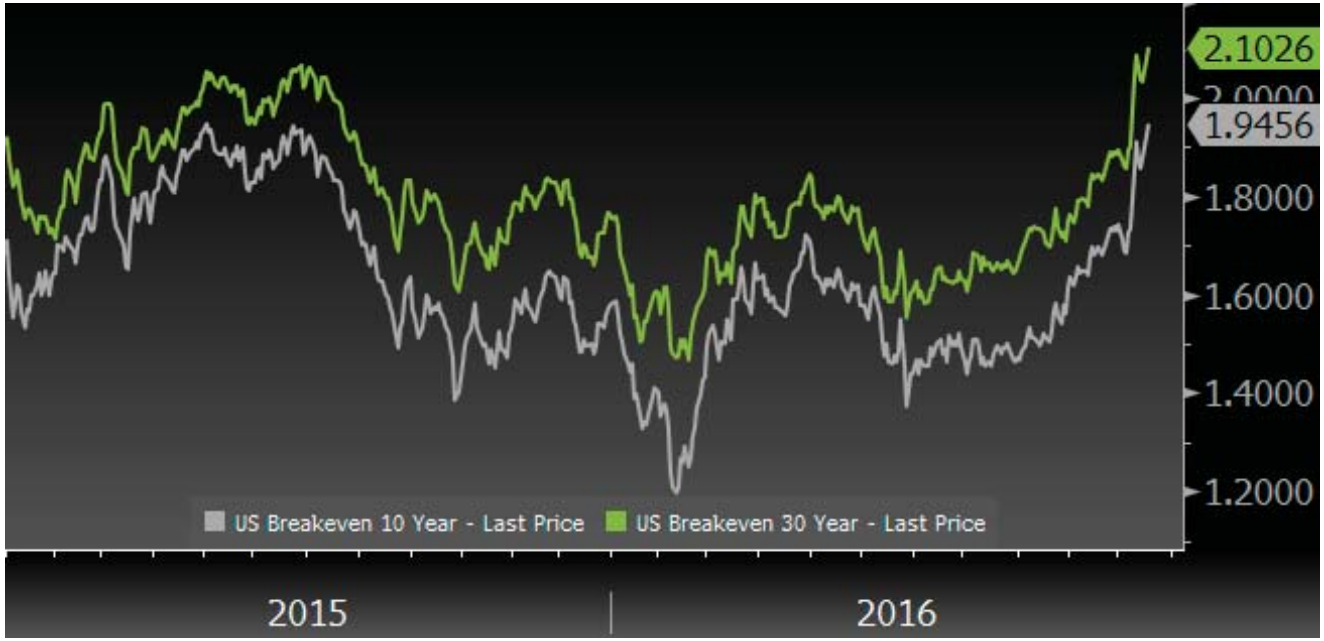


Source: Evergreen GaveKal, Bloomberg

Income Markets: Inflation Expectations Surge

BY JEFF DICKS, JONATHAN FULCHER, DAVID HAY

US 10-YEAR AND 30-YEAR BREAKEVEN RATES



Source: Evergreen GaveKal, Bloomberg

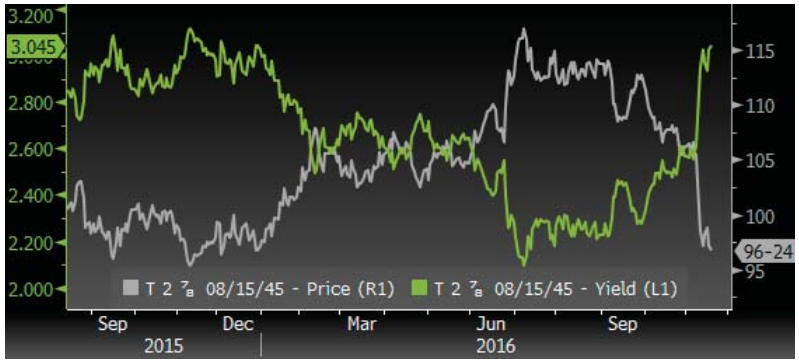
- The most significant impact to income portfolios has been the surge in inflation expectations, which can be seen through the 10-year and 30-year *breakeven rates.
- This uptick can be attributed to the expectation for higher deficits from lower revenue (lower taxes) and higher spending (infrastructure projects).
- Perhaps also adding fuel to the fire is the notion that Donald Trump has an affinity for debt along with a history of not paying it back in full!

*Breakeven Rate – The breakeven inflation rate is the difference between the yield on a fixed-rate bond and the real yield on an inflation-linked bond. If inflation averages more than the break-even rates, the inflation-linked investment will outperform.

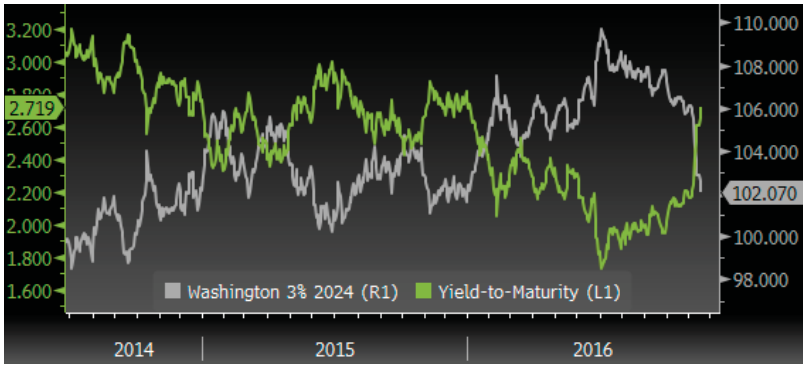
Income Markets: Treasuries, Munis and Closed-End Funds Take it on the Chin

BY JEFF DICKS, JONATHAN FULCHER, DAVID HAY

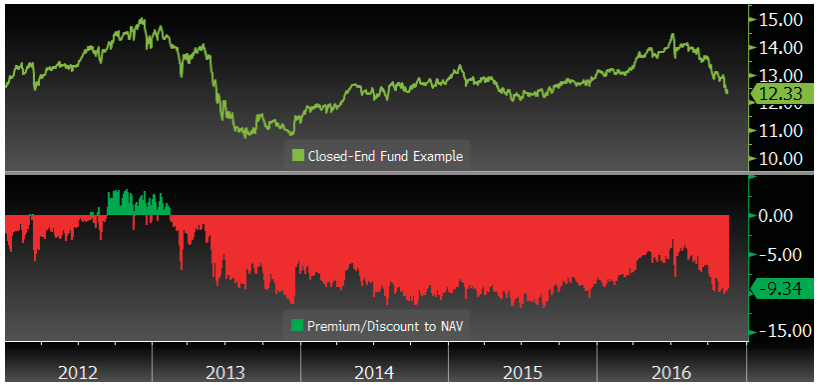
LONG-TERM TREASURY ETF PRICE AND YIELD



US TREASURY BOND DUE IN 2045 PRICE AND YIELD



CLOSED-END MUNI BOND FUND PRICE (UPPER) AND DISCOUNT/PREMIUM TO NAV (LOWER)



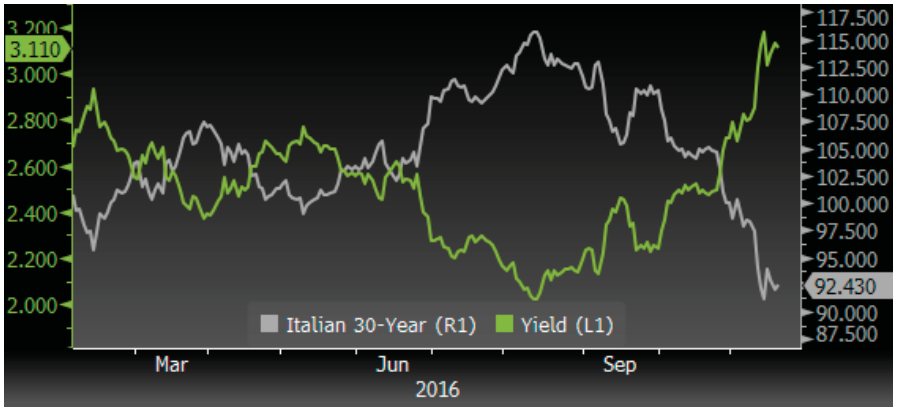
Source: Bloomberg, Evergreen GaveKal

- The shift in inflation sentiment has led to the sharpest bond market selloff since the "Taper Tantrum" in 2013. This decline has wiped out over one trillion globally from bond market values.
- Long-term treasuries and municipal bonds have been two of the hardest hit areas as seen with the top two chart examples above.
- Munis have been under particular scrutiny given the prospect for lower taxes, which makes the taxable-equivalent yield less compelling.
- Lastly some of the worst carnage has been in the closed-end fund space given both the decline in the actual bond prices they hold, as well as the substantial widening of the discount to underlying market values (i.e., NAV or Net Asset Value).

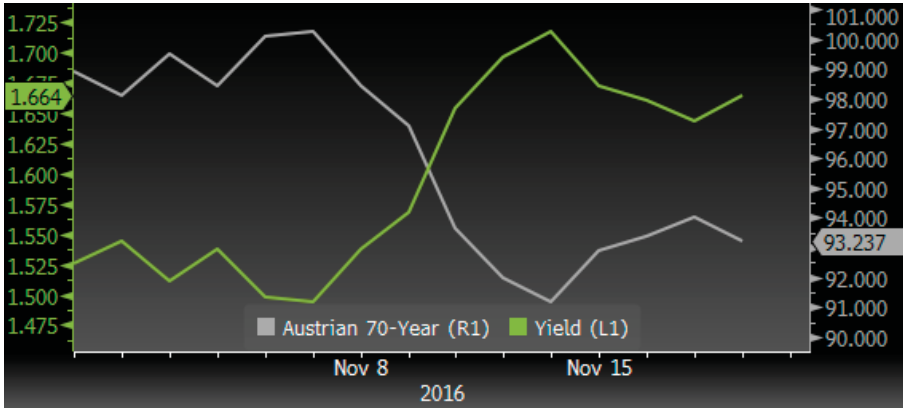
Income Markets: International Debt Markets also Feeling the Pain

BY JEFF DICKS, JONATHAN FULCHER, DAVID HAY

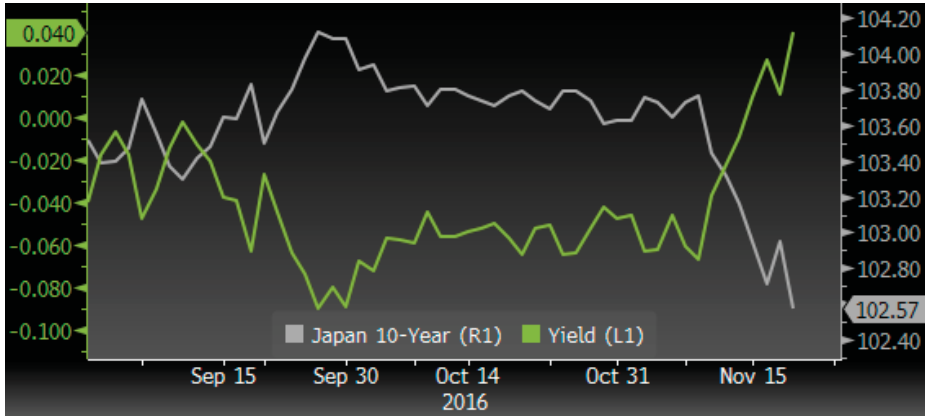
ITALY 30-YEAR BOND PRICE AND YIELD



AUSTRIA 70-YEAR BOND PRICE AND YIELD



JAPAN 10-YEAR PRICE AND YIELD



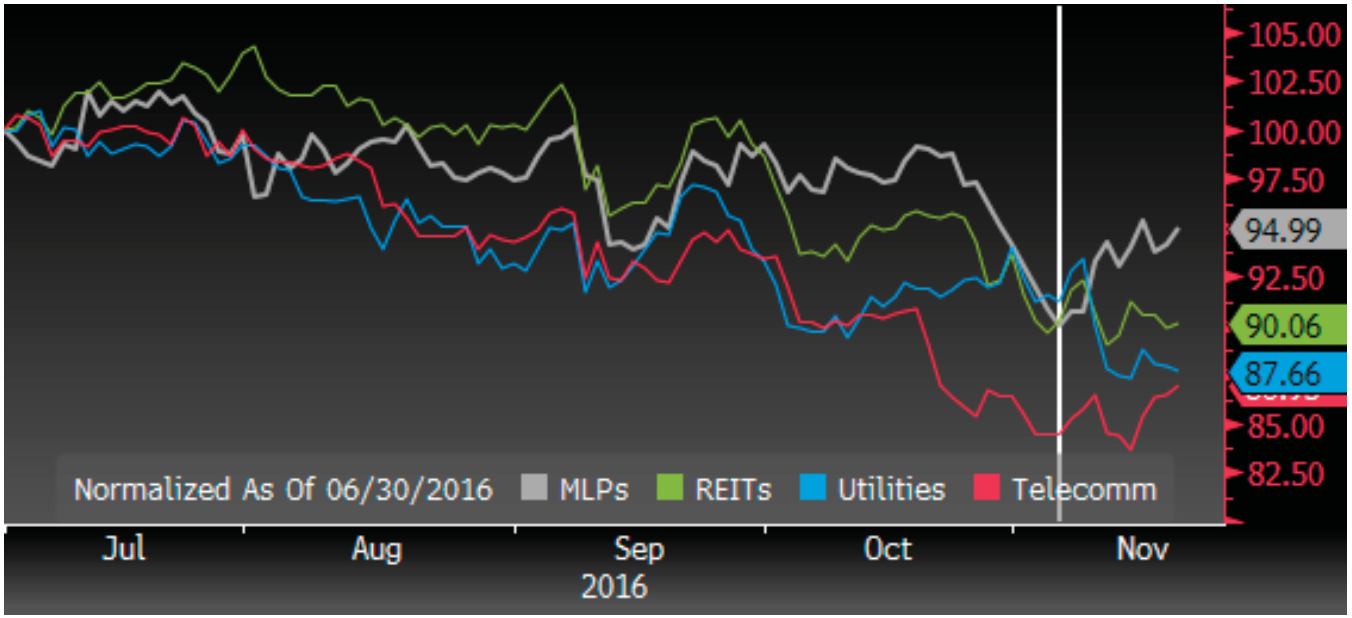
Source: Bloomberg, Evergreen GaveKal

- The bond market carnage has also spread internationally as you can see through the price declines and yield increases for Italian, Austrian, and Japanese government debt.
- In Austria, their latest 70-year bond (issued with a 1.5% coupon) has tumbled 9%, wiping out a cool six years of income.
- Lastly, in Japan, where the BOJ has begun to move away from NIRP (negative-interest-rate-policy), we have actually seen yields move back into positive territory.

Income Markets: Equity Income Markets Weak Outside of Recent MLP Strength

BY JEFF DICKS, JONATHAN FULCHER, DAVID HAY

MLPS, REITS, UTILITIES, AND TELECOMM



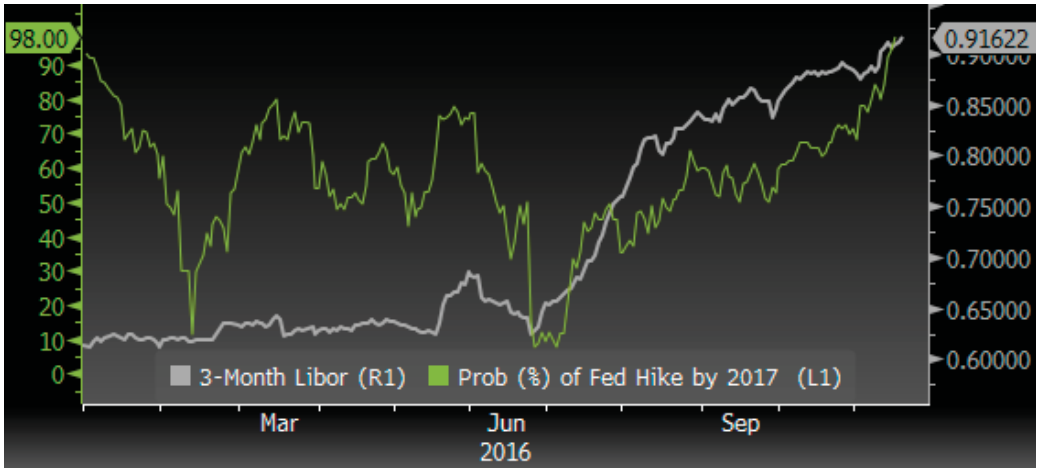
Source: Bloomberg, Evergreen GaveKal

- This global bond rout also caused havoc within equity-income markets. The REIT, utility, and telecomm sectors have each pulled back by over 10% from their 2016 peaks.
- MLPs, on the other hand, despite being down 5% from their highs for this year, have seen recent strength since Trump emerged victorious.
- The good news for these pipeline companies is that Trump is pro-energy infrastructure, which essentially means additional production gains and, ultimately, more hydrocarbons flowing through the pipes.

Income Markets: Fixed-to-Floaters Outperform as Short-Term Rates Continue to Climb

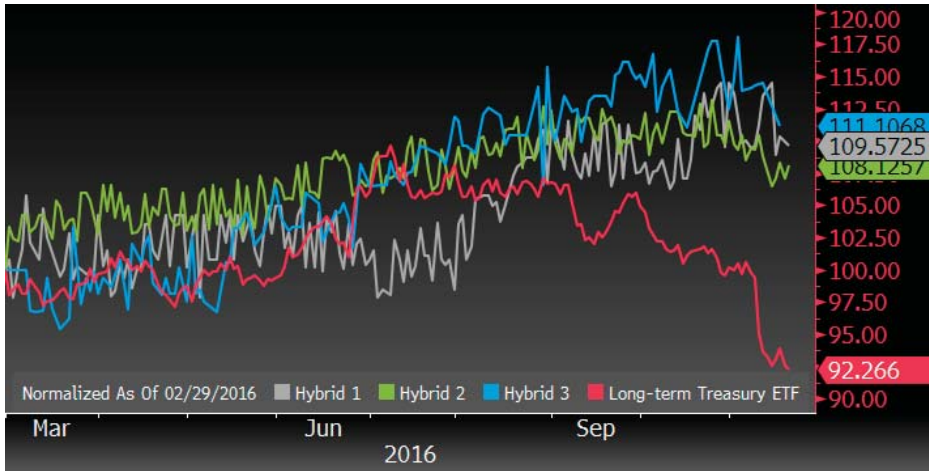
BY JEFF DICKS, JONATHAN FULCHER, DAVID HAY

3-MONTH LIBOR* AND PROBABILITY OF FED HIKE BY 2017



Source: Bloomberg, Evergreen GaveKal

HYBRID (FIXED-TO-FLOATER) EXAMPLES VS. LONG-TERM TREASURIES



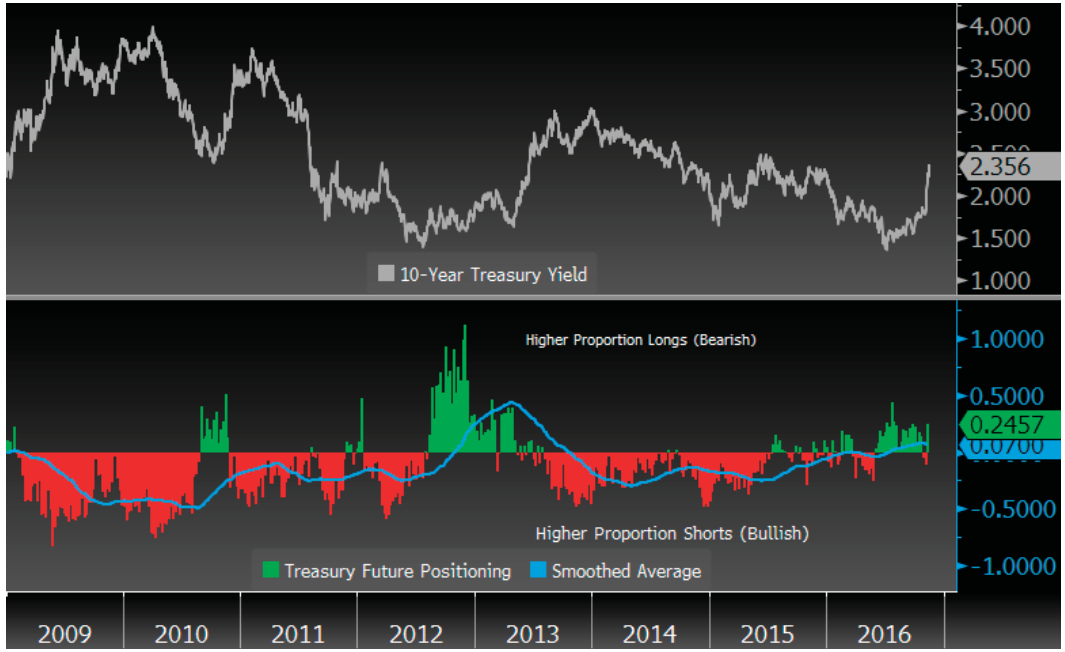
- Short-term rates have continued to edge higher over the last several months given the combination of Fed tightening along with new money market rules that allow floating net-asset values for "prime funds" (funds invested primarily in corporate debt securities)
- This trend appears to have legs with the December rate hike odds currently pegged at 98%.
- Higher rates have led to outperformance for floating-rate and fixed-to-floating rate bonds (hybrids) whose cash flows are pegged to 3-month Libor.

*London Interbank Offered Rate, a key short-term interest rate.

Income Markets: Wait for Positioning to Move Bearish Before Interest Rate Exposure

BY JEFF DICKS, JONATHAN FULCHER, DAVID HAY

10-YEAR TREASURY YIELD AND FUTURE POSITIONING (OPEN-INTEREST)



Source: Evergreen GaveKal, Bloomberg

- Despite the bond-market selloff, treasury future positioning remains neutral-to-bullish.
- Historically, this has been a solid contrarian indicator (meaning prices are likely to fall), and the current reading has us cautious on treasuries.
- Our plan is to wait for positioning to move bearish (again, from a contrarian standpoint, this is bullish) before we increase our exposure to high quality longer-term bonds.

Stock Markets: Developed Markets Outperform Emerging Markets Post-Trump

BY JEFF DICKS, JONATHAN FULCHER, DAVID HAY

MSCI WORLD VS. MSCI EMERGING MARKETS YEAR-TO-DATE

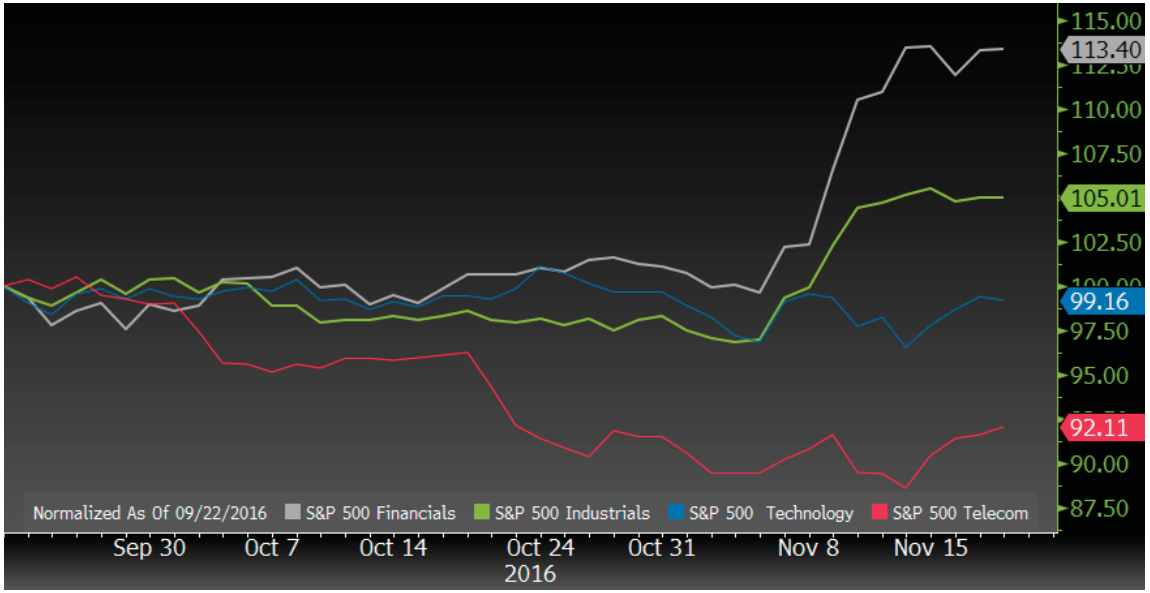
Source: Evergreen GaveKal, Bloomberg

- Moving on to stocks, we have seen a major reversal take hold in terms of relative performance of developed vs. emerging market (EM) shares.
- Specifically, we have seen this year's EM outperformance shrink from 15% to just 4% post-election.
- EM shares have been among the hardest hit asset classes given the strength we have seen in the dollar from the aforementioned interest rate surge.

Stock Markets: Sector Rotation Indicating Initial Winners and Losers

BY JEFF DICKS, JONATHAN FULCHER, DAVID HAY

S&P 500 RELATIVE PERFORMANCE FINANCIALS, INDUSTRIALS, TECHNOLOGY, AND TELECOMM



Source: Evergreen Gavekal, Bloomberg

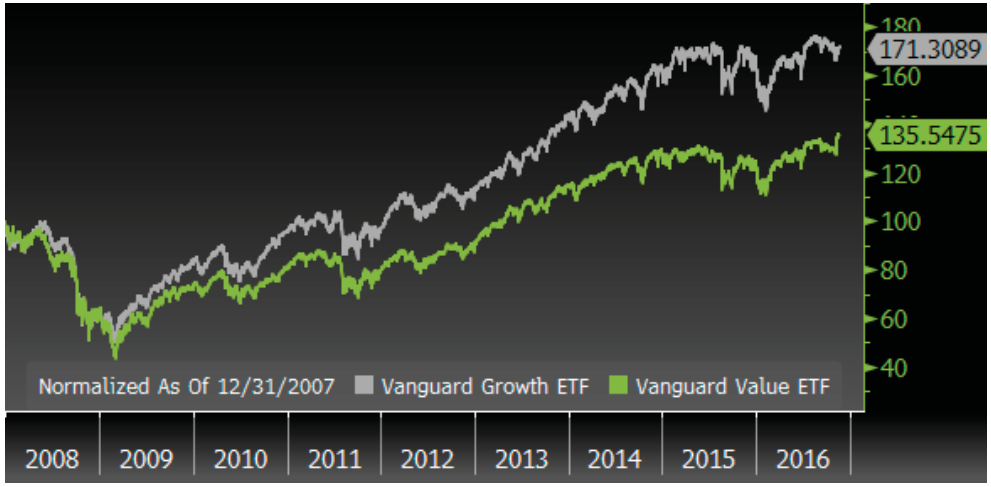
- Sector rotation has been equally remarkable post-election with financials and Industrials seen as key beneficiaries, while technology and telecomm have been laggards.
- As we noted last week, deregulation and a steeper yield curve have aided financials, while infrastructure spending has lifted industrials.
- On the flip side, Trump's negative comments towards Amazon and Apple, along with international policy concerns (where a bulk of this sector's business is done), has led to tech weakness.

Stock Markets: This Has Led to a Recent Surge in Value Relative to Growth

BY JEFF DICKS, JONATHAN FULCHER, DAVID HAY

VANGUARD GROWTH VS. VANGUARD VALUE (1-MONTH)

VANGUARD GROWTH VS. VANGUARD VALUE (SINCE 12/31/2007)



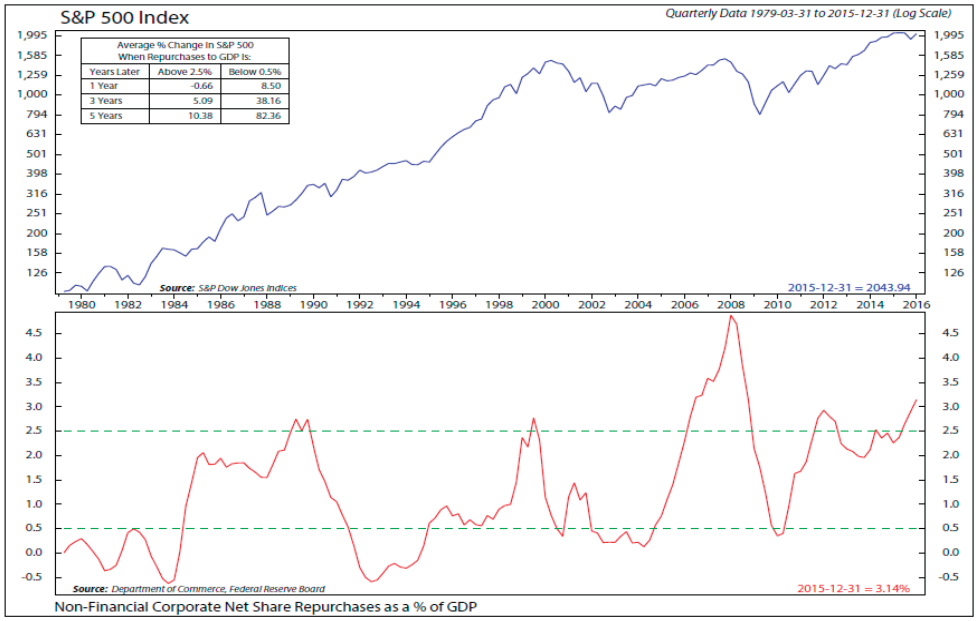
Source: Evergreen GaveKal, Bloomberg

- Considering over 50% of the value sector is comprised of financials, energy, and industrials, we have seen a marked reversal from the previous 8-years.
- Alternatively, growth stocks, heavily impacted by technology, have recently lagged.
- Based on our belief we are late in the current cycle, with elevated recession odds, we continue to be overweight large-cap growth, which historically holds up much better during challenging economic environments.

Stock Markets: Follow the Money

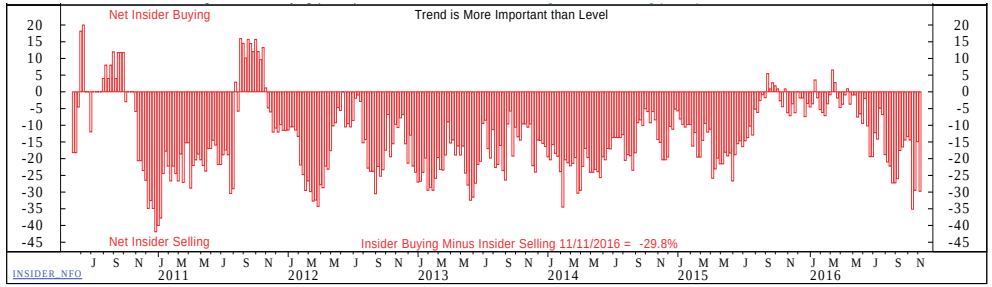
BY JEFF DICKS, JONATHAN FULCHER, DAVID HAY

NED DAVIS RESEARCH: S&P 500 AND NONFINANCIAL BUYBACKS AS A % OF GDP



Source: Ned Davis Research

NED DAVIS RESEARCH: NET INSIDER BUYING/SELLING

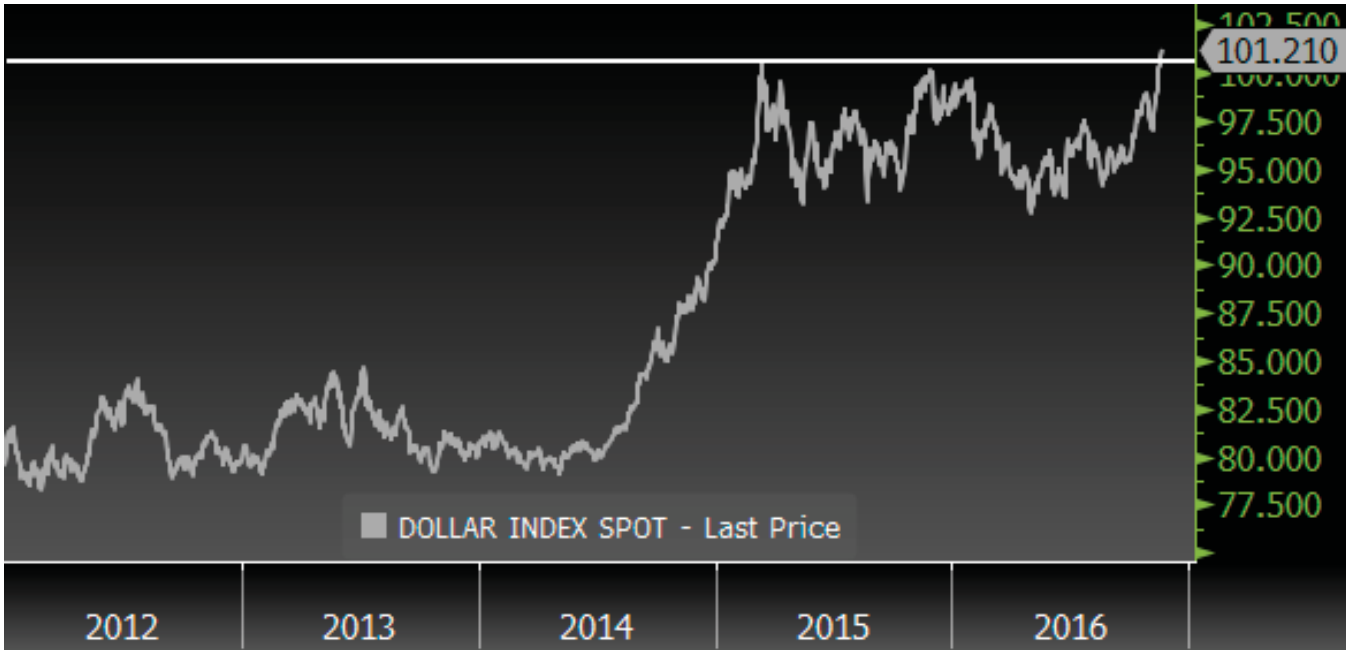


- Unquestionably, massive buy-backs of their own shares by companies have been one of the main forces keeping the S&P 500 close to its highs, despite an extended earnings downturn.
- The tendency of companies to acquire large amounts of stock at peak prices should concern shareholders, as well as the fact that currently insiders are aggressively selling in aggregate.

Currencies: US Dollar New Breakout, or Hitting Another Peak?

BY JEFF DICKS, JONATHAN FULCHER, DAVID HAY

THE DOLLAR INDEX SINCE 12/31/2011



Source: Evergreen GaveKal

- In the currency market, we have seen notable strength with the US Dollar, which recently brokered out to a multi-year high.
- As we highlighted last week, this puts extreme pressure on corporate profits, which have already been in a persistent bear market.
- It will be crucial to financial markets whether we are in the midst of a decisive dollar breakout, or nearing another near-term peak.

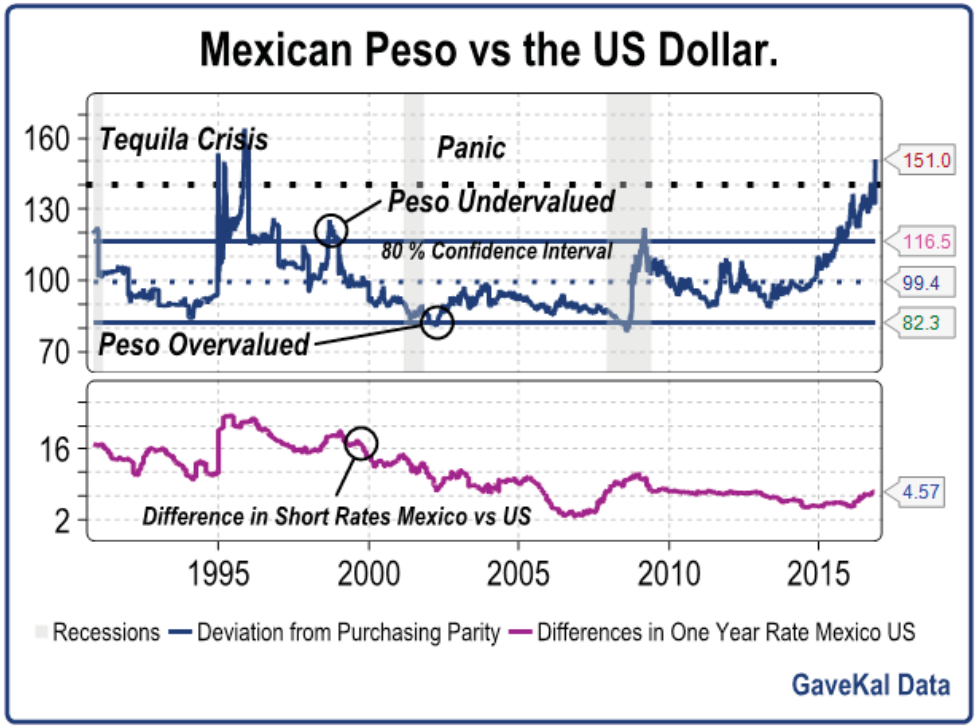
Currencies: Dollar Strength Leads to EM Currency Bloodbath

BY JEFF DICKS, JONATHAN FULCHER, DAVID HAY

EMERGING MARKET CURRENCIES SINCE 11/8/16

Source: Bloomberg

GAVEKAL – MEXICAN PESO VS. THE DOLLAR

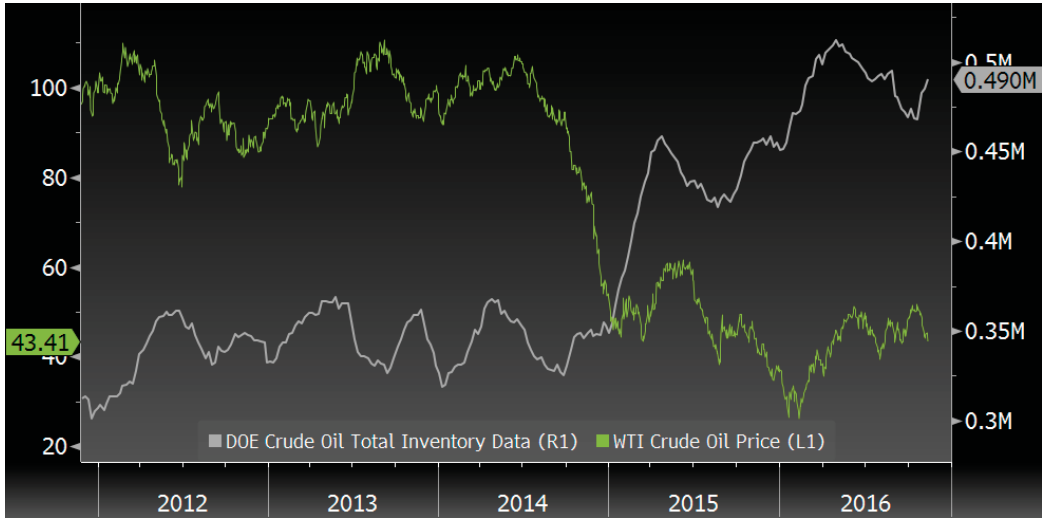


- One of the weakest areas has been emerging market currencies, which as you can see from the table above, have weakened materially since Trump was elected.
- The weakest performer has been the peso, which we believe is extremely undervalued.
- Our colleagues at Gavekal agree and, as you can see, they view the peso as the most undervalued since1995's "Tequila Crisis".

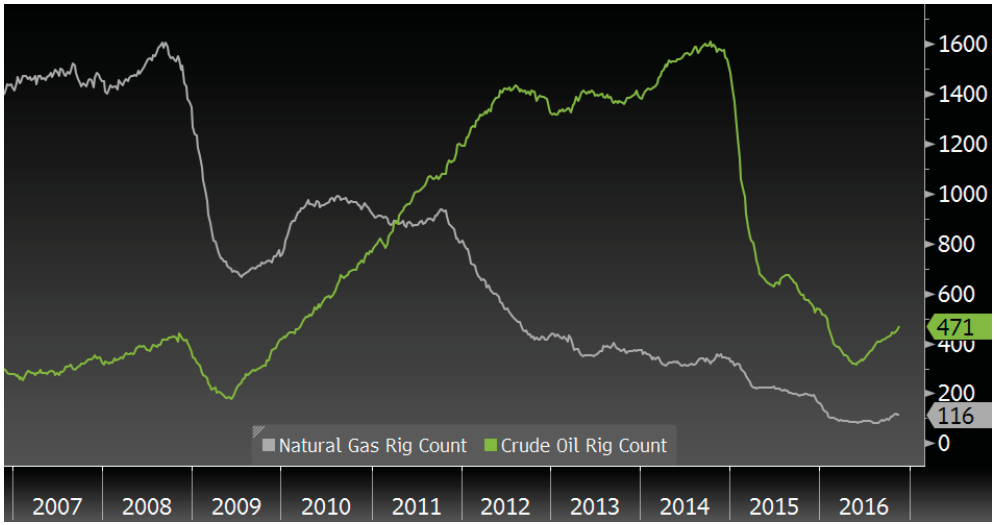
Commodities: A crude look at the Oil Market

BY JEFF DICKS, JONATHAN FULCHER, DAVID HAY

CRUDE OIL INVENTORY VS WTI SPOT PRICE



CRUDE OIL AND NATURAL GAS RIG COUNT



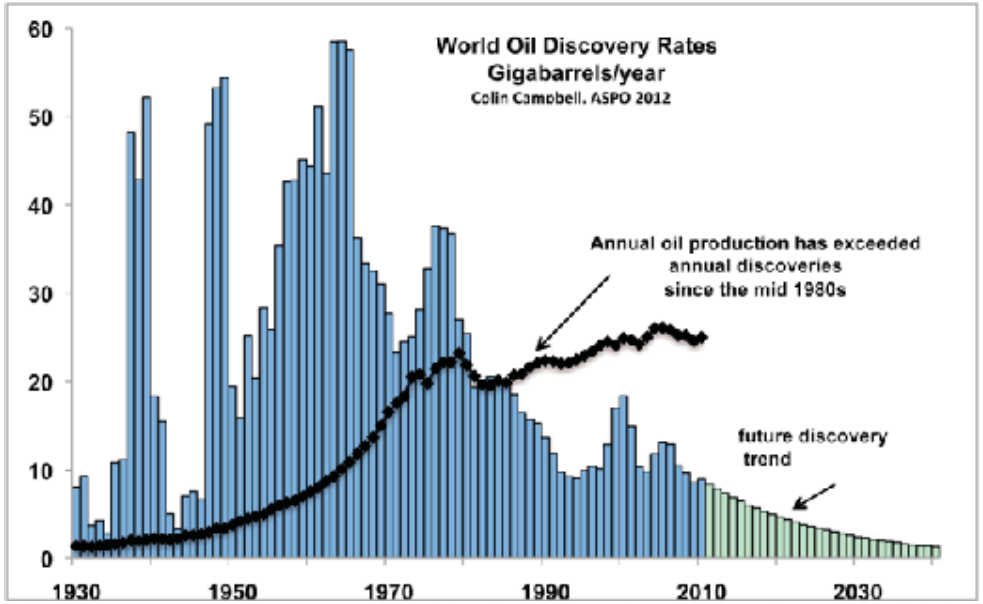
Source: Evergreen GaveKal

- Moving into the world of commodities, 'tis the season for rising oil inventories with a much sharper than anticipated move in recent months. Each week, the focus of the market shifts between wild optimism (OPEC cut?) or rampant pessimism (stubbornly high inventory and production levels). We would rather take a bit of a longer-term view.
- On the other hand, we have finally begun to see a steady rise in the number of oil rigs in the US. However, most of those coming back on-line (and by most, we mean something like 80%!) are based in the Permian Basin in Texas. Aside from this extreme low-cost area, rigs returning to work in the rest of the country are very few and far between.

Commodities: The World Awash in Oil? Only Temporarily

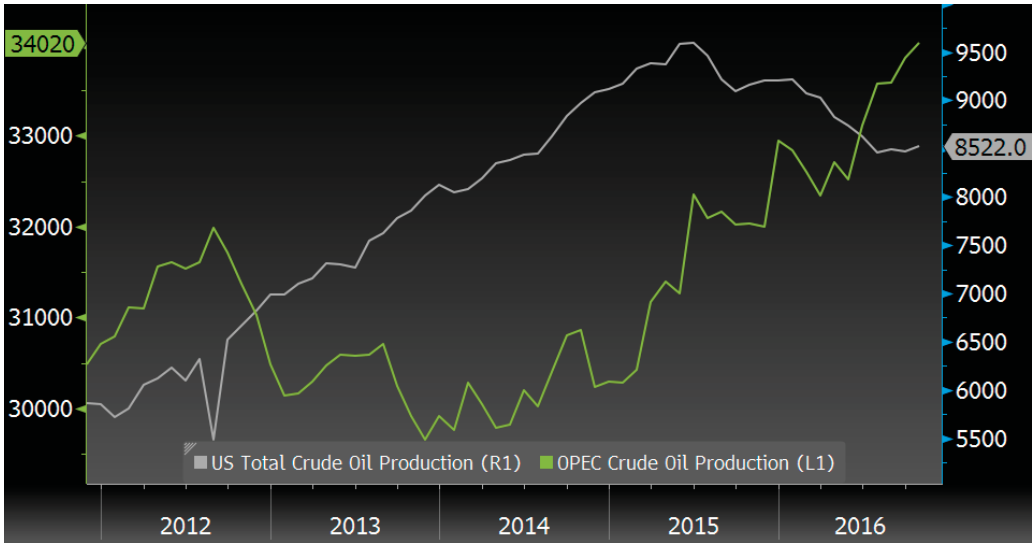
BY JEFF DICKS, JONATHAN FULCHER, DAVID HAY

WORLD OIL DISCOVERY OVER THE YEARS



Source: Colin Campbell, ASPO 2012

CRUDE OIL PRODUCTION: THE US VS OPEC



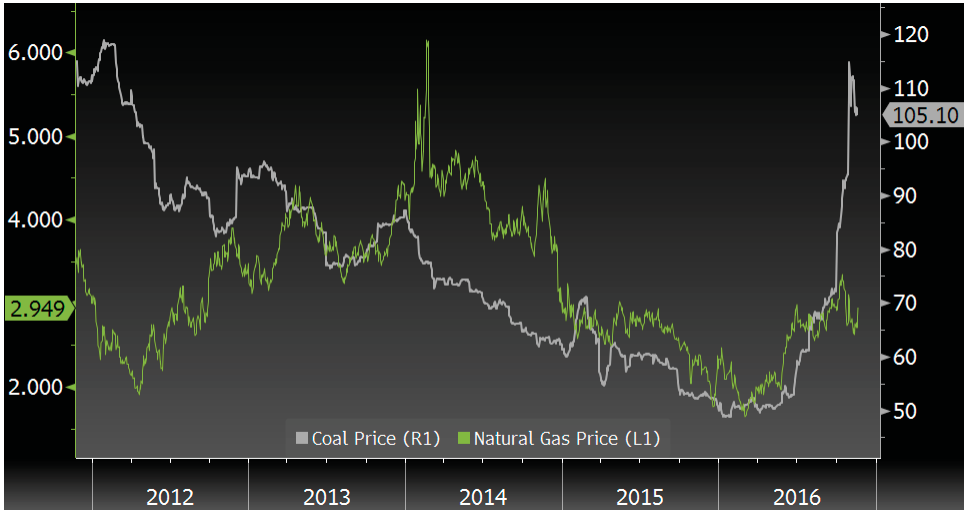
Source: Evergreen GaveKal

- Looking into the future, it is hard for us to imagine that the price of oil remains permanently depressed. New discoveries of oil reserves have fallen far short of production in recent years and this trend is set to continue.
- With global demand continuing to grow, exploration budgets around the world getting slashed, and exceedingly high decline rates for shale production (the supposed new "Swing Producer"), there must be a tipping point at which the market balances out (and potentially swings in the opposite direction).
- However, near-term we still have a glut of oil in inventory and certain OPEC countries that seem set on increasing oil production at a breakneck speed in order to be at a high level prior to any negotiated cutbacks. Make no mistake, these countries need higher prices (particularly Venezuela!); they just don't want to be the one to cut production for the benefit of everyone else.

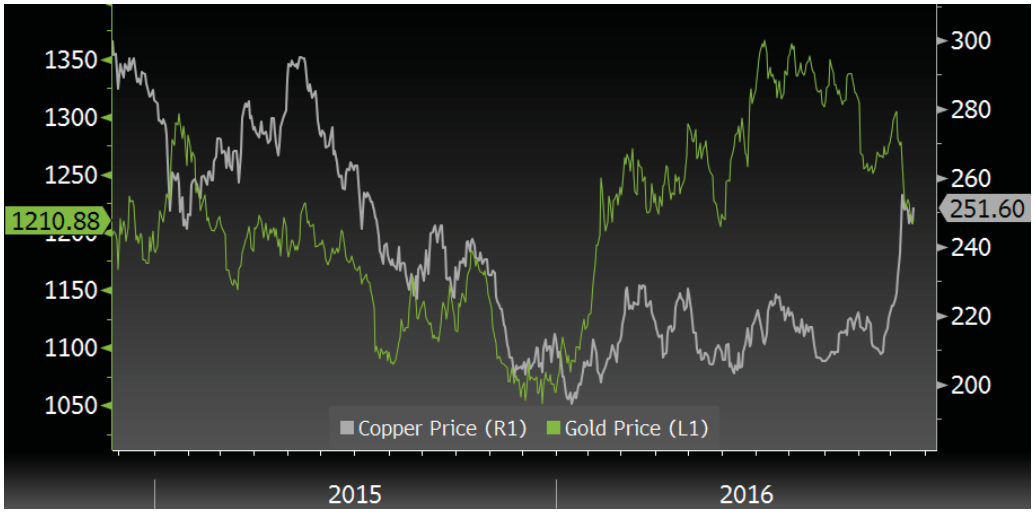
Commodities: The Year of the Paradigm Shift

BY JEFF DICKS, JONATHAN FULCHER, DAVID HAY

COAL VS NATURAL GAS



COPPER AND GOLD



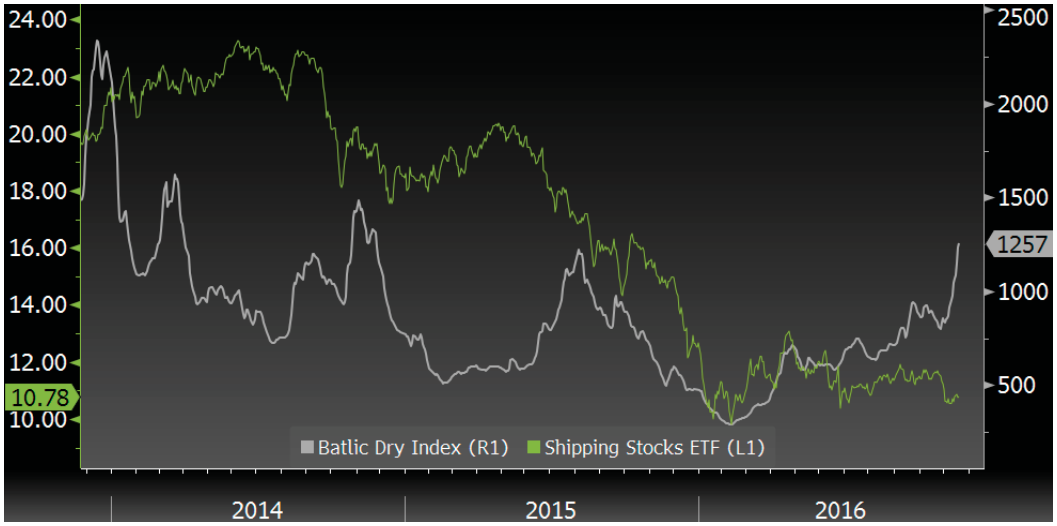
Source: Evergreen GaveKal

- In many ways, 2016 has been a year of reversals, none more so than in the commodity complex. One that stands out in particular was given a huge boost due the stunning results of the US Election: coal
- Enthusiasm should be slightly tempered as the near overnight doubling in price gets directly reflected in the cost of production for utilities (coal's largest end-market) and ultimately, electricity prices. Coal also continues to face stiff competition from plentiful natural gas and many utilities have already made the switch.
- 2016 also marked the change in fortunes for everyone's favorite shiny yellow metal. The rise began due to worries about global growth and unconventional Central Bank policies (NIRP!)
- However, November 8th changed the world overnight (or so it is believed) and all worries have been alleviated by the mere *potential* of the incoming government.
- Copper seems to agree as November 8th marked the sudden expectation of greater industrial activity.

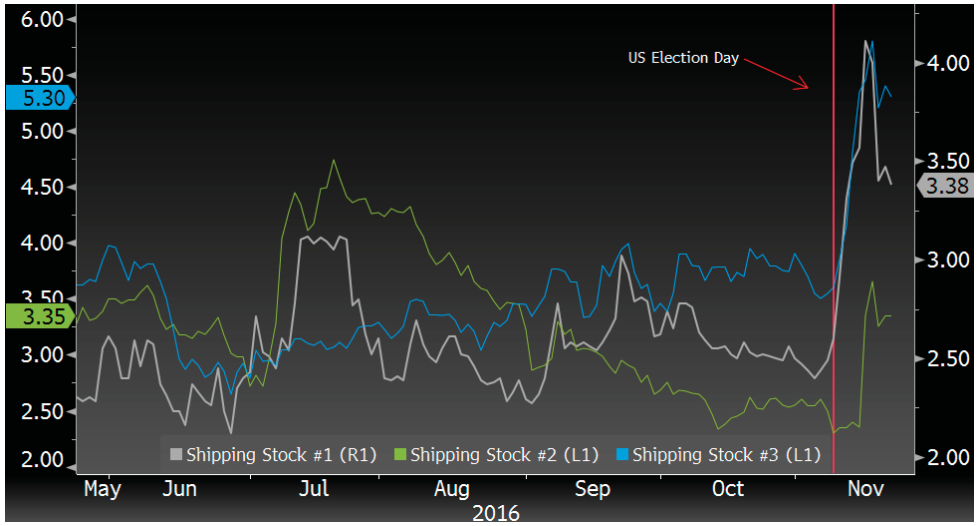
Commodities: Shipping as a Barometer of Global Trade

BY JEFF DICKS, JONATHAN FULCHER, DAVID HAY

SHIPPING STOCKS & THE BALTIC DRY INDEX



SMALL-CAP SHIPPING STOCKS: WILD ENTHUSIASM!



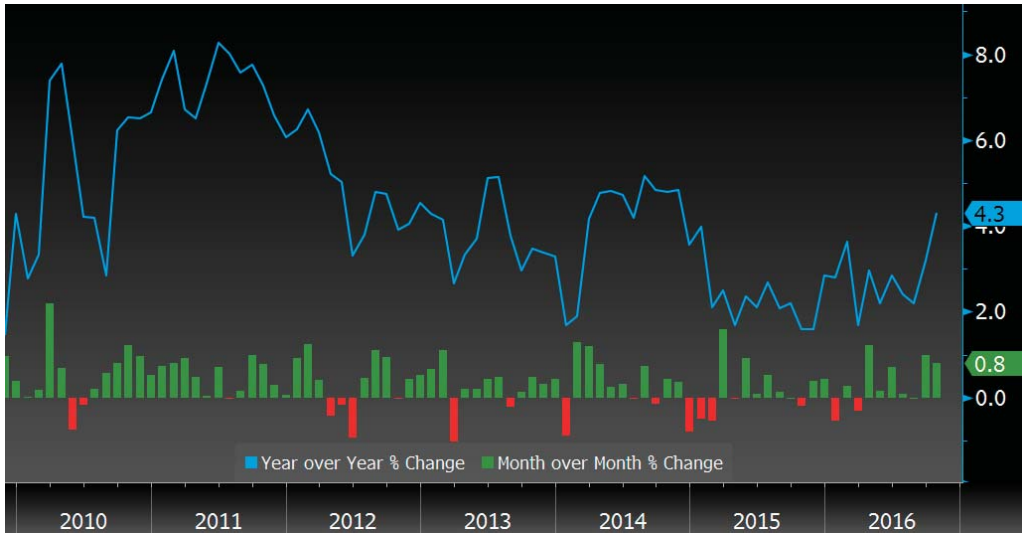
Source: Evergreen GaveKal

- If the health of shipping companies is indicative of the health of global trade, things are not looking good! To be fair, this sector is suffering through one of the longest periods of overbuilding in the history of shipping, but growth in seaborne trade has been incredibly weak for the past several years.
- On the other hand, the Baltic Dry Index (essentially a measure of profitability in the shipping sector) has finally begun to rise, which is in sharp contrast to the overtly protectionist rhetoric that we have heard over the past few months.
- In small-cap shipping stocks, the irrationality of the market is on full display. Many had a massive spike after the election with some rallying over 100% in just one week!

Macro: On the (Relatively) Positive Side

BY JEFF DICKS, JONATHAN FULCHER, DAVID HAY

TOTAL US RETAIL SALES



US HOUSING STARTS

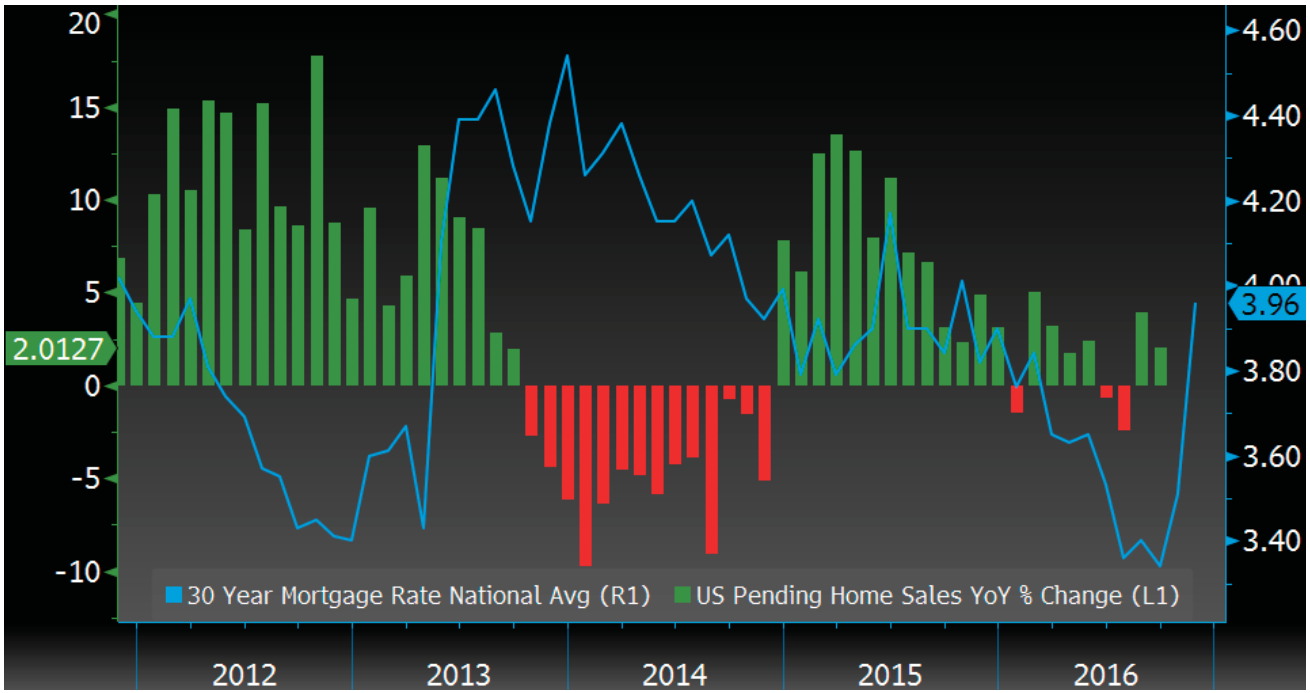
Source: Evergreen GaveKal

- Throughout 2016, we have received a mixed bag of economic data. Some good, some bad, some downright confusing. The consumer, however, suddenly seems to have broken out to the positive side of that equation with total retail sales rebounding strongly in October to a +4.3% year-over-year pace.
- The housing market in the US also continues its long recovery with surprisingly strong data coming out of October. Residential home starts were up 25% month-over month in October with multi-family starts growing 68% over that same time frame.

Macro: On the Less Positive Side

BY JEFF DICKS, JONATHAN FULCHER, DAVID HAY

30 YR MORTGAGE RATE VS HOME SALES: TAPER TANTRUM 2.0?



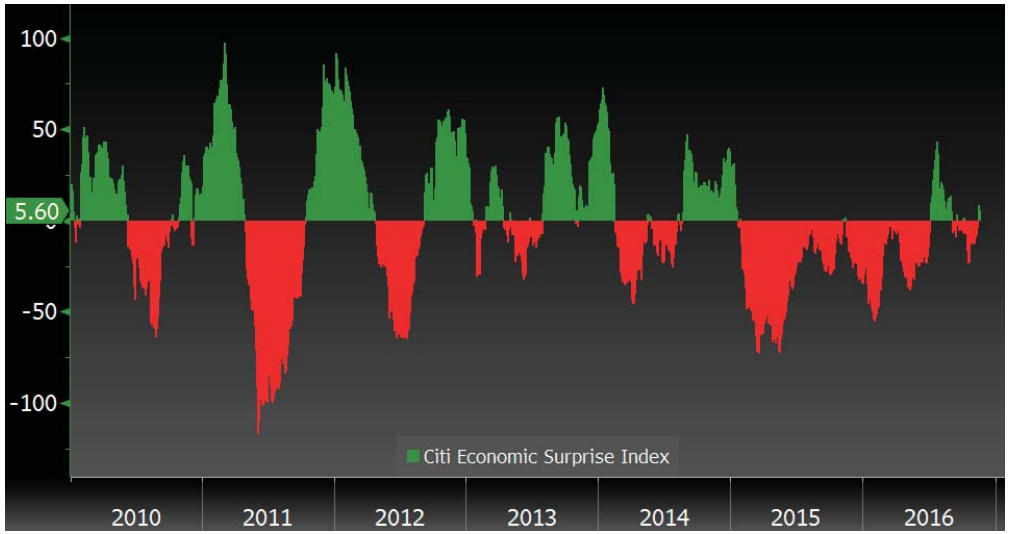
Source: Evergreen Gavekal, Bloomberg

- Unfortunately, somewhat positive data out of October does not take into account the massive spike in interest rates that we have seen in the past two weeks. The last time rates had a similar leap was in 2013 (the Taper Tantrum) and the effect on US home sales was felt for an entire year after that event.
- The 30-year mortgage rate has had a near identical move in rates (so far!) while home sales have been in a year-long downward trend. Any guesses on where we go from here?

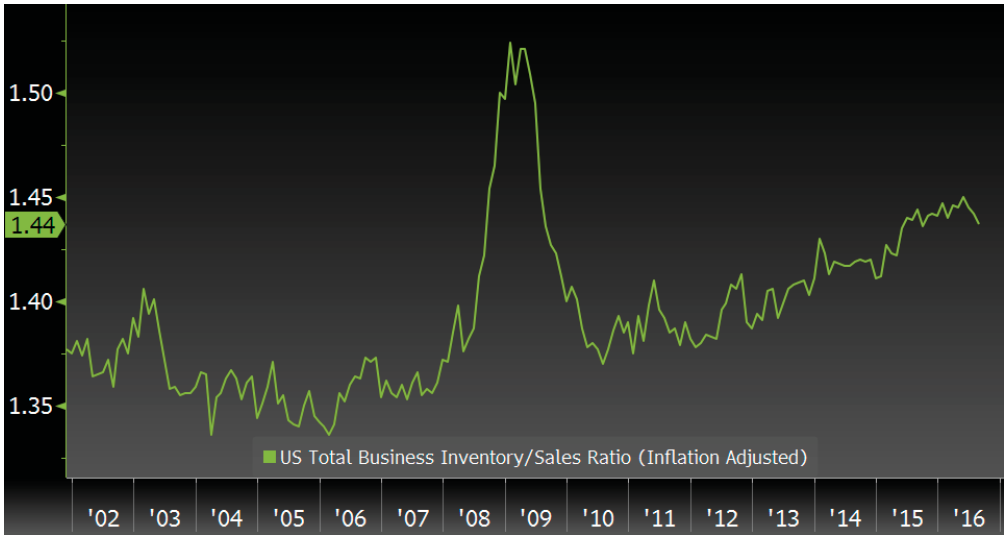
Macro: On the Less Positive Side

BY JEFF DICKS, JONATHAN FULCHER, DAVID HAY

ECONOMIC SURPRISE INDEX



US TOTAL INVENTORY/SALES RATIO



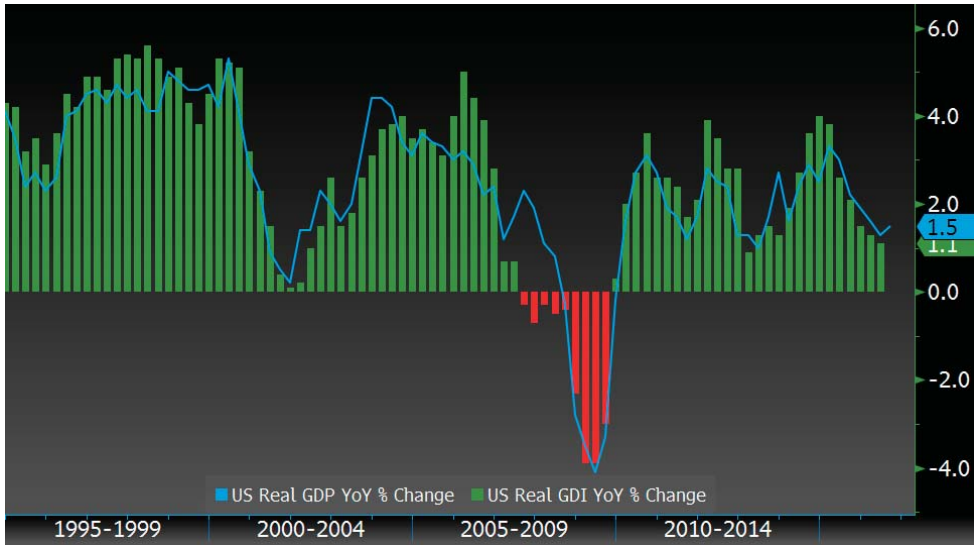
Source: Evergreen GaveKal

- After a near two year run of disappointing economic data, we had a summer that revealed some bright spots. The theme since that time has been mixed and confusing data.
- Some of this confusion undoubtedly stems from the uncertainty that the economy has faced over the past year, particularly with the election looming large.
- Consistent with a confused economy that is always expected to grow faster than what actually occurs, inventories have crept up over the years while sales growth has simply not kept pace. An ever-growing drag from inventories cannot end well.

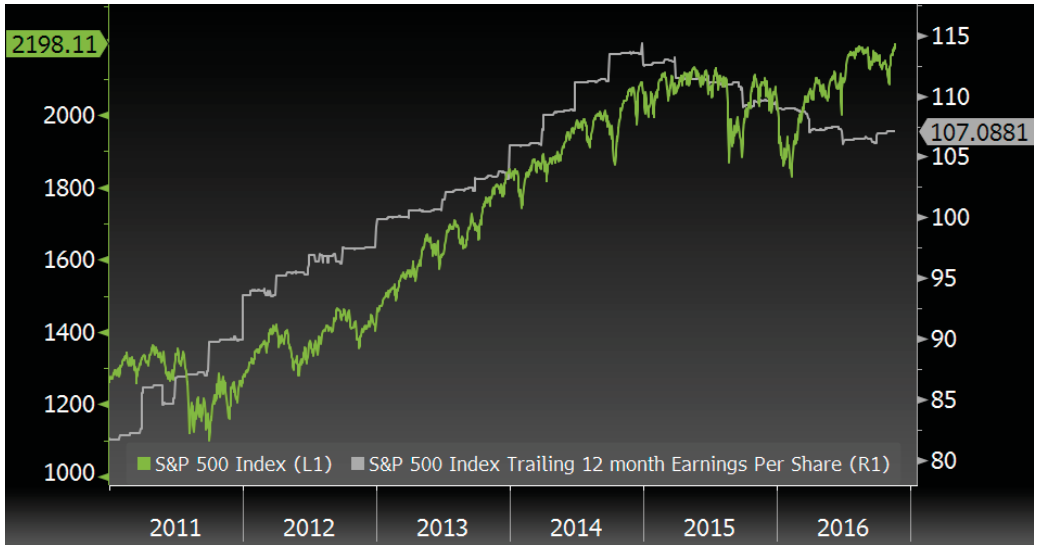
Macro: A Trend of Weakness

BY JEFF DICKS, JONATHAN FULCHER, DAVID HAY

GDP & GDI



S&P 500 VS TRAILING 12 MONTH EARNINGS



Source: Evergreen GaveKal

- Whichever way you look at the US economy, whether through GDP (what the economy produces) or Gross Domestic Income (GDI, what the economy earns), both measures agree that the trend is in the wrong direction, particularly over the past 7 quarters or so.
- We have been here before, back in 2013, in what turned out to be a temporary dip in growth. Is this 2013 or something worse?
- At some level, optimists might claim that the earnings recession may finally be over while pessimists will point to the fact that the S&P 500 has marched upward anyway, discounting the return to positive earnings. On a broad basis we are more likely to agree with the latter, though there are certainly pockets that can still offer value.

Conclusion

BY JEFF DICKS, JONATHAN FULCHER, DAVID HAY

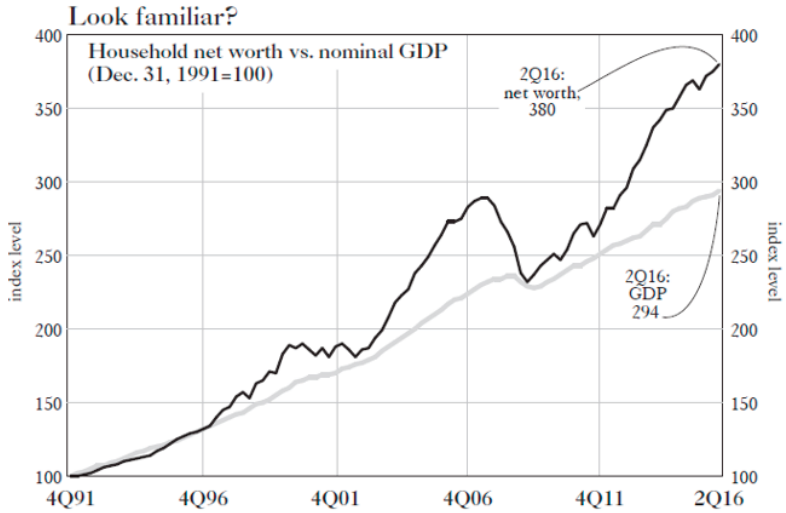
As you have seen, it's been a noteworthy couple of weeks for financial markets. Clearly, there has been a shift in economic sentiment towards higher inflation and growth. Additionally, there have been clear winners and losers displayed by the dislocations we have seen in various asset classes. At Evergreen, as we have articulated since the election, we are hesitant to call for a growth pickup simply on the heels of a Trump presidency.

On one hand, we see some clear potential positives for growth in the form of deregulation, tax reform (at the corporate and individual level), as well as re-building our aging infrastructure. On the other hand, there are potential inhibitors to growth such as trade policy, protectionism, and immigration reform, all of which have largely been ignored by the markets. It's also unclear what translates from Trump's promises as a candidate to what he will deliver as our president, which adds an additional element of uncertainty. For the growth thesis, it's also concerning what happens to the budget deficit and the potential hurdles in passing these giant spending bills. Furthermore, if an infrastructure bill does get passed, implementation will be critical. At this stage, with the amount of debt we have on our government's balance sheet, the multiplier effect from these projects is much lower compared with previous decades. This means less margin for error for re-building America. There is a substantial lag until these projects actual lead towards more growth. Accordingly, we believe that market participants purely discounting the growth side of equation might be getting a bit ahead of themselves.

Lastly, when we analyze the global economic landscape, we still see a mostly weak backdrop. The world continues to operate with far too much excess capacity and global debt continues to ascend to even more dangerous levels. Our final chart shows household net worth relative to nominal GDP. As you can see, the gap between asset prices and GDP is at the highest level in 25 years. The key point is that this time series has historically been mean reverting. This means that we either have a massive growth pickup or a nasty reset in asset prices. While we lean towards the latter, we also believe when the market heavily discounts one outcome, like it is today, it makes sense to hedge the other way.

Today, one of the biggest risks we see is the economy tilting into recession. If a downturn were to occur, we think this could lead to a nasty feedback loop where the drop in financial assets leads to a contraction with consumer spending. Furthermore, with rates still near-zero, the Fed has a much more limited toolbox to combat a downturn compared to previous cycles. Therefore, we'd be quite wary of the constructive reaction so far, and would even take this opportunity to trim back on some of the areas that have benefited on optimism alone.

HOUSEHOLD NET WORTH VS. NOMINAL GDP



Source: Federal Reserve, Bureau of Economic Analysis

Our Current Likes and Dislikes

EVERGREEN GAVEKAL

We moved emerging stock markets to "We Don't Like" this week.

WE LIKE

- Large-cap growth (on a deeper pull back)
- International developed markets (on a deeper pull back)
- Canadian REITs
- Intermediate Treasure 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

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
- Blue chip oil stocks
- Emerging bond markets (dollar-based)
- 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