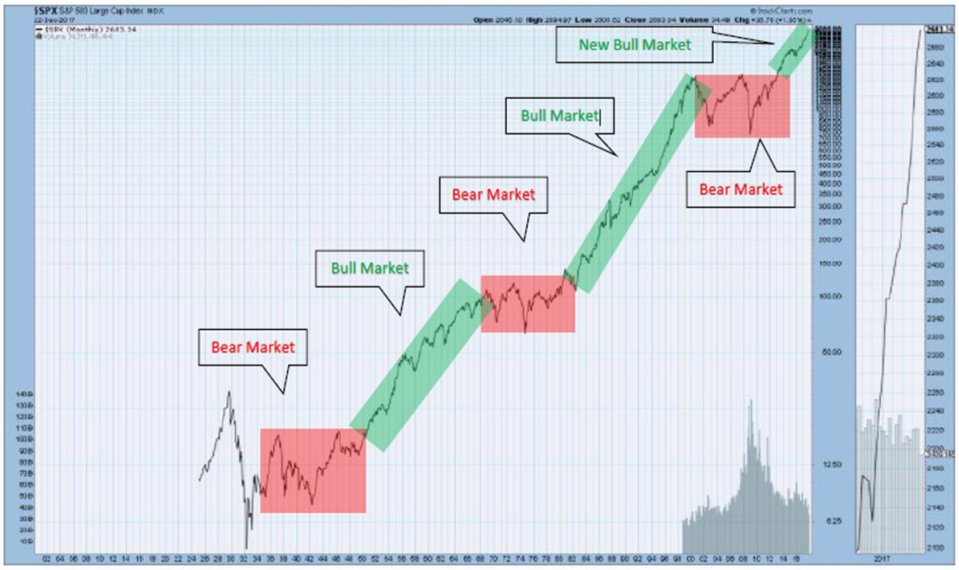
FSPI Client Newsletter

January 2018

COMMENTARY

The year 2017 could be described in vastly different ways, depending on whom you talked to. The free world's inauguration of a divisive new leader, Russian political scandals, tension and missile testing from North Korea, and dozens of other things about as wild as a snowstorm in Florida all took place—but the stock market was historically quiet, as volatility (gauged by the VIX – a popular measure of the stock market's expectation of volatility implied by S&P 500 index options) stayed at low levels all year. The year ended the way it started, with the market never seeing a drawdown of more than 3 percent. We think many investors were waiting for any small pullback to invest additional cash into the market. As such, the pullbacks were shallow and short in nature. Our secular (long-term) thesis continues to be intact as we believe we are in the earlier stages of a major bull market cycle (see chart). The majority of markets around the world finished in the green and the S&P 500 total return (TR) finished up 21.83 percent for the year. Growth stocks (Russell 3000 Growth TR index) outperformed Value stocks (Russell 3000 Value TR index) by 16.4 percent. From a sector level, the top two performers were Technology (+34.25 percent) and Materials (+24.01 percent), and the bottom two performers were Energy (-0.90 percent) and Real Estate (+10.69 percent). This is pretty widespread when comparing growth and value stocks in 2017 and from a sector level inside the S&P 500. Internationally, Emerging Markets stocks lead the way and look to continue strengthening into 2018. In the fixed income market, the search for yield continued, which helped depressed high yield spreads (spreads are the difference between a basket of high bond yields and Treasury bond yields). Although spreads are tight, we currently do not see a lot of default risk in the economy which would put high yield bonds in danger. We're monitoring spread levels and will move quickly if spreads widen in anticipation of higher default risk.

S&P 500 Large Cap Index - 1925-Present



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ECONOMIC HIGHLIGHTS

S&P 500	2,673.61
DJIA	24,719.22
NASDAQ	6,903.39
OIL	$60.42/barrel
GOLD	$1,309.30/ounce
10-YEAR TREASURY YIELD	2.40%
UNEMPLOYMENT	4.1%
GDP	3.3% (Q3 2nd estimate)
CONSUMER PRICE INDEX (CPI)	+0.4% / 12 month change: +2.2%
CORE CPI	+0.1% / 12 month change: +1.7%

2018 Aggressive Bullish Case (20%): With our base case being bullish, our highly bullish scenario would mirror much of what we had in 2017. Stock markets continue their bullish ways and pullbacks are bought quickly. World economy growth and low volatility continue.

2018 Base Bullish Case (60%): Markets continue to be strong and the economy grows at a steady pace. Volatility comes back into the market and pullbacks are more along the lines of 5% to 10% drawdowns. We would view these pullbacks as buying opportunities unless something fundamental changes in the economy or stock market.

2018 Bearish Case (10%): Valuations get too far ahead either due to prices advancing too fast and/or earnings falling short of expectations. Inflation rises too fast and the Fed needs to raise rates more than the projected range of 2-4 times. High-yield spreads widen and default rates rise rapidly.

(cont'd.) As we head into 2018, a majority of economic indicators are still indicating to us that a recession is not likely over the next 6-12 months. GDP is growing at a steady pace, with the latest reading coming in at 3.3 percent for the second estimate for the third quarter of 2017. Unemployment remains at low levels (4.1 percent) and wage growth is improving, although at a slower pace than we anticipated a year ago. Both GDP and unemployment are lagging indicators, but are helpful for confirming the economy is still on track. The best leading economic indicator is the stock market, and all signs point to another solid year for the markets. Our 2018 price target is on the S&P 500 is 3050 (+14.1 percent on a price return basis). Emerging Markets look to be in favor compared to International Developed Markets, and we'll look to take advantage of that in 2018. We recently concluded a long research project and we are currently building out a strategy to add in a momentum factor for higher risk tolerance models. We are looking forward to rolling this out in 2018. In the fixed income market, we are maintaining our low duration compared to the benchmark (Core US Aggregate Bond) as we think we will see rates increase in 2018. Our price target on the 10-Year US Treasury Yield is 3.0 percent. High-yield bond spreads are something we are watching very closely as spreads are very tight. Default risk is low, but if things change we'll be quick to act. There is risk out there like always, and if things change we'll make adjustments to our portfolios too. A few risks we do see and are watching closely are high-yield spreads and possible widening, US inflation and the reaction (over or under) by the Federal Reserve (with a new Fed chair), European Central Banks beginning to exit from quantitative easing and Brexit developments. Obviously, any black swan event (North Korea nuclear missiles) could be a game changer, but these are impossible to predict (hence the name: a black swan is an event or occurrence that deviates beyond what is normally expected of a situation and is extremely difficult to predict).

Overall, the long-term view of the economy is strong, with many indicators pointing to a bullish economy and strong stock market. An improving economy and strong balance sheets for U.S. consumers and businesses should continue to drive the economy forward, which should lead to an increase in investors' risk appetite. Here in the U.S., we are seeing healthy rotations in the stock market between style, size, and sector. This action speaks to the strength of the current bull market. International Equities have had a nice run in 2017 as investors looked past Brexit. Emerging Markets have benefited greatly from a falling U.S. dollar and a commodities rally. Although EM had a solid 2017 we still see attractive valuations and will be looking to add to Emerging Markets in 2018. Our research team is constantly evaluating our products and tactical position inside both our fixed income portfolio and equity portfolio looking both at the larger trends and short-term opportunities. With daily monitoring to accounts on an individual basis, we continue to rebalance accounts when they fall too far from their equity-to-fixed income ratio.

MARKET TRACKER

Index	3 Mo	1 Yr	3 Yr	5 Yr
S & P 500	6.64	21.83	11.41	15.79
MSCI EAFE	4.27	25.62	8.30	8.39
BARCAP AGG BOND	0.39	3.54	2.24	2.10

Data as of 12/31/2017. Investments cannot be made directly into an index.

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