NOISES OFF

Throughout the third quarter of the year equity markets continued to march forward focusing on domestic and international GDP growth, strong corporate earnings growth, increased economic activity, year-over-year gains in capital goods orders and corporate capital expenditures, gains in employment, business and consumer optimism, and the Federal Reserve's and European Central Bank's promises to ever so slowly unwind their balance sheets and judiciously raise short-term interest rates so as not to derail economic growth (and the capital markets). Investors shrugged off the considerable noise of vitriolic political rhetoric, escalating tensions with North Korea, legislative deadlock including the failure to make progress on health care legislation, the societal stresses of the cultural divide, a combative environment in Washington and an ongoing investigation of the administration by a special prosecutor, confused signals regarding international trade and international relations, and a potential change in leadership at the Federal Reserve.

Developed world GDP growth continues to track in the 2 - 2.5% range, consistent, but not robust. Analysts continue to project strong earnings growth for the quarter and the year for S&P 500 companies (as well as domestically based mid-cap and small-cap companies), including earnings gains attributable to currency conversion resulting from a weaker dollar year to date (notwithstanding some recent dollar strength). Positive investor and business sentiment has been reinforced by "lower for longer" interest rates as the Fed moves slowly to reverse course. Resistance to higher interest rates is also supported by lower interest rates abroad which incentivize investors to buy US bonds. Inflation remains subdued both domestically and in Europe, providing a cautionary signal to central bankers who remain on guard against a policy misstep that could give rise to deflation.

Anticipating rising interest rates and bolstered by an administration supportive of lessening their financial regulatory burden, bank shares rose and remain strong. Year to date, healthcare and information technology sectors have produced the greatest returns for investors. Oil prices firmed during the quarter but continue to react to short-term supply and demand imbalances and producer agreements/disagreements as to production restraint. Finally, the retail sector remains under pressure from technology disruptors changing consumer behavior, with implications for retail oriented real estate. Additionally, technology disruptors have also significantly impacted the nature and composition of employment, lessening manpower needs for certain jobs, creating more demand for higher-order technology skills, and forcing many mid-level employees into lower-level/lesser paid jobs while creating even fewer jobs at the higher skilled/higher paid level.

Both the domestic service sector and manufacturing sector reported gains in economic activity. Employment gains continued during the quarter although job losses were reported in September as severe hurricane activity negatively impacted job gain/loss and hourly wage increase data. Property and casualty insurance company earnings have also been adversely affected this hurricane season.

The Dow Jones Industrial Average, S&P 500, Russell 1000, Wilshire 5000, and S&P 400 Mid Cap Index all rose in the third quarter of 2017 (5.58%, 4.48%, 4.48%, 4.59%, and 3.22% respectively for the quarter, and 15.45%, 14.24%, 14.17%, 13.72%, and 9.40%, respectively year to date). The Russell 2000 Small Cap Index rose 5.67% (10.93% ytd), and the NASDAQ gained 6.07% (21.73% ytd), as technology shares continued to outperform as did healthcare stocks.

This strong equity performance was supported by high levels of corporate debt (and fewer shares outstanding) that continue to energize growth in earnings per share. We also note that leveraged loan issuance is at record levels, additional evidence of both corporate and investor optimism. After the close of the quarter, domestic equity markets were further buoyed after the House of Representatives passed a budget resolution which included a framework for a tax bill. As of this writing, the budget resolution and tax bill is awaiting Senate action.

International equity markets also gained. The MSCI Emerging Markets Index rose 7.89% for the quarter (27.78% ytd), the MSCI All Country World Index 5.40% (19.96% ytd) and the MSCI European Equity Index 6.45% (22.79% ytd). These returns, stated after US currency conversion are substantially higher than local currency denominated rates of return as the US dollar has declined year to date.

As of this writing, the price-earnings ratio of the S&P 500 is approximately 20x analyst consensus earnings estimates for the year and 17.8x analyst consensus for 2018 (10% year-over-year growth). The forward-looking P/E ratio implies an earnings yield of approximately 5.5%, significantly higher than the BBB corporate investment grade long-term bond currently yielding approximately 4.4% which implies a fair value equity multiple 22.7x for analogous risk, thus leaving room for further multiple expansion (or cushion against a rise in interest rates which would lower the implied equity valuation multiple). In this regard, we note that corporate credit spreads (the additional interest rates in excess of comparable term US Treasury securities) are presently tight and in the event they should expand would provide resistance to multiple expansion for equity valuation.

Going forward, a significant risk to equity market valuation is an economic policy misstep that would give rise to a rapid and steep increase in interest rates, slow economic activity and weigh on corporate earnings. Both performance of the equity markets and analyst commentary are not presently signaling this as a concern given the Federal Reserve's "assurances" but investors remain keenly aware of the desire of some Fed governors and potential appointees to replenish their economic toolbox by raising interest rates. An upside surprise, however, could be the economic stimulus resulting from tax rate reduction and/or tax reform should legislation be enacted. It is not clear whether this is reflected in current market levels or whether future equity gains will be unleashed by a stimulative income tax program. A lower net corporate rate would enhance corporate earnings and share valuation, and repatriation of earnings by multinationals would bring capital back to the United States to fund economic activity and additional share buybacks, all of which are positive for equities. But for now, we are an audience captive to polemics and politics.

Portfolio Construction

Year to date, we have been underweight international equities in most client portfolios and continue to be so. Notwithstanding currency gains that supported the performance of international equities we continue to emphasize domestic equities (including large-cap multinationals) in client portfolios, preferring to participate in international markets through the operations of the multinationals. We note that these currency gains may reverse as result of US dollar strengthening if US interest rates rise faster (as is likely) than foreign rates. We are also mindful of the challenges of the implementation of Brexit and the separatist tensions in Spain. Finally, we also continue to maintain substantial equity allocations in most client accounts, as economic conditions are supportive of earnings growth and further equity gains.

We continue to have a meaningful allocation to fixed income securities in most client portfolios. This asset class has performed well year to date. Notwithstanding a rise in interest rates at the shorter end of the yield curve, we view a high credit quality fixed income portfolio with a duration of 6 to 7 years as providing a counterbalance to the risks inherent in equity investing. We continue to believe that this is appropriate.

Although there are many unknowns that may affect the economy and capital markets going forward we are encouraged by the resilience of the domestic economy and the continued improvement of the European economy. These are the drivers of our investment policy.

October 10, 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.

The material contained herein is intended as a general market commentary. The prices/quotes/statistics referenced herein have been obtained from sources deemed to be reliable, but we do not guarantee their accuracy or completeness; any yield referenced is indicative and subject to change. The views and strategies described herein may not be suitable for all investors. Certain opinions, estimates, investment strategies and views expressed in this document constitute our judgment based on current market conditions and are subject to change without notice. The information contained herein should not be relied upon in isolation for the purpose of making an investment decision. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Past performance is not indicative of future results.