2020 Fourth Quarter Commentary and Outlook

U.S. equity markets rallied sharply for the third straight quarter, closing out a tumultuous 2020 at near record highs. The S&P 500 rose by more than 12% in the fourth quarter to finish the year up 18.4%, marking a rebound of over 70% from its March 23rd lows. Global equities, as represented by the MSCI All Country World index, also posted a strong quarter, appreciating by 14.7% during the past three months to end 2020 with a 16.3% return.

Index / Market	Q4 2020	2020
Dow Jones Industrial Average	10.73%	9.72%
S&P 500	12.15%	18.40%
S&P 400 (Mid Cap)	24.37%	13.66%
NASDAQ	15.63%	44.92%
Wilshire 5000	14.47%	20.82%
Russell 2000 (Small Cap)	31.37%	19.96%
MSCI Europe	15.62%	5.38%
MSCI EAFE	16.05%	7.82%
MSCI Emerging Markets	19.70%	18.31%
MSCI All Country World	14.68%	16.25%
MSCI All Country World ex USA	17.01%	10.65%

After a shaky start in October, equity markets rallied in November and December based on news of successful Phase 3 coronavirus vaccine trials, the declaration of Joe Biden's win in the contentious Presidential election, the lack of a sweeping Democratic "Blue Wave" in Congress, and the FDA's emergency use authorization of the Pfizer and Moderna COVID-19 vaccines.

Better-than-expected third quarter earnings which were reported during the fourth quarter also bolstered investor confidence, as a record 84% of S&P 500 constituents reported earnings for the period that topped estimates. Earnings for these companies were down -5.7% year-over-year for the third quarter reporting season, but the results were markedly better than the expected decline of -21%.

In the most recent quarter all sectors of the S&P 500 had positive investment returns, led by energy, financials, industrials and materials, each of which benefitted from a procyclical rotation. For the year, the technology sector was the clear outperformer, rising by nearly 44%, followed by consumer discretionary and communications, which were up 33.3% and 23.6%, respectively. Energy was by far the worst performing sector for the year, finishing down -33.7%. Value stocks in particular benefitted from positive news throughout the quarter, with the Russell 1000 Value Index gaining 16.3%, while the Russell 1000 Growth Index climbed by 11.4%. For the year, growth maintained its dominance, outperforming value by 30%. From a market capitalization perspective, small and mid-cap companies rose sharply during the fourth quarter, with the S&P 400 and Russell 2000 Index returning 24.4% and 31.4%, respectively. For the year, the S&P 500 outperformed the mid-cap index by nearly 5%, but trailed the small-cap index by just over 1%.

Equity market valuations ended the quarter high, with the price-earnings (P/E) ratio of the S&P 500 at 22.5 based on forward looking twelve month earnings forecasts. These are well above the 5-year (17.6) and 10-year (15.7) forward looking averages. We anticipate higher multiples when interest rates are low as companies' future cash flows are discounted at lower rates. In addition, we must evaluate valuations on a relative basis among investment alternatives, and equity P/E multiples were not high when compared to the multiples paid at the end of the quarter for 10 year Treasury bonds (107.5) and investment grade (BBB) corporate bonds (39.1). Thus, in evaluating current investment choices, historical equity valuation metrics are informative but not determinative.

In fixed income, the short end of U.S. Treasury yield curve remained largely unchanged for the quarter as inflation remained low and the Federal Reserve kept short-term interest rates at near zero levels. The longer end of the yield curve steepened, signaling perhaps both investor optimism for economic expansion fueled by Federal stimulus and the reality that U.S. budget deficits continue to expand and interest rates will have to satisfy investor demand for U.S. debt. The positive sentiment also led credit spreads in both high yield and investment grade corporate debt to tighten meaningfully during the quarter, while the municipal bond market benefitted from the prospect of Federal aid to states and municipalities in proposed stimulus packages. Mortgage rates continued to remain low, helping to sustain the strong housing market.

Index / Market	**Q4 2020**	**2020**
Bloomberg Barclays U.S. Aggregate Index	0.67%	7.51%
Bloomberg Barclays U.S. Corporate Bond Index	3.05%	9.89%
Bloomberg Barclays U.S. High Yield Index	6.45%	7.11%
Bloomberg Barclays U.S. Treasury Index	-0.83%	8.00%
Bloomberg Barclays U.S. Municipal Bond Index	1.82%	5.21%

Outlook

Following an unprecedented year marked by the devastating human impact of the coronavirus pandemic, social and political unrest, and remarkably resilient equity markets, we enter the first quarter of 2021 with guarded optimism. As always, we will continue to closely track and evaluate a number of key themes that will help provide clarity on the direction of the economy and financial markets going forward.

U.S. Political Landscape

The Biden Administration has immediately begun to implement its plans through executive orders, notably taking many steps to combat the coronavirus pandemic and rejoining the Paris Climate Agreement and the World Health Organization. The 117th Congress has been sworn in with a Democratic majority so slim that the most progressive items in the Biden-Harris platform are unlikely to find sufficient support to be enacted. Compromise, gridlock, or both are likely legislative outcomes in the year to come. The Biden Administration's agenda of curbing the pandemic, providing further economic stimulus, strengthening small business, investing in jobs of the future and reforming immigration law should be viewed favorably by the markets, but concerns surrounding the long-term impact of substantial increases in government spending remain. The potential for higher interest rates, corporate tax increases and increased regulation could prove a headwind to equity markets. We believe increases in personal income tax rates and a reduction in the amount exempt from Federal estate tax ($11.7 million in 2021) remain in play.

COVID-19 Vaccine Rollout Begins while Infections Rise
Fears of a surge in COVID-19 cases following the holidays and through the winter season unfortunately have come to fruition, as the U.S. experienced record numbers of infections and deaths during the early weeks of January. While the FDA's emergency use authorization of vaccines has given hope that a return to normalcy is on the horizon, the inefficient rollout of vaccinations across the country has muted some of the optimism. The Biden Administration has promised improved direction, funding, coordination and communication for vaccine distribution, but, in the interim, the increase in the number of coronavirus cases will continue to be a major risk to the economic outlook in the short to medium-term.

Labor Markets
The U.S. unemployment rate continued to fall during the fourth quarter, finishing the year at 6.7%, down from its 14.8% peak in April, and 7.8% level at the end of September. The Federal Reserve recently revised its economic outlook for 2021, projecting that the unemployment rate will fall to 5.0% for the coming year, down from its previous 5.5% estimate. However, initial jobless claims have risen in early January to the highest levels since the summer, a sign of the impact of recently increased restrictions on business activity aimed at combating the pandemic. As the vaccination rollout continues, coronavirus cases decline, and expected fiscal stimulus takes hold, the unemployment numbers should improve. The U.S. is not expected to return to pre-pandemic employment levels until 2023.

Corporate Earnings & Consumer Spending
Expected fourth quarter earnings for the S&P 500 have been revised higher over the course of the past three months, reflecting increased optimism from analysts and companies. While the quarterly earnings projections are expected to show a -2.3% decline from the fourth quarter of 2019, this would be an improvement from the -12.8% year-over-year decline in earnings that was projected as of September 30. For 2021, analysts expect to see 22.1% earnings growth, albeit over the pandemic affected earnings of 2020. Although the outlook is improving, retail sales fell for the fourth straight month in December, as rising COVID-19 cases, renewed lockdowns, and increased job losses weighed on consumer spending. The $900 billion COVID-19 relief package passed by Congress in December, including direct payments of $600, Federal weekly unemployment benefits of $300, and another $284 billion of small business loans, should have a positive impact on spending this quarter. Data indicates that savings have increased for many Americans during the pandemic, indicating potentially pent-up demand to spend once the economy re-opens in earnest.

Monetary Policy & Inflation
Following a year of repeated aggressive action to stabilize the overall economy and provide liquidity to markets, the Federal Reserve has continued to maintain an extremely accommodative monetary policy stance and has indicated that short-term interest rates are likely to stay at the current low levels for the foreseeable future. Overall inflation has remained well under the Fed's two percent target. Slack in the labor markets and low energy demand caused by the pandemic

suggest that inflation may be slow to accelerate, but the unprecedented fiscal stimulus and ever increasing fiscal deficits portend eventual price and interest rate increases.

Portfolio Construction

In line with our expectation that the U.S. economy will gradually return to pre- COVID-19 levels, we continue to maintain a significant allocation to U.S. equities within most client portfolios. This positioning reflects our continued belief that equities provide the most attractive risk-reward proposition. We have added to short duration fixed income and intermediate duration municipal bonds within most client portfolios, reducing cash exposure, based on our comfort in the liquidity of fixed income markets and the ability of our fund managers to evaluate the creditworthiness of municipalities and issuers of short-term corporate debt.

Within the equity portion of the portfolio we have maintained our tilt to large capitalization and growth-oriented companies since spring 2020. Client portfolios continue to be broadly diversified and well positioned to capture any rally in value-oriented or small and mid-capitalization companies. In the most recent quarter we re-allocated a portion of S&P 500 exposure in many tax-deferred retirement accounts to an investment in the Akre Focus Fund. Akre focuses on growth-oriented companies that we believe are well positioned to thrive during and after the coronavirus pandemic, and does not have meaningful exposure to the FAANG companies[1] that have grown in value to compose over one-fifth of the S&P 500 index. The KLS Investment Committee remains focused on continually assessing any developments and changes in the market environment, and we remain prepared to adjust client portfolios as appropriate.

As always, please do not hesitate to reach out to your KLS advisor with any questions you may have regarding the economic landscape, the capital markets, the merger of Boston Private and Silicon Valley Bank, or your specific needs. As we begin this new year following an enormously challenging 2020, we would like to express our sincere gratitude for your continuing confidence in KLS and wish each of you and your loved ones a healthy and happy 2021.

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[1] Facebook, Amazon, Apple, Netflix and Alphabet (parent of Google).

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