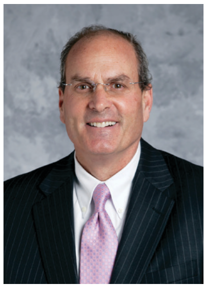
# Quarterly NEWSLETTER

Winter 2017

Commonwealth Bank & Trust Company

4350 Brownsboro Road, Suite 210 • Louisville, Kentucky 40207

502.259.2500 • www.CBandT.com



## Boldly Yet Chaotically Forward . . .

*Mark J. Kennedy, Executive VP*

*p:* ***502.259.2517***

*e:* ***mark.kennedy@cbandt.com***

Many in the media are calling 2016 an astounding year both in terms of the magnitude of political upheavals and the financial market's capacity to digest and reset. U.S. and international equity markets generated robust returns and bond markets saw the beginning of the end of easy monetary policy in the U.S. as well as signals that central bankers may soon end quantitative easing in the EU, China and elsewhere. Perhaps more important for markets in 2017, major global economies are exiting 2016 with a significant upswing in economic strength in a synchronized fashion not demonstrated since before the financial crisis. Brexit, the Trump election, the Italian referendum and the French primaries are signaling a shift from easy monetary policy and fiscal austerity to contractionary monetary policy and fiscal stimulus. Even though the economic recovery/bull market recently surpassed the third longest in over 100 years, we believe the shift to fiscal stimulus in the U.S. and abroad will keep the U.S. economy and stock market moving forward for at least another two years barring significant trade wars or geopolitical events.

U.S. equity markets read like a storied horse race in 2016. The S&P 500 stumbled out of the gate in 2016, dropping 11% by mid-February, but recovered by the end of the first quarter to post a 1% gain -- well behind emerging market equities and U.S. bonds (up 6% and 3% in 1Q16, respectively). The S&P 500 hit its stride in April, May and early June, but then fell 5% in response to the Brexit vote on June 23, snapping back 4% the last week of June to finish the first half of 2016 up 4%, however, it still trailed bonds and emerging market stocks. S&P 500 returns moved steadily higher in the third quarter (up 8% by 9/30/16) edging ahead of bonds, but started to fade into the November elections, falling 4%. Trump's election and promising economic policies boosted domestic equity markets as the S&P 500 cruised to an 11.93% finish, ahead of emerging markets (+11.60%) and handily beating the BBG Barclays Bond Aggregate (+2.65%). The more domestic-focused Russell 2000 small cap index came from behind, rallying strongly in the second half of 2016, to finish as the best performing asset class (+21.31%) in our universe. **(Continued on page 4)**

*Chart 1*

**Q4 2016**
**Market Performance – Total Returns**

| | 12.30.16 Level | Q4 | YTD |
|---|---|---|---|
| ***Dow Jones*** | 19763 | 7.94% | 13.38% |
| ***S&P 500*** | 2239 | 3.82% | 11.92% |
| ***NASDAQ Composite*** | 5383 | 1.69% | 8.94% |
| ***Russell 2000*** | 1357 | 8.82% | 21.21% |
| ***S&P Midcap*** | 1661 | 7.41% | 20.67% |
| ***Russell 1000 Growth*** | 1047 | 4.58% | 5.98% |
| ***Russell 1000 Value*** | 1040 | 3.48% | 9.97% |
| ***MSCI EAFE*** | 1701 | -0.62% | 1.59% |
| | Yield | Q4 | YTD |
| ***Barclays Municipal*** | 1.82 | -2.62% | -0.10% |
| ***Barclays Aggregate*** | 1.96 | -2.98% | 2.64% |
| ***Barclays High Yield*** | 6.17 | 1.75% | 17.08% |

*Chart 2*

**Q4 2016**
**S&P 500 Sector Performance**

| | Q4 | Year-to-Date |
|---|---|---|
| ***Healthcare*** | -4.00% | -2.68% |
| ***Information Technology*** | 2.31% | 6.01% |
| ***Telecommunication*** | -2.02% | 5.36% |
| ***Financials*** | 21.05% | 22.68% |
| ***Consumer Staples*** | 4.78% | 23.41% |
| ***Consumer Discretionary*** | 1.19% | 13.81% |
| ***Materials*** | 4.70% | 16.64% |
| ***Industrials*** | 7.28% | 27.27% |
| ***Utilities*** | 7.20% | 18.79% |
| ***Energy*** | 0.14% | 16.24% |

### *Proprietary Performance Results*

| | 4th Quarter | 1 Year | 3 Year | 5 Year | Since Inception |
|---|---|---|---|---|---|
| Focused Equity Fund [2] | 2.17% | 7.36% | 7.81% | 12.19% | 13.89% |
| Aggressive Growth Fund [1, 3] | 2.88% | 6.36% | 7.47% | 14.60% | 8.83%[1] |
| Science/Technology Fund [4] | -1.06% | 3.52% | 8.01% | 13.62% | 7.41% |
| **S&P 500** | 3.81% | 11.93% | 8.85% | 14.64% | 14.39%[2], 9.34%[3], 7.29%[4] |
| **Russell 2000** | 8.83% | 21.31% | 6.74% | 14.46% | 14.16%[2], 7.09%[3], 6.25%[4] |
| **MSCI EAFE** | -0.62% | 1.59% | -1.03% | 7.13% | 7.79%[2], 2.18%[3], 4.12%[4] |
| Strategic Income Fund [5] | 3.00% | 8.89% | 5.62% | 8.11% | 9.75% |
| **60% Russell 3000 Val / 40% Barclay Agg** | 3.13% | 12.06% | 6.49% | 9.79% | 9.97% |

*There is no assurance that any of these investment strategies will meet its investment objective. Performance results for each strategy are computed on the strategy's overall returns. Each strategy and index includes the reinvestment of dividends. Past performance does not guarantee future results. Current performance may be lower or higher than the performance results quoted. [1] Net of management fees; performance results of SMC Capital and/or its principals as advisor from inception to 2/28/06 and as sub-advisors to CBandT since 3/1/06. [2] Inception date 12/31/2008. [3] Inception date 7/1/1989. [4] Inception date 3/31/2006. [5] Inception date 12/31/2008.*

## Fixed Income

On December 14th, the Federal Reserve raised the Fed Funds rate by 0.25%. Its new range of 0.50%-0.75% puts the Prime borrowing rate at 3.75%. Market expectations, as measured by Fed Funds Futures, call for another two 0.25% increases in 2017. Given the pro-growth focus of the Trump administration, we suspect there could be more. That said, the outlook into this new political environment comes with a high degree of uncertainty. Common risks cited are the transitions from monetary to fiscal policy, globalization to nationalism including protectionist trade and currency policies, immigration, national security and geopolitical relationships.

Treasury yields moved markedly higher after the November 8th election and unexpected Trump win with the 10-year Treasury rising 0.74% from 1.86% to 2.60% through mid-December in reaction to anticipated borrowing with respect to Trump's proposed infrastructure spending. For the quarter, the 10-year Treasury rose 0.85% to finish the year at 2.44%.

U.S. investment-grade bond returns through June were the best start since 1995 and returns through September the best since 2011. Despite declining roughly 3% in the fourth quarter, they finished the year up 2.6%. The U.S. high yield market has been especially interesting this year. Returns were under pressure through February 11th with prices down nearly 6%. The junk bond universe actually yielded in excess of 10% on that day. Since then, high yield has performed exceptionally well. For the quarter, the U.S. high yield market returned roughly 1.8% pushing the 2016 return in excess of 17%, outpacing the S&P 500 by over 5%. With high yield spreads quickly approaching 4%, we are somewhat cautious on this asset class.

Tax-exempt municipal bonds were also impacted by the Trump victory. Market reaction is based on the tax-exemption being less beneficial given his proposed tax cuts, particularly to the highest marginal rate. During the quarter, tax-exempt returns declined over 3.5%. Longer-term bonds (22+ years) fell 5.5% in November before rebounding 1.8% in December. In reality, many bonds were hit much harder. We were very active during this correction in what we describe as "opportunistic buying" and "selective selling".

Midyear, we lowered our outlook for investment-grade & municipal bonds to overvalued, from somewhat overvalued given the record low yields. So, we are not surprised that returns struggled during the second half. We remained positive on high yield and are pleased with its relative performance. We suspect that tax-exempts will outperform taxable investment-grade indices during 2017. Given the move upward in rates, we are less cautious on fixed income. However, we continue to recommend a tactical underweight to core fixed income in favor of high quality dividend paying stocks and alternative strategies.

## Focused Equity

For the fourth quarter and the twelve months ending December 30, the strategy returned 2.17% and 7.36%, respectively, versus a 3.81% and 11.93% increase for the S&P 500 Equity Index. Since inception, the strategy has narrowly trailed the S&P 500's annual return of 14.44% by -0.55% with a gain of 13.89%. However, the fund has achieved these results taking on meaningfully less risk than the S&P 500 with a beta of 0.87 and capturing only 89% of the index's annualized standard deviation, thus producing annualized alpha (the amount of risk-adjusted performance greater than the benchmark) of 1.20 since inception (12/31/2008).

JP Morgan Chase (JPM)
10/1/2016 – 12/30/2016

**Leaders:** The financial sector led the index in the fourth quarter (+11.51%) as the Fed raised rates and a new political regime in Washington boded well for these firms in many regards. Overweight financials positions in JPMorgan Chase (JPM +30.48%) and Berkshire Hathaway (BRK.B +12.81%) made significant contributions to the strategy's total return. JPMorgan Chase led Focused Equity in terms of absolute return during the quarter. Strong overweight positions in Humana (HUM +15.54%) and Celgene (CELG +10.73%) were the strategy's best active selections relative to the index, as these names outperformed the S&P Health Care sector by 12.96% and 8.15% respectively.

**Laggards:** REITs (-10.39%), Utilities (-2.89%), and Telecommunications (-6.39%) companies, including Ventas (VTR -10.39%), Crown Castle (CCI -6.89%) and American Tower (AMT -6.24%) were among the leading detractors on the fund's results during the fourth quarter. These interest rate sensitive sectors and companies fell in response to sharp moves in interest rates as it became apparent the Fed would raise rates in December and in coming quarters. Facebook (FB -10.31%) was the largest negative contributor to results, as their expense guidance in the Q3 earnings report came in well ahead of expectations, coupled with news of exaggerated video-ad metrics.

## Strategic Income Builder

For the quarter, the strategy (SIB) returned 3.00%, slightly trailing the blended benchmark return of 3.13%, which is comprised of a 60% weighting to the Russell 3000 Value Index & 40% to the Barclay's Aggregate Index. Since the election small and midcap companies were especially strong as they may benefit more from Trump's proposed corporate tax cuts and stocks in general have moved higher while bonds moved lower. Since inception (1/1/09), the SIB strategy has returned an annualized 9.75%, in line with the benchmark return of 9.97%. The yield generated from the strategy has consistently exceeded that of the benchmark.

For the quarter, our equities returned 5.27% vs. 7.22% for the Russell 3000 Value. An overweight in Consumer Staples (-6.6% return) and Healthcare (-3.5%) stocks was most costly while the Energy (+12.0%) sector was most beneficial despite being significantly underweight. Consumer Staples' valuation premium relative to the market has come down significantly since November, as higher interest rates led to sector rotation out of staples and into financials and cyclicals. Within our consumer staples, Anheuser-Busch InBev (BUD -18.5%) was hardest hit. In October, BUD was down following poor results for its third quarter earnings report. The company noted "very weak" sales in Brazil. Management has said the annual dividend payout of $7.4 billion will be maintained until the company's debt has been reduced. It raised over $70 billion from asset sales and bond issuance during 2016, so we may be at a level where dividends can be increased again.

Quarterly fixed income performance of -1.66% was substantially better than the Bloomberg Barclays Aggregate Bond return of -2.98%. For 2016, fixed income results in the portfolio were 4.12% vs. 2.65% for that index. A tactical position within High Yield bond funds helped with returns of +2.3% for the quarter and +14.4% for the year. Our tax-free holdings, which are roughly 12% of fixed income, returned -2.4% during the quarter. Our international bond funds also held up well, returning -0.9% for the quarter and +5.0% in 2016. We have kept our international allocation at roughly 6% of fixed income for several quarters now.

It was a challenging year for many alternative strategies. Our alternative funds returned –1.6% for the quarter and -4% during 2016. Our portfolio allocation within alternatives is currently 4.1%. In general, we believe we can reduce portfolio volatility and enhance returns over time utilizing alternatives. While income generation is possible in these strategies, it is difficult to predict.

## Science & Technology Strategy

The Science & Technology strategy (SciTech) returned -1.06% for the fourth quarter vs. the Nasdaq 100 (0.07%), the broader Nasdaq Composite (1.69%) and the Lipper Science & Tech Fund Index (-1.21%). For the last twelve months, the SciTech returned 3.52% vs. 7.26% for the Nasdaq 100, 8.95% for the Nasdaq Composite and 9.79% for the Lipper Science & Technology index. Most of the underperformance for the fund in the quarter and over the last twelve months resulted from a 30% allocation to healthcare relative to the benchmarks. Furthermore, the healthcare allocation is heavily weighted to biotech and pharma as well as distributors and pharmacy benefit managers, which began to underperform with the Hilary Clinton's biotech "price gouging" tweet in September of 2015 and continued into 2017 with Donald Trump's press conference quip that pharma is "getting away with murder". We expect the political rhetoric to remain difficult for much of the year and will likely be resolved via legislation that replaces Obamacare. We trimmed holdings in the biopharma space in 2016, but have retained some exposure to companies that have upcoming catalysts to move beyond the political rhetoric.

**Leaders:** Technology was the leading contributor of performance for the last twelve months with Apple (AAPL) up 12.48% and Netflix (NFLX) up 21.10%. Netflix rallied throughout the year on greater than expected subscriber growth in newly opened international markets. Apple had a volatile year but ended the last two months with a rally on the back of stronger than expected iPhone 7 sales. Align Technology (ALGN, +45.98%) had a standout year as their flagship product, InvisAlign, exceeded growth expectations as the adoption of cosmetic dentistry continues to expand in European markets.

Align Technology, Inc. (ALGN)
10/1/2016 – 12/30/2016

**Laggards:** Despite underweighting the healthcare sector, biopharma and the drug supply chain reached bear market territory in 2016, falling more than 20% by year end. As mentioned above, political rhetoric has created an overhang on these sectors causing a sell-off that has driven valuations and multiples lower even though most of the companies impacted continue to deliver above market earnings growth and make significant progress with their pipelines of new drugs. The remaining drug and drug supply chain companies we hold have above average growth prospects, upcoming catalysts, and/or are trading at a significant discount to their intrinsic value. On average it costs roughly $1.3 billion and takes 10-12 years to develop a drug. Companies with drugs that treat small patient populations often have to price these drugs around $75,000-$100,000 or higher to recoup costs. As a result, Alexion (ALXN, -35.86%), which makes drugs that treat rare metabolic disorders, Gilead (GILD, -27.61%), which makes drugs to treat the AIDS and HEP C viruses, and Vertex (VRTX, -41.45%), which makes drugs to treat Cystic Fibrosis, were the most significant laggards in the portfolio in 2016.

## Small Cap Value

The Small Cap Value Composite returned 12.84% for Q4 versus 14.05% for the Russell 2000 Value index. For the full year 2016, the Composite returned 26.63% versus 31.67% for the index.

A top contributing holding during the 4th quarter was private prison REIT GEO Group Inc. (GEO), which offers correctional and detention facilities and services to federal, state, local, and foreign governments. The stock surged following the U.S. presidential election as it is widely expected the incoming Trump administration will reverse the U.S. Department of Justice's August directive to reduce – and ultimately end – its use of privately operated prisons. Another top contributor was SodaStream International Ltd. (SODA, +49%), a maker and distributor of home carbonation systems. SODA rallied after reporting a third consecutive quarter of revenue growth, growth in all geographies, and substantial margin expansion. Another positive contributor during Q4 was Blackhawk Network Holdings Inc. (HAWK, +25%), a prepaid payment network offering gift cards and rewards. In mid-October, HAWK reported better-than-expected profitability and provided a favorable update on EMV compliance (chip card mandate).

SodaStream International Ltd. (SODA)
10/1/2016 – 12/30/2016

One bottom contributing holding during the quarter was Akorn Inc. (AKRX, -20%), a specialty generic pharmaceutical company focused on higher margin niche dosage forms. During the quarter, the company disclosed a required re-inspection of its Decatur, IL manufacturing facility, which threatened to delay new product approvals and raised investor concerns. However, the re-inspection was successfully completed in mid-December. Gas station chain Murphy USA Inc. (MUSA, -14%) was another poor performer during the quarter. The company reported weaker-than-expected Q3 results largely due to gasoline shortages caused by an unplanned 12-day shutdown of the Colonial pipeline. Another negative contributor during the quarter was Motorcar Parts of America Inc. (MPAA, -6%), a remanufacturer of starters, alternators, and other auto parts. Despite reporting strong quarterly results, the stock lagged the benchmark due to facilities in Mexico. However, MPAA has the ability to move 100% of its Mexico production to existing facilities in California if necessary. We maintained our position in the quarter.

## Kentucky Municipals

Quarterly bond issuance by Kentucky municipalities declined to $1.05 billion from an extremely robust $1.926 billion in the previous quarter. Competitively awarded deals were $688 million with negotiated deals of $361 million. Deal size was averaged $17.2 million with 61 new issues in total. $57.8 million of issuance was postponed most likely due to rising rates. Much of the supply in recent years has refinanced (refunded) outstanding debt. Purchasing "refunding" candidates over the years has proven very successful and we now own a substantial amount of pre-refunded municipals with "Treasury equivalent" credit profiles. These become top picks for "selective selling" during pullbacks like the one we saw this quarter.

Bank-qualified (BQ) issuance was $89 million or 8% for the quarter with non-BQ making up the majority at $868 million or 83%. We tend to utilize non-BQ because yields are usually higher. Taxable issuance was $92 million or 9%. We prefer taxable municipals to corporates as credits are more stable and spreads are generally wider. Once again there was no AMT-subject issuance this quarter. Visible supply is reasonable to start the year with $335 million on the calendar in coming months.

Deals of note included $78 million of issuance by the University of Louisville rated Aa3 (Enhanced) by Moody's and AA- by S&P. The new money portion of the deal is $51 million (tax-exempt and taxable), which will finance the expansion of Papa John Cardinal Stadium while nearly $28 million will refund the outstanding Series 2008A stadium project bonds. In rating the deal, Moody's lowered its underlying rating on the University of Louisville to A1 from Aa3. Its enhanced rating remains Aa3 due to the Kentucky Public University Intercept Program. The outlook on the underlying rating is stable at the lower level and the enhanced rating is also stable. At the same time, Moody's downgraded the University of Louisville Foundation. Here the downgrade was more substantial going from Aa3 to A3 with the outlook revised to negative from developing. This action affects approximately $112 million of debt & debt guarantees outstanding. On December 6th, the accrediting body for the University placed the university's accreditation status on probation for one year with a possible extension of an additional year. Like Moody's, we believe the loss of accreditation is unlikely, but this further impairs the university's brand and reputation posing near term risks to enrollment and donor support.

## Republicans Take Control of Kentucky Legislature

Similar to the national election, Republicans took control of the Kentucky legislature. In addition, Republicans have super majorities in both chambers, clearing the way for them to pass an aggressive agenda over the objections of Democrats. On January 3rd, the House of Representatives unanimously elected Jeff Hoover as the state's first Republican Speaker of the House since 1921. The House and Senate approved a series of bills during the first three days after convening their legislative session. The bills targeted labor unions, abortion and lawmakers' pensions. Taking on an issue embroiling one of the state's largest public universities, the Senate quickly passed legislation to reshape the University of Louisville's board of trustees. The turnover in Kentucky cemented Republican's control over every state legislature in the South.

## **2016 Investment Review** *(Continued)*

Investors holding emerging markets, international and small/mid- cap equities, which generated negative returns in 2015 as a group for the first time since 1990, were rewarded, in most cases, with double digit returns for holding these diversifying asset classes in 2016. It was one of the few years that income stocks outperformed growth stocks and low quality/low growth companies outperformed high quality/growth companies (by about 12%). During the first half of the year, the bond market reached all-time highs (all-time low yields) as investors sought the safety of bond substitutes with high dividends: telecom, utility, REIT and consumer staples stocks. These stocks retreated somewhat in the second half of the year as economic data improved and cyclical sectors such as industrials, energy and materials and were given an election boost from the anticipated economic policies of President-elect Trump. Financials rallied the strongest from the election results, making 21% of their 23% 2016 gain after November 7.

The recovery in developed international equity indices (+1.59%) lagged the recovery of emerging market indices (+11.23%). Developed international equities spent the first half of the year in the red over fears of a European banking crisis involving Italian banks generally and Germany's Deutsche Bank specifically. The MSCI EAFE rallied 6.50% in the third quarter as banking, Brexit and economic concerns were allayed, but gave back almost 1% in the fourth quarter over expectations that Trumponomic policies would cause the dollar to strengthen. The MSCI Emerging Market index rally continued in the third quarter, posting a 16.29% return for the first 9 months, recovering losses experienced in the last half of 2015 before giving up over 4% in the fourth quarter over concerns of a stronger dollar.

## **Market Outlook**

We exit 2016 with the broadest global economic recovery outlook in five years. While global growth is not expected to return to pre-crisis levels, almost all of the major developed and emerging market economies are demonstrating strong manufacturing and service sector expansion, higher employment, increased consumer confidence and rising leading economic indicators. Recent economic strength, coupled with Trump tax cuts, infrastructure spending and regulatory reform should result in a strong dollar in the near term and higher GDP growth and inflation in the longer term.

**For more details on CBandT's investment outlook, please visit our Investment Commentary page at https://cbandt.com/wealth-trust/resources/.**

***Our comprehensive wealth management service integrates Commonwealth Trust Company's wide-ranging capabilities and highly qualified staff, with a network of external resources and advisors you may designate, such as your personal attorney or accountant. Coordinating these resources, our team of professionals can provide you with the following services:***

***INVESTMENT MANAGEMENT:***

Our staff of investment professionals can serve as a full-service investment advisor, establishing investment objectives, developing asset allocation, analyzing risk, constructing portfolios and monitoring and reporting on performance.

***TRUST & ESTATE PLANNING:***

Our staff of experts can help develop plans for the effective transfer of assets through wills and trusts. We have extensive expertise serving as trustee or co-trustee for all types of personal and corporate retirement plan trusts, including trusts that have direct investments in private companies, real estate or other less liquid assets. We may also assist with the settlement of estates, serving as executor or personal representative.

***CHARITABLE PLANNING:***

Our team is highly experienced in all aspects of charitable planning. We can help you locate worthy charities in your area of interest or help you leverage the value of charitable gifts to your pre-selected organization(s). Our expertise will allow you to maximize your charitable giving for the benefit of you and the recipient.

***TAX, IRA, AND RETIREMENT PLANNING:***

Our staff of experienced financial planning professionals can help minimize the burden of estate, inheritance and income tax through careful planning techniques. We can also assist with the creation or rollover of IRA assets.

***CUSTODY SERVICES:***

Commonwealth Trust Company's investment management service includes full custody services for all assets. For clients who employ multiple managers or for clients who prefer to self-direct a portion of their assets, we offer stand-alone custody services.

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Our staff of fully-licensed brokerage professionals can help you buy and sell a large selection of securities at competitive commission rates. We offer a variety of accounts designed to fit your individual investing needs and feature unique services to help you plan and implement your financial strategy. While still offering the strength and resources of a large financial organization, our personalized service will also provide you with a one-on-one approach and convenient local delivery.

**Investment Research & Portfolio Management:** ***Darrell R. Wells; Robert R. Hawkins, CFA; Brian S. Stivers; John M. Fidler; Erik N. Evans, CFA; Stephen L. McCool; Christopher J. Beneke; Peter M. Ward; Nathan J. Kinney; William T. Husband | Trust & Estate Administration: Jack M. Combs, Jr.; Mary Beth Byron; Michael R. Motsinger; Patricia L. Hayes; Mark J. Kennedy; Beth A. Russell; Christopher A. Nunnelley; Nancye W. Olt; Fran E. Clark; Alex D. Croft; Robin A. Barnett | Private Banking, Family Office and Brokerage Services: Susan L. Roberts; Wendy O'Banion; Toby K. Nutt; Christine S. Gandara; Heather M. Hardin; Sam Ronald; Jill H. Cooper; Justin Beavers***