2018 THIRD QUARTER COMMENTARY AND OUTLOOK

Sailing through the Trade Winds

Continued U.S. Outperformance

U.S. equity markets, as represented by the S&P 500, wrapped up their best quarter in five years despite tariff and trade war rhetoric dominating the headlines for most of the third quarter. The strong performance was propelled by the accelerating growth in the U.S. economy and corporate earnings. The domestic economy continued to produce strong gains in labor markets, GDP (second quarter growth of 4.2%, quarter over quarter, and an estimated 4% for the third quarter) and S&P 500 corporate earnings (second quarter growth of 25% year over year and an estimated 21% for the third quarter) alleviating concerns, at least for now, that earnings had peaked earlier in the year. Sales growth, which is arguably a better indicator of corporate health as earnings are more directly impacted by the reduction in corporate tax rates, grew at an impressive rate of 11% in the second quarter. All 11 sectors of the S&P 500 increased year over year earnings in both the second and third calendar year quarters. Domestic growth stocks continued to dominate, in particular the consumer discretionary and technology sectors, as the Russell 1000 Growth Index rose 9.17% for the third quarter while domestic value stocks, represented by the Russell 1000 Value, rose 5.70%. Through the end of the third quarter, the value index has lagged growth by 13 percentage points year to date. Large capitalization stocks regained leadership over small capitalization stocks for the quarter as Amazon, Apple and Microsoft each posted double digit returns for the quarter.

While the U.S. equity markets meaningfully outperformed international developed and emerging markets, a number of international markets joined the rising tide as the MSCI All Country World ex U.S. Index produced its first positive quarterly return of the year (up 0.71% in 3Q). Developed international markets, represented by the MSCI EAFE Index, rose 1.35% while emerging markets, represented by the MSCI EM Index, fell 1.09% for the quarter. Through the end of the third quarter, international and emerging markets lagged the U.S. markets by 12 and 18 percentage points, respectively. The stark divergence in performance was due to the relative strength of the U.S. economy and dollar (which negatively impacted U.S. investors in foreign shares), the slowdown of economic growth in Europe and heightened trade tensions between the U.S. and China.

Index/Market	3rd Quarter Performance	Year-to-Date Performance
Dow Jones Industrial Average	9.63%	8.83%
S&P 500	7.71%	10.56%
S&P 400 (Mid Cap)	3.86%	7.48%
NASDAQ	7.42%	17.49%
Wilshire 5000	7.27%	10.53%
Russell 2000 (Small Cap)	3.57%	11.51%
MSCI Europe*	0.80%	-2.46%
MSCI EAFE Index*	1.35%	-1.43%
MSCI Emerging Markets*	-1.09%	-7.68%
MSCI All Country World*	4.28%	3.83%
MSCI All Country World ex U.S.*	0.71%	-3.09%

* Returns in U.S. dollars

At the close of the quarter, the price-earnings ratio of the S&P 500 was approximately 18.1x analyst consensus earnings estimates for calendar year 2018 and 16.5x earnings for 2019. This reflects an anticipated earnings growth of 22% for 2018 and 10% for 2019. Recently, a number of S&P 500 companies have stated that 2019 projected earnings will not meet analysts' estimates. Given the potential for higher labor and energy costs, weaker overseas demand and escalating headwinds from trade tensions, a slower growth trajectory than currently estimated is a reasonable possibility. We recognize that analysts, after seeing their first half estimates surpassed by reported earnings, raised their end of year and 2019 forecasts. We also note, though, that after robust growth in 2018, companies may be seeking to create room to ensure that they can continue to exceed estimates. In the second quarter, over 80% of S&P 500 companies exceeded earnings estimates – a record level.

A price-earnings ratio of 18.1x, at the close of the quarter, implies an equity earnings yield of approximately 5.5%. The 30 year BBB corporate bond, currently 4.84%, is a credit market proxy for the equity earnings yield, the inverse of which would imply a fair price to earnings multiple of 20.6x. We view this equity valuation as reasonable, albeit moderately higher than our last commentary due to third quarter stock price appreciation, and supported by the strong economic and corporate fundamentals discussed above. Nevertheless, we caution that the uncertainties involving trade, rising interest rates, political discord, deteriorating international relationships and the vulnerability of the global economy to the emerging markets may impact investor sentiment, economic conditions and, as experienced during the first two weeks of the fourth quarter, weigh heavy on the equity markets.

The Federal Reserve raised the federal funds rate for a third time this year supported by strong domestic data and reported inflation approaching the Fed's target of 2%. The yield on the 10-year Treasury note rose from 2.85% to 3.05% in the quarter as all interest rates across the maturity spectrum shifted upward. While U.S. Treasury prices declined for the quarter, corporate credit spreads (the additional interest rates in excess of comparable term U.S. Treasury securities paid by companies) tightened due to improving corporate fundamentals. The Barclays U.S. Corporate Bond Index, which is a composite index for U.S. investment grade corporate debt, rose almost 1% for the quarter.

Index/Market	3rd Quarter Performance	Year-to-Date Performance
Barclays US Aggregate Index	0.02%	-1.60%
Barclays US Corporate Bond Index	0.97%	-2.33%
Barclays US Treasury Index	-0.59%	-1.67%
Barclays US Municipal Bond Index	-0.15%	-0.40%

Trade and other Headwinds

Trade and other headwinds, while creating uncertainty and discord, have not detracted, as yet, from global growth. In fact, U.S. equity markets sailed right through these headwinds, gaining over 7% in the third quarter alone, propelled by strong fundamentals. However, as of the date of this Commentary, the waters of the global markets have become turbulent and the near term path is less certain.

The recent progress in negotiations between the U.S., Mexico and Canada and détente with Europe has mitigated some of the risks of a global trade war. While the actual tariffs imposed to date have been relatively small ($250bn by the U.S. and $60bn by China), China and the US appear to be slipping into a downward spiral of tit-for-tat trade actions and are digging in for the long haul. After the close of the quarter, a new dimension of tension and concern emerged as China reportedly planted chips, for espionage purposes, in the computer components of almost 30 U.S. firms and a dangerous near confrontation between U.S. and Chinese warships occurred in the South China Sea. This tension has the potential to destabilize key regions of the world that depend upon strong relations with both sides. As business investment is delayed due to prolonged trade instability, the risk and depth of the potential economic impact will be re-calibrated by investors.

With the Federal Reserve intent on tightening monetary policy, Treasury yields started to approach multi-year highs. Wage and price inflation, however, continues to be modest and within the Federal Reserve's overall target of 2%. In September, the pace of annual inflation slowed for the second month in a row, annualizing at 2.2%, excluding the volatile food and energy categories. A rise in uncertainty, rather than expectations of accelerating inflation, appears to be the primary catalyst for the rise in rates. Bond investors are less certain about the future (impact of trade tensions, an accelerating economy and tight labor markets and ballooning federal deficits) and are therefore demanding a higher return or yield to account for the perceived risk. After the close of the quarter, a sharp increase in interest rates startled investors and, with additional looming uncertainties, caused a swift rotation out of equities. Whether this is temporary turbulence, as investors adjust to a new era of higher interest rates, or something more is yet to be determined.

Optimism about the prospect of technology-centric companies increasing productivity gave way to anxiety over the abuse of personal data, increased government regulation, trade tariffs and the impact of rising rates on high growth stocks. Despite these heightened concerns, many of the favorite stocks continued their market dominance and posted double digits gains for the quarter. The "FAANG's" now represent approximately 15% of the market capitalization of the S&P 500. By comparison, during the technology bubble of 2000 and the "nifty fifty" era of the 1960s and 1970s, the five largest technology companies represented 16% and 20%, respectively. While the profitability of today's leaders provides counterbalance to "bubble" concerns of the past, the vulnerability of the technology stocks to regulatory and trade headwinds and rising interest rates will continue to be tested. If these stocks stumble, so too may the larger market.

The vulnerability of the emerging markets, further heightened by the rebound in the U.S. dollar and slowing growth in China, prompted fears, predominately in the international developed economies, of contagion. Emerging market currencies have faced headwinds throughout the entirety of 2018, particularly those in the most vulnerable countries that have large current-account deficits and foreign financing needs. Most notably, the Turkish Lira and Argentine Peso plunged by 30% and 40% respectively in the quarter against the U.S. dollar, creating surging inflation, as global investors became increasingly concerned about worsening economic policy and the ability of both countries to repay debts amid rising borrowing costs. China's industrial sector signaled weakness and, in response, the central bank eased monetary policy. Policymakers there face a delicate balance of easing conditions while not adding to elevated debt levels. The further escalation of trade disputes between the U.S. and China has the potential to further shock the developing economies.

Portfolio Construction

As reefing the sails provides vessel stability and is the primary safety precaution in stormy weather, so too does proper asset allocation in markets with strong fundamentals but uncertain risks.

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. The domestic equity bias of client portfolios has proven beneficial as U.S. equity returns continue to meaningfully outperform international and emerging market returns.

We continue to have a meaningful allocation to fixed income securities, principally high quality municipal bonds, and money market funds in most client portfolios as a hedge against equity risk. The municipal bond market continues to outperform the broader investment grade fixed income market predominately due to the limited supply of new issuance this year. We have acted to shorten duration (sensitivity to interest rate movements) and capture higher money market yields as taxable yields have passed through 2%. As the Federal Reserve continues its policy of raising short term rates (one additional rate increase is expected for 2018 and three additional are targeted for 2019), we will closely monitor client portfolio duration and seek to balance the risk and reward of holding shorter versus longer maturity fixed income.

The recent market volatility has demonstrated the importance of prudent asset allocation, including maintaining exposure to high quality fixed income and money markets and controlling portfolio interest rate risk. While economic fundamentals and corporate earnings growth remain strong, we expect continued volatility as investors tack through these uncertain times.

October 19, 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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