2019 THIRD QUARTER COMMENTARY AND OUTLOOK

Headlines Dominate

The third quarter of 2019 was marked by the continuation of great volatility as an escalation of global trade tensions, the path of interest rates and fear of a U.S. recession dominated headlines. While these themes have been ongoing and led to significant fluctuations in the equity markets for the prior 18 months, the most recent quarter was particularly vertigo-inducing. The S&P 500 surged to an all-time high in July, ahead of the Federal Reserve's first interest rate cut in a decade, then sharply descended in August as U.S. and China trade tensions re-escalated and then recovered in September, as the S&P 500 eked out a 1.7% return for the third quarter, allowing the U.S. equity markets to hold on to its best year-to-date performance since 1997. Entering the fourth quarter, the S&P 500 is up 20.6%, extending the longest bull market on record.

Led by the traditionally defensive sectors of Utilities, Real Estate and Consumer Staples, eight of the eleven sectors of the S&P 500 posted positive returns as investors sought yield and stability in a declining interest rate and economic environment. While domestic growth stocks, as represented by the Russell 1000 Growth Index, did modestly outperform their Value counterparts, as represented by the Russell 1000 Value Index, the gap in performance narrowed substantially for the quarter. It is unclear whether this is the start of rotation into long underperforming value stocks or just a brief revival. Large capitalization outperformed small capitalization stocks, as represented, respectively, by the S&P 500 and Russell 2000 Indexes for the third quarter. While small capitalization companies typically outperform during periods of international turmoil due to their limited non-U.S. exposure, ongoing concerns regarding a slowing US economy were most likely an offset.

The pace of U.S. economic growth was 2.0% (quarter over quarter) for the second quarter of 2019 and is estimated, according to the Atlanta Federal Reserve, to be 1.8% for the third quarter. While U.S growth has slowed meaningfully relative to 2018 (manufacturing in particular), it does not appear to be on the cusp of a recession as the consumer, bolstered by employment and wage gains, continues to be the driving force behind the economy. The U.S. consumer represents approximately two-thirds while manufacturing represents less than 12% of U.S. economic activity. Employers added an average of 157,000 jobs a month in the third quarter as the unemployment rate declined to 3.5% in September. Wage growth, while recently slowing below 3% on an annualized basis, remains solid and consumer confidence remains high. In August, the number of job openings exceeded the number of hires by 1.3 million according to the Bureau of Labor Statistics. Consumers, however, may ultimately be impacted through the contraction of jobs and wages if expenditures by businesses continue to decline due to the ongoing trade conflict and general environment of uncertainty. The lack of business spending on long term capital investments is one of the largest constraints to growth. The tax bill, enacted in 2017, produced the expected rise in corporate earnings but the secondary effect of increasing capital investment has not meaningfully materialized.

S&P 500 corporate earnings for the second quarter of 2019 improved modestly, growing at 2.1% (year over year), according to Capital IQ, as a strong dollar and weakness in international economies impacted U.S. based multinational companies. While year over year growth for the second quarter slowed appreciably relative to 2018, earnings did meaningfully surpass second

quarter consensus expectations. For the third quarter, consensus analyst estimates project a 4.2% year over year earnings decline according to Capital IQ. Third quarter corporate earnings face a number of headwinds, including lower oil prices (impacting energy companies), a relatively strong dollar and higher input costs. Corporate earnings are projected to rebound in the fourth quarter of 2019 and end the year up a modest 0.7% relative to 2018 according to Capital IQ.

International developed market equities, as represented by the MSCI EAFE Index, were down 1% for the third quarter, underperforming U.S. equities, as manufacturing and consumption data across the Eurozone continued to weaken (Eurozone manufacturing data pointed to the steepest contraction since 2012 according to IHS Markit) and uncertainty surrounding Brexit remained. The German economy is on the verge of a recession as exports (China and the U.K. are amongst the two largest export destinations for Germany) contracted sharply over the second and third quarters and domestic consumption was unable to cushion the downturn. The potential escalation of the trade war by the U.S. administration to include tariffs on European goods will create further headwinds to economic expansion.

The prolonged trade conflict with the U.S. appears to have impacted China's growth in the second quarter as GDP grew 6.2%, the slowest quarterly growth rate since 1992. The Chinese government has responded with fiscal and monetary policy that has somewhat dampened the magnitude of the impact and recent economic data within China has been stronger. The political and potential economic impact of the Hong Kong protests, however, has added a new element of uncertainty to the region. We expect, at a minimum, congressional support for the protesters to further complicate trade negotiations. Emerging market equities, as represented by the MSCI EM Index, were down over 4% for the third 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.

Index/Market	3rd Quarter Performance
Dow Jones Industrial Average	1.83%
S&P 500	1.70%
S&P 400 (Mid Cap)	-0.09%
NASDAQ	0.18%
Wilshire 5000	1.23%
Russell 2000 (Small Cap)	-2.41%
MSCI Europe*	-1.80%
MSCI EAFE Index*	-1.07%
MSCI Emerging Markets*	-4.25%
MSCI All Country World*	-0.03%
MSCI All Country World ex U.S.*	-1.80%

* Returns in U.S. dollars

At the close of the quarter, the price-earnings ratio of the S&P 500 was approximately 18.2x analyst consensus earnings estimates for calendar year 2019, and 16.5x for calendar year 2020 according to Capital IQ, a moderate multiple expansion relative to the second quarter. This reflects a 0.7% and 10.3% anticipated earnings growth rate, respectively, for the 2019 and 2020 calendar years. We view the 2019 price-earnings ratio valuation as somewhat elevated but 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

near term uncertainties of trade negotiations, ongoing political discord and investor expectations surrounding the pace of interest rate cuts may impact investor sentiment and weigh on the equity markets.

The volatility in the third quarter was not limited to the equity markets as government bond yields in Europe plunged and the yield on the 10-year Treasury note fell to near record lows.
This represents the fourth consecutive quarter of yield declines for the 10-year Treasury note, totaling, in aggregate, more than one hundred and thirty basis points (1.30%). 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 or zero yielding government debt, which includes the majority of the Eurozone, is currently $15 trillion. This "frozen capital", as described by the World Bank, is diverting resources from economic growth and may likely expand given the increase in asset purchases and loose monetary policy by the European Central Bank and Bank of Japan.

U.S. Fixed Income markets posted strong gains for the quarter across government, municipal and corporate bonds as the Federal Reserve reduced interest rates by 0.25% in both July and September. Through the end of the third quarter, the Barclays U.S. Aggregate Bond Index was up approximately 8.5%. The simultaneous rise of safer assets, such as U.S. Treasuries, alongside that of U.S. equities, reflects investors' unease regarding geopolitical tensions and low expectations for economic growth. The discrepancy between the fixed income markets and the Federal Reserve regarding the prospects for U.S. economic growth and inflation was clearly evident in the third quarter. While the Federal Reserve announced that the July reduction was a "mid-cycle" adjustment rather than the start of a rate cutting cycle, the market reacted with skepticism, driving the yield on the ten-year Treasury note down from 2.06% on the day prior to the July cut to 1.68% at end of quarter.

Municipal bond prices, as represented by the Barclays U.S. Municipal Bond Index, continued to march higher in the third quarter (up 1.6%). The pace of municipal bond issuance has started to accelerate as officials take advantage of historically low borrowing costs. However, the demand for municipals continues to be strong and has not, as yet, meaningfully impacted the supply/demand balance in the marketplace.

Index/Market	3rd Quarter Performance
Barclays US Aggregate Index	2.27%
Barclays US Corporate Bond Index	3.05%
Barclays US Treasury Index	2.40%
Barclays US Municipal Bond Index	1.58%

Outlook
While U.S. economic and manufacturing growth is clearly decelerating, the economic slowdown may be a natural progression, rather than a signal of a near-term recession, as the economy re-gathers itself within a continuing but slower long term expansion. A slowdown such as this occurred most recently in 2016. We do recognize, though, that there are a number of pressures that could negatively impact consumer and business spending and push the U.S. economy either closer to or into a recession. As we have discussed in prior quarterly reviews, we are

experiencing a dynamic in the financial markets where non-cyclical mechanisms are impacting the U.S. economy's progression through the economic cycle. While the economy continues its natural advancement through the latter stages of the cycle, man-made issues, whether through trade negotiations or political dysfunction, are greatly influencing this progression – raising fears of a near-term economic contraction.

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

Global Trade Tensions
The de-escalation of U.S. and China trade tensions and announcement of a "substantial phase one deal", after the end of the third quarter, was a positive development for the markets. The details of any proposed deal, however, are expected to be highly scrutinized by investors. While the announcement of a delay of tariff increases scheduled for October is welcome news, the fate of existing tariffs, those scheduled for December, intellectual property enforcement and benefits to state owned companies appear to have been left unresolved. Small, interim steps are unlikely to diminish the uncertainty that has been restraining business investment and global manufacturing growth. In the meantime, the U.S. administration is continuing to escalate tensions on the European front, targeting a broad list of goods. The continuing uncertainty over trade policy has the potential to further weaken business sentiment and delay corporate investment plans which may eventually lead to cut backs in employment and consequently lower consumer spending.

Corporate Earnings & Consumer Spending
While trade-related and political news has dominated headlines, investors' focus will shortly return to corporate earnings. As stock prices ultimately follow earnings, the market will be closely monitoring the release of third quarter earnings and, more importantly, guidance for the rest of 2019 and 2020 by corporate executives. Particular attention will be paid to the impact of trade frictions and the strong dollar on multinational companies. While third quarter consensus expectations are for a meaningful decline in year over year earnings, it does not appear that the slowing global economy and uncertainty over trade policy are, as yet, deflating corporate profits. U.S. consumer spending has remained resilient even as manufacturing has contracted, business investment has weakened and the housing market has softened (despite lower mortgage rates). We will be keeping a watchful eye on consumer sentiment and spending and capital expenditures by businesses as this may be a signal that the economy is decelerating faster than expected.

Monetary Policy
The traditional catalysts for a recession have been a spike in interest rates and the unwinding of financial and economic excess. The current fear of a U.S. recession, however, is driven predominately by geopolitical tensions that are prompting U.S. companies to curb spending within an environment of uncertainty. This poses a problem for the Federal Reserve as the central bank seeks to address political uncertainties through the easing of credit. 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.

The fixed income markets are currently forecasting three quarter point rate cuts by the end of 2020. As the Federal Reserve attempts to navigate monetary policy within a slowing but moderately growing economy and a healthy labor market, there is the potential for market disappointment regarding the path of interest rates. As the market expectation for lower interest rates continues to support risk assets, a re-calculation of the timing and pace of rate reductions by the Federal Reserve may weigh on the equity markets.

Portfolio Construction

Market volatility will likely continue as trade negotiations, impeachment proceedings and geopolitical issues dominate the media headlines. In the face of turbulent, headline driven markets underscored by a steady, if unspectacular, U.S. economy, a well-diversified portfolio will best serve investors. 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 and strong consumer spending continues to provide 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 material 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 has provided formidable ballast to equity risk during recent volatile periods.

While we remain positive on the U.S. economy and corporate earnings, we recognize the risks posed by global trade tensions, a weakening global economy and an equity market potentially entering the later stages of the market cycle. As the mercurial performance of the equity markets during the third quarter reminds us, market sentiment can change swiftly. Given this opportunity for continued growth while acknowledging that uncertainty and market volatility will likely remain for the foreseeable future, we view the proper investment approach to be a balanced portfolio of diversified equity exposure and high quality fixed income.

October 23, 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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