Positioning Portfolios for this Cycle's Economic Expansion

Q2 CHARTBOOK - June 2021

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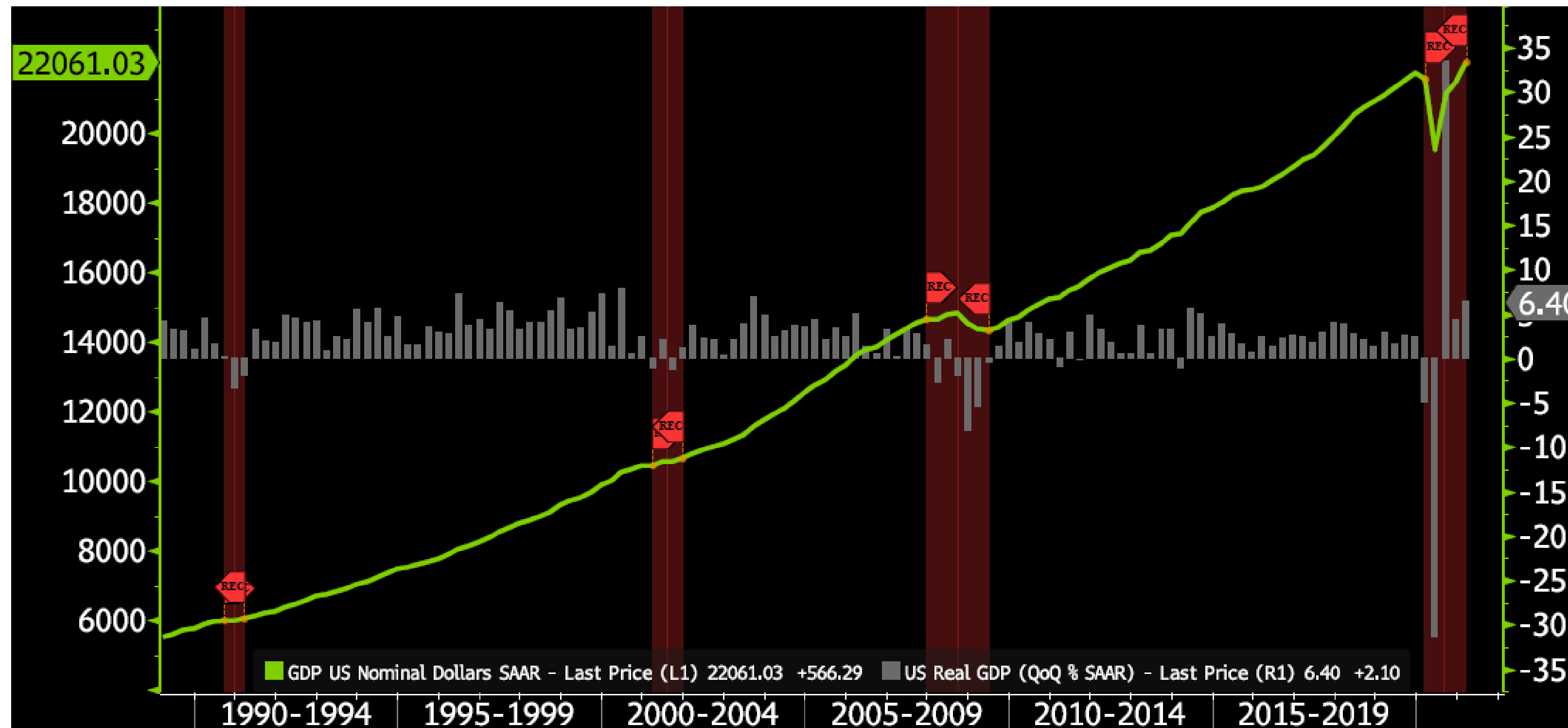
See important disclosures following the presentation.

Chartbook Preview

In this edition of *Evergreen Chartbook,* we will look at the emerging trends in the US economy, which has official entered “an expansion”. We will also dive into how we are positioning both our growth and income portfolios for this environment.

The US Moves into Economic Expansion with Strong Q1 GDP



- The US economy, after reporting a 6.4% quarterly real GDP advance in Q1, officially moved into an "economic expansion" (green line shows nominal GDP moving above prior peak).
- It's worth highlighting that the last three economic expansions lasted an average of 48 quarters, with average stock market returns of +185%.

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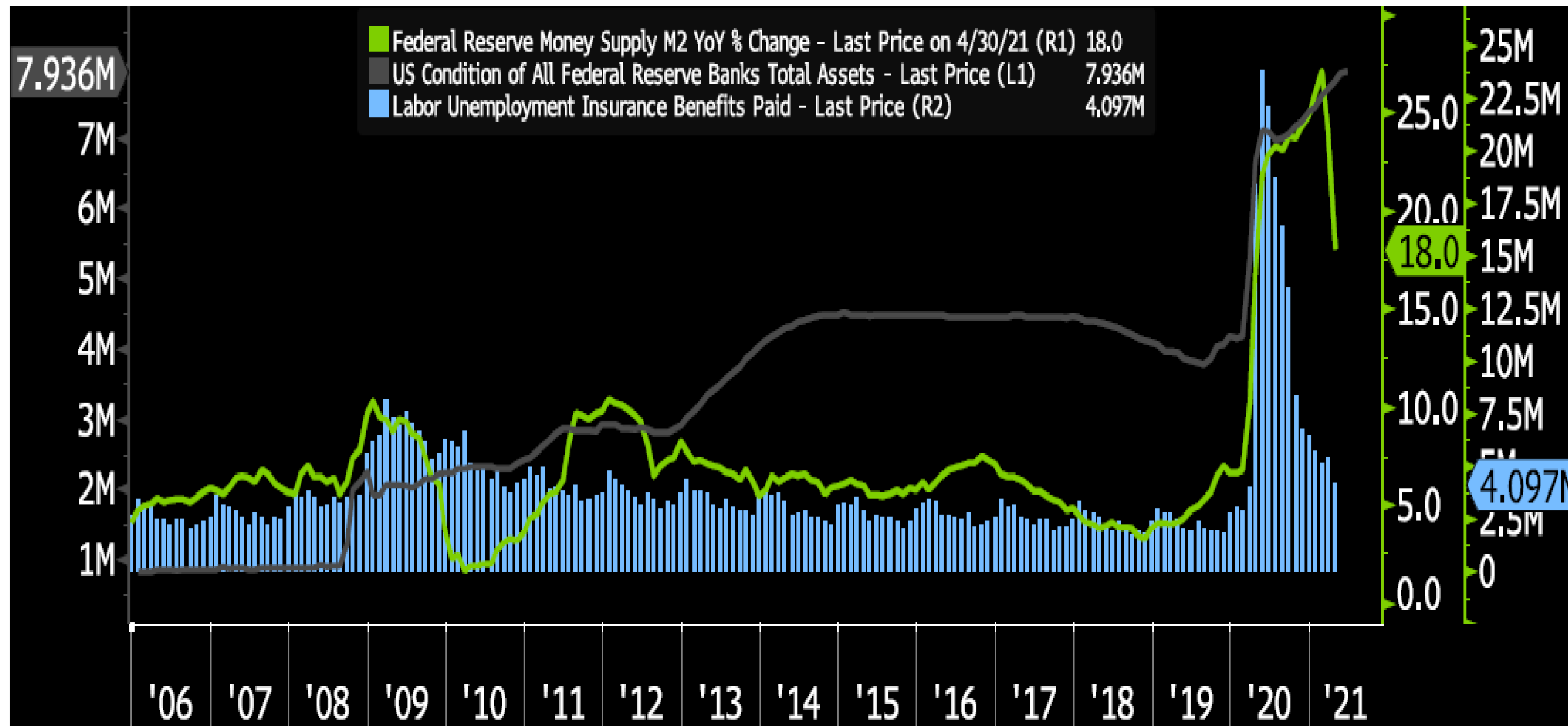
The Sharp Recovery Propelled by Extreme Government Intervention



- The rapid recovery in GDP was a function of immediate and massive government response. As you can see in this chart, the Fed has taken its balance sheet from around $4 trillion to roughly $8 trillion – a figure that's likely to head even higher over the next few years.
- In addition, money supply has been consistently running north of 20% YoY, as the US government has been spending massively via significant unemployment benefits and cash handouts.
- While it's helped fuel the unbelievably impressive recovery, the additional and enormous debt will need to be dealt with over time.

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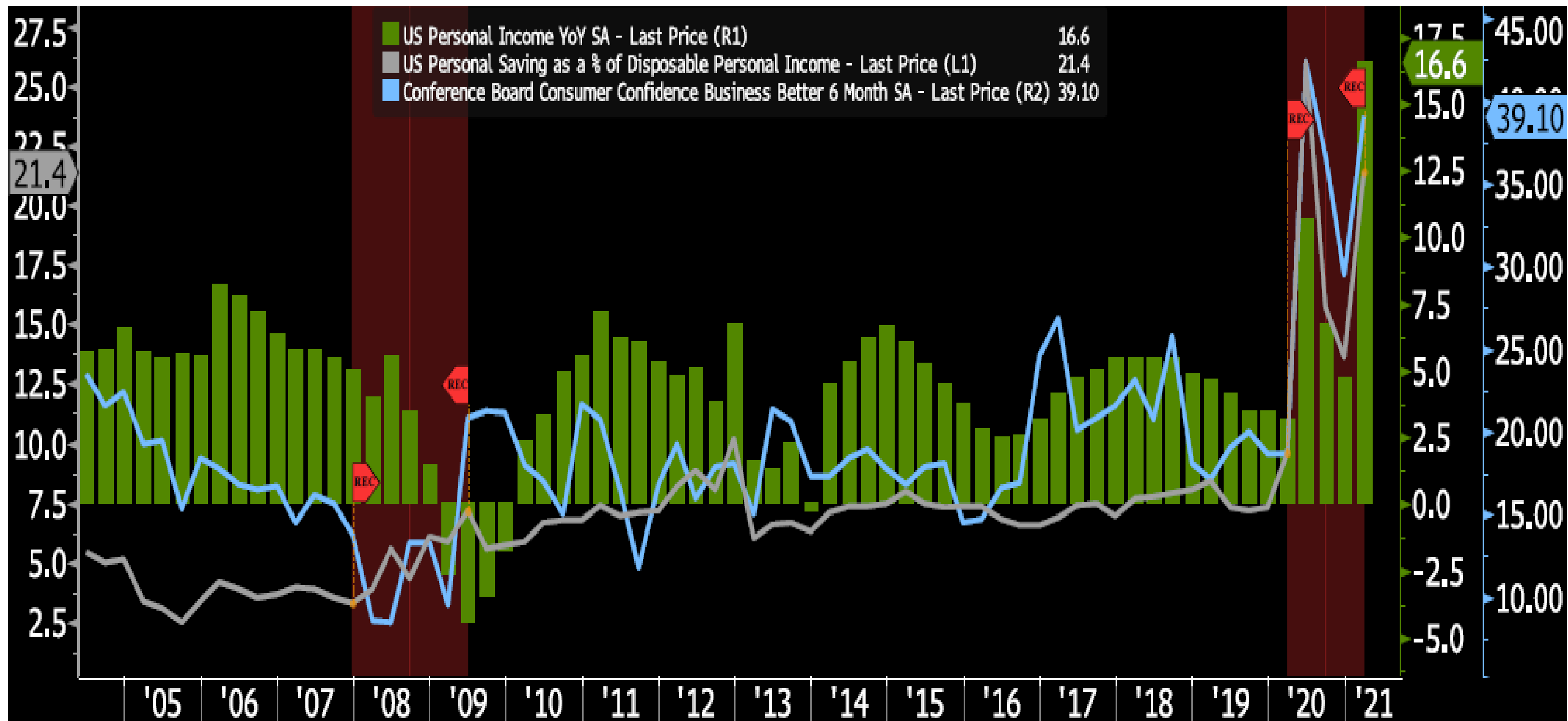
This Government Intervention Has Resuscitated Labor Markets

- The US unemployment rate continues to trend lower at a blistering pace, with the official unemployment rate at 5.8% - down from over 15% during the depths of the pandemic.
- Weekly jobless claims continue to trend lower and, with job openings at a 20-year high, hiring looks primed to continue.
- The trouble today is that many people are earning more on government stimulus than working. But as stimulus fades in the back half of 2021, people will need to get back to work.

The Consumer is Well Positioned for a Reopening



- Personal income from government stimulus is running +16% YoY, and with savings (as a percentage of disposable income) higher than at any point from 2004 to 2021, the data indicate significant spending potential.
- The consumer is also the most confident about business conditions 6 months out in nearly 20 years. Blended together, these data- points suggest very strong growth in the back half of 2021.

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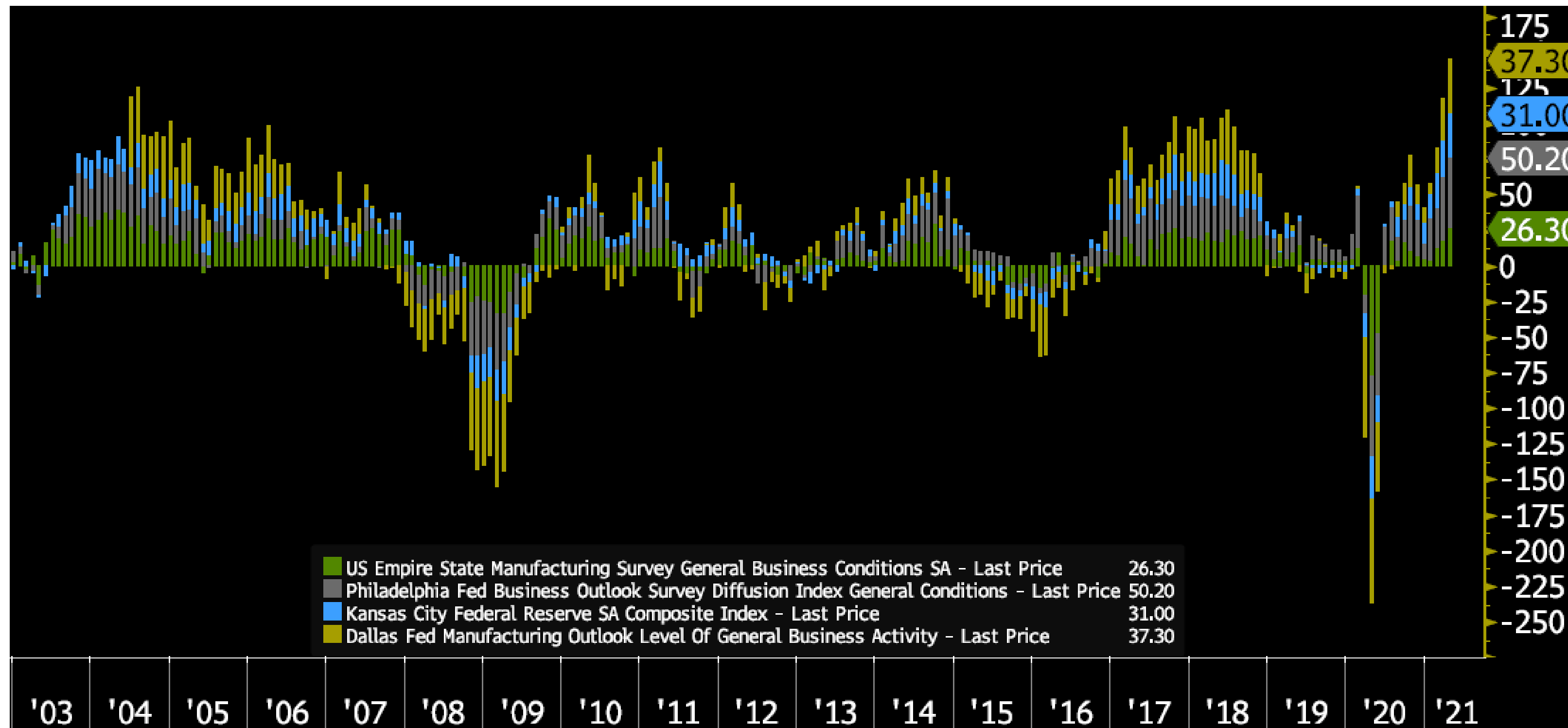
The Manufacturing Side of the Economy Running Red Hot



- Regional manufacturing indices are trending at the highest rate in the last 20 years. The bounce back has been so strong that the industrial side of the economy is experiencing both supply shortages and low inventory levels.
- We are clearly seeing inflationary pressures across the manufacturing supply chains, but bottlenecks are expected to ease over the next six to twelve months.

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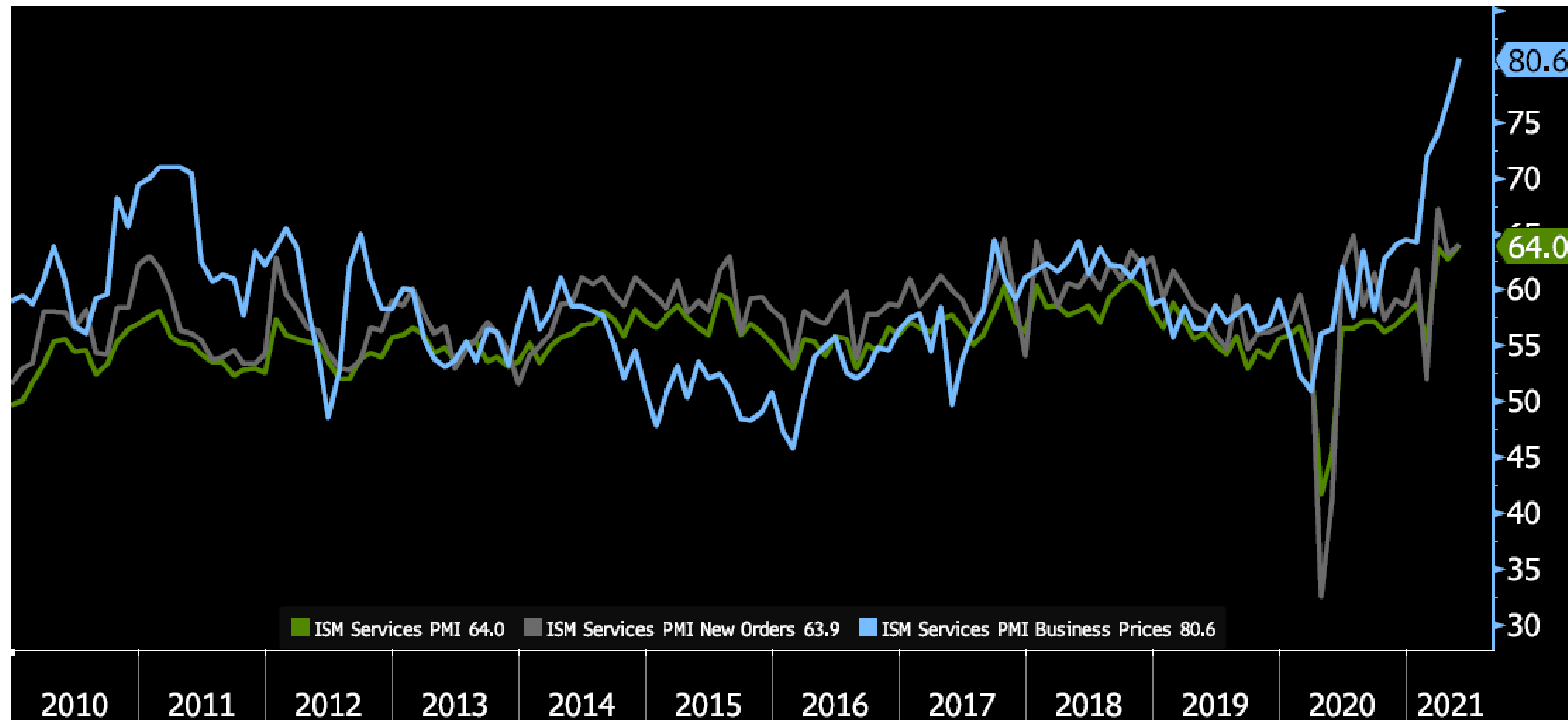
The Service Side of the Economy is Improving as Well



- Covid-19 impacted service-centric businesses particularly hard but, as the vaccine has rolled out, we have seen an impressive pickup in this area of the economy.
- With new orders remaining extremely strong, and America continuing to reopen, the outlook for the service sector looks promising.
- It's worth noting that pricing pressures are starting to pop up due to supply issues. As these price hikes trickle down to consumers, the demand side could see an impact as well.

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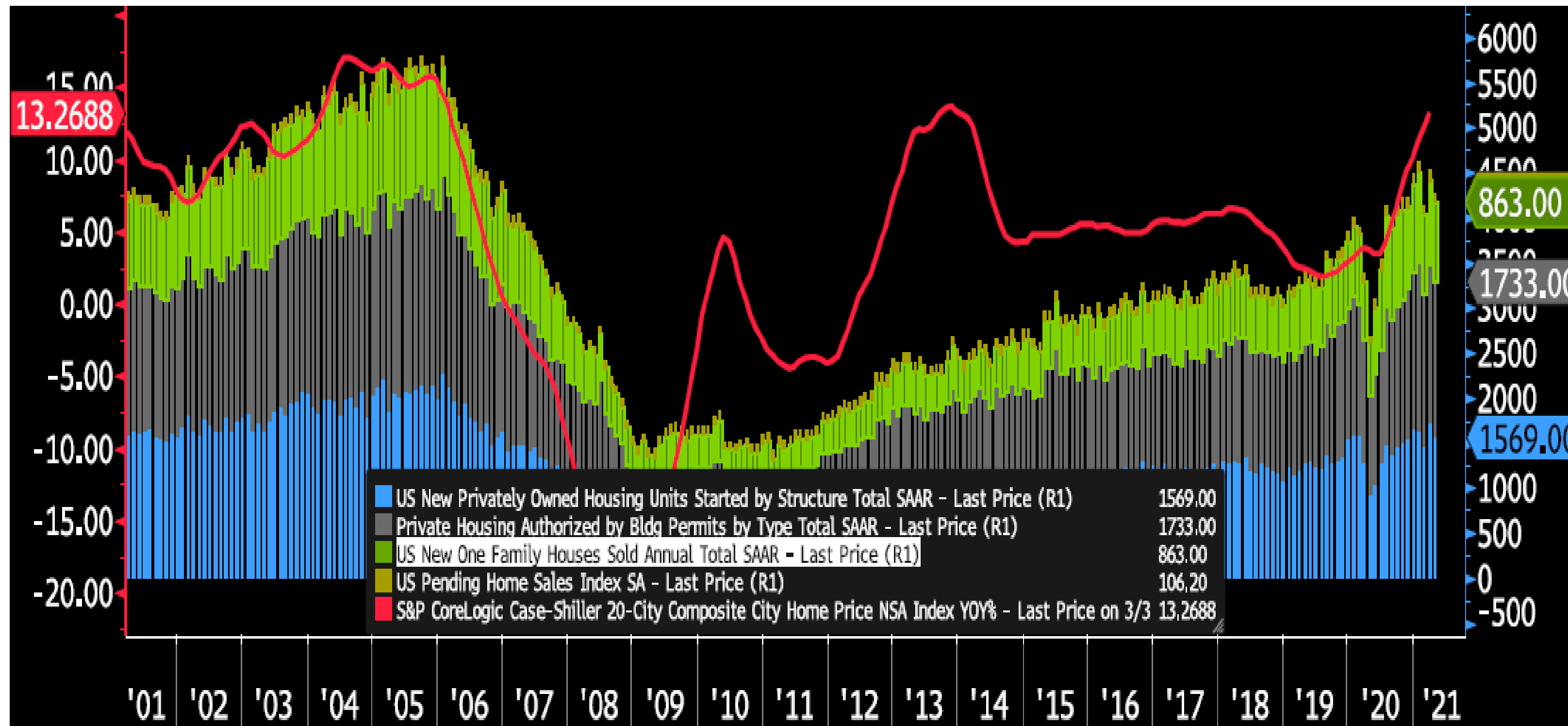
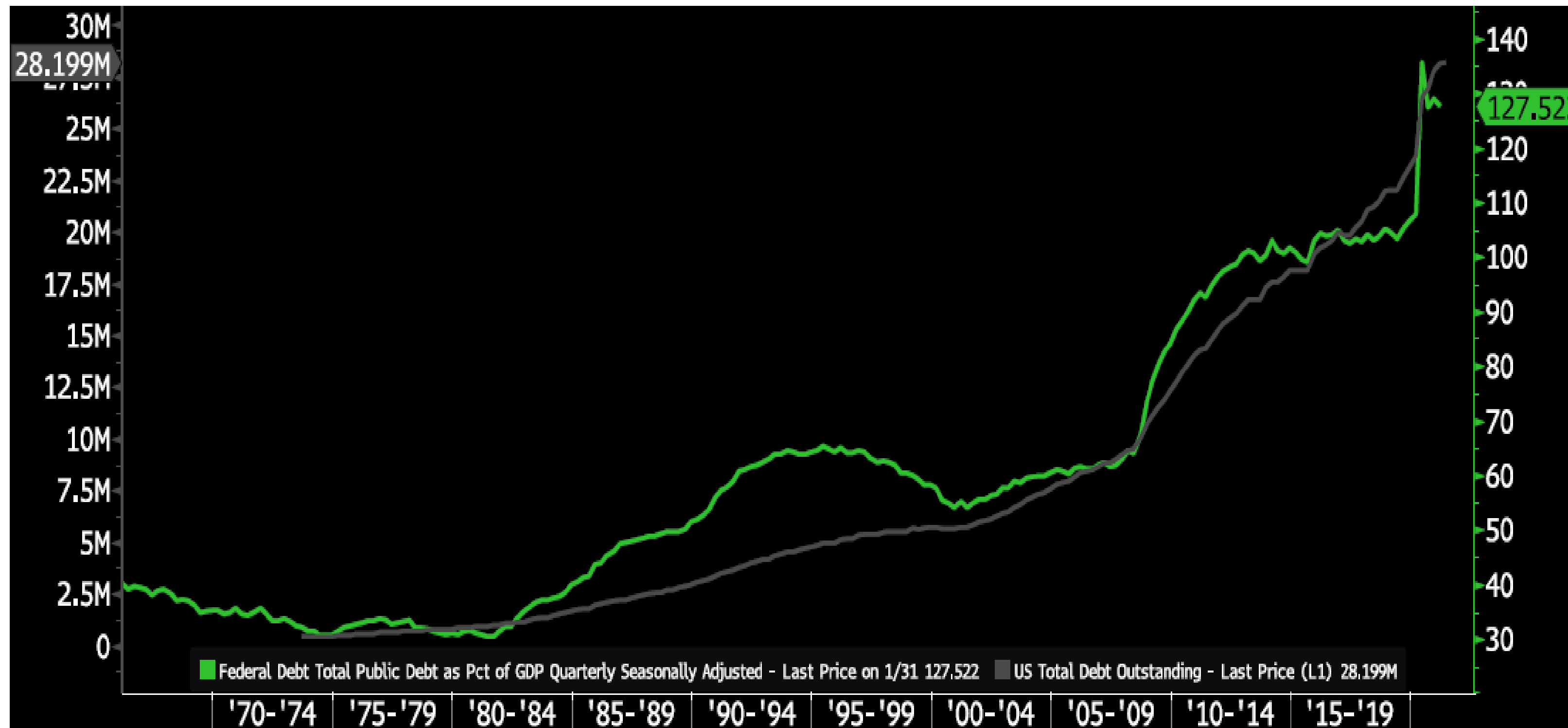
US Housing Market Remains Strong, but Activity Slowing



- While US housing prices continue to surge higher, activity levels are starting to moderate due to extremely lean inventories.
- We believe the housing market should remain solid, but there is certainly some froth in this corner of the economy.
- Still, the banking system is in great shape and overall consumer balance sheets are quite healthy. Ultimately, we don't think this is an area to be overly concerned with despite exceedingly high prices in some key markets (like Seattle).

The Recovery has been Remarkable, but so has the Additional Debt Added



- While the economy has taken off, it has also required well over $4T of added federal debt to get us here.
- This borrowing binge has brought our debt-to-GDP up to 127%, from just over 100% pre-pandemic.
- This ratio is at a critical juncture that has historically hamstrung other countries in the same position. It's vital to grow out of this debt burden over time, but it will get increasingly more challenging with each trillion added.

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Inflation is also Moving Up at a Rather Uncomfortable Clip

- Another major risk going forward is inflation overheating and dragging on the economy. We are witnessing a major breakout in that regard with both inflation and inflation expectations reaching multi-year highs.
- We are currently seeing an unleashing of pent-up demand coinciding with strained supply chains, resulting in bottlenecks and shortages. The hope is that supply issues will be resolved and the overall supply / demand balance will normalize.
- The other factor in the equation is that government oversight will need to keep spending under control.
- Ultimately, moderate inflation would actually be a good thing for our economy to help grow out of our debt burden, but too much could be disastrous.

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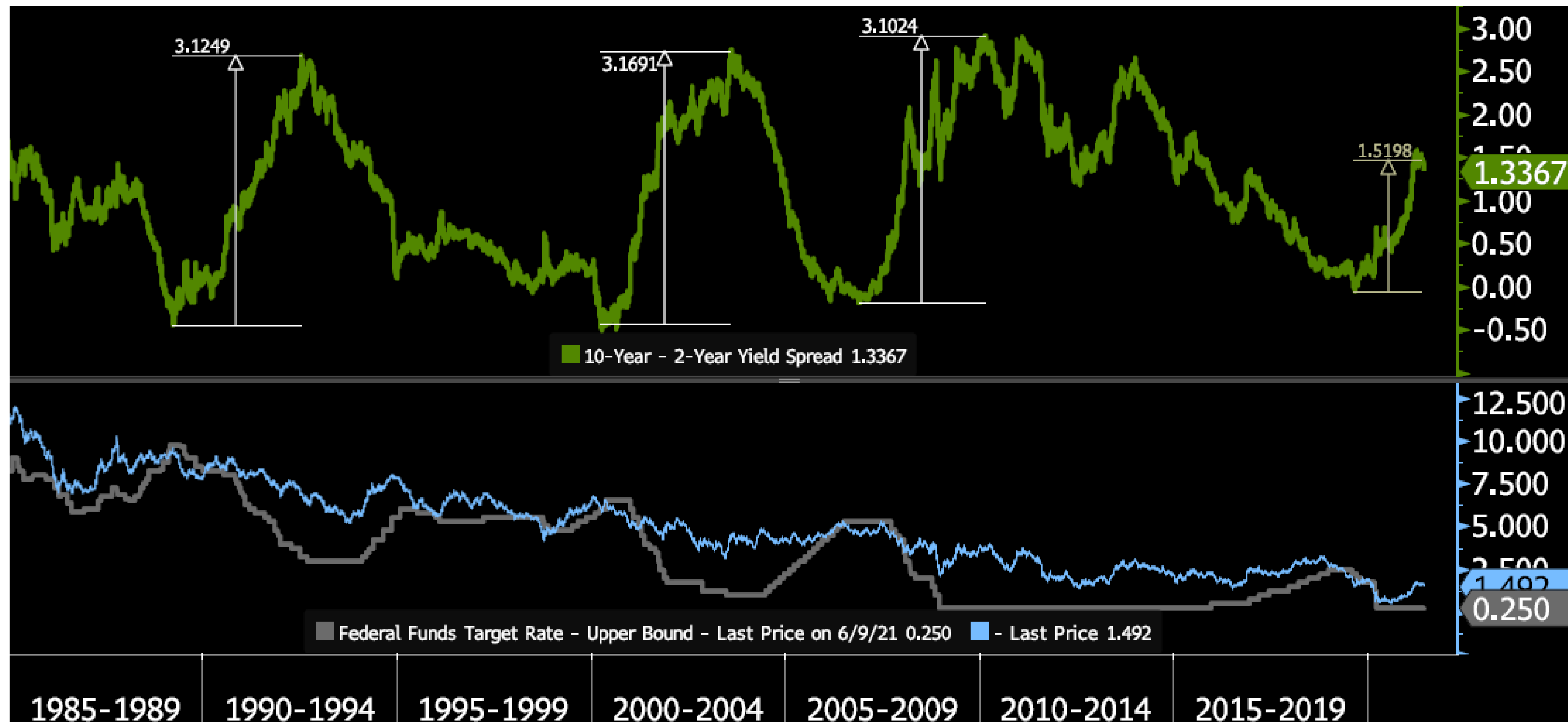
Long-term Interest Rates Likely Move Higher with a Steeper Yield Curve



- The growth outlook remains robust and interest rates should continue to trend higher.
- We expect the 10-year treasury to creep up towards 2.0% and above over the next year.
- At the same time, the Fed is almost certain to attempt to keep short-term rates near zero, which means a steeper yield curve.
- Historically, the yield curve tends to steepen by 3.0% during these cycles, which means the bond bear market is likely to continue.

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The US Twin Deficits Now at A Record and Point Towards a Weaker USD

- The US budget and current account deficit (the twin deficits) are now at a record level, relative to GDP.
- As you can see in the chart above, the US twin deficits have had a remarkably tight correlation on a lagged two-year basis vs. the USD index.
- This coupling indicates the USD is likely to weaken over the next few years.
- The counter-argument is that the US will cut back on spending as we move into the back half of this year, but it remains to be seen if the current administration is willing to turn off the fiscal firehose.

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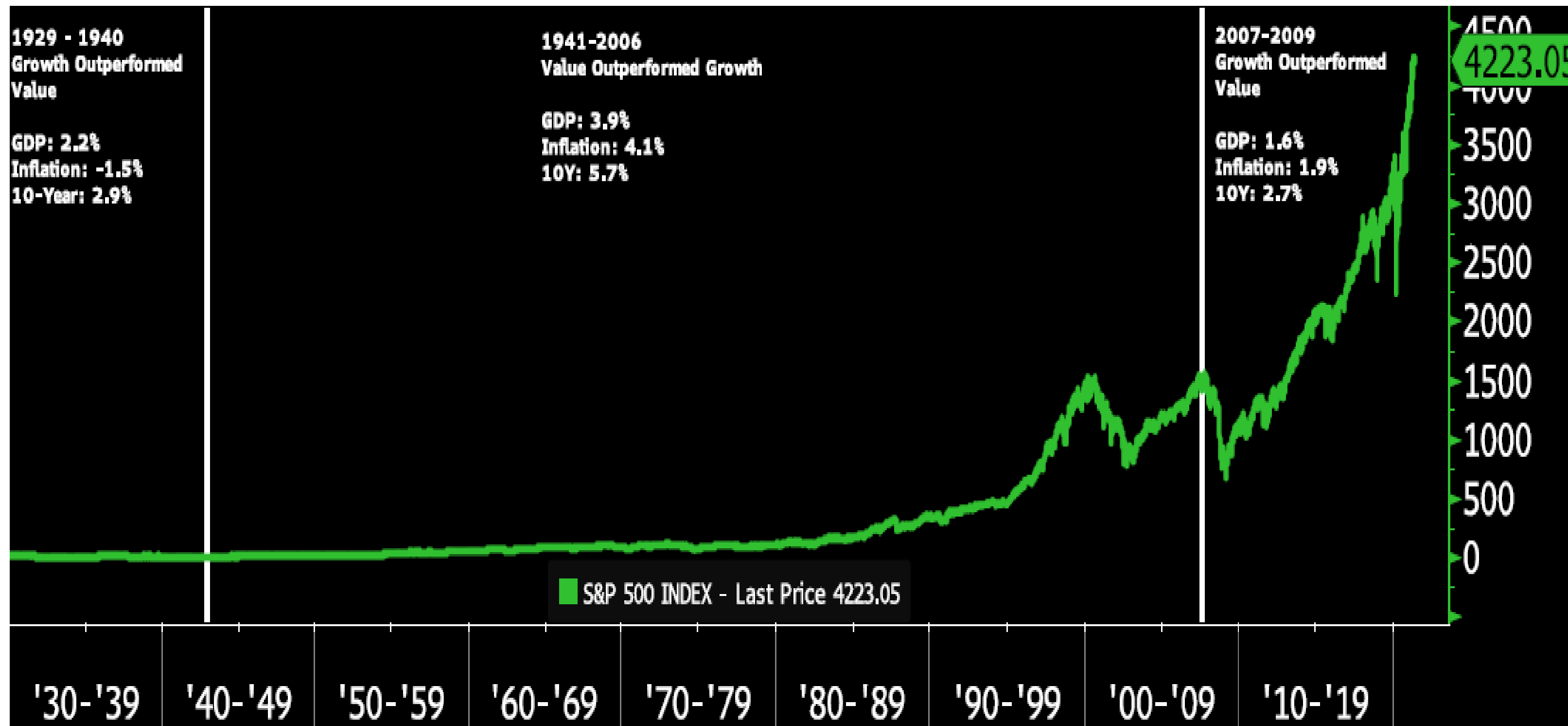
Value Tends to Outperform Growth During Periods of High Growth and High Inflation



- In terms of portfolio positioning, we do think we are entering at least a near-term phase (maybe long-term as well) of higher growth and higher inflation.
- As you can see in the chart above, value typically outperforms during periods of higher growth and higher inflation.
- The last eight months have corroborated that trend with value outperforming growth by 22% since last November.
- Value still trades at a 10-point valuation discount relative to growth vs. the 5-point historical average, so there's reason to believe this trend has legs.

International Equities Tend to Outperform US Equities During USD Bear Cycles

- Given the theme of a weaker USD, it makes sense to us to begin populating equity portfolios with a larger international allocation – specifically, an emphasis on Asia and emerging economies.
- Not only is there the potential currency kicker, but valuation still favors international and EM equities over US equities.

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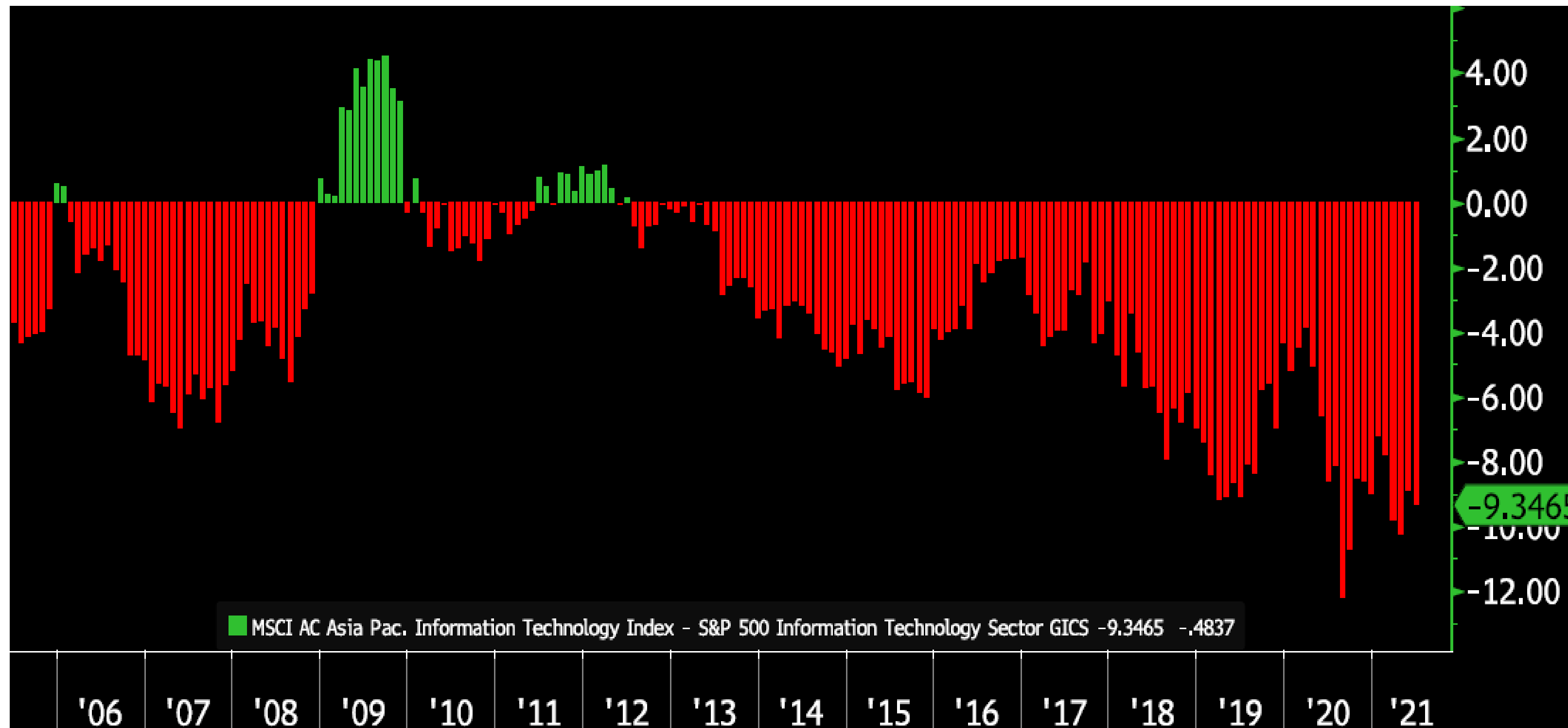
On the Growth Side, Asian Technology Looks Cheap Relative to US Technology



- Speaking of the Far East, Asian technology looks quite interesting relative to US technology stocks.
- In fact, the valuation discount between Asia and US tech is near a 10-year low in favor of Asian tech issues.
- We also believe technology companies in this region have a larger target market opportunity, or more growth potential relative to US peers.
- Said another way, the PEG ratios (price/earnings ratio relative to growth) look quite compelling.

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Commodity and Resource-Based Plays Look Depressed with an Inflation Hedge

- We also think having solid exposure to commodity or resourced-based equities makes a ton of sense in this environment.
- As you can see above, the Bloomberg commodity index has moved up, but compared to other periods of strength, the move is rather minor.
- The relevant comparison to today's market environment is the 1970s where inflation really took off.
- Holding energy, other resources, or even precious metal-type securities could provide significant diversification and alpha (excess return) for portfolios.
- We would note that some plays in this area (like cooper and energy stocks) have experienced incredible rallies, so waiting for a pullback might be the smart move.

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Banks’ Relative Performance Follows Interest Rates

- Financials are a great play on rising long-term interest rates. As you’ll notice in the chart above, financials outperform the market when rates rise and underperform when they fall. They also benefit from an improving economy as loan losses recede and lending improves.
- Finally, these stocks are still cheap relative to the market, so you’re paying a reasonable price to protect your equity (or bond portfolios) from rising interest rates.

Pent-Up Consumer Demand Should be Good for Auto-Related Equities

- This is on a bit more of a micro level, but the auto sector has an attractive setup given improving pricing and volume.
- And even though auto stocks have been performing well, many still trade at reasonable levels, and we believe there is rather significant pent-up demand from consumers.
- We especially like international autos where you can add overseas exposure while also investing in an attractive theme.

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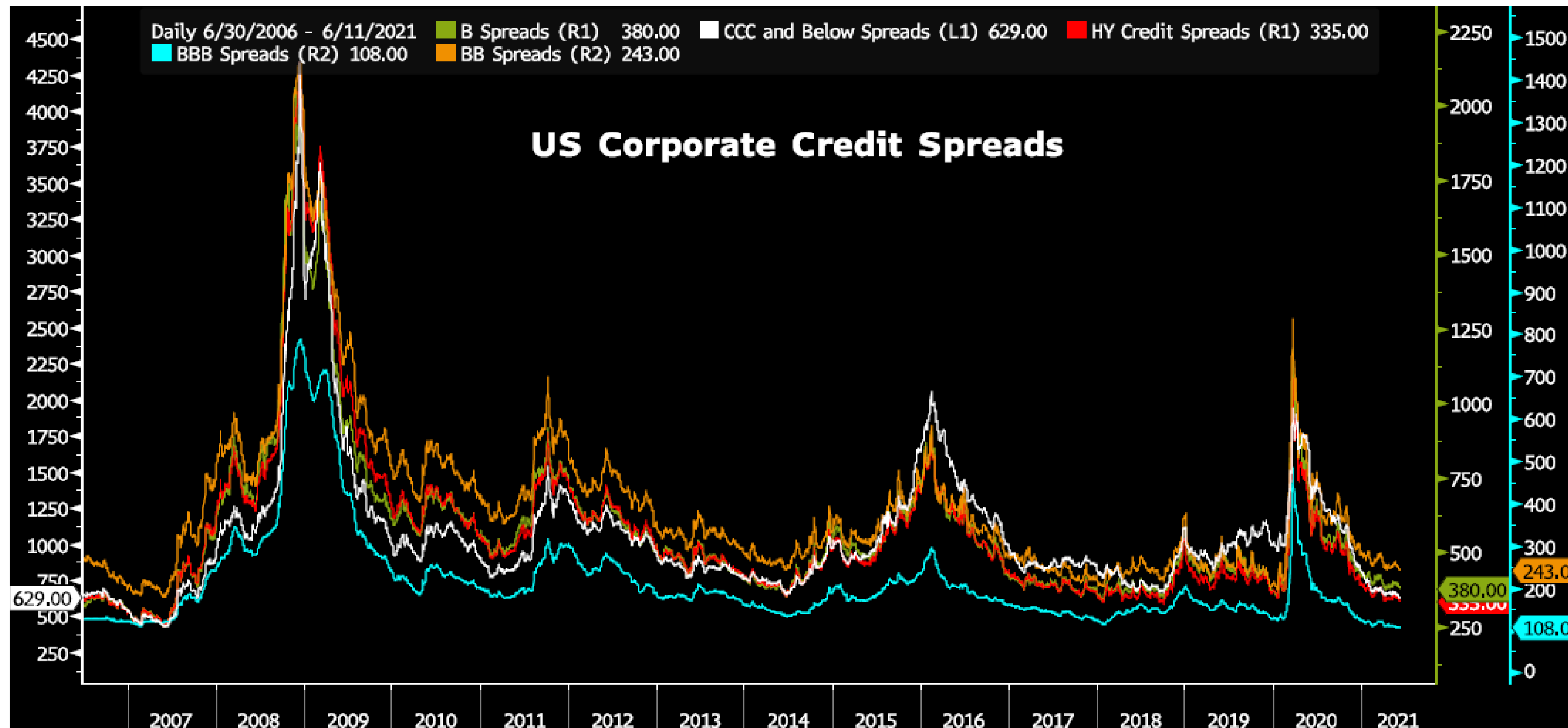
We Recommend Staying High-Quality and Short-Duration in Bond Portfolios



- On the bond side, it does not pay very well to take on incremental credit or interest rate risk.
- As you can see in the chart above, credit spreads are near multi-decade lows.
- Corporate bonds are exposed both to credit, and interest rate risk; based on how little these bonds pay, it's not worth taking either, let alone, both risks.
- As such, we are keeping our bond portfolios both short in duration (maturity profile) and high in credit quality.

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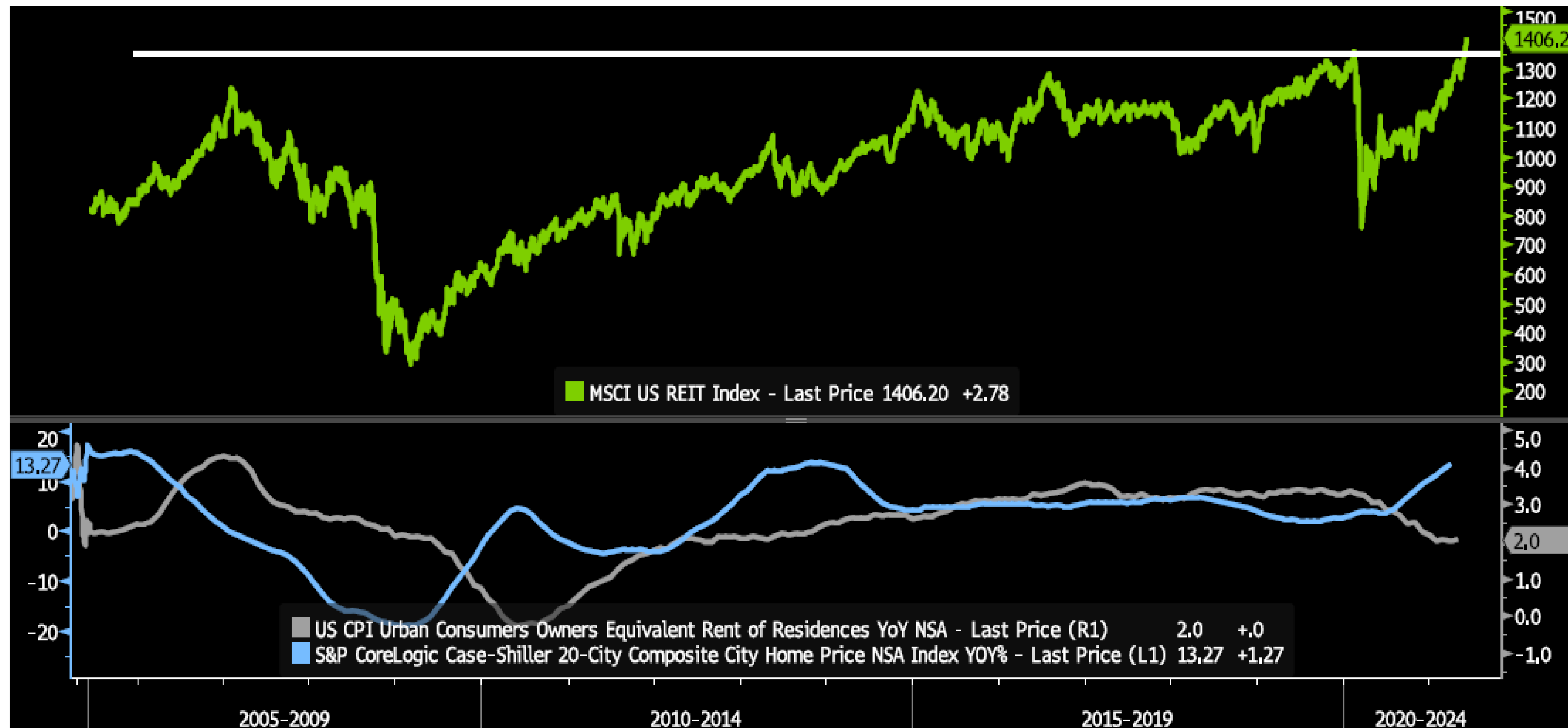
Real Estate Investment Trusts Should Hold Value Well in an Inflationary Environment

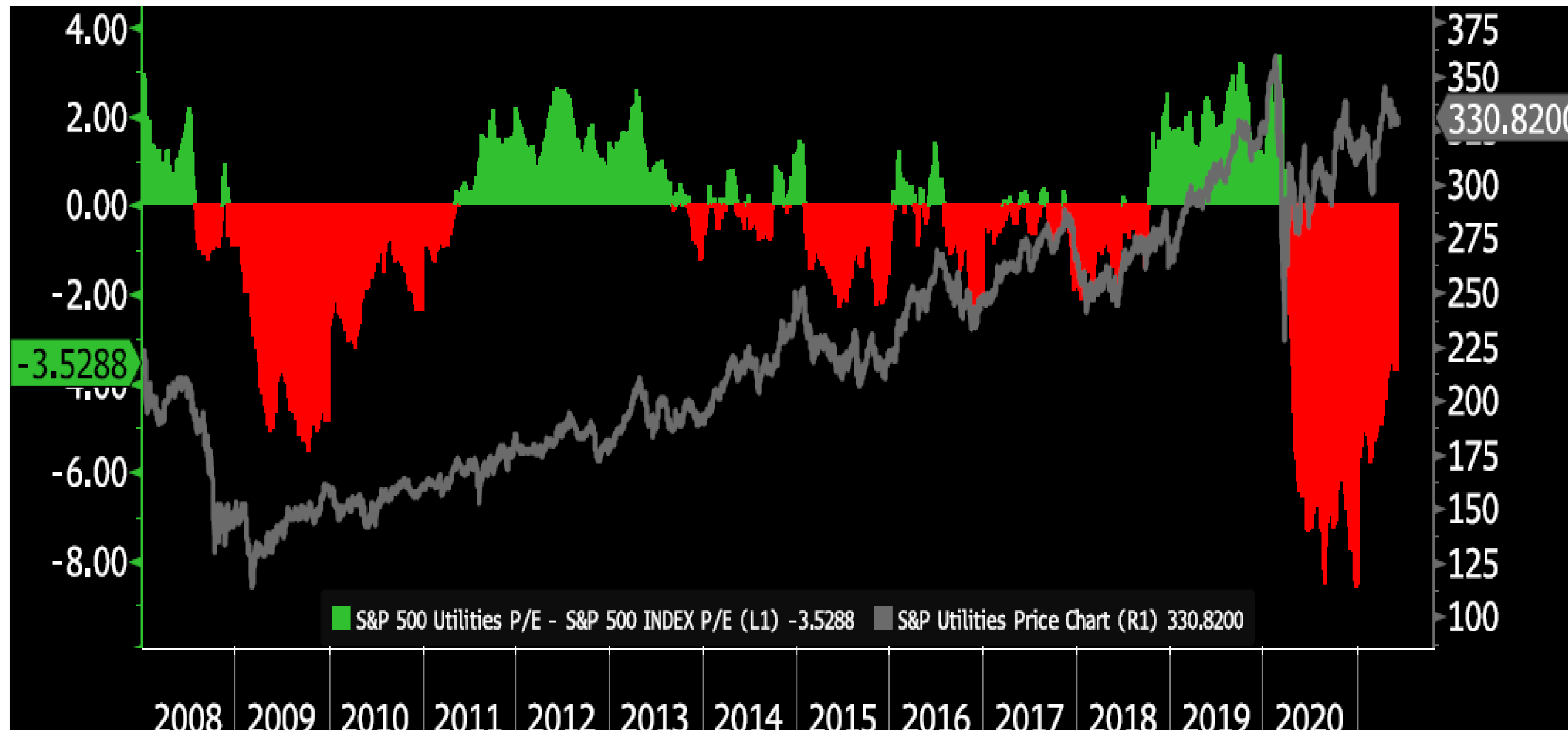


- For the income side of our clients' portfolios, we still like Real Estate Investment Trusts, which we have been steadily accumulating since the pandemic.
- Typically, these investments provide a nice hedge on inflation as rental rates tend to rise in that environment.
- The sector also trades less expensive than it did a few years ago, and we have been able to find good values in the 20-25x underlying cash flow range (4% to 5% cap rates).
- Multi-family is one area we have been buying more recently, as we think rental rates will move higher over the next several years.

YieldCo's Look Attractive after the Recent Pullback

- Another area we've been investing in is a group of securities called YieldCo's, which are utility-like companies that own clean power-generating assets.
- The dividend yields for companies in the space are 3-5% and we expect those to grow in the mid-single digit range over time (a few names even faster).
- If Joe Biden accelerates his clean energy transition, the growth in this space should see a big boost.
- The sector has pulled back about 20%, so this is a great opportunity to add to (or enter) the space.

Utilities Seem Like Solid Bond Equivalents over the next 5-10 Years



- We have also been slowly buying utilities within our income portfolios as an alternative to traditional bond investments.
- The utility sector yields right around 3% and we expect mid single-digit growth over time.
- The space has traded with a premium valuation several times over the last decade relative to the S&P and today is trading at a rather deep discount (the red section to the right, below the line).

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Midstream Energy Securities offer Solid Cash Flow and Inflation Protection

- Midstream energy securities are likely to benefit from a high-growth and high-inflation environment.
- The sector finally broke out of a six-year downtrend, and we are seeing a major snapback in global energy demand.
- Companies in the space have really placed an emphasis on free cash flow and balance sheets are much improved form the 2014-2016 time frame.
- The sector still yields over 9% and we think there is not only growth potential for those payouts, but most midstream companies we own are also buying back shares.
- The sector has rallied 50% this year so we would caution that a near-term correction is likely.

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Private Credit Should Also Perform Quite Well in a Rising Rate Environment

Private Credit: Fixed Income Performance in Context

Annual Returns of Select Fixed Income Indices Ranked in Order of Performance (2011-2020)

2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Total Return[1]	Volatility[1]	Sharpe Ratio
9.8% Private Credit	15.8% High Yield	12.7% Private Credit	9.6% Private Credit	5.5% Private Credit	17.1% High Yield	8.6% Private Credit	8.1% Private Credit	14.3% High Yield	7.5% Investment Grade Bonds	9.4% Private Credit	0.4% Cash	2.7% Private Credit
7.8% Investment Grade Bonds	14.0% Private Credit	7.4% High Yield	6.0% Investment Grade Bonds	1.2% Treasuries	11.2% Private Credit	7.5% High Yield	1.8% Cash	9.0% Private Credit	7.1% High Yield	6.8% High Yield	2.7% Treasuries	1.1% Investment Grade Bonds
6.6% Treasuries	9.7% Senior Loans	5.3% Senior Loans	2.6% Treasuries	0.5% Investment Grade Bonds	10.2% Senior Loans	4.1% Senior Loans	1.4% Treasuries	8.7% Investment Grade Bonds	5.8% Treasuries	4.3% Senior Loans	3.0% Investment Grade Bonds	0.8% High Yield
5.0% High Yield	4.2% Investment Grade Bonds	0.05% Cash	2.5% High Yield	0.03% Cash	2.6% Investment Grade Bonds	3.5% Investment Grade Bonds	0.4% Senior Loans	8.6% Senior Loans	5.5% Private Credit	3.8% Investment Grade Bonds	3.0% Private Credit	0.7% Treasuries
1.5% Senior Loans	1.7% Treasuries	-1.3% Treasuries	1.6% Senior Loans	-0.7% Senior Loans	1.1% Treasuries	1.1% Treasuries	0.0% Investment Grade Bonds	5.2% Treasuries	3.1% Senior Loans	2.5% Treasuries	6.4% Senior Loans	0.6% Senior Loans
0.07% Cash	0.08% Cash	-2.0% Investment Grade Bonds	0.02% Cash	-4.5% High Yield	0.3% Cash	0.8% Cash	-2.1% High Yield	2.2% Cash	0.5% Cash	0.6% Cash	8.1% High Yield	-0.4% Cash

Source: Morningstar, Cliffwater. Represents the annual returns for the respective calendar year, ranked in order of performance. The asset classes presented are based on the following indices: Clifffwater Direct Lending Index for Private Credit Bloomberg Barclays U.S. High Yield for High Yield, Bloomberg Barclays U.S. Aggregate Bond Index for Investment Grade Bonds, S&P/LSTA Leveraged Loan Index for Senior Loans, Bloomberg Barclays U.S. Intermediate Treasury Index for Treasu Bloomberg Barclays U.S. Treasury Bill 1-3 Month Index for Cash. **Past performance is not necessarily indicative of future results**. There can be no assurance any alternative asset classes will achieve their objectives or avoid significant losse

- Lastly, for certain clients, we have been making a push into private credit in lieu of public market fixed income.
- The table above highlights not only the high returns relative to other fixed income asset classes, but the extremely low volatility.
- The space is also largely floating rate in nature, which limits the negative impact of rising rates compared to traditional debt investments.
- Given the low interest rate environment, if you can give up some portfolio liquidity, we think private credit can enhance the risk-return profile for income portfolios.

Index Definitions

- The S&P 500 Utilities comprises those companies included in the S&P 500 that are classified as members of the GICS® utilities sector.
- The Alerian MLP Index is the leading gauge of energy infrastructure Master Limited Partnerships (MLPs).
- The FTSE Nareit Mortgage REITs Index is a free-float adjusted, market capitalization-weighted index of U.S. Mortgage REITs.
- The S&P BDC Index measures the performance of Business Development Companies that trade on major U.S. exchanges.
- The Russell 1000 Value Index® measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.
- S&P Healthcare Index measures the performance of the health care sector of the U.S. equity market.
- 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.
- The Dollar Index Spot measures the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of U.S. trade partners' currencies.

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