WATERLOO CAPITAL

OUTLOOK 2024

Defying Gravity: Navigating the New Normal

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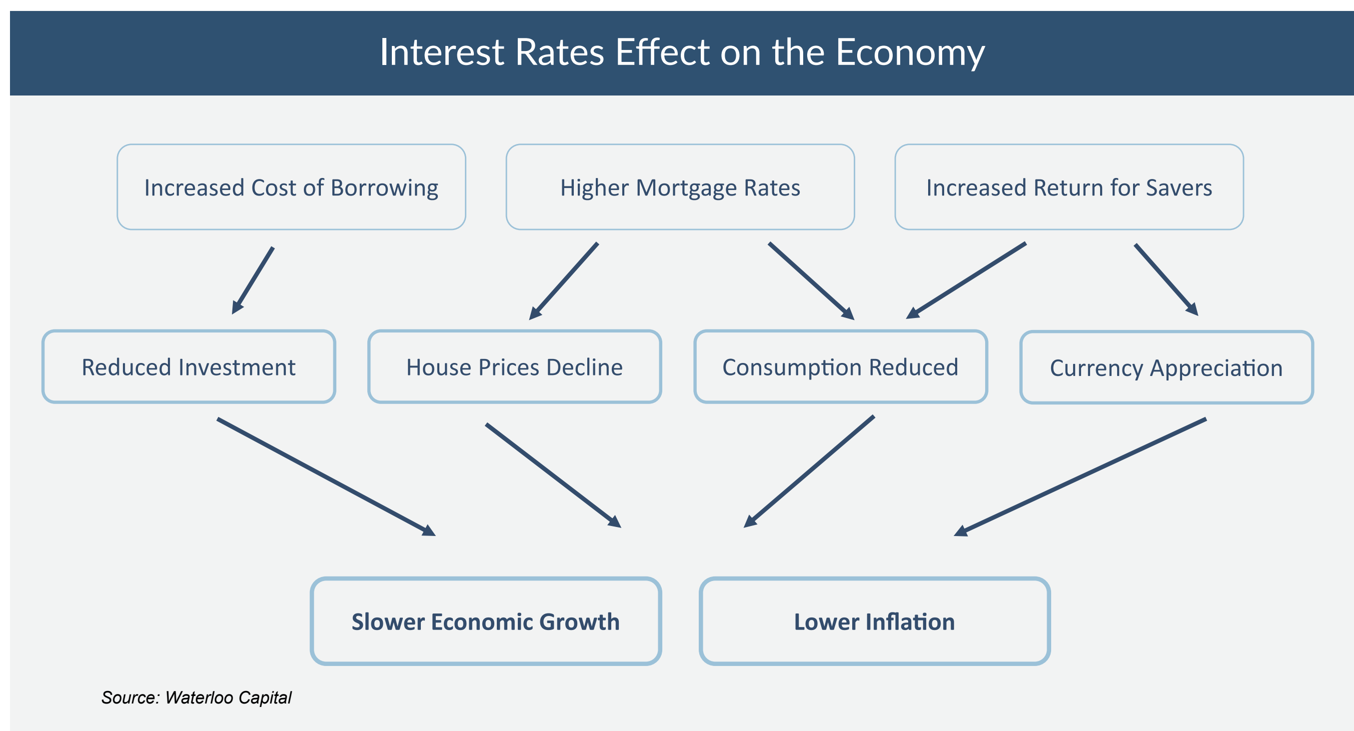
Where have we been... Where are we now?

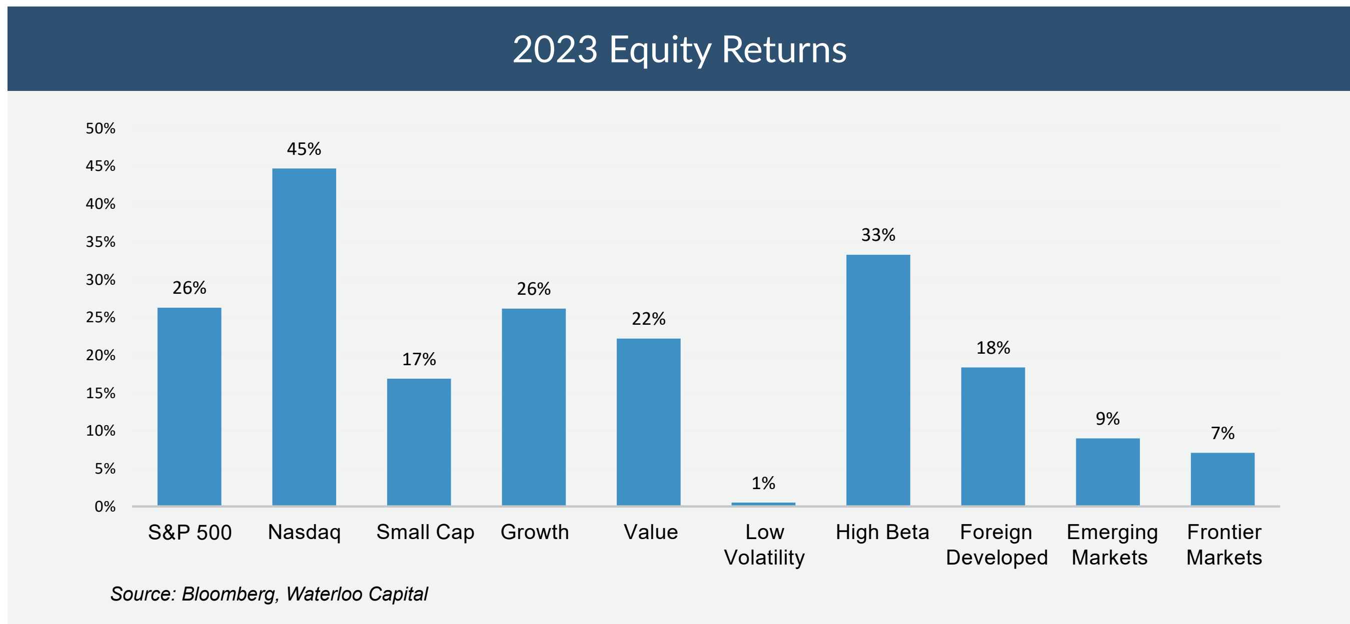
2023 emerged as a year of resilience and unexpected positive turns, defying the new normal of higher interest rates, which were expected to exert pressure on the economy and markets. Following a challenging 2022, the consensus among economists leaned heavily towards the anticipation of a recession within the year. Wall Street's S&P 500 forecasts mirrored this caution, spanning a conservative range from 3,675 to 4,500, with a median target near 4,000, signaling minimal growth expectations. This pervasive pessimism was largely fueled by the aggressive interest rate hiking cycle implemented by the Federal Reserve in a bid to curb decades high inflation. Monetary policy adjustments, coupled with ongoing concerns over consumer financial stability amid persistent inflation and market volatility, set a cautious tone for the year. In addition, central bank intervention, key economic indicators such as the yield curve inverting, a regional banking crisis, and increasing geopolitical tensions amplified uncertainty.



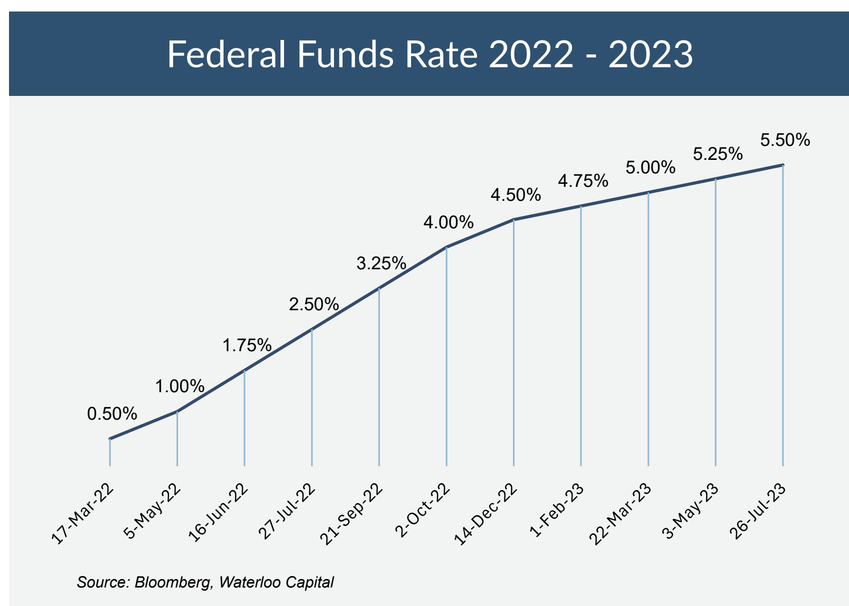
Source: Waterloo Capital

2023 emerged as a year of resilience and unexpected positive turns, defying the new normal of higher interest rates, which were expected to exert pressure on the economy and markets.

Despite this overwhelmingly worrying backdrop, the US economy proved to be more resilient than expected, achieving annualized real GDP up 2.5%, higher than 2022's 1.9% figure. The surprisingly strong performance was mainly fueled by consumer resilience, bolstered by two years of stimulative government actions giving way to the largest government debt to GDP ratio since World War II. The strength of the labor market contributed to historically low unemployment as real wage gains bolstered American citizen's financial positions allowing them to engage in economic activity in the face of the higher interest rate environment.

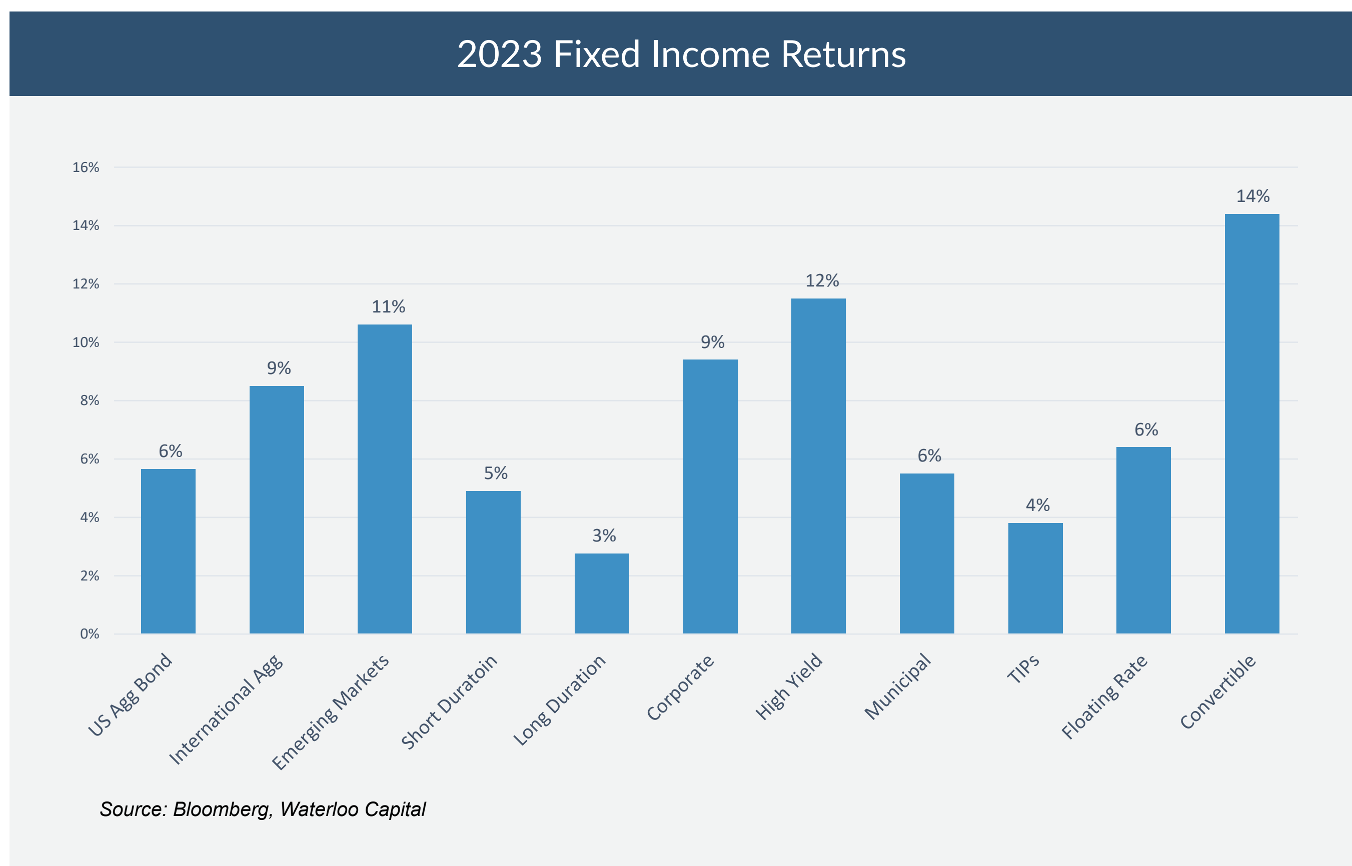


The Federal Reserve continued to the pace of hikes from 4.5% to 5.5% on the federal funds rate through the first half of 2023, marking 2022-2023 one of the largest and fastest hiking cycles in history. Once it was clear that inflation had peaked mid-year, the Fed paused and kept rates between 5.25%-5.5% where they have stayed since last July. The question that remains is when inflation will soften enough for the Fed to begin a cutting cycle.



The U.S. stock market's performance was nothing short of extraordinary versus Wall Street's expectations. The S&P 500, including dividends, recorded a +26.4% gain due to several factors, the most important of which are the economic resilience previously mentioned and the artificial intelligence (AI) induced rally in a select few technology sector companies. Last year's equity market performance was marked by the intense concentration of gains in just a handful of mega cap technology and communications stocks dubbed "The Magnificent Seven." The 7 companies (Apple, Microsoft, Amazon, Google, Nvidia, Meta, and Tesla) averaged over 100% return for 2023, while the remainder of the 493 companies in the S&P 500 averaged a return of 8%. The year also saw a pronounced divergence in favor of growth compared to value stocks. Not all sectors fared well, with utilities and dividend stocks having their worst year since 2008, challenged by the rising rate environment.

Fixed income markets were marked by high volatility, reflecting the ongoing uncertainties concerning inflation and the ultimate path of central bank policy. The yield on the benchmark U.S. Treasury 10-year note started and finished 2023 near 3.8%, but during the year the yield rose to a 17-year high, near 5%. Despite struggles in the treasury market, credit-sensitive segments of the bond market performed better, benefiting from broader economic stability and the avoidance of a recession. High-yield bonds enjoyed their best year since 2019, indicating a strong appetite for riskier assets.

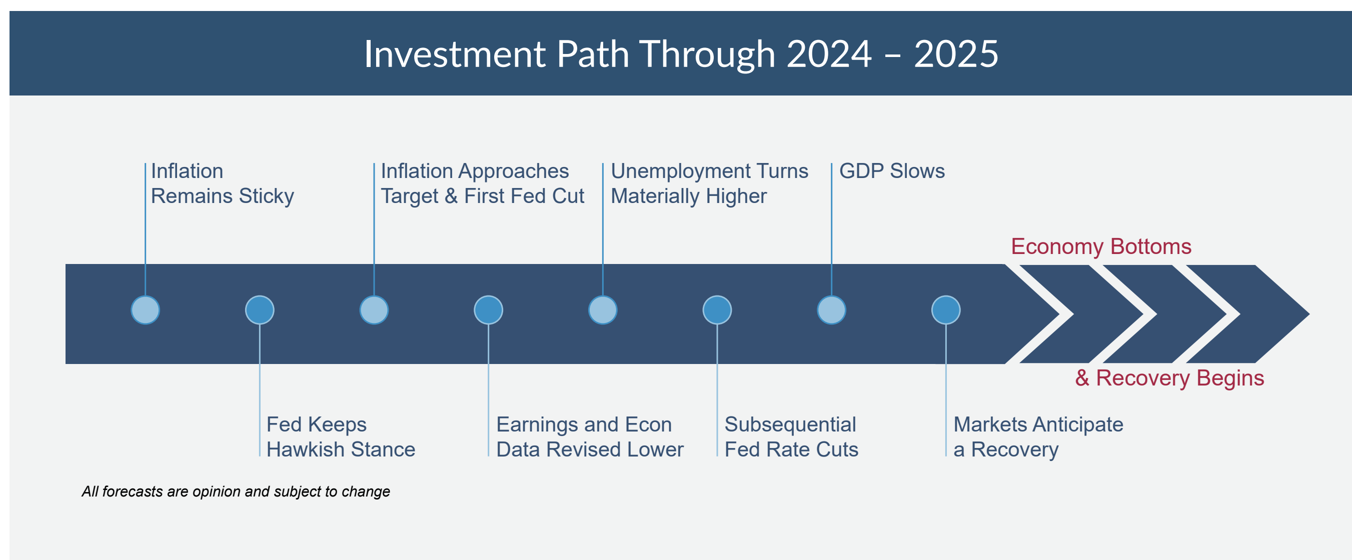


Source: Bloomberg, Waterloo Capital

The story of 2023 in financial markets was one of unexpected turns and better than expected growth. This performance, set against a backdrop of economic uncertainties and tight monetary policies, illustrates the dynamic and often unpredictable nature of financial markets. It serves as a reminder of the complexities of economic forecasting and the potential for markets to defy expectations, driven by innovation, investor sentiment, and shifting economic fundamentals.

As the dust settles, we entered 2024 with an unsettling amount of exuberance around markets as the S&P 500 aims to finish the first two months of 2024 at all-time highs. This backdrop is supported by the dovish rhetoric of the Fed, what seems to be improving economic data, and Q1 earnings boosted by the AI movement, which suggests the economy and markets may be out of the woods. However, the primary risks remain that inflation may be sticky, the consumer balance sheet is deteriorating after fiscal fueled Covid stimulus, the labor market is slowing, coupled with slowing earnings and economic growth. Pair all these risks together and add the fact that we are in an election year, makes the chances of a black swan event all the higher. Best case scenario, the Fed makes a soft landing in which economic growth slows but not enough to dip into a recession, while markets look forward to the recovery. History, on the other hand, shows that it usually takes 1-2 years after the yield curve inverts before the start of a recession. Whether there will be a mild or major slowdown remains to be seen, but we are certainly in for another unpredictable year.

We present 5 key themes to provide a roadmap for investors in the coming year. This is our best thinking at the time of writing and the investment team continually evaluates incoming information to adjust our thinking and portfolios. On behalf of our team at Waterloo Capital, we want to thank you for reading our 2024 Market Outlook.

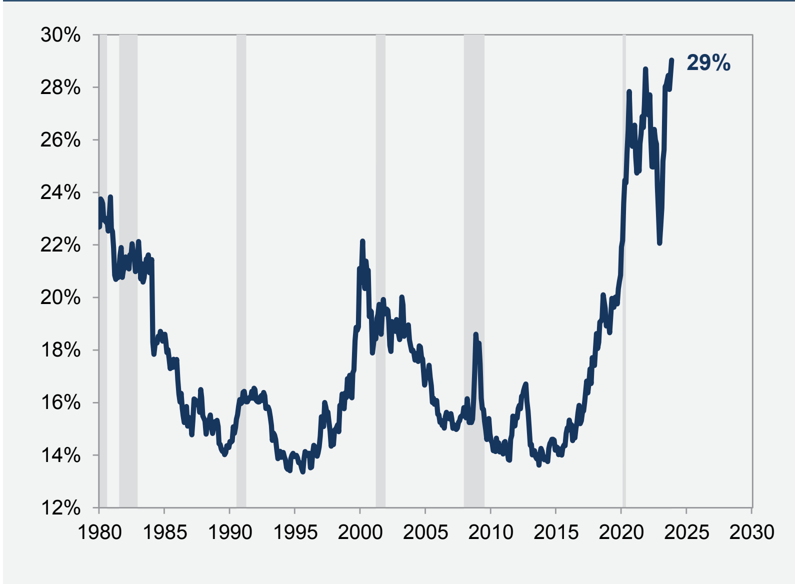


Magnificent 7: Marathon or Sprint?

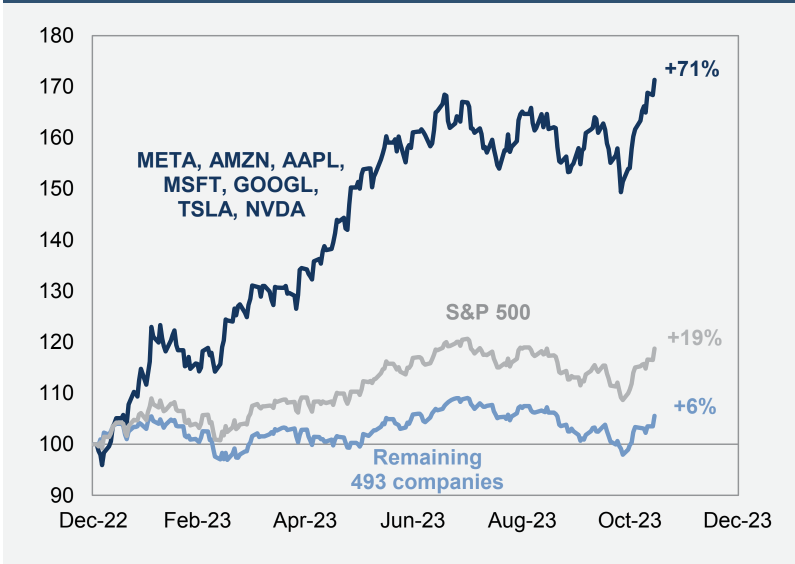
Last year the performance of the stock market presented a tale of two narratives which hinged on whether one considers the average stock, or the elite group known as the "Magnificent 7" (Mag 7). The S&P 500 index closed the year up 25%, yet the average stock lingered near single digit levels, showcasing one of the most concentrated patterns of equity performance. Given the impressive run up, will the remarkable run of the Mag 7 continue to set the pace in the market, or are we witnessing a fleeting sprint like the Nifty Fifty's or 1999, with stocks soon to be tempered by the gravity of their soaring valuations?

The Mag 7 consists of Apple, Amazon, Google, Amazon, Nvidia, Meta, and Tesla which command nearly 30% of the S&P 500's weight. Throughout 2023, the group returned eyeball catching gains while the rest of the 4companies in the S&P 500 were up high single digits. This resulted in one of the narrowest market advances in history as the Mag 7 accounted for over 75% of the S&P 500's return.

Seven Largest Companies as Share of S&P 500 Total Market Cap

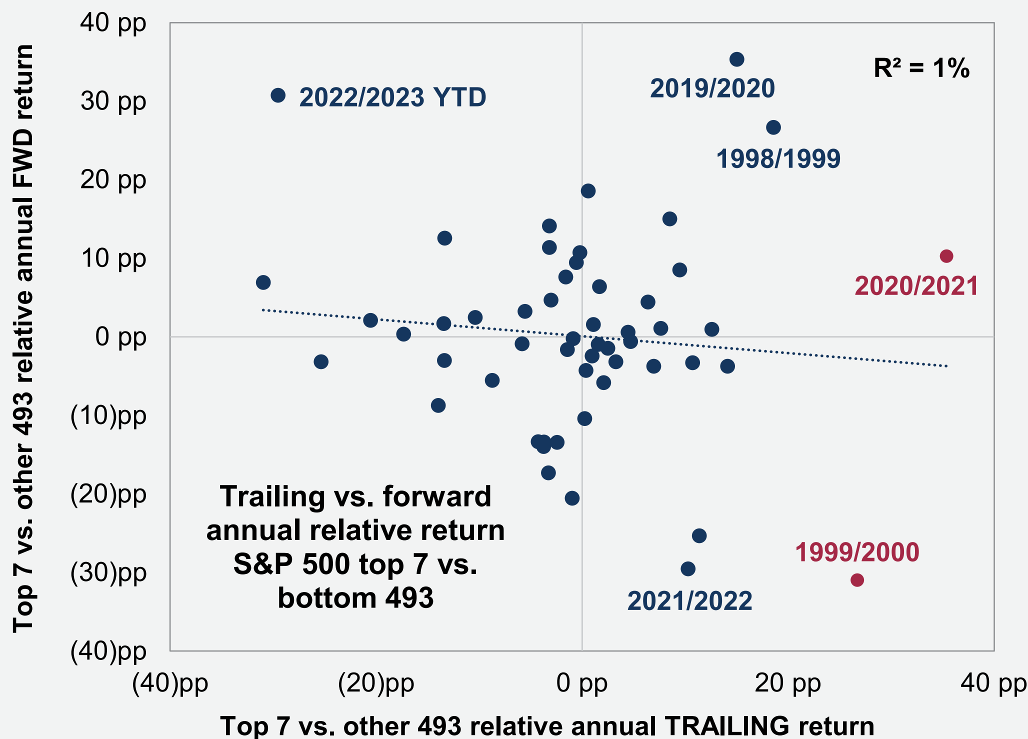


Index Return



As we move into 2024, predicting the future of the relationship between Mag 7 and the rest of the index is complicated. Despite a record-setting outperformance, historical data does not offer a constant pattern for predicting future performance over a 12-month period. Per Goldman Sachs, this relationship has an R-squared of 1% indicating that previous returns of the seven largest names versus the rest of the market is a horrible predictor for future returns of the relationship. For instance, during the tech bubble in 1999, a similar concentration in mega-cap stocks led to significant gains, only for these stocks to underperform the broader market by over 30% in 2000. In a contrasting scenario, the remarkable success of the top seven stocks in 2020 was followed by another impressive performance in 2021. Although only two examples, they exemplify the unpredictable nature of the relationship from a fundamental sense and create a challenging estimate of the market backdrop. It is worth noting that over the long term, innovation drives markets. If some of these companies can continue to innovate, fundamentals will take the backseat to future expectations and sentiment in the short run.

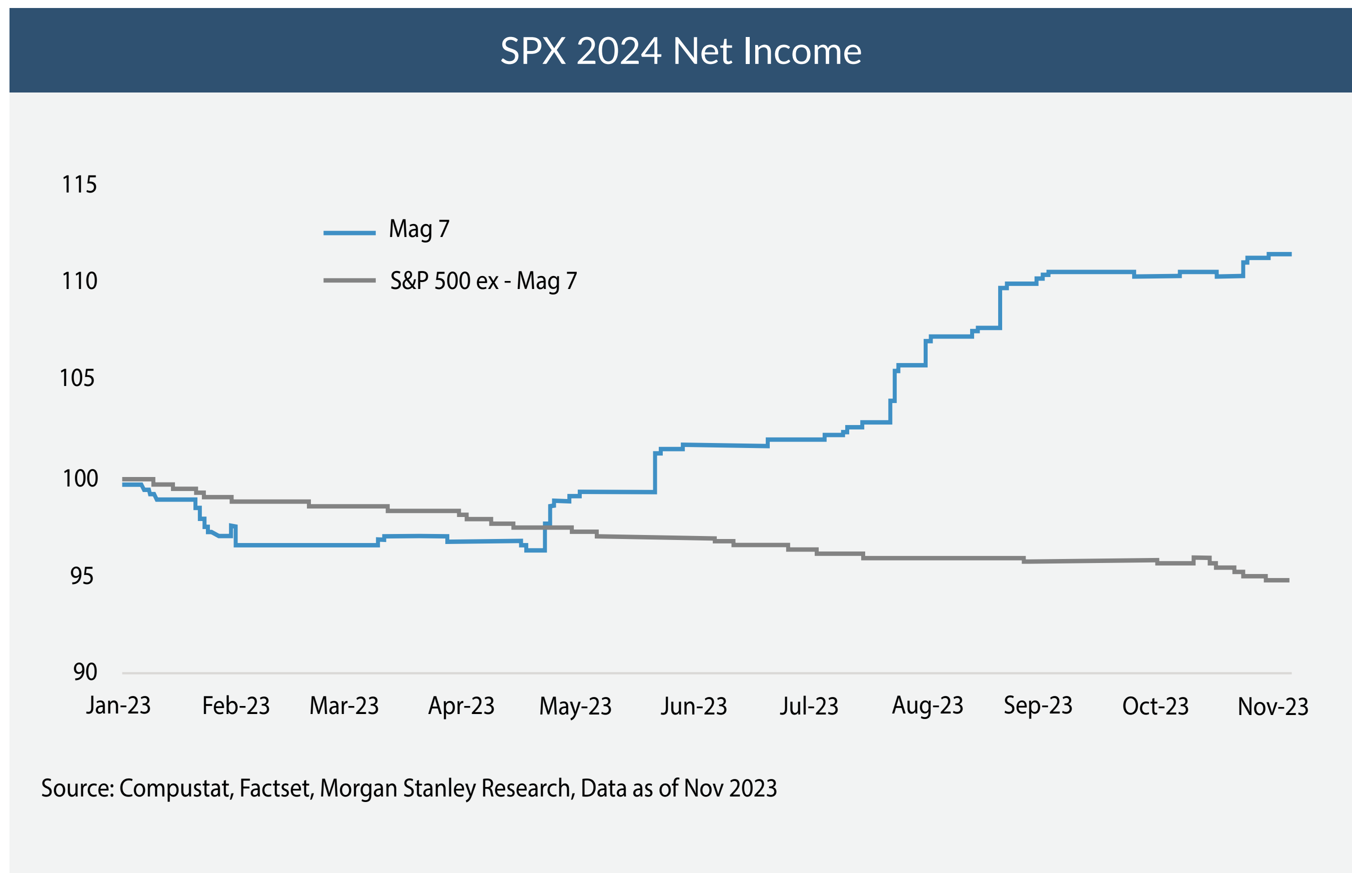
Little Relationship Between Trailing and Forward Returns of Top 7 vs. S&P 493



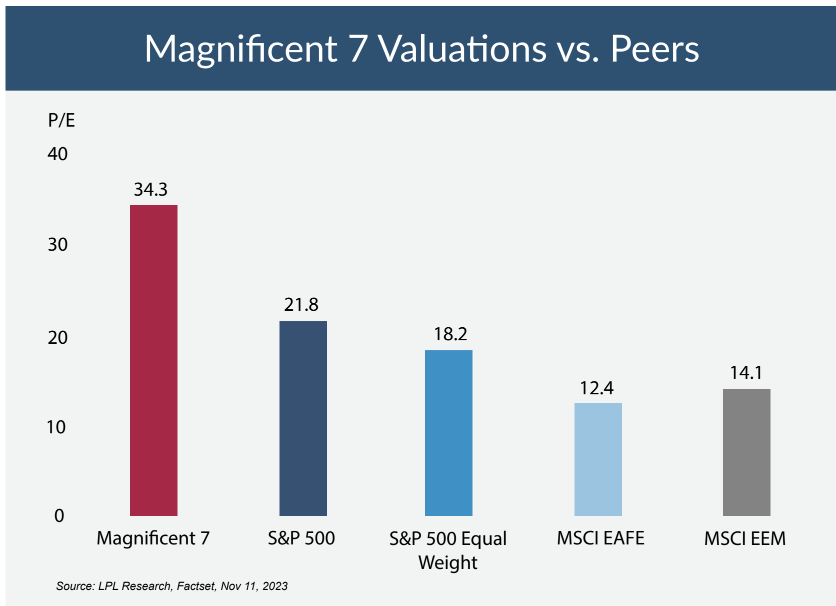
Source: Goldman Sachs

To gain more valuable insights, we take a broader view. Looking back at 2022, it's notable that the Mag 7 significantly underperformed compared to the other 493 companies, with a nearly 40% drop against a 10% decline in the rest of the market. After seeing the recent catchup trade or trend reversal, the key to the Mag 7 continuing to outperform and propel indexes higher will depend on if their lofty financial projections are realized.

The deviation between the Mag 7 and the rest of the market underscores the broader earnings challenges faced by a majority of companies. As we transition into a late-cycle economic phase, most of these mega-cap leaders, along with a select group of other high-quality companies, might continue to defy the prevailing trend of stagnant or negative trailing earnings growth. Operational efficiency, cost leadership, and dominant market positions have already enabled the Mag 7 to achieve robust free cash flow, profit margins nearly twice those of their peers, and anticipated earnings growth outpacing the market. Investors will likely continue to place a premium on quality when they realign to the late cycle playbook. This could see the Mag 7 have staying power in the stock "flight to safety" trade away from the rest of the market.



It will be compelling to watch if this growth materializes or if investors have overpaid for it. There is a difference between value and price. On one hand, the commanding position of the Mag 7 is sound, thanks to their pioneering roles in key megatrends such as cloud computing, artificial intelligence, and data analytics. This dominance has been a critical factor in their robust performance as they generate high levels of free cash flow and have stronger balance sheets than competitors. On the other hand, the dramatic surge in returns has propelled their valuations to almost stratospheric levels compared to other market segments. Historical trends remind us that valuation is a significant factor in the long term, particularly if the late-cycle economic phase evolves into a more pronounced slowdown or even a recession. As we enter 2024, some of these names are being priced for perfection with hopes for extreme future growth, leaving these firms vulnerable to the smallest disappointment.



As 2024 unfolds, the Mag 7 are expected to largely maintain their lead, buoyed by their robust financial standings amidst a late-cycle economic landscape. Still, it's conceivable that the spotlight might shift, leading to a newly coined Magnificent Three or Four in 2024, consisting of the group that lives up to or even surprises and surpasses analysts' lofty expectations. Looking from an index perspective, it also seems increasingly unlikely that these frontrunners will be able to carry the market's laggards along in their wake. Couple this with the outsized holdings by hedge funds and mutual funds, we could see back-to-back years of a frustrating environment for stock pickers as most of the Mag 7 continue their charge. In 2024, investors should keep an eye on the market's breadth, the percentage of stocks performing well, and the emergence of new sustained breakouts, signaling a potential "catch up" trade. These factors are going to likely be critical for driving indices like the S&P 500 and Nasdaq 100 sustainably past their all-time highs. It's a challenging feat for just a handful of stocks to spearhead such a breakthrough without the collective momentum of a broader market rally.

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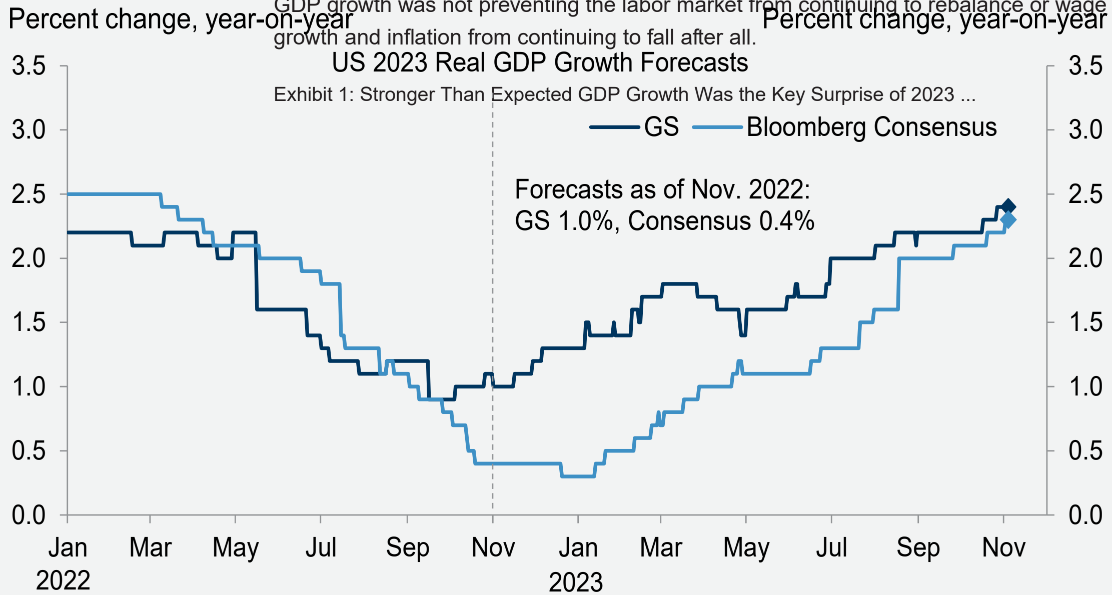
Economy: Crash Landing or Controlled Descent

Entering 2023, the consensus among economists was that the Federal Reserve's aggressive campaign to curb inflation would steer the US economy towards a significant deceleration, potentially culminating in a recession in the latter half of the year. Contrary to these forecasts, the economy didn't miss a beat, achieving growth above expectations as the year concluded. This led investors and economists to reassess their outlooks for 2024, balancing persistent concerns of a slowdown against new factors, such as the peak of global inflation, the government's fiscal policy, the culmination of the Federal Reserve's rate hikes, and a wealth of fresh economic data to inform future projections. The question shifts from whether growth will decelerate from its 2023 trajectory to whether the expected slowdown will result in a crash or a controlled descent.

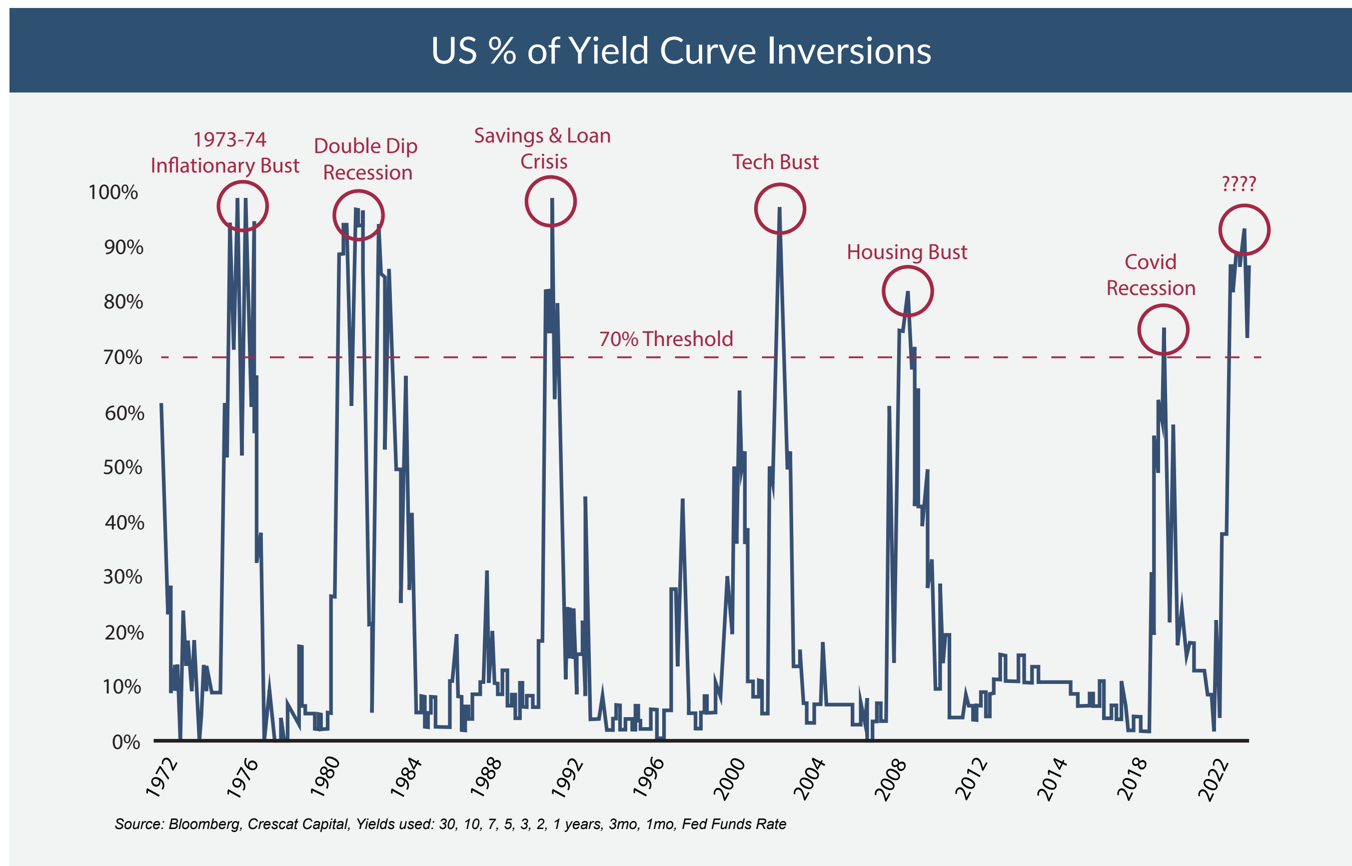
Consensus Forecasts Were Wrong, Moving Them Up All Year



Source: Goldman Sachs, Bloomberg

In 2024, the discussion persists, with evidence underpinning both possible scenarios. Many anticipate a notable deceleration in the US economic growth from its 2023 pace, faltering under the lagged effects of the Federal Reserve's tight monetary policy and an exhausted consumer, possibly leading to a mild recession by year-end.

As written in last year's outlook, the inversion of the yield curve—where short-term treasury yields surpass those of long-term rates—remains a critical indicator of potential future banking distress that affects the economy. The depression of the longer-term rates indicates concerns about both economic stability and fiscal health in the years to come. Historically, this phenomenon has preceded every recession since 1950, with only two exceptions. Although an initial inversion signals caution, recession risk is highest when this discrepancy starts to correct itself, and the curve begins to re-steepen. The recent peak inversion and its reversal align with historical patterns, suggesting heightened recession risks.



Source: Bloomberg, Crescat Capital, Yields used: 30, 10, 7, 5, 3, 2, 1 years, 3mo, 1mo, Fed Funds Rate

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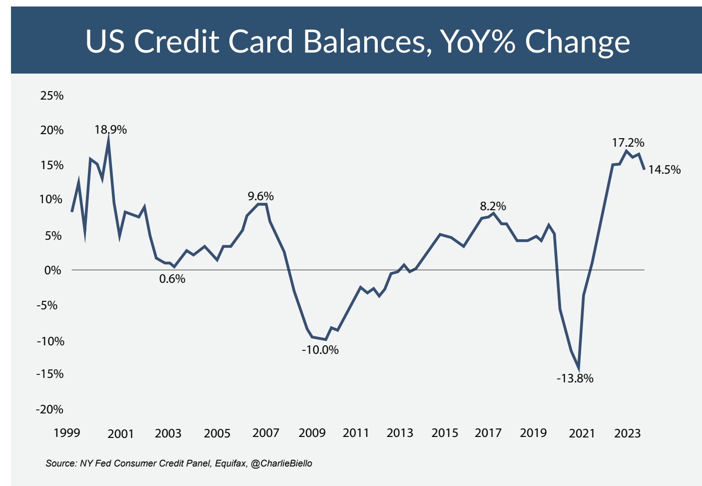
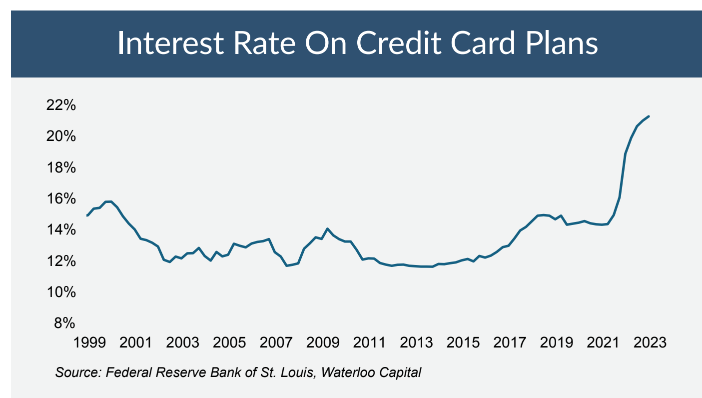
The robustness of the American consumer, which comprises nearly two-thirds of the country's economic activity, was a key factor in last year's strength. Nevertheless, emerging signs suggest potential challenges on the horizon. Employment drives consumption, so the status and evolution of the labor market provides a key input into the direction of the consumer. Despite a strong job market at the surface level, recent data indicates some slowing momentum. The rate of job creation in the private sector is slowing down, indicated by a decrease in hiring activities. This trend is reflected in the gradual rise of the unemployment rate from its April low of 3.4% to a recent high of 3.8%. If we see the labor market continue to deteriorate, the breakdown scenario for the economy becomes much more likely.





Additional evidence suggests that the financial security of households is softening in such a way that consumption will be increasingly burdensome moving forward. One key indicator is credit card balances which are rising at rates not seen in decades. This, and other data on savings rates, indicates that Americans are depleting their savings accumulated during the Covid pandemic era. Consumers who are less well-off are increasingly relying on debt to sustain their lifestyle. Not only are the balances themselves rising but as are the interest costs associated with them. The cost of debt has surged with the era of near-zero baseline interest rates behind us, illustrated by the spike in average credit card interest rates over the past two years. This suggests that a larger share of consumer income is being allocated to debt repayment which should impact retail sales and lead to an economic downturn if delinquency rates rise more.

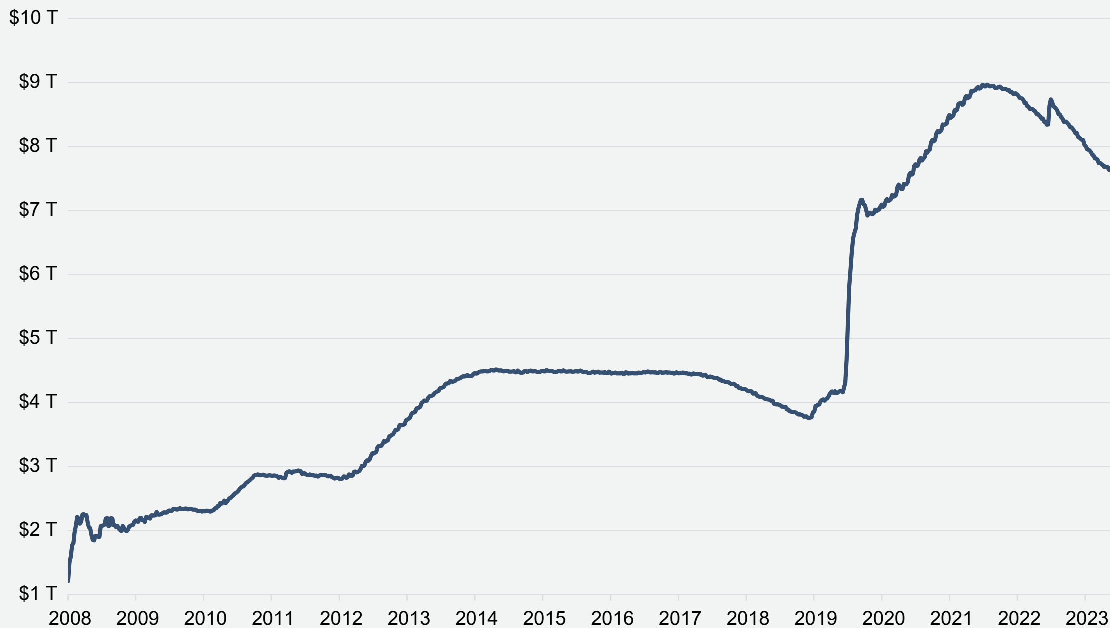
Yet, there is other data, clustered in the services side of the U.S. economy, indicating it will experience a slowdown from the surprising pace witnessed last year without entering a recession. Many are referring to this as a "soft landing." Credit spreads, another good barometer for perceived levels of overall economic risk, remain low. Advocates of the soft-landing scenario also point to a relaxing, but resilient labor market that could loosen sustainably without significantly impacting unemployment. As pointed to previously, employment and income are key drivers for the sustainability of American's impulse to consume and if these factors can hold steady to produce a muted but similar effect as in 2023, there is a material chance the economy extends its resilience and avoids deteriorating into larger recession.

For 2024, we anticipate a moderation in growth of the US economy, though the ultimate severity of which remains uncertain. With the Federal Reserve's rate hiking cycle likely behind us, the strength of the consumer will be paramount in determining whether the economy can avoid a recession. If the labor market and consumer spending can hold their resolve as inflation eases, we can land without crashing. Yet, that is a delicate and difficult balance that has historically been hard to achieve.

Fed's Game of Tug of War

It's easy to forget that the Fed was holding its policy rates near 0% as recently as Q1 2022 while simultaneously purchasing billions of dollars of bonds every month, in a program known as Quantitative Easing (QE). This happened during the highest inflation levels in a half century. However, as it became evident that the inflationary pressures were more enduring than anticipated, the Fed shifted gears dramatically. In a little over a year, reacting belatedly, it escalated its policy interest rate from virtually zero to upwards of 5% and commenced Quantitative Tightening (QT). QT is a monetary policy strategy used by central banks to reverse QE and reduce the supply of money and credit in the financial system by selling assets previously acquired. QT aims to control inflation by restricting the economy and so far, the Fed has shrunk its balance sheet by $1.3T since the start of QT in June 2022. The execution of these policies instigated a disinflationary trend, one in which the pace of prices increases slows but price levels themselves have not returned to previously prevailing levels. The goal of Fed policy was to hike interest rates to cool down inflation while faced with a robust economy and low unemployment.

The Fed Has Been Reducing the Size of Their Balance Sheet



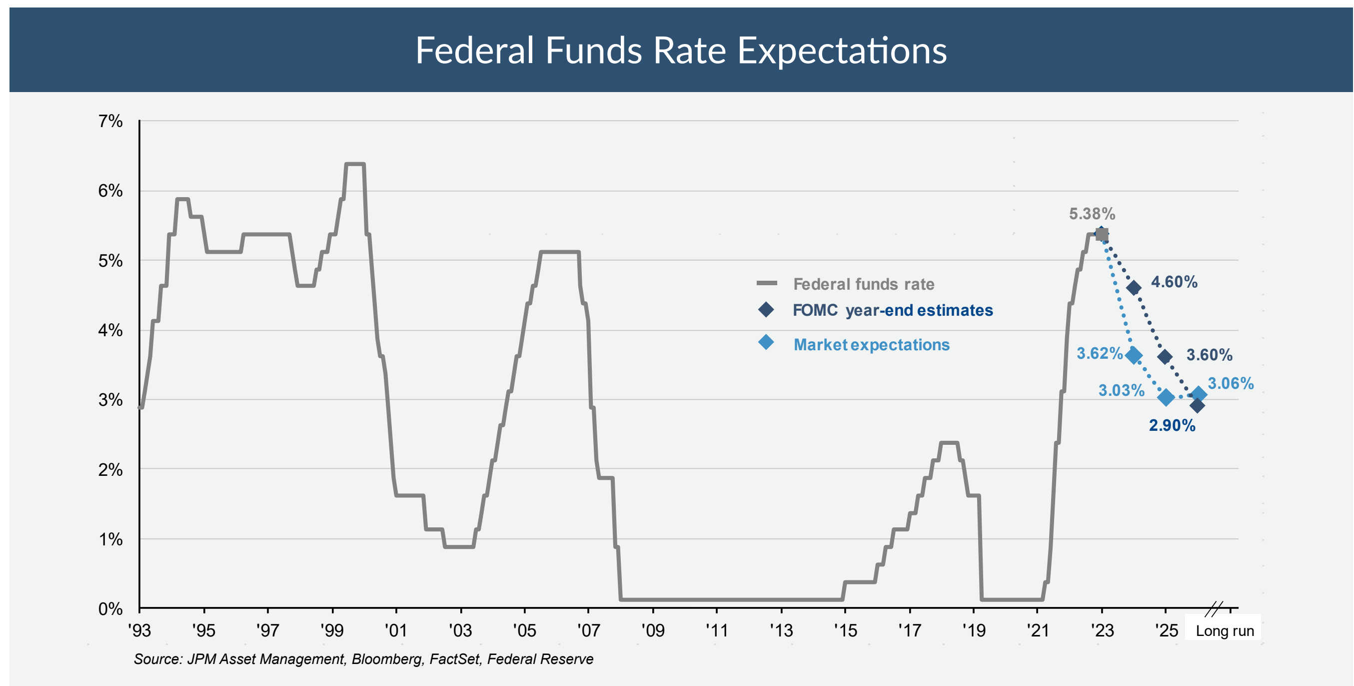
Source: Bloomberg, Waterloo Capital

Amidst a backdrop of historically low unemployment rates and ongoing disinflationary trends, the Federal Reserve opted for a strategic pause in rate hikes during mid-summer 2023. Transitioning into 2024, Jerome Powell and the Federal Reserve began hinting at the impending conclusion of their monetary tightening phase. This suggestion sparked optimism among investors, leading to a fervent risk-on rally in asset markets starting in October, despite the Fed merely pausing rate hikes without initiating any reductions. In a post-December Fed Meeting Q&A session, Chair Jerome Powell hinted at the possibility of the Fed reducing interest rates up to three times in 2024 and Fed projections then confirmed this. This quickly fueled market speculation, with investors betting on rate cuts potentially exceeding double Powell's indicated number, reflecting heightened anticipation for looser monetary policy.

We believe markets overpriced the number of Fed interest rate cuts for 2024.

So far inflation has come down from extremely high levels, yet it has since plateaued around 3% since June 2023 according to the Consumer Price Index (CPI). Reaching the Fed's 2% inflation target—a level at which Fed officials unanimously agree they'd be comfortable reducing rates—is turning out to be more challenging than both the Fed and markets initially anticipated. We believe, given the amount of upside surprises in economic data, and with inflation remaining sticky due to the excess in the large services sector in the U.S. economy, markets overpriced the number of Fed interest rate cuts for 2024. This assessment is grounded in the persistence of inflation, particularly influenced by a stronger than expected service sector, coupled with a resilient labor market and record issuance of government debt. While the prospect of significant rate cuts seems less plausible with inflation persistently above 3% and a strong labor force, we also view a rate hike as unlikely in the near term, considering the delayed effects of monetary policy adjustments. Furthermore, considering current market pricing, we raise the question: if there are expectations for numerous rate cuts throughout 2024 amid the economy showing such resilience, what is the reason?

Federal Funds Rate Expectations



Source: JPM Asset Management, Bloomberg, FactSet, Federal Reserve

There is a complex interplay between Fed policy, market expectations, and economic data. A nuanced approach involves the potential pricing in of downside risks to the economy that the futures market seems to see on the horizon. Equity markets have rallied this year with the idea that there is a light at the end of the tunnel in potential rate cuts. However, that light could be an oncoming train of slower economic and earnings growth. History shows that markets do not react bullishly to the actual initial rate cuts. As mentioned earlier, Fed tightening is a very lagged effect so the effects of tightening monetary policy are never immediately evident. The Fed and investors must remain vigilant for signs of strength or weakness in the service economy, the ultimate arbitrator of further disinflation and Fed easing.

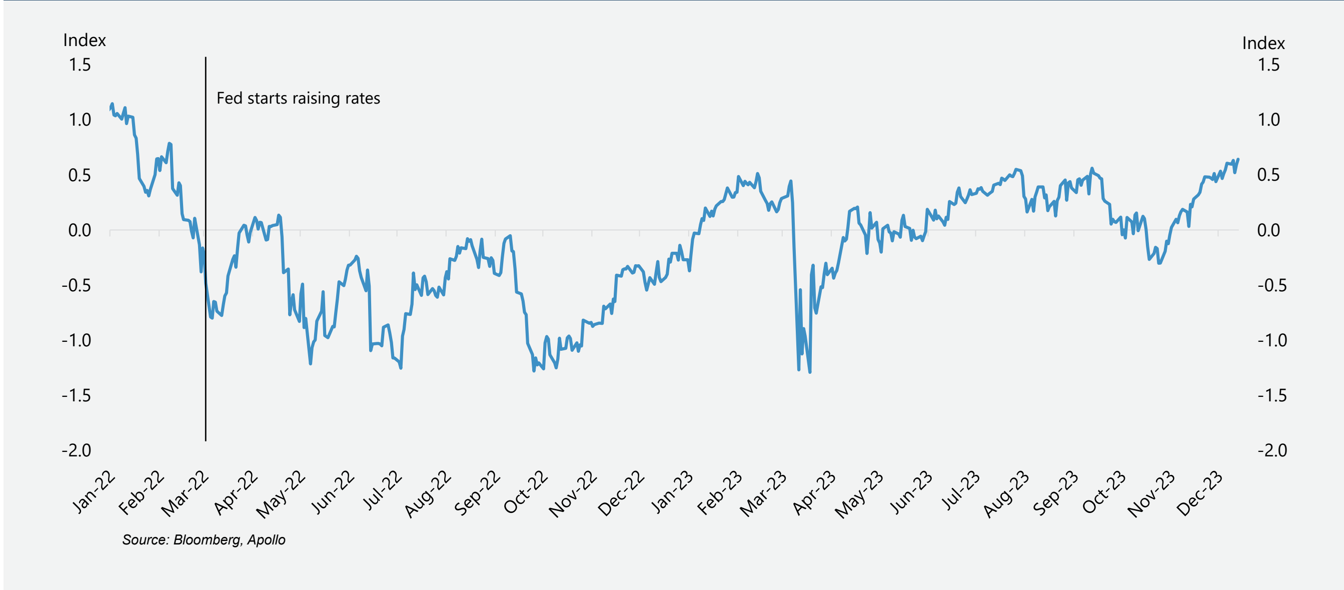
When the Fed Pivots, Stocks Decline by More

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

Source: Nick Gerli/Reventure Consulting

Until then, although we are acutely aware of potential downside risks in the future, we believe the Fed will have a more hawkish than expected stance despite their dovish rhetoric. One reason could be the presence of loose credit market conditions and strong consumer behavior, signaling that easy financial conditions have been prevalent recently despite the implementation of tight monetary policy. Fiscal stimulus programs started during the pandemic have helped mute the impact of tighter policy and likely extended the lag previously talked about. This discrepancy between the Fed's tightening efforts and ongoing loose financial conditions is a complicated topic that investors and Fed policymakers are carefully pondering. If easy financial conditions fuel continued strong demand, it could make it harder for the Fed to control inflation, potentially leading to even higher interest rates in the future. The fear of reigniting inflation trends implies that the Fed won't jump the gun on cuts just because of one inflation print or soft employment numbers.

Financial Conditions are Easier than when the Fed Started Hiking



Source: Bloomberg, Apollo

We believe that the Fed is stuck in a monetary tug of war with the economy, leading to a situation where they risk being overly reactive in policy decisions. Moving too early to loosen monetary policy could cause a reacceleration in inflation dynamics while waiting for the lag to show up definitively in the data might be too late. While there is a possibility of achieving a soft economic landing in the near term, various factors loom that could precipitate a more severe downturn later. This is why we are cognizant of market pricing and believe in the potential that the easiness of financial conditions can wear off, especially if the brunt of monetary policy has a longer than usual lag. In 2024 and into 2025, this scenario can put a "hard landing" or recession on the table, in which case the Fed would be forced to not cut one or two times but cut aggressively to prevent a larger economic slowdown.

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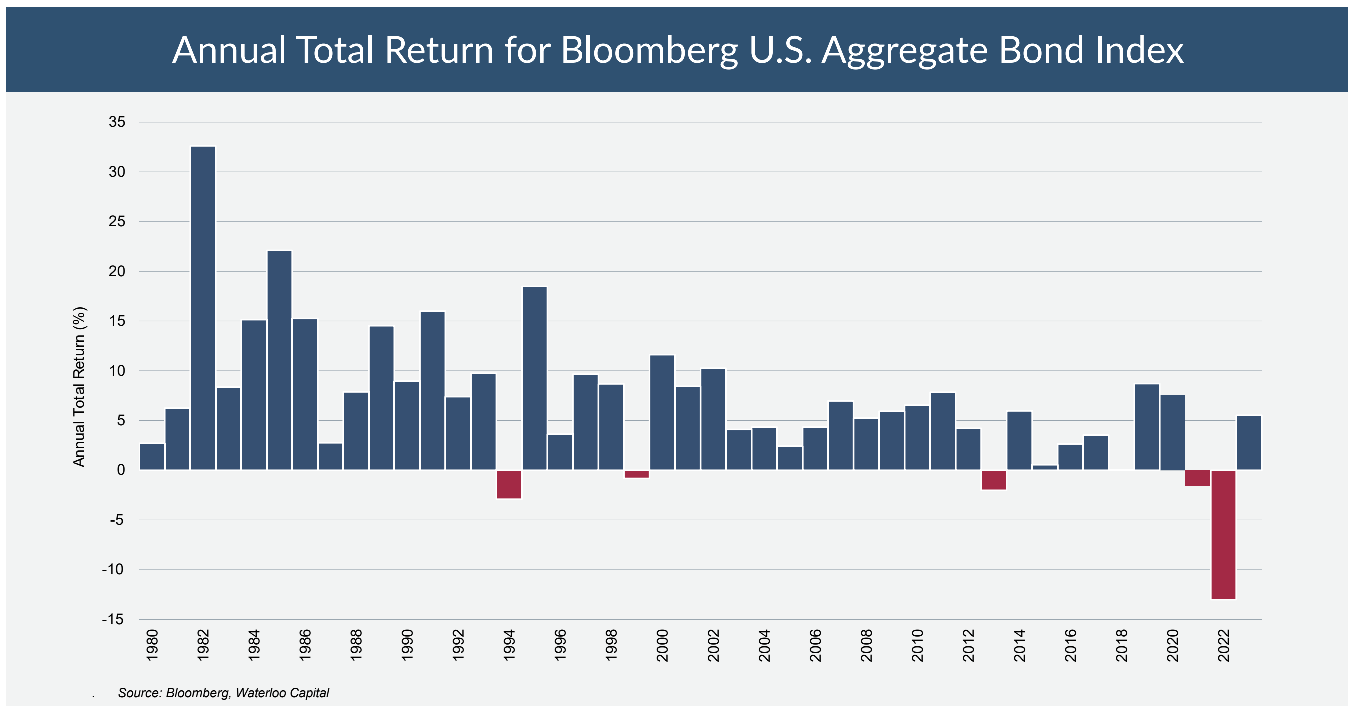
Fixed Income – Rangebound and Down

In recent years, the appeal of fixed income investments has diminished across investment portfolios, overshadowed by the allure of riskier assets such as equities. This trend stems from an extended period of low-interest policies elevating bond prices to unprecedented heights. Consequently, we've previously labeled this asset class as offering "return-free risk." This scenario has ignited a relentless search for higher yields, leading investors to gravitate towards riskier assets which, despite their inflated valuations, appeared more enticing than the increasingly unattractive bonds. This investment landscape, shaped by the anticipation of enduring low rates boosting the attractiveness and expected returns of equities, is encapsulated by the acronym TINA, signifying "There Is No Alternative."

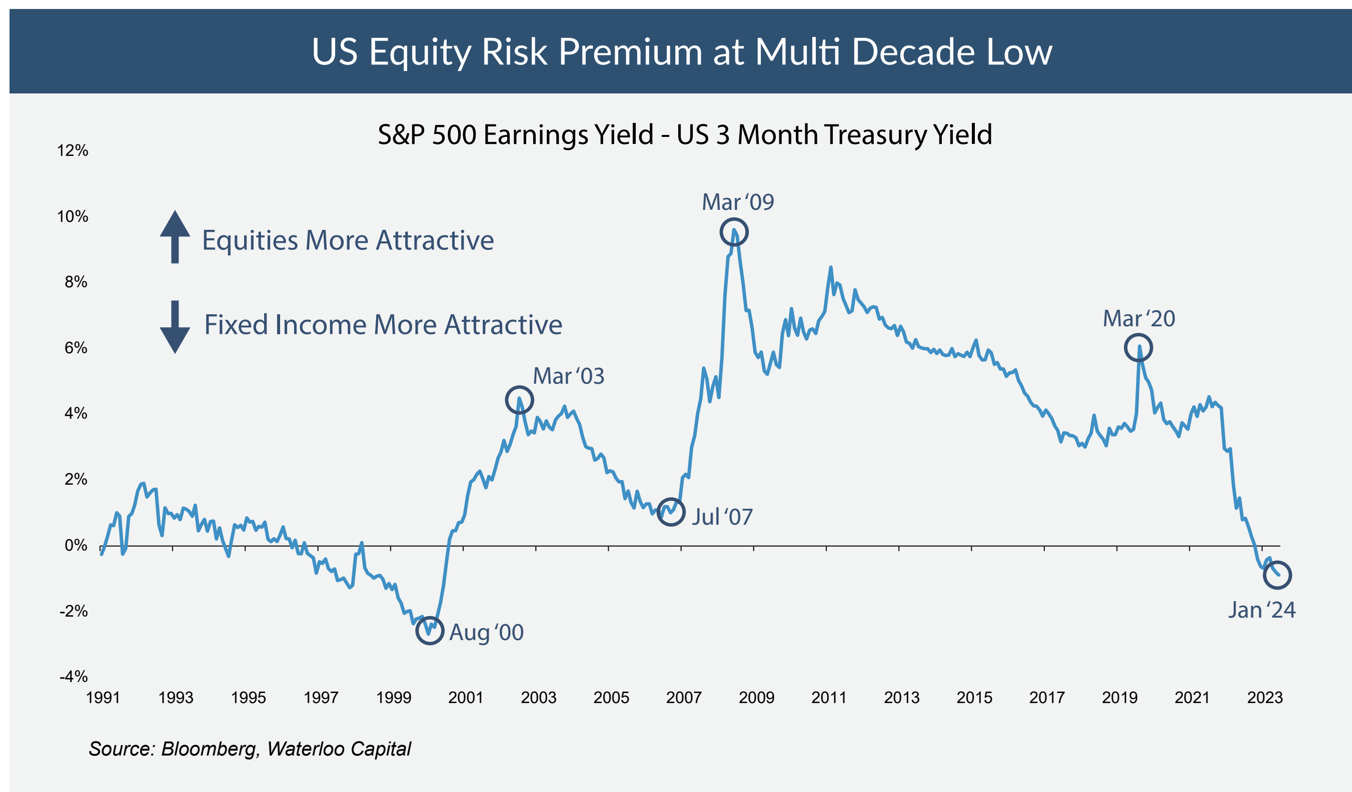
In our "Return to Gravity" outlook, we introduced "There Are Reasonable Alternatives" or TARA for equities. This highlighted an incrementally more appealing fixed income sector, albeit with challenges to overcome. Throughout much of the previous year, our strategy emphasized an overweight position in short-duration or less interest rate sensitive instruments in anticipation of a slowdown in economic growth. Contrary to our expectations, 2023 unfolded with continual positive economic surprises, driving yields higher. Given the current landscape, especially the positioning of the Treasury curve, allocations to fixed income investments now demand greater consideration. Looking ahead, with slower growth on the horizon and bonds providing tangible returns, the downside risk associated with fixed income appears more limited. The reasonable alternative is becoming more reasonable.



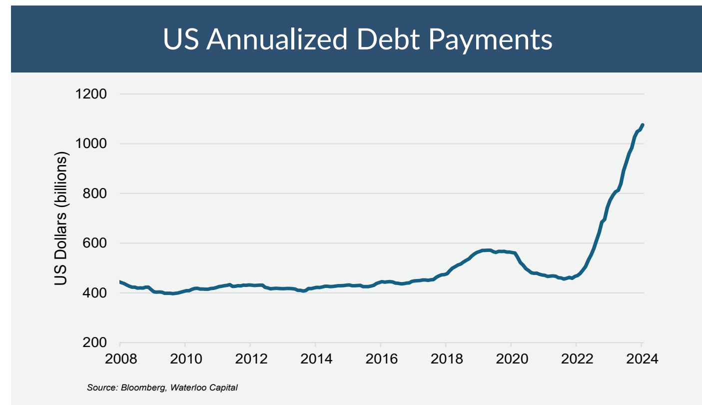
The reasonable alternative is becoming more reasonable.

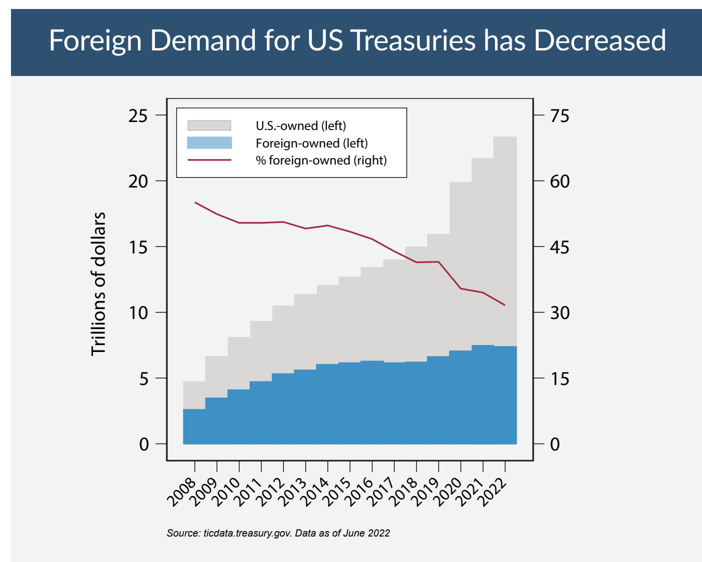
Utilizing relative value metrics, the attractiveness of fixed income to equities has reached levels not seen for decades. Shown below is the historical and current status of the equity risk premium, which provides a gauge for expected excess return for stocks over bonds. The relationship has compressed significantly as rising yields have elevated the go-forward return potential of bonds. Put simply, current interest rate levels provide a case that more consideration should now be given to fixed income securities in a portfolio's allocation. In addition to this relative value case, coupon rates in the market now allow investors reasonable levels of income without stepping out further along the risk curve.

The possibility exists for potential economic weakness to instigate a material decline in market rates and therefore a much more bullish market for bonds. As discussed in the "Crash Landing or Controlled Descent" theme of this outlook, the economy has continued to show its resilience to this point. However, the possibility of emerging vulnerabilities suggests that a downturn in labor and consumer data could lead to a more pronounced economic decline than anticipated. Should this situation unfold, it's probable that the Federal Reserve would intervene with accommodative policy action, driving yields lower and elevating bond prices.



However, challenges that were not surmounted in 2023 lie ahead. Without considering all options, blindly extending duration in portfolios will not be a prudent strategy. The main concern is a variety of factors exerting upward pressure on market yields across both short and long-term horizons. Specifically, as discussed regarding the Federal Reserve, Jerome Powell and Co. are navigating a delicate balancing act with policy decisions. They must ensure inflation is thoroughly tamed before easing monetary policy, yet avoiding restrictive measures that stunt economic growth. Despite some indications of a willingness to cut rates proactively, stickier inflation and the upside risk for growth to outperform expectations will necessitate a cautious approach, resulting in a longer period of elevated rates. This "higher for longer" scenario is likely to prompt market participants to adjust their expectations for future yields upwards in the near term.





Over the secular horizon, various factors, including changing demographics and entitlements, defense spending, and new policy initiatives, are likely to escalate the government's funding needs when they are already stretched. Financing these activities through increased issuance of treasury bonds will accelerate the pace of new supply, consequently not allowing yields to fall as much as in previous cycles. Concurrently, the balance between supply and demand in the treasury market could be disrupted by a diminishing appetite for US bonds among international investors. Should this trend of key global purchasers reducing their treasury investments, the pressure on interest rates to rise may intensify. Signs of this shift have already emerged, as evidenced by a significant decline in the proportion of treasury debt owned by foreign entities such as China and Japan over the past decade.

Fixed income has been reestablished as a viable component of an investor's portfolio, thanks to its relative valuation profile and the resurgence of income generation. In the current landscape, bonds can serve as a potential hedge against a downside economic shock, where aggressive rate cuts by the Federal Reserve could spur a rally in the bond market. Nonetheless, we believe it's premature to pile into longer-duration assets, as the current dynamics suggest a rangebound, volatile yield landscape with upside risks aplenty. Fortunately, short duration assets offer reasonable yields, providing a safe harbor until the market conditions become more favorable for longer duration investments. At Waterloo, we are poised to explore extending duration later this year, should more positive shifts for the asset class emerge.

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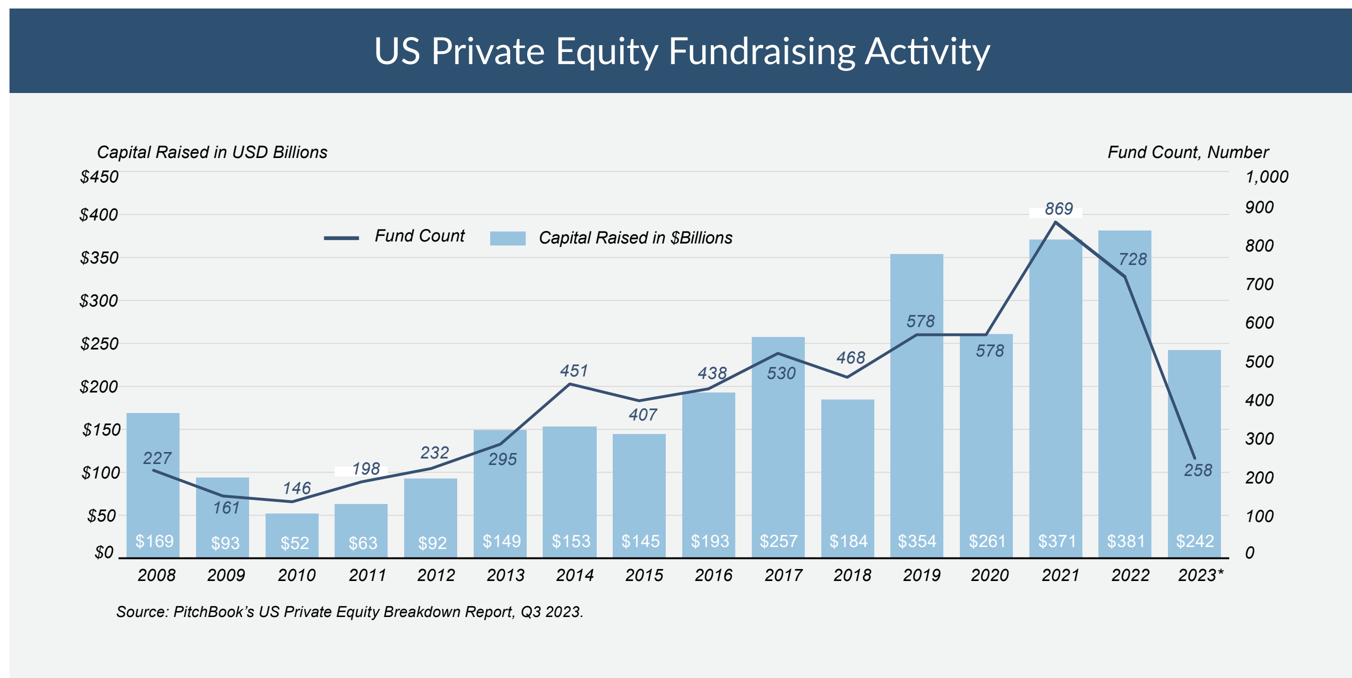
Alternatives: The Art of Portage

2023 was a tough year for Real Estate as interest rates stayed elevated and regional banks pulled back from lending, limiting access to traditional credit sources and increasing the cost of capital for borrowers. Regional banks shifted their focus to maintaining existing portfolios versus originating new loans which led to appealing risk return profiles for real estate lenders on assets with attractive risk profiles, indicated by collateral values and borrower risk.

Office still faces severe headwinds and is a sector that we feel still has farther to fall. Both owners and borrowers have incentives to extend and pretend that the loan is still at par rather than default on the loan. Loan defaults result in the equity being wiped out and the loan being marked down, hurting both parties. In addition, we do not believe the often-repeated high-level office to residential conversion thesis is practical for most office buildings for a magnitude of reasons. Unique real estate assets and ground up developments with experienced operators can offer attractive risk-adjusted returns. Forced sales or constraints outside of real estate provide opportunities for investors with capital. However, with interest rates at levels not seen in over a decade, the required return on all real estate assets and investments now has a much higher hurdle.

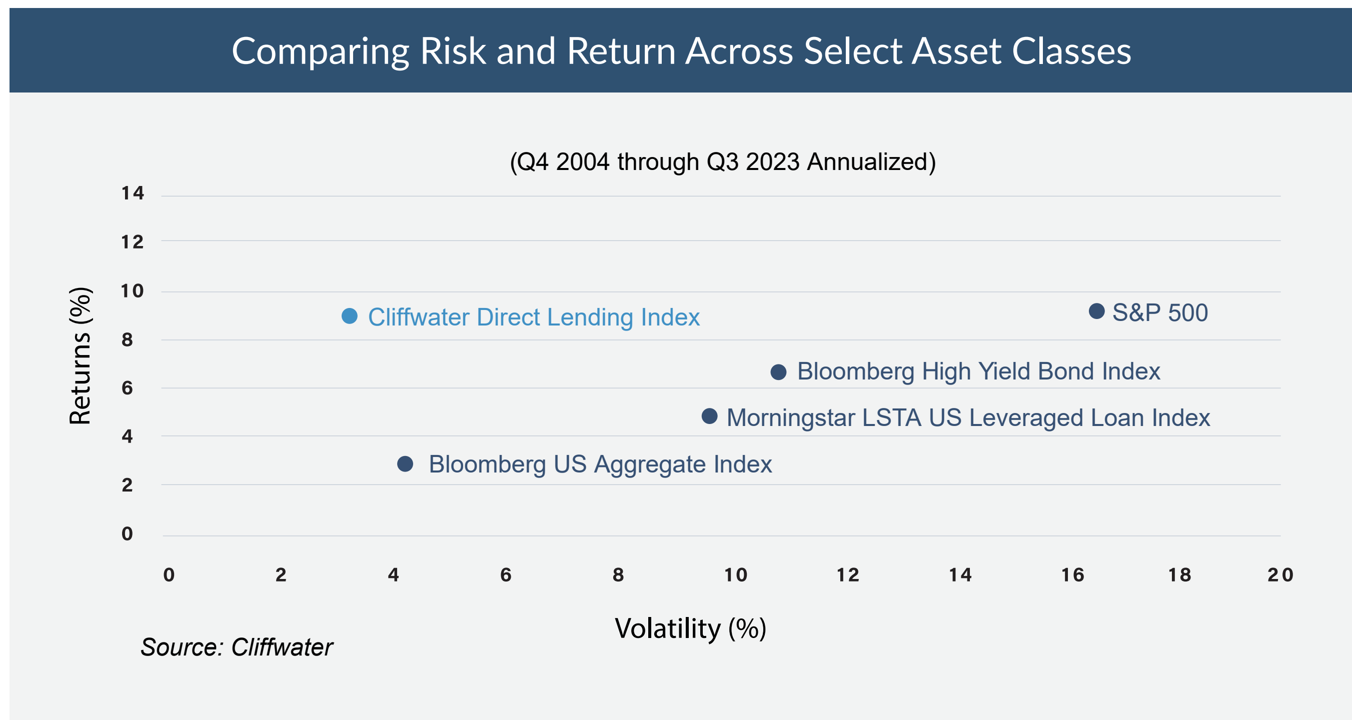
In Private Equity, a decade of rapid growth due to cheap capital and growing demand has caused challenges over the past 18 months. Starting in the second of half 2022, private equity exits via sales, IPOs, etc. slowed dramatically as the Fed embarked on its interest rate hiking cycle. The lack of exits caused a material reduction in distributions to investors, significantly affecting the fundraising ability of said investment managers as investors found themselves overallocated to private equity.



Source: PitchBook's US Private Equity Breakdown Report, Q3 2023.

This demand for liquidity has led to an increased spotlight on secondaries. The need for General Partners to provide liquidity from older vintages, so limited partners can recycle into new vintages, has led to increased deal activity and attractive discounts for managers with flexible time horizons. Looking forward over the next 12 months, we believe that private equity as an asset class will face headwinds as multiples remain compressed and the cost of capital remains elevated. That being said, Waterloo continues to find certain areas of private equity attractive such as secondaries, niche capacity constrained opportunities, and sector specialists. We believe that mega cap managers raising $10-$20B+ funds will face difficulties generating attractive risk adjusted returns when compared with the previous decade.

Private credit was the soup de jour in 2023. With treasury rates above 5% for the first time in over a decade, the higher yields became attractive to many investors. As we enter the later stages of this business cycle, it is important as a credit investor to focus on downside protection and locating sustainable yields. With the Cliffwater Direct Lending Index now yielding 11 – 12%, and the economy beginning to show warning signs of potential deterioration, Waterloo is focused on preserving capital over chasing the highest yields.



Banks are focused on maintenance of their existing loans portfolios, yet companies are increasingly needing to refinance their debt obligations. The lack of capital from traditional sources provides an opportunity for private credit managers to pursue attractive deal terms. We believe that attractive areas of private credit include senior secured asset-based lenders generating high risk adjusted returns or senior lenders that provide a value add beyond the capital allowing them to charge a premium, often equity upside. For the borrower, this value-add capital is expensive relative to bank financing but gives them a partner and is still cheaper than giving up equity in the business at a time when valuations are unfavorable. Given the robust growth of private credit over the last decade, investors should be cautious about the potential hidden risks within the sector. We believe in managing that risk by offering private credit portfolios diversified across geography, asset class, lending type, and manager.

Waterloo is also evaluating attractive special situations investment opportunities. This segment includes unique niche asset classes such as litigation finance and life settlements. Given the distinct nature of these investments, it's possible to find investment managers producing high risk adjusted returns with relatively low correlations to parts of a diversified portfolio. By focusing on investment managers that have constrained capacity for investment, are specialists in their respective sectors, and retain competitive advantages, allocations to this area can provide alpha and diversification to investor portfolios.

After a strong 2023 in which bitcoin rallied 160% from ~$16K to $25.6K, the SEC finally approved a Bitcoin ETF in January 2024. The same dynamic appears to be on the horizon for Ethereum ETFs to be approved in May which will allow increased flows into the second largest cryptocurrency. It is important to note that the CFTC considers both bitcoin and ether to be commodities. As with any new industry or emerging technology, there will be intense volatility and potential black swan events. However, given these technical dynamics, we expect 2024 to be a year of continued crypto adoption as supply remains steady and new demand avenues continue to emerge such as ETFs.

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