

# Evergreen Roundtable 2018

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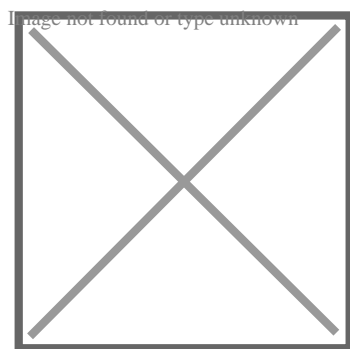
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The Evergreen Virtual Advisor is nearly 10,000 subscribers strong, up from just 500 readers, 7 years ago. Roughly 10% of subscribers are clients, leaving us with the sometimes-difficult task of writing to two distinct audiences. Clients are keenly interested in Evergreen-specific happenings, whereas outside readers are more interested in our macro market outlook. This week's newsletter attempts to carefully thread the needle between both interests.

*Evergreen Roundtable 2018* is our take on the different Roundtable Q&A pieces you might find in *Barron's* or other financial publications this time of year. Evergreen's investment decisions are not made by any single individual. Instead, our team meets nearly every business day to discuss our various investment strategies. This team consists of people with very different lenses through which they view the world and, oftentimes, these daily investment meetings become quite "spirited." We foster the competition of ideas. Evidence and logic outweigh seniority or rank.

In the newsletter to follow, our team was asked to look both back on 2017 and forward to 2018. They reflect on what transpired and forecast what may lay ahead. We've sprinkled in some more personal questions for our more casual readers, hoping they might go beyond this brief introduction. As always, we welcome your feedback and appreciate your loyal readership.

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## **Tyler Hay**

Chief Executive Officer

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**S&P 500 2018 Return Forecast:** +16%

**S&P 500 3-Year Return Forecast:** Down 10-20%

**Favorite Foreign Stock Market:** China

**Fed Rate Hikes 2018 (in Percent):** 1%

**Favorite Book Read This Year:** *Shoe Dog*

**Favorite Movie/TV Show:** *Wind River*

**Favorite Financial Personality:** Anyone but Jim Cramer

## **What is your favorite asset class?**

I like technology. It's the only sector where companies can grow exponentially without having to

massively scale their workforce or rely on intensive capital investment. Not long ago, a company called MySpace was the dominant social media company in the world. When Mark Zuckerberg came along with a better application and idea, MySpace became extinct. Technology is naturally Darwinian; bad ideas go down in flames and good ones thrive. But the MySpace vs. Facebook story highlights two key considerations when investing in tech. First, it clearly shows how fast the pace of change occurs. Second, it shows just how wrong you can be if you bet on the wrong horse when it comes to tech.

### **What is your least favorite asset class?**

Anything that's labor intensive (i.e. hospitality, transportation, food service and agriculture). Employing people is expensive and it's complicated. Everyone I know who runs a company says that dealing with interpersonal dynamics is the most frustrating and unrewarding part of their job. Minimum wage hikes are here to stay. The ripple effect of this will lead companies to do one of two things: pass higher wages on to consumers in the form of higher prices or cut back on their workforce.

### **What's the best piece of advice you got in 2017 (non-financial)?**

Ironically, the advice came from a competitor. In talking about analyzing people, he told me that you should totally ignore what people say and look at what they've actually done. It's tempting to want to believe what people say whether it's in an interview or in a business deal, but the best predictor of their future actions is past behavior. How many people have you met that were totally unsuccessful until 40, then all of sudden successful? If it occurs, it's the exception not the rule.

### **What excites you most when looking at the economy?**

In three letters, CES. Annually, in Las Vegas during the second week of January, the Consumer Electronics Show takes place. Businesses from all over the world convene to talk technology. A few topics including gaming, virtual reality, self-driving cars, 3D printing, eSports, artificial intelligence, drones, and digital health. Consider the following:

- Kids who may never drive a car
- Soldiers who will fight from a computer
- Parents who won't have to worry about their teenagers drinking and driving
- Patients who may never see a doctor in person
- Commuters who could skip road traffic because a drone carries them
- An entire hospitality industry without human employees
- Diseases detected by smartphones

The world is changing and it's exciting. Above all else I think people underestimate the rate of change. In 1980, the famed business consulting firm McKinsey and Co. was hired by AT&T to forecast mobile phone adoption by the year 2000. They posited that 20 years down the road an estimated 900,000 Americans would use cell phones. Turns out they were off by a factor of 100x as over 109,000,000 consumers had turned to cell phones. People consistently underestimate the effect of Moore's Law.\*

*\* The theory originated by Intel co-founder Gordon Moore that the number of transistors on an integrated circuit chip—i.e., computing power—would double every two years.*

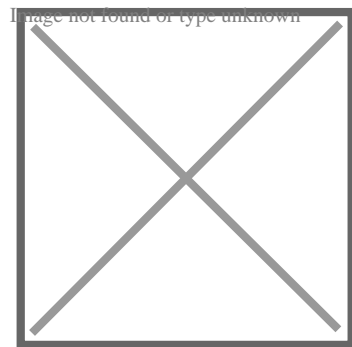
### **What worries you the most?**

Driving talented people out of our country, universities, businesses, and economy is not only

stupid, it's dangerous. Bureaucratic regulations, senseless immigration laws, and excessive taxes all stifle innovation. In the Seattle area, we are living through a real-world example. No one can argue the positive economic effect Amazon has had on the Seattle area, yet they have decided to begin looking for another city to form a second headquarters in with more favorable tax treatment. If Jeff Bezos – owner of the *Washington Post* and enemy of Donald Trump – will move for tax reasons, the question becomes: who won't?

### **What was the coolest thing you did in 2017?**

I saw Hamilton. I had very high expectations and it still blew me away. It made me excited about the future of education. To take a topic that's generally discussed by a college professor via a textbook to a bunch of students largely disinterested in what happened over 200 years ago and make it cool and relevant is the work of pure genius. Having the founding fathers rapping out lyrics seems laughably silly, but it's a transformational piece of art.



### **David Hay**

Chief Investment Officer

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**S&P 500 2018 Return Forecast:** Flattish to small decline (big up move followed by a sharp decline with 1987 as a likely template)

**S&P 500 3-Year Return Forecast:** Down 5-15% after inflation

**Favorite Foreign Stock Market:** Japan (currently, though, it looks extended, but what market isn't?)

**Fed Rate Hikes 2018 (in Percent):** 1%

**Favorite Book Read This Year:** *Is There Life Out There?*

**Favorite Movie/TV Show:** *Darkest Hour*

**Favorite Financial Personality:** Our partner, Louis Gave, of course! Runner-up: Jim Grant.

### **What is your favorite asset class?**

Energy. It is one of only two S&P 500 sectors (along with telecom) that is lower in price today than it was in 2007, prior to the last major bear market. Energy also went through its own severe bear market from mid-2014 to early 2016, flushing out all of the speculative excesses—and then some. Additionally, fundamentals have been improving with the oversupply of both oil and natural gas coming down dramatically. Demand has also been strong for both crude and natural gas, particularly during the recent Arctic blast. The long-term demand story is also positive with Asia, in particular, importing increasing amounts of US natural gas and also increasing shipments of refined products (e.g., gasoline) to Central and South America. In short, America has become an energy powerhouse and yet the sector has been in the penalty box for years. One near-term risk is that speculative open interest (i.e., by hedge funds) is extremely bullish

right now and even oil and gas stocks themselves are extended after big recent rallies. Long-term, though, I see this sector outperforming the S&P 500 by a wide margin.

**What is your least favorite asset class?**

Crypto-currencies like Bitcoin. It may be a stretch to consider these an asset class. However, due to the obscene levels at which these are now trading, their combined valuation is nearing \$1 trillion which means that if they were a stock market they would be the 17th most valuable in the world.

**What's the best piece of advice you got in 2017 (non-financial)?**

"The main thing is to keep the main thing the main thing." Stephen Covey.

**What excites you most when looking at the economy?**

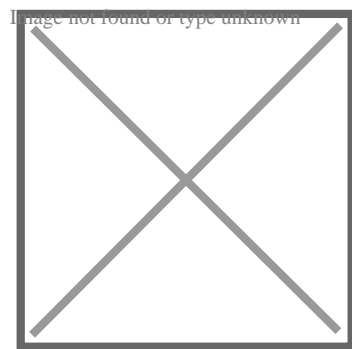
America's ability to continue innovating despite often wrong-headed government policies. High-tech is an obvious example but also what US energy producers have been able to do over the past decade is truly an extraordinary—and under-appreciated—story. In five short years, US oil production has soared 80% thanks to new drilling technologies. Natural gas output is up by roughly 50% over the past decade and America is now becoming a major exporter of energy products such as Liquefied Natural Gas (LNG). Rationalization of regulatory policies should accentuate the USA's myriad of innovation strengths.

**What worries you the most?**

My answer can only be a paragraph long, right? Ok, let's just say the payback from years and years of exceedingly loose central bank policies. This has led to a lethal combination of sky-high asset prices (with stocks, bonds, and real estate around the world the most inflated they've ever been on a collective basis), record debt levels (global debt has increased by over \$60 trillion since 2007), and investors losing nearly all appreciation of downside risks. The latter is reflected in US stock market volatility being at a record low, not to mention the incredible mania now playing out with Bitcoin, et al. (Someday, I think they'll drop the second "i" out of Bitcoin and it will be much more appropriately known as Bitcon!). Another huge risk is the massive position betting against volatility rebounding to anything approaching normal levels (which is almost certain to greatly amplify the next market decline). The highest amount of margin debt ever and historic lows in cash reserves are also indicative of pervasive investor complacency and a reckless desire to stretch for return in the late stages of an extremely long-running bull market.

**What was the coolest thing you did in 2017?**

I'm too old to do anything that would be even remotely considered cool!



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Director of Wealth Management

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**S&P 500 2018 Return Forecast:** 0-5% gain, with increased volatility throughout the year

**S&P 500 3-Year Return Forecast:** Negative to break-even after inflation

**Favorite Foreign Stock Market:** China/Hong Kong

**Fed Rate Hikes 2018 (in Percent):** .50%

**Favorite Book Read This Year:** *Hillbilly Elegy*, by J.D. Vance

**Favorite Movie/TV Show:** *Lady Bird*

**Favorite Financial Personality:** Howard Marks

### **What is your favorite asset class?**

Master limited partnerships (MLPs) currently offer the best long-term return potential of any asset class that we invest in. Today, it's a challenge to find an asset class trading at a reasonable historical valuation. MLPs not only trade at a reasonable valuation, but offer fantastic cash-flow, a good long-term growth story and a stable business model. Undoubtedly, with the shale explosion in full force in the early part of this decade, the asset class became overleveraged and many firms got caught up in the speculative mania that followed. However, today, the fundamentals of the group have improved dramatically and offer a great combination of high cash flows and attractive valuations.

### **What is your least favorite asset class?**

Broadly, the US equity markets are the most expensive place to invest today. Obviously, we are still investing in the US, but doing so with more caution than I can ever remember. In our individual stock portfolios, we're significantly underweight our equity targets due to these lofty valuations and the challenge of finding attractive companies to buy. At these levels, I believe the long-term return potential for index investors in the Russell 2000 and S&P 500 are likely to be quite disappointing. I fear that there are a significant amount of baby boomers invested in the indexes who will wake up at one point and realize that their retirement date just got moved back quite a bit due to a significant equity market correction in the US.

### **What's the best piece of advice you got in 2017 (non-financial)?**

In the early part of 2017 I stumbled across a quote from Seattle Seahawks coach Pete Carroll. He said, "This world trains people to be pessimistic...one of the most important things I do is make sure my players and staff believe that tomorrow will be better than today." I printed this quote out and taped it to my computer at work. I think this is great advice for an investor, business leader, or head of a household. Every day is not going to go as we expect or desire, but becoming disgruntled and disenchanted does not help us achieve our goals.

### **What excites you most when looking at the economy?**

I'm excited about the US economy because "main street" appears to be showing legitimate signs of strength. Unemployment remains low and wages are starting to tick up. In the first part of this decade, as unprecedented quantitative easing elevated asset prices, the wealthy and Wall Street were the primary benefactors. As the economy strengthens and signs of inflation start to sprout, central banks around the world are taking notice and monetary policy is changing towards a more hawkish approach. A changing of the guard has begun and this will put significant pressure on assets that have enjoyed unprecedented accommodative policies from global central banks. I'm excited that the broad economy is strengthening, but I fear that an asset price correction could derail the positive momentum.

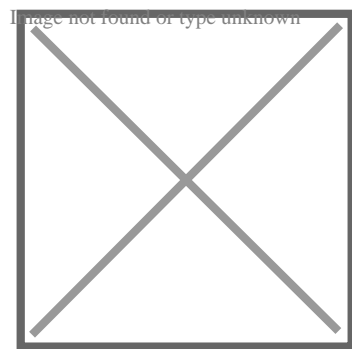
### **What worries you the most?**

Interest rates worry me the most. At some point this year, I expect the bond market to test the strength of equity markets. This will either be done with yields on the 10-year treasury bond rising faster than the market anticipates, or the yield curve will continue to flatten and possibly invert at some point this year. Either of these occurrences should spook this incredibly unflappable equity market.

### **What was the coolest thing you did in 2017?**

The coolest thing I got to experience in 2017 was the birth of my daughter, Reagan. Self-reflection and appreciation for what you have comes with any new birth, but it was an especially cool thing to see our 4-year-old take on the big sister role.

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### **Mark Nicoletti**

Managing Director, Family Office

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**S&P 500 2018 Return Forecast:** +6%

**S&P 500 3-Year Return Forecast:** Slightly up with rampant volatility

**Favorite Foreign Stock Market:** India

**Fed Rate Hikes 2018 (in Percent):** +.75% then -.25%

**Favorite Book Read This Year:** *The Sun & The Moon & The Rolling Stones*, by Rich Cohen

**Favorite Movie/TV Show:** *Baby Driver*

**Favorite Financial Personality:** Grant Williams (for all the wrong reasons)

### **What is your favorite asset class?**

Commodities. I look for precious metal and energy commodity shares to move higher in 2018. True to my contrarian spirit, it's apparent to me that global commodity prices are near a cyclical bottom. As measured by the ratio of U.S. stock prices to an index of commodity prices, you'd be hard pressed to find commodities cheaper anytime in the last 100 years. Unlike equities, which discount future growth, commodities rise as the current levels of demand offset the amount of available supply. This phenomenon, coupled with momentum created in late 2017, and a possible inflation sighting, makes me a buyer today.

### **What is your least favorite asset class?**

U.S. equities. Poet Derek Walcott wrote, "History is boredom interrupted by war". It's true, conflict and adversity shape history, not times of peace and prosperity. Wars spread terror and destruction but also spawn new inventions and technologies. Similarly, the most studied and impactful periods of stock market history are inflection points, when markets swing dramatically from bullish to bearish; when bubbles burst. Granted, U.S. equities have been posting record highs which makes this 'least favorite asset class' claim a little easier to make (see: contrarian

spirit above). In one corner: enthusiasm over tax reform and strong-ish economic data. In the other corner: monetary policy normalization and extremely high valuations...price to earnings, price to book value, margin usage, etc. I'm betting on the don't come.

### **What's best piece of advice you got in 2017 (non-financial)?**

Although I don't do it enough, I sat down with my 92-year-old grandmother last year and watched a 1953 Tyrone Power film called The Mississippi Gambler. Her advice was simple but profound: be happy. She says her happiness comes from watching more TCM and less Fox News; she challenged me, "Where's yours going to come from?"

### **What excites you most when looking at the economy?**

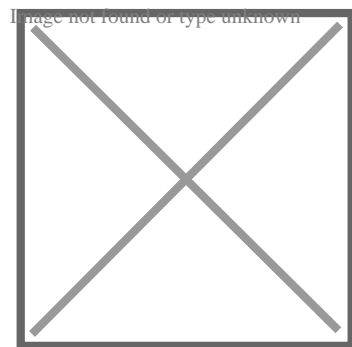
The potential for meaningful wage growth to occur, finally (but it's a double-edged sword). Faster wage growth for low- and middle- wage workers could create real economy-wide productivity growth. For the last 40 years income inequality in the U.S. has gotten progressively worse. This is a phenomenon that has suppressed growth by shifting a larger share of income to rich households that save rather than spend. If this reverses, maybe the U.S. economy doesn't need lower and lower (and lower) interest rates simply to provide the same growth of aggregate demand over time.

### **What worries you the most?**

The explosion in consumer debt, just to be able to stand still. It took nearly a decade, but consumer debt is back above pre-financial crisis levels. Yes, Americans have borrowed more money than they did at the height of the '08 credit bubble. Is this a positive indicator? Growing debt levels show that millions of Americans have restored their credit to qualify for loans. And it suggests a rising optimism about economic growth among banks and other lenders. Debt can fuel consumer spending which accounts for a majority share of all economic spending in the U.S. But in reality, debt growth that greatly exceeds economic growth, as has happened around the world for years, is a monumental red flag. Families are using debt as a mechanism to pay for things their incomes don't support.

### **What was the coolest thing you did in 2017?**

Having an affinity for golf and having grown up (at least partially) on the Monterey Peninsula, I've been lucky enough to play Cypress Point Golf Club with gaudy regularity over the years. In 2017, I setup and hosted a few of my colleagues for their maiden round at Cypress. Not only did we get out of the office to enjoy the walk together on what Robert Louis Stevenson called "the most felicitous meeting of land and sea ever created," I was reminded how poorly developed their golf skills are...a revelation that I can only surmise stems from a lack of golf reps; or said another way, an intense commitment to their responsibilities at Evergreen! ?



**Jeff Dicks, CFA**



Director of Portfolio Management

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**S&P 500 2018 Return Forecast:** +6%

**S&P 500 3-Year Return Forecast:** 0% (with a 20%+ correction between now and then)

**Favorite Foreign Stock Market:** Hong Kong Hang Seng Index

**Fed Rate Hikes 2018 (in Percent):** .75% (three hikes)

**Favorite Book Read This Year:** *The Wolf of Wall Street* (The book is better than the movie!)

**Favorite Movie/TV Show:** *Game of Thrones*

**Favorite Financial Personality:** Jeffrey Gundlach

### **What is your favorite asset class?**

Energy-related stocks are my pick for 2018. The S&P 500 weighting in energy is just 6%, which is down from 16% in 2008. The last two times energy made up only 6% of the S&P 500 we saw energy outperform the broader market by 30% and 92% over the next three years. Additionally, we have seen marked improvement in fundamentals within the commodity complex. On the oil side, we have seen weekly inventories draw down more than the 5-year average for 36 out of the last 44 months. This has helped propel the price of oil to a 3-year high. We have also seen US production increase back to pre-crisis levels as OPEC has lowered production. On the natural gas side, we continue to believe the future remains bright as emerging markets, particularly India and China, move from coal to natural gas. The US also exported three times as much LNG during 2017 relative to 2016, and this should continue to increase for the foreseeable future. Despite the positive trends, energy-related equities posted a return of -1% during 2017, which lagged the broader market by over 20%. If you go back to mid-2014 energy stocks have underperformed by a staggering 66%. One trend we have noticed is that when an individual sector underperforms over a multiple-year period, you very often see outperformance over the next three to five years. So far, we have seen the energy sector rise 7% to start the year, or 3% more than the S&P! This is a trend I believe has legs.

### **What is your least favorite asset class?**

International government bonds are my least favorite asset class for 2018. Now this asset class doesn't necessarily carry the most downside, but when you think about the risk-relative-to-return relationship the prospects look grim. The Bank of America sovereign bond index yields just 1.16% yet carries a duration of nearly 8-years. The latter means that if interest rates were to move up by 1.0% the value of the bonds would fall by roughly 8%. Ridiculously low yields have been, as we have extensively written, anchored by central bank asset purchases. This is a big reason why the 10-year German bund and 10-year JGB (Japanese government bond) currently yield just .06% and .46% respectively. These are extremely low return numbers when considering the interest rate risk their buyers are taking. Additionally, this year we are likely to see a shift from global easing to a more coordinated tightening. The Fed has already begun winding down its balance sheet and has hiked short-term interest rates five times. This year we likely see the ECB, and BOJ, begin to slowly shift away from ultra-easy policy. This shift, combined with the global synchronized growth we have seen over the last several quarters, is likely to push longer term rates higher in 2018 leading to negative returns for international government debt.



### **What's best piece of advice you got in 2017 (non-financial)?**

As a happily married newlywed there are all sorts of antiquated quotes on marriage, but honestly the best piece of advice I received in 2017 was that a happy wife equals a happy life!

### **What excites you most when looking at the economy?**

What excites me most about the US economy is that wages are likely to finally accelerate for American workers. We have published this statistic countless times, but real (after-inflation) median incomes are only 1% above where they were in 1999. This has led to significant income inequality with the share of income from the top one percent more than doubling over this timeframe. It looks like we are entering an inflection point with the labor market the tightest it's been in over 50 years reflected in an unemployment rate at 4.1%. At this level, you typically see wages move higher as it becomes problematic finding and filling job openings. We also have seen minimum wage hikes kicking in, and set to kick in, across multiple states in 2018. In addition, several mega-corporations have enacted immediate raises across their workforce after the US corporate tax cut. With consumer savings rates at the lowest rate since the financial crisis, US households would certainly welcome the pay bump!

### **What worries you the most?**

My biggest concern is the massive amount of debt our country has added since the financial crisis. Government borrowings have more than doubled to over \$20 trillion. At the same time GDP has only risen by half that much. This has pushed the federal debt-to-GDP ratio well over 100%. The debt load right now is somewhat manageable given an annual interest rate of just 2.3%, but if interest rates do move significantly higher this could be extremely problematic for the economy. What makes matters worse is the pickle the Federal reserve is in. They are now looking to shrink their \$4.5 trillion balance sheet that is mostly filled with government debt. The excess supply hitting the market along with other central banks tightening could be what causes a major backup in interest rates. I want to believe they can manage this tightrope walk, but Fed tightening almost always ends in a recession. At this stage in the game, we strongly advise carrying a more conservative portfolio than normal, even though—make that, especially because—more and more investors are doing the exact opposite!

### **What was the coolest thing you did in 2017?**

The most exciting thing that happened to my wife and I during 2017 was the addition of our puppy Jack to our family. As first-time puppy parents, we were blown away by how much of a positive impact having a dog has on our daily lives. We were also blown away by how difficult raising a puppy can be! There have been countless bathroom “accidents” (both #1s and #2s), numerous shoe victims, and daily midnight wakeup calls, but despite these growing pains, Jack has been truly a blessing and we can't imagine life without him!

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## **OUR CURRENT LIKES AND DISLIKES**

No changes this week.

### **LIKE**

- Large-cap growth (during a correction)
- International developed markets (during a correction)
- Cash
- Publicly-traded pipeline partnerships (MLPs) yielding 7%-12% (buy less aggressively due

to the recent sharp rally)

- Intermediate-term investment-grade corporate bonds, yielding approximately 4%
- Gold-mining stocks
- Gold
- Select blue chip oil stocks (wait for a pull-back after their recent strong run)
- Mexican stocks (at lower prices after this year's robust rally)
- Bonds denominated in renminbi trading in Hong Kong (dim sum bonds)
- Short euro ETF (due to the euro's weakness of late, refrain from initiating or adding to this short)
- Intermediate municipal bonds with strong credit ratings
- Investment-grade floating rate corporate bonds

## **NEUTRAL**

- Most cyclical resource-based stocks
- Short-term investment grade corporate bonds
- High-quality preferred stocks yielding 6%
- Mid-cap growth
- Emerging stock markets, however a number of Asian developing markets, ex-India, appear undervalued
- Select European banks
- BB-rated corporate bonds (i.e., high-quality, high yield)
- Long-term Treasury bonds
- Long-term investment grade corporate bonds
- Intermediate-term Treasury bonds
- Long-term municipal bonds
- Emerging bond markets (dollar-based or hedged); local currency in a few select cases
- Solar Yield Cos (taking partial profits on these)
- Large-cap value
- Canadian REITs

## **DISLIKE**

- US-based Real Estate Investment Trusts (REITs) (once again, some small-and mid-cap issues appear attractive; also, some retail-exposed REITs look deeply undervalued)
- Small-cap value
- Mid-cap value
- Small-cap growth
- Lower-rated junk bonds
- Canadian dollar-denominated bonds (the loonie is currently overbought)
- Short yen ETF (in fact, the yen looks poised to rally)
- Emerging market bonds (local currency)
- Emerging market bonds (local currency)
- 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)

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