2018 FOURTH QUARTER COMMENTARY AND OUTLOOK

CLIMATE CHANGE

2018 was a year marked by great stock and bond market volatility. At the outset of the year, the S&P 500 surged 7.5% in anticipation of expanding economic growth propelled by the recently enacted tax legislation and prospects of increased government infrastructure spending. The U.S. equity markets then abruptly reversed course in early February over inflation and rising interest rate concerns, leading to an almost 9% correction. Over the second and third quarters, U.S. equities regained their momentum, fueled by accelerating earnings and economic growth, and by late September had reached all-time highs. And then the polar ice caps of market sentiment began to rapidly melt…

Shaken by the concern that rising interest rates, trade tensions and political dysfunction might materially impact global growth, worldwide equity markets experienced their worst quarter since 2011. The U.S. equity market, as represented by the S&P 500 Index, declined by 13.5% for the quarter as pessimism, risk aversion and a climate of uncertainty consumed investors. From the closing high of the S&P 500 in September to the low in December, the Index declined close to 20% - the traditional threshold for entering a "bear" market. The S&P 500 Index rebounded in the final week but ended the year in negative territory for the first time in a decade, declining 4.4% for the year. Whether this is the advent of a new recessionary economic cycle or a correction and moderation of growth within a long running bull market is yet to be determined. Achieving this clarity may take some time.

The spark for the fourth quarter decline appeared to be primarily attributable to concerns regarding the direction of monetary policy. Investors, who were already grappling with the economic implications of escalating trade tensions and global political gridlock, began to fret that an aggressive Federal Reserve could push a decelerating economy into a recession. Inconsistent comments by policy makers did little to provide transparency and market consensus. Over a six week period, Chairman Powell provided contrasting remarks that the Central Bank was "a long way" from a neutral interest rate position (a federal funds rate that neither stimulates nor restrains economic growth) to a softened "just below" to then declaring that the Central Bank remained on course to reverse quantitative easing. The continued reduction of the Federal Reserve's balance sheet ("reverse quantitative easing") has the potential to weigh on bond prices and conversely increase rates by expanding the supply of bonds in the market.

Despite the market turbulence, the domestic economy continued to produce strong gains in labor markets, GDP (third quarter growth of 3.4%, quarter over quarter, and an estimated 2.8% for the fourth quarter) and S&P 500 corporate earnings (third quarter growth of 26%, year over year, and an estimated 11% for the fourth quarter). Consumer spending remained resilient (third quarter growth of 3.5%, quarter over quarter, and an estimated 3% for the fourth quarter) as Mastercard SpendingPulse reported the strongest holiday sales growth in the last six years. However, forward-looking company commentary and recent business surveys have shown a weakening outlook. It is not unexpected that the U.S. economy is decelerating as the stimulus

provided by the tax cuts and de-regulation is fading and the impact of trade restrictions is rising. The magnitude of this change is the subject of ongoing debate.

For the fourth quarter, economically sensitive sectors of the S&P 500 Index, such as Consumer Discretionary and Industrials, underperformed less discretionary sectors such as Consumer Staples. The only S&P 500 sector in positive territory for the quarter was Utilities (up 1.36%) – a traditional "defensive" sector as the demand for the essential services provided by Utility companies remains stable in weak economic environments. Energy was the worst performing sector (down 24%) as the price of oil plunged from $76 to the low-$40s due to surging global oil supply and a weaker economic outlook. As investors rushed to exit equities with elevated price-to-earnings ratios, domestic value stocks (as represented by the Russell 1000 Value Index) outperformed domestic growth stocks (as represented by the Russell 1000 Growth Index). Although the quarterly performance of domestic value stocks reversed the prior nine month trend, domestic growth stocks maintained their leadership by almost 7 percentage points for 2018.

International developed markets were not spared the turmoil as the MSCI EAFE Index fell 12.5% for the quarter. Emerging markets fared better than developed international markets, declining 7.5% for the quarter. We question, though, whether this relative outperformance is newfound investor enthusiasm for emerging markets or more the effect of a temporary detente between the U.S. and China and a narrowing of the performance gap. Through the first nine months of 2018, international developed markets outperformed emerging markets by over 7 percentage points. For 2018, the MSCI EAFE Index fell 13.8% and MSCI Emerging Market Index fell 14.6%, lagging the U.S. equity markets by approximately 9 and 10 percentage points, respectively. After a period of synchronized global growth in 2017, performance diverged materially across geographical regions in 2018. The stark divergence in annual 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 China and heightened global trade tensions.

Index/Market	4th Quarter Performance	2018 Performance
Dow Jones Industrial Ave	-11.31%	-3.48%
S&P 500	-13.52%	-4.39%
S&P 400 (Mid Cap)	-17.28%	-11.10%
NASDAQ	-17.28%	-2.81%
Wilshire 5000	-14.29%	-5.27%
Russell 2000 (Small Cap)	-20.21%	-11.03%
MSCI Europe*	-12.72%	-14.86%
MSCI EAFE*	-12.54%	-13.79%
MSCI Emerging Markets*	-7.47%	-14.58%
MSCI All Country World*	-12.75%	-9.42%
MSCI All Country World ex USA*	-11.46%	-14.20%

* Returns are in U.S. dollars.
Note: performance is based on total returns.

At the close of 2018, the price-earnings ratio of the S&P 500 was approximately 15.5x analyst consensus earnings estimates for calendar year 2018 and 14.6x estimates for 2019. This reflects an anticipated earnings growth rate of 22.5% for 2018 (an annual growth rate that was materially inflated due to the now fading stimulus of tax cuts) and 6.7% for 2019. While corporate earnings growth most likely peaked in mid-2018, earnings are still projected to grow in 2019 - albeit at a more moderate pace. We do note, though, that 2019 earnings expectations have steadily decreased from 9.9% at the end of the third quarter to 6.7% at year-end. Citing weaker overseas demand and escalating headwinds from trade tensions, a number of multinationals have recently lowered fourth quarter and 2019 earnings expectations. The market will be closely monitoring fourth quarter earnings and, more importantly, the guidance for 2019 provided by corporate executives.

A price-earnings ratio of 15.5x, at the end of 2018, implies an equity earnings yield of approximately 6.5%. The 30-year BBB corporate bond yield of 5.06% is a credit market proxy for the equity earnings yield, the inverse of which would imply a fair price to earnings multiple of 19.8x for the analogous risk. We view this equity valuation as attractive, but note that until better clarity is achieved surrounding the uncertainties outlined in this Commentary, the evolving climate of market sentiment may weigh further on equities in the near term.

In December, the Federal Reserve raised the federal funds rate for the fourth time in 2018 and, in an acknowledgement of the changing environment, reduced the projected number of rate increases for 2019 from three to two. The yield on the 10-year Treasury note declined from 3.06% at the start of the fourth quarter to 2.69% at year end, as “risk-off” investors sought the safety of U.S. Treasuries. The yield curve continued to flatten over the quarter with the difference in yields between the 2 and 10-year Treasury note ending at 20 basis points. For a brief period in December a portion of the yield curve did invert between 2 and 5-year notes (i.e., the yield on 2-year notes exceeded 5-year notes), although this was not the historically more reliable recessionary indicator of an inversion between the 2 and 10-year note.

Amid the equity market turmoil, U.S. Treasuries and investment grade municipal bonds produced solid gains for the quarter. Investment grade corporate credit spreads (the additional interest rates paid by companies in excess of comparable term U.S. Treasury securities) widened modestly due to perceived weakening of corporate fundamentals.

Index/Market	4th Quarter Performance	2018 Performance
Barclays US Aggregate Index	1.64%	0.01%
Barclays US Corporate Bond Index	-0.18%	-2.51%
Barclays US Treasury Index	2.57%	0.86%
Barclays US Municipal Bond Index	1.69%	1.28%

Note: Performance is based on total returns.

2019 Outlook

Domestic

On the surface, there is an apparent disconnect between market sentiment and domestic economic fundamentals. While recent economic data has been mixed, being negatively impacted by weak purchasing manager surveys, capital expenditures by corporations and housing starts, the broader fundamentals remain solid. Labor markets are strong, wages continue to rise (3.2% annual increase in December) and consumer spending, which represents greater than two thirds of the U.S. economy, remains robust. In December, non-farm payrolls increased by 312,000 jobs – substantially above the 177,000 consensus estimate – representing the strongest reported increase in ten years. The unemployment rate did increase from 3.7 to 3.9%, but this was due to an increase in labor force participation. We do note, though, that employment is often the last indicator to deteriorate as the economic cycle turns. Price and wage inflation continues to be modest and within the Federal Reserve's overall target of 2%. The leading economic indicators continue to support expansion.

Within the study of climate change, scientists refer to two factors or "forcing mechanisms" that shape climate. Internal forcing mechanisms are natural processes that organically impact the environment while external forcing mechanisms are artificial or influenced by humans. We appear to be experiencing a similar dynamic within the financial markets. While the economy continues its natural advancement through the latter stages of the economic cycle, man-made issues, whether through monetary policy and the communication thereof, trade negotiations or political dysfunction, are greatly influencing this progression – raising fears of a near-term economic contraction.

The announcement at the G-20 summit in December of a 90 day cease fire on tariff increases between the U.S. and China was a promising development. Recent optimistic statements by the Trump Administration and the announcement of Chinese Vice Premier Liu's January 30th meeting in Washington continue to build on this momentum. It is not surprising that the U.S. and China are starting to show a sense of urgency with respect to moving trade negotiations forward. Six months after the U.S. first imposed tariffs on Chinese goods, signs are growing that the trade war is exacting an economic toll - increasing the incentive for both sides to resolve the conflict. This trade conflict is also occurring against the back drop of a material slow-down in the Chinese economy.

After the close of the year, comments by Chairman Powell that the Federal Reserve will be patient with monetary policy, and has no preset path for raising rates or reducing their balance sheet, calmed the markets. As we recognize that in 2016 the Federal Reserve approved only one of the four indicated rate hikes, remaining data dependent and patient amid tightening financial conditions and geopolitical concerns, we are optimistic that a similar "wait and see" approach will be maintained throughout 2019.

The partial government shutdown, now the longest in U.S. history, is a return to man-made forcing mechanisms. While it is too early to determine the full impact of the shutdown, the effects are starting to trickle down through the economy, impacting an estimated 800,000 government employees. Economists have begun to calibrate the impact of the drag on

government spending and the delay in business investment, due to policy uncertainty, on first quarter U.S. economic growth. We are concerned that a stalemate between President Trump and Congress appears to have been reached and that both parties are digging in along ideological lines.

While economic fundamentals have generally trumped politics historically, the uniqueness of today's political environment appears to be driving the 24/7 news cycle and forcing the uncertainty to the forefront of investors' minds.

Abroad

Uncertainties regarding the outcome of Brexit, the showdown between the European Union and Italy and the outcome of budget revisions in France amid the "yellow vest" anti-government protests are impacting business confidence and continue to restrain growth. Business surveys have been weakening throughout the year with certain Eurozone economies flirting with a recession. Manufacturing exports are in sharp decline which is likely attributable to the slowdown in demand from China. Adding to the uncertainty in 2019 is the outcome and consequent policy implications of new parliamentary elections and the selection of a new head of the European Central Bank.

The Chinese economy continues to weaken as the December Purchasing Manager Index showed its first contraction since 2016. While the outcome and impact of the trade conflict with the U.S. remains uncertain, the Chinese government is embarking on a fiscal stimulus plan to control the magnitude of the slowdown. Policymakers there face a delicate balance of further stimulating the economy while not adding to elevated debt levels. As China's growth materially impacts the economies of the emerging and international developed markets, we view China as one of the biggest risks to global growth.

Portfolio Construction

In light of the uncertainties detailed above, a portfolio that is well diversified by asset class, sector and investment style is necessary to achieve the appropriate balance of risk and reward. A cautious approach to risk and a meaningful participation in equities are both warranted at this time.

We continue to maintain a substantial equity allocation in most client portfolios, as domestic economic conditions and fundamentals, while moderating, remain supportive of continued corporate earnings growth. The domestic equity bias of client portfolios has proven beneficial as U.S. equity returns have meaningfully outperformed international and emerging market returns.

We continue to have a meaningful allocation to fixed income securities, principally short-term U.S. Treasury bills and high quality intermediate-duration municipal bonds, as a hedge against equity risk. In the fourth quarter of 2018, the correlation between asset classes became negative as Treasuries and municipal bonds appreciated while equities stumbled. This was a reversal of a pattern seen earlier in 2018 when both bond and stocks retreated amid rising interest rates. We

view this as a positive development as fixed income provided formidable ballast to equity risk at the time of the largest peak to trough equity market decline in a decade.

The U.S. Treasury and municipal bond markets continue to outperform the broader investment grade fixed income market predominately due to investor risk aversion and the limited supply of municipal bond issuance throughout 2018. We have acted to shorten duration (i.e., sensitivity to interest rate movements) and capture the higher yields of Treasury Bills and money markets as taxable yields have surpassed 2%.

The recent market volatility has demonstrated the importance of prudent asset allocation, including maintaining exposure to high quality fixed income. The fundamentals that support continued growth remain but will be challenged by the uncertainties that abound. We will continue to use our best judgement to adapt to the changes in this uncertain investing climate.

January 17, 2019

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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