2022 Market Outlook:
Healthy Economic Growth, with a Side of Volatility

Q1 CHARTBOOK – January 2022

JEFF DICKS, CFA
Partner, Managing Director - Investments

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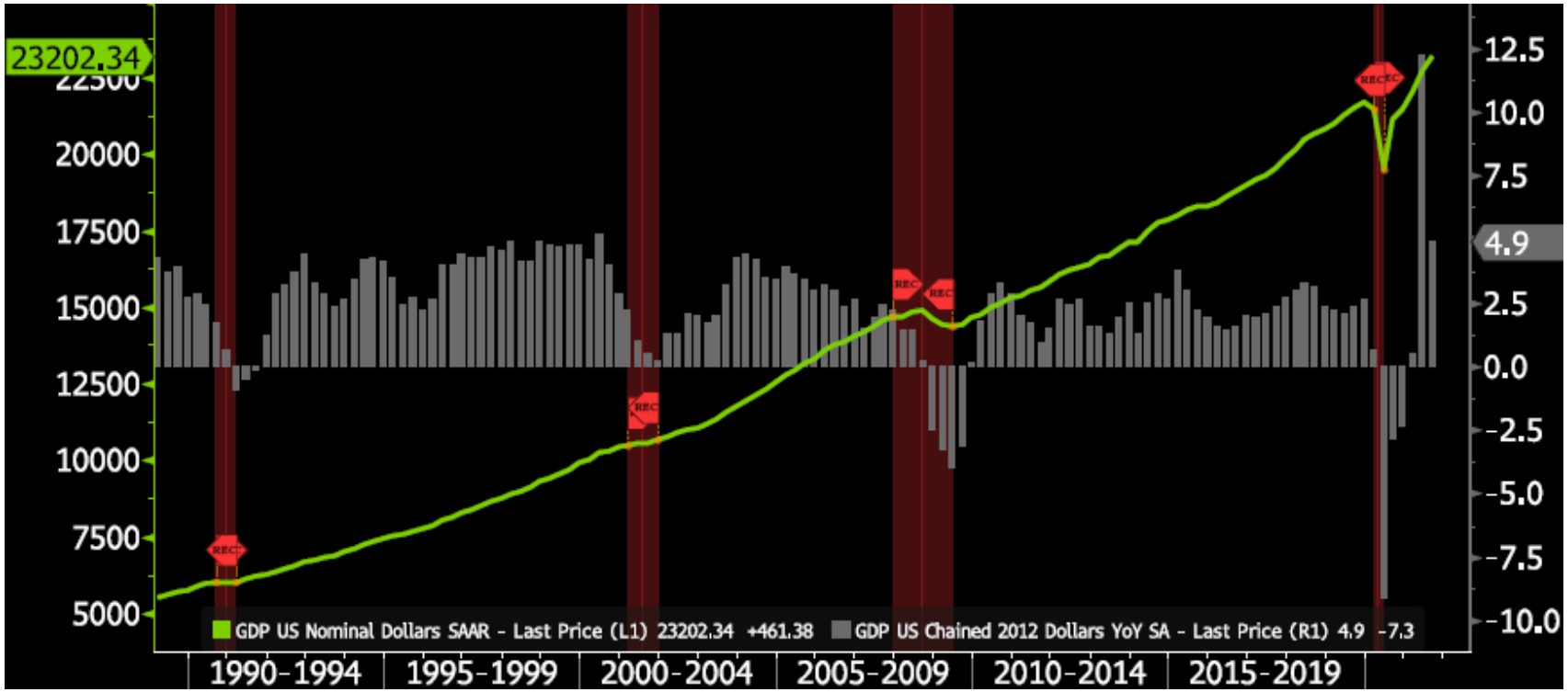
See important disclosures following the presentation.

Chartbook Preview

In this edition of *Evergreen Chartbook,* we will provide our economic outlook for 2022, along with our views on how to position portfolios. We are still leaning optimistic for risk assets, but also expect a higher level of market volatility as markets continue to digest a less accommodative policy from the Federal Reserve.

US Economic Growth Set to Slow in 2022, but Will Remain Above Trend



- The US economy in 2021 turned from recovery mode to economic expansion as GDP (green line) moved well above the previous peak.
- With one quarter left to be reported, the rate of growth for 2021 is expected to be 5.6% year-over-year, the largest yearly gain since 1984.
- GDP growth looking out to 2022 will no doubt slow from 2021 levels, but consensus expectations for 4% real GDP growth would still be well above the 20-year average growth rate of just 1.7%.

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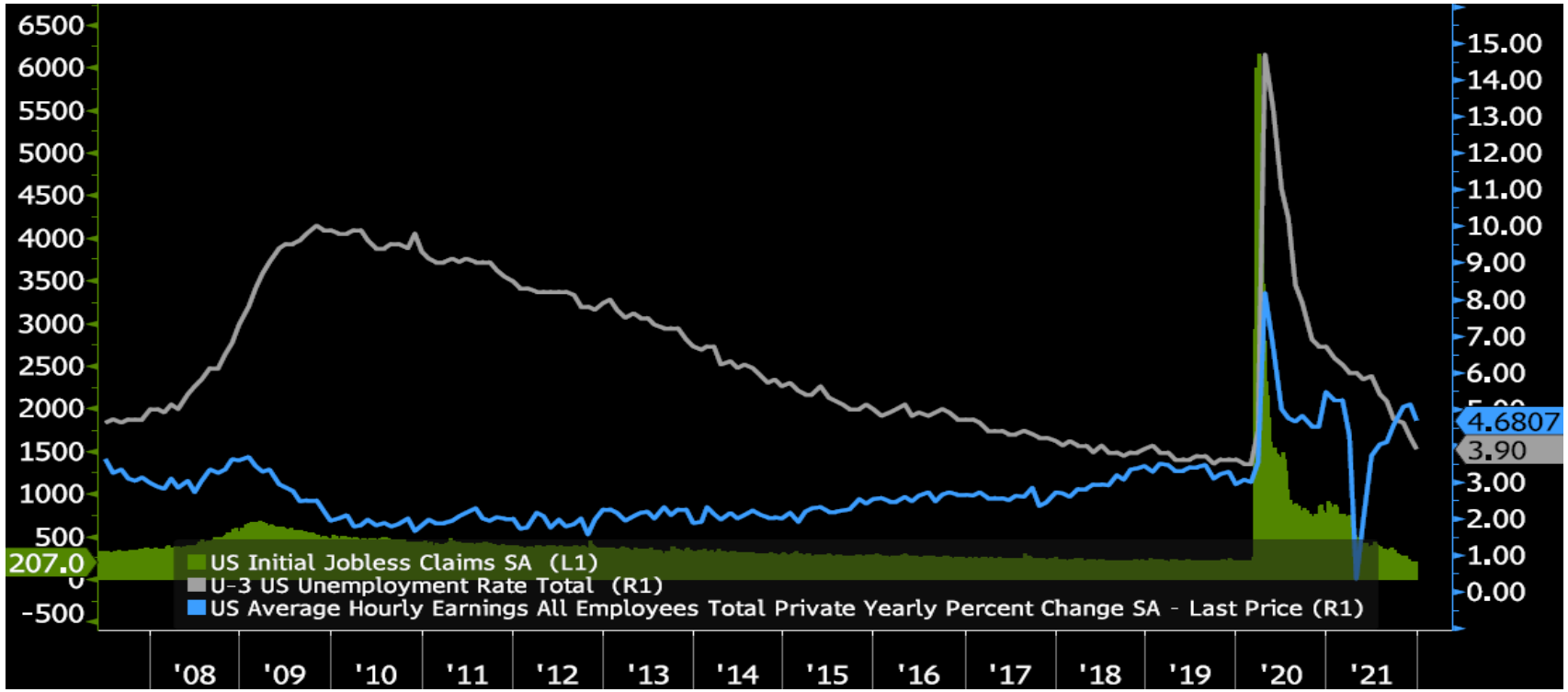
The Labor Market Continues to Improve at a Rapid Clip



- The unemployment rate dropped considerably during 2021 from 7% to start the year down to 3.9%.
- It is our expectation that this number continues to improve, and given the tight labor market, we expect employee compensation (blue line) to remain elevated.
- The lowest level of unemployment in 2019 was 3.5% and it is our expectation that it continues to drop below this level in 2022 as the labor market continues to aid economic growth over the near-term.

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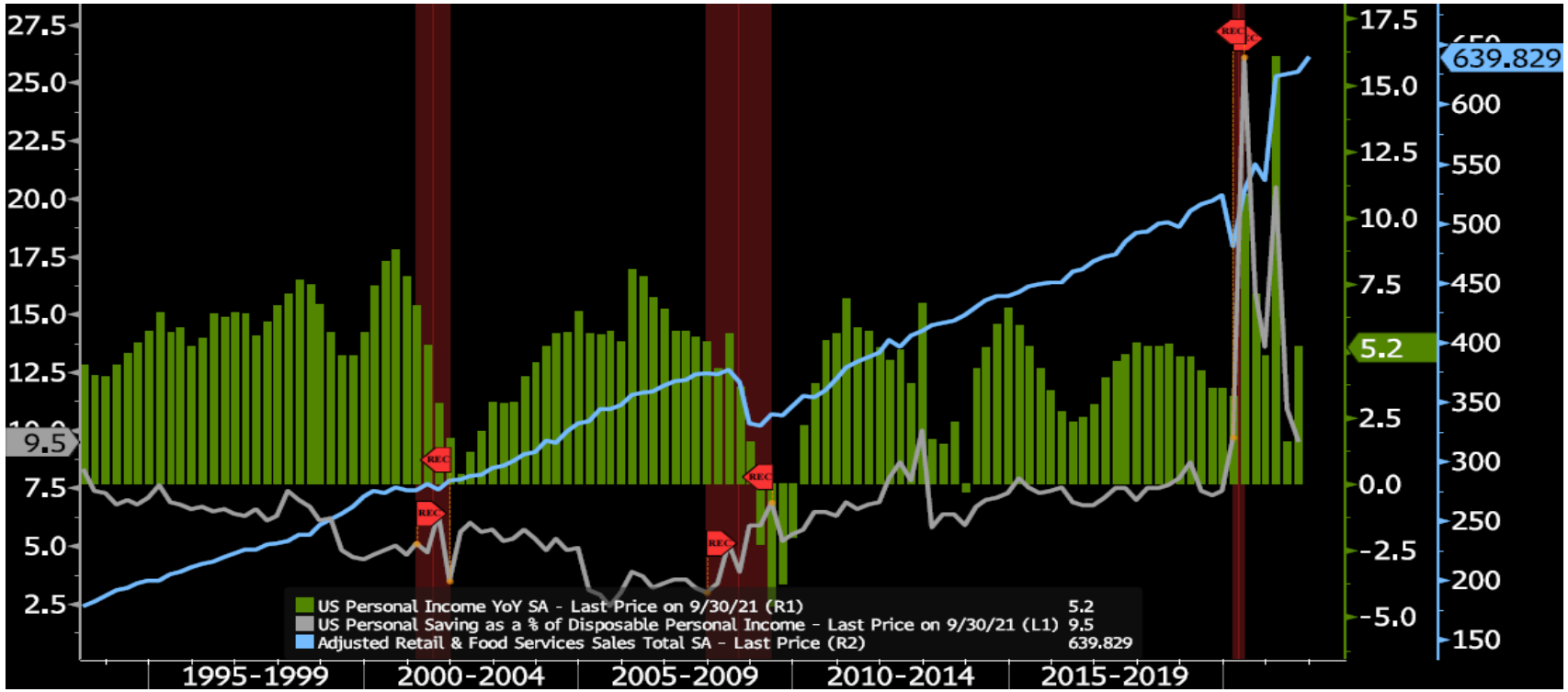
The US Consumer is in Good Shape with a High Level of Savings



- The US consumer looks poised to propel the economy in 2022 with healthy balance sheets and still significant pent-up demand.
- When you combine improving employment and higher wages, along with a high degree of savings relative to income (grey line), consumer spending should be robust.
- With that said, retail sales did spike in 2021 (blue line) so the year-over-year growth likely slows considerably.
- And with inflation currently running high, real (after-inflation) spending on a year-over-year comparison basis may be even more challenged.

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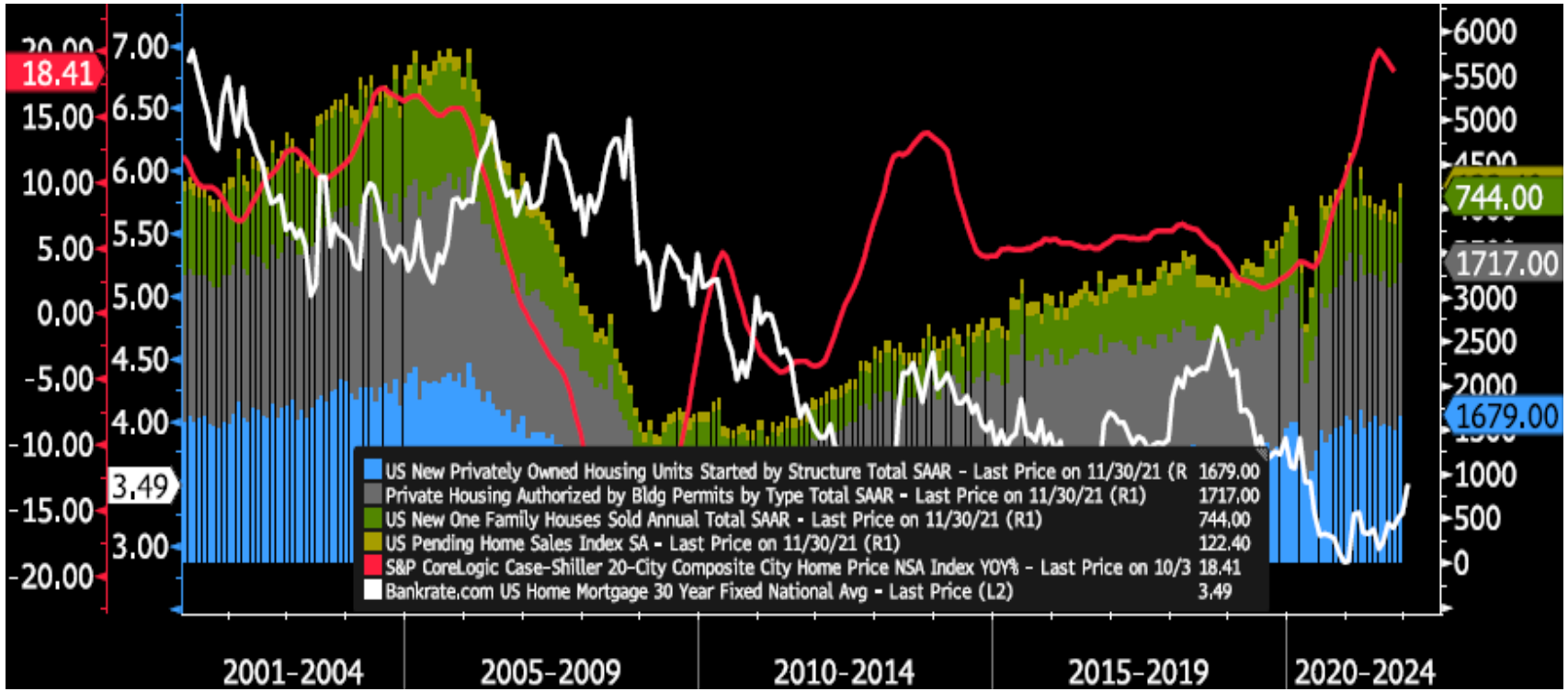
The Housing Market is Firing on All Cylinders, but Expect Pricing Growth to Slow



- The housing market remains the strongest in decades with housing starts, building permits, and home sales running at the highest combined level since 2007.
- Pricing has been even stronger with home prices registering an 18.4% year-over-year advance recently.
- Looking out to 2022, pricing comparisons will present a challenge. And, when considering slowly rising mortgage rates (white line), it is our expectation that year-over-year price gains trend down significantly over the next 12-months, but remain in positive territory. A risk, of course, would be an interest rate spike rather than a gentle uptrend.

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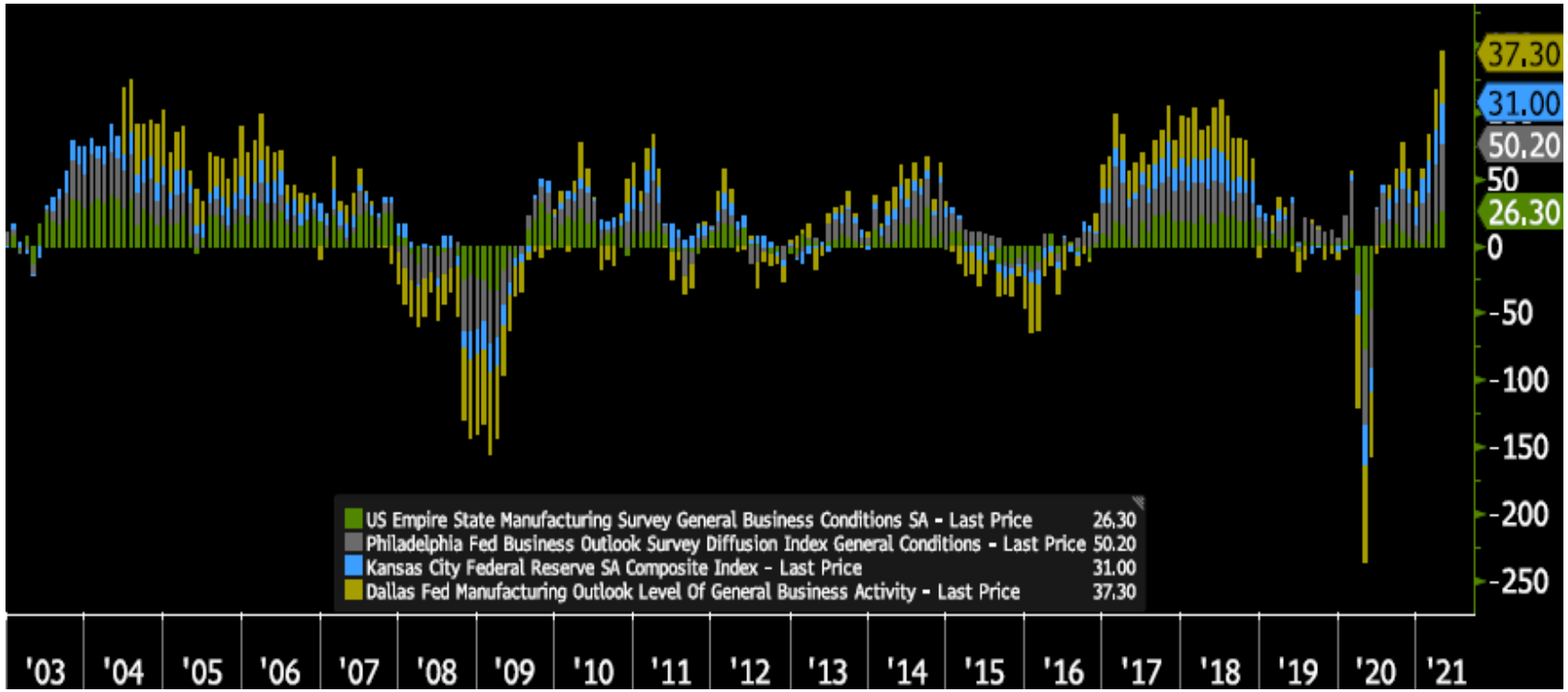
The Manufacturing Sector is Firmly in Expansion Mode



- Similar to the housing sector, regional manufacturing indices remain at the highest levels in decades.
- We would note that demand has been more robust than producers were prepared for, which has led to a depletion in inventories. This will likely result in further investment and an inventory restocking, which will ultimately lead to strong growth in the manufacturing side of our economy.
- We do recognize that many of these readings are unlikely to remain at current levels; however, we believe they are likely to stay firmly in expansion territory.

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Inflation Rates Registering New Highs But Should Moderate Over Next Year

- The previously mentioned shortages, along with record stimulus, have pushed prices higher with the CPI (blue line) registering a 30-year high of 7.0% recently.
- It is worth noting that the 10-year breakeven rate (grey line) indicates that the market view of inflation over the next 10-years is 2.88%. In other words, the market is telling us inflation rates will come back down over the next few years. However, we do worry that heavy Fed purchases of Treasury Inflation Protected Securities (TIPS) could be distorting this signal.
- Cooling inflation seems logical as supply bottlenecks ease and pricing comparisons become more challenging. Despite that, we feel it is likely inflation remains elevated -- especially compared to the previous decade when the CPI ran sub-2%.

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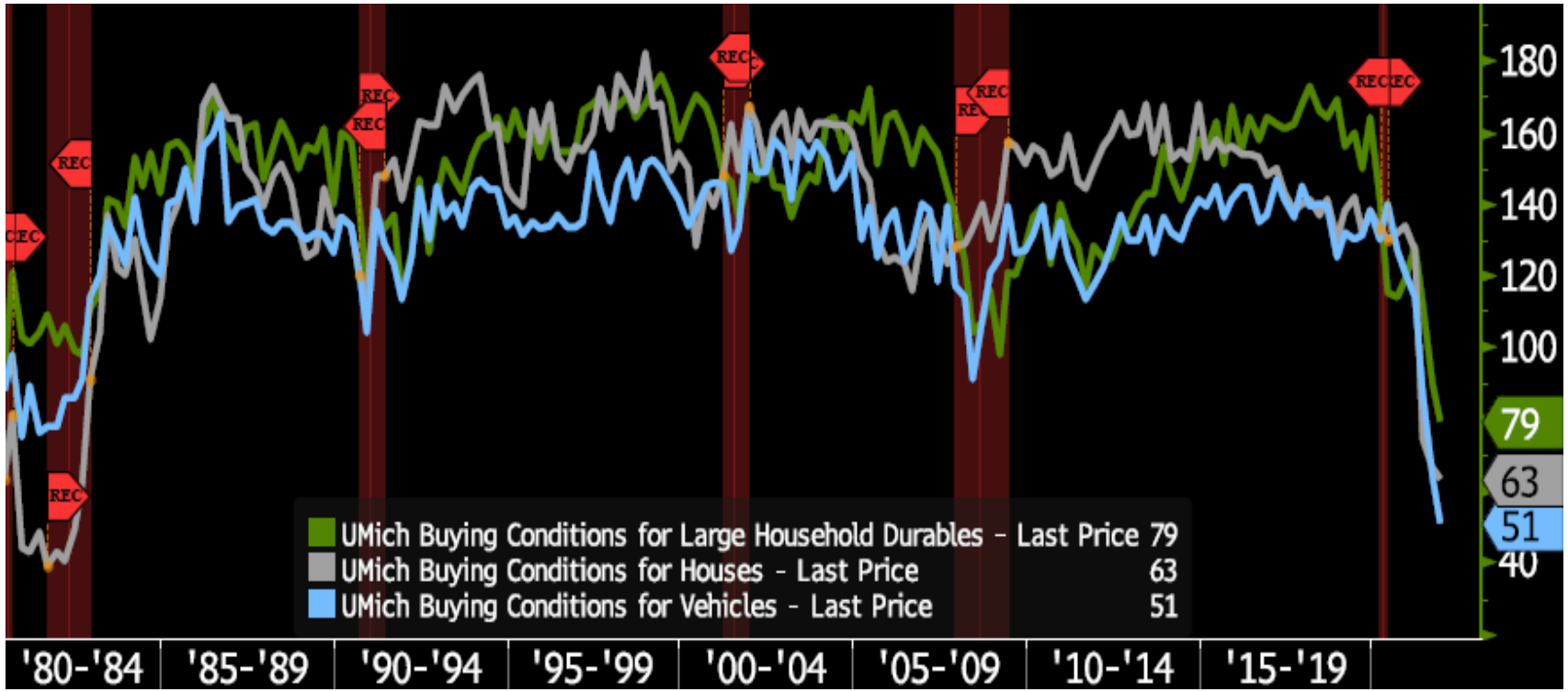
Consumer Buying Intentions have Plunged Due to High Prices and Low Inventories



- Interestingly, given rising prices along with supply side issues, buying intentions for big ticket items have plunged.
- Naturally, the cure for higher prices tends to be higher prices, and suggests that demand has slipped rather significantly.
- However, the larger issue is likely low inventories making buying nearly impossible, or at least prohibitively expensive, for some goods such as autos and appliances.

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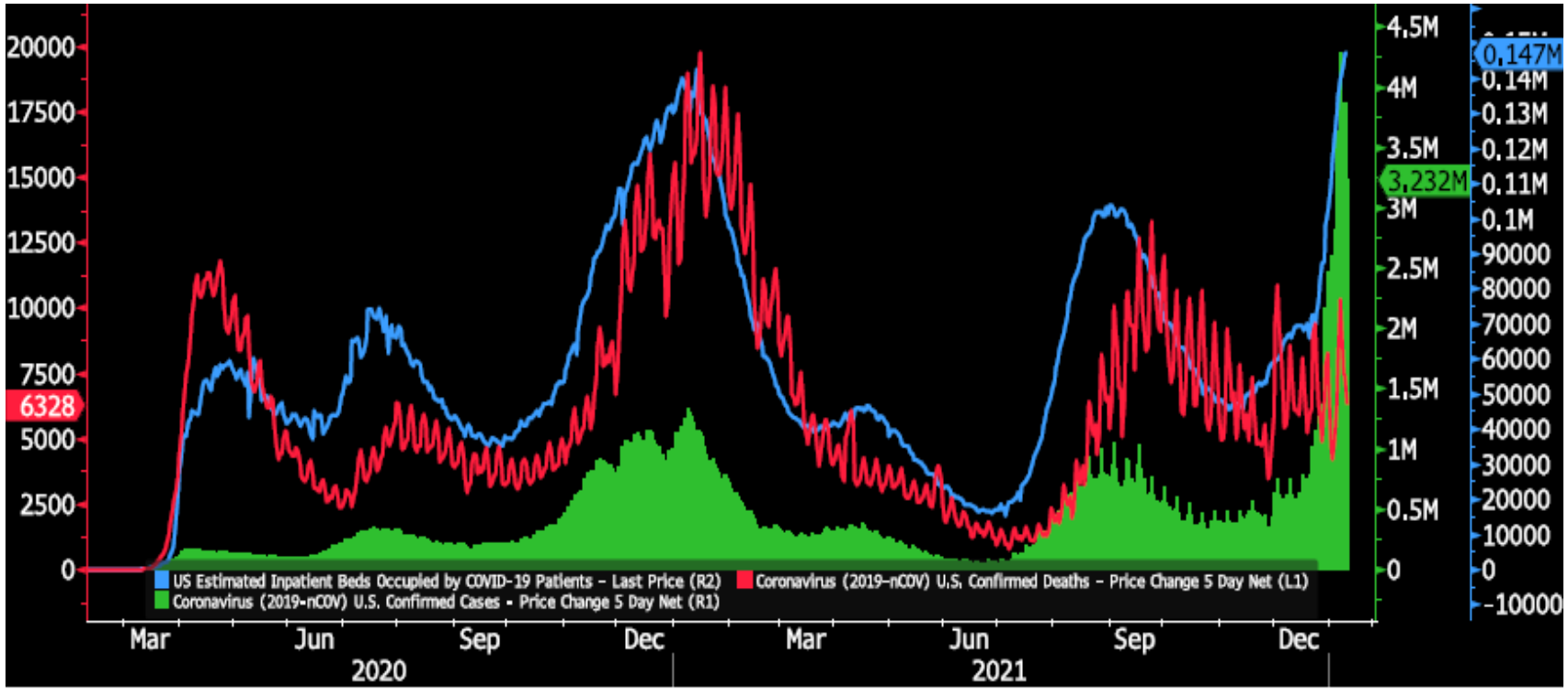
Covid Cases Spiking, but Fortunately Deaths have Decoupled from Infections



- In terms of risks that could derail this economic expansion, Covid is one that keeps popping up.
- This spike has been the worst in terms of total cases (green line), but fortunately deaths have stayed relatively low.
- Additionally, our economy has stayed open and as a result, markets have largely shrugged off this infection surge.
- We believe that over the next few months we could see the case count drop significantly, and as vaccination and herd immunity builds, Covid should be less of an issue as we progress through 2022.

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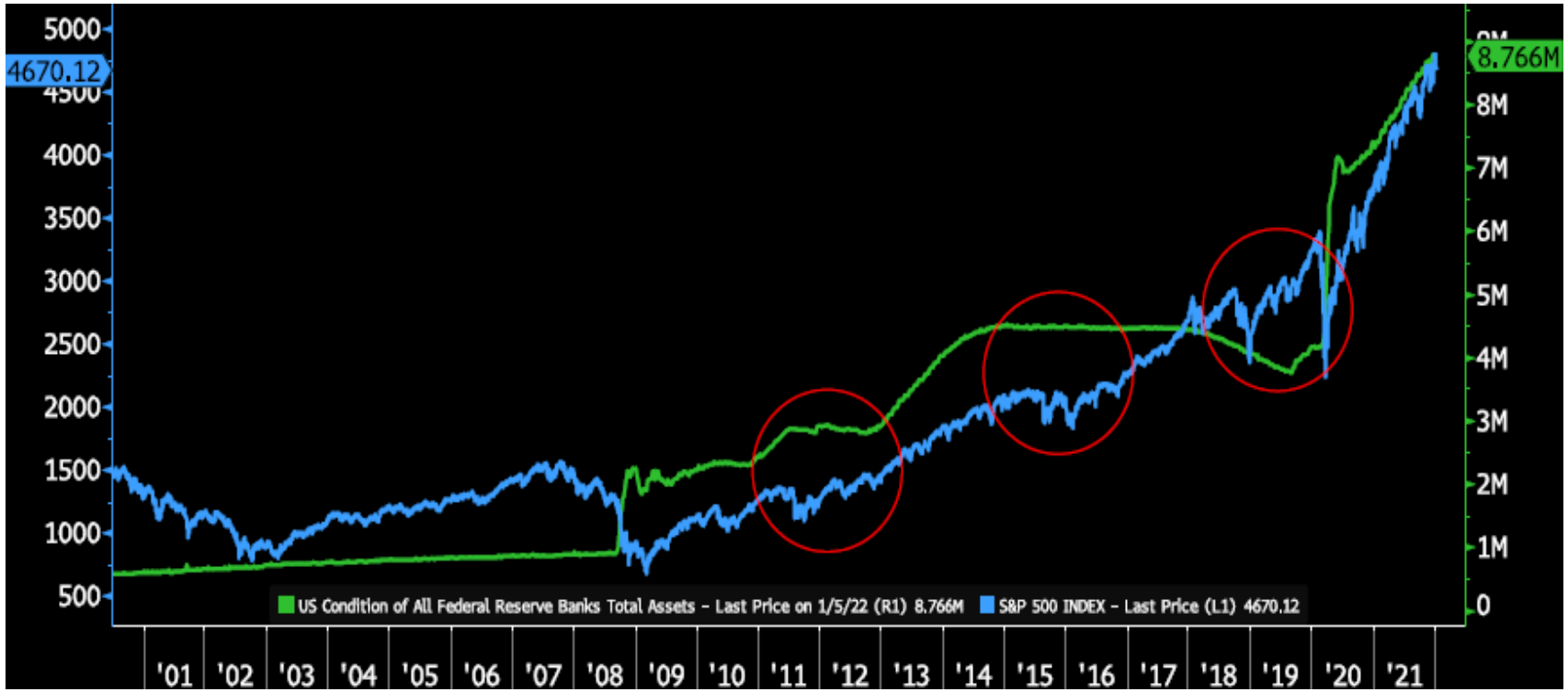
Fed Balance Sheet Biggest Risk for 2022 and Will add to Market Volatility



- The bigger risk facing financial markets is the shift by the Fed from highly accommodative to more restrictive policy.
- As you can see above, when the FED moves away from quantitative easing (green line turning flat, or down), there's more volatility in stocks (blue line).
- We believe equity market volatility will increase this year as the Fed begins to normalize its balance sheet and eventually raise short-term interest rates.

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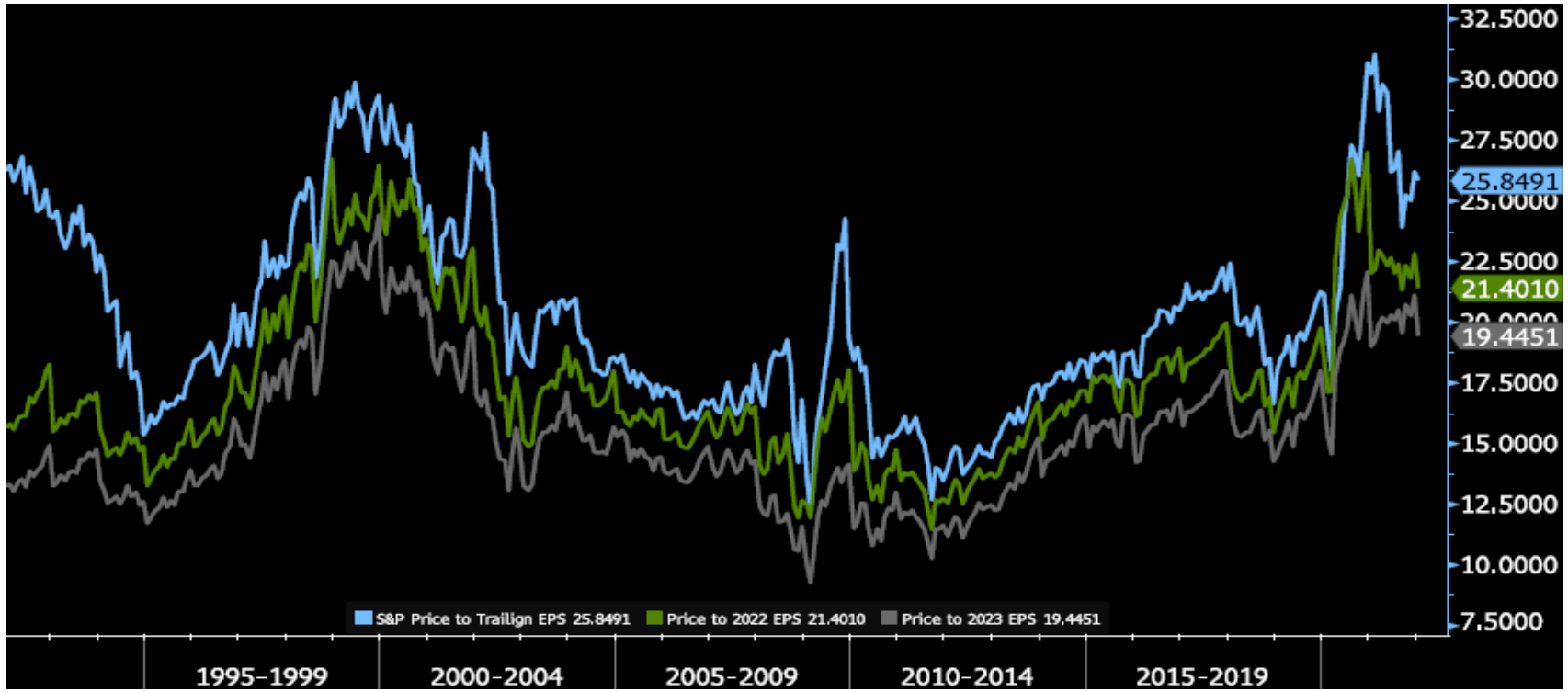
Absolute Valuation Elevated, but Earnings Growth will Remain Robust



- We are optimistic on equities, but market valuation remains elevated with the S&P 500 trading at 21.4x 2022 estimated earnings per share.
- It is worth noting that last year this metric was over 25x yet 2021 was still a phenomenal year to hold stocks as earnings grew north of 30%.
- Looking at 2022, the growth rate for earnings should slow, but still be strong with a reasonable shot at the 10%+ range for this calendar year.

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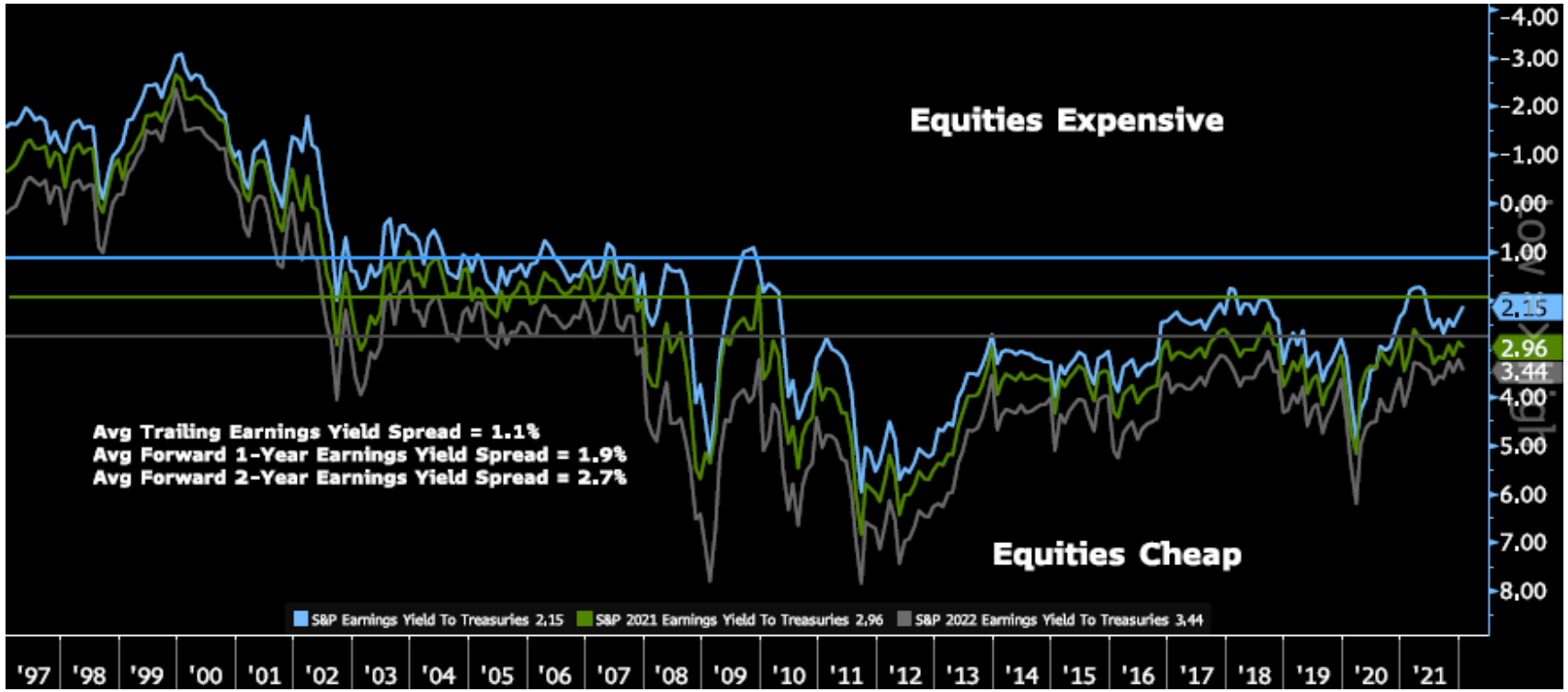
Valuation Relative to Interest Rates Still Look Attractive



- When comparing valuation relative to interest rates, we are still at a relatively inexpensive level versus the 25-year average.
- It's worth highlighting we think that interest rates will trend higher, which will make stocks, according to this valuation metric, more expensive.
- Still, with rates likely to remain very low and valuations still reasonable for many stocks and sectors (but certainly not all), we think it makes to hold equities despite higher volatility this year compared to 2021.

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We Are Tilting Our Portfolios To More Value-Based Equities

- We do have preference for value stocks as we head into 2022 due to the significant underperformance over the last decade (green line moving down) and a deep valuation discount for value versus growth (red histogram).
- Additionally, value tends to outperform in periods of rising interest rates and based on how inexpensively it now trades relative to growth stocks, it is an inexpensive way to protect portfolios from higher rates.

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We Are Leaning Our Portfolio Into More International Exposure

- During 2021, US equities outperformed emerging market equities by over 30%.
- Valuation for emerging markets (EM) look cheap (lower histogram) and the space has underperformed US markets for the last decade (green line moving down). We think you could see a surge in growth rates across EM and Asia due to lagging, but improving, vaccination rates.
- The US dollar has also appreciated rather significantly over the past decade, so that would provide a tailwind if the USD were to turn the other direction, as we feel is likely.

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On The Value Side, We Think Overweight In Financials Makes Sense

- In the value space, financials still look quite reasonable with the sector trading near a six-point discount to the market.
- The sector's performance versus the S&P (green line) also tracks interest rates (blue line) with a strong correlation.
- If rates continue to move higher, financials should (and likely will) continue to outperform the overall market.

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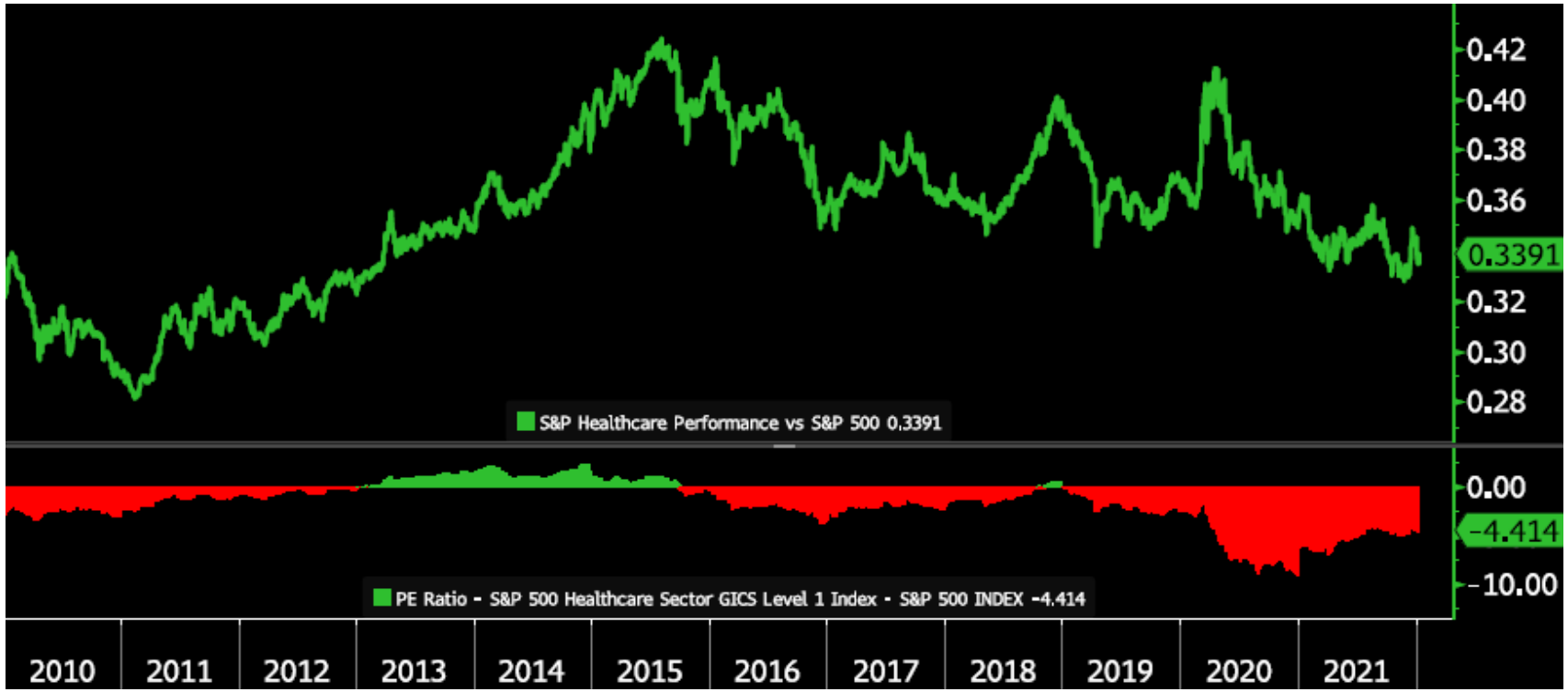
The Healthcare Sector Looks Attractive



- Healthcare stocks also look cheap relative to the market (lower histogram) and healthcare at times has traded with a premium valuation to the S&P.
- We have also had a period of underperformance within healthcare stocks (upper green line moving down), so it makes sense to us to accumulate this relatively cheap and battered sector of the market.
- We do think there are tailwinds in this area such as pent-up demand for treatments and surgeries post-covid. Further, there is a nice growth aspect given many cutting-edge drugs and treatments that are either coming to market or are in the pipeline.

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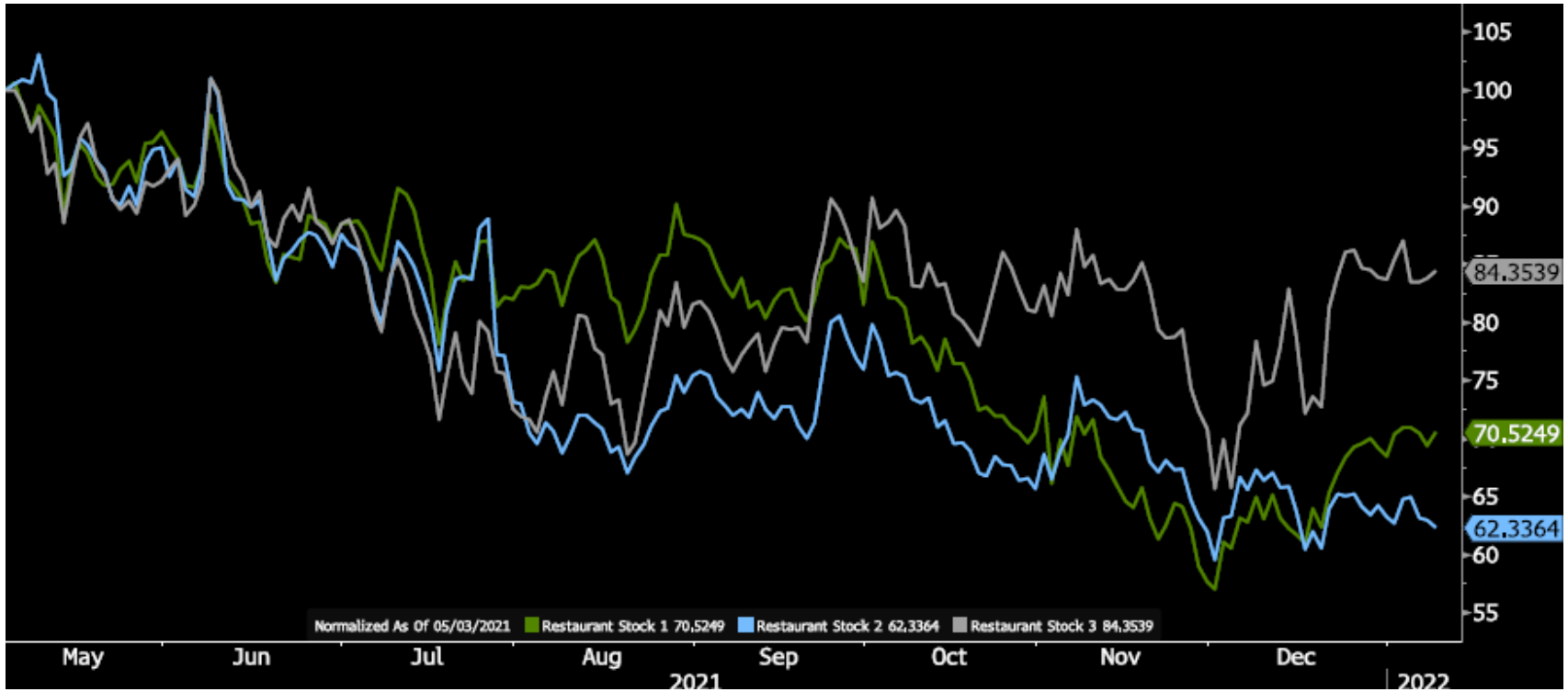
On a Micro Level We Like Restaurant Stocks



- In a more "niche" sub sector, we think restaurant stocks offer good value as a re-opening play.
- The three example stocks in the chart above highlight the significant draw down since May of 2021 when the Delta variant reared its ugly head.
- As we look out through the rest of the year, we think there could be a rather significant amount of pent-up demand and, as Covid dies down there is likely to be renewed interest from investors.

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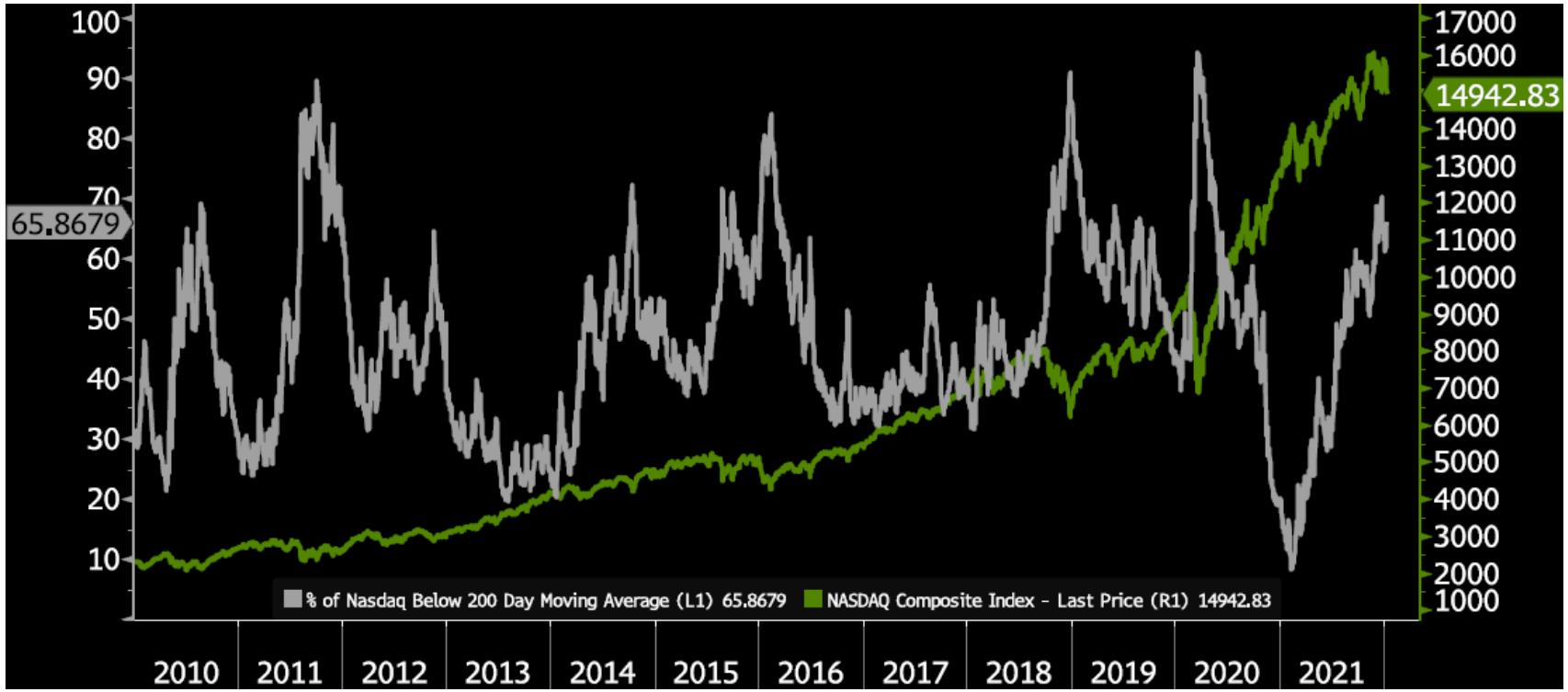
Beaten Up Tech Names Are Also Looking Interesting



- On the growth side, there's been remarkable weakness in "concept" and other high-multiple stocks.
- Over 40% of the Nasdaq has fallen 50% from their 2021 peaks.
- The chart above shows the number of companies trading below the 200-day moving average (grey line).
- There are some very good companies that are down 35-50% that we are nibbling at given the selloff.
- We recommend taking a measured approach given valuations for the hardest hit companies tend to still be quite punchy.

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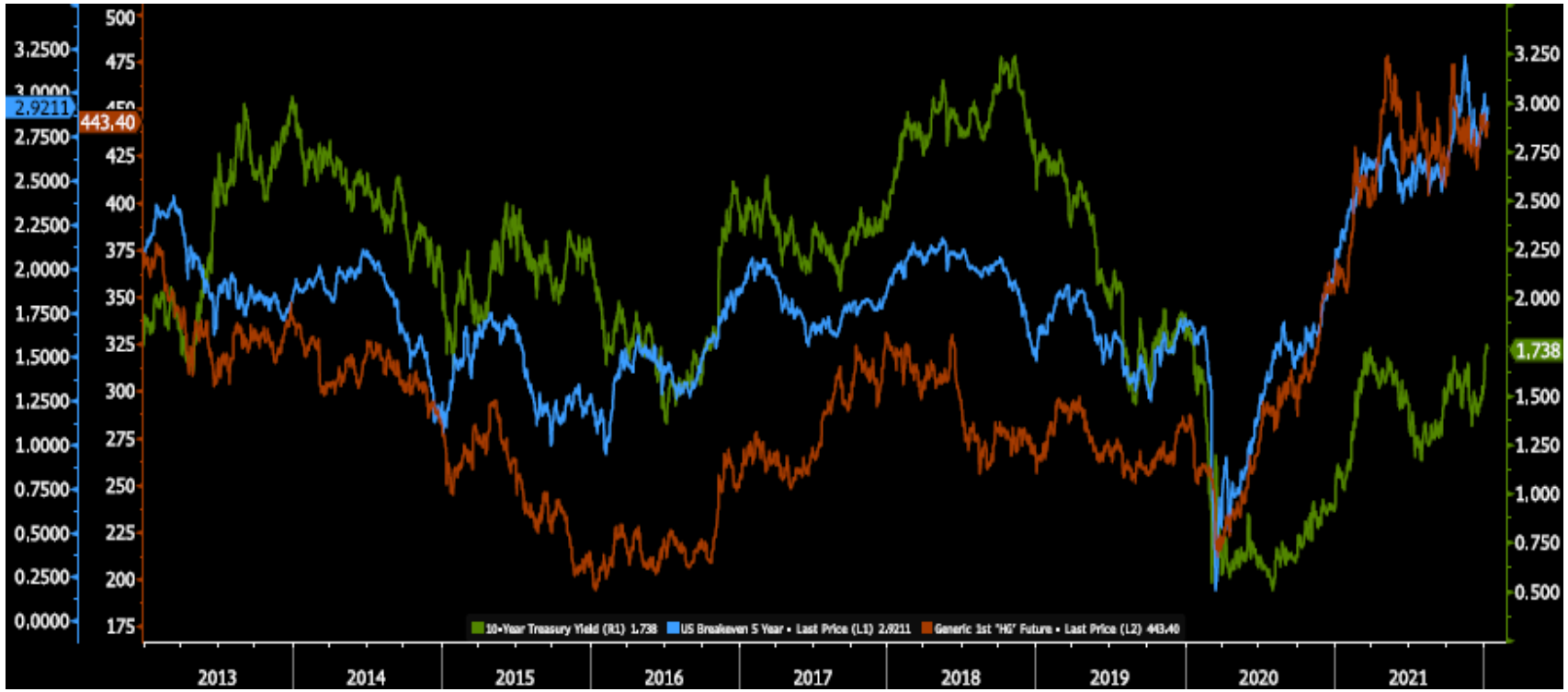
In The Bond Market, We Believe Interest Rates Are Heading Higher



- Interest rates tend to follow inflation expectations (blue line), and typically correlate closely with the price of copper (red line) given the economic sensitivity of the metal.
- What you can see above is interest rates (green line) are significantly below both inflation expectations and the price of copper.
- We believe the logical path is for rates to move up as our economy continues to expand over the next few years.

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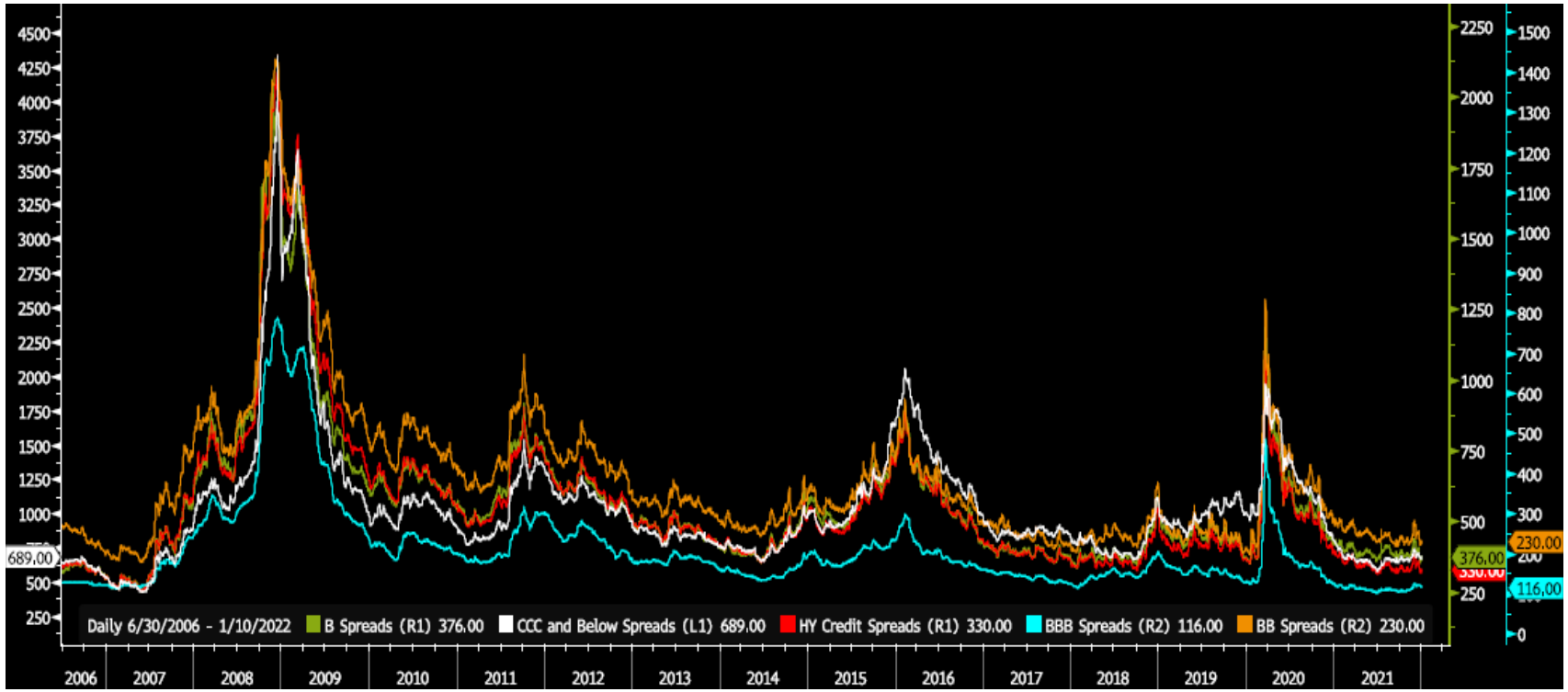
Credit Spreads Are Tight, But We Do Not Expect A Blow Out In 2022



- Credit spreads, which measure the difference between corporate borrowing costs and US treasury rates, are tight compared to historical standards.
- This means investors are relatively comfortable with default rates staying low and corporate fundamentals remaining relatively robust.
- Corporate bond yields do not offer stellar returns in today's environment. But with defaults low, corporate bonds offer a decent risk-adjusted return.
- We prefer shorter-duration corporate bonds with high-grade high-yield credit ratings (BB).

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Short-Duration, High-Yield Bonds, And Bank Loans Perform Well With Rising Rates

I18844US Index | Settings | Comparative Returns

Range 07/20/2012 - 01/02/2014 Period Daily No. of Period 531 Day(s) Table

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	I18844US Index	USD	13.24%	13.24%	3.97%	8.92%
2)	SPBDLL Index	USD	9.27%	9.27%	--	6.29%
3)	LBUSTRUU Index	USD	-1.50%	-1.50%	-10.78%	-1.04%
4)	TLT US Equity	USD	-21.44%	-18.01%	-27.28%	-12.76%
5)	IEF US Equity	USD	-8.95%	-6.62%	-15.89%	-4.60%
6)						

1M 3M 6M YTD 1Y 2Y 3Y 5Y 10Y

Track Annotate Zoom

- The total return chart above highlights how short-duration, high-yield (white line), and bank loans (orange line) performed during 2012-2014 when long-term interest rates moved up by 150 basis points (1.5%).
- As you can see, these areas of the bond market returned 13% and 9%, respectively, compared to -1.5% for the Barclays Aggregate Bond Index and -18% and -7% for long and intermediate treasuries.
- We believe this will be a good space to be invested in once again on the bond side, and especially on a relative basis if rates were to move up as much as we anticipate.

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We Still Favor Holding Midstream Infrastructure Stocks

- Within our equity income portfolio we believe midstream energy infrastructure stocks look attractive.
- Valuations are quite cheap with the sector trading at under 5x underlying cash flow.
- The sector's balance sheet has also significantly improved with excess cash now funding shares buybacks.
- However, there has been a powerful recent rally as we had hoped, and anticipated; as a result, a pull-back is very possible.

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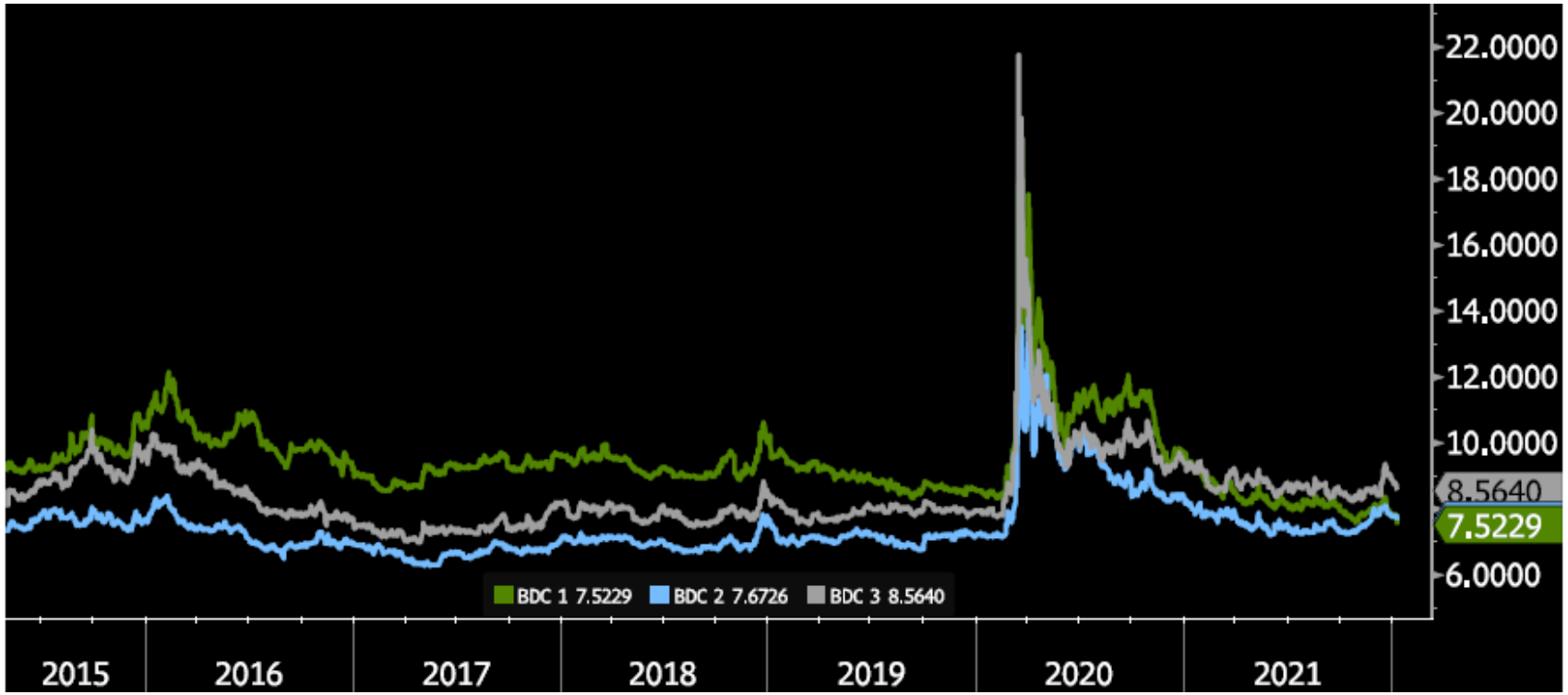
Business Development Companies Still Offer Solid Risk Adjusted Returns



- Business development companies, which primarily lend to private businesses', offer attractive dividend yields in the 7.5-8.5% range.
- These companies trade with very reasonable valuations in the 10-13x earnings range.
- We also think with defaults likely staying low over the next year, this area will provide outsized returns relative to the bond market.

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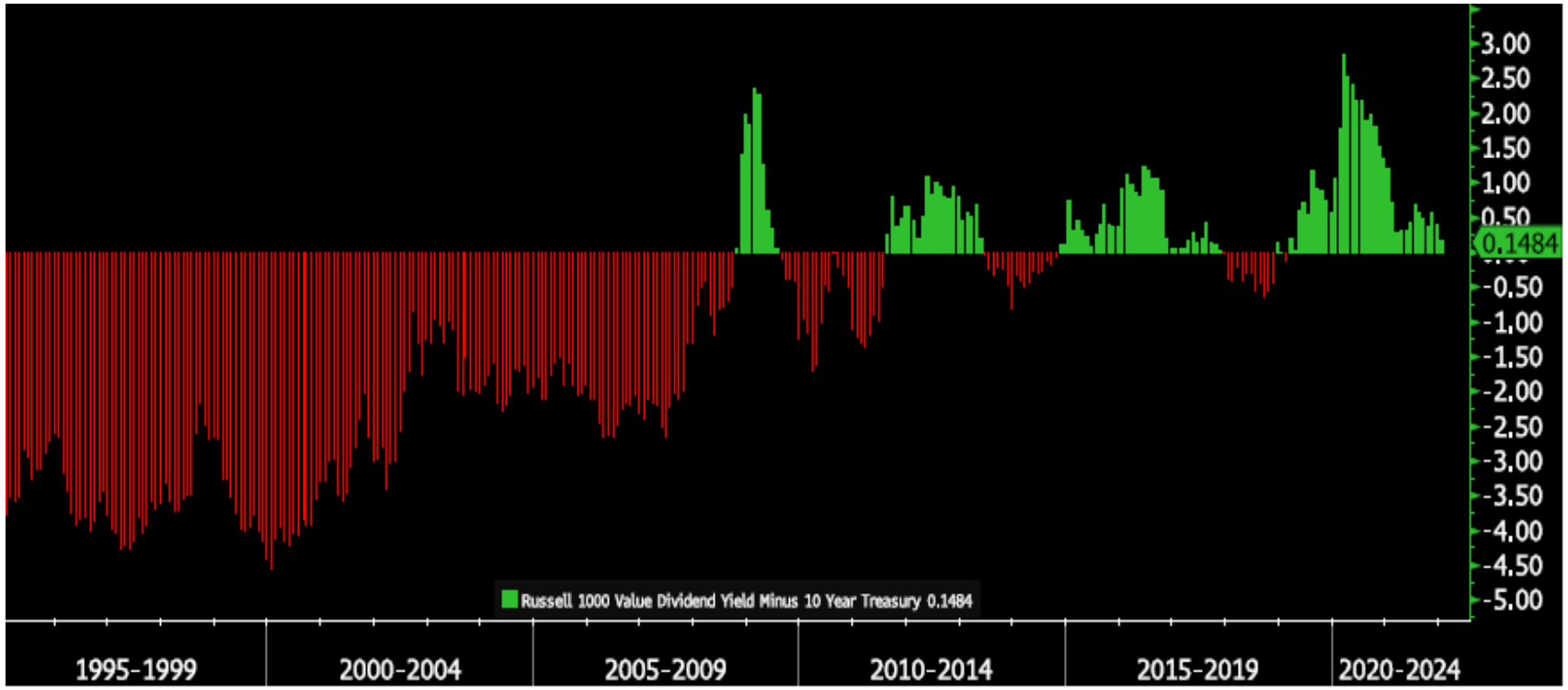
Dividend-Paying Value Stocks Offer Higher Cash Flow Than Bonds



- We still like holding a collection of high-quality dividend stocks within our income portfolios.
- The 2%-4% dividend yields in these securities are, in many cases, higher than bond yields, and we believe these dividends have the capacity to grow on average by 5-10% over time.
- We are focusing on companies with investment-grade balance sheets, high free cash flow generation, and the capacity to buy back shares.
- As you can see above, dividend paying stocks still generate a healthy cash flow relative to bonds, especially when looking at the long-term chart.

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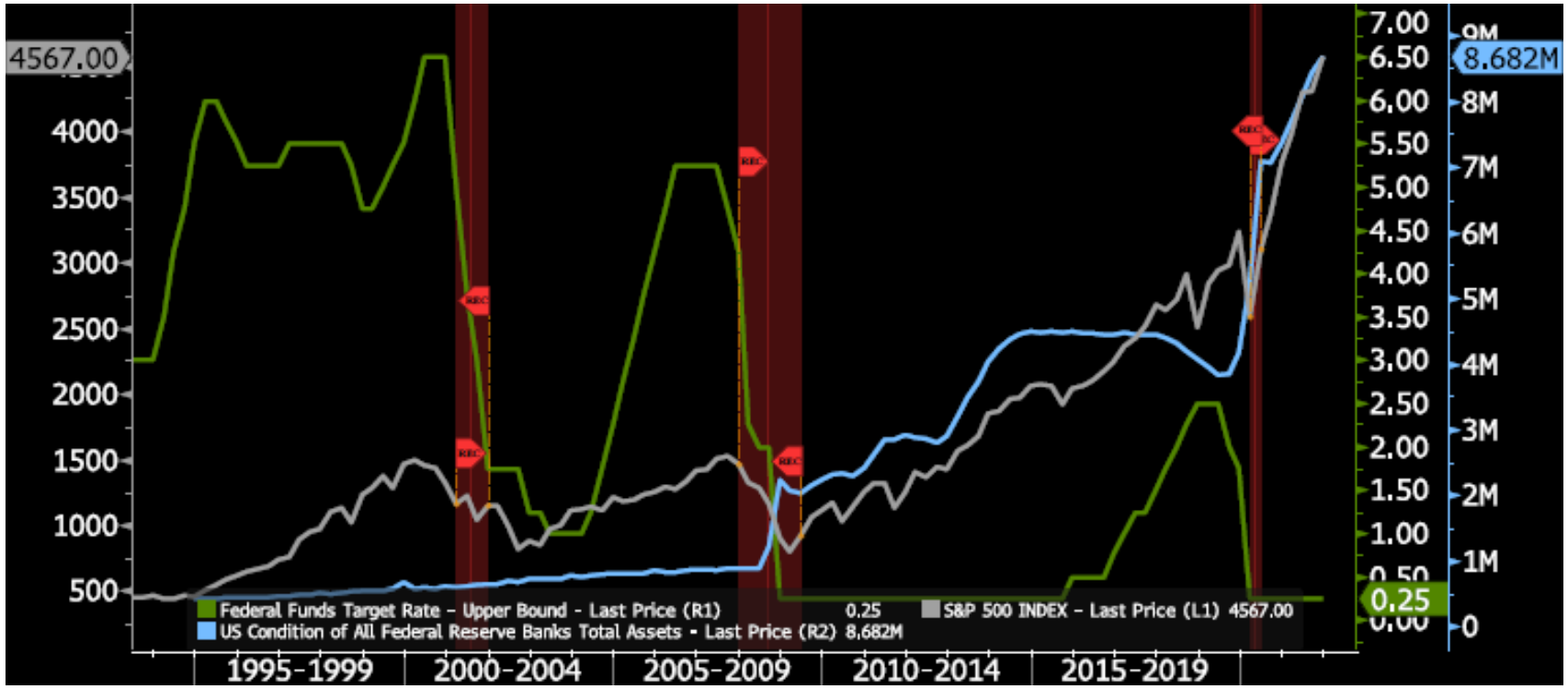
Overall, Stay Invested And Use Pullbacks As Buying Opportunities



- Ultimately, we believe it makes sense to keep portfolios invested throughout 2022 despite the likelihood of more volatility relative to 2021.
- We also think investor expectations need to be reset. While forward-looking equity returns are likely to be positive, we believe they will be lower than the last three years.
- Additionally, our conviction is strong that growth will remain robust, and a recession is highly unlikely.
- Looking at the chart, it is important to remember and note that corrections outside of recessions should be used as buying opportunities, and that will be our plan if we experience a pullback this year.

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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.
- Russell 1000 Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

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