No time for gloating.

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“Always look for forced urgent selling.”
- Seth Klarman, Superstar Money Manager

SUMMARY

- As our investment team at Evergreen GaveKal has been warning for the past couple of years, the US equity market is now in the throes of a well-overdue correction—if not in the early stages of a bear market. Fortunately, we are underweight this richly-valued asset class with a large allocation to US Treasuries, high-quality corporate bonds, and cash.
- On the less fortunate side, at least short-term, we have been selectively dollar-cost-averaging in to crashing midstream Master Limited Partnerships (MLPs) for several quarters. While most of Evergreen’s high-conviction energy infrastructure businesses continue to generate steady revenue growth and meet their distributions, despite a hostile environment, even the highest quality securities have been falling almost in lock-step with oil prices. As we last saw in the fall of 2008, we believe such indiscriminate selling is clearly due to forced liquidation, such as closed-end MLP funds receiving margin calls. Even though this experience has been painful, we believe it presents a tremendous opportunity for investors who are getting paid to wait patiently for a recovery.
- Looking at the broader US economy, it appears we are now on the edge of yet another deflationary bust where debt levels can no longer be sustained as a result of falling asset prices and declining cash flows. In 2007 and 2008, the deflationary bust came from the US housing market. Today, it appears to be coming from energy and other commodity markets, and what is happening in energy is not staying in energy. In the event that equities weaken further and corporate bond spreads* continue to blow out, we believe the coming quarters could give us just the opportunity we’ve been waiting for to put our cash reserves to work.

*Credit spreads represent the difference between yields on corporate and US government bonds.

The following commentary is from the Evergreen Investment Team:

No time for gloating. One of our investment committee members was recently approached by an EVA reader who asked, “Why aren’t you looking more excited?” When the reader received a confused look in return, he went onto to explain that because Evergreen has so often expressed its concerns about an unhappy ending to years and years of central bank incontinence, we should be feeling vindicated.

Certainly, we don’t feel as silly as we did a couple of years ago in warning that stocks were way over-priced and due for a sharp correction, if not an actual bear market. And, even though we were early, the reality is that the NYSE Composite, which includes 2000 issues, essentially topped out in the summer of 2014 (as did so many parts of the investment world). It is now down 11% from that time.

We also feel like we’ve given plenty of cautionary comments about the potential for a “deflationary bust”. For those who don’t fully grasp that concept, it can be summed up as a time

when a wide range of asset prices begin falling, causing investors to panic and consumers to freeze up. The trigger for this nasty turn of events is often related to debt levels that can no longer be supported by the cash flow produced by the assets in question. The housing bust of eight years ago was a classic example of a deflationary bust. Reduced consumer spending due to plunging net worth (the negative wealth effect) causes profits to slide, making corporate debts harder to service. Layoffs soon follow, pressuring household debt servicing abilities. Thus, these forces feed on each other, often producing an even deeper dive in asset prices including, of course, the stock market.

This time around, it appears that ground zero for the deflationary bust is anything related to commodities, especially energy. There is little doubt the Federal Reserve's zero-interest rate and QE policies fed (pun intended) the US oil and gas boom. Energy companies were able to access cheap equity and debt financing, due to rising stock prices and falling interest rates.

Fears of high inflation, when money printing went viral several years ago, initially drove up commodity prices, including oil. Consequently, the US energy industry ramped up its drilling and exploration activities. Historically high prices created frenetic investment as companies attempted to pump as much as they could as fast as they could. Aided by technology breakthrough such as hydraulic fracturing of rock formations, horizontal drilling, and 4-D imaging of subterranean oil deposits, American energy firms were able to double US crude output this decade.

Unfortunately for the US oil and gas industry, Saudi Arabia was not thrilled to see America quickly becoming less and less dependent on Middle East oil. To protect their market share, the Saudis began flooding the market with its low cost crude. So far, they have remained committed to this strategy, even though it's starting to take a serious toll on their own economy. Many of the economic subsidies the Saudi royal family has offered its citizens are beginning to be scaled back, as it rapidly depletes its foreign currency reserves.

Despite the Saudis running production flat out, the amount of excess oil production only amounts to about 1% to 2% of global demand. Yet, the fact that this has been going on for over a year has created a massive overhang of oil in storage. In turn, this forced crude prices into the $20s earlier this week, down nearly $100 a barrel from their 2014 peak (and almost $120 per barrel from the all-time high in 2008).

And this is why Evergreen is definitely a no-gloating zone these days…

Not quite immaculate execution. We'd love to announce to the world that our clients' portfolios are sitting serenely in cash and treasuries but that would only be partially true. The good news is that we do hold our highest level ever of cash, government bonds, and AAA-rated corporate bonds. Additionally, we've taken steps to make sure that the types of companies we own have durable businesses that can weather even tough economic climates. Further, Evergreen has its lowest stock exposure ever, with most clients at half of their normal equity targets. And we also have almost zero direct commodity exposure. Sounds great, right?

Well, as even casual EVA readers know, we also have been advocating—and implementing for clients--the gradual accumulation of master limited partnerships (MLPs) that operate mid-stream energy assets such as pipelines and storage facilities. As they have moved from a deep correction into a bear market and, more recently, into the most extreme plunge these typically steady-Eddie enterprises have ever experienced, Evergreen has been dollar-cost-averaging into

the free-fall. (We would also point out that we have been putting our own skin in the game. The firm's principals have been buying right along side of our clients. In case you're wondering if there's something in the office water tank, we aren't alone. Other notable investors like Kyle Bass, Carl Icahn and David Einhorn have also pointed out energy's relative attractiveness.) Click here for the Kyle Bass interview on Wall Streeet Week.

Despite yields that are often in double-digits—even from some of the safest names in the MLP world—the new year has brought another vicious decline in MLPs (and, of course, the entire energy complex with even the bluest chip oil and gas companies under relentless selling pressure). Meanwhile, MLP insiders have stepped up with large and repeated purchases. Just last week, the biggest MLP announced a $100 million insider-purchase. Three weeks ago, it also stated its intent to raise its distribution by 5%. However, this has not prevented it from falling another 13% this year, despite a snap-back rally in MLPs over the last two days.

Then there is a smaller MLP, which had fallen from $48 to $10. Its yield at $10 had rocketed up to over 25% as the market worried it would be unable to finance its new projects and would need to cut its distribution (as Kinder Morgan and Teekay** did late last year). Yet, 10 days ago, it disclosed the sale of one of its holdings that eliminated any financing issues over the next two years. Initially, it zoomed up 40% to $14 as most analysts asserted that its distribution was now safe. But by Wednesday of this week, it had melted all the way down to $8 where it was yielding 32%!

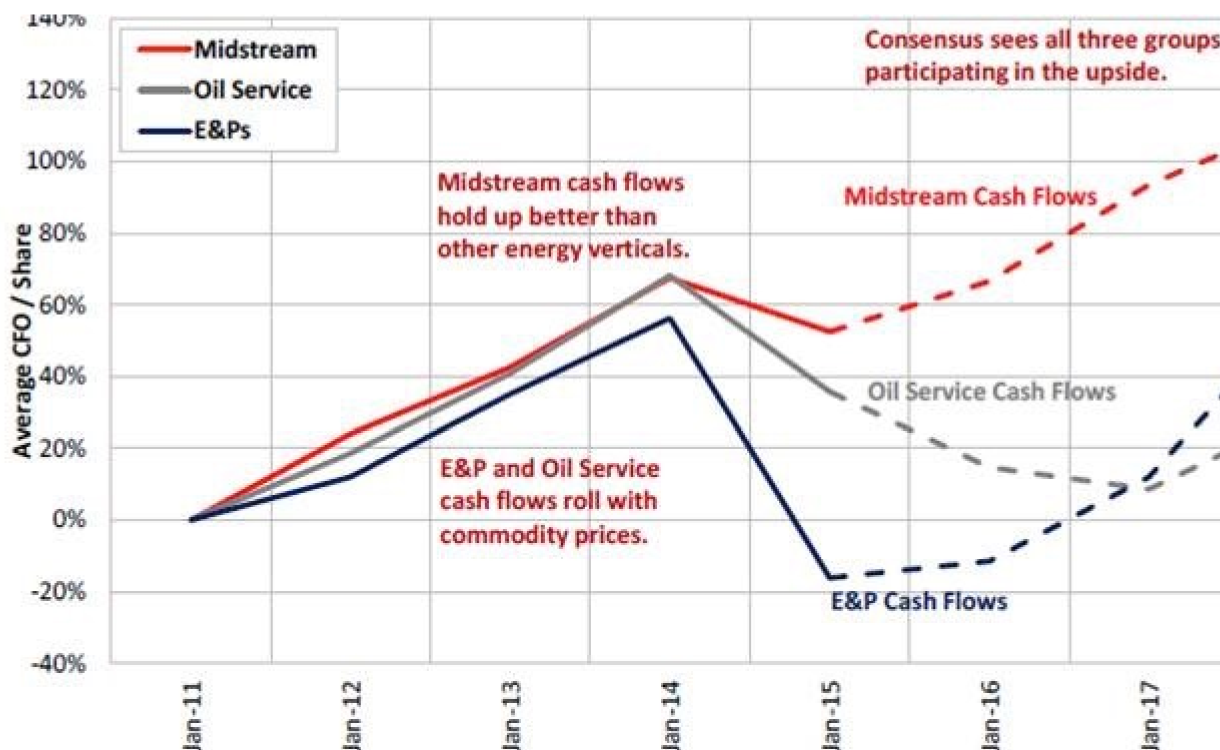
You might be wondering why anyone would sell an MLP yielding over 30% with a good chance of sustaining that payout. Or why even one of the bluest chip MLPs, with virtually zero commodity price risk, was down 25% for the year, as of Wednesday, elevating its yield to nearly 11%. The answer, we are convinced, is that terrible situation which brought the world to its knees eight years ago: forced liquidation.

This is where investors, usually institutions, have bought securities on margin. In the case of MLPs, closed-end mutual funds hold them with what is normally a fairly conservative 20% to 30% leverage amount. But the situation is far from normal these days in anything energy-related.

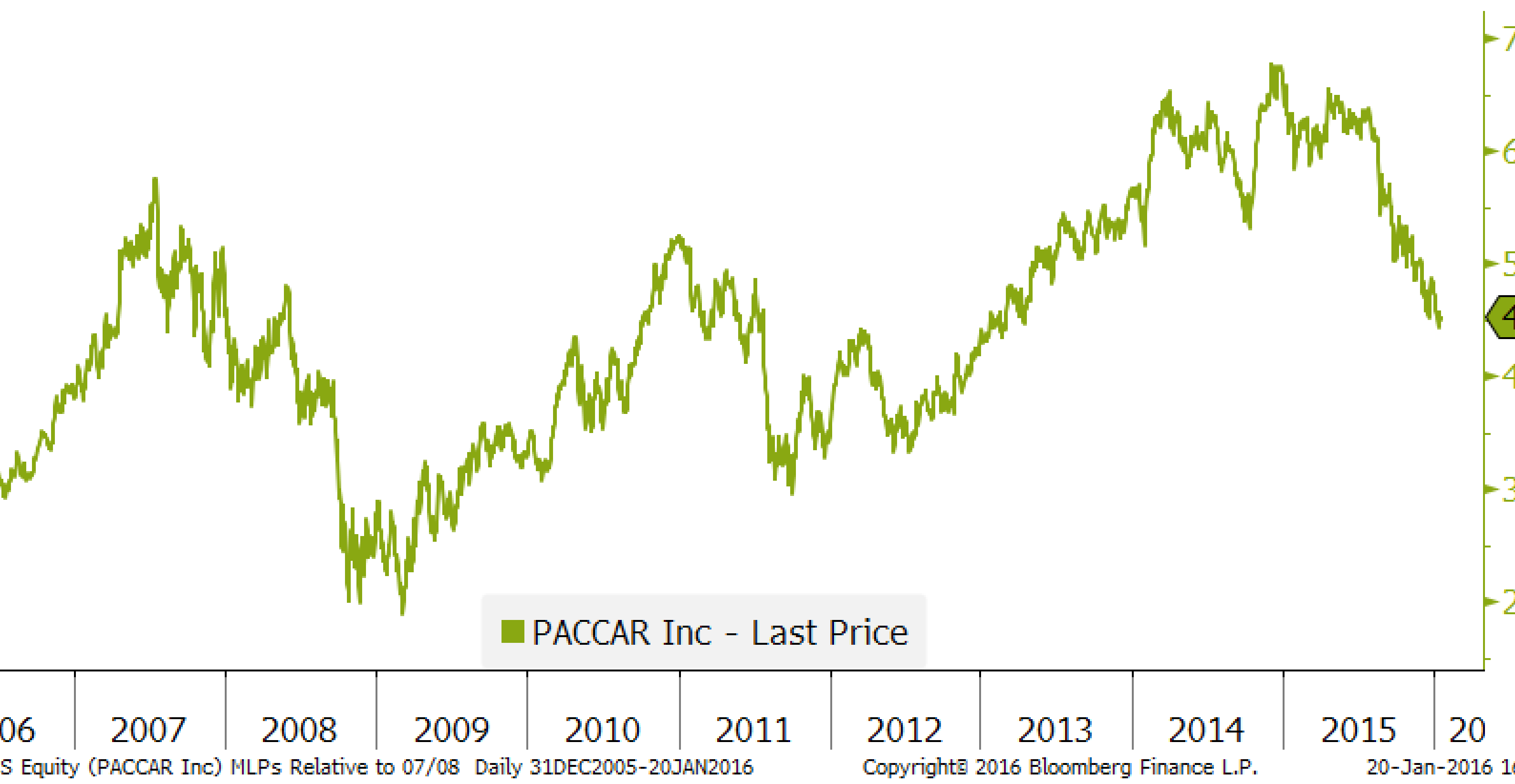
If this isn't capitulation, what is? Veteran investors look for a selling climax to indicate that almost all those involved with the market, or a segment of it, are throwing in the towel—in other words, they are capitulating. With so many MLPs down 60% to 80%—and with free cash flow yields often in the mid-teens to even the twenties—we've got to be getting close to full-blown capitulation.

This has happened at least three times with MLPs over the last six months. But what initially looked like total capitulation has turned out to be merely a temporary hiatus in the selling tsunami. Each downward lurch has produced another wave of forced liquidation by the MLP closed-end funds whose 25% margin levels have been elevated to well over 50% due to the price collapse (the debt doesn't go down when the market values do, which is another example of a deflationary bust).

It's ironic that in many cases MLPs are down to a greater extent than even energy companies with far more exposure to oil and gas prices that are now below breakeven for most producers (per veteran economist David Rosenberg, 90% of the planet's crude output is now uneconomical). As you can see below, MLP cash flows are also far less impaired by the price collapse.

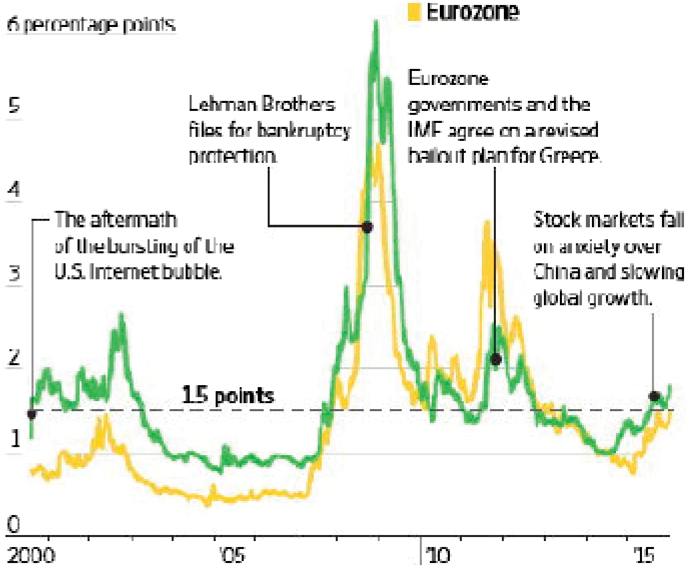


When oil first broke down a year ago, the consensus view was that this would be a good thing for most of the world, excluding OPEC, Russia, and the US energy sector. That sunny outlook has been contradicted by reality but it may have been true if it was just oil that was slaughtered. But the fact that so many other commodities, and even industrial prices, are under pressure may be reflecting a deeper problem: too little growth, too much debt, and overcapacity in a wide range of industries. As you can see from the chart below of Paccar**, the owner of the Kenworth** and Peterbilt** heavy truck brands, this outstanding industrial company is back to where it traded almost a decade ago.

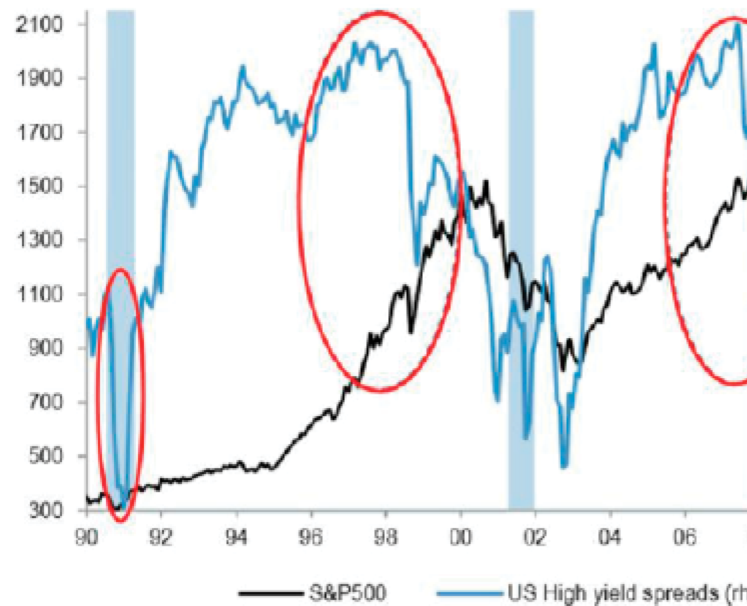


Source: Evergreen GaveKal, Bloomberg

Corporate debt, both investment grade and high-yield, is another area indicating that the up-cycle in stocks and the economy is likely ending. As the *Wall Street Journal* pointed out this week, the yield premium (spread) of investment grade corporate bonds, both in the US and Europe, is at a level that normally corresponds to recessions. In the case of high-yield bonds, the spread is now at 8% (note the right hand scale is inverted). Based on history, either junk bonds are going to rally a bunch or stocks have much further to fall.

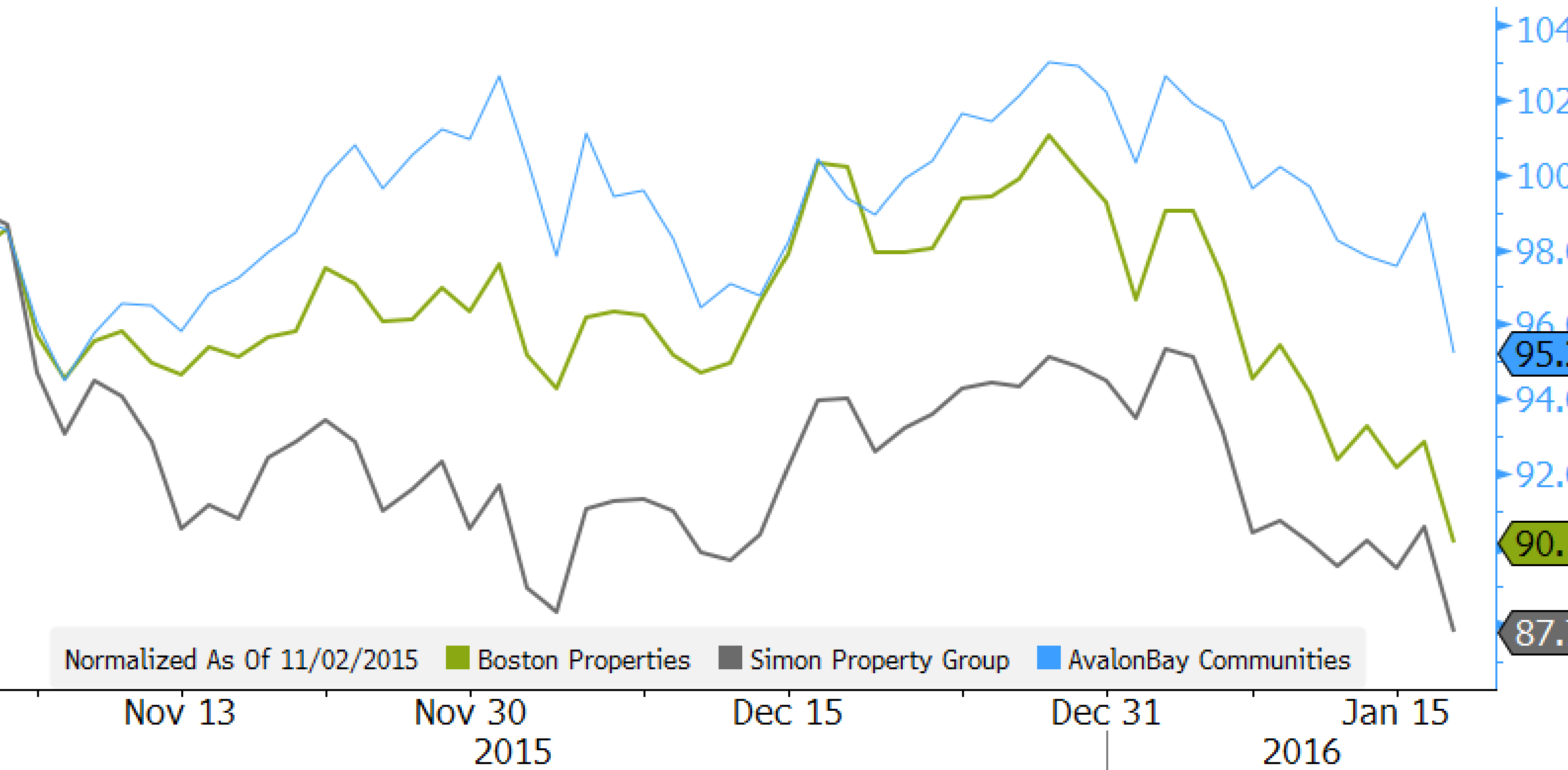


Source: Barclays



Source: DoubleLine

Even the big US blue chip REITs, so resilient for so long, have started to break down.



Source: Evergreen GaveKal, Bloomberg

As with housing and sub-prime mortgages eight years ago, what happens in energy isn't staying in energy. Rather, its travails seem to be symptomatic of deeper problems, including that the

power of the central bank printing presses to continually inflate assets is in at least partial eclipse. If so, those of us who have resisted the pressure to be fully invested in stocks may soon have the chance to put our cash reserves to work. (We should note that the S&P 500 is extremely over-sold and a short-term rally is probable; in fact, appears to be underway.)

We may also have the opportunity to buy even investment grade corporate bonds at high single-digit—possibly even low double-digit—yields. We can't emphasize enough how crucial it is for investors to buy into deep sell-offs in order to attain the type of returns needed to provide lifestyle funding. Sometimes, as with energy, those declines will considerably overshoot on the downside. But for a truly long-term focused investor that's good news, not bad—as long as you still have plenty of buying power in reserve.

Speaking of long-term, Evergreen strongly believes that energy has tremendous snap-back potential. We also continue to doubt the "lower for longer" mantra that has become popular with regard to oil prices. Whenever we hear that the cure for low prices is no longer low prices, our contrarian juices begin to flow. Prices in the 30s, much less the 20s, are unquestionably going to pull an enormous amount of future production off-line. For those companies—and the investors in them—who are still around when prices turn, the rewards promise to be immense. If you missed the chance to buy financial stocks and bonds back in 2009 when they were crushed, another window is wide open.

** 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. Kinder Morgan and Teekay are used as examples to illustrate the well-publicized examples of distribution. ECM currently holds Teekay Offshore, as well as Kinder and Teekay bonds, and recommends them for client accounts if ECM believes that they are suitable investments for the clients, considering various factors such as investment objective and risk tolerance. They may not be suitable for all investors. Certain clients hold PACCAR, Boston Properties, and Simon Property Group in their accounts, at their discretion; these securities have not been recommended by Evergreen. AvalonBay Communities has not been held in any client accounts. Please see important disclosures included following this letter.

OUR LIKES AND DISLIKES.

No changes this week.

WE LIKE

- -cap growth (on a deeper ack)
- ational developed markets deeper pull back)
- lian REITs
- nediate Treasure notes
- ted corporate bonds (i.e., quality, high yield)
- ly-traded pipeline erships yielding 7%-12%)
- nediate-term investment corporate bonds, yielding ximately 4%
- mining stocks
- nediate municipal bonds with g credit ratings
- term municipal bonds
- dian stock market
- term Treasury bonds
- blue chip oil stocks
- ging bond markets (dollar- or hedged)

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
- Bonds denominated in renminbi trading in Hong Kong (dim sum bonds)
- Canadian dollar-denominated bonds

WE DON'T LIK

- Real Estate Investment T (REITs)*
- Small-cap value
- Mid-cap value
- Small-cap growth
- Mid-cap growth
- Floating-rate bank debt
- Lower-rated junk bonds
- Emerging stock markets

*However, some small and m issues look attractive

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