Domestic Equities

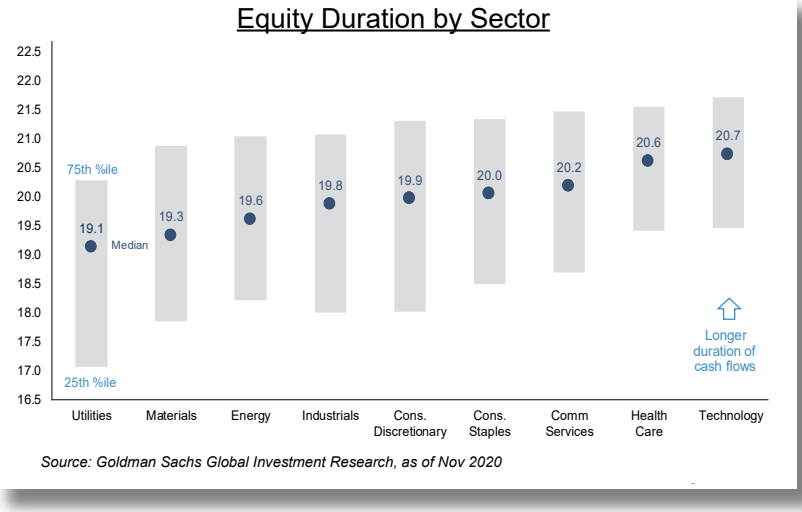
Quicktake: **The early cycle snapback from pandemic lows could be nearing an end as the economy moves into the mid- to late-cycle phases of the market cycle. The back end of market cycles are characterized by weaker breadth and higher volatility. In this environment, tactical allocations and security selection will be more important to improving outcomes than passive index exposure. The TINA environment is still intact, but inflation and rising interest rates pose significant risks to market valuations. With valuations offering little appeal, earnings growth will determine the path of where the markets head in 2022. Favor value and growth at a reasonable price over high-octane, high-multiple growth. Tactical strategies will be a key component of domestic equity exposure and will perform well during periods of volatility and internal rotations. Ultimately, valuations, moderating economic growth, and multiple contraction will bring expected returns back in line with historical mid-single digit levels.**

In 2021 US equity markets performed better than expected. Headline indices hit record highs propped up by positive sentiment and a mix of record profit growth, vast amounts of fiscal and monetary liquidity, and a stronger consumer. The culmination of these factors pulled forward business and consumer demand which provided massive tailwinds for markets and pushed prices and valuations to near record levels. While the economic backdrop has been strong, we believe that in markets, where you start from still matters. To begin 2022, nearly every traditional financial metric suggests that domestic equity markets are expensive relative to history. We believe the early market cycle snapback from the pandemic could be nearing an end as we move into the mid- to late-cycle of the market cycle. This transition will shift the economy away from policy-fueled growth levels and back towards normal historical growth rates. While valuations do tend to dictate long term results, narratives and psychology can often have greater influence over short term market action. Mid- to late-cycle markets are characterized by weaker breadth and higher volatility. This year we believe investors will need to retool their investment portfolios away from purely passive index exposure and lean on more tactical security selection to find prospective leaders and investment success.

The pendulum shift from the Fed in response to higher inflation will continue to test expensive market valuations. The vast amount of liquidity provided by the Federal Reserve and government has certainly helped drive markets to all-time highs, but it has also created fragility by disrupting traditional asset pricing formulas. Stocks are long duration assets, and interest rates have a strong influence on how these assets are valued. Rising interest rates are the top risk for valuations this year. If interest rates rise consistently, a higher discount rate will cause markets to reset at lower stock valuations. The rate of change in yields will likely matter more than the absolute level. Faster tightening brings valuation risk forward and increases the potential for valuation adjustments to overshoot to the downside. We have already started seeing this play out among many of the high-flying growth names coming out the pandemic. Tactically, underweighting positions with longer duration and being more comfortable taking exposure as a trade rather than a long-term buy-and-hold will be key this year.

RISING INTEREST RATES ARE THE TOP RISK TO MARKET VALUATIONS THIS YEAR

Growth oriented sectors have the longest durations



Relatively speaking we believe equities are a more constructive asset class than fixed income. The TINA ("There Is No Alternative") environment, although weakening, is still intact with interest rates near historically lows and earnings growth near historically highs. Going into 2022 the price to earnings (P/E) ratio was over 20x. When applying the same price to earnings methodology to bonds we see why stocks remain relatively attractive despite higher valuations. You would need to buy a bond yielding around 5% to achieve an 20x P/E ratio and match the value you gain for each dollar you invest in the stock market. Considering the longest maturity treasury yield, the US 30-year, was only yielding 2% at the end of the year, yields would need to dramatically increase to start making bonds look more attractive on a relative valuation basis. Other measures such as Shiller's excess CAPE yield also show that equities are attractively priced relative to their long-term average excess yield of 2.6% over bonds. Long-term valuation data on many of these models, however, may be biased due to periods of low and stable inflation which was the norm for many decades. If cost and inflation trends from 2021 persist, equities valuations could become less attractive, further increasing the probability of margin compression and downside price movements.

Valuations are high for both stocks and bonds, but on a relative basis stocks are still more attractive

Stocks, Bonds and the P/E Ratio

Stocks at current P/E levels	→	$\frac{\$100}{\$5.00}$	=	20 P/E	Stocks are trading above their long-run average valuation...
Bonds Assuming a 2.0% Yield	→	$\frac{\$100}{\$2.00}$	=	50 P/E	... but at low interest rate levels equities still look attractive compared to bonds

The P/E ratio of the S&P 500 was around 20x at the end of 2021. This tells us that investors were willing to pay $20 for every $1 in expected S&P 500 earnings they would get back. A quick rearranging of the P/E formula shows this would indicate an "earnings yield" of about $5.00.

Applying the same process to bonds, we can take the 30-Year Treasury yield of 2.0% and calculate a P/E ratio of 50x.

Source: Waterloo Capital

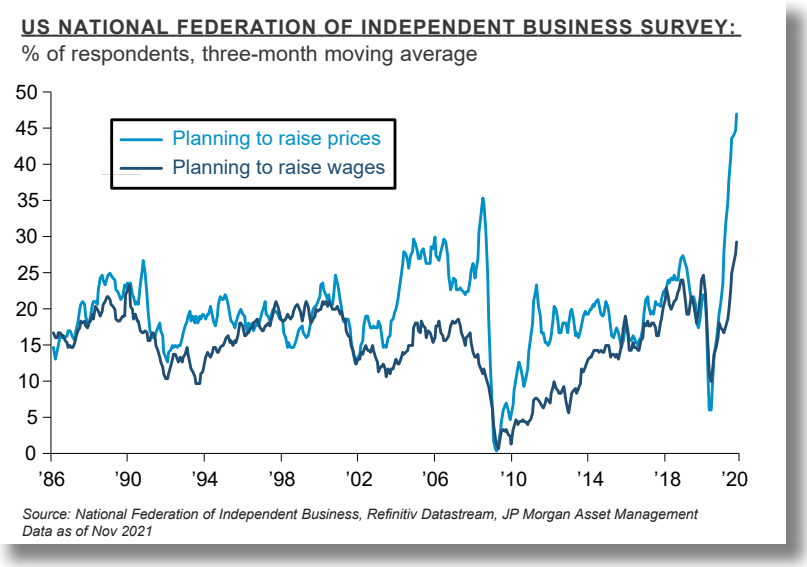
An equity's total return is made up of 3 main parts: earnings growth, changes in the level of the price to earnings ratio, and dividend yield. Last year even as price to earnings (P/E) ratios fell, the surge in earnings drove outsized returns. This year, we will likely see modest downward pressure on P/E ratios given higher risk premiums and the potential rise in interest rates as discussed above. Since the dividend yield of the index is largely unchanged, earnings growth will determine the path for where markets head in 2022.

Valuations are facing headwinds which means earnings growth will be key to improving total returns

Source: Waterloo Capital

We expect solid earnings growth in 2022 as a result of durable consumer balance sheets and near-term economic momentum, but the growth rates of last year will moderate from elevated levels. So far, rising profit margins have protected stocks from rising inflation and interest rates. Many corporations have been able to either pass higher costs on to their customers or find efficiency gains in their production processes. This year, companies will likely enjoy above average revenue growth, but earnings could be squeezed if factors such as higher input costs, wage increases, and supply chain bottlenecks continue. The impact these issues have on companies' profit margins will be felt unequally among sectors and individual names. Cyclical companies have a higher sensitivity to profit margin compression compared to defensives, and watching how the economic growth outlook progresses will be key for differentiating winners and losers. Ultimately, earnings are likely to remain elevated compared to historical averages, but given the market's forward-looking nature we expect earnings misses and lowered forecasts to be punished more severely as many names may be priced to perfection heading into reporting.

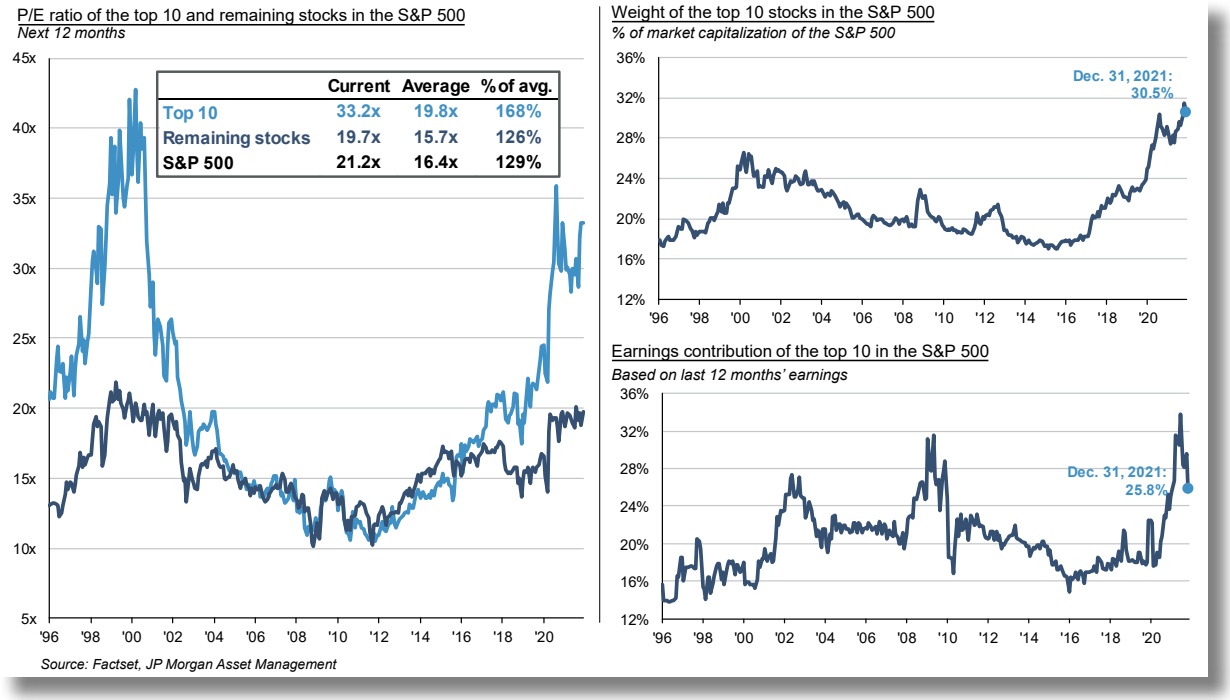
Businesses have been able to pass higher costs on to customers which has kept high profit margins intact



Source: National Federation of Independent Business, Refinitiv Datastream, JP Morgan Asset Management
Data as of Nov 2021

While we remain constructive on the outlook for US equities, we acknowledge that downside risks have been building. High index prices, questions regarding what Fed policy will look like, and the influences of external risks from geopolitical developments are likely to stir up volatility this year. As markets have been increasingly influenced by factors and sentiment rather than fundamentals, price reactions to both the positive and negative side will likely be more aggressive. Given the outsized weight of a handful of stocks on the index, we also believe market concentration risk is elevated going into the new year. The top names; Apple, Google, Facebook, Netflix, Amazon, Nvidia, and Tesla, account for nearly 30% of the S&P 500 capitalization. Early in 2021, the other 493 names in the index had strong returns as the rebound off the pandemic fueled an everything rally. As we moved into the latter half of the year, the top mega cap names began to mask damage beneath the surface. If these large names lose their dominant strength it would put downward pressure on the entire index. If economic and earnings growth expectations begin to fade the new mantra may become sell-the-rip rather than buy the dip.

A handful of stocks have an outsized impact on the index



We favor value over growth, short duration over long, and recommend focusing on high quality names growing at a reasonable price, not any price. Our upgrade of the quality factor means that we favor large cap equity exposure over small caps which tend to have higher debt exposure and weaker balance sheets. Growth at a reasonable price (GARP) factors such as lower price to sales (P/S), price to book (P/B), and price to earnings growth (PEG) help determine whether a company is priced attractively relative revenue and earnings growth. Many cyclical and value companies exhibit these trends, and we expect value to continue gaining relative strength versus growth this year. However, new variants and fears of economic disruption weighed on the value factor. Pure cyclical value names which are especially sensitive to the economy typically outperform during periods of consistent above trend economic growth, but given we are dusting off the mid- to late-cycle playbook we favor more defensively oriented value names. This does not mean that investors should completely abandon growth. Growth will still need to be owned to take advantage of long-term structural and secular

trends. Investors, though, should be prepared to be more defensive in growth allocations and be wary of names trading at high valuations with excessive price to sales ratios and low cash flows.

Finally, we expect domestic markets will be characterized by heightened volatility and returns will be harder to find than in years past. 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. We believe these opportunities will be more frequent due to heightened volatility and the lack of better alternatives to investing in stocks. Additionally, we think that investors can benefit from holding a higher allocation in cash or short-term bond alternatives as "dry-powder" to take advantage of trading opportunities throughout the year.

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

S&P 500 Return Potential: Earnings Growth Will Be Key

EPS \ P/E	17X	18X	19X	20X	21X	22X	23X
0%	(25.2%)	(20.8%)	(16.4%)	(12.0%)	(7.6%)	(3.2%)	1.2%
3%	(22.9%)	(18.4%)	(13.9%)	(9.4%)	(4.8%)	(0.3%)	4.2%
6%	(20.7%)	(16.1%)	(11.4%)	(6.7%)	(2.1%)	2.6%	7.3%
9%	(18.5%)	(13.7%)	(8.9%)	(4.1%)	0.7%	5.6%	10.3%
12%	(16.2%)	(11.3%)	(6.4%)	(1.5%)	3.5%	8.4%	13.3%
15%	(14.0%)	(8.9%)	(3.9%)	1.2%	6.2%	11.3%	16.4%
18%	(11.8%)	(6.6%)	(1.4%)	3.8%	9.0%	14.2%	19.4%
21%	(9.5%)	(4.2%)	1.1%	6.5%	11.8%	17.1%	22.4%

Source: Waterloo Capital

TACTICAL INVESTING WILL PERFORM WELL IN AN ENVIRONMENT WHERE VOLATILITY IS MORE COMMON

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