Will the Fed Put Extend to the Corporate Bond Market?

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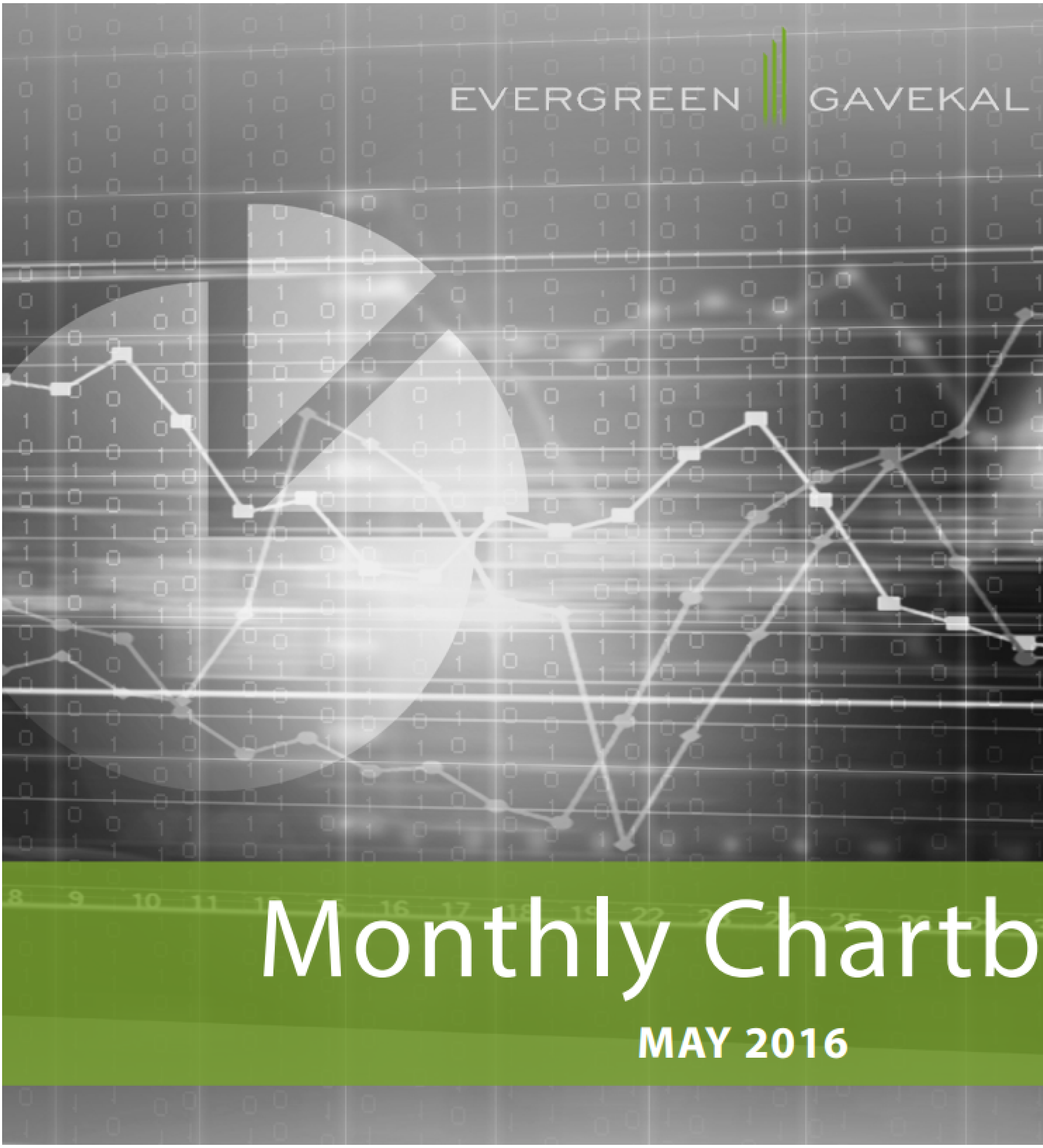

Introduction

BY JEFF DICKS & DAVID HAY

Central bank policy over the last several years has become increasingly linked to financial markets. As you can see in our first chart, the S&P 500 (green line) has tracked the Fed's balance sheet (grey line) remarkably well. It's interesting to note that almost precisely when the Fed cut off asset purchases the S&P 500 has been basically range-bound. In fact, the S&P 500 has actually made lower highs and lower lows ever since the 2015 peak, which often times marks a major reversal. However, whenever the S&P has experienced any meaningful decline we have seen the index resiliently rally back each time. We believe this can be at least partially attributed to the notorious "Fed Put". As we described in last week's Evergreen Virtual Advisor (EVA), the "Fed Put" relates to the belief that it will intercede to prevent bear markets from getting out of control. Over the last seven years, this has played out precisely as the meaning implies given we have avoided a bear market during this timeframe. (As noted last week, the Fed Put's longer term results are much more mixed.)

Credit spreads (in this case, the yield differential between government and junk-rated corporate bonds) are also overlaid on this chart (red line). The credit spread line is inverted, which means that as the line moves lower spreads are widening (this usually indicates corporate bond prices are falling). Interestingly, the "Fed Put" did not fully translate to the corporate bond market in the first quarter of this year. Essentially, you can see that corporate bond prices continued to fall and now reside well below their peak; on the other hand, stocks are trading within spitting distance of their all-time highs (though they are down slightly over the past year, indicating a tired market). Or said

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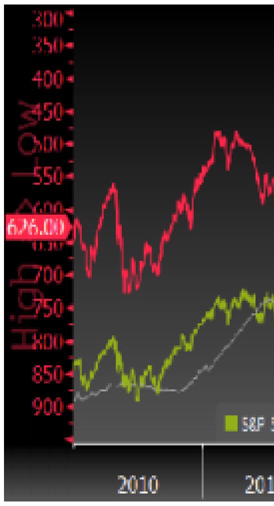

Source: Evergreen GaveKa

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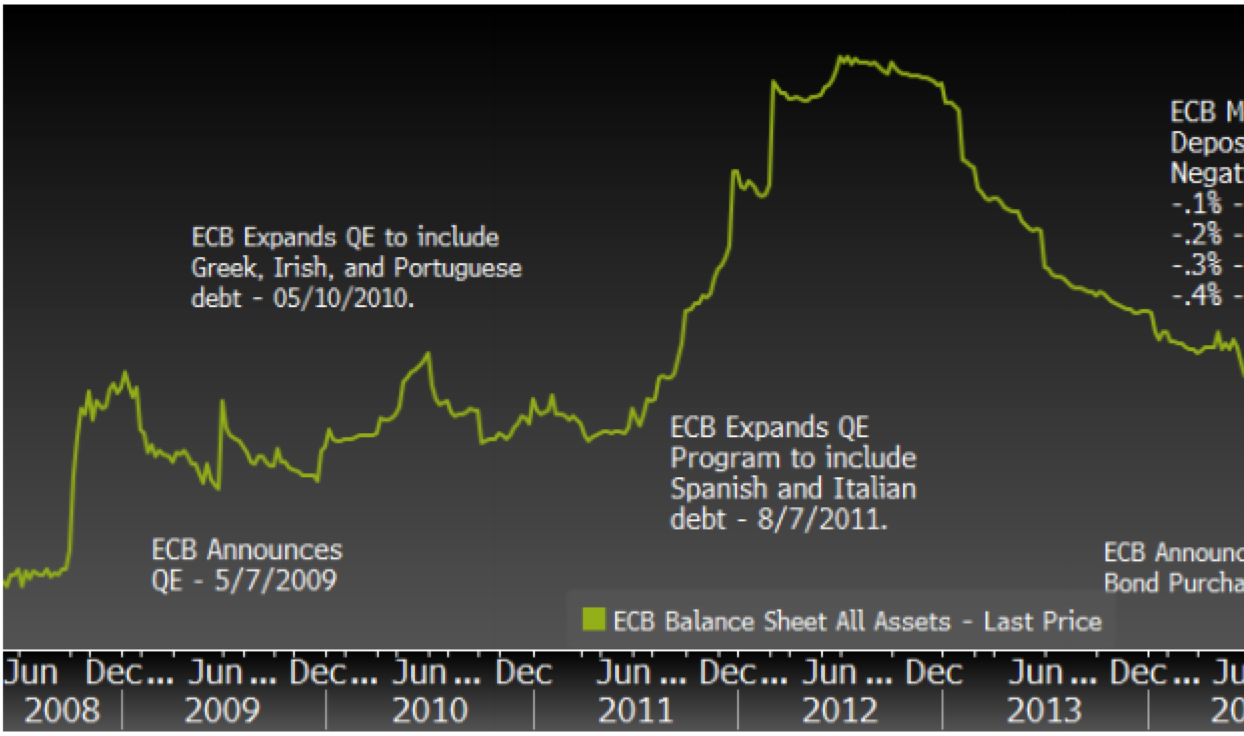
EUROPEAN CENTRAL BANK BALANCE SHEET AND KE



Source: Evergreen GaveKal, Bloomberg

- In the above chart, you can see several key policy moves by the ECB and the
  has continued to lower rates deeper into negative territory and continued c
- More recently the key policy shift to include corporate bond was announce

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EUROPEAN SOVEREIGN INTEREST

Source: Bloomberg, Evergreen GaveKal

- When the ECB fist adopted quantitative easing, followed by its negative int borrowing costs were significantly reduced, as you can see in the chart abo
- However, as it brought rates further into negative territory there was less o getting the same "bang for their buck" (or euro).

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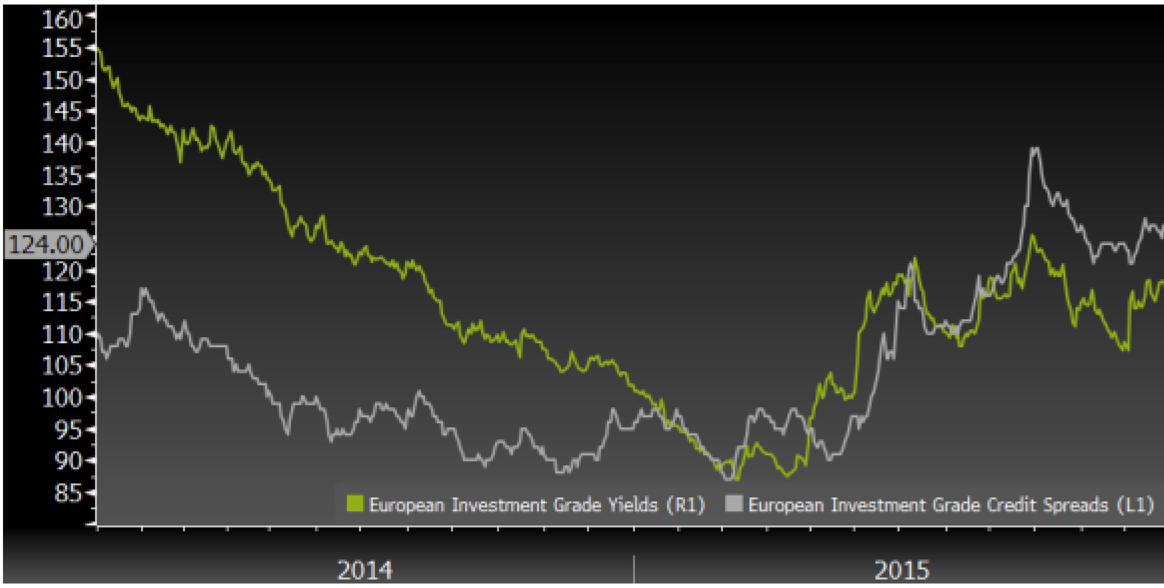
EUROPEAN SPREADS AND YIELDS



Source: Bloomberg, Evergreen GaveKal

- By adding the narrowing of corporate bond spreads to their arsenal, the ECB immediately
  European private and government debt yields (even though actual bond buys don't start u
- Because Evergreen believes credit spreads are such a powerful force in financial markets, w
  banks are now targeting these is a very important development. (The Bank of Japan—BOJ-
  bonds.)
- However, the high and rising amount of leverage in the system is concerning. And with th
  corporations are being incentivized to leverage up even more.
- Additionally, we question the degree of impact it will actually have in the eurozone given
  are, in that region (overall corporate borrowing rates have fallen from a ridiculously low 1.

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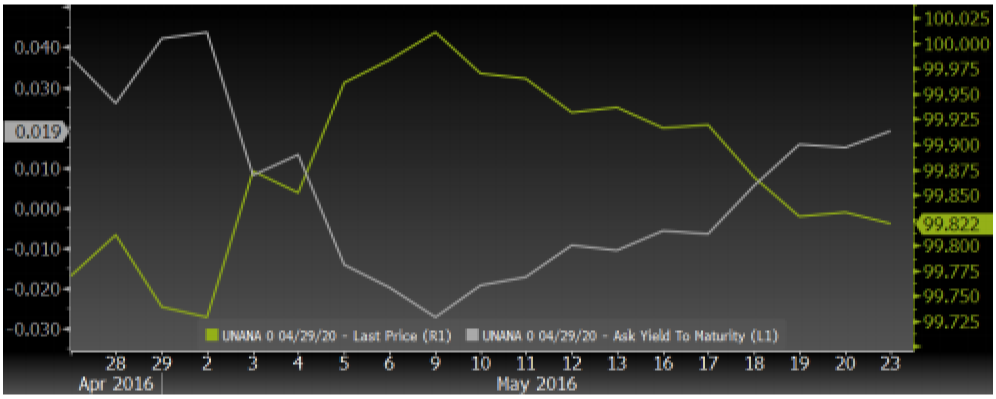
UNILEVER* 0% DUE 04/29/2020
CURRENT YIELD = 0.019%



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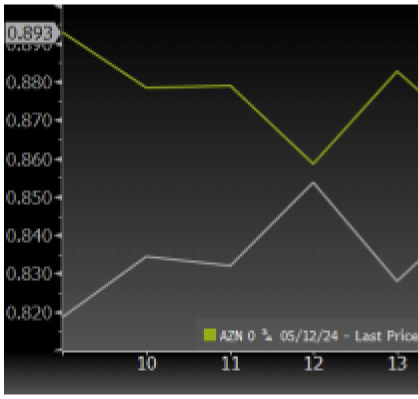

Source: Bloomberg, Evergreen GaveKal

- Whether this works in the long-run or not, European corporations are without a dou opportunity. As you can see, European corporations are able to come to market at s some cases, going all the way down to negative territory!).
- While this helps lower borrowing costs, our concern is that instead of putting this m R&D, or capital spending, funds are being used for share buybacks. This not only inc also can destroy shareholder value given what are potentially top-of-cycle purchase more modest in Europe than in the US, currently.)

*The specific securities identified and described do not represent all of the securities purchased, held, or sold for advisory clients, and you should not assume that investments in the securities were or will be profitable. The specific Unilever and Astrazeneca bonds shown are used only to illustrate examples of the extraordinary low rates (in our view) that companies have recently been able to borrow at. ECM does not currently holds or recommend these bonds for client accounts. Please see important disclosures included following this letter.

Will the Fed Put Extend to the Corporate Bond Ma

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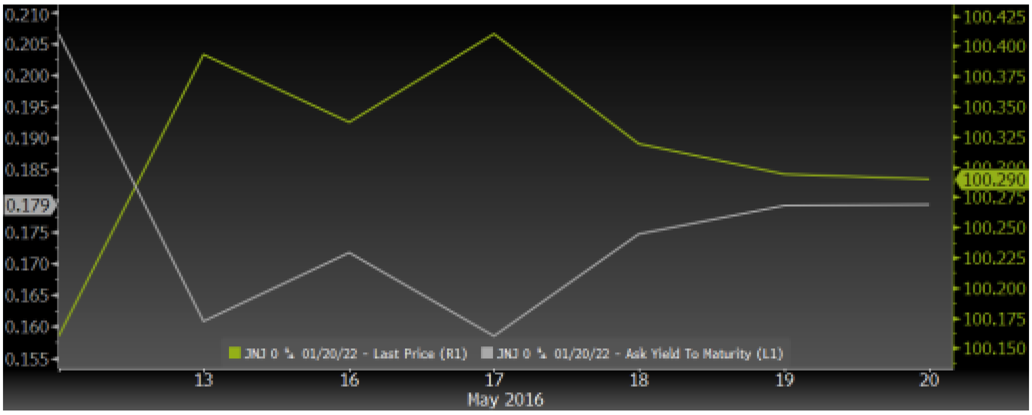
JOHNSON AND JOHNSON* 0.25% DUE 01/20/2022
CURRENT YIELD = 0.179%



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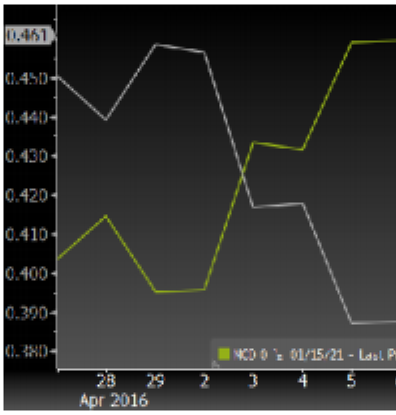

Source: Bloomberg, Evergreen GaveKal

- As mentioned, US companies (at least those with European operations) can access th
- Unsurprisingly, to take advantage of negligible borrowing costs, we have seen a surg issuing in Europe.
- In fact, over 20% of euro debt sales this year have come from US-based companies.
- As you can see, Johnson and Johnson*, as well as McDonald's*, were able to come to yields,respectively. What's even more unbelievable is that both of these bonds trade

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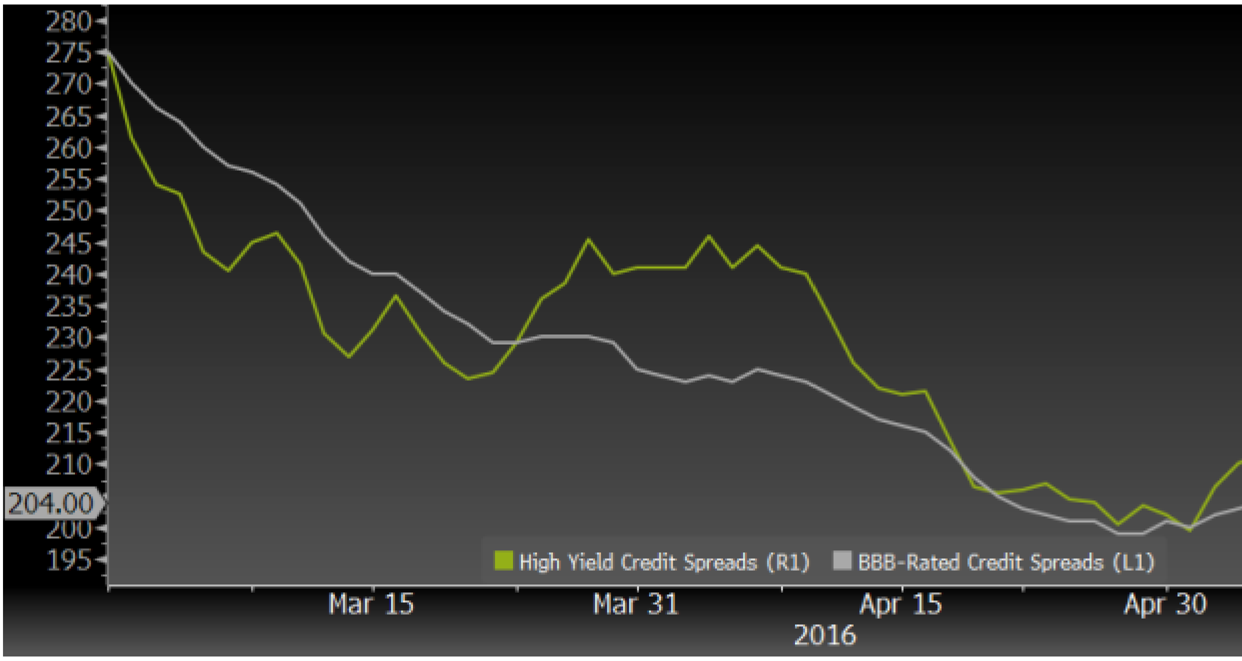
THIS HAS HAD A RIPPLE THROUGH EFFECT ON US CREDIT



Source: Evergreen GaveKal, Bloomberg

- The ECB's new initiative has almost certainly had a ripple through effect on US credit
- Since the announcement, US high yield (i.e, junk) and investment grade spreads hav (1/2%).

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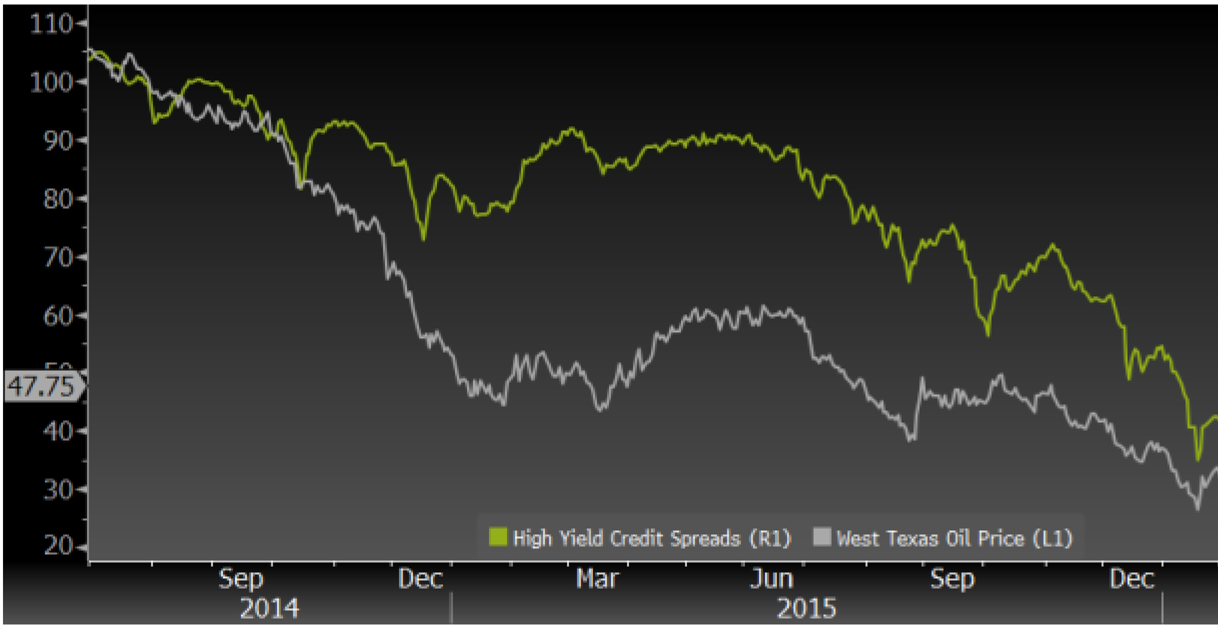
THE RALLY IN OIL HAS ALSO NO DOUBT PLAYED A R



Source: Evergreen GaveKal, Bloomberg

- A rebound in oil prices has no doubt also played a role in the tightening of credit spr
- As you can see in the chart above, there has been a very tight linkage between the t that the credit spread line is inverted; thus, when it is falling, spreads are narrowing
- Also, in the high yield market, energy now represents roughly 15% of outstanding ju just a decade ago.

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CENTRAL BANKS ALSO TEND TO GROUP THINK

Source: TABB Group, BCG

- Shifting back to central bank policy for a moment, you can clearly see that globa other's policy actions. The chart above illustrates this by showing the Fed, ECB, and B last decade.
- This leads us to believe that during the next crisis the Fed might follow the ECB's bonds.
- It's important to note that current legislation may prohibit this from occurring; howe the Fed might push the envelope on this during the next episode of extreme market

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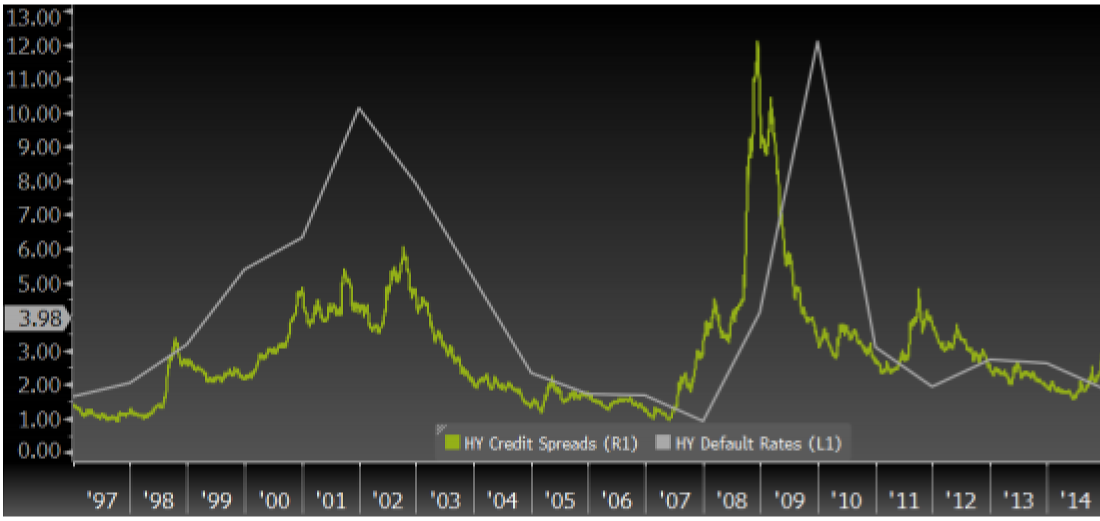
HIGH YIELD CREDIT SPREADS AND HISTORICAL DEFAUL



Source: Evergreen GaveKal, Bloomberg

- This chart illustrates the trend in default rates for high yield corporate bonds as well as cr rates have begun to tick up.
- Once default rates began rising during the last two cycles, they tended to shoot much with them.
- Therefore, we believe default rates will continue to grind higher. Additionally, we think th
- However, due to the ECB's new program and the Fed's potential imitation of that, spreads hit in early February.
- It's probable that the sharp decline in credit spreads since then was a major factor in t investment sector in recent months.

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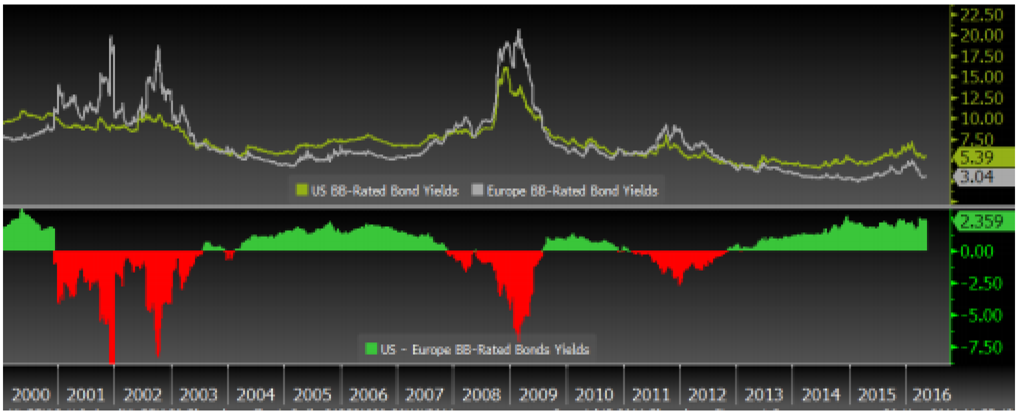
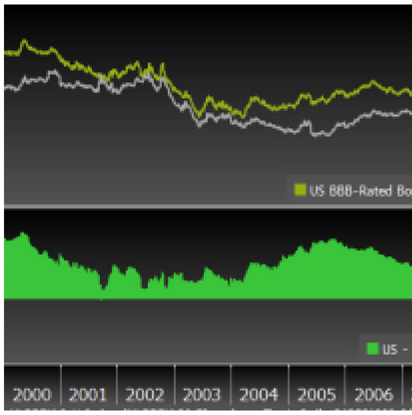
BB-RATED BOND YIELDS IN EUROPE AND THE US



Source: Evergreen GaveKal, Bloomberg

BBB-RATED BOND Y



- The good news for American investors is that US corporate bonds still offer decent c now.
- This is especially true relative to Europe and most other developed countries.
- BB and BBB-rated corporate bonds currently yield close to a 15-year high when com

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HIGH YIELD CREDIT SPREADS AND THE S&P 5

Source: Evergreen GaveKal

- The same is true for US treasuries relative to eurozone sovereign debt. The chart abo relative to various European countries.
- We usually don't get very excited about a 1.8% yield; however, clearly these rates ha converging with European yields.

Conclusion

BY JEFF DICKS & DAVID HAY

In sum, we think the ECB's policy shift to buy corporate debt was a game changer. In the short time since its unveiling, we have seen the cost of debt for corporations both in Europe and the US drop significantly. This has led to a rush of new issuance by both European and US multinationals in euro debt markets. We believe in the short-run this will relieve pressure on these issuers through lower borrowing costs and could be a positive catalyst for corporate profits. However, longer-term we are concerned these corporations will abuse this opportunity, driving overall leverage in the system even higher than it is today. As a reminder, total global debt has increased by nearly $60 trillion since 2007.

Our final chart simply shows credit spreads and the S&P 500 over a longer time frame. As you can see, leading up to the last two recessions credit spreads were a critical warning sign for the stock market. If we again zoom in on the last 18 months you can see a similar pattern has taken hold. We do believe default rates are likely to continue to grind higher, which will correspond to spreads widening back out. However, with the new marginal buyer of corporate credit (the ECB), and even the mere possibility of the Fed mimicking this during the next crisis, we believe US investors should pounce on any spread widening that might occur from here. Accordingly, Evergreen plans to add fairly aggressively to its US corporate bond holdings in the event credit spreads approach were they were in February.

As regular EVA readers kno
solid returns in this enviro
periods of price weakness
oriented areas during 2015

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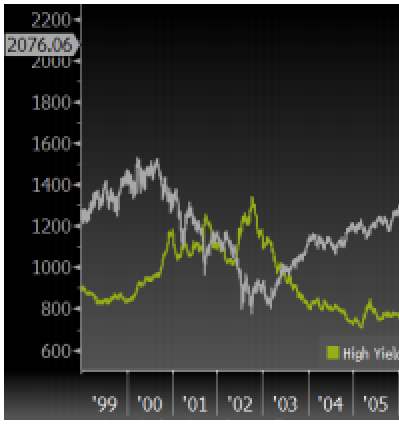
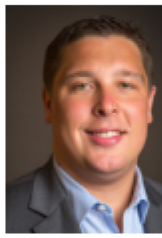


Source: Evergreen GaveKal, Bloomberg

CHARTBOOK AUTHORS:



JEFF DICKS
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Our Current Likes and Dislikes

EVERG

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

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