Q3 Chartbook

The Fed Wrecking Ball

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JEFF DICKS, CFA
Partner, Co-CIO

Gherman Howell
Senior Analyst

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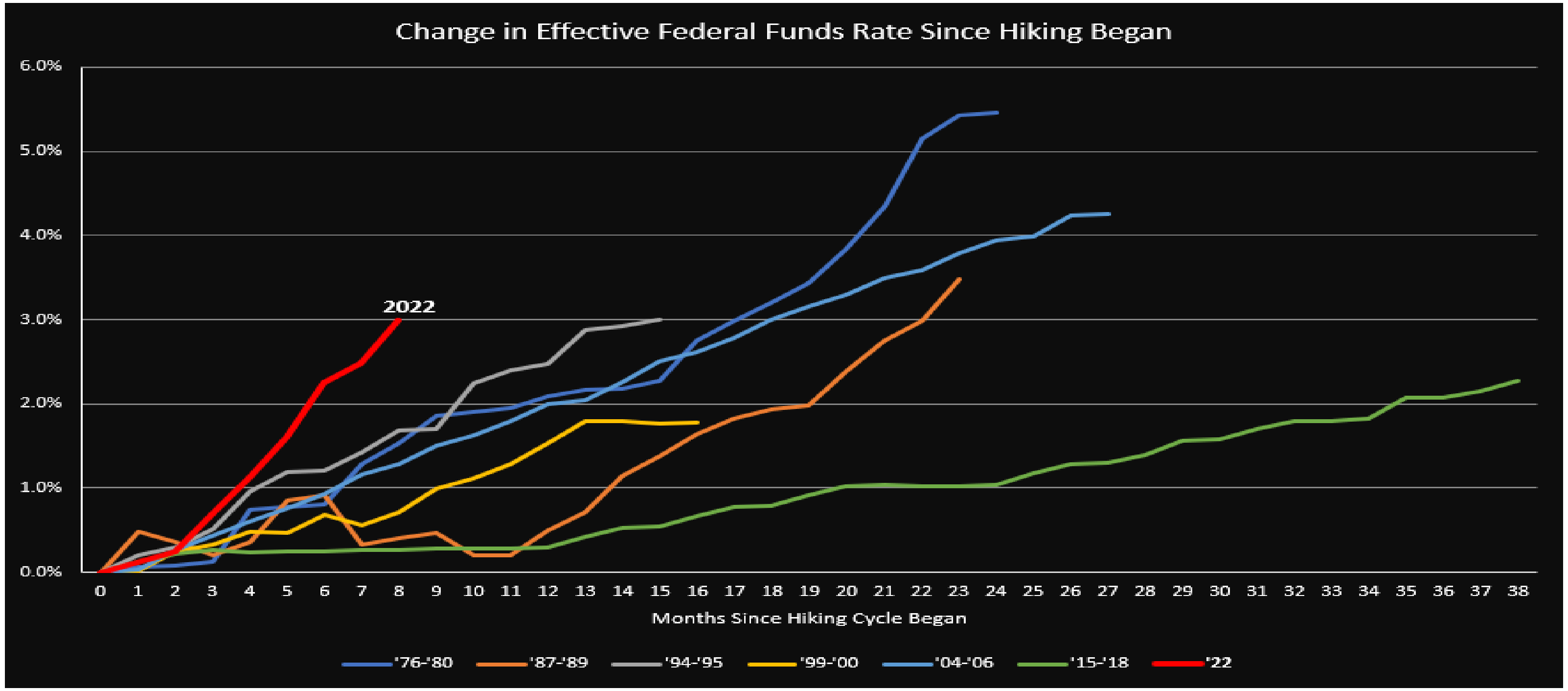
See important disclosures following the presentation.

Chartbook Preview

In this edition of *Evergreen Chartbook*, we dive into the Fed's aggressive tightening campaign that has been both the sharpest and fastest on record. We'll then take a close look at how these actions have inflicted significant carnage on the financial markets. While there's no doubt there's been massive collateral damage from highly aggressive fiscal policy drawdowns in fixed income and equities also create opportunities for investors. We'll conclude by discussing how we are reacting to the selloff and where we are deploying capital.

The Fed is Hiking Faster Than Any Cycle in History



- The 2022 hiking campaign (as you can see on the chart above) has been the sharpest rate increase relative to the past seven hiking campaigns
- The current odds are near 100% that the Fed hikes 75bps in early November, which would bring the federal funds rate to 3.75% in under nine months
- As you can see in the visual, that's more than twice as fast as any cycle on record. Note: the next sharpest was '94/'95 when the FED raised 1.75% over a nine-month period

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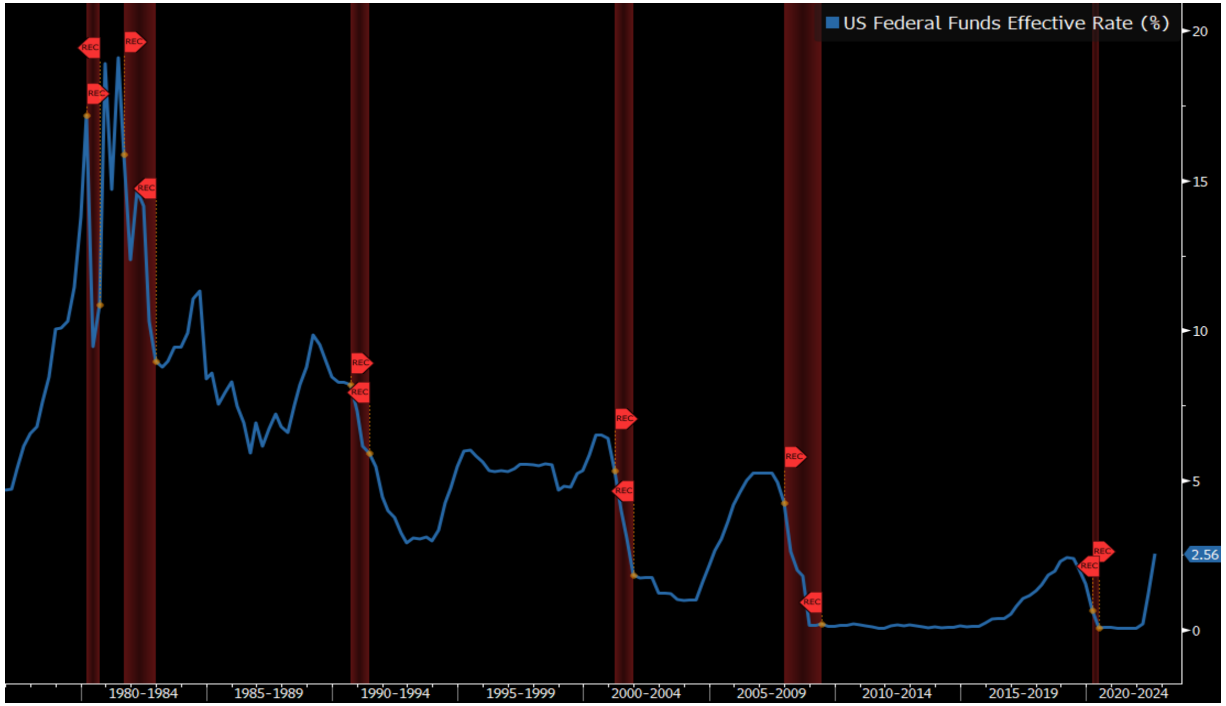
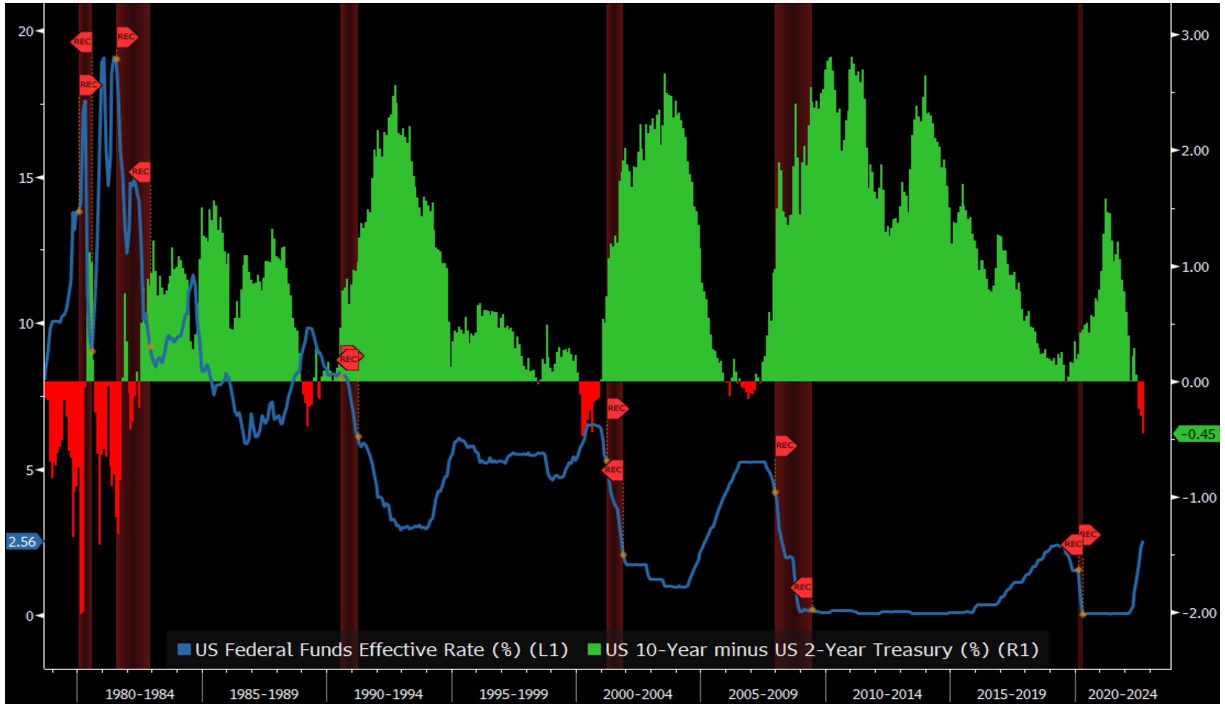
The FED Has a Track Record of Overtightening into Recessions

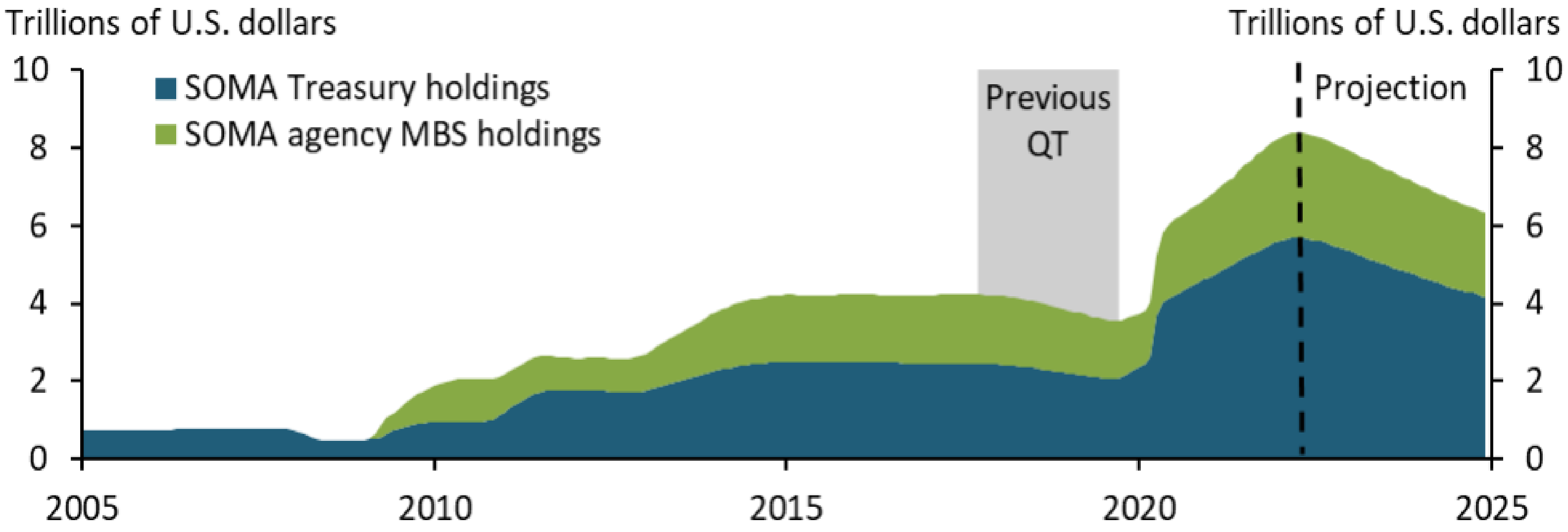




- As you can see with the chart on the left, almost every tightening cycle leads to an economic recession
- Additionally, the yield curve is deeply inverted at this point, which would also suggest a contraction
- In Q2, we did see two consecutive quarters of negative real GDP growth, but it's likely the National Bureau of Economic Activity also declares a recession for the US economy; based on its history, that is likely to be after the next recovery has started
- It's worth pointing out that every hiking cycle eventually leads to an easing cycle that unwinds the previous tightening

The Fed is Also Shrinking its Balance Sheet at an Unprecedented Pace

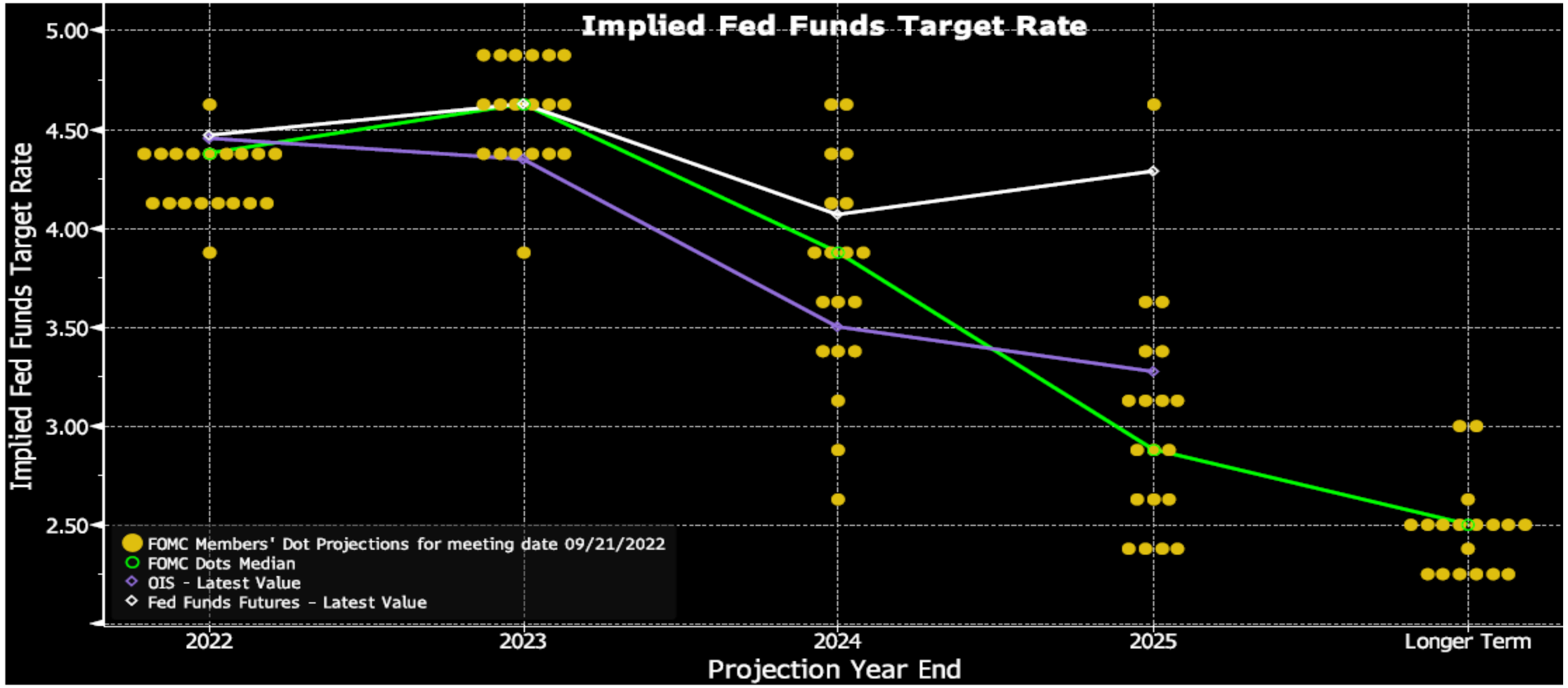
Chart 1: Quantitative tightening is projected to significantly reduce the Federal Reserve's asset holdings



Note: Projections shown are based on Logan (2022).
Sources: Board of Governors of the Federal Reserve System (Haver Analytics) and Logan (2022).

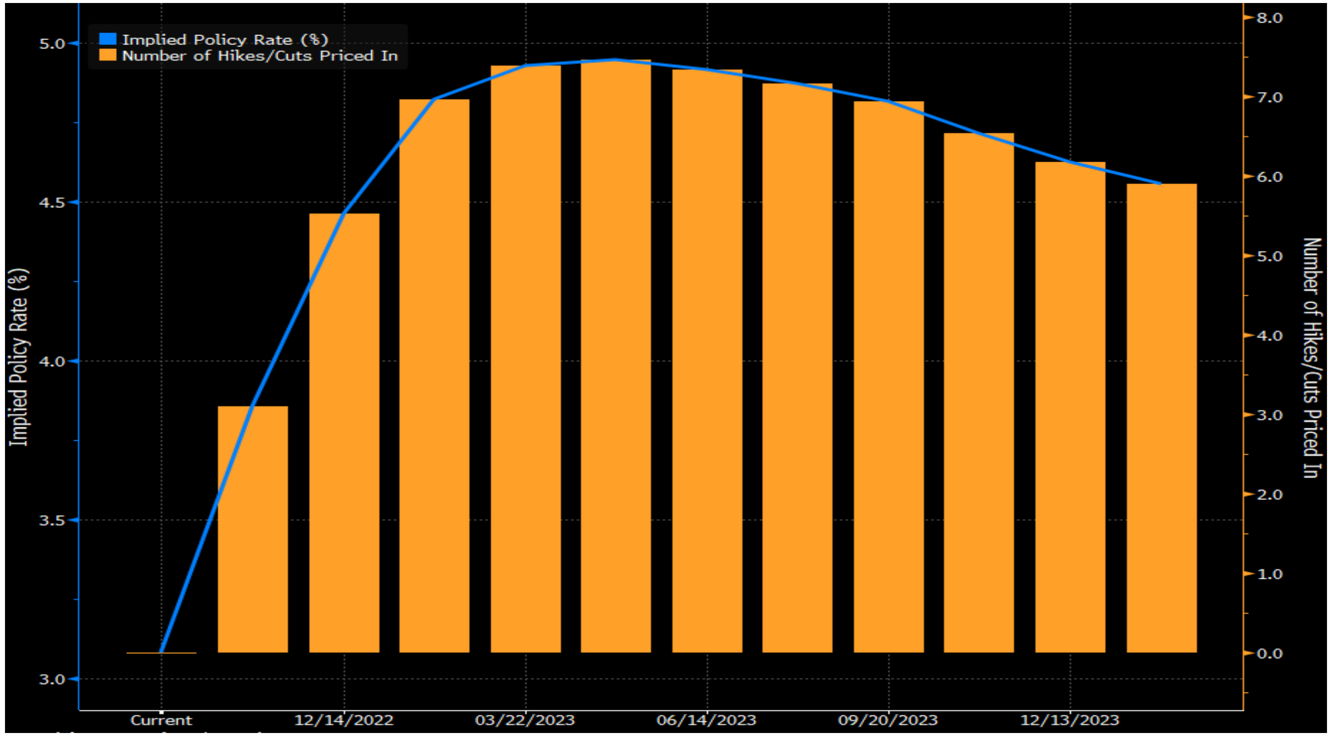
- The Federal Open Market Committee (FOMC) began to work down their nearly $9 Trillion balance sheet in June by allowing maturing securities to "run off" and beginning in September, the FOMC's maximum allowable runoff increased to $95 Billion per month ($60 Billion in Treasuries and $35 Billion in mortgage-backed securities (MBS))
- If the Federal Reserve were to reduce their balance sheet at the maximum amount allowable, its balance sheet would come down to roughly $5 Trillion by 2025, a 45% reduction
- However, because of the significant pace of rate hikes (year-to-date), and the uncertainty surrounding the pace and size of hikes going forward, it is unlikely that the Fed will be able to reduce at their allowable pace. As a result, estimates are for a roughly $80Bn per month reduction through 2025, putting the Fed's balance sheet at roughly $6 Trillion by year-end 2025

The Fed Expects to Reverse Course During 2024



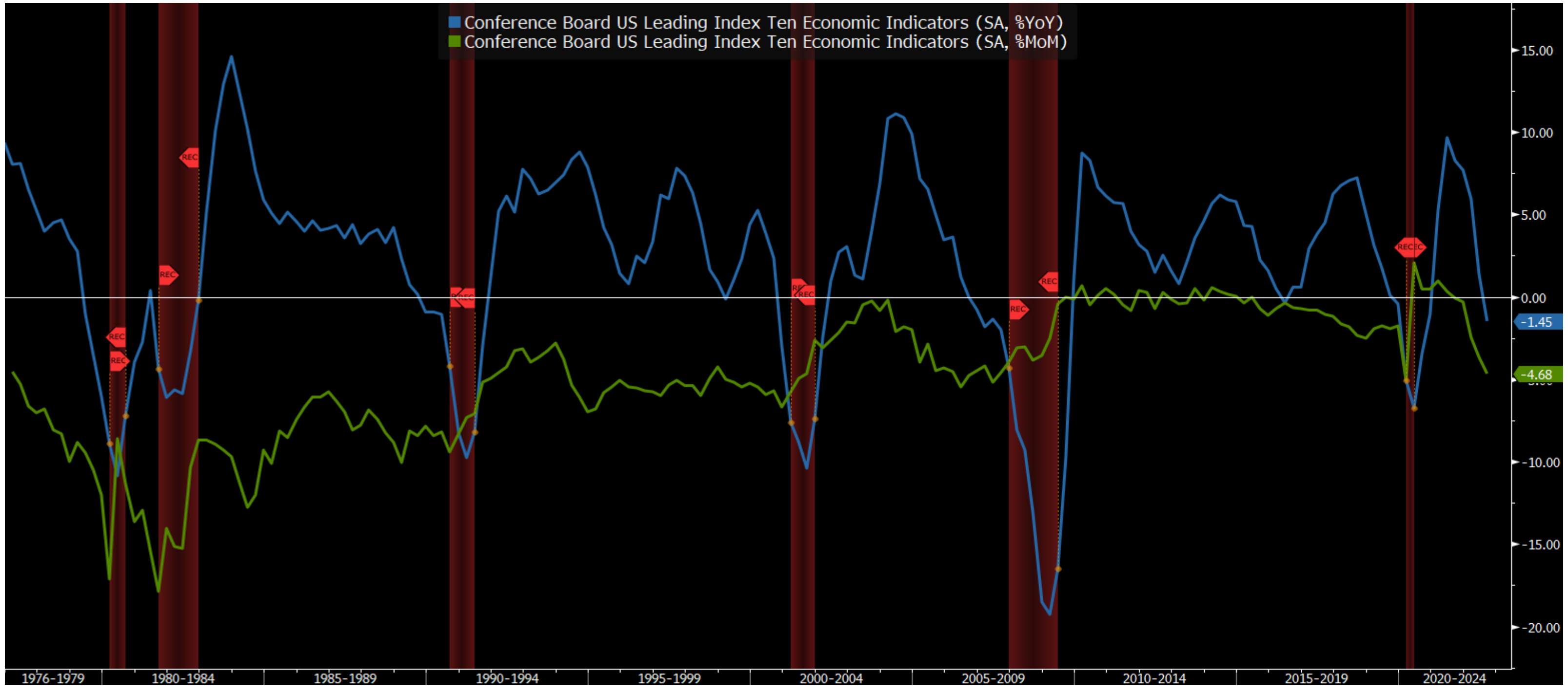
- Interestingly, the Fed expects to cut rates during 2024 after the federal funds rate peaks out during 2023 at around 4.75%
- Notice that the longer-term projection is 2.5%, but it is worth pointing out that each tightening cycle is fully unwound during the next easing phase

The Market Anticipates a Faster Pivot



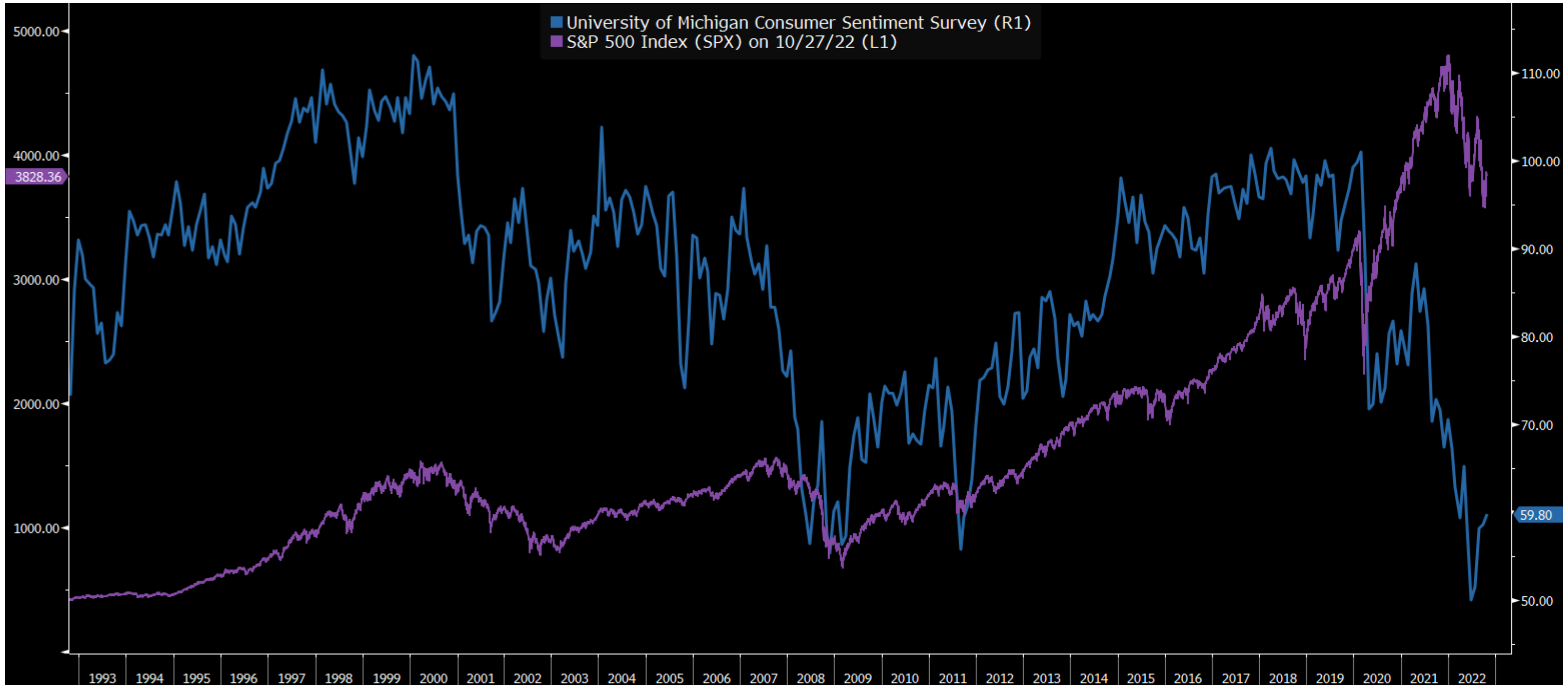
- The interest rate futures market currently anticipates that a rate cut will occur earlier than the Fed's projection of mid-2024
- The market historically has been a much more accurate predictor of interest rates, and we would agree that a cut is likely around the time frame shown above

Leading Economic Indicators are Deteriorating Rapidly



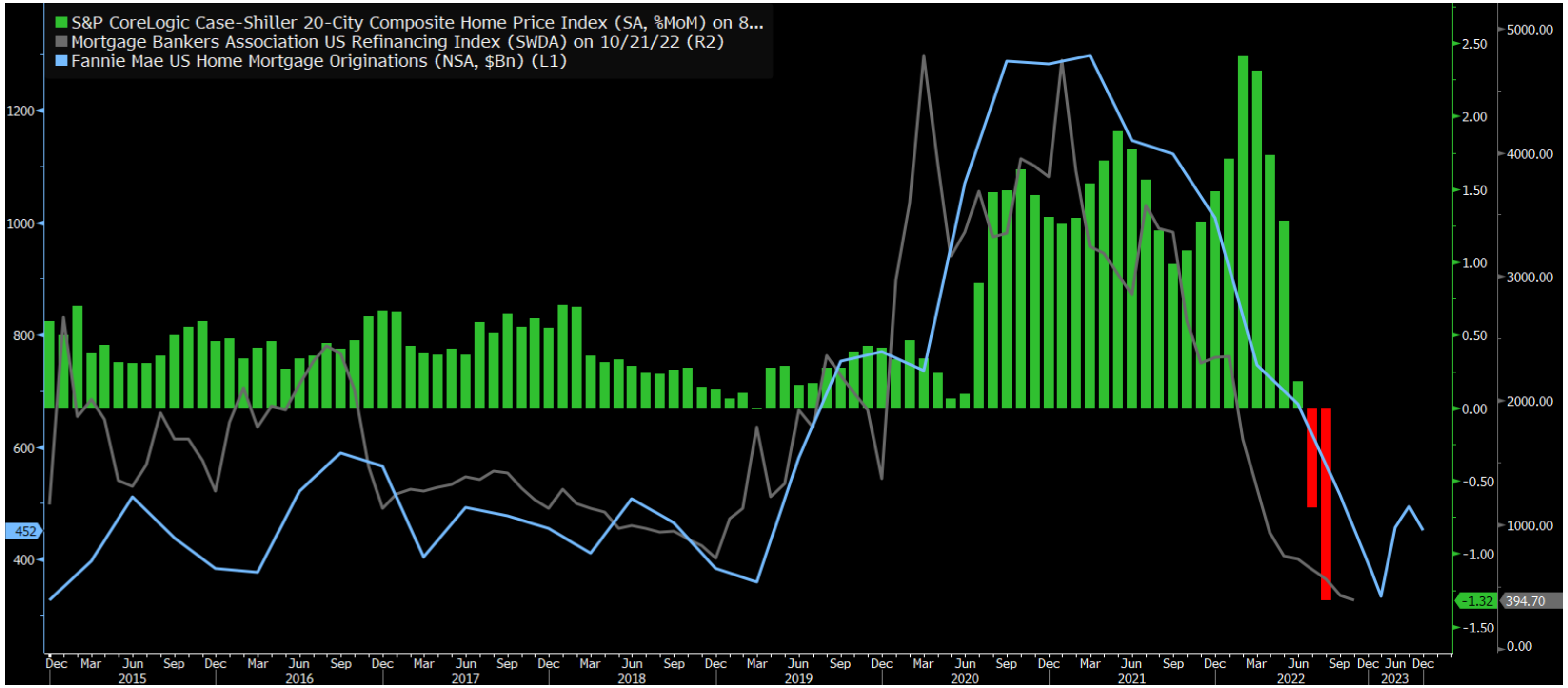
- The Conference Board's Leading Economic Indicators Index has also been a solid predictor of economic contraction
- Six of the ten signals are currently deteriorating, and as you can see, when the YoY line (blue line) moves below zero, it almost always coincides with recession

Consumer Sentiment Also Looking Sluggish



- Consumer confidence remains stubbornly low, which is likely a function of persistent inflation
- It is worth mentioning that low points for consumer confidence can be somewhat of a contrarian indicator for forward-looking equity returns

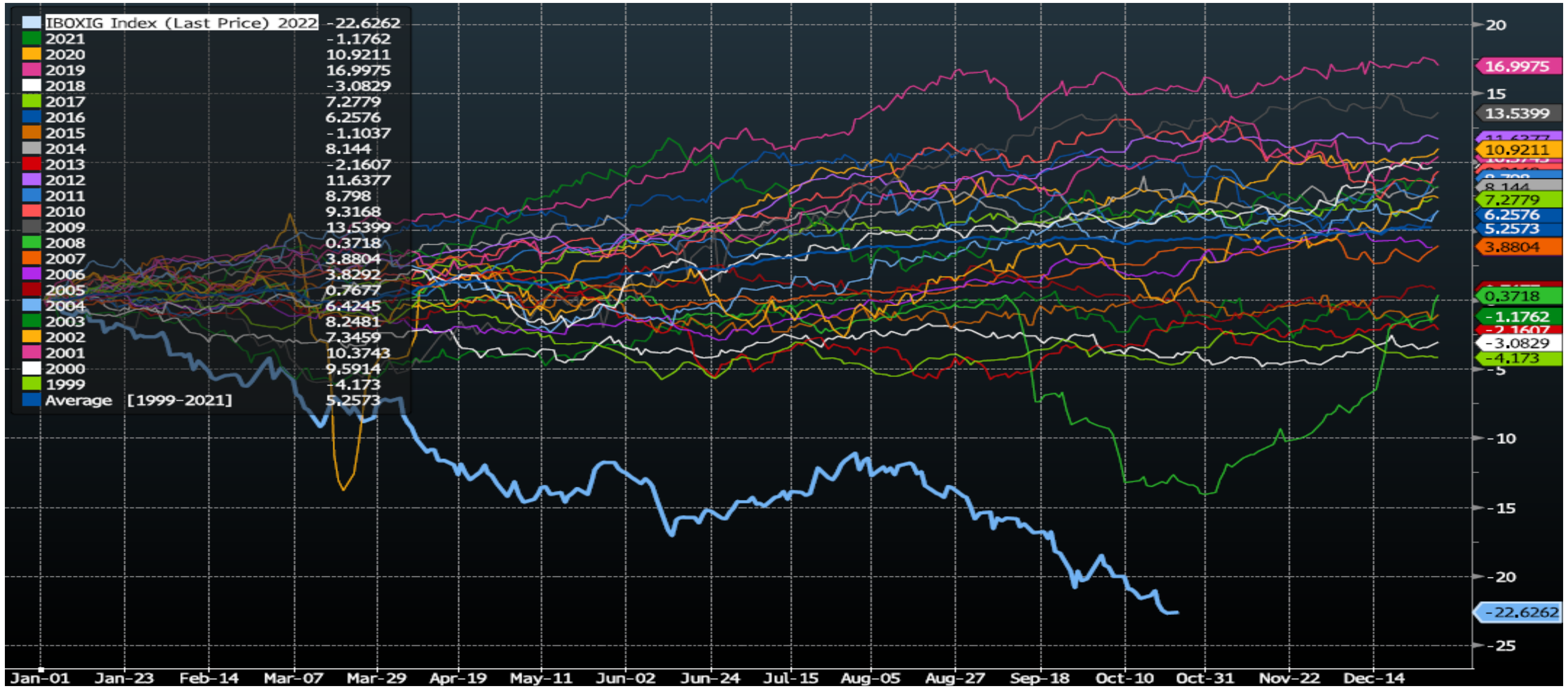
Housing May be the Hardest Hit Economic Area



- Housing activity has ground to a halt with mortgage originations down 65%
- Given the spike in interest rates, mortgage refi's are down even more with a 94% plunge. (However, that number is a little misleading, as it was off a bubble-like spike in early 2020)
- Housing prices are even starting to crack with two straight month-over-month declines

Besides the Economy, what else is Cracking?

Investment Grade Corporate Bonds, Down the Most on Record



- Investment grade corporate bonds are down 22.6% year-to-date, which as you can see, is an extreme outlier relative to any years in the past
- If this segment of the bond market finished the year where it is today, it would be five times greater than the previously worst loss, in 1999, which was -4.2%

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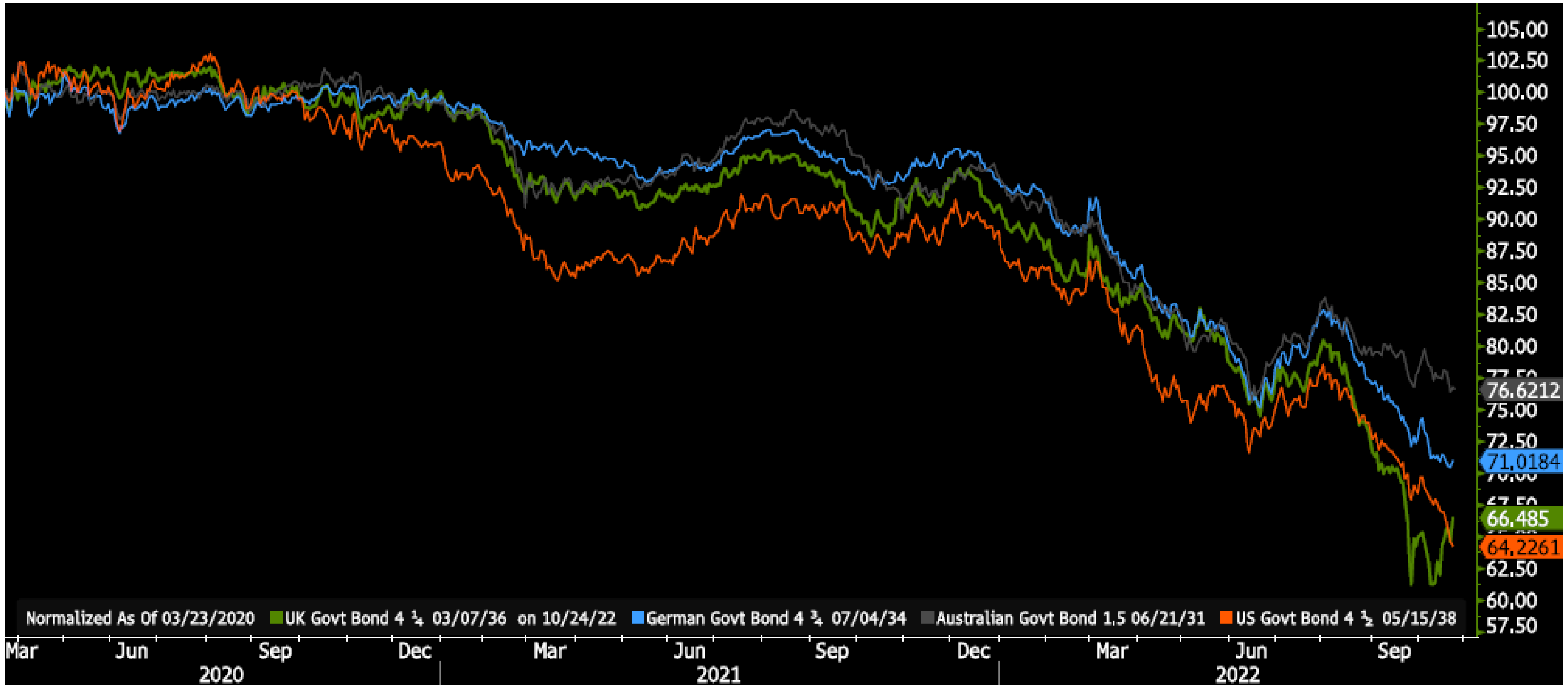
Global Government Bond Markets also in a Deep Bear Market



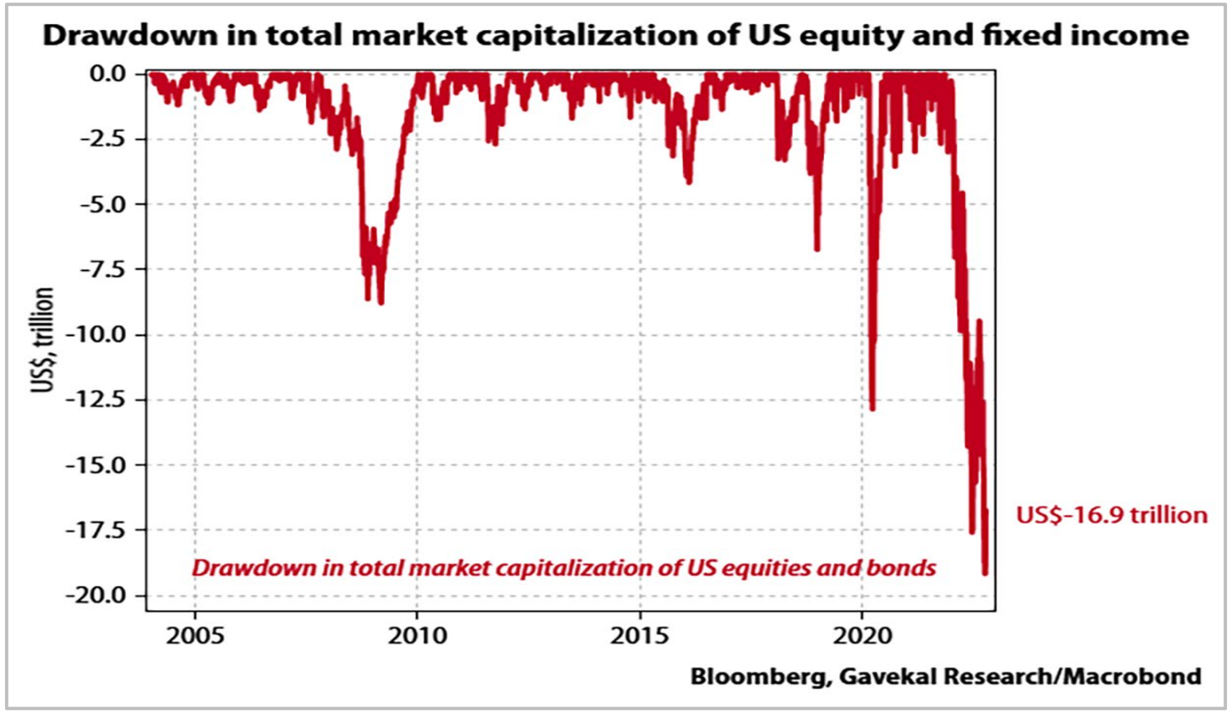
- Government bond markets across the globe have performed nearly as bad as corporates with many longer-term issues down 24-36% over the last two and a half years

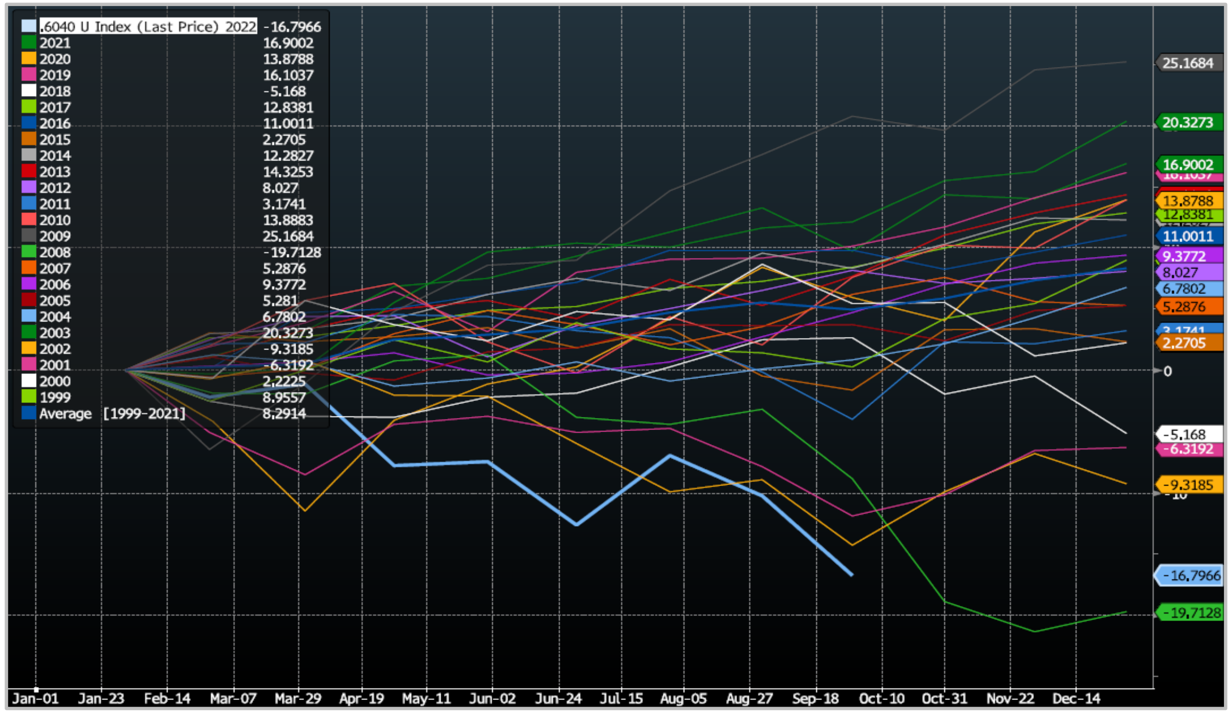
As Many Know All too Well, Equities are Deeply in the Red

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	SPX Index	USD	-21.26%	-20.27%	4.61%	-24.51%
2)	MXWOU Index	USD	-27.08%	-24.88%	--	-29.89%
3)	MXEF Index	USD	-29.79%	-27.83%	-2.95%	-33.30%
4)	CCMP Index	USD	-30.59%	-30.14%	-5.26%	-35.94%
5)	MXEU Index	USD	-28.77%	-26.64%	-1.76%	-31.93%
6)	MXAP Index	USD	-29.68%	-27.76%	-2.88%	-33.21%

- Equity markets are down 20-30% depending on what index/region/style you are tracking, ranging from the S&P down 20% to the NASDAQ down 30%

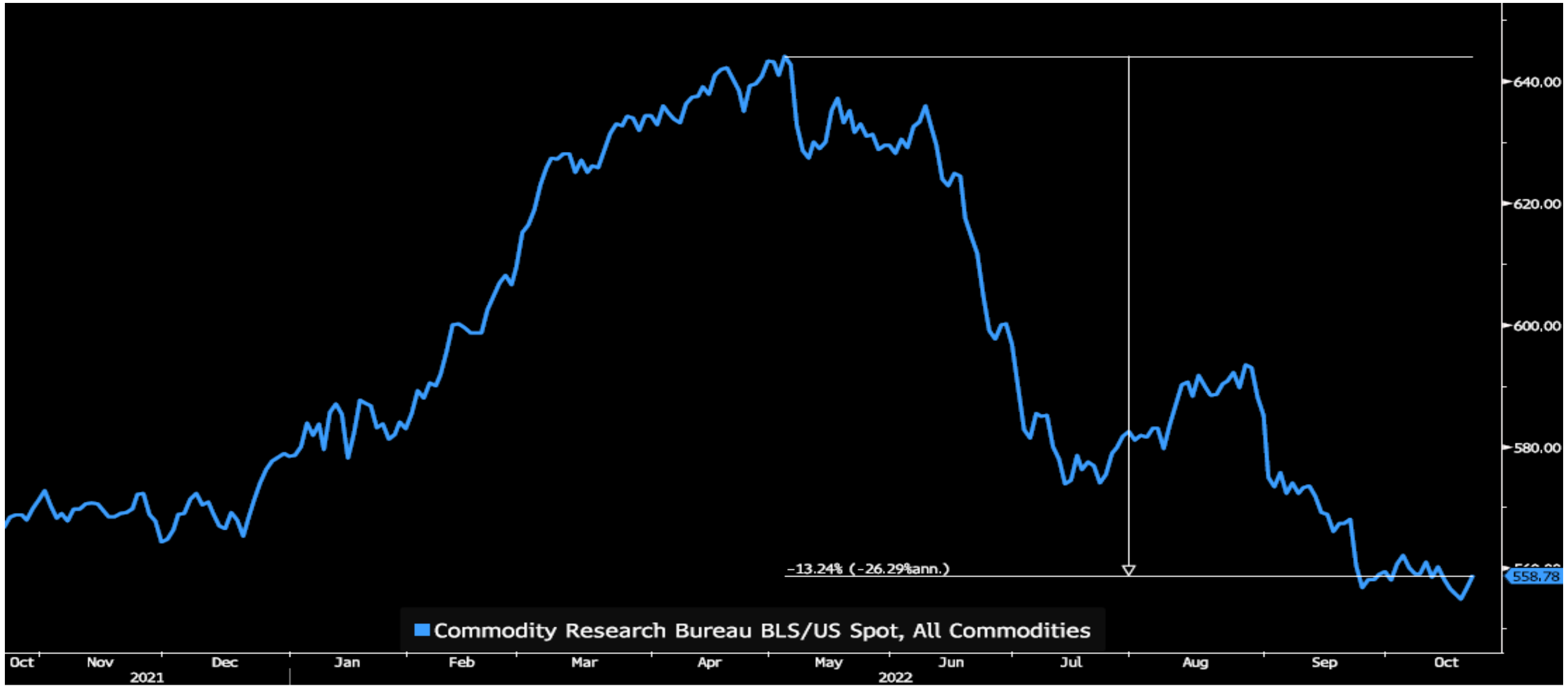
We're Witnessing a Historic Wealth Wipeout for Stocks and Bonds





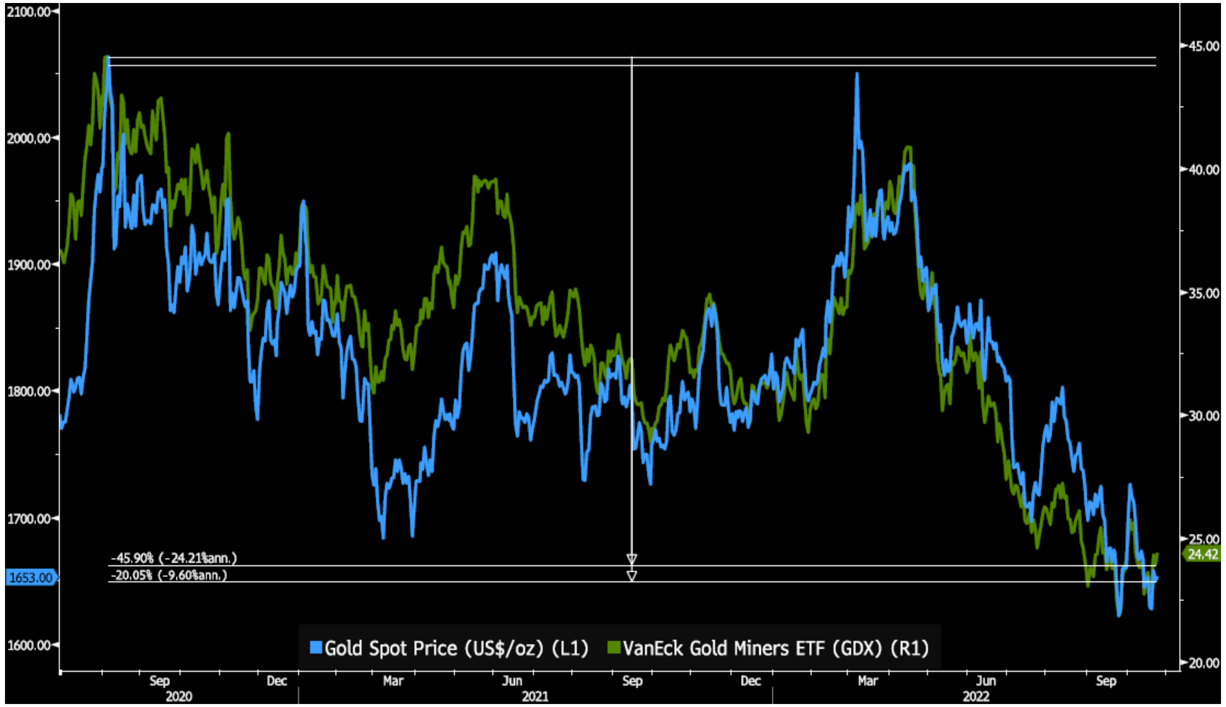
- The right axis of the Gavekal chart (on the left) illustrates the scale of the wealth destruction we have seen in stocks and bonds
- A staggering stat: this has been the worst start to the year for a traditional 60/40 portfolio in the last 100 years

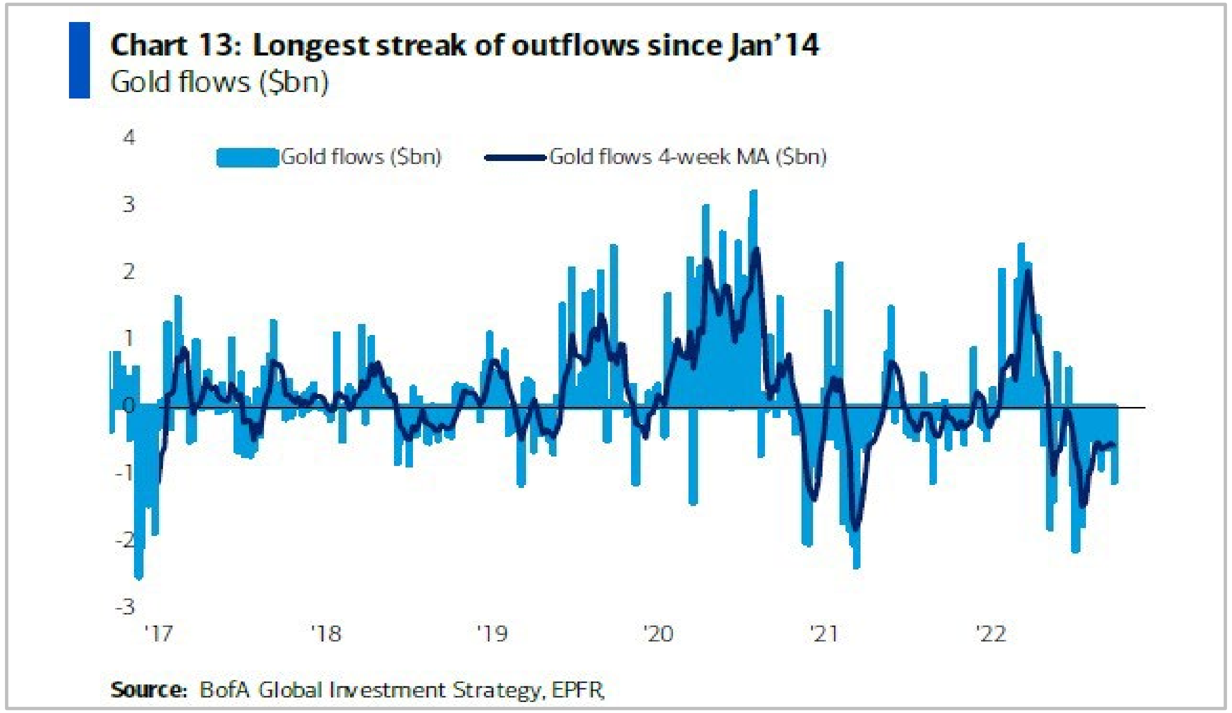
Even Commodities Have Pulled Back



- Global fiscal tightening policies we have seen have also slammed most real assets
- This is quite a remarkable occurrence given the stubbornly high level of inflation

Gold and Gold Mining Stocks Haven't Been a Port in this Storm

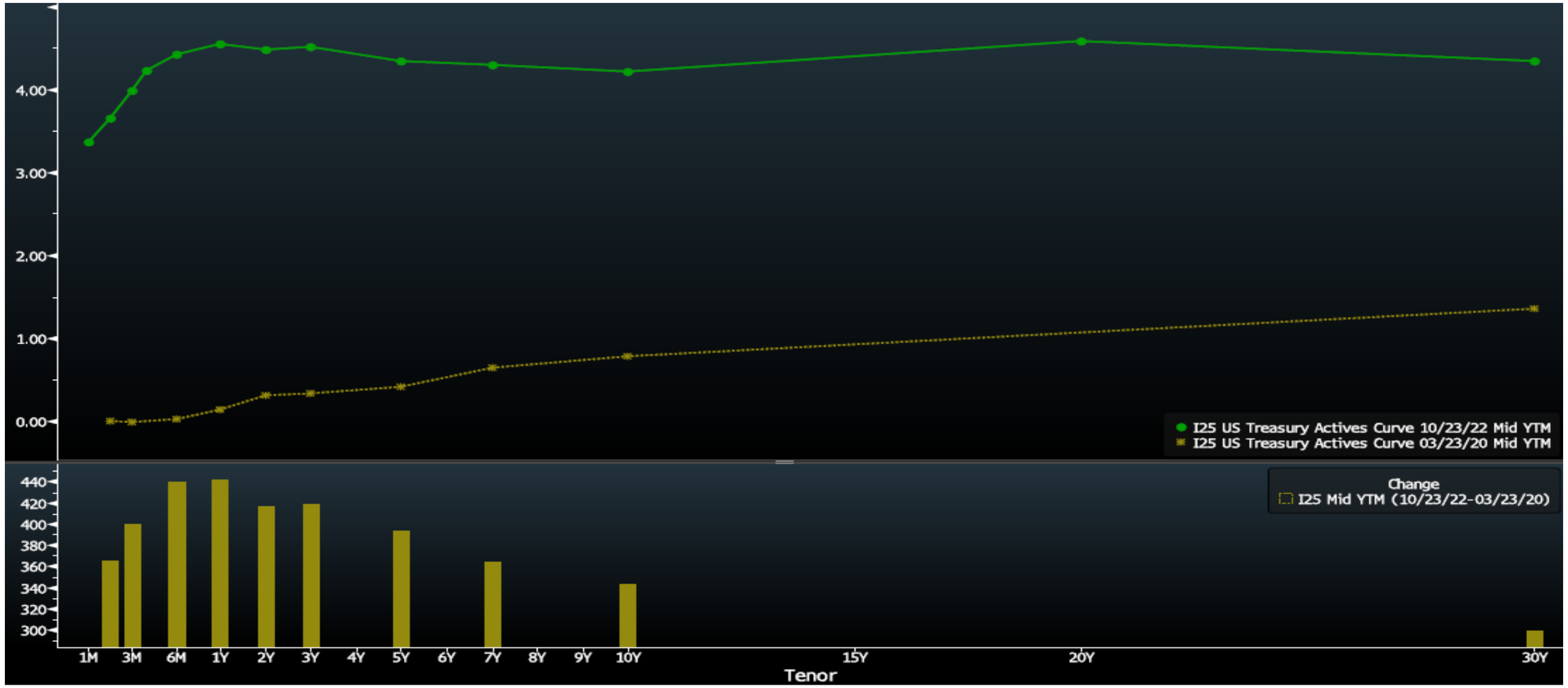




- From the 2020 peak, gold is down 20% and the higher-beta gold miners are down nearly 46%
- We have also seen consistent outflows, which is actually good news since these tend to lead to major rallies
- In other currencies, gold has done reasonably well, particularly relative to the Turkish and Argentinian varieties

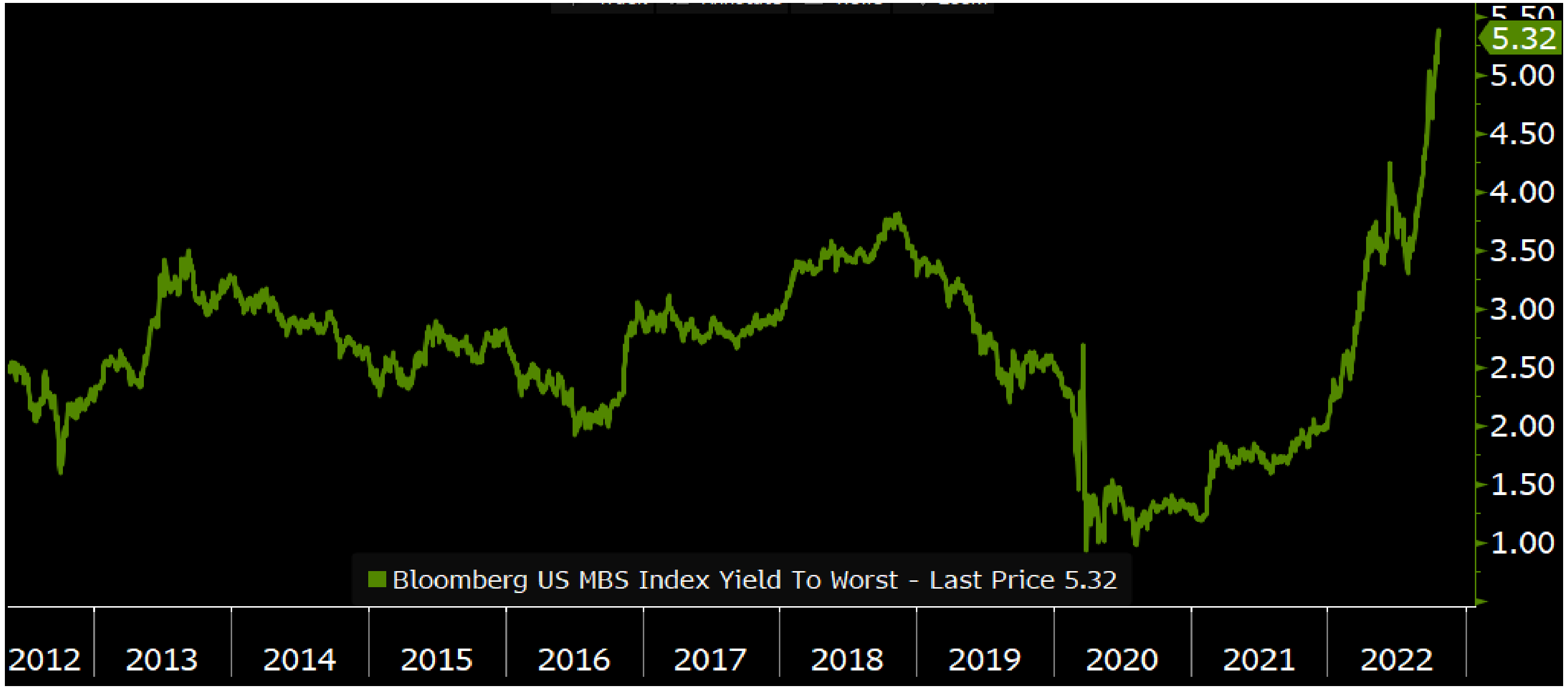
The Good News: Volatility Creates Opportunity

US Treasurys are Now Offering Juicy Yields



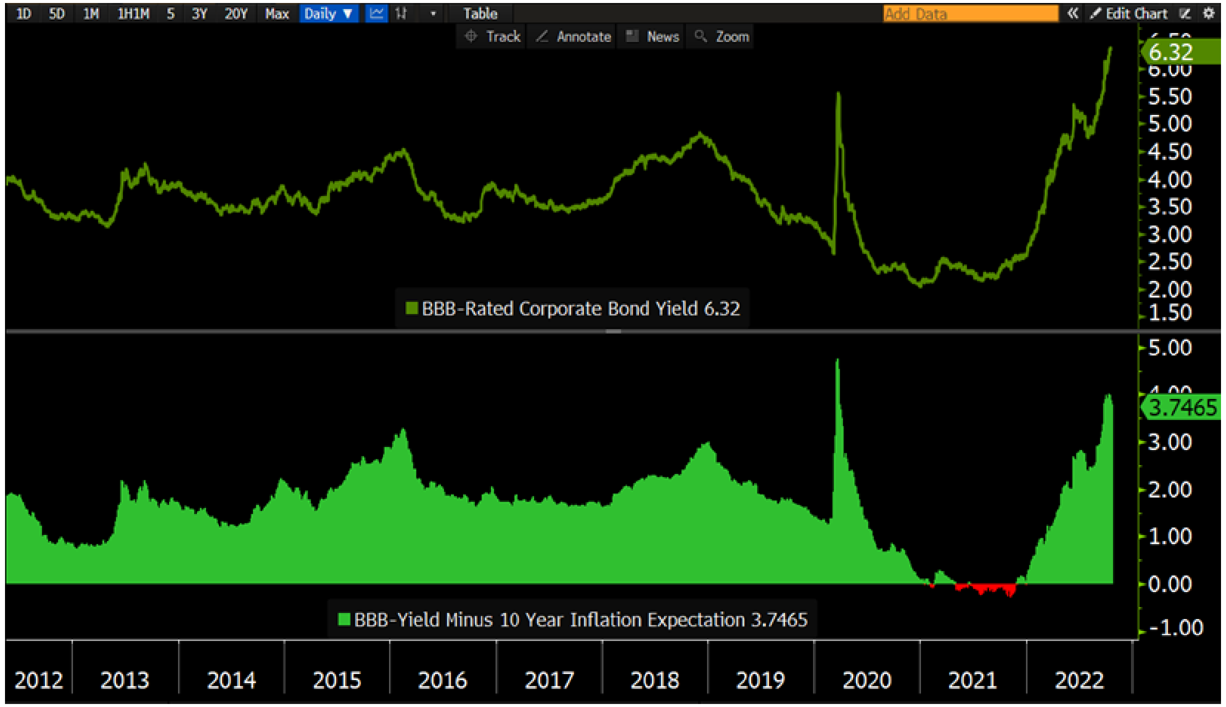
- Since 2020, the yield curve has moved up around 300bps, give or take, across the entire curve
- At Evergreen, we own the short-end (two-year yields 4.5%) and the intermediate (five-year yields 4.25%)
- At some point, it will make sense to extend duration further within the US treasury segment of the bond market. For now, we’re continuing to look at other sleeves of the bond market for duration extension (duration is similar to maturity length, adjusted for cash flow from interest payments)

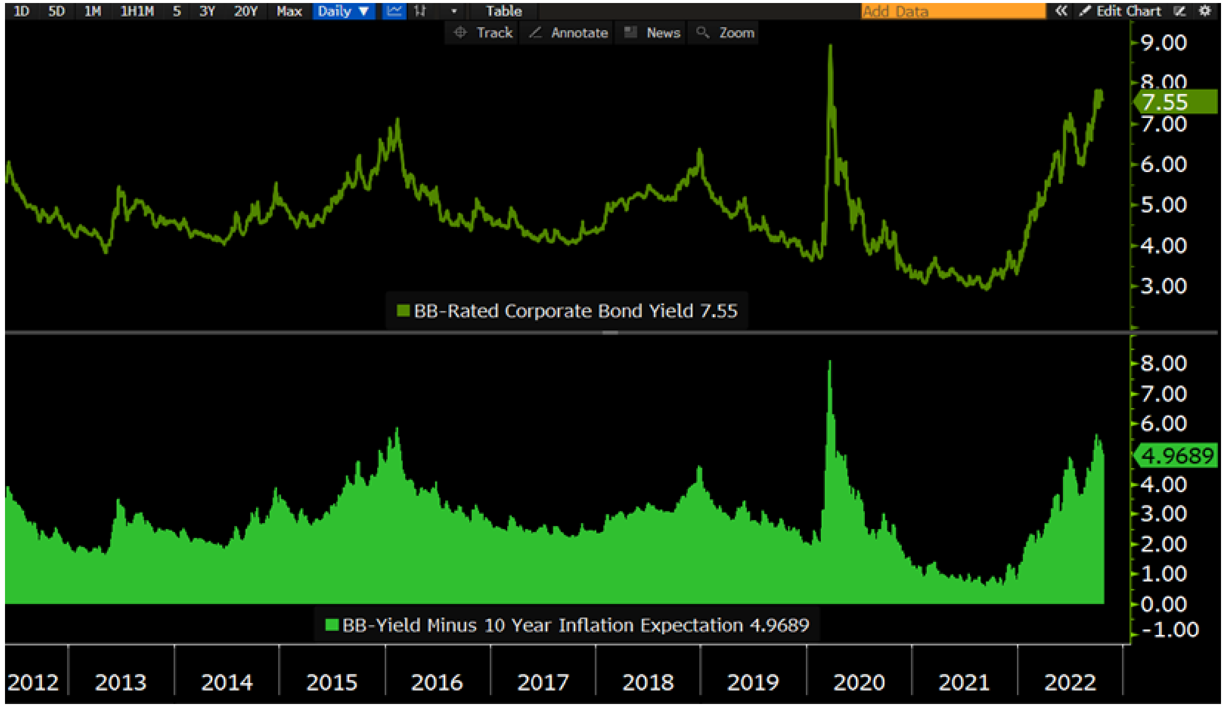
Agency Mortgage-Backed Securities (MBS) Pay Handsomely as Well



- Agency MBS is one area where we have added some duration to income portfolios, given the yields are around 1.50% above the previous 10-year high
- It's worth noting the duration has extended due to the severe drop-off in prepayment assumptions (i.e. refi's)
- With a yield profile that is higher - and most MBS bonds at discounts to par - fewer prepayments upgrades the return profile

BBB- and BB-Rated Corporate Bond Yields Look Attractive





- Another way we are boosting yield and extending duration is through the accumulation of corporate bonds with 6-8% yields
- The lower halves of the charts above show the spreads between yields and inflation expectations, or real (after-inflation) yields
- As you can see, real yields are some of the highest we have seen this decade

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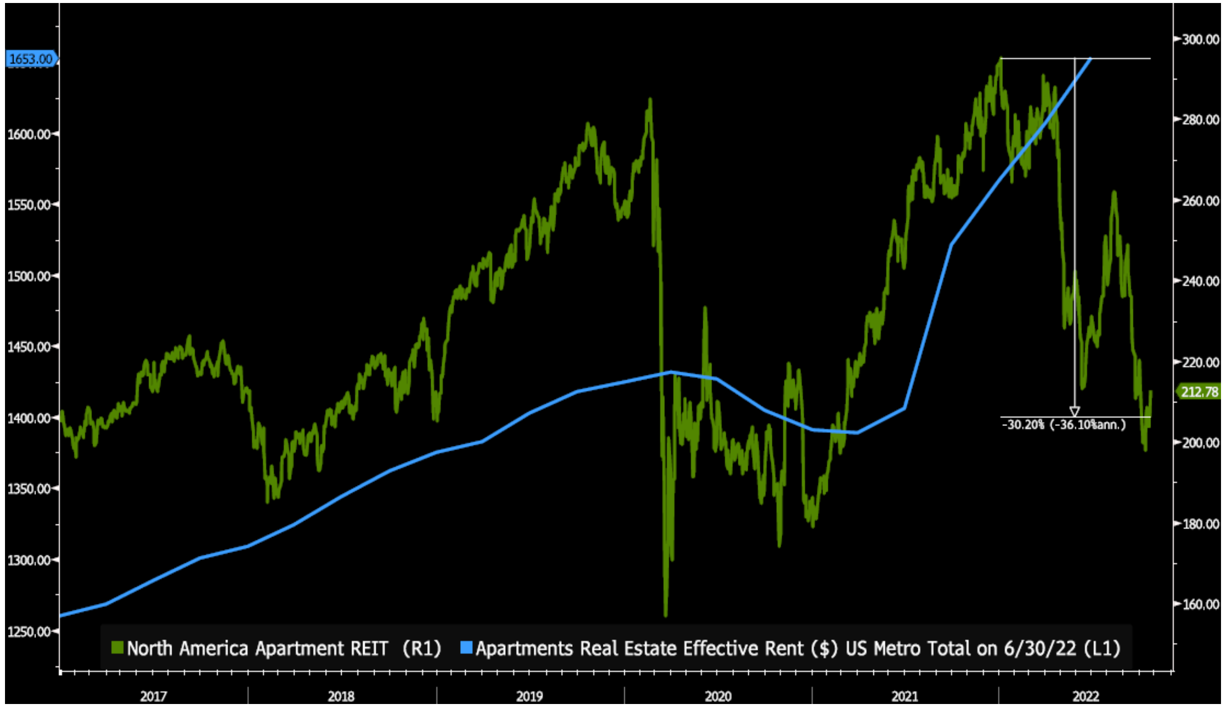
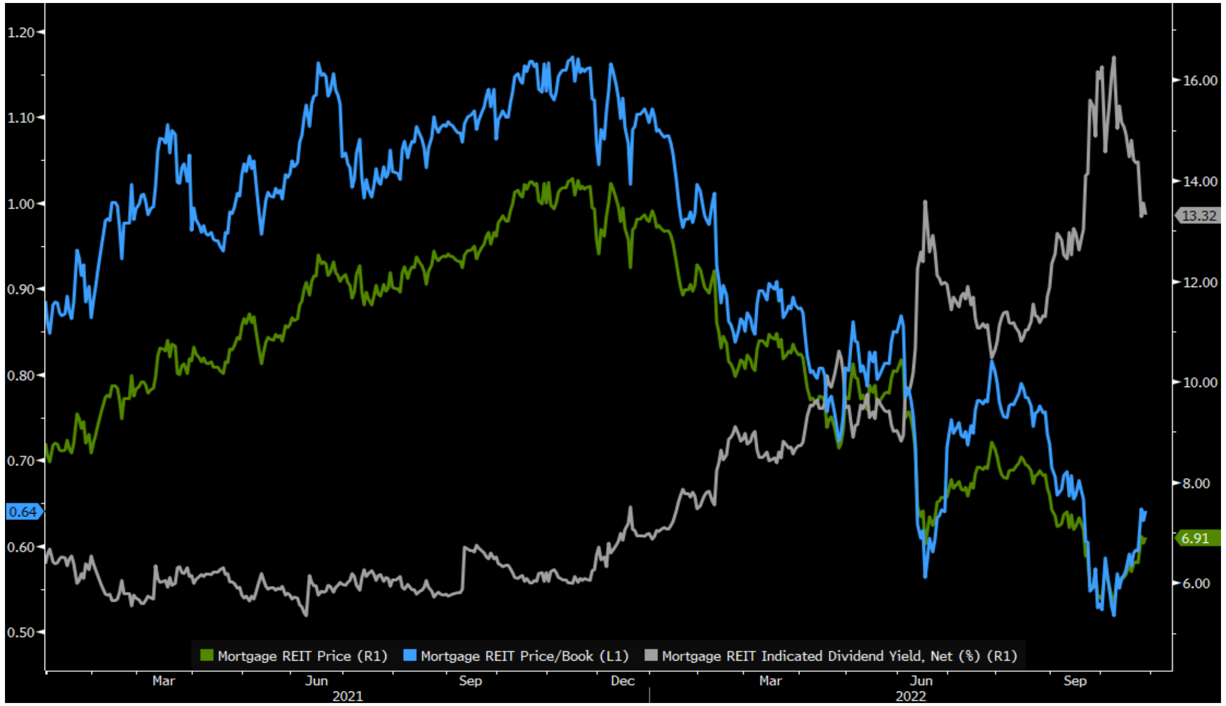
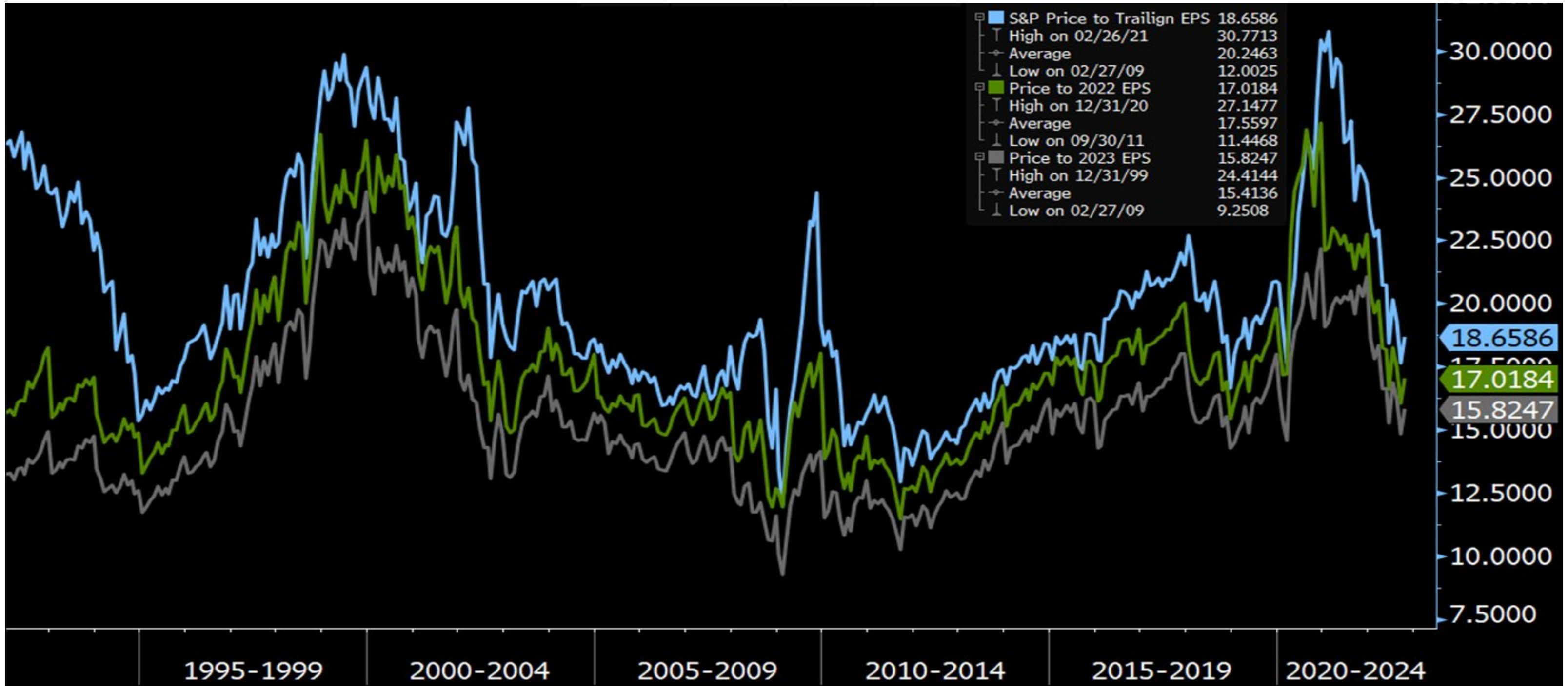
The REIT Market Has Cracked… Hard





- The REIT market - depending on the subsector - has declined 20-50% from the 2022-high
- The first chart on the left shows the multi-family sub-index down 30% (green line), and average apartment rents up around 20% year-over-year
- Rental rates are slowing, and we would recommend erring on the side of being selective on geographic exposure, but high-quality apartment REITs look appealing at this price point
- The chart on the right shows a mortgage REIT that is down 50% on the year, with a valuation trading near the low at .65x book value and a current yield of 13%

Stock Valuations Look Reasonable vs. Long-Term Averages



- The S&P 500 trades at 17x 2022 earnings, which is below the long-run average of 18x over the last 30 years
- It's also worth highlighting stock valuations are near their 10-year low, which look relatively cheap compared to recent history
- We would caution that earnings growth is slowing, and relative to interest rates, stocks look more expensive; additionally, profit margins are well above trend, implying the normalized P/E ratio could be much higher than officially reported

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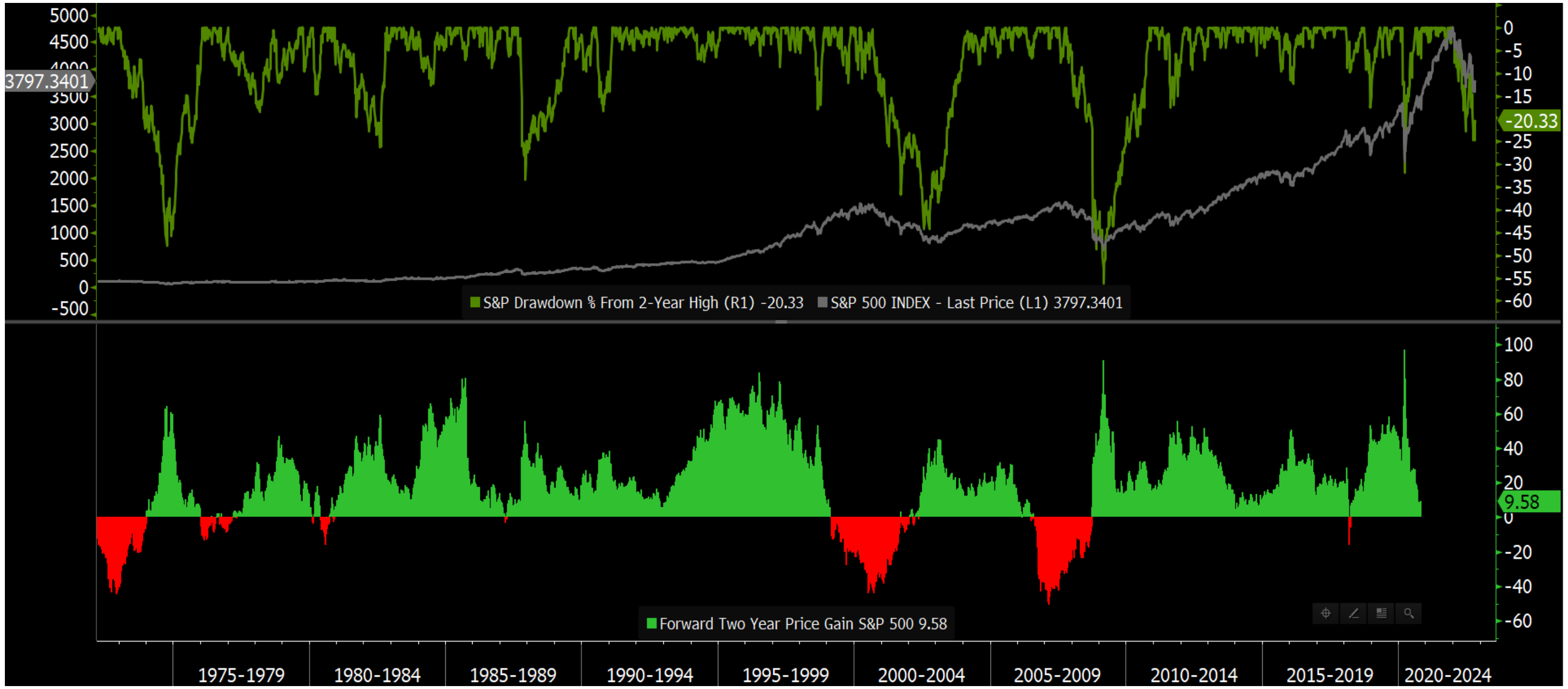
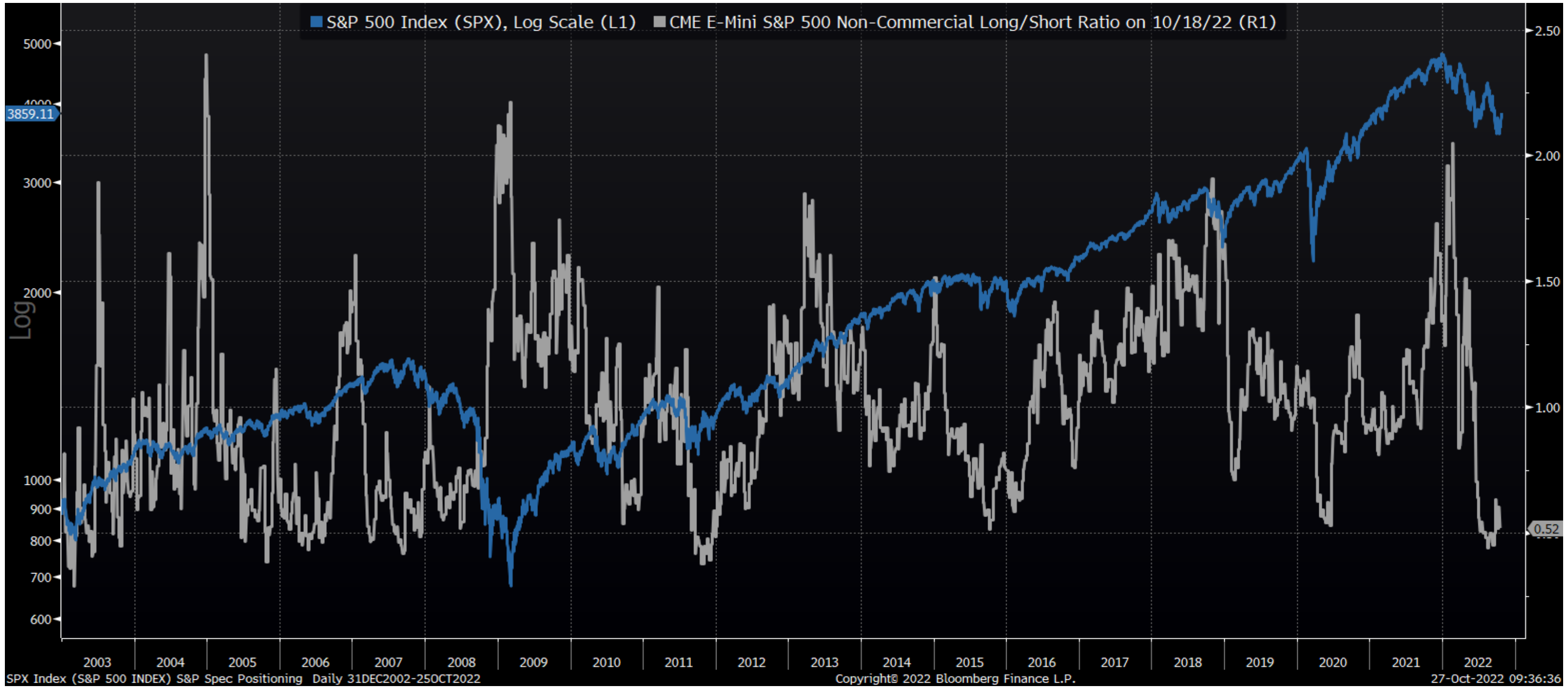
Equity Drawdowns and Forward 2-Year Returns for S&P 500



- While stocks are not dirt cheap, when the market experiences drawdown of –15-25%, the average two-year price gain for the S&P 500 is 16%
- The upper chart shows drawdown of the S&P from the two-year high and forward two-year returns. As you would expect, the further the market corrects, the higher the subsequent return for stocks. That's why we are continuing to methodically add to equities on the way down
- However, given that stocks are clearly in a bear market, we have also trimmed into the various rallies we've seen this year

S&P 500 and Speculative Positioning in Futures Contracts



- Another item to point out for stocks is that speculative positioning is quite bearish for S&P future contracts (more speculative investors are short relative to long)
- As you can see on the chart above, low points for this metric can mark near-term bottoms for the market. This makes intuitive sense given when this metric flips, shorts are cashed in and/or longs are established, which thereby creates upward pressure on the market
- We do feel like there's a decent chance of a near-term rally between now and year-end, and we believe our portfolios are well-positioned to benefit from that potential outcome
- For now, however, sharp rallies should continue to be opportunities to proactively raise cash

Index Definitions

- *Effective Federal Funds rate is provided by the New York Fed subject to a one-day lag and is calculated as a volume-weighted mean of overnight rates on trades arranged by major brokers*
- *Federal Reserve Balance sheet is reported by the Federal Reserve weekly and tracks the aggregate assets and liabilities of banks within an economy*
- *Federal Reserve Dot plot is a median of the Federal Open Market Committee's (FOMC) projections for the Federal Reserve's target overnight rate, released at the end of every other FOMC meeting*
- *Implied Policy Rate is a market-derived futures-based expected policy rate estimating the future Fed funds rate and the number of hikes/cuts the Fed would need to make to achieve each respective rate in each corresponding year*
- *Conference Board US Leading Index tracks 10 economic variables that tend to move prior to changes in the overall economy, giving a sense of the future state of the economy, provided by The Conference Board Inc.; data is provided monthly*
- *University of Michigan Consumer Sentiment Index collects data on consumer attitudes and expectations in order to predict their subsequent discretionary expenditures; the Index is comprised of measures of attitudes towards personal finances, general business conditions, and market conditions or prices*
- *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.*
- *Mortgage Bankers Association's Mortgage Finance Forecast Origination Refinance Index tracks the creation of new home loans or mortgages for the purposes of refinancing an existing home*
- *Fannie Mae US Home Mortgage Originations tracks the creation of new home loans/mortgages for the purpose of buying/acquiring a new home*
- *iBoxx USD Liquid Investment Grade Total Return Index measures the USD-denominated, investment grade, corporate bond market with a minimum 3-years to maturity, minimum outstanding amount of US$750m; bond type includes fixed-coupon, step-up, bonds with sinking funds, medium term notes, callable, and putable bonds*
- *The S&P 500 is widely regarded as the best single gauge of large-cap US equities and serves as the foundation for a wide range of investment products; the index includes 500 leading companies and captures approximately 80% coverage of available market capitalization*
- *The MSCI World ex.-USA Index is a free-float weighted equity index; it was developed with a base value of 100 as of 12/31/1969*
- *MSCI Emerging Markets Index is a free-float weighted equity index that captures large and mid-cap representation across Emerging Markets (EM) countries; the index covers approximately 85% of the free-float-adjusted market capitalization in each country*
- *The NASDAQ Composite Index is a broad-based capitalization-weighted index of stocks in all three NASDAQ tiers: Global Select, Global Market, and Capital Market; the index was developed with a base level of 100 as of February 5th, 1971*
- *The MSCI Europe Index in EUR is a free-float weighted equity index measuring the performance of Europe Developed Markets. It was developed with a base value of 100 as of December 31, 1998*
- *The MSCI AC Asia Pacific Index is a free-float weighted equity index. It was developed with a base value of 100 as of December 31, 1987*
- *The 60/40 portfolio is a sample portfolio comprised 60% in the S&P 500 Index and 40% in the Bloomberg US Agg Index, a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed rate taxable bond market*
- *Commodity Research Bureau (CRB) Index tracks the spot price of 22 sensitive basic commodities whose markets are presumed to be among the first to be influenced by changes in economic conditions*
- *VanEck Gold Miners ETF is an exchanged-traded fund incorporated in the US; it tracks the performance of the NYSE Arca Gold Miners Index which tracks stocks of all cap sizes across the globe*
- *The Bloomberg US Mortgage-Backed Securities (MBS) Index tracks fixed-rate agency mortgage backed pass-through securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC); the index is constructed by grouping individual TBA-deliverable MBS pools into aggregates or generics based on program, coupon and vintage*
- *Bloomberg Intelligence North American Apartment REIT Valuation Peer group is an equal-weighted basket of REITs which derive most of their sales from apartment rentals*
- *Apartments Real Estate Effective Rent ($) US Metro Total tracks USD per square foot rents across major metro areas, provided by Reis Inc.*
- *Sample Mortgage chosen is Redwood Mortgage Trust (RWT), an internally-managed specialty finance company focused on making credit sensitive investments in residential loans and other mortgage-related assets as well as residential mortgage banking activities*
- *S&P 500 E-mini contracts are electronically traded futures contracts one-fifth the size of the standard S&P futures, E-mini S&P 500 futures and options are based on the underlying Standard & Poor's 500 stock Index*

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