# 2015 OUTLOOK

## Navigating Divergent Waters

WATERLOO
CAPITAL MANAGEMENT


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"One ship drives east and the other drives west by the same winds that blow. It's the set of the sails and not the gales that determines the way they go."

*– Ella Wheeler Wilcox*

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"We expect the theme of 2015 to be divergence, as markets, sectors, countries, and central banks begin to show increasing incongruities..."

## 2014 Review

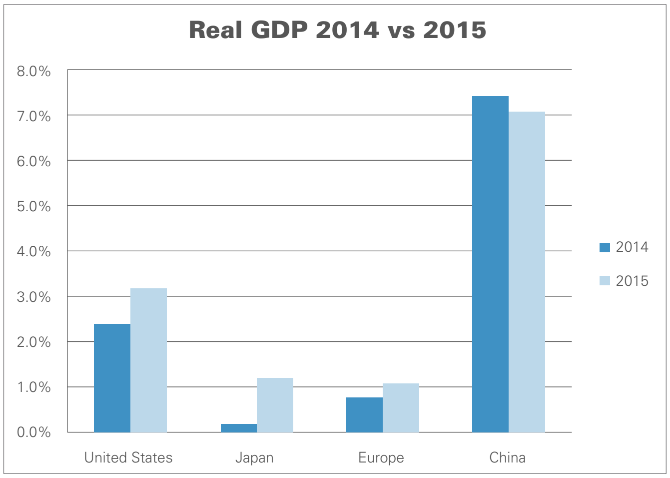
The bull market run was resilient in 2014 despite facing several headwinds throughout the year. The year began with tensions in Eastern Europe, as Russia took advantage of instability in Ukraine to annex the coastal region of Crimea. This was followed by the largest Ebola outbreak in history, increased energy production in the U.S., and the decision by Saudi Arabia not to cut production put downward pressure on oil futures prices beginning in July. Global economic weakness, a rising U.S. dollar, and a report by the IMF which warned of a global growth slowdown had the effect of cratering energy prices in the second half of the year to lows not seen since 2008. Additionally, the U.S. Federal Reserve elected to remove its quantitative easing policies which had served to buoy markets since the program was launched in 2008.

Despite these issues, U.S. equity markets were relatively calm, facing only two pullbacks throughout the year. The S&P 500 finished the year up 11.4% and S&P earnings per share increased 6% compared to 2013. Large cap stocks served as a global safe haven and outperformed small caps by 9%, the largest margin since 1998. The performance of the bond market was one of the biggest surprises of 2014. The consensus call that interest rates would rise during the year turned out to be one of the worst forecasts of 2014. The U.S. 10-year Treasury started the year at 3.0% and finished the year at 2.17%. U.S. fixed income generated positive returns for all durations and 20-year Treasuries appreciated 27.5%, outperforming the stock market by a considerable margin.

## 2015 Intro

We expect the theme of 2015 to be divergence, as markets, sectors, countries, and central banks begin to show increasing incongruities. The U.S. Federal Reserve has removed accommodative monetary policies while the European Central Bank, the Bank of Japan, and the People's Bank of China have made commitments to increase accommodative monetary policies. We believe this will create tensions in currencies, global trade, and equity prices ultimately leading to spikes in volatility that we have rarely seen since the onset of quantitative easing by the Federal Reserve in 2008. The increase in divergence has led the global economy into uncharted waters and is reshaping policy-making guidelines around the world. In our opinion, the divergence of global monetary policies will be the strongest external factor facing global equities in 2015. While it appears that economic improvements are gaining traction in many parts of the world, many economies are still struggling to surmount stubborn economic woes. The end results are impossible to predict, but we expect 2015 to be a year in which investors should expect some turbulence.

Many of our economic forecasts are similar to where they were 12 months ago. The U.S. is likely to achieve above trend growth with GDP approaching 3%. The U.S. economic recovery is on solid footing: job creation has remained strong, corporate earnings are accelerating, and consumer spending should accelerate with higher wages and lower energy prices. Europe and Japan will fight deflationary pressures; however, we forecast growth in both regions to be around 1%. China will continue its deceleration, but still achieve 7% growth. U.S. interest rates will rise in 2015, and the 10-year US Treasury will end the year at or above 3%.




*Data as of December 31, 2014 Source: Robert Shiller*

## U.S. Leads the way

The U.S. showed consistent economic improvements in 2014 and should continue to play the lead role in the global growth recovery. GDP growth should continue to outpace Japan and Europe. The dollar is poised to continue appreciating. The removal of quantitative easing (QE), improving domestic growth, higher interest rates relative to other developed economies, and political stability are all factors which contribute to a higher demand and appreciation potential for the U.S. dollar. It is likely that economic growth will need to be generated domestically, as the stronger dollar will hurt exporters and economic demand and growth are muted in the vast majority of the world. Market returns for the year will be driven by earnings growth, not by multiple expansion. However, at current valuations we only forecast for mid-to-high single-digit returns for U.S. equities in 2015.

> "At current valuations we only forecast for mid to high single-digit returns for U.S. equities in 2015."

**S&P 500 IMPLIED TOTAL RETURN FOR 2015**

| S&P 500 | S&P 500 P/E MULTIPLE | | | | | |
|---|---|---|---|---|---|---|
| EPS Y/Y | 16.0 | 16.5 | 17.0 | 17.5 | 18.0 | 18.5 |
| -0.4% | -6.3% | -3.4% | -0.6% | 2.3% | 5.2% | 8.0% |
| 0.4% | -5.5% | -2.6% | 0.3% | 3.19% | 6.0% | 8.9% |
| 1.3% | -4.7% | -1.8% | 1.2% | 4.0% | 6.9% | 9.8% |
| 2.1% | -4.0% | 1.0% | 1.9% | 4.8% | 7.8% | 10.7% |
| 3.0% | -3.2% | -0.2% | 2.7% | 5.7% | 8.7% | 11.6% |
| 3.8% | -2.4% | 0.6% | 3.6% | 6.5% | 9.5% | 12.5% |
| 4.6% | -1.6% | 1.4% | 4.4% | 7.4% | 10.4% | 13.4% |
| 5.5% | -0.9% | 2.2% | 5.2% | 8.2% | 11.3% | 14.3% |
| 6.3% | -0.1% | **3.0%** | **6.0%** | **9.1%** | 12.2% | 15.2% |
| 7.2% | 0.7% | **3.8%** | **6.9%** | **9.9%** | 13.0% | 16.1% |
| 8.0% | 1.5% | **4.6%** | **7.7%** | **10.8%** | 13.9% | 17.0% |
| 8.9% | 2.2% | 5.4% | 8.5% | 11.6% | 14.8% | 17.9% |
| 9.7% | 3.0% | 6.2% | 9.3% | 12.5% | 15.7% | 18.8% |

*Data as at December 31, 2014 Source: Factset*

## Questions remain for foreign markets

As the U.S. ends its QE program and sets the stage for an interest rate hike in mid-2015, central banks in many countries are introducing or expanding accommodative policies. In Europe, the European Central Bank (ECB) has launched a full scale QE program in an attempt to boost investment and stimulate growth and inflation pressures. The ECB decided to launch the program without the blessing of Germany, the strongest economy in the Eurozone. Factions between the countries pushing for reform and austerity, and those supporting monetary stimulus could make future policy decisions more challenging. The UK is the closest counterpart to the U.S. in terms of growth, recovery, and monetary policy. The Bank of England (BOE) announced that it will raise interest rates in mid-2015, but stagnant inflation and uncertainty regarding May elections may delay an increase until later in the year. Japan has shown no signs of putting the brakes on its accommodations any time soon. Prime Minister Shinzo Abe may have a difficult time rolling out the structural reforms he proposed under the third arrow of his economic reform program, dubbed "Abenomics". The third arrow is aimed at an array of economic challenges as well as corporate governance regulations and cultural taboos, such as allowing Japanese households to sponsor foreign maids to care for children and the elderly, efforts which have been previously stymied. From an investment prospective, investors could consider Europe and Japan as being in a similar market environment to the U.S. in 2011 or 2012. Accommodative central bank policies may serve to boost equity prices, however investors should expect heightened volatility. The range of expected outcomes in these two regions are wide, however valuations are attractive and prolonged accommodation should provide some downside protection. The patient, long-term investor in these areas should be rewarded.

| | USA | Europe | UK | Japan | MSCI AC World |
|---|---|---|---|---|---|
| Shiller P/E | 24.1 | 14.8 | 12.4 | 24.7 | 19.1 |
| Long Term Media | 19.5 | 16.6 | 14.6 | 38.4 | 17.5 |
| Discount | | -17% | -17% | -43% | 1% |

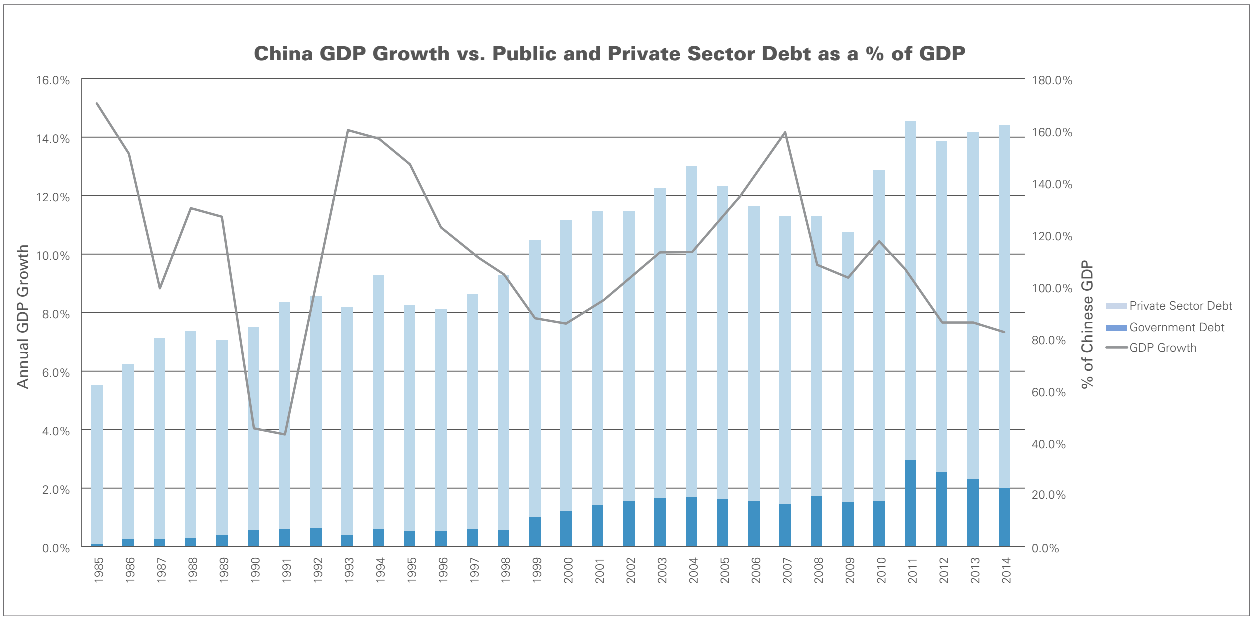
*Data as at December 31, 2014 Source: Robert Shiller*

"Investors could consider Europe and Japan as being in a similar market environment to the U.S. in 2011 or 2012. Accommodative central bank policies may serve to boost equity prices, however investors should expect heightened volatility."

## Slowdown in China

The rate of growth in China appears to have leveled out and is now slowing down. In 2015 the U.S. will contribute more to global GDP than China for the first time since 2006. The government has been wary of using excessive amounts of monetary stimulus to catalyze growth while it implements expansive structural reforms. Policymakers are attempting to shift China's economic growth from a debt-fueled economy to one that is consumption driven. So far, the government seems to be content with accepting slowing growth while reforms are being implemented. The slowdown could be partially offset by increased demand for Chinese equities stemming from the Chinese stock market link with the Hong Kong exchange. Additionally, the introduction of provincial-level government lending has created the municipal bond market in China and should help boost investment in local economies. However, this fact may also signal that the nation's debt load has become unsustainable, leaving the central bank few options to stimulate growth. Since 2008, private sector debt-to-GDP has increased 78.2%. Chronic overinvestment in real estate in the last decade has left a huge overhang of housing stock in the country as well. While a hard landing is not likely, investors should be wary of heightened tail risks.

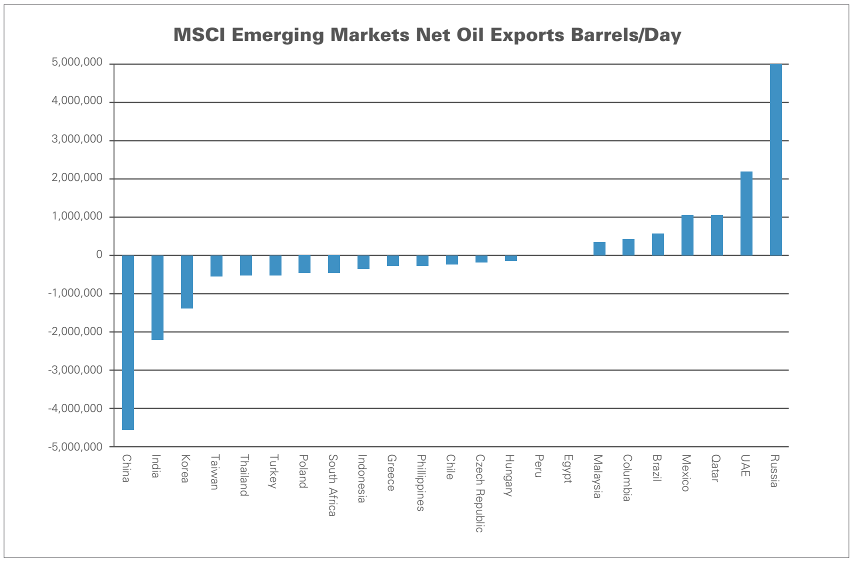
"In 2015 the U.S. will contribute more to global GDP than China for the first time since 2006."




*Source: IMF and World Bank*

## Emerging markets shift to idiosyncrasy

The vast majority of emerging and frontier market countries' economies depend predominately on developed market demand and growth. The lack of global growth has led to idiosyncrasies in the economic growth and outlook for emerging market countries. The precipitous decline in commodity prices paired with stubbornly low global inflation and a strong U.S. dollar have created substantial headwinds for many countries. Countries that are supported by commodity exports or have a large amount of debt held in U.S. dollars are almost sure to struggle this year. That being said, we think that this discrepancy in the market will provide opportunities to take advantage of pricing dislocations in countries and sectors with strong fundamentals. Countries that are net importers of oil will likely see a net benefit from lower oil prices. Changes in central bank and governmental policies should also be a positive development in many countries. Accommodative reforms are likely to drive growth on a country-by-country basis. We think that India, Mexico, Turkey, and the Philippines are a few of the countries in which these conditions exist.




*Source: CIA World Factbook*

> "The precipitous decline in commodity prices paired with stubbornly low global inflation and a strong U.S. dollar have created substantial headwinds for many [emerging market] countries."

## Cautious outlook on fixed income

Interest rates in developed economies began the year at unprecedentedly low levels. In January, U.S. 10-year Treasury yields fell to 1.65%, near the cyclical lows experienced in 2012. However, relative to other developed economies, U.S. yields seem sky high. Due to global central bank policies, many sovereign bonds offer negative real returns. Looking forward, the global landscape of suppressed yields greatly decreases the return potential for fixed income investments. Since the end of January, rates on the 10-year Treasury have actually reversed course and are approaching 2%. Assuming U.S. economic growth continues, we see this trend continuing throughout the year. We think that unconstrained strategies will be able to take advantage of a rising interest rate environment in the U.S. and the UK. High-quality fixed income with medium term duration will be useful for hedging against stock market volatility while mitigating the effects of an interest rate hike on the yield curve. An attractive area in fixed income is high yield. Despite recent volatility, current pricing in "junk bonds" (i.e. CCC rated debt) imply default rates of greater than 80%. In the near term, a spike in defaults is not likely. Rather than stretching for return in public high-yield vehicles, we favor distressed credit hedge fund strategies that can arbitrage the liquidity premium which ETFs and mutual funds sacrifice.

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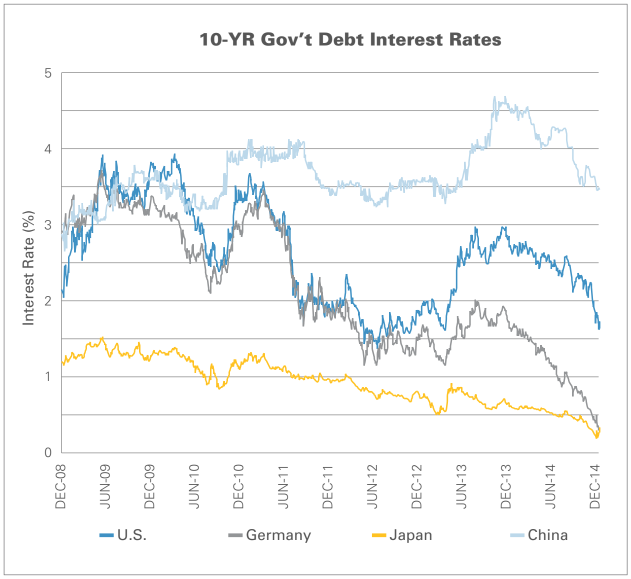
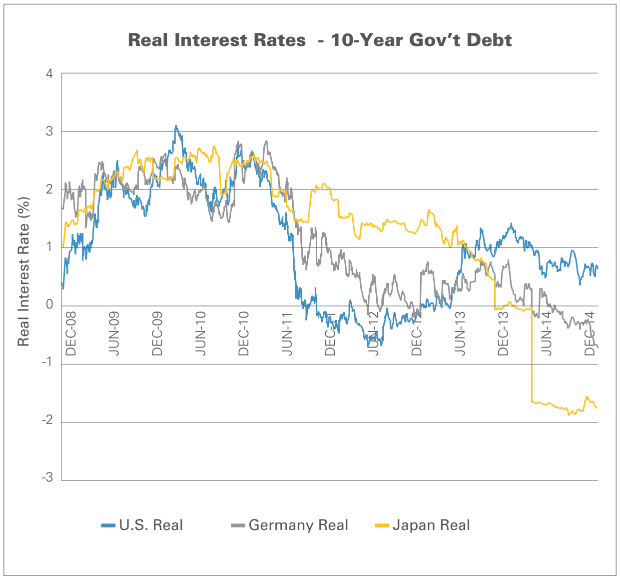



*Source: Bloomberg*

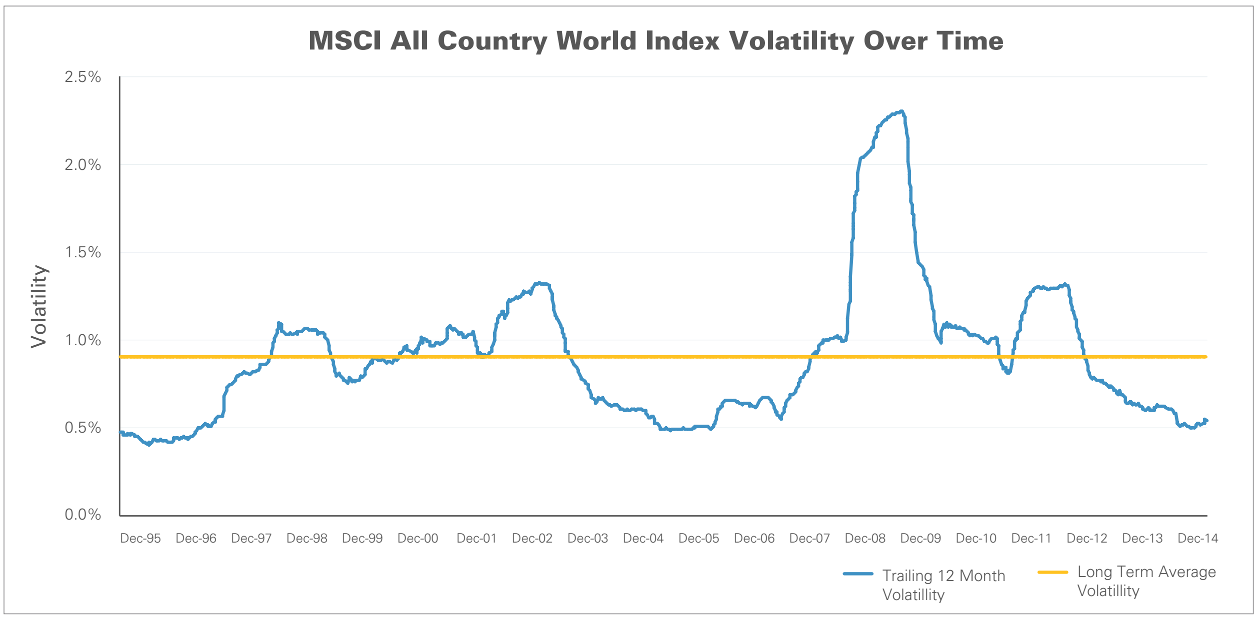
## Positive environment for hedge fund strategies

Many hedge fund strategies have struggled to maintain pace with equities over the last few years. The struggles are due in some part to markets' reliance on central bank accommodation, which has inflated asset prices and artificially subdued volatility. The return of market volatility and divergence of global growth and policies should be powerful tailwinds for hedge funds. Dislocations in international currencies and interest rates create opportunities for long/short, relative value, global macro, managed futures, and systematic hedge fund strategies. These strategies are at their best when markets' and countries' growth outlooks deviate and volatility becomes ubiquitous. In our discussions with hedge fund managers, they do expect a spike in volatility in 2015 and are prepared to exploit that market environment when it occurs.

"Dislocations in international currencies and interest rates create opportunities for long/short, relative value, global macro, managed futures, and systematic hedge fund strategies."

## Divergence in global monetary policies create dislocations and tactical opportunities

The tensions created by diverging global monetary policies will create levels of volatility not seen for some years in global markets. We suggest utilizing volatility to tactically deploy capital in market downturns. Market dislocations (i.e. "baby thrown out with the bathwater" situations) should allow opportunistic investors to exploit market mispricing in asset classes, regions, and sectors. In order to take advantage of these situations we are raising the allocation to cash in order to respond to opportunities when they present themselves.




*Sources: Waterloo calculation, based on MSCI data*

> "The tensions created by diverging global monetary policies will create levels of volatility not seen for some years in global markets. We suggest utilizing volatility to tactically deploy capital in market downturns."

| Asset Class | 2015 Target | % Change | 2014 Target |
|---|---|---|---|
| Domestic Equities | 19.0% | | 20.0% |
| Large Cap | 9.0% | -3.0% | 12.0% |
| Mid Cap | 5.5% | 1.5% | 4.0% |
| Small Cap | 4.5% | 0.5% | 4.0% |
| Foreign Equities | 14.0% | | 13.0% |
| Foreign Developed | 10.0% | 1.0% | 9.0% |
| Emerging Markets | 4.0% | - | 4.0% |
| Fixed Income | 10.5% | | 12.0% |
| Global Bond | 5.0% | -1.0% | 6.0% |
| Unconstrained Bond | 3.0% | - | 3.0% |
| Municipal Bond | 0.5% | -0.5% | 1.0% |
| Private Debt | 2.0% | - | 2.0% |
| Absolute Return | 22.0% | | 22.0% |
| L/S Strategy | 4.0% | - | 4.0% |
| Global Macro | 4.0% | - | 4.0% |
| Distressed Securities | 3.0% | -1.5% | 4.5% |
| Relative Value Arbitrage | 2.5% | -0.5% | 3.0% |
| Managed Futures | 3.5% | 2.5% | 1.0% |
| Equity Market Neutral | 2.5% | - | 2.5% |
| Multi-Strategy | 2.5% | -0.5% | 3.0% |
| Real Assets | 9.5% | | 10.0% |
| Domestic REIT | 1.5% | -1.5% | 3.0% |
| Foreign REIT | 3.0% | - | 3.0% |
| Commodities | 0.0% | - | 0.0% |
| Energy | 5.0% | 1.0% | 4.0% |
| Private Equity | 20.0% | | 20.0% |
| PE Partnerships | 18.0% | - | 18.0% |
| Listed Private Equity | 2.0% | - | 2.0% |
| Cash | 5.0% | | 3.0% |

## Domestic Equity Outlook

U.S. stocks have the economic support to continue their run in 2015. An improving economy and rising corporate earnings should support rising stock prices. While we are optimistic on U.S. equities for the year, we think that at current valuations, equity returns are likely to be capped in the high single digits. One could make the case that smaller caps should outperform larger cap stocks, given that they derive a larger portion of their revenues domestically. However, despite the recent outperformance of large-cap stocks, small- and mid-cap stocks are still over valued compared to 20-year average price-to-earnings multiples, whereas large-caps are fairly valued. Additionally, given the late stage of the market cycle, we favor large-cap equities over small-caps, however this overweight is smaller than in years past. Regarding the U.S. economy, we believe that suppressed energy prices and expected wage growth will put more money in consumers' pockets which should benefit sectors with a growth tilt. We think that an overweight to technology, healthcare, and consumer discretionary sectors will benefit from continued U.S. growth. We are neutral on financials and telecom pre-rate hike, and underweight utilities and basic materials. Following a Fed rate hike, an increased allocation to financials has the potential to outperform and utilities and telecom should be underweighted, as historically these sectors are negatively correlated with rising interest rates.

### Current P/E vs. 20-year avg. P/E

| | Value | Blend | Growth |
|---|---|---|---|
| Large | 15.5 / 14.0 | 16.2 / 16.1 | 18.7 / 21.0 |
| Mid | 16.4 / 14.2 | 18.6 / 16.5 | 20.0 / 21.9 |
| Small | 16.4 / 14.5 | 18.1 / 17.3 | 20.0 / 21.5 |

### Current P/E as % of 20-year avg. P/E

| | Value | Blend | Growth |
|---|---|---|---|
| Large | 110.1% | 100.6% | 89.0% |
| Mid | 118.1% | 112.7% | 94.5% |
| Small | 113.1% | 104.4% | 93.3% |

*Data as of December 31, 2014 Source: JPM Asset Management*

## Eurozone

We recommend a tactical overweight to European equities. The current valuation levels and potential tailwinds from the European Central Bank's (ECB) quantitative easing (QE) program create a fertile landscape for asset appreciation. Aggressive stimulus and recovering corporate profits should also be beneficial to growth in 2015. Equity valuations are cheap relative to the U.S., and if the stimulus package can spark reflationary pressures, there is opportunity to buy into a relatively cheap market with positive earnings momentum. Additionally, risks of a market crash should be somewhat mitigated by the dovish policies of the ECB. We could see European equity markets behaving similarly to the U.S. markets during its QE program. In order for QE to make a lasting impact, the Eurozone needs to have serious credit growth. There is potential for credit expansion emanating from European banks' completion of the ECB's asset quality review program. Banks should be more comfortable lending and QE could push the real interest rate farther into negative territory, encouraging banks to move money into the economy. Another risk will be the struggle for structural reforms to take hold. Reforms in the Eurozone will prove challenging because the different stages of recovery and growth present in the individual countries. The impact of the election of the Syriza party in Greece and their desire to roll back austerity has yet to fully play out and could be the source of volatility in Eurozone markets. If the recent ceasefire between Ukraine and Russian backed separatists holds, that may remove a tail risk that has been lingering over European markets for the last year.

"We recommend a tactical overweight to European equities. The current valuation levels and potential tailwinds from the European Central Bank's quantitative easing program create a fertile landscape for asset appreciation."

# Foreign Equity Outlook

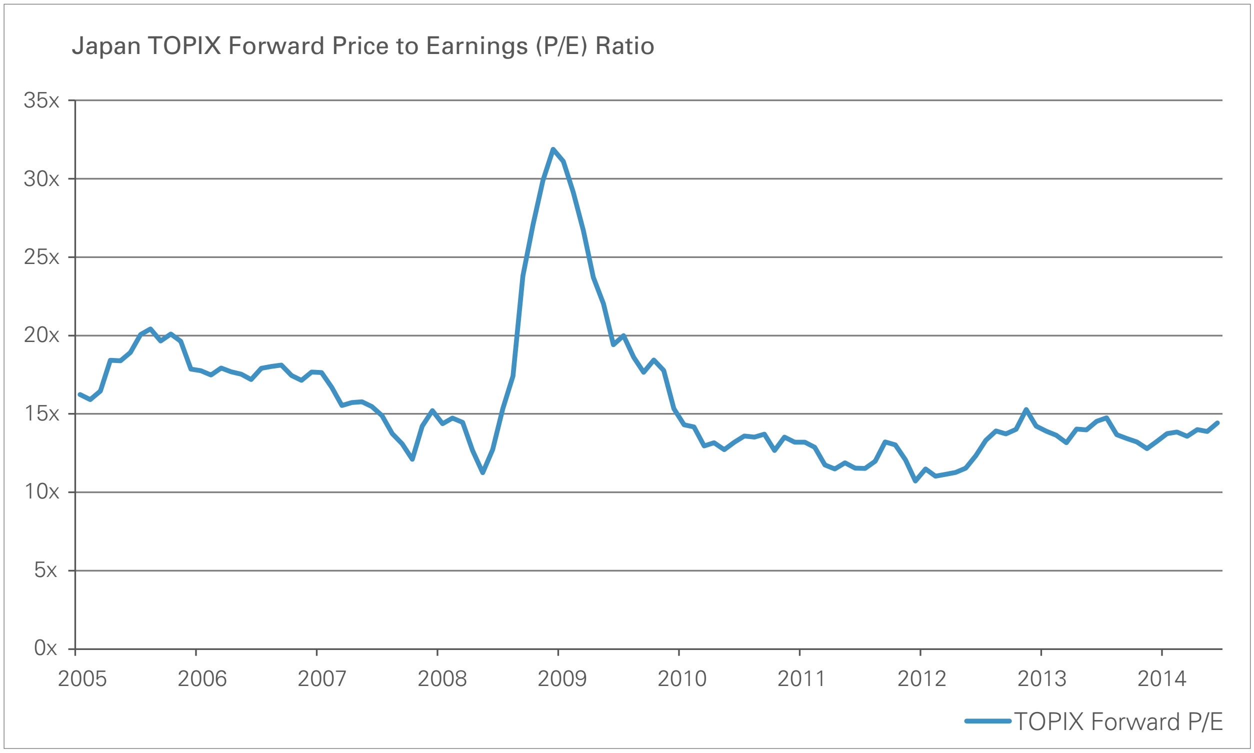
## UK

The UK economy is the most similar to the U.S. in terms of economic recovery. The real estate market has been booming, especially in central London. Unemployment has dropped and appears to be under control, and businesses have been steadily increasing their investment spending. As with the rest of Europe, we see ample opportunity in the UK with a stronger growth backbone. The positive developments in the economy have led to the Bank of England (BOE) giving forward guidance that it will raise interest rates in 2015. We believe that the BOE will stick to its word and raise rates, but the increase may not be as considerable as was expected toward the end of 2014. Economic concerns over global growth and a slowdown in the rest of Europe are still evident. Elections in May could cause an upswing in volatility if the conservative party is victorious and opens the possibility of a referendum on the UK's membership in the European Union.

"The UK economy is the most similar to the U.S. in terms of economic recovery."

## Japan

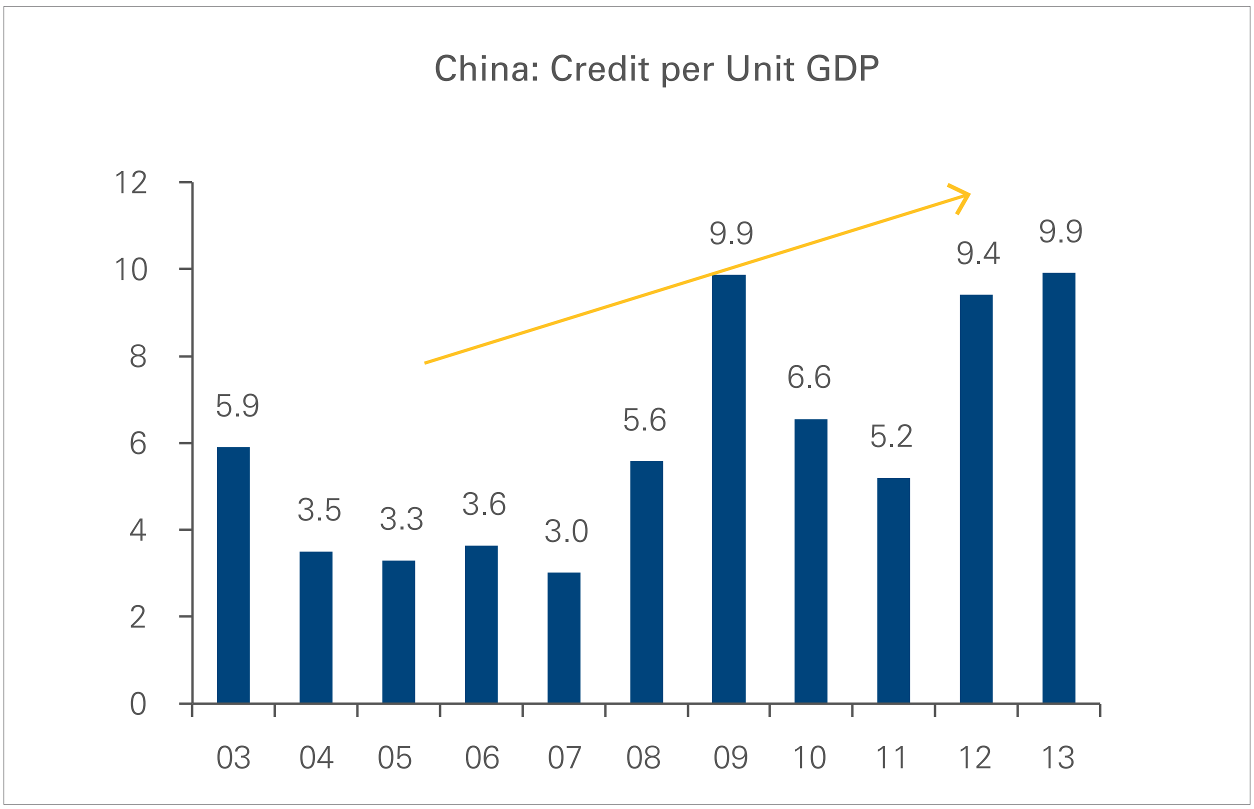
We have a positive, yet cautious outlook for Japanese equities. Deflationary pressures appear to be officially subsiding, which paves the way for inflation to continue getting a boost from monetary easing and yen depreciation. The equity market should continue to be bolstered by the government's easy money policies. Another positive development is the Government Pension Investment Fund's (GPIF) new equity allocation target which is expected to shift $187 billion into stock markets across the globe, likely overweighting its home market. The continued depreciation of the yen should provide some tailwind as it helps boost exports. That being said, there are plenty of risks associated with Japan. Prime Minister Abe has already had to delay a tax hike which is part of a slew of bold structural reforms he plans to push forward. Additionally, foreign investment flows into the country last year were dramatically lower than in 2013. Further QE is much less likely to be announced this year, and the demand for Japanese equities could be constrained by the country's murky growth outlook and uncertainty surrounding the success of structural reforms.




*Source: Bloombeg. Monthly Data, June 2005*

## China

China has the difficult task of using monetary tools to help support growth while implementing fiscal and structural reforms that undermine sectors that have generated strong growth in recent years. Growth is expected to slow, but not fall off of a cliff. We expect demand for Chinese equities to remain robust, driven by the stock market connection with the Hong Kong exchange. Volatility will be a major factor as the kinks in the new market structure are worked out. Wage growth has caused challenges to China's rein as the cheap labor capital of the world, which could impair a large portion of its export economy. Higher wages will not be a total negative for China. The increase in wages will likely lead to an increase in domestic consumption, which is one of the many goals of the government's reforms. The major risks to the market are credit related. There is potential for the financial sector to collapse as massive amounts of credit related to the shadow banking system is unwound. Oversupply in the real estate sector could also lead to potential hiccups for reforms and weigh on investment demand. Even if the reforms are successful, consumption led growth may not be sustainable.




*Data as of October 31, 2014. Source: China National Bureau of Statistics, Haver Analytics*

## Emerging Markets

We are underweight emerging markets as a whole, but we believe that there will be positive growth and equity appreciation in select regions and countries. We are underweight countries that generate the majority of economic growth from commodity exports. Supply slide gluts will make it difficult for these countries to gain ground in 2015. We believe that there are investment opportunities in countries that are net importers of oil or that have an export relationship with the U.S. oil-importing countries will be able to use the lower price of oil to help clean up government balance sheets and to invest money into other important economic factors such as infrastructure. Countries that have a strong export relationship with the U.S. should benefit from continued U.S. growth which should boost demand for these countries' goods. While we do think that a stronger U.S. dollar could put downward pressure on the outlook for commodity exporters, we do not think it will have as great of an effect on countries without a commodity-based economy. Another risk is the continued decoupling of central bank policies in emerging markets. While some central banks, like India, are using loose monetary policies to stimulate growth, other countries, such as Brazil, are tightening policies in order to control inflation and implement structural reforms. The divergence in policies could make it difficult to navigate emerging markets as their economies will begin to move more independently than they have in the past.

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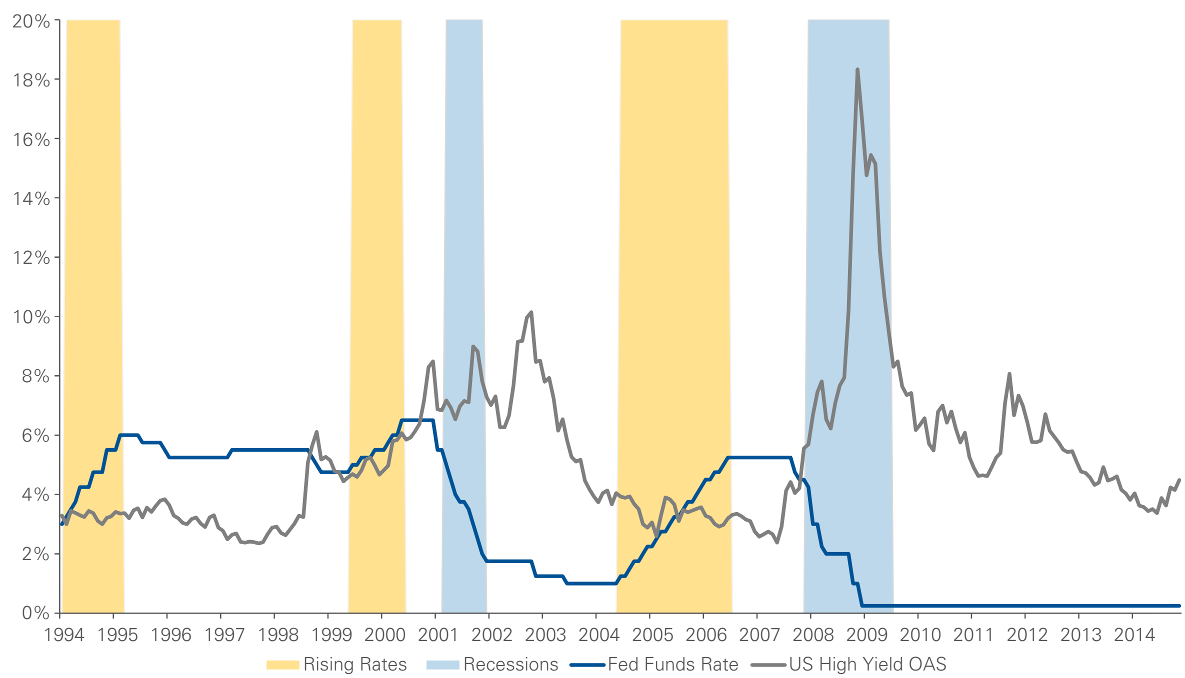
## U.S. Fixed Income

Fixed income was a vexing asset class in 2014. According to Bloomberg, nearly all tracked economists called for rising U.S. treasury yields in 2014 and the median expectation last December was for the 10-year Treasury to rise to 3% by year end 2014. In actuality, yields fell consistently throughout the year and the 10-year U.S. Treasuries finished the year at 2.17%. This year, U.S. fixed income is unlikely to generate similar returns to 2014. U.S. rates still remain high relative to other developed economies, and since finding lows in January the U.S. 10-year rate has reversed course and is now hovering around 2%. With the Fed likely to raise interest rates in mid-2015, the outlook for U.S. fixed income becomes even more unfavorable. When the Fed does announce a rate hike, the yield curve will begin to flatten which is generally a bearish indicator for the bond market. We think that fixed income will be best used as a way to counter the increase in domestic and foreign stock market volatility. Bonds with intermediate term maturities, in the 5-7 year range, should avoid most of the negative effects of interest rate volatility. We also see opportunities in the municipal bond space where improving economic conditions are likely to create more stability in the market. The use of unconventional bond strategies could also help mitigate some fixed-income risks. Unconventional strategies have the ability to generate greater returns when interest rates are rising and therefore act as a hedge and alpha generator during rising interest rate environments. The systemic selloff of high-yield bonds in late 2014 presents opportunity to take advantage of undervalued issues. Because of the higher spreads relative to investment grade bonds, the risk profile for this sector has become much more attractive.

Rising rates have not historically been a negative on High Yield and EMD credit spreads

**SPREAD BEHAVIOR IN RISING RATE ENVIRONMENTS**




*Source: J.P. Morgan, Barclays (high yield OAS).*
*Past performance is not necessarily indicative of future results.*
*As with any investment, there is the possibility of profit as well as the risk of loss.*

International developed fixed income has a bleak outlook, as globally suppressed yield levels will make it difficult to find opportunities in this sector. Interest rates are at or near historical lows in many European countries and in Japan. The UK is expected to raise rates in 2015. We think that demand for these bonds will diminish as the ECB implements QE and Japan continues to keep its monetary policy extremely accommodative. There are potential opportunities in countries with growth prospects and manageable debt-to-GDP levels. Liquidity levels are still adequate to keep the markets moving, and default rates are near historical lows in many areas. QE in Europe should help improve company balance sheets and keep interest rates low, improving the outlook for corporate debt.

> "International developed fixed income has a bleak outlook, as globally-suppressed yield levels will make it difficult to find opportunities in this sector."

## Emerging Market Debt

Opportunities in emerging market debt will be similar to opportunities in emerging market equities. Many countries have strengthened their current accounts to the point where they will be able to survive the downturn in commodity prices and global growth, but the increased risk and lack of upside potential in sovereign emerging market debt is enough for us to avoid the market at this time. Local currency debt has some potential, but the opportunities need to be evaluated on a country-by-country basis. Currency risk is the main deterrent to investing in local currency debt. If the dollar continues to appreciate against global currencies, the higher yields on local emerging market debt could potentially be wiped out by the effects of exchange rates. Given the likelihood of an appreciating U.S. dollar, we recommend avoiding the asset class.

> "Given the likelihood of an appreciating U.S. dollar, we recommend avoiding the [emerging market debt]."

We have mixed views on U.S. real estate in the near term. A rising interest rate environment could prove detrimental to real estate demand, but we think that this headwind can be overcome. Supply has not been able to keep up with demand in many regions of the U.S., and therefore we expect new construction and the current demand to continue putting upward pressures on the market. The market should also be bolstered by capital expenditures by companies that have strong balance sheets and ample amounts of cash to spend on expansion and building upgrades. That being said, valuations have gotten a bit frothy for publicly traded REITs. Internationally, Japanese property market fundamentals are showing signs of a recovery, and infrastructure should get a boost from spending related to prepping for the 2020 Olympic Games. In China and Hong Kong, property sales and price growth are likely to decelerate as government measures will subdue sales and prices. In Europe, positive economic results in the UK will continue to support real estate fundamentals, but the downward revision of economic forecasts in the rest of Europe may put downward pressure on prices in 2015. On a positive note, unemployment in Europe appears to be stabilizing. If unemployment remains low and the ECB's stimulus package can generate consumer confidence, we expect the demand for real estate to increase.

"A rising interest rate environment could prove detrimental to real estate demand, but we think that this headwind can be overcome."

## Real Assets

We have a negative outlook for real assets. The supplies of nearly all major commodities have grown at a faster rate than demand and as a result, prices have fallen drastically in the commodity markets. Also, because they are priced in U.S. dollar terms, a stronger U.S. dollar without inflation puts downward pressure on commodity prices. Most notably, oil fell to a 6-year low and had still not stabilized at the beginning of 2015. Crashes like those seen in the oil market tend to overshoot on the bottom end, and we expect that oil prices will begin to stabilize during the first half of the year and should end the year higher than they started. The cooling global growth outlook and tempered inflation expectations will be major headwinds for the commodities market. A slowdown in China also tempers our expectations in this sector. The real estate boom in China has left the country with oversupply, and reforms in the debt market discourage future investment in this sector. Seeing as China has been one of the largest importers of many commodities, this development will most likely put additional strain on prices. Although the energy market has been systematically declining, we see opportunities in MLPs, oil and gas services, and energy storage. These subsectors have been dragged down with the rest of the oil market, but many of the companies remain fundamentally sound. U.S. oil production is actually expected to increase in 2015 due to the number of wells currently in operation. As long as production is not slowing, the aforementioned subsectors will still operate as usual, many under contractual agreements which help keep cash flow steady. The vast majority of energy infrastructure projects have continued to move forward despite the decline in oil prices.

"The supplies of nearly all major commodities have grown at a faster rate than demand and as a result, prices have fallen drastically in the commodity markets."

The return of volatility to the markets, as well as the global divergence of economic policies and reforms creates an enticing investment landscape for many hedge fund strategies. Relative value, long/short, and systematic strategies tend to perform well during periods of increased volatility. Disparity between the central banks' policies and goals is likely to create tensions between international currencies and interest rates. These tensions create alpha generation opportunities for global macro strategies and relative value strategies. The distressed credit sector took a big hit with falling oil prices, but the systematic decline has created opportunities for distressed credit managers to capitalize on undervalued issues that were pulled down with the market but whose fundamentals have not changed. We will continue to include an overweight allocation to hedge fund strategies as a means of improving the risk-return characteristics of our portfolios.

"The return of volatility to the markets as well as the global divergence of economic policies and reforms creates an enticing investment landscape for many hedge fund strategies."

## Private Equity

Valuations in the private equity market have become inflated along with the stock market. Easy financing and large amounts of dry powder have also contributed to driving acquisition multiples higher. We expect 2015 to be a positive year for funds that already have capital deployed because the increase in acquisitions, buy-outs, and mergers is likely to continue in 2015 despite the surge in multiples. We are less optimistic toward new private equity vehicles currently being raised. Deploying new capital in the current market environment will make it difficult for funds to generate positive returns seeing as acquisition multiples are not likely to extend much farther beyond current levels during the average life cycle of most funds. Manager selection will continue to be the most important factor in selecting quality private equity investments. We believe that our private equity investments will continue to strengthen as the managers that we have allocated to continue to find and develop quality investments.

> "Manager selection will continue to be the most important factor in selecting quality private equity investments."

> "I think that the first thing is you should have a strategic asset allocation mix that assumes that you don't know what the future is going to hold."

*– Ray Dalio*

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