EMLES

AS OF DECEMBER 31, 2020

EMLES ANNUAL OUTLOOK

THOSE THAT RUN WITH THE PACK WILL BE LEFT BEHIND

2021 | Inaugural Annual Edition

WHAT'S INSIDE

A ‘SOUND BANKER’ ALAS! IS NOT ONE WHO FORESEES DANGER AND AVOIDS IT, BUT ONE WHO, WHEN HE IS RUINED, IS RUINED IN A CONVENTIONAL AND ORTHODOX WAY ALONG WITH HIS FELLOWS, SO THAT NO ONE CAN REALLY BLAME HIM.

— JOHN MAYNARD KEYNES

FOREWORD

Gabriel Hammond
Chief Executive Officer
Emles Advisors

We believe that the market outlook for 2021 is strained and challenging at best – but I'll spare you the platitudes surrounding pandemics and diminishing asset returns that you have read in other investor letters. We believe a different approach is warranted to outperform, not just in 2021, but in the coming decade. The challenge is not how to position yourself for the coming year, but for the next ten years.

In 2007, I was running SteelPath and managing several funds; after monitoring the markets for months, I made the tough decision to reposition my investment portfolios and move almost entirely to cash. At the time, this did not make me a popular man. Investors argued that I shouldn't be making market calls, that they expected me to invest in energy infrastructure companies and energy infrastructure companies alone. But no matter how well I managed the portfolio, it was going to fall 50%. Instead of waiting with me to return to the market, they withdrew their funds and placed them with my highly leveraged competitors, which lost over 75% the following year.

But this isn't a story of prescience. It is a story to illustrate the incredible difficulty of not doing as others do. The decision to exit the market, and then to stay out of the market was the hardest decision I have ever made. It was painful, stressful, financially straining and destroyed relationships. My investors abandoned me, too impatient to wait. Nobody wants to be the one to tell his clients to sell equities.

However, this isn't a call to go to cash (a quick aside: that would be preposterous, I would never recommend putting your money into a depreciating asset. If you are looking to get out of the stock market, I would suggest considering bitcoin.) But it is a call to the fact that uncertainty has never been greater. This is not a philosophical musing; regardless of what the VIX is doing, the confluence of globalization, population growth, and technology will lead to more events like last year's pandemic, not fewer of them, over the next decade (not always in the form of a zoonotic virus). That means risk and opportunity. It means Carnival Cruise Lines and Peloton. It means bigger separation between the winners and the losers. Out with the old, in with the new. Investors must look beyond the old themes and investment offerings if they are to participate in the markets, let alone outperform.

Acting like a 'sound banker,' investing the same as everybody else, may work great for the issuers who manage your current fund portfolios. They will call apologetically with great excuses when the market capitulates — but will it work for you? Do they suffer financial loss when you suffer loss? Look out for the dangers and the opportunities; in the coming decade, those that run with the pack will be left behind.

Gabriel Hammond

EXECUTIVE SUMMARY

Gabriel Hammond
Chief Executive Officer

Dave Saxena
Chief Financial Officer

Agam Sharma
Chief Investment Officer

Emanuel Zareh
SVP of Investment Research and Portfolio Manager

Rachel Deinhart
Portfolio Manager

Yev Shelkovskiy, CFA, CIMA
Portfolio Manager

IN BRIEF

- **Macroeconomic Outlook:** Following a pandemic-triggered recession, we are now at the onset of a new reflationary business cycle. In 2021, we expect central banks globally to maintain yields at low or negative levels and governments to ratchet up fiscal stimuli to stoke demand and economic growth. GDP growth will most likely not cross into positive territory until the back half of 2021, however we expect it to normalize across both developed and emerging markets over the next decade. Looking specifically at the U.S., output gap is substantially negative. Combined with the shift of pricing power towards consumers, we expect low inflation over the near-term. Inflation should rise and surpass a 2% level in the mid-long term alongside tightening employment, burgeoning money supply and a highly tolerant Federal Reserve.
- **Equity Markets:** We believe that continued government intervention and a gradual reopening will further support U.S. equity markets in 2021. With the backdrop of fiscal stimulus, we believe corporate earnings will be stronger across the board, and that equity prices, while seemingly at risk of high P/E multiples, have additional room to grow. Looking outside the U.S., emerging market equities appear attractive and should benefit from a weakening dollar and lower valuations relative to the U.S. Over the next decade, we estimate a modest growth rate of ~4-6% globally for equities, but along with that growth may come spikes in volatility due to asset bubbles or reversals in over-concentration. The gap between developed and emerging markets is expected to shrink, as growth in international - in particular emerging - markets pick up.
- **Fixed Income Markets:** With short-term rates in the U.S. pegged securely between 0 and 25 basis points, additional asset purchases by the Federal Reserve, and fiscal spending set to rise with a Democratic administration, we believe that the yield curve will have modest steepening over the coming year. Over the long-term, we believe the steepening of the yield curve and inflation expectations to accelerate in pace as fundamental data strengthens. As such, duration may not be able to play the role

of a key diversifier in portfolios nor be a significant contributor of returns ahead. Instead, we are shifting to an environment where credit risk premia and selectivity will be the key drivers of fixed income returns. Broadly, we view credit markets to lean negative, yet select credit pockets look attractive: bank loans, high quality structured credit, real estate debt and emerging market debt, particularly regions in Asia. These credit sectors may offer a blend of yield, total return and diversification benefits to investor portfolios in the future.

- **Alternative Assets:** While traditional pockets of alternative assets have found patient and growing allocations in investor portfolios over the years, newer exposures in private credit and digital assets, such as bitcoin, are fast-rising creative alternatives that offer a blend of cash flow and long-term value creation. The "Fourth Industrial Revolution in Technology" has transformed untapped sectors like lifestyle assets and innovation financing into investable assets, offering cash flow streams that mimic the "alternative" behavior. We believe that these newer dimensions are going to increasingly redefine the alternatives universe and should be considered a more integral allocation in portfolios going forward.

- **Bottom line:** As investors face a challenging economic landscape, they are confronted with financial markets where asset class behaviors often evolve faster than can be understood. In this heightened uncertainty, it is increasingly clear that what has worked in the past may not necessarily solve for portfolio needs ahead. Investors should consider tapping into unique markets, regions, sectors or alternatives to find pockets of uncorrelated growth. Over the upcoming decade, assets and investment opportunities that are positioned well are structurally and fundamentally strong, rather than mere market-timing, trade-driven ideas. New drivers of risk, like inflation, need to be guarded against with caution, particularly since they may invoke periods of sharp drawdowns and volatility. Remember: this may not be the time to follow the pack.

MACROECONOMIC OUTLOOK

THE BEGINNING OF A NEW REFLATIONARY BUSINESS CYCLE

Agam Sharma, Chief Investment Officer

IN BRIEF

- **The world entered 2020 with a late-cycle prognosis,** yet the COVID-19 pandemic upstaged the perceived trajectory of fundamentals, resulting in a drop in consumer and investment activity, and a shock to markets. Government intervention was swift and hefty; central banks across the globe pumped a record ~$30 trillion of liquidity to support and assist in recovery.
- **While uncertainties remain on the efficacy of vaccines,** additional virus strains and lockdowns, we believe we are at the onset of a new business cycle. Positive GDP growth driven by business capital expenditure and rising consumer spending should feed into price inflation and wage growth over the long-term. Resurgence in consumer and business activity is expected by the second half of 2021, as sentiment-driven soft data has mostly recovered and fundamentals-driven hard data, while lagging, is on an upward trajectory. In 2021, we expect central banks globally to maintain yields at low or negative levels and introduce substantive fiscal stimuli to stoke demand and economic growth.
- **GDP growth will most likely not cross into positive territory** until the back half of 2021, however we expect it to normalize across both developed and emerging markets over the next decade. Looking specifically at the U.S., output gap is substantially negative. Combined with the shift of pricing power towards consumers, we expect low inflation over the near-term. Inflation should rise and surpass a 2% level in the mid-long term alongside tightening employment, burgeoning money supply and a highly tolerant Federal Reserve. Over the coming decade, growth and inflation metrics should generally rise. Investors should prepare proactively for unexpected (pandemic-like) shocks or overheating periods which could necessitate policy intervention and end the cycle prematurely.

Does 2020 hindsight help or hurt?

2020 has been a year of both complete disbelief and extraordinary belief, in markets as much as in human resilience. The world entered 2020 amidst rampant calls for late-cycle prognosis, with market risks spanning from escalating geopolitical acrimony to the rise of populism on national levels. The COVID-19 pandemic upstaged that gradual trajectory of fundamentals, inducing a health shock that resulted in unprecedented lockdowns, a drop in consumer and investment activity, and accompanying shocks to markets. Policy makers around the world pumped a record (in quantum and speed) ~$30 trillion of liquidity into the markets to support and assist recovery. This was accompanied by scientific ingenuity and collaborative research for the first few effective vaccines, alongside setting up manufacturing and distribution chains for their rapid dissemination. Yet, as we embark into a new year and decade, it is more important than ever to dissect market performance from economic health.

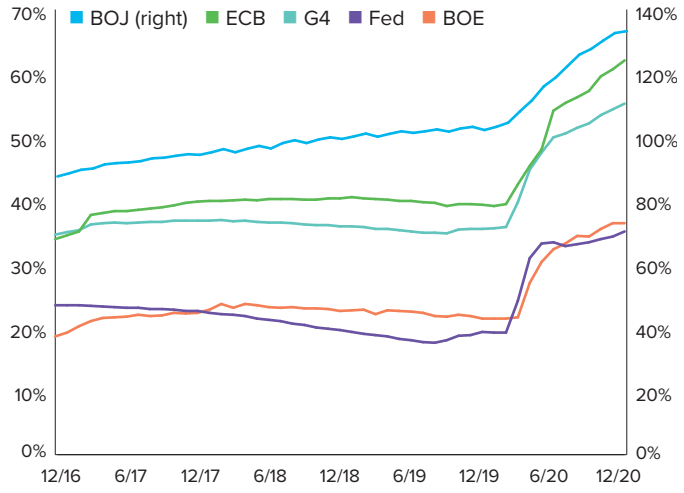
Reflating into a new cycle

Over the past few decades, global business cycles have become increasingly longer and more robust, accompanied by persistently low inflation and uber-ready policy makers. Output gap, or the difference between actual and potential capacity of an economy, went through a deep trough during the Global Financial Crisis ("GFC") and then a slow-motion recovery to form a decade-plus long cycle. We believe we are bracing for another marathon cycle ahead. While risks remain on efficacy of recent vaccine approvals, additional virus strains and regional lockdowns, we believe there is high likelihood of normalization in consumer and business activity by late 2021.

However, the ingredients in this cycle are expected to be substantially different. For starters, the last cycle post-GFC was driven and sustained by highly accommodative monetary policy, with fiscal policy being a sidebar. Such a combination is indeed stimulative to markets, yet only indirectly to real economic growth. In 2021, we expect to see central banks globally create a standing commitment

Central banks pumped massive liquidity into the market to support recovery, we estimate central bank assistance will continue through 2021

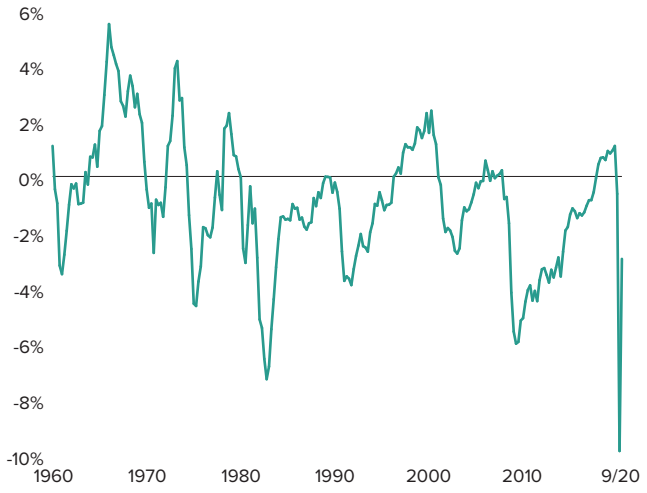
FIGURE 1A: CENTRAL BANK BALANCE SHEET (% OF GDP) 2016 – 2020



Source: Bloomberg, data as of December 31, 2020.

After dropping to record lows, we believe the normalization of output gap will be slow

FIGURE 1B: OUTPUT GAP (%) 1960 – 2020



Source: Bloomberg, data as of December 31, 2020.

to hold sovereign yields to zero, or below, to catalyze demand and drive real economic growth. Even beyond the U.S., there is evidence of this approach already: the European Central Bank recently extended the horizon for asset purchases to at least 2022. We have started to see soft data like the Purchasing Managers Indices ("PMI") in both developed and emerging markets start to rebound in anticipation of this expected global shift from monetary to fiscal policy. The bounce in manufacturing PMI, for instance, is encouraging given the recent trend of diminished business investment, which was driven by rising uncertainty around tariffs, the pandemic and U.S. elections. We view 2021 as the start of a new business and manufacturing cycle; soft data, for example, confidence and PMI metrics, has already experienced a sharp recoil. We expect hard data, such as private consumption and industrial production, to slowly catchup - yet we will be closely watching that hard data as the "proof in the pudding" of economic recovery.

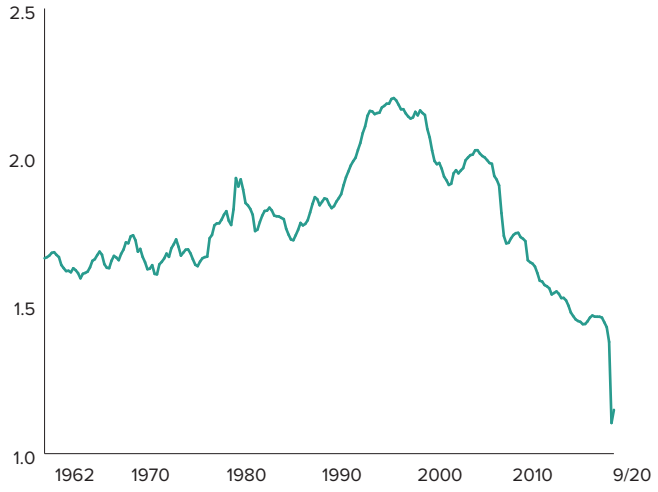
Uncertainty creates pockets of growth and spikes in volatility

Long-term growth expectations have been modest for years, with most industry experts including ourselves, benchmarking to low-mid single digit growth over the next decade. The pandemic has of course, has just lowered economic "starting points" for both developed and emerging markets. While anticipated recoveries may boost 2021 and 2022 growth rates, we believe growth over the long term will continue to remain modest.

Seeded during the 2000 dot-com craze and catalyzed by the pandemic, the forces of digitization (e.g., e-commerce) have re-engineered consumer behavior and business models. The Amazonian effect has shifted pricing power towards consumers, which, along with the excess capacity evidenced by negative output gap, suggests that inflation, as measured by the Core Consumer Price Inflation ("CPI") index will remain low over the near term. Inflation should

Velocity of money is at lowest levels since the Great Depression, implying consumers' aversion to risk

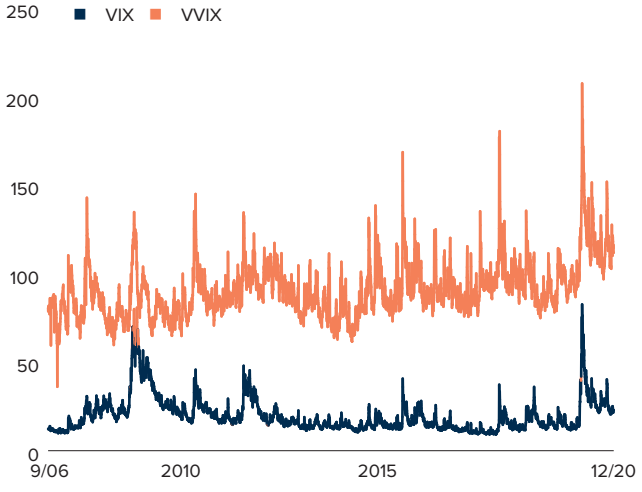
FIGURE 2A: VELOCITY OF MONEY 1961 – 2020



Source: Bloomberg, data as of December 31, 2020.

Volatility of volatility continues to trend high; we expect unforeseen stresses in markets

FIGURE 2B: VOLATILITY INDEX (VIX) AND VVIX INDEX 2006 – 2020



Source: Bloomberg, data as of December 31, 2020.

rise and surpass a 2% level in the mid-long term alongside tightening employment, burgeoning money supply and a highly tolerant Federal Reserve. We believe these macro shifts will persist, yet one trend, globalization, will look different – globalization will be focused instead on protecting intellectual capital and localizing supply chains, particularly for essential services and manufacturing. This trend incentivizes countries to create trading blocks, much like the recent initiative by China and south-east Asian countries which resulted in the biggest trade bloc in history, the Regional Comprehensive Economic Partnership ("RCEP").

The rise of Asia is in stark contrast to the challenges Europe is going through, including resolving virus concerns, Brexit and ongoing populism. China has recovered quicker and faster from the pandemic, driven significantly by its fiscal push towards traditional infrastructure-led spending and a "new" digital economy. This augers well for growth in several emerging markets, particularly regions in Asia, as the consumption engines within China and India pick up steam. These emerging markets may benefit from China-related tailwinds as well as a recent weakening of the dollar, which we expect to persist at least in the first half of 2021, if not longer given the anticipated U.S. fiscal push.

Capital market metrics, in the meantime, continue to push and pull against the slow recovery of economic fundamentals. Extremely high savings rates have dropped the velocity of money to its lowest levels since the Great Depression, while rising spikes in volatility signal towards pockets of sudden stresses in markets, even as fundamentals gather resiliency in the new cycle ahead.

EQUITY MARKETS

AN OPTIMISTIC OUTLOOK FOR EQUITIES

Emanuel Zareh, SVP of Investment Research and Portfolio Manager

IN BRIEF

- **Despite the many challenges stemming from the pandemic,** equity markets have had a remarkable year. After plunging ~30% in the beginning of the year, U.S. equities recovered at record speeds and traded at or near all-time highs throughout the second half of 2020. Unparalleled government intervention, both on the monetary and fiscal sides, combined with investors willingness to look through the pandemic to a future recovery and pull forward cash flows, has supported equity markets to date.
- **We believe that continued government intervention** and a gradual reopening will further support U.S. equity markets in 2021. With the backdrop of fiscal stimulus, we believe corporate earnings will be stronger across the board. We have a preference for value and small and mid-cap equities given the significant runup in growth and large-cap.
- **Shifting to valuations,** we believe U.S. markets are still cheap relative to 2000's highs, signally valuations may have some runway left as earnings growth catches up to prices. However, we need to monitor for inflection points.
- **Looking outside the U.S.,** international equities, particularly Asian emerging markets, should benefit from a weakening dollar and lower valuations relative to the U.S. We believe emerging markets that stand to benefit from China-related tailwinds look attractive as potential areas of opportunities in the year ahead.
- **Over the next decade,** we estimate a modest growth rate of ~4-6% globally for equities, but along with that growth may come spikes in volatility due to asset bubbles or reversals in over-concentration. The gap between developed and emerging markets is expected to shrink, as growth in international, in particular emerging, markets growth picks up.

A market pullback to match the exogenous shock

Fueled by willing policy makers and low interest rates, economic growth during the past decade has been slow, steady and strong. While this growth extended to many sectors, it was most pronounced in the equity markets; the S&P 500 rose an impressive ~500% from the Great Financial Crisis lows to 2019. Coming off a strong decade, we entered 2020 late cycle, which quickly ended with a sharp, steep and short pandemic-driven recession. Despite the many challenges stemming from a once-in-a-century pandemic, equity markets have had a remarkable year. After plunging ~30% in the beginning of the year, U.S. equities recovered at record speeds and traded at or near all-time highs throughout the second half of 2020. Unparalleled government intervention, both on the monetary and fiscal sides, combined with investors willingness to look through the pandemic to a future recovery, supported equity markets to date.

An optimistic outlook for equities

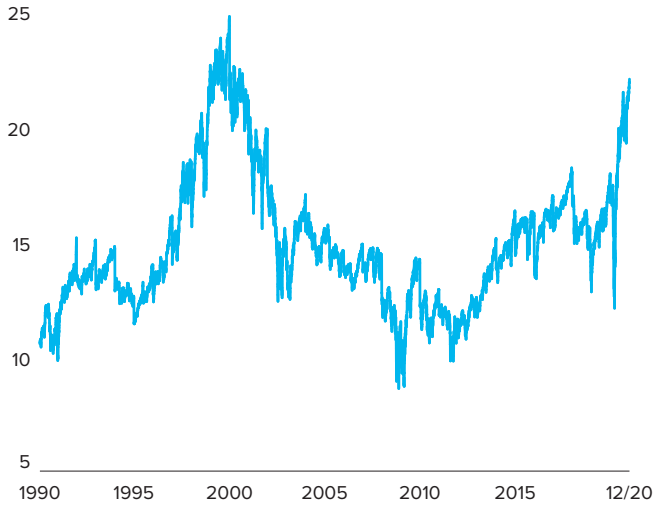
We believe that continued government intervention will further support U.S. equity markets in 2021. Our outlook is optimistic, indeed, despite recognizing risks stemming from the largest fiscal deficit in decades, many state and local governments on the brink of bankruptcies and high unemployment levels. The incoming administration is expected to increase taxes, scrutinize anticipated merger and acquisition ("M&A") deals and propose anti-trust regulation, creating risks for market leaders, such as large-cap technology companies.

With strong economic recovery expected, we believe corporate earnings will experience a stellar year of growth. We anticipate earnings for sectors aligned to secular "at-home" trends, such as technology, e-commerce and communications, to continue experiencing healthy demand despite near-term headwinds of anti-trust concerns and cyclical rotation — or until vaccine distribution and economic recovery allows the world to "re-emerge." We expect corporate earnings for cyclical sectors like industrials and manufacturing to bounce back strongly. Inventory levels remain depleted from the supply shock of the pandemic, setting up for a massive re-stock opportunity for industrial and manufacturing related companies. Such growth will likely be paced by "green shoots" in aerospace, machinery, agriculture, and even oil and gas. Lastly, the U.S. consumer will enter 2021 with among the highest savings rate in decades, and combined with anticipated fiscal support, suggests better-than-expected discretionary spend on retail and restaurants and healthy levels of spending in housing and auto end markets.

Equity valuations, as measured by price/trailing earnings, are at, or close to, historically high levels. While valuations are certainly elevated, they are cheaper when compared to valuation measures during the last big bubble (the dot.com period of 1999-2000), signaling to us that, on a relative basis, there is further room to grow. Looking at the S&P500 and Nasdaq Composite indexes, current valuations are ~4 times cheaper than their respective valuations during the 1999-2000 period. This is further evidenced by a favorable free cash flow yield and dividend yield over the 10-year Treasury and the Bloomberg Barclays US Aggregate Bond Index, respectively. We believe elevated valuations of U.S. companies are being driven by consumer perceptions that the quality of the companies and their strong growth will continue in the future, thus justifying the premium. The question then becomes, "will investors continue to pay this premium?" or "will these companies see earnings growth that catches up to their prices?" Despite a potential uptick in discount rates and moderation in price/earnings ("P/E"), we believe earnings growth will help drive total returns in U.S. equities in 2021 and over the coming decade.

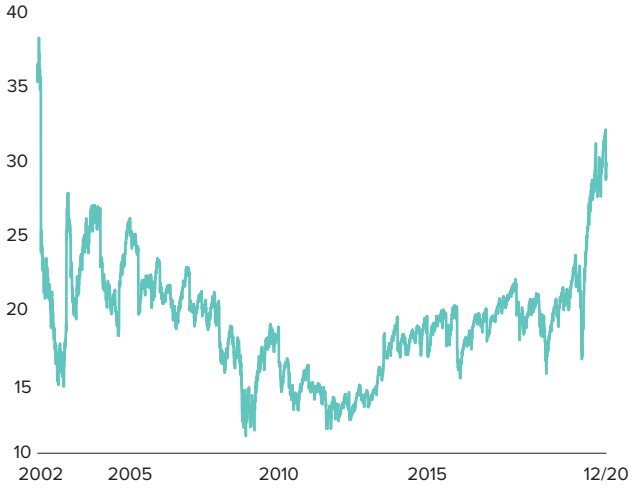
U.S. equity valuations look cheaper relative to dot.com levels

FIGURE 3A: P/E RATIOS OF S&P 500 INDEX 1990 – 2020



Source: Bloomberg, data as of December 31, 2020.

FIGURE 3B: P/E RATIOS OF NASDAQ COMPOSITE INDEX 2001 – 2020



Source: Bloomberg, data as of December 31, 2020.

Looking outside the U.S., we anticipate international equities, particularly emerging markets, to be a source of growth in 2021. We expect the recent weakening of the dollar to persist through the first half of 2021, which should provide a currency boost to international equity total returns for U.S. investors. Additionally, valuations for international developed equities, such as Europe and Japan, are lower compared to the high valuation levels of U.S. equities, allowing further room for growth. As mentioned in the macroeconomic outlook, Asia, and in particular China, has recovered quickly from the pandemic, driven mainly by infrastructure-led spending and an emphasis on technological innovation. We believe emerging markets, particularly regions in South East Asia, that stand to benefit from China-related tailwinds look attractive as areas of opportunities in the years ahead.

Modest return potential in the long-term, favoring selective emerging markets

Continuing the pace of the past decade will be a challenge for U.S. equity markets. While economic recoveries following the pandemic may boost overall growth rates in the short term, over the next decade, we estimate a modest growth rate of ~4-6% globally for equities. This growth may be accompanied by bouts of volatility due to asset bubbles or reversals in over-concentration. Additionally, we expect the yield curve to steepen over the next few years, moving long-term interest rates higher and putting further pressure on U.S. equity valuations. We anticipate Asian emerging markets to be an attractive growth opportunity, as a new wave of globalization, shifts in consumer trends and innovation propels growth over the long-term.

FIXED INCOME MARKETS

EYES WIDE OPEN ON CREDIT... SELECTIVELY

Agam Sharma, Chief Investment Officer

IN BRIEF

- **The government-mandated stress tests** induced tremendous capital discipline in banks and corporate balance sheets. Most credit asset classes benefited from the rate rally and extraordinary monetary policies during the pandemic. Yet, at the historically low rates of today and with elevated correlations across asset classes, we believe the ability of fixed income, and sovereign yields in particular, to offer lower risk or hedging capabilities will be increasingly limited.
- **With short-term rates in the U.S.** pegged securely between 0 and 25 basis points ("bps"), additional asset purchases by the Federal Reserve, and fiscal spending set to rise with Democratic administration, we believe that the yield curve will have modest steepening over the coming year.
- **Over the long-term, we expect the steepening of the yield curve** and inflation expectations to accelerate in pace as fundamental data strengthens. As such, duration will not be able to play the diversifying role nor be a significant contributor of returns ahead. Instead, we are shifting to an environment where credit risk premia and selectivity will be the key drivers of fixed income returns. Broadly, we view credit markets to lean negative, yet select credit pockets look attractive: bank loans, high quality structured credit, real estate debt and emerging market debt, particularly regions in Asia. These credit sectors may offer a blend of yield, total return and diversification benefits to investor portfolios in the future.

Fixed income, a safe haven no more

Post the 2008 Global Financial Crisis ("GFC"), the government-mandated stress tests induced tremendous capital discipline in banks and corporate balance sheets, making credit risk attractive on a risk-adjusted basis. Most credit asset classes benefited from the secular rally in rates, which recently ended after nearly four decades, and extraordinary monetary policies during the pandemic. This combination made credit attractive for both yield and total return-seeking investors. Yet, at the historically low rates of today and with elevated correlations across asset classes, we believe the ability of fixed income, and sovereign yields in particular, to offer lower risk or hedging capabilities going forward will be increasingly limited.

A year of credit selectivity

The Federal Reserve continues to peg U.S. short-term rates securely between 0 and 25bps, broadcasting to the market that monetary policy will remain accommodative for the intermediate term. Despite a potential uptick in the yield curve resulting from an anticipated Democratic fiscal push, we believe that this continuation of monetary policy is generally supportive of an economic recovery in 2021. While short-term rates will remain pegged, we expect a modest steepening of the yield curve throughout next year as longer-term rates increase with growing fiscal spending and strengthening fundamentals.

With rates at such a low level, the upside for long bonds is limited in the face of additional equity market volatility. Investors need to also be cognizant of the potential risk that a more significant and unexpected increase in long term rates could carry. A sharp increase in rates (potentially driven by inflationary concerns) could inflict meaningful capital losses on those investors that have taken on more duration risk in the face of the economic uncertainty of 2020, without adequate credit risk premia

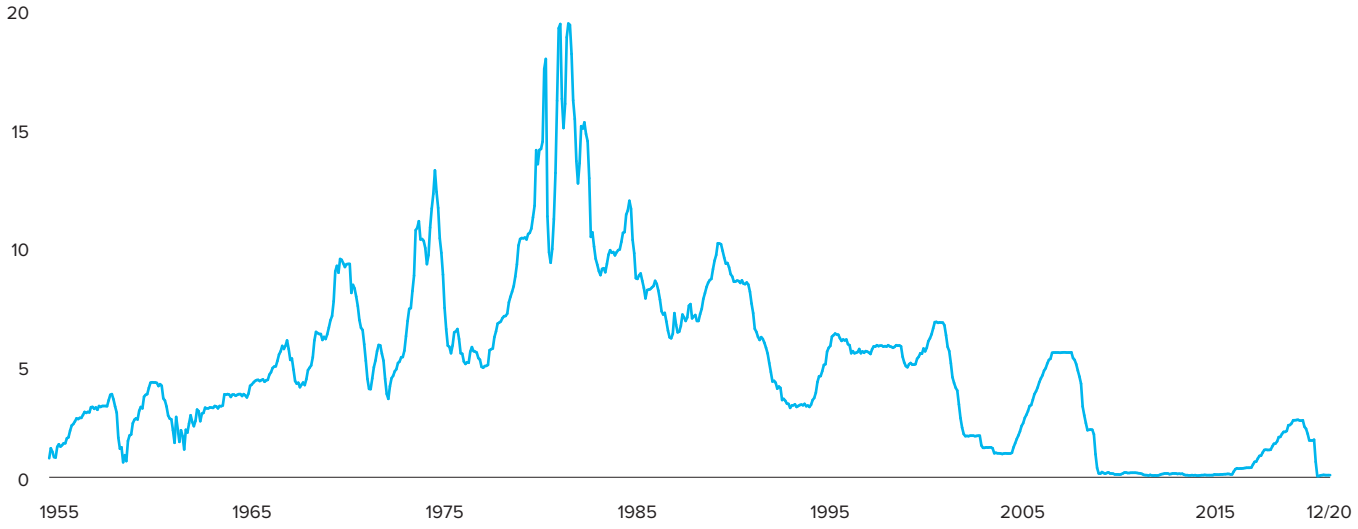
Yields are at historic lows

FIGURE 4: U.S. 10-YEAR TREASURY YIELDS 1970 – 2020

Source: Federal Reserve Bank of St. Louis, data as of December 31, 2020.

The Federal Reserve has indicated that they will keep rates accommodative for recovery

FIGURE 5: FEDERAL FUNDS RATE



Source: Federal Reserve Bank of St. Louis, data as of December 31, 2020.

to deliver return. As such, duration will not be able to play the diversifying role nor be a significant contributor of returns ahead. Instead, we are shifting to an environment where credit risk premia and selectivity will be the key drivers of fixed income returns.

Another consideration for fixed income investors is the realities of a high-debt world. Over the past decade, we've seen debt issuance from corporations increase dramatically as investor appetite for yield ballooned alongside a low-rate environment. While the debt level is reason for pause, we believe that corporate balance sheet risks have generally been underwritten well. Large-cap corporations have exhibited substantial improvement in their fundamentals by growing and diversifying the sources of their operating funds, improving debt levels and interest coverage ratios, and lengthening their maturity profiles following the GFC. We suggest small to mid-cap size companies should be assessed on a security selection basis. These high levels of debt combined with a steepening yield curve may make core fixed income more susceptible to market and economic shocks over the upcoming decade.

We do recognize the valuation risk of current credit spreads being at close to historic tights since the GFC. Lower-for-longer monetary policy, balance sheet strength and technical buying from international investors should continue to keep investment grade credit spreads tight and range-bound within 80-120bps over the near-term. As such, we see opportunities for security selection, particularly in the high yield and emerging market debt ("EM debt") sectors. We expect U.S. high yield spreads to modestly tighten to 325-350bps following an economic recovery, which we expect to gain steam in the second half of 2021. The weakening of the U.S. dollar (as measured by the DXY) and the broad-based demand for yield should favor certain USD-denominated EM debt assets in 2021.

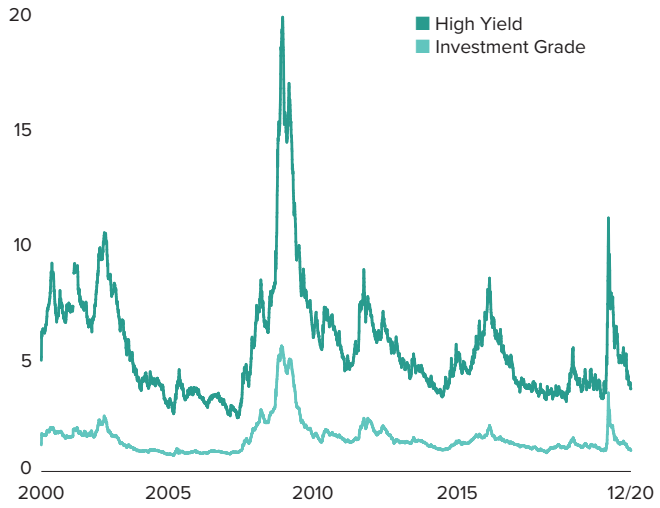
We believe that in the short-term, fixed income will be an area of extracting total returns and yield through credit risk premia (versus duration risk) using sectoral and security-specific alpha. Certain credit sectors like EM debt and high yield may benefit from strengthening financials

and spread compression alongside a broader economic recovery. While investors should be judicious of liquidity or concentration risk in credit sectors, we believe there are pockets of investment opportunity offering appropriate yield, total return and diversification benefits to investor portfolios. Select areas of alternative credit, such as real estate debt, bank loans, securitized assets (ABS) and CLO debt, may stand to do better as the search intensifies for yield and lower correlation assets. Save for illiquidity spikes, we expect higher quality segments of these assets to deliver better risk-adjusted returns than traditional fixed income sectors. Over 2021 and beyond, we expect differentiation across credit risk premia, with caution for duration risk, being key in assessing and selecting fixed income markets.

We do expect the steepening of the yield curve and inflation expectations to accelerate in pace over the long-term as fundamental data strengthens and a patient Federal Reserve toggles asset purchases and tolerates higher inflation levels. As mentioned, investment grade corporations have strengthened their balance sheets and lengthened their maturity profiles, making them a sound opportunity for now. However, with a longer maturity profile comes increased sensitivity to rising long-term rates; as longer-term yields rise and inflation gradually surpasses the Federal Reserve's 2% target, the potential for investment grade debt over the in the future is limited. Technical pressures from international buyers will partially mitigate the risk of a spike in yields. Non-investment grade fixed income markets or alternative sources of credit will continue to be security-selection driven based on dispersion in default and recovery rates, with average returns staying in the low-mid single digits over the longer term. Emerging markets, on the other hand, should continue to see more elevated returns than developed markets, particularly sovereign and EM bonds, given the tailwinds from the weakening of the U.S. dollar, capital flows and improving fundamentals.

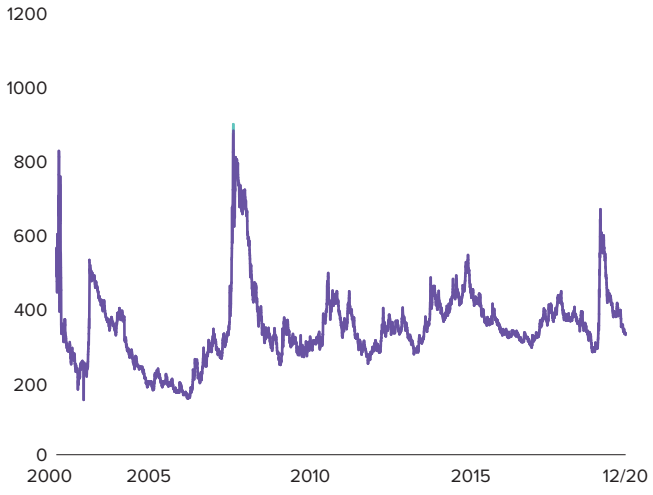
We see opportunities in the high yield and emerging market debt sectors

FIGURE 6A: US INVESTMENT GRADE SPREADS VS. US HY SPREADS 2000 – 2020



Source: Bloomberg, data as of December 31, 2020.

FIGURE 6B: J.P. MORGAN EMBI GLOBAL SPREAD 2000 – 2020



Source: Bloomberg, data as of December 31, 2020.

ALTERNATIVES OUTLOOK

REDEFINING ALTERNATIVES

Agam Sharma, Chief Investment Officer
Yev Shelkovskiy, CFA, CIMA, Portfolio Manager

IN BRIEF

- **Historically, alternatives have been considered an optional or rounding allocation for portfolios,** reserved for the most sophisticated and well-funded investors. However, the realities of today's markets are making it increasingly difficult for investors to reach their investment goals – and as such, we believe alternatives need to be redefined to include newer assets and should be considered a more integral allocation in portfolios going forward.
- **While we believe that established alternative asset types** like hedge funds, private equity and venture capital will continue to offer attractive illiquidity premia, newer alternative options provide additional opportunities to access uncorrelated returns or total return potential. With the search for yield and lack of correlation intensifying, there is an urgent need within the industry to rethink alternatives in a way that both acknowledges established asset types, but more importantly, expands and redefines the asset class based on evolving and innovative options coming to market, such as newer exposures in private credit, digital assets and untapped sectors like lifestyle assets and innovation financing. We believe that the universe of "alternative" opportunities, and their accessibility, continues to grow rapidly.

Alternatives, not so alternative anymore

Historically, alternatives have been considered an optional allocation for portfolios, reserved for the most sophisticated and well-funded investors. Liquidity, transparency and access concerns, coupled with high, complex fee structures has limited broad adoption of alternatives, despite the role alternatives can play in portfolios, such as generating low or uncorrelated returns to traditional asset classes. The realities of today's markets, including low return expectations, the absence of yield and elevated correlations during periods of market stress, are making it increasingly difficult for investors to reach their investment goals. As such, we believe alternatives should be considered a more integral allocation in portfolios going forward. The universe of alternatives is expanding beyond established asset classes; new investments and distribution platforms are being developed, providing investors with additional, and accessible, alternatives options.

An urgent need to rethink and redefine alternatives

"Alternatives" is a loosely defined category and a term often haphazardly assigned to any asset class, and associated cash flows, that are uncorrelated to public markets, reduce overall portfolio volatility and/or deliver total returns via illiquidity premium or value creation. Yet with the search for yield and lack of correlation intensifying, there is an urgent need within the industry to rethink alternatives in a way that both acknowledges established asset types, but more importantly, expands and redefines the asset class based on evolving and innovative options coming to market.

While traditional pockets of venture capital, private equity, hedge fund and real assets have often found patient and growing allocations in investor portfolios over the years, newer exposures in private credit, for example, credit financing to portfolio companies or Fintech lending, and digital assets such as bitcoin are fast-rising creative alternatives that offer a blend of cash flow and long-term value creation. The "Fourth Industrial Revolution in Technology" has transformed untapped sectors like lifestyle assets (e.g. art, wine, e-sports infrastructure) and innovation financing (e.g. Intellectual Property rights, royalty-financing) into investable assets, offering cash flow streams that mimic the "alternative" behavior. We believe that these newer dimensions within alternatives are going to increasingly change and redefine what "alternatives" truly are within investor portfolios. Within this expanding universe, we favor opportunities in the following areas:

ESTABLISHED ALTERNATIVE ASSET TYPES SHOULD CONTINUE TO OFFER ILLIQUIDITY PREMIA AND YIELDS

The high levels of dry powder that have been backing private assets coming into 2020 was put through a rigorous test during the pandemic, as investors were focused on preserving value, capital discipline and reengineering business models of their portfolio companies. We expect to see yields on private credit range from high single digits to mid-teens, providing a health illiquidity premium consistent with historical levels. Illiquidity premiums on private equity assets should rise in 2021 to high single digits as transaction volumes increase following a defensive positioning in 2020. Specifically, we view real assets or infrastructure-linked cash flows that have modest yield and inflation-hedged models attractive, given the fiscal stimulus' tilt towards infrastructure spending and the long-term nature of such cash flows.

NEW EXPOSURES IN PRIVATE CREDIT

As the Technological Revolution infiltrates and transforms global markets, economies, operations and lifestyles, the growth of Fintech, or technology-based start-ups that provide financial or lending services, has been exponential. The Fintech industry globally reached a value globally of nearly $111,240.5 million in 2019, having grown

at a compound annual growth rate ("CAGR") of 7.9% since 2015.[1] With the explosion of the Fintech industry, new private credit exposures have emerged; asset managers are investing in private credit assets derived from non-bank Fintech lending platforms and similar structured credit opportunities. Fintech lending private credit exposure may offer differentiated and diversified return streams across industries including secured real estate, small business, education and consumer credit sectors. Gaining direct exposures through privately styled vehicles offers a much more focused approach relative to typical structures like business development companies.

THE RISE OF DIGITAL ASSETS

Digital currencies, such as bitcoin, have started to experience significant capital deepening and investor adoption globally. After climbing to all-time record highs at the end of 2020, bitcoin has continued to rally, recently topping a price of $40,000 and pushing the cryptocurrency market value past $1 trillion,[2] as investors embrace bitcoin as a store of value for portfolios. We believe bitcoin offers similar characteristics to gold as a store of value, as its supply is guaranteed and predictable, capped at 21 million bitcoins. As a result, it is independent of global markets and macroeconomic conditions. As an asset class, bitcoin is continuing to mature for investor adoption, with trading volumes consistently increasing and institutional service providers offering support to deliver operational efficiencies.

We believe an allocation to bitcoin has the potential to provide investors with attractive risk-adjusted returns. Bitcoin has historically delivered strong performance relative to traditional asset classes, like equities and fixed income, while also delivering attractive diversification properties. At small allocations, bitcoin can act as a strong diversification tool for portfolio construction.

A FAST-GROWING INDUSTRY WITH GROWING INFRASTRUCTURE NEEDS — ESPORTS

Reliable internet access paired with a wealth of sophisticated gaming options has allowed avid gaming communities to develop into a multi-billion-dollar asset class: esports, or "electronic sports." The esports industry is sitting on a powerful combination of a large, engaged target market, inexpensive broadcasting infrastructure, and the best viewership analytic capabilities in history; these factors combined are likely to drive growth. We see the highest growth opportunities primarily concentrated in private markets, which can be accessible with the help of entities that are "endemic" to esports.

SUPPORTING INNOVATION THROUGH ROYALTY-FINANCING

Royalty-financing involves funding a new business in exchange for a fixed percentage, or royalty-rate, based on the company's future revenues, not unlike an advance on a paycheck. Often, the royalty payments are capped at a pre-determined level; the dollar amount paid fluctuates with the company's revenue until the obligation is complete. As an alternative to traditional equity and debt, royalty-financing provides investors with a stable return stream, although it may be inconsistent and slow depending on the revenue growth of the company. Royalty-financing provides investors an avenue to support innovation and a hands-off way to participate in the development of a new company, while potentially generating returns.

As investors increasingly look beyond traditional asset classes, they should consider tapping into illiquidity risk premia or exploring investments that mimic "alternative" behavior. The aforementioned are only some examples of this broadening asset class; we will continue to discover and democratize alternative options to provide investors a range of attractive, uncorrelated investments for portfolios.

REFERENCES

Unless stated, all data sourced from Bloomberg as of December 31, 2020.
[1] The *Business Research Company*, "Fintech Global Market Opportunities and Strategies," data as of July 2020.
[2] CNBC, "Bitcoin tops $40,000 for first time, pushing cryptocurrency market value past $1 trillion," data as of January 7, 2021.

Learn more at
www.emles.com

The views contained herein are for informational purposes only and should not be taken as investment advice or a recommendation to buy or sell any investment. The material presented is current as of the date of publication and may become stale, inaccurate, or incomplete over time. This material does not contain sufficient information to support an investment decision and it should not be relied upon by you in evaluating the merits of investing in any securities or products.

An investor should not construe the information contained herein as legal, tax, investment or other advice. Investors should consult with their professional advisers to determine any legal, regulatory, tax, credit, and accounting implications to determine if any investment mentioned herein is believed to be suitable to their personal goals.

Past-performance does not guarantee future results. Investing involves risk including the loss of principal and fluctuation of value.

Any forecasts, market outlooks, or estimates contained herein are forward-looking statements and are based upon certain assumptions. No forecasts can be guaranteed. Other events that were not taken into account may occur and may significantly affect the returns or performance. Any projections, outlooks, or assumptions should not be construed to be indicative of the actual events which will occur.

Opinions and examples are meant to be an illustration of broader themes and are not an indication of intent. They are subject to change at any time due to changes in market or economic conditions. There is no guarantee that the information supplied is accurate, complete, timely, or timely, nor are there any warranties with regards to the results obtained from its use.

Index definitions

All indexes are unmanaged and an individual cannot invest directly in an index. Index returns do not include fees or expenses.

The **S&P 500 Index** is an unmanaged index of 500 common stocks primarily traded on the New York Stock Exchange, weighted by market capitalization. Index performance includes the reinvestment of dividends and capital gains.

The **Nasdaq Composite Index** is a broad-based market index that includes over 3000 of the equities listed on the Nasdaq stock exchange.

The **Bloomberg Barclays US Aggregate Bond Index** is a broad-based benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency).

The **U.S. Dollar Index (DXY)** averages the exchange rate between USD and major world currencies.

The **Cboe Volatility Index (VIX)** is a real-time market index representing the market's expectations for volatility over the coming 30 days.

IHS Markit's Purchasing Managers' Index ("PMI"), which is an index of economic trends in the manufacturing and service sectors

The **Consumer Price Index (CPI)** is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

The **Cboe VVIX Index (VVIX)** is a volatility of volatility measure in that it represents the expected volatility of the 30-day forward price of the CBOE Volatility Index (the VIX®).

Risks and definitions

Alternatives Risk: Alternatives investments involve greater risks than traditional investments and should not be deemed a complete investment program.

Bitcoin Risks: Digital currency such as Bitcoin is not legal tender. No law requires companies or individuals to accept bitcoins as a form of payment. Instead, Bitcoin use is limited to businesses and individuals that are willing to accept bitcoins. If no one accepts bitcoins, bitcoins will become worthless. Platforms that buy and sell bitcoins can be hacked, and some have failed. In addition, like the platforms themselves, digital wallets can be hacked. As a result, consumers can—and have—lost money. Bitcoin transactions can be subject to fraud and theft. For example, a fraudster could pose as a Bitcoin exchange, Bitcoin intermediary or trader in an effort to lure you to send money, which is then stolen. Unlike US banks and credit unions that provide certain guarantees of safety to depositors, there are no such safeguards provided to digital wallets. Bitcoin payments are irreversible. Once you complete a transaction, it cannot be reversed. Purchases can be refunded, but that depends solely on the willingness of the establishment to do so. In part because of the anonymity Bitcoin offers, it has been used in illegal activity, including drug dealing, money laundering and other forms of illegal commerce. Abuses could impact consumers and speculators; for instance, law enforcement agencies could shut down or restrict the use of platforms and exchanges, limiting or shutting off the ability to use or trade bitcoins.

Bond Risk: The Fund is subject to the same risks as the underlying bonds in the portfolio such as credit, prepayment, call and interest rate risk. As interest rates rise the value of bond prices will decline.

Commodities Risk: Investments in commodities may have greater volatility than investments in traditional securities, particularly if the instruments involve leverage. The value of commodity-linked derivative instruments may be affected by changes in overall market movements, commodity index volatility, changes in interest rates, or factors affecting a particular industry or commodity, such as drought, floods, weather, livestock disease, embargoes, tariffs and international economic, political and regulatory developments. Use of leveraged commodity-linked derivatives creates an opportunity for increased return but, at the same time, creates the possibility for greater loss.

Credit Risk: Credit risk refers to the loss in the value of a security based on a default in the payment of principle and/or interest of the security, or the perception of the market of such default.

Equity Securities Risk: Equity securities, such as common stocks, are subject to market, economic and business risks that may cause their prices to fluctuate.

Foreign and Emerging Markets Risks: Investments in foreign securities may involve risks such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation. Investing in emerging markets involves different and greater risks, as these countries are substantially smaller, less liquid and more volatile than securities markets in more developed market.

High Yield Bond Risk: High-yield bonds have a higher risk of default or other adverse credit events but have the potential to pay higher earnings over investment grade bonds. The higher risk of default, or the inability of the creditor to repay its debt, is the primary reason for the higher interest rates on high -yield bonds. Examples of other adverse credit events are interest rate risk (when interest rates rise, bond prices fall) and economic risk (the risk associated with downturns in the economy).

Price-to-Earnings Ratio ("P/E Ratio"): Current share price of a stock divided by its earnings per share. Price to trailing earnings is a measure of the price-to-earnings ratio (P/E) using historical or trailing earnings.

Risk Premium or Premia: A risk premium is the return in excess of the risk-free rate of return that an investment is expected to yield.

Securities Market Risk: The value of the securities may go up or down, sometimes rapidly or unpredictably, due to factors affecting particular companies or the securities market generally. A general downturn in the securities market may cause multiple asset classes to decline in value simultaneously, although equity securities generally have greater price volatility than fixed income securities.

Emles Advisors LLC is an investment adviser registered with the U S Securities and Exchange Commission (SEC).