Meet the New Boss

Navigating Fiscal Policy-Driven Markets

Dear Friends, Investors and Partners:

At Salient we are fond of saying that we don't have a crystal ball. We think that anyone who tells you they can accurately predict what is going to happen over the next calendar year is either fooling themselves or selling something, and usually both. What we do feel confident in is our ability to identify some of what is going to matter—in the global economy, in markets and in investor sentiment.

In our letter last year, one of the main drivers we had our eye on for 2016 was the rise of populism. A bit on the nose. To be sure, we couldn't and wouldn't have predicted that markets would hear discussion of 35% tariffs and press the buy button. We unequivocally believed and continue to believe that trade protectionism is a "bad thing." Let this be a reminder: a lot can change, but the value of a well-told story rarely does.

In some markets and in some circumstances, the answer to "What will matter?" must still be, "We honestly don't know." But there is still information in that. When not only the outcomes but the drivers are unknown, the risk of taking active positions may be high—and what's worse—less likely to be well-compensated.

Ultimately we think that this is where investors' attention should be when they consider their outlook for the year. There is little value in guessing whether the market will be up 5% or 10%, but there is a great deal of value in focusing effort and attention on the events and decisions that will matter, being honest about our ability to capitalize on those decisions and making a plan to take focused risks in those rare cases where opportunity and edge coexist. That also means avoiding taking risks in markets where uncertainty around drivers will be significant and the opportunity to add value nebulous.

Our outlook for 2017 synthesizes the views of Salient's specialists in several key investment areas, who together form the executive team for our asset management business. We don't agree on everything, but that is by design. After all, the right answer in markets driven by different investors and different sentiment isn't always the same. We hope that you find this approach additive to your strategic review process for the year.

The Big Things That Matter in 2017

Ben Hunt, Ph.D.
Chief Investment Strategist

Typically the end of a calendar year provides a convenient demarcation line for an annual investment report. We tend to look back and look forward at markets in 12-month chunks anyway, and wrapping everything up in a year-end bow is a Wall Street tradition. In 2016, however, the demarcation line had nothing to do with year-end and everything to do with the November 8 election of Donald J. Trump to the White House and Republican majorities to both the Senate and the House of Representatives.

Before the election, global markets in general and the U.S. stock market in particular were in a 2-year holding pattern, with the S&P 500 Index up a grand total of

4.8% from November 7, 2014, through November 7, 2016. The Russell 2000 Index, a broad index of smaller, domestically focused U.S. companies, was up 2.4% over the same 2-year span. Before the election, the overwhelmingly dominant market concern was U.S. Federal Reserve (Fed) monetary policy, with media and investor narratives for the past five years overwhelmed by questions of will-they-or-won't-they raise interest rates. For the most part, the answer was always "they won't!"—with 10-year U.S. Treasury yields hitting a 50-year low of 1.36% on July 8, 2016.

In the two months since the election (November 8, 2016 through January 8, 2017), the S&P 500 is up more than 7%. The Russell 2000 is up more than 15%. In two months. Since the Trump election, the 10-year U.S. Treasury yield has spiked from 1.8% to 2.6%. The U.S. dollar is up almost 5%. Consumer confidence is now at a 10+ year high.

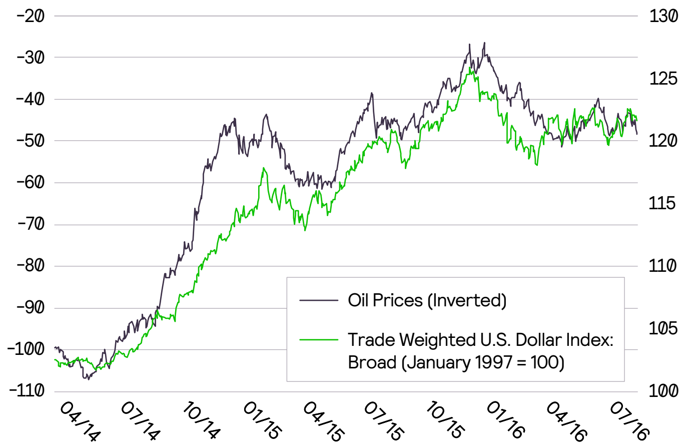
In reality, of course, very little has changed in the world since November 8, and what has changed outside of the U.S. (Chinese currency flight resumed and the Italian government began collapsing…again) isn't good news. But since when did reality matter? Global markets today are gripped not by fear but by hope: a new hope that the swamp will be drained, that regulations will be rolled back, that taxes will be reformed, that corporate cash will be repatriated back to the U.S. (and spent on new factories and new jobs), that infrastructure will be built and that the Fed will stand down, etc. It's as if Donald Trump has worked a Jedi mind trick on markets, in which everything he whispers (or tweets) is treated as reality instead of an aspiration.

Are we still in a policy-driven market? Absolutely. But the market's gaze has shifted from monetary policy and what the Fed does or doesn't do to fiscal policy and what the Republican Congress plus Donald Trump will or won't do. That's an enormously important shift, with far-reaching consequences on the behavior of all market participants. Why? Because the correlations and trends are shifting. Because what's important as a proxy for monetary policy intentions, like the dollar going up or down, isn't very important as a proxy for fiscal policy intentions. If you're a mega-sovereign wealth fund and your decision on buying risk assets like stocks or commodities depends on your assessment of the Fed, you care about the dollar. If your decision depends on your assessment of Donald Trump and the Republican Congress, you don't care about the dollar. Right now the latter decision-making is ascendant, and you see that in a breakdown of the correlations that have dominated markets since the summer of 2014.

Here's a chart that I've used a lot over the past year *(Figure 1)*. It shows how oil prices (in eggplant, left-hand vertical axis with price inverted) and the dollar (in green, right-hand vertical axis) have moved in lockstep over the past two+ years, with a -96% correlation from June 2014 through September 2016. This is an insanely powerful correlation.

FIGURE 1

Oil Prices (Inverted) vs. the Dollar

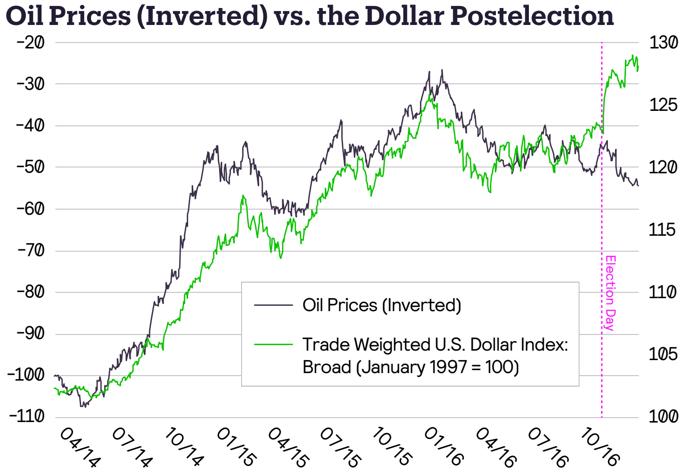


Sources: Salient and Bloomberg, as of 09/30/16

And here's the same chart updated through December 2016 *(Figure 2)*, with a vertical line drawn at the U.S. election date. Crazy, right? The correlation has totally vanished. If anything, it's reversed itself.

FIGURE 2

Oil Prices (Inverted) vs. the Dollar Postelection



Source: Salient and Bloomberg, as of 12/31/16

For a game theorist like me, someone who believes not only in playing the cards but also in playing the players, these are heady times, indeed. It's a reminder that our job is to deal with the market as it is, not as it was, and right now this is a market that favors risk assets, which is usually the case with hope-based investor behaviors. In more colorful terms, a hope-based market is a 2x4 market. Meaning that this market, like a rented mule, will need to be hit between the eyes with a 2x4 before it goes down.

Here are four places I'm watching closely for the materialization of that 2x4:

1. **Dollar Strength and S&P Earnings:** The knee-jerk behavioral correlation between dollar strength and risk asset weakness may have broken down as attention shifts from monetary policy to fiscal policy, but there is still a distinct real-world consequence of dollar strength: S&P 500 earnings go down. Right now there is extreme optimism regarding 2017 corporate earnings growth—optimism that will be smashed by a strong dollar.
2. **Dollar Strength and Chinese Monetary Policy:** The other real-world consequence of a stronger dollar is that China, whose currency is tied closely to the dollar, suffers. A stronger currency makes it harder for China to export its manufactured goods, and that's bad news for China growth and China politics. There is a nontrivial chance that China rips off the currency exchange rate Band-Aid by floating its currency and sparking a dramatic devaluation. That's a deflationary atom bomb for the rest of the world and horrible for risk assets.
3. **Eurozone Political Splintering and Bank Bail-Ins:** We're going to have national elections in the Netherlands, France, Germany and probably Italy in 2017, and in each country an anti-status-quo / anti-Europe party appears poised to make dramatic gains if not secure an outright victory. With Europe splintering, there's no way that Germany or the European Central Bank (ECB) ponies up hard cash to bail-out critically undercapitalized European banks (most notably in Italy but also France, Spain and Germany), and that leaves existing investors on the hook for bail-ins. Ugly.
4. **Rising Rates:** Okay, I'll say it. I think the Yellen-led Fed would be perfectly happy to hang a big fat recession around Donald Trump's neck. How do you do that? By raising rates three times in 2017, as the Fed's December commentary suggested.

What's the bull scenario? In my opinion, it's very simple. If a Republican White House and Congress can push through a legislative trifecta of tax reform/repatriation, regulatory reform/rollback and infrastructure spending, then we're off to the races. It will be a challenge, to say the least, to push this agenda through. But it's conceivable. That doesn't mean that any of this will justify current valuations or change the dire trajectory of global growth and demographics. But for the attitudes of investors, it is monumental. This may be a market built on hope, but it's not a crazy hope.

Coming into 2017 we have a market that favors hope over experience. Maybe that hope will be borne out over the course of the year. Maybe it won't. I really don't know. But I think we're looking at the right things and in the right places for adapting to whatever comes down the pike.

The best, most complete view we have at Salient of what's coming down that pike comes from our multi-asset and quantitative teams, which take the broadest view of asset classes as they build adaptive portfolios that are focused on maximizing diversification and income in context of the risks they take across these markets.

What Matters for Multi-Asset Portfolios in 2017

Roberto Croce, Ph.D.
Managing Director,
Quantitative Strategies

Generally speaking, the performance of global stock and bond markets following the election provided investors with a peek into what the world of 2017 may look like. Overall, we think the world appears to be shifting from a global economy that marches to the beat of central bank policy to one that will be dictated by the fiscal policy of newly anointed populist governments throughout developed and emerging economies. The biggest piece of evidence that an investor can point to is the general enthusiasm in markets that have shifted toward a more populist political regime (or movements) such as the United Kingdom, China, Italy and the U.S. The change in policy can have direct implications that could be positive in the form of deregulation and increased investing in energy, banking, industrials, health care and materials.

For investors across financial markets, hope and optimism have manifested themselves very broadly:

- **Equities:** Our internal measures of stock market sentiment are bullish in all but three of the 23 countries where we invest. In addition, risk-adjusted equity yields remain above historical averages in most countries.
- **Commodities:** Sentiment has improved dramatically and many markets are now trading in backwardation, indicating a strong expectation of appreciation and trend continuation in the year ahead.

- **Sovereign Debt:** The recent increases in yield leave many of our markets offering better than 3% income on a rolling basis. At these levels, rolling yields cushion investors against the first 50 basis points (bps) of surprise interest rate increases. We think earning a 3% yield with a significant cushion against capital losses and the potential to offset crisis risk in other asset classes make sovereign bonds more attractive than they have been for several years.
- **Credit:** Risk-adjusted credit spreads are a bit narrower than they have been historically. We believe that credit markets will outperform equities on a risk-adjusted basis if global growth remains sluggish, and thus credit remains an important part of our recommended asset allocation strategies.

We happen to think that recent market movement isn't just based on pure, unbridled optimism. While the global economy was sitting on the edge of possible recession during most of 2016, as the year drew to a close some key economic data points began to shift into a more positive and expansionary position. For example, the Global OECD (Organization for Economic Cooperation and Development) Leading Indicator is up 1% year over year, turning positive for the first time since 2014. Additionally, the Global Purchasing Managers Index has been increasing since summer 2016 and currently sits at 53.4, indicating economic growth. Finally, money supply as measured by M2, is very healthy. Given these metrics, a global recession seems unlikely as we enter 2017, and therefore the potential returns for risky assets such as stocks look promising.

Key Views on Equities

Given the case for economic growth highlighted above, the question is: "Which markets should benefit?" As of now, many of the least expensive opportunities are in emerging markets, including Russia, China, South Korea and India. Many of these countries have the wind at their back with strong momentum; meanwhile, some of the most expensive markets are developed countries such as the United Kingdom, France, Canada, Italy and Spain, which exhibit very weak momentum. The combination of high valuations and a lack of investor enthusiasm usually spells trouble.

At a high level, when we build portfolios today we incorporate the following equity views:

- We expect that we will continue to be overweight emerging markets stocks over developed markets stocks in multi-asset portfolios.
- We believe U.S. dollar strength and Chinese monetary policy are among the critical "Things that Matter" to global stock market positioning in 2017.
- Given the high valuations and weak sentiment around European stocks—not to mention the political risks of a populist outcome in France and/or Italy—we think that investors should be very cautious and intentional in any active positions made with respect to Europe.

Key Views on Fixed Income

As the Federal Reserve has indicated, rates are going to continue to go up in the U.S., a tightening theme that is likely to play out across the globe. At the margin, the European Central Bank and the Bank of England have started to slow down asset purchases, making it safe to assume that while the U.S. will lead the way in rising rates, the rest of the world will probably be dragged along. As we build portfolios for our clients, we will continue to seek to reduce duration through higher levels of current income.

Despite their strong performance and narrowing spreads, we still believe high-yield bonds are one good option. In particular, deregulation in U.S. energy and financials seems likely given the current political environment. These two sectors make up a disproportionate share of the issuers in the high-yield bond space. When potential fiscal policy is coupled with a low probability of recession, this sets up a relative winner among bonds.

Our portfolios have tended to favor the use of preferred stocks in this environment as well. The timing is attractive. Most preferred stock is issued by banks, and during the fourth quarter of 2016, bank stocks increased by double digits while preferred stocks declined slightly. We think the potential for deregulation of banks is a positive for this asset class.

Likewise, muni bonds and high-yield muni bonds may offer a good conservative option for investors. Both types of bonds were sold off heavily following the election and the broad expectation of lower taxes that resulted. Investors have retraced their steps here slightly, but there is still some value. Munis are a good alternative to Treasurys and high-yield munis also offer a good alternative to corporate high-yield with more income before any tax benefit.

Absent the kind of sentiment-stopping 2x4 that Ben refers to earlier, we believe it pays to keep most portfolios biased toward higher-risk asset classes such as stocks and high-yield bonds. Maintaining an adaptive risk management process is also critical in order to rotate back into deflationary assets like sovereign debt whenever critical drivers start to shape the market narrative in a more bearish direction.

What Matters for Energy and MLPs in 2017

Gregory A. Reid
President, Salient MLP Complex

Well 2016 was fun. Let's not ever do that again.

It was a year that brought the lowest of lows as well as what we believe may be the early stages of a multiyear recovery for master limited partnerships (MLPs).

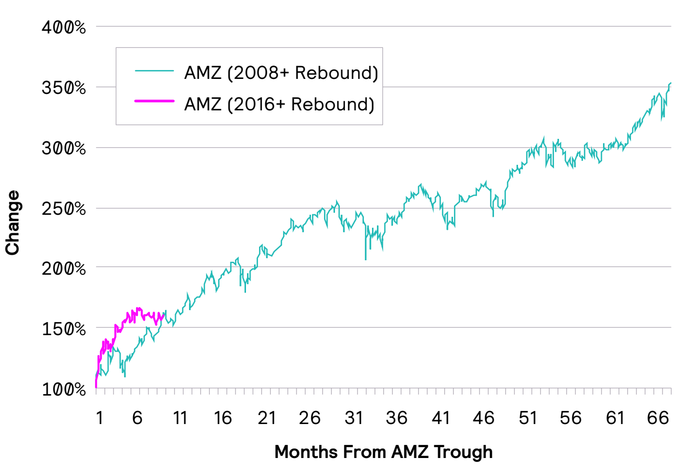
Harkening back to the end of 2015, the U.S. energy sector and MLPs suffered through a recent decline not seen since the 2008 financial crisis. Beginning at the end of 2015, crude oil prices slumped to their lowest levels in a decade, overall domestic crude oil production and rig counts plummeted and even natural gas prices remained below $2.50. A year ago, the outlook for 2016 appeared bleak. Now, with signs of improving fundamentals, we believe we may be in the early stages of a multiyear recovery for MLPs.

When crude oil prices bottomed on February 11, 2016, at $26.21—a 13-year low—the Alerian MLP Index (AMZ) just finished its fourth worst month in the history of the index (–11.1% in January 2016) was down 28.2% in 2016 and was down 58.2% from its all-time high in August 2014. Using historical returns as a proxy, we remind investors that the recovery from November 2008 to August 2014 took the AMZ from approximately 150 to nearly 540, for a total return of 412%. Furthermore, despite a 59% total return since February 2016, we believe the current AMZ recovery remains in its infancy.

During the darkest days of the 2016 decline, investors were concerned with MLPs' ability to fund growth

FIGURE 3

Current MLP Rebound vs. 2008



Sources: Salient and Bloomberg, as of December 2016

projects, the sustainability of distributions and the sanctity of midstream contracts given the multitude of producer bankruptcies. Some even questioned the growing risk of bankruptcy for MLPs themselves. While it is difficult to pinpoint the exact catalyst that spurred the 2016 turnaround, we believe there were a few factors at play. For one, MLPs became inexpensive on a valuation basis as EV/EBITDA multiples approached 2008–2009 trough levels that were 10%–20% below what they were in the last MLP bull market from 2010–2014. In addition, MLPs began to trade at higher than historical yield spreads compared to other yield asset classes such as 10-year U.S. Treasurys, investment-grade corporate bonds and high-yield corporate bonds as shown in *Figure 4*.

FIGURE 4

Current MLP Valuation Metrics vs. Historical

Valuation Metrics	Current	Average Since 2006
Enterprise Value-to EBITDA Multiple[1]	10.6x	10.8x
Price-to-Distributable Cash Flow Multiple[1*]	9.0x	11.7x
Yield Spread of AMZ vs. 10-Year Treasury[1]	500 bps	400 bps
Yield Spread of AMZ vs. Moody's Baa[1]	281 bps	113 bps
Bloomberg Barclays High Yield Index[†] vs. AMZ[2]	-80 bps	143 bps

For illustrative purposes only. Past performance does not guarantee future results. The indices reflect the reinvestment of dividends and income and do not reflect deductions for fees, expenses or taxes. The indices are unmanaged and are not available for direct investment.

1. Source: FactSet, as of 12/31/16
2. Source: Bloomberg, as of 12/31/16

† Bloomberg Barclays US Corporate High Yield Bond Index
* Price-to-Distributable Cash Flow Multiple = Market Cap / EBITDA – Interest – Taxes – Maintenance Capex Indications based on +/- one standard deviation range.

Following the turmoil of the first half of 2016, major news from the Organization of the Petroleum Exporting Countries (OPEC) helped crude oil to rally to over $51 per barrel as it headed into the fourth quarter. The organization announced an agreement to cut production by 1.2 million barrels per day (bpd). Non-OPEC countries, including Russia, also agreed to cut production by 600,000 bpd. The new production targets were implemented in January 2017, and thus far, it appears that the nations included have delivered on their respective promises. Prior to the announcement, our view was that oil markets appeared to be tightening even without OPEC intervention, as demand has continued to grow while global supply has declined. We believe the OPEC cut significantly accelerates the timeline to a balanced market, with a possibility for supply deficits as early as the first half of this year.

As it relates to domestic energy infrastructure, we believe that reduced supply will lead to higher oil prices which, in turn, will be met by increased domestic drilling. More domestic drilling means increased volumes across the midstream value chain, which may result in increased cash flow for a number of the companies in our investable universe.

A surprise win by Donald Trump has bolstered our outlook across the energy sector. Experts assumed a Hillary Clinton victory, but as it turns out, fears over a Trump victory proved unwarranted when markets rallied following his election. We believe that Trump's energy policies may be more favorable to the domestic energy sector than what a Clinton administration would have proposed. Since Election Day, Trump has made a number of appointments that may lead to a streamlined and less-politicized pipeline permitting process for midstream companies than what we endured under the Obama administration.

As total return investors, we have long held a view that growth prospects are the fundamental driver of total return for MLPs. We will carefully watch—and advise our clients to watch—for a few key Things that Matter to MLPs: recession risks (which could negatively impact energy demand and midstream volumes), a strong U.S. dollar (which typically results in lower commodity prices) and weakening credit markets (particularly high-yield). However, the combined tailwind of OPEC's production cuts, greater drilling activity in the U.S. and the Trump administration should translate into volume growth for the midstream sector in 2017 and an acceleration of growth in 2018.

What Matters for Real Estate in 2017

Joel Beam
Managing Director &
Senior Portfolio Manager

2016: A Tale of Three Years

Real estate investment trust (REIT) equities produced three distinct return opportunities throughout calendar year 2016. From January 1 through the market bottom on February 11, broad REIT equity indices witnessed double-digit declines, mainly due to expectations of a more aggressive interest rate posture by the Fed following the December 16, 2015, federal funds rate hike, the first since 2006. As these fears receded throughout the spring and summer, real estate operating fundamentals continued to deliver solid performance. From February 11 to August 1, REIT equities responded with an extraordinary rebound, climbing over 32% during the period; however, investor enthusiasm for REITs declined during the final five months of the year, as concerns related to Fed tightening reemerged and the uncertainty regarding the U.S. election took hold. REIT equities responded with a decline of -8.4% over that final five-month period. So while REIT equities generated a relatively "normal" 8.5% total return for calendar year 2016, the path to that return was anything but normal.

While not following quite so dramatic a path, the performance of REIT preferreds tended to mimic that of REIT equities. The bulk of the period-to-period volatility was attributable to the ever-changing consensus related to interest rate expectations. REIT preferreds finished the year up an underwhelming 3.7%, well below the long-term average these securities have tended to generate. *Figure 5* illustrates the returns for both REIT equities and REIT preferreds throughout the year.

FIGURE 5

Returns for REIT Equities & REIT Preferreds

	01/01/16 to 02/11/16	02/11/16 to 08/01/16	08/01/16 to 12/31/16	Calendar Year 2016
REIT Equities[1]	-10.3%	32.1%	-8.4%	8.5%
REIT Preferreds[2]	-4.7%	13.4%	-4.1%	3.7%

1. REIT equities represented by FTSE NAREIT Equity REITs Total Return Index
2. REIT preferreds represented by Wells Fargo Hybrid and Preferred Securities REIT Index

Source: Bloomberg, as of 12/31/16

At the operating level, domestic REIT fundamentals currently remain healthy for most property types and across most geographic areas. Occupancy trends are robust and re-leasing spreads continue to be positive (albeit less positive than previous years). Leverage levels and coverage ratios are sound, capital markets continue to be accommodative for equity/debt/preferred issuances, new building supply remains muted in most cases and transaction volumes (both property-level and corporate M&A) are healthy. As always, there are exceptions to this sanguine investing landscape. For example, Class A office space in Houston and "C" malls nationwide are facing significant headwinds. Despite this, investor interest in REITs remains elevated given the near-universal thirst for yield and as a result of the real estate industry being separated from the broad financials sector during the September GICS reclassification.

Opportunity Set for 2017

Barring a truly unexpected exogenous shock such as a trade war or a dramatic change in the interest rate environment, we head into 2017 feeling relatively comfortable about the operating environment for REITs. Following the conclusion of the U.S. election in early November, REIT CEOs have broadly expressed optimism that a few more innings have been added to the game, given their expectations of potentially faster GDP growth and a lighter regulatory touch. We generally agree with this viewpoint. While we remain somewhat cautious about overall valuations for both REIT equities and REIT preferreds, we continue to believe that average valuation statistics obscure the fact that attractive investment opportunities exist across the REIT landscape. The REIT equities in our portfolios tend to skew toward small- and mid-cap companies where cash-flow multiples and cap rates are more in line with historical norms and where less growth appears priced into the market.

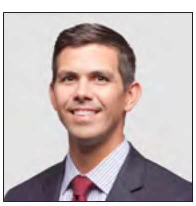
Our portfolios also express a desire to have greater exposure to shorter lease duration property types, such as hotels, given our belief that the U.S. economy should continue to strengthen throughout the year. In REIT preferreds, we are embracing credit risk in order to gain higher current yields and wider spreads, as we believe that REIT balance sheets are in very good shape. We remain committed to harvesting gains on preferreds trading at premium values that carry future price risk, especially as the call date approaches. Further, we endeavor to source unique and creative transactions, such as convertible structures and coupons that step up over time, which can provide both current income as well as optionality on the future and provide insulation to interest rate changes.

Risks to Our 2017 Outlook

We believe that the single biggest risk to our 2017 forecast is the potential for a comprehensive resetting of the investment return landscape. By this, we are referring to the probability that discount rates (or risk premia) increase across all asset types, leading to a broad resetting of asset prices. As mentioned, wide swaths of the REIT universe are trading at fairly rich valuations compared to long-term averages. In many of these situations, we believe that investors are either 1) betting on too much growth, 2) accepting too little return for the inherent risks they are taking, or 3) betting on the "greater fool" theory that valuation multiples will expand even further. Given our well-honed value orientation, we resist these temptations and attempt to buy attractive merchandise at the right price, protecting us somewhat in the event that a price/return reset occurs.

What could cause such a resetting? The three most likely shocks, or the Things that Matter for those observing the space, are a jarring interest rate move, an unforeseen geopolitical event or broad economic deterioration across the U.S. In each case, we think the individual probability of one of those events happening in 2017 is low. Yet, we remain steadfast in our belief that elevated valuations diminish a margin of safety and require caution.

What Matters for Alternative Investments in 2017



Bill Enszer
Managing Director,
Portfolio Management

The alternatives industry faced a turbulent 2016, with headlines ranging from whether hedge funds add value to investors' portfolios to covering the struggles of venture capital-backed companies. It appears that many private investments are now trading at similarly elevated valuation levels as public markets. The truth is always more nuanced than what headlines imply, which is why we are still finding pockets of compelling investment opportunities across hedge funds and private equity while being cautious with traditional approaches to this asset class.

Hedge Funds

Numerous public pensions and other institutional investors made headlines in 2016 as they announced plans to scale back or completely eliminate their allocations to hedge funds. The move comes on the back of years of middling performance out of proportion with the high fees of the asset class. While we believe that the benchmarking of hedge funds to the S&P 500 Index is flawed and that carefully selected strategies can play an important role in diversifying a portfolio away from dominant equity risk, it is difficult to argue that hedge funds have been adequately pulling their weight within portfolios for the last several years.

Through December 31, 2016, the HFRI Fund of Funds Composite Index returned a disappointing year-to-date 0.71% and has generated 1.26% and 3.46% annualized returns over the past three and five years, respectively.

This prolonged modest performance has strengthened the argument that traditional 2-and-20 fee structures are not universally appropriate in the space, and in response we have seen increased flexibility and rationalization of hedge funds' fee structures. We expect this trend to continue as those institutional investors who choose to remain invested in hedge funds wield their purchasing power to promote stronger alignment between managers and investors.

As the global economy heads into an uncertain future, we view hedge funds—particularly those which can respond quickly to macroeconomic events and those which take relative value positions and hedge out their market exposure—as valuable building blocks to investors' portfolios.

Private Equity

As private equity funds continued to put capital to work in 2016, an alarming trend of expanding purchase multiples in sympathy with the expansion of public price-earnings (P/E) ratios emerged. Median EV/EBITDA buyout multiples rose to 8.4x by the third quarter of the year, the highest number observed since 2012, while median purchase revenue multiples of companies with EVs larger than $250 million spiked to 3.2x, the highest number observed in years. We view these expansions as symptoms of a richly valued public market, increased competition from strategic acquirers with excess cash and an overabundance of dry powder among buyout funds (particularly mega-buyout funds with committed capital in excess of $5 billion per fund). While we certainly would not advocate for a greater utilization of leverage in these conditions, median debt levels on acquisitions have simultaneously declined to 50% of total deal value, down from over 60% in 2013.

With elevated valuations and reduced debt levels, private equity funds investing today face an environment in which two of their three primary avenues for value creation (multiple expansion and deleveraging) feel fully priced into the market. This leaves growth as the third and sole avenue for generating outsized returns. We believe reports of recent multibillion dollar fundraises by Carlyle Group, Blackstone, CVC Capital Partners and others, with stated fund terms of 14-15 years and base case IRR targets of 15% (as opposed to the traditional 20%+ private equity-style returns), reflect the industry's honest assessment of its ability to overcome these headwinds and drive incremental growth in new investments.

Consequently, we prefer smaller, sub-$1 billion funds, which themselves target much smaller companies, since median purchase revenue multiples for sub-$250 million EV companies are less than half that of megadeals. Higher deal volume, lower competition levels and greater opportunities to drive earnings growth also contribute to the attractiveness of the middle market and sub-middle market spaces.

Venture Capital

Venture capital (VC) news headlines last year were dominated by high-profile "dying unicorns" such as Theranos, Zenefits and LivingSocial. These stories obscured the important reality of the space: the almost complete closure of public markets earlier in the year and the dramatic expansion of the average size of venture deals. No private equity-backed company successfully completed a public offering in the first quarter of 2016, and by the end of the third quarter, 2016 was on pace to be the most sluggish IPO market since 2009. We have also observed an increasing trend of large, private, venture-backed companies such as Uber and Palantir that elect to remain private and continue raising incremental funding in private rounds. We believe that these effects are likely to persist in the near future, extending the average life of and increasing the cost basis of venture investments.

As these factors continue to intensify in the coming years, we continue to advise a focus on partnerships with established VC firms that have generated strong track records of tangible returns, realized capital and exits from the portfolio in a timely manner.

Private Energy

Last year was unkind to private energy fund managers. Widespread losses during the first quarter triggered by year-end audits were particularly painful. Many funds delayed fully re-marking their books in order to take a year's worth of impairments and write-downs at once. While we would have expected to find value and excellent buying opportunities in the sector due to depressed valuations, many other investors deployed a similar tactic, causing opportunities to be far more limited than anticipated. We view the largely uninvested $130+ billion in capital commitments raised by energy funds from 2014 through the third quarter of 2016 as the primary culprit.

Many energy funds pursue a strategy that provides funding to a management team and allows the team to pursue acquisitions. As the number of U.S. basins with attractive potential returns shrank in tandem with oil prices, funds were forced to concentrate their management teams in fewer geographic regions. This resulted in more intense competition, as sponsor-backed teams began to compete not only with other funds but with other teams backed by the same firm. In one particularly stunning example, we spoke to a seller that observed over 10 management teams backed by the same firm performing diligence on a single asset package!

Asset values outside of a handful of prominent basins plummeted, as much of the acreage is largely uneconomic in a sub-$70 oil price environment. Pockets of opportunity have appeared, particularly in the decidedly out-of-favor conventional extraction space. We remain exceptionally cautious with investments in larger funds and transactions due to the competitive pressure of the aforementioned undeployed capital. Instead, similar to the broader private equity space, we favor smaller managers, specifically those that pursue a strategy of investing in established companies and in-process acquisitions rather than the sponsor-backed management team model.

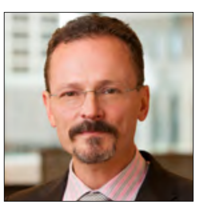
In addition to the benefits of lower levels of competition and avoidance of the “blind pool” risk that most multibillion-dollar energy funds offer, we believe this strategy could actually exploit the glut of capital on the sidelines. By focusing on smaller opportunities and developing them prudently through conservative drilling and bolt-on acquisitions, these smaller managers may be able to build up large enough assets to entice increasingly desperate 2014-2016 vintage sponsor-backed management teams to overpay before their investment periods expire in three to four years. This tactic would eliminate their source of funding and prevent them from successfully forming a company.

Private Credit

Contrary to the experience of private equity investors, those invested in private credit likely captured upside performance in 2016 as economic conditions, interest rates and credit spreads remained within a comfortable band. With the exception of existing energy debt investments, this supportive environment allowed credit to generally perform as expected throughout the year. Private credit continues to draw increasing levels of institutional interest from pensions, endowments and foundations because they have the ability to accept greater illiquidity and continue their search for yield.

Entering 2017, we continue to like private credit as an asset class and consider the prospective risk-adjusted returns available in the sector to be some of the most attractive of any market. Upon entering the eighth year of a bull market, the structural seniority, yield generation and shorter duration of most private credit investments offer an appealing opportunity to generate double-digit returns while taking substantially less expected risk than public or private equities. We also believe that the shorter life of private credit funds may enable us to reinvest principal in a much more attractive equity valuation environment in three to five years. In particular, we favor lending opportunities to companies with special situations, asset-backed lending and certain niche strategies in which specialized execution expertise offers an attractive opportunity to a patient investor.

What Matters for Stocks in 2017



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After struggling for much of 2016, the global economy ended the year with a meaningful acceleration of growth. This tailwind received a sharp and immediate boost in optimism from market participants approaching the new year. In fact, most annual outlooks and estimates for 2017 have already become more optimistic given the recent strengthening of many global indicators, especially industrial production, manufacturing data covering orders, inventories, employment, and export data.

For our part, we think the most reasonable base-case scenario is that the resurgence, while broad-based at the moment, is mainly a short-term cyclical bounce that will fade by the end of 2017. Global potential growth after the Great Recession is severely constrained compared to prior periods. This is due to a host of headwinds, including accentuated political pressures as countries increasingly vote for more populist administrations, rising trade tensions especially between the U.S. and China, geopolitical risks including terrorism and migration problems, unfavorable demographics in the world’s major economies and extremely high global debt levels.

In the end, we expect very little global earnings growth this year.

U.S. Stocks

Equity markets cheered the brighter outlook in the U.S., which started with better third quarter economic data in 2016 and continued after the end of the polarizing presidential election. President Trump promised change in his campaign for the business environment—some good, some probably bad—but as noted, U.S. markets appear to be focusing mainly on the positive.

We prefer to focus on the aforementioned trifecta scenarios. Potential negatives include populist policies such as more rigorous immigration controls and revised terms restricting free trade. How these proposals balance out and the speed at which they are implemented is not yet clear, but Trump's various appointments lend credence to both the optimism and fears of investors. Steven Mnuchin, the nominee for Treasury secretary, is a noted critic of financial regulation. Yet Wilbur Ross, the nominee for Commerce secretary and a successful investor in the steel and coal industries, is a noted critic of unrestricted free trade.

These appointments also suggest that the early thrust of the new administration will be to dismantle what they view as overly oppressive environmental and financial institution regulations and to renegotiate trade agreements. U.S.-China relations will undoubtedly be a focus. Whether this means import tariffs on China-made goods remains to be seen. We note tensions between Taiwan and China escalated with Trump's call from Taiwan President Tsai Ing-wen. Tourism from China to Taiwan dropped 43% year-over-year in November—not a coincidence. In the short term, however, if aggressive action toward China is delayed, economic momentum should continue now through mid-2017. Optimism regarding the new administration and prospect for reform may release "animal spirits," helping to unleash greater investment in equipment, software and commercial buildings.

European Stocks

Europe's business and consumer confidence improved recently, leading to better manufacturing output and services activity and suggesting a stronger fourth quarter versus the middle two quarters of 2016. The year-end resurgence should help the region match the U.S. economic performance at 1.6% for the year. The outlook for European stocks is different, however, as upcoming key elections in Germany and France heighten investor political anxiety, already elevated due to the uncertainty regarding the nature and timeline of Brexit—the U.K.'s exit from the European Union (EU).

The U.K. managed to defy expectations that the country's economy would rapidly contract after Brexit. Economic performance proved resilient in the third quarter and indications suggest the fourth quarter was also solid. Nonetheless, the U.K. economy should decelerate with subdued business confidence engendered by worries about U.K.-eurozone negotiations. Will it be a "soft exit" with fairly open trade but restricted borders, or does the EU, in an effort to influence other countries contemplating exit, mandate a "hard exit" resulting in protracted, contentious trade discussions? Again, no easy answers, but this is clearly something that will Matter to equity investors in 2017.

In contrast to U.S. equities, many European equities look relatively cheap. Investor sentiment is generally bearish toward the region, but many companies are generating positive free cash flow, providing investment opportunities while exporters have the tailwind of a weaker currency.

Japanese Stocks

Even more than the U.S. economy, Japan's economy suffers from an excessive debt load and aged demographic. Like Europe, Japan has other structural problems, including labor inflexibility, immigrant restrictions and an inability to address ongoing deflationary pressures. It is little surprise that the economy has registered notoriously weak and unsteady economic performance for more than two decades. The undervalued yen and improved net exports are helping the recent economic performance figures but investors and economists are understandably skeptical that this momentum will continue. However, during the intermediate term, there may be signs of life. Inventories are at a two-and-a-half-year low, housing and construction show ongoing strength and small business confidence hit a recent all-time high. The tightening labor market should continue leading up to the Tokyo Olympics in 2020, while bank loan rates have started to lift, helping to alleviate deflationary pressures.

Emerging Market Stocks

There is no question that valuations are far more supportive for emerging market (EM) outperformance than they are for the U.S. or other developed markets. EM's cyclically adjusted P/E ratio is less than 15x, while the average P/E in the U.S. is above 25x. Beyond compelling valuations, there are a number of interesting trends and investment themes that are worthy of discussion in 2017.

On the surface, much of the macroeconomic story in China looks positive. Multiple macroeconomic indicators are seeing double-digit expansions, including vehicle sales, bank loans/deposits, real estate sales, airline passenger miles, railway freight and consumer spending. Other areas of strength include business services, education, entertainment and information technology. While growth continues to lag in construction spending, fixed asset investment and financial services, our conclusion is that policymakers are having some success broadening the economy by placing it on a more sustainable track for long-term growth. That said, longer-term growth will be lower than the historical average, not only because of the law of large numbers but also because some of that growth was fueled by excessive credit growth. Like the major developed economies, China has major structural problems including excessive leverage and excess capacity, and like other major economies, China is also "kicking the can down the road." Along with gradual slower credit growth, we expect continuing but modest reforms that do not jeopardize political stability or create massive unemployment.

Given this backdrop in China, our investment themes focus on sectors supported by growth initiatives and de-emphasize the "old economy" sectors that are still threatened by risks like overcapacity. Further, we will continue to focus on companies that benefit from structural reforms around environmental issues such as air quality and food safety.

Resource-based emerging markets, including Russia and Brazil, have received some relief lately from the 2014–2015 commodity price crash. The partial commodity price recovery recently has improved their finances and thus, they are in much less dire shape than they were in 2015. Russia may even see decent growth this year after four years of dismal economic performance. The possible lifting of Western sanctions could release pent-up demand. Prospects for Brazil's recovery, while contingent on rising mineral prices, are also improving on the prospects of better government after several years of corruption scandals.

Nonetheless, we anticipate limited scope for sustainable above-average growth in these resource-based markets given their dependence on the notoriously volatile raw material/energy prices and their governments' observed inability to put in place structural reforms. Other emerging markets, particularly in Asia, are much more appealing as the economies are more dynamic and have competitive manufacturing industries.

Definition of Terms

Alerian MLP Index is the leading gauge of large- and mid-cap energy master limited partnerships (MLPs). The float-adjusted, capitalization-weighted index includes some of the most prominent companies and captures approximately 75% of available market capitalization.

Bloomberg Barclays US Corporate High Yield Bond Index covers the USD-denominated, noninvestment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

Commodity is a basic good used in commerce such as grains, gold, beef, oil and natural gas that is interchangeable with other commodities of the same type.

Correlation is a statistical measure of how two securities move in relation to each other.

EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) is a standard measure of profitability and reflects a company's financial health.

Fiscal policy refers to government policies that are created to control the economy and can influence macroeconomic conditions. These policies affect tax rates, interest rates and government spending.

Free cash flow represents the cash that a company is able to generate after laying out the money required to maintain or expand its asset base.

FTSE NAREIT Equity REITs Total Return Index is representative of the tax-qualified REITs listed on the New York Stock Exchange, the American Stock Exchange and the NASDAQ National Market, excluding timber and infrastructure REITs.

HFRI Fund of Funds Composite Index is an equal-weighted index comprised of fund of funds. The index includes over 600 constituents, both domestic and offshore funds.

Internal rate of return (IRR) is the rate of growth a project is expected to generate. Higher IRR values offer a better chance of strong growth.

Monetary policy refers to the actions of a central bank, currency board or other regulatory committee that determine the size and rate of growth of the money supply, including an increase in interest rates or changing the amount of money banks need to keep in bank reserves.

Price-earnings (P/E) ratio is a measure of the price paid for a share of stock relative to the annual income or profit earned by the company per share. A higher P/E ratio means that investors are paying more for each unit of income.

Purchasing Managers Index (PMI) measures the health of the manufacturing sector and is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index. The Russell 3000 Index represents approximately 98% of the investable U.S. equity market.

S&P 500 Index is an unmanaged, capitalization weighted index comprising publicly traded common stocks issued by companies in various industries. The S&P 500 Index is widely recognized as the leading broad-based measurement of changes in conditions of the U.S. equities market.

U.S. Treasurys are marketable U.S. government debt securities with fixed interest rates and maturities.

Wells Fargo Hybrid and Preferred Securities REIT Index is a modified market capitalization-weighted index that tracks the performance of preferred securities issued in the U.S. market by real estate investment trusts.

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