

Return of Gravity



John Chatmas – Chief Executive Officer
Bennett Woodward – Chief Investment Officer
Don Simoneaux – Director of Alternative Investments
Logan Moulton – Portfolio Manager
Randy Flowers – Investment Analyst

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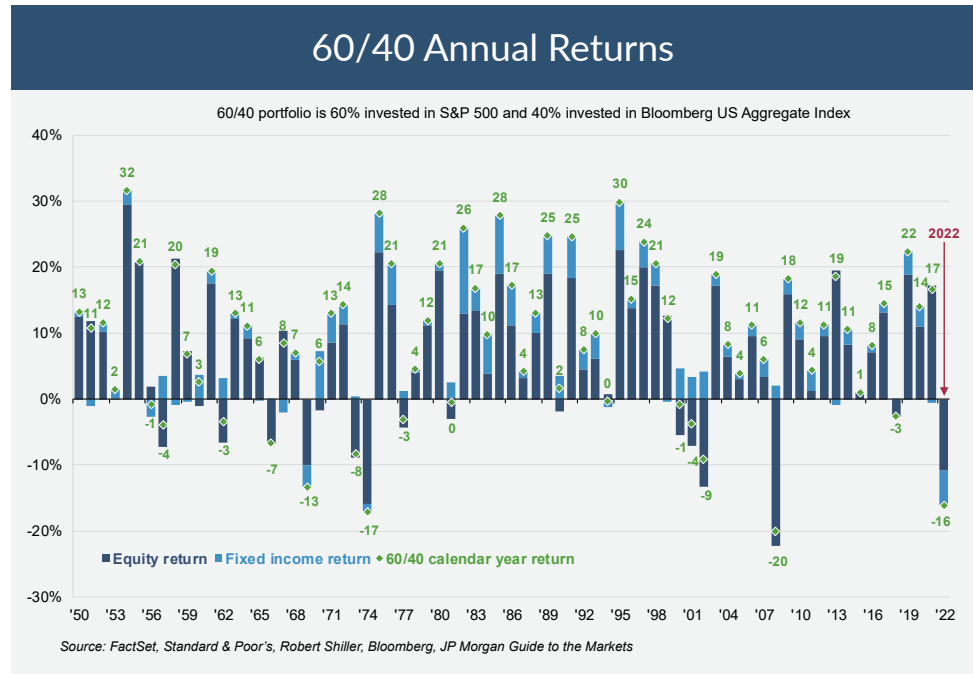
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2022 Review

“It was the best of times, it was the worst of times” is not only a famous quote from Dickens’ *A Tale of Two Cities* but perfectly encapsulates the last few years of market activity. Investors experienced three straight years of double digit returns before turning the calendar to 2022 where they faced daunting challenges. Last year, markets experienced one of the most volatile environments in decades. High inflation across the globe, war overseas, restrictive central banks, global energy shortages, dollar strength, and yield curve inversion all presented major headwinds for risk-on markets. There were few areas for investors to hide. Bonds, which typically serve as a hedge during volatile market environments, were impacted by higher rates. Traditional 60/40 investors experienced the 3rd worst annual performance in 70 years.



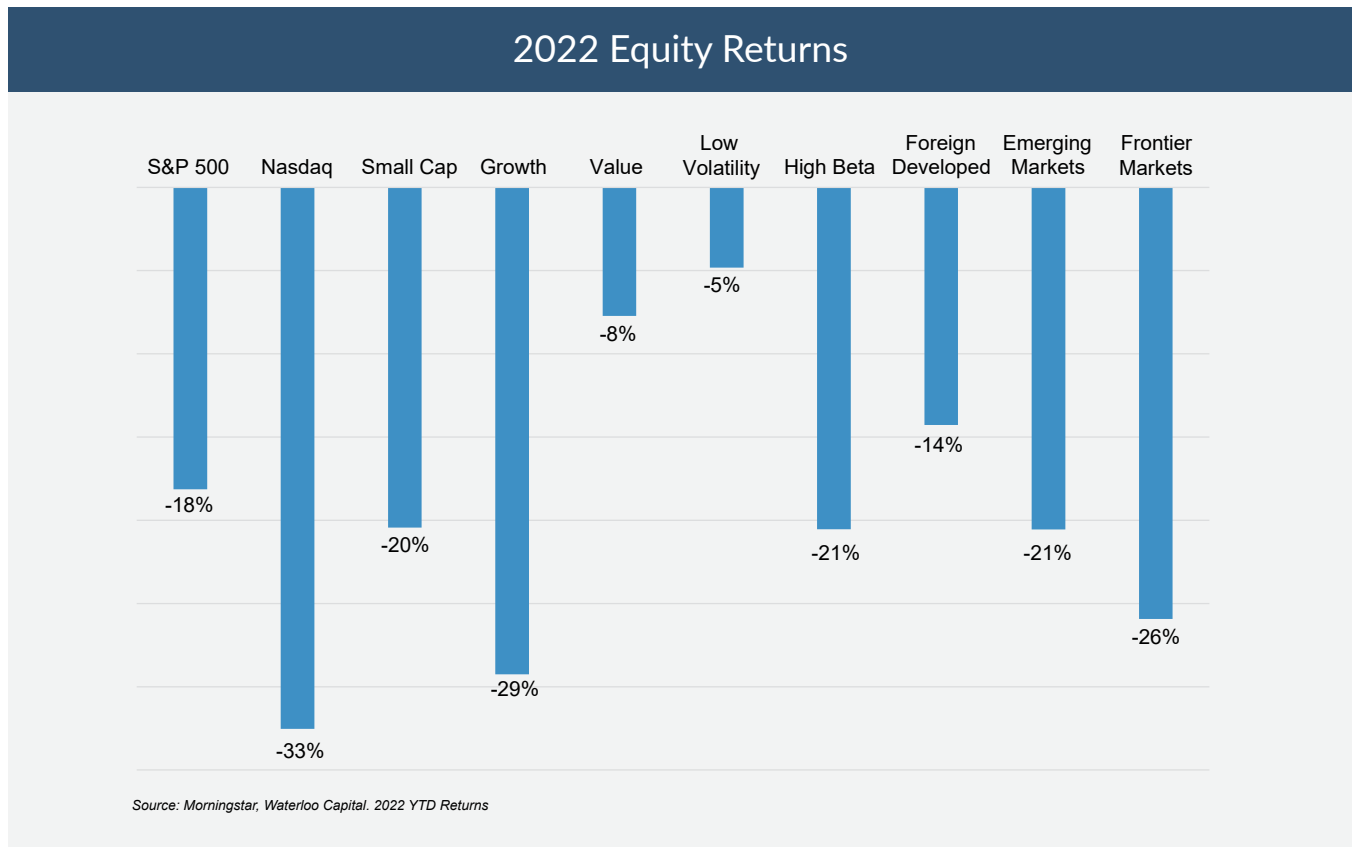
While all the aforementioned factors played a role in the decline of asset prices, central banks’ war on inflation was the key driver of volatility. Inflation, which had begun to show signs of being not so transitory in late 2021, firmly established itself as a formidable opponent for central bankers to contend with early in the year. Across the globe, monetary authorities initiated their hiking cycles, with the Fed taking center stage. The aggressive reversal from Covid-era zero interest rate policy drove a swift repricing of assets. Russia’s invasion of Ukraine added fuel to the fire by shocking commodity markets and exacerbating already strained global supply chain issues, deepening the pain. As spring gave way to summer, inflation readings proved to be sticky, and central banks provided increasingly hawkish rhetoric as rebuttal. This gripped markets through year-end as investor fears of an incoming recession and earnings damage escalated.

“Inflation showed signs of being not so transitory in late 2021, establishing itself as a formidable opponent for central bankers to contend with.”

The US stock market, and most other equity markets, recorded their 2022 high on just the second trading session of the year. Stagnating economic data, soaring energy and goods prices, and a hawkish Federal Reserve amalgamated to form a potent poison for domestic equity returns. Stock valuations were hit with a 1-2 punch as higher interest rates and earnings uncertainty caused significant repricing. Hopes of a Fed pivot were repeatedly thwarted by stubborn inflation and a tight labor market. In the first true bear market since 2018, the S&P 500 fell 25% at its lowest point.

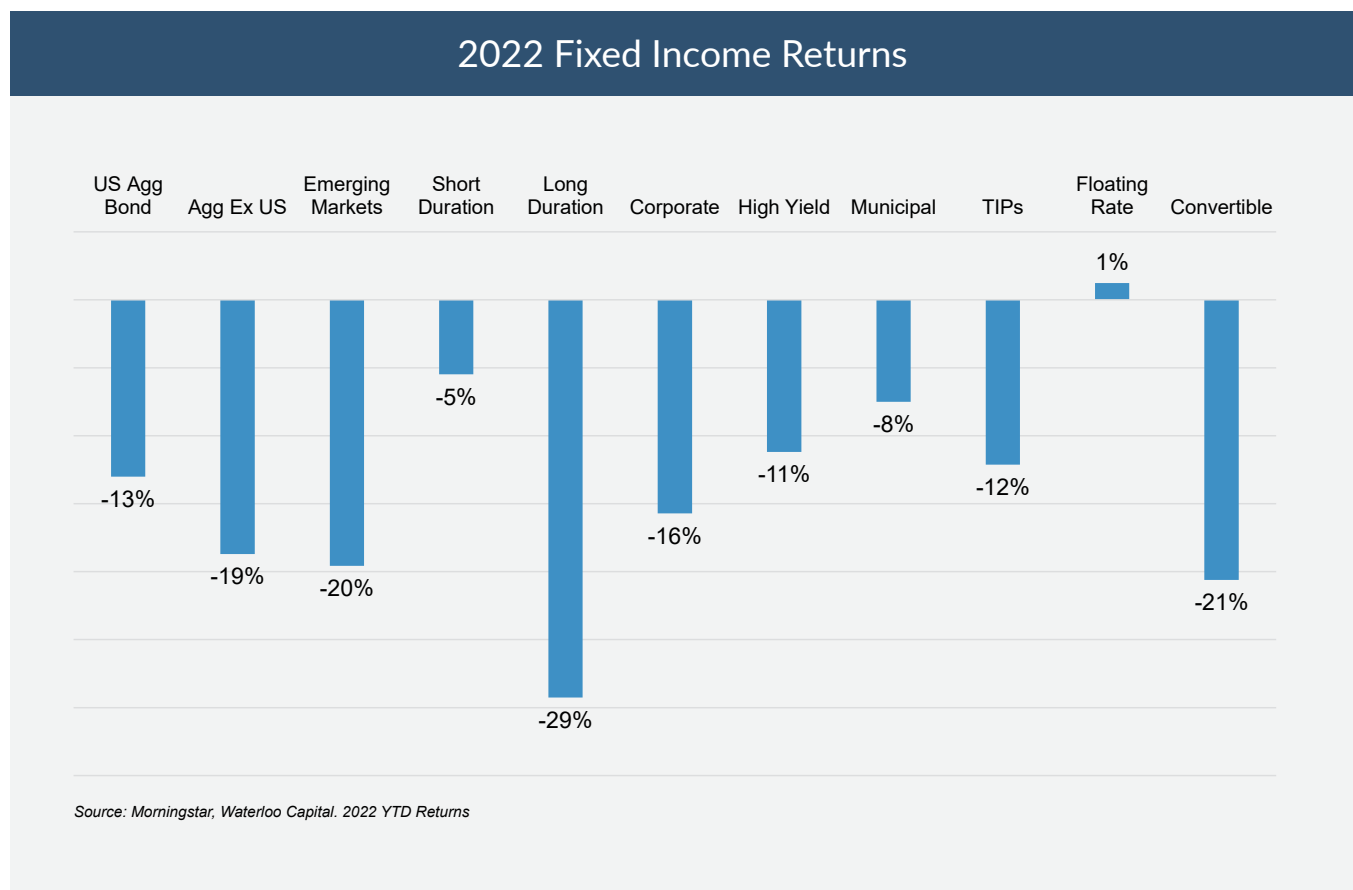
Foreign markets faced even larger challenges. While the US began its tightening with a relatively robust economy, other nations did not have that luxury. The strength of the US Dollar also had an intense, negative impact on the world’s resiliency. In Europe, the weaker economic growth recovery from the pandemic was substantially worsened by Russia’s invasion of Ukraine. With most of Europe’s energy originating in Russia, sanctions and uncertainty surrounding supply forced prices to skyrocket, causing another leg up in inflation. Despite these economic challenges, central banks were forced to hike interest rates in an effort to slow the economy even further to battle persistent price increases.

Emerging markets (EM) sharply underperformed as an asset class throughout the year. The economic headwinds of an incredibly strong US Dollar combined with slowing global demand for exports, produced relatively poor returns from EM equities. The index was hamstrung by China’s surprising slowdown catalyzed by the country’s strict “zero covid policy” and the deterioration of its real estate market. These factors led China to underperform and, given its significant weight in the emerging markets index, hauled EM performance down with it.

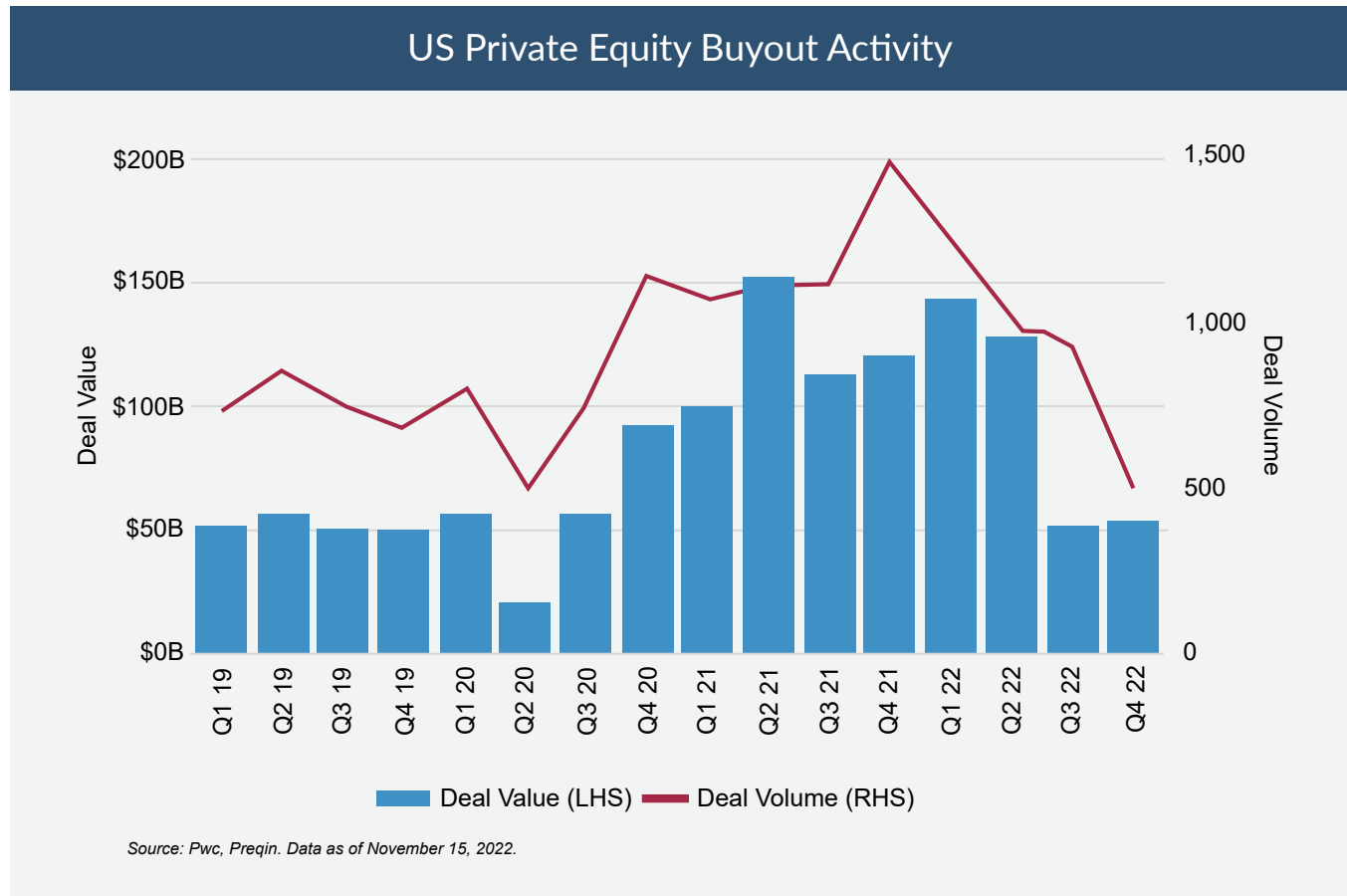


While traditionally serving as a ballast for portfolios in equity bear markets, fixed income turned in its worst year in decades. Yields had already begun to rise towards the end of 2021 in anticipation of global central banks removing covid-era stimulus and eyeing interest rate hikes to curtail the then “transitory” inflation. As hotter inflation prints rolled in, policy makers shifted their tone to aggressively hawkish. Liquidity fell as rates began to skyrocket across the yield curve.

As bond prices are negatively impacted by higher interest rates, the historic rise in rates quickly led to a deep bear market for fixed income. With higher policy rates pushing up the front end of the curve and the weak economic outlook keeping longer dated bond rates subdued, we saw a consistent inversion of the yield curve with the 2-10 treasury spread maxing out at -80 bps. Long duration bonds performed the worst this year given their heightened sensitivity to interest rate changes. Corporate credit outperformed the global bond market due to its credit risk component, generating lower sensitivity to interest rates. Spreads, which incorporate the risk of default in corporate bonds, were relatively stable throughout the year as default rates remained low.



Private markets were not insulated from the issues plaguing the global economy. Through the first half of the year the Cambridge Associates Private Equity index was down 5.3%, compared to an increase of 25.5% for the same period in 2021. The heady days of COVID-era buyout deals slowed as inflation and higher interest rates decelerated new deal activity. Private equity deal volume fell 22% compared to the prior year and broadly returned to pre-COVID levels.



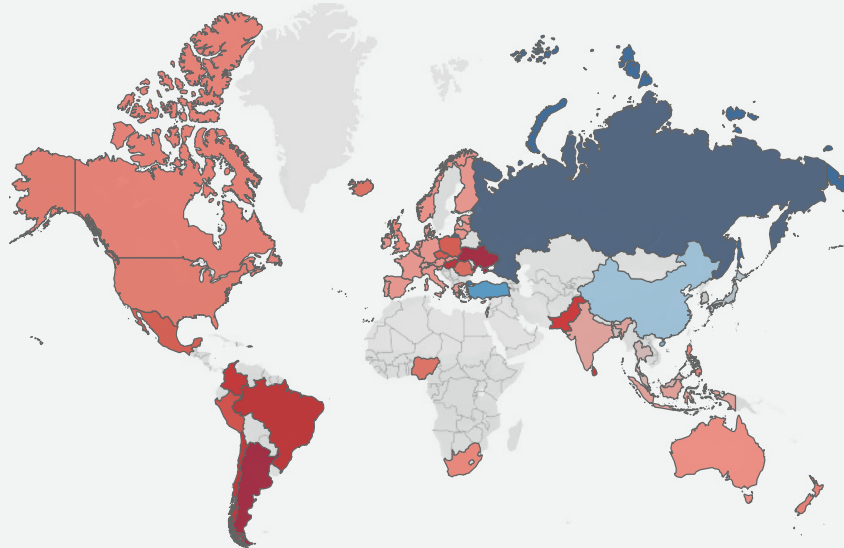
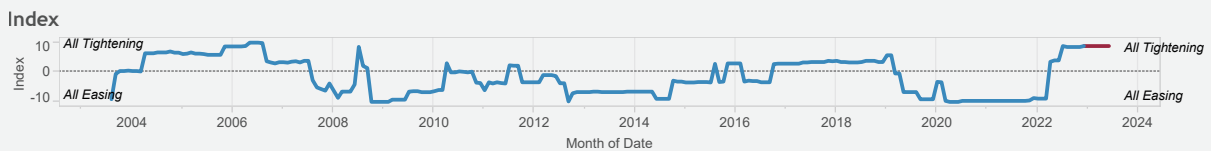
Other areas in the alternative market did perform well during the year. Direct lending and specialty finance strategies offered investors inflation protection and a steady income stream tied to contractual obligations. The floating rate nature of this asset class offered investors protection against rising rates, while the broad based public bond indices experienced the worst year on record.

In hedge funds, performance last year was mixed. From an industry perspective, the hedge fund index posted its worst performance since 2018 as the HFRI 500 index fell 4.25%. Though the index is overly weighted toward more equity sensitive strategies like long/short and equity hedged strategies. Less correlated strategies, such as global macro and managed futures, we able to sidestep the drawdown in 2022 and posted double digit returns. Quantitative multi-strategy funds, like Citadel and D.E. Shaw, performed exceedingly well with performance in excess of 20%.

2023 Introduction

We are delighted to turn the calendar on a year that served investors a double whammy as both equities and fixed income investments suffered double digit losses. Markets are expected to now enter a new-found regime characterized by lower growth, higher interest rates, and higher inflation than investors have grown accustomed to.

Central Banks Around the World are Tightening



© 2023 Mapbox © OpenStreetMap

Magnitude of Easing (-) / Tightening (+) (ppt)
-15.00 15.00

Source: CFR Global Monetary Policy Tracker, Bloomberg, IMF

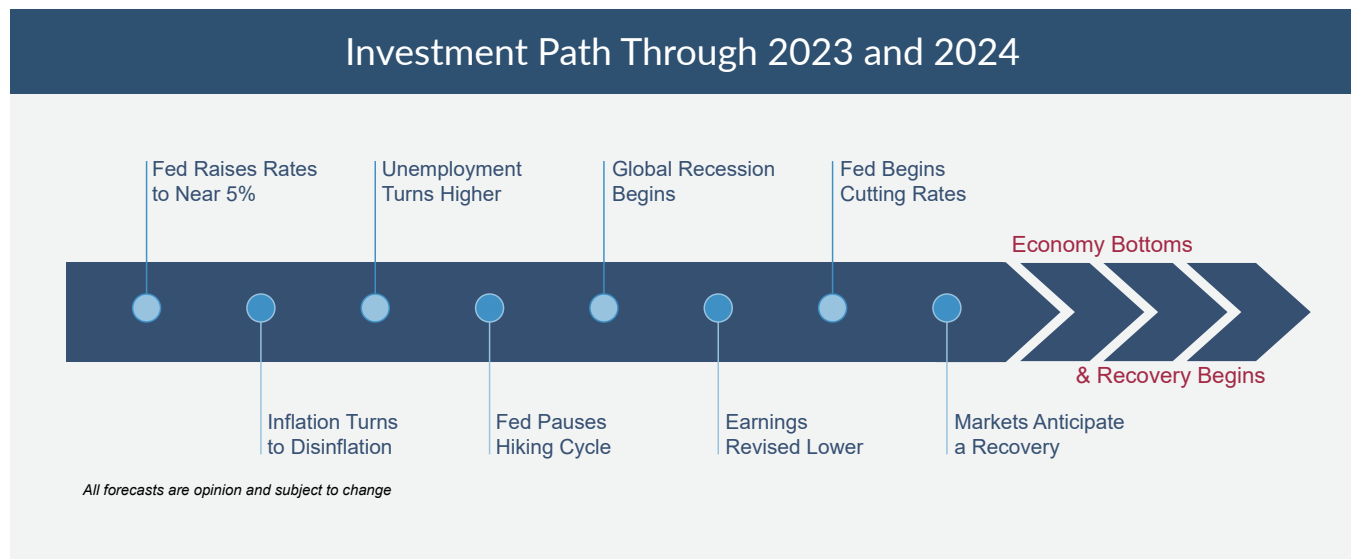
We enter the 2023 investment arena on unstable footing as central banks around the world continue their synchronized global tightening cycle. This dynamic is paramount as interest rates provide a gravitational force, anchoring asset prices to fundamentals. As famed investor Warren Buffet puts it, interest rates are to asset prices as gravity is to the apple. This “gravity” will persistently weigh on valuations and inject volatility as the world works toward recovery in both the economy and markets in the years ahead. The last decade of central bank policy has embedded an expectation in investors that central banks will have their back and aggressively step in with a safety net. However, this current coordination in tightening conditions suggests that investors cannot count on intervention if conditions worsen. We believe the year ahead will reflect more of a reset in financial markets, not a V-shaped recovery.

“Interest rates are to asset prices as gravity is to the apple.”

As we navigate this bear market, we acknowledge the number of challenges to be encountered in the coming year. Yet, with time we believe the bear will retreat and ultimately enter hibernation. Until then, we continue to emphasize the prolonged importance of a defensive stance to protect capital until leading indicators begin a bottoming process. Patience will be critical and separating the signals from noise imperative for investors on the road to recovery.

We anticipate the slowdown in the US economy to stagnate into recession with Europe experiencing an even more severe deceleration. On the inflation front, we expect the rapid price increases to transition towards disinflation as the Federal Reserve pauses their hiking cycle due to deterioration in economic data. The culmination of factors stemming from progressing into this late cycle environment will have an outsized impact on markets and earnings, exalting instability. Eventually, markets will anticipate brighter times ahead and lead us into a new bull market.

We present 6 key themes and their investment implications to provide a roadmap for investors in the coming year. On behalf of our team at Waterloo Capital, we want to thank you for reading our 2023 Market Outlook.

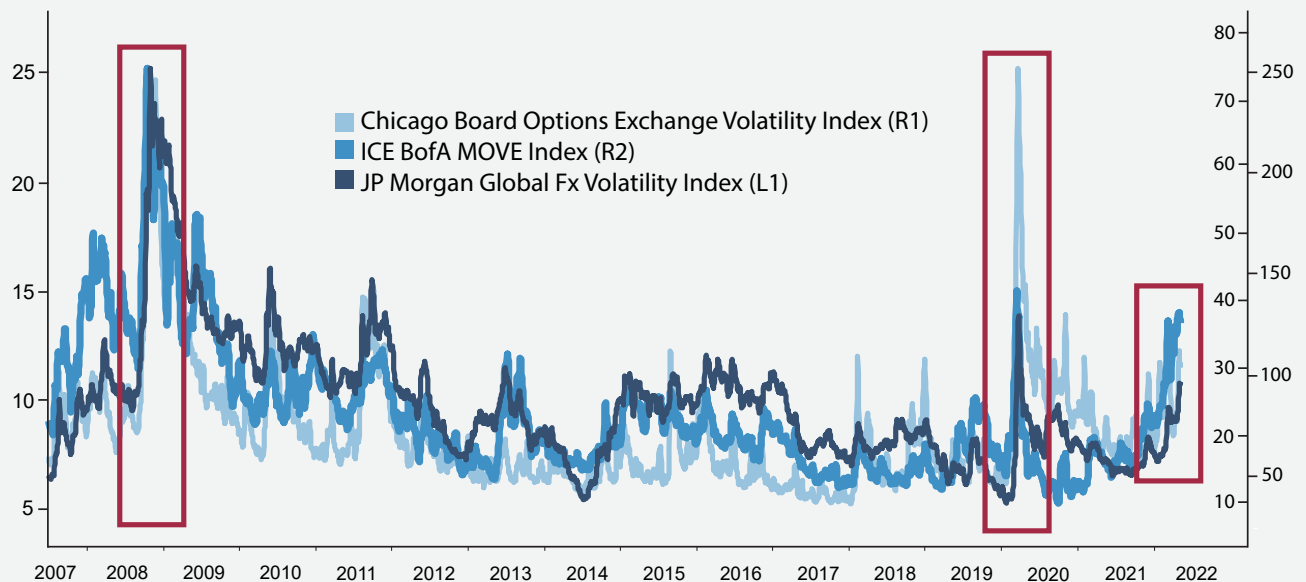


You're Going to Need a Smaller Boat

Although a good plan in dealing with Great White sharks, we believe in fading Roy Scheider's advice in the investment arena over the years to come. You don't always need a bigger boat to take on what lurks below, dexterity and quickness are key in avoiding risks. The temptation to be influenced by recency bias and keep the bow pointed straight ahead will lead to many strategies being beached before they can steer clear of potential dangers. Our bias is to take a more active approach to navigating the markets this year.

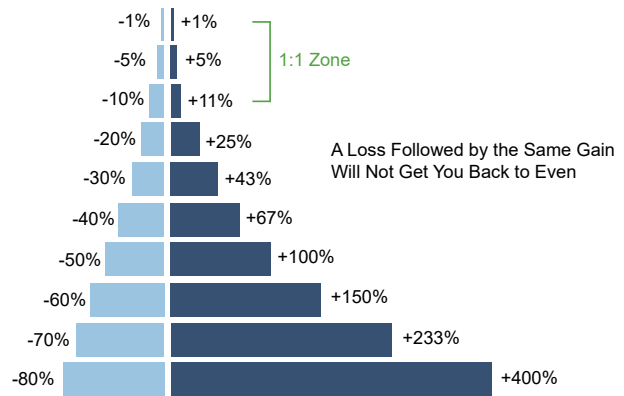
As we leave 2022, a year in which 50% of trading days saw the S&P500 up or down 1%, behind, we acknowledge the amount of uncertainty ahead. Markets have suffered a significant decline and we are hoping for better times ahead. However, the road to redemption will be a volatile one. At this juncture, we expect larger price moves to both the upside and downside given the questions regarding the effects of the Fed's tightening regime on inflation, the economy, and markets. This will keep volatility across assets elevated compared to history and force a shift in the direction of tactical management. The ability to quickly determine when to soar with high flying positions and when to shift away from specific names and asset classes will be crucial again this year. We expect portfolios with exposure to these strategies to outperform in 2023 as returns might be harder to find than in years past.

Volatility Across Asset Classes Remains Elevated



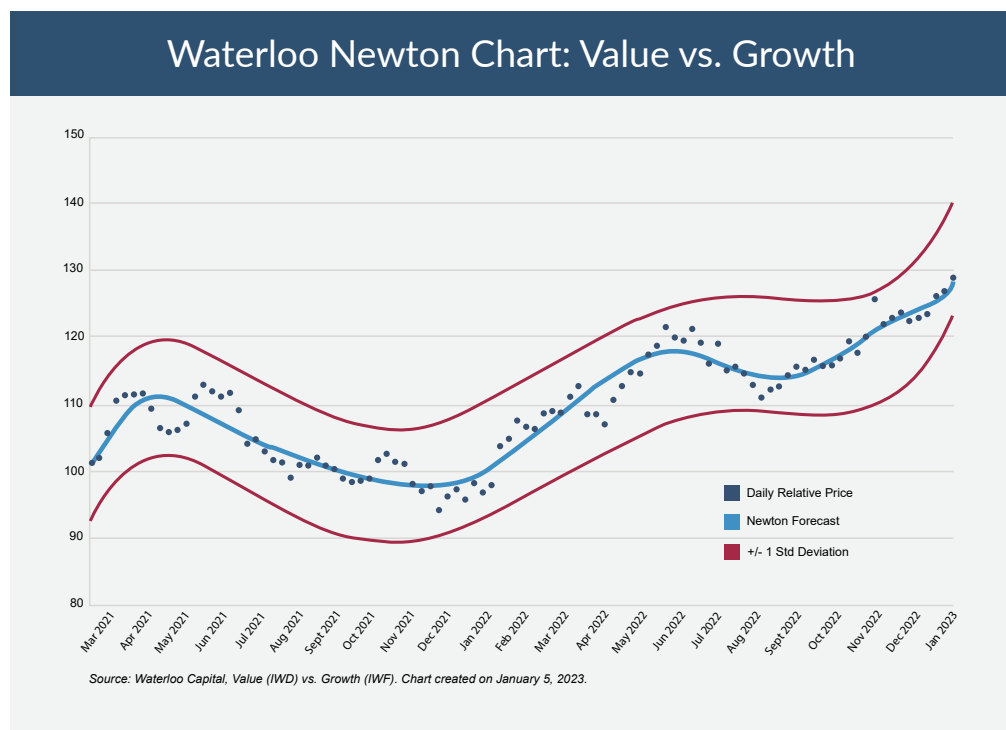
Source: Bloomberg, Waterloo Capital. Data as of December 2022.

We believe investors should continue to diversify not only at the position level, but also between passive and active management. Tactical investing approaches are designed to perform well in environments which are driven more by sentiment than fundamentals. As with traditional allocation strategies, which focus on stocks and bonds, this added layer of diversification allows investors to take advantage of short-term opportunities and rapid market rotations. Additionally, we think 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. We believe in throwing on the brakes during downtrends and accelerating during upturns, with increased focus on protecting against downside risks. In more volatile times, it pays to be defensive as it takes proportionally greater gains to recuperate from large losses due to the change in the denominator when calculating returns. For instance, a decline of 50% requires a gain of 100% to return back to even.



Source: Waterloo Capital

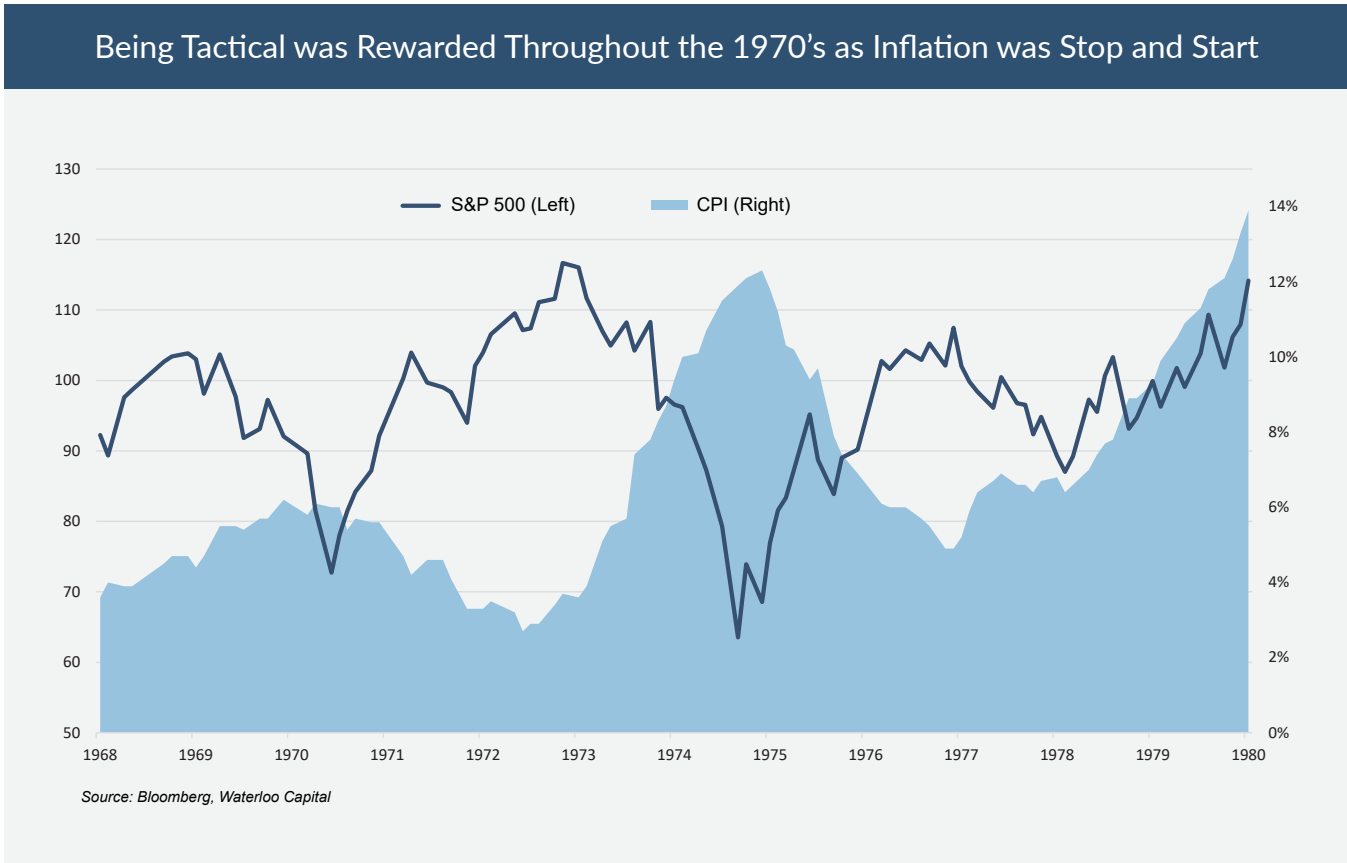
At Waterloo we supplement this decision-making process by utilizing our high order algorithmic powered screening and trend identification tool, Newton. Our Newton models serve to provide opportunities to catch price shifts to the upside and protect portfolios on the downside by identifying potential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



“The ability to quickly determine when to soar with high flying positions and when to shift away from specific names and asset classes will be crucial again this year.”

Finally, we want to touch on a related topic being discussed as of late in which many economists and market historians are drawing comparisons between the current macro environment and other time periods. One of particular interest is the late 60s to 70s. A few intriguing parallels include the extent of government expenditure on war efforts and Johnson’s Great Society program in the late 60s, the multiple inflation and volatility surges in the early 70s, the oil embargo, wage increases, budgetary stresses of the mid to late 70s, and the overall underperformance by both stocks and bonds. We can clearly see contemporary variations of these today and believe the Fed is acutely cognizant of them as well. The pressure is on as they must minimize the risk of an environment similar to the 1970s period where the Fed was in a relentless inflation battle while markets and the economy experienced repeated downturns.

In that environment, passive investing was ineffective as the market return after inflation from 1965 to 1980 was flat to negative. The expectation of steadily rising markets, like we’ve all enjoyed the last decade, was met with mean reversion and extreme volatility. Every investment regime is different, and although there are many parallels from that period, supply and consumption patterns have drastically changed as globalization entered the stage. We highlight this comparison not as a prediction of where we are headed, but as a lesson learned from a time where tactical management was rewarded. Digging your feet in and refusing to adapt to novel information is a shortcoming investors should avoid.



From TINA to TARA

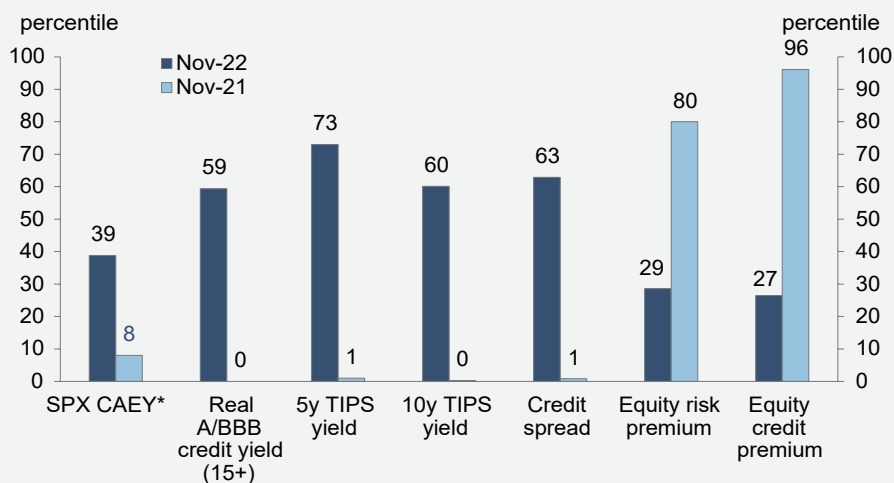
The previous investment landscape was characterized by the dominance of riskier assets, specifically equities, in part due to a prolonged period of easy money policies generating a gradual decline in interest rates. Rates were pushed to the zero lower bound and bond valuations reached all-time highs, leading us to dub the asset class “return free risk” in our 2022 outlook. The search for yield was on, and it had investors settling for above trend valuations in risky assets given the relative unattractiveness of bonds. Many sum up that environment, one in which expectations of lower rates for the foreseeable future made stock valuations and expected returns increasingly attractive, with the acronym TINA (there is no alternative).

The rise of global interest rates in 2022, though incredibly painful for market participants, has returned us to a long-forgotten destination where investors are no longer forced to participate in risk on markets to achieve return. We argue for the emergence of TARA (there are reasonable alternatives) which allows for meaningful yield to be found in both real and nominal terms. In other words, investors finally have options from a risk-adjusted standpoint in the fixed income space.

Given the 2023 fixed income landscape, the gap between stock and bond valuations has now closed to a historically reasonable spread. It’s evident the ramping up of interest rates during 2022 has shifted the real return picture for fixed income from an all-time low in late 2021 to meaningfully attractive levels.

These points illustrate that investors are presently being compensated less than they were in the past for taking on the additional risks associated with equity investments. Said another way, the relative valuation divergence that was in favor of equities is closing rapidly. Applying the same price-to-earnings methodology used for equities to bonds; that gap has closed considerably from years past. This, among other examples found in the market, makes the case for TARA and the reinstatement of fixed income’s place in portfolios as a return generator.

Fixed Income Real Returns Reclaim Top Half of Historical Distribution in 2022



*S&P 500 cyclically-adjusted earnings yield

Source: Haver Analytics, Goldman Sachs

The Valuation Divergence, Historically in Favor of Equities, Is Quickly Closing

$$\text{Stocks at Current P/E Levels} \rightarrow \frac{\$100}{\$6} = \mathbf{17 \text{ P/E}}$$

$$\text{Bonds Assuming a 4% Yield} \rightarrow \frac{\$100}{\$4} = \mathbf{25 \text{ P/E}}$$

The P/E of the S&P500 was around 17X at the end of 2022. This tells us that investors were willing to pay \$6 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 \$6.

Applying the same process to bonds, we can take the 30-Year Treasury yield of 4% and calculate a P/E ratio of 25X. In 2022 the P/E ratio was 50X.

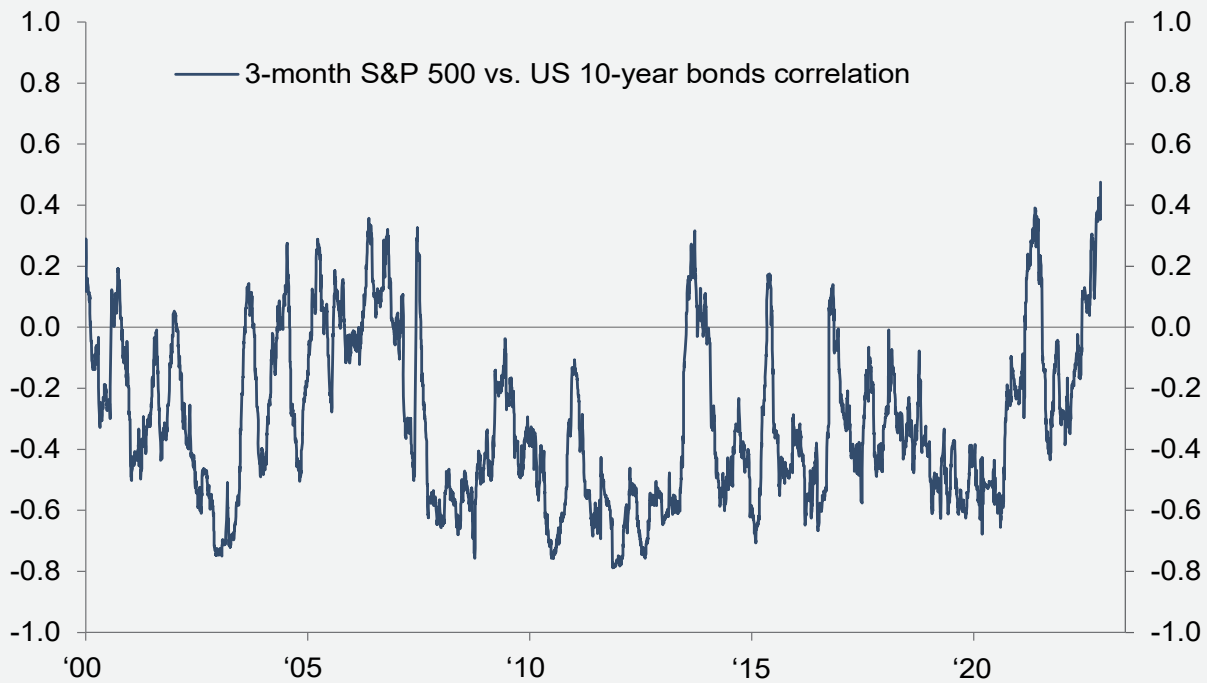
Source: Waterloo Capital

The comparisons above do not incorporate the numerous potential headwinds we see ahead for equity investments which, when considered, makes the relative value story for bonds even more compelling. Many major players on Wall Street expect a potent slowdown in 2023, severe enough to bring on recession. This deceleration will have earnings implications for equity markets that, though uncertain, will likely have material repercussions for stock performance and volatility in the year ahead. In addition, we expect 2023 to experience a hand-off from the policy risk environment that plagued 2022 to a growth risk environment, which was, until this point, avoided due to economic resiliency. That resiliency is likely fading and the transition between these risk scenarios presents another challenge to equity performance and favors an overweight allocation to yield-bearing, risk-off assets.

“Investors finally have options from a risk-adjusted standpoint in the fixed income space.”

In addition to the reinvigoration of fixed income’s return prospects, the asset’s diversification benefits are likely to strengthen in the expected environment. Historically, bonds record a relatively low correlation with equities, which has long been leveraged to reduce risk in portfolios. Fixed income’s historical outperformance during periods of disinflationary pressure and slowing economic growth, both of which tend to hinder returns for equity investments, is partially responsible for this phenomenon and should return as we see the economic tides turn with the calendar.

Bond-Equity Correlations Should Normalize in Transition from Policy Shocks to Growth Shocks



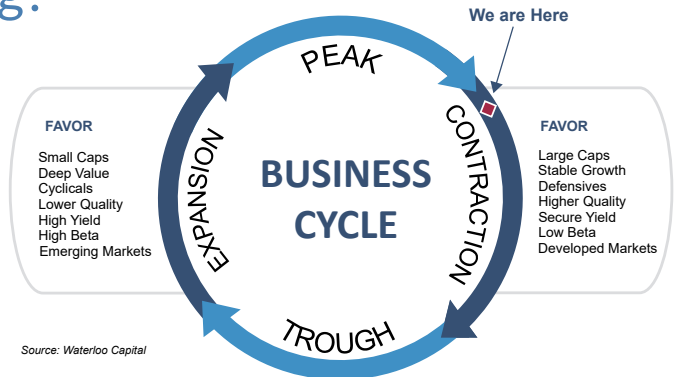
Source: Goldman Sachs

Now that we do see reasonable alternatives in fixed income versus riskier assets, the natural question on investors' minds is, "when is it appropriate to take advantage of this scenario?" Given that global central banks have not yet finished their hiking cycles and inflation has not fully buckled under the weight of these policy regimes, we believe that early 2023 is not quite the time to begin piling into longer duration. Inflation presents a particular issue for bonds as their coupon and principal payments are notional and high inflation deteriorates the purchasing power of the investor's deferred compensation.

Although we see hurdles for the asset class early on, we are constructive that disinflation and a slower economic outlook will exert downward pressure on rates. As this transition presents itself, it should generate tailwinds for the asset class. Extending the duration of portfolios to capture the pickup in incremental yield available and elevating exposure to interest rate sensitivity to benefit from potentially lower market rates will likely be a robust strategy. Until we see more constructive market repricing, short-duration instruments such as T-bills and commercial paper will be an appropriate destination to generate yield without bearing much interest rate risk.

Can We Cool Without Freezing?

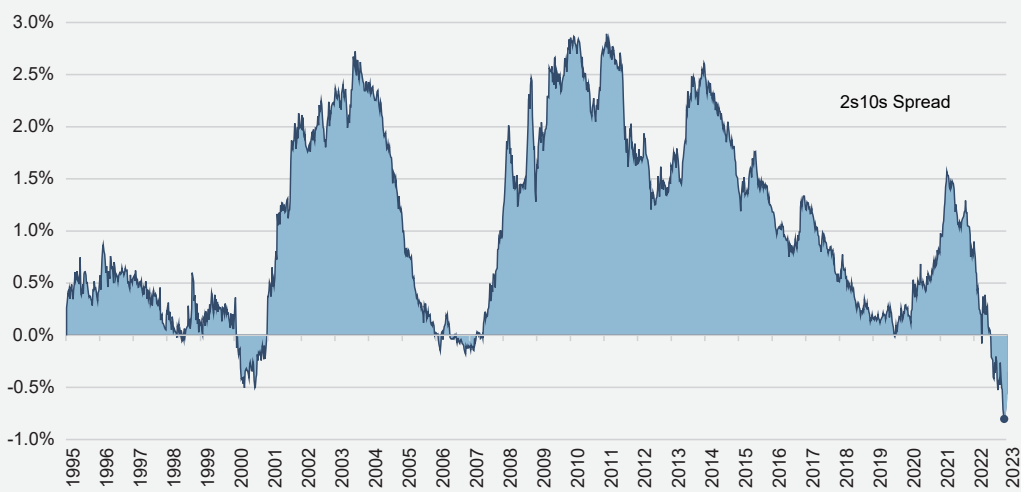
The Fed's tightening of monetary conditions due to inflation's return to fold has markets entering the new year on relatively unsure footing. In 2023, we expect the slowdown inherited from last year to gain depth and tip the US into recession territory late in the year based on the deterioration of economic health indicators. The looming question for markets: Can the Federal Reserve cool the economy without freezing it?



It's important to expand beyond the classic definition of a recession, two consecutive quarters of negative GDP growth, as it is somewhat simplistic and only defines a recession after the fact. We believe in building a framework to determine when the economy is in recession by looking out of the windshield instead of in the rearview mirror.

Maybe the most famous and cited indicator for a coming recession relates to the US Treasury Yield curve, which plots interest rates associated with maturities ranging from 3 months to 30 years. In times of growth, we normally see an upward sloping curve, with longer term yields at higher levels compared to short term. As the Fed raises rates, these actions are reflected in higher levels at the short end of the curve. On the long end, when market participants begin to sniff out a potential slowdown and see disinflation ahead, we usually see these rates begin to fall. This dynamic causes what is called an "inversion" of the curve, and a key relationship is the 2YR-10YR spread. Put simply, when the yield on a 2-year treasury note exceeds that of the 10-year iteration we have a yield curve that is inverted. The inverting of the curve has preceded each recession since the 1950's and, on average, leads the recession by 6 to 24 months. Since last July, the curve has remained inverted and hit its deepest level in November. Though the initial inversion is an important predictor, recession risk is greatest once the inversion begins to reverse.

Recession Risk is Greatest Once the Yield Curve Starts to Steepen

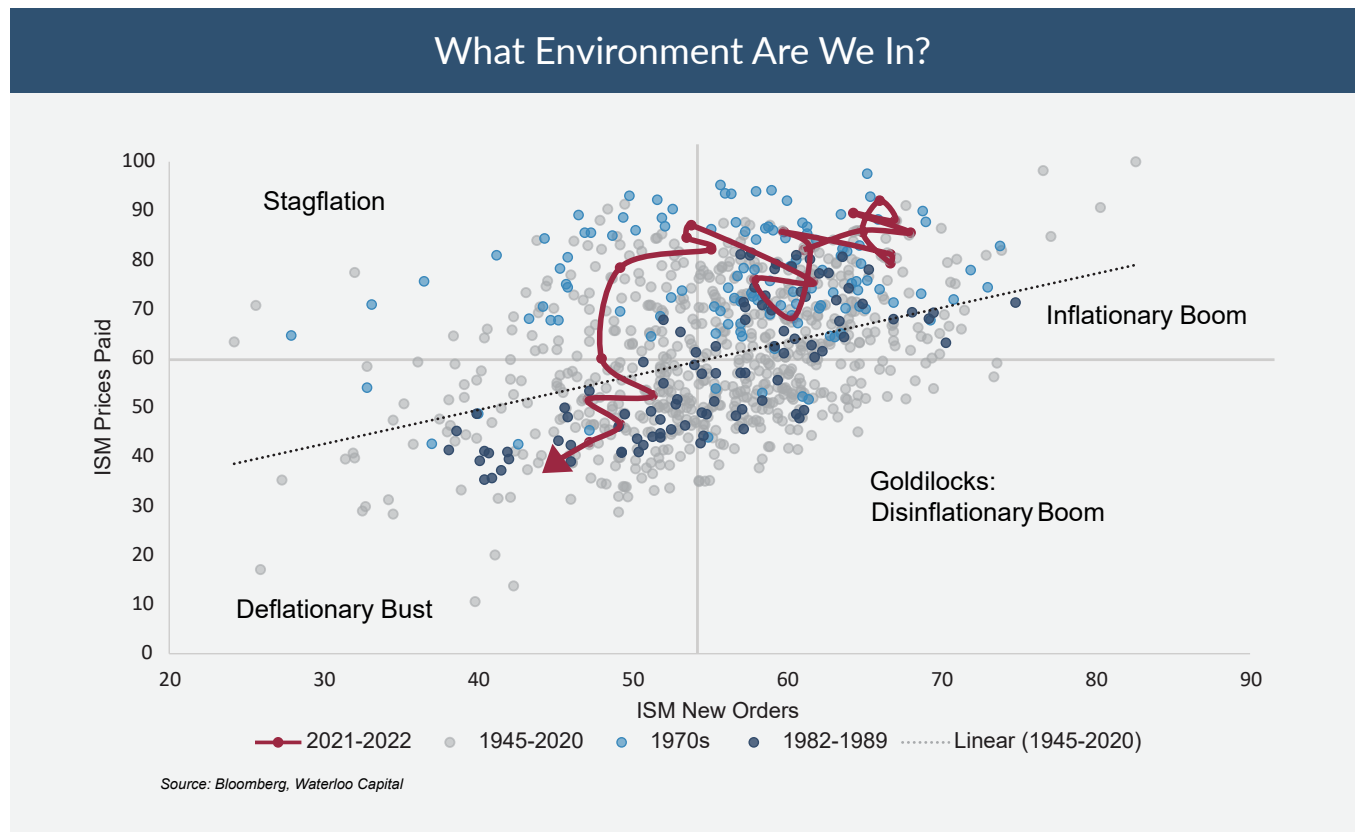


Source: Bloomberg, Waterloo Capital

Next, we turn to the housing market, one of the foremost leading indicators of economic health and consumer activity, which was deep in the throes of its own recession for most of 2022. Mortgage rates exploded throughout the year as the Federal Reserve progressed through its interest rate hiking cycle, deteriorating home affordability along the way. The higher borrowing costs stifled demand for homes from consumers, led to tapering off in new permits from builders, and saw home prices fall. Housing is usually the first hat to drop for indications of a larger slowdown.

“We expect the slowdown inherited from last year to gain depth and tip the US into recession territory late in the year.”

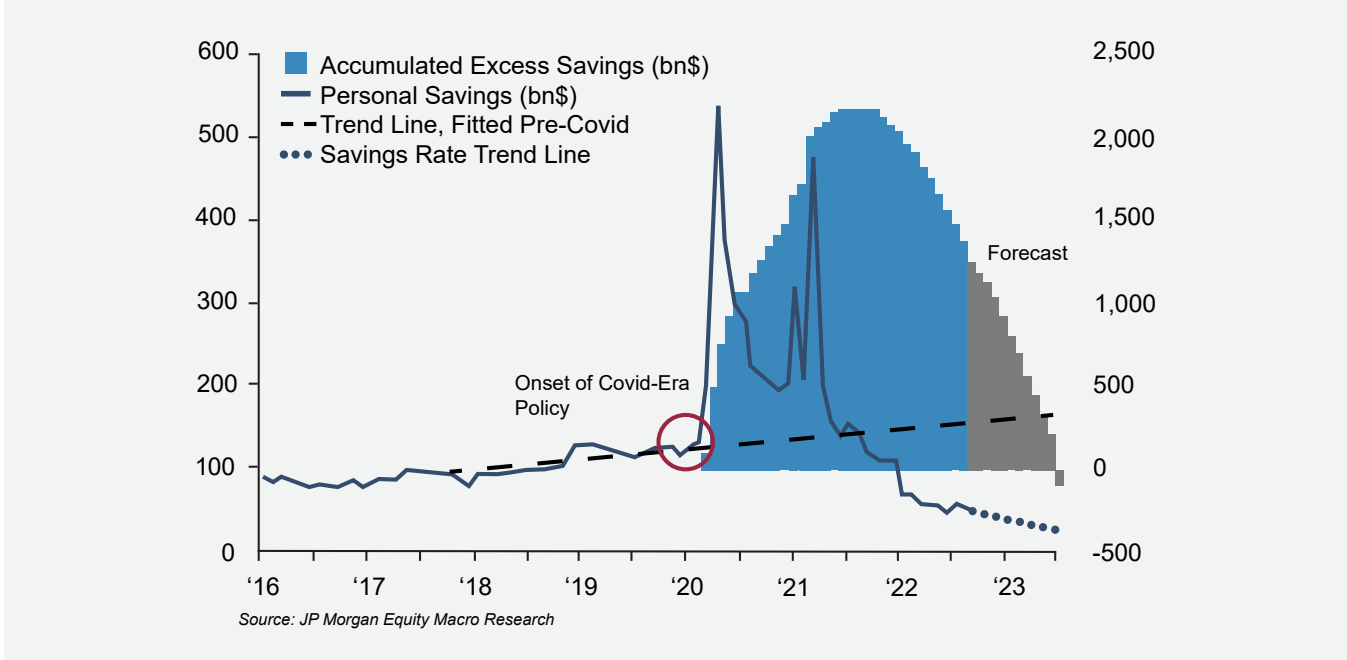
As the economy progresses through the late-stage cycle of growth, business activity begins to waver. The Institute of Supply Management (ISM) publishes data providing insight into economic activity and pricing through its survey of purchasing managers. In plotting components of this index that relate to inflation and economic growth we can discern how our economy is currently positioned versus history. As you see below, over the last two years we have transitioned from an inflationary boom environment to the deflationary bust quadrant illustrating that both inflation and growth are falling. While the prices paid index declining is good news for now, the level of output indicates production in the US economy is worsening. The decrease in demand evidenced by falling new orders will likely flow through to corporate earnings, damaging profitability and dampening economic growth overall.



The global economy, which is experiencing many of the same effects, is facing additional idiosyncratic challenges to growth. These will likely bleed into global demand and present headwinds for the US economy and corporate profits. If these factors materialize into recession, we expect a relatively moderate recession brought on by tight monetary policy, unlike the previous two deep recessions instigated by intense demand shocks.

While a lagging indicator of progression through the economic cycle, a mainstay of resiliency has been the labor market as the unemployment rate has fully recovered from the pandemic spike and hovers around all-time low levels. A decline in labor demand via fewer job openings and/or a steady return of workers who have been on the sidelines since the pandemic could loosen the labor tightness without causing a dramatic spike in unemployment. The labor picture, along with the strength of household balance sheets due to covid-era stimulus, have produced a resilient consumer who weathered 2022 extremely well. A strong consumer can solve a lot of economic problems and if stable, could provide a potent force in averting a recession. That being said, consumer strength seems to be fading, as households have redirected spending habits from debt utilization to eating down savings buffers. If this continues, consumers could wear out the cushion built up over the last few years.

Household Savings Buffer Built During Pandemic Deteriorating as Savings Rates Drop

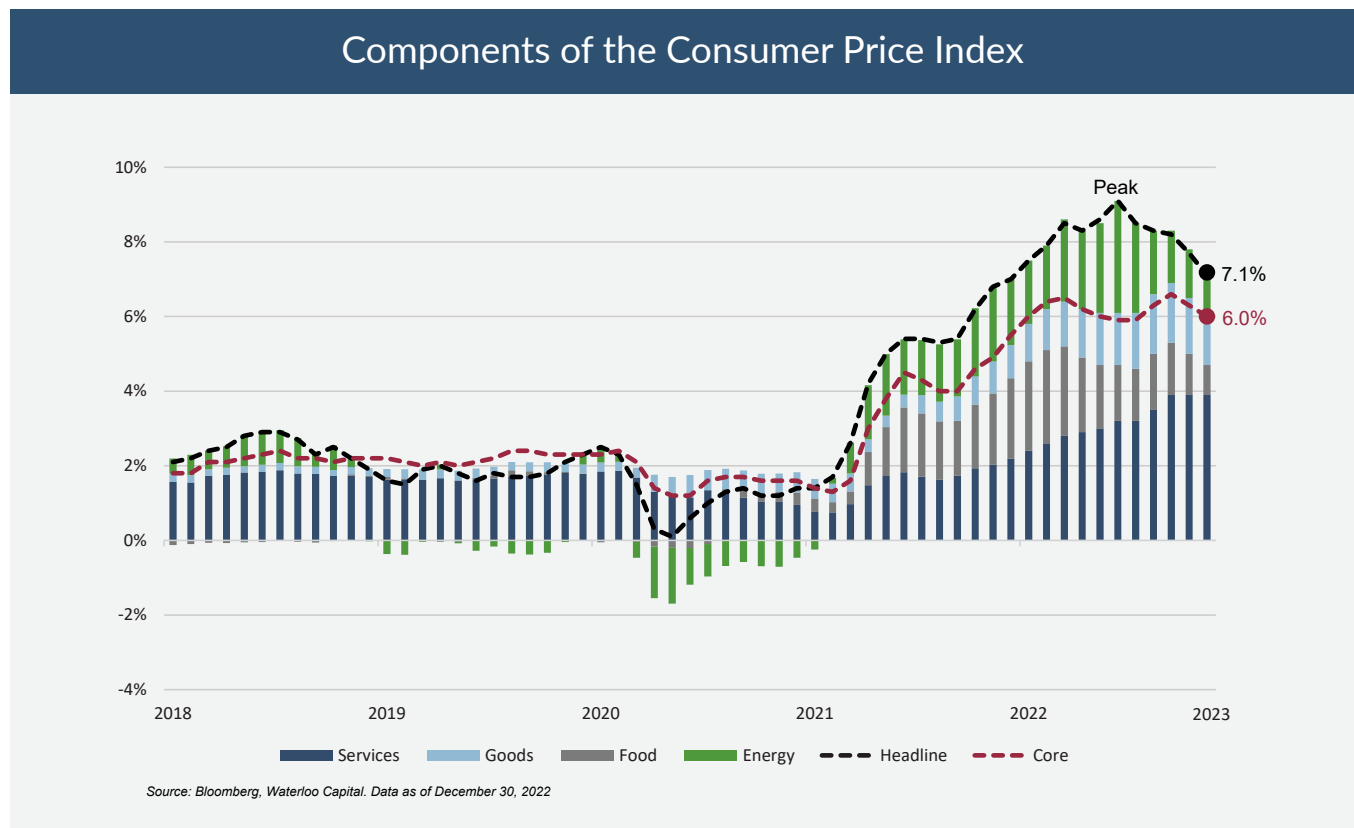


Overall, we believe the case for a strong economic slowdown, and ultimately recession, in the US evidenced by leading indicators, current economic data, and global headwinds constructs a compelling argument. However, conflicting economic signals, such as an extremely robust labor market, show signs of strength that could reinforce a soft landing. In this more bullish scenario, we would expect demand to slow from currently resilient levels, inflation to fall near the Fed's 2% target range, unemployment to tick up rather than expand aggressively, and GDP growth to be marginally positive. Still, the dynamics of this deceleration in growth will likely have implications for not only businesses, investors, and the economy, but also the Fed's archenemy, inflation.

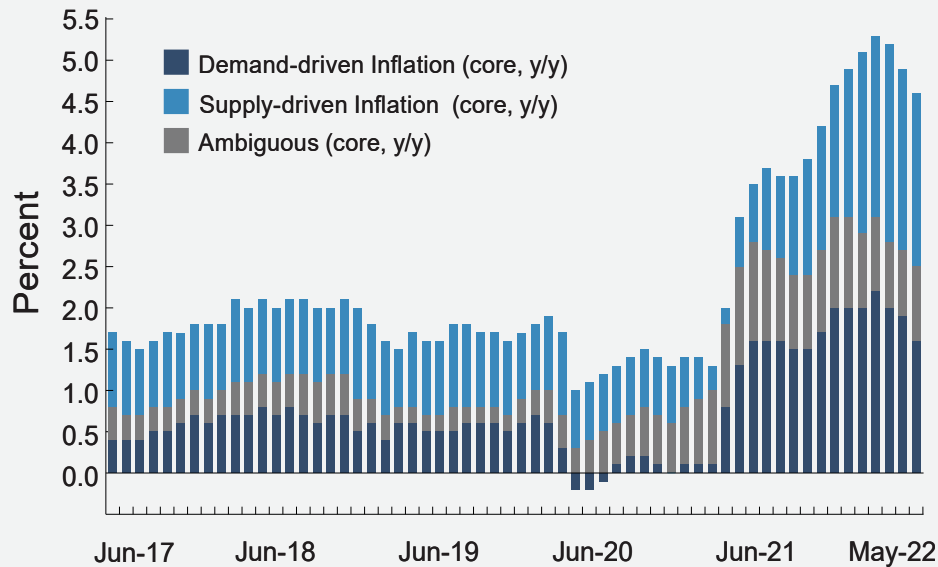
Tale of Two Years

A major determinate for the broader economy and investment landscape will be how the path of inflation unfolds throughout the year. Overall, we believe peak price growth has been seen and upward pressures will continue to moderate, with core and headline inflation falling significantly. While a comforting thought given the prints seen recently, this level will likely stabilize well above the Federal Reserve’s 2% target rate and is expected to remain elevated longer term.

Drilling down to the component parts of inflation provides important nuance into how investors should consider this topic and how the Fed may act moving forward. The goods element of inflation, which was a key issue early last year, has been decelerating from its peak in mid-2022 due to supply chain recovery, inventory build-up, and moderating commodity and transportation costs. Over the coming year, goods could contribute significantly to disinflationary pressures. Shelter costs, primarily owner equivalent rents, make up over a third of CPI but operate on a substantial lag. High frequency data on new rental prices indicate that this component is decelerating meaningfully and while its lag will keep formal readings higher for now, it could apply strong downward pressure as soon as the middle of next year. Services inflation, however, will likely be the strongest inflationary force in 2023 as it primarily reflects the job market due to the labor intensiveness of service industries. While the labor market remains tight, sticky wage growth will inhibit the categories’ ability to move meaningfully downward.



Supply Side Inflation Accounts for Over Half of Core Inflation



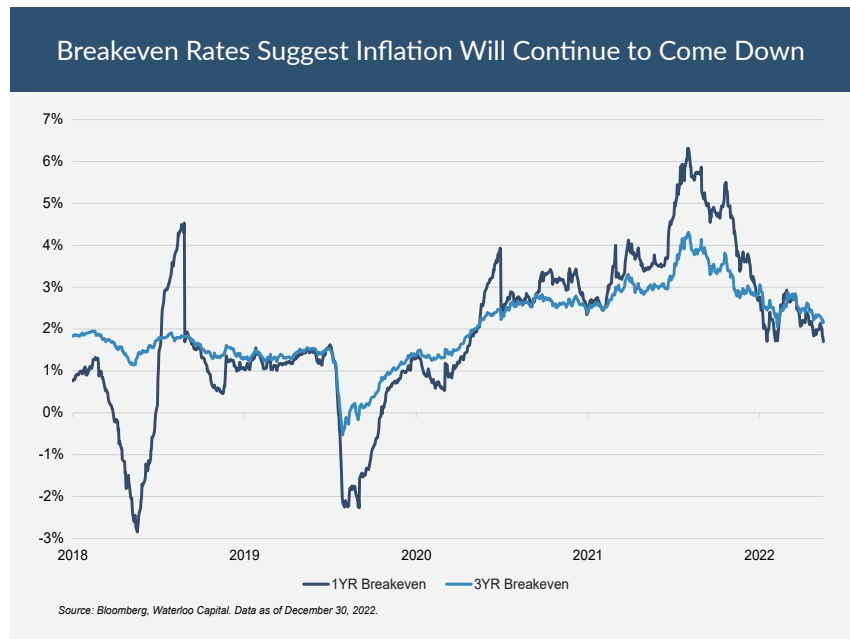
Source: Federal Reserve Bank of San Francisco, Morgan Stanley, Waterloo Capital

Zooming out to broader supply and demand dynamics, disruptions to the supply side have had a more pronounced impact. Loosening of global supply issues that have constrained businesses could provide a substantial tailwind for the disinflation story. The supply shocks in commodity markets instigated by the Russia-Ukraine War should continue to dampen its contribution to upward price pressure. The same is likely to occur in China as their zero covid policy rolls off and they begin returning the economy to full production. Domestically, production from certain sectors is recovering after experiencing extreme challenges in supply chains. A reprieve from these dynamics would likely have profound dampening effects on inflation, yet the scale remains largely unknown given structural modifications to supply chains since Covid.

“We believe we have seen peak price growth, although several factors will keep the level of inflation above the Fed’s target.”

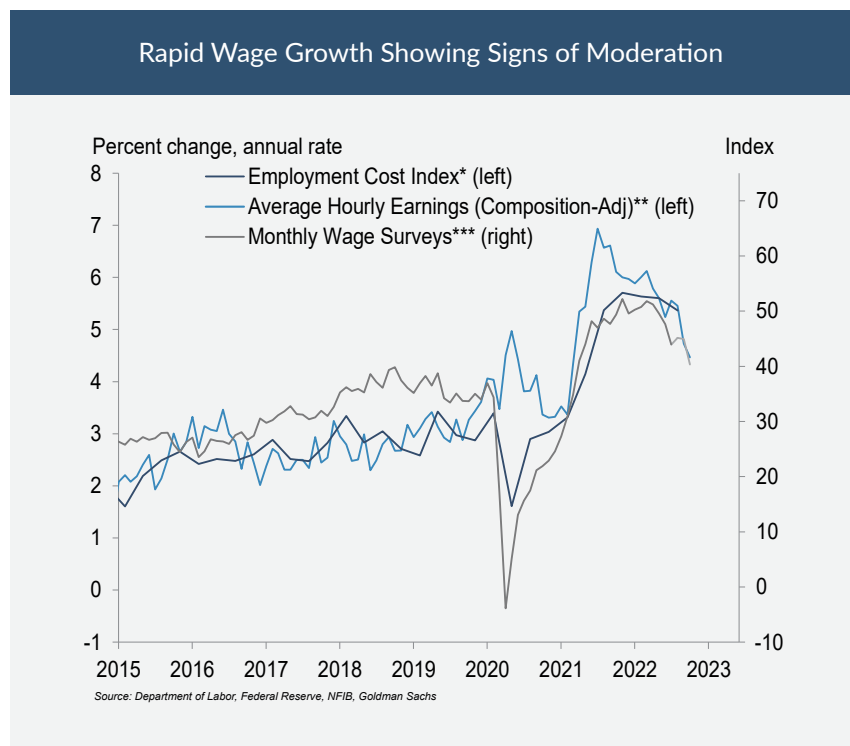
From a demand perspective, we see the lagging effects of swift and robust policy tightening from the Federal Reserve taking root and beginning to work its way through the economy. As discussed, we expect to see a decline in economic activity throughout the year as the slow acting impacts of tightened monetary policy bear fruit. Higher borrowing costs are likely to slow the incredibly resilient consumer spending and cool business investment across sectors. Wage growth, which helps fuel consumer demand, is decelerating meaningfully as job openings slow which should feed through to moderating price increases if it continues.

Looking toward market expectations via breakeven rates presents more insight into where investors believe inflation will settle in the years ahead. Breakeven rates are market-based measures of expected inflation calculated by comparing the nominal yield of a bond to the yield on an inflation linked bond of the same maturity. These rates suggest that the supply and demand dynamics could bring inflation down significantly, to around 2% by the end of the year, which is lower than our base case. While this indicator does provide insight into market expectations, shorter-term indicators haven't historically been the most accurate prediction tool.



There are material risks to our belief of how far and fast inflation comes down as well. While most do expect wages to moderate, a wage-price spiral presents a meaningful risk to inflation in the short-term. If the labor market remains overly tight and employees can leverage their position for continued raises, the expected increases in costs could spill over into price tags charged to consumers, worsening inflation. Per below, we have seen a moderation in wage indicators that eases our concern regarding this upside risk.

Over the long term, we expect several factors to keep the level of inflation above the Fed's target. Higher price expectations are now entrenched in the economy as workers and businesses predict paying more for consumption and production. These higher expectations become a self-fulfilling prophecy and provide a tailwind for inflation. Additionally, due to issues presented by the pandemic and international relations, we are seeing a broad distancing from the once disinflationary phenomenon of globalization that anchored prices lower over the past decade, shifting towards deglobalization and supply chain diversification. Both are inherently inflationary as companies increase costs and attempt to pass these to the consumer with higher prices.



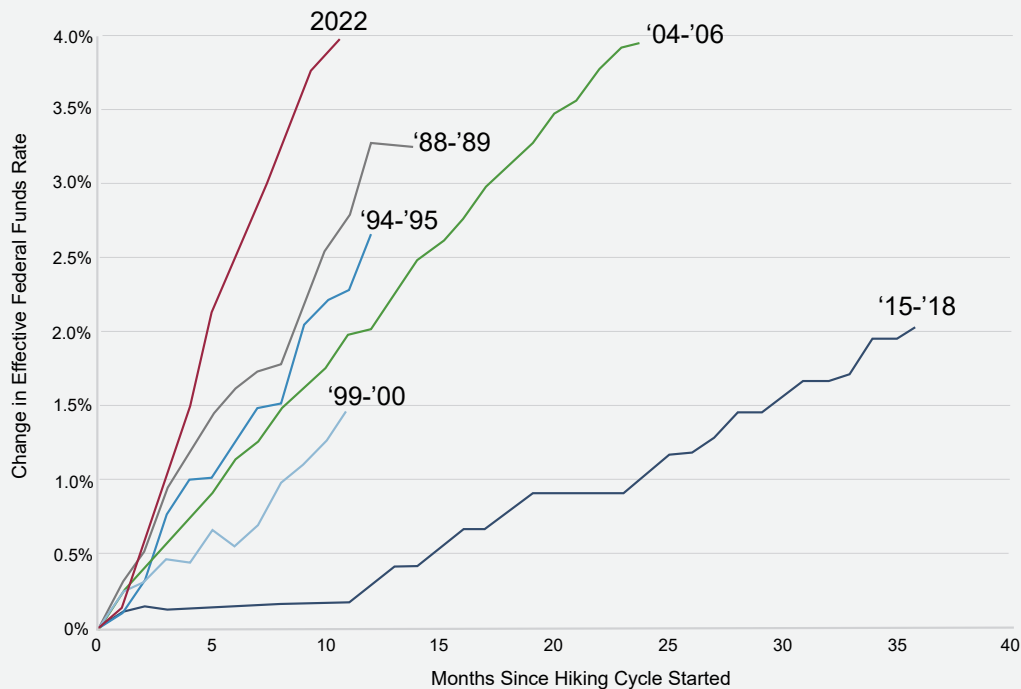
I Thought We Said Don't Fight the Fed

An Wall Street, the saying “Don’t Fight the Fed” has been not only an infamous tagline but a robust investing game plan coming out of the Great Financial Crisis. The Federal Reserve employed extraordinary measures after 2008 consisting of zero interest rate policy and quantitative easing. As the Fed remained accommodative and asset prices rose, being invested in risky assets was the only game in town, and to bet against that trend made little sense. In 2023, we still agree with the tagline, yet it brings on an entirely new meaning.

Markets and the economy have entered a new regime, decoupled from the easy policy enjoyed for many years. With the Fed solely focused on slaying the dragon that is inflation, we expect slower spending, higher unemployment, declining earnings, and many other indicators of a slower, contracting economy to continue in 2023.

In the 2022 Outlook: Threading the Needle, we argued that a policy mistake by the Fed was a top risk for markets. That risk quickly materialized as the Fed was slow to begin raising rates in the face of inflation and spent much of the last year playing catch up. This drastic response brought on the fastest monetary tightening cycle in the last four decades as they attempted to stifle excessive inflation due to an overheated post-Covid economy.

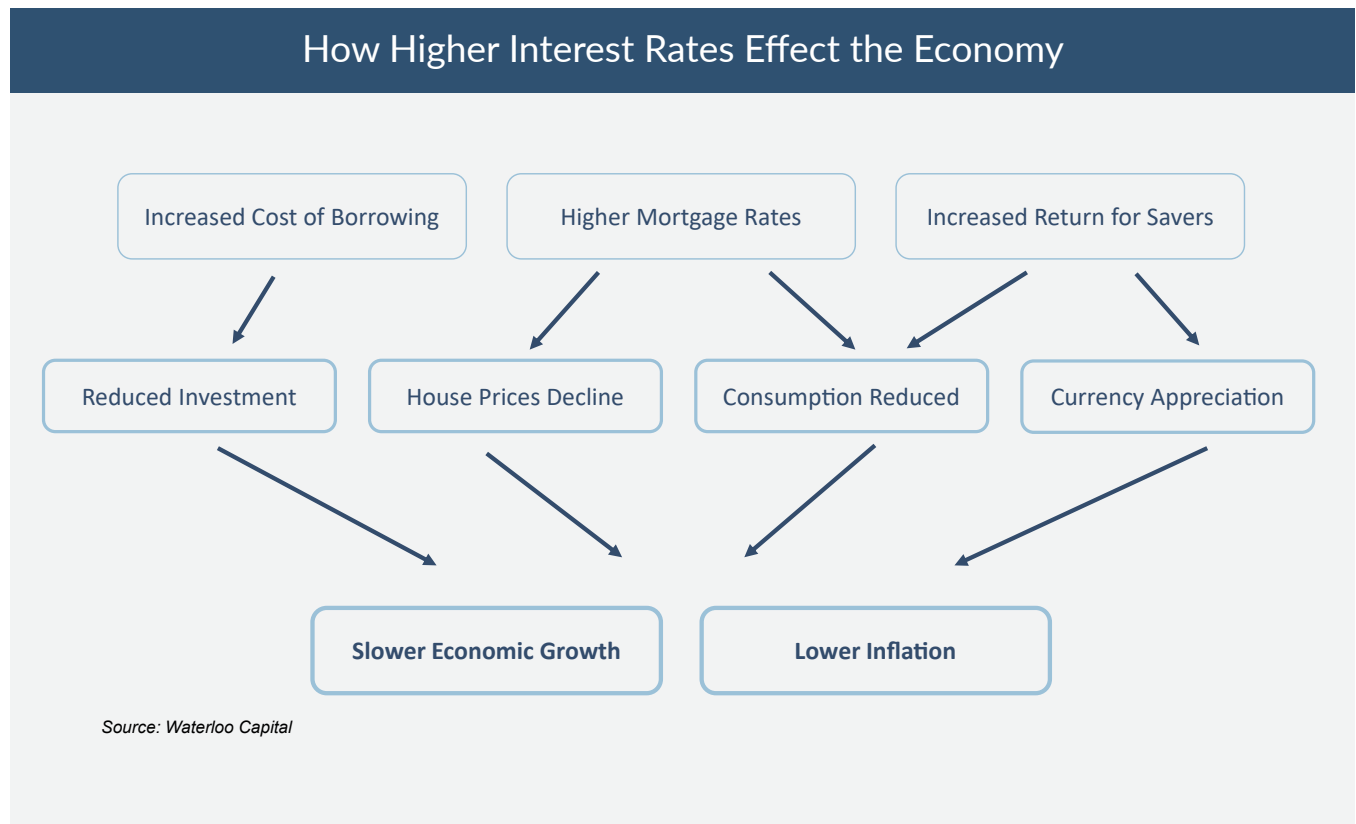
Fed has Hiked at the Fastest Pace in History in 2022



Source: Federal Reserve, Visual Capitalist, as of December 2022

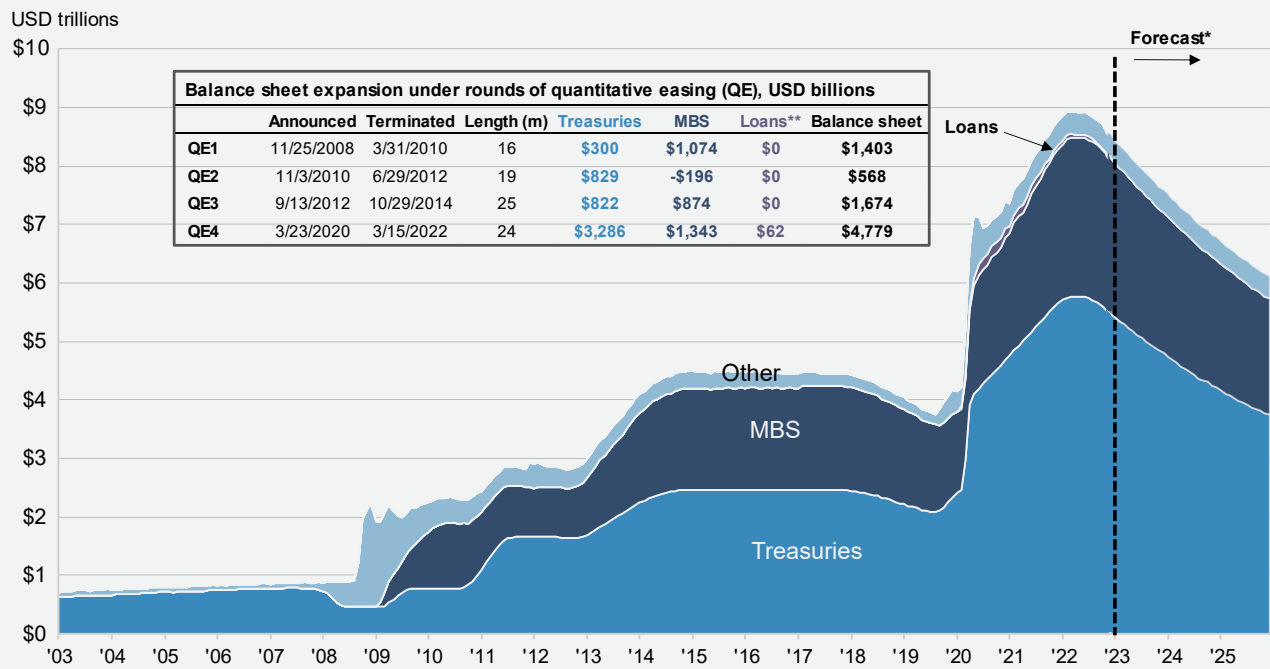
The Fed’s dual mandate of full employment and low inflation has forced the world’s prominent central bank between a rock and a hard place. Given that the labor market remains stubbornly tight and inflation persistently elevated, keeping rates higher for longer than many expect is the likely course of action as they attempt to engineer a soft landing, meaning a slowdown without a recession. In the past, we have seen only three instances of this, each with unique economic situations.

As a consequence of their fight to bring inflation back to their 2% target, they will be willing to accept price volatility and macroeconomic deterioration so long as financial markets function as intended. As inflation sits near 7%, tightening mode has been activated with rates going from near 0% to 4.5%. Higher rates have caused an increase in borrowing costs for companies, consumers, and the government.



Not only are we seeing an extreme rate liftoff, but the once extremely accommodative Quantitative Easing (QE) has turned to Quantitative Tightening (QT). The process of QE, which was fully implemented after the GFC, provided substantial amounts of liquidity to financial markets, and thus supported risk-on assets. Once more, it was executed in tandem with fiscal stimulus during the boom of the pandemic recovery. The process involves large scale asset purchases, such as treasuries and mortgage-backed securities, inducing stimulative effects across markets. Quantitative tightening is exactly the opposite. The process can consist of the Fed selling or letting assets roll off the balance sheet, hence removing the once stimulative effect by reducing the supply of money. QT does not always create outright tighter credit policies for the economy, but it does create tighter financial conditions for markets. Considering these factors, we predict that the Fed rapidly increasing rates while simultaneously implementing QT will likely continue to have adverse effects for not only financial markets but economic growth over the next year.

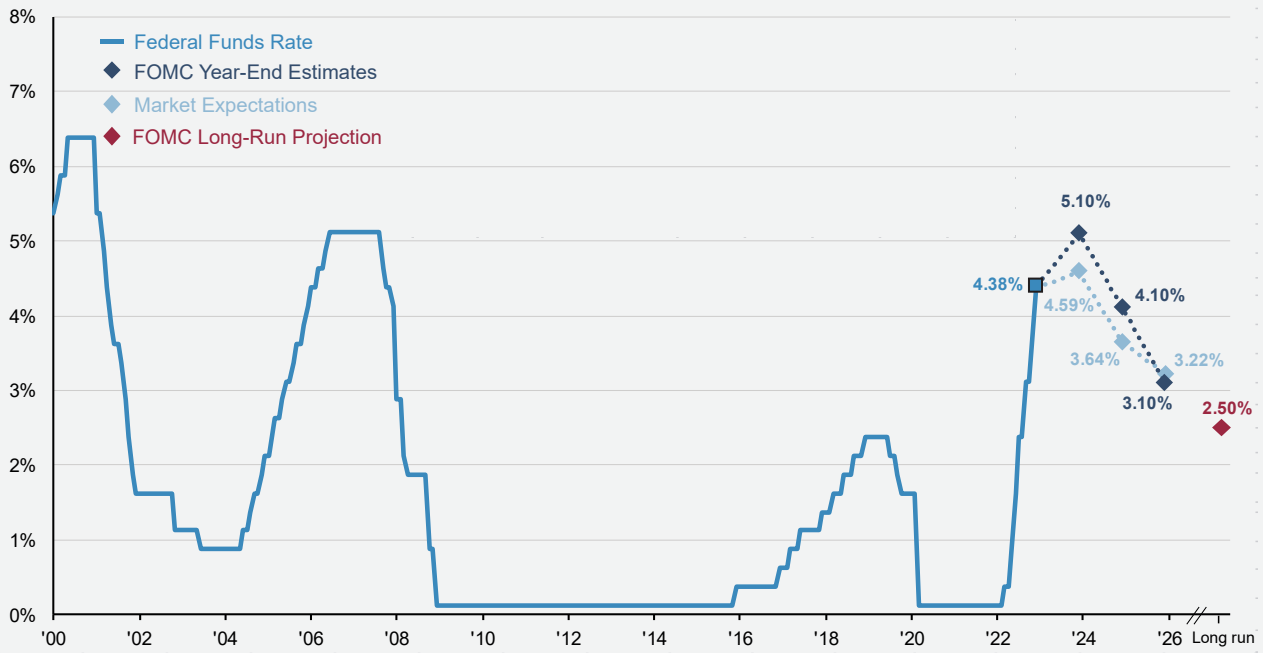
Quantitative Easing is Turning into Quantitative Tightening



Source: FactSet, Federal Reserve, JP Morgan Guide to the Markets. Data as of December 30, 2022.

Enormous pain has been felt, causing many investors to attempt predicting when the Fed will “pivot” away from its increasingly restrictive policies. But what does a pivot really mean for 2023 and beyond, how likely is it, and what would make the Fed go through with it? These are the burning questions on investors’ minds. We believe the Fed will pause rate hikes next year, but how long they stay higher, and the implications of such an action will be unknown for quite some time. The Fed will likely pivot, or begin cutting rates, not because financial markets have declined by some arbitrary amount or because a few inflation reports ticked slightly lower. They would do it when presented with a material drop in inflation data and several signs that the labor market is loosening due to a significant deterioration in macroeconomic conditions. Despite that, the Fed communicated clearly that they would rather err on the side of over tightening than under tightening to avoid the risk of inflation becoming entrenched. Predicting the terminal rate is difficult, but it is likely the ultimate destination will be higher than many market participants forecast in 2023.

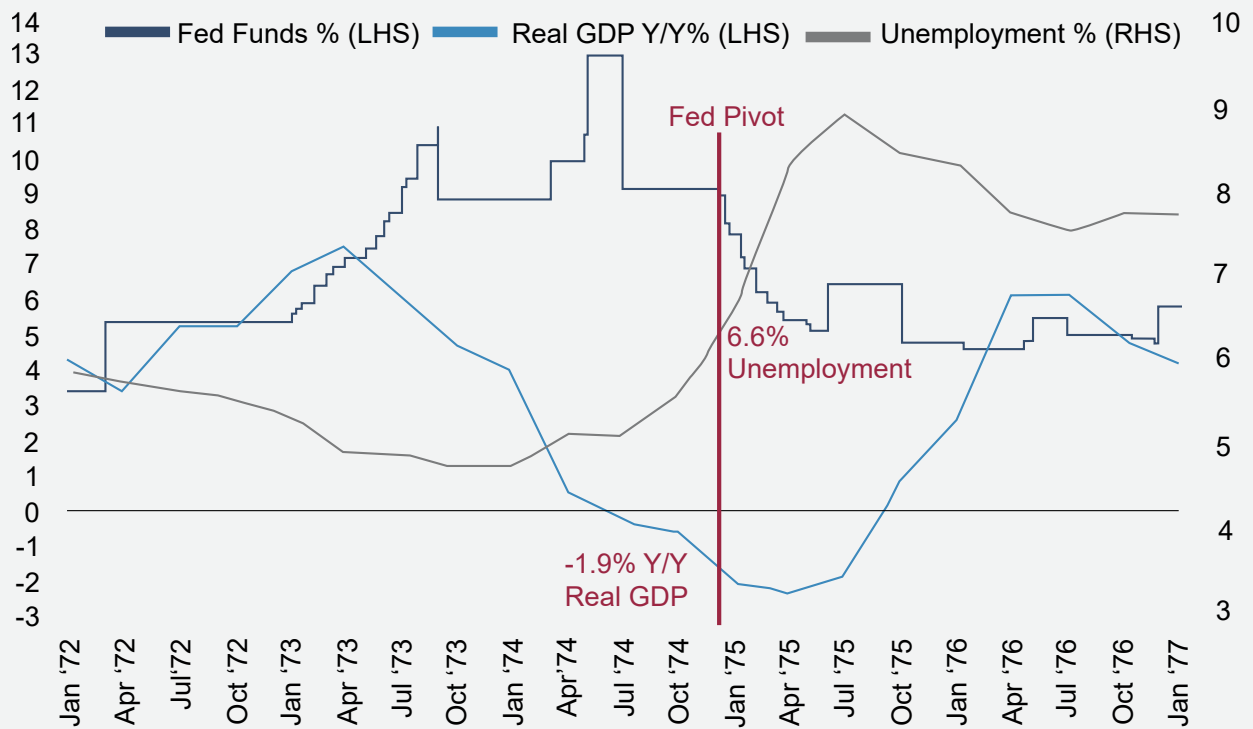
Market Expectations for Rates is Lower than the Fed Projects



Source: Bloomberg, FactSet, Federal Reserve, JP Morgan Guide to the Markets. Data as of December 30, 2022.

This view is supported by the 1970's, from which we believe the Fed is taking a lesson. History suggests that if the Fed eases policy too soon, risky assets could rise in the short term, yet this could also bring about negative and, more importantly, persistent longer-term risks.

The Pivot in 1974: Driven by a Worsening Recession



Source: BofA Global Investment Strategy, Bloomberg

The Fed is watching inflation like a hawk, and lower readings might be cheered by financial markets in the short term as markets price out total stagflation scenarios. However, the answer to why inflation is falling precipitously in the year ahead might remove the perceived bullishness of a pivot scenario. The Fed is withdrawing the liquidity tide that has lifted all boats and although the total effect is still not known, we believe the risk of overtightening has increased. The spillover effects of this policy, namely a stronger dollar and weaker demand abroad, will likely be a tailwind for inflation to come down yet, importantly, a negative for the economy. Fighting against the Fed's shift from buttressing the economy to decelerating it is a fight in which you want to pick your punches and be patient rather than aggressive. Although markets are forward-looking and will begin to see past the torment, we are in a markedly different environment than in the past.

As inflation moderates due to a slowdown instigated by policy tightening and the Fed is forced to pivot, a light will appear at the end of the tunnel. Unfortunately, that light could be an oncoming train with economic and earnings challenges on board. History shows that markets do not react bullishly to initial rate cuts before forming a bottom. Until more positive signs in leading economic indicators show themselves in the year ahead, protecting capital is critical in this part of the Fed cycle.

When the Fed Pivots, Stocks Decline by More				
Recession	Stocks Crash	Fed Pivot	S&P Bottom	Pivot to Bottom
<i>Great Financial Crisis</i>	-50.10%	Aug 2007	Feb 2009	18 Months
<i>Dotcom Bubble</i>	-38.30%	Dec 2000	Sep 2002	21 Months
<i>Gulf War Recession</i>	-4.40%	Jun 1989	Oct 1990	16 Months
<i>Double Dip Recession</i>	-16.50%	Jun 1981	Jul 1982	13 Months
<i>1973 Recession</i>	-41.30%	Oct 1973	Sep 1974	11 Months
<i>1969 Recession</i>	-18.90%	Mar 1970	Jun 1970	3 Months
Average	-28.25%			14 Months

Source: Nick Gerli/Reventure Consulting

“The Fed would rather err on the side of over tightening to avoid the risk of inflation becoming entrenched.”

Under Pressure

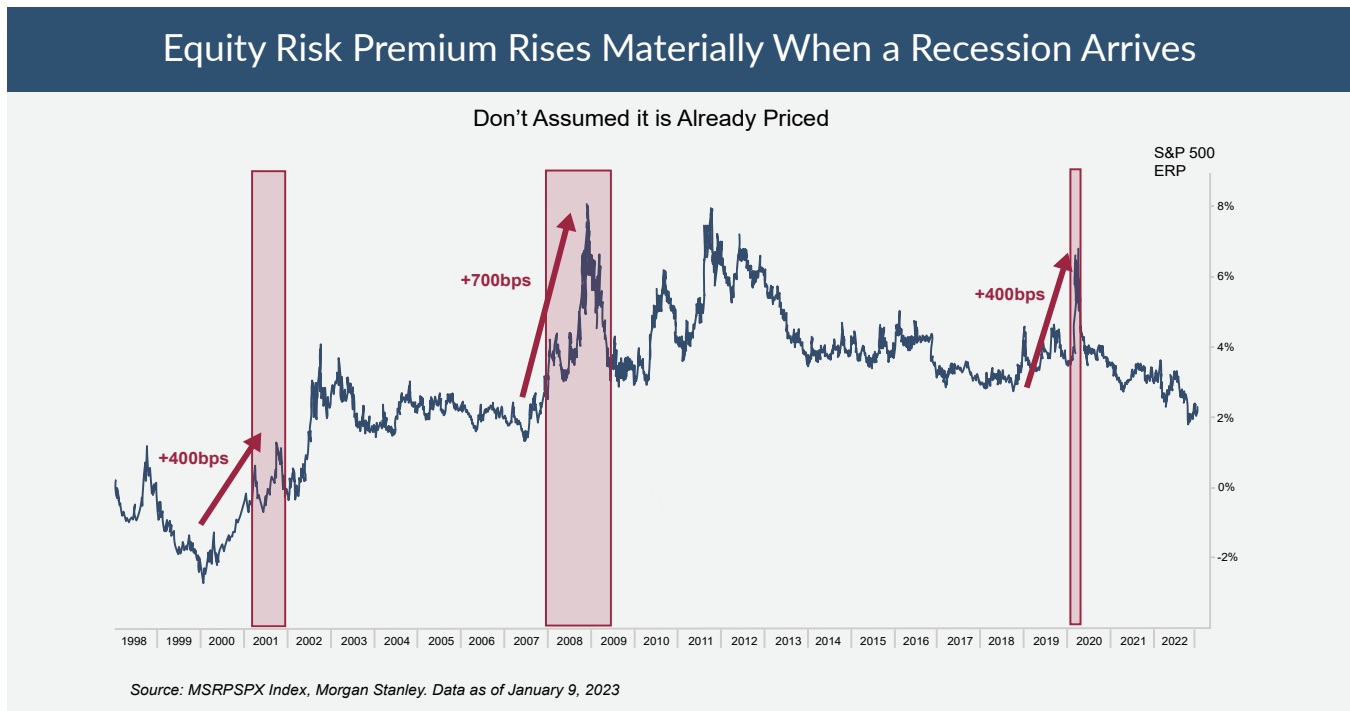
An increasingly uncertain backdrop has caused analysts to begin lowering earnings expectations, but have these projections been cut enough? In the last year, markets held in contempt companies who rely on cheap money and have been consistently unprofitable. Investors are now calling bluffs on firms of this sort, forcing them to show their hand and prove the strength of their business models. Now that much of the Federal Reserve policy risk has been priced into markets, we believe that the expected growth risks in 2023 have not been fully captured in earnings estimates. A larger than expected slowdown in 2023 is a material risk that we believe could place meaningful downward pressure on earnings. Not all is sour however, as brighter news is on the more distant horizon.



Source: Waterloo Capital

An equity’s total return is made up of 3 primary components: earnings growth, changes in the level of the price to earnings multiple, and a dividend yield. The previous easy policy environment fueled multiple expansion via low discount rates, driving stock returns higher. Next year we will continue exiting that accommodative regime and transition towards a more tumultuous period in equity markets. History shows that multiples are usually the first thing to compress given the change in the price of money due to Fed policy. That first phase played out in 2022 as the decline from peak to trough stock prices in the summer was more due to outsized multiple compression while we saw forward earnings rise.

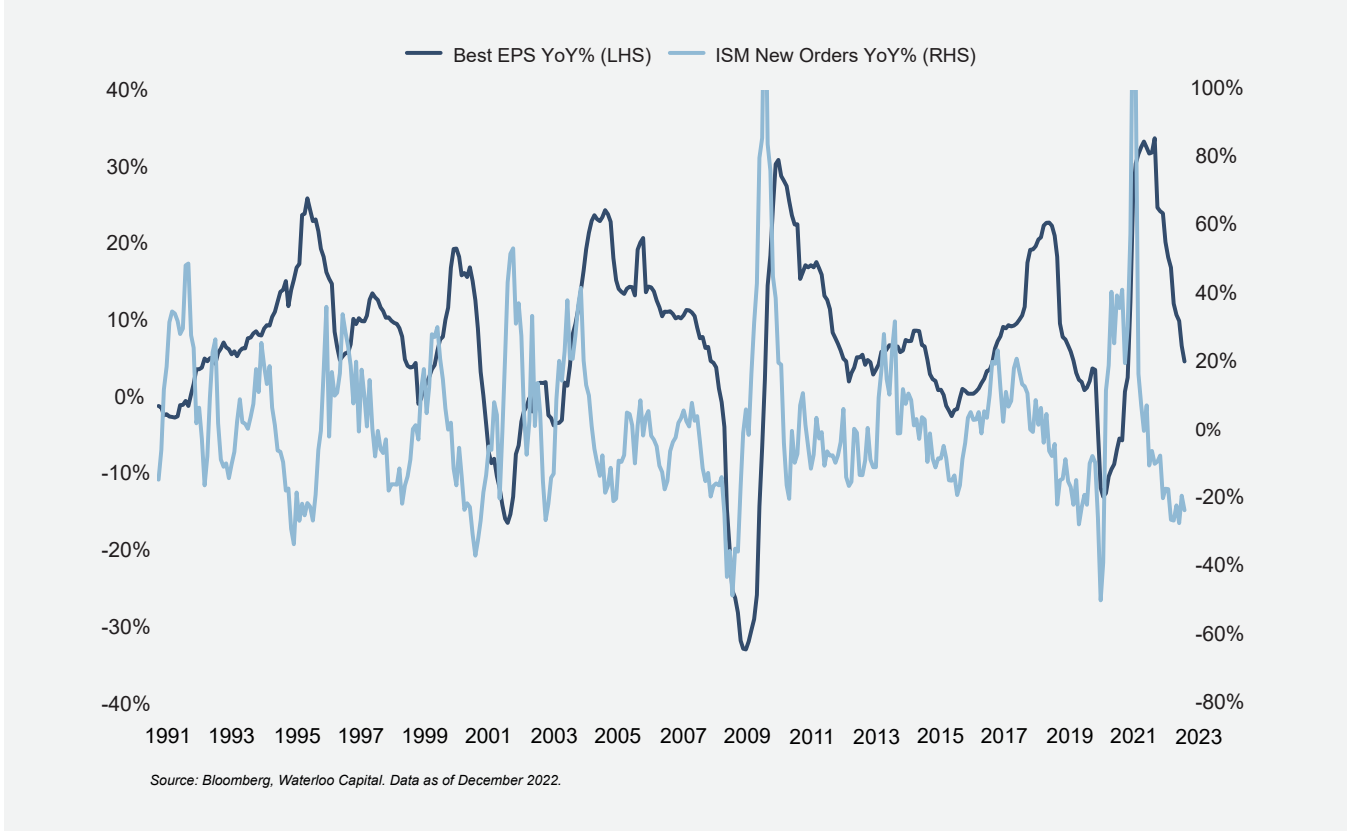
As multiple expansion remains on the back burner, stock returns and valuations, to be stout in 2023, will likely need to be powered by earnings growth. Though, given our growth outlook, we think the next hat to drop will be earnings, exposing equity markets to additional pricing headwinds via demand for a higher equity risk premium. Current acceptance of the lower level of risk premium could become more justifiable if we see an upside surprise to growth in 2023.



The economic boom that coincided with the rise in inflation gave companies a great deal of pricing power and they could protect margins as consumer balance sheets were strengthened by major economic stimulus. They were either able to pass higher costs onto their customers by raising prices or find efficiency gains in the production process. Yet as we progress through the economic cycle, the cost pressures are catching up; margins are falling under pressure. Higher input costs, wage increases, and the effects of the Fed’s hiking cycle are starting to inflict pain. The last reporting season reflected this as margins came under additional pressure.

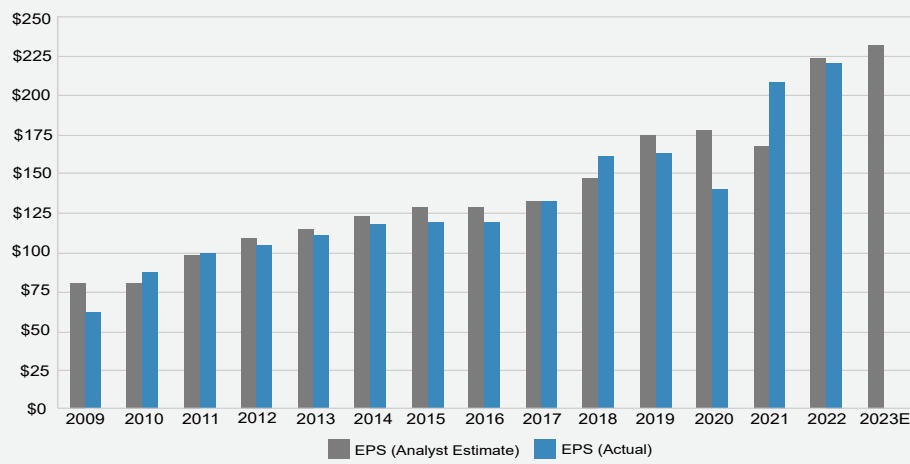
Even with our unfavorable forward-looking growth backdrop, the consumer has been strong and Fed policy has not seemed to have significantly reined in economic demand thus far. Yet, we have begun to see a slowdown in many leading data points like housing, PMIs, and surveys which have historically been a good indicator of the direction of earnings. Given the lagging nature of policy, it’s expected to take some time before we see adjustments in demand and thus less durable consumer balance sheets. Analysts will likely start to recognize this reality and begin pricing in how the latest backdrop will flow through corporate income statements, in the form of earnings compression.

ISM New Orders Tends to Lead Earnings



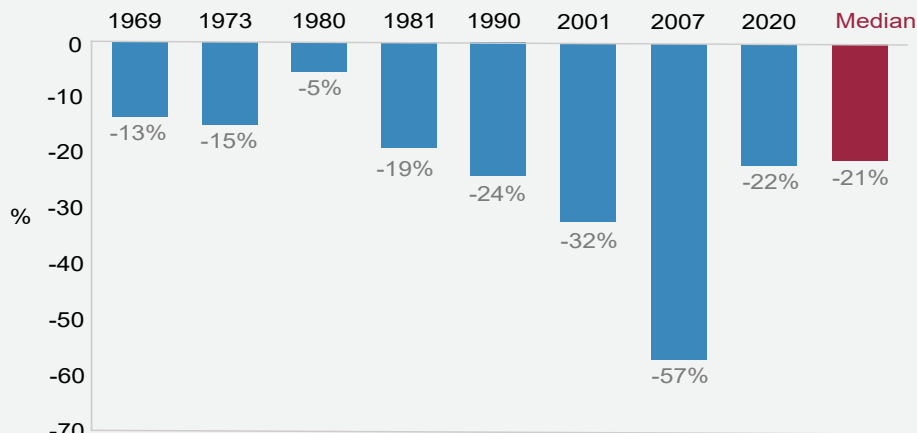
The question is likely not if earnings revisions occur but by how much. Traditionally on Wall Street, there is a lot of resistance for analysts to immediately change estimates due to uncertainty in forecasting. In many cases, it is easier to stick with the status quo and play the waiting game, than move away from the herd. Furthermore, we can see that analysts typically err on the side of overshooting their earnings estimates. Over the past 25 years, the average difference between analyst estimates and the final figure has been about 7%. We argue that analyst forecasts have embedded a larger overshoot than normal which will begin to be adjusted downward as we move through the year, especially if growth risks begin to materialize. During previous recessions, the median earnings decline was 21%. Current projections of earnings suggest a rise in 2023; an increase of 5% for EPS on the S&P 500. However, this is the consensus view and significant dispersion between forecasts exists. The large degree of separation between estimates for next year is why we continue to advocate for acting tactically with views on not only earnings, but economic policy and valuations as we navigate this late cycle environment. Factors can change abruptly, and we believe in evolving opinions when presented with new information.

Industry Analysts on Average Have Overestimated the Final EPS Number by 7%



Source: FactSet. Data as of December 5, 2022.

Peak to Trough Earnings Decline in Recessions



Source: MSIM GMA Team, Haver

If the Fed does engineer something resembling a soft landing, the potential earnings damage will be much more modest as investors price in a slowdown instead of genuine recession. Overall, the magnitude of the slowdown will continuously be reflected in earnings estimates and guidance. Though we are calling for a larger downgrade than what is currently expected for next year, we don't believe the decline in stock prices will be as steep. The reason being stocks tend to bottom around 3-6 months before the end of a downward earnings revision cycle. We must remember that markets are a discounting mechanism and will eventually price in the end of the bloodshed, more clarity, and positive surprises in the future. Protecting capital in the meantime, in anticipation of a better environment, is a consistent theme throughout the 2023 outlook. The road there will be neither straight nor obvious as we will continue to see persistent volatility and uncertainty until the subsequent recovery.

2023 S&P 500 Price Targets Based on P/E Change and Earnings Growth

		P/E Ratio						
		14	15	16	17	18	19	20
earnings growth	-8%	-27.9%	-22.7%	-17.6%	-12.4%	-7.3%	-2.1%	3.0%
	-5%	-25.5%	-20.2%	-14.9%	-9.6%	-4.2%	1.1%	6.4%
	-3%	-24.0%	-18.5%	-13.1%	-7.7%	-2.2%	3.2%	8.6%
	0%	-21.6%	-16.0%	-10.4%	-4.8%	0.8%	6.4%	12.0%
	3%	-19.3%	-13.5%	-7.7%	-1.9%	3.8%	9.6%	15.4%
	5%	-17.7%	-11.8%	-5.9%	0.0%	5.8%	11.7%	17.6%
	8%	-15.3%	-9.3%	-3.2%	2.8%	8.9%	14.9%	21.0%
	11%	-13.0%	-6.8%	-0.5%	5.7%	11.9%	18.1%	24.3%

		P/E Ratio						
		14	15	16	17	18	19	20
earnings growth	-8%	2,769	2,967	3,165	3,363	3,560	3,758	3,956
	-5%	2,860	3,064	3,268	3,472	3,677	3,881	4,085
	-3%	2,920	3,128	3,337	3,545	3,754	3,962	4,171
	0%	3,010	3,225	3,440	3,655	3,870	4,085	4,300
	3%	3,100	3,322	3,543	3,765	3,986	4,208	4,429
	5%	3,161	3,386	3,612	3,838	4,064	4,289	4,515
	8%	3,251	3,483	3,715	3,947	4,180	4,412	4,644
	11%	3,341	3,580	3,818	4,057	4,296	4,534	4,773

Source: Assumes S&P 500 Closing Price \$3,839.50 on December 30, 2022, Yardeni 2022 EPS Estimate of \$215, Waterloo Capital

“We think the next hat to drop will be earnings, which would expose equity markets to additional pricing headwinds via a demand for a higher equity risk premium.”

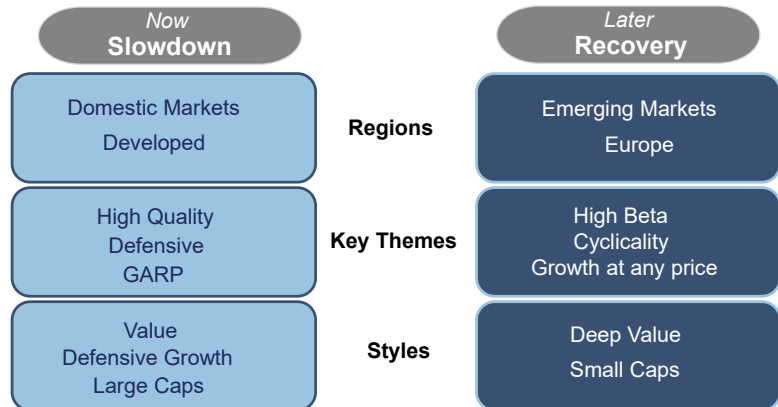
Investment Implications

<i>Tactical Decision</i>	2023 Investment Implications
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

Equities

Though we recommend an underweight to equities, our overall outlook is marginally improving based upon evidence that inflation has peaked, markets have priced in much of the Fed policy risk, and geopolitical worries have more certainty. However, the headwinds and themes discussed have not disappeared and many variables remain unanswered. The primary theme for equities broadly in the year ahead will be marked by elevated volatility given the amount of economic uncertainty. While equity markets repricing lower has increased future returns, until we observe improving constructive action under the surface and additional positive catalysts, we encourage investors to remain nimble and defensive.



Source: Waterloo Capital. All forecasts are opinions and subject to change.

Overseas, both foreign developed and emerging markets appear more constructive given attractive valuations, moderating energy prices, the pivot away from zero-Covid policy in China, and a weaker dollar. However, zooming out, we recognize the global tightening phenomenon and its effect on the economic backdrop. Earnings prospects internationally are much more benign than in the US, and while geopolitical tensions are receding, they produce a strong enough headwind to keep outperformance on the back burner. As we approach the end of the cycle and see brighter days on the horizon, we prefer layering on additional exposure to global markets as they are more levered to cyclicality.

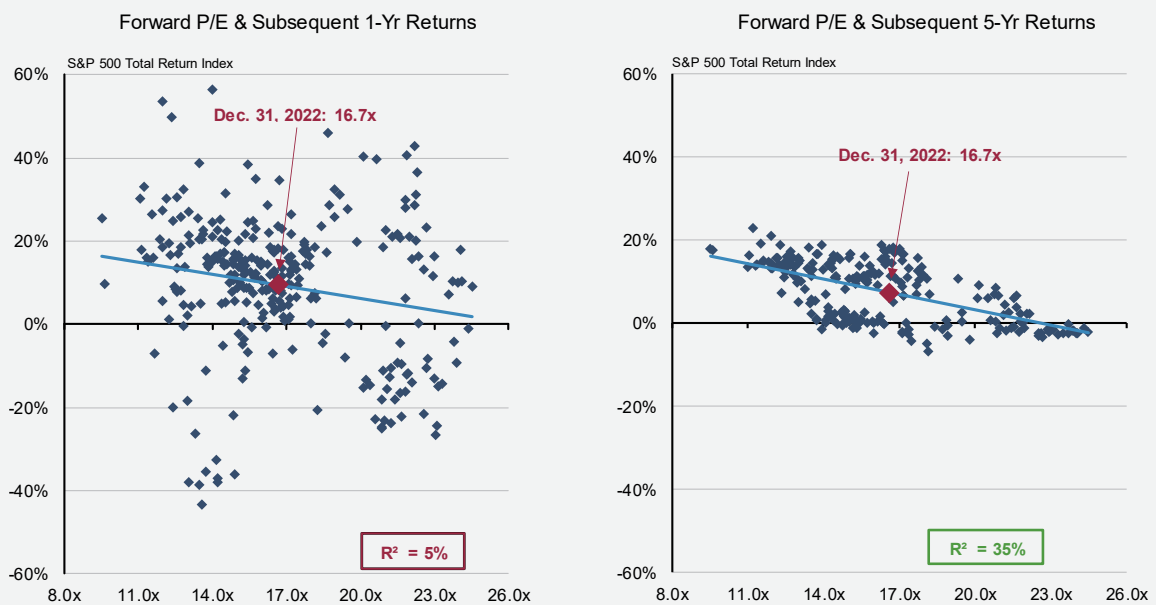
Foreign Markets Valuations are Exceedingly Attractive



We have seen valuations retract from near all-time highs last year after the huge liquidity surge emerging out of the pandemic. It is important to remember that when it comes to future returns, your starting point does matter. Valuations are one factor that can be used to handicap where future returns will be, however they should not be leveraged in isolation. Other factors like economic growth, corporate profits, and interest rate changes can also have significant influences on returns. As we enter 2023, the S&P 500's forward P/E sits at about 17X, implying single digit returns over the next 5 years. 1-year returns suggest nearly 10% gains, but with extremely low statistical significance, indicating valuations are not a great predictor for the short term.

The level of absolute valuations is, importantly, predicated on the denominator of the equation being correct. If earnings are less than analysts expect, the amount investors are willing to pay for these earnings will come into question. It is extremely uncertain if valuations retreat and by how much. If we experience a gentler slowdown next year, markets could support higher valuations. Lower interest rates could also provide help. That being said, we believe investors should look further out and anticipate a 2024 economic and earnings recovery to provide tailwinds to forward looking equity prices and assist multiple expansion. Also, from a relative valuation perspective compared to fixed income, we see the once constructive TINA environment beginning to fade as interest rates have risen.

Valuations are Predicated on the Denominator Being Correctly Assumed



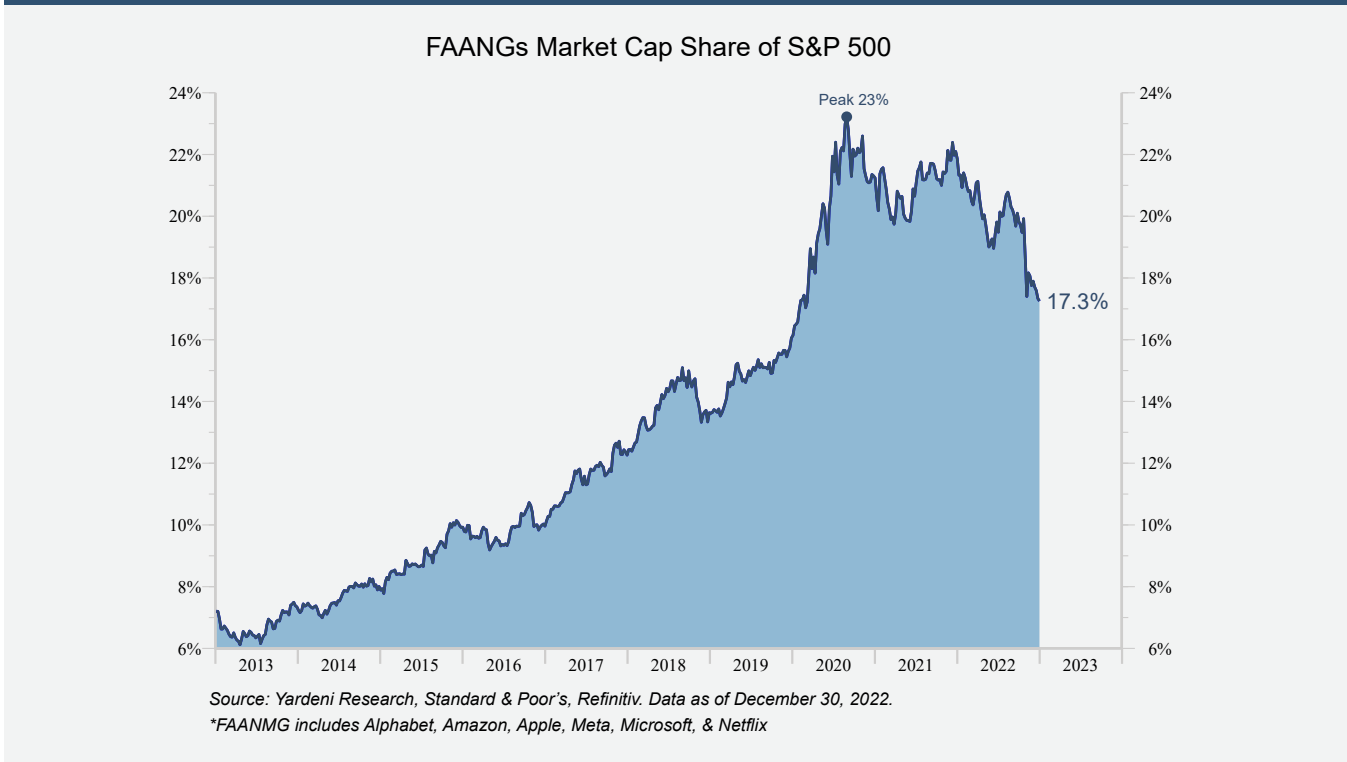
Source: FactSet, Refinitiv Datastream, Standard & Poor's, Thomson Reuters, JP Morgan. R² represents the % of total variation in total returns that can be explained by forward P/E ratios.

Enter 2023, we must dust off the late cycle playbook. The first play is a tilt toward defensive areas which should benefit investors in the next stages of the slowdown. Digging deeper, we favor value over growth, shorter duration over long, and recommend focusing on names that exhibit higher quality traits such as high free cash flow yields, lower debt exposure, and stronger balance sheets. We can classify these names as GARP or growth at a reasonable price. We prefer large caps over small caps as these traits are more prevalent in established companies, however we do not believe in simply buying the index.

“The primary theme for equities in the year ahead will be marked by elevated volatility.”

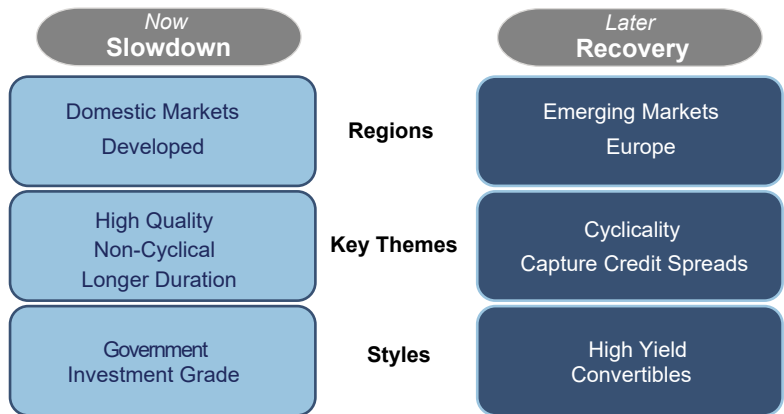
For years returns on the index level were driven, in large part, by the dominance of a small handful of companies due to their outsized weight in the index. Yet history shows that market leaders of one regime usually don't dominate the next. That transition could be underway, and the era of FAANG+ along with it, instigating a strong headwind on performance at the index level. We prefer an overweight to the equal weighted index vs the market cap weighted as a result. Additionally, given increased volatility and uncertainty, we believe in remaining tactical when investing next year. Allocating towards equities exhibiting relative strength within strong industries and sectors versus indices will likely outperform. As we progress from the slowdown and into the rebound stages of the cycle, we will shift our preference towards cyclical, smaller, and deep value stocks. This theme, which is especially sensitive to the economy, typically outperforms during periods of above trend economic growth.

Handful of Companies Have an Outsized Weight on the Index



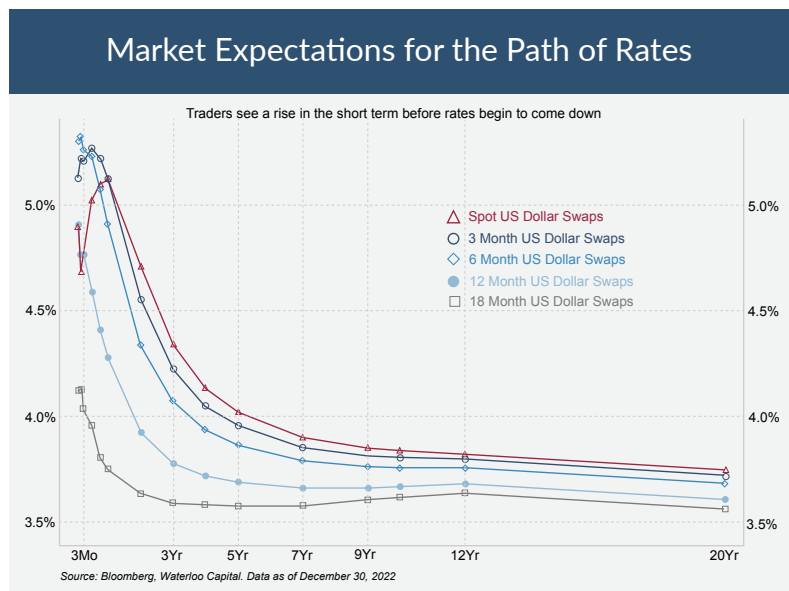
Fixed Income

While we see the potential for the asset class to regain prominence in the next year due to attractive relative valuations, expectations for moderating inflation, economic slowdown, and a somewhat tempered hiking cycle to develop over the course of 2023, we recommend remaining relatively underweight duration early on. Inflation remains a significant concern for global central banks and is still forcing their hands. Even Japan's central bank, the most dovish of them all and who first experimented with QE before moving to yield curve control for the last half decade has now, on the margin, become more hawkish. Elevated inflation, compared not only historical levels but the central bank's long-term targets, presents a challenge to the real return prospects of longer-dated fixed income instruments. Given these dynamics, the time for adding duration is approaching but has not yet arrived. We recommend refraining from venturing out on the yield curve until we can see the light at the end of the tunnel on global tightening. Until this light brightens, there is more upside risk embedded into interest rates.



Source: Waterloo Capital. All forecasts are opinions and subject to change.

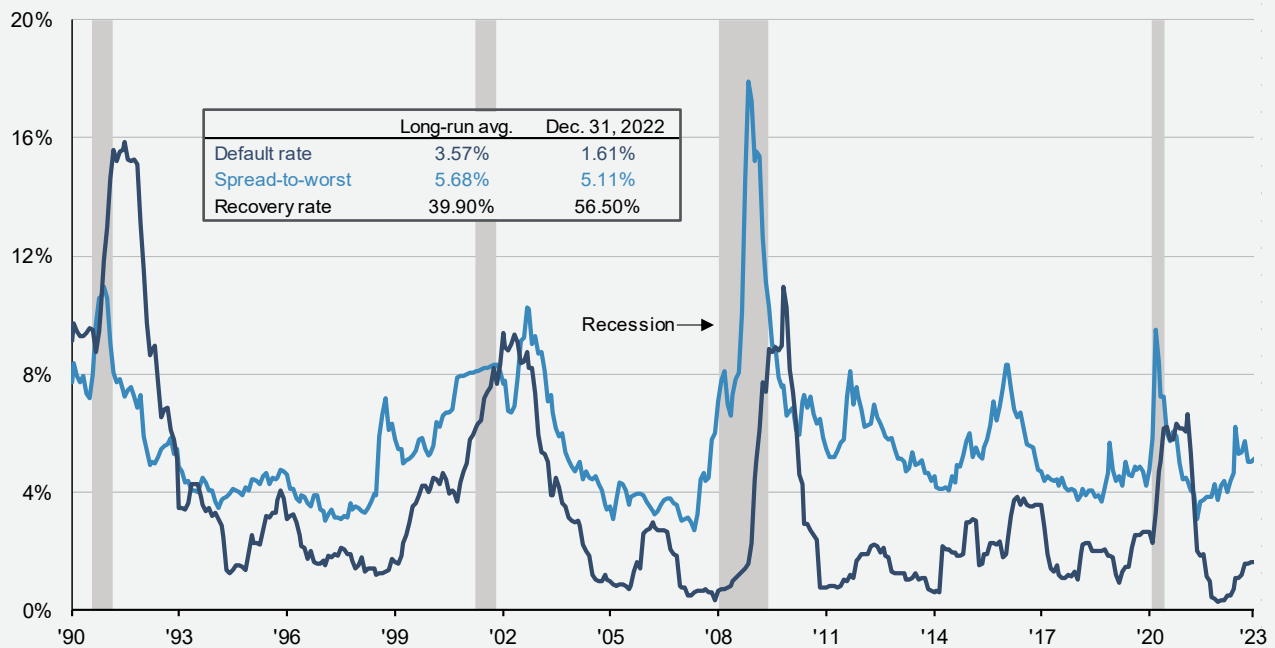
For now, a relative underweight to duration via short-term instruments or bonds with floating rate features will likely outperform. Investors can still capture attractive yield on the short end of the curve. Market participants will need to be nimble, though, as the transition between these environments will happen rapidly once inflation begins to buckle under the weight of tight monetary policy and markets start pricing in future policy cuts due to economic weakening. Yields across the curve should fall in a bull steepening action i.e. with the front end declining quicker given its tie to monetary policy expectations. At that point, we believe developing an overweight stance in duration will be key in providing total return to fixed income portfolios as rates fall and bonds provide added price appreciation. As presented below, markets currently agree with this prediction given falling implied forward rates, but first we must get over the hump.



Macro level uncertainty in the global fixed income market, as well as idiosyncratic and country-specific risks, lead us to recommend a tilt towards domestic bond allocations relative to the foreign market. International bonds continue to contend with many of the same challenges as the US but face a sharper weakening in economic growth prospects. Rates in the US are likely to remain higher due to a more resilient economy, supporting a stronger dollar and more attractive valuations versus the world.

As we march forward toward the slowdown that many expect, the credit landscape that was impressively stable during 2022 due to strong corporate fundamentals will begin to face headwinds and display signs of relative weakness. As profitability comes under pressure, corporate issuers with weaker balance sheets and who are highly sensitive to the impacts of higher debt service costs, could experience credit issues in a true credit default cycle. An increase in downgrades, which affect the credit spread of a bond and therefore its value, is likely to appear. In this environment, we recommend an overweight to investment grade fixed income versus high yield with an emphasis on balance sheet quality. With the economy fresh off two years of rapid growth post-pandemic, investment grade issuers enter the year from a position of strength having bolstered their balance sheets. While high yield corporates have done the same in shoring up their financials, they are more susceptible to the coming economic pain and likely have less cash flow to pay down debt and service interest payments. Additionally, they are more likely to be impacted by higher borrowing costs and tighter financial conditions such as lower liquidity. Per below, spreads and default rates tend to drastically rise during a recession. The impact of both metrics on the valuations of lower-quality issuers is more pronounced than in the investment grade space.

Default Rates and Spreads Historically Expand During Recession Leading to Credit Valuation Damage



Source: J.P. Morgan Asset Management

Based on our market and economic expectations for the year ahead, we are becoming increasingly constructive on the fixed income asset class. Valuations compared to equities, slower growth, and disinflation persuade us to recommend economically resilient areas of the market, longer duration, domestically focused, and high-quality bond allocations to provide higher relative returns as we move further into the year. Once the world weathers much of the potential economic deterioration and markets begin looking forward, possibly in the later months of 2023 and into 2024, these recommendations will shift as positive growth dynamics unfold. In such a recovery scenario, we would begin tilting portfolios towards more economically sensitive sectors of the market to capture the return drivers of a recovery environment: lower interest rates, falling spreads and default rates, and increased global liquidity. In this environment, international and high-yield bonds would become relatively attractive and, eventually, demand overweight within fixed income portfolios.

“Based on our market and economic expectations for the year ahead, we are becoming increasingly constructive on the fixed income asset class.”

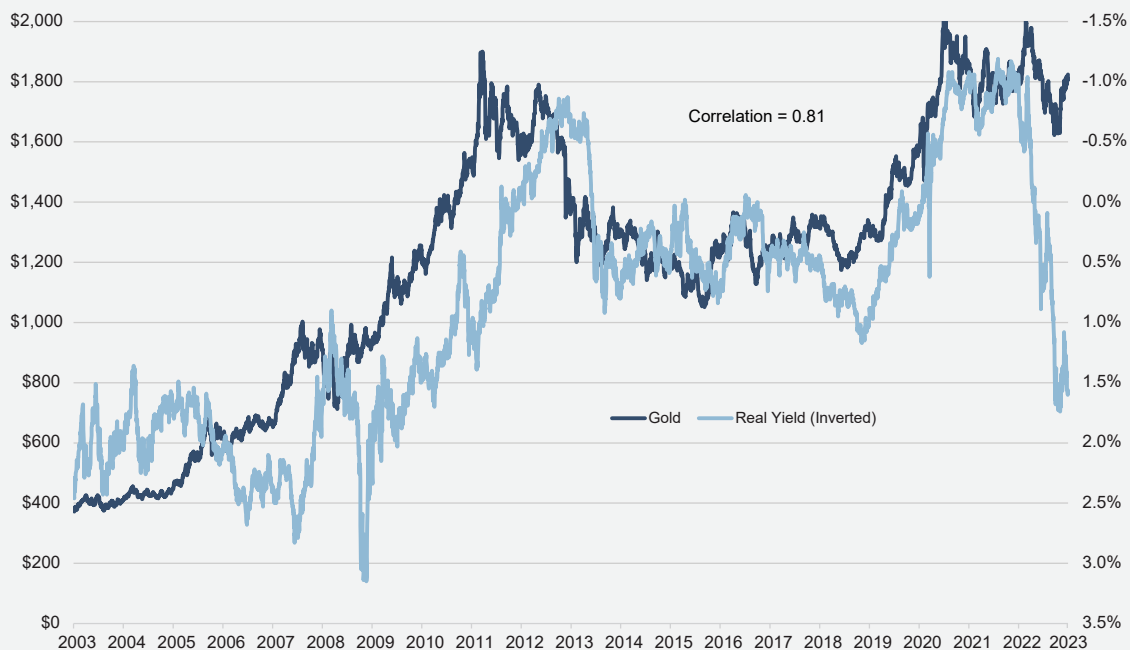
Real Assets

Metals

With news of inflation dominating conversations and headlines in 2022, many might have assumed that gold, which is considered a classic hedge against rising prices, would record a spectacular year. Although the asset class outperformed both equities and fixed income, the commodity was caught between the forces of inflation, which are supportive, and higher real interest rates, which are unfavorable. Additionally, a stronger dollar weighed heavily on gold prices. Real yield, the return on a bond adjusted for inflation, along with the US dollar, has historically had an inverse relationship with gold's performance. Next year, we believe that gold can have a little more luster than it did in 2022 as the metal tends to perform well when fears of a recession loom, real rates fall and the dollar tempers. Additionally, any rise in geopolitical tensions could instigate a scenario promoting a recharge in demand for precious metals.

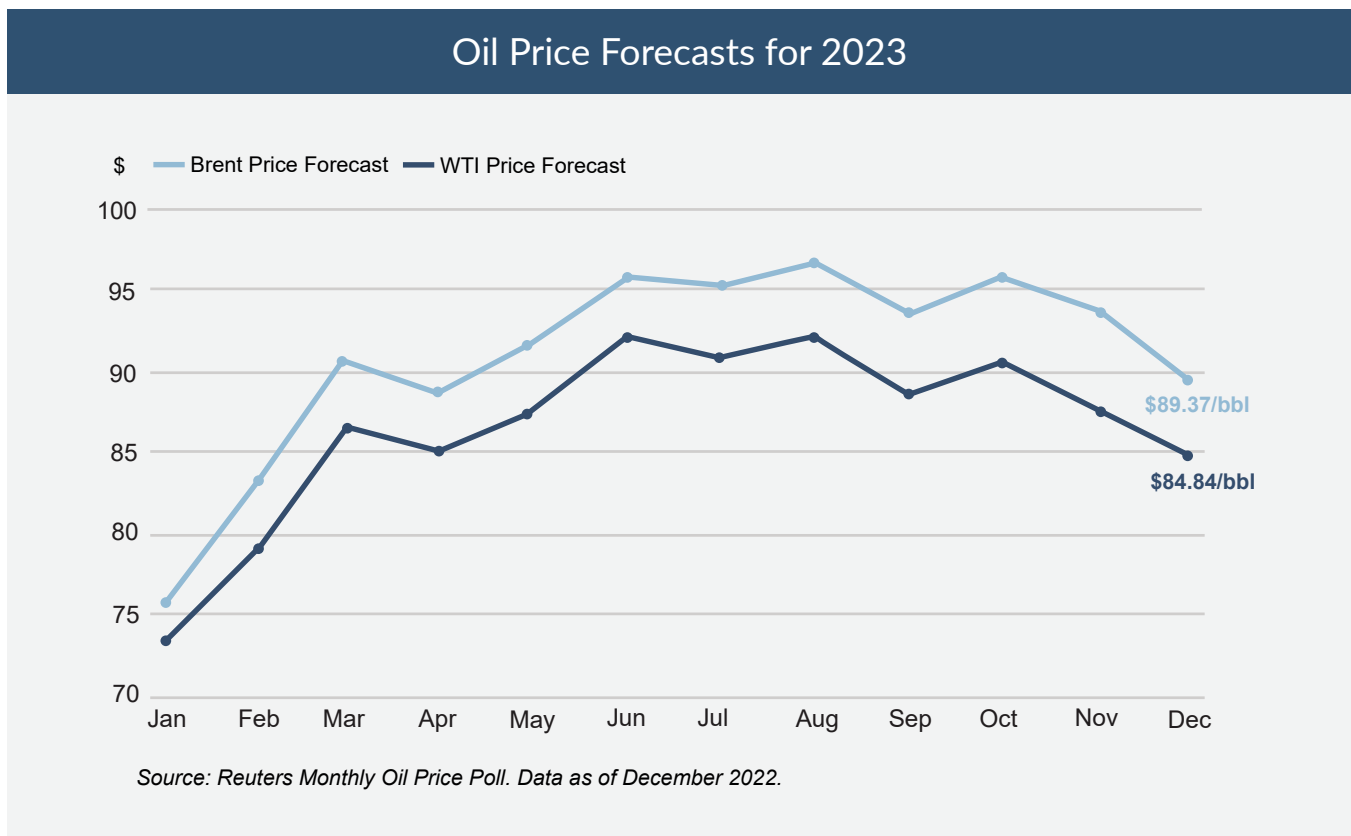
We remain slightly pessimistic towards base metals as slowing global demand and easing supply constraints put downward pressure on prices. While the likely headwind of slowing global growth in the year ahead is significant, there is a slight tailwind from China reopening that could support prices.

Gold and Real Yields are Inversely Correlated



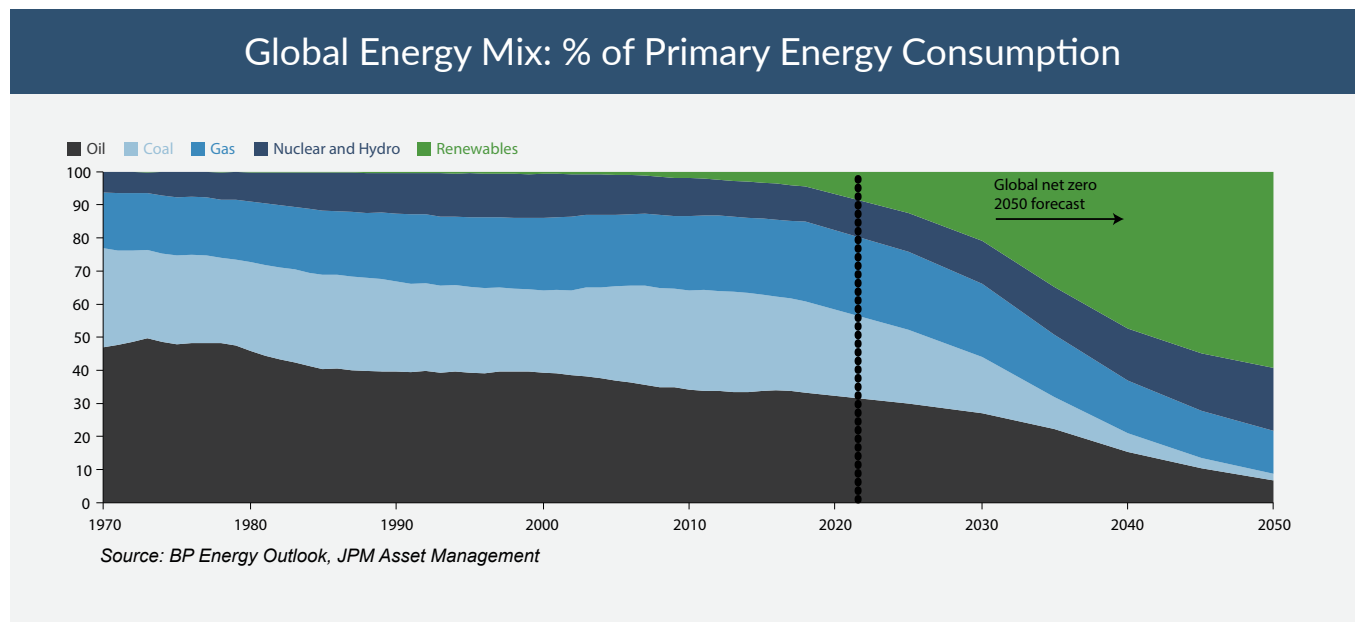
Oil

Although oil prices have fallen sharply from their mid-year high, we expect prices to remain elevated throughout next year. Immediate supply side pressures easing combined with an economic slowdown suggests further price declines to come. However, much of this price pressure will likely be balanced out by the resurgence of Chinese demand exceeding pre-pandemic levels, ongoing supply problems, and underinvestment outside of OPEC. OPEC has remained determined to maintain higher crude prices. Late last year they announced the decision to cut 2 million barrels a day from global supply and appear ready to act if prices threaten to fall below certain thresholds. World oil demand in 2023 will rise by 2.25 million barrels per day (bpd), or about 2.3%, according to OPEC which is well in advance of the cartel's 2010-2019 average increase of 1.5 million barrels daily.



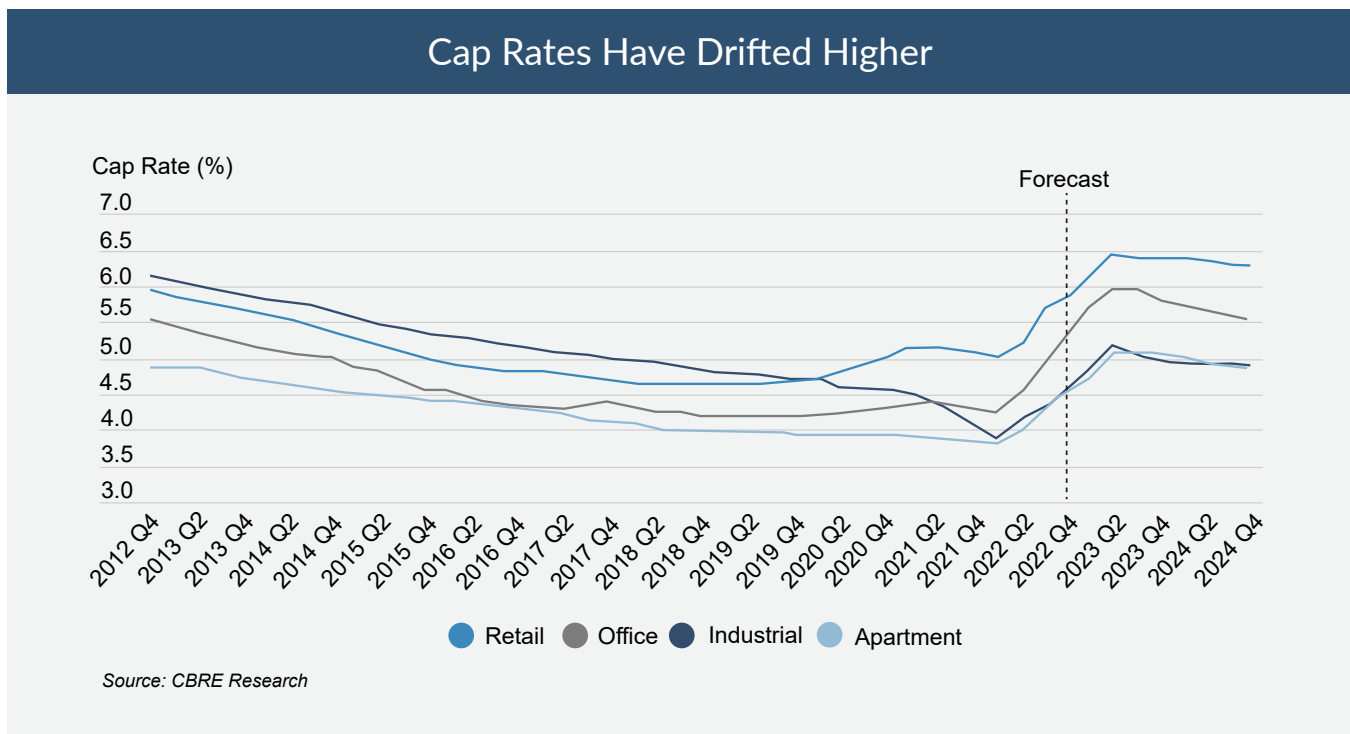
Worldwide, and especially in the current United States administration, there has been a secular push towards renewable energy. Although renewables are beginning to play a larger role in production by gaining marginal efficiency and scale, the medium-term demand for oil and natural gas will continue to grow. At the same time, given the push to a greener economy, supply for fossil fuels is being progressively constrained by the lack of investment in new capacity. The implication in the short to medium run is support for higher oil prices.

Given the massive demand and future investment goals of global governments, over the long run, renewable energy is expected to perform well, though the path to get there will be volatile and require recalibration. The Inflation Reduction Act signed in the US last year is just one such green initiative and makes capital outlays on green energy projects far more attractive. However, much of this future “green” growth is being priced in throughout equity markets and picking the winners and losers in the industry will be ever challenging in the years ahead. The prospects are high, but for investors it will be more complex than a simple strategy of buying clean energy and selling traditional “old energy” stalwarts.



Real Estate

For real estate investments, we expect the fundamental challenges that plagued the sector last year, i.e., higher borrowing costs leading to lower prices and sales, to continue. The emergent weakness in the global economy, generating lower investment and demand, will pile onto these contractionary factors to paint a gloomy picture for the asset class in the upcoming environment. We believe in pursuing areas of the market that combine quality with resiliency in the initial stages of the downturn and avoiding cyclically sensitive sectors. Overall, we recommend a relative underweight exposure to real estate given these challenges.



Expectations for the various sectors of the real estate market differ drastically and any investment in these areas should be nuanced. Within the market itself, we identify resiliency within the data center, retail, self-storage, and multi-family residential sectors. The combined dynamics of increased demand for data centers and limited supply, due to space and power constraints, produce a relatively strong picture for this area. Retail and self-storage favorability is mostly a supply story as new developments have stalled, tightening the reservoir of units, while demand remains stable. Multi-family is likely to outperform as renters are still abundant and home affordability issues discourage consumer ownership. The single-family residential and office sectors are likely to underperform the broader real estate market due to their pronounced sensitivity to the economic cycle. Single-family residential investments will probably see an extension of the pain felt in 2022 as home prices continue to be impacted by lower affordability and falling demand. Office spaces are likely to be damaged by the slowing environment and external labor dynamics, such as remote work and shared spaces. The high-quality, prime segment, however, will likely be more insulated and perform better than the secondary market.

Alternative Investments

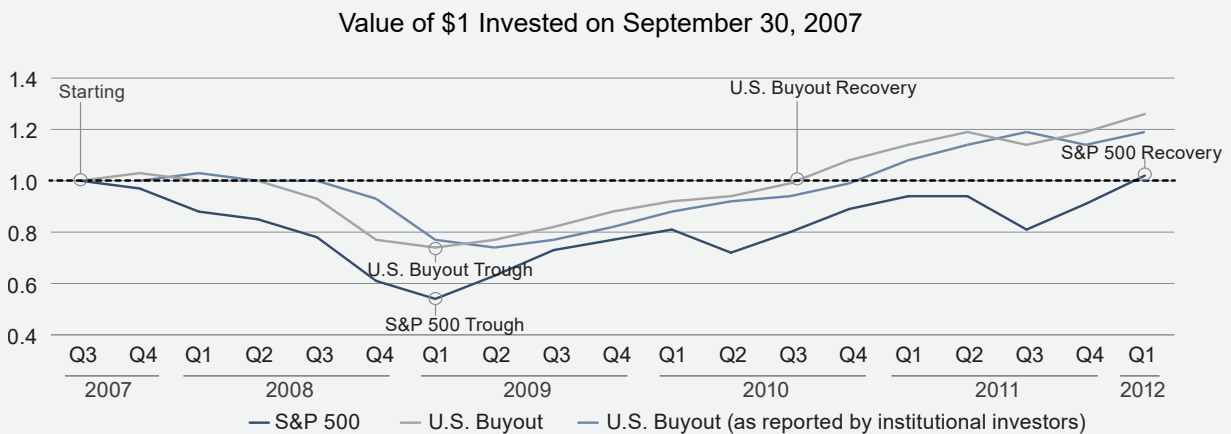
Alternative investments encompass a wide range of strategies across the private markets. Typically, these investments offer investors key differentiators when compared to their public market counterparts, stocks and bonds, namely lower correlation to broad market trends, lower volatility, and the potential for enhanced risk adjusted returns. In no year were these benefits more apparent than in 2022. Looking forward, believe alternative investments can play an important role in portfolio construction as we enter a period of prolonged uncertainty.

At Waterloo, we provide our investors access with institutional quality alternative investment offerings. We source these through our network of relationships and negotiate access at reduced minimum investments. We divided our offerings into two categories: return enhancing investments and risk mitigating investments. We work with our clients individually to determine how alternative investment strategies can help mitigate volatility and the risk/return dynamics in their portfolios.

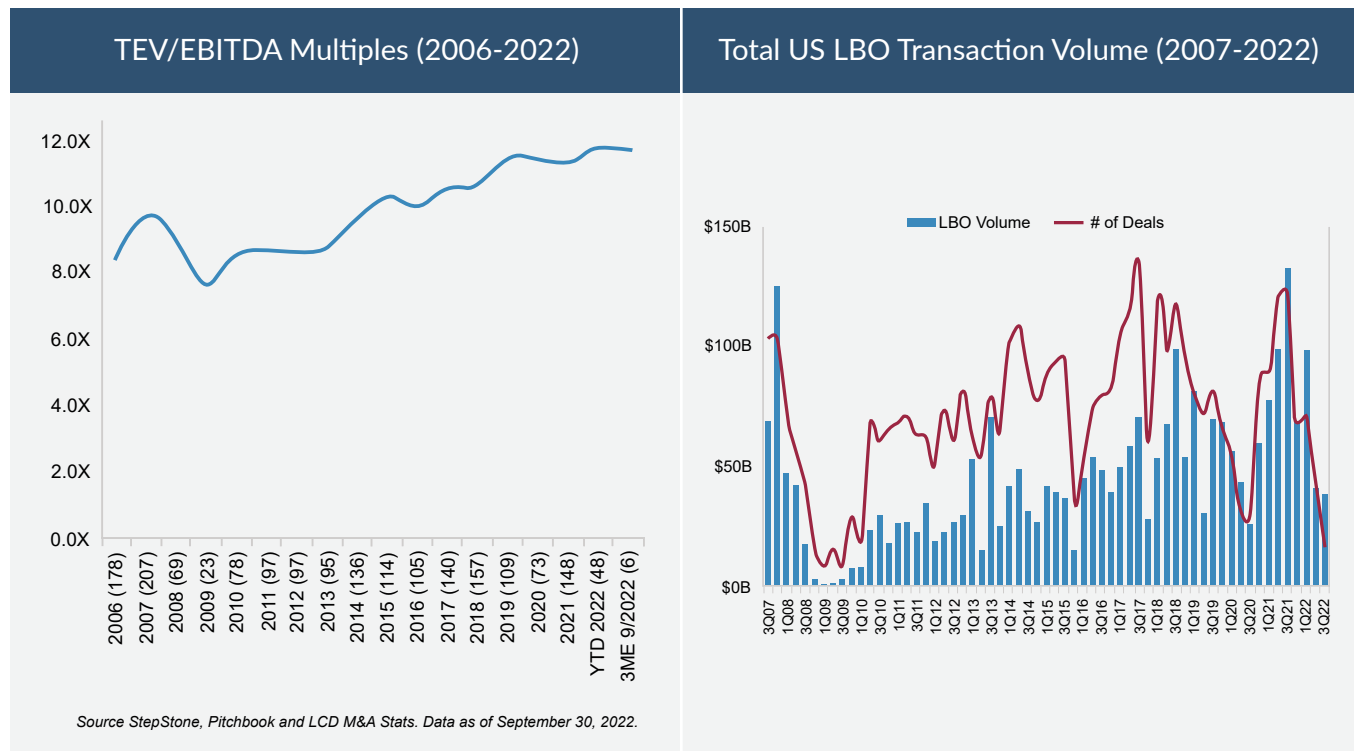
Private Equity

Last year proved the asset class still offers investors diversification benefits difficult to replicate in public equities. Private equity is often considered synonymous with high risk and high return, so one would assume negative returns would have outpaced public equity. While private equity funds were down for the year, returns through Q2 2022 were -5.3%, compared to -20.0% for the S&P 500. Valuation adjustments are still making their way through to marks held on NAV statements, however private equity has historically offered investors less downside during drawdowns and better performance through recessionary environments.

Drawdown Analysis of Private Equity During the GFC

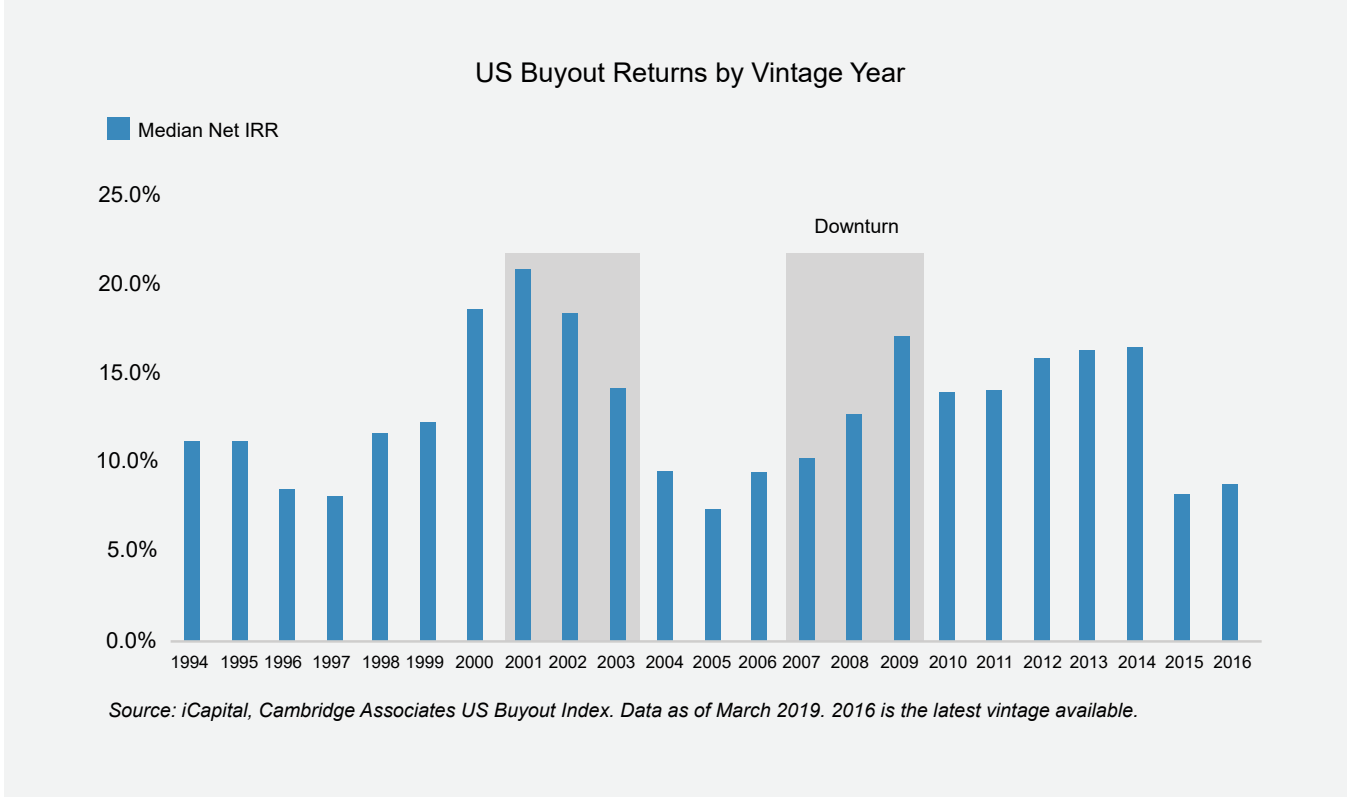


Despite this, private equity will not be insulated from the current slowdown in markets. Purchase price multiples for leveraged buyouts have been slow to adjust to lower valuations in the public market. PE firms have simply gravitated toward higher quality companies to deploy capital and been hesitant to purchase the high growth/high multiple companies that were in vogue post-COVID. This slowdown in transactions has caused the available capital for PE firms to deploy (i.e. “dry powder”) to pile up to record levels. Investors have become hesitant to invest as new deal activity hit lows not seen since 2008.



Over the next few quarters, we expect funds raised between 2017-2020 to experience write downs as valuations multiples adjust to the new environment. However, new funds and recent vintages will benefit from their ability to be judicious with new acquisitions and their available “dry powder” to acquire companies at these favorable valuations. It’s because of this dynamic and PE’s long-term approach, we are very positive on new allocations to private equity in 2023. Historically, funds raised in vintage years with recessions have often offered investors better returns.

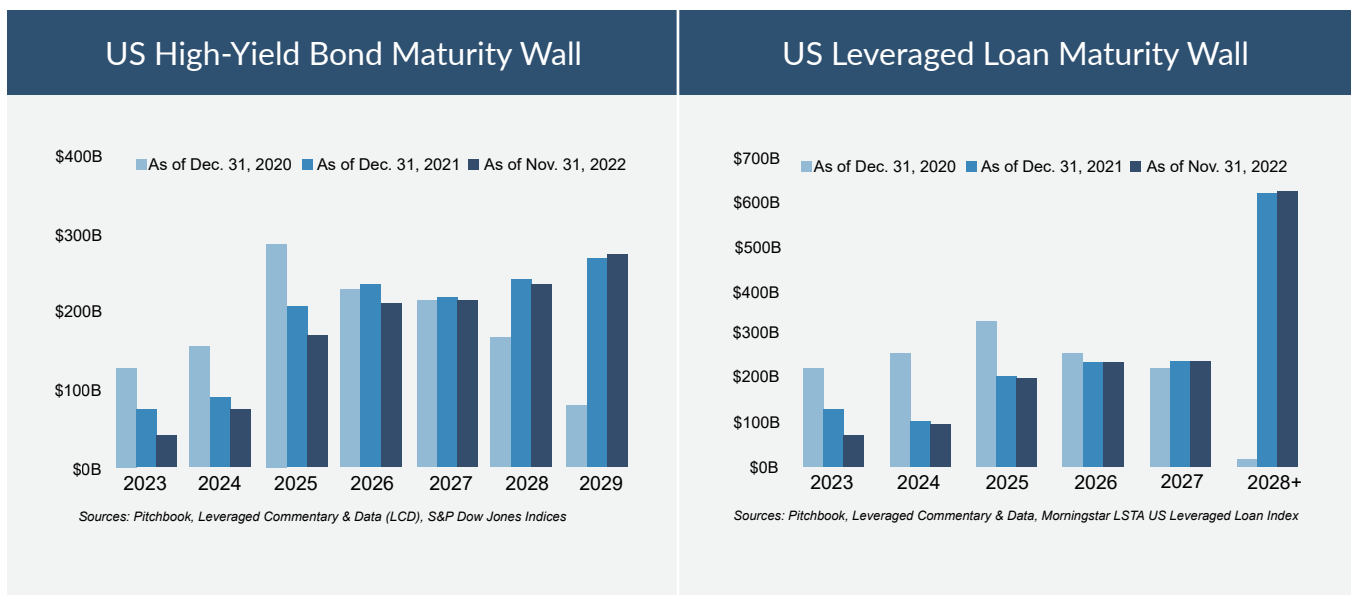
Some of PE’s Strongest Vintages Began Investing During Drawdowns



Private Debt & Alternative Income

In 2022, private debt investments offered their investors the largest relative outperformance compared to bonds in its history. Through the third quarter, the Cliffwater Direct Lending Index returned 4.1% while Barclays Aggregated Bond Index was down over 13%. Private debt has been a popular asset class among institutional investors due to its contractual returns, floating rates, and its ability to offer a higher risk premium in liquidity constrained environments. However, we do expect the next year to be increasingly difficult for private debt investors. While default rates have remained low, investors have enjoyed higher spreads and low credit losses. As we near the end of this credit cycle, we believe over-levered companies will struggle to adjust to this higher interest rate environment. We do see value in non-bank, senior, collateralized lending strategies. The position of these investors as both underwriters and lenders allow more flexibility in defining loan terms. We favor managers in the lower middle markets, where access to capital is increasingly constrained. In this market segment, lenders are able to underwrite complex collateral agreements to protect capital in the event of default.

As credit defaults increase, we believe this will offer distressed investors a fertile hunting ground for new opportunities. Given the higher rate environment, we predict that many high yield and leveraged loan borrowers will fail to functionally adjust, generating attractive distressed debt investments. However, this opportunity set will likely manifest itself in 2024-2025. Investors should monitor credit spreads in over-levered high yield issues as we near the end of 2023.



“Looking forward, believe alternative investments can play an important role in portfolio construction as we enter a period of prolonged uncertainty.”

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2700 Via Fortuna #100, Austin, TX 78746 • (512) 777-5900 • www.WaterlooCap.com

5555 Glenridge Connector, Suite 200 Atlanta, GA 30432 • (470) 552-5902 • www.WaterlooCap.com/IWS