

2019 OUTLOOK

Receding Tides



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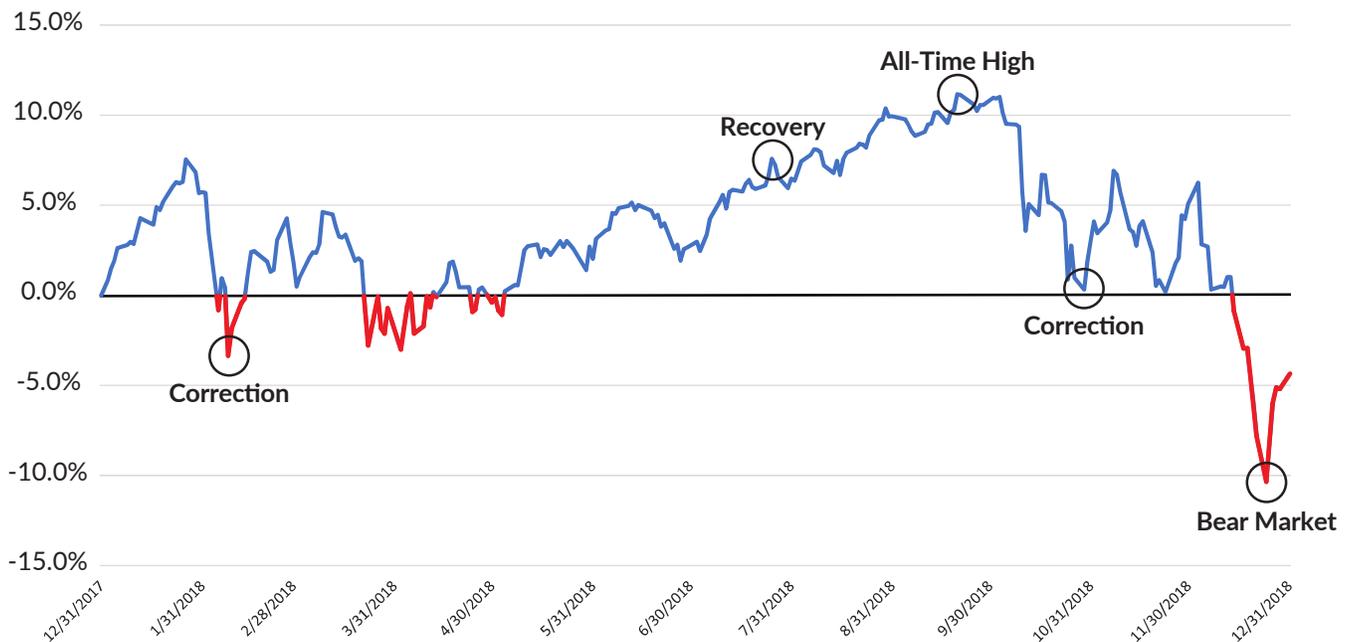
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It was the Best of Times, it was the Worst of Times

2018 was one of the most volatile years for the markets since the current rally began in 2009. The tug-of-war between buyers and sellers was driven by rapidly changing geopolitical, macroeconomic, and market environments. Investors began the year emboldened by US tax cuts and positive economic data. Confidence in the outlook for the US drove major indices to all-time highs in January. In February we saw the first example of how quickly market sentiment could shift. A positive jobs report roused fears that too much good economic data would lead to the Fed raising rates at a faster pace than expected. Investors feared that higher rates would create headwinds for growth and hasten the end of the economic expansion. The ensuing selloff incited an extreme spike in volatility, which fueled a deeper selloff and led to market correction with losses of more than 10% in equity markets.

Following the volatile start to the year, tariff talks between the Trump administration and China, combined with uncertainty regarding the Fed's rate hike path, put further downward pressure on the markets. Fears gave way to cheers during the second quarter as consecutive quarters of strong earnings helped boost the markets back to all-time highs in September. The break in volatility was to be short lived. Major indices rapidly fell into their second technical correction of the year in October. The decline was primarily driven by the perception of the Fed's insistent rate-hike plans and companies issuing lower than expected forward guidance for profits and earnings. Higher wage costs, increased materials costs due to tariffs, and a stronger US dollar were all cited as hurdles to future growth.

S&P 500 Total Returns



Source: Morningstar Direct, Standard & Poors, Waterloo Capital Management; A correction is a decline of 10% or more from a recent peak, a bear markets is a decline of 20% or more from a recent peak

Outlook 2019: 2018 Review

Heading into the fourth quarter, Fed Chairman Jerome Powell and President Trump seemed to be battling to see whose comments could cause bigger moves in the market. Investors were eager to buy stocks after President Trump touted the mid-term election results, better than expected trade regulations, and the potential for additional tax cuts in 2019. Chairman Powell then whipsawed the markets during two press conferences. First, his comments that the Fed was "a long way" from the neutral interest rate implied that more rate hikes were planned and sent the markets into a tailspin. At his next public appearance, Powell said that the Fed was "just below" its neutral rate and stocks posted one of their best days of the year. The degree to which the markets moved around headlines from political leaders and policy makers was a sign that investors were struggling to find and trust a market direction. Stocks went on to touch bear-market territory in December, falling 20% from recent highs, but closed just short of that psychological level. A rebound during the final trading days of the year eased the pain, but major indices couldn't make it back into positive territory. Overall, 2018 ended up being a year that over-promised and under-delivered. Major markets across the globe ended the year in the red and cash was the top performing major asset class.

2018 Asset Class Returns

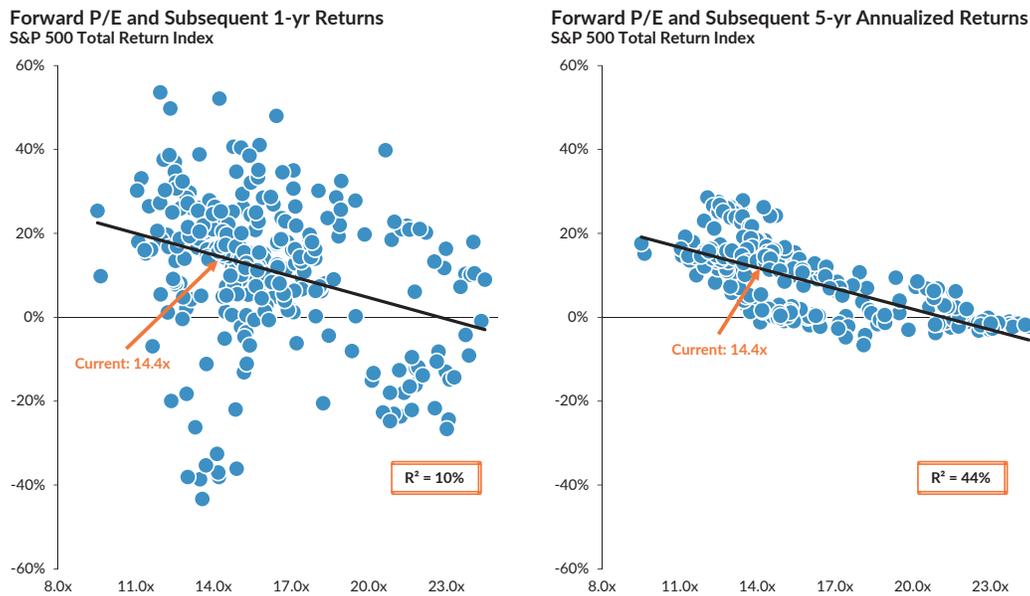


"2018 WAS A YEAR THAT OVER PROMISED AND UNDER DELIVERED."

Receding Tides

The end of 2018 was akin to hitting the reset button for the markets. Valuations have retreated to more attractive levels, investor expectations have pulled back from exuberant levels, and new factors are impacting returns and market leadership. Last year was a reminder that the current expansion is getting long in the tooth and that having an eye on the horizon and a dynamic allocation strategy is essential for investing in a late cycle environment.

Year End Valuations Indicate Higher Long-Term Return Potential

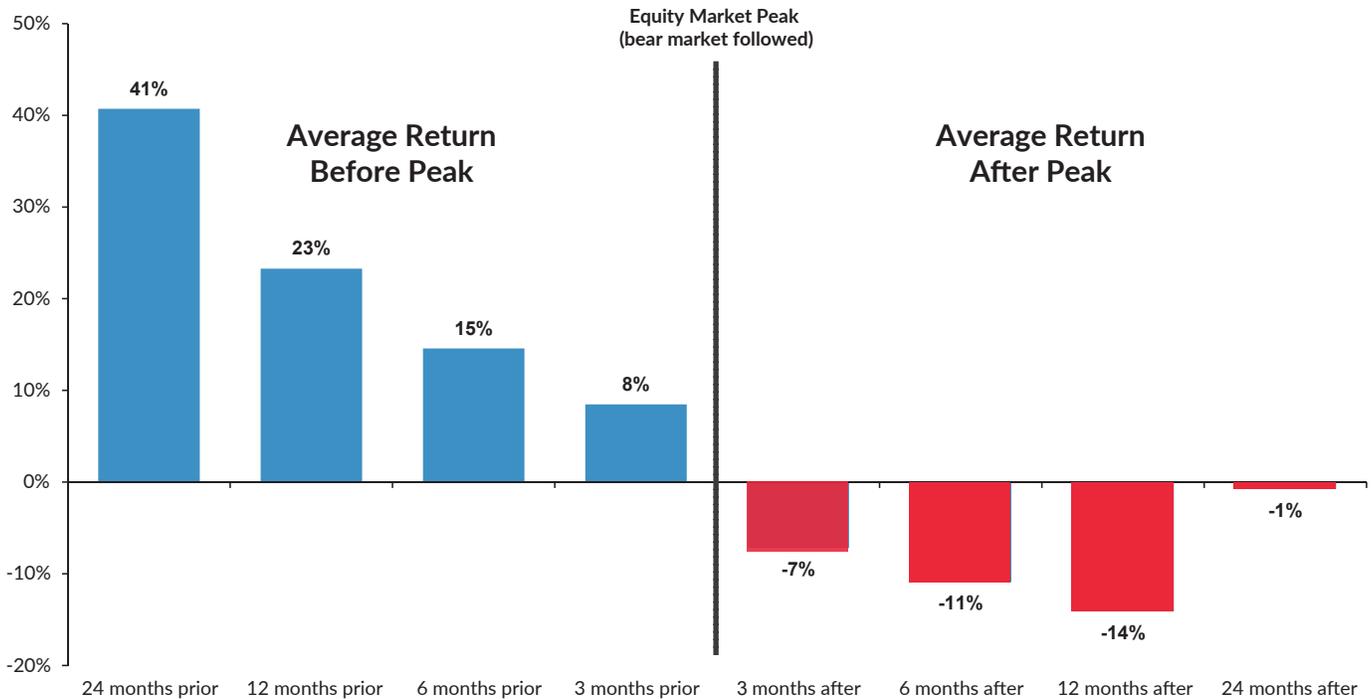


Source: FactSet, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.
Returns are 12-month and 60-month annualized total returns, measured monthly beginning in 1993. R^2 represents the percent of total variation in total returns that can be explained by forward P/E ratios.

Heading into 2019 it is important to recall that over the short-term, the markets are a voting machine, and potential downside risks are working hard to win the campaign. In the US, the yield curve is still flattening, and the Fed is still looking for reasons to raise interest rates. The fallout from tariffs and an ongoing trade war is making it difficult for businesses to increase investment activity and complicates profit projections. Politics in the US, China, the UK, Germany, France, and Italy threaten to inject more uncertainty into the outlook for the year. Central banks are entering a potential make-or-break period where they will take off the economic training wheels and see if the economies can balance on their own. All these issues have the potential to influence the markets and weigh on investor sentiment.

While these factors add a sense of uncertainty to the markets, they also provide opportunities. We expect the sledding to be tough this year, but that doesn't mean the trip is over. The global economy remains on sound footing and consumer activity is at the strongest level it has been during the recovery. Also, central banks are showing a tendency to be more sensitive to market activity. A shift in investor sentiment could be another key to keeping the expansion going. Sentiment, which is a contrarian indicator, flipped to negative during December. Going forward, we expect lowered expectations to lead to more upside surprises for both stocks and the economy. A stable economic backdrop and the decline in valuations creates better value for long-term investors, and these trends make entering a recession this year unlikely.

S&P 500 Returns Leading Up to and Following Market Cycle Peaks (1945 - 2018)

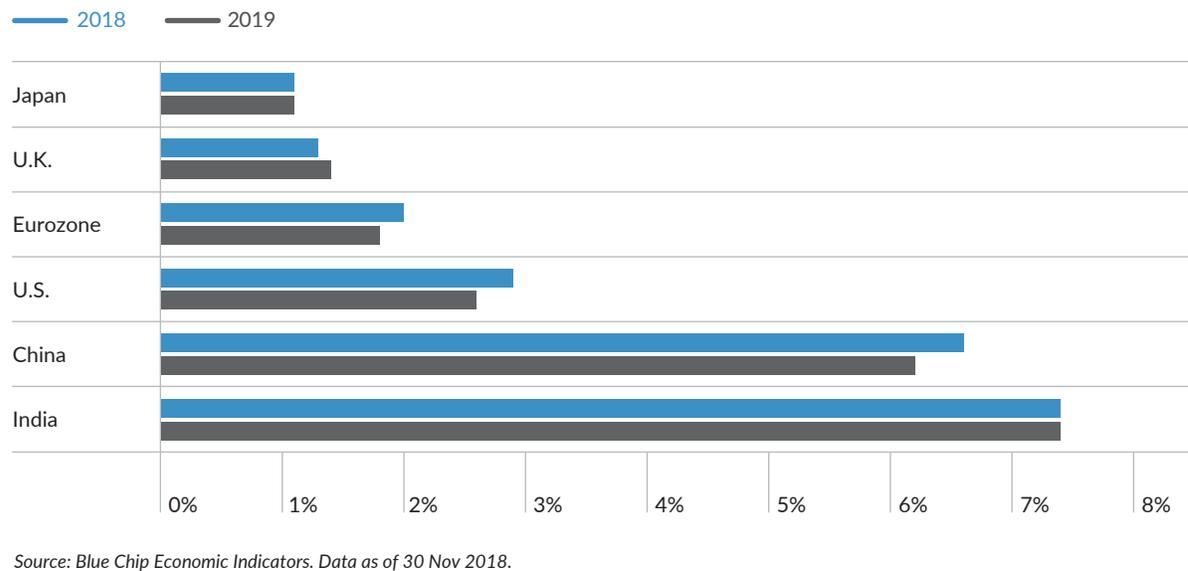


Source: FactSet, Robert Shiller, Standard & Poor's, J.P. Morgan Asset Management. Chart is based on return data from 11 bear markets since 1945. A bear market is defined as a decline of 20% or more in the S&P 500 index

Even though a recession may not be on the near-term horizon, investors will have to be more diligent and pay more attention to the signals the markets, rates, and the economy are sending. A typical buy-and-hold allocation strategy is likely to generate returns below long-term averages in this environment. Volatility is here to stay and divergences between sectors, companies, and economies will create swings in market leadership. The resulting market will provide opportunities for active asset allocators to add value by transitioning between positions throughout the year.

We expect to see US equity returns in the mid- to high- single digits. Even though many of the risks that led to selloffs last year are still relevant, the probabilities are increasing that major fallouts from these risks will be staved off. A more restrained Fed and positive Q4 earnings will likely lead to a rebound in investor sentiment. Overseas, markets look cheap on a relative basis. European equities and emerging markets will likely begin the year with a short-term bounce, but we do not think that investors should overweight either as a long-term position at this point. The risks for foreign markets are becoming more binary but are still leaning towards negative. If we get clarity on trade negotiations, a weakened US dollar, or a definitive Brexit solution there will be a more pronounced recovery in foreign markets. However, in Europe a lack of economic momentum and centralized fiscal and structural issues lead us to believe that these markets are cheap for a reason. Emerging markets (EM) have more potential to outperform expectations. With so much negativity priced into EM assets, any positive news regarding trade and Chinese growth will likely lead to a turnaround for the asset class.

Global Growth is Expected to Slow Slightly in 2019



At this point in the economic cycle, the relationship between risk and return can become distorted. In 2019 more risk may not be synonymous with more return. Contrary to previous periods during the bull market run, investment strategies will need to focus on producing alpha rather than maximizing beta. As the market continues to flip between risk-off and risk-on, disciplined and precise allocation decisions capitalizing on changes in leadership will generate the best risk-adjusted returns. The tides that were lifting all boats are starting to recede, and this year we will see who brought their swimsuit. This may be a year where it is difficult to stomach volatility, but we think that long-term investors will benefit from maintaining an active allocation to risky assets. The silver lining of all corrections is that they can help shake out built up excesses and bring valuations back to more attractive levels. Returns this year may be modest and we will likely see more frequent pullbacks, but over the long-term it is important to remember that corrections always end, and while markets settle down prices settle up.

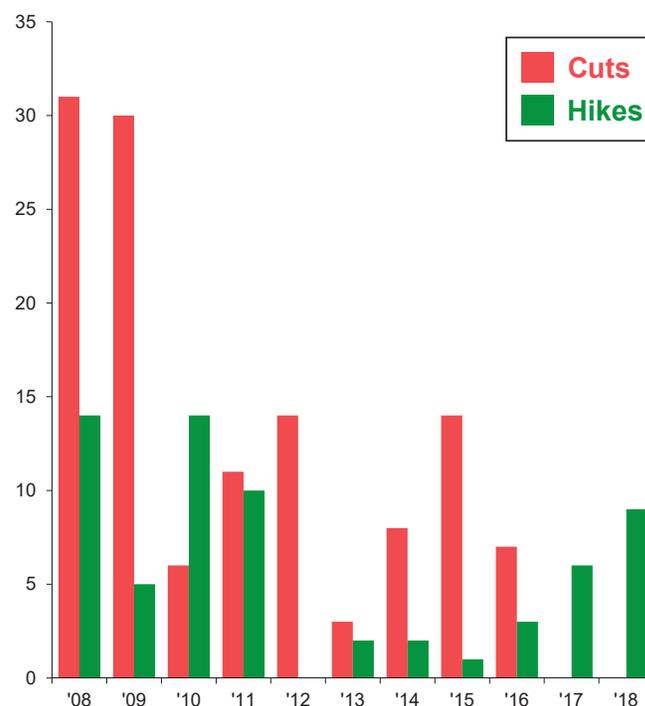
**"THE TIDES THAT WERE LIFTING ALL BOATS
ARE STARTING TO RECEDE..."**

The Shift From Quantitative Easing to Quantitative Tightening

The shift from quantitative easing (QE) to quantitative tightening (QT) is momentous and will have far-reaching implications. The record amount of global quantitative easing kept us from experiencing a collapse of the global banking system in 2008-2009. Since then, we've had 124 months of negative real Fed Funds rates. Interest rates are at the core of asset valuations and factor into the pricing of all sectors of the market. Therefore, it is unlikely that unwinding these unprecedented stimulus measures will be a smooth ride. In the US, higher rates may already be revealing cracks in the credit, auto, and real estate markets. A tighter fiscal environment would be a stark shift from what we have seen since quantitative easing began. During QE, massive amounts of capital flowed into the markets. The majority of the money was allocated to riskier assets because the return potential of lower risk investments, like bonds, was so poor. Investors' easy access to capital and increased demand for higher yields and returns inflated risky asset prices. The shift from QE to QT will slow the increases in available liquidity and lead to higher interest rates. Higher interest rates will require the market to reprice assets and will make bonds more attractive which could lead to a decline in the demand for stocks.

In the US, we think that the Fed has been raising rates for the right reasons. The economy is stable, unemployment is low, and consumer activity is high. Policy makers are in a difficult position this year. Although continuing to raise rates is a signal that the economy is strong enough to grow without Fed stimulus, investors see higher rates as a potential obstruction to future economic growth. On the other hand, reversing course and cutting rates would likely be a confirmation that the shakiness seen in the markets last year was a sign of deeper economic concerns.

Rate Changes by Top Ten Developed Market Central Banks



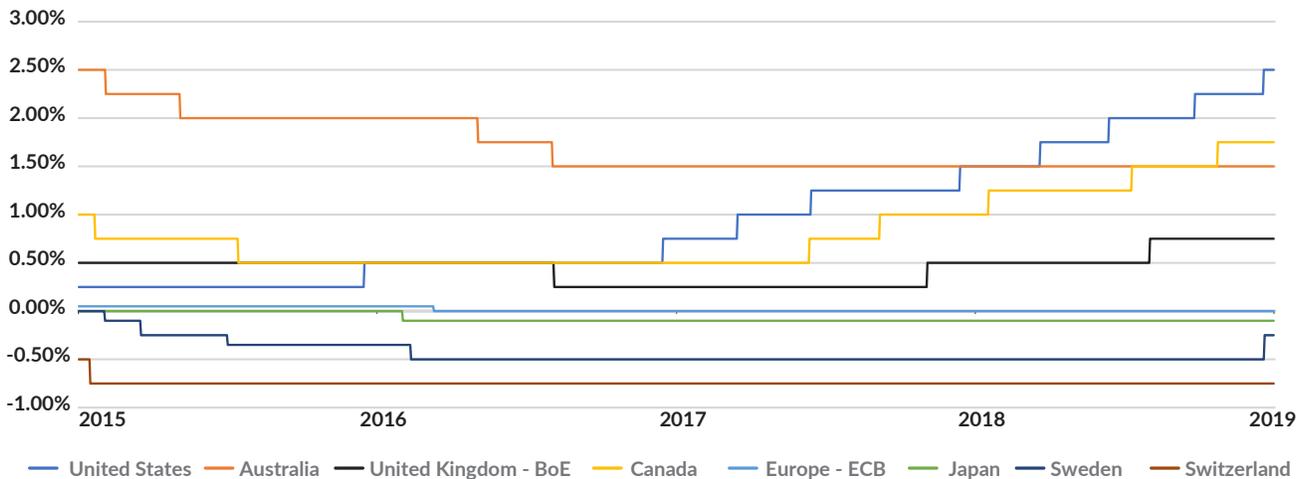
Source: Bloomberg Including: Australia, Canada, Denmark, Eurozone, Japan, Norway, Sweden, Switzerland, UK and U.S.

Outlook 2019: Investment Themes

Despite Chairman Powell's attempt to keep Fed policy and the stock markets' desires independent, we think that he will end up going the way of his two most recent predecessors and take his foot off the gas when the markets are flashing red. If the Fed can calm fears that a recession is around the corner, we could re-enter the "goldilocks" scenario where things are just strong enough to keep the economy moving but not strong enough to raise rates. In this scenario, we would likely see markets finish at the high end of our expectations for 2019.

At the global level, central banks are diverging from the US's rate path. Many global central banks expected to follow the Fed's strategy, but foreign economies don't look as strong relative to the US. One of the consequences of foreign markets diverging from the US on monetary policy is that lower global interest rates have led to a lack in demand for foreign bonds and a higher demand for US bonds. If foreign rates stay lower for longer we will likely see a flatter yield curve as investors searching yield buy into longer duration US bonds, putting downward pressure on long-term rates, while the Fed is raising rates on the shorter end of the curve.

Global Central Bank Key Interest Rates



Source: Waterloo Capital Management, Global-Rates.com

Late Cycle but Low Risk of Recession

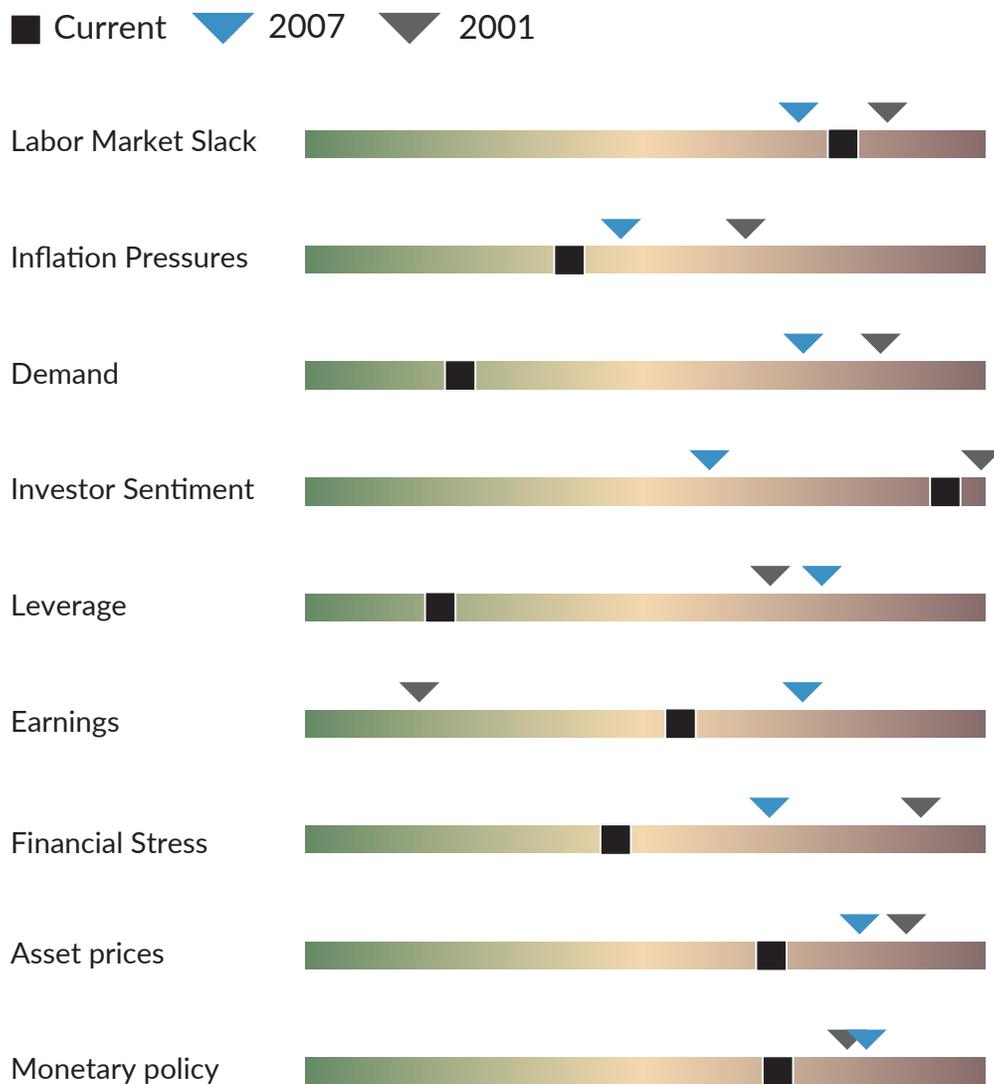
Although we are starting to see some warning signs of a slowdown, it is also important to view a pullback in market and economic activity in the right context. We caution investors to not mistake a mean reversion back to the historical growth trend for a true recession. The US has been experiencing a period of excessive growth and the markets have gotten used to seeing better and better numbers. GDP is running at roughly double the economy's long-term potential, and earnings growth for the S&P 500 is expected to exceed 10% for the fifth consecutive quarter and average over 20% for 2018. A pullback from such high levels is likely, but we do not think that the current economic cycle will end this year.

Economic data shows that there is still a productivity and wage growth gap holding back growth at the consumer level. Any improvements in this realm will be a benefit to the consumer and to GDP. Additionally, even if the US slows slightly, the economy is still setting the bar for the rest of

Outlook 2019: Investment Themes

developed markets. Stellar earnings throughout 2018 are a sign that many businesses are reaping the benefits of the ongoing easy money and low inflation environment. Rising wages, the windfall from tax reform, and tame inflation should help consumer sentiment to rebound early in the year. Also, more docile Fed policy should lead to lower rates during the first half of the year, which could lead to a recovery in big ticket purchases as financing becomes more affordable. The world may be slowing down, but we've built up enough speed to keep the boat afloat through 2019 and we believe that the strong foundation built in recent years will keep the economy from falling into a recession this year.

Recessionary Indicators Are Not at Extreme Levels



Source: Vanguard, Moody's Analytics, Federal Reserve Bank of St. Louis, Bureau of Labor Statistics

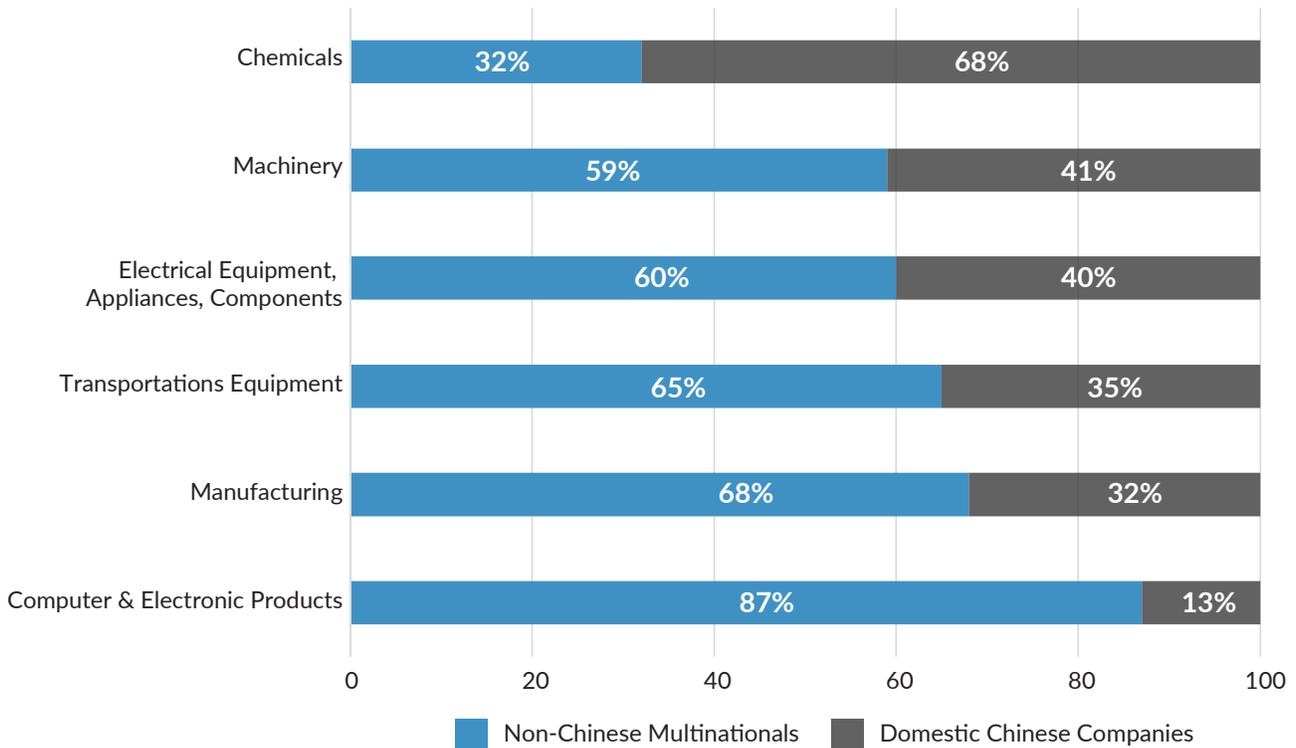
Risks Dominated by Geopolitics

The trade war between the US and China will remain a key market driver. Almost all market concerns heading into the year are connected in some way to the result of US and China trade negotiations. Both sides have shown a willingness to negotiate, but so far there has been a lot of window dressing and a lack of concrete resolutions. We are closing in on a point where the desire to produce a zero-sum outcome could turn into a lose-lose situation.

Although the US appears to have the upper hand, the final plan could backfire if it cripples the Chinese economy. Despite the messages delivered by both sides in trade negotiations, the world is more connected now than ever. Tariffs on China inevitably affect companies around the world because the country is entrenched as a global manufacturing center. A significant slowdown in China would lead to fallout in other emerging markets and could spill over into Europe, Japan, and the US which all benefit from a stronger Chinese consumer. A decline in China's economy would also be a major headwind for the commodities markets because it would likely spark a decline in demand for base metals and oil.

Tariffs on China May Have a Greater Impact on Multinational Companies

Percent Share of Tariff Targeted US Imports From China by Industry



Source: Peterson Institute for International Economics, Lazard Asset Management, US Section 301 Product List Covering \$50 Billion Tariff Targets

On the business side of things, the shoot-from-the-hip mentality of both sides in negotiations makes it difficult for companies to plan for the future. This uncertainty could create a stagnant business environment and lead to a pullback in business investment and hiring if a clear path forward is not established during the first half of the year.

The recent government shutdown has not affected the overall economy and we don't think it will become a significant headwind this year. Any slowdown in activity during the first quarter will likely be transitory and should be overcome in later quarters as government employees receive backpay and money begins flowing into the private sector again. The long-term risks of the shutdown may lie in the example being set by both sides of the aisle. Stalemates on Capitol Hill have historically been beneficial to markets because they usually mean that only a minimal amount of legislation will be passed which keeps businesses and individuals from having to react to regulatory or policy changes. This time around the same inaction that helped markets in the past could be harmful. Many of the significant risks to the market hinge on the outcome of trade policies which will have to go through a divided Congress. The pros of a trade deal far outweigh the cons, so we think that the risk of a deal not gaining bipartisan approval is unlikely. That being said, the obstinance of both sides during negotiations over border security show that political leaders are not afraid to use dissension to prove a point heading into an election year. If either party decides to take a hard stance on trade it would be detrimental to the markets and the economy.

In Europe, ongoing Brexit negotiations cloud the outlook for the British markets. Prime Minister Theresa May has made it clear that she feels obligated to push forward with a plan to leave the European Union (EU). A lack of confidence in her plans from her opposition brought negotiations to a gridlock. The lack of direction has led some politicians to call for a "hard Brexit" in which the UK would leave the EU without a deal. Exiting without a deal may solve the problem of trying to please everyone, but it would force the UK to negotiate trade deals with individual EU countries. That process would likely be a drag on the UK economy for years to come. Elsewhere in Europe, France has shown that it is willing to give in to the "Yellow Vest" protests. The new government has conceded some ground on fiscal measures and has floated the idea of additional fiscal policy changes that would lower tax rate. Passing fiscal cuts today is one way of boosting consumption and consumer sentiment in the short-term, but these policies are borrowing from the future and will eventually stall progress on structural reforms.

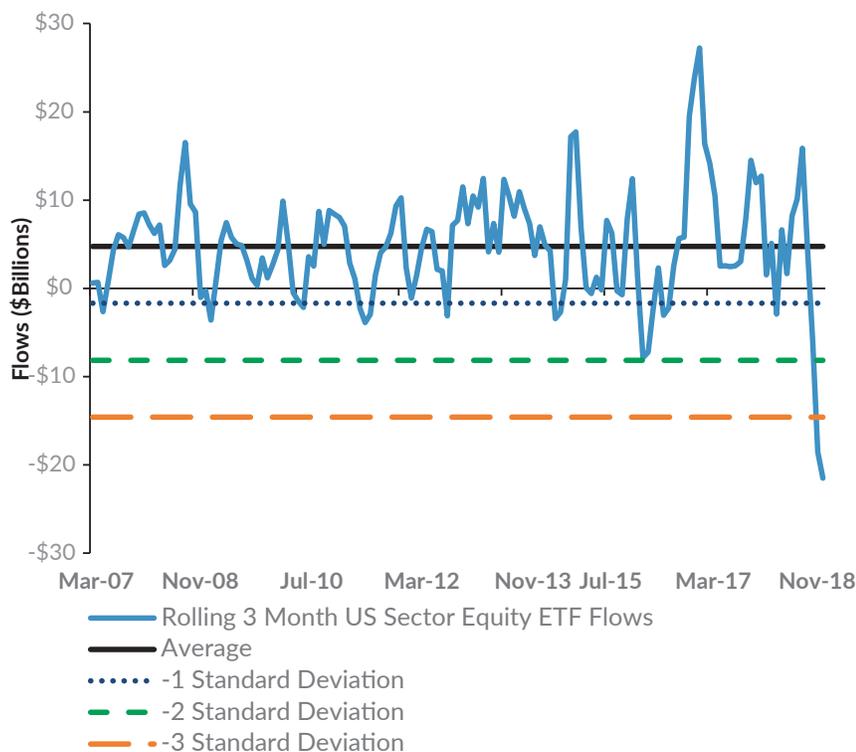
**"WE ARE CLOSING IN ON A POINT WHERE
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SITUATION."**

Stay Active and Stay Selective

Divergence in global economies and politics has contributed to a steady rise in global volatility. We think that the rapid shifts from positive to negative sentiment seen in 2018 is a portent of the new norm. Extrinsic factors such as politics, fiscal policy, and monetary policy are exerting a greater influence on market trajectories and amplifying volatility. In 2019, we expect the markets to recover, rise, and fall in mini-cycles throughout the year. The popular "buy-the-dip" strategy will still work but will be better utilized when allocating to individual companies and sectors. This year, investors will have to be ready to "sell-the-rip" and take profits before markets rotate against them.

The return of sustained volatility will likely lead to jittery investors in traditional buy-and-hold strategies and allocations. Capital flows into ETFs are already providing insight into how investors struggled to hold onto risky assets during market corrections. Despite the rebound in equity markets heading into January, US equity ETFs experienced significant outflows. In fact, investors were net sellers of equities from November 2018 through January 2019. The market environment will continue to challenge investors as the ubiquitous upward price pressures from quantitative easing begin to fade and we see more divergence in individual equity and sector performance.

Rolling 3 Month US Sector Equity ETF Flows

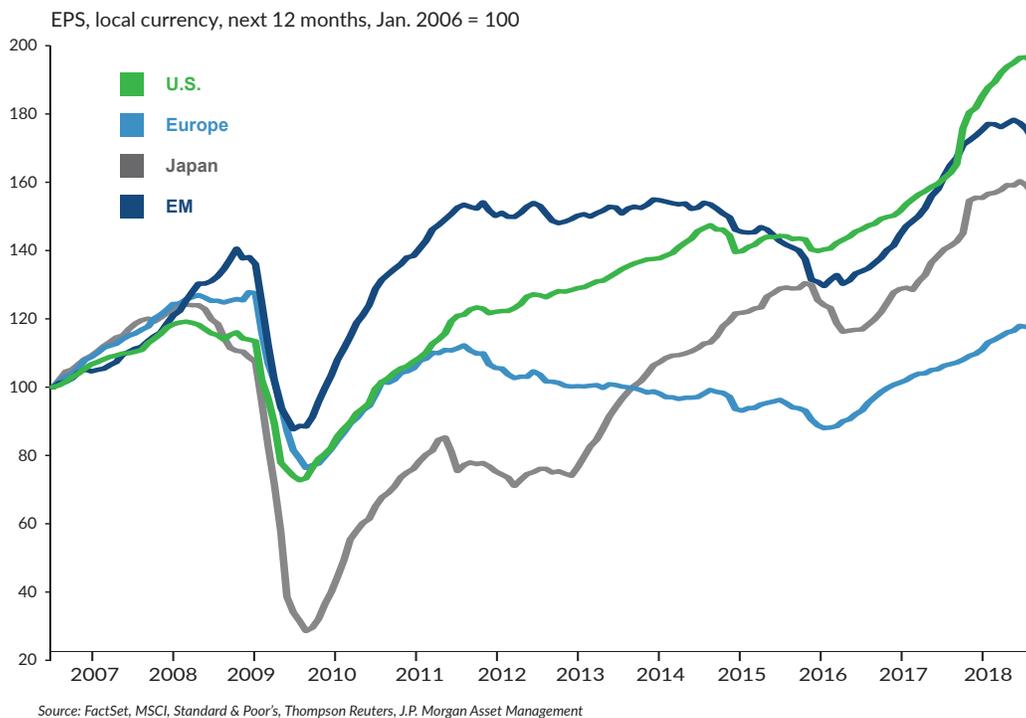


Source: State Street Global Advisors, Bloomberg Financial, L.P.

Outlook 2019: Investment Themes

Additionally, we expect market leadership to rotate faster than usual this year. The benefit of this environment is that it provides more frequent opportunities to capitalize on mispriced segments which have been oversold and take profits in positions that may be overbought. We believe that investors can also take advantage of these changes by holding a higher allocation of "dry-powder", or cash, rather than traditional fixed income positions. Even if interest rates reverse course and head lower, they are still firmly in the low end of their historical range which limits the potential return for bonds. Holding a higher allocation to cash or ultra-short-term bonds will serve to mitigate portfolio volatility and give investors the flexibility to allocate to new opportunities as they arise.

Global Earnings Expectations Are Declining



Foreign Markets Pop, Then Drop

The argument for allocating to both foreign developed and emerging markets is appealing heading into the year. After fighting through a nearly perfect storm of negative influences last year, a combination of extremely attractive relative valuations and portfolio rebalancing will likely increase the demand for both foreign developed and emerging market equities entering 2019. Additionally, although US rates are likely to continue rising, the US dollar is showing signs of peaking and any pullback on the currency front will be supportive to foreign markets. The gap in valuations and earnings between the US and the rest of the world has expanded to a point where the tension is likely to break. Last year, the selloff in foreign indices and underperformance versus the US likely set foreign markets up for a positive mean reversion in early 2019. As the year goes on, the rosy outlook is likely to fade. The long-term fundamentals for both asset classes do not look as attractive. Emerging and developed markets are still struggling to gain economic momentum, and many of the positive drivers of the economic acceleration over the last few years have the potential to deteriorate in 2019.

Outlook 2019: Investment Themes

Incongruent growth in different areas of the world is leading to more policy uncertainty and the divergence in global economies raises even more uncertainties in the markets. This lack of stability generally leads to an outflow of capital from foreign markets and into the US markets where economic growth is more durable. Moreover, the shift from synchronized growth to widespread uncertainty at both the political and economic level will likely lead to a decline in local business development and foreign investment. Threats of declining Chinese growth, tariff threats, and commodity supply and demand imbalances are handicapping emerging markets. Political uncertainties surrounding the Brexit, divergences in local economies, and mediocre policy shifts by the ECB are handicapping Europe.

In the end, this environment creates volatility and stimulates uncertainty. Overcoming lowered expectations may lure investors back into foreign markets, but negative sentiment can lead to hasty shifts in investor capital out of unfavorable regions. We think that many foreign markets are cheap for a reason and could pose a value trap in 2019. We are more inclined to hold a position in emerging markets but feel that both asset classes should be utilized for shorter-term trading opportunities rather than long-term allocations.

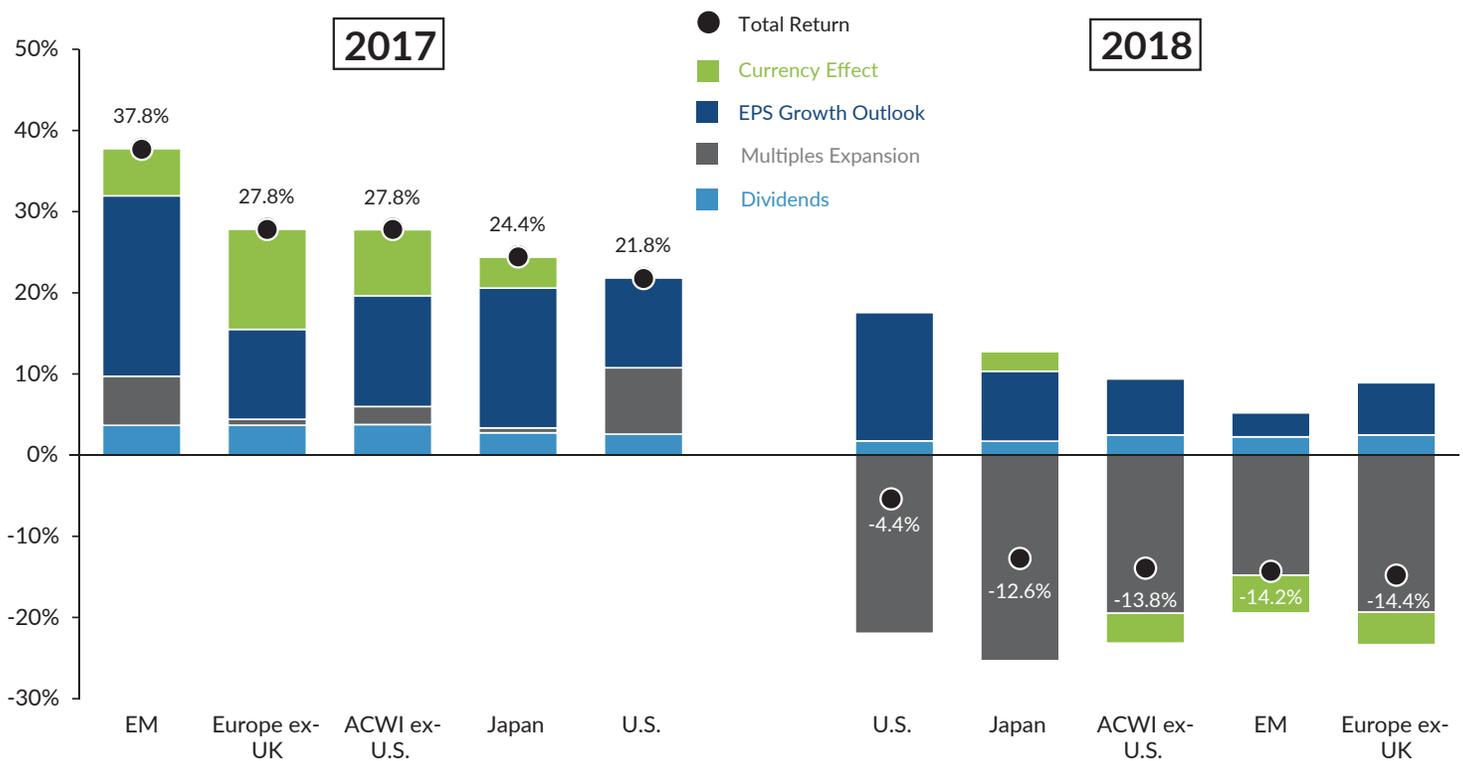
**"MANY FOREIGN MARKETS ARE CHEAP FOR
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Outlook 2019: Domestic Equities

Domestic Equities: Still the Best Game in Town

The disconnect between Main Street and Wall Street will keep volatility elevated. The markets have shown a propensity for overreacting to both good news and bad news as the bull market has aged. We think that this will continue due to the number of external forces influencing investor and business sentiment this year. From the lows of the financial crisis the S&P 500 has gained 16% per year. Double digit returns have become the norm and have consistently pushed the markets to new all-time highs. Returns have been driven by rising valuation multiples and, more recently, surging earnings. This year, both multiples and earnings are expected to contract. We are beginning to see a shift in market leadership and a decline in the influence of factors that have been supporting higher stock prices during the run-up over the last five years.

Sources of Global Equity Returns



Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management; Multiple expansion is based on the forward P/E ratio

More scrutiny on incoming economic and company data will lead to more rapid shifts in market leadership during the year. Investors can take advantage of this environment by being more active and keeping cash or short-term alternatives on hand to buy into better performing companies and sectors. From a portfolio construction stand point, investors should focus on increasing the quality of equity holdings this year. Historically low interest rates motivated investors to search for yield and fueled massive runs in growth companies. Going forward, we think that demand for pure growth will begin to fade as investors focus more on the quality of companies' balance sheets and earnings. Many companies are facing rising costs of capital, wages, input costs, and uncertainty as trade talks and tariff negotiations drag on. We also expect profit margins to contract as we experience some mean reversion

Outlook 2019: Domestic Equities

down from historical highs over the past few years. Our focus on quality stems from our belief that companies with higher quality debt and earnings will be able to keep operations more consistent through any short-term downturns.

Because of the divergence in fundamental quality and forward guidance between companies, stock performance within sectors will vary significantly. Absolute earnings growth may no longer be as important as simply beating expectations, and the positive results of one company will no longer be enough to boost an entire sector. To take advantage of these divergences we expect to invest in more concentrated positions and zero in on individual companies highlighted by our quantitative models. Our baseline assumption this year is that both economic growth and profits will slow from 2018 levels. Although an earnings pullback from the highs hit in Q3 of last year is likely, strong economic data will continue to support a positive outlook for many businesses.

S&P TOTAL RETURN AT VARIOUS P/E AND EPS Y/Y LEVELS

P/E \ EPS	14.5X	15.0X	15.5X	16.0X	16.5X	17.0X	17.5X
(2.4%)	(5.7%)	(2.4%)	0.8%	4.1%	7.3%	10.6%	13.8%
(1.2%)	(4.5%)	(1.2%)	2.1%	5.4%	8.7%	12.0%	15.3%
0.1%	(3.3%)	0.0%	3.3%	6.7%	10.0%	13.3%	16.7%
1.3%	(2.1%)	1.2%	4.6%	8.0%	11.4%	14.7%	18.1%
2.5%	(1.0%)	2.5%	5.9%	9.3%	12.7%	16.1%	19.5%
3.7%	0.2%	3.7%	7.1%	10.6%	14.1%	17.5%	21.0%
4.9%	1.4%	4.9%	8.4%	11.9%	15.4%	18.9%	22.4%
6.2%	2.6%	6.1%	9.7%	13.2%	16.7%	20.3%	23.8%
7.4%	3.8%	7.4%	10.9%	14.5%	18.1%	21.7%	25.2%

Source: KKR Global Institute, Bloomberg

Our forecast could be positively impacted by a trade resolution between the US and China. While we do not think that the immediate impact would be enough to boost earnings and market multiples back to 2018 levels we think that a psychological hurdle will be cleared for many investors and lead to a significant increase in demand for risk assets. We could also see a rebound in prices if the Fed decides to take a slower normalization path than previously expected. While a Fed decision to cut rates would be a negative, a slower wait-and-see approach will feel more like the status quo experienced during the bull market run and will be supportive of higher stock prices. In this environment we expect major indices to fluctuate from positive to negative returns throughout the year and end up posting gains in the mid-single digit range.

Europe and United Kingdom: Introspection Reveals Issues

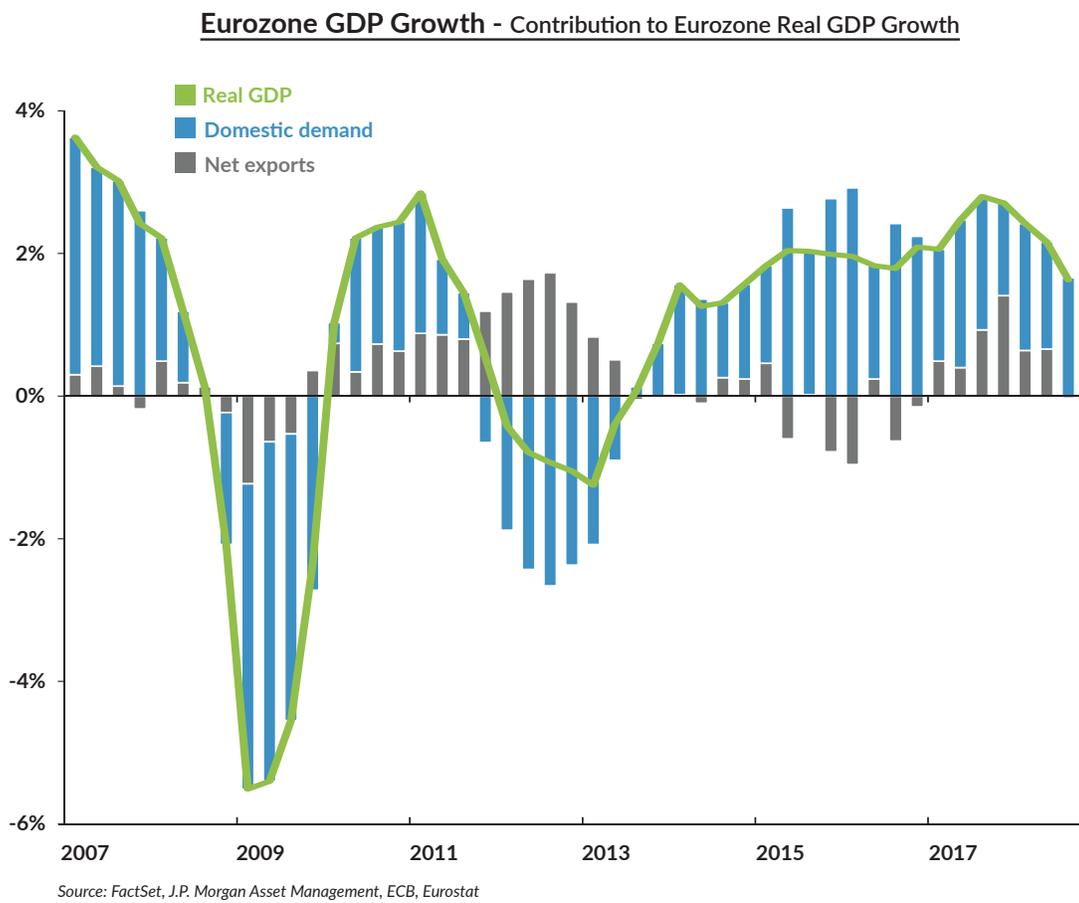
Much like emerging markets, we think that European markets have sold off to the point where a short-term rebound is likely. Many of the issues that European countries faced in 2018 will carry over into the new year, but the majority have already been priced in. There are also transitory factors that we think will subside and help build some confidence in the region's 2019 prospects. While we expect monetary policy to remain accommodative and for business and consumer activity to rebound to start the year, we are less confident that the region will build up enough momentum to sustain a rebound throughout 2019. Surmounting structural, political, and fiscal problems over the long-term will be a challenge. Policy makers will continue their efforts to invigorate growth, but the decline of global growth expectations has led to sputtering GDP data. The region is struggling to cope with weakening global trade, which has caused a slowdown in exports. Additionally, an abundance of political uncertainty, stagnant wages, and the return of deflationary pressures will likely curb upside potential in consumer activity.

The European Central Bank (ECB) will be a key focus after the Fed's decision to raise rates was met with disdain. The ECB has told the markets that it will keep interest rates on hold through the summer of 2019, and the markets are not expecting any rate hikes until 2020. We think that after the poor market reaction to the Fed's plans to raise rates, the ECB will remain idle with rate hikes and tightening policy changes this year. There is even a slight possibility for additional stimulus measures to be enacted this year. The ECB may introduce another round of long-term refinancing operations (LTRO) which would provide additional funding to European banks. Based on the underlying economic and political factors, the most likely scenario is that the ECB ends up hitting the pause button on suggesting tightening measures are forthcoming. The disjointed recovery and political outlook for the various countries in the region will continue to make it difficult for Europe to generate sustainable growth as a unit. We are skeptical that the problems in Italy, the UK, and now France can be fixed without taking a few steps backward.

"DISJOINTED RECOVERIES AND POLITICS ARE HEADWINDS TO SUSTAINABLE EUROPEAN GROWTH "

Outlook 2019: Foreign Developed Market Equities

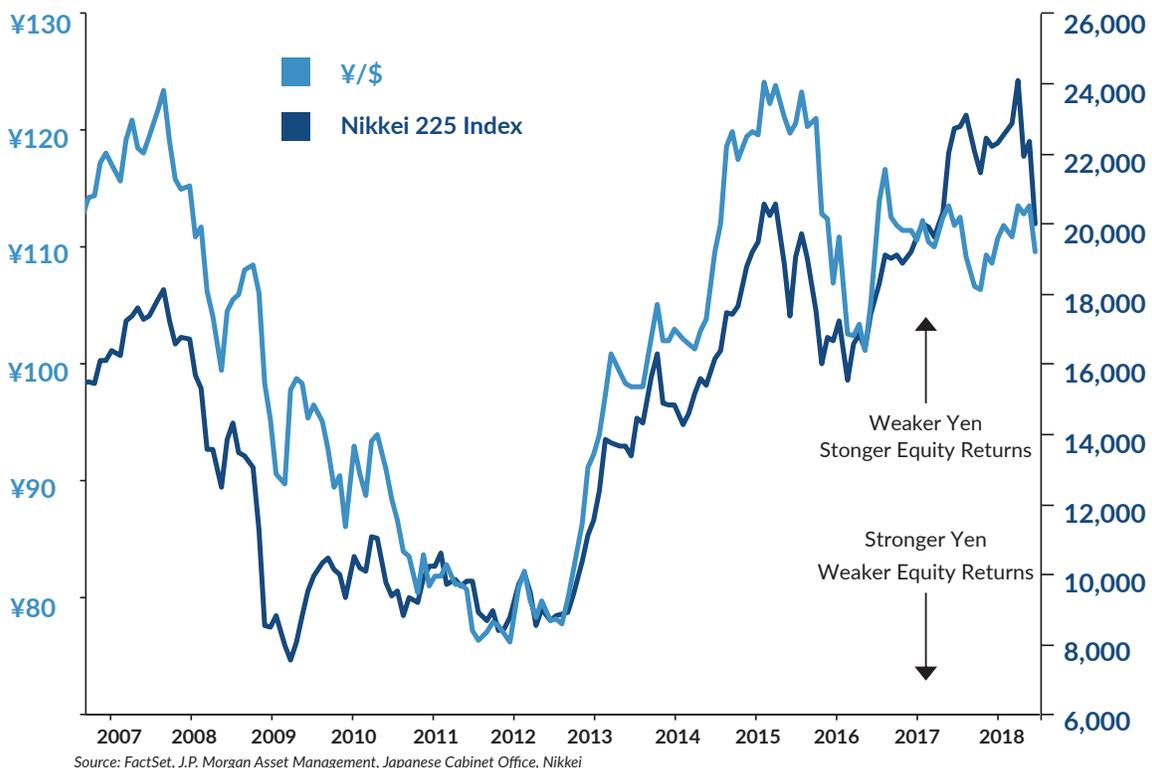
With risks tilted towards the downside, Europe offers the potential to add value to portfolios if economic data and political threats turn out to not be as bad as expected. Signs of stability in growth, even if it is weak growth, should postpone any significant economic deterioration. Additionally, it is looking increasingly likely that some external pressures such as tightening monetary policies and fallout from the Brexit will be delayed beyond 2019. A lukewarm environment may be the best-case scenario, but the region will still need help on the consumer activity and earnings front. In summary, while we see the potential for Europe to clear the short bar that has been set; the region's fundamental problems and a poor outlook for business and consumer activity leave us inclined to take an underweight allocation to the region this year.



Japan: The Experiment Isn't Over Yet

Japanese growth should recover slightly this year due to positive employment and business investment trends. The country will also benefit from a continuation of extremely easy monetary policy by the Bank of Japan (BOJ). At the consumer level, low unemployment should lead to higher wages and boost consumer spending. Spending activity will likely be higher earlier in the year before a consumption tax hike goes into effect in October. Business investment will be focused on increasing productivity as the tight labor market makes it more difficult to boost production through hiring. Additionally, construction spending is likely to jump as the country continues to rebuild areas damaged by natural disasters and expands projects related to the 2020 Olympics. A sustainable recovery in consumer activity and GDP growth would be welcome given the lack of economic momentum in recent years.

Japanese Equities Are Inversely Correlated to The Yen

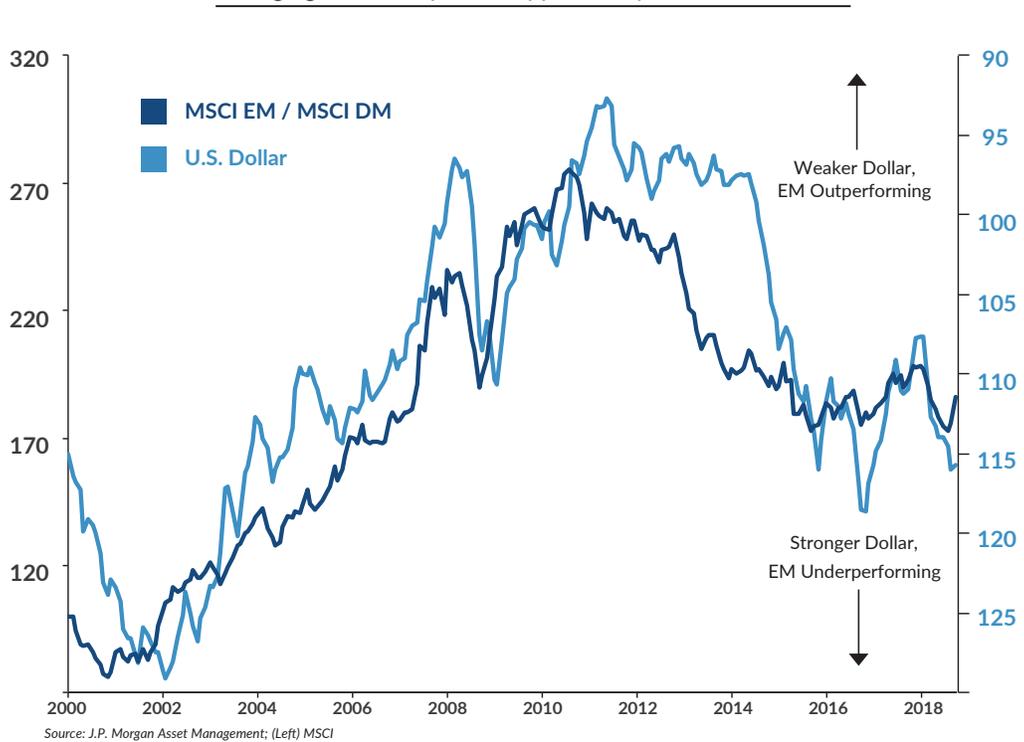


The Bank of Japan is unlikely to radically change their interest rate policy ahead of the consumption tax hike which mitigates the potential for monetary policy and interest rate risks to hinder the economy. Because Japan is an export driven economy, the biggest risk to the region stems from trade uncertainties and global slowdown concerns. Also, because the yen is seen as a safe-haven asset, global market volatility increases the demand for the currency which in turn increases the value of the yen and could negatively impact foreign demand and company earnings. The headwinds of a rising Yen and the potential for a slowdown in business activity due to trade policy uncertainties could be enough to blow the fragile market off course this year. We recommend an underweighted allocation to the region until we have more clarity on economic activity and how companies are dealing with the trade outlook and slowdown in China.

Emerging Markets: Opportunities to be Found

Expectations for markets outside of the US have been beaten down so far that it wouldn't take much for emerging markets to exceed 2019 expectations. 2018 provided a nearly perfect storm of hurdles for emerging markets. A more active Federal Reserve, a rising US dollar, and shift to risk-off sentiment weighed on the demand for the asset class. Additionally, signs of idiosyncratic collapses in Turkey and Argentina raised more red flags and made investors nervous about investing in EM equities. Although global financial conditions tightened in 2018, a weaker or more stable US dollar, more accommodative central banks, possible trade resolutions, and the potential to exceed market earnings expectations are all constructive for EM's performance this year. We think that a combination of these positive factors will stimulate a reversal of the trend and coax investors back into the asset class. At an aggregate level, EM still have fairly easy financial conditions and we are not seeing signs of excessive inflation which would typically precede rate hikes. Finally, as mentioned earlier, it is becoming clearer that neither China nor the US can afford to double down on protectionist trade tactics without potentially harming the global economy. Any indication of progress on the trade front will be supportive to EM equities.

Emerging Market Equities Supported By Weaker US Dollar



Our outlook for the asset class follows one of our overarching themes. Investors will have to be more active and selective when allocating capital. We see the potential for opportunities in the BRIC economies, with Brazil and India leading the way. Our outlook for Brazil is trending positive under the new president Jair Bolsonaro. He is adamant about securing pro-growth reforms and reshaping the country's massive pension system which has been a significant detractor of GDP. In India, a massive consumer base paired with low inflation and a lack of significant activity from the Central Bank of India should support growth in consumer activity and business spending in the region. Additionally, because India is a significant importer of crude oil, the decline in oil prices will free up capital. China is likely to keep the government stimulus engine running to try and stave off further declines in growth. A trade resolution with the US would also help China continue to grow above its stated 6% target.



We expect volatility will remain elevated and that investors will begin to shift away from more beta seeking asset classes, which limits our upside return expectations for emerging markets. EM has become much more susceptible to headline risks and political actions in developed markets. An interdependency on these factors means that all political disputes and trade negotiations will have a peripheral effect on emerging economies. Signs of a pullback in the outlook for the US, a diminishing recovery in Europe, a hard Brexit, or a lack of progress on US and China trade negotiations will undoubtedly hurt the prospects for emerging markets this year. Although the overall risks for emerging assets are tilted towards negative, the best investments tend to be disliked by the majority when they are purchased. We think that there will be opportunities to capitalize on upside swings and expect the asset class to outperform this year. That being said, much like other foreign markets, we will be ready to enter and exit the position opportunistically.

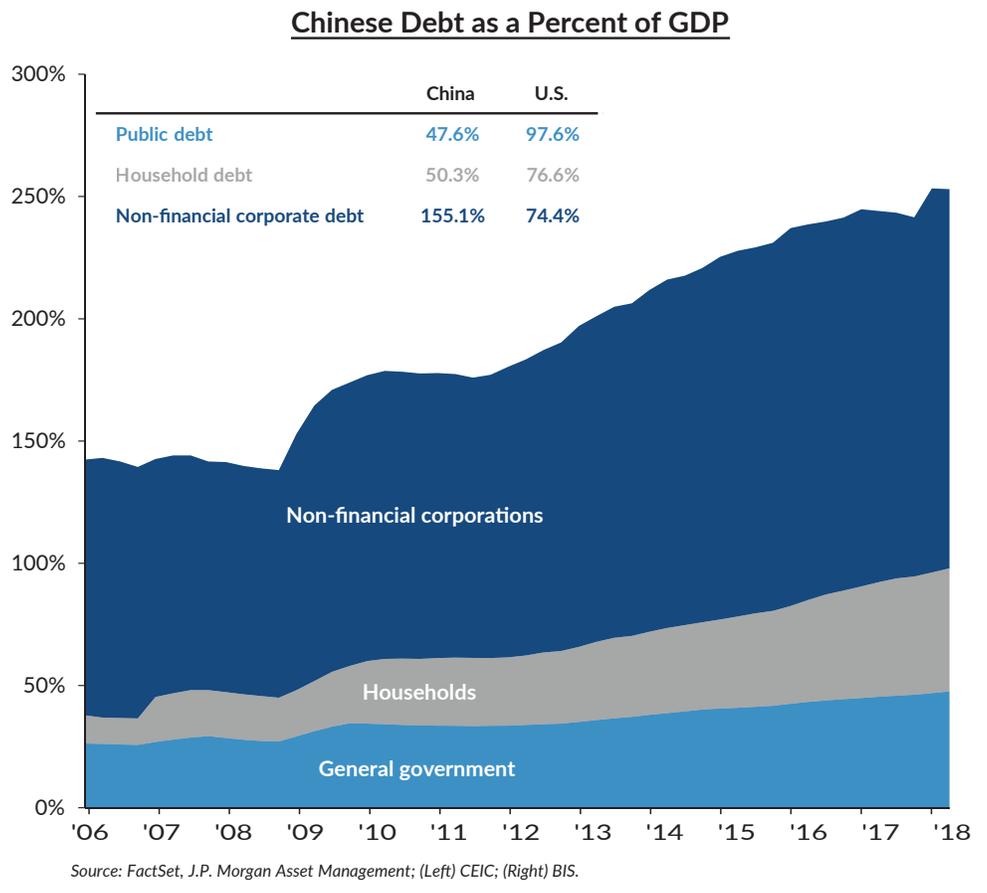
China: Keeping a Foot on the Gas

Since the Global Financial Crisis as China has gone, the world has gone. Now, the world's second largest economy is showing signs of slowing. New business orders recently fell for the first time in two and a half years, and manufacturing PMI, a measure of economic strength, recently fell into contraction territory for the first time since 2015. Consumer demand has been declining and a year-end decline in input costs has many companies waiting on the sidelines for lower prices instead of increasing production heading into 2019. The data indicates that China is clearly feeling the effects of last year's trade negotiations.

On top of the negative effects from tariffs, China is attempting to avoid the middle-income trap. This economic phenomenon typically occurs after a country experiences rapid growth and a large majority of the population enters a "middle income" range. Historically, middle-income economies go through a period of contraction as rising wages mitigate their competitive edge in exports and domestic, consumer-focused sectors of the economy can't make up for the lost growth. As China shifts towards

Outlook 2019: Emerging Markets

a more domestically driven mature economy a slowdown is highly likely, but the potential for a deeper slowdown has put the government and central bank in a tough spot. The typical monetary policy response to a slowdown is to provide easier access to money by loosening bank regulations or lowering interest rates which encourages borrowing. Unfortunately for policy makers, China has already infused massive amounts of capital into the economy and the reliance on cheap debt has pushed their debt-to-GDP ratio to around 260%.



Reining in debt could push the economy into a full-blown slowdown and would likely weaken support for the current government. We think that the government will downplay the risks of adding more debt to the economy and continue to supply the markets with more accommodative policies in 2019. Domestically, government stimulus measures are seen as a vote of confidence in the economy which will help shore up consumer confidence and keep state owned enterprises running smoothly. These policy moves will allow China to continue pushing out their debt overhang deadline beyond this year and should help stabilize economic growth around the 6%-7% range. The biggest risks to our outlook are the ongoing tariff negotiations with the US and the potential for a lack of clarity to continue weighing on business and consumer activity. China and emerging market economies will likely be the greatest beneficiaries of a sustained trade deal and we would expect both EM and China to outperform in this scenario.

China's GDP Likely to Moderate Further

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



Source: KKR Global Institute, China National Bureau of Statistics, Haver Analytics

"GOVERNMENT STIMULUS WILL HELP
STABILIZE CHINESE GROWTH REGARDLESS
OF TARIFFS."

Fixed Income: Expect Return of Equity, Not Return on Equity

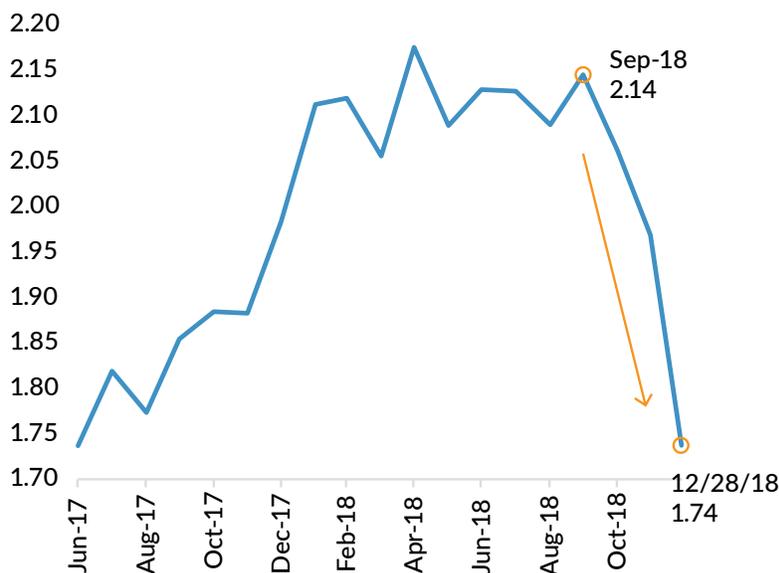
Interest rates are important because they influence asset pricing in all financial markets. When interest rates rise, prices must change to reflect the impact of a different input in their calculations. This influence is why analysts spend so much time trying to decipher the trajectory of global central banks. Loose, or accommodative financial conditions mean lower interest rates which means easier access to capital, lower relative stock valuations, and lower costs to businesses and individuals. The US has entered a period of tightening, or restrictive financial conditions which counter or reduce the previously mentioned positive effects on economic activity. This year we expect that interest rate moves will be restrained and a surprising spike in rates is unlikely. With interest rates still firmly in historically low ranges and a high potential for sideways interest rate moves we do not expect fixed income holdings to generate substantial returns in 2019. Fixed income will remain a key component of diversified portfolios, but once again should be held more for insurance than for return attribution.

United States

We expect fixed income to continue to struggle on a risk adjusted basis in 2019, but as volatility continues to rattle the equity markets, maintaining an allocation to fixed income assets will be essential. As with stocks, investors benefit from holding higher quality fixed income investments in the late stages of market cycles. We favor investment grade bonds over high yield and recommend an allocation to government bonds for portfolio stability. Interest rates have risen to a point where investors are at least getting paid some yield, and the stable performance of bonds during the selloff during Q4 2018 showed that bonds will continue to play a key role in downside portfolio protection.

Low Inflation Gives Fed Flexibility to Pause

Breakeven U.S. 10-Year Inflation Expectation Embedded in TIPS

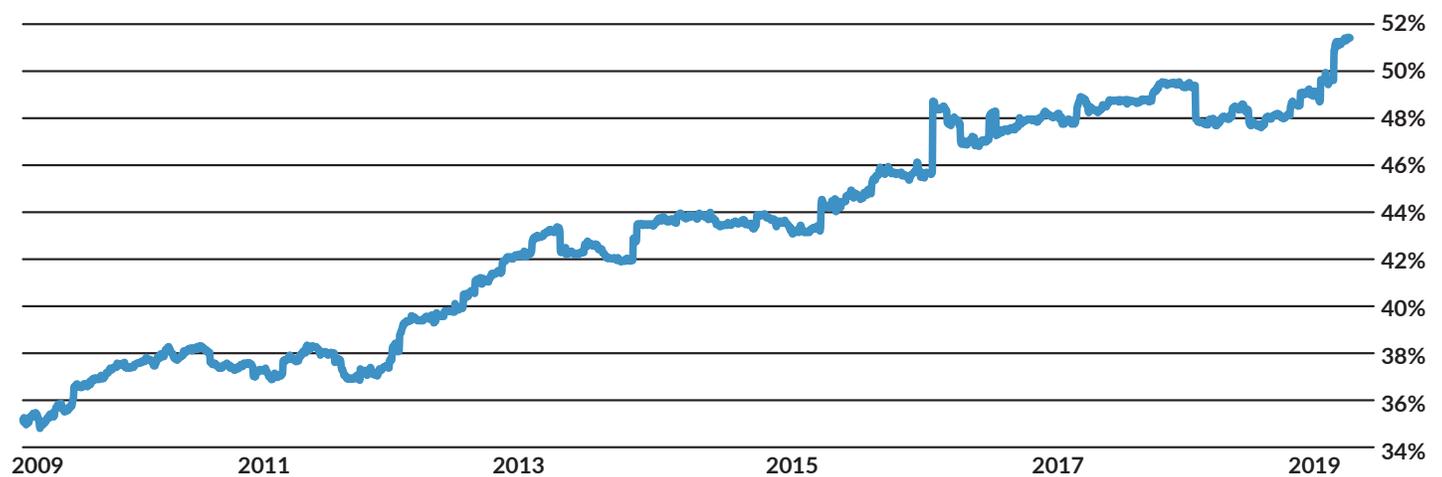


Source: KKR Global Institute, Bloomberg

Outlook 2019: Fixed Income

Although the Fed has taken a step back from their rate hike strategy, we think that a strong economy will keep upward pressure on rates. Interest rates were significantly compressed during the December 2018 selloff but should begin to trend higher early in the year as the psychological selling pressures from equity markets begin to fade. Higher volatility, lower inflation pressures, and the likelihood of the Fed raising rates fewer times than projected will likely keep the 10-year US Treasury rate capped below 3.25%. Furthermore, if equity markets fail to break out from recent lows during the first half of the year, we expect rates will begin to compress again as the demand for capital preservation rises.

Percentage of BBB Rated Bonds in Investment Grade Index



Source: Bloomberg, Barclays, Waterloo Capital Management

The premium for corporate bonds are less appealing. Entering the year, wider spreads increased the risk premia for corporate bonds. Spreads will likely compress if equity markets continue to recover which gives us a positive short-term outlook for the asset class. Going forward, lowered earnings expectations and a higher probability of tighter financial conditions make us wary of long-term appreciation potential. Over half of the Bloomberg Barclays US Corporate debt universe is now rated BBB. Additionally, over \$1.2 trillion in corporate debt will mature in 2019 and 2020. If rates rise, more companies will have to refinance at higher interest rates, which would increase expenses and lower earnings projections. The potential for a contraction in revenues and earnings could lead to further credit downgrades and the potential for "fallen-angels", downgrades from investment grade credit to high yield, to spur forced selling. This would likely lead to wider spreads and price declines for the overall sector. The expansion in high-yield credit spreads during the recent market sell-offs was an indicator that investors will be quick to sell riskier credits. With lower return expectations, we think that the risks outweigh the opportunities. 2019 will be another year in which investors should be happy with the return of their capital rather than a return on their capital in the fixed income space.

Foreign Markets

In Europe, a more challenging growth environment and rising political risks limit the potential for European bonds to outperform. Spreads are likely to compress slightly early in the year as fears of an Italian collapse, a hard Brexit, and a slowdown in Germany abate, but these risks are not going away. A subdued growth backdrop and potential perils from both internal and external forces leaves little upside to gain from taking a risk in the region. Additionally, the rising gap between US rates and local European rates will likely pull investor capital away from Eurozone bonds.



Emerging market debt provides some opportunities because of higher spreads and attractive relative yields. Additionally, emerging market debt experienced its worst selloff since 2003 last year. A recovery in the asset class indicates that prices entered oversold territory and that investors were too quick to write off EM growth prospects. Higher spreads and interest rates in the asset class can be a benefit for investors who are willing to accept equity like volatility in exchange for a boost in yield. Additionally, the potential for a decline in the value of the US dollar, a steadier outlook for US interest rates, and stabilization of trade risks are all tailwinds for EM debt. Overall, we think that investors should be cautious when reaching for yield in the current bond market. A late cycle environment is a headwind for all bonds given the probability of higher inflation pressures and tightening financial conditions which put upward pressure on interest rates.

Commodities

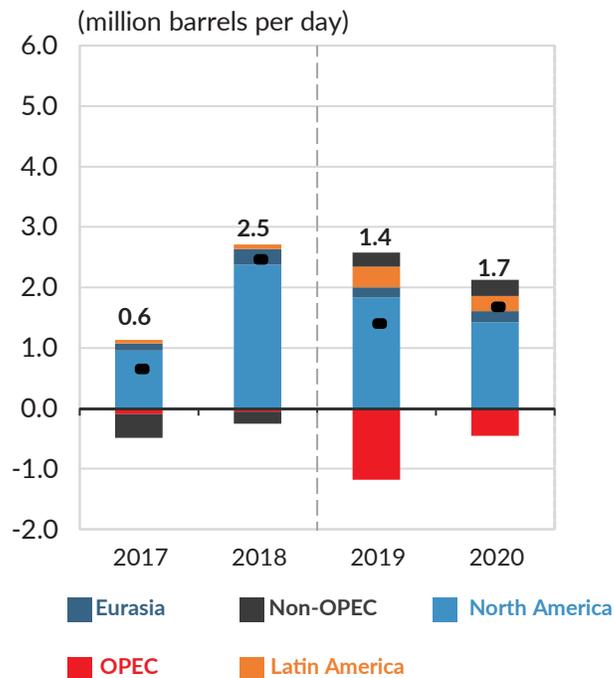
A rising US dollar, ongoing trade negotiations, and substantial supply and demand imbalances have weighed on commodity prices. Additional pressures from a projected slowdown in China and the return of deflationary pressures have also weighed on the asset class. Overall, the sector is still facing headwinds that are unlikely to abate during the first quarter of 2019, but many sub-sectors have a constructive foundation to build on for full year returns. Within commodity sub-sectors we favor oil services and pipeline companies, precious metals over industrial metals, and commercial real estate over multi-family and retail focused operations.

Oil

Despite the decline in crude oil prices during the fourth quarter of last year, shale producers in the US are still pumping at a profit. We expect WTI prices to remain stable in the \$50-\$60 range and think that fears that a supply and demand imbalance would continue in 2019 look to have been overdone. Multiple production cuts from OPEC and their allies should help build a floor for prices and lower energy prices for both businesses and consumers should lead to an uptick in demand.

We see opportunities within the energy industry for both producers and services. Many of the companies that survived the 2014 oil price collapse revamped their balance sheets and business strategies. The shift from focusing on increasing reserves and production to increasing return on equity and earnings per share has made the industry much healthier. On the services side, we think that MLPs are an attractive investment. The surge in US production has led to an increase in the demand to transport oil and gas products. With no end in sight for domestic production, MLPs are in a great position to capitalize on a recovery in demand. Both sub-sectors are trading at discounts to historical valuations and offer the potential for upside earnings surprises. Additionally, the late 2018 selloff in the sector significantly increased yields on MLPs which boosts total return prospects.

Expected Annual Net Change in Oil Production



Source: U.S. Energy Information Administration, Waterloo Capital Management

Outlook 2019: Real Assets

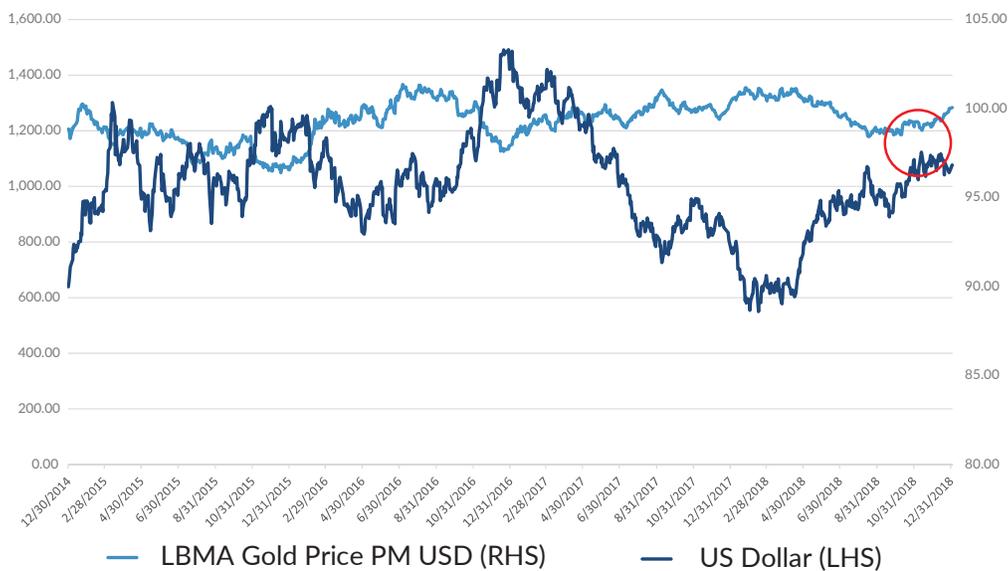
Metals

Lower overall prices and a weaker US dollar along with a rebound in business sentiment may be enough of a tailwind to get a rebound in demand but industrial metals are still facing challenges. The trend of businesses spending capital on share buybacks and increasing dividends has lowered expectations for hard asset capital expenditures. Additionally, a global slowdown in manufacturing will limit the demand for base metals inputs.

There could be a rebound opportunity if tariff talks subside but even in that case, we think that expectations for the sector should remain low. Demand has potentially been inflated by producers and buyers both ramping up transactions ahead of tariffs to avoid extra costs. Larger than normal purchases combined with a slowdown in production and manufacturing demand could lead to an inventory overhang and put further downward pressure on prices.

Although inflationary pressures have been low, precious metals have been rising as the US dollar has flattened. We think that stabilization in both the stock market and the dollar will lead to flatter price movement in precious metals. If the Fed continues to project a pause in interest rate hikes, we could see an increase in the demand for precious metal assets as the dollar declines and inflationary pressures continue to build.

Gold Prices Bottomed as US Dollar Flattened Out



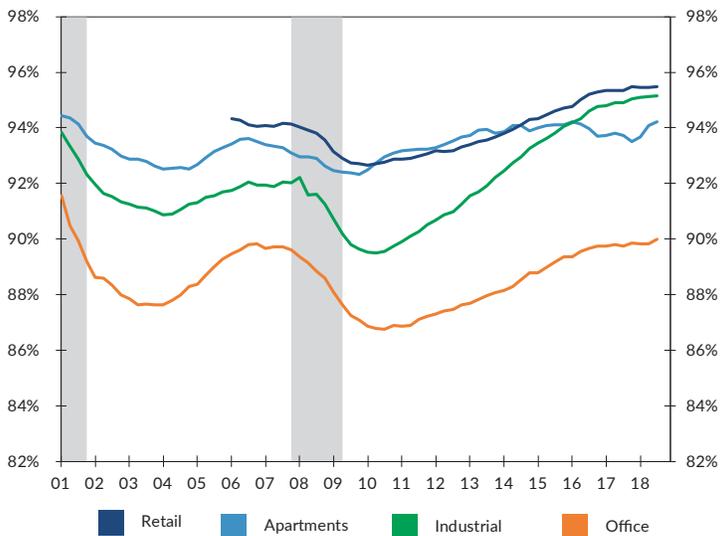
Source: Morningstar Direct, Waterloo Capital Management

Real Estate

High valuations and the potential for softening economic conditions create an uncertain environment for real estate entering 2019. Given the strong appreciation of real estate valuations over the last few years, we think much of the easy money has been made. As with other asset classes, we believe selectivity will be key. We expect broad dispersion between returns of individual property types. Commercial real estate has benefited from strong employment trends. Vacancy rates are at the lows of this expansion and rent growth has been strong. Valuation increases in the commercial space have largely been supported by growth of net operating income. New construction has been moderate, which has served to keep available supply relatively low.

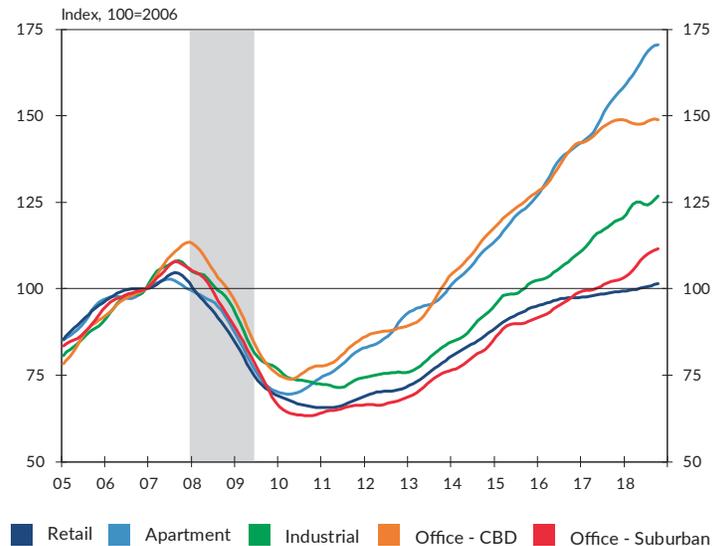
Looking forward, investors will have to be selective in identifying property types which have favorable supply/demand dynamics and regions with high barriers to entry and diverse economic drivers. Broadly speaking, commercial real estate is more susceptible to economic contractions. We believe the opportunities in real estate are region and property type specific. We favor high quality commercial real estate in gateway markets and more niche property types, such as work force housing, senior living, and medical office space, which are less dependent on economic factors to drive net operating income. We also believe real estate debt is well positioned to provide stable income return. In this area, investors must target issues with strong equity collateral.

Commercial Occupancy Rates



Source: CoStar, Inc. Real Capital Analytics, Wells Fargo Securities

Commercial Property Price Index



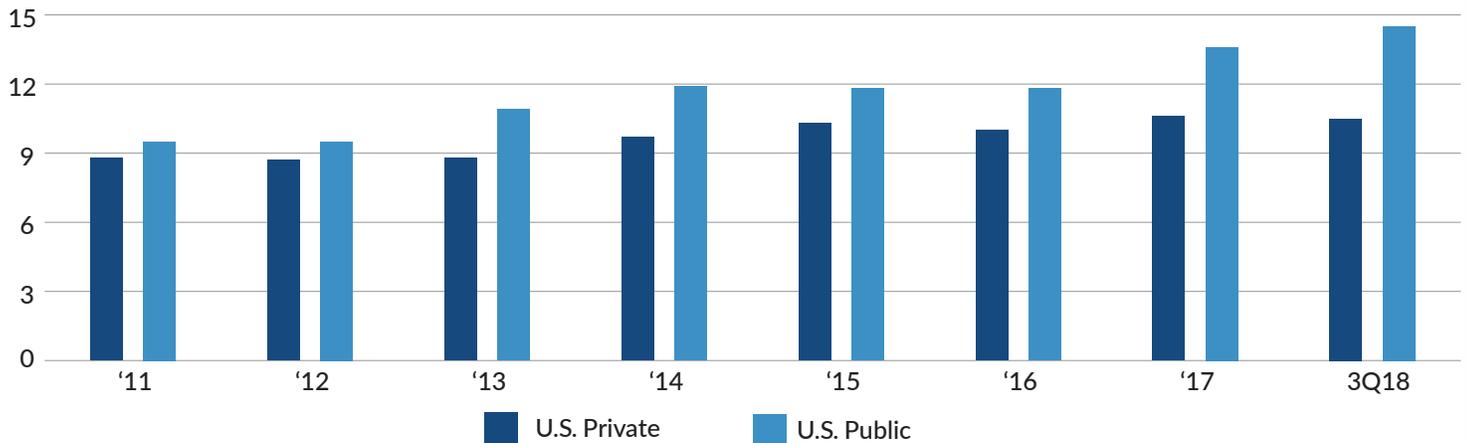
Source: CoStar, Inc. Real Capital Analytics, Wells Fargo Securities

Private Equity

The amount of dry powder raised in the asset class has continued to push up valuations. With a large number of investors looking for places to allocate capital, new vintage year funds may struggle to find attractive opportunities. The long-term nature of the asset class and the more recent phenomenon of extending investment periods could have more managers sitting on the sidelines until more attractive options arise. Funds that have already invested capital will likely have to deal with companies tightening their belts based on the poor outlook for the next few years. The decline in equity valuations and the potential for a decline in M&A activity will lead to lower portfolio valuations heading into 2019. Exit strategies may be harder to come by for funds that are wrapping up.

PRIVATE MARKET MULTIPLES HAVE RISEN, BUT STILL NOT AS FAR AS PUBLIC MARKET MULTIPLES

U.S. private versus public equity valuations (EV/LTM EBITDA)



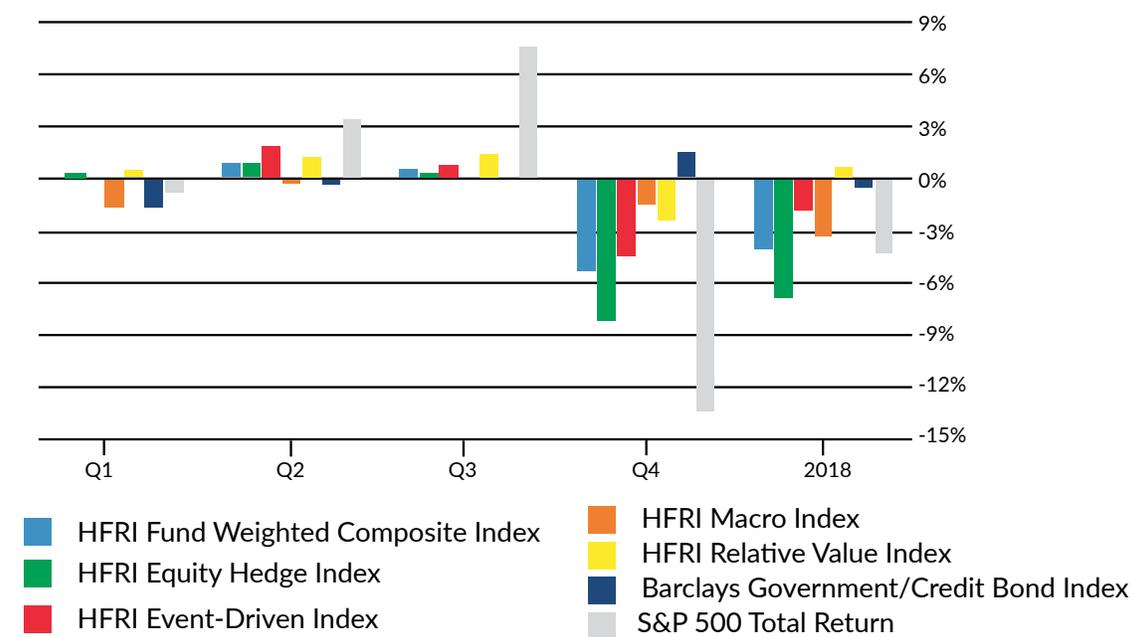
Source: S&P Capital IQ LCD. Neuberger Berman

Private equity will always be an asset class in which the investment in people is more important than the strategy. The sledding has been easy for the past few years and the demand for the asset class has likely drawn poor operators and investors into the space. We have, and always will, focus on manager selection first and the strategy second. We think that private equity will continue to outperform the markets over full cycles and continues to offer attractive opportunities to capitalize on any future downturn. Due to the long deployment of capital, investors must diversify across vintage years and not attempt to time their investments.

Hedge Funds

Despite ending the year with negative returns, hedge funds recorded their best year of outperformance compared to global stocks since 2008. For the year, the Credit Suisse Hedge Fund Index was down 3.2%. As typical in more volatile environments, hedge funds provided investors protection during the drawdown markets experienced in the fourth quarter. December saw the largest relative outperformance for hedge funds as 93% of the index constituents beat the S&P 500 for the month. Despite the relative outperformance, hedge funds did have their worst absolute year since 2011. The transition from a low to a high volatility regime was a challenge to many managers. Moving forward, we believe that manager selection and actively managing strategy exposures will be more important than ever.

Hedge Funds Outperformed in 2018



Source: HFR, MarketWatch, Waterloo Capital Management

As we approach the end of this cycle, we expect sustained levels of high volatility, which should create opportunities for hedge funds to continue their outperformance in 2019. We do expect a strong shift in demand from long beta strategies toward strategies with lower correlation to the capital markets. We favor managers and strategies which can take advantage of volatility while maintaining a defensive stance. In this spirit we have over-weighted quantitatively-oriented managers who maintain low equity beta exposure and have proven to have a well-defined process for generating alpha. From a strategy perspective we favor relative value, event arbitrage, managed futures and statistical arbitrage. From a portfolio construction standpoint, we maintain the view that hedge funds can serve to lower overall portfolio beta and serve as a fixed income surrogate, while insulating portfolios from interest rate and equity market risks.

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

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