Second Quarter 2017

Market Outlook

Outlook Summary

U.S. equity markets continued to make new highs during the first quarter of 2017, as the Dow surpassed the 20,000 mark and the S&P 500 briefly reached 2,400. Overall, the S&P 500 gained 6.1% for the period, continuing the strong gains posted after November's presidential election. While post-election appreciation was largely driven by stocks considered to be most levered to the "Trump Trade" – Financials and Industrials – the first quarter's success was broader and more diversified. Global equity markets performed even better, as both developed international and emerging market indices outperformed their U.S. counterparts.

Most economic data suggest that the global economic expansion will continue to strengthen and broaden over the rest of 2017, allowing central banks worldwide to scale back ultra-accommodative monetary policy. While short term interest rates moved slightly higher, absolute levels remain near historic lows and are unlikely to negatively affect reflation and global economic growth in the near term. In fixed income, the benchmark Bloomberg Barclays U.S. Aggregate gained 0.82% during the quarter, as both investment grade and high yield corporate bonds delivered strong performances.

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What is in store for investors in 2017?

The fundamental narrative entering the second quarter remains unchanged, as the market focuses on two key pillars for direction – global GDP growth expectations and political impacts from Washington and abroad. Any progress on the Trump economic agenda will be market friendly. Both tax reform and deregulation are perceived to be market supportive, yet the timing and implementation of these are uncertain. Equity valuations have risen to above-average levels, but are not at historical highs and continue to be supported by lower inflation and interest rates. Overall, the solid fundamental backdrop appears to be supportive and correlations between asset classes have begun to unwind. We continue to see 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.

Source: FactSet, As of 3.31.2017

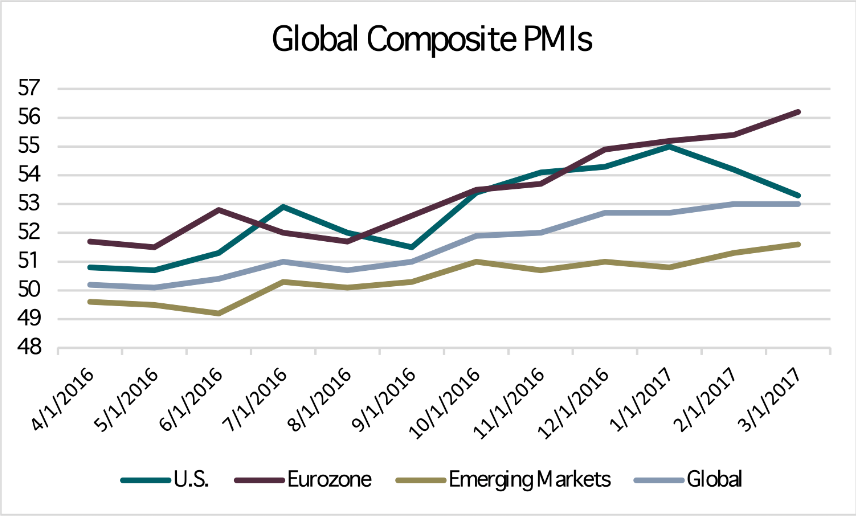
ECONOMICS

As we begin the second quarter, the debate in financial markets about the U.S. economy and the divergence between "hard" and "soft" economic data is taking center stage. "Hard data" refers to concrete improvements in the economy, such as the unemployment rate or wage growth. Meanwhile "soft data" is acquired through the use of surveys reflecting sentiment and beliefs about the direction of the economy. Since the U.S. elections, sentiment indicators have reached record high levels, however, "hard data" indicators released in the first quarter did not show similar improvements. The crux of the debate is will the improvement in sentiment indicators actually translate to concrete improvements in the economic data for both the consumer and the business sector? Overall, we believe that the outlook for the U.S. economic cycle remains positive. While consumer and business optimism may be excessive, we think they're directionally correct and expect US growth to expand over the course of the year.

First quarter GDP growth is tracking weaker than what was estimated at the beginning of the year, however, we expect growth to pick-up over the remaining three quarters. The slow start to 2017 is due to some familiar forces, many of which may be transitory: a rare decline in real personal consumption expenditures in January due in part to a mild winter; consumer spending was limited by a rebound in gasoline prices and higher healthcare insurance costs; and lastly, tax refunds were delayed. We look for the influences of weather and delayed tax refunds to reverse direction in the second quarter and for the pace of consumer spending to increase throughout the year. Job and income growth remains solid and the unemployment rate is trending lower.

In his first six weeks in office, President Trump signed 15 executive orders. Six of the executive orders were related to regulatory rollback, including one requiring that for each new rule, two should be scrapped. Regulatory relief could be an added growth impulse for a healthy economy that was already making positive strides. In the short term, the expectation of less regulation is helping to build confidence in corporate America as reflected in business confidence which is near record high levels. Over a one to three year horizon, the boost to growth could be meaningful, in combination with tax reform and infrastructure spending. Strong manufacturing data (PMI Index) also points to expansion consistent with annualized economic growth around 2.5%. While loan growth has slowed, the pace is still healthy.

Outside the U.S., global growth is expanding. In mainland Europe, economic growth has advanced and leading indicators suggest further momentum in coming months. Employment gains have been solid and consumer confidence is beginning to increase. Business investment is also improving and PMIs across Europe continue to remain strong. However, we remain mindful of the risk associated with the numerous upcoming elections and the wave of "popular politics" which is weighing on valuations. The market is viewing the French elections as a barometer of the strength of the populism movements in Europe. While we view the odds of a Le Pen victory as quite low, that outcome would likely inject short term volatility in European, and potentially global markets.



Source: Bloomberg. Market PMI. As of 04.12.2017

The outlook for emerging markets also appears to be improving. Given the large portion of emerging market economies reliant on exports, the fortunes of the asset class are often tied to the strength of the global economy. An improving growth outlook in the developed world should translate to greater demand for their exports.

Putting it all together, the nearly eight-year-old global economic expansion appears that it will strengthen and broaden over the remainder of the year. The main drivers of this expansion are: 1) generally supportive fiscal policies in most developed market economies, 2) more positive animal spirits as evidenced by consumer and business confidence data and 3) a rebound in global trade in recent months, in combination with a decrease in concerns about the trade policies of the new U.S. administration.

EQUITIES

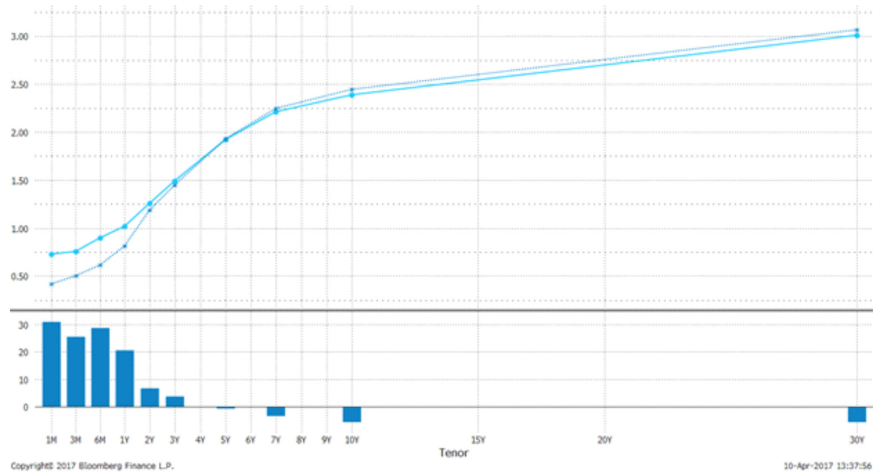
While the potential growth stimulus from Trump's economic agenda became a "known" factor that boosted equity markets during the fourth quarter of 2016 – in particular those areas that would benefit most from longer term US economic growth (small caps) and potential regulatory reform (financials) - the market drivers thus far in 2017 have been more balanced. The Dow surpassed 20,000 and S&P 500 index marked an all-time level of 2400 in early March, as new highs were driven by large cap equities, which outperformed small and mid-cap stocks and stylistically, growth, which outperformed value across the market cap spectrum. Technology stocks led the market with a nearly 12% return, which aided our portfolios that are equal or overweight the sector. A robust start to the 2017 also brings with it elevated risk. Market valuation will likely emerge as the primary concern in the second quarter as investors challenge the expanding P/E multiple of the S&P 500 in the face of balancing the short term divergence of "hard" and "soft" economic data.

U.S. equities do not look cheap, and gains since the presidential election have been powered by multiple expansion. The S&P 500 enters the second quarter trading on the high side relative to historical averages, with a forward P/E multiple of 17.5x. However, this elevated level is still within one standard deviation of the 25-year average P/E multiple of 15.9x for the S&P 500, suggesting room remains for the market to move higher. Muted inflation and lower interest rates on an absolute basis keep the current elevated valuation somewhat reasonable. Additionally, the global economy is transitioning to a reflationary expansion and barring any external economic shocks, a recession is not likely in the next couple of years. Overall, we see optimism in 2017, as we believe the outlook for the U.S. economic cycle remains positive. Many non-U.S. markets tend to have greater leverage to growth in global industrial production, which points to an even bigger earnings boost from stronger global activity.

With this backdrop, FSP maintains a constructive view on portfolio allocation to global equities with an eye towards monitoring the relative valuation between U.S. equities and international developed markets. We continue to look selectively for high quality companies with distinct advantages and trading within our valuation discipline framework. Volatility is likely to increase as investors balance the delicate tradeoff between growth and valuation as we've seen in several instances over this last economic expansion cycle. We are mindful of these potential pullbacks and view them as opportunities for client portfolios.

FIXED INCOME

Interest Rates: Interest rates moved higher during the second half of 2016 due to stronger economic growth and the expectation of increased fiscal stimulus following the U.S. election in November. The rate environment in early 2017, however, has been fairly benign outside of Fed-related volatility which pushed interest rates on short maturities higher leading to a flattening yield curve (i.e. short end rates moving up more than long end rates). The chart included shows the change in different tenors of U.S. Treasury yields since the start of the year.



Source: Bloomberg As of 4.10.2017

With improving growth prospects and inflation having moved closer to target levels, central banks are likely to scale back from their ultra-accommodative monetary policies. The transition from monetary to fiscal policy appears to be underway. The Fed increased the level of the Fed Funds rate at both the December and March meetings, and the market is currently pricing in two more rate hikes this year, which would take the Fed Funds to 1.25-1.5% by year end. The FOMC would like to begin the process of normalizing the size of their balance sheet later this year by either ceasing or phasing out reinvestment of both Treasuries and agency mortgage backed securities.

It is important to recognize the Fed is not the only game in town. Actions taken by the European Central Bank (ECB), the Bank of Japan (BoJ) and the Swiss National Bank (SNB), as well as others, also affect global liquidity. Currently, the aforementioned central banks remain in easing mode and continue to provide the system with liquidity. As such, on average, short dated risk-free yields (two-year and in) remain negative in much of the developed world. This continues to reinforce the powerful technical flows of investors reaching for yield and pouring excess savings into corporate credit. This remains firmly in place today, but could change later this year. Stronger growth in Europe should cause yields to rise, particularly if core inflation maintains its recent higher levels. If the ECB and others start to follow the Fed's lead and move away from their easy monetary policies and front-end yields start to move toward a positive rate, then global flows could shift dramatically.

Reflation became a prominent market theme in the second half of 2016. Commodity prices had rebounded, U.S. economic data was moving in a positive direction and market participants began pricing in the potential for stronger growth and sustained inflation. The outcome of the U.S. election and President Trump's promises for growth-enhancing fiscal policies amplified this optimism. So far this year, modestly positive trends in inflation have emerged: U.S. inflation rose 2.1% year-over-year, exceeding the Fed's 2% inflation target for the first time since 2012. However, looking forward, near-term inflationary pressures in the U.S. seem to be waning. One reason is that labor force participation has increased in recent months, which is likely to dampen wage inflation for now. Another reason is that oil prices have recently declined in response to fears of an expiration of last year's OPEC deal on supply constraint just at a time when more U.S. shale supply is coming to the market. To be sure, we think longer-term risks to inflation are skewed to the upside, but at the same time the momentum behind the recent reflation trade is likely to ebb temporarily.

While Fed rate hikes will pressure short term rates higher in the

U.S., longer term rates are driven by different factors. Absent further inflation or a sharp rise in global bond yields, it is difficult to see yields on the 10-year U.S. Treasury pushing much beyond 3%. Further, U.S. Treasuries remain a safe-haven asset class and they continue to offer some of the highest yields among developed market sovereign debt, which should continue to attract investors.

Investment Grade: Investment grade (IG) corporate credit remains in many ways a policy-driven market. Looking forward, we expect the tension between monetary and fiscal policy to cause volatility to increase from current levels – which are close to record lows. However, we believe fundamentals are in good shape as corporate profitability improves, which helps decrease leverage ratios. From a technical perspective, many of the themes have been in place for some time: strong demand from yield-starved global investors, and an onslaught of new issuance. In the first quarter, supply approached $400 billion, which is a record amount of new supply in one quarter. Some of this issuance may have been pulled forward in advance of future Fed rate hikes and/or potential corporate tax reform. Overall, we expect spreads to grind slightly tighter over the course of the year with pockets of volatility along the way.

High Yield: Although the U.S. high yield (HY) market rally continued in the first quarter, it showed some weakness later in the quarter due to a large amount of new issuance, outflows from the asset class, the sell-off in equities and a decline in oil prices. The risk/reward profile of the HY market remains attractive given the strong fundamentals and benign default outlook. However, we continue to be cognizant of the supply and demand technical picture as they will remain the key driver of short-term price movement. Recently, there has been evidence that investors are slowly reallocating capital out of HY and into Leveraged Loans and Equities. Therefore, we continue to pay close attention to technical trends, particularly the direction of ETFs, which can offer opportunities to increase and reduce risk at more compelling valuations.

OTHER SECTORS

Non-Agency mortgages continue to offer one of the most compelling risk/return opportunities in fixed income markets. The strength in home prices should continue, though at a more moderate pace, with forecasts for home price appreciation for 2017 in the 2-4% range versus the 6% appreciation realized in 2016. Despite the increase in interest rates, housing continues to remain affordable on a payment-to-income basis relative to the long-term average. In addition, technical in the non-agency market remain overwhelmingly favorable. From a supply perspective, the outstanding amount of non-agency mortgages are declining by 10-15% on an annual basis, while demand from money managers and investors remains strong.

Preferred securities also offer a value proposition for fixed income investors. Underlying fundamentals for U.S. banks are extremely strong and complimented by balance sheets that have record amounts of capital, lower leverage, and reduced off-balance sheet risk exposures. Additionally, there has been very little new supply year-to-date. Against the favorable supply backdrop, there is a strong demand for yield from a fundamentally improving asset class.