

## A Rare Divergence: Economic Data vs. Financial Markets - Where Do We Go Next?

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*“Abnormally good or abnormally bad conditions do not last forever. This is true not only of general business but of particular industries as well.”*

—BEN GRAHAM

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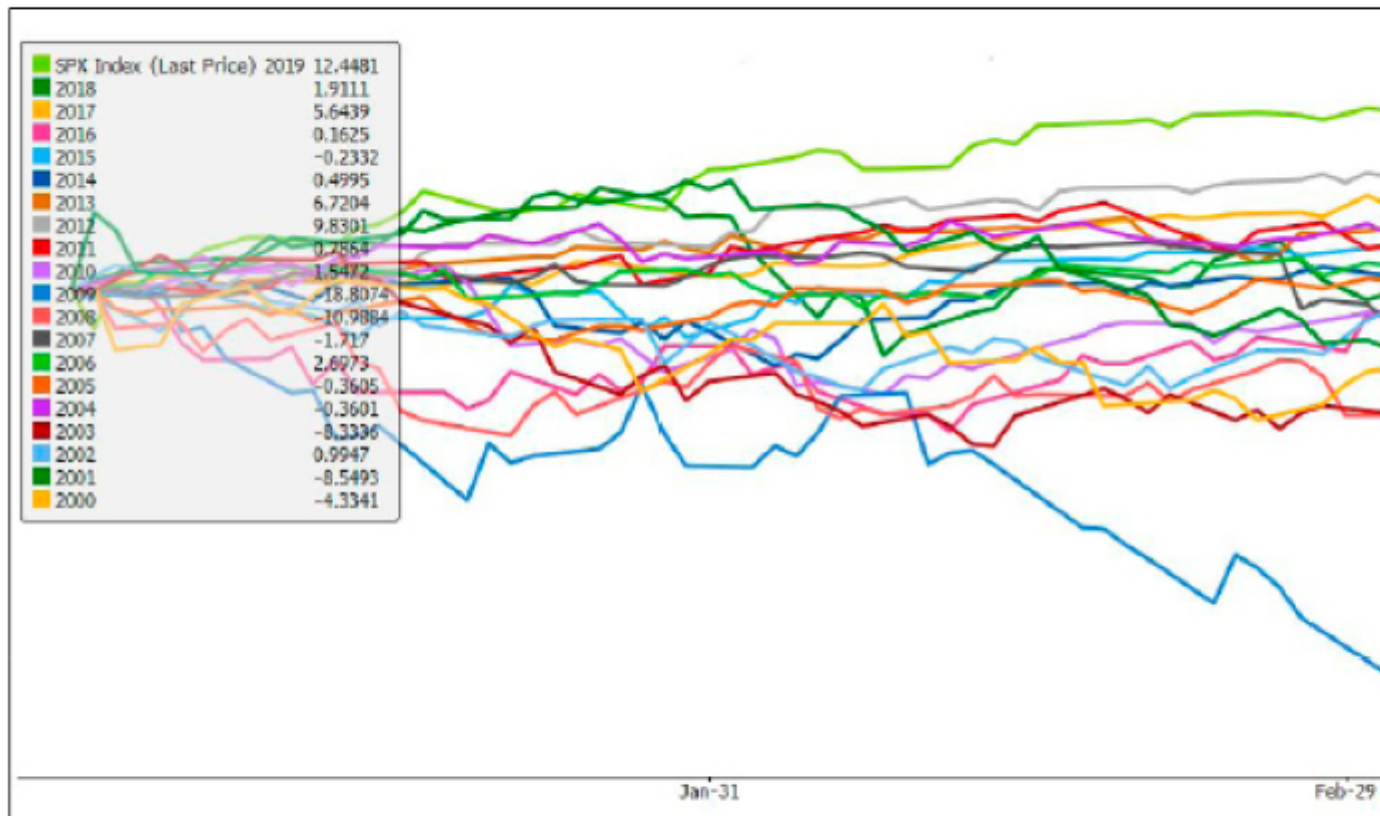
Financial markets have been breathtakingly strong so far in 2019. In fact, it's been the best start for the US stock market since 1992, with the S&P 500 posting a 13.1% total return through mid-March. Another impressive stat is that the NASDAQ began the year with nine straight up weeks – a feat not seen since 1964. International stocks, corporate bonds, REITs, and midstream energy assets have also posted remarkable returns.

This has been a polar shift relative to Q4 of 2018 when all of these markets were in freefall. We believe there are two main reasons for the sentiment swing. First, the Fed has completely shifted its stance in regards to rate hikes. Late last year they forecasted two bumps for 2019, and more recently announced a pause, as several key members have hinted the next move could just as likely be a cut as a hike. In addition, the Fed will cut off its quantitative tightening process far sooner than previously anticipated. Bottom line: the Fed's tone has become more dovish. The next rationale for the recent rally is the market has become more optimistic on trade negotiations with China. A simple tweet from President Donald Trump saying: “Talks with China are going very well!” has proven enough to push stocks up significantly intraday, and Asian stocks even more. This has been consistent within financial media, and at this point seems to be mostly discounted within financial markets.

What is fascinating about this record run, and shift in sentiment, is that it has occurred in the face of weakening economic data. In the US, GDP estimates have been ratcheted down due to a weakening consumer, falling industrial and manufacturing activity, and generally weak corporate earnings and company guidance. International data points have been just as bad, or worse, with some economies abroad, like Italy, officially tipping into recession. We have also seen a continued deterioration globally for leading economic indicators, which doesn't bode well for a near-term economic rebound.

In this week's chartbook edition of Evergreen Virtual Advisor, we will dive into financial markets this year, economic data points, and where we go from here. Below, you'll see our first chart illustrating the S&P 500 year-to-date compared with the last 20-years.

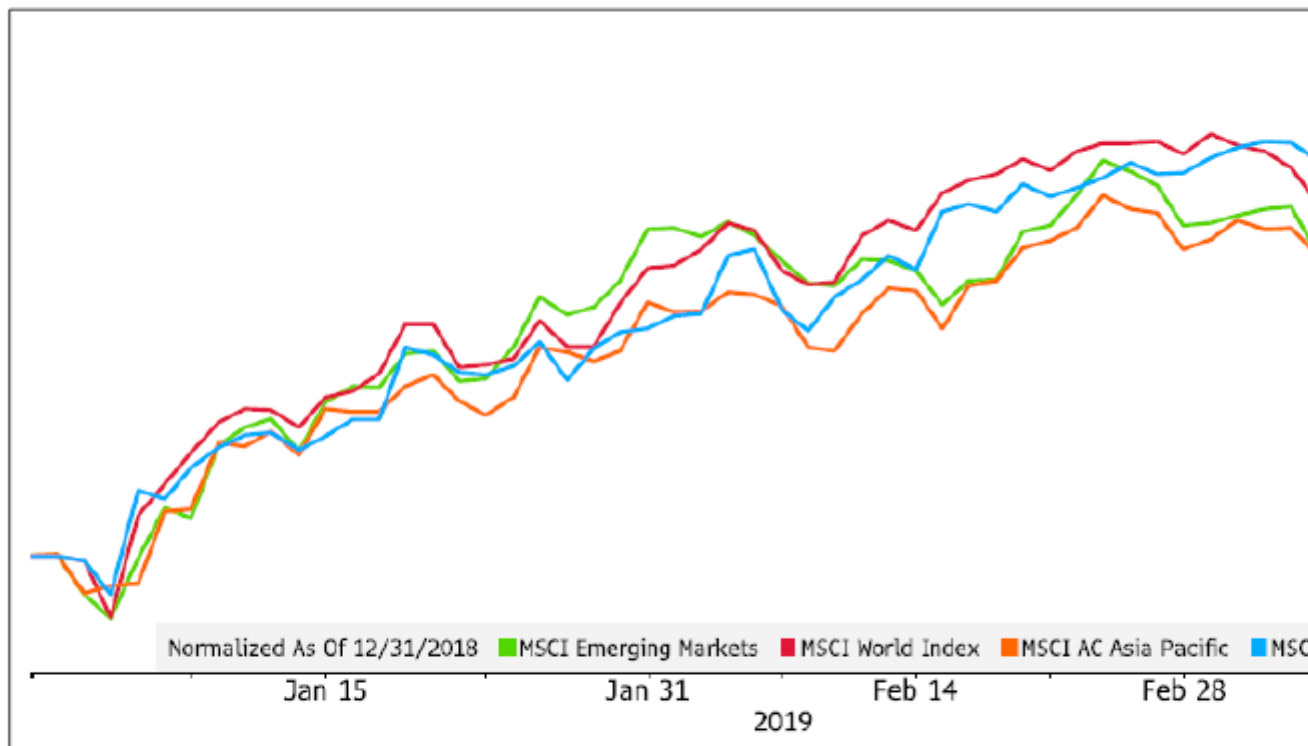
## S&P YEAR-TO-DATE VS. LAST 20 YEARS



SOURCE: BLOOMBERG, EVERGREEN GAVEKAL, 3/19/2019

- As mentioned on the previous page, our first chart shows the return of the S&P 500 year-to-date through any year over the last two decades.

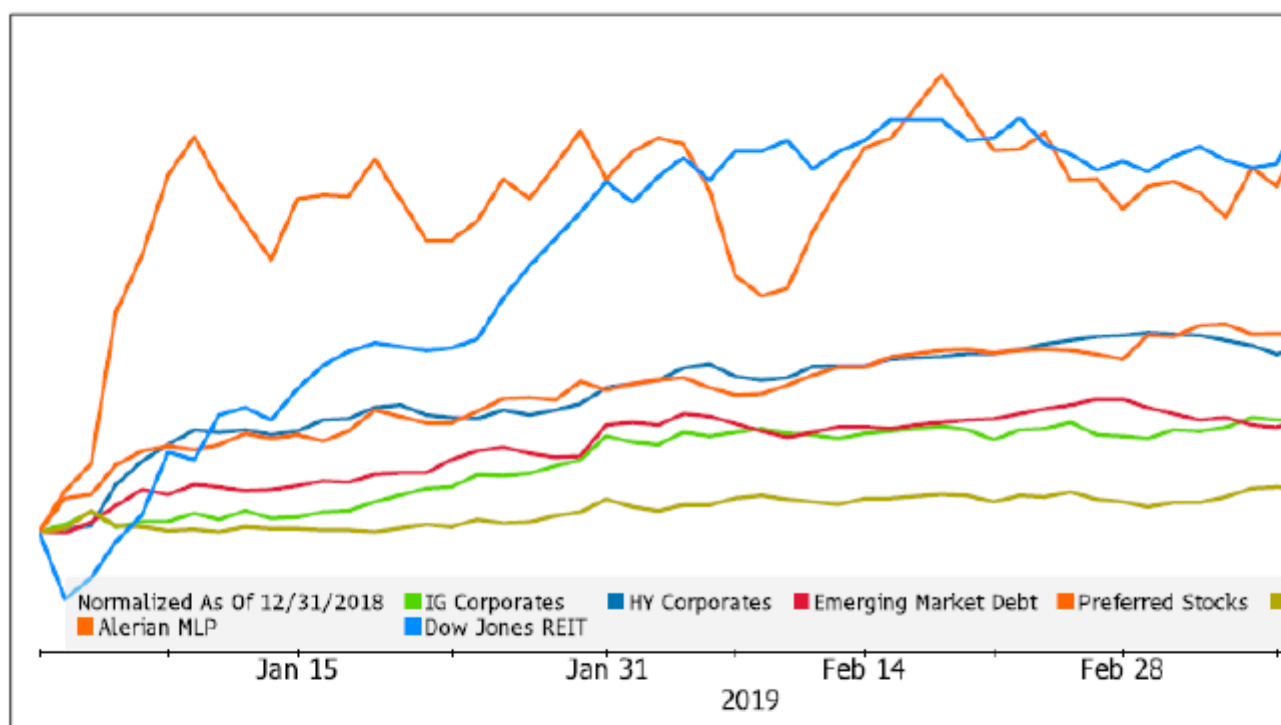
## EQUITY MARKETS YEAR-TO-DATE



SOURCE: BLOOMBERG, EVERGREEN GAVEKAL, 3/20/2019

- The chart above shows year-to-date performance for the global equity indices.
- The MSCI World and MSCI Europe have also posted their best start to the year since 1999.

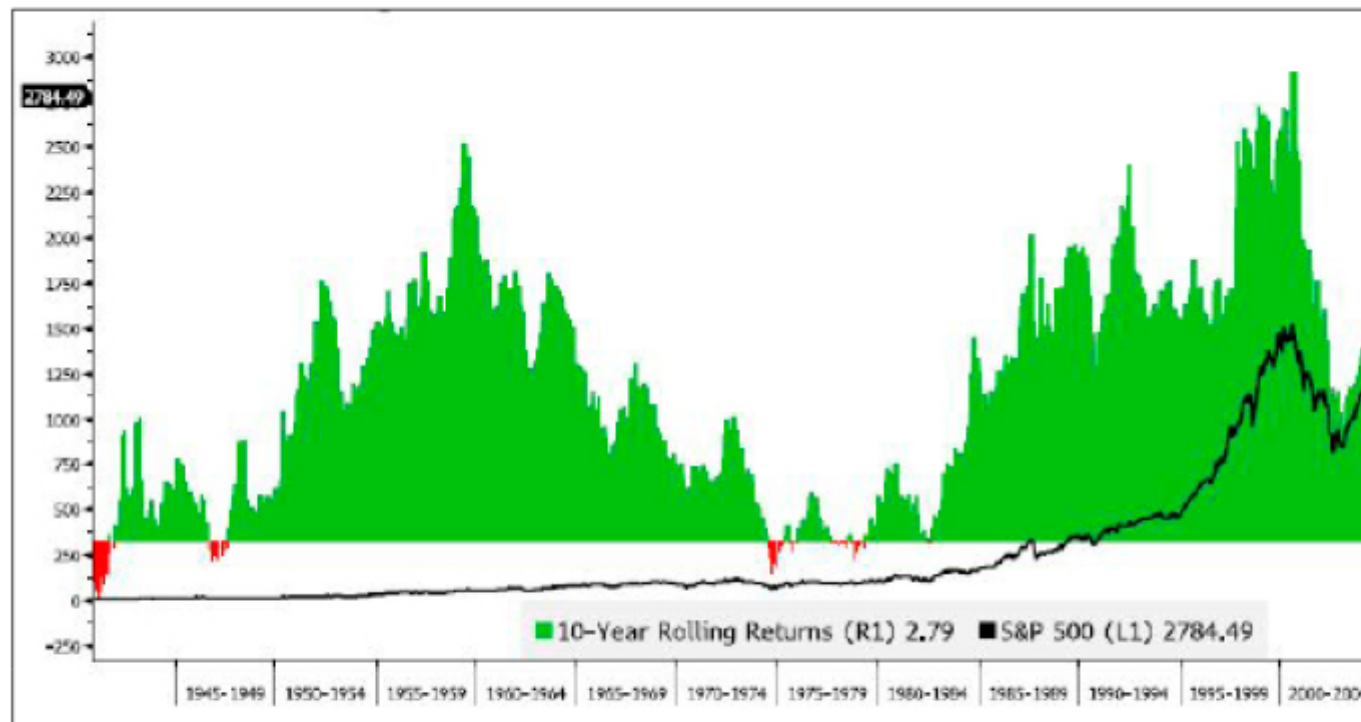
## INCOME MARKETS YEAR-TO-DATE



SOURCE: BLOOMBERG, EVERGREEN GAVEKAL, 3/20/2019

- Income markets have run up in similar fashion, with US investment grade and high yield corporate bond
  - It's worth noting the total return is more than 100% of the current yield for these areas of the bond market.
- In the equity income universe we have witnessed remarkable runs for MLPs (midstream energy securities) and preferred stocks.
- The Barclays Agg, mostly invested in treasuries, is also up 1.7% on the year, highlighting the broad-based nature of the rally in risky and risk-free-type assets.

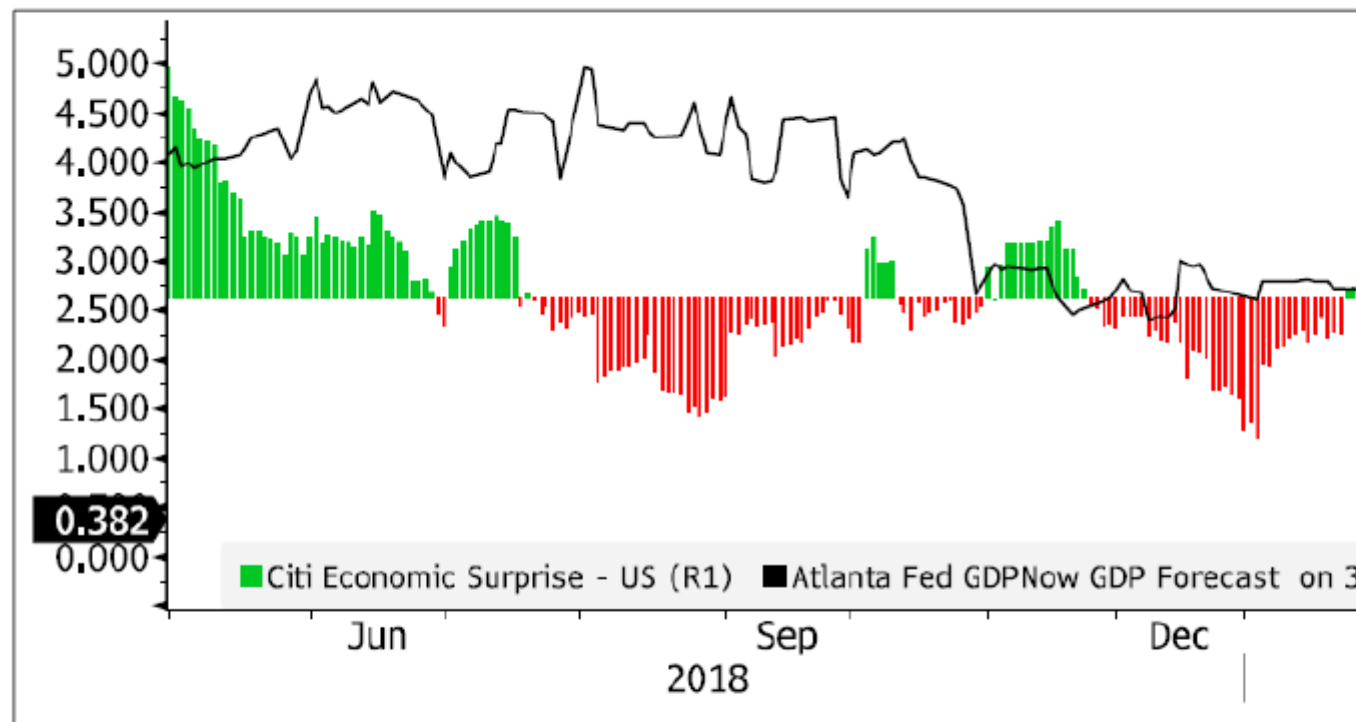
## S&P 500 AND ROLLING 10-YEAR RETURNS



SOURCE: BLOOMBERG, EVERGREEN GAVEKAL, 3/19/2019

- On a longer-term basis, the rolling 10-year return for the S&P 500, according to Goldman Sachs, is in the 9% range.
- The other two peaks on charts (1959 and 2000) were followed by 3-year returns of 0% and -27% respectively.
- Looking at the chart, large up-moves are generally followed by retracements, which indicates a period of consolidation for 3 to 5 years.

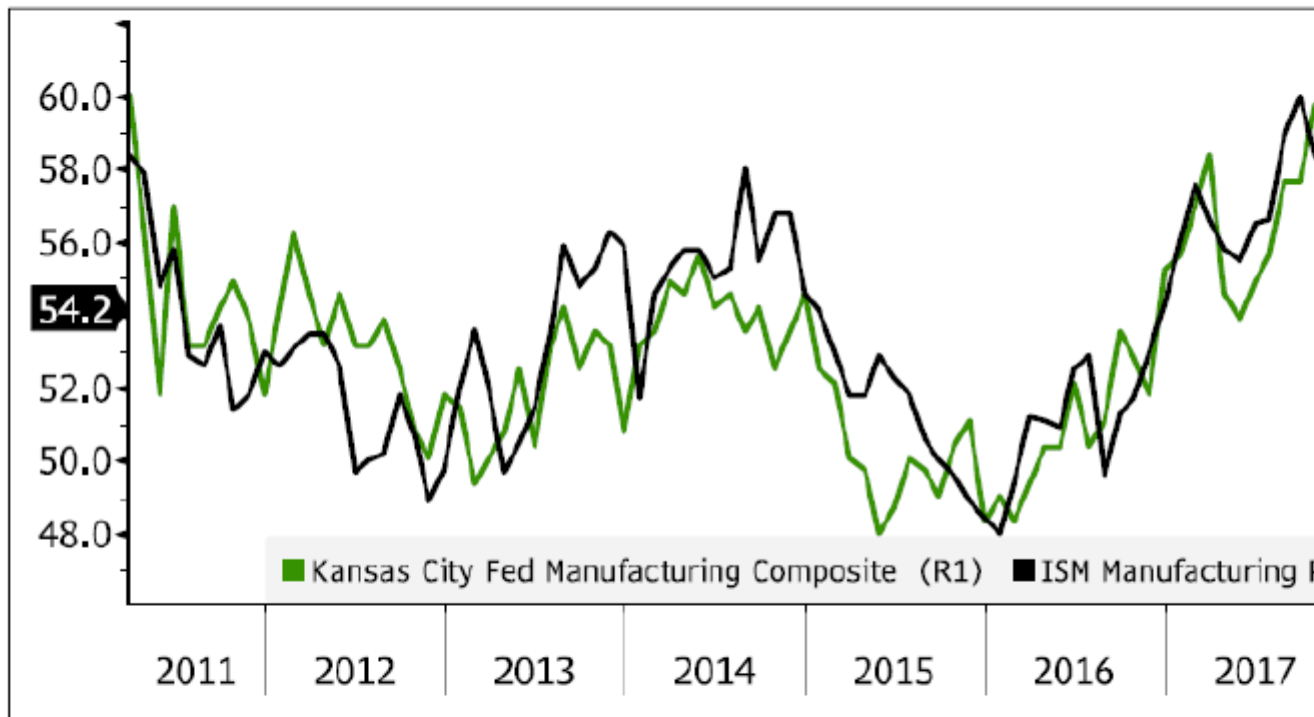
## US ECONOMIC SURPRISE INDEX, AND ATLANTA GDP



SOURCE: BLOOMBERG, EVERGREEN GAVEKAL, 3/19/2019

- Moving onto US economic data, we have seen a decisive turn for the worst.
- The chart above shows the Citi US Economic Surprise Index (bar chart), which illustrates a series of significant negative surprises in the last few months.
- This has led to downward revisions to growth, and as you can see the Atlanta Fed GDP Now tracker (black line) has fallen from over 4% back in mid-2018 to the current quarter – down from over 4% back in mid-2018.

## US MANUFACTURING DATA

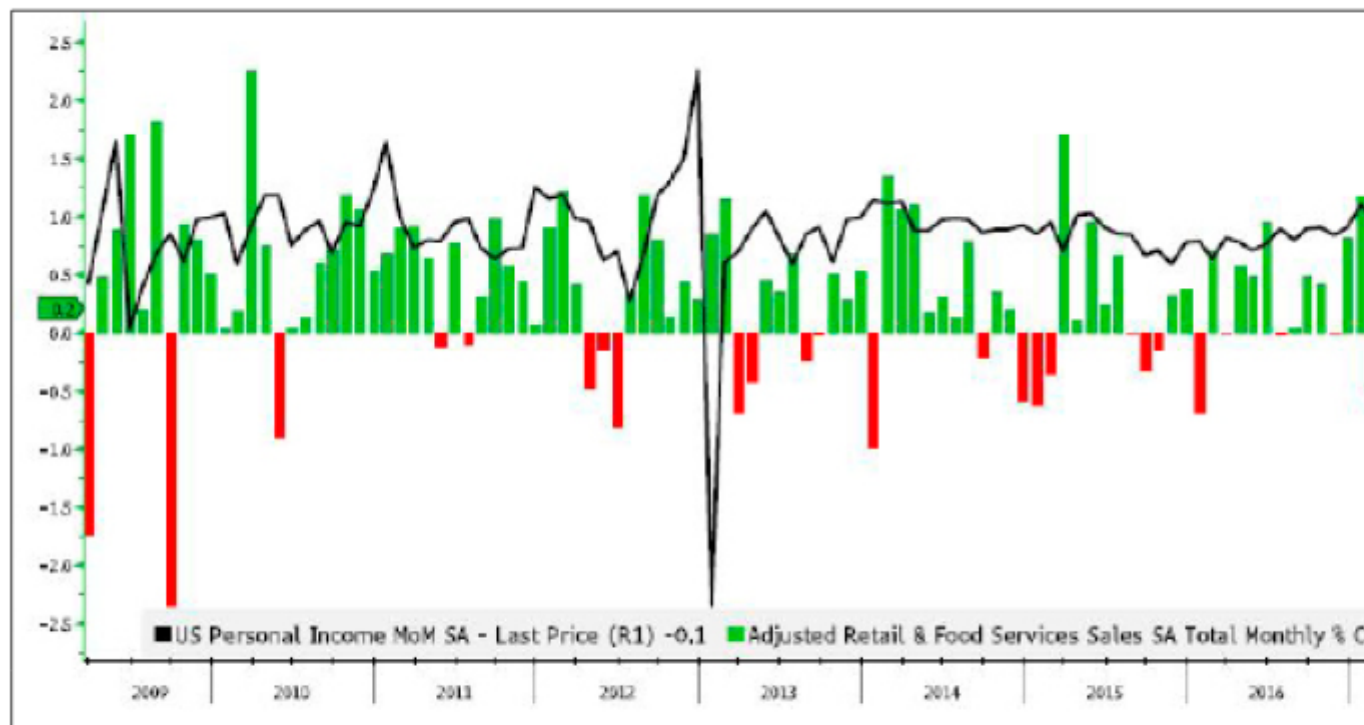


SOURCE: BLOOMBERG, EVERGREEN GAVEKAL, 3/19/2019

- Indices that track US manufacturing have moved down rather drastically as well.
- It's worth noting that once these head south, they tend to move into negative territory (i.e. likely head south).
- Confirmation of this view is that the Philly Fed New Orders Index, a key leading indicator for manufacturing, is at its lowest level since May of 2016.



## US CONSUMER SENTIMENT AND RETAIL SALES

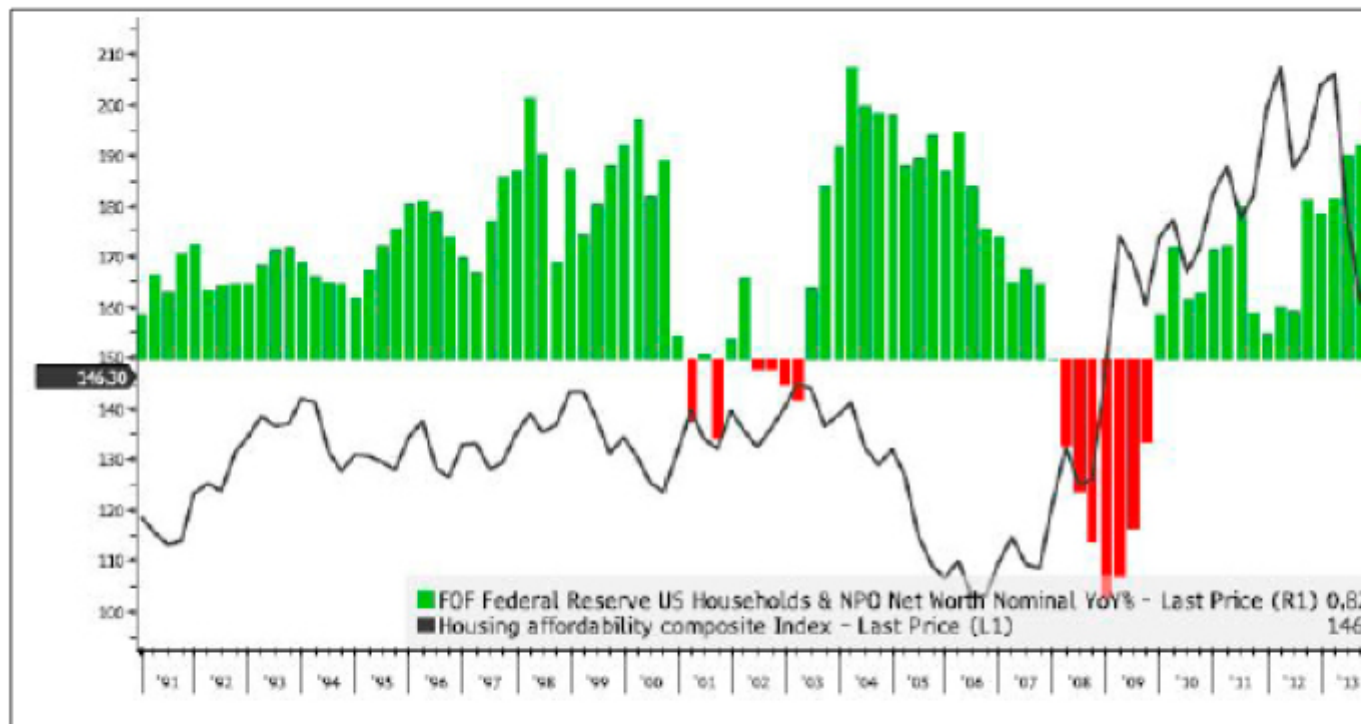


SOURCE: BLOOMBERG, EVERGREEN GAVEKAL, 3/19/2019

- Consumer data has also taken a turn for the worse, with retail sales falling -1.6% in December, or the lowest
- Personal income also fell 0.1% in January, the lowest figure in 5-years.
- A fascinating statistic ran by Gluskin Sheff's chief economist David Rosenberg is that the average tax refund, which could mean less of a spending boost than normal post-tax season.



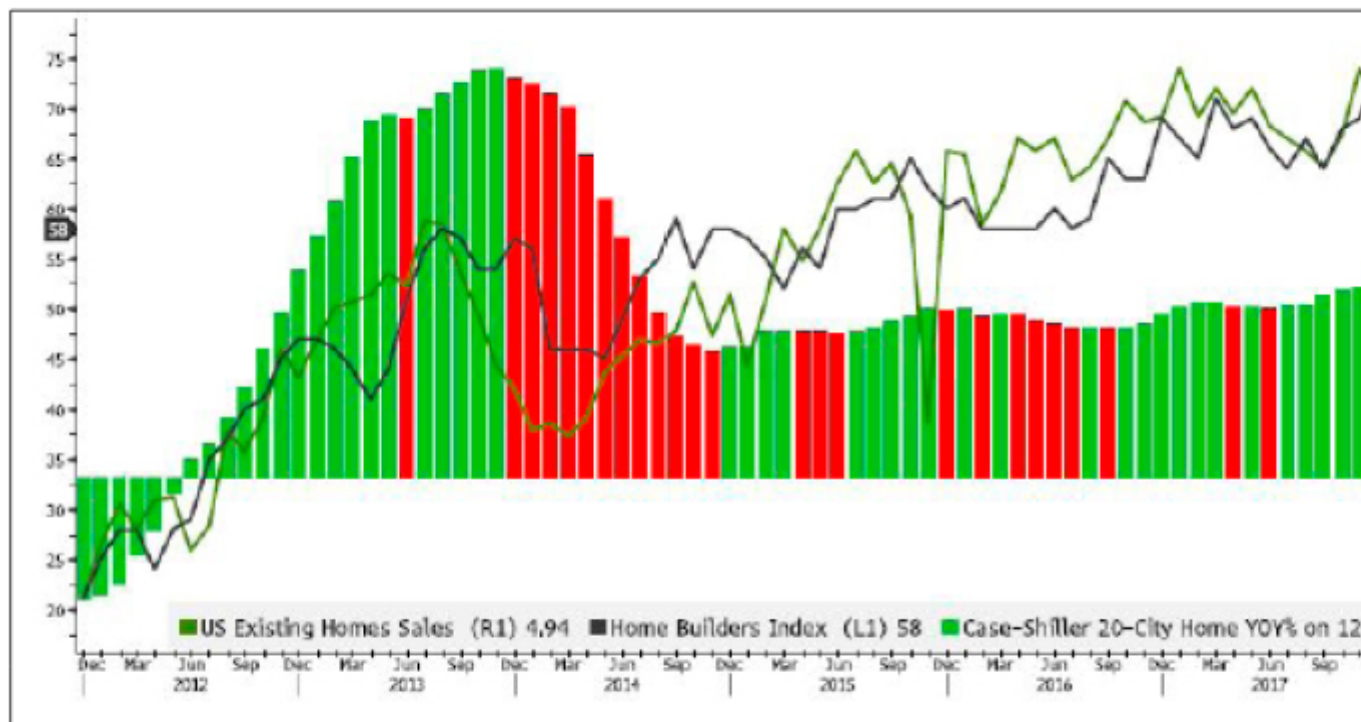
## NET WORTH AND HOUSING AFFORDABILITY



SOURCE: BLOOMBERG, EVERGREEN GAVEKAL, 3/19/2019

- On a longer-term basis, it's interesting to look at household net worth YoY, as measured by the federal reserve.
- As you can see, this metric has dipped to the lowest positive annual gain since right before the financial crisis.
- Housing affordability is overlaid on this chart, and with this metric at the lowest level this cycle, it highlights a good time to buy.

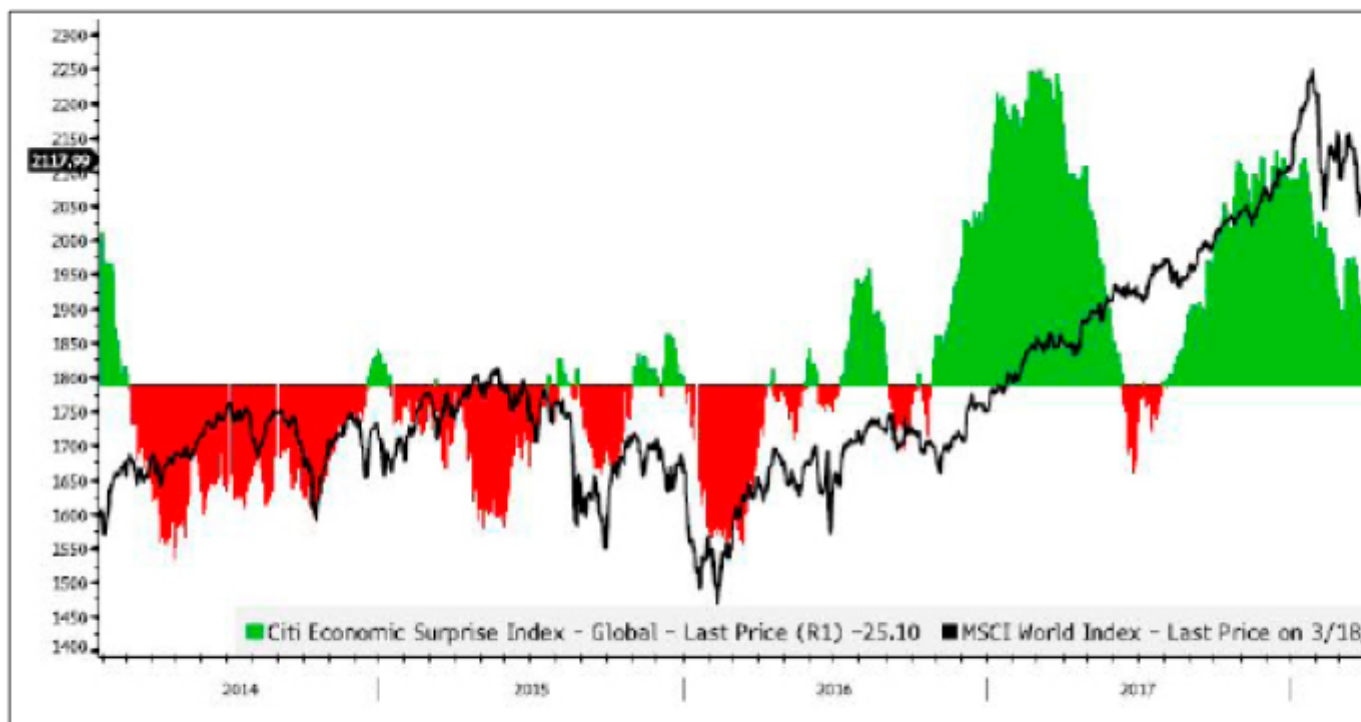
## EXISTING HOMES SALES AND OTHER MORTGAG



SOURCE: BLOOMBERG, EVERGREEN GAVEKAL, 3/19/2019

- Speaking of housing trends, you can see existing home sales have really taken a nose-dive over the last y
- Ditto for the NAHB home builder index, which fell 8 out of 12 months during 2018, or the highest such rate
- Also overlaid are housing prices year-over-year according to Case Shiller, which are still up but have slow
- Given affordability has dropped with the magnitude shown on the previous page, it's hard to envision ho

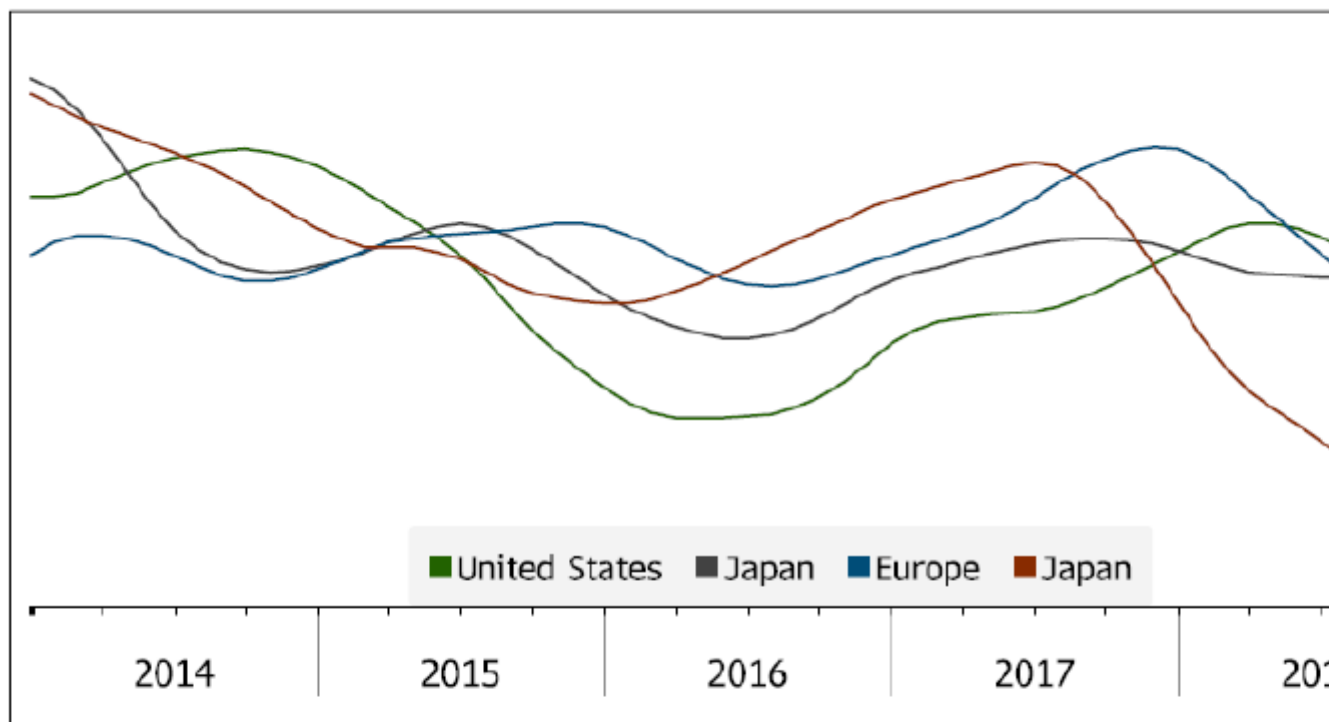
## GLOBAL SURPRISE INDEX AND MSCI WORLD



SOURCE: BLOOMBERG, EVERGREEN GAVEKAL, 3/19/2019

- Global data has also taken a downward turn, with the Global Citi Economic Surprise Index registering a 5-
- As previously mentioned, but worth keeping in mind, is the rare divergence that is occurring with deeply stock market rally.

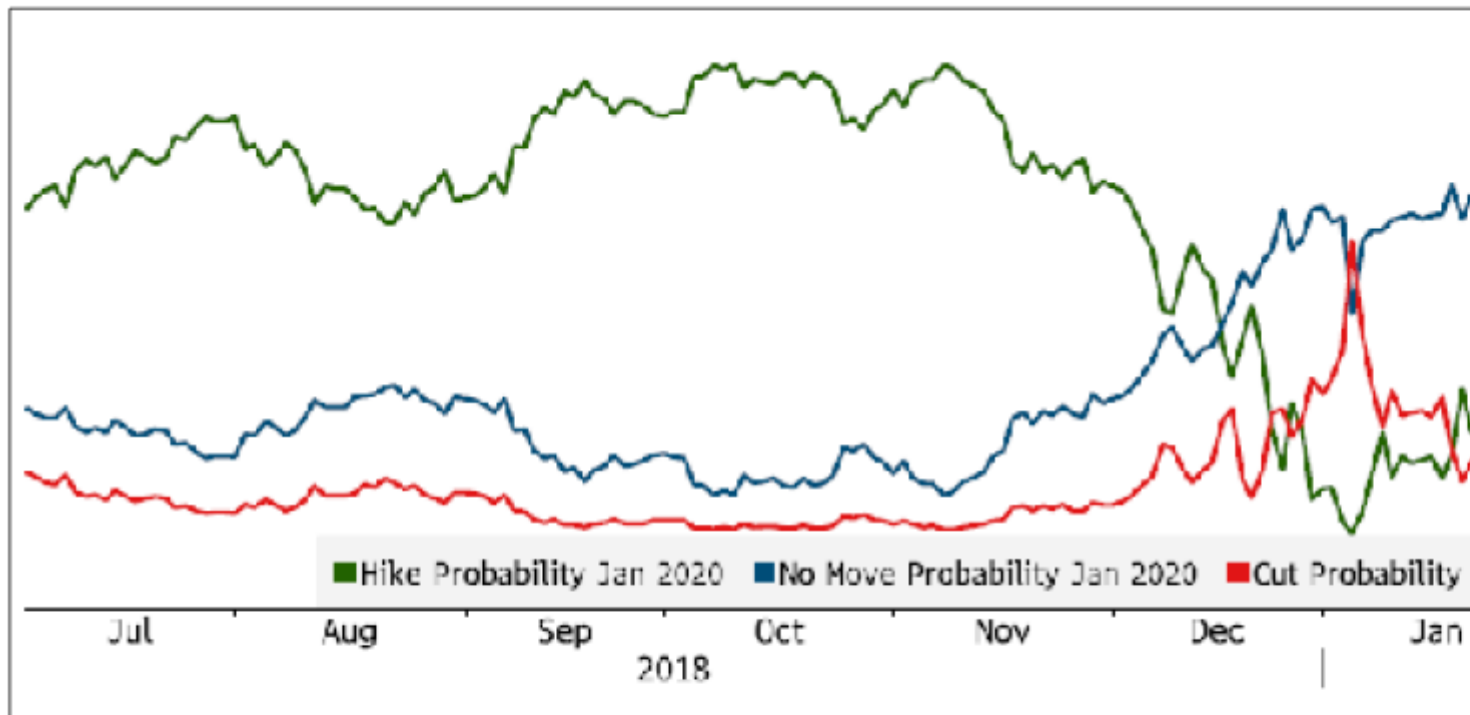
## OECD LEADING INDICATORS



SOURCE: BLOOMBERG, EVERGREEN GAVEKAL, 3/19/2019

- After prolonged periods of weak economic releases, you typically tend to get some mean reversion. However, a near-term bounce might be unlikely.
- In fact, according to Ned Davis Research, the OECD composite Index (including India and China) fell for a lowest reading in a decade.
- It's worth noting the OECD recently downgraded its global growth forecast by .2% to 3.3% from 3.5%, and continues to lose momentum."

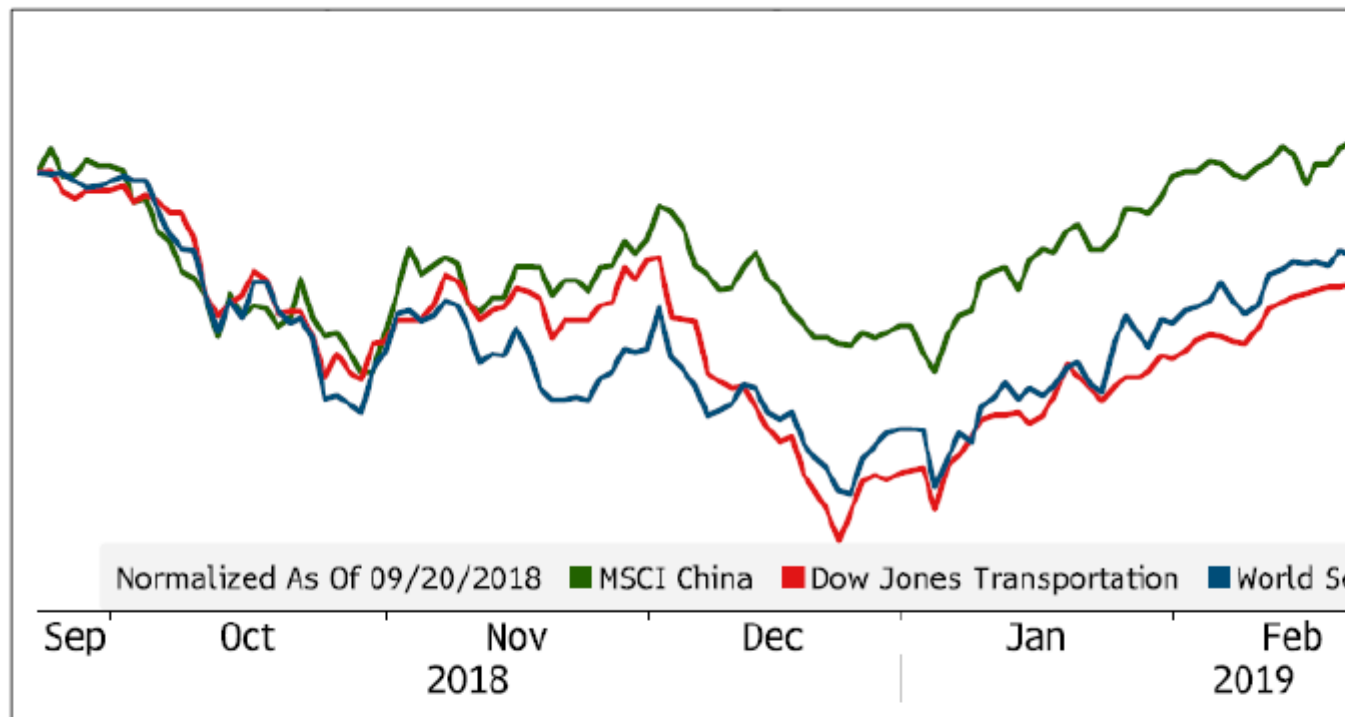
## FED INTEREST RATE PROBABILITIES FOR JANUARY 2020



SOURCE: BLOOMBERG, EVERGREEN GAVEKAL, 3/19/2019

- The weak data, and quarter four volatility, no doubt spurred the Fed to become more dovish.
- The chart above highlights probabilities, implied by interest rate futures, for what the Fed will do in Jan
- Interestingly, there is now a 40% probability of a cut (up from 3% mid-2018) and 0% for a hike (down from
- So far, this has been perceived as good news by markets, but it's worth noting a Fed pause tends to be r often precedes economic recessions.

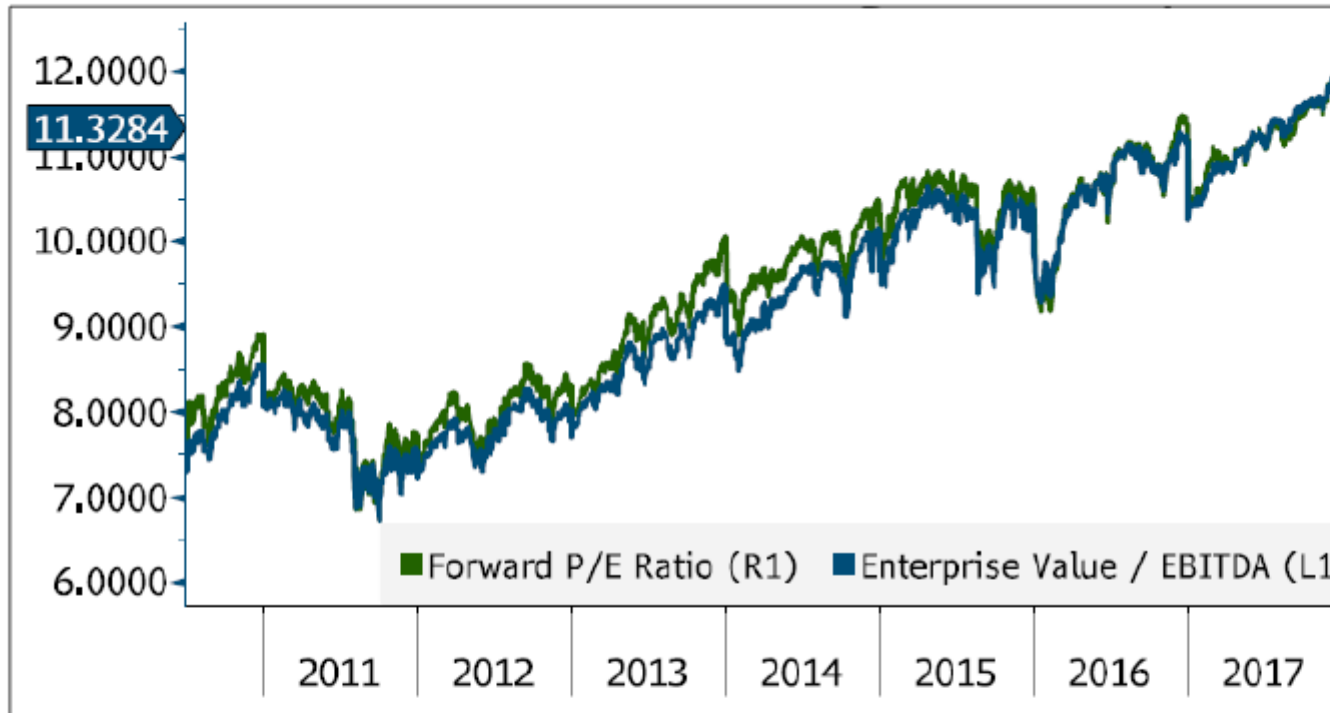
## CHINA TRADE PROXIES



SOURCE: BLOOMBERG, EVERGREEN GAVEKAL, 3/19/2019

- Along with a more dovish Fed, financial markets have been rallying hard on hints of a potential trade deal.
- As you can see, key proxies for a China trade deal (Chinese stocks, the World Semiconductor Index, and the Dow Jones Transportation Index) have recovered their Q4 losses with China now above its Q4 peak.
- This highlights a Trump/Xi trade deal is basically priced into the markets at this point.

## S&P VALUATION

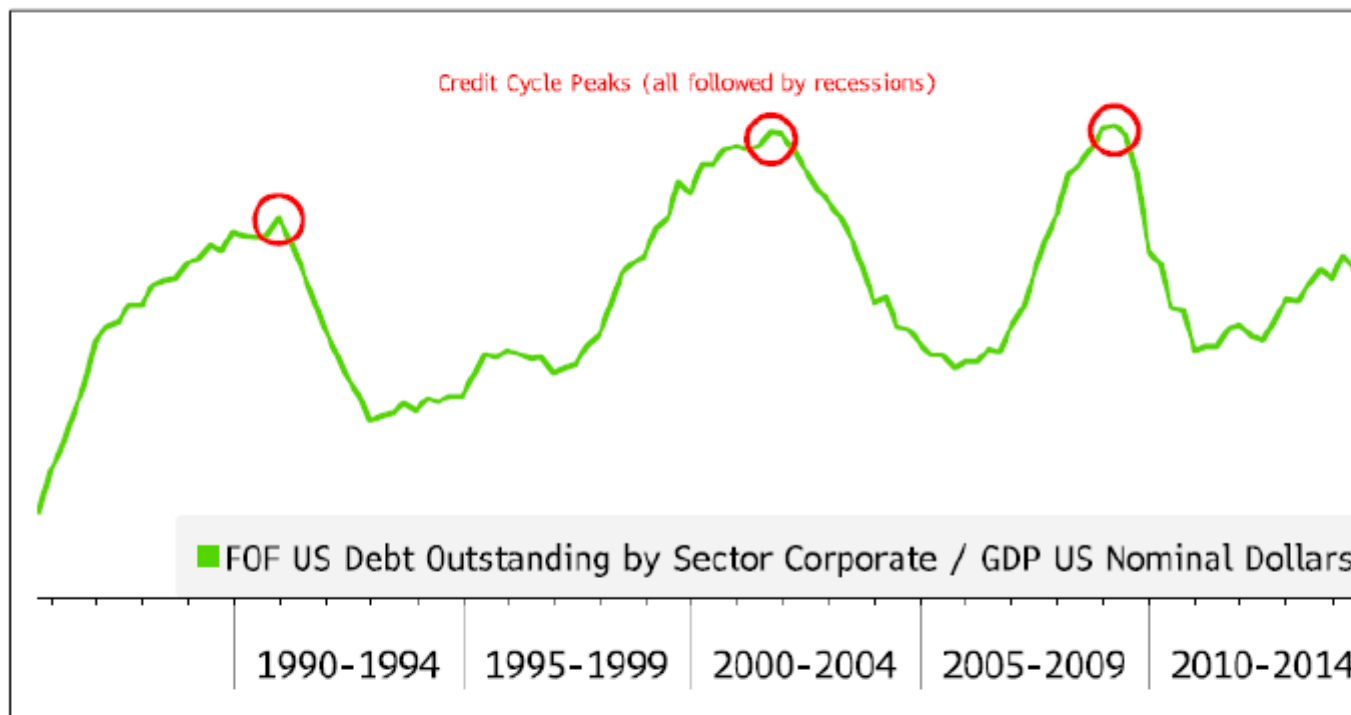


SOURCE: BLOOMBERG, EVERGREEN GAVEKAL, 3/19/2019

- From a valuation perspective, for US stocks, the forward P/E multiple has come down to 17x.
- That said, EPS estimates have receded sharply with Q1 and Q2 expected to be flat YoY from a 3-4% growth.
- If we annualized Q1 and Q2 that would bring the multiple to 18x, and the expectation for back half of the year is destined to disappoint.
- On an EV/EBITDA basis (Enterprise Value includes debt minus cash to market value) the market looks quite cheap relative to this cycle's peak in terms of earnings and cash flow (note: EBITDA is a gross cash flow measure).



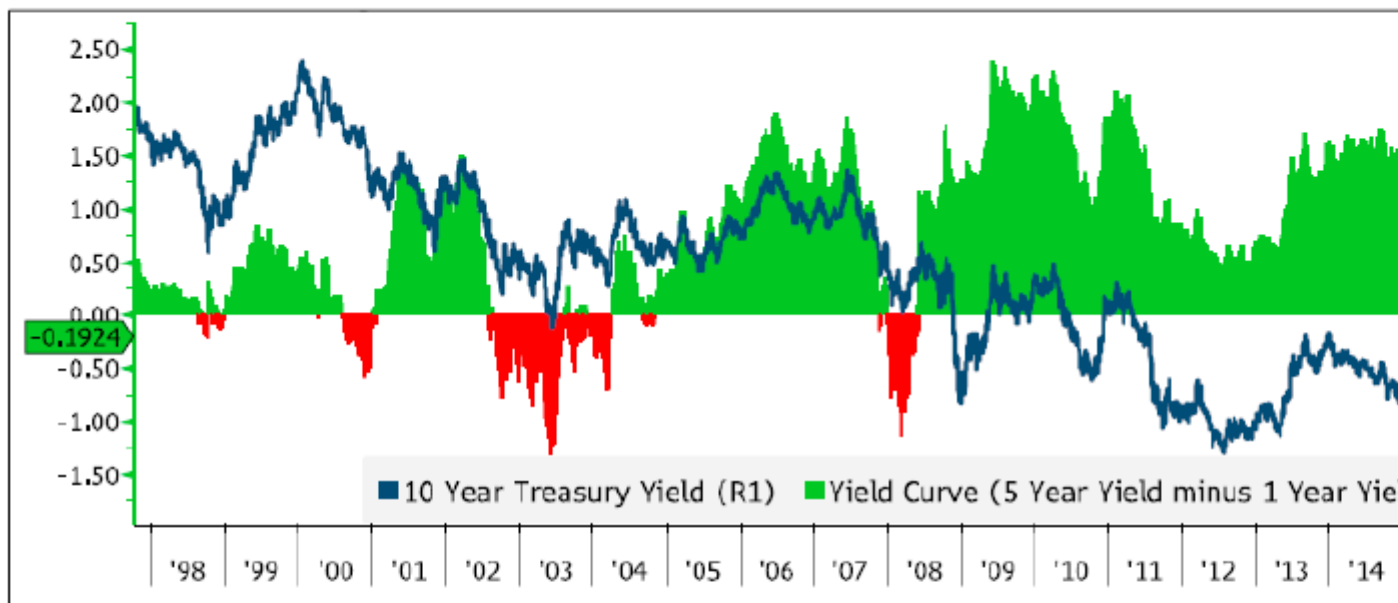
## CORPORATE DEBT TO GDP



SOURCE: BLOOMBERG, EVERGREEN GAVEKAL, 3/19/2019

- One stat that looks very late-cycle is total corporate debt-to-GDP, which as you can see just hit a 30-year
- The disturbing part about this metric is that the three previous peaks preceded US recessions (1990, 2000, 2008) and we're in a rollover on our hands.

## INTEREST RATES AND TREASURY YIELD CUR



*SOURCE: BLOOMBERG, EVERGREEN GAVEKAL, 3/22/2019*

- The next chart illustrates the 10-year treasury yield and shape of the yield curve based on difference between 10-year and 1-year yields (the histogram indicates an inverted yield curve).
- For the 10-year, we have seen a large drop in yield in the last 4-months (3.25% to 2.45%), which highlights the current economic conditions and also the Fed's new pause approach to raising interest rates.
- As one of the most accurate leading recession indicators, the inverted yield curve confirms that global growth faces significant recession risks.
- All of this combines to form a very, very conflicted message between the stock and bond markets.

It's no doubt been one heck of a run this year for investment portfolios, and even more remarkable is the winning streak paired with deteriorating economic data. A logical question from here is what will give way first? I think going back to why this happened is critical to understanding the larger picture. For the Fed and its pause, they basically conceded that the economy cannot handle higher rates. This is rather dubious with short-term rates at a piddly 2.5%. We'd argue that past shifts like this are reminiscent of 2000 and 2007, and tend to telegraph an upcoming recession. For now, markets continue to embrace a looser Fed. But rates are still up over the last few years and the Fed will continue to pare back its balance sheet, which still means tighter conditions. As for China, the cyclical industries most tied to trade have recouped their losses from late 2018. This situation seems like a classic case of "buy the rumor, sell the news", and the market is certainly not pricing in any risk of a deal failing.

In terms of economic data, I think the most likely outcomes are either continued deterioration, or more of a stabilization from here with lower growth relative to recent history. An upside breakout for growth seems unlikely with leading indicators deteriorating, tight financial conditions (at least relative to this cycle), high debt levels in corporate America, and a more frugal consumer. It's tough to forecast if economic conditions rapidly deteriorate, or stabilize, but either way, chasing

this rally right now doesn't make much sense. At this point in the cycle valuations are extended, debt levels are high, and earnings expectations are rolling over. We are 10 years removed from the last recession, and based on recent data, recession risks are no doubt rising.

At Evergreen, we have taken this opportunity to sell a part of what we purchased during the December selloff, and reposition portfolios to hold up even better during any pullbacks. Financial markets have experienced a full year of solid returns in less than one quarter, so locking in a portion of that profit makes a lot of sense to us. We are fairly concerned that investor focus will shift back towards actual economic data, and when that happens, financial market performance will look much different than what we've seen so far in Q1.



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## OUR CURRENT LIKES AND DISLIKES

Changes highlighted in **bold**.

### LIKE

- Large-cap growth (focus on lower P/E issues within this style; i.e., “growth at a reasonable price”)
- Some international developed markets (especially Japan)
- Cash
- Publicly-traded pipeline partnerships (MLPs and other mid-stream energy securities) yielding 7%-15% (as a result of the continuing rally, do limited buying for now; however, the momentum is strong and long-term value remains)
- Gold-mining stocks (**buy into the latest mini-correction**)
- Gold
- Select blue chip oil stocks (**buy more cautiously based on the continuing rally; we still like their long-term outlook, however**)
- One- to two-year Treasury notes
- Canadian dollar-denominated short-term bonds
- Short-term investment grade corporate bonds (1-2 year maturities)
- Emerging market bonds in local currency (start a dollar-cost-averaging process and be prepared to buy more on further weakness)
- Large-cap value (there are still bargains in this style, but not nearly as many as there were two months ago)

- Intermediate municipal bonds with strong credit ratings
- Intermediate-term Treasury bonds (especially the five-year maturity)
- **Long-term municipal bonds**
- **Long-term Treasury bonds**

## NEUTRAL

- Most cyclical resource-based stocks (some are looking more attractive)
- Mid-cap growth
- Emerging stock markets; however, a number of Asian developing markets appear undervalued
- Canadian REITs
- Intermediate-term investment-grade corporate bonds, yielding approximately 4%
- US-based Real Estate Investment Trusts (REITs)
- Long-term investment grade corporate bonds
- Short euro ETF
- Investment-grade floating rate corporate bonds
- Select European banks
- Small-cap growth
- Preferred stocks
- Solar Yield Cos (PG&E's bankruptcy has weakened the fundamentals for some of these)
- **Mexican stocks (after a sharp recovery, we are again trimming back on our REIT holdings)**

## DISLIKE

- Small-cap value
- Mid-cap value
- Lower-rated junk bonds
- Floating-rate bank debt (junk)
- US industrial machinery stocks (such as one that runs like a certain forest animal, and another famous for its yellow-colored equipment)
- BB-rated corporate bonds (credit spreads widened significantly during the 4th quarter of 2018 but have declined sharply this year; we expect renewed widening in the months ahead) \* \*\*
- Short yen ETF (i.e., we believe the yen is poised to rally)
- Dim sum bond ETF; individual issues, such as blue-chip multi-nationals, are attractive if your broker/custodian is able to buy them

\* Credit spreads are the difference between non-government bond interest rates and treasury yields.

\*\* Due to recent weakness, certain BB issues look attractive.

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