KLS PROFESSIONAL ADVISORS GROUP, LLC
Complete Financial Management

2018 SECOND QUARTER COMMENTARY AND OUTLOOK

Trade, Tariffs, Turmoil and Politics

Worldwide Market Volatility

Market volatility continued throughout the second quarter as positive domestic fundamentals were periodically eclipsed by the uncertainties and discord over trade, tariffs, and national security. The domestic economy produced a strong increase in job creation, GDP growth (estimated at 3% year over year net of inflation), and growth in S&P 500 corporate earnings (estimated at 20% year over year in the second quarter). Although the reduction in the corporate tax rate enhanced earnings growth in both the first and second quarter of the year, revenue and earnings per share growth attributable to share buybacks also contributed meaningfully. At the close of the quarter, the price-earnings ratio of the S&P 500 was approximately 17.1x analyst consensus earnings estimates for calendar year 2018 and 15.5x earnings for 2019. Relative to both historical and current corporate bond yields, we view this valuation as reasonable and supported by fundamentals. As we have observed in prior quarters, the yield on the 30 year BBB corporate bond, currently 4.75%, is a credit market proxy for the equity earnings yield, the inverse of which would imply a fair earnings multiple or price to earnings ratio of 21x. Nevertheless, we caution that the many uncertainties involving trade and international relationships may result in investor concerns or economic consequences that may impact the equity markets.

Although interest rates remain low, notwithstanding two Federal Reserve rate increases this year, corporate credit spreads (the additional interest rates in excess of comparable term U.S. Treasury securities) have widened during the quarter resulting in a decline in the market prices of investment grade debt.

After the close of the quarter, the United States implemented tariffs on China, who then responded with retaliatory tariffs against the United States. Tariffs had already been imposed on Canada, Mexico and Europe. In the days that followed China's response, equity markets advanced, for now shrugging off uncertainty. Trade uncertainties, however, have seemingly begun to impact some corporate plans for capital spending as CEOs expressed caution in recent surveys.

The Dow Jones Industrial Average, S&P 500, Russell 1000, Wilshire 5000, and S&P 400 Mid Cap Index all gained in the second quarter of 2018 (1.26%, 3.43%, 3.57%, 3.83%, and 4.29%, respectively) resulting in corresponding first half performance of -.73%, 2.65%, 2.85%, 3.04%, and 3.49%. The Russell 2000 Small Cap Index soared 7.75% in the quarter (7.67% ytd), and the NASDAQ gained 6.61% for the quarter (9.38% ytd), as technology shares continued to lead.

The MSCI All Country World Index had a modest gain, up .53% for the quarter (-.43% ytd) and the MSCI European Equity Index declined -1.27% (-3.23% ytd). U.S. investors in foreign shares suffered as the dollar gained during the quarter against the euro, yen and sterling, and as

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concerns over rising U.S. interest rates pressured Emerging Markets. Softer economic data from Europe and trade/tariff cautions were headwinds for international investors.

The Economy

The fundamentals remain intact, evidenced by consistent GDP growth and job creation, and modest hourly wage gains that have not yet fueled inflation or significant erosion of corporate profit margins. However, we note the recent rise in shipping costs.

Increases in oil prices resulting from production declines by OPEC and Venezuela and domestic infrastructure transmission constraints have added to the energy sector performance within the S&P 500. However, increased energy costs, if protracted, could adversely impact corporate margins and consumer spending.

The tax legislation has apparently stoked animal spirits and provided incentives for further corporate investment. Some economists have observed that since unemployment was relatively low and excess capacity in the economy had already declined, a more dramatic effect on GDP growth from the tax legislation was muted. Nevertheless, some growth was likely brought forward. It remains to be seen, however, whether trade and tariffs will slow the economy and/or drag on corporate earnings.

Although wage gains year to date have been modest, companies are reporting the beginnings of an impact on operating margins as increases in worker productivity have not yet materialized and competitive restraints on price increases have emerged. Labor costs account for approximately 13% of the revenue of the S&P 500 companies, and 20% for the industrial sector. A tight labor market underscored by a reported dearth of skilled workers may eventually increase labor costs, possibly fueling inflation and further straining operating margins. We note, however, that consumer spending has continued to be strong as evidenced by rising credit card debt and recent retail industry data without powering the inflation rate to a point of concern. Finally, the imposition of tariffs has already elevated prices on certain products and commodities.

Both domestic and international economies are continuing to recalibrate as technology and changing values have impacted business models and economic sectors. For example, formidable online competition has resulted in retailers closing store locations, forcing real estate owners to repurpose real estate that has heretofore been occupied by retail operations.

In Europe, investor confidence and sentiment has declined year to date as evidenced by substantial European equity outflows and negative equity market performance. Low interest rates in Europe have further tempered intermediate and long term interest rates in the United States as investors sought a more competitive rate of return, increasing U.S. bond prices and moderating U.S. interest rates. Investment flows such as these have also added strength to the U.S. dollar, though negatively impacting unhedged foreign earnings of U.S. multinationals.

Finally, the GDP growth rate of the combined economies of the G7 (ex the U.S.) is substantially slower than the U.S. domestic economy. Looking forward, we will be closely monitoring the responses of our trading partners to the implemented and threatened new tariffs. While investors have recently been brushing aside concerns, the rising prospects of a global trade war and the economic impact of prolonged uncertainty as business investment is delayed may eventually

weigh heavily on the equity markets. Additionally, as the Federal Reserve continues its policy of raising short term rates (two additional rate increases are expected for 2018) the yield difference between short and long term interest rates is expected to continue to compress (a "flattening yield curve"). Historically a flat or potentially inverted yield curve, where short term rates exceed long term rates, has been a headwind to economic growth and preceded a recession. The Federal Reserve has not expressed concern with the flattening yield curve as it expects the future issuance of debt required to finance the rising federal deficit to put downward pressure on treasury prices resulting in a corresponding increase in longer term yields. Nevertheless, investors will be focused on the risk of the Federal Reserve overshooting the number of rate increases, in the spirit of normalization, and eventually constraining economic growth.

Finally, protectionist and populist factions continue to inject political risk at home and abroad and may have negative economic implications if such escalate. The politics and geopolitics of the moment and the potential consequences for investors speak for themselves.

Portfolio Construction

We continue to maintain a substantial equity allocation in most client portfolios, as domestic economic conditions and worldwide economic growth are supportive of corporate earnings and further equity gains. The domestic equity bias of client portfolios has proven beneficial as U.S. equity returns continue to outpace international and emerging market returns this year.

We continue to have a meaningful allocation to fixed income securities (principally high quality municipal bonds) in most client portfolios as a hedge against equity risk. Municipal bonds have continued to perform well relative to the broader investment grade fixed income market. This is predominately due to the limited supply of new issuance this year, caused by the rush of municipalities to issue new debt in the 4th quarter of 2017 ahead of potential tax law changes. In the 2nd quarter, we further increased our allocation to money markets, where yields are approaching 2%, to continue lessening the interest rate risk within client portfolios.

Although we have outlined mixed economic signals and policy concerns that could impact corporate earnings and market valuations, we view the current range of price to earnings ratios for equities as reasonable, providing investors with significant risk mitigation.

July 23, 2018

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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