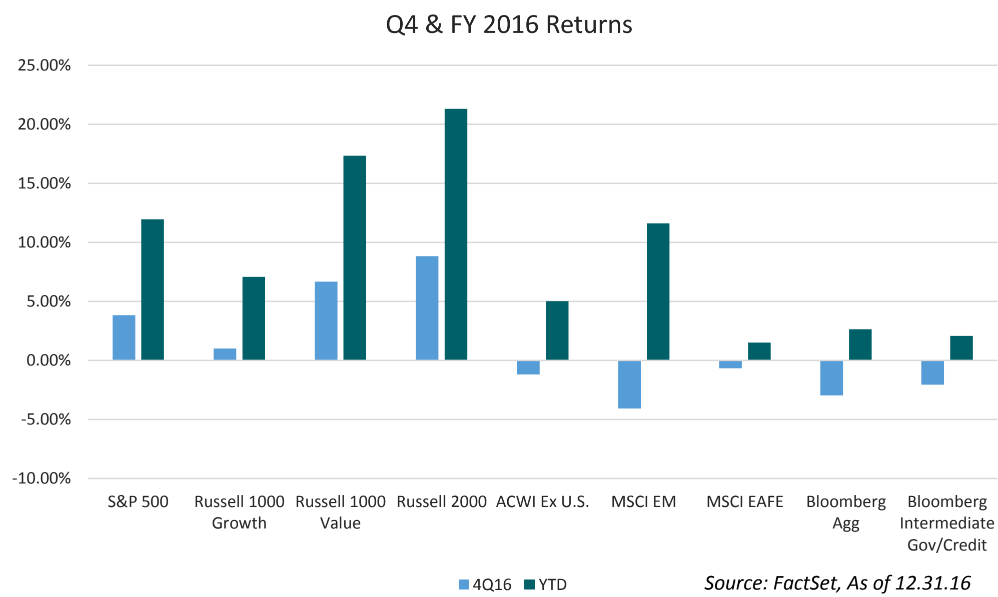
Outlook Summary

We enter 2017 with the stock market reaching new highs and the yield on the 10 year Treasury at 2.44%, following strong moves by both since the November election. "Dow 20,000" is within reach and the "Trump effect" continues to bolster the more cyclical components of the equity markets (financials, energy, industrials) that represented market leadership during the second half of 2016 and continue to garner investor attention in the first 10 days of the New Year. This January is off to a dramatically different start than a year ago with the S&P 500 up 1.4% versus the nearly 5.0% decline registered in the first 10 days of January 2016.

What is in store for investors in 2017?

We believe 2017 will be largely influenced by equities and fixed income returning to a more normalized environment in which investors seek to own equities in their portfolios for capital appreciation and fixed income for capital preservation and income. The Trump presidency and policy priorities shaped in the first 100 days will likely have the most influence on macroeconomic outlooks, as investors digest both the magnitude of change and the timeline for implementation of Trump's "Big 3" pro-growth topics (tax reform, deregulation, and infrastructure spending). We also believe 2017 will solidify the end of the "earnings recession" that began in 2014, and earnings growth will emerge as a key fundamental factor for U.S. equity market valuations. Interest rates will likely trend higher over the course of the year due to a confluence of variables including the need to normalize Fed policy, a confidence boost from Trump's pro-business policies, a likely increase in inflation measures driven by commodities, and a potential reversal in global monetary policies as central banks appear to be questioning the effectiveness of quantitative easing (QE) programs. ***All of the above in our view will lead to increased volatility and be a constant theme throughout 2017, but also opportunities.***

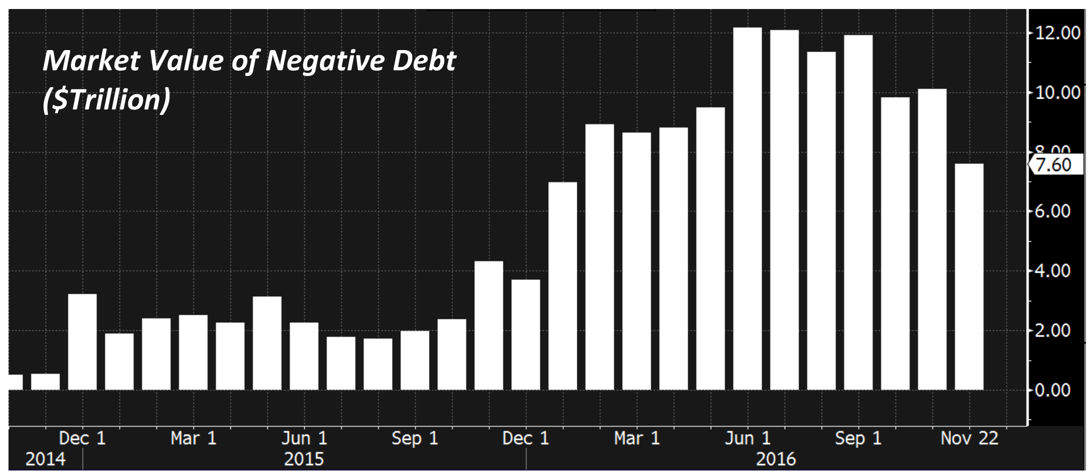


Source: FactSet, As of 12.31.16

The global economy is transitioning to a reflationary expansion that should last for a few more years. Barring any external economic shocks, a recession is not likely in the next couple of years. With this backdrop, FSP maintains a constructive view on portfolio allocation to global equities but with a preference for domestic companies. Within fixed income, we will target a shorter than benchmark maturity duration and prefer spread sectors such as corporate bonds, non-agency mortgages, and fixed-to-floating rate preferred securities over government issues. Finally, in what we expect to be a reflationary environment a modest allocation to inflation sensitive real assets and inflation protected securities should be part of a diversified portfolio.

Economics

In the seminal work *A History of Interest Rates* by Sidney Homer and Richard Sylla, originally published in 1962, the authors provide a detailed history of interest rates and the price of credit for the past four thousand years, starting with the time of ancient Babylonia. The fourth edition was published in 2005 and as with prior editions, contains no mention of zero or negative interest rates. If there is a fifth edition, for the first time in recorded human history the authors will need to dedicate a section to zero and negative interest rates. In just over a decade since the fourth edition was published, hardly even a speck on their historical timeline, market participants followed major central banks in rationalizing that current times were so different from anything in post-ancient human history that it was appropriate to turn even the most basic economic postulates on their head, despite having their endurance vetted by dozens of generations, rises and falls of empires, through times of wars and peace, famines and prosperity. For a brief moment earlier this summer, the policies of global central banks pushed the market to price more than $12 trillion of bonds, or a quarter of all in existence, to levels implying negative yields.

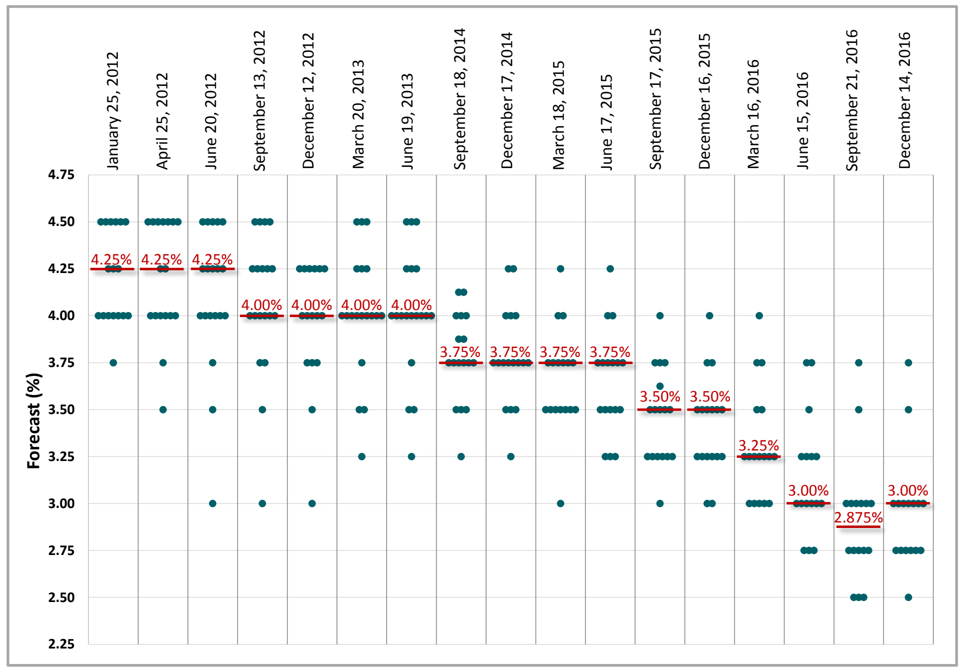


Source: Bloomberg, As of 12.19.16

However, as often happens in financial markets when things reach extreme levels, the excess of negative interest rates has quickly unwound. Most often there is a catalyst which triggers the unwind from the extreme levels; in this case the trigger came in the form of the U.K. referendum (Brexit) result to leave the European Union and the U.S. presidential election, both of which signified a tide turning away from policies and politics that have ruled for the past thirty-plus years. The modern-day global economy is a product of more inclusive trade, a shift from manufacturing capacity to new entrants, and automation of production processes all leading to lower labor costs and lower inflation. Global central banks, with their hands strapped behind their backs by inflexible inflation mandates and lack of fiscal engagement, have pushed their policies to previously unimaginable extremes.

As we look ahead to 2017, it is not an understatement to say economies appear to be sitting on the precipice of a secular shift in policy following the U.S. election and ongoing political changes in Europe. However, it remains to be seen what actually gets implemented. Rarely have so few details about so loosely defined policies made 'experts' change their minds as quickly as what we have witnessed following Trump's victory. In addition, a transition from financial repression to fiscal expansion appears to be under way, and it will likely have major implications for economies, politics and financial markets. The confluence of uncertainties including the transition from monetary to fiscal policy dominance, political elections in Europe, and the beginning of a new administration in the U.S. will, in our view, lead to an increase in volatility, but also opportunities.

U.S. growth had been improving even prior to the election and the Federal Reserve (Fed) is close to meeting its dual mandate; the U.S. unemployment rate has fallen to 4.6%, below the Fed's own estimate of full employment, and wage growth and core inflation continue to increase. Given this backdrop, the Fed increased the Federal Funds Rate by 25 basis points (bps) at their December meeting. This increase was universally expected and heading into the meeting, the market was pricing a 100% probability that the Fed would increase rates. However, the market was caught by surprise by the upward revision of the Fed's economic forecast of the 'dots' in their Summary of Economic Projections (SEP), which are released on a quarterly basis. The graph to the right shows the FOMC's projections for the long term Fed Funds rate. The December 2016 meeting was the 17th update provided by the Federal Open Market Committee (FOMC) on this projection and it is the first time that the median dot increased.

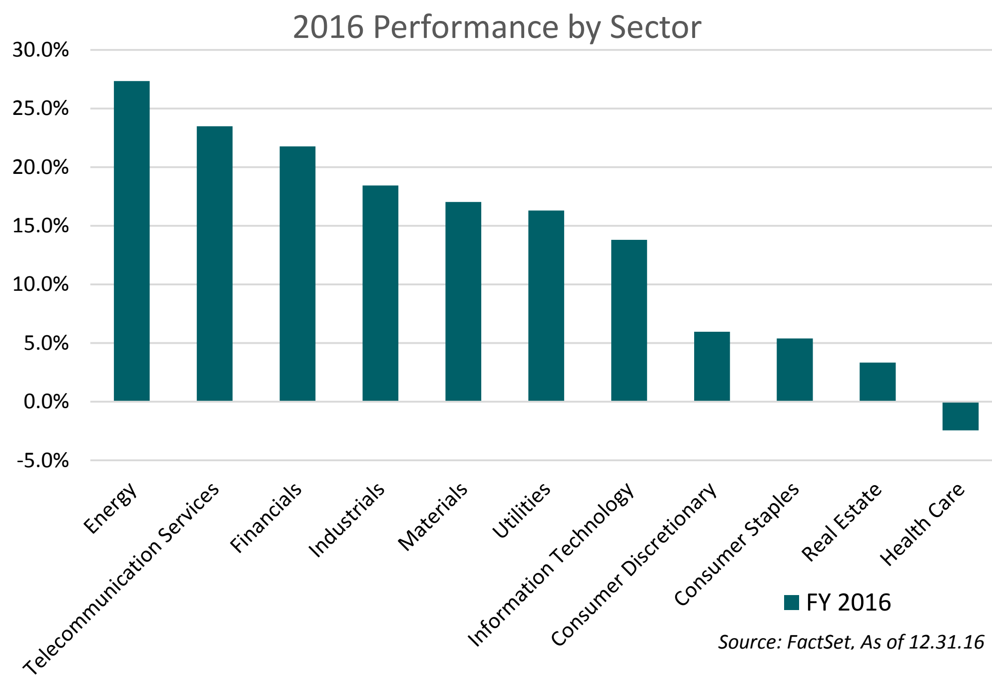


Source: Federal Reserve, Bloomberg. As of 12.19.16

Away from monetary policy, decisions made by President-elect Trump and a new Congress will be critical factors which will dictate moves in Treasury yields. The odds of looser fiscal policy, centered on tax reform and increased defense and infrastructure spending have risen, based on both campaign and post-election rhetoric from President-elect Trump. However, these initiatives will take time to materialize and most could face legislative hurdles, making implementation in 2017 challenging.

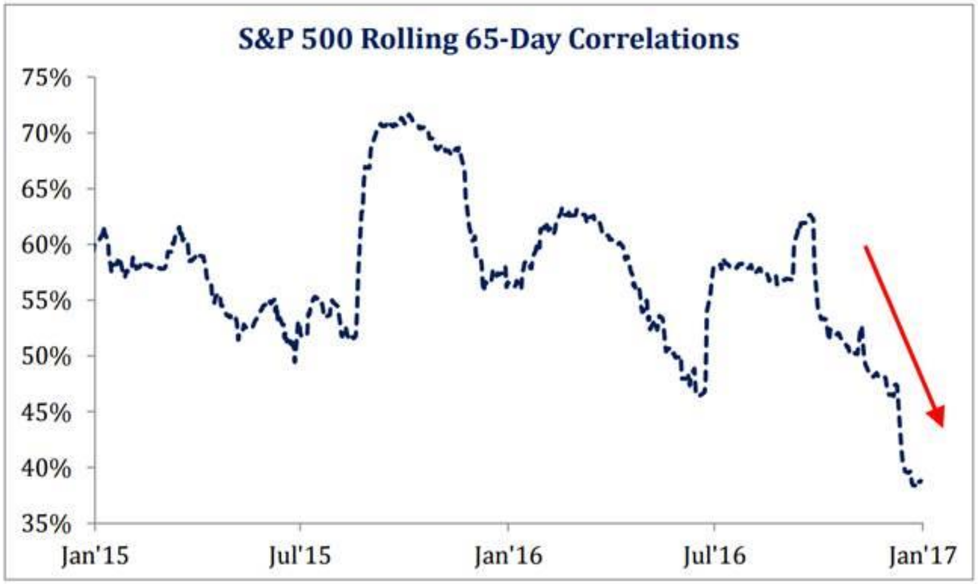
Equities

Equity markets made a robust recovery from the lows of February 2016 and finished the year in positive territory; the S&P 500 posted an 11.96% return (including dividends), while the small cap index (Russell 2000) delivered an impressive 21.31% return. Confidence that the U.S. will continue to experience positive growth was enhanced considerably by election outcomes in November. Investors embraced Trump's pro-growth business model and accelerated the rotation into cyclical sectors even further. A combination of rising rates and speculation of favorable Trump administration policies bolstered bank stocks in particular. Overall, the large cap financial sector posted a 21.77% return for 2016, and was bested by the energy sector's 27.33% return, as the strength of these two sectors enabled value stocks to outpace growth strategies for the year. With hope for the US economy to see a real lift from Trump's "Big 3" policy proposals (tax reform, deregulation, infrastructure spending), domestic markets outperformed developed international equities. In summary, 2016 was a year driven by "Trump stocks," just as 2015's returns were largely dominated by the F.A.N.G. group.



Source: FactSet, As of 12.31.16

As we enter 2017, the S&P 500 is trading at 16.9x forward 2017 EPS estimates, slightly lower than the average 20 year forward P/E multiple of 17.2x – suggesting the market has room to move higher. Consensus estimates anticipate 2017 S&P 500 earnings to grow nearly 11.5% versus 2016 – marking the first year of earnings growth after three relatively flat years beginning in 2014. In our view, a resurgence in earnings growth is the most significant fundamental factor that supports equity valuations moving higher throughout 2017. The sectors with the largest increase in earnings growth rates are those hardest hit going into the earnings recession in 2014 – energy and financials. However, there should be broad based participation by most other components of the S&P 500 that would contribute to the overall acceleration – setting a stage for 2017 equity returns to be driven by that which is most important to us – individual company fundamentals. Thus, we remain bullish on equities with a bias toward U.S. markets.



Source: Strategas, As of 01.03.17

2017 sets up to be a year in which equity markets are influenced by Trump tweets, pro-growth fiscal policies, a resurgence of corporate earnings, interest rate movements, globalization, and to some extent demographics. As a result, we expect market volatility to increase and persist throughout the year. As long term investors, we view shorter term market volatility as an opportunity to upgrade portfolios with high quality companies that meet our valuation discipline. Patience and philosophical consistency are paramount to achieving any portfolio's investment objectives during periods of market volatility. We believe outperforming in this environment will require holding concentrated positions in the right sectors and companies, and more than ever, the onus will be on disciplined stock picking.

Fixed Income

The trend of US interest rates will likely continue higher in 2017, due to a confluence of factors including the need to normalize Fed policy, a confidence boost from Trump's pro-business policies, a likely increase in inflation measures driven by commodities, and a potential reversal in global monetary policies as central banks appear to be questioning the effectiveness of quantitative easing (QE) programs. However, in the near term, much of the repricing higher in rates may have already occurred. The market is a discounting mechanism and investors are well aware of the potential interaction of the above factors and are already positioned for the risk of higher rates. Furthermore, the level of other developed market (German and Japan in particular) government bonds will also be a factor. If the yields on other sovereign bond markets stay near zero, then investors in those markets will buy the higher yielding U.S. Treasury bond, which will act as a ceiling on U.S. rates.

We remain constructive on U.S. investment grade (IG) corporate bonds and believe that spreads could tighten modestly in 2017. With the outlook for modest spread tightening over the course of the year, wider-trading sectors should outperform due to higher carry (yields) and generic spread compression. However, that must be balanced against the volatility of the sector – some sectors which trade at wide spreads should trade cheap due to poor fundamentals and/or outlook. We favor industrials tied to the U.S. consumer such as airlines, autos, housing, and leisure, which should remain supported by solid consumer balance sheets, rising confidence and potential tax cuts. In addition, we like sectors which would benefit from increased fiscal stimulus such as building materials / aggregates. We continue to remain underweight the healthcare and technology sectors due to the elevated event risks of M&A activity or re-leveraging of balance sheets that many issuers in these sectors continue to engage in.

The fundamental backdrop for U.S. bank preferreds, as well as select European preferreds, remains strong and should support valuations in the asset class. Banks continue to increase their capital ratios, a trend which will continue through 2018 to meet new stricter regulatory requirements outlined in the international accord known as Basel III. In addition, bank profitability stands to benefit from an increase in interest rates as well as a potential uptick in economic activity driving higher loan demand. From a technical perspective, the asset class should benefit from a decrease in issuance, as banks have, by in large, already issued enough preferreds to meet their threshold for regulatory requirement to fill their additional tier 1 (AT1) needs, meaning that net new issuance in the coming year should be limited.

Following a very strong performance year for high yield, preferreds now look cheap relative to the high yield asset class. Interest rate risk is a key risk to preferreds and we therefore continue to favor fixed-to-float preferreds, which are securities where the coupon rate is fixed for 5 or 10 years after issuance and then is either called by the issuer or it converts to a floating rate coupon over a reference rate – most commonly Libor. This structure limits the interest rates sensitivity, or duration, to the length of the fixed rate period.

We remain comfortable with the outlook for housing despite the move higher in interest rates given a solid labor market, strong household balance sheets and favorable demand / supply characteristics in the current housing market. With this backdrop, non-agency mortgages continue to be an asset class with an attractive risk/return profile. Furthermore, non-agency mortgage provide diversification since they are relatively uncorrelated with other risk assets.