PATHSTONE

FEDERAL STREET

Quarterly Market Overview

Q4 2016

A Path to Define and Achieve Your Goals

OVERVIEW OF GLOBAL MARKETS

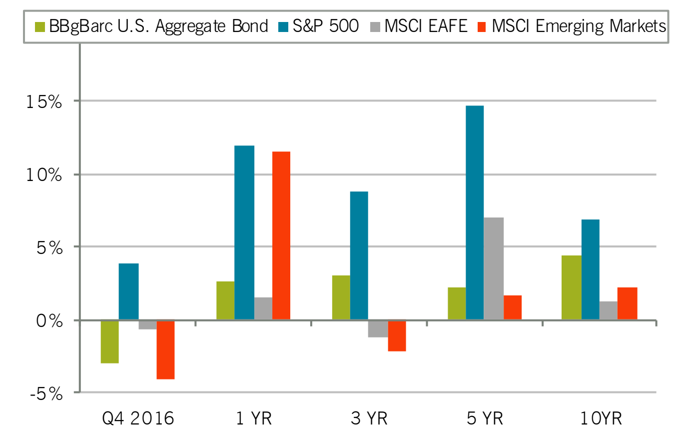
- **A Presidential rally.** Subsequent to the election, U.S. stock markets turned in a solid fourth quarter performance on hopes for a growth revival.
- **Government bond yields bounce off historic lows.** The widely-expected Fed rate hike, along with rising growth and inflation expectations, have driven yields higher (and bond prices lower).
- **A strong dollar** hindered returns of overseas markets (when converted into dollar terms). Earnings prospects of foreign companies, however, are improved.
- **U.S. valuations are elevated.** The outlook for U.S. stocks may be muted unless a meaningful improvement in corporate earnings is seen.

INDEX	4TH QTR RETURN	2016 YTD RETURN	3-YEAR RETURN	5-YEAR RETURN
GROWTH				
U.S. Equity				
S&P 500	3.83%	11.97%	8.86%	14.65%
Russell 2000	8.83%	21.31%	6.74%	14.46%
International Equity				
MSCI EAFE	(0.68%)	1.51%	(1.15%)	7.02%
MSCI Emerging Markets	(4.08%)	11.60%	(2.19%)	1.64%
Equity Risk Alternatives				
HFRI Equity Hedge	1.32%	5.54%	2.09%	5.48%
REAL ASSETS				
S&P Global Property	(5.40%)	4.92%	6.06%	10.20%
Bloomberg Commodity	2.65%	11.75%	(11.26%)	(8.96%)
S&P North America Natural Resources	5.02%	30.87%	(3.66%)	1.26%
STABILITY				
Credit Risk Alternatives				
Bloomberg Barclays U.S. Corporate High Yield	1.77%	17.14%	4.67%	7.37%
Bloomberg Barclays Mortgage Backed Securities	(1.97%)	1.69%	3.06%	2.06%
JPM GBI-EM Global Diversified	(6.10%)	9.93%	(4.10%)	(1.29%)
HFRI Fund of Funds Conservative	2.05%	2.29%	1.93%	3.51%
Core Bonds				
Bloomberg Barclays U.S. Aggregate Bond	(2.98%)	2.66%	3.03%	2.24%
Bloomberg Barclays U.S. Treasury	(3.85%)	1.04%	2.29%	1.20%
Bloomberg Barclays Municipal 1-10 Year	(2.62%)	(0.08%)	2.32%	2.03%
Citi 3-Month Treasury Bill	0.09%	0.26%	0.09%	0.08%

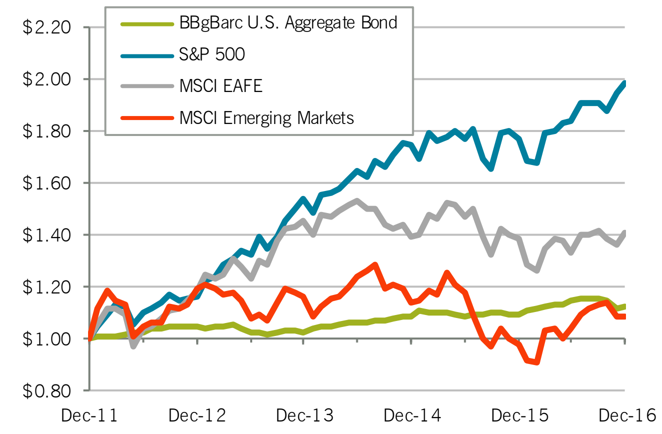
Sources: Bloomberg, HFR, Morningstar, MSCI. Data as of 12/31/16. Returns longer than one year have been annualized.

- **A bull market transition.** Monetary policy supported U.S. stocks during the recent market cycle, even as the economic expansion has been tepid. For the next leg of this bull market, fiscal policy will likely be relied upon to help boost earnings growth.
- **Emerging markets turning a corner?** Stock markets in developing regions bottomed out earlier in the year but anti-trade rhetoric and a rising dollar were a headwind in Q4.
- **The end of an era?** Rising yields have dragged down returns of core bonds, leading many to question whether the multi-decade bull market in bonds is finally over.

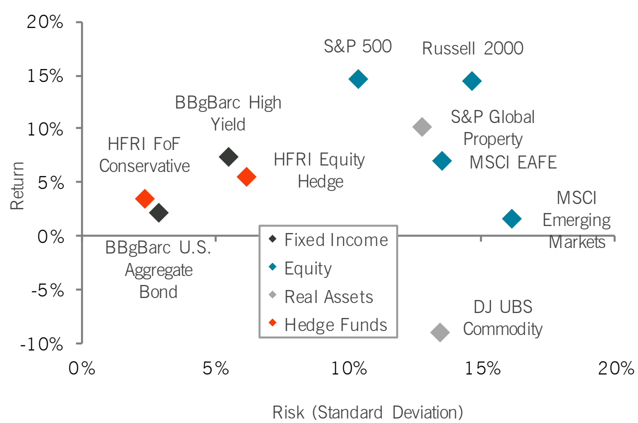
TRAILING PERIOD RETURNS



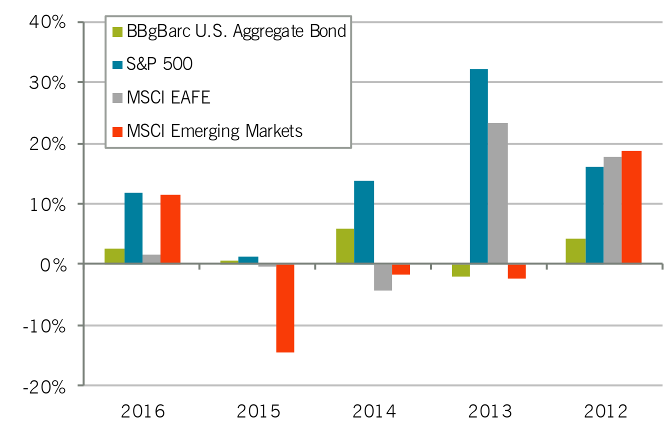
GROWTH OF $1 OVER PAST 5 YEARS



FIVE-YEAR ANNUALIZED RISK VS. RETURN



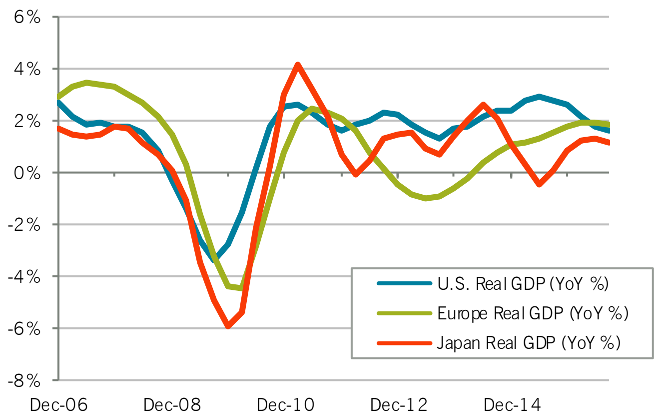
ANNUAL RETURNS: 2012-2016



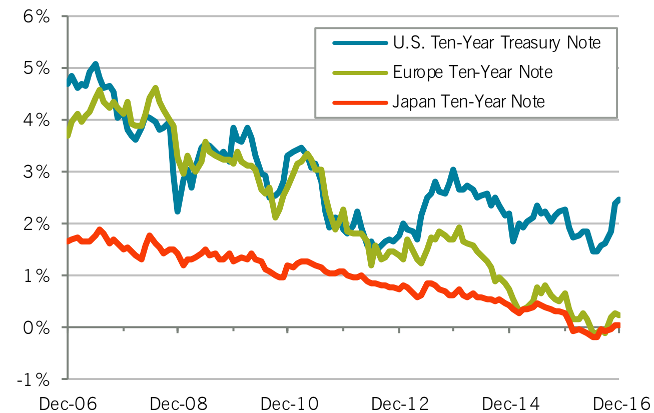
Sources: Bloomberg, HFR, Morningstar, MSCI. Data as of 12/31/16. Returns over periods longer than one year have been annualized.

- **Stagnant economic growth.** The U.S. has been struggling to sustain a better than 2% year-over-year growth rate during this slow-paced expansion. There are hopes that the new administration's policies (tax, regulatory, spending) may provide a boost.
- **Bond yields spike higher.** The yield on the U.S. ten-year Treasury jumped to 2.5% at quarter-end as inflation *risks* heated up.
- **Actual prices not yet overheating.** While U.S. wages are starting to pick up and commodity prices have stabilized, sustained inflation above the Fed's 2% target inflation has yet to be seen.
- **Hiring at a steady clip.** The headline U.S. unemployment rate is near its lowest levels since 2007.

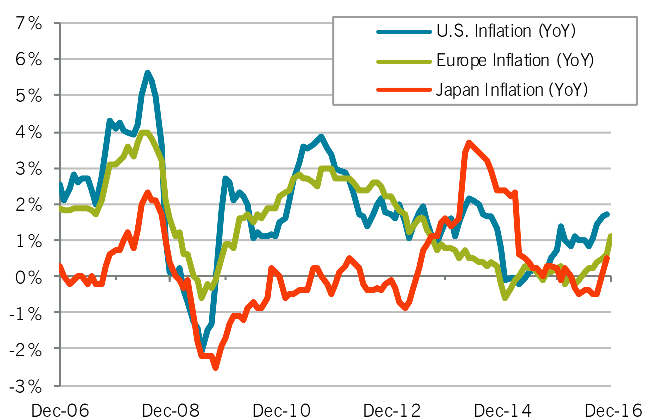
GDP YEAR-OVER-YEAR GROWTH



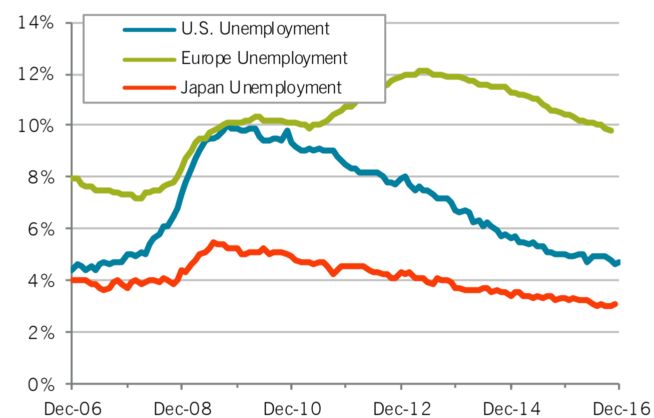
TEN-YEAR GOVERNMENT BOND YIELDS



INFLATION



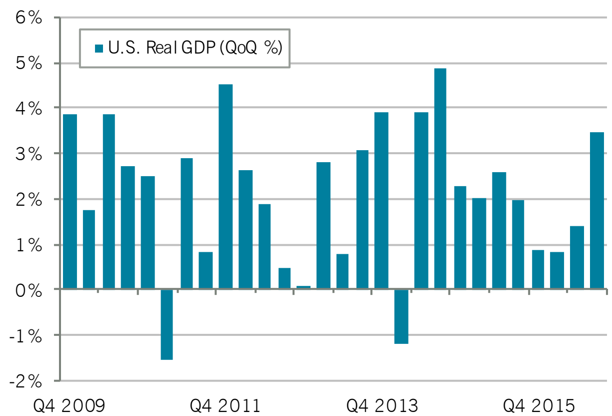
UNEMPLOYMENT



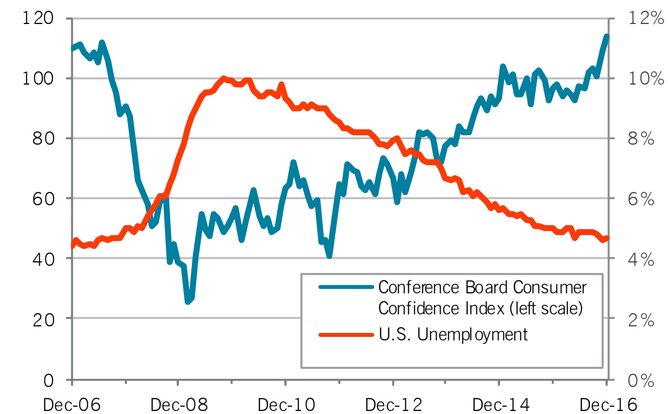
Sources: Bloomberg, Morningstar. Data as of 12/31/16.

- **A good quarter of growth.** Gross domestic product expanded at an inflation-adjusted annual rate of 3.5% in the third quarter, the strongest quarterly pace of growth in two years. That said, the annual growth rate of less than 2% is still uninspiring.
- **Leading indicators suggest softness but not recession.** With consumer confidence at pre-credit crisis levels and employment near full levels, the economy should continue to muddle along.
- **Manufacturing on the mend.** December was solid, with ISM hitting a level of 54.7 (readings over 50 indicate expansion relative to the prior month).

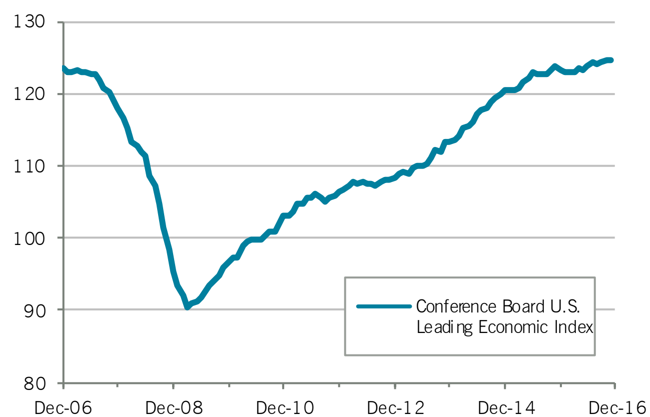
U.S. REAL GDP QUARTERLY ANNUALIZED %



CONSUMER CONFIDENCE AND UNEMPLOYMENT



LEADING INDICATORS

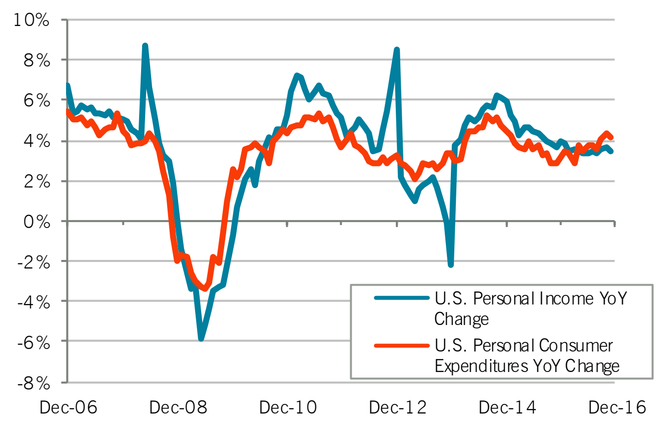


MANUFACTURING

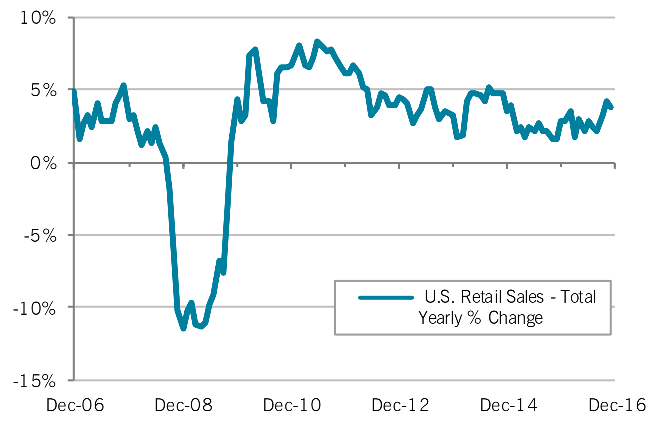
Sources: Bloomberg, Morningstar, MSCI. Data as of 12/31/16.

- **The consumer remains anemic.** There has been hope that a pick-up in wages could drive a resurgence in consumer spending and retail sales. Unfortunately, while there has been a slight uptick in retail sales, significant improvement remains yet to be seen.
- **Housing on a moderate uptrend.** The housing market is moving forward in fits and starts, but generally remains on a positive trajectory. Mortgage rates remain low while prices and building activity are rising at a modest pace.

CONSUMER INCOME AND SPENDING

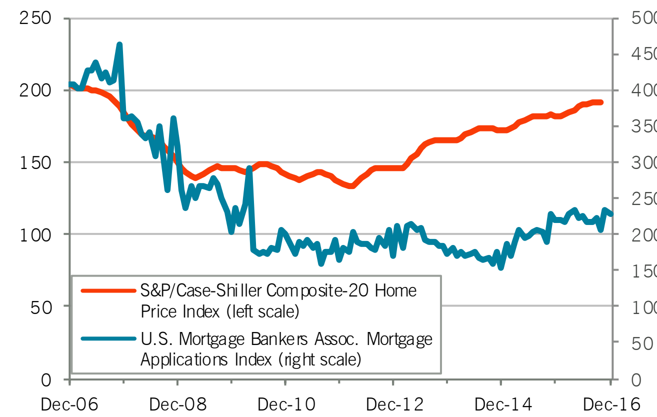


RETAIL SALES



HOUSING STARTS AND NEW HOME SALES

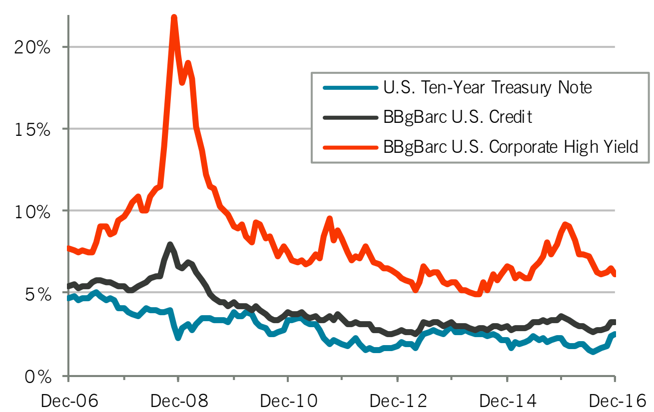
HOME PRICES AND MORTGAGE APPLICATIONS



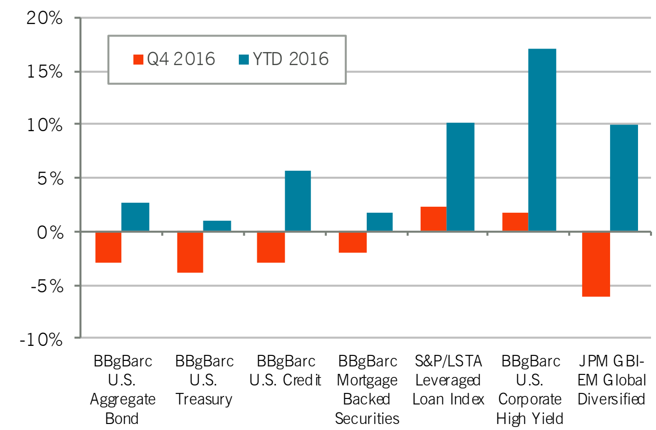
Sources: Bloomberg, Morningstar, MSCI. Data as of 12/31/16.

- **Treasury yields rose meaningfully in Q4** on rising growth and inflation expectations. That said, rates still relatively low on a historical basis.
- **A faster pace of Fed rate hikes?** Not only did the Fed raise rates by 25 basis points in December, but they indicated that three (rather than two) hikes are on the table for 2017.
- **High yield is where it's at.** Investors, desperate for income, pushed aside qualms about defaults to help junk bonds post solid 2016 returns.
- **Treasury yield curve steepens.** This typically implies expectations of positive economic growth and a low risk of recession.

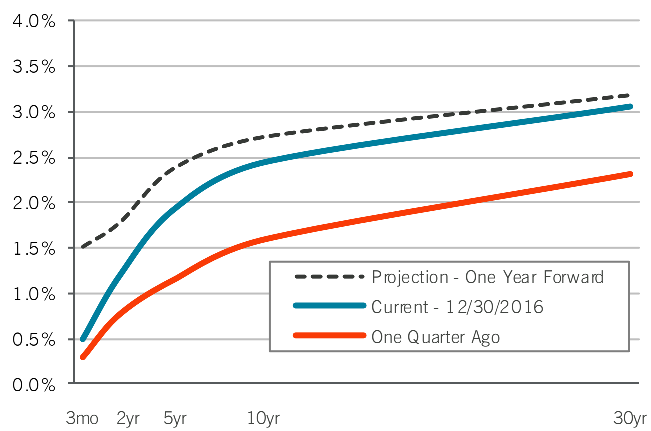
HISTORICAL BOND YIELDS



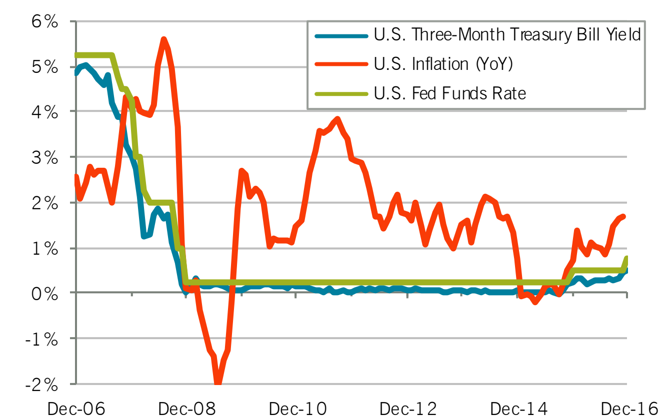
PERFORMANCE BY SEGMENT



U.S. TREASURY YIELD CURVE



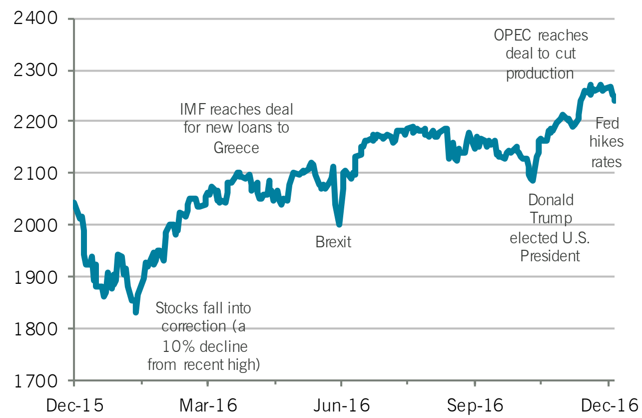
U.S. T-BILL, INFLATION, AND FEDERAL FUNDS



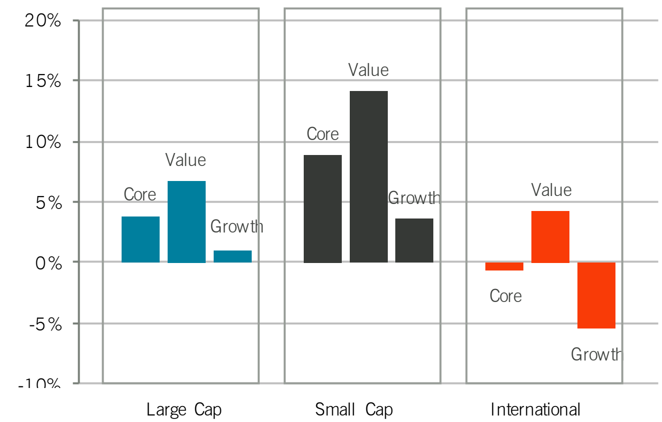
Sources: Bloomberg, Morningstar. Data as of 12/31/16.

- **A solid end to the year.** The S&P 500 gained nearly 4% in Q4, benefitting from a post-election rally on hopes that tax cuts, slashed regulation, and infrastructure spending may be a boon to earnings growth.
- **Small cap stocks did even better**, rising nearly 9% in the quarter and over 21% for all of 2016.
- **Nearly all sectors were positive in 2016.** Healthcare stocks were the sole detractor for the year, while energy stocks led the way.

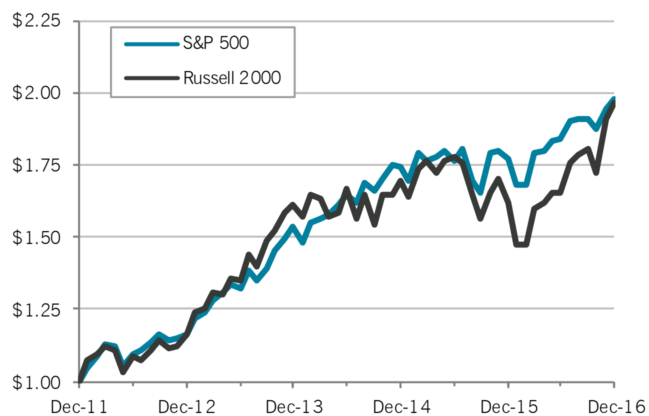
S&P 500 PRICE (OVER PAST YEAR)



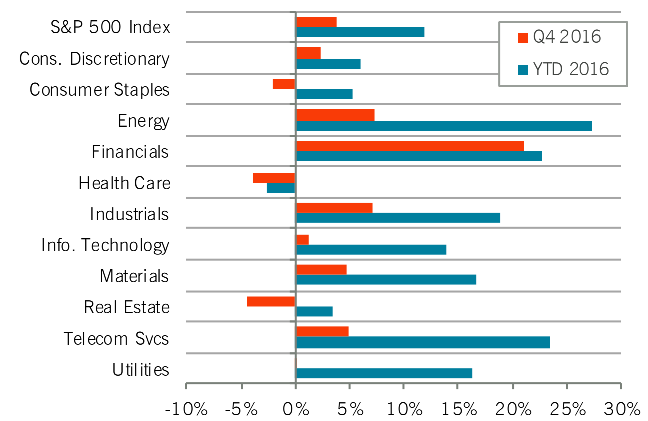
Q4 2016 PERFORMANCE BY SEGMENT



LARGE CAP VS. SMALL CAP — GROWTH OF $1



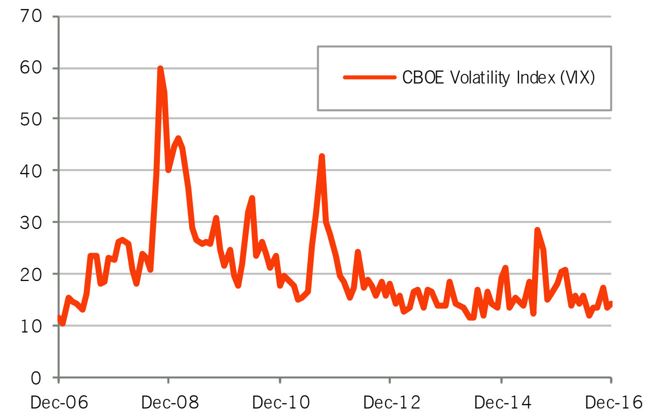
Q4 2016 PERFORMANCE BY SECTOR (S&P 500)



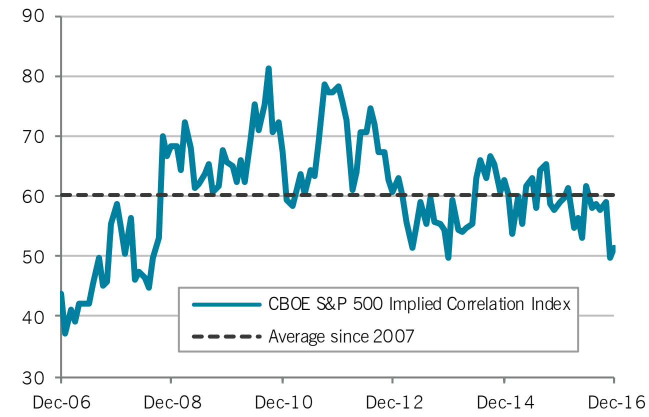
Sources: Bloomberg, Morningstar, MSCI. Data as of 12/31/16.

- **A dearth of volatility.** The U.S. election and late-year Fed rate hike somewhat surprisingly did not bring increased volatility.
- **A better time for active management.** Dispersion amongst stocks comprising the S&P 500 has increased, making it easier for managers to add value.
- **Momentum on track.** The S&P 500 50-day moving average is above its 200-day average, considered by many to be a bullish technical indicator.
- **Generating income.** The 2% dividend yield on the S&P 500 is not much to write home about, but it remains competitive with that of core government bonds (Treasuries and municipals).

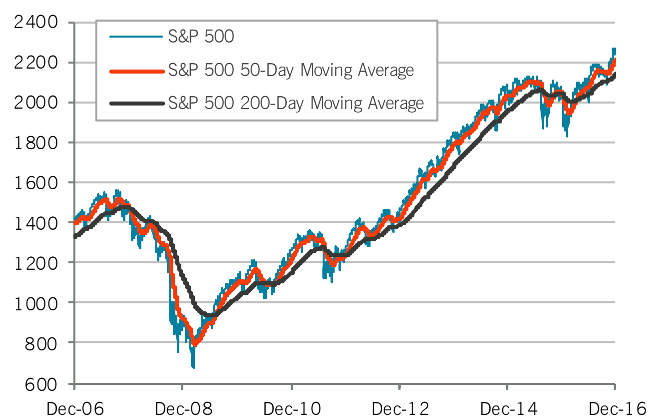
VOLATILITY



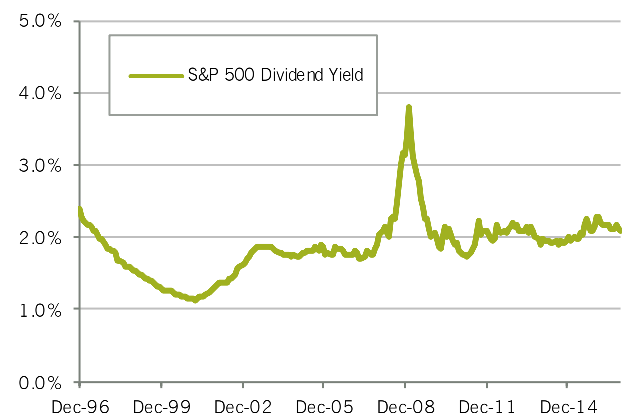
CORRELATIONS



STOCK MARKET MOMENTUM



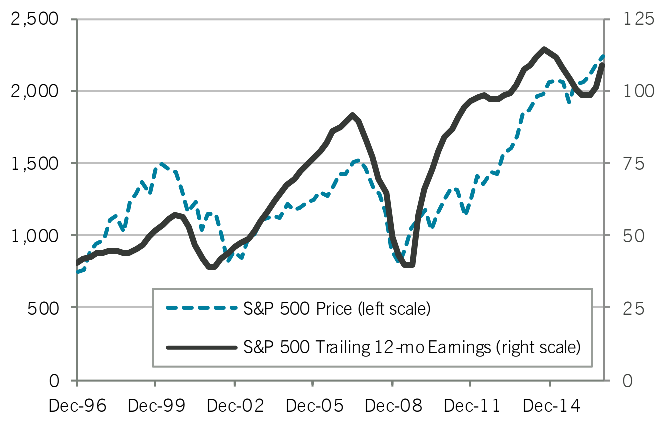
S&P 500 DIVIDEND YIELD



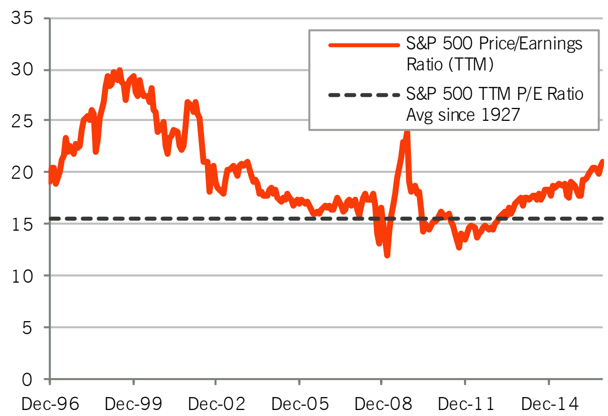
Sources: Bloomberg, Morningstar, MSCI, Chicago Board Options Exchange. Data as of 12/31/16.

- **Corporate earnings and profit margins have carved out a trough.** Q4 year-over-year earnings growth is expected to show gains, as the detraction from the struggling energy sector has abated. Further improvement in corporate earnings from here could help stock prices in 2017.
- **Low returns ahead (eventually).** While there can be little argument that valuations are a bit extended, by many metrics (such as price/book and price/cash flow) they are not really egregiously expensive either. Higher valuations may imply lower than typical returns going forward, but jittery investors should not look to them as a reliable market timing mechanism.

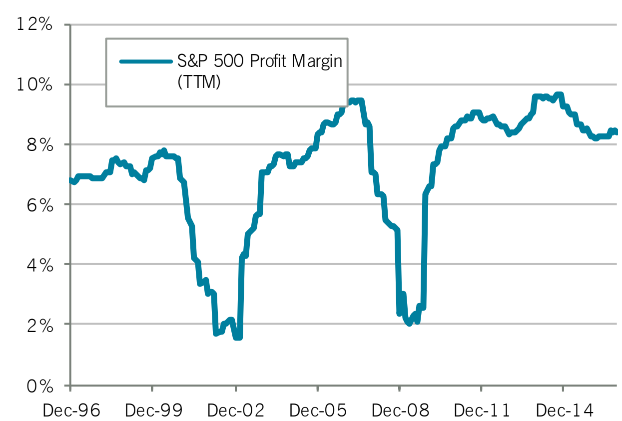
CORPORATE EARNINGS



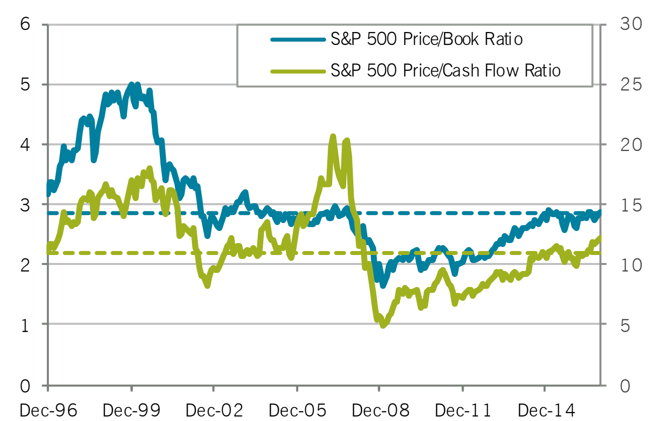
VALUATIONS — PRICE/EARNINGS RATIO



PROFIT MARGINS



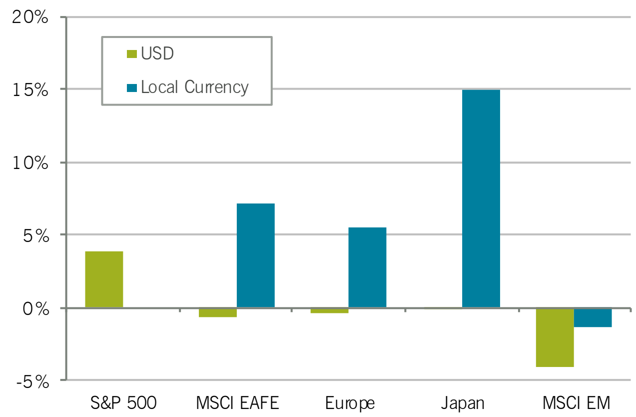
PRICE/BOOK AND PRICE/CASH FLOW



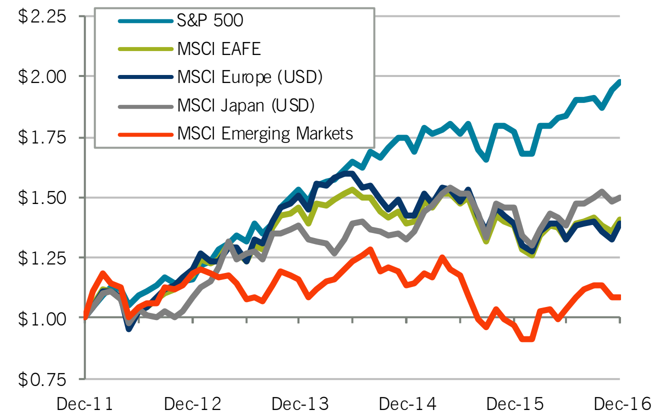
Sources: Bloomberg, Morningstar, MSCI, Standard and Poor's. Data as of 12/31/16.

- **A strong dollar weighed on Q4 international stock returns.** But in local terms, developed overseas stock markets actually outperformed the U.S. during the quarter. While headwinds remain for developed international regions (structural issues in particular), over time devalued currencies should benefit local companies.
- **Thanks to years of underperformance, emerging market valuations remain at a wide discount to developed regions.** Attractive valuations, alongside stronger growth potential, make emerging market stocks a compelling long-term opportunity.

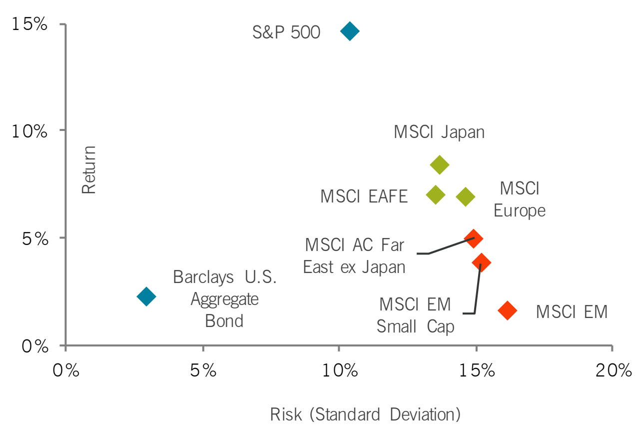
Q4 2016 PERFORMANCE



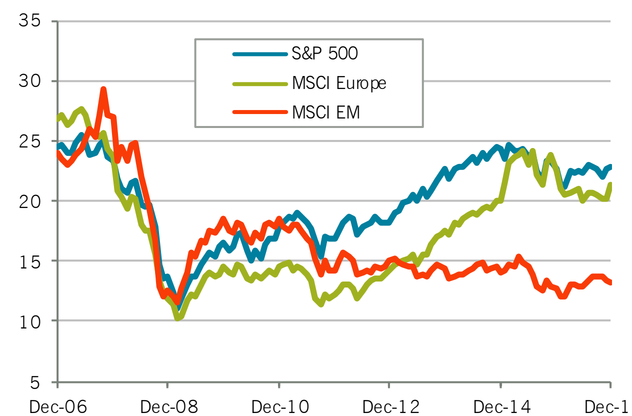
GROWTH OF $1 OVER PAST FIVE YEARS



FIVE-YEAR ANNUALIZED RISK VS RETURN



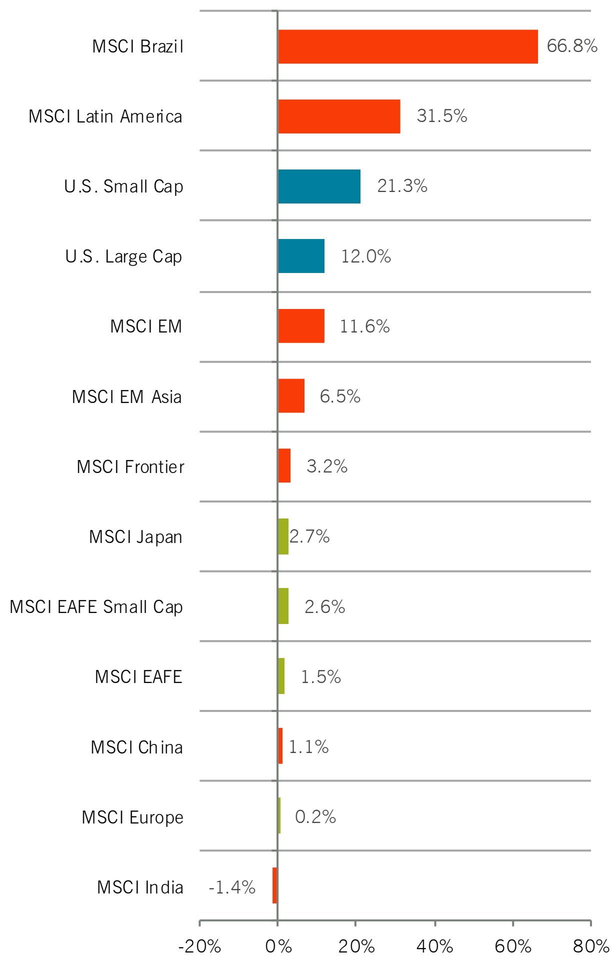
VALUATIONS (CYCLICALLY-ADJUSTED P/E)



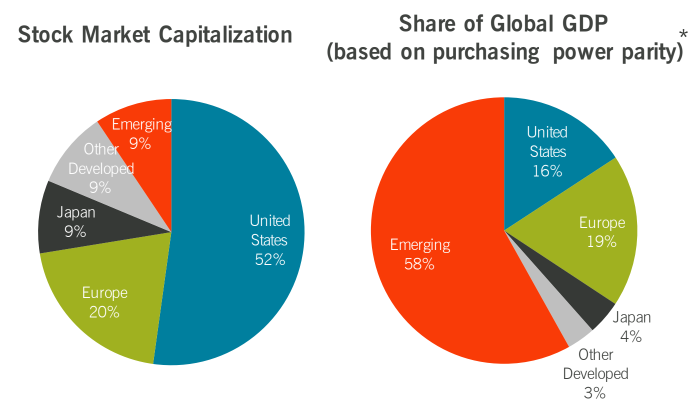
Sources: Bloomberg, Morningstar, MSCI. Data as of 12/31/16.

- **Emerging markets starting to roll.** Reversing a multi-year trend, emerging markets were amongst the strongest performers in 2016, benefiting in part from a rebound in oil prices.
- **Secular growth outlook favors emerging markets.** In the near-term, however, emerging markets may remain volatile and closely tied to dollar and oil price moves.
- **Why consider emerging markets?** Emerging markets account for more than half of global production, yet only a small fraction of overall stock market capitalization. That gap should narrow over time.

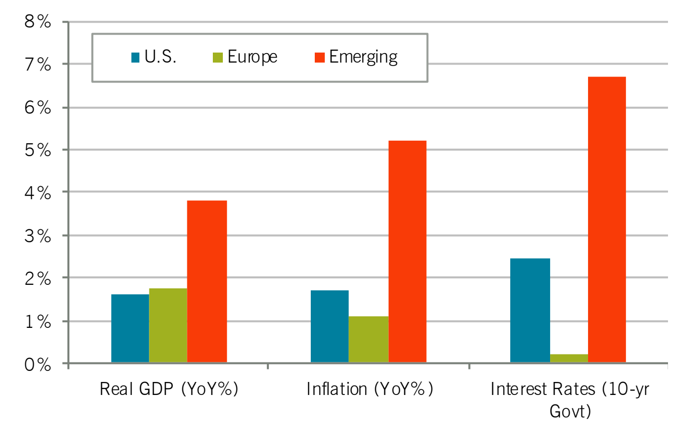
YEAR-TO-DATE EQUITY RETURNS (IN USD)



GLOBAL MARKET CAP VS. PRODUCTION



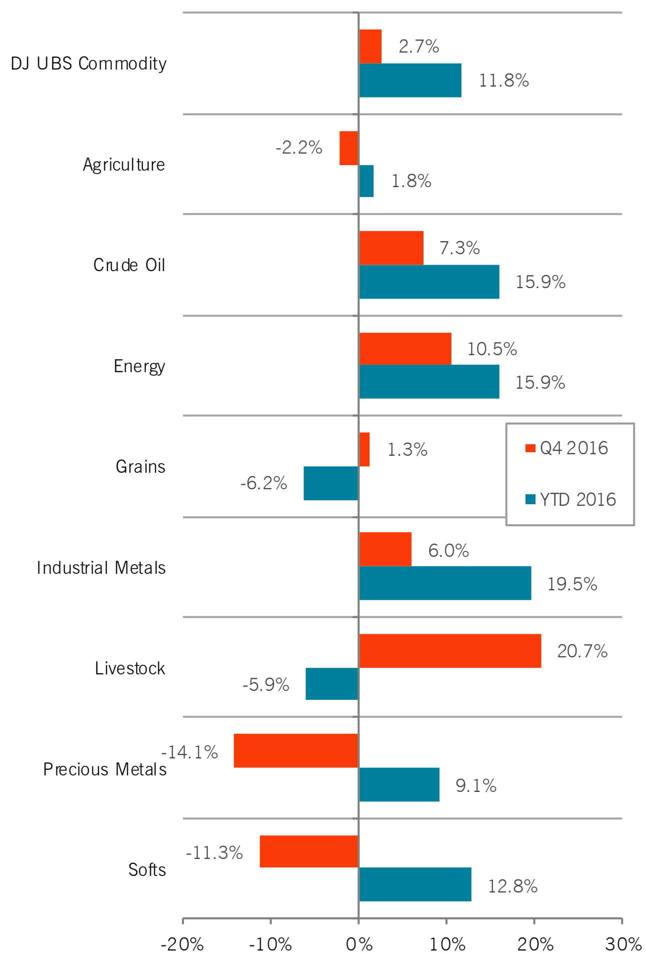
COMPARISON OF ECONOMIC FUNDAMENTALS



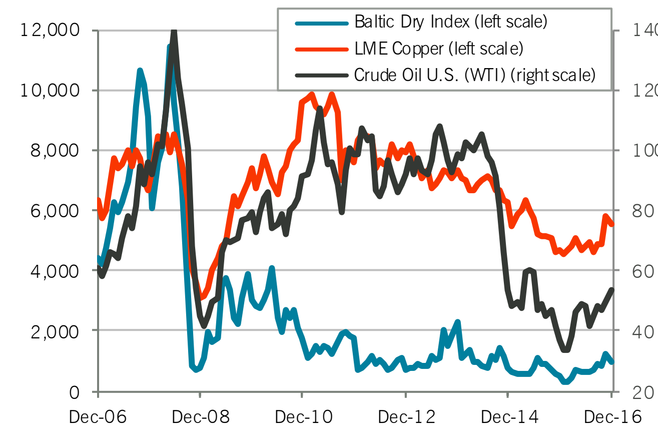
Sources: Bloomberg, Morningstar, MSCI. Data as of 12/31/16.
*The use of purchasing power parity calculations lessen the effect of currency shifts when comparing GDP across countries.

- **Commodity prices regain ground in 2016.** While advances in the energy sector have been welcoming, there is still a long way to go to recover from losses seen over the past few years.
- **Why consider a modest allocation to real assets?** Commodities and real estate generally provide a portfolio with several potential benefits, including a hedge against inflation, longer-term diversification from stocks and bonds, and in certain segments, relatively higher income yields.

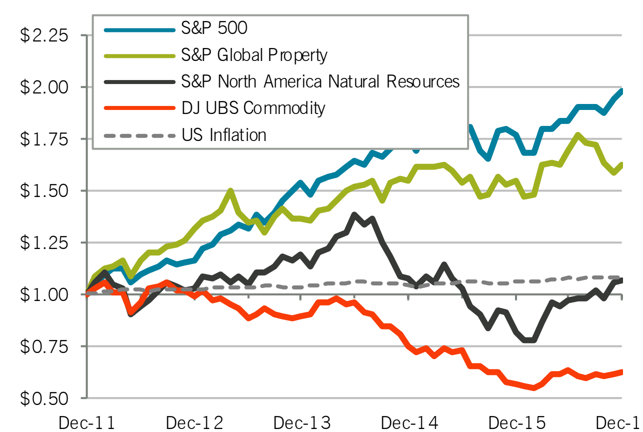
DJ UBS COMMODITY SUB-INDEX PERFORMANCE



COMMODITY PRICES AND BALTIC DRY INDEX



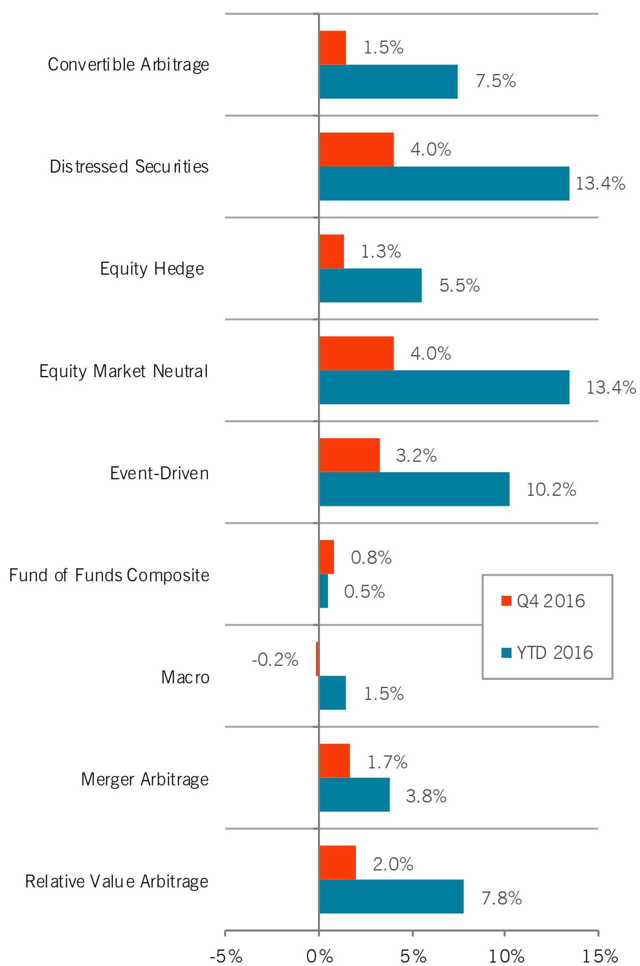
GROWTH OF $1 OVER PAST FIVE YEARS



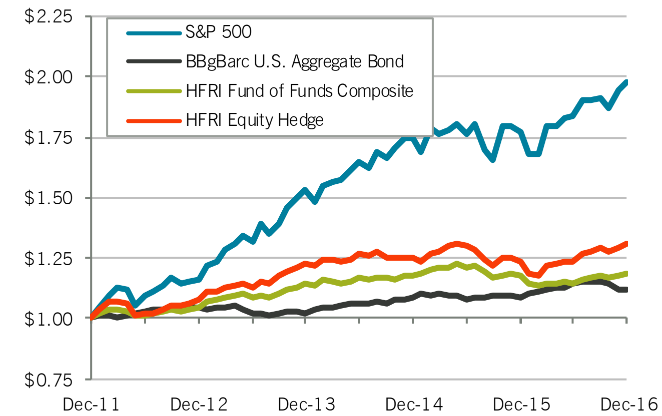
Sources: Bloomberg, Morningstar. Data as of 12/31/16.

- **Hedge fund returns are improving.** Outside of macro, most segments were positive for the quarter.
- **A turning of the tide?** Generally speaking, hedge funds have underwhelmed during this market cycle of massive stimulus and zero interest rate policies. With those factors abating, perhaps active management strategies are finding their footing.
- **Hard to put a label on.** With varying strategies and exposures, hedge funds can produce an array of risk/return profiles. However, one element tends to be consistent: most strategies exhibit lower volatility than long-only equities as their returns are not solely driven by market beta.

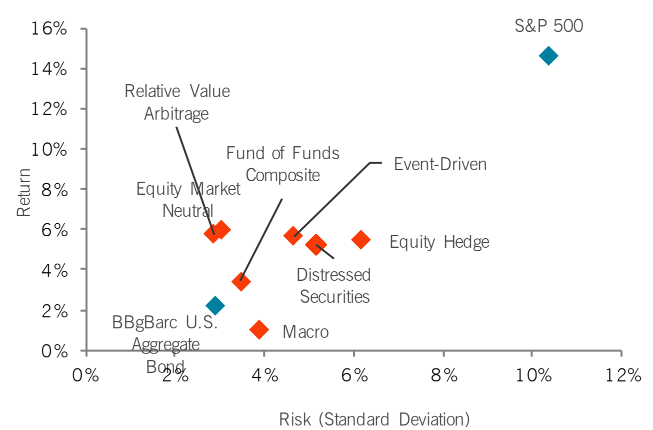
HEDGE FUND PERFORMANCE



GROWTH OF $1 OVER PAST FIVE YEARS



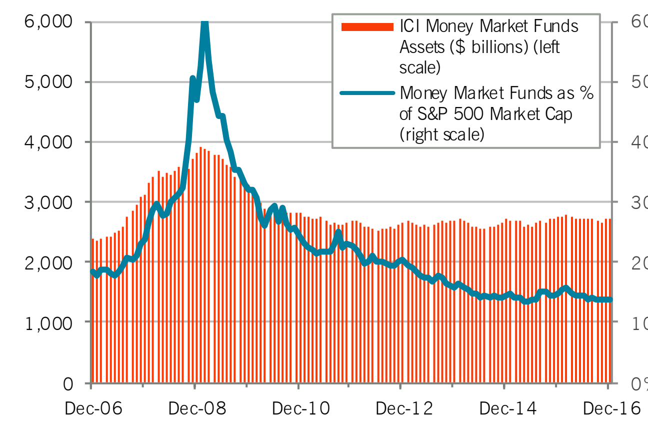
FIVE-YEAR ANNUALIZED RISK VS. RETURN



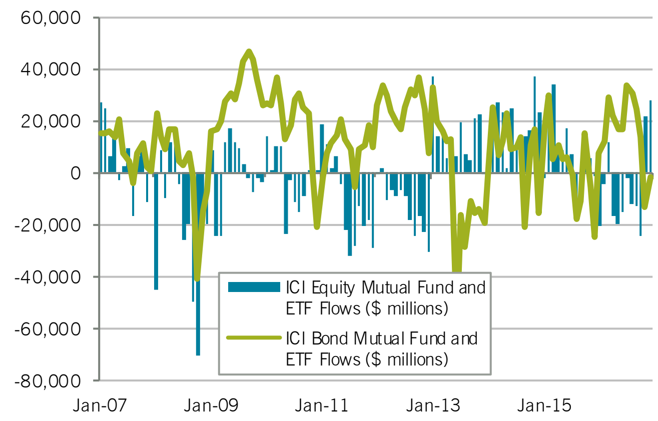
Sources: Bloomberg, Morningstar, HFR. Data as of 12/31/16.

- **A wall of worry.** Investors have mostly stayed away from stocks during this unloved rally, perhaps unconvinced of its sustainability. There is still a fair amount of money on the sidelines, earning next to nothing and waiting to be invested.
- **Poor timing?** Despite decent returns posted by stock markets in 2016, through most of the year investors reduced allocations to equity ETFs and mutual funds in favor of underperforming bond funds.
- **Signs of improving investor sentiment.** Expanding margin debt could be a reflection of improved investor sentiment.

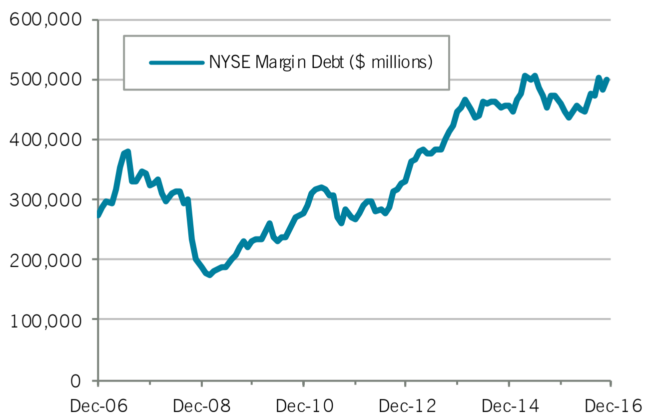
MONEY MARKET FUND ASSETS



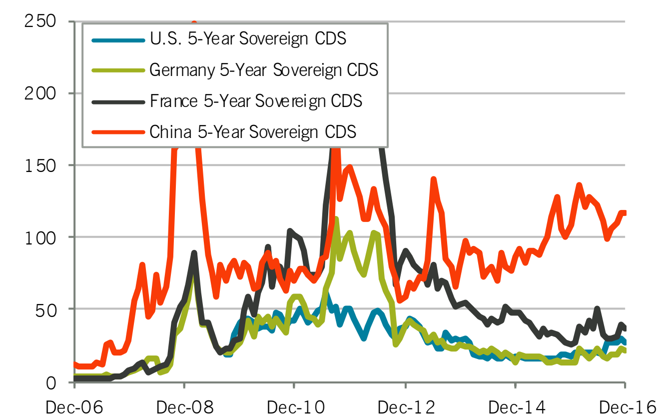
MUTUAL FUND AND ETF CASH FLOWS



MARGIN DEBT



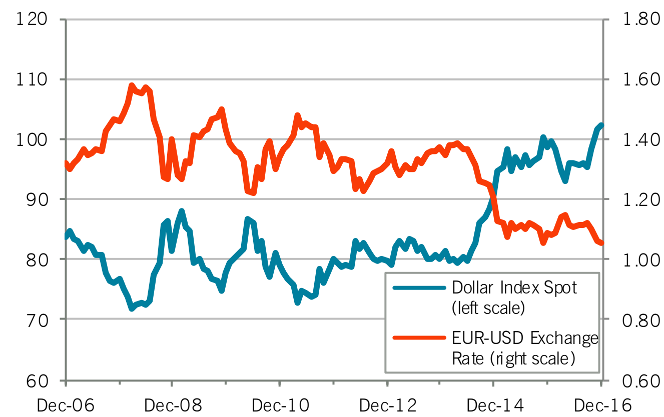
SOVEREIGN CDS SPREADS



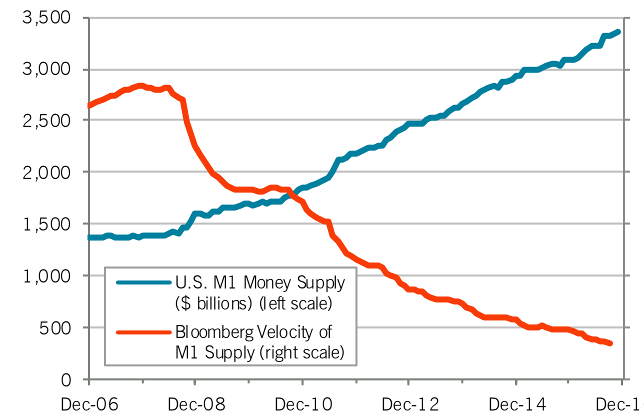
Sources: Bloomberg, Morningstar, Investment Company Institute. Data as of 12/31/16.

- **A resurgent dollar.** The U.S. dollar index gained 7% in Q4. This could present a challenge for U.S.-based companies dependent upon overseas sales.
- **Pushing on a string.** Fed monetary policies have driven M1[1] to high levels, creating concerns about eventual inflation. However, the Velocity of Money[2] remains extremely low, illustrating a continued lack of pressure on pricing.
- **The borrowing headwind.** The Fed has an incentive to keep interest rates relatively low—if rates rise sharply, so too will payments on the vast amount of existing personal debt, thereby hindering consumer spending.

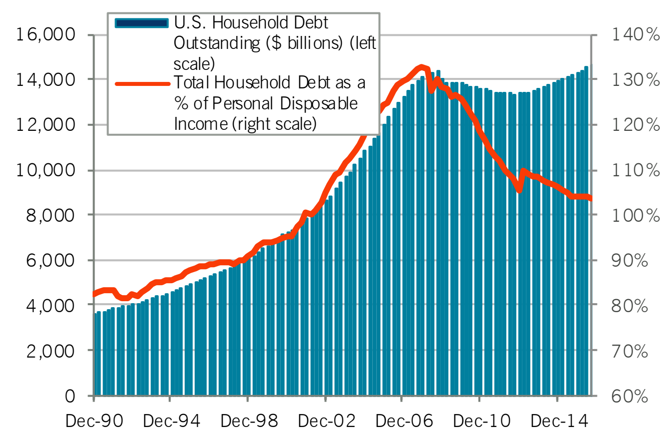
U.S. DOLLAR AND EURO



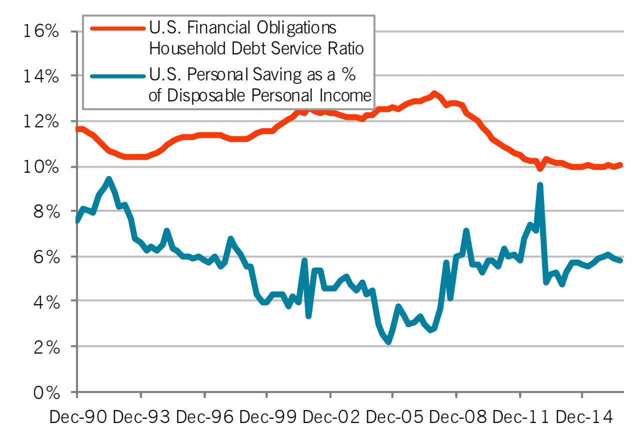
MONEY SUPPLY AND VELOCITY



HOUSEHOLD DEBT



SAVINGS RATE & HOUSEHOLD DEBT SERVICE RATIO



Sources: Bloomberg, Morningstar. Data as of 12/31/16.

[1]M1 Money Supply, the most liquid measure how much money is in circulation, consists of physical currency and checkable deposits.

[2] Velocity of Money measures the rate at which money changes hands in order to purchase goods and services.

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