Market Update Chartbook:

No (Short-Term FED) Pain, No (Long-Term Economic) Gain

Q2 CHARTBOOK – May 2022

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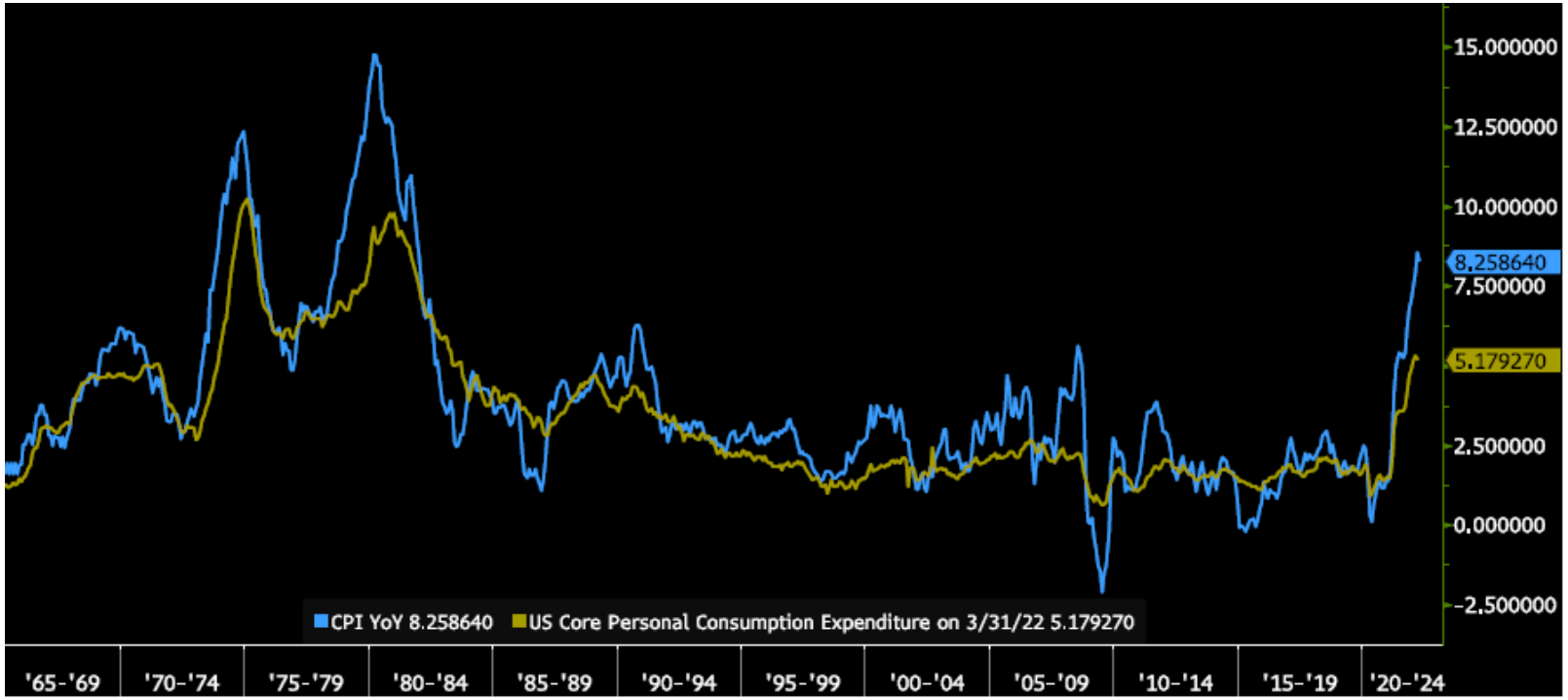
See important disclosures following the presentation.

Chartbook Preview

In this edition of *Evergreen Chartbook,* we will discuss the current state of the economy, markets, and our general outlook. 2022 has seen a volatile start to the year, as policymakers have had no choice but to tighten conditions in order to combat inflation. Near-term, we see risks skewed to the downside with the Fed's current approach. However, we also believe that their actions will ultimately curb inflation and put the economy on a healthier long-term trajectory. The hope is that once pricing cools off, it will set the stage for a substantial recovery in both the markets and the overall US economy.

Inflation Rates Soar to Highest Level in Over 40 Years



- Inflation has clearly been a major problem in 2022, with the CPI registering an 8.54% advance in March - the largest increase in prices since 1981.
- Even excluding the volatile food and energy components (yellow line), prices rose 5.2% year-over-year, well above the Fed's target.
- This week the April CPI print came in at 8.25% and slowed for the first time since August of 2021, which indicates prices may have finally peaked out.
- However, the release was higher than the expectation so could take time for prices to cool meaningfully.

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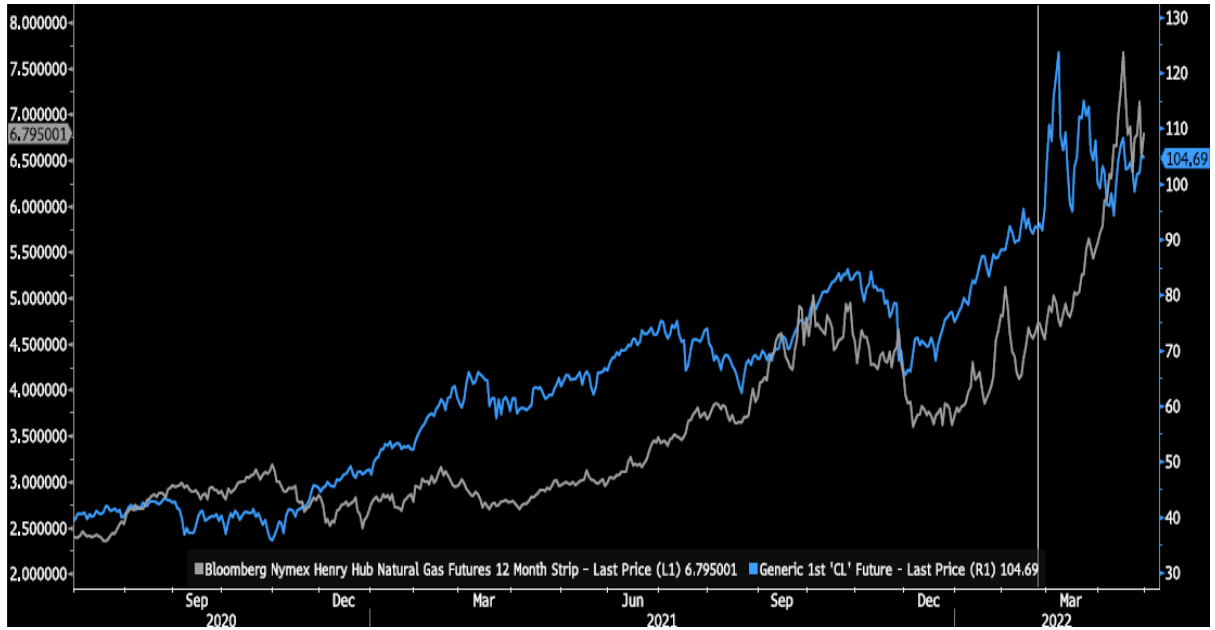
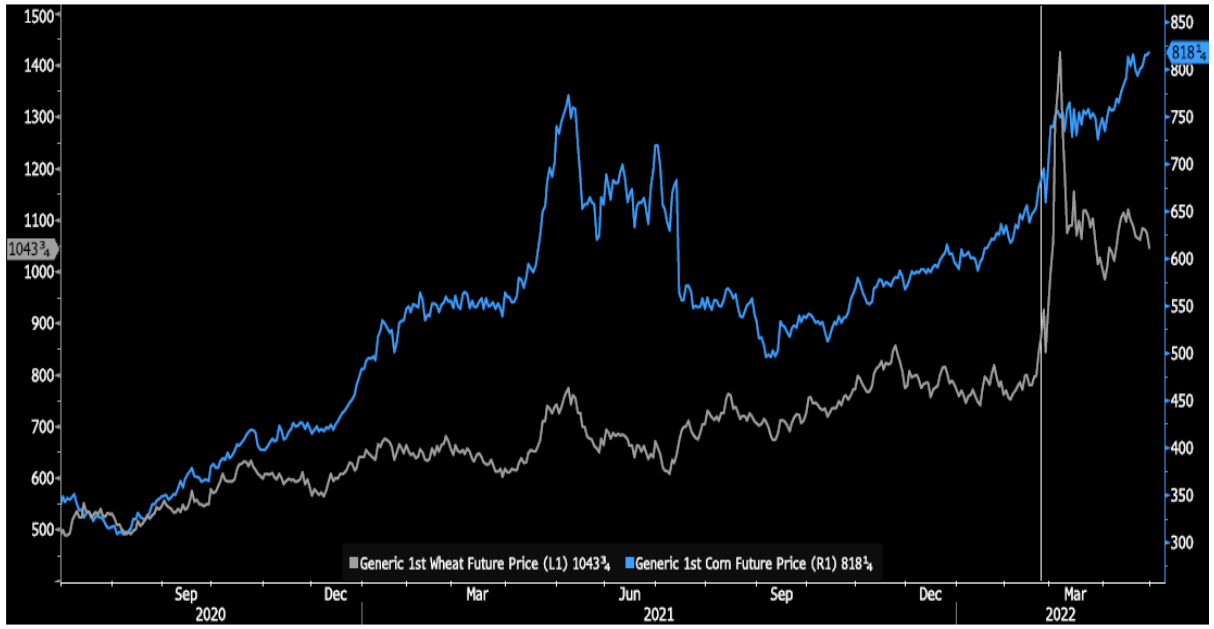
The Russia / Ukraine Conflict Has Pushed Energy and Food Prices Even Higher





- The recent move higher for inflation rates caught many investors off-guard, as expectations were for inflation to move sharply lower in early-2022.
- Of course, not many predicted Russia was going to invade Ukraine and - as you'll notice in the charts above - both energy (oil & gas) and agriculture (wheat & corn) prices have moved sharply higher since the conflict began (see grey horizontal line on chart).
- Making matters worse, Covid has resurged in China, putting even more pressure on already-strained supply chains.

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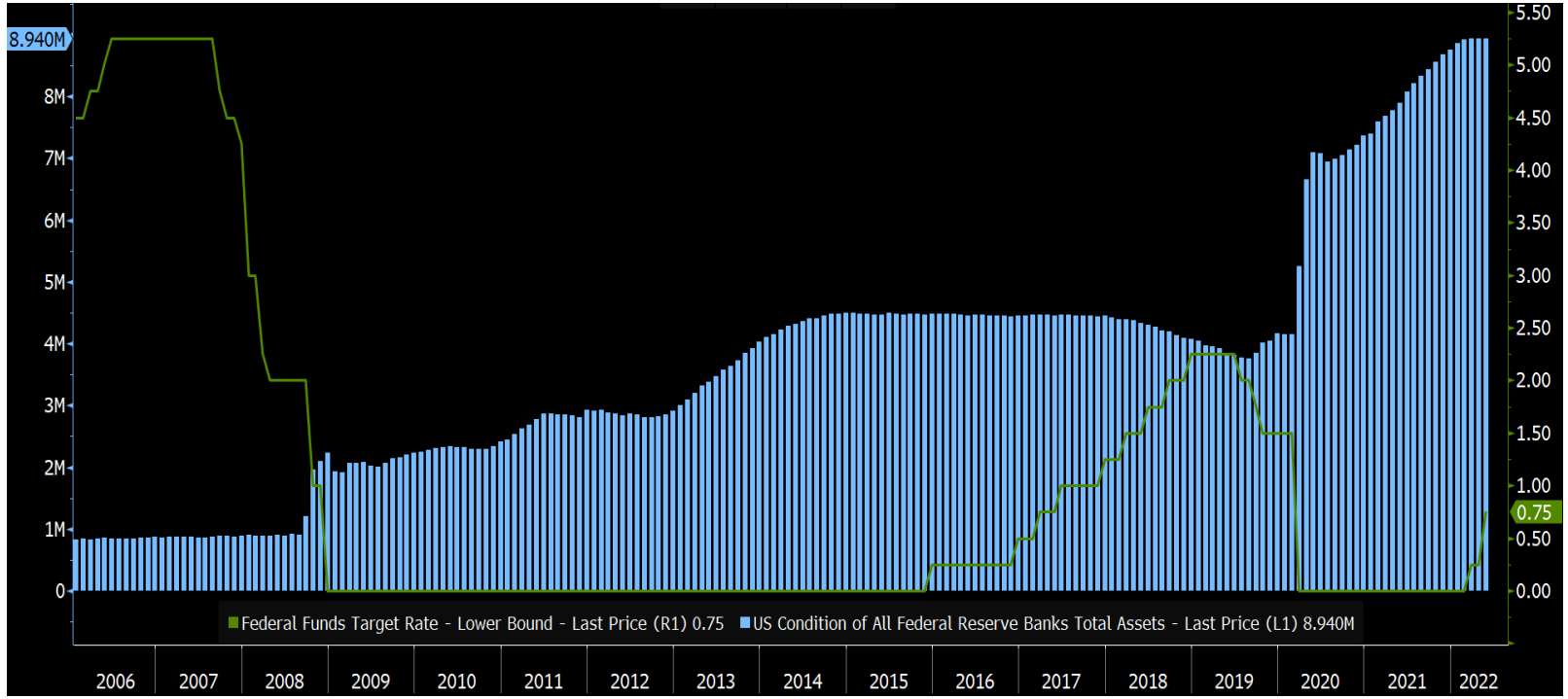
The Fed Has Begun to Raise Rates, but Balance Sheet Still Bloated



- Exacerbating the inflation problem is the fact that there is far too much liquidity in the system.
- The Fed is significantly behind the tightening curve by not reducing its balance sheet, which is still $5 trillion higher than pre-Covid levels.
- Additionally, we have only seen two rate hikes so far, or 75bps in total, which has only made the inflation squeeze even more acute.

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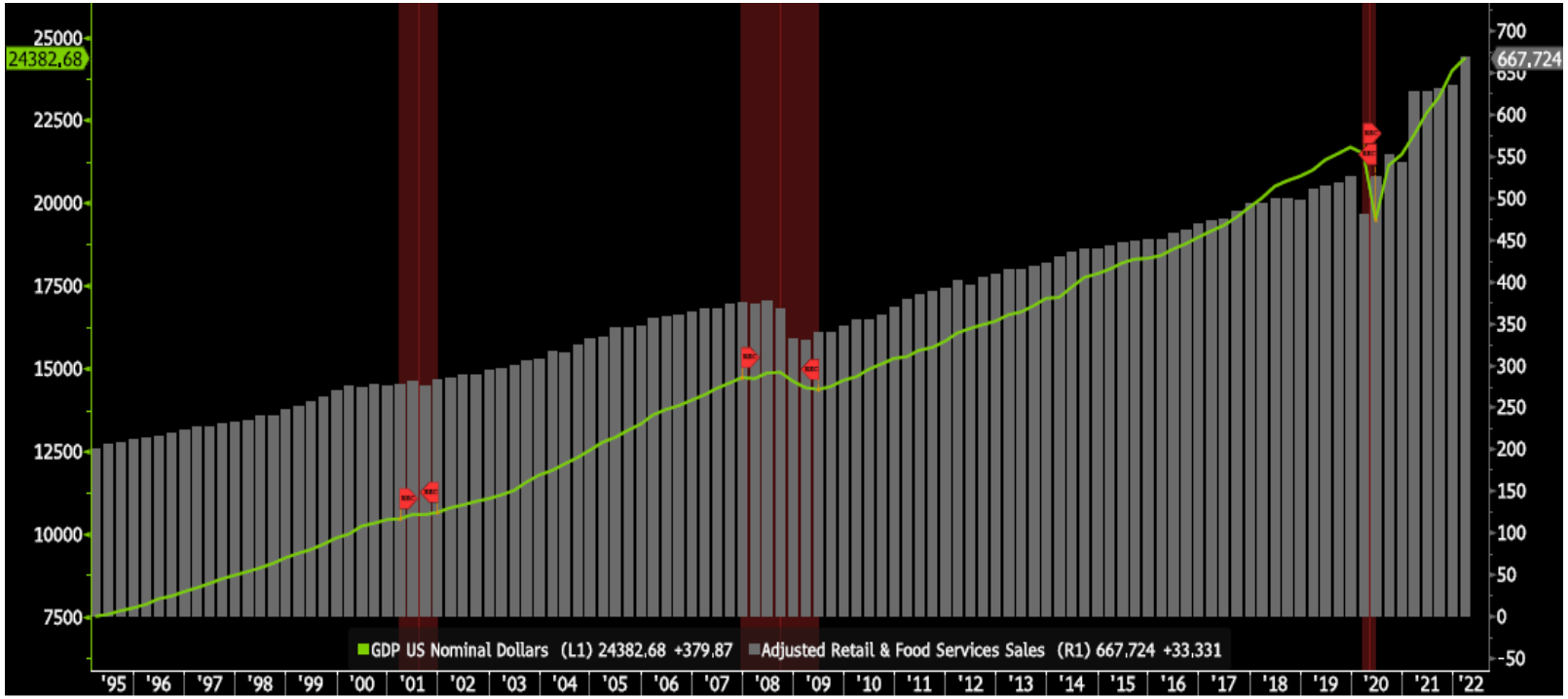
Fed is Behind the Curve – GDP and Retail Sales Well Above Pre-Pandemic Peak



- We have highlighted this in previous *Evergreen Virtual Advisor* editions, but the Fed should have acted last year when both GDP and retail sales exploded and went well above the pre-pandemic high (early 2021).
- The excess cash in the system not only pushed prices of goods higher, but also pushed asset prices, like stocks and real estate, to artificially high levels.

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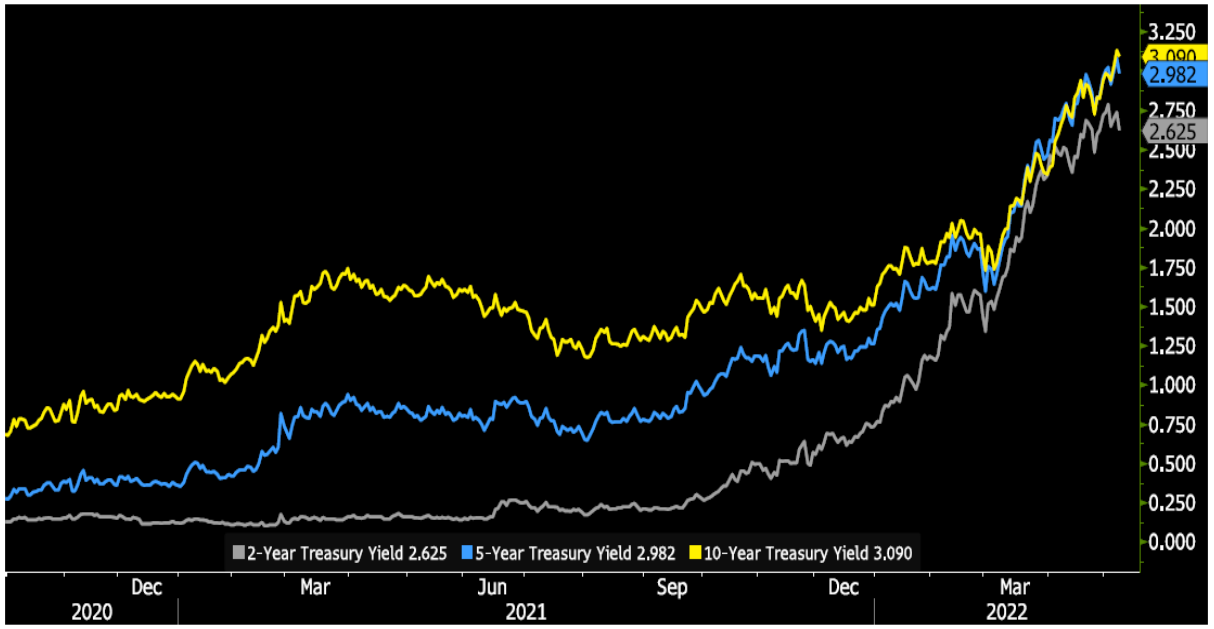
Financially, Conditions have Tightened in a Big Way



- The Fed has now been forced to act much quicker and their (apparent) plan is for nine more interest rate hikes over the next nine months.
- Interest rates are currently discounting the Fed's trajectory with treasury, mortgage rates, and corporate borrowing costs up sharply.
- Their goal is a delicate balancing act: slow the economy to bring inflation down, but not so much that the US tips into a recession – what many have dubbed as pulling off a "soft landing".

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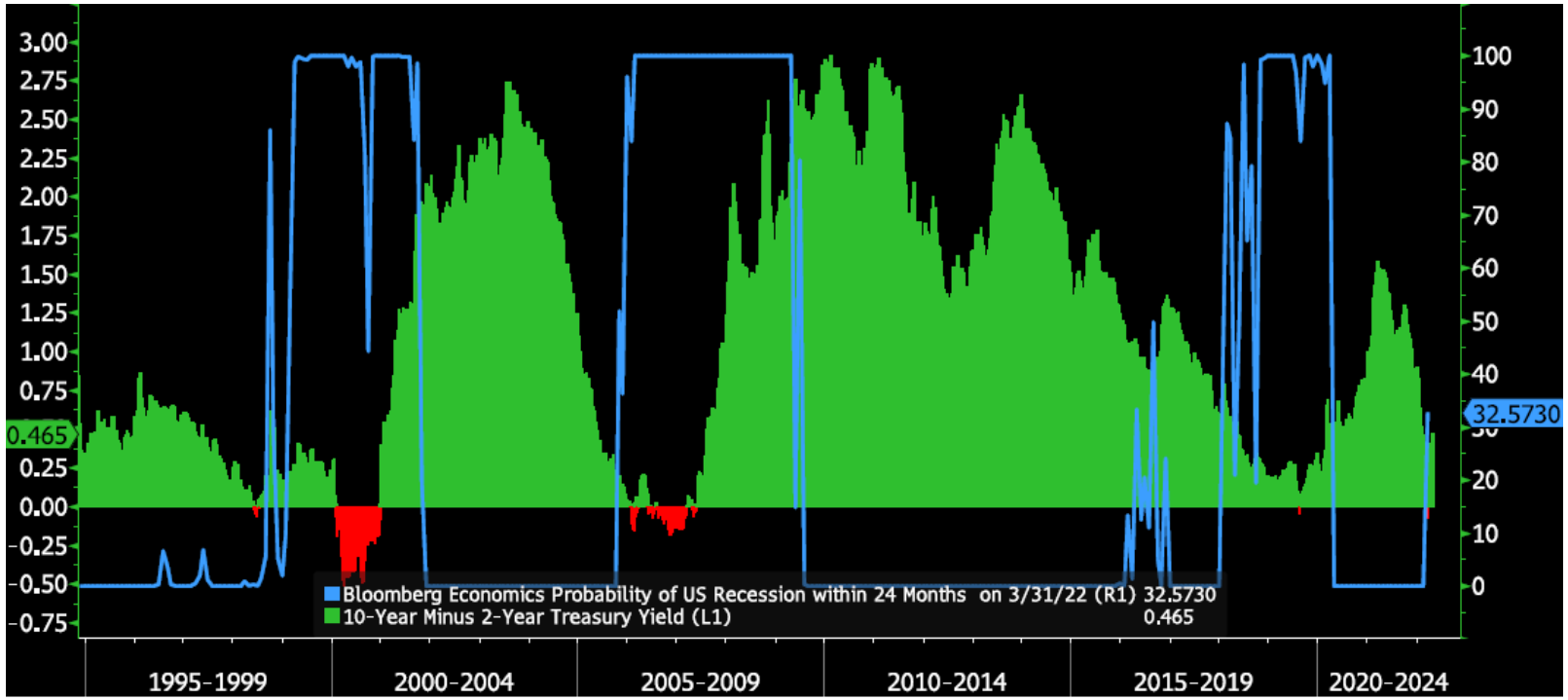
Recession Odds and the Yield Curve



- The best historic indicator predicting a recession has been the yield curve inverting, or short-term rates moving above long-term rates (red/green histogram).
- This warning briefly flashed red earlier this year, but the yield curve has since moved to positive sloping territory.
- The blue line is Bloomberg estimate of recession odds over the next 24 months, which currently stands at 32.5%.
- In other words, the data is starting to show there's growing skepticism in the Fed's ability to engineer the aforementioned "soft-landing".
- While possible, it's rare for this indicator to move up and not have a recession occur.

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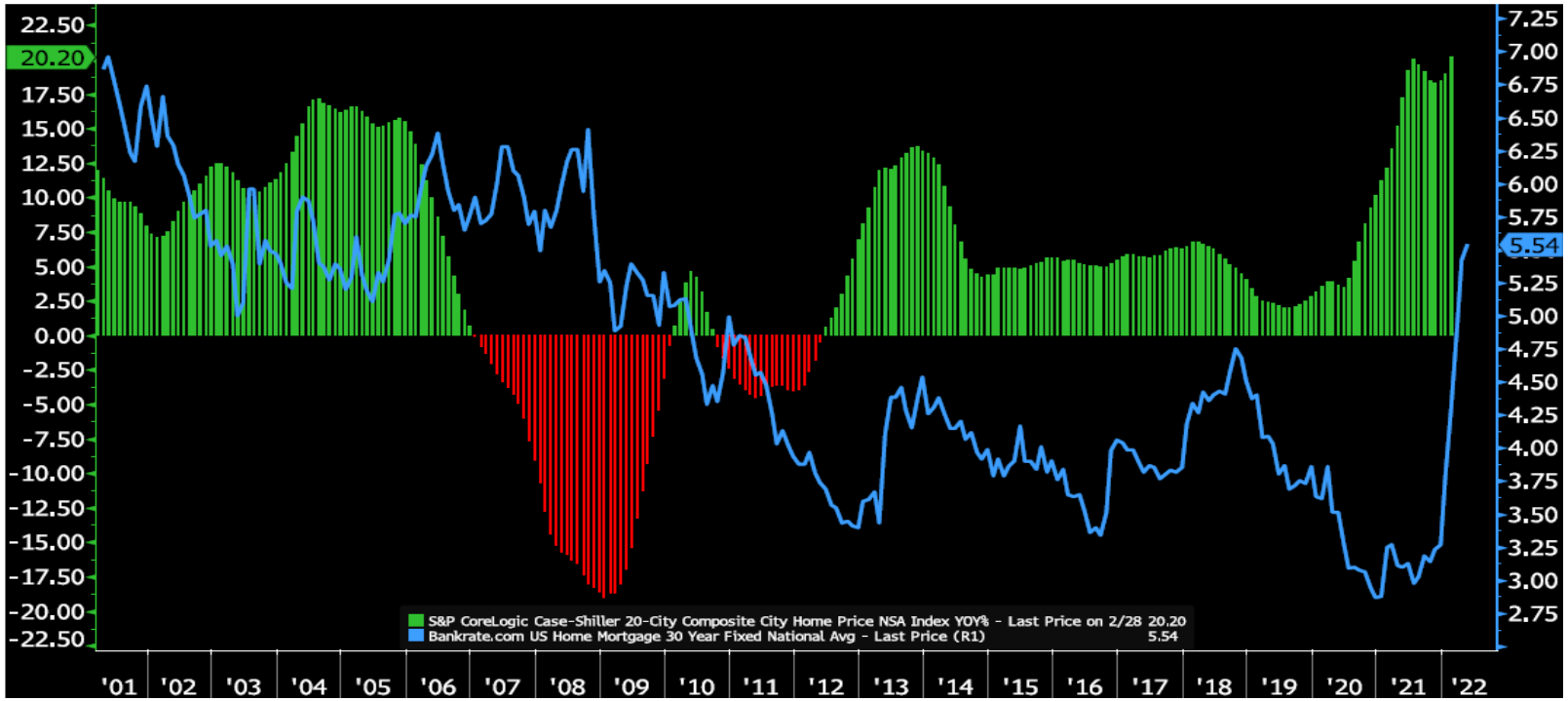
The Housing Market Will Slow Way Down Over the Next Year



- Given higher interest rates, we will undoubtedly see a widespread slowdown across the US economy. The real estate sector is a prime example, as the 30-year mortgage rate has moved up from 2.75% at the low to a 10-year high of 5.5%.
- As you can see, year-over-year housing prices tend to move lower after a move up in mortgage rates.
- Today, we are at the cycle-high for home price appreciation (+20% year-over-year) and mortgage interest rates, which suggests price future price appreciation should slow sharply.
- Our expectation over the next year is that home prices stop moving up and will likely go down in some regions.

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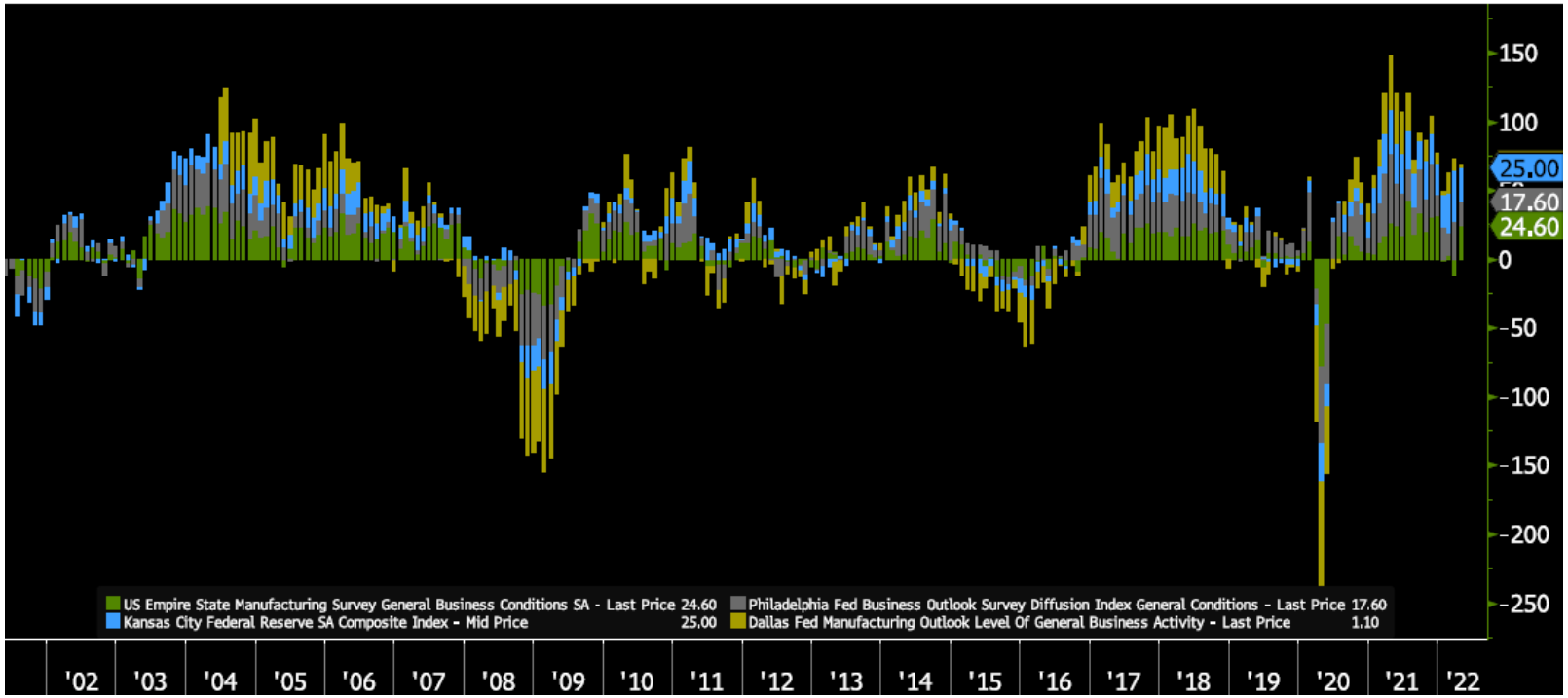
Demand for Goods Remains Strong, but Manufacturing Riddled with Supply Chain Issues



- The manufacturing sector is firmly in expansion mode but has been slowing in recent months.
- We are seeing intensifying headwinds from supply constraints, which is causing softness in inventory levels and production.
- The good news is that domestic demand remains strong. The bad news is that the manufacturing outlook will continue to be cloudy given current lockdowns in China that are intensifying supply constraints.

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The Labor Market Remains Red Hot, but Wages Trailing Current Inflation

- The bright spot for the economy continues to be the labor market, which has added over 400,000 jobs each of the past 12 months.
- This has brought the unemployment rate down from 15% during the worst of the pandemic to 3.6% today.
- Wages are also increasing, with the employment cost index rising 4.4% for the month of April (though that does lag the current rate of inflation).

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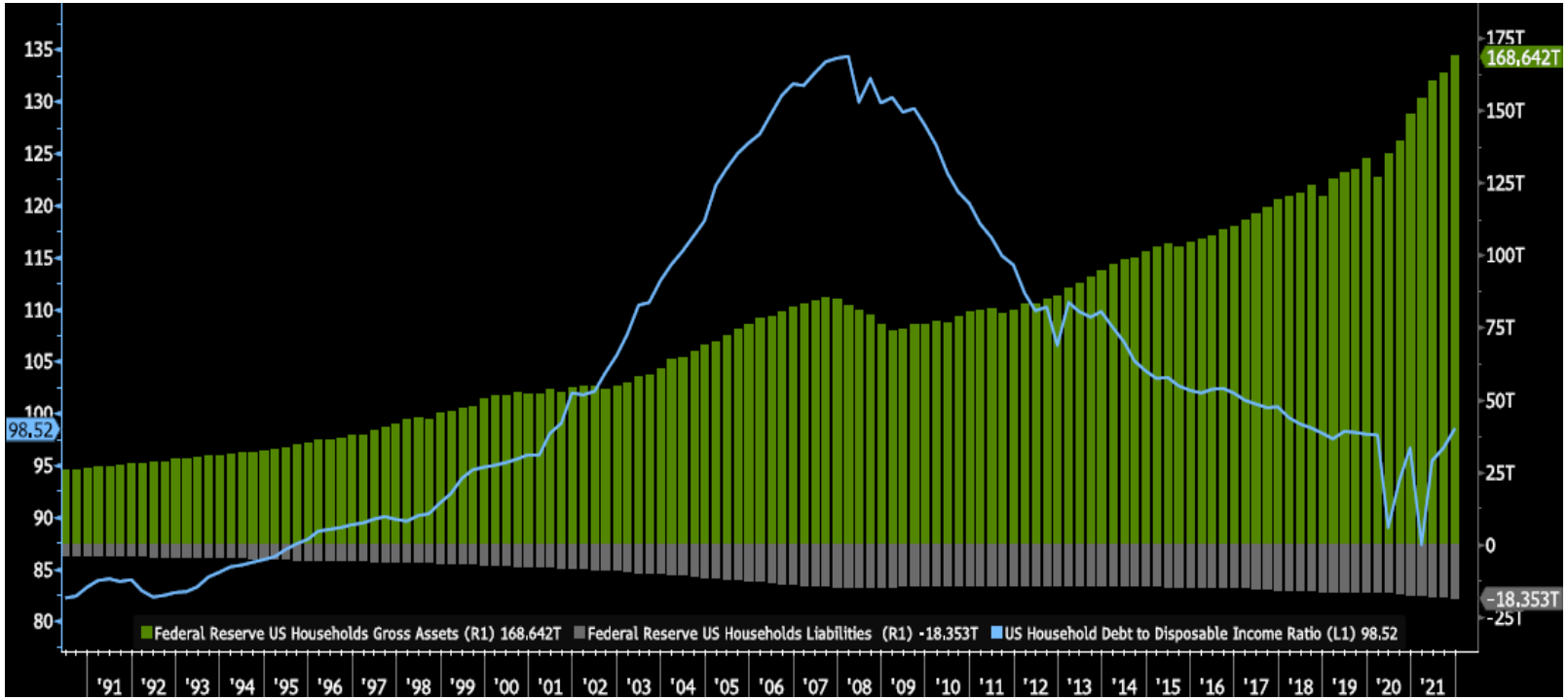
Household Balance Sheets in Great Shape Relative to the Last Decade



- US household balance sheets remain very strong with net assets (assets minus debts) at the highest level ever.
- In addition, household debt to disposable income remains near the lowest point over the last 20 years.
- With the labor market and consumer as strong as they are today, we still think the US economy avoids a recession in the near-term but concede the odds of one occurring over the next two years are rising.

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Stocks Are Off to A Very Rocky Start in 2022

SPX Index | Settings | Comparative Returns

Range 12/31/2021 - 05/09/2022 Period Daily No. of Period 129 Day(s) Table

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	SPX Index	USD	-16.26%	-15.86%	9.66%	-38.65%
2)	CCMP Index	USD	-25.71%	-25.52%	--	-56.56%
3)	RTY Index	USD	-21.52%	-21.24%	4.29%	-49.11%
4)	MXEF Index	USD	-17.64%	-17.12%	8.40%	-41.22%
5)	MXEA Index	USD	-18.03%	-16.73%	8.79%	-40.43%
6)	INDU Index	USD	-11.26%	-10.70%	14.82%	-27.40%

- Stock indices are down 10-25% this year - depending on the segment of the market - with the S&P 500 down 15.86% year-to-date.
- It's worth noting that since 12/31/2019, the S&P 500 has still returned an annualized return of 11.1%, so at least part of the sell-off is due to the extreme run-up we experienced leading up to 2022.
- With that said, high inflation, rising rates, a hawkish Fed, and geopolitical risks have rapidly changed market sentiment.

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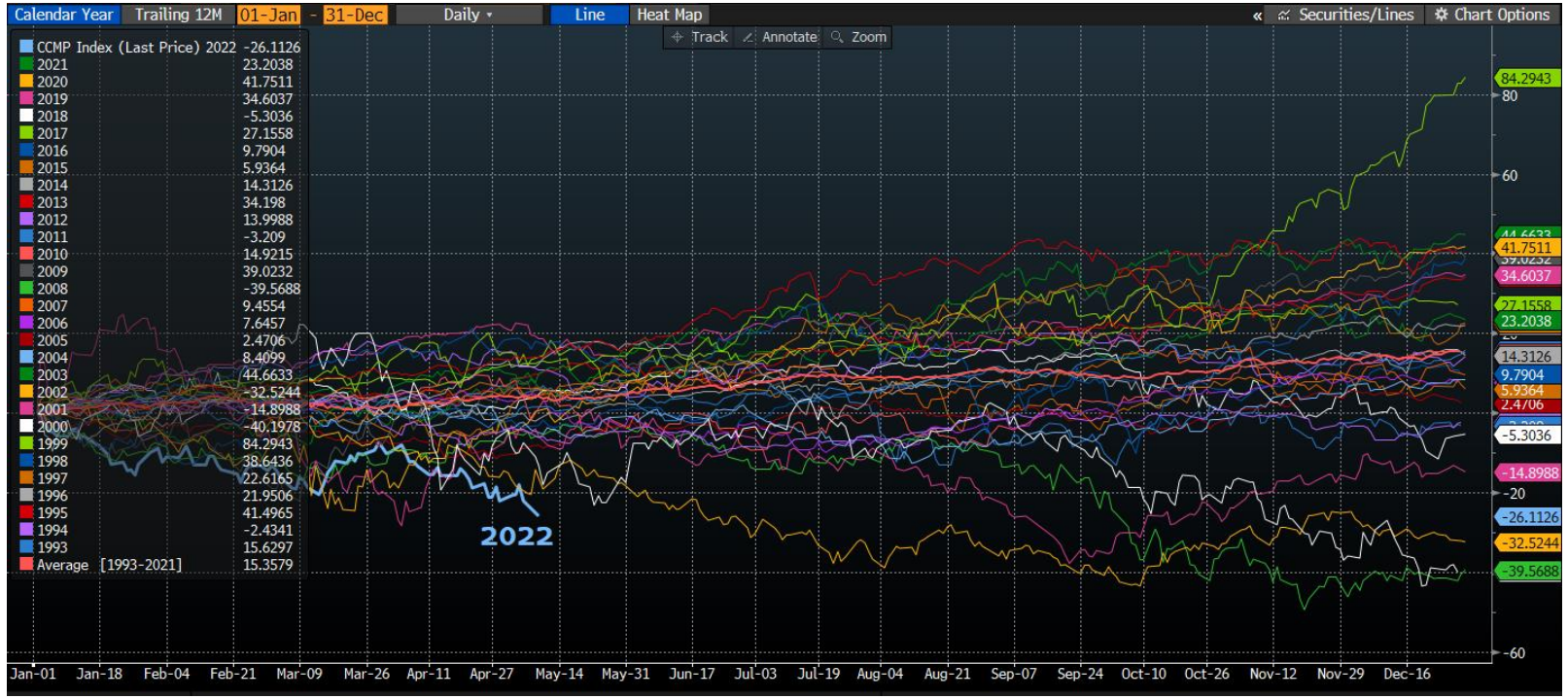
Worst Start for the Nasdaq in 30 Years



- The hardest hit corner of the market has been the NASDAQ, which is off to its worst start to the year in three decades (and even worse than any year during the tech bubble).
- The damage has been widespread, as over 50% of the NASDAQ constituents are now down 50% from their two-year high.
- The not-so-good news is that when the NASDAQ starts off the year down big through May, it typically ends the year lower.
- With that said, the following year tends to be up about 70% of the time, so we'd suggest dollar cost averaging slowly.

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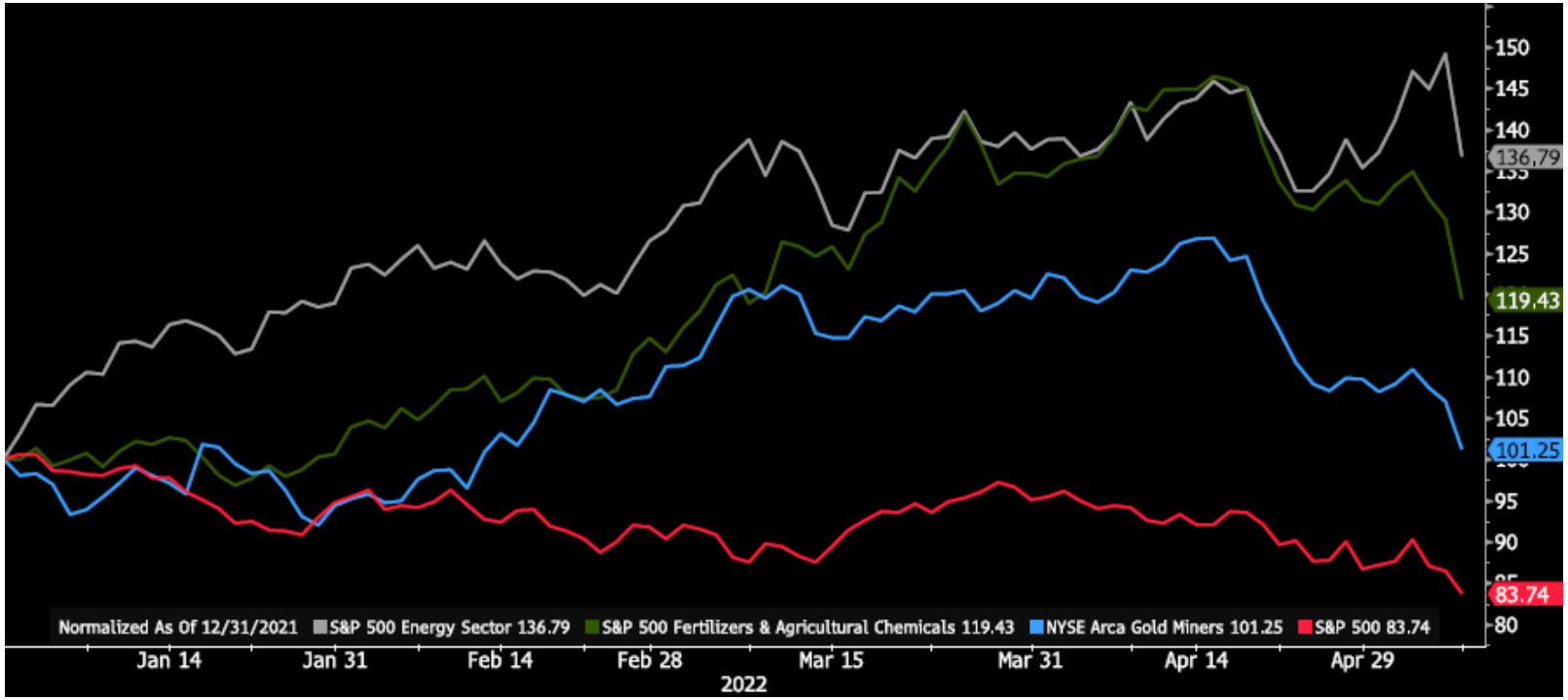
Energy Stocks and Commodities



- Energy and commodity-related sectors have been one of the only places to hide within equity markets this year with the energy sector up 36%.
- The fertilizer and agriculture sub-sector is also up 20%, and gold mining-related stocks have at least held their value with a positive 1% return.
- Fortunately, we have held and recommended a healthy allocation to energy-related issues, which has helped Evergreen portfolios hold up relatively well vs. benchmark indices (outside of our tech-heavy equity strategy).

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Earnings Season Strong, but Forward-Looking Estimates Appear High

S&P 500 INDEX

Surprise | Growth

Sector (GICS)	Reported	Sales Growth	Earnings Growth
11) All Securities	443 / 499	13.96%	9.30%
12) > Energy	20 / 21	59.04%	248.34%
13) > Materials	28 / 28	24.14%	42.59%
14) > Industrials	67 / 71	12.16%	34.35%
15) > Consumer Discretionary	41 / 59	13.34%	-17.94%
16) > Consumer Staples	24 / 32	5.50%	7.12%
17) > Health Care	60 / 65	14.68%	16.25%
18) > Financials	66 / 66	1.90%	-20.96%
19) > Information Technology	61 / 76	12.07%	10.73%
20) > Communication Services	19 / 23	5.64%	-0.22%
21) > Utilities	28 / 28	2.32%	9.78%
22) > Real Estate	29 / 30	19.99%	31.59%

- Q2 earnings season has been strong with average earnings and sales growth of 9.3% and 13.9%, respectively.
- Over the next three years ('22-24), earnings are expected to grow 14.5%, 9.3%, and 9.3%.
- The back-half of this year, and next two years, look a bit high given the Fed's pivot to tighten and slow the economy.
- With that said, earnings are still strong and growing, and that should help eventually stabilize the market as valuations continue to come down.

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Equity Valuations Have Come Down and Now Look Reasonable

- The S&P now trades at 17.5x 2022 or 16x 2023 earnings per share - basically right around the average over the last couple of decades.
- One caveat, is that profit margins are well above historical averages, and could come under pressure given wage and cost pressures.
- Still, for intermediate or long-term investors, it makes sense to dollar-cost-average into this decline.

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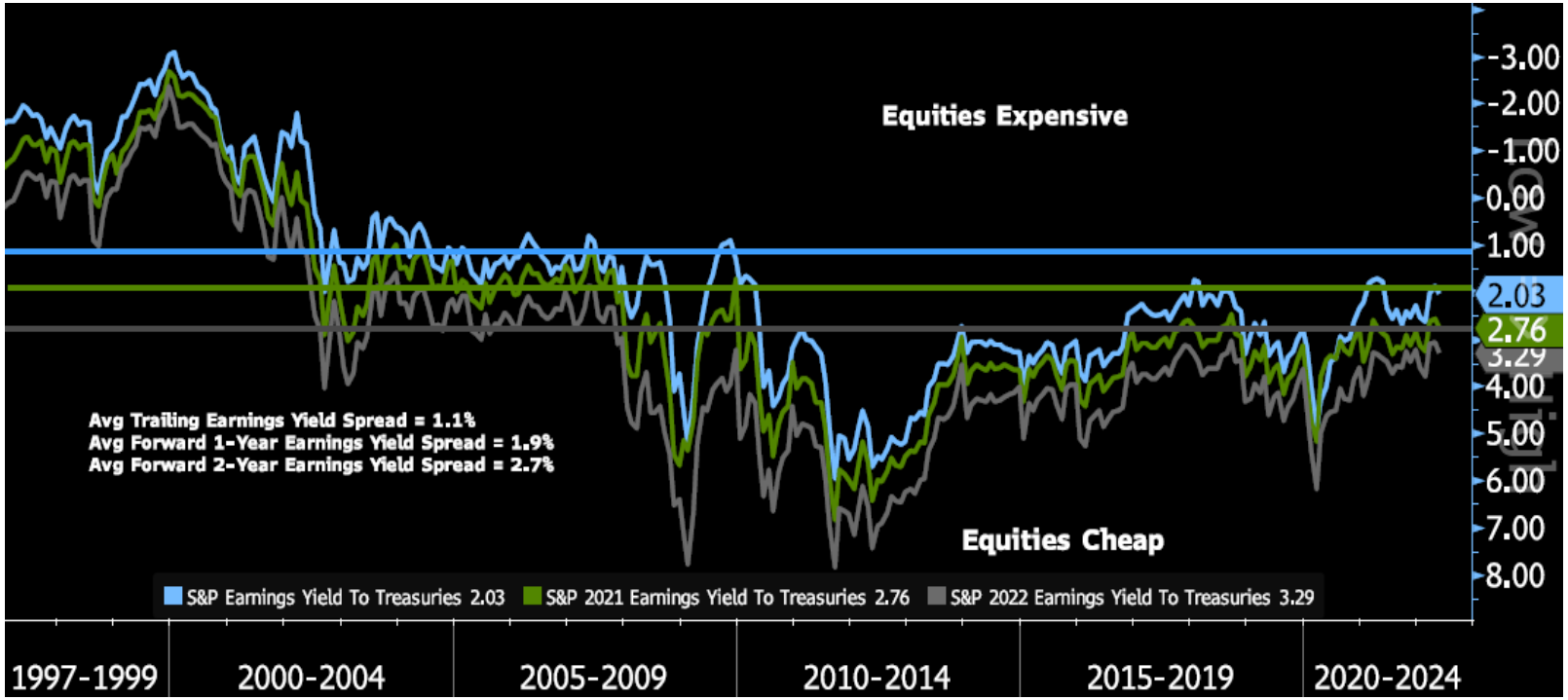
Valuations Relative to Interest Rates



- Interestingly, valuations relative to interest rates (equity risk premium) has slightly worsened this year because of the spike in interest rates.
- This metric still stocks look attractive relative to the last 30 years, but slightly pricey compared to the last decade.

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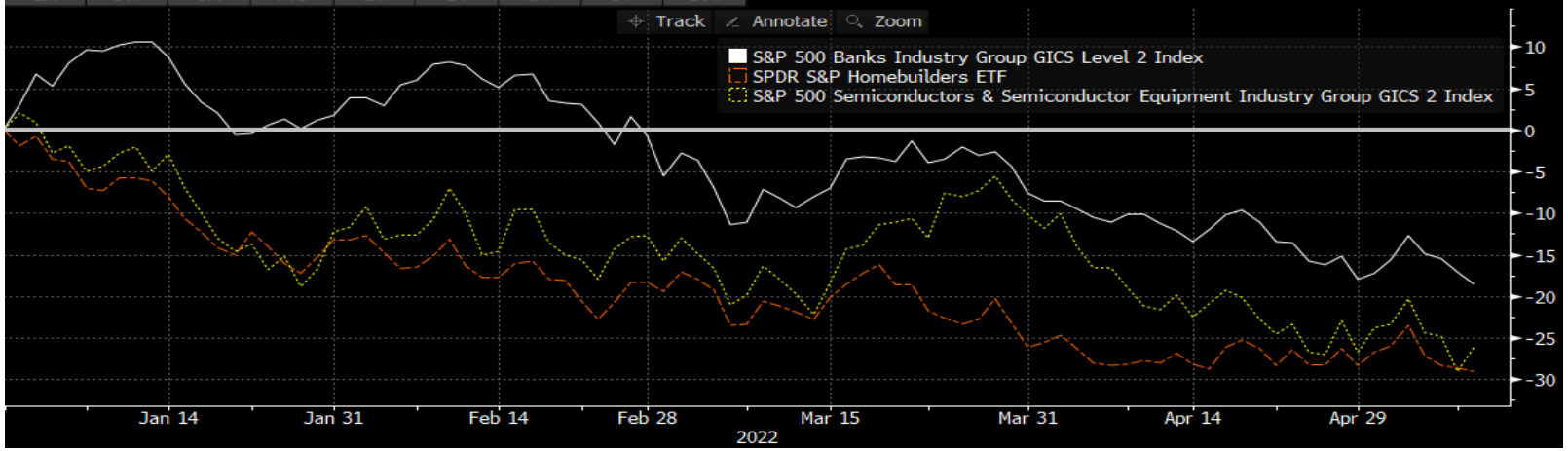
We’ve Been Selectively Adding to Financial, Home Builder, and Semiconductor Names

Range 12/31/2021 - 05/10/2022 Period Daily No. of Period 130 Day(s) Table

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	S5BANKX Index	USD	-19.33%	-18.51%	10.57%	-43.71%
2)	XHB US Equity	USD	-29.24%	-29.08%	--	-61.89%
3)	S5SSEQX Index	USD	-26.44%	-26.11%	2.97%	-57.24%
4)						
5)						
6)						



- Of late, we have been scooping up banks, home builders, and semiconductor equipment stocks.
- These sectors have dipped sharply this year and all look relatively cheap vs. their history.

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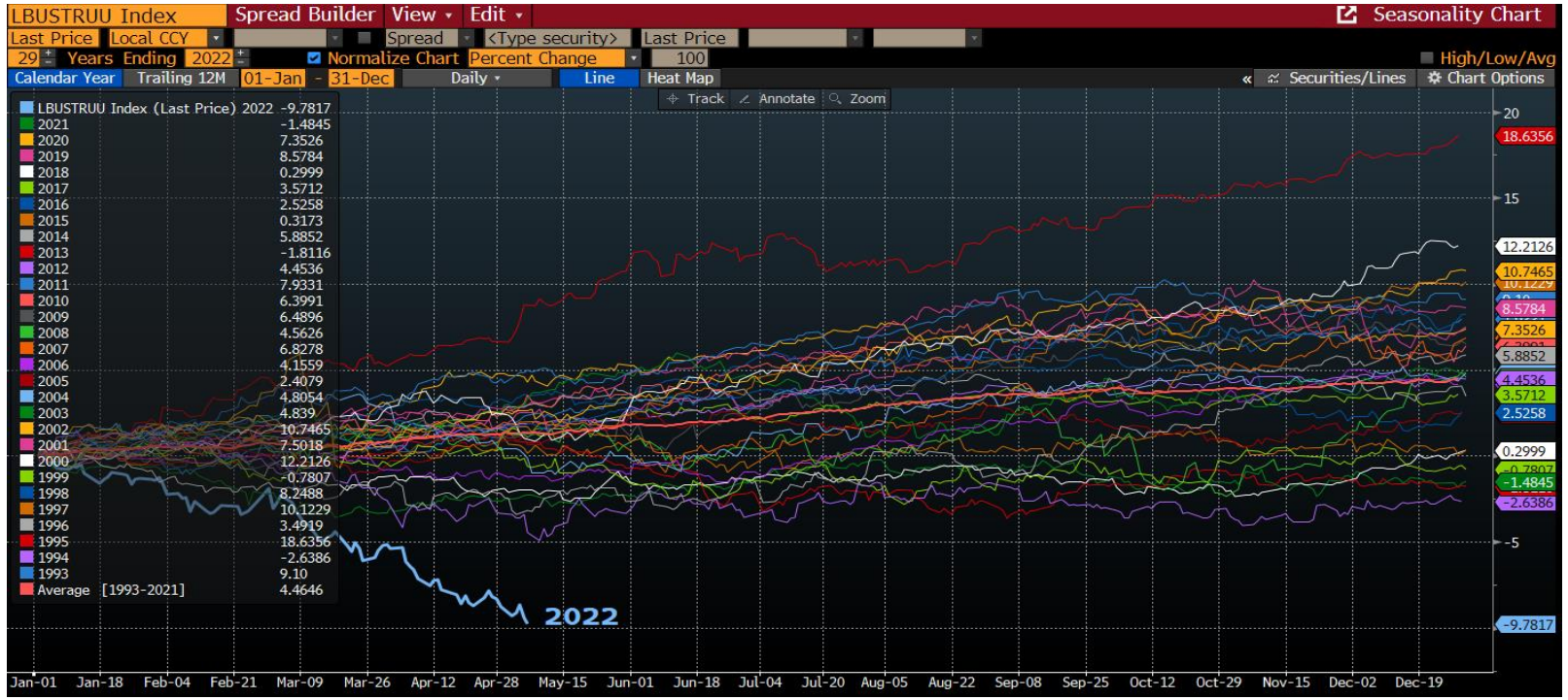
Income Markets: It's Been the Worst Start to the Year for Bonds Since 1980



- As you can see in the seasonality chart above, bonds are down 10% to start the year, which is 5% more through early-May in any year since 1993!
- Bonds historically have tended to stabilize after sharp drawdowns, and by most measures, bonds look deeply oversold.
- Interest rates will continue to move up on the short-end as the Fed raises rates, but on the intermediate and long-end we believe most of damage has been incurred.

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Short-to-Intermediate Treasury Yields Look Attractive

- The two-year and five-year treasury yields currently stand at 2.6% and 2.95% and look attractive in today's environment.
- This provides a reasonable yield and should offer a high degree of safety if growth slows meaningfully over the next 12-18 months. Essentially, we feel like these are equivalent to cash and have recently been buying them with that mindset.

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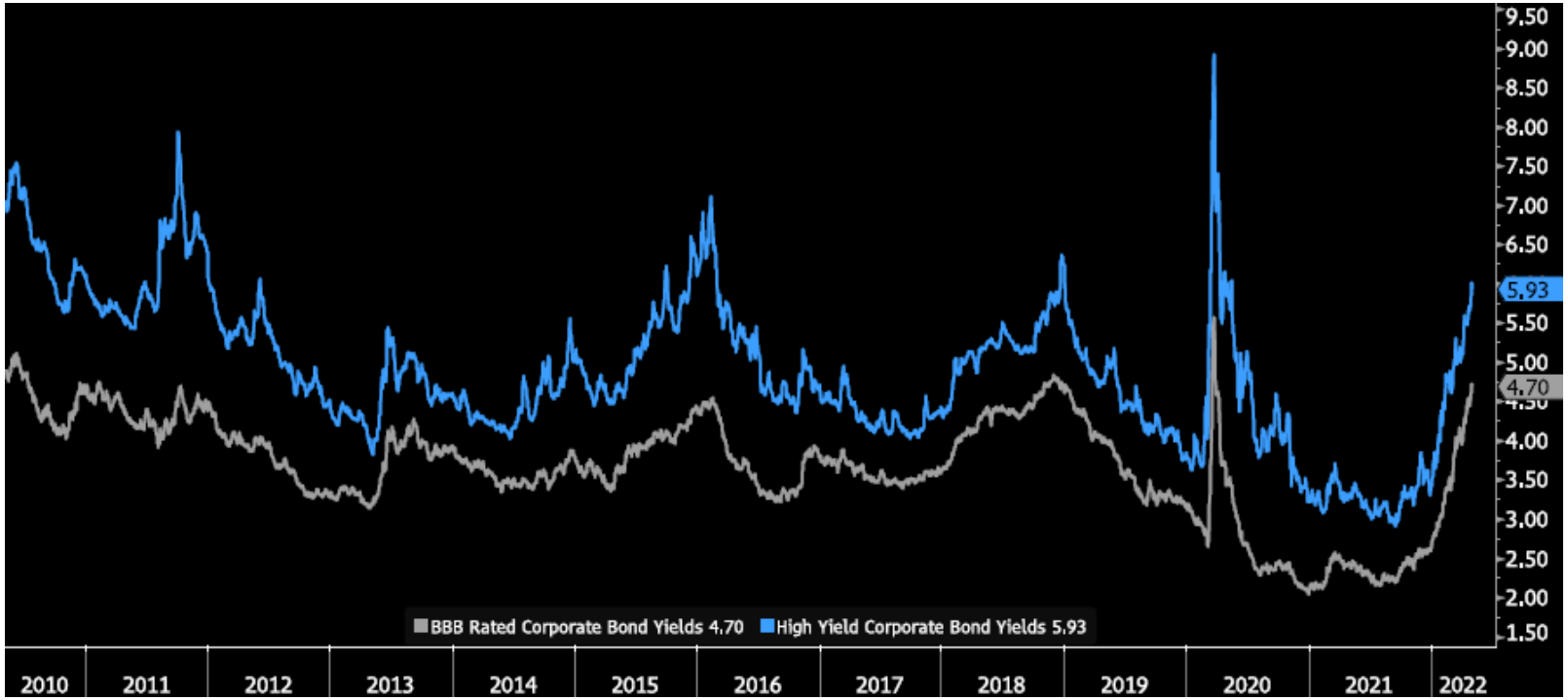
Investment-Grade and High-Yield Corporate Bonds also Look Interesting



- BBB-rated corporate bond (IG) yields (4.7%) are near the 10-year in terms of cashflow.
- High-yield bonds (HY) yielding 6% are now also approaching previous peaks.
- We have been selectively adding to corporate credit in recent weeks (both IG and HY) given the reasonably attractive cashflows they now offer.
- It's worth noting corporate balance sheets generally are in good shape, and with growing earnings, default rates should stay low.

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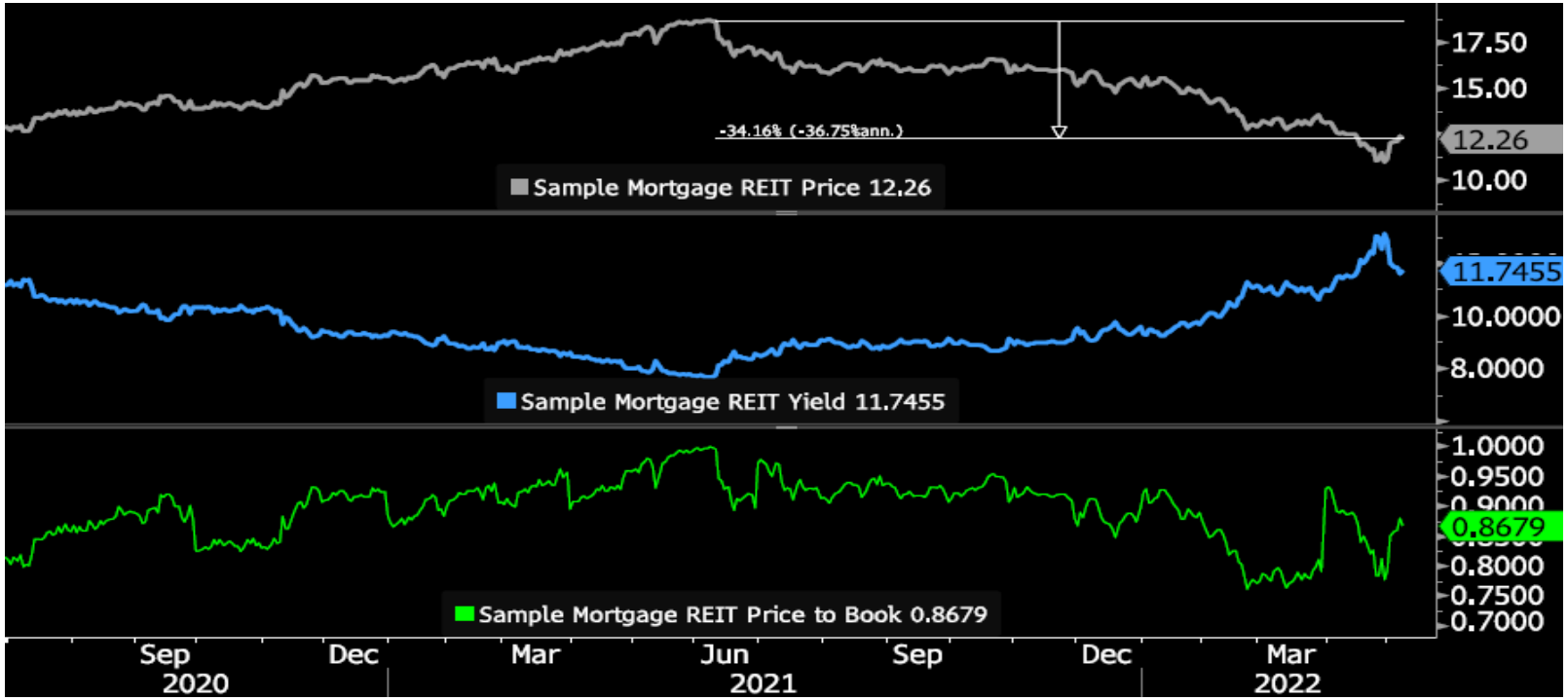
Mortgage REITs Have Been Hit Hard, but Now Look Quite Attractive



- The mortgage REIT space has corrected sharply during this rising interest rate environment and now look quite attractive.
- The yields in the space range from 8-13% and the stocks today trade well below book value.
- We have been adding weight to these positions and believe they will provide solid total returns over the next six-18 months.

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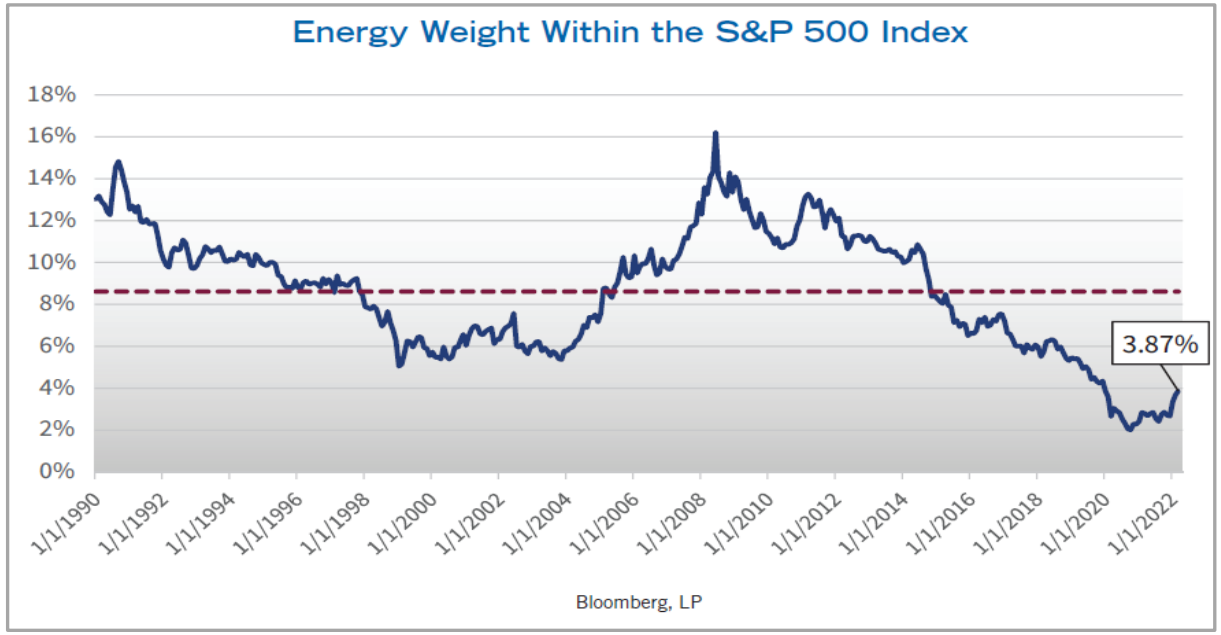
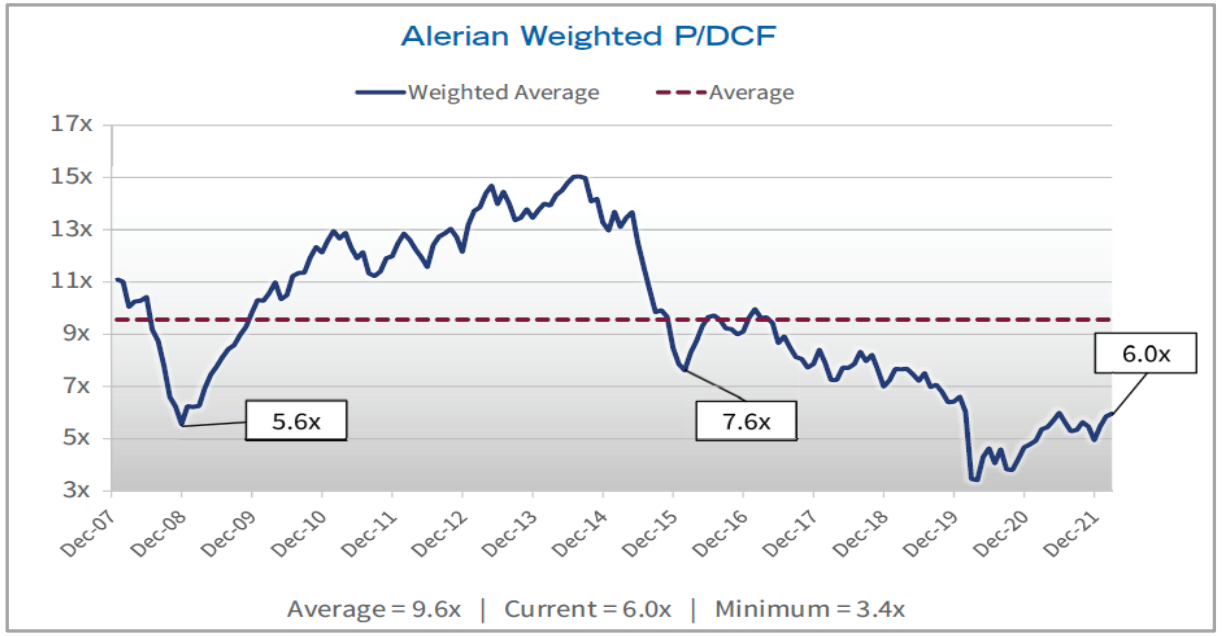
Midstream Energy Securities





- Midstream energy securities have been a stellar performer within the equity income space, with a total return of 17% year-to-date.
- The move up has been on the heels of continued growth in earnings, which means valuation still looks quite attractive (6.0x price-to-cashflow).
- The energy sector is still under-owned and we believe in this environment will continue to gain traction due to global geopolitical tension.
- We believe energy infrastructure assets in the US also demand a premium, given the world's need and desire to move away from Russian energy supply.

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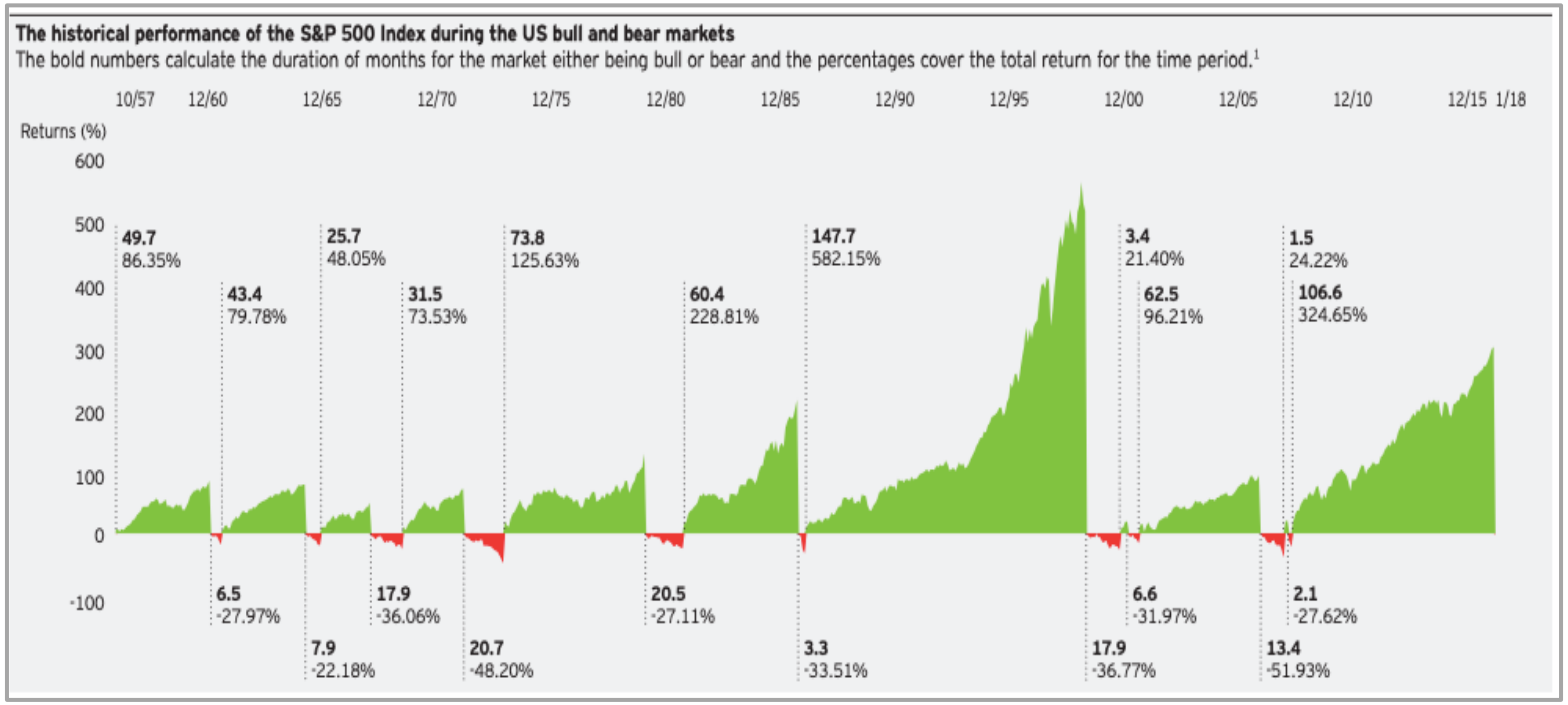
Corrections Are a Tough Pill to Swallow, But Set the Stage for the Next Bull Market

- So far, 2022 has been a challenging year for financial markets as the Fed attempts to combat inflation.
- Near-term, that is creating heartburn for both stock and bond investors as they try to assess the impact of rising interest rates and slowing growth.
- Corrections are painful to go through, but they're also healthy as they purge weak hands and provide active investors with the opportunity to redeploy capital.
- Looking out several years, we feel very good overall about the competitive advantage for the US economy and corporate America.

"There will be bear markets about twice every 10 years and recessions about twice every 10 or 12 years but nobody has been able to predict them reliably. So, the best thing to do is to buy when shares are thoroughly depressed and that means when other people are selling." John Templeton



Source: Invesco

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Index Definitions

- The Alerian MLP Index is the leading gauge of energy infrastructure Master Limited Partnerships (MLPs)..
- MSCI Emerging Markets Index: The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets..
- *CPI represents changes in prices of all goods and services purchased for consumption by urban households. User fees (such as water and sewer service) and sales and excise taxes paid by the consumer are also included.*
- *US Personal Consumption Expenditure Core Price Index tracks overall price changes for goods and services purchased by consumers. Deflators are calculated by dividing the appropriate nominal series by the corresponding real series and multiplying by 100.*
- *Generic 1st 'CL' Future is a contract that provides for delivery of several grades of domestic and internationally traded foreign crude oils, and serves the diverse needs of the physical market.*
- *Federal Funds Target Rate Lower Bound is the short-term interest rate targeted by the Federal Reserve's Federal Open Market Committee (FOMC) as part of its monetary policy.*
- *US Condition of All Federal Reserve Banks Total Assets tracks the aggregate assets and liabilities of banks within an economy (including private or commercial banks, central banks or both).*
- *Gross domestic product (GDP) measures the final market value of all goods and services produced within a country. It is the most frequently used indicator of economic activity. The GDP by expenditure approach measures total final expenditures (at purchasers' prices), including exports less imports. This concept is not adjusted for inflation.*
- *Adjusted Retail & Food Services Sales (also referred to as retail trade) tracks the resale of new and used goods to the general public, for personal or household consumption.*
- *Bloomberg Economics Probability of US Recession within 24 Months probability model shows the chance of a downturn within the next N-months. The model uses a range of financial market, real economy, and economic imbalance indicators to gauge the N-month risk of recession.*
- *S&P CoreLogic Case-Shiller 20-City Composite City Home Price NSA Index tracks the value of single-family housing within the United States. The index is a composite of single-family home price indices for the nine U.S. Census divisions.*
- *Bankrate.com US Home Mortgage 30 Year Fixed National Avg. includes only 30-Year Fixed Mortgage products, with and without points. This index is the Overnight National Average. You will see daily rate averages on Bankrate.com in boxes labeled overnight averages (these calculations are run after the close of the business day). Included there are rates we have collected on the previous day for a specific banking product.*
- *US Empire State Manufacturing Survey General Business Conditions SA is a survey conducted on a monthly basis by the Federal Reserve Bank of New York and tracks sentiment among manufacturers in the state of New York.*
- *Philadelphia Fed Business Outlook Survey Diffusion Index General Conditions is a survey, conducted on a monthly basis by the Federal Reserve Bank of Philadelphia, and tracks sentiment among manufacturers in the Philadelphia Fed's district which includes Eastern Pennsylvania, Southern New Jersey and Delaware.*
- *Kansas City Federal Reserve SA Composite Index is a survey, conducted on a monthly basis by the Federal Reserve Bank of Kansas City, that tracks sentiment among manufacturers in the Kansas City Fed's district which includes Kansas, Colorado, Nebraska, Oklahoma, Wyoming, the northern half of New Mexico and the western third of Missouri.*
- *Dallas Fed Manufacturing Outlook Level of General Business Activity is a survey, conducted on a monthly basis by the Federal Reserve Bank of Dallas, that tracks sentiment among manufacturers in Texas.*
- *US Initial Jobless Claims SA track the number of people who have filed jobless claims for the first time during the specified period with the appropriate government labor office. This number represents an inflow of people receiving unemployment benefits.*
- *US Unemployment Rate tracks the number of unemployed persons as a percentage of the labor force (the total number of employed plus unemployed). These figures generally come from a household labor force survey.*
- *US Job Openings By Industry Total SA tracks the number of specific job openings in an economy. Job vacancies generally include either newly created or unoccupied positions (or those that are about to become vacant) where an employer is taking specific actions to fill these positions.*
- *Federal Reserve US Households Gross Assets is a data series part of the Federal Reserve's Financial Accounts data set (formerly known as the Flow of Funds Accounts). This specific data set tracks a breakdown of assets, liabilities and net worth for households and nonprofit organizations. It includes domestic hedge funds, private equity funds and personal trusts.*
- *Federal Reserve US Households Liabilities is a data seriers part of the Federal Reserve's Financial Accounts data set (formerly known as the Flow of Funds Accounts). This specific data set tracks a breakdown of assets, liabilities and net worth for households and nonprofit organizations. It includes domestic hedge funds, private equity funds and personal trusts.*
- *US Household Debt to Disposable Income Ratio is the US Debt Outstanding by Sector Household divided by US Disposable Personal Income flow of funds.*
- *LBUSTRUU Index is the Bloomberg US Aggregate Bond Index, a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency). (Future Ticker: I00001US)*

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