2017 OUTLOOK

Back to Business

WATERLOO
CAPITAL MANAGEMENT

Authors:
John Chatmas – Chief Executive Officer
Bennett Woodward – Chief Investment Officer
Don Simoneaux – Managing Director - Alternative Investments
Trey Graham – Analyst

March 2017

Introduction to Our New CIO

We'd like to take this opportunity to introduce our new Chief Investment Officer, Bennett Woodward. We've known Ben and his team for several years and, effective last November, his firm, Black Diamond Investment Partners, is now part of Waterloo Capital Management. Ben brings a wealth of experience in the investment industry, having previously served as Chief Strategist for the ING Investment Centre and subsequently Director of Equities for the $100 billion Teacher Retirement System of Texas.

Ben has spent the past few years developing a proprietary model for identifying trends in the stock market. Ben's model relies on a neural network, which utilizes past data and computational artificial intelligence to predict changes in market dynamics. We can say with certainty that his work is cutting edge in the investment industry. As we sat down to write our Spring 2017 Outlook we worked with Ben to incorporate his research into our core investment themes for the year. In past years, we've approached this research as top-down macro-economists, utilizing fundamental data and research to build our themes. Ben's approach takes a quantitative view of the market, stripping away the noise and emotion from investing. We think that our combined firm has enormous synergies which will translate to more consistent investment performance.

To better explain his work, Ben has written a white paper which describes his models and the science behind it. We've included a few excerpts below.

John Chatmas
CEO - Waterloo Capital Management

"Differences in the concepts of randomness and chaos are crucial to our abilities to make predictions about a system with complex and chaotic properties. A random system that the efficient market hypothesis supposes is totally unpredictable so they (investment managers) recommend giving up and indexing. Chaotic processes are controlled by several competing paradigms: Stability, Memory, and Sudden and Drastic Change. Stability is seen in the stock market as a stock trend either increases or decreases."

"Creating a model of chaotic systems using mathematics is difficult due, in part, to what is commonly referred to as the Butterfly Effect. Small changes can cause drastic changes in the outcome. However, the presence of gradual trends and the rarity of drastic events, such as we see in the stock market, can be modeled well enough to exploit. Through use of artificial intelligence and machine learning people like us are discovering that there is an intermediate state between random white noise and random walk noise. In chaotic processes, past events influence current and future events. In statistics, this connection between a time series and its past and future values is called autocorrelation. While autocorrelation functions for random processes decay exponentially, for chaotic processes they have a certain degree of persistence which makes them exploitable for making predictions and forecasts. This is crucial, as it allows us to examine the high ordered polynomial equations that describe trends in prices and relative performance."

"Due to the complicated nature of modeling chaos using statistics, scientists look to computers to solve problems. Artificial intelligence and machine learning have proven to be incredibly successful in modeling chaotic structures and ultimately in making predictions. The purpose of machine learning is to generalize trends that most of use can't comprehend. The machine, aka the computer, can take in an inordinate amount of data, find patterns within the data and then predict change based on the hidden patterns that it finds. We have found that it is possible to make much more accurate predictions about future market behavior using machine learning techniques. This approach is the root of our predictive algorithm, GMDH which stands for Group Method of Data Handling."

"We constantly track market data, adding it to the database of historical time series data. Then, based on this database, using a proprietary GMDH algorithm, we can make accurate forecasts and predictions for market action over differing time horizons. As our computer receives more additional data input, the algorithm learns from its successes and failures to optimize high order polynomial curves that accurately describe the time series of data. The GMDH methodology forecasts waves in market action giving insight into current and possible future trend trajectories. Each week our GMDH algorithm analyzes raw data to generate an updated forecast for over one thousand Exchange Traded Funds (ETFs), hundreds of mutual funds, and highly liquid stocks with market capitalizations of over a billion dollars. Our GMDH method then produces "noise filtered" signals that we can analyze quickly. These signals represent predicted movement direction -- up, down, topping or bottoming, and the angle, or slope, of the increase or decrease for each asset. The model also calculates the statistical predictability of the historical correlation between the past GMDH predictions and the actual market movement for each asset. We have found it best to avoid securities that top and begin to trend down especially when the model has shown high correlations between past forecasts and subsequent action. For example, when we first fed our computer mountains of information back in mid-2014, it suggested a topping in energy prices and energy related securities. Few fundamental or any other type of analyst was making any kind of forecast that foresaw this. I searched everywhere and most fundamental analysts, macro-analysts, and economists were bullish. The price of oil and the energy sector theb fell over 50%, and many formerly high flying companies even went bankrupt. As we watched this unfold in 2014 and 2015, we fed the computer more historical data from earlier in the decade and low and behold, it picked up the coming financial crisis of 2008 and the dotcom crash of 2000 months before they happened. This is when we kicked our research into overdrive. I have created some very good models that have helped me to analyze leading performance before, but in my opinion, this is the best model that I have developed thus far and I will never attempt to manage money without its aid in the future. I think it's that good."

- Bennet Woodward - CIO, March 2017

Table of Contents

2016 Review

2016 will go down as the year where the market "got it wrong" time and time again. Several times during the year the market was caught off guard by major events which contributed to bouts of volatility and forced investors to reassess their investment assumptions. The year began with a sell-off sparked by the belief that China could not stabilize its economy and would see its GDP contract significantly. Additionally, oil prices continued to plummet as the supply and demand dynamics of the market remained out of sync.

The Brexit vote was the next test, and market participants had it wrong once again. Most investors and market observers assumed a "stay" vote was certain. Financial markets were blindsided when the referendum passed and British and European markets collapsed. The dramatic effect on the markets led many economists to forecast an immediate recession in the UK and a reversal of economic gains in the eurozone. However after a two day downturn, markets captured back all of their losses and soared higher, confounding investors again.

Finally, the U.S. presidential election shocked the markets in both the nature of the victory and the ensuing reaction. Nearly all political pundits gave Donald Trump little chance to win, and most were of the opinion that Trump would be disastrous for both the economy and the financial markets. Leading into election week, markets experienced a "relief rally" when a Clinton victory seemed certain. The election night polls told a different story than the prediction polls, and Donald Trump cruised to a surprising and profound victory. Similar to the Brexit, Dow futures fell over 800 points in afterhours trading. However, in the days following the elections, stock markets rallied to new highs and pundits reversed their outlook for the U.S. economy under Trump.

Domestic Equities	
DJ Industrial Average	16.50%
S&P 500	11.96%
NASDAQ	8.87%
Russell 3000	12.74%
Russell 1000 Growth	7.08%
Russell 1000 Value	17.34%
Russell Mid Cap Growth	7.33%
Russell Mid Cap Value	20.00%
Russell Small Cap Complete	16.59%
Russell Small Cap Value	24.26%
Foreign Equities	
MSCI World ex USA	-0.13%
MSCI EMU	-2.82%
MSCI EAFE	1.00%
MSCI EM	11.19%
FTSE China 50	-0.79%
Fixed Income	
Barclays US Agg Bond	2.65%
Markit iBoxx Liquid IG	2.38%
Barclays US Treasury 7-10 Yr	1.05%
Barclays US Treasury US TIPS	4.68%
S&P National AMT Free Muni	0.36%
Barclays US MBS	1.67%
Real Assets	
S&P GSCI	11.37%
FTSE NAREIT All Equity REITs	8.63%
DJ US Real Estate	3.31%
LBMA Gold Price PM	8.10%
Oil Price Brent Crude	52.14%

Outlook 2017: Back to Business

2016 Review

Even though the markets "got it wrong" many times last year, the rapid rebound in asset prices showed the resilience of the current economic recovery and the strength of investor sentiment. In a world starved for yield, the demand for risky assets has remained high. Bouts of excessive volatility like those experienced during 2016 could have sparked contagion sell-offs and shaken the core of the global economic recovery. Instead, these events created attractive buying opportunities for long-term investors.

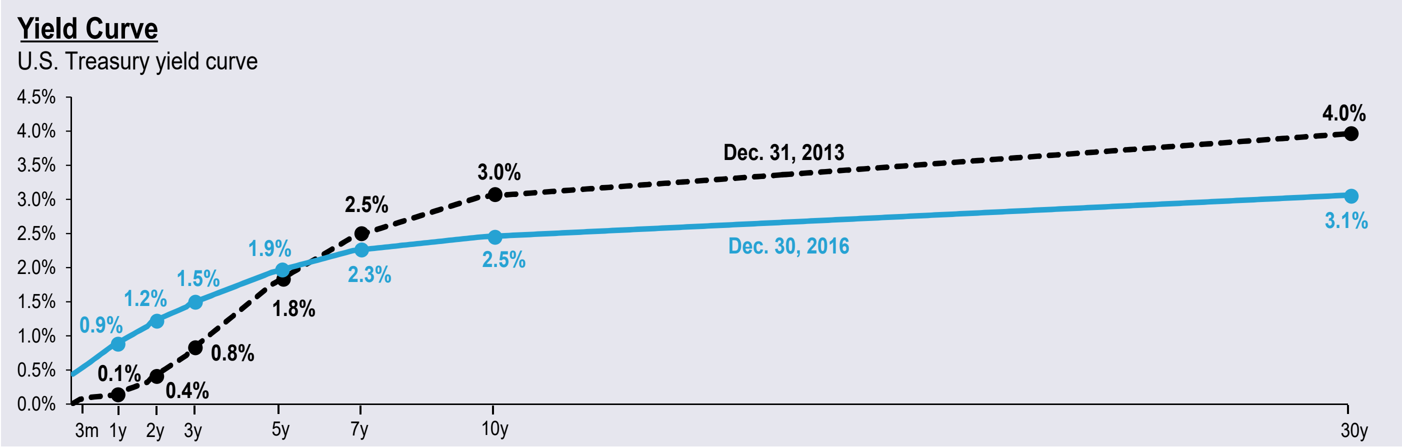
The events of 2016 laid a foundation for a market environment that is notably different from that which investors have become acclimated to since the end of the Global Financial Crisis (GFC). Central bank strategies are shifting and diverging as monetary support has nearly run its course in developed economies and appears to lack the vigor to support sustainable economic growth. Fiscal policy and geopolitics are edging their way to the forefront of economic sway across the globe. As we look ahead, we expect factors related to both of these domains to be the most important drivers of the economy. The current expansion still has room to run, but the potential for surprise downside stresses on the market will continue to increase. Evolving policies will lead to dispersion in the outlook for market returns among regions as well as asset classes. All ships will no longer rise with the tide. Selectivity and active portfolio management will be essential to successfully navigating the new environment.

Waterloo's active portfolio management strategy is designed to thrive in environments where the market direction can change dramatically on short notice. Our diligent study of market internals, asset class interrelationships, macroeconomic factors, and quantitative analysis leads to the generation of portfolios specifically crafted to take advantage of attractive market opportunities while actively managing downside risk. The 2017 economic landscape is sure to generate many challenges. The Waterloo team looks forward to navigating through whatever comes our way.

> "2016 will go down as the year where the market "got it wrong" time and time again."

Higher Interest Rates and Inflation

One of the most important market events of 2016 was overshadowed by the media frenzy surrounding the U.S. presidential election and the Brexit vote. In July, the U.S. 30-year Treasury rate bottomed, signaling the beginning of the end for the bond bull market which began in the early 1980's. The aftermath of Donald Trump's election victory and the Federal Reserve's decision to raise interest rates sparked higher short-term interest rate expectations for 2017 leading to a flatter yield curve and a swift sell-off in fixed income securities. We expect rates to continue moving higher over the next year based on higher inflation expectations and additional rate hikes from the Federal Reserve. The 10-year Treasury will likely end the year between 3% and 3.5%. If we see rates accelerate through 3.5%, we expect turbulence in bonds as well as equities. At those levels current market valuations become excessively stretched and hard to justify.



Source: J. P. Morgan Asset Management, FactSet

We expect inflation to trend higher in 2017 based on a multitude of factors. The labor market is near full employment which puts upward pressure on wages and, in turn, inflation. Additionally, prices have continued to rise in some of the largest household spending categories. Health care and housing cost increases have outpaced inflation for many years, and this trend shows no signs of slowing down. Inflation is also influenced by government policies. The new regime in Washington is expected to promote fiscal policies which stimulate inflationary pressures. Infrastructure spending, defense spending, corporate tax reform, and personal tax reform have all been floated as key focus areas for President Trump. While a bill proposing increased infrastructure spending is likely in 2017, it is unlikely that inflation will be affected before the end of the year due to the slow moving nature of infrastructure projects. The most likely policy change to affect 2017 inflation is corporate tax reform. Creating a more accommodative corporate tax structure encourages companies to expand domestic operations and frees up capital for business spending, something which has been severely lacking during the recovery. An increase in business spending paired with strong consumer activity and a growing ecnomy puts upward pressure on prices.

Monetary policy will take a backseat to fiscal policy this year, but the Fed will continue to exert influence on the economy despite the end of QE. Fed policy remains accommodative by historical standards, and it is important to remember that rates are going up for the right reasons. The economy is getting stronger, and as consumers and businesses continue to strengthen we need to have higher rates. The challenge facing the Fed is finding the right pace to tighten policy rates. Fed Chair Janet Yellen has flip-flopped around the idea of letting the economy "run hot" in order to boost growth and inflation. Our concern is that the Fed will feel that it is no longer in control of the economy.

Higher Interest Rates and Inflation

The Fed's voting committee has been following the market since the GFC and could begin raising rates faster than expected in order to regain a feeling of control. After the first rate hike in March, we expect all remaining Fed meetings which include press conferences (June, September, and December) to be live rate hike meetings. The Fed will likely raise rates at least twice again this year, and we expect the Federal Funds Rate to end the year between 1.25% and 1.75%.

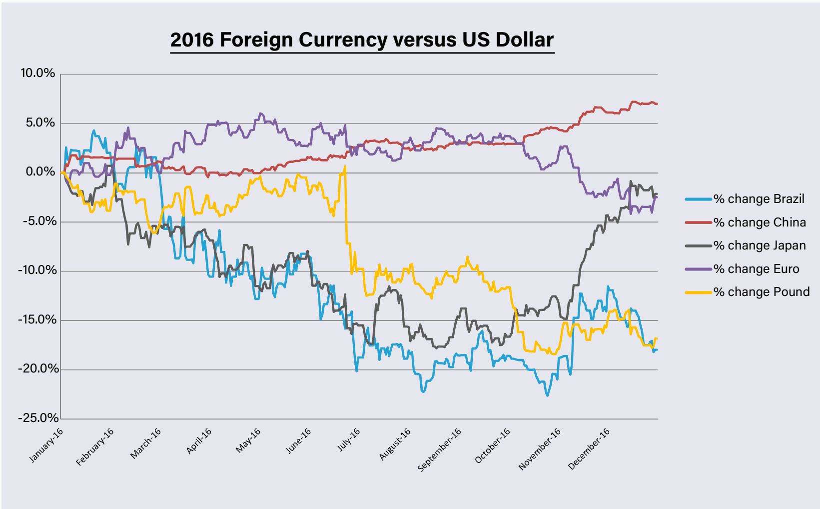
The rise in yields is due to increased expectations for more fiscal spending and the possible inflation that may cause. Investors hope that fiscal stimulus will boost economic growth, but the U.S. deficit and inflation must be controlled too. Most businessmen and investors are applauding a move towards more fiscal stimulus and growth that the new administration campaigned upon. However, these factors are already pushing the Federal Reserve to raise interest rates more aggressively than previously believed and, in turn, pushing up yields on U.S. Treasuries. Markets that appreciate due to higher growth expectations, like equities, like what they see thus far, but opinions and market levels can change quickly. If market participants collectively think the Fed is becoming hawkish in its efforts to keep inflation in check rising rates will become a headwind to future growth.

As former Fed chief, Ben Bernanke remarked, "the slope of the Treasury yield curve" has been "recognized for some time as a useful indicator of cyclical conditions," in that it "has turned negative between two and six quarters before every U.S. recession since 1964," that U.S. recessions invariably have "followed the inversion of the yield curve," and that the yield curve "captures the stance of monetary policy." This latter concession means that the Fed can easily and deliberately flatten and then invert the yield curve whenever it chooses, either with short-term rate hikes or passivity in the face of falling long term bond yields. Likewise, the Fed can always act to prevent an inverted yield curve, and thus prevent future recessions like it has done consistently since the GFC with an unprecedented zero interest rate policy. Notably, the U.S. yield curve has first flattened and inverted prior to all seven U.S. recessions in the past half-century and no recession occurred in that time without a prior inversion. That's a perfect forecasting record that our models constantly monitor!

"In July, the U.S. 30-year Treasury rate bottomed, signaling the beginning of the end for the bond bull market which began in the early 1980's."

Geopolitics Catalyze Volatility

In 2016, geopolitical events dominated the headlines and led to dramatic short-term bouts of volatility. We expect the geopolitical landscape to continue catalyzing volatility throughout 2017. Europe is a hotbed of geopolitical activity. Populism continues to gain momentum and multiple elections this year will lend insight into the movement's traction. The Netherlands, France, and Germany have elections which will likely feature a populist candidate. Italy has clearly been affected by the populist Five Star Movement which influenced the outcome of the December referendum that led to the resignation of the president. Additionally, Greece remains a stubborn reminder of the EU's struggles to support its fledgling peripheral economies, and Brexit negotiations will likely inject more volatility into the region.



Source: St. Louis Fed

Currency fluctuations will also be one of the strongest drivers of volatility. Although it rarely makes the headlines, the currency exchange is the biggest market in the world and valuation changes can send ripples throughout the global economy. Europe has been devaluing their currency through quantitative easing. Japan has undergone unprecedented printing of the yen in an attempt to keep exchange rates in a favorable range. The U.S. dollar, on the other hand, has appreciated substantially versus a basket of global currencies, but it is beginning to plateau. The Trump administration wants a weaker U.S. dollar to help boost the global competitiveness of U.S. companies, and the central bank is no longer heading to the printing presses. We are seeing central banks' influences fading, while political influences are on the rise. The pound has steadily declined since the Brexit vote, the euro has faltered in the face of political uncertainty, and China is attempting to keep the yuan in check and limit capital outflows. Shifts in the currency markets are also important because they create demand for either export companies or domestically focused companies depending on currency weakness or strength.

Additional geopolitical stresses will add to 2017 wrinkles. Russia remains a threat to disrupt the Middle East and could increase risks in the energy markets by attempting to exert leverage over OPEC in relation to the recent production cut agreement. In India, long-term prospects are positive, but economy will need time to recover from President Modi's demonetization efforts and new tax laws. Domestically, Trump's policies will be one of the most important factors of 2017. His campaign rhetoric focused on a no nonsense approach to foreign policy which could strain relationships with other world powers.

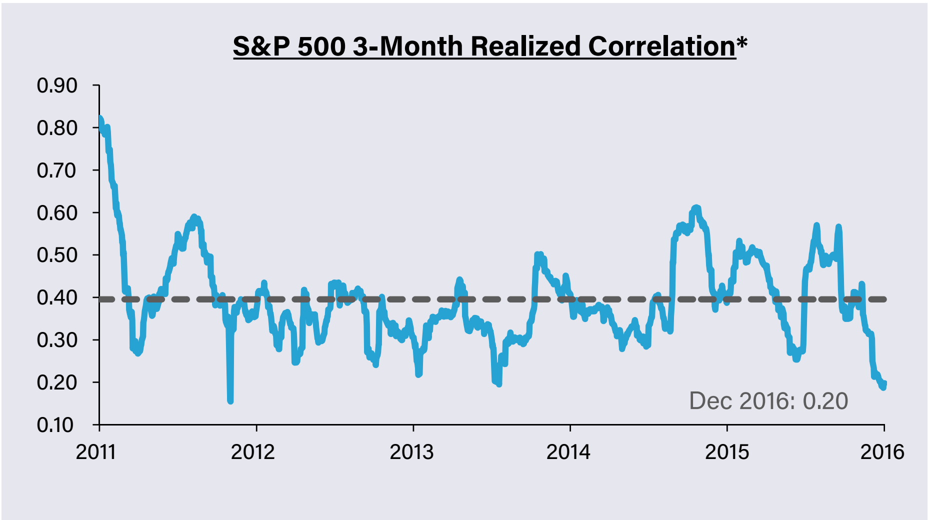
In hindsight, 2016 political events created attractive buying opportunities as equities quickly recovered from sell-offs. It is unlikely that the market reaction and recovery pattern which followed the Brexit and the U.S. presidential election is a template for 2017 events. The shift of influence from central banks to political leadership and government policies will lead to a significant increase in the breadth of volatility surrounding 2017 political events. Investors will need to be more cautious leading up to these events and will benefit from allocating to strategies with low correlation to the broader market.

Selectivity and Flexibility are Key

Since the inception of quantitative easing in the U.S., passive investors have enjoyed a sensational bull-market run which has carried indexes to all-time highs. The most accommodative monetary policy period in history made passively investing in major stock and bond indexes an easy decision. The Fed's December 2016 decision to begin normalizing interest rates changed the underlying drivers of future bond and stock appreciation and has forced investors to reanalyze market fundamentals. This year, we expect increased return dispersion within similar sectors and between companies of similar market caps. The breadth of expected returns and potential for sharp incidents of volatility will force investors to take a more active approach to asset and risk allocation.

With market indexes at all-time highs, multiple expansion will be ineffective in driving prices higher. We expect earnings to take the reins as the leading fundamental driver. The recent earnings recession is over, and early data suggests a continued rebound in 2017 earnings as the energy sector appears to have bottomed and cyclical sectors continue to improve. Earnings growth will be supported by strong consumer activity and a renewed focus on business spending. Many businesses have been sitting on cash during the recovery due to uncertainty surrounding the Fed and the political landscape. The Republican Party's control of the White House and Congress should lead to more political stability and business friendly policy proposals. Moving forward we expect businesses to begin spending due to increased confidence in the political and regulatory landscape and the desire to lock in lower interest rates.

This shift in market drivers increases the need for active quantitative and qualitative analysis. It is no longer beneficial to take a simple market capitalization indexing approach and expect to generate meaningful returns. As cyclical sectors continue to lead the way in 2017, it is necessary to key in on early moves and react quickly by shifting allocations to take advantage of the changing market environment. Currently our models indicate healthcare, utilities, and technology companies are favored. This is a rotation away from financials, energy, and materials, which were favored at year end.



Source: Standard & Poor's, Bloomberg, Lipper, FactSet, J.P. Morgan Asset Management.
**Realized correlation is a trailing 3-month measure of the pairwise correlation among the largest 50 stocks in the S&P 500, calculated using the realized volatilities of those stocks and the index.*

The Great Rotation

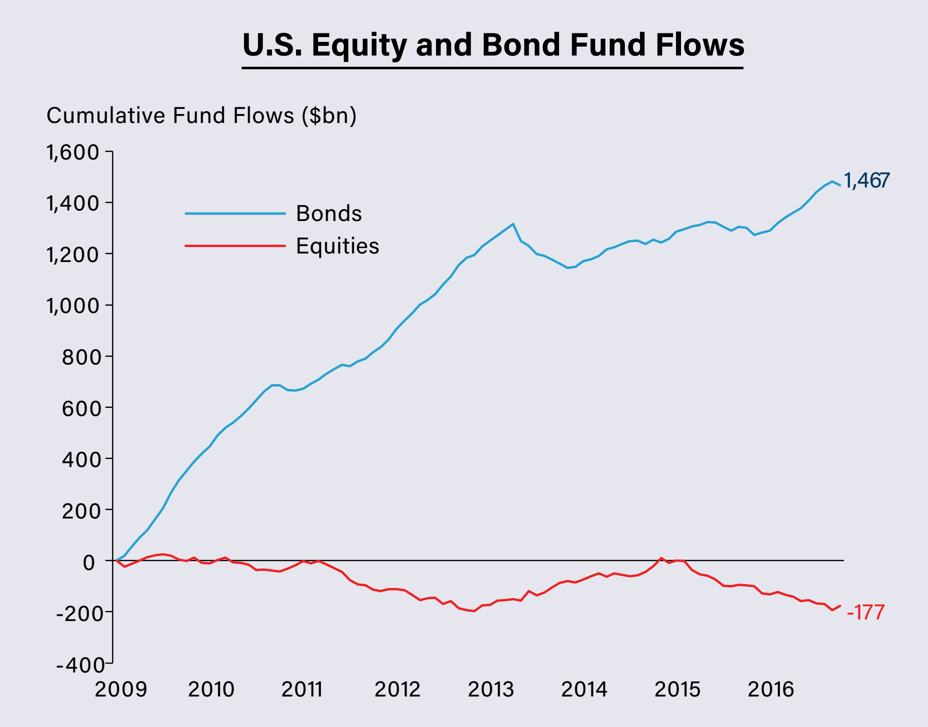
Despite a seven-year bull-market in the U.S. and a recovery in the global economy, asset flows into fixed income have remained consistently positive. Fixed income holdings have soared since the Global Financial Crisis (GFC), but with rates in negative territory in much of the developed world, and the Fed embarking on a tightening cycle, bonds have lost their luster. Fixed income assets are facing a nearly perfect storm of negative influences. Fiscal stimulus prospects, low unemployment, and rising wages have all bolstered higher inflation expectations. Additionally, the Fed is actively raising rates, and with rates at historically low levels improving GDP growth is also a headwind to bonds. Core fixed income holdings are necessary in a fully diversified portfolio, however investors must be more tactical and expect higher volatility if allocating to longer duration or higher yielding securities. The asset class will struggle to generate meaningful returns in 2017.

Wall Street investors have largely ignored the recent havoc in the bond market, but they could face a rude awakening in 2017 and the coming years. Interest rates have already climbed rapidly with the 10-year yield rising more than 1% just since last July. If yields on the 10-year U.S. Treasury note rise above 3%, all markets could be in for a bit of turbulence in the short run. Fixed income is the most vulnerable asset class to rising rates because rising yields mean lower prices for bonds. Also, since cash flows from bonds are generally fixed, nothing other than lower rates can cause much appreciation. If rates climb too high too quickly, other asset classes such as equities will face challenges because high rates eventually slow the economy and dilute earnings growth. Our models suggest that headwind is further off in the future, but it is paramount to monitor.

> “The rotation out of fixed income securities and into risk-on assets picked up considerable momentum during the fourth quarter of last year and we expect this trend to continue.”

The Great Rotation

The rotation out of fixed income securities and into risk-on assets picked up considerable momentum during the fourth quarter of last year and we expect this trend to continue. Stocks will be direct beneficiaries of this rotation along with the shift to fiscal policy, healthier market activity, and an improving economic outlook. Demand for stocks will improve as the markets price in corporate tax breaks or reforms expected to be announced by Washington. Additionally, the rotation of market leadership from bond-proxy sectors to more cyclical sectors indicates that consumer activity is healthy and that market fundamentals, rather than margin expansion, are returning as the drivers of stock prices.



Source: GS Investment Strategy Group, Bloomberg, ICI

While the positives are stacked in favor of equities, we expect an increase in volatility as more capital is shifted into risk-on assets. The increase in demand at historically high market valuations forces us to consider the notion that many investors are dumping capital into equities to avoid being left behind by the recent rally. Any time a shift of this sort occurs it is likely that volatility will increase and downside moves could be more violent as larger downside trading volumes tend to spark contagion sell-offs. Despite these risks, we are confident that equities provide attractive upside and that actively managing allocations will be the key to avoiding participation in volatile downside moves.

Alternatives Fill The Gap

Diversification remains a fundamental component of portfolio construction. Looking ahead at 2017, we see signs that the traditional allocation strategy inclusive of stocks and bonds will need to be tweaked in order to provide the risk adjusted returns investors expect. Traditional fixed income allocations will still provide downside protection during short-term flights to safety, but correlation between fixed income and equities tends to increase during periods of rising inflation expectations, and the downside risks may not be worth the benefits. We expect the Fed to raise rates at least two more times this year, which along with increasing inflation expectations, will put upward pressure on rates. Bond prices fall when rates rise, and it is not unreasonable to expect negative price returns for the majority of Treasuries and investment grade corporate bonds. During 2016, cash became a popular option for managing portfolio risk and we expect this trend to continue in 2017. Unfortunately, interest rates are still near historical lows and while cash provides downside protection, there is little upside.

> "Alternative strategies offer significant diversification benefits, and the lack of correlation to the public markets helps balance portfolio risk without sacrificing upside potential."

We believe that a more attractive option is to allocate to non-correlated alternative strategies. Alternative investments offer significant diversification benefits and minimal correlation to the public markets. These attributes help balance portfolio risk without sacrificing upside potential. For example, alternative lending strategies fare better than traditional fixed income during periods of rising rates due to their ability to adjust their interest rates and actively manage duration. Additionally, these strategies provide income streams that tend to be on par with public high yield debt. Low correlation to public markets, the ability to counter rising rates, managing risk through duration exposure, and providing attractive income make private market alternatives an appealing asset class.

Another way that investors benefit from adding alternative assets to their portfolios is by capturing an illiquidity premium. Patient capital, deployed into private markets, has the ability to capture a significant premium compared to publicly traded assets. Inefficiencies in illiquid assets have allowed investors to capture +3% annually relative to their publicly traded counterparts. Investing in asset classes such as private equity, private real estate, and private debt allows investor to capture this premium while providing a differentiated return source in a diversified portfolio.

Investment Themes 2017

Trumponomics

Quite possibly the most important market event of the year occurred when Donald Trump claimed a surprising victory in the U.S. presidential election. Market futures sold off to levels not seen since the Brexit vote, but recovered almost immediately after the markets opened. The recovery continued through the end of the year and the "Trump Rally" sent the markets to new highs. Republicans retained control of the House of Representatives and investors cheered a united Capitol and policy proposals which are expected to include infrastructure spending, corporate tax reforms, military spending, and personal tax reform.

Infrastructure spending plans were somewhat priced into the market going into the year. Industrials and base metals surged following the election, but the buying may be over-done. Although infrastructure spending is the most likely policy to pass, the nature of these projects are long-term and the effects on the underlying economy are unlikely to be seen in 2017. Corporate tax reform has the best chance of passing in 2017. Republicans have pushed for reforms in this space since well before the election. Additionally, it would have an immediate effect on the economy by directly influencing businesses' bottom-lines and freeing up capital for a much needed boost in business spending. The expectation is that capital expenditures will lead to an increase in production which has lagged during the current expansion. There is a chance that higher production could lead to deflationary pressures rather than inflationary. If consumer activity slows down and businesses are spending tax savings on increases in production, there could be a supply and demand mismatch. Oversupply would lead to deflationary pressure and a pull-back in the market if earnings falter. Despite this risk, we expect corporate tax cuts to be a net positive for the markets and the economy this year due to their accretive effect on net earnings.

Trade policies will likely be the most important focus of the Trump administration. Trump has hinted at a desire to push protectionist policies. If he succeeds, these policies could stretch the U.S.'s relationship with foreign markets and create a larger tail risk than Trump's other policy proposals. If protectionist policies are put in place it is likely that the cost of domestic goods would increase which would dent consumer confidence and spending habits. Additionally, if inflation increases too quickly, then the Fed could be forced to raise rates faster than expected. Higher rates and excessive inflation are eventually detrimental to economic growth and would likely lead to a decline in the demand for risk-on assets.

Tactical Decision	H1 2017 Investment Outlook	
Relative Risk	Risk Off	Risk On
U.S. Equity Style	Value	Growth
U.S. Market Cap	Large-Cap	Small-Cap
Regional Equity Selection	U.S.	Non-U.S.
Equity Market Preference	Developed	Emerging
Fixed Income Quality	Investment Grade	High Yield
Fixed Income Duration	Short	Long
Regional Bond Selection	U.S.	International

Asset Class	Stocks	Bonds	Cash
U.S. Equity Sectors	Technology	Consumer Cyclicals	Healthcare
Commodities	Energy	Metals	Agriculture

The post-election rally was been largely unexpected and extraordinary. Businesses have been reinvigorated by the new president's primary focus on the domestic economy. The rosier business outlook is supported by dialogue related to deregulation and lower taxes. Additionally, the end of the recent earnings recession points to a longer business expansion than is typical during economic recoveries.

Since the end of the 2008 Global Financial Crisis, the Federal Reserve has been inflating asset prices through radical monetary policy known as quantitative easing (QE) measures and zero interest rate policy (ZIRP). Global central banks reduced interest rates to near 5,000 year lows. Thus, valuations appear stretched by historical standards. Many pundits claim that valuations are stretched based on price to earnings (P/E) levels during past market tops such as the dot-com bubble and the 2008 financial crisis. However, because interest rates are at unprecedented historical lows, the argument can be made that equity markets levels are well within norms relative to fixed income alternatives. That was not the case in 2000 or 2008.

This year we could witness a change in the dynamics pushing equity prices higher. The Fed is embarking on a mission to raise interest rates. This clearly shifts potential equity market drivers from a valuation or price to earnings multiple expansion to a focus upon earnings growth. The post-election rally has created a market of enormous momentum where investors have shrugged off muted growth expectations despite little substantive change in actual growth. The rally to new highs is the result of a newfound optimism that Washington can engender an economic expansion by enacting new and better policies. Looking ahead, a resurgence in growth should support further market appreciation the end of the year. Expansionary fiscal policies, if combined with tempered monetary policy, should reconfigure the market landscape which will require savvy portfolio navigation as the effects of these policy changes will become evident only slowly.

In this new environment, we expect growth companies to lead the way. Many growth companies refinanced debt and raised inexpensive capital during the recent period of low interest rates. The majority have kept large quantities of that cash on reserve due to a perception of an anti-business climate in Washington and concerns that harsh regulations and political uncertainties were always lurking. Thus, the expectation of scaled back regulations and a more business friendly administration is expected to entice businesses to finally increase capital spending on productivity boosting projects. A boost in productivity should be absorbed by improving consumer spending trends and will be accretive to 2017 earnings.

> "This year we could witness a change in the dynamics pushing equity prices higher."

Domestic Equity Outlook

Our models forecast that the healthcare, information technology, and consumer staples sectors have the most positive trends initially. Although our models forecast that these sectors are the most attractive now, sector leadership will change as the markets gain further insight into external market factors and Washington's ability to deliver on producing pro-growth policies. Hopefully as this occurs, the Fed's monetary policy will not get too hawkish and stifle nascent economic strength.

Current P/E vs. 15-year avg. P/E

	Value	Blend	Growth
Large	16.2 / 13.8	16.9 / 15.3	18.1 / 17.6
Mid	17.0 / 14.7	18.1 / 16.4	19.5 / 19.1
Small	19.6 / 16.5	23.5 / 20.1	30.3 / 26.4

Current P/E as % of 15-year avg. P/E

	Value	Blend	Growth
Large	117.5%	110.3%	103.1%
Mid	115.7%	110.4%	102.3%
Small	118.5%	117.4%	114.8%

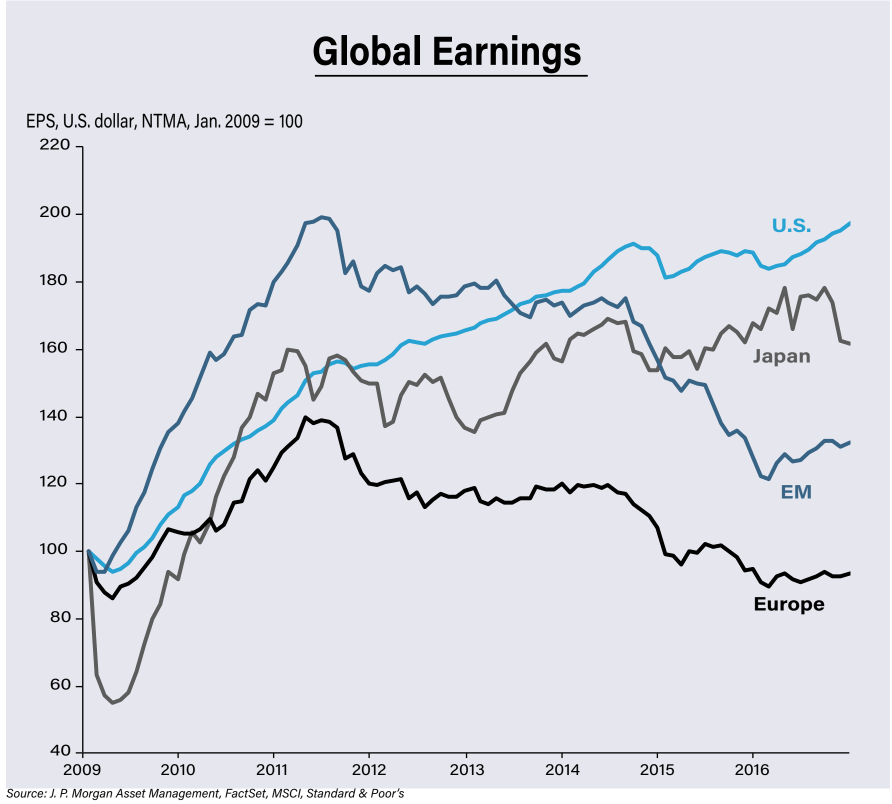
Source: FactSet, Russell Investment Group, Standard & Poor's, J.P. Morgan

The strongest external forces that could adversely impact the economy and markets are a dysfunctional government and an uncooperative Federal Reserve. Without question, the shift towards confidence in future economic expectations is the result of more optimistic business rhetoric coming from the new administration. Policy changes are promised to be precise and swift. Unfortunately, Washington does not have a reputation for having either of those qualities. If fiscal and regulatory changes fall victim to political squabbling, many campaign promises which supported the market rally could easily reverse. We have already seen problems in the proceedings related to the repeal and replacement of the Affordable Care Act (or Obamacare). The risk from Washington is that Capitol Hill moves too slowly in implementing positive legislation while the Fed moves too fast raising interest rates. Rates may need to rise if growth and inflation accelerate, but we feel it is wiser for the Fed to err on the side of certainty and thus let the economy run somewhat hotter until they know for certain that we have left the overhanging morass of the Global Financial Crisis. Federal Reserve Chairwoman Janet Yellen recently offered an argument for letting the U.S. economy expand beyond the Fed's mandates for a period to ensure moribund growth doesn't become an entrenched feature of the business landscape. We agree, but if she changes her mind and tightens monetary policy too quickly it could cause faster economic growth to be prematurely and even permanently aborted. This would lead to a decline in consumer and investment activity, resurrecting deflationary fears and debilitating long-run conditions arising from an over levered economy.

Economic hysteresis can occur when weak demand becomes a self-perpetuating problem that affects the whole course of the economy. An example is the delayed effects of lasting unemployment. As unemployment increases, more people leave the workforce because low growth seems more permanent. People then adjust to a lower standard of living which decreases overall demand for the entire macro-economy and exacerbates the original downturn. Thus, we certainly hope that Janet and the Fed will be cautious enough and prevent us from catching this dreadful economic disease.

Foreign Equity Outlook

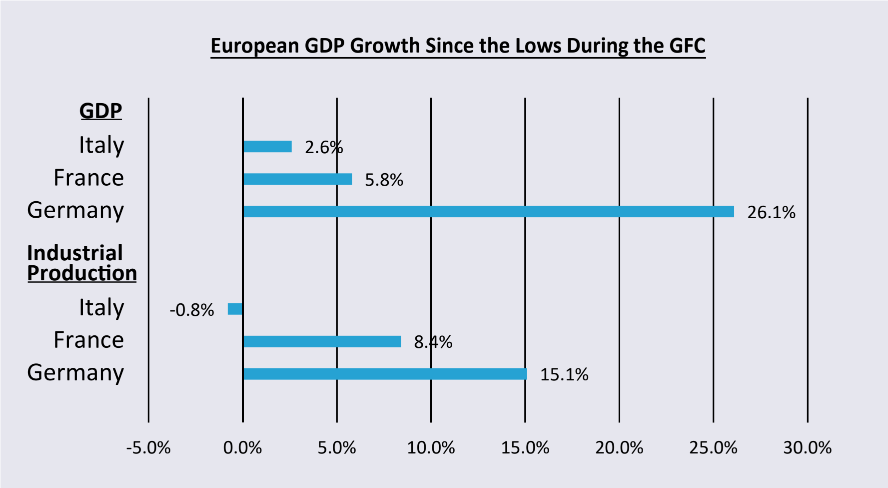
Our models indicate that foreign developed markets are poised to outperform this year. We believe that attractive valuations, earnings potential, and currency trends create attractive opportunities in overseas markets. From a valuation standpoint, foreign markets are attractive relative to the U.S.. When compared to their 25-year average valuations, European markets are trading in line with their average, Japanese markets are trading significantly below their average valuation, and the U.S. is trading well above its average. Additional upside comes from the earnings potential in foreign developed markets. Since 2009, both Europe and Japan have been outpaced by the U.S. on the earnings front. European earnings have rarely trailed the U.S. by such a wide margin and are poised for a rebound in earnings growth this year. Foreign markets are growing slowly, but they are growing. European companies stand to benefit from attractive currency valuations boosting export demand as well as improving domestic consumer trends. Structural problems still need to be remedied, but current central bank policies will continue to provide downside protection. Rates are still extremely accommodative and are unlikely to change course in 2017. With central banks acting as a backstop, local governments should be able to focus on implementing supportive economic policy measures. Investors will have to endure higher volatility around major geopolitical events, but an allocation to foreign developed markets should boost overall portfolio returns.



Source: J. P. Morgan Asset Management, FactSet, MSCI, Standard & Poor's

Europe

Geopolitical factors are likely to dominate the European headlines. Voters are heading to the polls the Netherlands, France, Germany, Italy, and Austria. Additionally, UK Prime Minister Theresa May is charging ahead with Brexit plans, and the power struggle between the ECB and Germany is likely to continue as divergence in euro-area recoveries expands. Brexit questions are still unanswered, but May's comments indicate the likely acceptance of a "hard" Brexit. Parliament's decision to let May invoke Article 50 allow her to meet her March deadline for beginning the process of leaving the EU. Meeting the deadline is unlikely to have a negative effect on the market given that the best case scenario for completing negotiations is eighteen to twenty-four months. Economic data from the UK points to sustainable growth over the short-term. The economy has strengthened on the back of depreciating sterling, improving employment and wages, and a rebound in consumer spending. Higher inflation will be a tailwind this year, and should be an additional boost to wage growth which has struggled to find traction since the financial crisis. Furthermore, a weaker sterling and improving global demand should stimulate growth for export driven businesses which make up the majority of the UK economy. We are maintaining a market weight on UK equities.



Source: IMF, Oxford Economics, SSGA Economics Team

The eurozone stands to benefit from many of the same factors as the UK. The depreciation of the euro against the U.S. dollar boosts earnings potential for many European countries by increasing export demand. Additionally, the resurgence of global demand has improved manufacturing sector data in many countries, and signs of more consistent inflation and wage growth indicate a potential expansion in consumer activity. These factors give the market great potential to rebound, but investors will have to be able to brave the macroeconomic risks. Geopolitical factors remain the headline risk for the region. Populist candidate Marie Le-Pen has been gaining positive traction in France. Italians are also likely to vote this year after Matteo Renzi stood by his promise to resign after his recent referendum was defeated by popular vote. The populist Italian Five Star Movement has been pushing further into the mainstream and populist parties will surely influence future Italian elections. On top of the political uncertainty, Italy is also facing a potential banking crisis. Further political and economic tensions from Greece and Germany's relationship with the ECB and other eurozone counties are likely to increase volatility and pressure the euro. That being said, the countries which have been on the economic fringe since the european soverign debt crisis are seeing signs of stabilization. The political risks will remain tilted toward the downside, but support from the European Central Bank and improving domestic and global economic growth should support market appreciation. We are maintaining a market weight on eurozone equities.

Japan

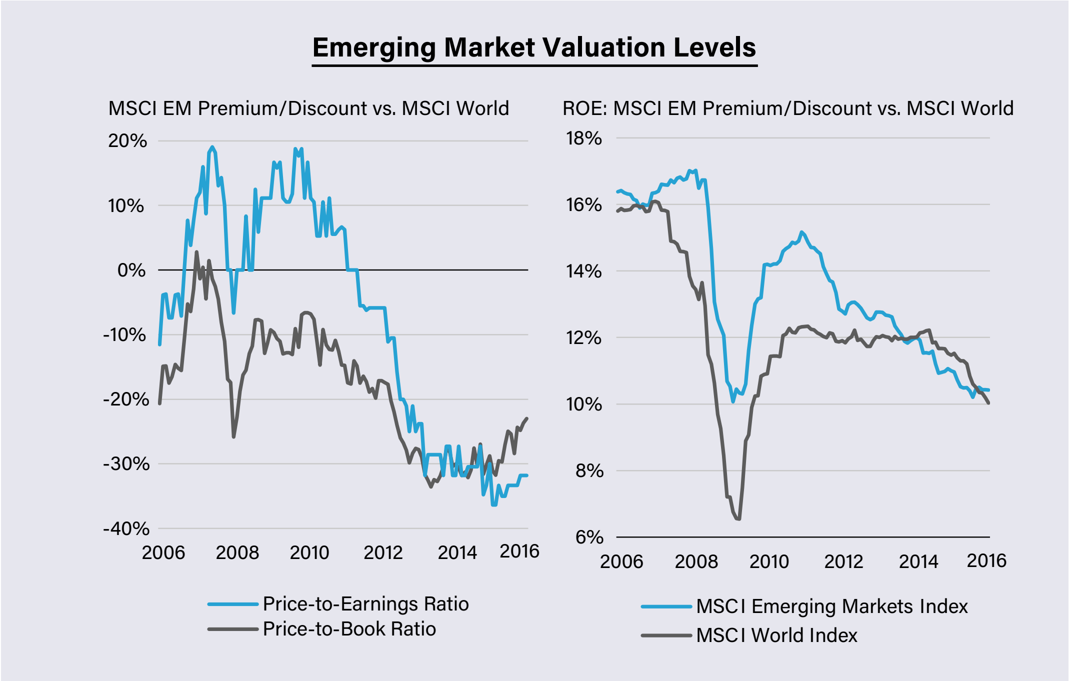
Japan's economy is beginning to show signs of life. Shinzo Abe's party has full control of the government which buys him time to push through fiscal measures and work on improving the economic effects of his 3-Arrows programs. Demographic and structural problems are still apparent, but the economy has gained some recent traction from a depreciating yen which has boosted exports. On the policy front, the Bank of Japan (BOJ) and the government are warming up to implementing more fiscal and structural reforms rather than hoping that monetary policy will eventually work itself out and generate growth. Additionally, the BOJ's shift from printing copious amounts of money to maintaining a stable 10-year interest rate will allow longer dated rates to move in a more normalized manner and should help build confidence for savers and investors with long term obligations. These changes, along with a stable outlook for global growth, keep us optimistic, but we will remain underweight to Japanese equities until we see more significant signs that the economy is back on track.

> "The Bank of Japan (BOJ) and the government are warming up to implementing more fiscal and structural reforms..."

Emerging Markets

Emerging markets (EM) took a hit following the election of Donald Trump but have since recovered. The sell-off in EM equities was driven by the expectation of a more protectionist U.S. trade policy, a strengthening U.S. dollar, and higher interest rates, all of which are headwinds to emerging markets. As the dust has settled following the election, it is clear that Washington wants to keep the value of the dollar in check and that many investors feel the Fed lacks the conviction to raise rates more than a few times this year. Both of these realizations are tailwinds for emerging markets. Demand for EM assets has also rebounded along with confidence in the future of the domestic and global economies. We expect demand to remain robust going forward driven by investors seeking higher return potential as well as improving confidence in the sector to overcome external political influences.

China remains the emerging market leader. The attempt to shift the world's second largest economy from export driven to consumption driven is still underway and the process will not be completed this year. China's economy has risen on the shockwave of explosive debt growth which has led to fears of a credit collapse. The government has the unenviable task of reining in access to debt without negatively impacting GDP. Changes have been made to shift the borrowing base away from problem sectors, such as state owned enterprises and zombie corporations, and towards individuals and municipalities. Unfortunately, individuals have used easy access to debt to rapidly push up real estate prices, and regional government debt usage has had little impact on headline data. Although credit risk is a concern, we believe that China will be able to circumvent a credit collapse and generate significant returns this year. The government has shown that it will support the economy in any way possible and that it is not afraid to push through new rules to curb troublesome sectors. The expansion of the middle class and strength in the services sector support strong consumer activity. Additionally, efforts to modernize rural regions and improving developed market demand will support an increase in economic activity.



Source: Bloomberg, Nomura Research

Emerging Markets

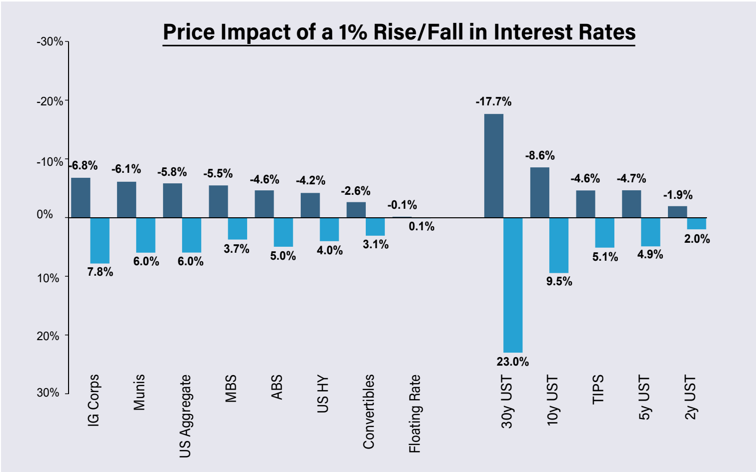
India has surged to the forefront of the emerging Asian economic expansion. President Modi has put great effort into making the country more business friendly and encouraging both domestic and foreign investment. Swift demonetization of the country's most widely used bills at the end of 2016 caused a short term contraction in the economy, but the long term effects will be positive. The program is expected to decrease black market activity and significantly increase future tax revenues, further strengthening the government's financial standing. Additionally, India has been a welcome beneficiary of China's efforts to decrease its reliance on manufacturing. We expect positive economic reforms to increase investment into manufacturing and infrastructure this year. India is also experiencing its own surge in middle class wealth which will help support the country's rapid pace of economic growth.

The remaining BRIC countries, Brazil and Russia, are heading in the right direction but in our opinion the risks outweigh the rewards. Brazil has emerged from a recession, but the bumps and bruises will take time to heal. Last year's political upheaval helped repair the population's confidence in the government and the oil price recovery helped get the economy back on track. Unfortunately, the country is still dealing with the problems of high unemployment and high inflation which are difficult to remedy with conventional monetary policy measures. Additionally, the battle against political and corporate corruption is ongoing and will likely stymy efforts by the government to implement policy reforms this year. Russia has been hit hard by sanctions and falling oil prices. The economy is eking its way out of a recent recession with the support of fiscal and structural reforms. The efforts have tempered the recession, but the country is still overly dependent on oil prices and lacks the consumer strength to generate meaningful growth in 2017.

> “Demand for EM assets has rebounded along with confidence in the future of the domestic and global economies. We expect demand to remain robust going forward...”

Domestic Fixed Income

The fixed income markets have enjoyed one of the longest bull runs in history, but all things must come to an end and we expect the fixed income markets to reverse course along with interest rates in 2017. Unprecedented monetary policy is coming to an end and the U.S. Fed is embarking on a rate hike cycle which will neagtively impact all fixed income assets. Recalling that bond prices rise as interest rates fall, it is clear that it is all but impossible for bonds to generate returns similar to the last 30 years. Interest rates are at or near historical lows, and would have to decline far into negative territory to generate similar returns. Fixed income will still serve as downside protection in a portfolio, but with interest rates on the rise the asset class will not have the true diversification properties that it has had in the past. Investors need to be more creative with building out fixed income holdings. Positive momentum in economic data, interest rates, and inflation create opportunities to utilize TIPS, floating rate securities, and high yield bonds. Unfortunately, these trades have become crowded and the return profile is unattractive. Facing high prices and low interest rates, investors are not adequately compensated for the risks they are taking.



Source: Barclays, U.S. Treasury, FactSet, J.P. Morgan Asset Management

Foreign Fixed Income

International developed market fixed income is stuck in a similar situation. The opportunities to generate meaningful total returns are sparse. Interest rates are already negative in many countries, and with inflation gaining some traction, investors are actually losing money by holding bonds to maturity. International fixed income will retain more of its risk diversification properties than its domestic counterpart. The European Central Bank and the Bank of England are not prepared to begin raising rates this year and eurozone political tensions and Brexit preparation will keep it that way, which limits the potential for rising rates in Europe.

Emerging market debt has been shunned in recent years, but the asset class is beginning to look more attractive. A targeted approach will benefit investors in this space given the disparity of economic drivers and recoveries among EM countries. It is in investors' best interest to hunt opportunities with a rifle rather than a shotgun. EM countries that have strengthened their financial standings since the GFC are in a good position to benefit from stable commodity prices, a plateauing U.S. dollar, and improving global growth. Additionally, many EM countries still have room for the central banks to cut interest rates if need be. Signs are pointing in the right direction, but sentiment and fundamentals can turn on a dime in emerging markets. The EM debt risk and reward dynamic is more attractive than developed markets. That being said, this asset class will increase overall portfolio volatility and it lacks the downside protection found in developed markets fixed income.

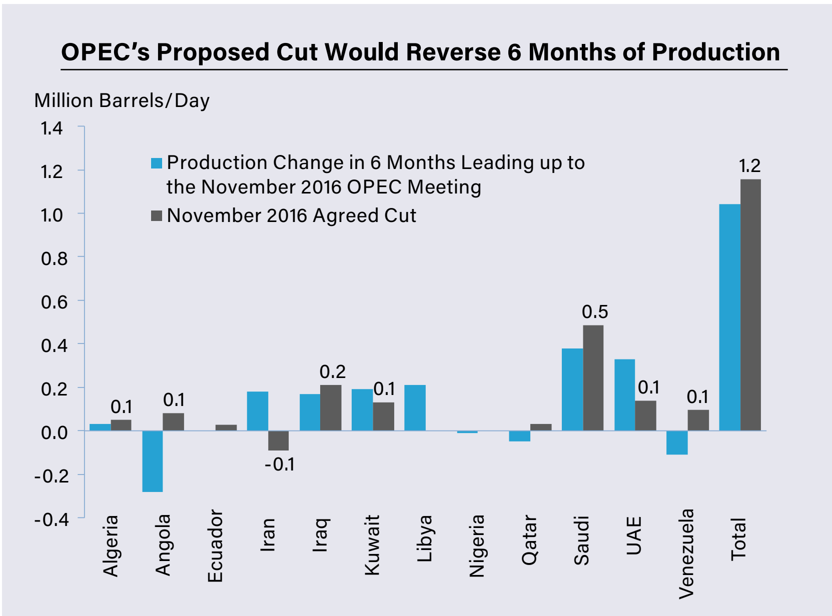
Based on this negative view we are advocating an underweight to the asset class, but not a zero weight. Traditional fixed income holdings will still add diversification benefits to portfolios, but the upside potential is minimal and investors should not expect the asset class to generate meaningful total returns this year. Strategically utilizing cash and alternatives will be a better way to lower portfolio volatility going forward.

Real Assets

The rebound in commodities will decelerate this year. Expectations of higher inflation and a stabilizing U.S. dollar make the asset class more attractive, but high supply of many commodities is limiting upward pressure on prices. Additionally, it is increasingly likely that many of the fiscal policies that are expected to boost inflation will not have a significant economic effect in 2017. Looking at the dollar, stabilizing does not mean weakening. Despite the plans of the President, almost all signs are pointing to a stronger dollar over the next 6 to 12 months while other major currencies have been plunging lower. Dollar pressures will not be as significant as they have been in recent years, but they can still limit commodity price appreciation.

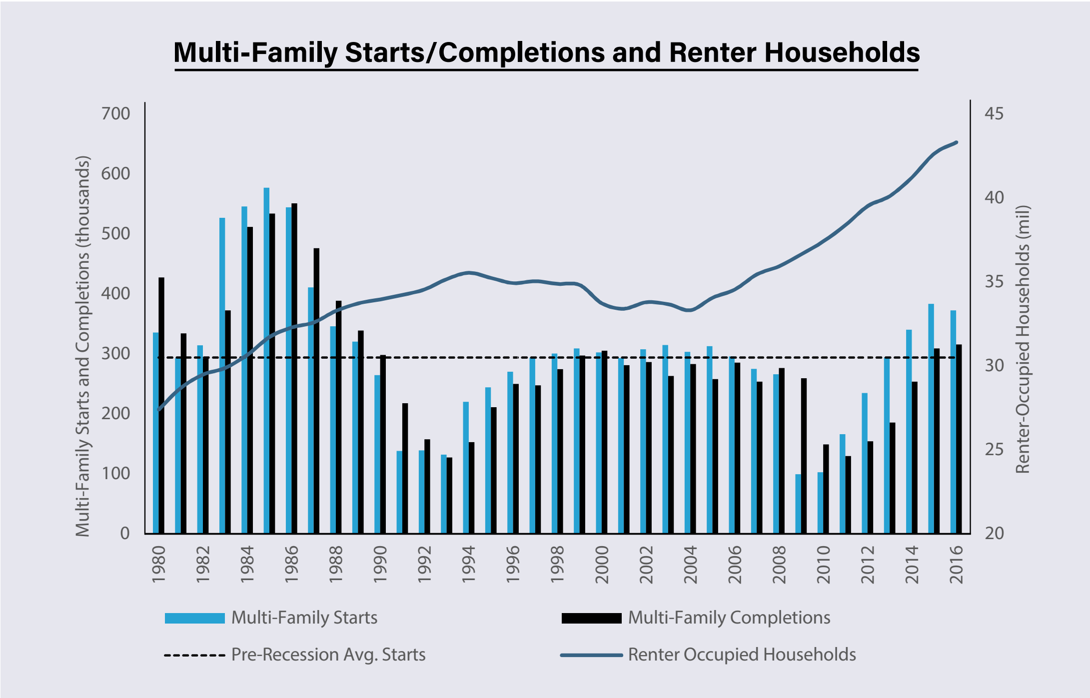
Oil had a roller-coaster of a 2016 and ended up as one of the best performing asset classes. The energy sector will not repeat last year's performance. Domestically, the industry should benefit from proposed roll-backs in the regulatory environment. Additionally, a stable prices range will lead to a rebound in energy company earnings in 2017. Prices could pullback if we get above the $55-$60 range as U.S. shale (the new swing production) comes back online, but ramping up production and drilling new wells does not happen overnight and we believe that there will be time to identify production ramp ups as a red flag to prices. Additional risk arises from OPEC which has become its own worst enemy by implementing widespread production cuts. The oil cartel has a poor history of sticking to production ceilings and any signs that countries are overproducing will cause a pullback in oil prices.

Gold and other precious metals will still be utilized as fear and inflation hedges. The asset class will remain volatile this year as investors parse inflation data, government policies, and the Fed's forward guidance. Consistent rate hikes by the Fed will lead to price declines in precious metals. Because precious metals generate no yield, rising rates tend to generate capital outflows from the asset class. Also, given the recent price appreciation we would expect selling pressures to snowball as investors pocket gains. The upside for gold lies in geopolitical and monetary policy uncertainty. Demand will remain high until the markets are more comfortable with the new U.S. President, the political climate in Europe, and can trust the Fed to follow through with multiple rate hikes this year.



Source: OPEC, Bloomberg, Goldman Sachs ISG

The real estate market will experience a divergence in returns between various strategies within the industry. Higher interest rates will make it difficult for the industry to continue generating consistent, positive returns. Property managers may not be able to raise rental rates as fast as interest rates rise, and higher borrowing costs cut into the margins of real estate acquisition companies. If property owners are not able to increase property income, higher costs will lead to cap rate expansion which is a negative for REIT investors. In the residential market, rising rates are negative for new home buyers which have struggled to return to the buying pace seen prior to the 2008 real estate collapse. One sub-sector that should continue to shine is multi-family and single family rentals. Builders have been wary to ratchet up new home production which has led to a supply constraint and higher prices for existing homes. Supply is unlikely to catch up with demand this year which means that prices for existing homes will stay elevated and demand for rental properties will remain robust. We see additional opportunities in real estate lending. The demand for capital to facilitate new builds, property remodels, and portfolio acquisitions is high. Lenders benefit from rising rates and should be able to take advantage of the rebound in positive real estate sentiment. Additionally, loans are generally backed by physical collateral or personal guarantees which protect investors from downside risk.



Source: Freddie Mac, U.S. Census Bureau, Moody's Analytics

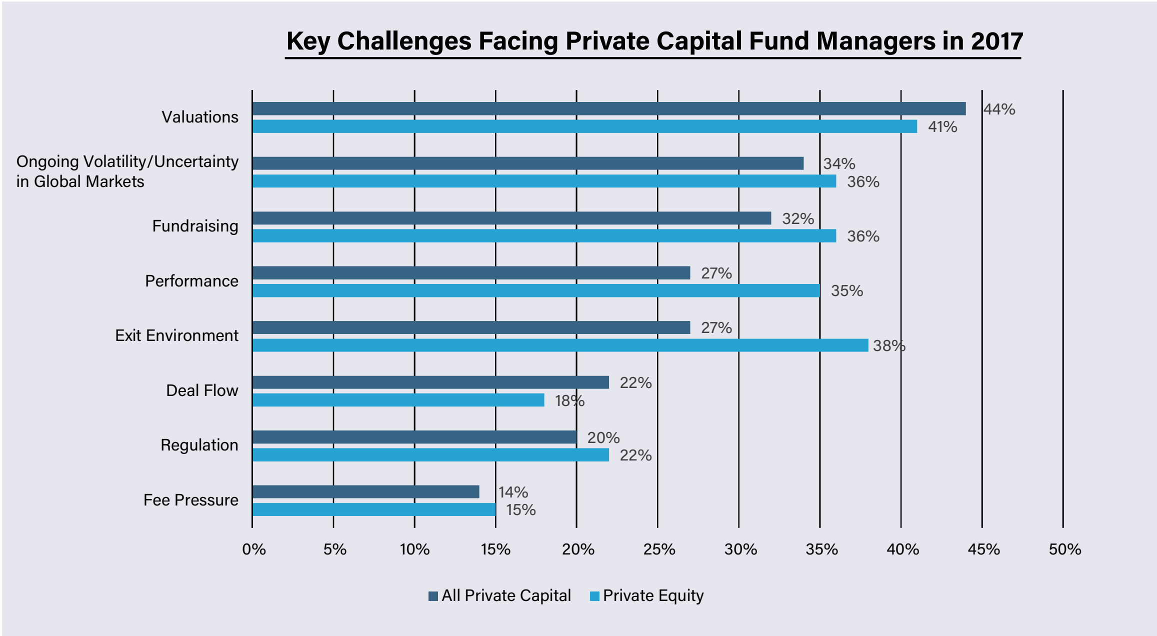
Alternative Investments

Alternative investment returns varied widely in 2016. Looking forward to 2017, we believe including alternatives in portfolio construction is more important than ever. Alternative investments should be utilized to diversify return drivers and mitigate volatility. As a refresher, we classify alternative investments as hedged trading strategies, private equity, and other absolute return strategies. These investments are affected by different factors than traditional assets, such as stocks and bonds. They may offer inflation protection and dampen portfolio volatility when public markets are under stress.

Hedged strategies experienced a difficult year in 2016. Low interest rates, low volatility, and heightened macro risks created a difficult environment for managers to execute strategies. Hedged strategies prove their worth in the face market downturns. This fact is even more prescient in a rising rate environment. Given this environment and the expectation for increased volatility, hedged strategies should benefit from market dislocations. Volatile markets have also proved very positive for systematic trading strategies. Strategies with a systematic tilt and an uncorrelated return history should be over-weighted.

Private equity strategies produced strong returns in 2016, despite a 20% year-over-year drop in deal activity. 2016 was marked by strong purchase price multiples, primarily driven by strategic acquirers looking to deploy cash off of balance sheets. We expect more of the same in 2017. Growth equity should benefit from the strong labor market as many portfolio companies are consumer oriented. The tech industry has been on a tear in the latter half of this cycle and has proved immune to the macroeconomic issues that have troubled manufacturing and multi-national companies. Additionally, energy related investments should benefit due to increased deal activity as oil has settled in a trading range in the low $50s.

> "Private equity strategies produced strong returns in 2016... We expect more of the same in 2017."



Source: Prequin Fund Manager Survey, November 2016

Overall, our expectations for 2017 are optimistic, but our optimism is tempered by the following risks: We think that the biggest tailrisks to the bull market are the Federal Reserve and currency manipulation.

Now that monetary policy has run its course, the Fed lacks the clout that it once had. We have seen the Fed following the markets rather than leading, and committee members may feel that the markets now have too much control. With fiscal policy changes looming, the Fed will have to find a new way to exert their influence on the economy and markets. The risk is that President Trump's policies or the economic expansion will generate too much inflation too quickly, requiring the Fed to catch up to the economy. In a scenario where inflation is trending above the Fed's 2% target, the committee could begin raising rates at a faster pace or with greater magnitude. Fed Chair Janet Yell had previously stated that the committee would allow economic measures to increase above their mandated targets, but she changed face after the U.S. election. Higher inflation and interest rates eventually become detrimental to economic expansion. In recent years, the Fed has struggled to analyze incoming economic data. The risk is that the Fed will ramp up its tightening cycle before the economy is strong enough to support higher rates. In this scenario, fundamentals will no longer support high valuation levels, earnings will be negatively affected, and we will see a correction in equity prices.

"The biggest risks to the bull market are the Federal Reserve and currency manipulation."

Currency manipulation is the biggest threat to the global economic recovery and could be the source of large shocks to the economic system. Countries have been trying to manipulate currencies throughout the recovery through quantitative easing and sometimes more direct measures such as removing pegs or changing valuation formulas. Historically, devaluing currency was an easy way for countries to boost growth by encouraging demand for exports and maintaining a competitive trade balance. This dynamic still exists at some level, but the introduction of quantitative easing has led to wrinkles in the system. Countries which went down the monetary expansion road will have to pay back their debts, and a weaker currency makes this an exceedingly difficult task. Additionally, weak global growth during the current recovery has led to a system in which central banks and governments will do whatever it takes to eke out additional growth. The available options almost always lead to attempts to keep domestic currencies weak. It would not be surprising if Trump's focus on making the U.S. more competitive in trade results in policies which aim to temper dollar strength. Struggling foreign markets may continue efforts to devalue their own currencies which could lead to an all-out currency war. Such an event would eventually lead to a decline in global spending power and consumer confidence which would derail the global economic recovery.

As 2016 showed us, geopolitical events are impossible to predict and can exert substantial effects on the markets. Geopolitical factors will continue to dominate the headlines in 2017 with the theme of populism carrying over into this year. Elections in France, Germany, the Netherlands, and potentially Italy will be important. Additionally, British Prime Minister Theresa May will officially trigger the Brexit by invoking Article 50 in March. Domestically, President Trump and the U.S. Congress are tasked with backing up campaign promises without derailing economic stability. Further support for protectionist policies could lead to a major shift in global economic relationships and generate zero-sum recession scenarios. Any economic pullback will likely be exacerbated because central banks have all but lost their ability to use monetary policy to hoist economies out of a recession.

2017 is shaping up to be a year which could define the next stage of global politics and economic policies. The interrelationships of these two factors are of utmost importance. Despite these risks, we are confident in the prospects for 2017. The current recovery has created a foundation for growth, and we expect the global economy to absorb external blows and continue getting back to business.

"A strategic asset allocation paired with active quantitative analysis is the best foundation to prepare your portfolio for whatever the future holds"

WATERLOO
CAPITAL MANAGEMENT

301 Congress Ave., Suite 120, Austin, TX 78701 ■ (512) 693-4330
53 Perimeter Center East, Suite 420, Atlanta, GA 30346 ■ (678) 331-7772
waterloocap.com