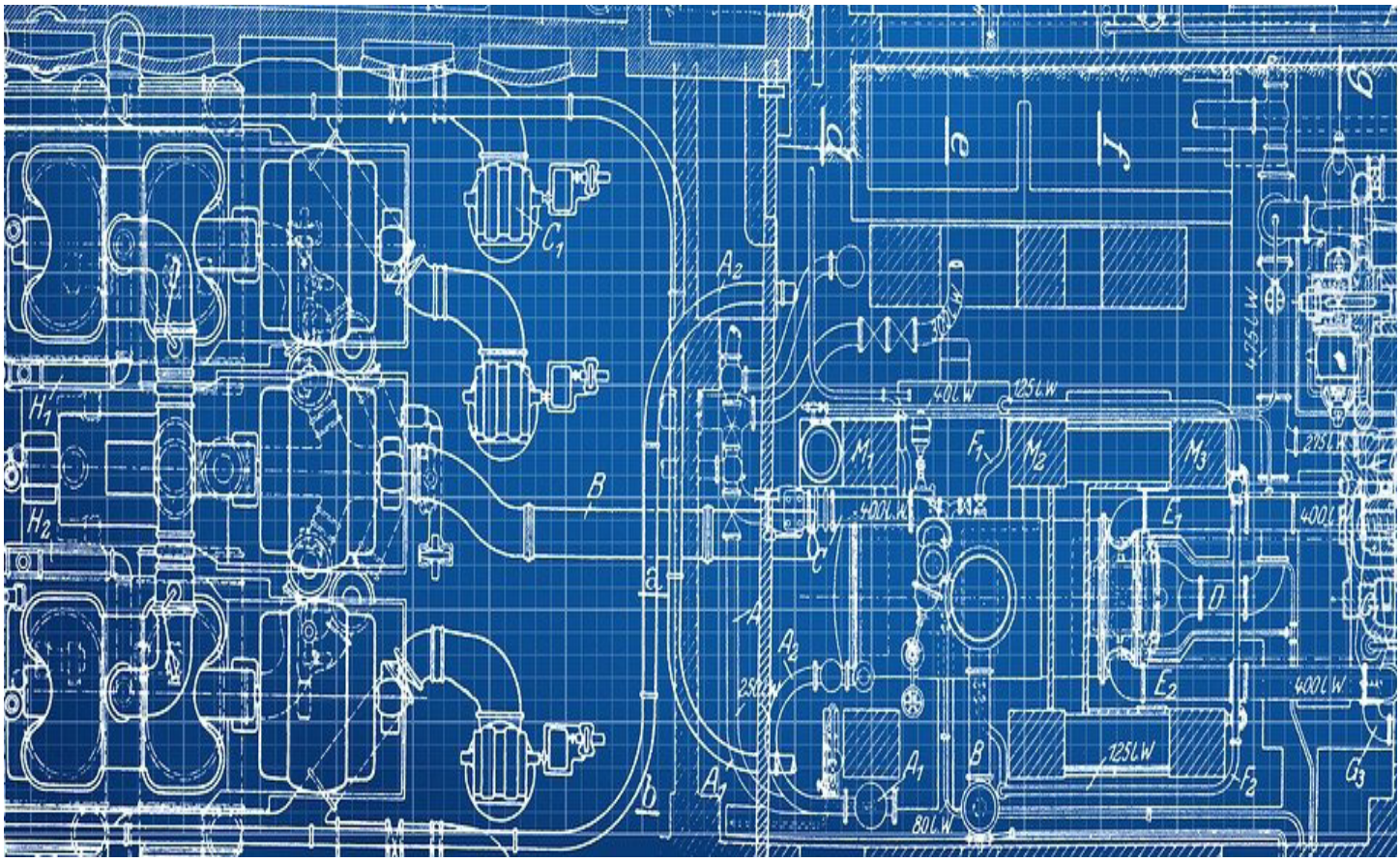
2022 OUTLOOK

Themes to Watch



WATERLOO™ CAPITAL

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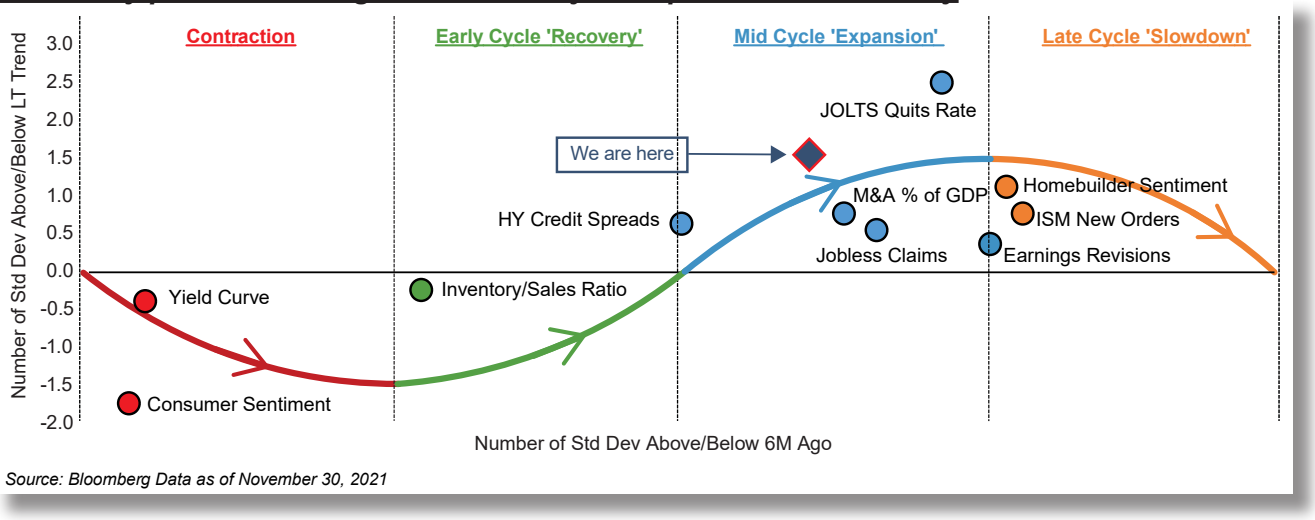
Markets: Volatility Loves Uncertainty

Quicktake: At high valuation levels volatility and drawdowns are much more likely. Given where valuations stand for both stock and bond markets, and uncertainty regarding the trajectory of the economy and Fed policy, we expect bigger price moves to both the upside and downside. The trajectory of growth will begin to taper from the sharp spike we experienced post-pandemic as the economy moves deeper into mid-cycle territory. Uncertainty regarding the effects of higher inflation and a tighter labor market on profitability will lead to wider price movements during earnings seasons. Finally, The first rate hike cycle in over a decade will likely have a destabilizing effect on markets as policy support is reduced. Higher interest rates will force a repricing of valuations and risks for both stocks and bonds. The concentration of long duration assets in stock and bond indexes will also contribute to volatility at the index level. Quality will be the most important factor this year. Focus on valuation, solid fundamentals, cash flows, and earnings growth to build a portfolio core and take advantage of volatility by tactically allocating to short-term opportunities.

The recovery phase is ending and the mid-cycle expansion is underway

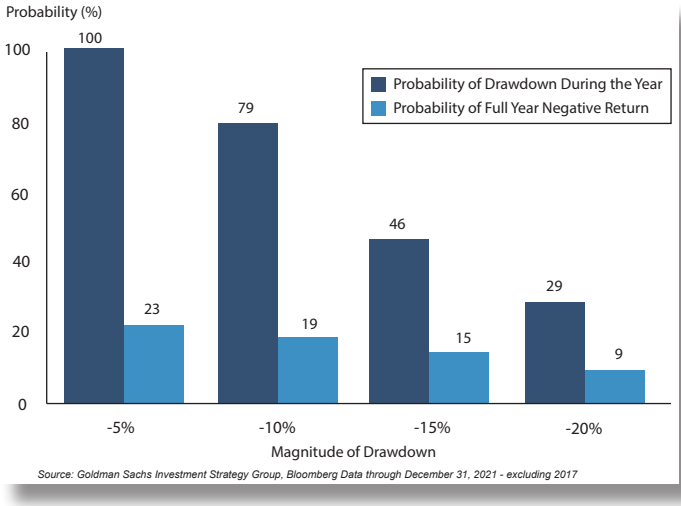


Source: Bloomberg Data as of November 30, 2021

The US economy is firmly in mid-cycle territory after moving swiftly through early-cycle stages coming off the pandemic lows. Due to the amount of government stimulus and benefit packages handed out over the past two years future spending was pulled forward. We expect US economic growth to continue accelerating in 2022 but at a more moderate pace. Mid-cycle environments are defined by moderating growth, high profitability, and a shift to more neutral monetary policies. They also tend to be the phase of the cycle where the most market corrections take place. Slower growth does not mean zero growth, and we think the economy is on track to keep the momentum going this year. That said, economic data may be harder to interpret, and we will likely see more volatility around data releases. In fact, many year-over-year numbers could show declines because of comparisons to 2021 measures which were extreme outliers. It will take time to get a better understanding of incoming data which may look worse on the surface than it actually is. Uncertainty in the headline numbers will add noise and volatility to markets, but ultimately, the direction of the trend is more important than individual data points.

Additionally, look for volatility to ramp up during earnings seasons this year. Rising P/E ratios, or multiple expansion, had been driving the majority of market returns in recent years, but as valuations reach excessive levels this tailwind has begun to fade. After surging nearly 40% last year, earnings will once again be the most important factor supporting equity markets. Like most other measures, earnings will moderate, but we are still expecting growth in the high single to low double-digit range. This level of growth will support equity market appreciation, but we expect significant divergences between sectors, industries, and companies. Investors have been willing to pay higher prices given the rosy 2022 expectations for many companies, but if earnings growth fall short of expectations, we will see a significant repricing.

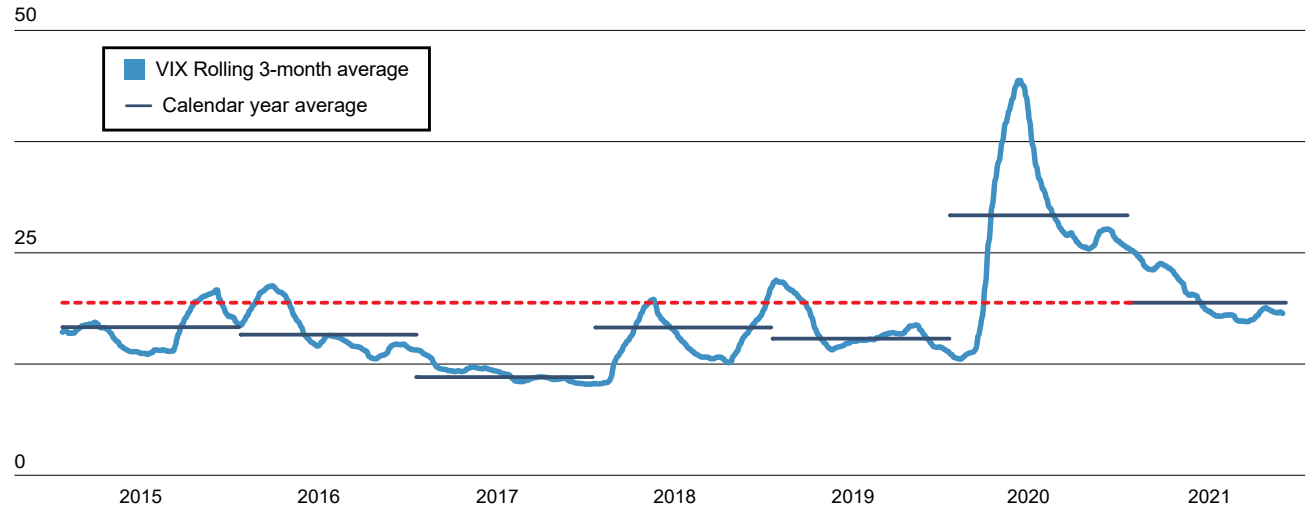
When valuations are in the upper deciles on a historical basis drawdowns are more likely



Source: Goldman Sachs Investment Strategy Group, Bloomberg Data through December 31, 2021 - excluding 2017

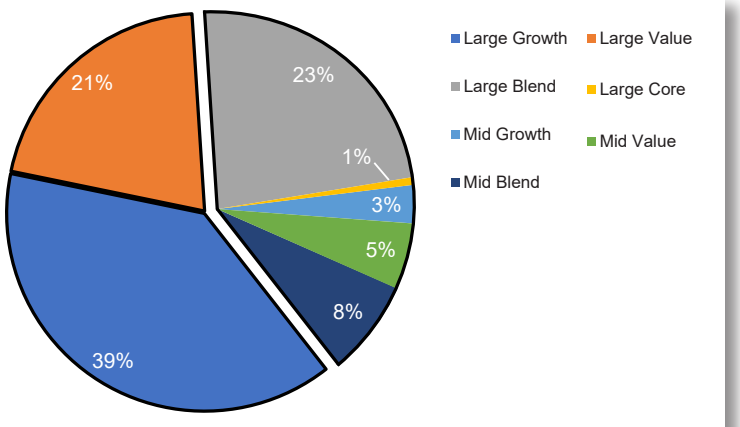
Finally, we expect to see additional volatility in both the bond and stock market as the Fed moves from QE to QT and interest rates begin to rise. One of the main reasons higher interest rates may create issues for the markets is the exposure of major indexes to long duration assets. Duration is a measure of the sensitivity of an asset's price to changes in interest rates. The measure is typically applied to bonds, but the concept can be applied to stocks as well. Longer duration assets are more sensitive to changes in interest rates and shorter duration assets are less sensitive. For bonds, the longer the time to maturity the longer the duration. For stocks, the longer the time to return capital to shareholders through earnings or dividends the longer the duration.

Average volatility is still higher than pre-covid levels despite investor optimism



Source: Bloomberg, Citi

Growth exposure outweighs value exposure by nearly 2x in the S&P 500

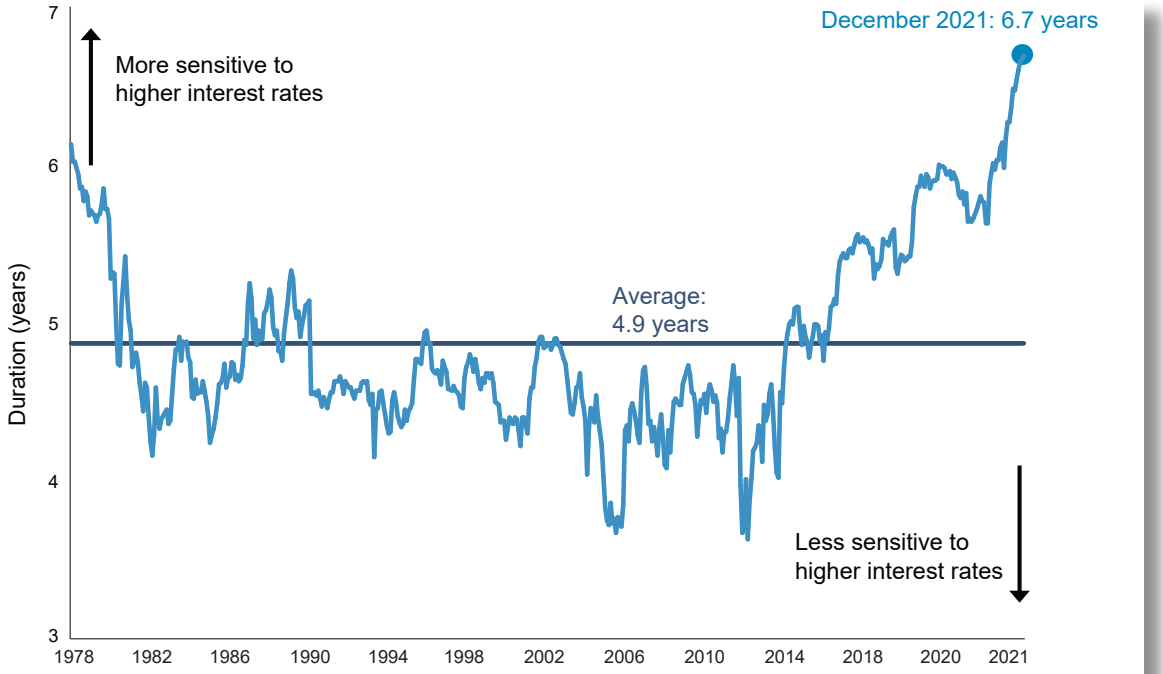


Source: Morningstar, Waterloo Capital

Many growth companies can be classified as long duration because they have low, or sometimes, no earnings and rarely pay dividends. Both the S&P 500 and the Barclays US Agg have experienced increases in duration exposure in recent years. The strength of growth stocks has pushed the S&P 500 exposure to the growth factor to nearly double the value factor. The duration of the Barclays US Agg has been rising since 2014 and is now the highest it has been since the 1970s. The changing characteristics of both indexes has helped support strong returns while interest rates declined, but the knife cuts both ways. Major indexes are likely to exhibit higher volatility as interest rates rise with long duration shifting out of favor and strength rotating towards the lower weighted factors and sectors. With rates expected to rise we still like equities over bonds and expect drawdowns to coax capital back into the market. Until real yields begin to trend higher, we will remain in a TINA environment where stocks maintain a high risk premium versus bonds and draw demand from investors looking for yield and inflation hedges.

As volatility spikes become more commonplace tactical investors stand to benefit by being able to capitalize on rapid internal rotations in market leadership. Investors should look to diversify not only between asset classes, but also between passive and active management. Additionally, as the risk and return outlook for fixed income has deteriorated, we think that investors can benefit from holding a higher allocation in cash or short-term bond alternatives as “dry-powder” to take advantage of trading opportunities throughout the year.

The duration of the Barclays Agg Bond Index has risen significantly since 2014



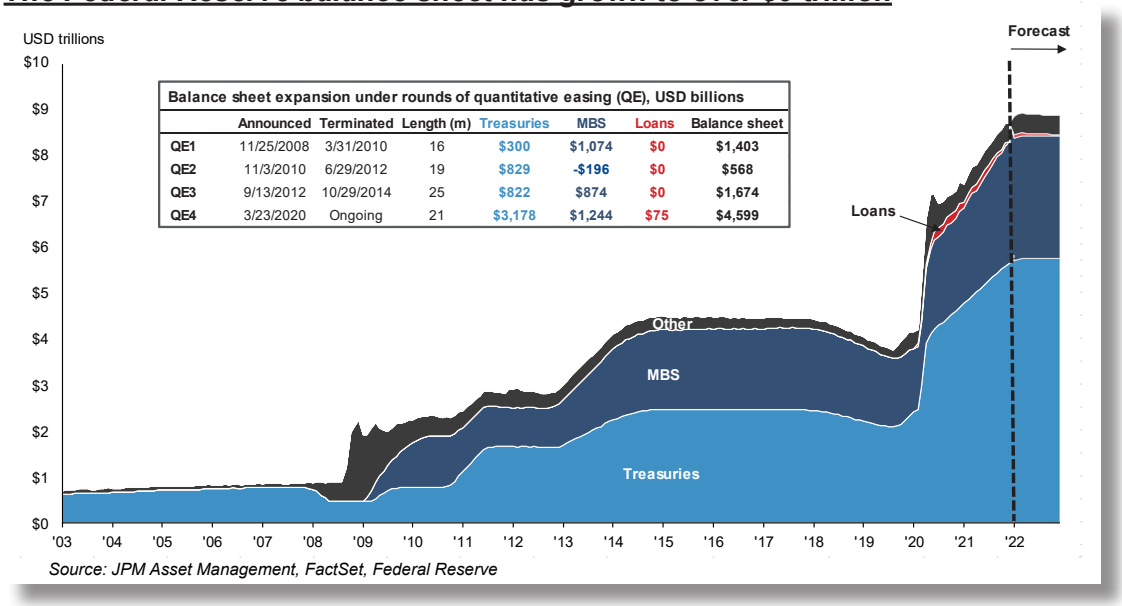
Source: Barclays Live, Bloomberg, and Hartford

The Fed: Threading the Needle

Quicktake: The Fed is attempting to thread the needle and engineer a smooth transition for the economy as they begin the first rate hike cycle we have seen in over a decade. Their motivation is two-fold. First, economic growth has been exceptionally strong since the pandemic lows which indicates the economy has gained enough momentum to continue growing without policy support. Second, policy makers are worried that inflation may be more durable than initially expected. Financial conditions are still at their loosest levels in history, and QE is not over yet, but major policy changes will likely be disruptive to markets. Market cycles typically end due the decline in spending and credit availability brought about by rising interest rates. Markets typically continue rising after digesting initial rate increases, and we think a soft landing is possible, but a Fed policy mistake is near the top of our list of downside risks.

The Fed will be on the front of every investor's mind this year. 2021 was defined by a continuation of extraordinary accommodation from the Fed and global central banks. The Fed has purchased almost $5 trillion of bonds since the start of the pandemic, expanding its balance sheet to nearly $9 trillion and pushing interest rates near the zero lower bound. This process of quantitative easing (QE) provided substantial amounts of liquidity to financial markets, and paired with the amplifying effects of fiscal policy out of Washington, has supported asset prices and kept interest rates low. Without question, the culmination of these actions helped protect the economy from a prolonged recession following pandemic related shutdowns.

The Federal Reserve balance sheet has grown to over $9 trillion



Balance sheet expansion under rounds of quantitative easing (QE), USD billions

	Announced	Terminated	Length (m)	Treasuries	MBS	Loans	Balance sheet
QE1	11/25/2008	3/31/2010	16	$300	$1,074	$0	$1,403
QE2	11/3/2010	6/29/2012	19	$829	-$196	$0	$568
QE3	9/13/2012	10/29/2014	25	$822	$874	$0	$1,674
QE4	3/23/2020	Ongoing	21	$3,178	$1,244	$75	$4,599

Source: JPM Asset Management, FactSet, Federal Reserve

The Fed has had their backs against the wall for years, but they have consistently found a way to take a few steps further back because of unforeseen risks cropping up in the economy and markets. Now, with their mandates of full employment and inflation data convincingly met, the walls are closing in again and they will be forced to make a move in 2022. The shift to a more hawkish policy began in November 2021 when the Federal Reserve announced it would reduce QE purchases by $15 billion per month. Given elevated inflation and a rapidly decreasing output gap, it took all of one month for the central bank to double the speed of reductions $30 billion per month and announce a timeline to end the bond buying program by the middle of this year. In addition to ending QE, the Fed has signaled

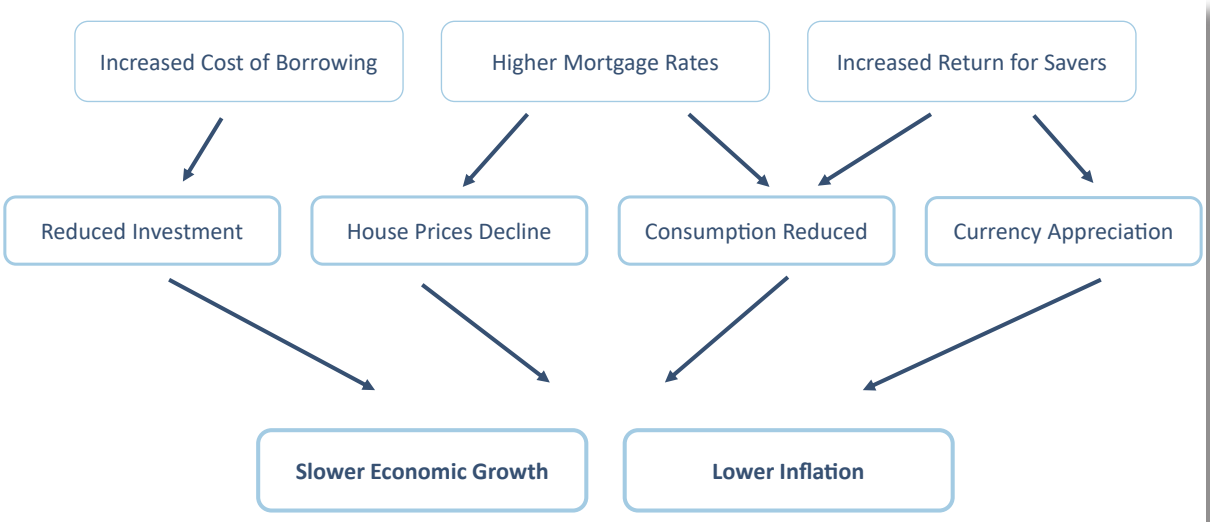
rate hikes are on the horizon and even hinted at QT (quantitative tightening) by rolling assets off the balance sheet. We expect the Fed to start rate liftoff as planned during their first meeting in March and continue raising rates for at least the first half of the year. Markets are now pricing in five rate hikes for 2022 which would indicate consistent hikes throughout the year. How many ultimately become a reality remains a large question that will affect the return potential for both stocks and bonds.

QE tapering alone does not always create outright tighter credit policies for the economy, but it does create tighter financial conditions for markets. As the Fed reverses the tide that has lifted all boats, liquidity will be reduced which is a headwind for financial markets. On the interest rate front, higher rates increase borrowing costs for companies, consumers, and the government. Additionally, investors using loans to purchase assets on margin will have to pay more for leverage. This could cause many market participants to reduce or remove leverage which would further reduce liquidity in the system.

Markets are trying to correctly price in these scenarios, and the Fed will be trying to thread the needle and engineer a soft landing which does not disrupt financial markets. However this is an enormously difficult task, and history is not in their favor. In 2017, the Fed tried tightening QE purchases which had been in place since the 2008 global financial crisis. Then-Fed Chair, Janet Yellen, said that tapering would be "something that will just run quietly in the background over a number of years" and equated it to "watching paint dry". While the process started without a hitch, other global central banks gave signals they would also be tightening their own policies. Fears of a credit crunch sending lenders scrambling for cash caused the dollar to strengthen which put enormous pressure on emerging market borrowers with dollar denominated debt. Global stock and bond prices slid, and credit spreads across developing nations soared. By the end of 2018, US markets had tumbled over 15% in three weeks and many were arguing the Fed had moved too fast. The fallout caused the Fed to abandon course and reconsider how quantitative easing should be phased out.

Although the words "this time is different" are dangerous to use in the investment world, the Fed has worked hard to communicate their plans for 2022 well in advance and help the markets know what to expect. Also, economic growth is expanding much faster than in the previous cycle which started after the Great Recession. On the other hand, risk premiums are much lower, valuations are much higher, and the size of the balance sheet has skyrocketed. If aggressive policy changes coincide with a reversal in positive supply and demand dynamics, the Fed may have to pivot to avoid rate hikes becoming

Higher interest rates affect all levels of the economy and eventually lead to slower growth

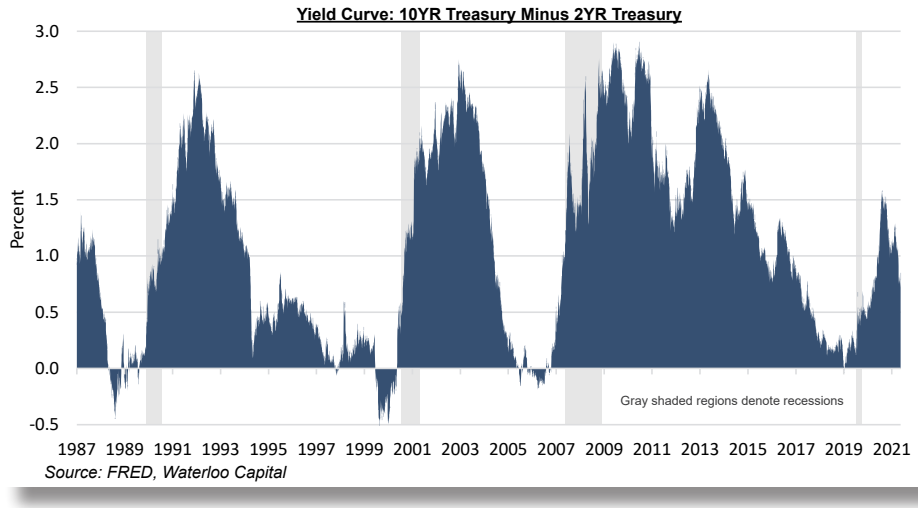


Source: Waterloo Capital

detrimental to growth. Additionally, the potential resurgence of new covid variants increases forecasting uncertainty and could continue to disrupt supply chains and broaden price pressures. Yet, if the Fed doesn't act quickly they risk losing face by sending the wrong signals to markets which are already pricing in tighter financial conditions.

Generally, when the Fed is tightening or less accommodative it creates headwinds for financial markets. Projections on tapering, rate hikes, and balance sheet reductions will dominate major headlines and inject volatility into markets, but separating what the Fed says and what they follow through on will be key. Financial conditions are still the loosest in history, rates are currently still at zero, and QE is still running. A strong consumer and healthy housing and labor markets have also helped bring us to this point and look strong enough support economic growth despite reduced policy support. It might take actual action for investors to react to the rhetoric. That said, markets practically have a Pavlovian response to any hints or talks of tightening and there will be pockets of elevated volatility surrounding Fed meetings throughout the year, further supporting a cautionary approach for investors.

The Fed risks making a policy mistake leading to lower growth expectations and a potential a yield curve inversion



Finally, given the Fed does not know how much of the recent rise in inflation is monetary induced or due to supply and demand shocks, being data dependent and flexible will be ever important for both policymakers and investors. If the Fed is right and supply side shocks are the primary driver of inflation higher prints are unlikely to be long lasting. However, monetary inflation tends to be more systemic and durable. Stronger economic reports and consistently hotter inflation prints could raise concerns of faster or larger than expected hikes, while easing inflation and poorer economic news could counterintuitively ease investor concerns by delaying future policy changes. Historically, equity returns have been turbulent around initial rate hikes, but markets ultimately digest the policy changes as a sign of a strong underlying economy and continue climbing. We think this trend will continue this year, but the situation is fluid. With the potential for slower growth in the back half of the year mixed with disruptive inflation prints a Fed policy mistake is a risk at the top of our list.

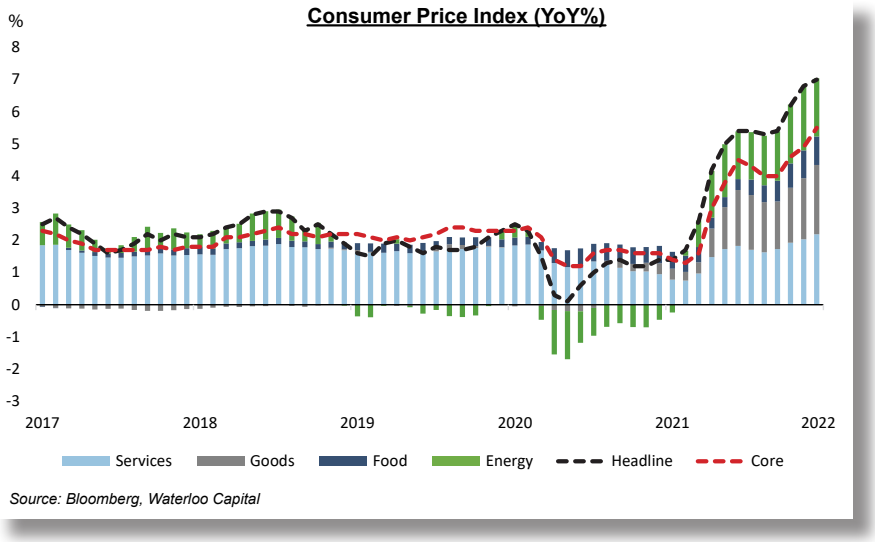
Inflation: Not Partying Like It's The 1970s

Quicktake: **No matter how you measure it inflation is high. Pandemic production cuts left massive gaps in supply chains which has led to ongoing supply and demand shocks. The real question is whether or not this trend is here to stay. Ongoing supply issues, wage growth, and housing costs will keep inflation elevated early in the year. Looking ahead, we expect inflation to remain above historical trends, but we see the current climb peaking earlier rather than later. Breakeven rates and consumer expectations indicate inflation expectations are falling over longer time frames. Also, shifts in consumer activity and a rebound in inventory production should help alleviate pressure from the demand side. Finally, multiple secular deflationary factors including low money velocity and technological innovation remain in force.**

Supply chain disruptions, surging oil prices, labor shortages, and pent-up demand from the lows of the pandemic have pushed global inflation to multi-decade highs. The Consumer Price Index (CPI) is at +7% year over year while the Fed's preferred gauge, Personal Consumption Expenditures (PCE), is up over 4%. It's interesting to note that in 1981 the Bureau of Labor Statistics (BLS) changed the way inflation is calculated and using the pre-1981 math, 2021 prices would have actually been 3-5% higher than reported. No matter how you look at it or what index you use, inflation is back.

The headline shocks many investors and consumers are experiencing turn our attention to the real question: Is inflation is here to stay?

Inflation is spiking but will the trend continue?

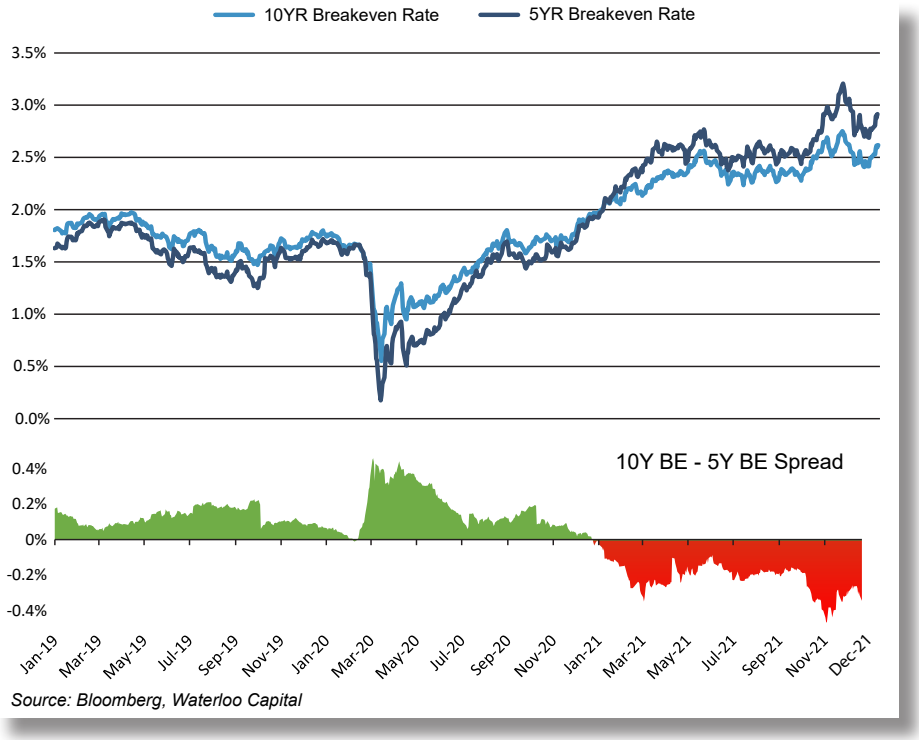


Source: Bloomberg, Waterloo Capital

In normal times, these types of numbers would be a clear sign for central banks to pump the brakes and begin a rate hike cycle. But the last couple years have been anything but normal. Just 18 months ago the world was arguing whether deflation was going to be long lasting given the massive demand disruption in global economies caused by the pandemic. This disruption caused a myriad of interruptions to global supply chains, as many corporations closed factories and laid off workers in response to and in anticipation of worldwide lockdowns. The tables quickly turned. Exploding consumer demand for goods combined with surplus capital from stimulus measures was a recipe for one of the largest demand bottlenecks we have ever seen. Raw material shortages, scarce transportation labor, factory closures, and port congestion were just a few of many problems in what has been dubbed the "everything shortage". Supply imbalances and the threat of ongoing local lockdowns in key supply regions pushed managers to source goods domestically. This shift to domestic supply and production continued to put upward pressures on prices. Economics 101 teaches us that when supply contracts at the same time demand is rising prices will increase. That theory became a reality throughout 2021. Used car prices spiked 45%, lumber was up over 100%, and oil prices rose as much as 75% in 2021.

As we head into 2022, we expect inflation to remain elevated above historical trends, but we believe we are nearing the peak. We recognize that the recent trend towards deglobalization and supply chain disruptions can persist, but many of the current distortions are unlikely to be permanent events. If using the word transitory means that the supply and demand relationship will move back toward equilibrium then we support that view. Just from an arithmetic standpoint, the year over year comparisons from such high levels in 2021 will be a headwind going forward for higher CPI prints. Looking at the gauges for input costs and barometers of inflation many are at or past their peak. Additionally, a shift in consumer spending from goods to services appears underway which should also help elevate some pricing pressures.

Break even spreads show the market does not expect inflation to become a secular long-term issue



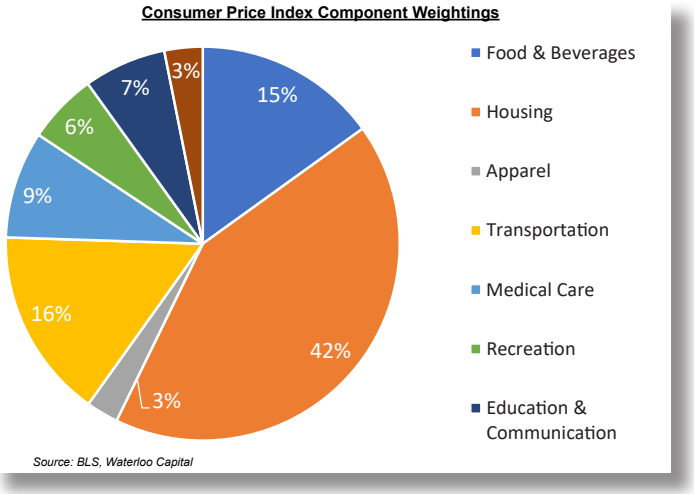
Source: Bloomberg, Waterloo Capital

The fixed income market is a great place to look for clues as to where market participants think inflation will be. Textbooks tell us that nominal yields are calculated by adding economic growth to inflation. By extension that means rising inflation should lead to higher rates. However, over the last year nominal yields are not rising out of control.

Looking at the breakeven rates provides even more insight into the potential peak in inflation expectations. Breakeven rates are market-based measures of expected inflation. They are calculated by comparing the nominal yield of a bond to the yield on an inflation linked bond with the same maturity. Clearly, we can see expectations of future inflation point to weaker price growth as the economy normalizes. Additionally, if we observe two key maturities of breakeven rates, the 5 Year and 10 Year, it tells an even better story. When the spread is negative that means that the shorter-term inflation expectations are higher than the longer-term expectations. Effectively the market is telling us that inflation will remain higher in the short run but taper off in the long run, further supporting our view. Even the public's longer run viewpoint of price pressures is retreating, though by a modest

margin. Consumer inflation expectations are important as they can build on themselves and lead to a feedback loop. The latest expectations survey waned to 4% in November 2021 from 4.2% in both September and October. It ended a four-month string of increases and marked the sharpest decline since September 2020. Furthermore, recent manufacturing PMI reports show that businesses are reflecting the same narrative. Supplier delivery delays, a good gauge of supply bottlenecks, declined from 75.6 in October to 72.2 in November to 64.9 in December. Drilling down to inflation itself, the prices paid index (PPI) sank from 82.4 to 68.2 in December which marked the lowest reading since November 2020.

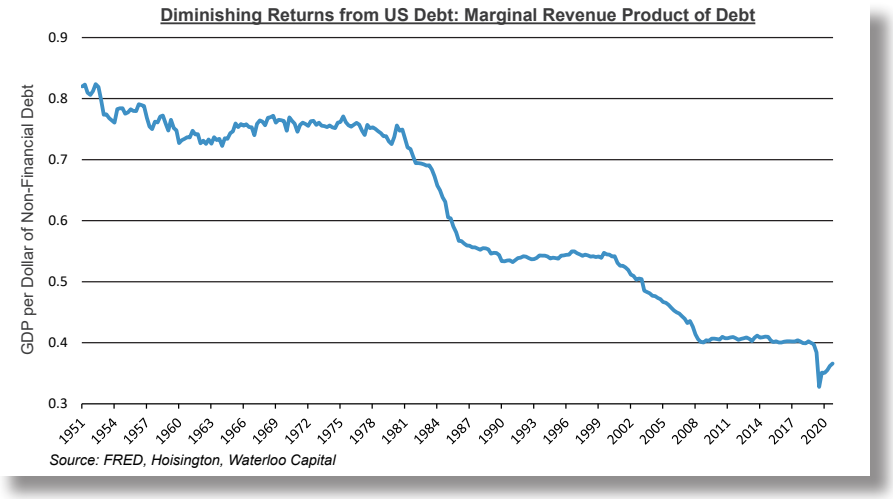
Housing is the largest component of the Consumer Price Index



Though we see supply chains and some input costs easing over the course of the next year and beyond, labor and rent could be key factors in stickier inflation. The latest JOLTS report reflected a tight labor market showing job openings at 10.6 million while the number of people looking for jobs is a little over 6 million. In tight labor markets workers can find jobs more easily and are likely to receive higher wages as businesses pay up to fill positions. This can cause a wage price spiral in which higher wages lead firms to increase prices on goods and services to cover costs, which in turn, leads workers to ask for higher wages to cover their own costs. This phenomenon remains a risk especially as the decrease in labor force participation rates may reflect secular changes in the economy. On the housing front, shelter costs are up over 4% for the year which is the largest increase since 2007. Shelter makes up about around 40% of the inflation index and is reported on a multi-month lag. Although many house prices and apartment rents may be near their peak, the lag in reporting could keep headline CPI elevated early in the year especially as input costs and wage pressures remain high.

Over the long term, many secular deflationary forces remain intact. Before the pandemic, inflation was kept in check due to a combination of high debt levels, increased globalization, aging demographic trends, and technological innovation. The rising level of both public and private outstanding debt is a problem facing many of the largest global economies today. Debt is not so much a problem if the economic growth per dollar of debt issued is increasing. Unfortunately, the marginal return on debt is at historic lows.

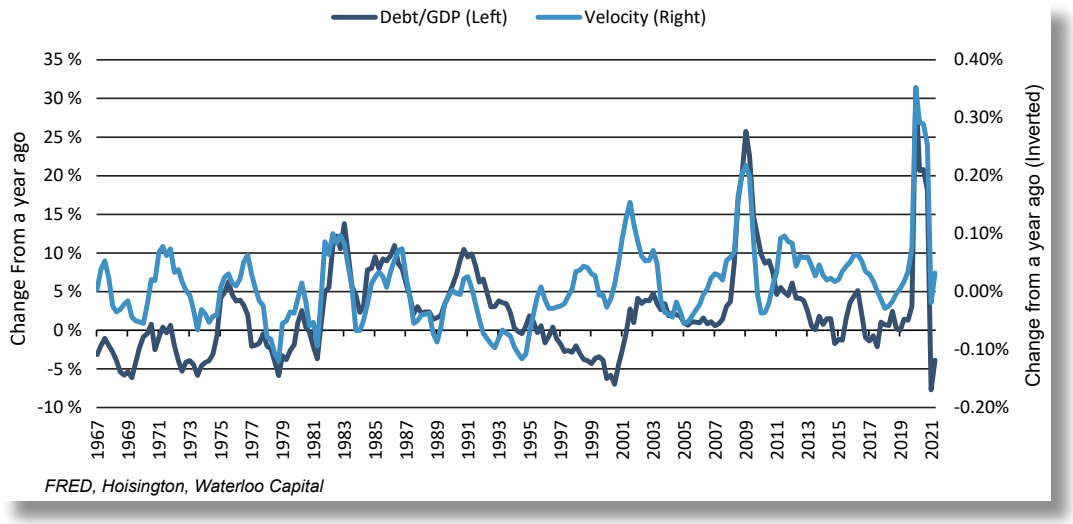
Debt has been increasing but it has not been as accretive to growth



The creation of debt leads to growth in money supply, and the destruction of debt equates to a contraction of capital which expands the output gap between actual and potential GDP growth. As all debts must be repaid, debt is by nature is deflationary over the long term.

To get a meaningful sustained increase in inflation, we would need to see an increase in the velocity of money. Money velocity is a function of debt, or money supply, relative to economic growth and there is an inverse relationship between the two. A bet on inflation over the long term is a bet on the increase in the marginal productivity of debt and economic growth exceeding debt growth. Additionally, although some secular disinflation trends like globalization were temporarily disrupted, one remains unimpeded. Technology has constantly increased worker productivity over time, putting downward pressure on inflation. As we put the pandemic behind us and businesses invest in technology and equipment upgrades there should be a productivity rebound which will put downward pressure on prices.

A bet on inflation is a bet on a sustained increase in velocity



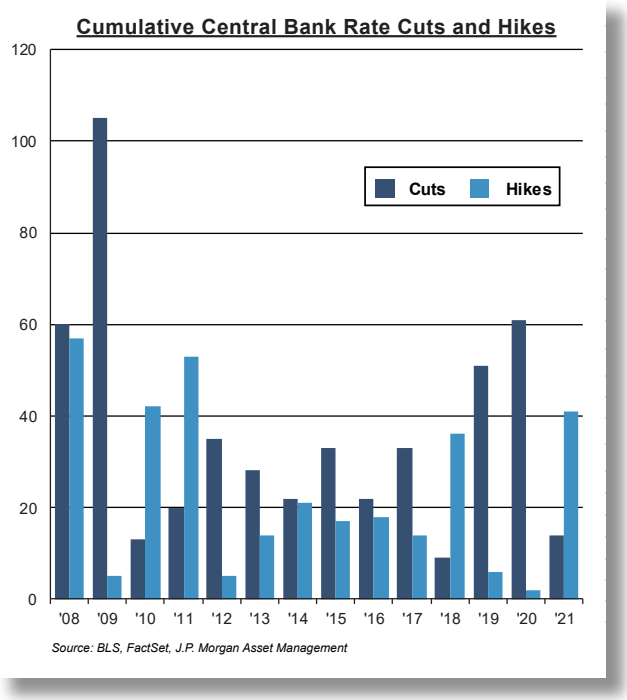
WITHOUT A PICK UP IN MONEY VELOCITY INFLATION BECOMES TRANSITORY AGAIN

Bonds: Return Free Risk

Quicktake: **The trajectory of interest rates is moving higher around the globe. The combination of rising rates, hawkish central banks, and higher inflation will be extremely difficult for bonds to overcome. Even with the potential for a flatter yield curve if growth expectations decline later in the year, the total return outlook for bonds is unattractive at current real interest rate levels. Outside of a recession, bonds will likely add return free risk to a portfolio and should be viewed as diversification and portfolio insurance rather than return drivers. Investors should look to alternative investments and private markets to compensate for low return expectations in traditional fixed income. We recommend an underweight to traditional credit and government bonds and overweight to floating rate, TIPs, and alternative fixed income strategies.**

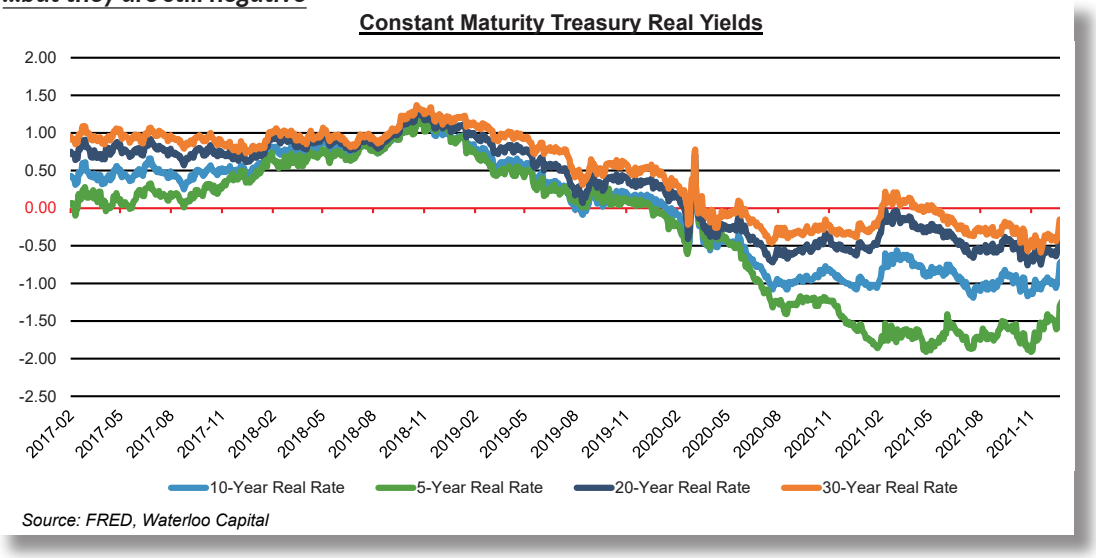
2021 was a difficult year for fixed income investors. Outside of high yield bonds, which have a higher correlation to equity returns, many major bond indexes posted flat or negative returns. Drawdowns were swift, and generated by just two significant spikes in yields at the beginning and the end of the year. Entering 2022, central banks are front and center once again, and they will be the bane of fixed income investors. Globally, we have seen central banks reverse course from extremely accommodative monetary policy to tightening financial conditions by reducing asset purchases and raising interest rates. More than 10 major central banks have already started raising rates, and many more are expected to follow. As a reminder, bond prices move inversely of yields which sets up 2022 to be a difficult environment for bonds from the outset. Additionally, we are finally seeing signs of consistent inflation, but it is coming on stronger than policy makers wanted. As we have touched on in our other themes, higher inflation influences monetary policy by forcing central banks to either allow inflationary pressures or raise interest rates to combat higher prices, usually at the expense of growth. Investors will need to be cautious as we enter this transition phase.

Global central banks have been aggressively raising rates



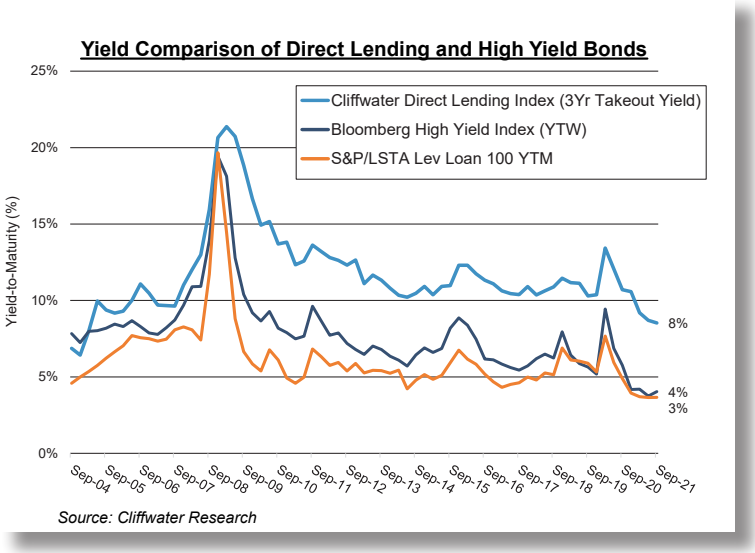
Having benefitted from over twenty years of declining interest rates, bonds enter the year with valuations near all-time highs. Now, rates are on the rise and the market is becoming riskier. Credit spreads are historically low, and at these levels, small moves in rates can lead to large moves in prices. For example, an increase of roughly 20 basis points or 0.20% in the US 10-year Treasury bond would wipe out a year of income from the bond's price. An increase of a full percentage point in the benchmark rate would cause losses of about 9%. Tack inflation onto the equation and real return expectations would be deep in negative territory. Real interest rates, which subtract inflation from current rates, have been negative since February 2020, meaning investors are actually losing spending power by holding bonds with yields that are lower than inflation. With inflation tracking above 5%, nearly all fixed income options enter the year in the negative real yield category.

Real rates began moving higher after the Fed announced tapering plans...
...but they are still negative



Ultimately, higher inflation and rising real rates will inhibit total returns and handicap income generation from traditional bond investments. We expect bond index returns to be close to flat or negative this year. This means fixed income allocations will need to be more innovative than in the past. We are looking to alternatives to help fill the total return and income gaps. Investors should look to add unique fixed income exposures through investments like direct lending and infrastructure strategies. Alternatives provide higher yields as compensation for illiquidity and more concentrated credit exposures. Additionally, many alternative income strategies can benefit from a rising rate environment by including floating rate covenants or adjusting rates higher alongside the yield curve. Investors who are comfortable with illiquidity will benefit from carving out a significant portion of their fixed income portfolio for an allocation to alternatives. If alternative strategies are inaccessible or increasing illiquid exposure is unfeasible, we recommend holding a higher allocation to short duration assets and cash to start the year. Real yields are still well below trend, but they have been rising. While an aggressive steepening above previous highs is unlikely, we do expect real rates to climb as inflation peaks and the effects of Fed rate hikes gain momentum. Investors holding short-term bonds and extra cash will be able to ladder in exposure and ideally reinvest capital at higher interest rates throughout the year.

Gross yields for direct lending have averaged 4% higher yields than high yield bonds over the last 15 years.



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