2020 Third Quarter Commentary and Outlook

U.S. equity markets continued a remarkable rebound, registering a second straight quarter of strong gains to continue the historic recovery from the COVID-19 driven stock market sell-offs in the first quarter of 2020. U.S. stocks soared in July and August, fueled by continuing monetary support from the Federal Reserve, stronger than expected employment results, consumer spending and corporate earnings, and optimism for the development of an effective COVID-19 vaccine. The S&P 500 closed at an all-time high on September 2nd, over 60% above its March 23rd low. September proved to be more turbulent for equities, however, as employment gains slowed and prospects for further U.S. fiscal stimulus dimmed as pre-election political activity rose. Despite increased volatility and a pullback in September, the S&P 500 ended the third quarter up 8.9% to cap its strongest two-quarter gain in over a decade with a 31% return during that span. Global equities, as represented by the MSCI All Country World index, also posted a strong quarter, finishing up 8.1% over the past three months.

Index / Market	**Q3 2020**	**YTD 2020**
Dow Jones Industrial Average	8.22%	-0.91%
S&P 500	8.93%	5.57%
S&P 400 (Mid Cap)	4.77%	-8.62%
NASDAQ	11.24%	25.33%
Wilshire 5000	9.14%	5.54%
Russell 2000 (Small Cap)	4.93%	-8.69%
MSCI Europe	4.51%	-8.85%
MSCI EAFE	4.80%	-7.09%
MSCI Emerging Markets	9.56%	-1.16%
MSCI All Country World	8.13%	1.37%
MSCI All Country World ex USA	6.26%	-5.44%

The stock market experienced a broad-based rally throughout the third quarter, as 10 of 11 S&P 500 equity sectors were positive for the period. Driven by the continued optimism for the successful recovery of the U.S. economy, the consumer discretionary sector led the way, climbing by over 15% for the quarter. This was followed by the materials and industrials sectors, which rose 13.3% and 12.5%, respectively. Energy was the only sector to post a negative quarter, falling by -19.7%, driven by concerns of the global economic outlook and its impact on energy demand. Through the first three quarters of the year, technology continues to be the best performing sector with a 28.7% YTD return, followed by consumer discretionary, which has risen by 23.4% during the period. The energy and financials sectors have struggled, falling -48.1% and -20.3%, respectively.

Within stocks, growth names remained the clear favorite in the third quarter with the Russell 1000 Growth Index gaining 13.2%, while the Russell 1000 Value Index rose by only 5.6%. This brings the YTD performance disparity between growth and value to nearly 36%. This dynamic demonstrates the continued confidence that investors have in growth-oriented companies, as was also reflected in the performance of the tech-heavy Nasdaq Composite Index, which rose 11.2%, bringing YTD returns to 25.3%. From a market capitalization perspective, large-cap stocks once again outperformed small and mid-cap companies, with the S&P 400 and Russell 2000 Index returning 4.8% and 4.9%, respectively, for the quarter. For the year, these mid and small cap indices have underperformed the S&P 500 by over 14%.

While the equity markets continued to demonstrate volatility, the bond markets remained quite stable during the third quarter. U.S. Treasuries were largely unchanged, as the Federal Reserve indicated that it expects to maintain an accommodative stance of monetary policy and likely will keep short-term interest rates near zero through 2023. The 2-year U.S. Treasury note yield fell three basis points to 0.13% at quarter end, while the 10-year Treasury note and the 30-year Treasury bond rose just three and five basis points, respectively, to finish the period with yields of 0.69% and 1.46%. The municipal bond market moved modestly upward as exhibited by the Bloomberg Barclays U.S. Municipal Bond Index return of 1.2% for the quarter, but the financial strain facing states and local municipalities continues to require close monitoring. Credit spreads in both high yield and investment grade corporate debt continued to narrow throughout the quarter, as the Bloomberg Barclays U.S. High Yield and U.S. Corporate Bond indices rose by 4.6% and 1.5%, respectively during the period. Stable interest rates and tighter credit spreads kept mortgage rates low, aiding a robust housing market. However, given the low interest rate environment, investors are not being adequately compensated for taking credit or duration risk.

Index / Market	**Q3 2020**	**YTD 2020**
Bloomberg Barclays U.S. Aggregate Index	0.62%	6.79%
Bloomberg Barclays U.S. Corporate Bond Index	1.54%	6.64%
Bloomberg Barclays U.S. High Yield Index	4.60%	0.62%
Bloomberg Barclays U.S. Treasury Index	0.17%	8.90%
Bloomberg Barclays U.S. Municipal Bond Index	1.23%	3.33%

The continued strong performance of the broader stock market throughout the third quarter has been seen by many investors as a reflection of steady improvement in the economy. We question, however, whether the *pace* of the recovery will continue. Businesses which can open have done so, but many are capacity constrained under local rules and face increased operating costs to comply with COVID-19 protocols. Future productivity gains, and a huge surge in consumer sentiment, may await the approval and wide distribution of therapeutic treatments and vaccines. While declines in the unemployment rate and higher than expected retail sales data support the initial stage of economic recovery being V-shaped, we now appear to be in a K-shaped phase, where those who can find work are doing so while over 23 million people are filing continuing unemployment claims. Early monetary and fiscal stimulus formed a solid floor for the U.S. economy, but further fiscal stimulus, which would provide a bridge to post-pandemic times, is stalled in Congress. With winter coming and the timeframe unknown for such stimulus and for development and deployment of medical breakthroughs, questions remain regarding the future mindset and activity of consumers already fatigued with behavioral modifications. We believe increased volatility may arise from both good and bad news, and we maintain a vigilant and cautious approach to investing.

Outlook and Ongoing Concerns

As we enter the final quarter of one of the most tumultuous years on record, we will continue to closely monitor and analyze several key themes that will drive the path of the economy and financial markets going forward.

November U.S. Elections

As November 3rd nears, the uncertainty associated with election results has continued to raise concerns for investors. The possibility that the winners of the U.S. Presidency and Congressional seats may not be known for some time raises the risks for an unstable environment, certainly socially but also with potential knock-on short-term economic effects. The re-election of Donald Trump would provide certainty to the U.S. equity markets regarding the regulatory environment and, in the near-term, corporate tax rates. A Joe Biden victory – particularly if the Democratic Party wins majority control of both houses of Congress, the so-called "Blue Wave"– will result in more uncertainty for the markets as a corporate tax increase and increased regulation could dampen corporate profits. Nevertheless, other portions of the Biden platform, including increased government spending on sustainable infrastructure, clean energy, and education and training, likely would stimulate certain sectors of the economy.

Risks of a COVID-19 Second Wave and Status of Therapeutic and Vaccine Development

Concerns remain that the number of COVID-19 infections could rise substantially in the colder months. The steady reopening of businesses and public services, such as restaurants, movie theaters and schools, already has led to a rise in new coronavirus cases, highlighting the risks as the loosening of restrictions continues across the world. News of progress on the development of effective therapeutics and a vaccine has increased optimism, but the timetable for the completion, approval and distribution of these drugs remains unknown. The Federal Reserve's September 16th press release highlights the importance of this issue: "The path of the economy will depend significantly on the course of the virus. The ongoing public health crisis will continue to weigh on economic activity, employment, and inflation in the near term, and poses considerable risks to the economic outlook over the medium term."

Labor Markets

The unemployment rate has fallen from its peak of 14.7% in April to 7.9% in September. Although 9 million people who originally lost work have returned to employment, initial and continuing jobless claims remain stubbornly high. Industries directly impacted by the pandemic (food services, hospitality, travel) are unlikely to see a meaningful recovery anytime soon, and there also remains the possibility of a setback to labor force recoveries should the winter months lead to increased COVID-19 cases and renewed business restrictions. Businesses will continue to look for workers, but these job opportunities likely will come from different industries, requiring transition and retraining of the workforce. These types of labor adjustments do not happen immediately, and reinforce the view that it will take a considerable amount of time to see a full economic recovery. The Federal Reserve estimates the unemployment rate will be 5.5% by the end of 2021, as compared to the January 2020 level of 3.6%.

Consumer Spending & Corporate Earnings
Better-than-projected retail sales and consumer spending through September raised expectations for a continuing rebound in economic growth and corporate profits. While quarterly earnings are projected to fall by approximately 20% from last year's third quarter, this is a rebound from the second quarter's year-over-year drop of over 31%, signaling the potential start of an economic turnaround. The first two weeks of reported earnings for the third quarter have been generally positive, with the majority of companies reporting thus far beating estimates. While we read these reports with optimism, we have concerns that without additional fiscal stimulus or improvement in the labor markets, the previously strengthening consumer dynamic, and thus corporate profits, may face serious headwinds. Additionally, many companies have yet to provide long-term guidance, highlighting the uncertainty they continue to face.

Monetary Policy & Inflation
Through its aggressive actions this year, the Federal Reserve's balance sheet has nearly doubled to a record $7 trillion, leading some to fear that inflation could be on the horizon. Realistically, the likelihood of runaway inflation is fairly low, as demonstrated in the period following the 2008 financial crisis, when the Fed grew its balance sheet by approximately 400% (albeit over a period of over 5 years), and inflation remained below trend throughout that time. For now, low oil prices, high unemployment and weaker demand are holding down consumer price inflation, but as the economy improves inflation will likely rise. The Federal Reserve announced in August that it would now shift to *average* inflation targeting, seeking to achieve periods of inflation above its 2% target to compensate for periods of below-target inflation, so that long term inflation expectations remain at 2%. This approach signals that short term interest rates will remain close to zero for even longer than initially expected.

Housing
Following a sharp decline in housing starts during the early months of the pandemic, the housing sector has outperformed the broader economy and continued to post strong sales numbers throughout the third quarter. Real estate buyers, sellers, and agents have leveraged technology to drive activity despite social distancing restrictions. Falling mortgage rates have fueled already strong demand, as buyers looking for more space for home offices, home classrooms and home gyms have been plentiful. We have seen a rise in home prices in desirable suburban locations, and, if new construction cannot keep up with demand, that trend is likely to continue. This flight to the suburbs has led to weakness in the densest urban markets, while smaller cities have seen population growth and a rise in housing prices.

Portfolio Construction

We continue to maintain a substantial allocation to U.S. equities within most client portfolios, reflecting our long-term conviction that equities are the best alternative for growth as well as a hedge against inflation. U.S. equities are highly valued in comparison to historical price-earnings multiples, but not on a relative basis as compared to bonds. We maintain significant cash, short duration fixed income and intermediate duration municipal bonds to temper volatility. We believe such an allocation acknowledges the risks to the markets and the economy described above while preserving the upside potential in equities should the market continue to rally.

We have maintained the tilt to large capitalization and growth-oriented companies we implemented in March and April, particularly to technology firms that should continue to successfully navigate the challenging environment and also adapt to and prosper from new trends and behaviors resulting from the pandemic. While these views have not changed in the past quarter, we do anticipate there will be winners and losers among sectors and companies as new economic realities take hold. The portfolio is broadly diversified and will capture a rebound in more value-oriented sectors that are expected to do well as the economy recovers. The KLS Investment Committee continues to be vigilant in assessing the unprecedented market environment, and we remain prepared to adjust client portfolios as appropriate.

Year-End Planning

As we await election results and move through the fourth quarter, we are mindful of potential U.S. tax changes proposed by the Biden campaign, although implementation of dramatic changes likely would require a Blue Wave. Proposals impacting individuals include:

- For individuals with income in excess of $1 million, elimination of the favorable Federal capital gains tax rate (current maximum rate 20%) and taxation of capital gains and qualified dividends at ordinary income tax rates.
- Reverting the top marginal Federal income tax rate to the pre-2018 rate of 39.6% for taxable income exceeding $400,000.
- Limiting the tax benefit of itemized deductions to 28% and re-introducing the pre-2018 phase out of itemized deductions for those earning more than $400,000.
- Phasing out the Section 199A pass-through reduction for those earning more than $400,000.
- Imposing the 12.4% Social Security payroll tax on income in excess of $400,000 (current cap of $137,000), evenly split between employers and employees.
- Reducing the Federal estate tax exemption (currently $11.58 million) in line with prior Democratic proposals (the pre-2018 exemption was one-half this amount, adjusted for inflation).

In the absence of any tax legislation, increases in marginal tax rates, elimination of the Section 199A pass-through deduction, and reduction of the Federal estate tax exemption will occur at the end of 2025 due to the temporary nature of the tax reductions under the 2017 Tax Cuts and Jobs Act. In addition, the constitutionality of the Affordable Care Act is before the U.S. Supreme Court. If the ACA is declared unconstitutional, the 3.8% net investment income tax and the 0.9% additional Medicare tax which support it presumably will be null and void.

There are many factors to consider in determining whether to take any planning action this year, presumably after election results are known. Acceleration of substantial charitable gifts and full payment of pledges in 2020 may be prudent if the tax benefit of such gifts will decline in the next few years. Selling investments to lock in lower capital gains rates in 2020 would make sense if realization of those gains would occur in the near term anyway, but not if those gains, and the resultant tax, could be deferred indefinitely. Clients who can maintain their standard of living after transferring wealth in excess of the proposed future Federal estate tax exemption (likely approximately $5.8 million) would be well served by utilizing their current exemption and having future growth occur outside of their taxable estates. These decisions must be taken based on each client's personal circumstances. Please speak with your KLS advisor to determine whether any proactive planning is appropriate for you, and also to handle your customary year end transactions. Please do this *early*, as remote working, by you, KLS and the custodians may slow down processing time in the waning weeks of the year

As always, we encourage you to reach out to your KLS advisor with any questions that you may have on the economic landscape, the capital markets, or regarding your specific circumstances. As we approach Thanksgiving, we express our sincere gratitude for your continuing confidence in KLS and for your well wishes for us personally throughout this challenging year.

October 26, 2020

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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