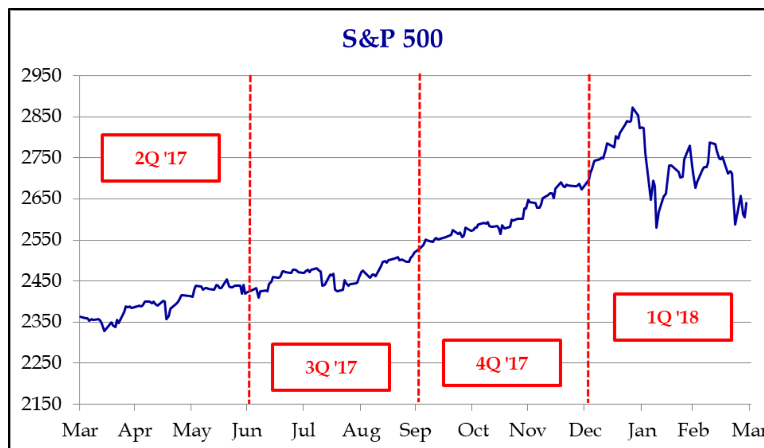
FIRST QUARTER WEATHER REPORT:

EQUITY MARKET TAILWINDS ARE BEGINNING TO SHIFT TO HEADWINDS EMERGING TRADEWINDS ARE TROUBLESOME

Our expectation of increased market volatility emerged in full force in the first quarter of the year (Chart I). At this juncture, we believe the current market correction and elevated levels of volatility may continue over the near term. The catalyst for this recent decline in equity prices probably reflects two factors. First, interest rates continue to move up as the Federal Reserve suggests that at least two more increases may occur this year. Secondly, President Trump has threatened a number of nations with a variety of tariffs. Thus, the dampening to global GDP growth because of possible trade wars is causing further equity volatility. It is a truism to say that the market in general hates uncertainty. This is clearly the current situation.

CHART I



Source: Strategas

Arguably, it is not the actual tariffs that are of concern, but rather the uncertainty that these actions could ultimately lead to a global trade war with one or more of our major trading partners. A trade war would have the effect of slowing growth in GDP for all countries involved. Additionally, the U.S. is currently in negotiations to rewrite some of the NAFTA trading agreements with Canada and Mexico. As a result, these free trade negotiations are also adding to equity market uncertainty.

By May or June, we should (along with the equity markets) know a lot more. The NAFTA agreement should be modified in relatively short order. Even prior to Trump's election, many believed that the NAFTA trade policies needed to be updated. Currently, the pending tariffs won't be effective until after May. Thus, many parties are in negotiations to bring a fair resolution to these issues over the next few months.

t: 516.439.5100 f:516.439.5102
111 Great Neck Road, Suite 310, Great Neck, NY 11021
t: 800.259.1331 t: 615.620.3900 f: 615.620.3920
112 Westwood Place, Suite 210, Brentwood, TN 37027
www.kingspointcap.com

CHART II

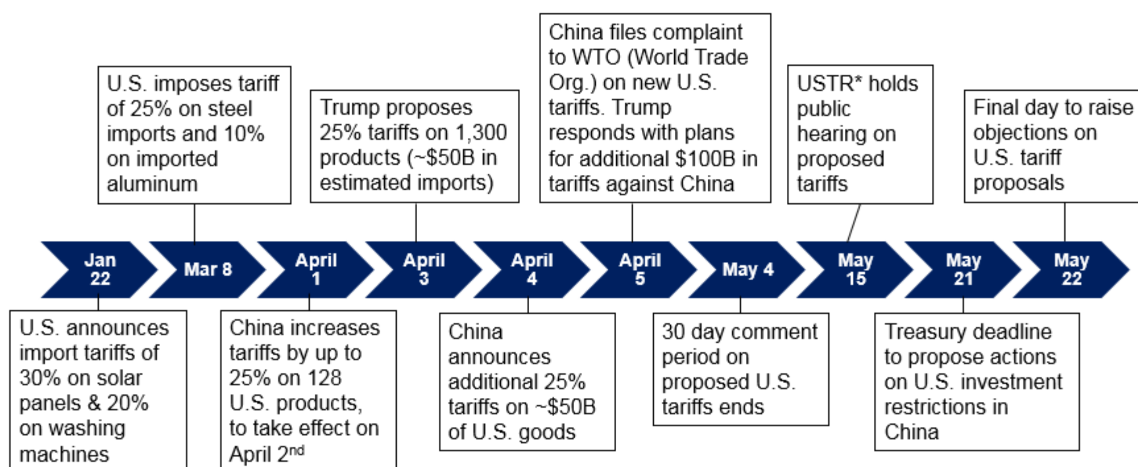


Chart II gives the timeline of current trade talks with China. Many believe that recent events represent the Trump technique of negotiating. We don't really know how it ends. Realistically, the two sides should come to a fair and reasonable compromise. Assuming no trade war erupts, we remain positive. U.S. economic expansion continues to accelerate, and GDP growth may exceed 3% in the next two (or more) quarters. Global economic growth is also continuing its upward trend. Market valuation, particularly given the current market correction, also appears reasonable (Chart III).

CHART III

S&P 500 Historical and Current Valuation

	March 2000	March 2009	Current	20-Yr Avg	Current Rel Avg
Trailing P/E (S&P)	29.6	13.7	21.3	19.7	1.08
Forward Consensus P/E	24.4	10.1	17.2	16.4	1.01
Trailing Normalized P/E	46.5	11.0	28.6	25.5	1.12
Shiller P/E	43.2	13.3	32.8	26.8	1.22
Price/Book Value	5.1	2.0	3.1	2.9	1.05
EV/EBITDA	15.7	10.1	14.5	12.5	1.15
Trailing PEG *	NA	0.9	1.6	1.4	1.09
Forward PEG *	NA	0.9	1.3	1.3	0.99
P/OCF	20.4	6.6	13.6	13.5	1.01
P/FCF	73.0	11.9	22.6	34.7	0.65
EV/Sales	2.9	1.4	2.5	2.1	1.19
S&P 500 in WTI Terms	54.5	14.4	40.7	32.4	1.26
S&P 500 in Gold Terms	5.4	0.7	2.0	2.3	0.86
ERP (bps)	-262.3	223.1	185.5	164.7	1.13
Normalized ERP (bps)	-390.5	356.8	64.7	50.1	1.29

**Uses 10-Year Average, All data as of 3/31/18* *Source: Strategas*

Most strategists are forecasting about $150 to $160 a share for the S&P 500. That puts the market at about 17X 2018 estimated earnings, which is a reasonable valuation given the current growth

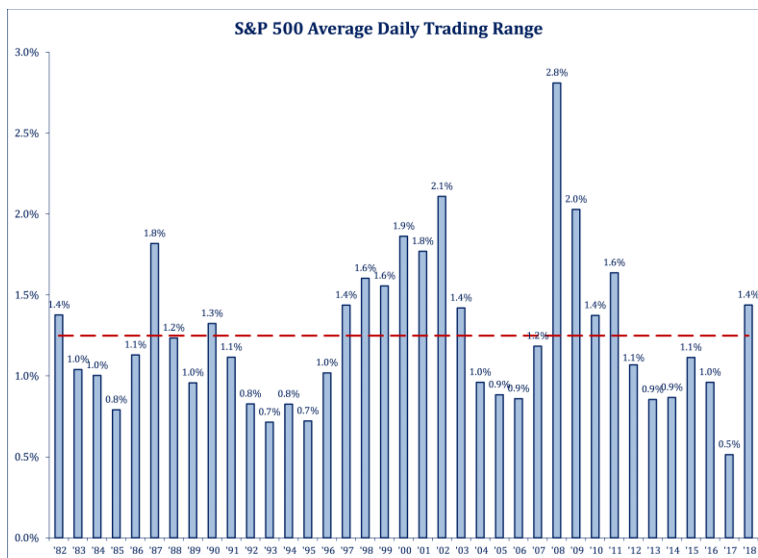
outlook economically. As a result, we remain a cautious bull expecting a 5% return in 2018 within a 0-10% band.

Interest rates, while up in the last few months, have still only risen modestly both here and overseas. Along with well contained inflation, the current economic trend appears to be along the lines of our original expectations. In fact, the U.S. unemployment rate and monthly job creation are both trending positive. Finally, the outlook for corporate profits remains very positive. Fueled by a significant reduction in corporate tax rates, most companies should generate good profit growth in 2018. Indeed, we believe that 2018 should represent the peak in ***rate of growth*** in the U.S. economy, concurrent with a peak in ***rate of growth*** in corporate profits. As long as the U.S. economy expands, even at a reduced rate of growth, the equity market should rise modestly in the intermediate term. This continues to assume a contained interest rate and inflation environment.

These factors are the critical underpinnings of future equity market expansion. With no recession likely in 2018 and (at this juncture) 2019, we think the current decline in equity prices exacerbated by rising volatility appears to be a "normal correction." **We will be wrong if a trade war breaks out to jeopardize U.S. and global economic expansion**. In our opinion, it is still not apparent that the U.S. will embark on this path. We continue to take a constructive approach to the market overall.

Volatility – Not as Bad as You Think

CHART IV: VOLATILITY REVERTING BACK TO THE MEAN



Source: Strategas

As the above Chart IV demonstrates, the recent volatility is now only reaching the long-term averages. Market volatility has been well below average for the past six years, and 2017 was the

lowest point in the last 25 years. As a result, the current trading patterns feel much worse than usual. Overall, we continue to believe that this is still a "normal correction" cycle in the continuing bull market.

The "Maturing" of E-Commerce and IoT (the Internet of Things)

We can't remember when an industry was born and grew so fast in such a short span of time as did the Internet and e-commerce industries. It's hard to believe that companies such as Netflix, Facebook, Google (Alphabet) and Amazon are less than 21 years old!

NEW KIDS ON THE BLOCK

Company	Initial Public Offering	Current Market Capitalization*
Amazon	May 1997	$683 Billion
Alibaba	September 2014	$440 Billion
Facebook	May 2012	$450 Billion
Google	August 2014	$714 Billion
Netflix	May 2002	$125 Billion

*as of 4/4/2018

With few and/or limited exceptions, these companies do not have any manufacturing or distribution networks. Their assets are largely the intellectual capital of their new technology workforce.

Such rapid growth creates a lot of opportunity and corporate power. Not surprisingly, most of these companies are still largely managed (at least creatively) by their entrepreneurial founders. It is rare to see these large companies continue to dominate and expand rapidly without a professional organizational structure. Simply put, few entrepreneurs want to cede organizational control. The recent privacy abuses at Facebook are a good example. Similar issues have been apparent at Twitter and other mobile communication companies. Google management, to their credit, has begun a system of developing a strong organizational foundation. Regardless, as these companies become more powerful and as abuses become more apparent, we believe government regulation is likely to occur in short order. This will have the tendency to "mature" growth rates to some degree, while also incurring costs associated with implementation of these new regulations.

How these current managements deal with the prospect of regulation will be a critical factor for each going forward. A professional senior and middle management layer will be essential to maintaining the proper growth trajectory.

t: 516.439.5100 f:516.439.5102
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t: 800.259.1331 t: 615.620.3900 f: 615.620.3920
112 Westwood Place, Suite 210, Brentwood, TN 37027
www.kingspointcap.com

Portfolio Themes

As we have discussed in past quarterly letters, the digital world is a favorite investment theme in our portfolios. More recently, we believe that valuations have been disproportionally depressed in the growth-challenged consumer staple stocks. We may be at a point where valuations are bottoming. The under-performance of this group reflects a number of fundamental factors. E-commerce has pushed traditional retail to the point that normal inventory levels in their distribution channels need to be downsized. This has put massive pressure on retailers to match sell-in (buying from vendors) to sell-through (consumer purchasing). Additionally, e-commerce has allowed small start-ups to reach millions of potential buyers through the Internet. Historically, it was extremely difficult to penetrate big box retailers for product positioning. Finally, it has been very difficult to implement even modest price increases in the past few years. When we factor in normal consumption growth of only 1-2%, it is apparent how volume pressure can build on marketers of food and non-food items found in traditional retail stores. In recent years most of these companies focused on cost reduction, mergers and acquisitions and share buybacks to boost earnings per share. The historical focus on new product introductions and volume growth initiatives took a back seat. We believe that many of these staple goods companies are beginning to realize that they can't cost-cut their way out of this secular demand shift in their industries. We are seeking out companies that can generate superior volume growth in this space as potential investments. With valuations coming down, companies that can grow top-line growth moderately should be attractive long-term investments.

Our existing core and dividend growth portfolios have held quite up well during the recent stock market correction. We continue to focus on strengthening the portfolio when opportunities present themselves.

We have attached a copy of our annual ADV brochure and privacy statement for your records. Please contact our offices with any questions.

Jack L. Salzman
Senior Managing Partner

Jeffrey P. Bates
Managing Partner

John A. Marshall, IV CFA, CFP®
Managing Director

Nathan T. Fend
Investment Advisor

Jason D. Beaird, CFA
Investment Advisor

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