2018 OUTLOOK

The View From the Top

WATERLOO
CAPITAL MANAGEMENT

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

Outlook 2018: The View From the Top

Letter from the CEO

The bull market that has persisted since the Global Financial Crisis has pushed both bond and stock markets into uncharted territory. In the equity markets, major stock indices have made a habit of frequently setting all-time highs as pullbacks have been few and far between. In fixed income markets, bond investors have enjoyed 38-years of mostly price appreciation as interest rates have been cut to historical lows. Central bank and financial market actions over the last decade have reshaped the economic landscape, but the final outcomes of the unique policies utilized to strengthen the global economy are still uncertain.

Looking out from the top you might expect that the view is clear, but we are entering uncharted territory. Many financial assets are sitting at or near the top of their historical valuation ranges, global monetary and fiscal policies are diverging, the factors that have supported the markets are shifting, and historical sources of volatility are returning to the fold. Due to these factors, navigating the ups and downs of the financial terrain in 2018 will require a more proactive approach to asset management.

The good news is that as the Federal Reserve is reducing their balance sheet, broad based economic growth drivers are improving. Main Street is finally starting to catch up to Wall Street. Businesses and consumers are extremely confident in future growth. Additionally, low interest rates and fiscal policy changes have increased spending power across the board. What's more, we are not yet seeing signs of the headwinds and excesses that typically precede recessions. Shifting market dynamics may lead to a few bumps and bruises along the way, but they will also lead to opportunities for active strategies like those we use at Waterloo to capture alpha while maintaining a competitive edge by actively managing portfolio risk. So, although the path might be more difficult to navigate, we expect the economy to continue expanding and support further market appreciation.

John Chatmas
CEO - Waterloo Capital Management

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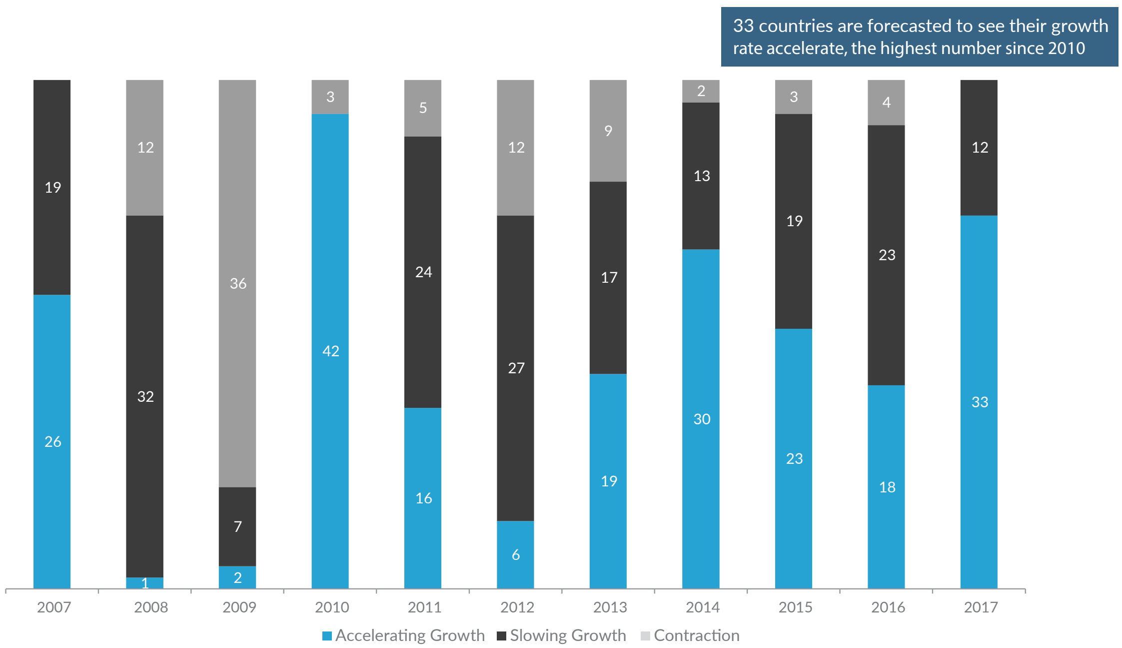
2017 Review

Last year marked the first time that the global economy grew in sync in nearly a decade. The Organization for Economic Development (OECD) expects all 45 countries that it tracks to post GDP growth when the final 2017 data is available.

# of Countries with Accelerating, Slowing and Contracting Economic Growth



Source: Organization for Economic Cooperation and Development (OECD).

Central bank activity continued to ramp up as policies diverged between the US and UK and the rest of the world, but extensive forward guidance from policy makers relegated the activity to the background. Policy makers' efforts to boost the global economy by printing cash over the last decade are still working their way through the markets. A massive amount of capital has stood ready on the sidelines and investors eagerly bought-the-dip following short-term selloffs.

Geopolitics dominated the headlines once again, but investors were selective with their reactions and tended to favor stories which supported a rebound in global growth while ignoring those that sparked squabbles between government leaders. Elections in France and Germany ended as expected, North Korean fears came and went, and in the US, Republicans were able to push through with their promise of tax reform.

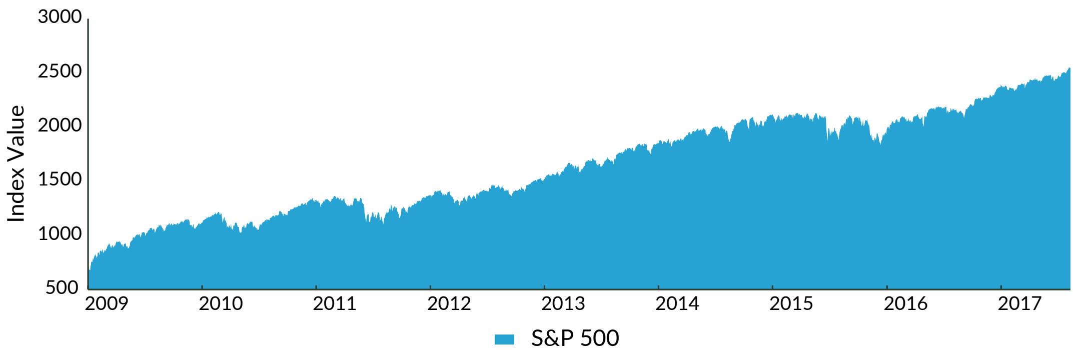
For investors, geopolitics and central bank activity took a back seat to improving GDP, falling unemployment, and surging consumer and business optimism around the globe. Improving economic prospects and stubbornly low inflation created a "Goldilocks" economy in which growth was strong enough to support the demand for risk assets, but not strong enough to boost inflation or interest rates back to historically normal levels. Although both the US and the UK raised interest rates in 2017, global yields on risk-off assets remained well below historical levels. The resulting environment cultivated a high demand for stocks around the world. Global stock markets had one of their best years in recent memory with emerging markets leading the way, followed by foreign developed markets, and finally the US all gaining around 20% for the year.

> "2017 was the first time that the global economy grew in sync in more than a decade."

2018 Introduction - Don't Fight the "Mo"

The global economy has gained significant traction in recent years. Looking ahead to 2018 we expect the positive momentum to continue, albeit at a slower pace. During the years central banks were deploying quantitative easing measures to support the economy, the message to the markets was “Don’t fight the Fed”. As the dust settles on the effects of monetary policy extremes and we are beginning to see fiscal policies take the reigns, we think that the new message is “Don’t Fight the Momentum (Mo)”.

S&P 500 Since March 2009 Low



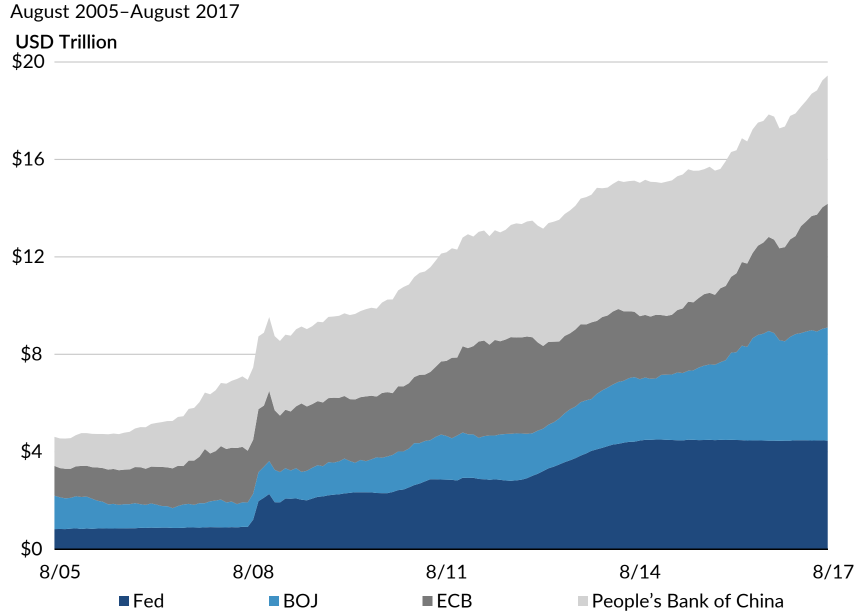
Source: S&P Dow Jones Indices LLC, FRED, SSGA

The current recovery has been long by historical standards, but we have also been in one of the most manipulated and hated bull markets in history. GDP growth appears to have hit escape velocity in many countries that were on the brink of economic stagnation. Synchronous growth paired with low inflation and low volatility in global interest rates has created enough momentum to support another year of stable growth.

Secondly, many market participants did not trust the recovery enough to take a firm position in risk assets which has led to a buildup of liquidity on the sidelines. As the markets continue to run, we think that this liquidity will be allocated to risk assets and support the next leg of the bull market.

Global Liquidity: Total Assets of Major Central Banks

August 2005–August 2017



Source: Bloomberg, Franklin Templeton

Additionally, traditional factors which have limited market upside in the past, such as rising interest rates and inflation, have been kept at bay by technological advancements, the shift to a more service oriented economy, a lack of business spending, and minimal wage growth. Barring major external shocks brought on by geopolitics, a rampant rise in inflation, or surprises from central banks, we expect the markets to continue their upward climb in 2018.

That being said, this year is likely to mark the return of normal volatility in both stock and bond markets. As rates in the US have started to rise, many carry trades which resulted in low volatility begetting low volatility are no longer as attractive. Also, positive results from 2017 have led to excessively high expectations for revenue, earnings, and GDP growth in 2018. Given the poor historical track record of economists' sell-side analysts, it is possible that the economy and markets will not meet these expectations. We expect market pullbacks to occur with more frequency and potency when disappointing results hit the headlines.

"As monetary policy measures subside and the economy gains traction 'Don't fight the Fed' becomes 'Don't fight the Mo' "

TINA - There is no Alternative

Major stock indices hit new high after new high in 2017 leading to the expansion of many valuation metrics. Many pundits have issued warning signs based on these measures but our indicators are not flashing red yet. For the first time in nearly a decade stock prices are being driven by a rebound in company fundamentals and consumer activity. Investors who have watched from the sidelines in what will likely go down as one of the most hated bull markets in history have gained confidence in both the economy and their personal financial standing.

All of this supports stocks, but one of the most important factors promoting demand for equities is explained by simple math. One of the most publicized stock market valuation metrics, the price to earnings ratio (P/E), has risen to near historically high levels. The P/E ratio can also be used to show the return potential of a bond. Assuming stock valuations are at a P/E of 20x, investors are willing to pay $20 for every $1 in earnings. Rearranging the formula shows that this would indicate a 5% earnings yield in the market (1/20). Applying the same process to bonds we see that if bonds are yielding 3% that would indicate a P/E ratio of over 33x (1/3%). The decision to choose stocks over bonds becomes even easier when you add price growth to the equation. Additionally, bond yields are near historical lows and are expected to rise along with interest rates as the economy and monetary policy return to normal. This is negative for fixed income because bond prices fall as yields rise. Stocks, on the other hand, have historically been less affected by rising inflation, tend to perform well when rates are rising slowly, and have the potential to generate price gains through earnings growth.

The result of this comparison between the two most utilized asset classes underscores why the demand for stocks has continued to rise along with valuations. Until interest rates break out to a higher level where the yield from investing in a bond is more beneficial to an investor than the yield and growth potential of the stock market we expect demand for equities to remain at elevated levels.

Stocks, Bonds and the P/E Ratio

Stocks at current P/E levels	→ $\frac{\$100}{\$5}$ =	20 P/E	Stock valuations are above their historical average of 18 P/E...
Bonds assuming a 3% yield	→ $\frac{\$100}{\$3}$ =	33 P/E	...but at low interest rate levels equities still look attractive compared to bonds

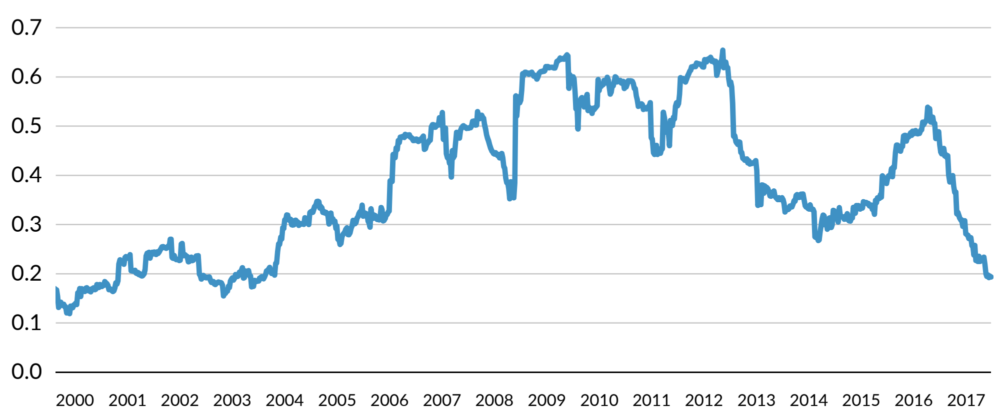
Source: Waterloo Capital Management

Active Over Passive

Integral changes in what is bolstering stocks will lead to greater success for active management in 2018. Active investors will be able to take advantage of lower correlations and expanding market breadth in global equities. These factors, along with swift rotations in market leadership, will provide active investors with ample opportunities to produce alpha.

Companies and sectors with robust momentum have been leading the bull market charge. FANG (Facebook, Amazon, Netflix, and Google) has become a household acronym as money has continued to flow into market leaders. Passive investors may get into trouble if they do not pay attention to how much of their portfolios depend on past market leaders to continue outperforming the markets. During downturns, stocks with a strong momentum factor typically go through more pronounced selloffs than the broader market. As volatility ramps up, rates rise, and valuations become harder to justify, there is a high probability that selloffs will be more pronounced than what investors have become accustomed to in recent years. Counterintuitively, as overall market volatility has declined (measured by the VIX) correlations among the S&P 500 and global stock markets have been falling.

One-Year Rolling Correlation in Weekly Price Change of 45 Markets against the MSCI All Country World Index



Source: Franklin Templeton Global Research, MSCI

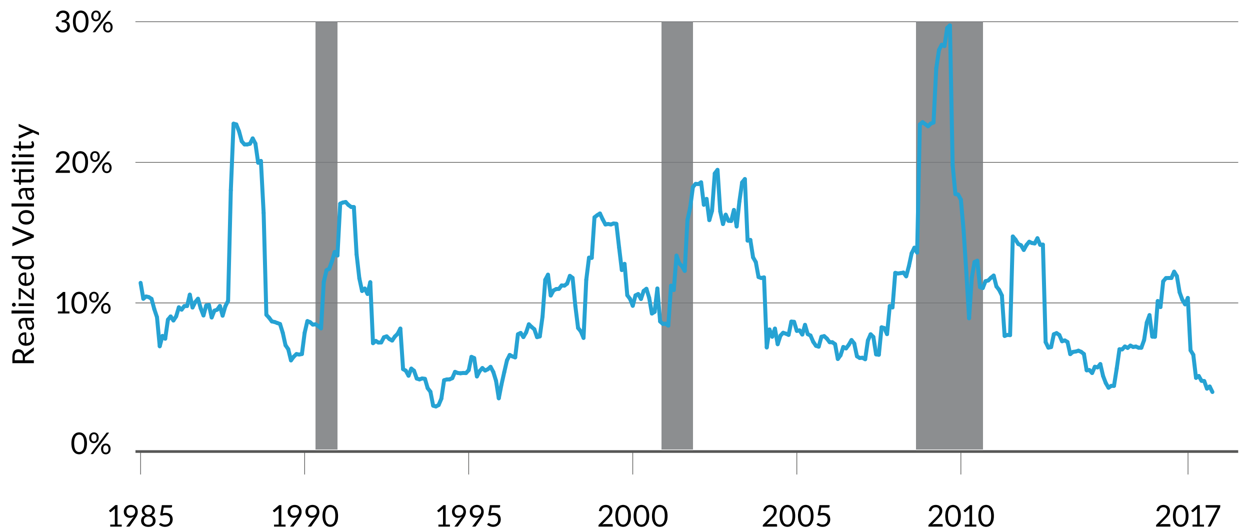
Rapid rotation into and out of leading and lagging sectors has led to the index appearing to rise without a significant increase in volatility while underlying constituents are exhibiting volatility near more normal levels. The result has been an increase in market breadth, the difference between the number of stocks that are rising in price and falling in price. An increase in breadth is advantageous to active portfolio management. The rotation among sectors and underlying companies creates opportunities to generate alpha by exiting positions before they begin to lag the overall index and holding positions that are leading the index. Set-it-and-forget-it indexed portfolios will struggle to cope with an increase in underlying market volatility and more frequent shifts in market leadership. The ability to ascertain when to stick with momentum and when to shift away from specific assets and asset classes is more important than ever. We remained focused on utilizing our quantitative and macro analyses to take advantage of the most attractive probabilities and prepare for the worst possibilities this year.

Volatility on The Rise

2018 will be the year when market volatility returns to more normal levels. Both stock and bond markets have experienced a significant decline in volatility during the current bull market, but changing market dynamics should lead to a rebound in volatility this year. The decline in volatility in the stock market can be partly explained by lower volatility in the bonds markets. Although the Fed has raised rates, spreads have continued to decline for many major fixed income sectors. High yield spreads have historically been a leading indicator of stock market volatility. These bonds in particular have seen a decline in spreads to near what we would expect to be a credit cycle low. Given that we expect rates to rise further this year, it is likely that high yield spreads will reverse course and widen which will catalyze stock market volatility.

Although we do not think that current valuation levels have hit “exuberance” levels, at the current measures it would be normal to see a 5% to 10% correction. It is likely that the market will begin to stair-step its way higher with a few steps down and a few steps up rather than the consistent ramp up that we have seen in recent years. Market participants have been surprisingly complacent in the face of external market events, but they have begun to punish areas of the market which fail to meet expectations. As earnings continue to move to the forefront of what is driving the bull market, failure to meet expectations will also lead to an increase in volatility. Additionally, as more and more investors have taken a passive approach to setting portfolio allocations, capital has surged into high-growth companies. The demand for these holdings has led to the belief that high-growth stocks provide stability. This runs counter to the high-growth and high-risk nature of growth oriented companies. A pullback in growth stocks would likely lead to a broader pullback in passive investment vehicles. Also, value stocks have been in the middle of their longest period of under performance versus growth stocks in the last 40 years. A significant rise in inflation and interest rates would make value stocks more attractive. The markets have been quick to react to underlying shifts in market leadership and a rotation from growth to value would likely increase volatility and could cause a sell-off in growth strategies.

Monthly US Equity Volatility



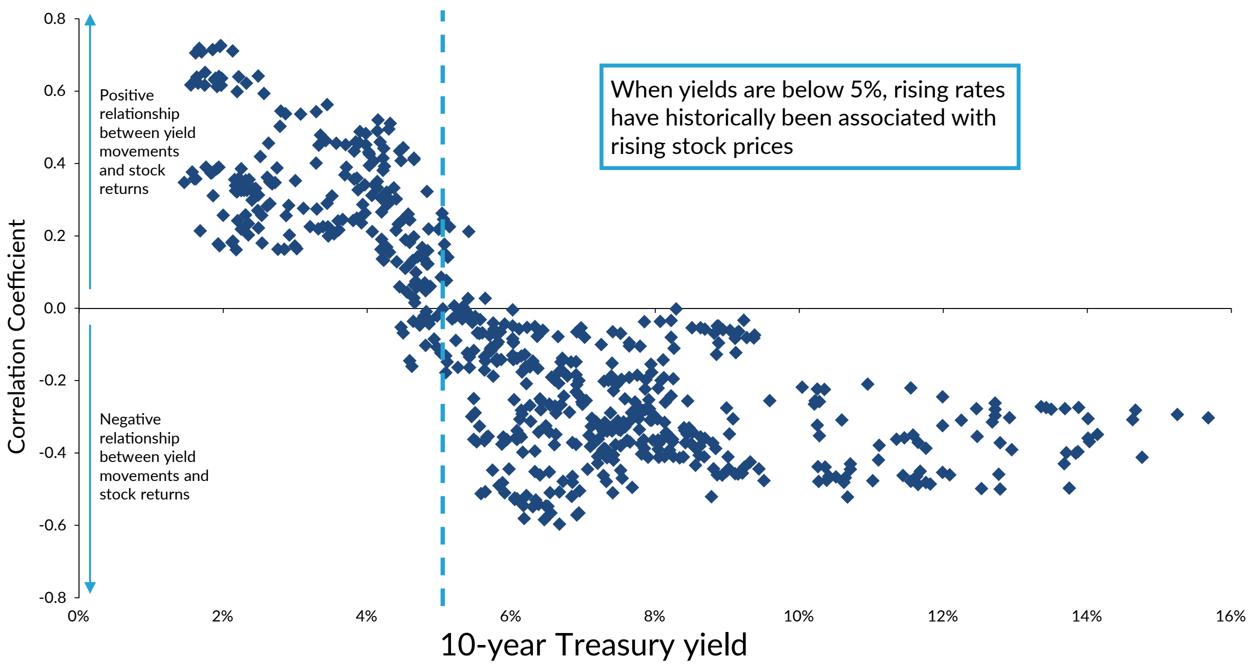
Sources: BlackRock Investment Institute, with data from Thomson Reuters and Robert Shiller, November 2017.

The Return to Normalcy

Interest rates have begun the trek back to normal levels and we expect rates to continue rising in 2018. The consequences of a return to normal interest rate levels will be felt throughout the economy and will likely provide insight into how much further this expansion can go. It has become more difficult to determine where we are in the business cycle as the expansion has aged. Typical headwinds to expansions have been manipulated by artificially low interest rates and stagnant inflation. The Fed is trying to do their part by projecting four rate hikes this year, but policy makers are not omnipotent. Fed policy has an effect on short-term interest rates, but long-term rates are driven by the markets and the expectation that future growth is going to be better or worse. The Fed has done what it can to support credit expansion by increasing the money supply and now banks are the gatekeepers. Rising interest rates should entice banks to increase lending volumes and give us more insight into the health of the current business cycle.

Correlations Between Weekly Stock Returns and Intererest Rate Movements

Weekly S&P 500 returns, 10-year Treasury yield, rolling 2-year correlation, May 1963 – December 2017

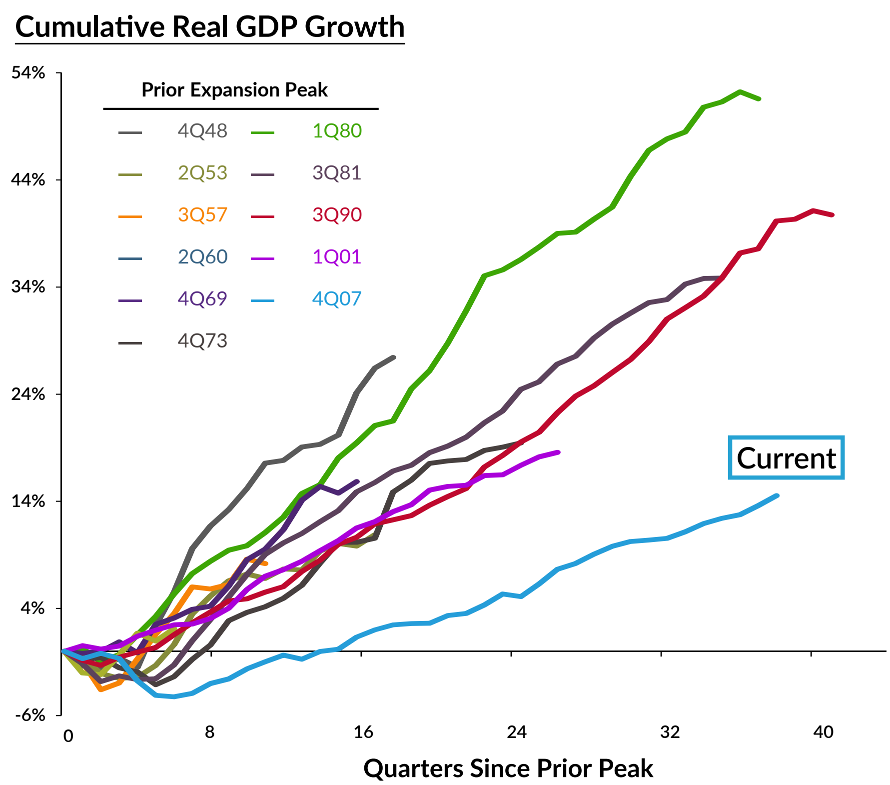


Source: FactSet, Standard & Poor's, FRB, J.P. Morgan Asset Management.

Rising rates could spell trouble for stocks. Stocks tend to rise along with interest rates up to a point. In the past that level has been 5% on the 10-year Treasury. Today that level may be lower because rates are rising from historical lows. That being said, one of the most consistent signals of a market pullback has not yet flashed red. Even after a 9-year bull market run we are not seeing signs of excesses in the economy or the markets. Optimism has been rising to levels that indicate we are close, but not there yet. Some signs of speculation are beginning to appear (i.e. Bitcoin, margin debt levels) but growing optimism should be a boon to the economy this year.

The Return to Normalcy (continued)

Interest rates have garnered the majority of the 'return to normal' attention, but the return to normal GDP growth is just as important. Recent financial headlines would have you think that the US is in the midst of an impressive economic expansion, but history tells a different story. Getting back to consistent 2% GDP growth has been an important step in the recovery, but 2% is far from normal and the economy has plenty of room to do better. Until recently, the rise in stock prices has not made a significant impact on business activity and productivity levels. Clearer insights into regulatory issues and taxes have caused a rebound in business confidence. The increase in business confidence coinciding with low unemployment and healthy consumer demand should spark pent up activity that will help push economic growth back to its normal range. Over time we would expect growth to reach 4%, but this year GDP should be closer to 3%.



Source: BEA, NBER, JP MORGAN ASSET MANAGEMENT

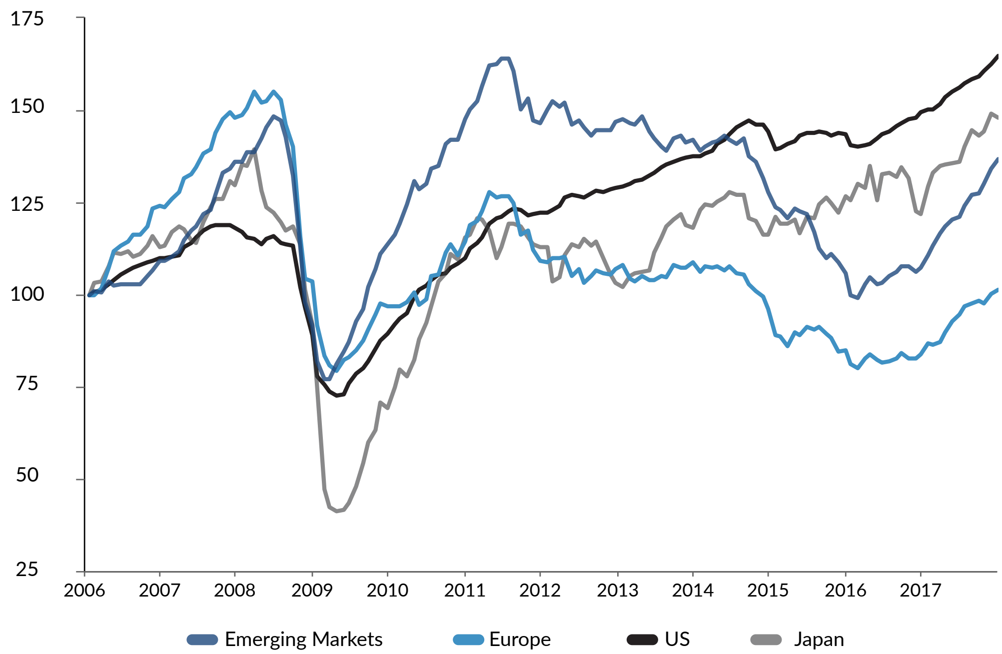
> "...2% GDP growth is far from normal and the economy has plenty of room to do better."

Earnings Fuel The Next Ascent

The effects of quantitative easing have fully penetrated global stock and bond markets. Central banks' decisions to lower interest rates to historically low levels bolstered the demand for equities and the expansion of market multiples that have fueled the rise in equity markets. As central banks begin to shift their focus away from increasing market liquidity, the market needs a new catalyst to drive price appreciation. We believe that a continued rebound in global earnings will take the place of margin expansion to propel the market to new highs. The not-too-hot, not-too-cold, economic environment has established a significant platform for earnings growth. Many companies are in position to take advantage of positive trends in consumer and business spending. Also, low interest rates decrease worries related to mounting debt servicing costs and low inflation keeps input costs low. This profit friendly environment and the expected benefits of fiscal policy measures lay the foundation for significant earnings growth.

Global Earnings Per Share

EPS, U.S. dollar



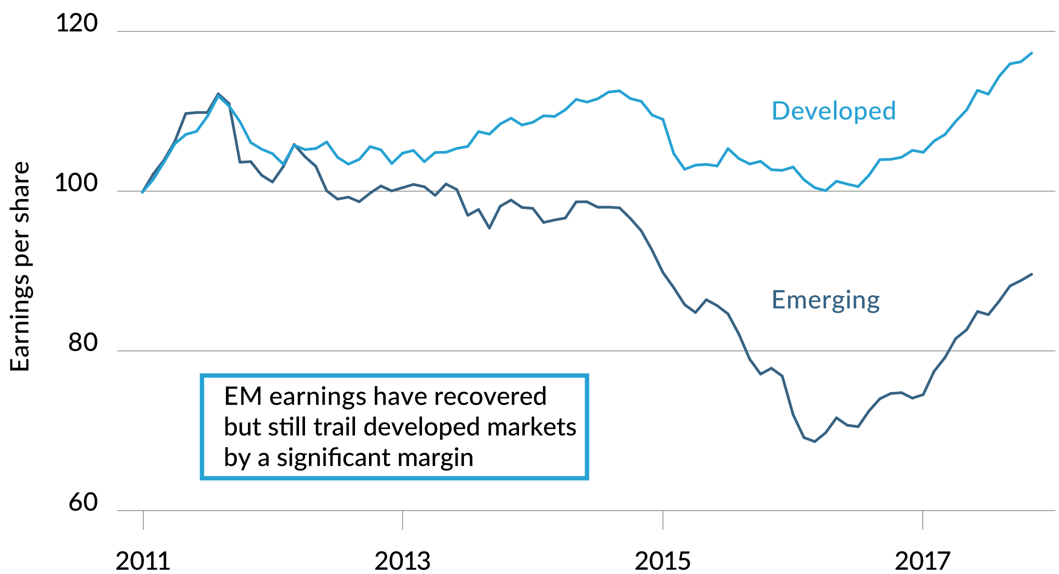
Source: FactSet, MSCI, Thomson Reuters, Standard & Poor's, J.P. Morgan Asset Management

In the US, many companies should see an immediate boost to their bottom line as a result of recently passed tax-reforms. Businesses were paralyzed by uncertain regulatory frameworks and tax policy expectations so they stayed conservative. Now that businesses are no longer facing these headwinds there will likely be an increases in business spending and earnings. Additionally, the recent decline in the US dollar against many major currencies dials back negative exchange rate effects which plagued multinational companies in recent years. Foreign developed markets stand to benefit from many of the same trends. Downward trending unemployment, rising consumer activity, and a renewed focus on buybacks and return on equity should support positive earnings growth this year.

Earnings Fuel The Next Ascent (continued)

Emerging markets also stand to benefit from this new trend. Many major emerging market economies, such as Russia and Brazil, appear to have turned the corner and have joined in on the global recovery. Chinese growth has slowed but has stabilized at levels which will still support emerging Asian economies. Additionally, surging global demand and a weaker US dollar supports growth in commodity prices. Because many emerging markets are commodity producers this trend will support 2018 growth expectations. The resulting environment leads us to believe that barring any unforeseen political or economic shocks earnings growth will persist this year.

Developed Market vs. Emerging Market Earnings Per Share



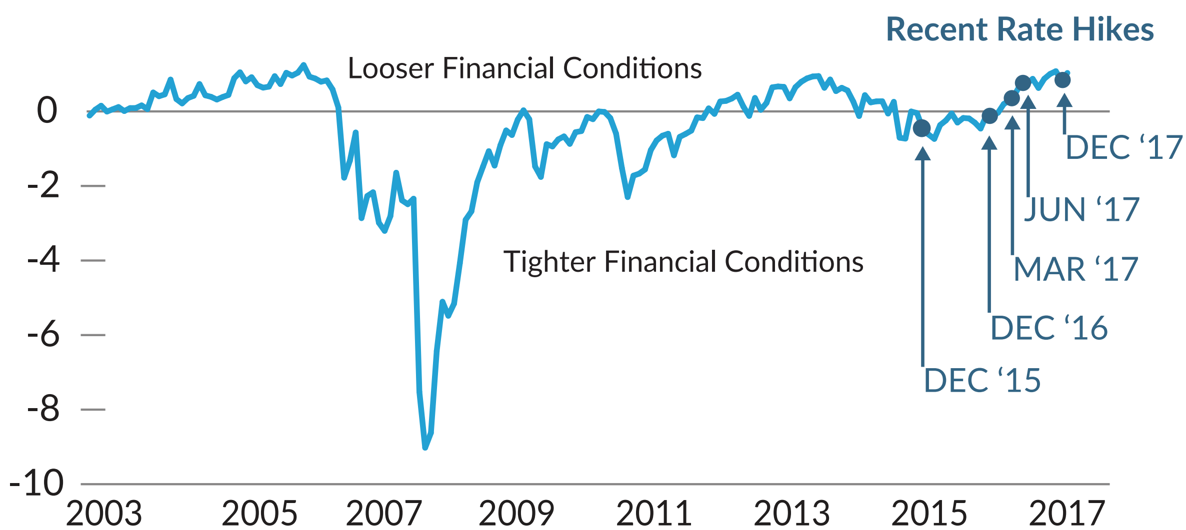
Sources: BlackRock Investment Institute, with data from Thomson Reuters, November 2017.
Notes: The lines show analysts' 12-month forward earnings-per-share estimates for the MSCI World and MSCI Emerging Markets indexes, rebased to 100 at the start of 2011.

We expect earnings to beat expectations this year but it is important to remember that earnings are a lagging indicator and that markets are forward looking. Positive results do not guarantee that stock prices will rise, but outperformance typically generates demand for equities by confirming investors' positive outlooks.

> "The continued rebound in global earnings will propel the markets to new highs."

Central Banks vs. Inflation

The removal of central bank accommodation will be a major test for financial markets, but the true test will likely be postponed until beyond 2018. Globally, monetary policy will still be tilted towards easing rather than tightening. The US, UK, and Canada have begun to raise rates, but fiscal conditions are still nearly as easy as they have ever been since the global financial crisis. The global economy is growing with more balance than in previous years, and peripheral economies that struggled to keep up with the global expansion now appear to be turning the corner. Because of this, the wind-down of central bank balance sheets is unlikely to pose a significant threat to broader global growth this year.



Source: Bloomberg. Data from December 2003 - January 2018

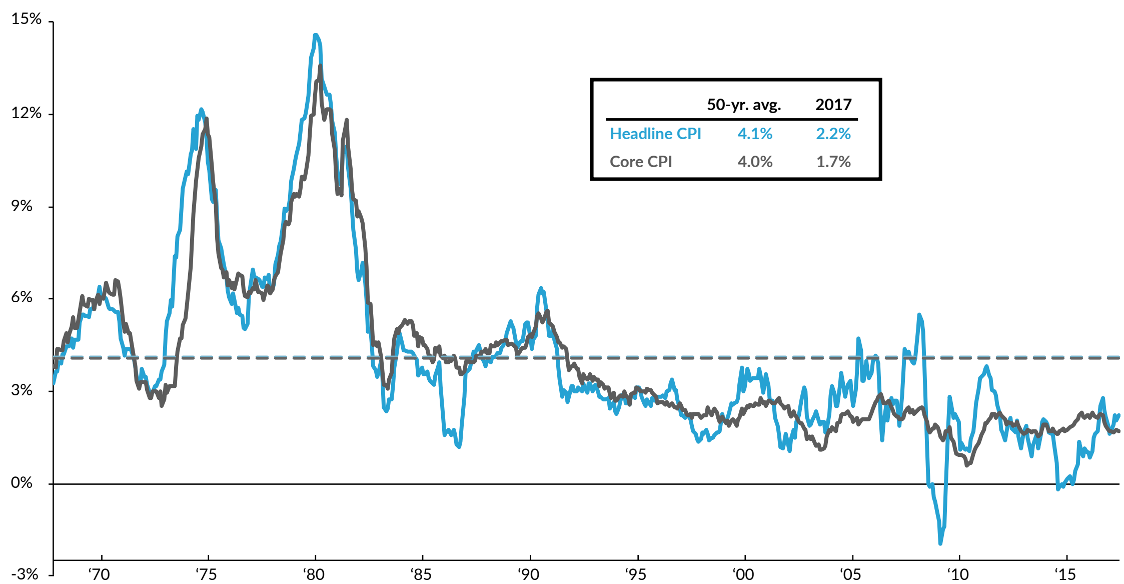
Policy makers are hoping that the staggered approach to accommodative policy removal will help avoid a spike in global interest rates. Policy divergence between the US, UK and Canada, relative to the Eurozone and Japan has become starker over the past year. This divergence should help global markets stay balanced without fueling excessive credit expansion.

In what could turn into the battle of the bull market, central banks will have their hands full playing defense against inflationary pressures while attempting to normalize monetary policy. The markets have been surprisingly complacent about rate normalization so far. The subdued reaction is likely a factor of extensive forward guidance from central banks, and up to this point, inflation has been kept in check. The lack of external pressures has allowed the Fed and other central banks to remain flexible with their policy announcements.

Central Banks vs. Inflation (continued)

Globally, inflation has remained stubbornly below central bank targets. As the global economy continues to gain traction it is possible that inflation begins to rise faster than expected. Higher inflation should result in higher interest rates based on historical monetary policy mandates. If inflation significantly outpaces the Fed's planned rise in interest rates it would force policy makers to make a difficult decision. They could let the economy run-hot and trust that rates will not rise to detrimental levels, or they could raise interest rates at a faster pace and risk derailing the current recovery.

CPI and Core CPI (% change vs. prior year)



Source: BLS, FactSet, J.P. Morgan Asset Management. CPI used is CPI-U and values shown are % change vs. one year ago. Core CPI is defined as CPI excluding food and energy prices. Data are as of December 31, 2017.

> "In what could turn into the battle of the bull market, central banks will have their hands full playing defense against inflationary pressures while attempting to normalize monetary policy."

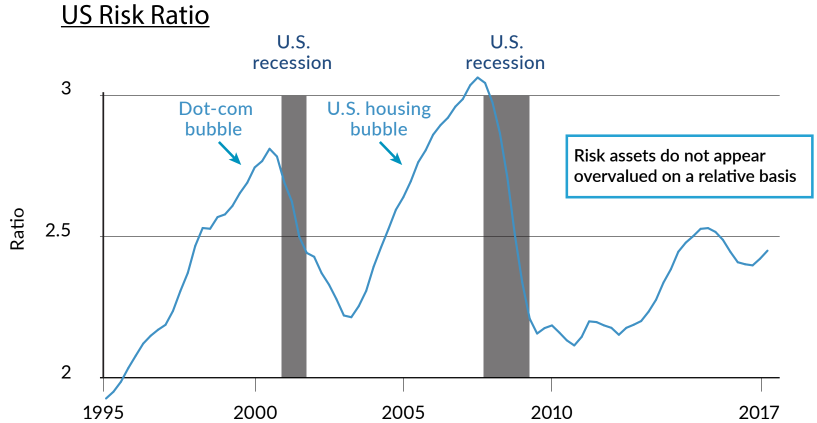
Tactical Decision	H1 2018 Investment Outlook	
Relative Risk	Risk Off	Risk On
U.S. Equity Style	Value	Growth
U.S. Market Cap	Large-Cap	Small-Cap
Regional Equity Selection	U.S.	Non-U.S.
Equity Market Preference	Developed	Emerging
Fixed Income Quality	Investment Grade	High Yield
Fixed Income Duration	Short	Long
Regional Bond Selection	U.S.	International

Asset Class	Stocks	Bonds	Cash
U.S. Equity Sectors	Industrials	Materials	Energy
Commodities	Energy	Metals	Agriculture

Domestic Equity

Despite a banner year in 2017, domestic equities are still one of the most attractive investment options in 2018. Market fundamentals are still strong, and leading economic indicators are signaling a prolonged expansion. Also, earnings growth and the ramifications of tax reform and other fiscal policies are expected to catalyze the next leg of the bull market. This year, we expect multiple expansion to slow and potentially contract as investors shift their focus towards earnings growth and financial stability as a sign of market strength. Earnings expectations are the highest they have been in over a decade, which is a clear indication that investors are anticipating more positive news for US businesses this year. The high hurdle set by these optimistic expectations may be difficult for stocks to achieve, but a few missteps will not result in a negative outcome. Even if year over year earnings growth levels slow, as long as investors perceive that growth trends are sustainable, equities should continue to appreciate.

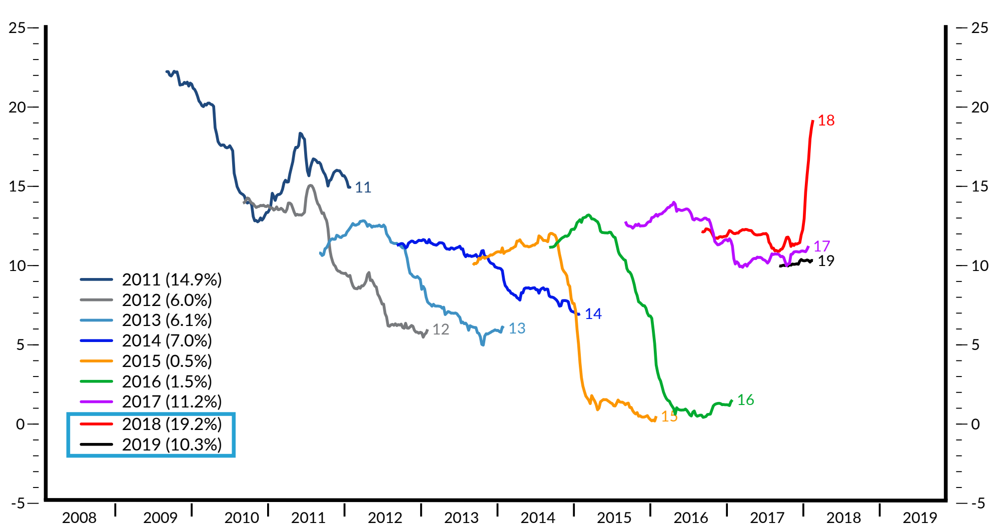
US Risk Ratio



Sources: BlackRock Investment Institute, with data from the U.S. Federal Reserve, November 2017.
Notes: The risk ratio is calculated by taking the value of outstanding U.S. risk assets (defined as equities, corporate bonds, mortgages and bank loans) and dividing this by the value of perceived safe-haven assets (government and agency mortgage securities and bank deposits).
Central bank holdings are excluded.

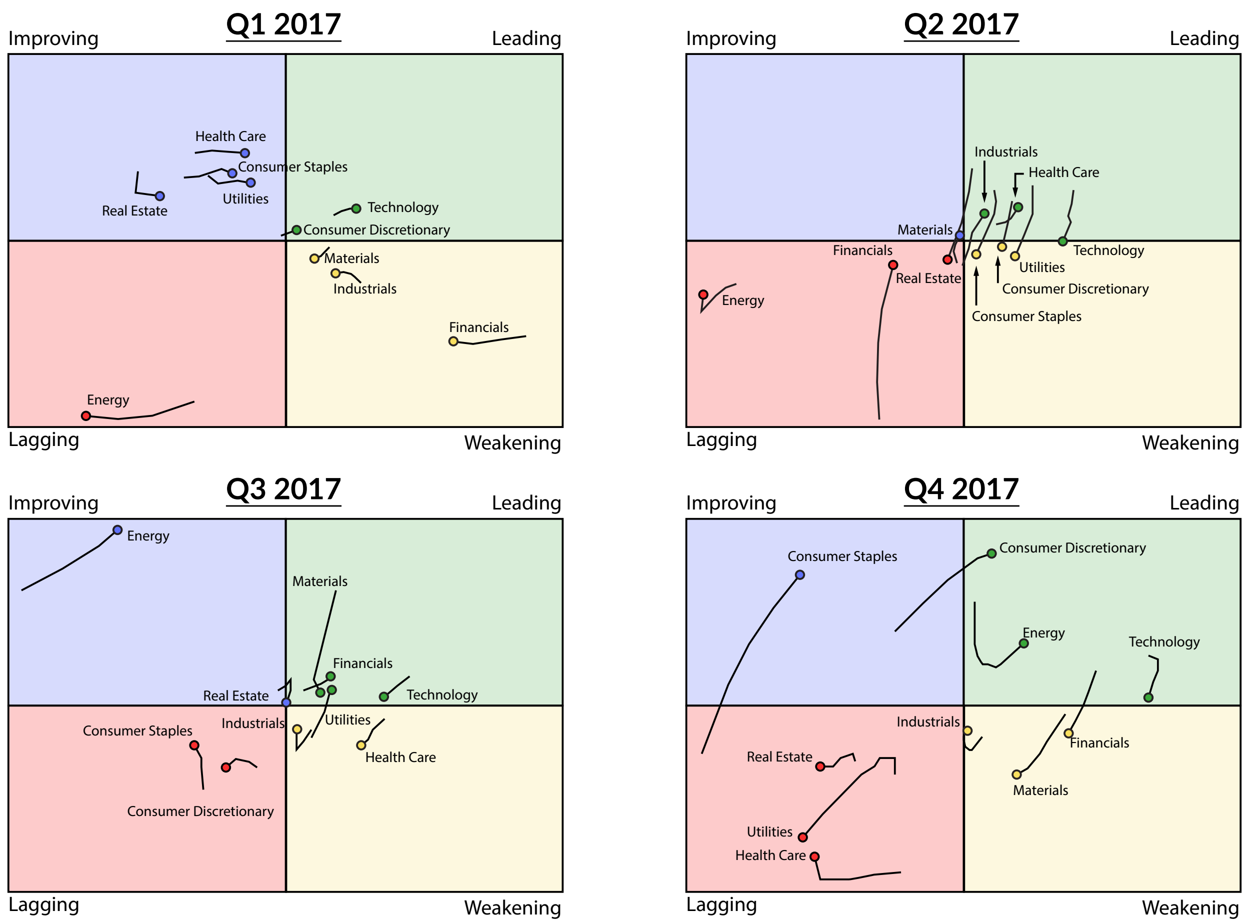
The recent tax reforms provide the greatest benefits to corporations. Lower tax rates will free up large amounts of cash and allow many companies to increase capital expenditure budgets, buyback stock, pay down debt, or raise wages. Additionally, the combination of durable GDP growth and low inflation should help support revenue production while keeping input costs low. The resulting environment will have a positive impact on bottom line earnings this year. Robust consumer spending trends will also support businesses. Consumer activity should continue to increase this year with support from personal tax savings, tame inflation, and full employment finally leading to rising wages.

S&P 500 CONSENSUS ANNUAL OPERATING EARNINGS GROWTH FORECASTS (percent)



Source: Thomson Reuters I/B/E/S, Yardeni Research

Investors began shifting their allocations in favor of sectors and asset classes that will benefit from changing market drivers in the fourth quarter of last year. Cyclical sectors such as materials, industrials, and consumer discretionary began outperforming the overall market leading up to the passage of tax reform. We believe that this rotation represents a defining change in market leadership that will continue in 2018. Financial engineering by the Fed forced investors into areas of the market that were being driven by excessive growth expectations. Typical factors that support sustainable growth were ignored. Now that the Fed has taken a step back and fiscal reform is taking the reins, investors have renewed their focus towards companies that stand to benefit from growth on Main Street as well as Wall Street. This shift will benefit companies that are investing capital back into their businesses to spur growth rather than focusing solely on shareholder returns. Fundamentals such as rising production and profits, growth of hard assets, and increasing cash flows are back en vogue. Investors that have the wherewithal to make targeted investments beyond the typical benchmarks stand to gain from these changes. With equity valuations in the 99th percentile of historical P/E valuations, investors will need to alter their strategy from of passively investing in indices and hoping for broad based rallies, to taking an active and fundamental approach to investment selection.



Source: StockCharts.com, Waterloo Capital Management

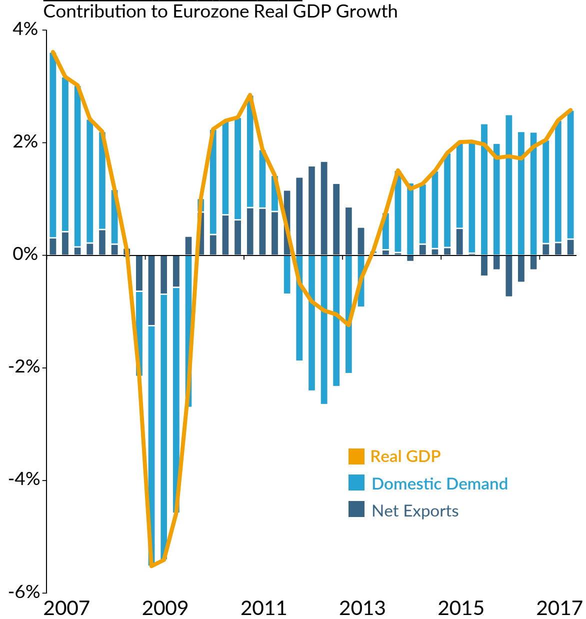
In accordance with our, models we are focusing on secular growth sectors with sound fundamentals as well as attractive value plays such as energy and financials. Materials and industrials are likely to lead the market early in the year as positive momentum from rising commodity prices rolls over from 2017. These sectors will also benefit from post-natural disaster rebuilding efforts and stable inflation. Overall we expect domestic equities to generate above average returns as the economic recovery gains traction on a global scale and continues powering ahead.

Eurozone

In 2018, the eurozone will continue to benefit from expanding global growth, central bank idleness, pro-growth political undertakings, and improving corporate fundamentals. Politically, the threat of the Brexit rallying separatist movements in the region seems to have passed. Elections in the region's strongest economies, France and Germany, resulted in pro-growth, pro-EU leadership maintaining their hold. Elsewhere, Italian elections are likely to inject some volatility into the markets this year. The populist Five Star Movement has maintained relevancy, and regardless of the election outcome, their ideals will likely influence the country's leadership in 2018. Despite the potential for the rekindling of populist rhetoric around the Italian election, we expect the influence of Angela Merkel in Germany and Emmanuel Macron in France to reinforce the trend towards growth friendly policies.

Eurozone GDP growth

Contribution to Eurozone Real GDP Growth



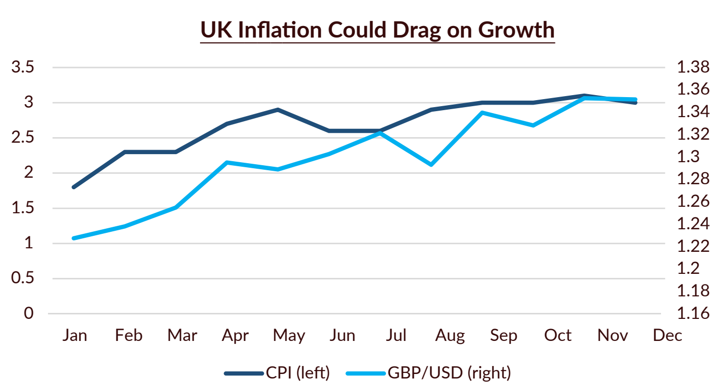
Source: FactSet, JP Morgan Asset Management, Eurostat, ECB

The eurozone economy has lagged the US throughout the current recovery. Fallout from the global financial crisis and the subsequent sovereign debt crisis led to dislocations in the pace of the recovery across the region. The distinctive struggles within individual eurozone countries have slowed down the speed of the turnaround in the region. The recovery may be progressing slowly but it has not gone unnoticed. The Eurozone gained cyclical strength in 2017 and we expect the positive momentum to continue this year. In contrast to previous years, the current expansion has been broad based with lower unemployment and strengthening economic indicators showing signs of life in the peripheral as well as core economies. Spain, Italy, and even the ever-struggling Greece are heading into the year with encouraging momentum. In regards to monetary policy, we expect increasing central bank policy divergence from the US. GDP has gained traction across the region, but there is still plenty of room for improvement. Furthermore, inflation is trending below the ECB's 2% target and is unlikely to accelerate beyond that point this year. Due to the lack of inflationary pressures and the strengthening of the Euro, we expect accommodative policies and record low interest rates to continue. The European Central Bank (ECB) asserted a vote of confidence in the economy when it announced that it would begin tapering its asset purchases this year, but it is unlikely that policy makers will make a material effort to modify their strategies until later in the year. Moreover, at 30 billion euros a month, the tapered purchases will still prolong an easy money environment that is supportive to further growth in equity markets.

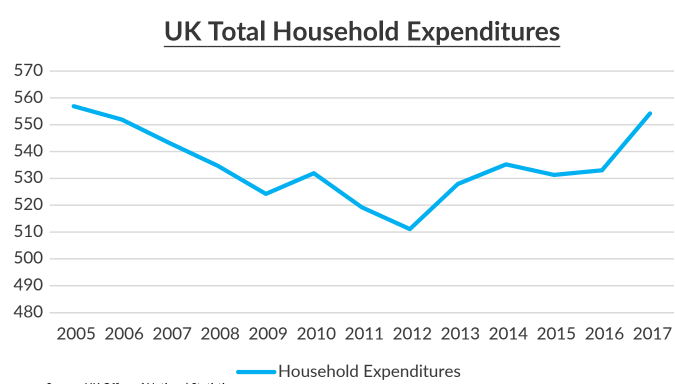
On the corporate front, businesses will benefit from improvements in the consumer sector. Broader economic improvements have led to declines in unemployment and rising household incomes. In conjunction with stronger wage growth, these factors support an acceleration of consumer spending and bolster demand. Higher demand gives companies pricing power, which should in turn expand profit margins and earnings. Both of these measures have failed to gain significant traction since the global financial crisis, but we expect the gap to begin closing at a faster pace this year. It can still be argued that the eurozone is in a similar position to where the US was two to three years ago. As businesses and consumers start to gain confidence, we expect to see an increase in productivity and more consistent earnings growth. The economy is unlikely to surprise much on the upside, but the groundwork has been laid for a return of stable growth, which will propel the region further into a cyclical recovery. We expect to maintain an overweight to the eurozone this year.

United Kingdom

Uncertainties regarding a Brexit deal with the European Union and the impact of rapid inflationary pressures have weighed on investment returns in the UK. On the Brexit front, Prime Minister Theresa May has struggled to build support within her own government and European Union leadership. Negotiations are expected to continue well into 2018 as both sides of the table have come to an impasse over trade deals and immigration issues. Political and economic threats arising from Brexit negotiations negatively weigh on our outlook for the region. Although UK stocks have held up well despite these external concerns, the outlook from here on out is more complicated. We expect British economic growth to be flat or contract slightly through this year. The Brexit won't officially happen until at least 2019, but the Bank of England will be preparing for the worst and will continue to raise rates to guard against runaway inflation. The depreciating pound has led to a rise in inflation to over 3% which has us worried that the central bank may move too quickly and that consumer spending will taper off as prices increase. Because the pound is unlikely to appreciate in a meaningful way before the Brexit, the currency will continue to falter under recent pressures. The rising tide of the global economy will support the UK this year, but given the downside risks and potential headwinds, we have a neutral to negative outlook on the region.



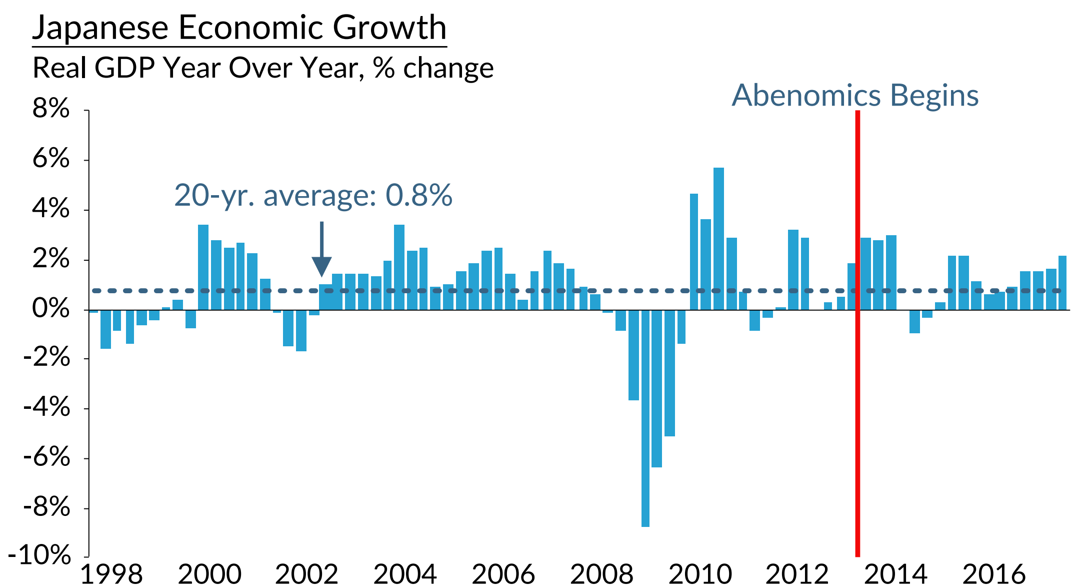
Source: UK Office of National Statistics



Source: UK Office of National Statistics

Japan

Japan has experienced some of the fastest earnings growth rates in the world since the great recession. Earnings hit a big milestone last year when they surpassed pre-crisis levels. Abenomics has worked its way through the economy and the results have been encouraging. Low unemployment and rising wages have buoyed consumer demand in the country. Japan has now posted the most consecutive periods of quarterly GDP growth since the 1990s.



Source: FactSet, JP Morgan Asset Management

We expect the economy to continue growing in 2018. Earnings should continue to expand as more companies focus on maximizing return on equity and buying back shares. Rising global demand will support export growth, and multinationals should benefit from persistent yen weakness as the Bank of Japan maintains its accommodative polices. The Bank of Japan is unlikely to make any drastic moves this year. We expect policy makers to remain focused on the new policy of targeting a zero percent interest rate on the 10-year government bond without massive currency printing measures. As the Bank of Japan holds steady, we expect fiscal spending packages to spur business and consumer spending. The Japanese economy has been gaining traction, but GDP growth remains well below historical norms. The economy is dependent on consumer activity remaining robust enough to support corporate growth expectations. A contraction in employment opportunities or wage growth would negatively impact equity markets.

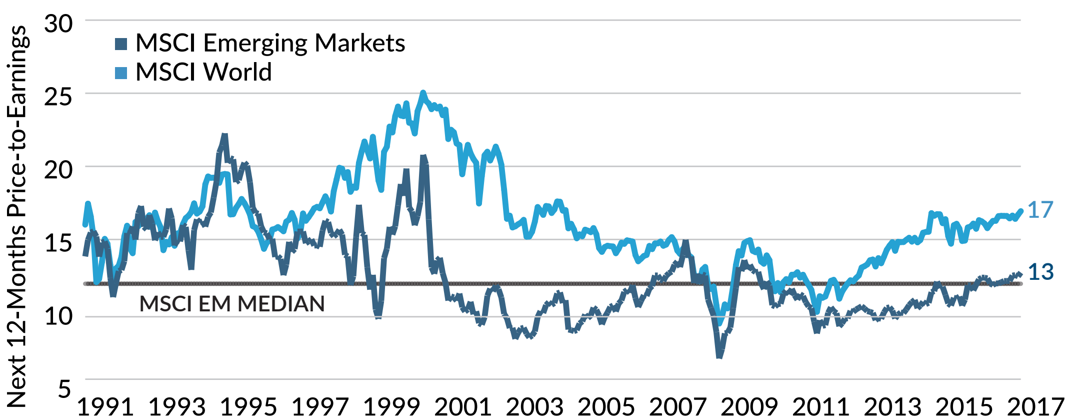
Currency risks are also apparent. Japanese markets have been inversely correlated with the yen. This could pose a risk because the yen has depreciated so significantly in recent years that the probability of appreciation is trending higher. If the global economy falters, investors could increase their demand for yen as a safe haven asset which would spark appreciation in the currency and potentially lead to a sell-off in the equity markets. Overall, the government, monetary policy makers, and consumers appear to be on the same page and we do not expect a significant downturn in the country. We believe that economic momentum and equity upside merit maintaining an allocation to Japanese stocks this year.

Emerging Markets

More than ninety-percent of emerging economies grew in 2017. Despite a breakout year, EM equities are still trailing developed markets since the financial crisis and they continue to trade at a meaningful discount to developed markets. Earnings growth has lagged developed markets since the GFC, but the rebound in global growth last year has laid the groundwork for an extended run for the asset class. Fundamentals are attractive, and manageable inflation coupled with an increase in profitability should support stronger earnings for many EM markets in 2018. Stable growth in developed economies and emerging market currencies should help earnings close the gap between emerging and developed market performances this year.

We see opportunities in some of the areas that have been key drivers of emerging markets in recent history. The BRIC economies have returned to the forefront after recovering from deep recessions and stagflation concerns. Brazil has weathered political turmoil and the economy is gaining momentum. Russia has been a major beneficiary of rising oil prices. India's massive middle class is driving an increase in consumer spending, and the fallout from recent fiscal policy missteps has faded. China was able to maintain impressive GDP growth last year despite cracking down on excessive lending and has maintained its position as the leader of the emerging world. This year in China, we expect that recent government spending measures and rising export volumes will pick up the slack from the pullback in credit growth and real estate investment activity.

Emerging Markets Equity Valuations Remain Attractive



Sources: MSCI and FactSet.

Developed market strength will continue to be the key driver of emerging market growth. The focus on fiscal policies in many developed markets should support EM economies, especially if infrastructure spending picks up and increases the demand for raw materials. Additionally, falling unemployment rates, soaring stocks markets, and firm wage growth will support ongoing growth in consumer spending trends. Furthermore, local focuses on fiscal and monetary reforms boost our outlook for emerging economies. EM governments and central banks have taken significant measures to correct imbalances that made many EM economies vulnerable to outsized corrections during past recessions.

US Dollar vs. Global Currency Basket

Source: Morningstar Direct

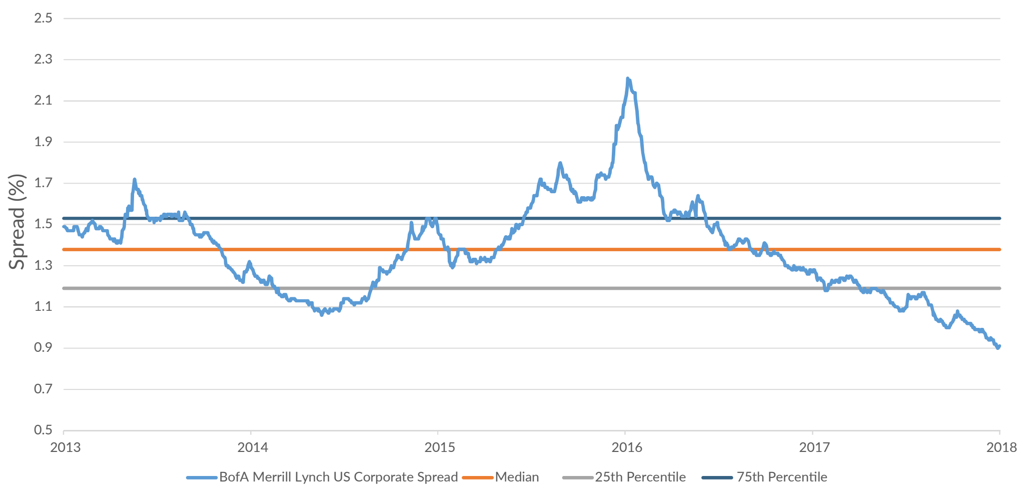
We expect 2018 to be constructive for EM economies, but investors will have to stomach more frequent price swings as volatility returns to the markets. Rising US interest rates are a potential risk, but we think that the gradual rate of increases and US dollar weakness will keep emerging market debt obligations in check. Emerging markets are much better prepared to deal with higher US interest rates than they were during the global financial crisis and the "taper tantrum". Firming export demand has helped balance the current account deficit (imports minus exports) of many countries and helped support capital spending in local currencies by businesses and governments alike. This year, it will be important to monitor the legislative risks applicable to emerging economies. Trade regulations are the biggest question mark heading into 2018. The potential for US tax reforms and ongoing NAFTA negotiations are potential threats to emerging market expansion this year. A lower corporate tax rate and repatriation efforts could discourage US business investment in emerging markets. Also, any significant changes to NAFTA have the potential to disrupt exporter's business models by increasing costs and negatively impacting US demand for foreign goods. Overall, stable inflation, positive capital flows, sufficient room to manage interest rates, and growing support for fiscal policy shifts reinforce our outlook for notable growth in emerging economies. We believe that the positives outweigh the negatives and argue for an overweight to the asset class.

> "Global economic prospects will be constructive for EM economies, but investors will have to stomach more frequent price swings..."

Fixed Income

Fixed income may be the most precarious asset class this year. We are truly entering uncharted territory for nearly all investors in the field. The world has never seen interest rates as low as they were following the global financial crisis, and the current investors have never had to grapple with the potential challenges created by a rising rate cycle. The asset class will always have a place in a well-diversified portfolio because of its ability to moderate negative returns during a bear market and cover the costs of known liabilities. However, investors should not expect to receive much in the way of portfolio gains generated from their bond holdings.

Corporate Credit Spreads



Source: FRED, Waterloo Capital Management

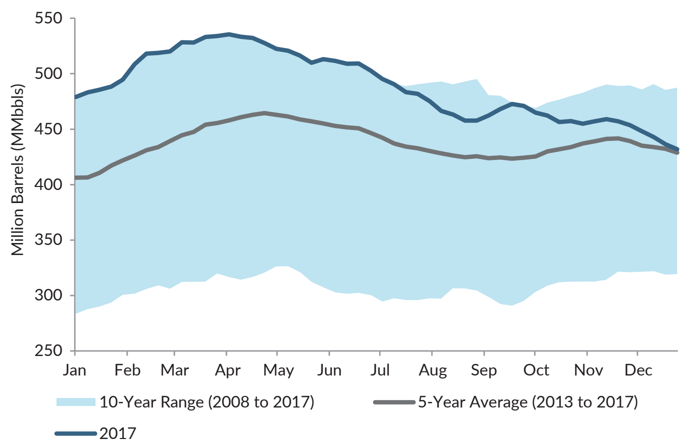
Overall, the risks are mounting for the sector. First, The markets are likely underestimating the pace of Fed tightening. The Fed has struggled to keep its word when issuing forward guidance regarding the number of expected rate hikes in a given year. Fixed income prices heading into 2018 imply that investors are expecting more of the same this year. Those who do not heed the Fed's word could find themselves holding onto significant losses this year. Yields gained momentum heading into January, and the Fed appears to have no intention of backing down on their projection for four rate hikes during 2018. Secondly, many investors are underestimating the interest rate risks associated with investing in fixed income as rates rise from historical lows. 2018 return expectations should be reined in. We expect total fixed income returns to be close to underlying yields. With rates almost guaranteed to rise, it is unlikely that investors will see any price appreciation in the asset class.

Overall, our outlook on the sector is negative. We think that the most prudent approach is to focus on the intermediate part of the yield curve (5-10 years) and increasing credit quality in corporate holdings. In the US, TIPS and floating rate bonds are beginning to look more attractive. Inflation has struggled to maintain upward momentum, but rising rates in conjunction with a weaker currency and a rebound in capacity utilization could catalyze the inflation rate. Investors may also benefit from tactically allocating to managers that are able to take short positions in bonds. Short positions make money when the price of an underlying asset declines. Because bond prices move inversely to interest rates, short positions stand to gain value as rates rise. International bonds may still have room to appreciate as demand for the asset class remains high and central banks continue to pursue accommodative spending policies.

Real Assets

Coming into 2018, we think that master limited partnerships offer a compelling tactical opportunity. In 2017, MLPs were one of the few asset classes that posted negative returns for the year. Bank financing slowed following the 2014 energy crisis, and the midstream industry has struggled to find funding for the almost $80 billion in new pipeline builds and expansions expected in the US. To fund this massive infrastructure build, many MLPs have elected to reduce dividends which discouraged many investors. This year, we see continued positive trends in on-land US energy production which should provide a supportive backdrop for the sector.

US Crude Oil Storage Levels



Source: EIA, Baker Hughes, Bloomberg, GSAM

Except for the depths of the financial crisis and the worst of the energy sell-off in early 2016, MLP valuations are the most attractive they have ever been. Whether we look at distribution rates, enterprise value to EBITDA, or spreads to other asset classes, MLPs appear cheap. Discounted valuations and strong fundamentals create a strong case for tactically allocating to MLPs. This year we expect growing energy volumes to catalyze free cash flow growth and improving financials for the sector. A rebound in cash flows should encourage companies to raise dividends back to previous levels. The greatest risk that we see to MLPs is continued bankruptcies in E&P companies; however, we think that bankruptcies have peaked for this cycle. The levels of capital spending for most MLPs are moderating and we believe that current yields in the sector are attractive and that valuations are well underpriced.

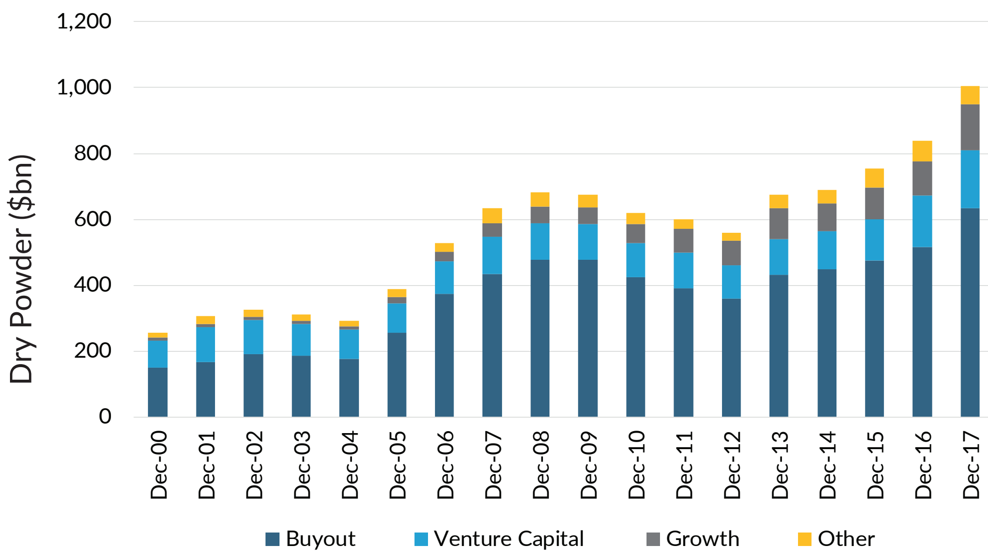
Valuation Method	Current Level	Long-Term Average	Premium/ Discount	Price Move to Historical Levels
EV/EBITDA	11.7x	12.5x	(0.8x)	10.2%
P/E	15.9x	19.7x	(3.8x)	23.6%
Yield Spread (10-yr Treasury)	4.6%	4.4%	(0.3%)	9.1%

Source: Bloomberg, Wells Fargo, Alerian, GSAM

Private Equity

Private equity purchase multiples remain elevated. Although corporate M&A has declined since the boom years of 2014 and 2015, deal activity remains robust and corporations have completed enough deals to keep valuations higher. Strong distributions and elevated fund sizes have created a large amount of dry powder for funds to deploy over the next investment period. 2017 saw another strong year for fundraising, with dry powder for US PE firms climbing to $565.9 billion. Given the finite investment period window, we expect sustained deal volume and competitive bidding processes to keep valuations elevated.

Private Equity Dry Powder by Fund Type



Source: Preqin Private Equity Online

There is no asset class where the dispersion of returns for a given year is higher than in private equity. It's important to find strong, stable teams with sound operational infrastructure in place. We favor niche, sector specific strategies in middle and lower middle market buyouts, where the competition for deals is not as pronounced.

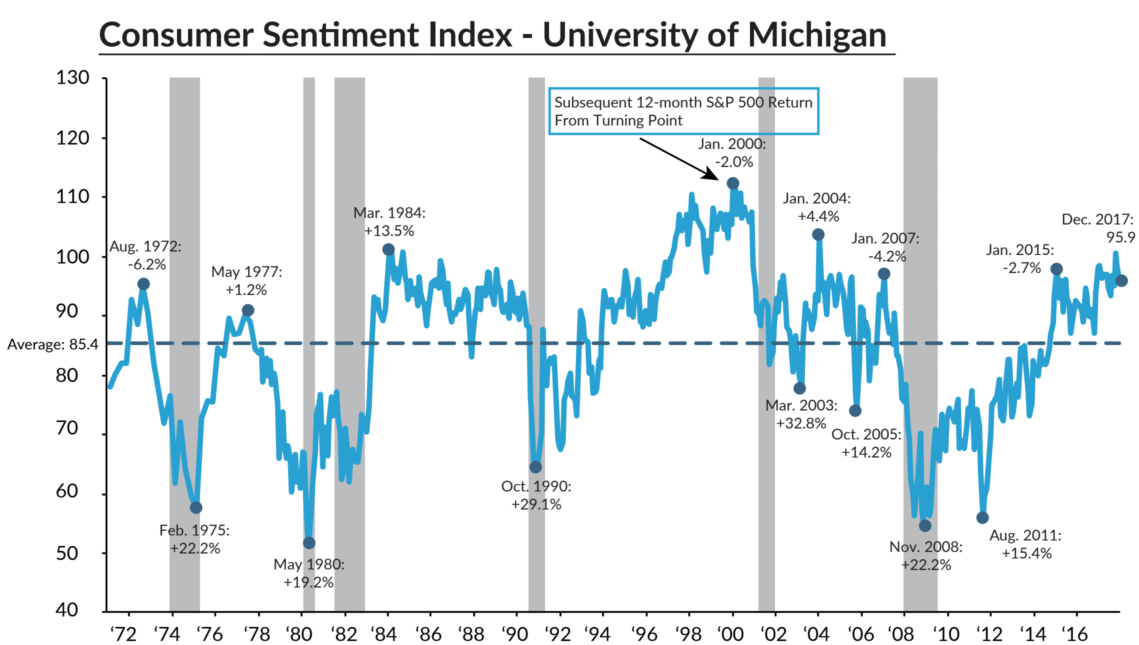
"There is no asset class where the dispersion of returns for a given year is higher than in private equity."

2018 Risks

Despite our relatively upbeat view of the economy and the prospective market returns for 2018, there are many risks to our outlook this year. The Fed is beginning to unwind the largest program of quantitative easing in our nation's history. We have a president who does not seem to shy away from the prospect of international conflict. We are at the end of a 30-year bull cycle in fixed income, and many equity valuations measures are at or near all time highs.

Our positive outlook on equities could be adversely affected by both internal and external factors. Internally, high valuation levels will be an impediment as rates continue to rise and may discourage new money from entering the market. First, exceedingly optimistic outlooks for earnings growth this year increases the potential for market pullbacks if companies fail to meet investors' lofty expectations. Secondly, contrarian indicators such as consumer and investor sentiment have risen past pre-crisis levels and are nearing all-time highs. These factors could spur valuations to exuberant highs and raise the potential for volatile selloffs throughout the year.

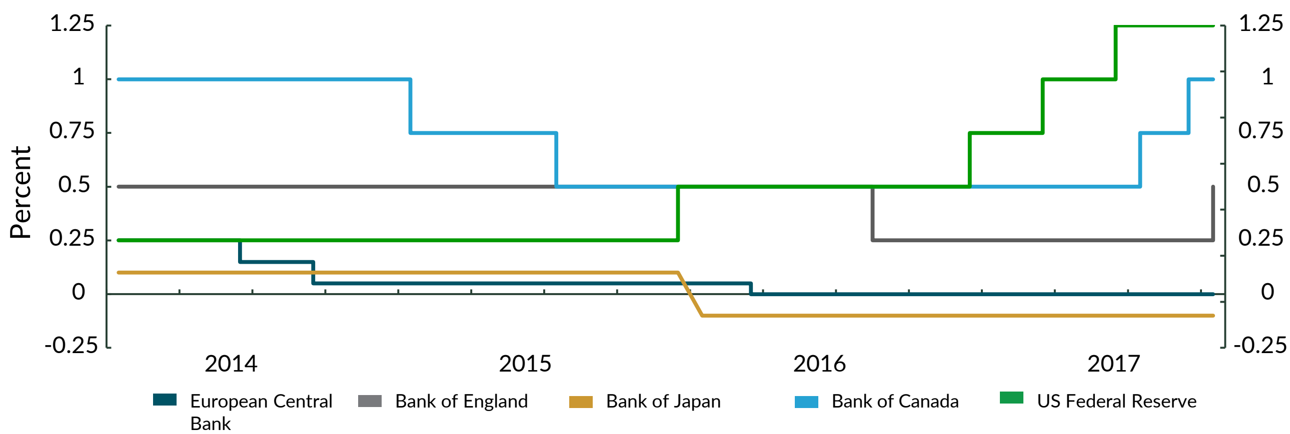
Finally, investors may be mistaking the secular bull market trend for the extension of the business cycle. Most major economies are at or above full employment and tightness in global labor markets could initiate a lift-off point for inflation. Inflation rising faster than expected has the potential to surprise both the market and policy makers. Looking back at other periods of labor market tightness there are only a few potential outcomes. Wage growth and inflation could accelerate and boost future spending growth, or economic growth could begin to taper off as we get closer to full production capacity. In order to maintain current growth levels, the markets would require a surge in business capital spending to generate sustainable productivity and earnings growth.



Source: Standard & Poor's, University of Michigan, FactSet, J.P. Morgan Asset Management.

Externally, geopolitics, central bank activity, and disappointing economic data could create headwinds for equities. Investors have brushed off geopolitical headlines in recent years, but as government officials turn their focus to trade and fiscal policies the markets will not be able to ignore politics forever. On the central bank front, QE might be over, but the Fed has a long road ahead of it to normalize monetary policy. Policy makers are entering uncharted territory by attempting to raise rates and liquidate balance sheet assets without negatively affecting the economy. The economy appears to have gained enough traction to grow with less help from central banks, but growth could become policy makers' enemy if inflation rises faster than expected. If that happens, policy makers may be forced to raise rates at a faster pace than previously expected to keep inflation in check. Rapidly rising rates would be a headwind for stock markets and could create a credit crunch as debt-servicing costs rise across the globe.

Central Bank Policy Interest Rates



Sources: Macrobond, Bloomberg, European Central Bank (ECB), SSGA

"Investors may be mistaking the secular bull market trend for an extension of the business cycle."

“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