Financial Insights:

Q4 & Full Year 2016 Capital Market Review & Outlook

MCFADVISORS

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Capital Markets Review & Outlook

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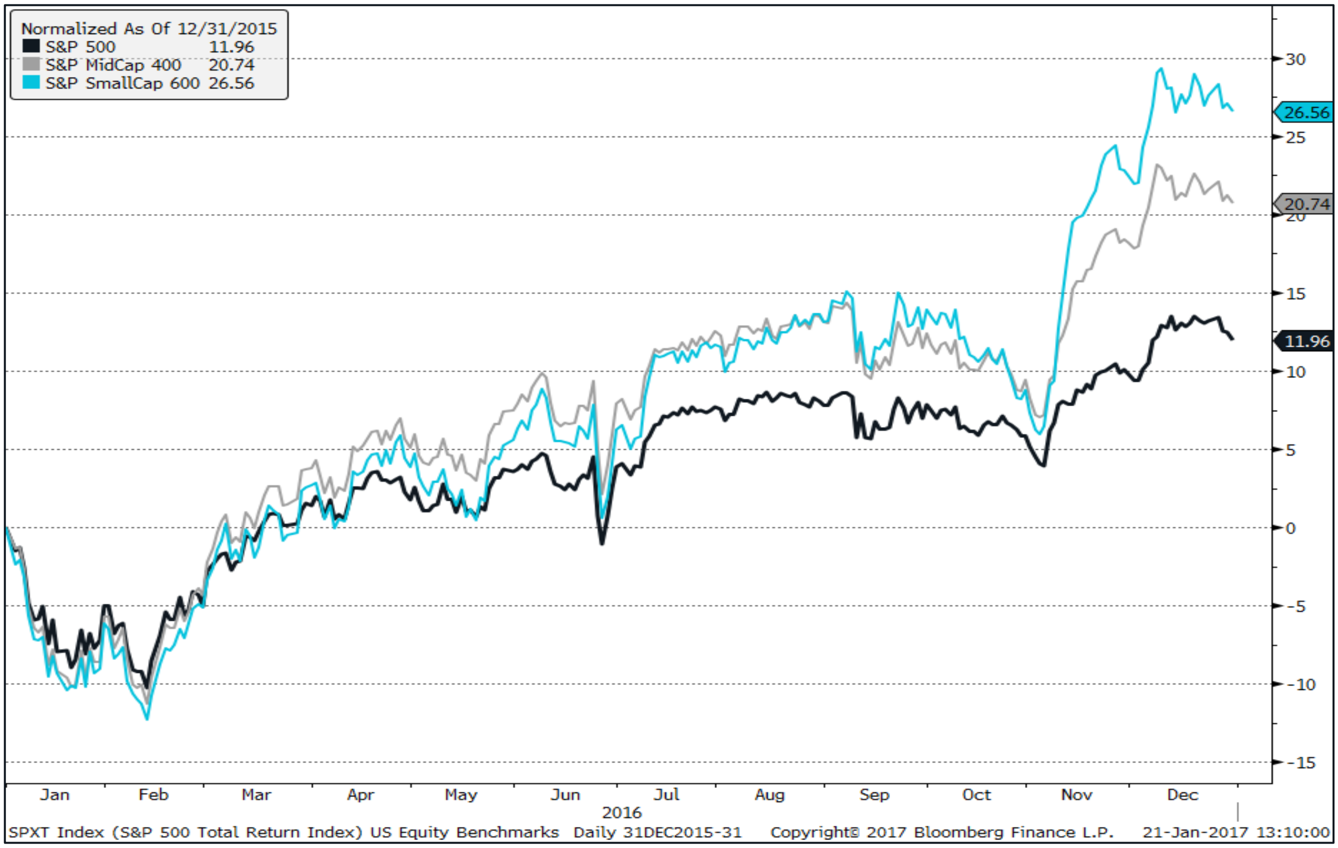
OVERVIEW

As the focus on November's presidential election weighed on investors, equity markets were down throughout the first month of the fourth quarter. Following Donald Trump's surprising victory, U.S. markets pivoted and the quarter ended on a much higher note, with very strong returns from small- and mid-cap stocks. In comparison, international stocks experienced a much rockier path, ending the quarter marginally lower. Overall economic data was positive, and investor sentiment greatly improved once the uncertainty of the election faded. Interest rates changed dramatically during this time, causing dropped prices and negative returns in bonds. The U.S. Treasury 10-year bond began the quarter with a yield of 1.59%, rising rapidly ahead of the Fed's December meeting. This increase peaked on December 15th at 2.59% - a 1.0% rise in just 45 days - before settling at 2.44% to end the year. The Fed raised short-term rates by 0.25% and projects two to three additional rate

2016 Returns for U.S. Equities by Market Cap



increases in 2017. Economic growth resulting from fiscal policy (government action), as opposed to monetary policy (central bank action), could greatly benefit equities and real assets, while rising rates would be detrimental to bonds and yield-focused investments.

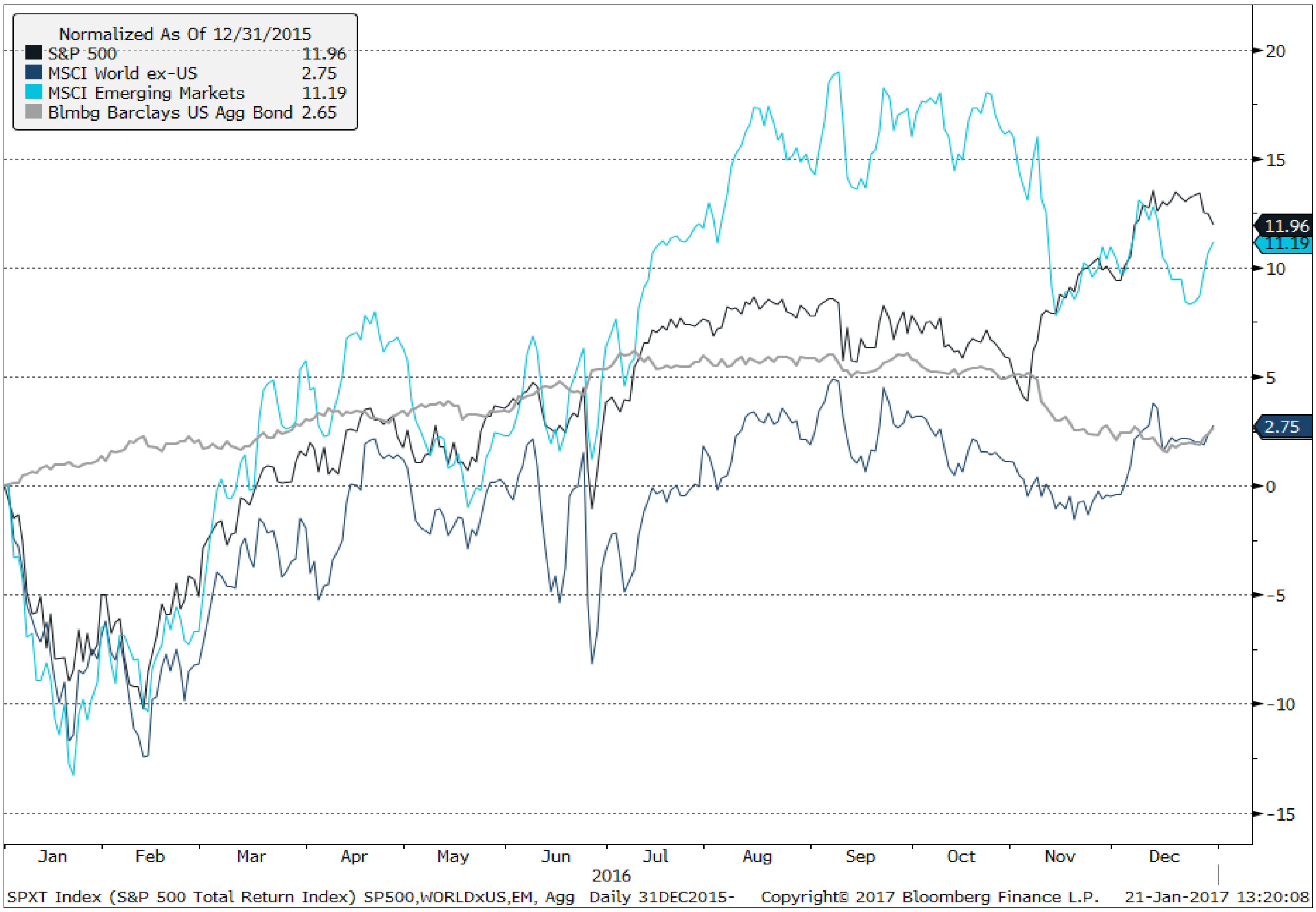
U.S. EQUITIES

Domestic large-cap stocks, as measured by the S&P 500 Index, finished the quarter up 3.8% (+12.0% for the year). Mid-cap stocks (S&P 400 Index) also ended strongly, up 7.4% (+20.7% for the year). Small-cap stocks (S&P 600 Index) experienced the strongest U.S. performance, both for the fourth quarter and overall year, finishing up 11.1% and 26.6% respectively. Value-oriented stocks outpaced growth-oriented stocks for the quarter and full year. S&P 500 year-over-year earnings for Q3 were positive despite analyst projections of negative growth and, according to FactSet, Q4 earnings are estimated to grow 3.2% year-over-year.

U.S. equity returns ended 2016 on a strong rally, but could pull back slightly if corporate earnings do not meet analysts' growth forecasts for Q4 2016 or each quarter of 2017.

Given the strong finish for U.S. equities in 2016, it is easy to forget the volatility we saw throughout the year. The above chart illustrates the rocky ride

2016 Returns for Equities and Bonds



for U.S. equities in 2016. By February 12th, U.S. equities had plunged by -10.0%. A strong rally boosted stocks until mid-June, when investor focus shifted to the weak jobs number reported for May and the negativity surrounding the "Brexit" vote on June 23. Stocks recovered again, until October brought increasing uncertainty ahead of the presidential election and a potential rate increase by the Fed. Following the end of the election and the subsequent results, investor sentiment and U.S. stocks rose rapidly. This outcome was not the only driver to boost stocks in the fourth quarter. Strong economic data, such as third-quarter GDP growth of 3.5% on an annualized rate, and positive earnings growth played a significant role in the rally as well.

Looking ahead, we remain in favor of equities and other asset classes over bonds, while expecting volatility across asset classes to continue – or even increase starting in 2017. Our current allocations provide the opportunity to participate in up markets, but also allow us the option to buy low if markets should draw down. In that same manner, we will look for opportunities to trim risk assets like equities if markets run higher. Forward-looking return expectations are much lower than those seen since the financial crisis, and our goal is to take advantage of volatility and short-term deviations from fundamental values to improve returns for our clients.

INTERNATIONAL EQUITIES

After very strong returns in the third quarter, international equities struggled for most of the fourth quarter. International developed markets, as measured by the MSCI World ex-USA Index, returned -0.4% for the quarter but remained positive (+2.8%) for the full year. Emerging markets, as measured by the MSCI Emerging Markets Index, returned -4.2% for the quarter, but still provided a positive return (+11.2%) for 2016. The results of the U.S. election, along with the increase in U.S. interest rates and strengthening U.S. Dollar, put downward pressure on international stocks for the quarter. However, valuations are relatively attractive and the economic outlook for global economies, especially emerging markets, appears to be improving.

Returns for non-U.S. equities were quite varied, not only between developed and emerging markets but also between the countries within each classification. Heavy commodity exposure was accretive to performance, boosting many emerging economies, but a strengthening U.S. dollar detracted from returns for U.S. investors. Economic growth forecasts also are quite varied, with Bloomberg consensus estimates for 2016 emerging markets real GDP growth of 3.7% (single country growth rates ranging from -10.0% to +8.0%) and developed market growth of 1.7% (single country growth rates ranging from +0.2% to 4.2%). For 2017, emerging markets real GDP growth is forecasted at 4.7%, but only 1.9% for developed economies.

We overweight international equities based on our belief that foreign markets have better upside potential over the next several years. The cyclical nature of historical relative performance between U.S. and international stocks, along with fundamental valuations and the potential that the U.S. Dollar reverts back to a more average level, indicate that international equities are poised to outperform U.S. equities over the next 5-7 years. Significant decreases in Chinese growth and demand for commodities, a hard "Brexit", and dysfunction in the European Union are a few of the major threats to international equities. Just as we will be more opportunistic with U.S. equities if volatility persists, we will make moves in our international equity portfolio to lock in gains (reduce allocations) after strong market returns or buy (increase allocations) at depressed levels if international equities hit a rough patch in 2017.

REAL ASSETS & DIVERSIFYING STRATEGIES

Allocations to Real Assets (Infrastructure and MLPs) and Diversifying Strategies were mixed for the quarter, but generally trailed U.S. equities and outperformed bonds. MCF's allocation to Real Assets was up an average of 2.0% for the fourth quarter and over 20.0% for 2016. PIMCO All Asset fell slightly for the quarter (-0.3%), but returned 13.3% for the year. Allocations to insurance-linked bonds continued to provide stability in portfolios and paid a distribution in December (6.0% yield).

We continue to believe that Real Assets and Diversifying Strategies provide better diversification benefits and inflation hedging protection than a portfolio comprised only of stocks and bonds. While bonds typically have lower volatility, this may not be the case moving forward as expectations for rising interest rates may cause turmoil in bond markets. Over the next several years, we believe Real Assets and Diversifying Strategies will play a larger role in portfolios due to expectations for lower returns and higher volatility for traditional asset classes such as stocks and bonds.

We reduced some exposure to Real Assets due to their very strong return in 2016. We are researching additional Real Asset investments to add to portfolios, but likely will keep allocations limited unless we feel there is a significant risk that inflation may greatly outpace expectations. Historically, Real Assets have provided attractive returns during high inflationary periods, but provide the best hedge when unexpected inflation is high (realized inflation is a combination of *expected inflation*, which is typically accounted for in asset prices, and *unexpected inflation*, which is the "surprise" element when realized inflation is different than expected inflation). According to the Department of Labor, inflation (as measured by the Consumer Price Index) in 2014 and 2015 was only 0.8% and 0.7%, respectively - two of the three lowest rates of annual inflation in the U.S. since 1967. For 2016 inflation jumped to 2.1%, and we expect inflation to stay above 2.0% for 2017 (consensus estimates are around 2.5% for 2017). If "Trumpenomics" truly sparks strong growth, we could see inflation closer to the 3.0% level by the end of the year, which could provide a strong boost to Real Assets.

We also are researching ways to enhance our Diversifying Strategies allocation, but proper due diligence can be tedious given the balancing act between portfolio benefit, risk, and higher fees (Diversifying Strategies tend to cost more). Before we make allocations to additional Diversifying Strategies (or any new asset class, for that matter), we thoroughly analyze the effect on the overall portfolio to ensure there is an added benefit given the return expectations, risks, and fees.

BONDS

U.S. intermediate bonds (Barclays Aggregate Bond Index) fell during the quarter, returning -3.0% for the fourth quarter and bringing the full-year return down to 2.7%, slightly higher than the index's yield at the beginning of the year. The index finished the year with a yield around 2.6%, higher than the 2.0% yield at the end of the third quarter. Intermediate-term municipal bonds trailed during the quarter with a return of -3.5% and finished the year slightly negative (-0.2%) based on the Morningstar category average. Short-term bonds also were down for the quarter (-0.5% for the Morningstar category average), but provided relatively better protection against rising rates.

As we have noted before, bond prices have an inverse relationship to changes in interest rates (when rates rise, bond prices fall, and vice versa). When the Fed finally raised interest rates in December of 2015, bonds dropped slightly before quickly rising higher – against conventional wisdom. However, it was not the increase in rates that drove bonds higher; rather it was a sudden drop in global equity prices that drove investors to flee to safe havens (U.S. Treasury bonds). With equities running higher after the U.S. presidential election, bonds reacted quite differently around the Fed's rate increase in December of 2016. The gains made on bonds during the first three quarters of 2016 were cut by more than half in the fourth quarter as bond prices tumbled. Although we place a lower probability of rates rising another 1.0% from current levels that rapidly, we do expect to see some of the same directional movements in 2017 – rates rising higher, and bond prices falling, potentially generating flat or negative returns for bondholders. Our allocation to bonds has been underweight for several years now, a move that was too early and initially detracted slightly from performance. We continue to be underweight bonds and maintain lower duration (interest rate risk) relative to the Barclays Agg Bond Index given our belief that the poor performance of bonds in the fourth quarter of 2016 is not an isolated event.

Our return expectations for investment grade (core) bonds in the coming years is close to 0%. There is certainly no excitement for a 0% return. But there will be periods where bonds will provide downside protection when equity volatility spikes, even if the Fed continues to raise interest rates – just as we saw positive bond returns right after the Fed's first rate increase in 2015 when equities dropped over -9.0%. In addition, bonds also provide cash flow and help cover liquidity needs, albeit at a lower rate than historical averages. If you are not comfortable with the higher risk associated with an all equity (Aggressive Growth) portfolio, it is prudent to have some allocation to core bonds. These core bonds can be complemented with smaller allocations to non-core bonds (floating rate, high yield, international bonds, etc.) that have more potential for generating returns, but do not provide as strong a cushion when equity volatility spikes. We utilize a mix of core and non-core bonds to achieve a more attractive risk-return profile for our portfolios.

ECONOMY

The U.S. continues to chug along at a slow and steady pace, but forecasts for 2017 are improving based on the expectations of fiscal stimulus and infrastructure investments. The current expansionary period, which "officially" began in June of 2009, is one of the longest expansionary periods on record, but with one of the lowest average annual GDP growth rates, just above 2.0%. Two recent expansionary periods have lasted longer though, and with higher average annual GDP growth rates: 120 months with average annual GDP growth of 3.6% from 1991 to 2001, and 106 months with average annual GDP growth close to 5.0% from 1961 to 1969. Given these numbers, the current expansionary period could run (or rather, walk) several more years.

Many international economies are projected to grow at a faster pace than the U.S. in 2017, but few countries have the general strength and stability of the current U.S. economy.

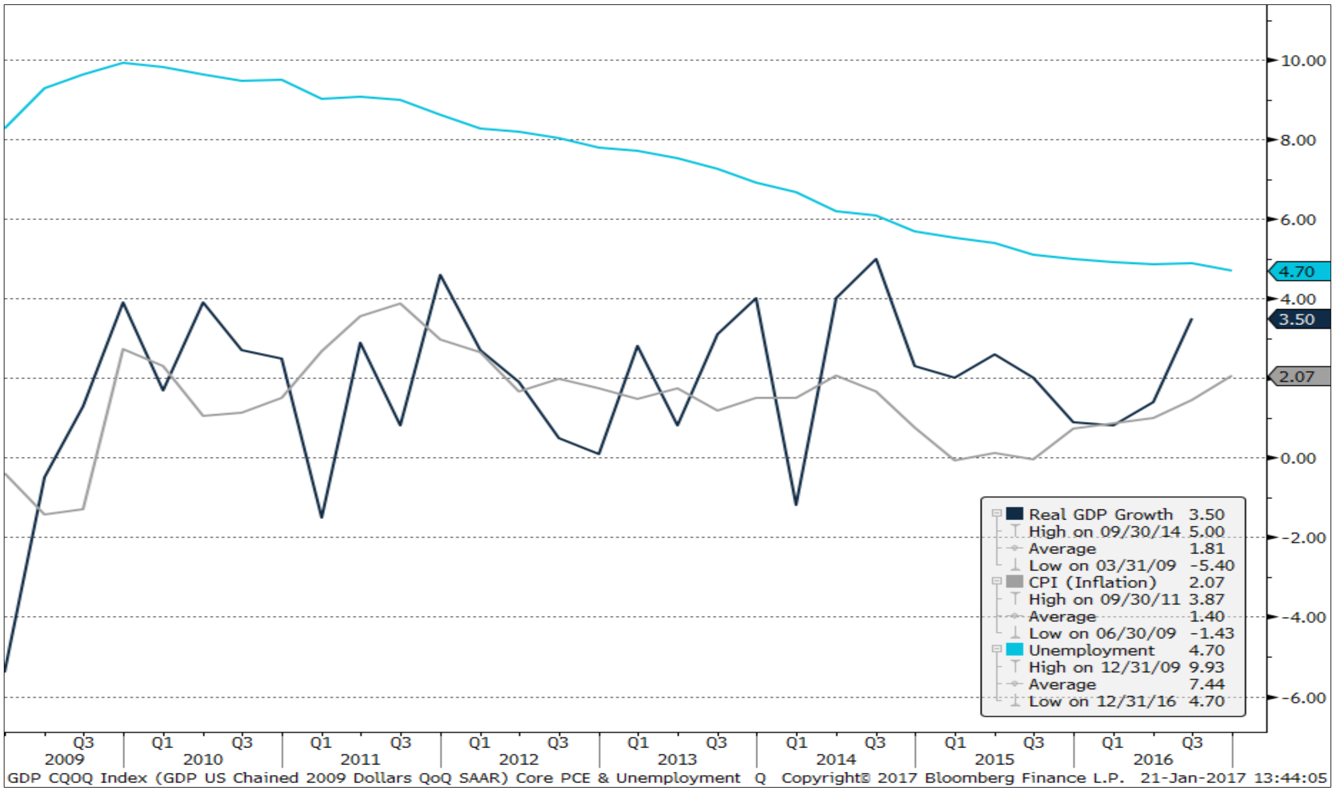
In contrast, according to BTN Research, the last Republican president who was voted into office to begin his time as POTUS who did not suffer through a recession within 18 months of his inauguration was Warren G. Harding, 29th president (served from 1921-23 before dying of a heart attack). That is not a promising stat for The Donald.

Viewing these statistics in isolation is very dangerous. There are numerous other factors that determine the economic health of a country. The economic environment, regulatory environment, central bank policies, and various issues that led to the recessions varied among each period. No single factor or statistic can reliably determine every recession and sometimes an exogenous event can lead to recession.

In aggregate, the current U.S. economy is in good shape and picking up speed, but is not at the point of overheating and the Fed plans to raise rates at a pace they believe the economy can absorb without negative impact. There will come a time when inflation rises too rapidly, rates rise high enough to restrict growth, and the U.S. economy will enter a recession. We do not believe this will be the case for 2017, and expect modestly better economic growth than 2016. In the unexpected scenario of a recession in 2017, we would expect a short, shallow dip before growth resurfaced.

International economies have a more intricate story to tell. Central banks are still very accommodative, employment numbers are improving, and many countries, especially within emerging markets, are expected to grow at a much faster pace than the U.S. However, the International Monetary Fund (IMF) has lowered several growth outlooks for various countries regarding the uncertain effects of Britain's exit from the European Union, potential issues with trade agreements, and stabilizing commodity prices. Foreign economies have better potential for growth over the next few years, which would help international stock performance. We expect the negative interest rates on sovereign debt that was so common in 2016 to be more of an outlier in 2017, but we do not expect foreign interest rate increases to match the U.S. Accommodative monetary policy from central banks, continued economic improvement, and lower unemployment rates (leading to more consumption) should help the global economy in 2017.

U.S. Economy: GDP Growth, Inflation, & Unemployment Trending Towards Fed's Goals



2017: A BRIEF LOOK AHEAD

Bloomberg consensus estimates place a 15% probability of a recession hitting the U.S. in the next 12 months. Historically, prolonged bear markets (generally defined as a sustained -20.0% or more drop in stocks) mainly coincide with recessionary periods. While we do not expect either of these events to occur in 2017, a -10.0% or more drop in equities during the year would not surprise us. Since 1951, U.S. stocks have an average spread of about 24.0% between the highest and lowest price on the S&P 500 Index in a given calendar year. The S&P 500 fell into negative territory in over 85.0% of the years since 1951 (but still finished positive for the year over 70.0% of the time). Average volatility on the S&P 500 Index historically is around 16.0%, but has only been around 11.0% for the past 5 years. We do not expect 2017 to be an outlier – so expect volatility, expect your portfolio to be down at some point, and expect investment activity to increase during large market movements. But most of all, expect communications and guidance from MCF Advisors through it all.

SUMMARY

We do not want to sound draconian in our writing, but we do want to provide realistic views on potential risks and expected returns. 2017 quite possibly could be a smooth ride higher for equities, inflation may remain muted, economic growth could accelerate, and the Fed could move with such grace that three rate hikes in 12 months go unnoticed by investors. And maybe, just maybe, Mexico does pay for that wall.

Rather than invest on "maybes" or the mere possibility of an event, we want to prepare for several higher probability scenarios and position ourselves to take advantage of short-term market disruptions caused by unforeseen catalysts. We are not able to predict the future, but we can work to construct portfolios that generate relatively attractive results in a variety of economic environments. While this means we may not match equity returns in strong rallies led by “animal spirits” instead of fundamentals, we can work diligently to protect our clients’ assets from the large losses that destroy wealth and ruin financial viability. Even through the volatility of 2016, our portfolios were able to generate attractive returns by focusing on fundamentals instead of emotions. We are investing portfolios for 2017 with a bit more caution, but will look for ways to add value so our clients can advance closer to their financial goals.

Summary of Outlook & Positioning

Asset Class	Long-Term Outlook	Current Positioning	Focus for Next 12 Months
U.S. Equities	Slightly Unfavorable	Slightly Underweight	Opportunistic (take advantage of volatility) and look for potential to add to relatively undervalued sectors
International Equities	Relatively Positive	Overweight	Mix of developed and emerging markets; opportunistic
Real Assets	Positive	Overweight	Researching opportunities outside MLPs & Infrastructure
Diversifying Strategies	Positive	Overweight	Researching opportunities to decrease portfolio risk
Bonds	Unfavorable	Underweight	Minimum core allocation with shorter duration and complimented with additional non-core exposure
Cash	Unfavorable	Underweight	Minimize; used for liquidity needs

INTEGRITY

We believe that you are served best when we share our expertise passionately and with transparency.

KNOWLEDGE

We must continually learn, building upon our intellectual capital and our technical ability in order to guide effectively.

SERVICE

When we continually strive to attain the highest standards, you experience superior service.

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