KLS PROFESSIONAL ADVISORS GROUP, LLC
Complete Financial Management

2019 SECOND QUARTER COMMENTARY AND OUTLOOK

Volatility Returns

The second quarter of 2019 was marked by great volatility as the uncertainty surrounding global trade reappeared. After marching steadily upward through the first four months of the year, amid a backdrop of renewed investor optimism, global stocks stumbled as the Trump Administration ratcheted up trade tensions with China and, briefly, Mexico. After closing at a record high in April, the S&P 500 tumbled over 6% in May, as President Trump, citing dissatisfaction with trade negotiations, raised tariffs from 10% to 25% on $200bn of Chinese imported goods and threatened to impose tariffs on the remaining $325bn. The Administration also threatened to implement new tariffs on all Mexican goods in response to the perception that Mexico was not adequately stemming the flow of immigrants to the U.S. The rapid rise in trade tensions along with weaker global manufacturing data re-ignited fears of an oncoming trade-induced recession. In June, the Federal Reserve came to the rescue, once again, indicating a willingness to cut rates to sustain the decade-long expansion, if economic conditions deteriorated. Investors cheered the news, as well as the Administration's decision to indefinitely suspend tariffs on Mexico, propelling the S&P 500 up over 7% for the month of June.

While the path through the first half of 2019 was vertigo-inducing, with a four month period of ascent followed by a one month period of sharp descent and then a recovery in June, the S&P 500 finished up over 18%, capping the best first-half performance since 1997. Equally as impressive was the breadth of the rally as the S&P 500 Index weighted by market capitalization (larger capitalization companies carry a higher percentage weighting within the Index) and weighted equally (each company has the same weighting within the Index) experienced similar year-to-date performance through the second quarter. This alleviates, at least temporarily, some concerns that certain Index components (e.g. large technology companies) are disproportionately driving overall market performance.

With the exception of Energy, all sectors of the S&P 500 experienced positive performance for the quarter with Financials leading the way. Domestic growth stocks, as represented by the Russell 1000 Growth Index, modestly outperformed their value counterparts, as represented by the Russell 1000 Value Index, while large capitalization outperformed small capitalization stocks, as represented, respectively, by the S&P 500 and Russell 2000 Indexes. While small capitalization companies typically outperform during periods of international turmoil due to their limited non-U.S. exposure, concerns regarding a cooling US economy and a declining dollar over the second quarter, relative to the euro and yen, were most likely an offset.

The pace of growth in the domestic economy was 3.1% (quarter over quarter) for the first quarter of 2019, an acceleration from the fourth quarter of 2018. While growth was meaningful, it should be noted that first quarter growth benefited from a large increase in unsold inventories. This was probably due to manufacturers producing goods in anticipation of future expected trade tariffs and is not expected to be repeated in the second quarter. Growth for the second quarter of 2019, according to the Atlanta Federal Reserve, is expected to taper off to 1.6% (quarter over quarter). While economists were encouraged by the first quarter's improvement in quarter over

quarter growth, concern has grown that the U.S. economy, with continuing trade policy friction and political uncertainty, is showing signs of slowing.

Corporate earnings for the first quarter of 2019 slowed appreciably, growing at 2.5% (year over year), according to Capital IQ, as consumer spending softened and the weakness in international economies impacted U.S. based multinational companies. First quarter earnings, however, did exceed consensus analyst expectations that had been declining over the quarter. Year over year earnings comparisons, for the first quarter of 2019, were expected to be weaker as 2018 earnings received a significant boost from lower corporate tax rates. For the second quarter, consensus analyst estimates project a 1.7% year over year earnings decline according to Capital IQ. Second quarter corporate earnings face a number of headwinds, including a relatively strong dollar (even with recent declines against the euro and yen), higher input costs, lower oil prices (impacting energy companies) and declining consumer and business sentiment (predominately due to the ongoing trade disputes). Corporate earnings are projected to rebound over the third and fourth quarters of 2019 and end the year up approximately 2% relative to 2018 according to Capital IQ.

International developed market equities, as represented by the MSCI EAFE Index, were up 3.7% for the second quarter, performing in line with the broad based U.S. equity markets. While manufacturing and consumption data across the Eurozone continued to weaken (Eurozone manufacturing declined for the fifth consecutive month according to IHS Markit) and uncertainty surrounding Brexit remains, investor optimism was bolstered by the European Central Bank's stated intention to further ease monetary policy, including new bond purchases, in response to the deteriorating conditions. Japanese equities, as represented by the Tokyo Stock Price Index, struggled relative to other international developed equity markets in the second quarter as corporate earnings were impacted by trade tensions and the strength of the yen. Emerging market equities, as represented by the MSCI EM Index, recorded a slight gain for quarter. The underperformance of emerging markets relative to U.S. and international developed markets continues to be predominately driven by the strength of the U.S. dollar and decelerating growth in China. In addition to trade tensions with the U.S., China faces the difficult task of transitioning from a government lead economy to a consumer driven one. While China continues to stimulate its economy through tax cuts and spending increases, more action may be needed if the trade friction between the U.S. and China persists. Longer term, we are concerned with the implications of continued stimulus as China's debt has surpassed 300% of its GDP.

Index/Market	2nd Quarter Performance
Dow Jones Industrial Average	3.21%
S&P 500	4.30%
S&P 400 (Mid Cap)	3.03%
NASDAQ	3.88%
Wilshire 5000	3.99%
Russell 2000 (Small Cap)	2.09%
MSCI Europe*	4.48%
MSCI EAFE Index*	3.68%
MSCI Emerging Markets*	0.61%
MSCI All Country World*	3.61%
MSCI All Country World ex U.S.*	2.98%

* Returns in U.S. dollars

At the close of the quarter, the price-earnings ratio of the S&P 500 was approximately 17.8x analyst consensus earnings estimates for calendar year 2019, and 16x for calendar year 2020 according to Capital IQ. This reflects a 1.9% anticipated earnings growth rate for the 2019 calendar year. While meaningfully below the tax-fueled earnings growth of 2018, earnings are still projected to grow for 2019 and accelerate in 2020, with forward P/E ratios around long-term averages. We view the 2019 price-earnings ratio valuation as reasonable and supported by low interest rates, strong consumer spending and corporate fundamentals that, while slowing, are continuing to grow, albeit modestly. We remain cautious, though, that the uncertainties of trade negotiations, monetary policy (investor expectations surrounding the path of interest rate cuts) and ongoing political discord may swiftly impact investor sentiment and, as experienced in May, weigh heavy on the equity markets.

It is frequently noted that the recent valuations of developed international market equities, in particular Europe, are cheaper than U.S. equity markets from a relative perspective. We contend that this valuation difference is warranted due to developed international markets' slower growth, limited technology sector, geopolitical issues and greater economic exposure to trade issues.

The yield on the 10-year Treasury note declined from 2.41% at the end of the first quarter to 2.00% at the end of the second quarter. This represents the third consecutive quarter of yield declines, totaling, in aggregate, more than one percentage point. The yield on the 10-year note continues to be driven down by low inflation and slowing economic growth, insatiable investor demand for safe assets and the yield differential of U.S. Treasuries relative to other global developed government debt. The total amount of negative yielding government debt, which includes the majority of the Eurozone, is currently $13 trillion and continues to expand driven by the European Central Bank's and Bank of Japan's loose monetary policy and increase in asset purchases. The yield curve remained inverted at quarter end as the yield on the 3-month Treasury bill exceeded that of the ten-year note, although, this was not the historically more reliable recessionary indicator of an inversion between the 2 and 10-year note. We expect the Federal Reserve to be sensitive to the shape of the yield curve (preferring a steeper curve) in determining monetary policy.

U.S. Fixed Income markets posted strong gains for the quarter across government, municipal and corporate bonds - although for seemingly contrasting reasons. The credit spread (interest rate spread above Treasuries) for both investment grade and high yield corporate bonds declined modestly for the quarter, implying stable corporate fundamentals and credit quality, while government bond prices rose (yields declined) amid lower inflation expectations, dovish statements by the Federal Reserve and rising concerns for economic growth. We believe that lower government bond yields are a function more of low inflation expectations and the attractiveness of U.S. Treasuries relative to developed global bonds than of an impending recession.

Municipal bond prices, as represented by the Barclays U.S. Municipal Bond Index, continued to march higher in the second quarter (up 2.1%). The limitation on state and local tax deductions enacted in the 2018 tax bill continues to fuel demand for municipal bonds in high tax states, such as New York, New Jersey and California, while the elimination of the federal tax-exemption for the issuance of "advanced refunding" bonds has decreased the supply. We do not expect a change in this supply and demand framework for municipal bonds in the near future.

Index/Market	2nd Quarter Performance
Barclays US Aggregate Index	3.08%
Barclays US Corporate Bond Index	4.48%
Barclays US Treasury Index	3.01%
Barclays US Municipal Bond Index	2.14%

Outlook

As we move into the third quarter, we will be closely monitoring a number of key issues.

Global Trade Tensions

The continuing uncertainty over trade policy has the potential to further weaken business sentiment and delay investment plans, raising risks for an otherwise stable U.S. economy. Further investment reductions by companies may eventually lead to cut backs in employment and consequently lower consumer spending. The existing tariffs are already having an impact on the global economy as the World Bank recently cut its forecast by 0.3 percentage points for global growth in 2019 due to weakness in trade and manufacturing. The June announcement by the Administration that the trade talks were "back on track" after President Trump's meeting with President Xi Jinping at the G20 is a welcomed development. However, the recent use of tariff threats against friendly trading partners, such as Mexico to address immigration issues, and the ongoing divisive transatlantic trade negotiations with Europe are unsettling. The longer companies are operating in an uncertain framework, the larger the expected drag on economic growth.

The replacement for the North America Free Trade Agreement, the United States-Mexico-Canada Agreement (USMCA), remains unapproved by lawmakers with a number of Congressional Democrats adamantly opposed to the deal without substantive changes. It is unclear, given the state of party relations, whether or not the Agreement will be approved in the near term. If a deal collapses, the implications for the U.S. economy could be meaningful as Mexico and Canada constitute 30% of U.S. global trade.

Monetary Policy

We are in a highly atypical investment environment whereby investors are hoping for slow economic growth in order for the Federal Reserve to remain on its anticipated path of interest rate cuts. The strong employment number in June (a positive development for the U.S. economy) is a case in point as the market consequently sold off due to investors' concerns that the central bank may no longer follow the market's expected path. Continued progress on trade negotiations, strength in labor markets and unexpected increases in wage inflation have the potential to reduce the urgency for the Federal Reserve to act. Given the market's current expectations for rate cuts, near-term positive economic and trade-related news may negatively impact investor sentiment and equity markets.

The positive impact of continued reductions to the federal funds rate on U.S. economic and corporate earnings growth without a resolution of global trade issues, in particular with China, is questionable. It is unlikely that reductions in the rate will spur businesses to increase productivity-enhancing capital expenditures while concerns remain about tariffs, market access and global supply chains. We expect the main benefit of further interest rate cuts to be

supporting asset prices and avoiding a stock market correction similar to that of the fourth quarter of 2018.

Corporate Earnings & Consumer Spending
As of the date of this Commentary, more than 80 S&P companies forewarned that second-quarter financial results will be weaker than expected. The market will be closely monitoring the release of second quarter earnings and, more importantly, guidance for the rest of 2019 by corporate executives to determine the health of the U.S. economy. Particular attention will be paid to the impact of trade frictions and the strong dollar on multinational companies.

While manufacturing has weakened over the course of 2019, consumer spending, bolstered by employment and wage gains, and the growth in the service sector, which compromises approximately 80% of the U.S. economy, remain solid. Consumers, however, may ultimately be impacted through a contraction of jobs and wages if expenditures by businesses continue to decline. We will be keeping a watchful eye on consumer sentiment and spending as this may be a signal that the economy is decelerating faster than expected.

Political
As the current two-year budget deal expires this September, U.S. lawmakers face another deadline to prevent cuts to government spending. The Treasury Secretary recently stated that the Administration was optimistic that a deal with congressional leaders could be completed prior to the August recess – a positive development. However, given the state of partisan politics and limited timeframe, the possibility exists for another government shut-down with an uncertain impact on business and consumer confidence.

Portfolio Construction

We continue to maintain a meaningful allocation to equities in most client portfolios, as domestic economic conditions, while moderating, are still growing and remain supportive of corporate earnings growth. The accommodative stance by the Federal Reserve, low interest rate environment, strong consumer spending and potential for further stimulus by China also provides further support for risk assets. The domestic equity bias of client portfolios has proven beneficial as U.S. equity returns continue to outperform 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 volatility and equity risk. High quality fixed income provided formidable ballast to equity risk during the fourth quarter of 2018 and May of 2019.

While we remain positive on the U.S. economy and corporate earnings, we recognize that near and longer-term uncertainties remain. As the mercurial performance of the equity markets during the second quarter reminds us, market sentiment can change swiftly. Given this opportunity for continued growth while acknowledging that volatility will likely remain for the foreseeable future, we view a balanced portfolio of meaningful equity participation coupled with a cautious approach to risk to continue to be warranted at this time.

July 18, 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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