2021 FIRST QUARTER COMMENTARY AND OUTLOOK

The first quarter of 2021 saw all major U.S. equity indices reach record highs as the market anticipated a rapid improvement in the economic landscape. This optimism was driven by the rollout of COVID-19 vaccines throughout the country, the continued accommodative stance of the Federal Reserve, and prospects for even more fiscal stimulus from Washington following the Democrats claiming a majority in the Senate and President Biden's swearing in. Positive earnings surprises for the fourth quarter of 2020 which were reported in early 2021 also improved investor confidence, as 79% of S&P 500 companies reported better-than-expected earnings results. The overall positive economic sentiment also helped lead global equities higher during the first three months of the year. For the quarter, the S&P 500 returned over 6%, while the MSCI All Country World Index rose by nearly 4.6%.

Index / Market	Q1 2021	2020
Dow Jones Industrial Average	8.29%	9.72%
S&P 500	6.17%	18.40%
S&P 400 (Mid Cap)	13.47%	13.66%
NASDAQ	2.95%	44.92%
Wilshire 5000	6.49%	20.82%
Russell 2000 (Small Cap)	12.70%	19.96%
MSCI Europe	4.08%	5.38%
MSCI EAFE	3.48%	7.82%
MSCI Emerging Markets	2.29%	18.31%
MSCI All Country World	4.57%	16.25%
MSCI All Country World ex USA	3.49%	10.65%

While all sectors of the U.S. equity markets rose during the first quarter, the market rotation that began in late 2020 continued. Small- and mid-capitalization companies outpaced large-caps, and value oriented companies, which are more cyclical in nature and are benefiting from improving economic conditions, outperformed growth. The increase in value stocks was helped in large part by the strength of the financial sector, the heaviest weighting in the value index, as prospects for profitability of banks improved with a rise in interest rates. Overall there was large dispersion within sectors, with energy and financials climbing by 31% and 16%, respectively, while technology and consumer staples rose by less than 2% for the quarter.

Equity market valuations remained at near-record highs, with the S&P 500's forward 12-month P/E ratio finishing the quarter at 21.8, below the 22.5 value recorded at the end of the fourth quarter, but still well above the 5-year (17.9) and 10-year (16.0) averages. The cryptocurrency market also experienced substantial appreciation, highlighted by the price of Bitcoin roughly doubling in the first quarter, likely due to wider investment interest, including by some corporate treasury departments.

The equities markets saw unusual activity during the quarter with social media-organized activity in a handful of thinly traded stocks. The most notable example was the wild path of GameStop

(GME). An influx of buyers seeking to hurt institutional investors with short positions caused the price to rise from $18.84 at year-end 2020 to a peak of $483.00 in late January. GME's share price has since traded in a volatile range, falling to $40.00 in late February before finishing the quarter at $189.82. While such activity may indicate new influence of the retail investor, this mob behavior did not spread beyond a few targeted stocks and did not impact the overall functioning of the markets.

During the quarter record levels of funds flowed into special purpose acquisition companies (SPACs), which are shell corporations listed on a stock exchange in order to raise capital to acquire a yet to be identified private company. SPACs – often referred to as "blank check companies" – have allure to retail investors who don't otherwise have the ability to invest in private companies before an initial public offering. SPACs are not themselves an asset class, but rather a pathway to achieve a public listing without the IPO regulatory and sales processes. Well known investors, celebrities and professional athletes have become SPAC sponsors with significant up-front financial incentives, and investors need to remain vigilant to understand the future potential of the acquired businesses.

While strong economic prospects and the expectation of further U.S. government spending helped fuel the rise in equity markets, the same factors also caused a decline in the value of intermediate and long term U.S. Treasury debt. The 10-year U.S. Treasury yield rose from 0.93% to 1.74% during the quarter, its highest level since early 2020, and up from its 0.52% bottom in August of last year. The U.S. municipal bond market remained relatively stable, as federal support for state and local finances helped maintain the confidence of investors, and state tax collections proved more resilient than expected during the early months of the pandemic. High yield corporate debt prices were driven slightly higher during the period, bolstered by the improving corporate earnings outlook.

Index / Market	**Q1 2021**	**2020**
Bloomberg Barclays U.S. Aggregate Index	-3.37%	7.51%
Bloomberg Barclays U.S. Corporate Bond Index	-4.65%	9.89%
Bloomberg Barclays U.S. High Yield Index	0.85%	7.11%
Bloomberg Barclays U.S. Treasury Index	-4.25%	8.00%
Bloomberg Barclays U.S. Municipal Bond Index	-0.35%	5.21%

Although concerns of future inflation pushed bond yields higher, overall inflation data during the quarter remained muted. The Core PCE Price Index, the Federal Reserve's primary inflation gauge, was constant in January and February at 1.4% and rose to 1.8% in March, still below the Fed's 2% average inflation target.

Outlook

The acceleration and success of the vaccination program across the country has allowed more economic activity to resume and has increased hope that a return to normalcy could soon be reality. We maintain a positive outlook while continuing to closely monitor and assess key themes that will impact the future state of the economy and financial markets.

U.S. Government: Fiscal Stimulus and Tax Policy Changes

On March 11th, the $1.9 trillion American Rescue Plan Act of 2021 became law, narrowly passing through Congress with only Democratic support via the budget reconciliation process, which required only simple majority Senate approval. This COVID-19 relief bill includes direct payments to eligible Americans, extends federal unemployment benefits of $300/week through September 6th, expands the child tax credit, provides relief for small businesses, and funding for state and local governments and public schools. This stimulus package is intended to provide an additional boost to the U.S. consumer and families, and gives a six month financial bridge to the unemployed, by which time job opportunities are expected to significantly improve.

Relief spending has already substantially increased the budget deficit, with the CBO projecting federal debt to reach 102% of gross domestic product (GDP) by the end of fiscal year 2021, raising questions regarding the impact to interest rates and future tax rates from sustained U.S. government borrowing at such a pace. While there is the potential for a loss in investor confidence in the U.S. debt in the long-term, at present there does not appear to be much concern as indicated by the continued low interest rates at which the U.S. issues debt.

Following the enactment of the COVID-19 relief bill, President Biden unveiled two additional enormous spending plans known as the America Jobs Plan (AJP) and the American Families Plan (AFP), with the aim of reimagining and rebuilding a new economy. The American Jobs Plan proposes $2.3 trillion in new federal spending on transportation infrastructure ($621 billion), domestic manufacturing, research and development and job training ($590 billion), caregiving ($400 billion), housing, schools, VA hospitals and federal buildings ($328 billion), and broadband, the electrical grid and clean drinking water ($311 billion). It also includes $400 billion in clean energy tax credits, and creates the Energy Efficiency and Clean Energy standard, which would move the U.S. toward 100% carbon-pollution free power by 2035. The AJP would be funded by increasing the corporate tax rate from 21% to 28%, establishing a minimum tax on corporate book income, raising the tax on foreign profits, and eliminating tax preferences for fossil fuels.

The American Families Plan proposes to spend approximately $1.8 trillion on a number of programs, the largest of which are universal pre-kindergarten, tuition free two year community college, affordable childcare, a national paid family and medical leave program, and expanding the child tax credit, Affordable Care Act premium tax credits, credits for qualified child care, and the earned income tax credit for childless workers. The AFP proposes to reduce $700 billion of the so-called tax gap – taxes owed to the federal government but not paid – by providing $80 billion of funding to the IRS. The AFP seeks to raise an additional $800 billion primarily by increasing the top individual income tax rate from 37% to 39.6% (the pre-2018 rate), taxing capital gains at a 43.4% rate (currently 23.8%) for households with income exceeding $1 million, and eliminating the step-up in income tax basis at death by taxing unrealized capital gains above a $1 million exemption amount.[1]

The revenue raising proposals of the AJP and AFP, if enacted, squarely impact the financial markets and prices of appreciated assets such as real estate. An increase in the corporate tax rate

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[1] As yet there is no draft legislation to parse, but the White House Fact Sheets on the AJP and AFP do not include a proposal to decrease the federal estate tax exemption amount, currently $11.7 million.

would reduce earnings per share, thus potentially impacting stock prices based on those earnings. A future increase in capital gains tax rates could incentivize investors to accelerate selling, with after-tax proceeds presumably reinvested. Given the divided and partisan state of the U.S. government, as well as challenges in passing sweeping tax hikes in general, we anticipate changes to these proposals as negotiations begin and will provide advice as legislation progresses.

Labor Markets
Job growth in March far exceeded expectations, with nonfarm payrolls rising by 770,000 and the unemployment rate falling to 6%. Employment gains were broad-based, but industries that were hardest hit by the pandemic (such as leisure, hospitality and restaurants) saw the strongest increases. Overall employment remains about 8 million below pre-pandemic levels. The steady resumption of business activity associated with the vaccine rollout should push higher the demand for workers in the coming months. People receiving state and extended federal unemployment benefits are, on average, collecting about $600/week, equivalent to the $15/hour minimum wage favored by the Biden Administration. We will be watching to see whether wages will need to rise over the next several months to coax people back to work in lieu of collecting unemployment benefits. The Fed's public statements confirm that it will maintain accommodative monetary policy until the U.S. is closer to full employment.

Corporate Earnings & Consumer Spending
As of May 7th, the first quarter blended earnings growth rate for the S&P 500 is expected to be 49.4%, albeit as compared year-over-year with first quarter 2020 earnings which had begun to feel the brunt of shutdowns in March 2020. Forward-looking projections continue to be revised higher, as analysts and companies remain optimistic about economic prospects for the U.S. For the calendar year 2021, analysts are projecting U.S. earnings growth of 33% and revenue growth of 11.5%. Consumer purchases surged in March, as advance retail sales rose 9.8% for the month, exceeding analysts' estimates of a 6.1% gain, and following a February decline of -2.7%. The increase in consumer spending was attributed to the most recent batch of stimulus checks and the continued re-opening of businesses throughout the country. A recent survey report from the New York Federal Reserve showed that recipients of the latest round of stimulus expect to save 41% of their checks, use 34% to pay down debt, and spend 25%. Personal savings as a percentage of disposable income surged in 2020 for many, and we anticipate continuing increases in consumer spending as more people return to work and pent-up demand, especially for services, is satisfied as more of the economy reopens.

Monetary Policy & Inflation
The Federal Reserve's early, swift and aggressive response to the pandemic has proven to be successful. However, the amount of liquidity injected into the marketplace, combined with the additional programs proposed by President Biden, has led to concerns that rapidly rising inflation could be on the horizon. There continues to be spare capacity in the U.S. economy and substantial ground to make up before returning to pre-pandemic levels, and the Fed anticipates that any sharp jump in price levels will be transitory. Strong post-coronavirus growth will likely create inflationary pressures in some sectors as already is evident in some commodity prices and in the manufacturing sector, and may also occur in sectors that will now see sharp increases in demand, such as airlines. Given the Fed's average inflation target of 2%, it is unlikely that we see the Fed hike interest rates in the near future. The Fed's slow movement on interest rates does raise longer

term concerns with inflation in asset prices that may need to adjust when interest rates eventually climb.

Portfolio Construction

The growth in the U.S. economy and equity markets over the past quarter further reinforces our view to maintain a significant allocation to U.S. equities within most client portfolios. Our belief that equities continue to provide a better risk-reward proposition to bonds with greater upside potential, despite near-record valuations, was bolstered during the first quarter, as the bond market pulled back with a spike in interest rates. Within equities, and where capital gains tax could be avoided, we trimmed the overweighted exposure to growth-oriented companies which was put in place in March 2020 and increased thereafter through market performance, and reallocated some capital to large capitalization value oriented companies. Overall our clients' portfolios remain tilted towards technology and other growth stocks, as the price appreciation of these companies over the past few years, and particularly during the pandemic, have made them the heaviest weight of the major equity indices.

The KLS Investment Committee continues to vigilantly monitor and evaluate any developments and changes in the market environment, and we remain prepared to adjust client portfolios as appropriate.

As always, we encourage you to contact your KLS advisor with any questions that you may have on the economic landscape and financial markets, or to discuss your particular circumstances. We remain enormously appreciative of your confidence in KLS.

May 17, 2021

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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