KLS PROFESSIONAL ADVISORS GROUP, LLC
Complete Financial Management

Staying the Course

The Economy

Domestic equity markets continued to rise during the second quarter of the year supported by a growing (though not robust) economy replete with employment gains and modest inflation. Internationally, Europe experienced similar economic results, while European capital markets experienced greater percentage gains as they were playing catch up as compared to the United States, whose recovery and ensuing gains commenced earlier. Emerging markets also positively responded to the uptick in economic activity.

Political deadlock impeding the Administration's agenda items, including tax reform, healthcare reform and infrastructure spending, did not cast a pall over the equity markets. Similarly, comments by the Federal Reserve and the European Central Bank as to their plans for raising interest rates and reducing their respective balance sheets attracted investor attention but did not give rise to dramatic and sustained market volatility.

Analyst consensus continues to project domestic GDP growth at an annualized rate of 2 – 2.5%. European growth, recently accelerating, is also trending positive at a modest rate based on consensus estimates. Recent gains in the manufacturing sector were not limited to Germany, and included notable participation by Greece.

Year to date, the rate of aggregate domestic inflation is below the Fed's target rate (although the rate of inflation for the 12 months ended June 30th approximated 2% as a result of a recovery in the prices of goods coming off of severely depressed levels a year earlier). Traditional drivers of inflation are seemingly not present. Energy prices are relatively low, wage pressure is not significant (due to the changing nature of employment in a gig/part-time economy, and the impact of technology), and capacity constraints on both the manufacturing and service sectors are not present. Overall, inflation demands on the Fed and the ECB are muted, making it unlikely that central banks will change policy to rapidly accelerate balance sheet reductions and tighten monetary policy (and unsettle capital markets).

As the Bank of Japan continues to deploy aggressive quantitative easing in the Japanese bond market to maintain near zero interest rates, and as European rates are generally lower than U. S. interest rates, bond investors look to the U.S. markets for income. This also underwrites higher bond prices and corresponding lower interest rates domestically.

Nevertheless, a sudden and significant rise in interest rates as a result of policy misstep or market repricing may adversely affect both the economy and the equity markets.

Finally, although the worldwide and domestic economies are much improved and growing, technology has been and will continue to be a catalyst for the recalibration of jobs and employment opportunities and will produce industry and sector dislocations going forward. For

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example, technology has negatively impacted brick and mortar retailers with follow on consequences for employment and commercial real estate in cities and in malls. This creates both uncertainty and opportunities.

Corporate Earnings and Valuation

Consensus estimates of 10.5% growth in the earnings of the S&P 500 remain although year over year earnings growth is estimated at 6 – 7% for the second quarter, down from first quarter growth of 15% (that was favorably impacted by the recovery in oil prices in year over year comparisons in the first quarter). We are, however, encouraged that earnings per share growth was fueled not only by share buybacks and cost reduction, but also by top line revenue growth.

At June 30th, the S&P 500 was valued at 19x earnings per share based upon 2017 estimated operating earnings. Multiples for mid- and small-cap companies are modestly higher. The equity valuation multiple implied by the Baa corporate bond, however, is currently 22x. We view equity market levels as reflective of a stable and growing economy and the continued prospect of low interest rates for the foreseeable future.

Apart from some increased volatility in March, interest rates varied moderately year to date. In the second quarter, treasury debt with maturities of a year or longer remained within a narrow range and the yield differential between the 10 year note and the 2 year note modestly narrowed.

Market Performance and Portfolio Construction

The Dow Jones Industrial Average, S&P 500, Russell 1000, Wilshire 5000, and S&P 400 Mid Cap Index each finished the second quarter of 2017 in positive territory, (3.95%, 3.09%, 3.06%, 2.95%, and 1.97% respectively for the quarter, and 9.35%, 9.34%, 9.27%, 8.73%, and 5.99%, respectively year to date). The Russell 2000 Small Cap Index rose 2.46% (4.98% ytd), and the NASDAQ gained 4.21% (14.76% ytd), as technology shares continued to outperform as did healthcare stocks. During the last month of the quarter, financial stocks also outperformed in anticipation of higher interest rates and increased economic activity. Looking forward, we expect that a more relaxed regulatory environment and even modestly rising interest rates will benefit financial stocks and support increased lending and economic activity.

International equity markets also gained. The MSCI Emerging Markets Index rose 6.27% for the quarter (18.43% ytd), the MSCI All Country World Index 4.27% (11.48% ytd) and the MSCI European Equity Index 7.37% (15.36% ytd).

We continue to maintain substantial equity exposure in most client portfolios, approximately neutral as compared to the broad domestic market in terms of market capitalization (i.e., large, mid and small cap companies). Most client portfolios remain underweight international equities reflecting our caution with respect to currency concerns and still unresolved banking issues and economic stabilization in Europe, though multinational companies in the portfolio with European (and emerging market) businesses and sales have benefitted from the recent upturn in economic activity.

Fixed income contributed to performance through a variety of styles and strategies. Most client portfolios participate through mutual fund investments in intermediate term municipal bond holdings, a tactically managed mutual fund investing in municipal bonds, and an exchange traded fund investing in high-quality corporate bonds. This combination of strategies in cost-efficient mutual funds has produced competitive returns during the year while allowing us to manage duration and credit risk through selection of funds that emphasize certain maturities and credit quality and should allow for a more efficient response when the interest rate environment changes.

Finally, during the second quarter and year to date, our active managers have added value, outperforming their respective benchmarks. Nevertheless, we continue to maintain broad exposure to equity market indices as they are cost effective, tax efficient and provide diversification (remaining mindful of the possibility of unintended consequences that may result from market excesses in capitalization weighted index funds).

We continue to stay the course.

July 13, 2017

The above commentary represents the economic and market views of our firm. We remind you, however, that each client's portfolio is managed individually. Please speak with your KLS advisor with respect to your personal circumstances and individual portfolio performance.

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