

# 2020 OUTLOOK

Not Too Hot, Not Too Cold, Just Right?

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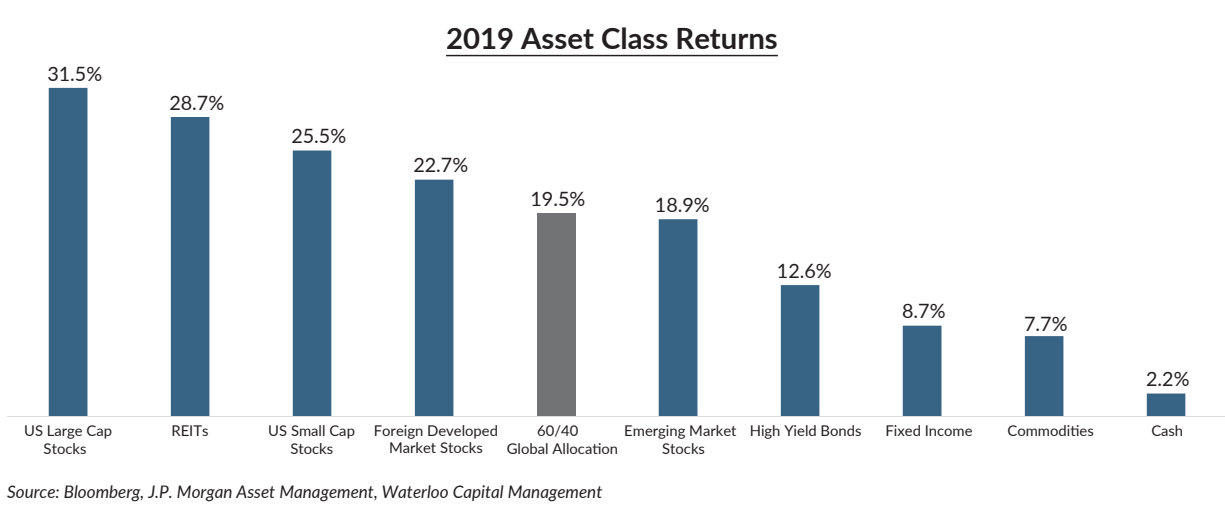
## Outlook 2020: Not Too Hot, Not Too Cold, Just Right?

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### 2019 Review: Getting by With a Little Help From Our Friends

2019 ended much as it began. Markets climbed on positive headlines coming out of Washington and renewed support from the Federal Reserve. Prices melted up as fears of a recession melted away. Major indexes stumbled and fell multiple times throughout 2019 but these "mini-cycles" were continuously resolved upwards by positive news on the US economic front, a change of face to more accommodative central bank policies, and de-escalations in the global trade war. The path higher from 2018 lows was fairly steady until late February. Investors were confident the meetings between the US and China in January and February would lead to President Trump extending his self-imposed March deadline to remove a tariff truce between the two countries. Trump gave the markets what they wanted and extended the truce in late February, but the lack of concrete details on when the next deadline would be and what actual progress had been made led to a sell-the-news reaction. In a trend that would continue throughout the year, markets recovered on the back of stable economic, employment, and consumer spending data which alleviated recession fears.



Volatility returned heading into the Fed's first significant meeting of the year due to concerns that the committee would make another policy mistake. Those concerns were mitigated after Fed Chairman Jerome Powell made it clear that the Fed had reconsidered raising rates and would be shifting to a more supportive role. With the potential headwind of the Fed tightening policy and trade war escalations falling to the wayside markets continued to climb through the end of April. Headline risks returned with a vengeance in early May after Presidents Trump and Xi released tit for tat tariff hikes. Who better to come to the rescue of the markets than the villain from Q4, Jerome Powell? At an early June speech Powell said that the Fed would "act as appropriate" to sustain economic growth in the face of ongoing trade war escalations and suggested that any rate adjustments through the end of the year would be cuts. Powell's comments put a floor beneath equity losses and prices never declined back to levels hit in May. In July the Fed cut interest rates for the first time since the global financial crisis in 2008 and we re-entered a TINA (There Is No Alternative) market.

Demand from a wide spectrum of investors resulted in the equity markets posting their greatest non-bear market recovery rally since 1995. The current bull market and economic expansion became the longest in recorded history as persistent consumer spending was enough to overcome negative trends

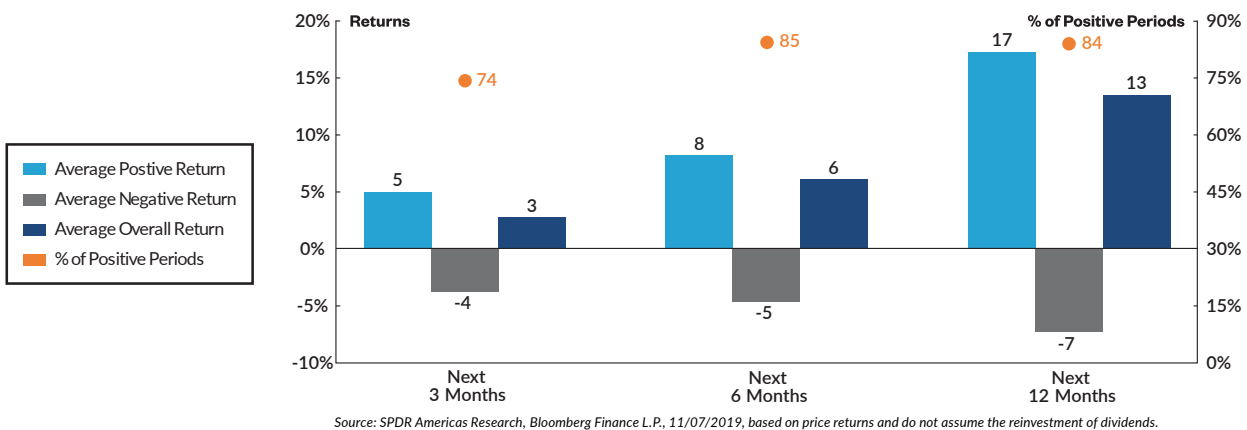
## Outlook 2020: 2019 Review

in manufacturing and business spending. The US settled back into a "Goldilocks" economy where incoming data was not hot enough to prompt Fed tightening and not cold enough to raise recession fears or cool consumer activity and investors' demand for stocks.

The overseas markets tended to echo developments in the US as they struggled to break free from the gravity of the ongoing political, monetary policy, and trade developments between the world's two largest economies. Central bank policies around the globe remained aggressively accommodative and both positive and negative headlines on trade developments between the US and China quickly rippled through global markets. Many foreign equity markets exhibited similar mini-cycles with prices trading within a well-defined range until the fourth quarter. The rollback of tariff threats from the US and China encouraged a year-end shift into risky assets and stimulated demand for many beaten down global markets such as Europe and emerging markets.

When all was said and done, every major equity index posted positive returns for the year. The reversal of fortunes for global equity markets from the beginning of the year to the holiday rally was one of the most impressive turnarounds in recent memory. The rapid shift in sentiment reminded us that despite the fears of a global recession, a ramping up of the trade war, Brexit fallout, and poor manufacturing data around the globe, drawdowns tend to resolve upwards and volatility can often be looked at as a trading opportunity rather than a reason to get out of the market. The length of the current bull market and the lack of expected catalysts heading into 2020 make extrapolating 2019 results a difficult call to make, but we believe that the outlook for the consumer, monetary policy, fiscal policy, and corporate activity will support investors' desire to buy and lead us to new highs in 2020.

### Equity Market Returns Following All-Time Highs Tend to be Higher but Exhibit Wide Dispersion



"IN 2019 WE RE-ENTERED A TINA (THERE IS NO ALTERNATIVE) MARKET AND STOCKS REMAINED THE HOTTEST GAME IN TOWN"

### 2020 Intro: The Three C's

2020 will be defined by the three C's: Consumer, China, and Credit. The lowest unemployment rate in decades has fueled an extraordinary run in consumer activity which has been the engine driving the current expansion. Signs of momentum in wage growth and persistent hiring activity should continue to boost spending trends this year which will help offset manufacturing's struggles as the sector tries to get back on its feet.

The US-China trade war will continue to dominate both positive and negative headlines, market expectations, and investor sentiment. Fortunately, the signing of a Phase One deal in January and a trend of positive discourse between the countries has led to a surge in optimism regarding 2020 developments. If the rhetoric of trade stability and cooperation without re-escalation persists, investors will continue to embrace riskier assets despite the lack of a timeline for either side to follow through on recent promises.

On the credit front, the Fed's reversal of monetary policy in 2019 redefined the outlook for global central bank policies. Rate cuts and a rise in "wait-and-see" approaches to monetary policy mean loose financial conditions and accommodative policies will likely persist through 2020. Keeping rates lower for longer will push investors back into a TINA environment in which There Is No Alternative to investing in risk-on assets. Additionally, access to cheap capital will keep debt servicing costs low for both businesses and consumers, which should promote investment and spending activity.

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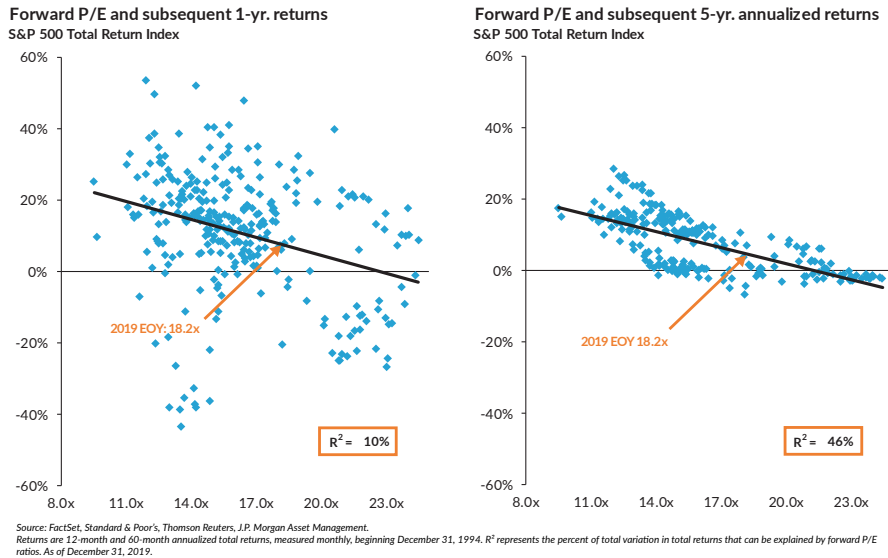
## "2020 WILL BE DEFINED BY THE THREE C's: CONSUMER, CHINA, AND CREDIT"

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The world is more connected than ever before. The interconnectivity of global supply chains, financial markets, and politics make spillover effects increasingly likely. This year, risks related to each of these categories still face question marks. Volatility has planted its roots, and until these risks are resolved we will continue to see divergences between different companies, sectors, and economies.

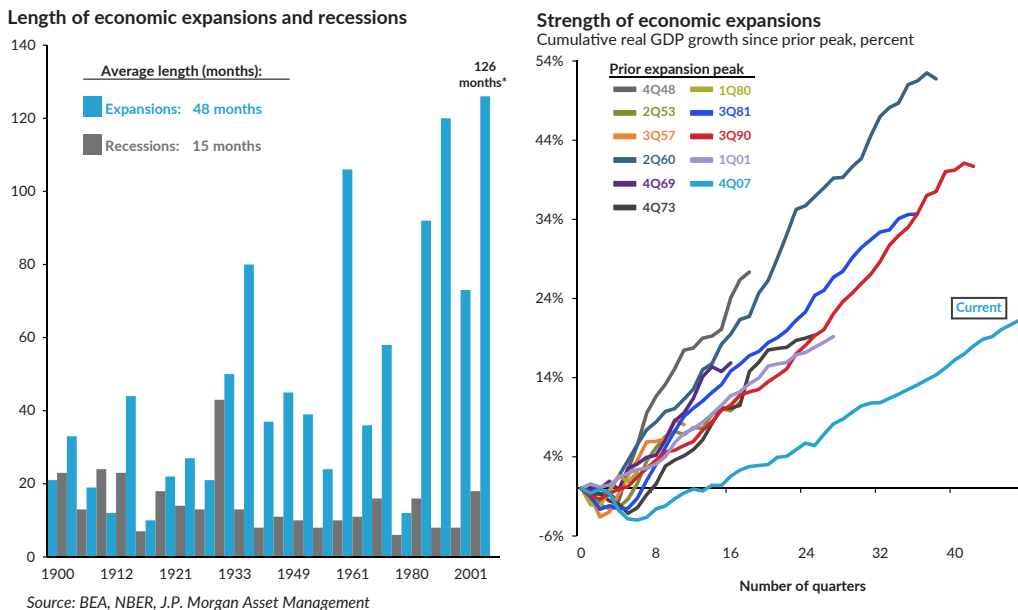
We advise investors to remember that where you start from still matters. With prices hitting new highs it will become increasingly important for investors to take advantage of shorter-term trends within markets and across global economies to achieve their desired long-term returns. A simple buy and hold approach is highly unlikely to generate the same return profile investors have become accustomed to since the Global Financial Crisis. Going forward, investors must be prepared to be more active and selective in their asset allocation and investment strategies.

### Investors Will Need to Get Creative to Meet Long-Term Return Goals



As the longest economic expansion on record continues, we have observed that new normal of slow and low growth is becoming more established and quietly lowering the bar for exceeding expectations. This environment should help keep the expansion going as growth is good enough to appease the naturally optimistic nature of investors, but weak enough to allow the Fed to act as a safeguard against downturns rather than clamp down on excesses. The negative side of the equation is the increase in the velocity of market rotations when low expectations are not met. Markets, sectors, and companies alike have been swiftly punished for failing to make it over lowered hurdles. For now, we remain optimistic that good enough results will offset downside aberrations, and the recent rebound in global sentiment and economic activity will keep the wheels of the current expansion turning forward slowly but surely.

### Economic Growth has Been Steady but Low





## Outlook 2020: 2020 Intro

Entering the year, we are squarely in a risk-on market. Our investment strategy will focus on barbell exposure between companies with higher beta growth and companies with high-quality fundamentals which gives us a neutral exposure to value and growth. Regionally, we remain overweight US equities. We are viewing international exposure as more of a trading opportunity than a long-term hold and see intriguing opportunities in developed Europe and emerging markets. In fixed income, we have lowered duration to avoid exposure to a steepening yield curve. High yield bonds have become more attractive due to their correlation with equity markets and signs that spread tightening gained momentum through the end of the year, but based on our expectation of more frequent spikes in volatility we still favor investment grade debt. The prospect of idle central bank activity in developed markets lowers the return potential for developed market bonds. Emerging market issues have the potential to outperform from a return standpoint, but based on the volatility characteristics of the asset class any exposure should be viewed more in the scope of equity risk rather than traditional fixed income risk. Overall, we expect to maintain a full target allocation to risk-on assets while holding short-term bonds or cash to mitigate volatility and take advantage of buying opportunities that arise during mini-drawdowns and internal market rotations.

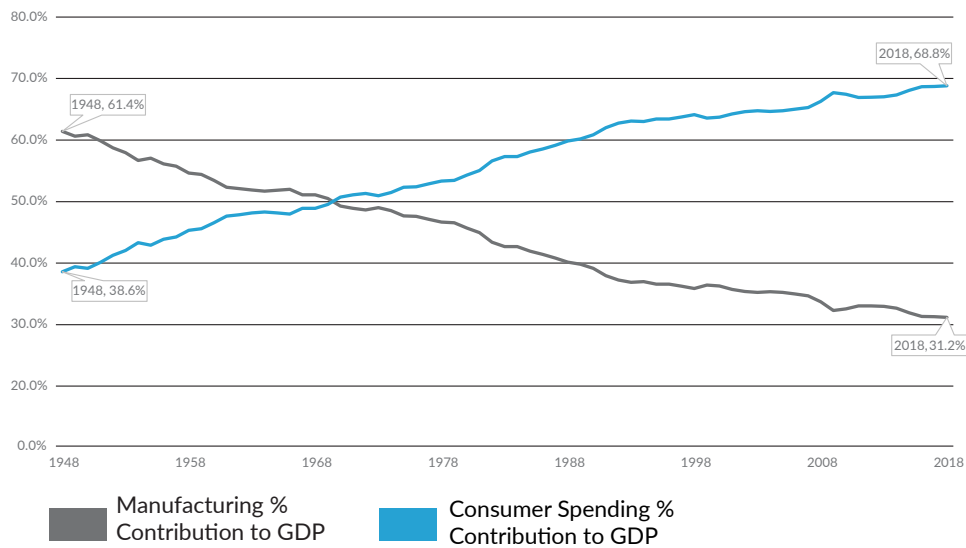
<i>Tactical Decision</i>	<b>2020 Investment Outlook</b>
Relative Risk	Risk Off ←————— —————●————→ Risk On
U.S. Equity Style	Value ←—————●————→ Growth
U.S. Market Cap	Large-Cap ←————●———— ————→ Small-Cap
Regional Equity Selection	U.S. ←—————● ————→ Non-U.S.
Non-U.S. Equity Market Preference	Developed ←————— —————●————→ Emerging
Fixed Income Quality	Investment Grade ←————●———— ————→ High Yield
Fixed Income Duration	Short ←————●————— ————→ Long
Regional Bond Selection	U.S. ←—————●———— ————→ International

Source: Waterloo Capital Management

### Consumers Carry The Load

The US consumer has been the workhorse of the economy during this market cycle and we think that the trend will continue this year. One of the most robust jobs markets in the history of the US, easy access to cheap capital, and signs of momentum in wage gains are all significant developments that should lead to a continuation of consumer strength and a tailwind for equity markets in 2020. Why is the consumer so important? Consumer spending accounts for nearly 70% of GDP growth and has become increasingly crucial in a US economy dominated by providing services rather than producing goods.

**Consumer Spending Accounts for Nearly 70% of GDP**



Source: Bureau of Economic Analysis, Waterloo Capital Management

It was interesting to note that consumer spending continued on a rapid clip throughout the year despite ongoing threats of higher prices due to tariffs. This may be a sign that consumers have been quick to dismiss the conflict between the US and China as long as they are still collecting a paycheck, and an incredible number of Americans still are. The unemployment rate has been consistently declining and is now stabilizing around levels not seen in 50 years. More working age individuals are entering the workforce, and the trend of "underemployment" has reversed as high demand for specialized workers and easier access to education has boosted opportunities for lower-income individuals. Additionally, wage growth has finally shown signs of life after stagnating for almost 5 years. A deeper dive into the data shows wage growth for lower-income and rank-and-file employees has outpaced that of high-income and management employees. We think this will be a tailwind for the economy given the large percentage of the workforce that these groups encompass. We expect wages to continue showing solid growth this year as the supply and demand imbalance in the workforce remains in favor of employees.

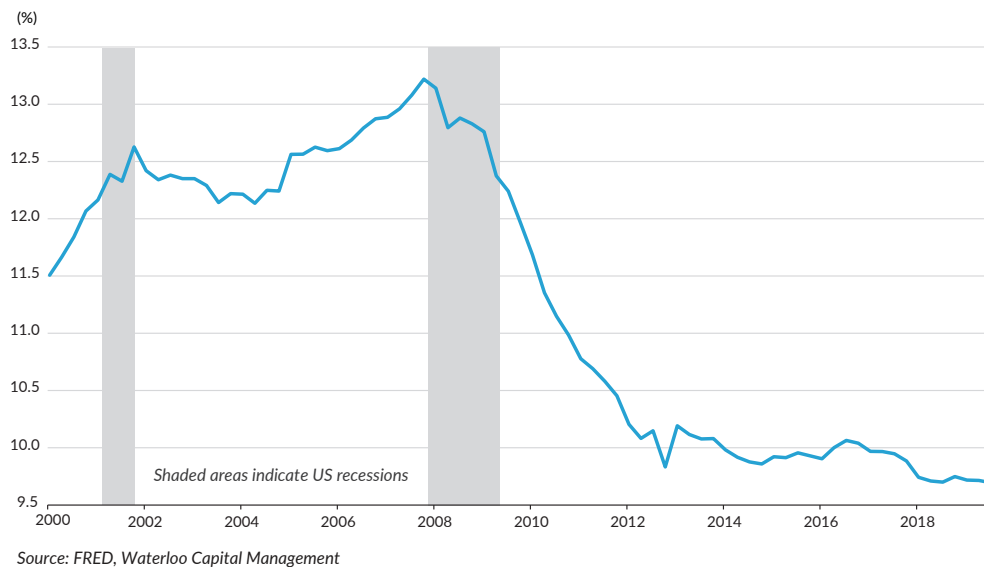
Consumers will also benefit from conservative corporate management decisions with regards to employment. The healthy job market tells us that many companies view the issues stemming from politics and the trade war as transitory. The most significant reaction has been to simply limit hours for some employees, a trend that could be easily reversed in the event of a rebound in business activity. Corporate managers' strong hands and lack of firing activity bode well for stable to rising wage growth, ongoing high employment demand, and a continuation of strong consumer spending trends this year.



## Outlook 2020: Investment Themes

Lastly, we find additional support for the consumer strength story when looking at household debt levels. Household debt as a percentage of GDP and as a percentage of disposable income are near lows for the current market cycle. US household debt to GDP is more than 23% lower than it was leading up to the Global Financial Crisis and household debt servicing costs as a percent of disposable income are more than 26% lower and have been below 10% since 2016. The key takeaways are we are not seeing signs of irrational exuberance and extreme debt expansions that have been present in previous economic downturns and consumers have substantial room to increase spending activity going forward. We are confident the consumer strength story will continue in 2020 and help support earnings growth, risk-on sentiment, and market prices throughout the year.

**Household Debt Costs as a % of Disposable Income**



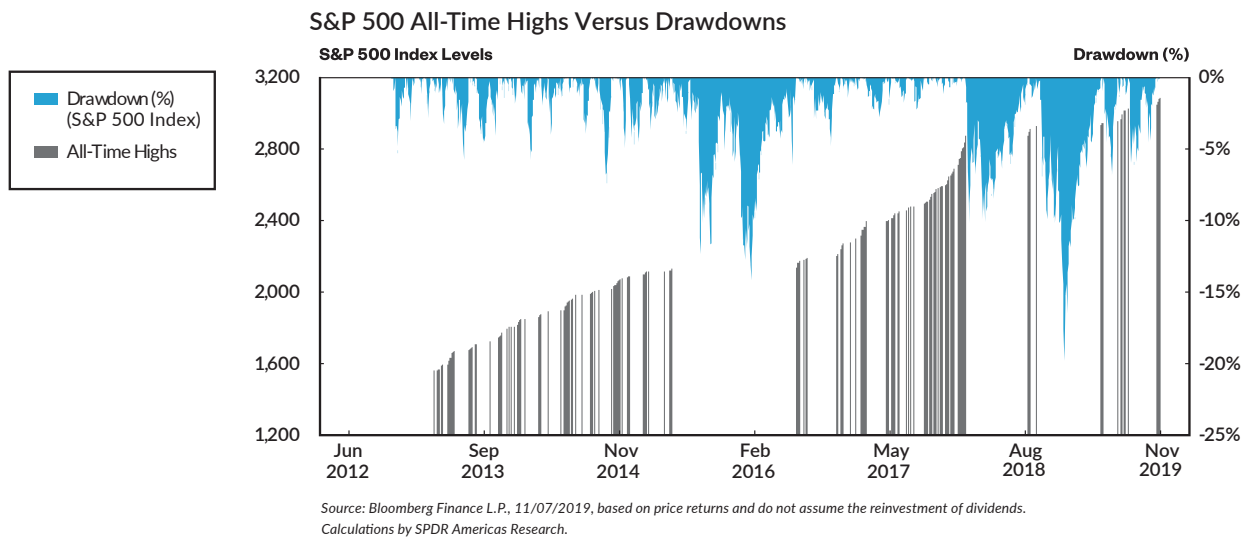
### Stay Active to Ride the Waves

The historic rise in stocks through 2019 has many investors asking how much higher can prices really go? Market headlines during the fourth quarter became a broken record of all-time highs for individual stocks and major indexes. An air of optimism quickly gave way to enthusiasm and finally to a level of complacency that stocks would only continue to go up.

While we are confident that the economic foundation and outlook for the global economy has improved, we are cautious of diving headfirst into markets that may be murkier than they appear on the surface. The temptation to be influenced by recency bias and keep the bow pointed straight ahead will lead to many strategies running aground before they can steer clear of potential risks. Our bias is to take a more active approach to navigating the markets this year. You don't always need a bigger boat to take on what lurks below, deftness and speed are key to avoiding pitfalls. We believe that these factors will become increasingly important in 2020 as ongoing risks remain unresolved and the potential for resurgences in volatility are likely.

The rise in short but more intense drawdown cycles will continue to lead to bouts of volatility and faster than usual rotations within the markets. Drawdown cycles from 2012 through 2017 tended to be small and short-lived. Over the past two years pullbacks have become both deeper and more frequent. As a result, price trends have become defined by “mini cycles” in which prices rise and fall with a wide price range but struggle to break out to new highs or new lows. These “mini cycles” can trigger rapid rotations in market leadership and make tactical allocation decisions more difficult but also provide active investors with substantial alpha producing opportunities.

### Drawdowns From All-Time Highs are Becoming Deeper and Longer



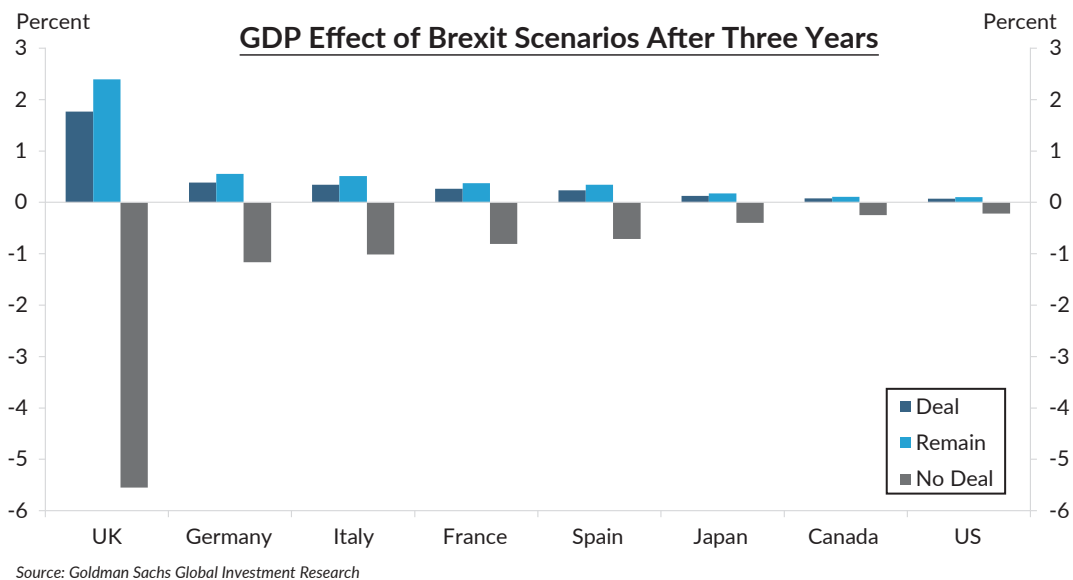
The ability to quickly determine when to stick with high flying positions and when to shift away from specific assets and asset classes will be crucial this year. We expect portfolios with exposure to tactical and dynamic strategies will outperform in 2020. As with traditional allocation strategies which focus on stocks and bonds, investors should also seek to diversify between passive and active management. This additional layer of diversification allows investors to take advantage of short-term opportunities that are increasing in occurrence due to heightened volatility and the lack of better alternatives to investing in stocks. Additionally, as the risk and return outlook for fixed income has deteriorated, we think that investors can benefit from holding a higher allocation in cash or short-term bond alternatives as “dry-powder” to take advantage of trading opportunities throughout the year.

At Waterloo we supplement our decision-making process by utilizing our neural network powered screening and trend identification tool, Newton. Our Newton models serve to provide opportunities to catch price shifts to the upside and protect portfolios on the downside by identifying potential trend reversals before traditional analysis techniques, staying in harmony with underlying market trends, and avoiding outsized drawdowns. As prices and optimism continue to climb, we are persistently pursuing strategies to take advantage of attractive short-term opportunities while refraining from adding unnecessary risks.

### Foreign Markets Manufacture a Spark

The overseas economy in 2019 weakened after uncertainty flooded the global stage due to trade tensions and Brexit uncertainty which ultimately slowed business investment, decreased trade volume, and lowered sentiment in developed and emerging markets. Weakening manufacturing data in the eurozone and Asia furthered this stress. Heading into 2020, we believe the headwinds that were a drag on the global economy abroad will stabilize setting foreign markets up for a mid-cycle recovery.

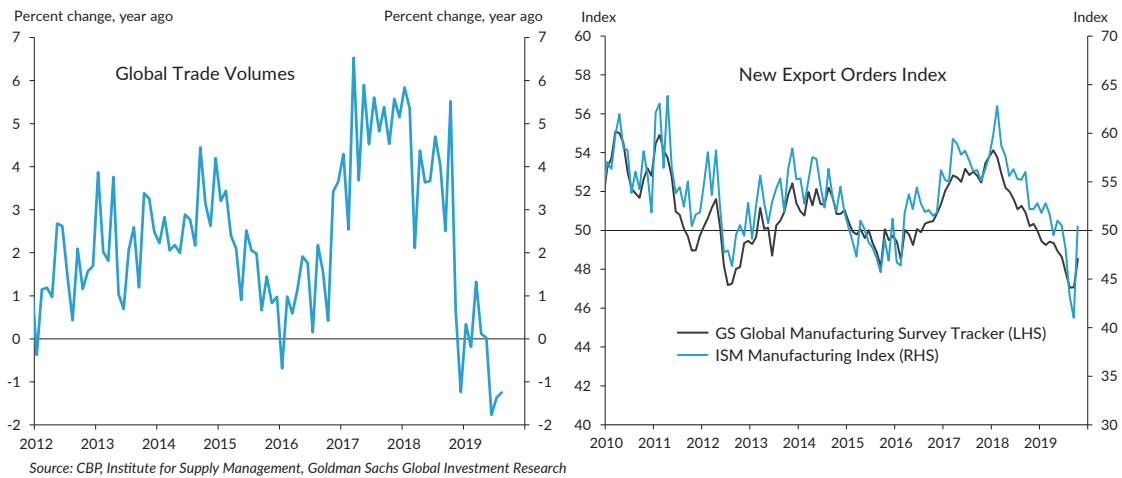
This year, with “QE infinity” in place, new ECB chairwoman Christine Lagarde has little ammunition to make significant changes to monetary policy in the region. Foreign markets are going to need additional support to keep their growth trajectory on pace. We will likely see pressure exerted on many European countries to start stepping up fiscal spending and expect these measures to come to fruition in 2020. The additional fiscal assistance with the backdrop of accommodative monetary policy, declining trade tensions, and more certainty on Brexit will likely prompt global trade and business investment to fortify and initiate a pickup in overseas economic activity. A Brexit resolution may be key to the resiliency of the global markets this year. Although we think it is unlikely, a “hard” Brexit could shave off a considerable portion of GDP in many developed economies and lead to a contraction of over 5% in the UK over the next three years.



## Outlook 2020: Investment Themes

Additional catalysts, such as clearer details on the trade path, are generating steadiness which can cause a positive spillover effect by ultimately increasing sentiment and much needed business investment. With some ambiguity already coming off the table, we are noticing expectations are brightening. The percentage of countries reporting improving PMIs has risen solidly since bottoming out at 30% in May. Heading into 2020, 63% of the world's economies were showing signs of improvement, representing the highest proportion since November 2017. Contributing heavily to the increase are faster growth rates in the US, China, Canada, Brazil, and Vietnam. Other gauges such as global trade volumes and the new orders index, a leading economic indicator, show a positive trajectory. If this leading trend remains, it will prove instrumental to improving sentiment abroad and the systematic effect will improve business conditions for global markets. Advancing expectations of a sustainable recovery in global trade should lead to an increase in capital flows to overseas markets.

### Trade Volumes and New Orders are Showing Signs of Bottoming



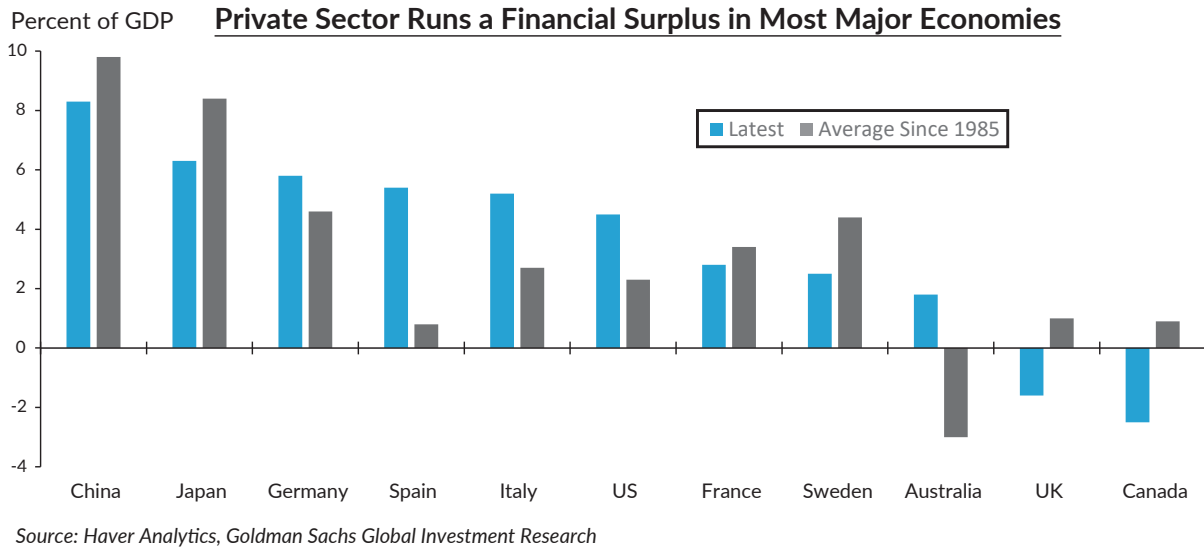
While manufacturing lost steam, the slowdown in global growth was not enough to slow consumer momentum. The G7 unemployment rate is hovering just under 5% which is putting upward pressure on wage growth, especially in the services sector. As uncertainties diminish and businesses unlock investment, we should see the strong consumer spending foundation continue to build.

Another tailwind supporting our thesis of strong consumer activity can be found in the financial stability of private sector balance sheets. A closer look at the financial position of households and businesses across advanced economies shows that we are far away from the sector running a deficit. This is positive for the economy because it indicates that total spending is less than total income and households are not reliant on debt to fund an increase in spending activity. In a purely debt filled expansion demand becomes highly susceptible to credit tightening, which can lead to a venomous cycle of collapsing consumer demand, high unemployment, and weakened profits.

On a positive note, entering 2020 nearly all developed economies are running a surplus. This suggests that robust spending trends are not only likely to continue but can weather a potential storm in the credit or equity markets. Private consumption is a crucial factor that can counter a slowdown and given we are in year eleven of an economic expansion, this late cycle reading is a positive sign that

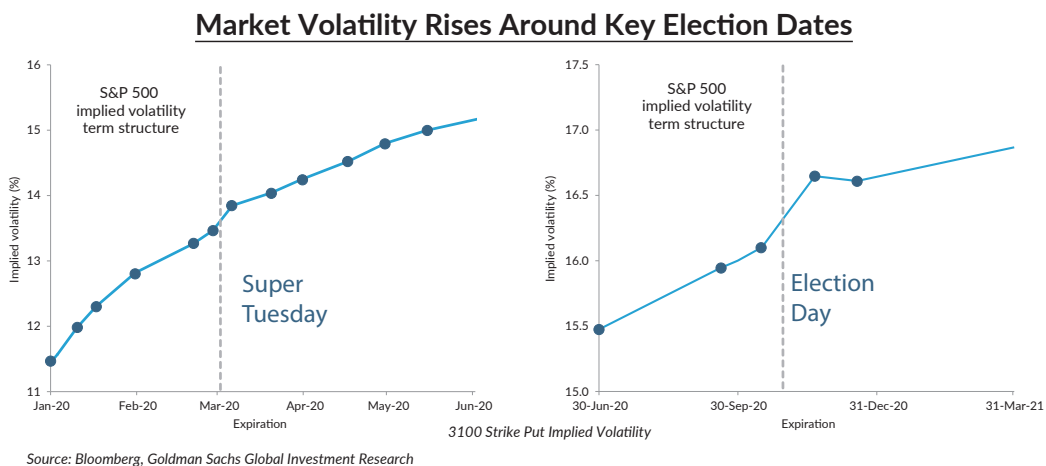
## Outlook 2020: Investment Themes

the global economy still has legs to run on. In our view, these developments along with consistently low global interest rates, lay the foundation for our improving growth outlook for foreign markets.



## Geopolitics Dealing Wildcards

As we move into 2020 the political date on investor's minds is November 3rd, US presidential election day. Election years tend to see higher volatility than in non-election years with geopolitical and economic news disproportionately influencing market prices, which makes staying active more prudent for investors. S&P 500 implied volatility increases noticeably around Super Tuesday and election day due to ambiguity in the Democratic nomination and presidential bid, which can produce select investing opportunities but also raise investor concerns. A Warren or Sanders Democratic bid will likely cause a spike in volatility, especially for healthcare and pharmaceutical stocks, which are highly influenced by regulations and make up more than 14% of the S&P 500.

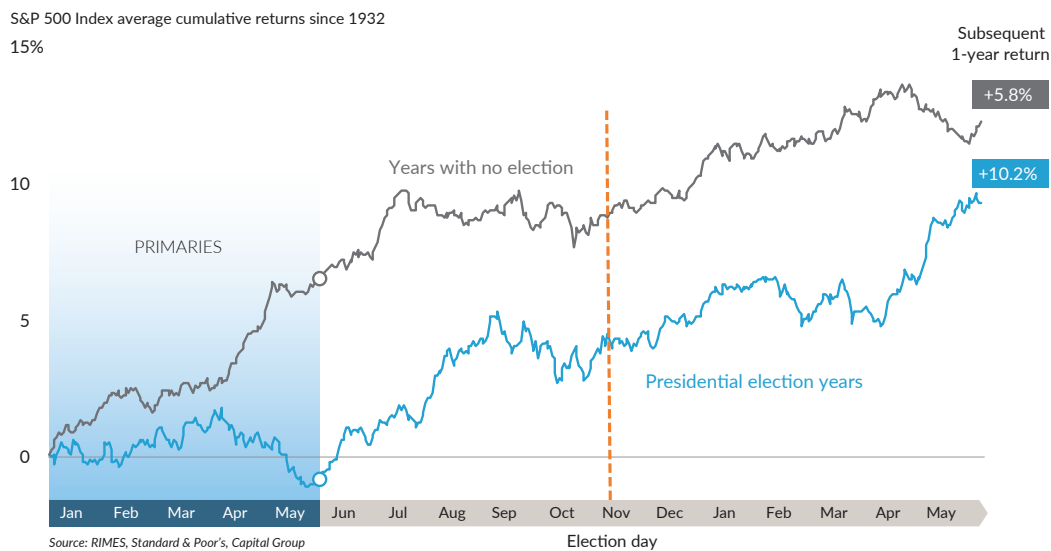


## Outlook 2020: Investment Themes

While the pre-election market environment has the potential to be turbulent, our post-election outlook is much tamer. The high probability of a divided congress will make it difficult for either party to pass meaningful legislation and should lead to a business as usual environment which has historically been a positive for equity markets. When the status quo prevails, businesses and consumers tend to be more confident taking on major expenses and new investments. Navigating through the election driven volatility in 2020, especially around the primaries, can make or break in returns this year.

The good news is that history is in equities' favor. Since 1928, only 4 of 23 election years saw negative returns in the S&P 500. Three of the four happened during recession years which indicates that the result was most likely a reaction to negative economic trends rather than the change in presidential leadership. Historically, markets react more positively to a Republican president due to their free market policies and laissez-faire approach to business being viewed as more 'market friendly'. Going back to 1928, Republicans have won 11 presidential elections with an average S&P 500 return of 15.3% while Democrats have won 12 times, with an average return of 7.6% in those election years.

### S&P 500 Returns Post Elections Have Been Strong



Across the pond, we saw a resounding victory for Boris Johnson and his Conservative Party in the snap General Election. Voters backed Johnson's vow to "get Brexit done" as certainty finally emerged in the three-and-a-half-year battle on how the country would leave the European Union. The UK had been due to leave the EU on March 29, 2019, and then on October 31, but the country's exit is finally on course to take place by January 31, 2020 after MPs backed the withdrawal bill days before Christmas. The transition period is expected to last until the end of the year. During the transition period, all regulations will apply as if the UK was still a part of the EU, and each side will be trying to strike a major trade deal which includes agreements on security and foreign policy. Based on negotiating history, this eleven-month window may be too short to strike a substantial agreement. A Brexit resolution or negotiating extension will be key to the resiliency of the UK and European markets this year. Although we think a "hard" Brexit is unlikely, UK political developments over the past few years have taught us not to ignore any possibilities. In our view, the recent progress has alleviated some of the uncertainty that has been a drag on the markets, currency, and business investment in the UK and should help stabilize these poor trends.



At the forefront of geopolitical uncertainty is the US-China trade war. The trade war has undoubtedly caused the economy to sputter and globalization has made it nearly impossible for large-scale trade wars not to inflict collateral damage on the global economy. The conflict between the US and China will likely dominate the headlines early and often with the Phase One trade deal being signed in January and the president pushing for Phase Two before the election. It will be interesting to see how eager China is to complete an additional deal this year. The fact that the US will be going through one of the most contentious election cycles in its history may give China a slight upper hand in timing the negotiations. Chinese officials are surely considering if having a new face in the oval office would facilitate easier negotiations. Any delay will be a gamble, but the inability of the Trump administration to close a tangible deal before November will almost certainly lead to fallout politically and economically.

With the US attempting to toe the line between progress and a firm hand, the risk of a misstep from Washington will be hanging over the market's head this year. So far, markets have cheered the reduction in hostilities between the two nations, but as we saw last year, threats of either country renewing tariffs or restricting business activities can quickly quash a market rally. The risk is that this optimism has already been priced into the market and expectations may be overextended. With prices at all-time highs, excessively optimistic expectations could be setting up investors for disappointment.

We think that governments and policy makers have noticed these adverse effects and will begin carefully shifting away from negative trade discourse as the year goes on. Furthermore, optimism will likely continue this year as the Trump administration ramps up positive rhetoric and looks to avoid economic unrest as the president tackles the campaign trail. The resulting positive effects of easing conflicts on the trade war should help support a rebound in profits and earnings growth this year leading to positive price movements.

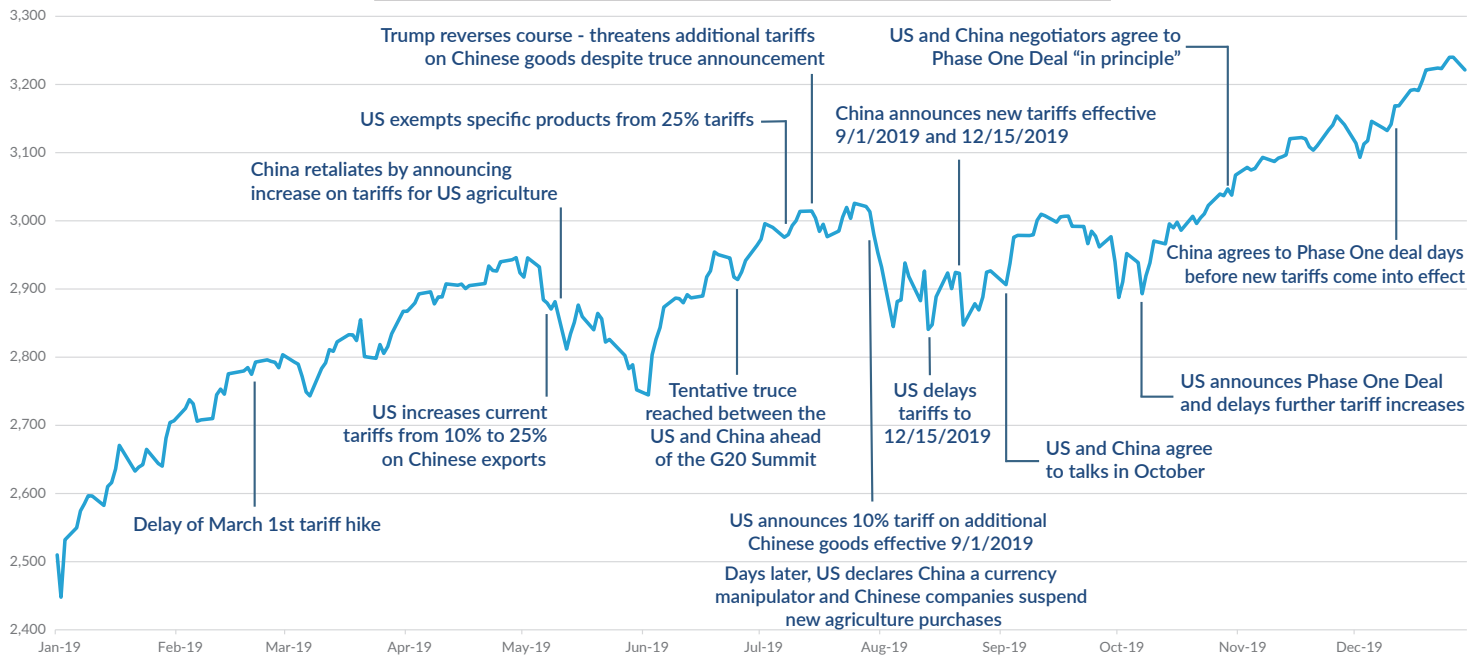
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**"THE POTENTIAL FOR MISSTEPS IN  
TRADE TALKS WILL BE HANGING OVER  
THE MARKET'S HEAD"**

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## Outlook 2020: Investment Themes

### 2019 Trade War Headlines and S&P 500 Price Reactions



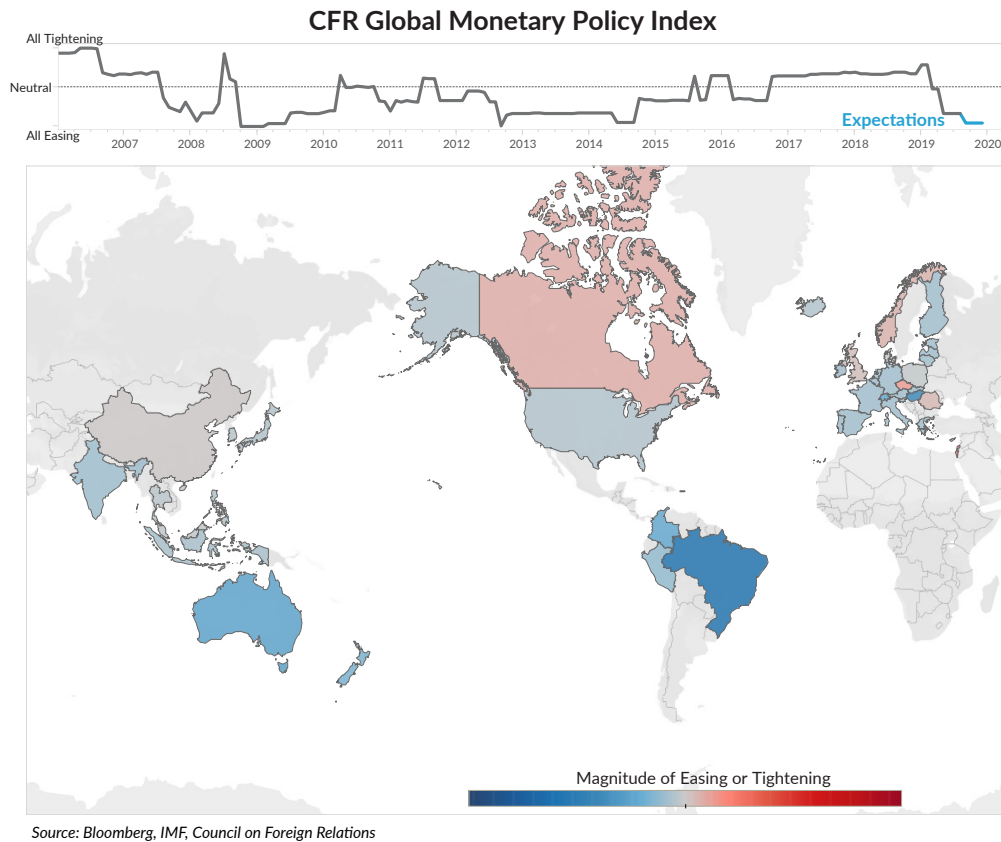
Source: Yahoo Finance, Waterloo Capital Management

### Credit: If it Ain't Broke...

Global central banks were poised to follow the Fed's strategy to raise rates, until they saw what transpired in Q4 2018. The dramatic reversal by the Fed in 2019 brought with it the return of global easy money policies. Twenty central banks cut their key policy rates over the past 12 months and we have quickly gone from an expectation of higher interest rates in the majority of developed economies to a projected path that will put the weighted average global central bank policy rate at its lowest level in seven years. The path of global policy rates is important for several reasons. Liquidity and the ability to borrow money are the lifeblood of the global economy and the effects of low interest rates flow through many facets of the markets. From determining stock valuations, to big-ticket consumer purchases like homes and cars, to business' future investment and spending expectations, interest rates are a key input into nearly every financial calculation and decision-making process.

Low rates underpin our ongoing thesis that 2020 will continue to be a TINA market which will lower demand for bonds and stimulate demand for equities. The problem for investors is that historically low yields have skewed the risk and return metrics of bonds and made the asset class much less effective as a hedge to equity market selloffs. As investors creep out on the yield curve they run the risk of taking "return-free risk" in an asset class that is historically known for its stability in times of crises.

### Global Monetary Policy Rates Have Reversed Course



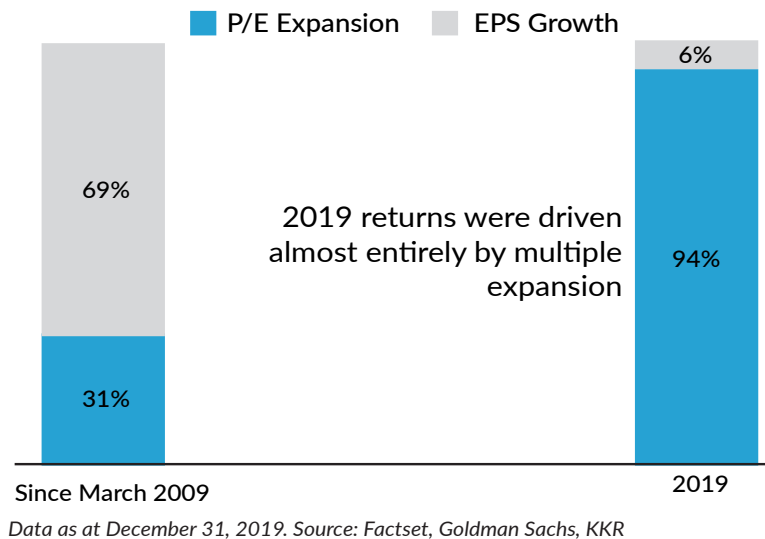
We think that passiveness on the monetary policy front will be the norm this year as the markets continue to send the message to policy makers that the equity markets and global economy are not broken yet, so what is there to fix? As confidence in the global growth rebound continues to increase, we do not expect significant changes to key policy rates. Instead, central banks are much more likely to push governments to take up the cause through fiscal policy changes or stay busy by pulling some less obvious strings behind the scenes like the Fed has been doing in the interbank overnight lending or "repo" market. The Fed's "not QE" activity in the repo market is an example of how unconventional actions can still stoke the stock market.

**The return to a prolonged period of easy money policies and idling central banks lowers the risk for a policy driven recession this year. The global economy back has moved back into a Goldilocks regime where growth is just hot enough to keep us on track and avoid central bank intervention. This environment improves our outlook for cyclical and risk-on assets as consumer activity remains elevated and global economic activity stabilizes.**

### Domestic Equities

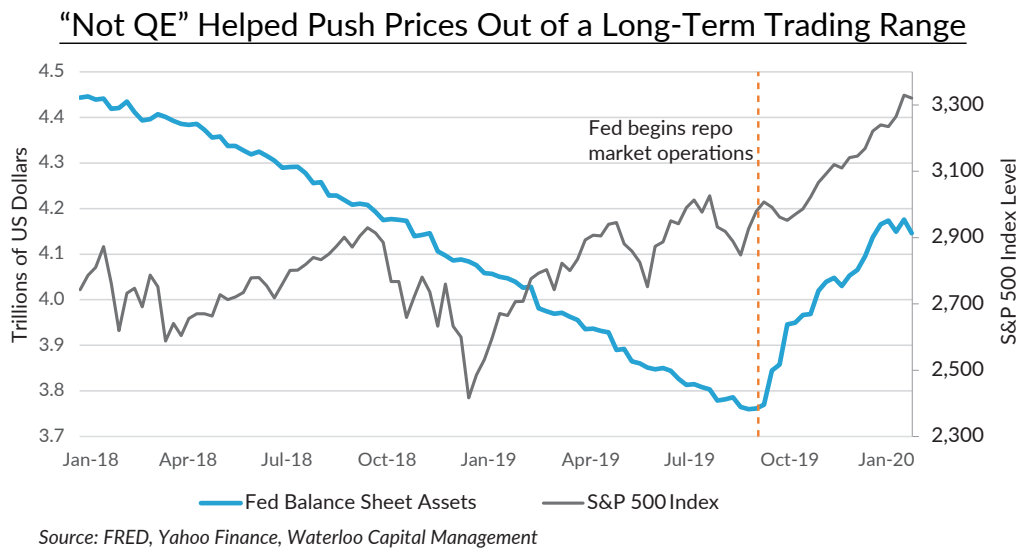
2019 was a banner year for US equities as stocks recovered from the 2018 correction assisted by a fresh round of rate cuts by the Fed. This year we think that equities will continue to climb higher, but the path forward will be more turbulent. Earnings growth will be one key to the markets meeting our 2020 expectations. Last year, trade uncertainty led to declining earnings expectations and a lack of business activity. Nearly all the gains in stocks could be attributed to margin expansion as prices surged but earnings growth disappointed. This year we expect only a small increase in multiples, so earnings will need to contribute more support to keep the market rally going. Our starting position looks promising for 2020 earnings. Moderating trade headwinds and signs of a recovery in global growth and business activity have laid the foundation for a recovery in profits and earnings. Additionally, consumer spending activity has been remarkably consistent and should continue to support positive momentum for profits.

#### Contribution to S&P 500 Price Return, %



The return of the TINA marketplace strengthens our argument for a positive outlook on domestic equities. The Fed has repeatedly stated that its intervention in the repo market is not quantitative easing, but the markets see things differently. Repo operations began in September of last year as a cautionary measure. Then, in early October the Fed made a pledge to support the repo market through the first half of 2020 which could lead to the Fed purchasing close to a trillion dollars of short-term bonds. The markets broke out to new highs over the following weeks. Coincidence? We don't think so. The Fed's repo operations through December 2019 reversed more than 50% of their balance sheet reductions and was clearly seen as a sign that the Fed will continue to step in to provide liquidity to struggling areas of the market which will keep interest rates lower for longer.

## Outlook 2020: Domestic Equity



The expectation that interest rates will remain low for the foreseeable future has once again diminished the attractiveness of bonds while improving the risk premium paid to equity investors. As we have explained in the past, low interest rates typically make stocks increasingly attractive relative to bonds from a valuation and expected return standpoint. With a price to earnings (P/E) ratio of just over 18x, stocks are not excessively overvalued relative to their historical average. When applying the same price to earnings methodology to bonds, stocks appear even more attractive on a relative basis. You would need to buy a bond yielding around 5.5% to achieve an 18x P/E ratio and match the value you gain for each dollar you invest in the stock market. Considering the largest treasury yield, the US 30-year, was only yielding 2.33% at the end of the year, yields would need to dramatically increase to make bonds more attractive on a relative basis. Additionally, the decline in rates has brought the S&P 500 dividend yield back in line with the yield on the 10-year Treasury which should lead to an increase in equity demand from yield seeking investors. Interest rate sensitive sectors such as utilities and real estate should benefit from this trend.

### Stocks, Bonds and the P/E Ratio

Stocks at current P/E levels	→	$\frac{\$100}{\$5.50} = 18 \text{ P/E}$	Stocks are trading slightly above their long-run average valuation...
<hr/>			
Bonds assuming a 2.3% yield	→	$\frac{\$100}{\$2.30} = 43 \text{ P/E}$	...but at low interest rate levels equities still look attractive compared to bonds

Source: Waterloo Capital Management

The P/E ratio of the S&P 500 was around 18.2x at the end of 2019. This tells us that investors were willing to pay \$18.20 for every \$1 in expected S&P 500 earnings they would get back. A quick rearranging of the P/E formula shows this would indicate an "earnings yield" of about 5.5%. Applying the same process to bonds, we can take the 30-Year Treasury yield of 2.3% and calculate a P/E ratio of 43x.

## Outlook 2020: Domestic Equity

While the data for demand looks to be in stock's favor over the long-term, short-term demand tends to be much more fickle. High index prices, questions regarding fundamentals, and the influences of external risks from geopolitical developments are likely to stir up volatility this year. The additional scrutiny on earnings could lead to spikes in volatility around the reporting dates for major index constituents. Furthermore, as markets have been increasingly influenced by factors rather than fundamentals, price reactions to both the positive and negative side will likely be more aggressive.

We are recommending an overweight allocation to domestic equities, but based on our expectation of a choppy market environment we will likely see a higher rate of turnover within our holdings as we see opportunities shift within the markets. We plan on shifting our investment strategy to a more dynamic and tactical approach to take advantage of short-term trends and rotations in market leadership. Within our core domestic equity holdings this year we expect to overweight our allocation to higher quality companies which have shown a penchant for performing well during drawdowns and the later stages of a market cycle. Our definition of high quality includes companies that have strong balance sheets, consistent dividend growth, and positive trending return on equity (ROE) and earnings growth. Demand for companies exhibiting quality criteria should increase as investors are forced to look to the equity markets for yield and savvy allocators shift away from investing in speculative growth companies at any cost and towards companies with stable growth at a more reasonable cost.

Overall, we are expecting earnings to grow 5% to 6% this year which, when paired with our forecast for mild multiple expansion, brings our expectations for equity returns into the high single digit to low double-digit range.

### We are Expecting High Single Digit Returns for Stocks This Year

P/E \ EPS	17.0X	18.0X	19.0X	19.5X	20.0X	21.0X	22.0X
(2.0%)	(11.3%)	(6.1%)	(0.9%)	1.7%	7.3%	10.6%	13.8%
(0.5%)	(9.9%)	(4.6%)	0.7%	3.3%	8.7%	12.0%	15.3%
1.0%	(8.6%)	(3.2%)	2.2%	4.9%	10.0%	13.3%	16.7%
2.5%	(7.2%)	(1.8%)	3.7%	6.4%	11.4%	14.7%	18.1%
4.0%	(5.9%)	(0.3%)	5.2%	8.0%	12.7%	16.1%	19.5%
5.5%	(4.5%)	1.1%	6.7%	9.5%	14.1%	17.5%	21.0%
7.0%	(3.2%)	2.5%	8.2%	11.1%	15.4%	18.9%	22.4%
8.5%	(1.8%)	4.0%	9.8%	13.2%	16.7%	20.3%	23.8%

Source: Waterloo Capital Management



## Outlook 2020: Foreign Equity

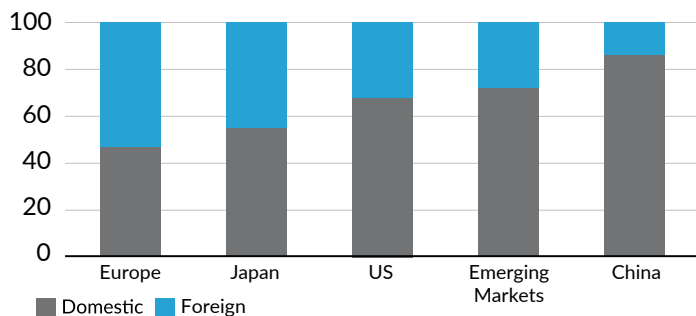
### Foreign Equities - Eurozone

Last year the MSCI Europe ex UK index saw double digit gains, some of which can be attributed to the ECB's easy money actions. This year there are reasons to be optimistic that positive trends can continue. We see the continuation of easy money policy measures, support from trade certainty, and implementation of fiscal policies alleviating many of the previous drags on economic data. The European market is actually the most exposed to global trade and investors have been eager to move into equities as trade war and Brexit escalation risks have waned.

We see emerging signs of optimism in the region in the positive outlook for manufacturing, improving leading indicators, and firming of the consumer base supporting business confidence. Continued declines in unemployment and wage growth outpacing inflation have led to rising household incomes across the eurozone which should support an acceleration in consumer spending this year. Broad based increases in demand have the potential to improve companies' pricing power, which should help expand margins and earnings later in the year. We expect these tailwinds to lead to step-by-step improvement in fundamentals, adequate growth, and resiliency in the region.

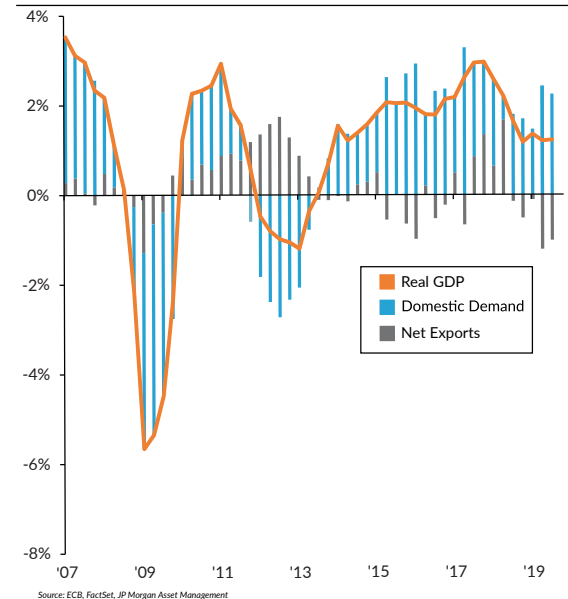
### Europe is the Most Exposed to Global Trade

Domestic vs. foreign exposure for listed companies in select regions, in %



Source: Morgan Stanley, as of 30 May 2019

### Contributions to Eurozone YoY GDP Growth



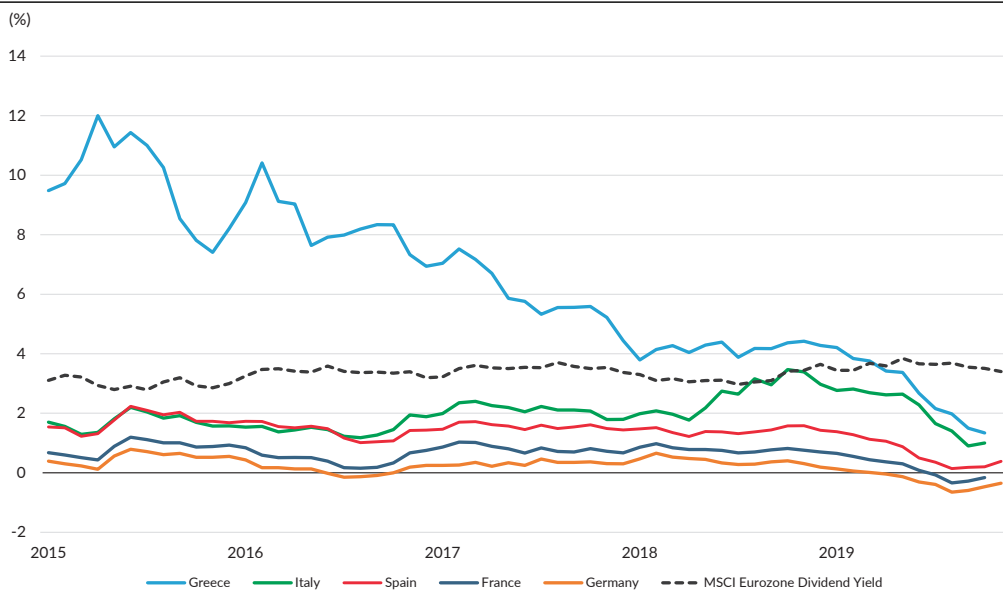
Source: ECB, FactSet, JP Morgan Asset Management

Like the US, Europe's equity markets tell a similar story involving a TINA scenario. After years of quantitative easing, equity yields have diverged significantly from major eurozone country's 10-year yields, triggering investors to move capital out of risk-off assets like bonds and into risk-on assets like stocks. Currently, eurozone stocks are offering a 3.4% yield which is significantly higher than the prevailing near 0% or negative yielding government bonds available. The bond market has been so manipulated by European Central Bank purchases that bonds in Greece, a country that has a junk bond rating and is still recovering from multiple financial crises, are yielding less than the United States bonds with the same maturities. Considering US government bonds are considered one of the safest investments in the world, this irrationality perfectly illustrates the TINA environment in which eurozone investors find themselves.

## Outlook 2020: Foreign Equity

We will likely see growth in eurozone equity demand as investors gain confidence in the region's growth outlook and begin shifting capital into risk assets. We think that additional demand for European equities could come from foreign investors looking for relative value opportunities. The MSCI Europe ex UK price to book value is 1.63x compared to the S&P 500's 3.44x, providing an attractive entry point as eurozone equities are trading at a significant discount compared to historical trends. In our opinion low valuations are overstating fears of a deeper slowdown this year. TINA in play and valuation analysis help explain in part why we believe European equities can hold up heading into 2020, despite trade concerns, Brexit uncertainties, and compressed GDP growth.

### Select Eurozone Government Bond Yields vs MSCI Eurozone Dividend Yield



Source: Morningstar Direct, Waterloo Capital Management

The green shoots we are seeing are encouraging but structural issues that have plagued the currency bloc since the global financial crisis are still lurking. The dispersion between the major economies in the region will make it difficult for fiscal reforms to spread to neighboring countries. Additionally, negative interest rates have put significant pressure on the financial sector by essentially wiping out net interest margins. Low but consistent GDP growth and an uptick in manufacturing and export activity will buoy the markets at the beginning of the year but investors should be wary of fading strength in incoming data which may indicate that Europe has become a value trap rather than a value opportunity. From an allocation perspective we recommend an overweight allocation to eurozone equities within foreign developed holdings but maintain an underweight allocation relative to US equities.

**"EUROPEAN EQUITIES ARE TRADING AT ATTRACTIVE RELATIVE VALUATIONS"**

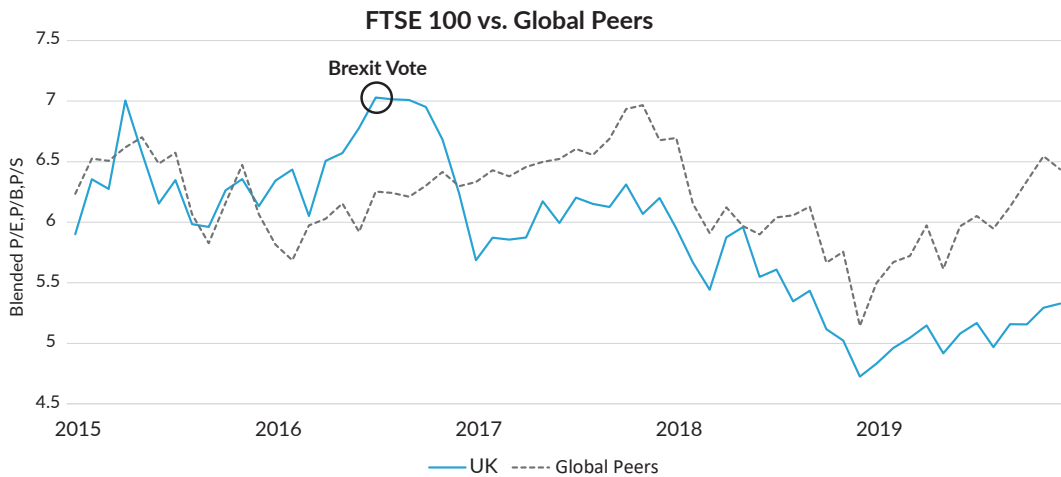
## Outlook 2020: Foreign Equity

### Foreign Equities - United Kingdom

We see potential opportunities in the UK this year due to potential for progress on Brexit negotiations and central bank easing, though we think it will be difficult for the market to repeat its 2019 performance. Stocks are still at the whim of external forces related to trade and Brexit, which we think tilts risks towards the downside. That being said, markets may be able to overcome those threats if the positive economic momentum we saw at the end of the year continues to build.

UK economic data has been distorted by Brexit and reversed the premium valuation investors had put on the market prior to the 2016 referendum to leave the EU. Also, political uncertainty and the lack of growth from the rest of Europe has lowered the bar for incoming economic data. 2020 economic reports do not need to be great to boost sentiment; they just need to be better than expected. After several months of declines, a tick up in retail sales in December was a sign that the economy may be stabilizing. A strong consumer will be key for economic growth to gain sustainable traction. Consumer spending accounts for nearly 80% of GDP in the UK compared to only 10% for manufacturing. On a positive note, several companies have recently initiated or lengthened share buyback programs, a clear signal that UK corporations see their own shares as undervalued. Share buybacks benefit shareholders because lowering the number of shares outstanding increases earnings per share which tends to support higher prices. While these developments are encouraging, we are fearful their effects may fizzle out as the year goes on and the UK will end up as a value trap that is cheap for a reason.

#### UK Markets Look Cheap on a Relative Basis, but may be Cheap for a Reason



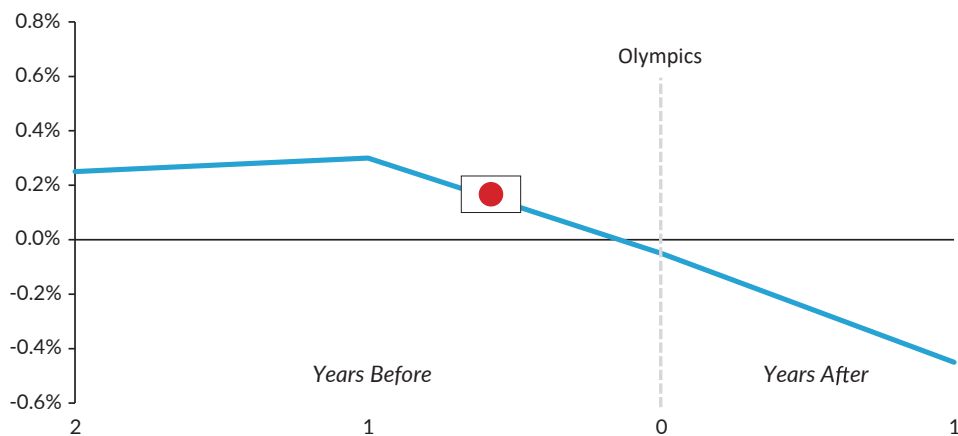
Source: Morningstar Direct, Waterloo Capital Management

The ongoing Brexit debacle is still the biggest risk for the region. Solidifying a deal with the EU would be an immediate tailwind for the UK and European equities by taking the doomsday scenario of a “hard” Brexit off the table. After consolidating power, new Prime Minister Boris Johnson has been able to make progress, however, previous negotiating rounds have shown us that investors shouldn’t hold their breath waiting for a final solution. Comments from both the UK and the EU indicating that it will take until the end of the year to complete meaningful progress on new trade and regulatory negotiations also temper our outlook for Brexit progress. Based on this, we think that negotiations may extend into 2021. Without a tangible resolution, markets are likely to rise and churn rather than hitting new highs throughout the year. Overall, positive developments in consumer and business activity and a rebound in investor sentiment have the potential to generate positive but uninspiring returns in 2020. As the risks to the market become more binary we recommend underweighting UK equities within foreign equity holdings.

### Foreign Equities - Japan

Throughout the last decade, there has been constant debate on whether Abenomics has delivered its intended benefits. The country has been in easing mode for years and with interest rates stuck in negative territory coupled with constant GDP growth under 1%, a flood of growth this year is unlikely. Recently, the consumption tax increase from 8% to 10% has put more burden on the economy, with government data showing that household spending declined at its fastest rate in nearly four years. However, the BOJ's late year implementation of a \$122 billion fiscal stimulus package should mitigate some of the downside risk. At the consumer level, an unemployment level of 2.4% and limited wage growth has failed to accelerate inflation due to an aging population, technological advances, and a high savings rate. Also, 2019 data may have been better than expected due to an enhanced stimulus boost from an increase in government spending related to hosting the 2020 Summer Olympics. Economies historically enjoy a 25-basis point stimulus from pre-Olympic investment and consumption expenditures which ultimately phases out during the year of the games. The Bank of Japan (BOJ) has helped support the economy over the last decade, but we think the central bank is unlikely to reach deeper into its toolkit in 2020 due to fears that it might exhaust its ability to cope with a downturn in the future.

**Impact of Olympics on Host Country's Y/Y Growth**



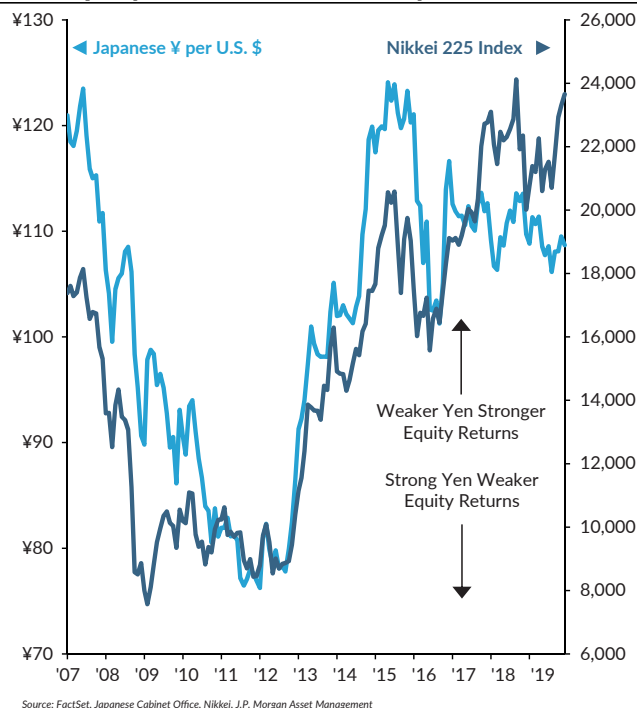
Source: World Bank, Vanguard Research

**"THE BANK OF JAPAN MAY BE LOSING ITS ABILITY TO COPE WITH FUTURE DOWNTURNS"**

## Outlook 2020: Foreign Equity

Despite lackluster growth expectations, we do not think that Japan will experience a recession this year. Improving global trade developments should help support the export driven economy. Also, the potential for a weaker yen could act as a tailwind for the equity market given the inverse correlation between the Japanese stock market and the currency. The yen is generally seen as a safe-haven asset and tends to see a decrease in demand when risk-on sentiment is strong. That being said, the steady but pedestrian outlook for the country has us looking elsewhere for better return opportunities. We recommend an underweight allocation to Japanese equities.

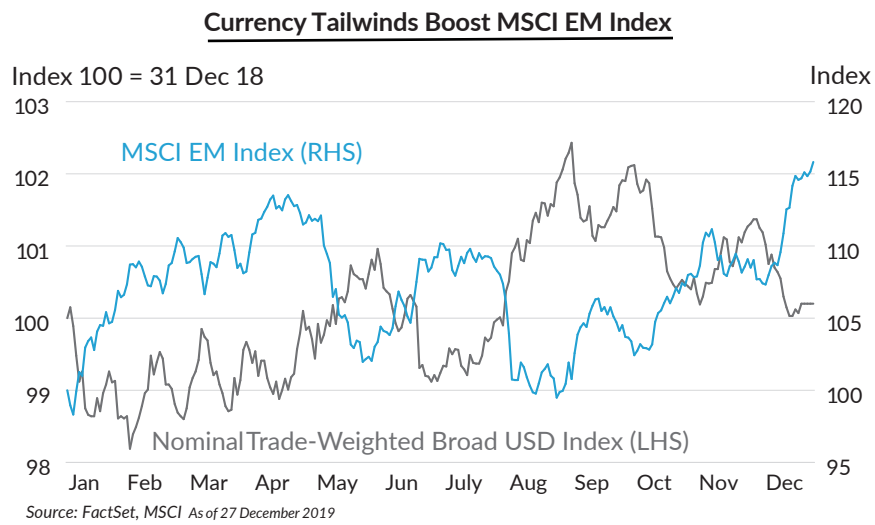
### Japanese Equity Prices are Inversely Correlated to the Yen



"FOREIGN MARKETS OFFER TRADING OPPORTUNITIES, BUT BE CAUTIOUS OF LONG-TERM HOLDS"

### Foreign Equities - Emerging Markets

Emerging market equities had a strong end to 2019 as a Phase One trade deal was announced by the US and China. The asset class is strongly influenced by global economic growth expectations and earnings are highly correlated to the global trade cycle. In 2020, trade tensions will continue to be the largest influence on the markets and investors will be watching how the US Presidential election shakes out to see what is in store for the trade war. Our view remains that details of the recent trade agreement will become clearer which we expect will improve the outlook for global manufacturing activity and business sentiment which will support strong gains for emerging market equities.



Another catalyst contributing to the resurgence in EM equities is the weakening of the dollar. The anticipated pickup in global growth should reverse the trend of investors pouring into US bonds as investors move out of safe-haven assets and into more risk-on investments. Lower demand for US Treasuries, which are used as cash reserves around the globe, lowers the demand for US dollars.

We do see opportunities in the classic BRIC economies this year. India slashed corporate taxes towards the end of the year from 30-40% to 22-25% which should work its way through the economy much like the corporate tax cut in the US last year by increased business investment or share repurchases. The country is also starting to modify their tax code to entice manufacturing to open up shop and diversify their operations away from China. In Brazil, we've seen a positive impact from fiscal reforms which should continue to encourage economic growth on the heels of heightened confidence in the first full year of President Bolsonaro's government reform agenda. These reforms are imperative to jumpstart economic growth as the main target, pension transfers, consumed 45% of the federal budget, equating to 8.6% of the nation's total GDP. Finally, many emerging market central banks still have room to cut key policy rates which could provide an additional tailwind to local economies by supporting investors' risk appetite for equities.

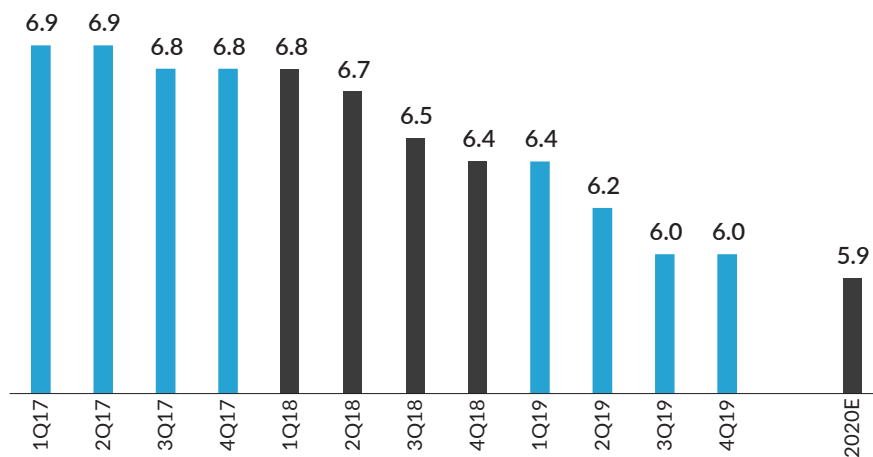


### Foreign Equities - China

2019 was a difficult year for China which saw a material slowdown in its economy, much of it attributable to the US-China trade war. China PMIs, an indicator of current economic strength, fell into contraction territory while consumer demand declines had many companies waiting on the sidelines instead of increasing production. Additionally, after years of positive gains, export volumes collapsed and imports fell from a 16% increase in 2018 to a 5% contraction.

On top of the negative effects from the trade war, the second largest economy is still trying to escape the middle-income trap. Typically, this economic situation occurs after a country experiences rapid growth leading to a large majority of the population entering a “middle income” range. Rising wages lower company profits and mitigate the country’s competitive edge in exports, while consumer focused sectors are not developed enough to replace the lost growth from manufacturing. As china shifts to a more domestically driven economy, a slowdown is to be expected, which has put the government and PBOC in a complicated spot. With inflation ticking up, the central bank does not have much room to cut key interest rates. Instead, we expect the People's Bank of China (PBOC) to continue easing by cutting the reserve requirement ratio for banks. The reserve requirement ratio is the percentage of deposits the government requires banks to hold in their reserves. When the ratio is cut, banks have more funds to lend out, which should push more capital into the economy and ultimately produce a multiplier effect as businesses and consumer borrow and spend. We believe these policy measures will help stabilize economic growth at or just under the 6% target mark.

**China: Quarterly and Full Year Estimate of Real GDP, Y/Y, %**

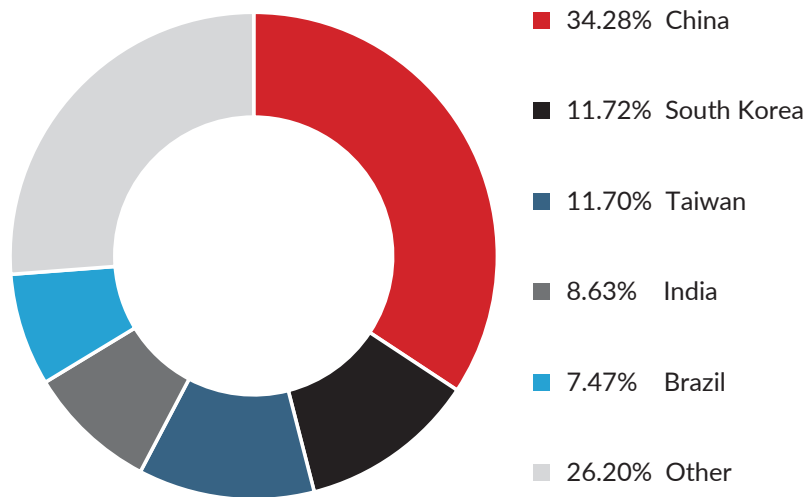


Source: China National Bureau of Statistics, Waterloo Capital Management

We expect a rebound in both consumer and business confidence in China and the US to spark a recovery in the industrial and export sectors. Many countries appear to have overreacted to the escalations of tensions between Trump and Xi which led to a surge in inventory buying as companies filled the coffers in an attempt to avoid paying higher prices due to future tariffs. This spending spree played a significant role in the decline in manufacturing and industrial output last year. We expect that China's import data will show signs of a turnaround during the first half of 2020 as tariffs are removed or eased and domestic demand continues to grow. A rebound in exports may take more time to materialize but will also be a tailwind to consumer activity as labor demand and wage growth recover.

China will be a major driver of emerging market performance this year, given the large percentage the country makes up in the MSCI EM index. We are optimistic that Chinese policymakers' emphasis on stimulus measures to help boost softer domestic demand, paired with a brighter backdrop on tariffs, will lead to improved returns this year.

### MSCI EM Index Country Weightings



Source: MSCI, Waterloo Capital Management

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**"CHINA WILL BE A MAJOR DRIVER OF  
EMERGING MARKET PERFORMANCE  
THIS YEAR"**

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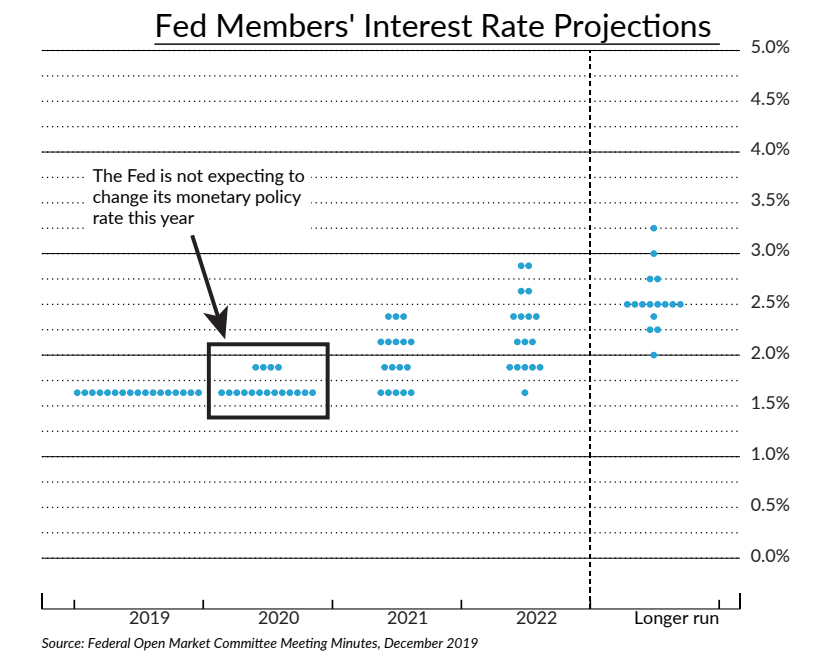
## Outlook 2020: Fixed Income

### Fixed Income - Domestic

US bond returns exceeded expectations in 2019 with support from the Fed cutting rates three times and demand for safe haven assets cycling into favor during periods of trade war induced volatility. The Fed's "mid-cycle" adjustment appears to have worked to keep the peace in the markets and may potentially be the first ever soft-landing engineered by policy makers following an interest rate hike. A "wait-and-see" approach this year may leave the Fed on the sidelines until 2021.

This year it's likely that we will see a steepening of the yield curve as optimism surrounding the global growth rebound gains traction and the Fed attempts to remain on the sidelines. Heading into 2020 thirteen of the seventeen voting Federal Open Market Committee (FOMC) members have backed Fed Chairman Jerome Powell's statements that the Fed is unlikely to adjust rates up or down this year. Powell himself indicated that the Fed is unlikely to step in unless inflation significantly overshoots the committee's target.

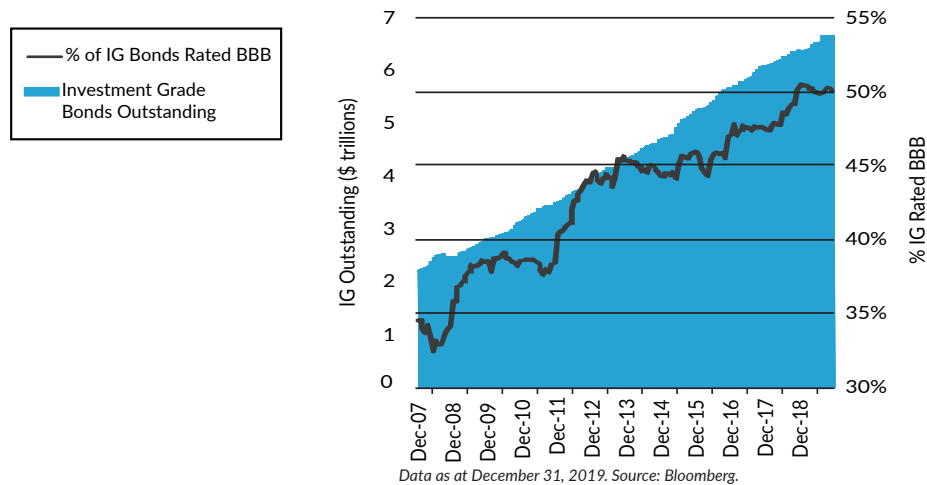
The potential for rising rates on the far end of the yield curve increases risk and decreases our return expectations for longer duration bonds. In our opinion, the pickup in yield for extending duration is not worth the additional risk long-term issues might add to a portfolio. Based on this expectation we are recommending that investors lower the duration of their bond portfolios this year. Holding shorter duration bonds will still add value to a portfolio by helping to mitigate volatility and allowing investors to shift risk to areas of the financial market with more attractive return expectations.



Investors looking for additional yield may find more attractive opportunities in the corporate bonds market. Corporate bond issuance has remained robust despite the decline in business investment last year. The improving outlook for global trade and business activity will benefit bonds issued by multinational companies as investors re-examine profit outlooks sans trade war headwinds. While we think more opportunities are available on the corporate side the sector comes with its own set of risks. The quality of the investment grade universe has been continuously deteriorating since 2010.

Bonds rated BBB, which is one rating above junk, make up 50% of the investment grade universe. Potentially even more concerning is that half of those companies are in the energy and healthcare sectors which could be susceptible to policy changes depending on the results of the presidential election. The sector could experience considerable drawdowns if the expected rebound in global economic activity fails to materialize and we see a ramp up in ratings downgrades.

### BBB Rated Bonds Make up Half of the Investment Grade Universe



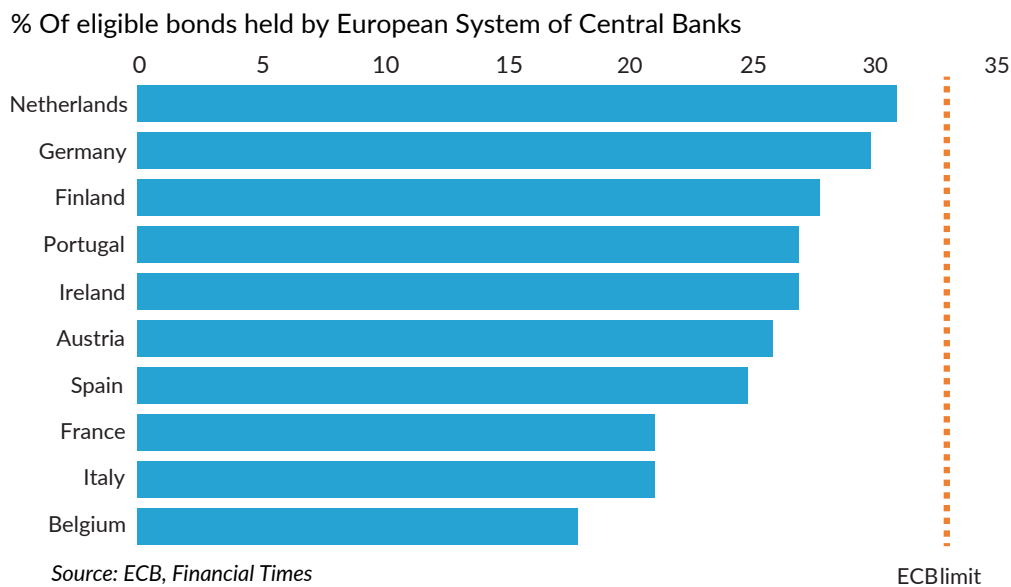
### Fixed Income - Foreign

We recommend an underweight to foreign developed bonds this year given the lack of forward guidance for further interest rate cuts and little room for interest rates to decline significantly. Betting on interest rates to continue falling in the eurozone has become increasingly speculative and the risk is not worth the reward.

In Europe, the European Central Bank (ECB) has an open-ended commitment to purchase at least \$20 billion of bonds every month. Economists estimate that this new purchase program can continue until at least 2021 before the central bank hits their upper limit of owning a third of any eurozone country's bond market. Christine Lagarde, the new chairwoman of the ECB, could be pressured to raise this limit if weak growth in the bloc persists. While the ongoing purchases can have a restricting effect on rising rates, we think that the ECB may be approaching a point where the effects of QE purchases are diminishing. Under this scenario, a drastic change in policy could be viewed as a sign that the outlook for the economy is worse than expected and may lead to tightening in the financial markets as banks and consumers become more cautious.

The Bank of Japan (BoJ) will likely try to keep rates as low as possible to negate the impact of a recent hike in consumption taxes but policy makers are showing a hesitancy to add more liquidity to a market that is swimming in debt. The BOJ's balance sheet currently exceeds the size of the entire Japanese economy, and the bank owns more than 50% of all outstanding government bonds. The potential for the BOJ to enter a holding pattern with policy rates still in negative territory makes it unlikely that there will be enough demand for Japanese bonds to push yields lower. Our expectation of declining activity in the market and potential for rates to remain in a tight range have us looking elsewhere for fixed income opportunities.

The ECB is Nearing Their Bond Buying Limits



Although inherently riskier, emerging market bonds in many regions look attractive heading into this year. The expectation that the rate cutting cycle is over for the time being in developed markets has led to an increase in demand for higher yielding EM debt. Local currency debt has outperformed recently, and we think that this trend will continue as lower US rates and a weaker dollar help to stimulate demand for pure currency exposure in many countries. Additionally, EM central banks are still active on the monetary policy front and have room to issue deeper cuts to interest rates this year. We expect countries that have a greater exposure to global trade to ramp up stimulus measures to take advantage of any rebound in global growth. Investors with a need for yield will be able to find opportunities in EM debt but should look to lower overall risk by increasing quality and shortening duration across the rest of their fixed income holdings.

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**"EMERGING MARKET BONDS MAY SURPRISE TO THE UPSIDE THIS YEAR"**

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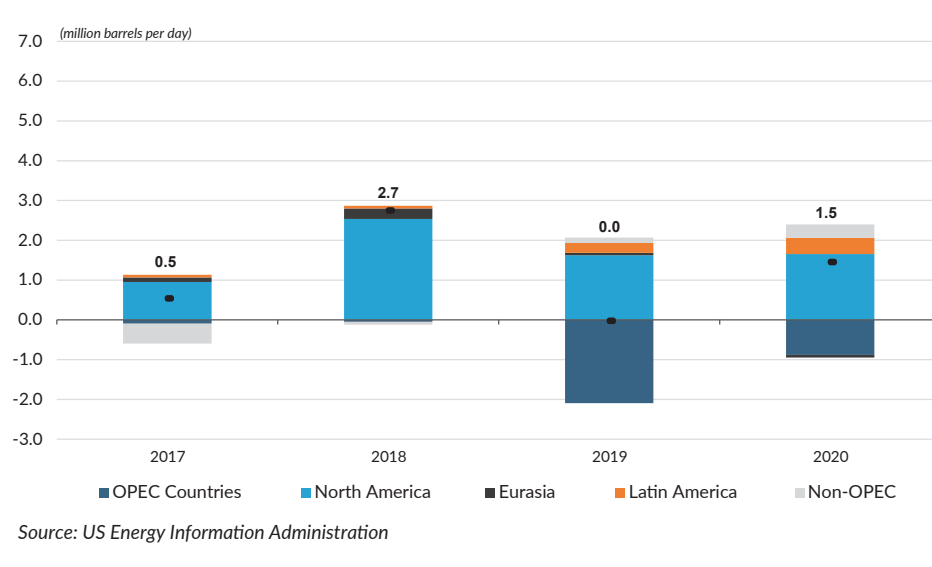
### Real Assets

We'll likely see a lift in demand for commodities due to easing trade tensions. However, supply and demand imbalances in many commodities are still tilted towards over-supply which will cap potential upside for the asset class this year. Within commodity sub-sectors we remain neutral on oil services, like precious metals over base metals, and remain selective in the real estate space favoring major metroplexes, multifamily, industrial, and real estate debt.

### Oil

Oil prices in 2019 posted a strong 35% comeback after the drastic fall towards the end of 2018. 2020 will be a year characterized by rising demand but also stronger supply growth. Amidst the growing supply problem, OPEC announced they were deepening supply cuts through March 2020 to 1.7 million barrels per day, which should help create a price floor heading into 2020. Global oil supply cuts are being rapidly offset by rising production in the US. This trend began in 2015 and has affected supply ever since. US oil production increased to a record 12.6 million barrels per day at the end of 2019, making it the world's largest oil producer. In total, additional demand from countries benefiting from steadier economic growth will help support oil prices, but as drilling technologies make it easier and faster to bring new supply online it will be difficult for demand to overtake supply in a meaningful way. Overall, we expect WTI prices to trade stay in a \$55-\$65 range on average this year.

#### Expected Annual Net Change in Oil Production



### Metals

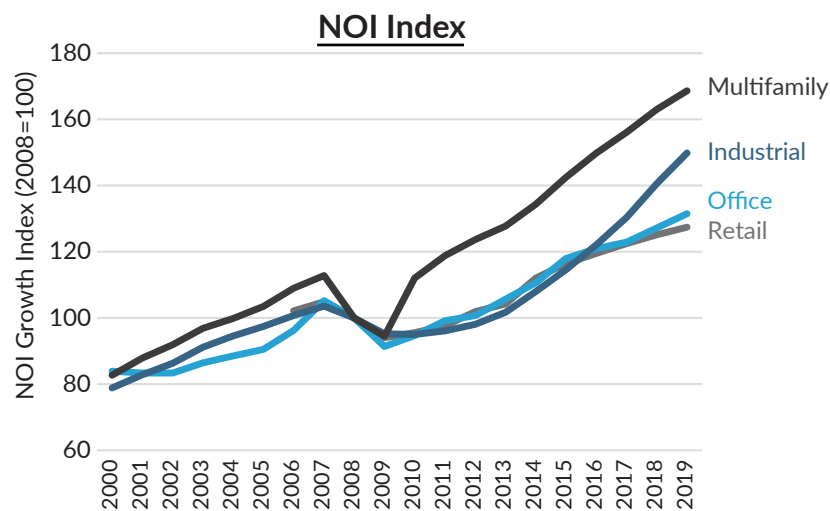
The global slowdown in manufacturing limited demand for base metal inputs last year while geopolitical tensions helped propel precious metals, causing a widening divide. This year, lower overall prices, elevated volatility, and a weaker US dollar should be enough of a tailwind to increase demand for both base and precious metals.

With the opportunity of rebound for base metals due to tariff certainty and a pickup in global growth, we remain optimistic for the sector. Demand for the metals due to their widespread input use should be the main driver in 2020 and will likely push the prices higher. Copper could be poised to make the biggest base metal run in 2020. Copper prices sank to two-year lows late in the year after escalation in trade tensions threatened global demand. Recently institutional investors have poured into long copper bets due to low inventories, supply constraints, and better business conditions amid an improving global economy.

Although inflationary pressures have remained stubbornly low, the US dollar softening, and persistent geopolitical tensions helped propel precious metals to recent highs last year. We think the asset class will continue to see solid demand this year due to heightened volatility prospects and investors holding positions as a risk hedge. Additionally, the possibility of rising inflation typically increases the demand for precious metals based on the view that the asset class can protect against eroding purchasing power.

### Real Estate

Persistent high valuations and the potential for uncertain economic conditions create an outlook defined by combining both offensive and defensive strategies in real estate. The current mature market cycle has investors paying higher prices and speculating on tighter cap rate compressions which could lead to an imbalance in risk and return for the asset class. Valuation increases in the commercial space have predominantly been supported by growing net operating incomes. This trend is likely to continue with vacancy rates at cycle lows allowing rent growth to remain robust.

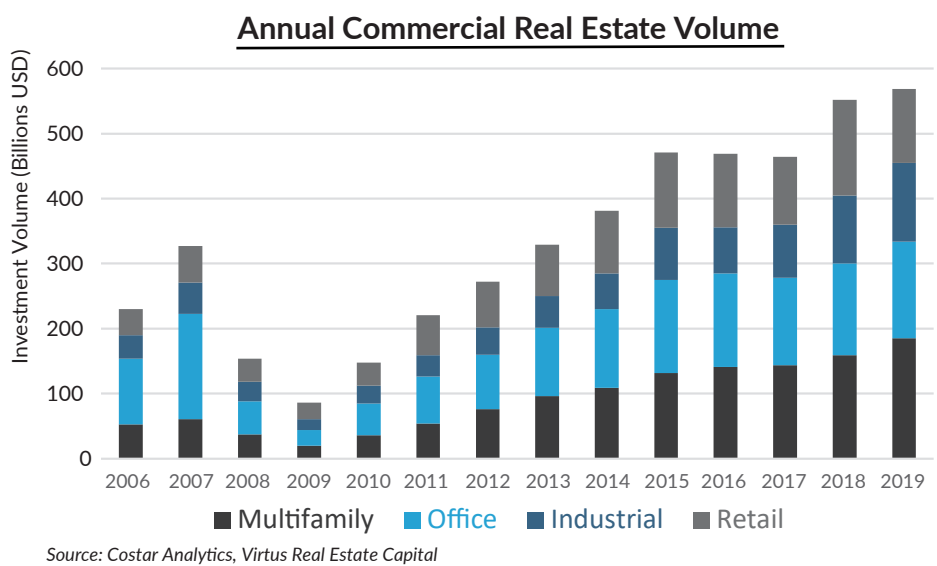


Source: Costar Analytics, Virtus Real Estate Capital



## Outlook 2020: Alternative Assets

We still favor multifamily as it continues to surprise to the upside in both occupancy and rate growth. For office and retail, selecting opportunities in locations focused on offering live-work-play environments can help position investors for success. These amenities appeal to the rising millennial workforce and should continue to see high demand. Store closures, bankruptcies, and the growing e-commerce threat solidify our downbeat view on pure retail spaces. On the bright side, as one door closes another one tends to open, and with growing e-commerce comes an increase in logistics and warehousing which will benefit the industrial sector going forward. Because value has been harder to find, understanding the downside risks to real estate investments will be vital this year. We are wary of strategies employing high levels of debt and investing at low loan to value ratios.

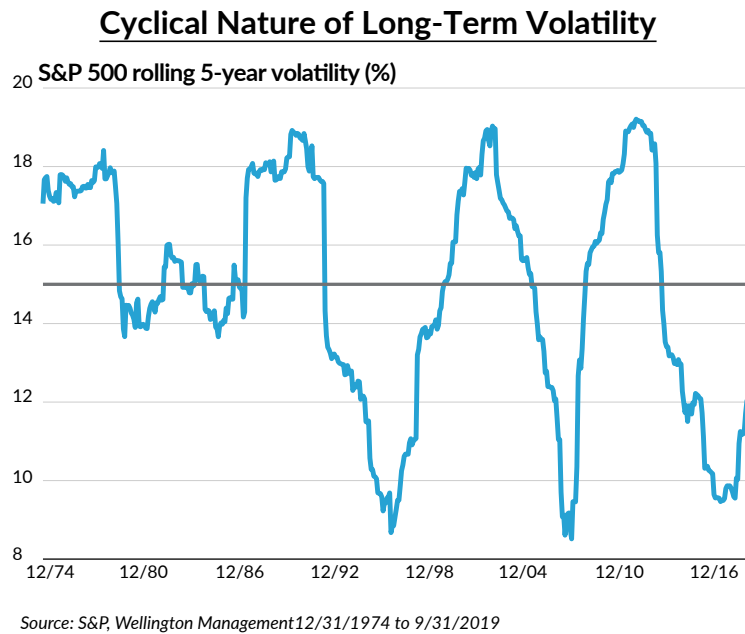


We also believe real estate debt is well positioned to succeed in the current environment. The demand for yield outside of traditional government and corporate bonds should boost investor interest in the space given its ability to provide stable income. We are focused on finding opportunities targeting more senior positions in the capital stack backed by strong collateral. Given the potential downside risks in the space, we also prefer to invest in debt issuers with operating capabilities. The ability to take over an asset in the event of a default and continue generating income adds an extra layer of protection for investors.

**"COMBINING BOTH OFFENSIVE AND DEFENSIVE STRATEGIES WILL BE KEY TO SUCCESS IN REAL ESTATE"**

### Alternative Investments

As investors, we have a tendency to measure investment performance for all asset classes in terms of traditional indices, such as the S&P 500 or Dow Jones Industrial Average. For investors who've allocated to alternatives, this has generally led to disappointment over the preceding 10-years. The prolonged bull market for traditional equity beta has also occurred during a period of extreme low volatility. This environment has put many alternative strategies at a structural disadvantage, as many benefit from volatility and market dislocations.

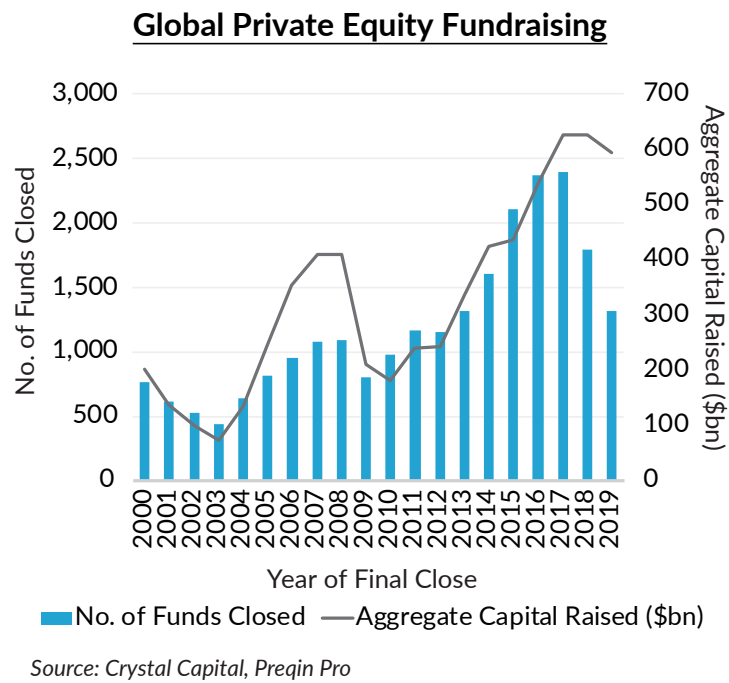


Over the preceding two-years, this has begun to change. Volatility is cyclical and typically more pronounced near market tops. We believe that investors who have made concerted efforts to build in alternative allocations in their portfolios, in hopes of increasing diversification and generating excess performance, will begin to see the benefits this year and in the years to come.

### Private Equity

2019 was another great year for private equity managers as fundraising and deal flow remained strong. The industry raised almost \$600 billion, making it the 4th year in a row to surpass the half a trillion mark. \$393 billion in buyout deals and \$224 billion in venture capital deals were completed during the year. This was boosted in part by high valuations, which saw the average buyout deal hit a 10-year high of \$490 million.

The private equity investment environment remains highly competitive, with valuations near the upper end of historical ranges. These valuations have bifurcated between types of companies in the buyout market. Stable, non-cyclical companies who have strong recurring revenues, supported by long-term demand drivers have traded in excess of 20x-25x EV/EBITDA multiples. On the opposite end of the spectrum are lower quality assets with cyclical exposures or disruption risks. Over the last year, over 100 of these companies have failed at auction. We believe that skilled special situation operators can take advantage of these pricing anomalies by identifying sector trends to generate top-line growth and value creation.



While deals in the mega-cap buyout space remain increasingly competitive, we see opportunities in small to mid-sized companies with revenues between \$10-100 million. These companies remain below the radar of large-cap private equity sponsors and transactions are typically less levered. The key to accessing these opportunities is sourcing sector specific mid-market managers who understand and have access to new economic opportunities. E-commerce, cyber security, and software-as-a-service (SaaS) are all areas we see as having enormous potential.

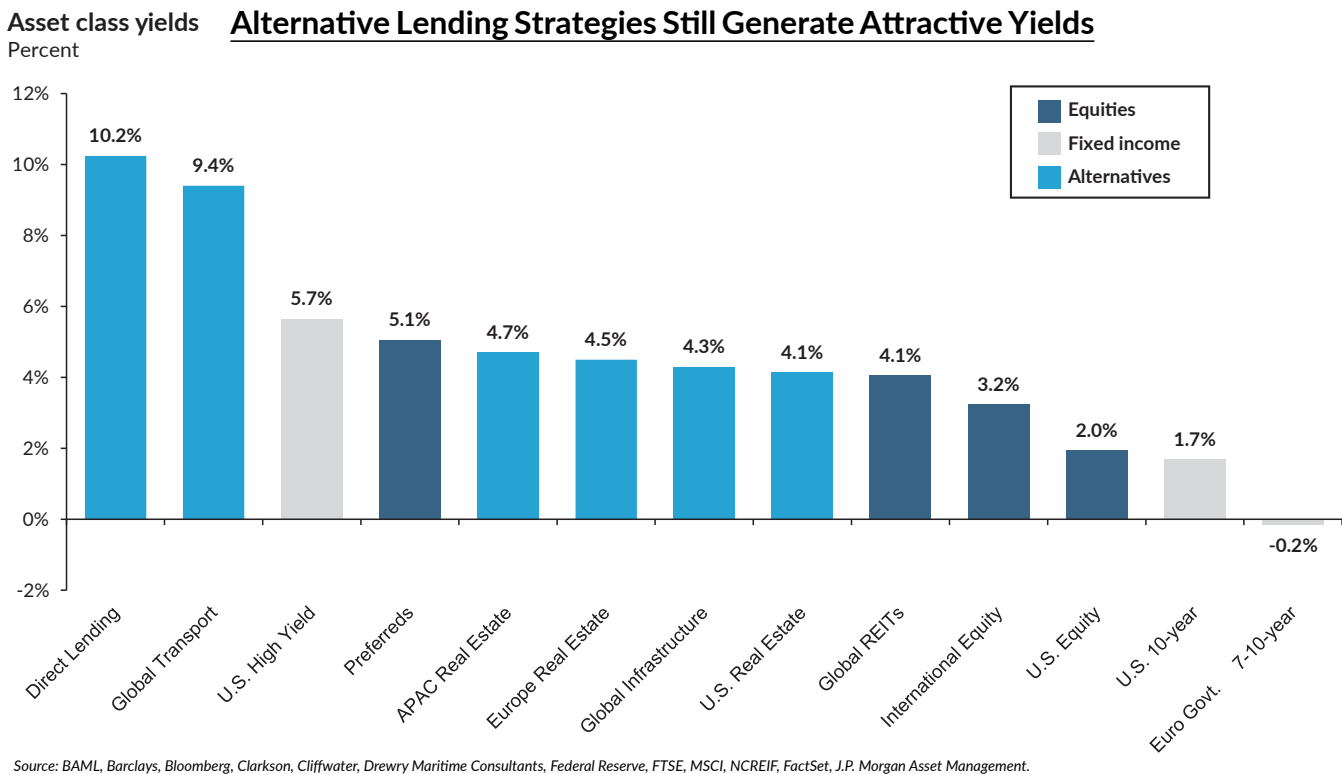
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**"WITHIN PRIVATE EQUITY WE ARE  
FINDING ATTRACTIVE OPPORTUNITIES  
IN THE MIDDLE MARKET"**

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## Private Credit

Despite signs of slowing global growth and rising volatility in capital markets, demand for private debt remains strong. As we mentioned in our investment themes, we maintain the view that interest rates will continue to be low due to ongoing central bank easing policies. This results in a “TINA” attitude toward yield assets. There are few options in the public markets to achieve attractive inflation-adjusted yields. One of the biggest risks facing investors in this environment is reinvestment risk. There is a strong appetite for yield from US consumers, who continue to increase savings rates even at this late stage of the cycle. Given this environment, we favor alternative investment opportunities in collateral-backed assets, with upfront cash flows. We are finding compelling opportunities in asset-backed finance to provide attractive short-term, hard asset backed loans to qualified buyers in stable markets. Additionally, global transportation assets, such as airplane and rail car leases, seem to offer attractive yields. These assets also provide a defensive benefit to portfolios by providing inflation protection and hedging against recession risks.



## Outlook 2020: Alternative Assets

### Hedge Funds

Hedge fund assets rose to \$3.32 trillion at the end of 2019, a record high. The hedge fund industry produced one of its best one-year performance in a decade as risk-on sentiment and upside volatility dominated public markets. The HFRI Composite Fund of Funds index was up 8.3% for the year. Though returns were strong, they materially underperformed public equity market returns.

#### Hedge Fund Strategy Returns

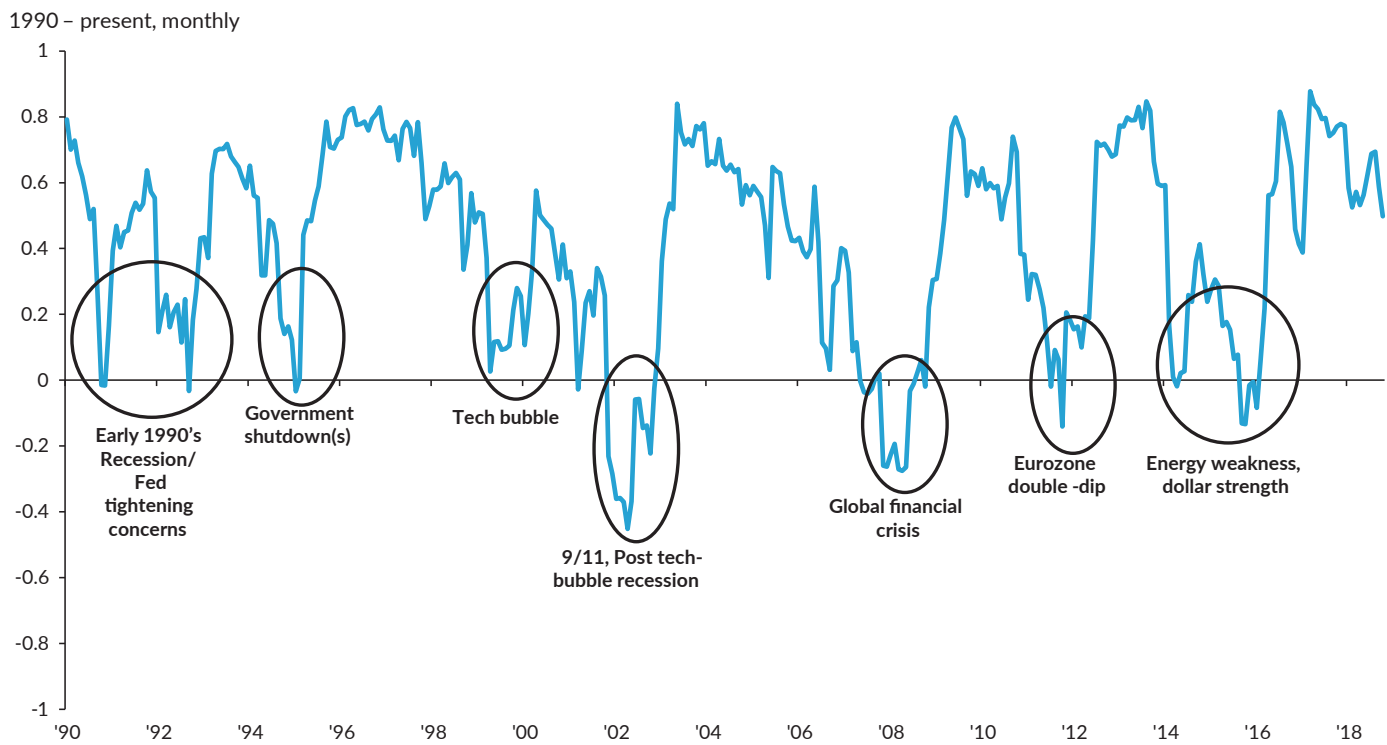
2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	YTD	2009-2018	
											Ann.	Vol.
Global Equities 35.4%	Global Equities 13.2%	Global Bonds 5.6%	Global Equities 16.8%	Global Equities 23.4%	Global Macro 5.6%	Eq. Market Neutral 4.3%	Distressed 15.1%	Global Equities 24.6%	Merger Arbitrage 3.3%	Global Equities 16.7%	Global Equities 10.0%	Global Equities 15.6%
Distressed 28.1%	Distressed 12.1%	Merger Arbitrage 1.5%	Relative Value 10.6%	Equity Long/Short 14.3%	Global Equities 4.7%	Merger Arbitrage 3.3%	Global Equities 8.5%	Equity Long/Short 13.3%	Relative Value -0.4%	Equity Long/Short 7.8%	Relative Value 6.9%	Equity Long/Short 8.6%
Relative Value 25.8%	Relative Value 11.4%	Relative Value 0.1%	Distressed 10.1%	Distressed 14.0%	Relative Value 4.0%	Relative Value -0.3%	Relative Value 7.7%	HFRI Composite 8.6%	Eq. Market Neutral -1.0%	HFRI Composite 6.8%	Distressed 6.8%	Distressed 7.8%
Equity Long/Short 24.6%	Equity Long/Short 10.5%	Distressed -1.8%	Equity Long/Short 7.4%	HFRI Composite 9.1%	Eq. Market Neutral 3.1%	Equity Long/Short -1.0%	Equity Long/Short 5.5%	Global Bonds 7.4%	Global Bonds -1.2%	Global Macro 6.8%	Equity Long/Short 5.6%	HFRI Composite 6.1%
HFRI Composite 20.0%	HFRI Composite 10.2%	Eq. Market Neutral -2.1%	HFRI Composite 6.4%	Relative Value 7.1%	HFRI Composite 3.0%	HFRI Composite -1.1%	HFRI Composite 5.4%	Distressed 6.3%	Distressed -1.7%	Global Bonds 6.3%	HFRI Composite 4.9%	Global Bonds 5.6%
Merger Arbitrage 11.6%	Global Macro 8.1%	Global Macro -4.2%	Global Bonds 4.3%	Eq. Market Neutral 6.5%	Equity Long/Short 1.8%	Global Macro -1.3%	Merger Arbitrage 3.6%	Relative Value 5.1%	Global Macro -4.1%	Relative Value 5.6%	Merger Arbitrage 4.1%	Relative Value 4.8%
Global Bonds 6.9%	Global Bonds 5.5%	HFRI Composite -5.3%	Eq. Market Neutral 3.0%	Merger Arbitrage 4.7%	Merger Arbitrage 1.7%	Global Equities -1.8%	Eq. Market Neutral 2.2%	Eq. Market Neutral 4.9%	HFRI Composite -4.7%	Merger Arbitrage 4.3%	Global Bonds 2.5%	Global Macro 3.7%
Global Macro 4.3%	Merger Arbitrage 4.6%	Global Equities -6.9%	Merger Arbitrage 2.8%	Global Macro -0.4%	Global Bonds 0.6%	Global Bonds -3.2%	Global Bonds 2.1%	Merger Arbitrage 4.3%	Equity Long/Short -7.1%	Distressed 3.0%	Eq. Market Neutral 2.5%	Eq. Market Neutral 2.8%
Eq. Market Neutral 1.4%	Eq. Market Neutral 2.9%	Equity Long/Short -8.4%	Global Macro -0.1%	Global Bonds -2.6%	Distressed -1.4%	Distressed -8.1%	Global Macro 1.0%	Global Macro 2.2%	Global Equities -8.9%	Eq. Market Neutral 1.9%	Global Macro 1.0%	Merger Arbitrage 2.5%

Source: MSCI, Bloomberg Barclays, HFRI, FactSet, J.P. Morgan Asset Management.

Despite the pervasive negative news from the financial news media, aggregate hedge funds assets have hit all-time highs in 10 of the last 11 years. Much of this disconnect stems from the rationale institutional investors have for allocating to hedge fund strategies. With interest rates and credit spreads near historic lows, we see an allocation to hedge funds benefiting portfolios in two ways. First, we have recommended an increase to low-correlation hedges away from fixed income to increase the diversification of a portfolio. Secondly, with yields on the aggregate bond index in the mid-2% range, the bar is low for hedge funds to add value on a risk-adjusted basis. Finally, the benefits to allocating to hedge funds have historically provided a hedge in periods of market volatility.

In this current environment we favor low-volatility and low-correlation strategies which can take advantage of dislocations in the market. In our opinion, we are likely to encounter more volatility in the quarters ahead, even if we do not enter a recession in 2020. Proper risk-budgeting across portfolios will be paramount, and hedged strategies which can reduce concentration risks, lower portfolio correlations, and improve portfolio efficiencies will be a key tool in an investor's tool box.

### Hedge Fund Correlation with a 60/40 Stock/Bond Portfolio



"WE FAVOR LOW VOLATILITY AND LOW-CORRELATION STRATEGIES WHICH CAN TAKE ADVANTAGE OF DISLOCATIONS IN THE MARKET"

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

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