2017 Year End Commentary and Outlook

2017 Recap

GDP growth, domestic and abroad, gained momentum in the fourth quarter of the year leading some analysts to expect growth in the coming year to attain or exceed 3%. Inflation remained below the Federal Reserve Bank's target rate of two percent notwithstanding moderate wage gains of 2.5% during the year. Analysts expect growth in corporate earnings of the S&P 500 companies for the year to reflect an 11 percent year-over-year gain following a strong earnings growth year in 2017 (10.87%) that was assisted by currency gains as a result of a declining dollar. Central banks in the United States, Europe, Japan, and England remain accommodative, signaling gradual interest rate increases in conjunction with a slow unwind of their balance sheets (ballooned by years of quantitative easing) while remaining cautious and vigilant with regard to signs of inflation. 2017 also transitioned to a more "business friendly" domestic environment with a lessening of regulatory burden by the Administration. And in the final days of the year, the United States enacted corporate tax reform that likely will enhance future corporate profits and further incentivize capital expenditures (following a strong year in 2017 for capex).

Tensions with North Korea, protests in Iran, and a combative environment in Washington continued in the final days of 2017 and early days of 2018, apparently not derailing enthusiastic investor sentiment and confidence as the first trading days of the new year brought domestic equity markets to new heights.

Worldwide equity markets reflected investor optimism in 2017 and continued into the new year. Strong performance of the technology sector, a strong housing index, gains in the manufacturing sector, low and declining rates of unemployment in the United States, and declining rates of unemployment in Europe all underscored and reinforced a growth oriented economic environment.

The Dow Jones Industrial Average, S&P 500, Russell 1000, Wilshire 5000, and S&P 400 Mid Cap Index all rose in the fourth quarter of 2017 (10.96%, 6.64%, 6.59%, 6.39%, and 6.24% respectively for the quarter, and 28.11%, 21.82%, 21.69%, 20.99%, and 16.23%, respectively for the year). The Russell 2000 Small Cap Index rose 3.33% (14.63% ytd), and the NASDAQ gained 6.57% (29.73% ytd), as technology shares surged.

International equity markets also gained. The MSCI Emerging Markets Index rose 7.44% for the quarter (37.28% ytd), the MSCI All Country World Index 5.73% (23.97% ytd) and the MSCI European Equity Index 2.21% (25.51% ytd). These returns, stated after US currency conversion, are higher than local currency denominated rates of return as the US dollar has declined during the year.

The price-earnings ratio of the S&P 500 is approximately 20.5x analyst consensus earnings estimates for the year just ended and 18.4x analyst consensus for 2018 (11% year-over-year growth). As we had observed last quarter, the forward-looking P/E ratio implies an earnings yield of approximately 5.4%, significantly higher than the BBB corporate investment grade long-term bond currently yielding approximately 4.3% which implies a fair value equity multiple of approximately 23x 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 again caution 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.

Outlook

Corporate Tax Reform

The 2017 tax legislation reduces domestic corporate income tax rates, and taxes (at favorable rates) previously untaxed profits held abroad thereby encouraging immediate repatriation (and allowing payment of this tax liability over an eight year period). It also encourages repatriation of future profits by exempting dividends from foreign subsidiaries from U.S. corporate income tax, while continuing to exempt certain foreign subsidiary profits from U.S. taxation (subject to certain anti-abuse provisions that safeguard against distortive allocation of profits overseas that erode the U.S. corporate tax base).

The prospect of near term repatriation of foreign profits that may fuel share buybacks, domestic capital investment and expansion of domestic operations by both domestic and foreign corporations (now that U.S. rates are competitive with corporate income tax rates abroad) has supercharged the equity markets. While the ultimate economic impact of this change in tax regime is less immediate than a substantial reduction in the middle class consumer income tax burden, the equity markets have anticipated the future benefits.

The potential impact of repatriation increasing demand for U.S. dollars thereby elevating the U.S. currency against others currencies may, however, provide some temporary earnings headwind as currency relationships adjust. Additionally, heretofore previously accumulated untaxed foreign subsidiary earnings for which a U.S. income tax liability has not been reflected on financial statements will now be recorded as a one-time charge, albeit at the new favorable rates, in the fourth quarter 2017 financial statements, but likely will not adversely impact investor outlook as to the positive ongoing earnings implications of the new tax regime. The reduction in corporate rate will also result in a fourth quarter adjustment of deferred tax assets that are worth less as the future benefit of such would be realized in a lower tax rate environment. Again, a technical accounting concept that will likely not affect investor outlook.

Inflation

While inflation has remained low and domestic wage inflation has been more muted than wage inflation in other regions of the developed world (which were coming off of a lower base and a higher level of unemployment), continued wage pressure could stoke inflation and shrink operating margins thereby tempering earnings gains. Increased demand for energy and metals may also add to inflation. As worldwide economic growth has advanced, excess capacity both as to manufacturing capacity and labor availability (counterforces to inflation) have declined. Finally, with increased competition in telecommunications and technology moderating prices and the potential strengthening of the dollar providing some relief in the cost of imported goods, a surge in inflation is not a foregone conclusion, though it continues to bear watching.

Policy Risk/Support

Policy risks remain the most significant risk to equity market valuation. This includes central bank policy, populist and political risks domestic and abroad, foreign policy that triggers trade repercussions, outright trade wars, and immigration policy that may adversely impact labor supply.

By contrast, an infrastructure program (perhaps more difficult to enact given the increased deficit cost of the new tax law) launched in Washington and enacted, funded and implemented, would provide further stimulus for the economy and the capital markets. If enacted, this would be a welcome upside surprise.

Portfolio Construction

We continue to maintain substantial equity allocations in most client accounts, as domestic economic conditions and worldwide economic growth are supportive of corporate earnings and further equity gains.

As observed last quarter, we have been underweight developed and emerging market international equities in most client portfolios and continue to be so. While Europe has attained a growth trajectory, it is presently being supported by more aggressive policy (including in some cases negative interest rates) than in effect in the United States. Notwithstanding currency gains that supported the performance of international equities, we continue to emphasize domestic equities in client portfolios, preferring to participate in international markets through the operations of large-cap domestic multinationals and not subjecting portfolios to the additional risk and volatility inherent in capital flows that have historically been characteristic of emerging markets and may impact developed markets as foreign subsidiary earnings are repatriated and currency markets adjust to the new U.S. corporate tax regime. We also note that currency gains may reverse as a result of U.S. dollar strengthening if U.S. interest rates rise faster than foreign rates, although the dollar continued its decline in the early trading sessions of the new year as investors wagered that foreign central banks may increase interest rates through policy rate or balance sheet unwind at a more rapid pace than will the U.S. Federal Reserve Bank. Repatriation of foreign earnings, on the other hand, may restrain a rise in intermediate term domestic interest rates.

We continue to have a meaningful allocation to fixed income securities in most client portfolios. This asset class has performed well in 2017 notwithstanding a rise in interest rates at the shorter end of the yield curve (while the interest rate inherent in the 10 year treasury bond yield finished the year at approximately the same level as it began). We continue to view a diversified 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.

Although equity markets are highly valued as compared to historical price earnings ratios, the continuing low interest rate and low inflation environment support these levels as do the prospects for increased growth as a function of tax and muted regulatory policy. Notwithstanding the many unknowns that may affect the economy and capital markets going forward, the domestic economy has proved resilient and apparently "animal spirits" of business and investors alike have been stoked.

January 9, 2018

Developments at KLS

Managing Director Promotion

We are delighted to announce the promotion of Susan Matlow to Managing Director. Susan, along with her client responsibilities, will be coordinating the technical development of our client advisors. During her tenure with the Firm, she has mentored many KLS professionals and is a leading proponent of the KLS culture. Prior to joining KLS in 2013, Susan was a private client advisor at a boutique wealth management firm in New York, advising individuals on comprehensive wealth management matters. She began her career as an associate with Arnold & Porter in Washington, D.C. and subsequently was a tax counsel at Exxon Mobil Corporation and American Express Company. Susan received her B.S. degree from the Wharton School at the University of Pennsylvania in 1988 and her J.D. degree from The Vanderbilt University School of Law in 1991 and is a CERTIFIED FINANCIAL PLANNER™ professional.

Ongoing Relationships

Continuity for our clients and our culture through the Firm's transition is paramount, and to that end, we are also pleased to announce that Alan Brod, a Senior Managing Director and voting member of the Investment Committee, will continue in these roles working on a part-time schedule effective January 1, 2018.

It is with great appreciation, affection and some sadness that we announce that founding partner Carl Klapper has retired as of year-end. Carl has been a trusted advisor and a valued colleague for almost thirty years and we will miss his wisdom, impeccable judgement and steady demeanor. We are pleased to announce that Carl will continue in his capacity as a voting member of the KLS Investment Committee. We wish Carl and his wife, Joanne, much happiness and good health as they begin the next chapter of their lives.

Happy New Year!

All at KLS are mindful of the trust that our clients have in our Firm, our abilities and our commitment to technical excellence and client service. We are committed to living up to our clients' expectations to be responsible stewards of their investment portfolios and act as thoughtful and creative advisors on all other personal financial matters. As we reflect upon another successful year, our thoughts turn to those who have made our growth and success possible. In this spirit, all of us at KLS would like to thank you and wish you a Happy New Year.

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.