2019 FOURTH QUARTER COMMENTARY AND OUTLOOK
Fading Headwinds

Global equity markets surged higher in the fourth quarter of 2019, propelled by positive trade developments, monetary easing and continued U.S. economic growth. The U.S. equity markets, as represented by the S&P 500, appreciated over 9% for the quarter and ended the year up 31.5%. This marked the best annual performance of the S&P 500 since 2013.

With the exception of a modest decline in Real Estate, all sectors of the S&P 500 posted positive returns for the quarter. Information Technology and Health Care led the way as investors' appetite for risk returned, while the bond proxy sectors of Utilities and Real Estate lagged as intermediate to long term yields rose. Domestic growth stocks, as represented by the Russell 1000 Growth Index, substantially outperformed their Value counterparts, as represented by the Russell 1000 Value. While the performance gap narrowed in the third quarter, growth stocks continue to dominate, outperforming value stocks by ten percentage points in 2019.

Global trade policy, which remained foremost in investors' minds throughout the first three quarters of 2019, finally brought substantive progress on two fronts during the month of December. The administration and House Democrats, in an uncommon bipartisan accomplishment, negotiated an agreement that cleared the way for passage of the United States-Mexico-Canada Agreement ("USMCA"). The passage of the USMCA, which is not as publicized as China trade negotiations, does have significant implications for the U.S. economy as Mexico and Canada constitute 30% of U.S. trade. The announcement of a "Phase One" trade deal with China during the quarter, and signing at the start of 2020, is also a welcome development. The agreement provides a reprieve from the escalating trade war and eliminates some of the uncertainty within the global economy. However, a number of the key issues, such Chinese state subsidies of industries and cyber security, as well as the mechanisms for enforcement, remain unresolved. The administration has stated that these issues will be covered in a second phase of the deal, although the timing of those talks remains uncertain. Since substantial tariffs remain after the Phase One signing, we do not expect these developments to lead to further economic growth, although the reduction in uncertainty may improve business sentiment and investment. As tensions between the U.S. and China will likely continue, we view this recent progress with cautious optimism.

As negotiations progress with China, new trade frictions are mounting with Europe. In response to France's digital tax on U.S. technology companies and the World Trade Organization's ruling that European governments are subsidizing Airbus, the administration has threatened tariffs on a broad range of European goods. While France and the U.S. announced a temporary truce at the start of 2020, the potential for additional new fronts in the global trade battle is unsettling.

The U.S. Federal Reserve cut interest rates by 0.25% in October, marking the third reduction for 2019. Unless there is a meaningful deterioration in the economy, this is expected to be the last rate cut for the foreseeable future. After the December meeting, Federal Reserve Chair Jerome Powell announced that "as long as incoming information about the economy remains broadly consistent with this outlook, the current stance of monetary policy likely will remain appropriate." Over 2019, the central bank's pivot to monetary easing has been a key driver of the U.S. equity market performance. While we do not expect monetary stimulus to be a catalyst for economic growth in

2020, the current low interest rate environment and accommodative stance by the Federal Reserve should continue to provide support for risk assets.

The U.S. economy continues to expand as Gross Domestic Product grew by 2.1%, quarter over quarter, in the third quarter and is expected to grow by 2.3% in the fourth quarter according to the Atlanta Federal Reserve. Labor markets continue to be strong, with unemployment at 3.5%, consumer confidence is high and inflation remains below the Federal Reserve's target of 2%. Boosted by the end of the General Motors strike, employers added 256,000 jobs in November, raising the three month average (September through November) of non-farm payroll increases to approximately 200,000 jobs. Consumer spending, which accounts for over two-thirds of U.S. economic activity, grew at a 3.2% annualized rate in the third quarter. While the manufacturing sector continues to be weak (ISM Manufacturing Index declined to 47.2 in December), fears of an imminent recession have dissipated. Consumers may ultimately be impacted though through the contraction of jobs and wages if expenditures by businesses continue to decline. The lack of business spending on long term capital investments, due to trade conflicts and a general environment of uncertainty, is a constraint 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 third quarter of 2019 declined modestly, decreasing by 0.6% (year over year), according to Capital IQ, as a strong dollar, higher input costs and weakness in international economies impacted U.S. based multinational companies. While year over year growth for the third quarter was slightly negative, the earnings did meaningfully surpass third quarter consensus expectations. For 2019, corporate earnings, according to Capital IQ, are projected to end the year up 0.5% and further rebound over the course of 2020.

International developed market equities, as represented by the MSCI EAFE Index, were up over 8% for the fourth quarter, benefiting from improved global economic data and progression in trade negotiations. The U.K. and German equity markets were both up 10% in the quarter as Boris Johnson removed some uncertainty by promising to "get Brexit done" by the end of 2020 and Germany reported improved economic data. Euro zone economic growth, however, remains subdued and is at risk of contracting in the fourth quarter according to IHS Markit. A potential escalation of trade tensions by the U.S. administration may create further headwinds to economic expansion.

The prolonged trade conflict with the U.S. continues to impact China's growth as GDP is estimated to decelerate to 6.1% for 2019 according to the World Bank. This is the slowest annual growth since 1990 according to Reuters. The Chinese government has responded with fiscal and monetary policy that has somewhat dampened the magnitude of the reduction in demand. Policy makers in China are attempting to balance the short-term requirement for stimulus against the longer-term need to reduce leverage in the economy. China faces a long-term structural issue of pivoting from a credit-driven and public investment-led economy towards one more reliant upon consumers, private investment and domestic consumption.

Index/Market	4th Quarter Performance	2019 Performance
Dow Jones Industrial Ave	6.67%	25.34%
S&P 500	9.06%	31.48%
S&P 400 (Mid Cap)	7.05%	26.17%
NASDAQ	12.49%	36.74%
Wilshire 5000	9.08%	31.02%
Russell 2000 (Small Cap)	9.93%	25.49%
MSCI Europe*	8.84%	23.77%
MSCI EAFE*	8.17%	22.01%
MSCI Emerging Markets*	11.84%	18.42%
MSCI All Country World*	8.95%	26.60%
MSCI All Country World ex USA*	8.92%	21.51%

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

At the close of the quarter, the price-earnings ratio of the S&P 500 was approximately 19.9x analyst consensus earnings estimates for calendar year 2019, and 18.4x for calendar year 2020 according to Capital IQ, an approximate two point multiple expansion relative to the third quarter. This reflects a 0.5% and 7.8% anticipated earnings growth rate, respectively, for the 2019 and 2020 calendar years. We view the 2020 price-earnings ratio valuation as elevated but not excessive and valuations continue to be supported by low interest rates, strong consumer spending and further growth in corporate fundamentals. We do, however, expect earnings growth, rather than multiple expansion, to be necessary for continued equity market appreciation in 2020.

The U.S. Fixed Income markets, as measured by the Barclays U.S. Aggregate Bond Index, were up 0.2% for the fourth quarter. The performance for the quarter across sectors was mixed as the Barclays US Treasury Index declined 0.79% while the US Corporate Bond Index rose 1.18%, amid an easing of investor concerns regarding economic growth. The U.S. Treasury curve steepened during the fourth quarter as the interest-rate spread between the two-year and ten-year Treasury notes expanded, ending the year at a spread of 34 basis points. Municipal bond prices, as represented by the Barclays U.S. Municipal Bond Index, continued to march higher in the fourth quarter (up 0.74%). The demand for municipals in light of tax reform and improving economic fundamentals continues to be strong.

Index/Market	4th Quarter Performance	2019 Performance
Barclays US Aggregate Index	0.18%	8.72%
Barclays US Corporate Bond Index	1.18%	14.54%
Barclays US Treasury Index	-0.79%	6.86%
Barclays US Municipal Bond Index	0.74%	7.54%

Note: Performance is based on total returns.

Outlook

After a decade of economic expansion and nearly eleven years of an equity bull market, it is understandable (and prudent) for investors to question further growth. As we enter 2020, we are cautiously optimistic that labor market strength, consumer spending, low inflation and accommodative monetary policy will continue to expand the U.S. economy and corporate earnings. We do acknowledge, though, that there are a number of risks that could influence consumer and business spending and negatively impact the U.S. economy.

As we move into the first quarter of 2020, we will be closely monitoring a number of key issues.

Consumer Spending
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). It appears that U.S. consumers to date have been more focused on their own situations rather than global trade and geopolitical issues. We will be keeping a watchful eye on labor market trends, consumer sentiment and consumer spending as these will provide indications of a potentially weakening economic outlook.

Corporate Earnings
Investors will be closely monitoring the release of fourth quarter 2019 earnings and, more importantly, the guidance for 2020 by corporate executives. We expect the equity markets to be heavily reliant upon earnings growth for continued returns in 2020.

Trade Policy Developments
A re-escalation of trade conflicts has the potential to further weaken global business confidence and investment spending. The continued lack of investment spending by corporations may eventually lead to cut backs in employment and consequently lower consumer spending.

Inflationary Pressures & Monetary Policy
Central banks may resume tightening monetary policy if they believe the risks to growth have waned and inflationary pressures are rising. While this appears to be a low probability at this point, market sentiment regarding the direction of interest rates can change quickly as we experienced in 2019. A spike in interest rates, as well as the unwinding of financial and economic excess, has historically been the traditional catalysts for a recession.

Political & Geopolitical
The markets will likely move in anticipation of who is expected to win the U.S. presidential election and what policies they may pursue. The potential victory of a candidate whose policies are viewed as negatively impacting consumer and business investment and corporate profits may weigh heavily on the equity markets. Escalations of geopolitical tensions, such as an aggressive response by China to the unrest in Hong Kong or an expanded Iranian response to the killing of General Soleimani, will further damage business confidence and potentially impact corporate fundamentals.

Portfolio Construction
We continue to maintain a meaningful allocation to equities in most client portfolios, as domestic economic conditions remain supportive of corporate earnings growth. The accommodative stance

by the Federal Reserve, the low interest rate environment and strong consumer spending continue 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 markets. Client equity portfolios remain well balanced across market capitalization and investment style. As a hedge against equity volatility and risk, we continue to have a material allocation to U.S. government securities and high quality municipal bonds. The limitation on state and local tax deductions enacted in the 2017 tax bill continues to fuel demand for municipal bonds which has out-paced issuance. We do not expect a change in this supply and demand framework for municipal bonds in the near future.

We enter 2020 in a much changed environment as compared to the end of 2018 where the risk of a global economic recession was rising. While we are cautiously optimistic of continued economic expansion, we recognize that the risks posed by global trade and geopolitical tensions remain. We remain focused, in client portfolios, on balancing the reward of continuing economic and corporate earnings expansion with the risks of an uncertain global environment.

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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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