JULY
2014

Mid-Year Recap & Outlook

Commonwealth Bank & Trust Company

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The S&P 500 increased 7% during the first half of the year (5% for 2Q14) led by utilities (19%), energy (13%) and healthcare (11%). In 2013 the bond market posted its first loss in 14 years as interest rates increased in the face of expected Fed tapering. However, bonds have rebounded this year with the 10-year Treasury's 6% return almost matching the S&P 500's 7% return as the yield on the 10-year fell back to levels seen last summer around ~2.5%.

Lower interest rates explain why interest rate-sensitive sectors such as utilities (19%), particularly gas utilities (26%), and REITs (16%) led in 1H14. A long and cold winter as well as Middle East and Russia/Ukraine turmoil have buoyed energy prices leading to the 13% move in energy stocks.

While healthcare partially benefited from expected Obamacare expansion (Managed care +13%; Facilities +11%), M&A activity drove larger cap sectors higher (Pharma +12%; Equipment +12%). The alarming trend driving Healthcare M&A has been "Tax Inversions". The U.S. has the highest corporate tax rate of all developed countries at 35%, while the average corporate tax rate of the 33 developed countries is 25%. In many cases, companies can cut their tax rate by more than half by merging with a company in a low tax domicile such as Ireland. While we worry about the broader implications of this trend, we purchased stock for accounts and our proprietary Common Trust Funds (CTFs) that benefited from the trend including Covidien (COV +34%; merger with Medtronic [MDT] +10%), Valeant (VRX +2%; bid for Allergan [AGN] +48%), Actavis (ACT +28%; purchase of Forest Labs [FRX]) and AbbVie (ABBV +4%; bid for Shire 69%). Look for Spinversions, as large companies such as General Electric (GE), Johnson & Johnson (JNJ) and Danaher (DHR), spin out divisions with high taxes and combine them with an overseas entity to unlock value.

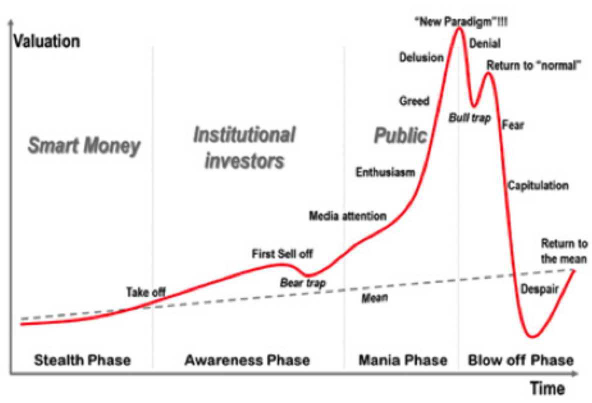
In the following section, we answer questions frequently asked by our customers about the investment environment.

At record stock market highs, should we expect a correction? How much higher can it go from here?

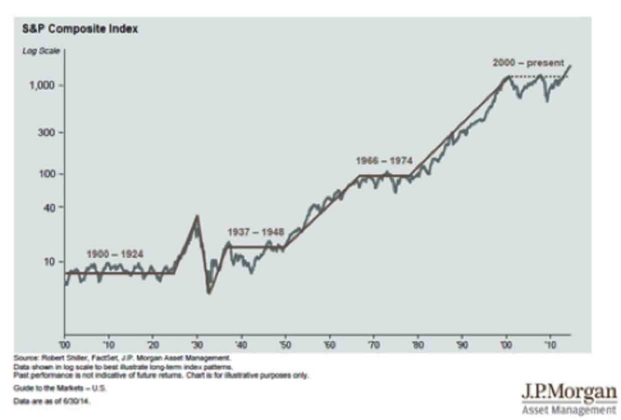
Short answers:

- Correction? – Possibly, but probably not much more than 10%.
- How much higher? – Using the market's current multiple of 15.6x on consensus 2015 earnings for the S&P 500 of $133, the implied valuation is 2075 or 6% higher (assumes current price of S&P 500 is 1960) over the next 12 months.

Bubble, or ...



...break out



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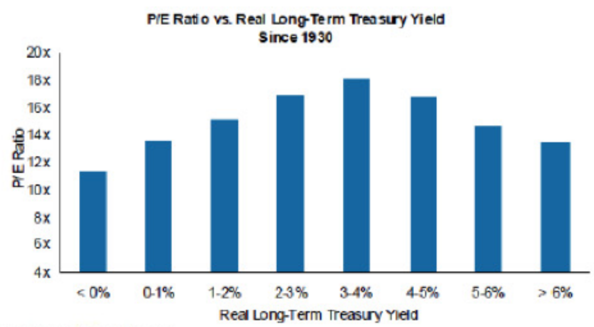
DETAILS:

- Market Multiple: If you look at a longer 25-year period, the forward market multiple of 15.6x is in line with market averages. At current levels the market (S&P 500 - 1960) looks fairly valued, not over-valued, relative to historic levels, even though it has hit new highs.

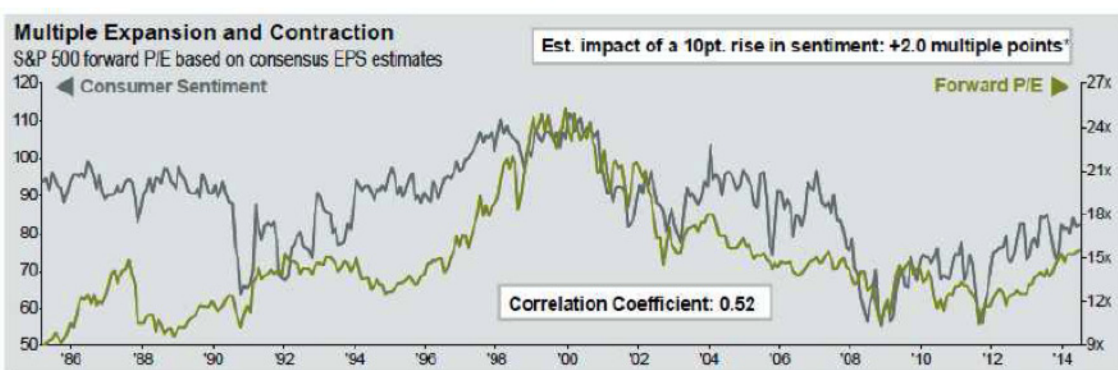
U.S. Equity: Valuation Measures

Valuation Measure	Description	Latest	Historical Averages: 1-year ago	5-year avg.	10-year avg.	25-year avg.*
P/E	Price to Earnings	15.6x	13.8x	13.4x	13.8x	15.5x
CAPE	Shiller's P/E	25.6	24.4	21.7	22.9	25.1
Div. Yield	Dividend Yield	1.9%	2.0%	2.0%	2.0%	2.1%
PEG	Price/Earnings to Growth	1.5	0.8	1.1	1.7	1.4
P/B	Price to Book	2.8	2.6	2.2	2.4	2.9
P/CF	Price to Cash Flow	11.0	10.3	8.9	9.5	10.6
EY Spread	EY Minus Baa Yield	1.7%	1.5%	2.0%	1.2%	-0.7%

- Multiple Expansion Potential: While currently fairly valued, in our opinion, conditions are right for the market to become overheated. As you can see in the charts below, multiple expansion takes place when the Fed begins to raise rates in the face an improving economy, which tends to coincide with an improvement in consumer sentiment.



Source: ClariFi, Thomson Reuters, Morgan Stanley Research



Source: Standard & Poor's, FactSet, J.P. Morgan Asset Management

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- **Market Value Range:** Applying recent multiples and current earnings estimates implies a range of +/- 10% for the S&P 500. Even though we are seeing a downturn at the beginning of July, we believe there is a bias to the upside for the market.

Implied S&P 500 Valuation

	$120	$125	$130	$135
14.0x	1,680	1,750	1,820	1,890
14.5x	1,740	1,813	1,885	1,958
15.0x	1,800	1,875	1,950	2,025
15.5x	1,860	1,938	2,015	2,093
16.0x	1,920	2,000	2,080	2,160
16.5x	1,980	2,063	2,145	2,228

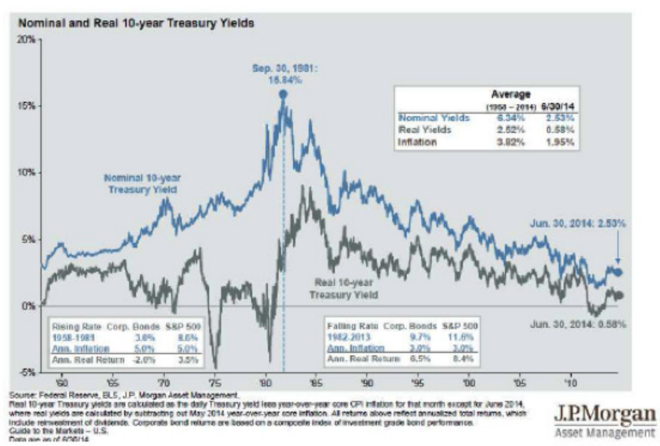
Implied S&P 500 Upside/Downside

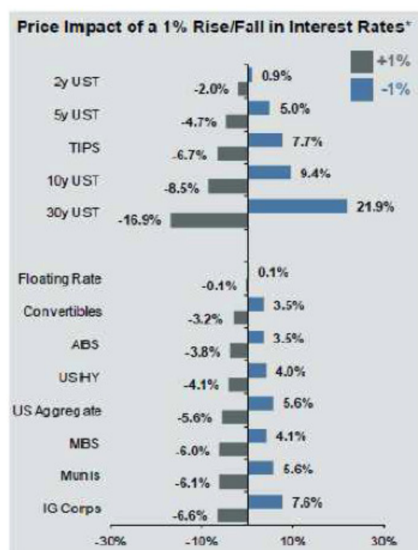
	$120	$125	$130	$135
14.0x	-15%	-11%	-8%	-4%
14.5x	-12%	-8%	-4%	-1%
15.0x	-9%	-5%	-1%	3%
15.5x	-6%	-2%	2%	6%
16.0x	-3%	2%	6%	10%
16.5x	1%	5%	9%	13%

Source: CBandT, Thomson Reuters, Morgan Stanley, J.P. Morgan Asset Management

Bond yields are at record lows. When can we expect them to go higher?

- As usual, the Fed is attempting a soft landing transition to higher rates. For the last year, we have expected the Fed's "tapering" of bond purchases to result in a annual increase in rates of ~0.25%-0.50% for 10-year Treasuries for a few years until rates return to normal levels (4.00%+) and the economy recovers.
- With the increased inter-connectivity of markets, the actions of central bankers in the U.S., Europe, Japan and China are impacting rates outside of their home countries. This and weakness in the first quarter caused the 10-Year Treasury, which started the year at ~3.00%, to fall back to the ~2.50% level of July 2013.
- The Fed announced on July 9 that it expects to stop buying securities in the open market or complete its "tapering" by October via printing money. The Fed remains committed to keeping short-term rates low into 2015. While it may not print money to purchase securities, the interest income from and redemptions of the bonds it now owns on its balance sheet, is expected to provide cash flow for open market activities to bring the economy in for a soft landing in the next few years.
- The chart below on the right illustrates the impact of a 1% rise or fall in interest rates across several bond asset classes. We expect rates to move 0.25%-0.50% higher over the course of the next 12 months. A weaker economy or the actions of foreign central bankers, however, may cause the path to higher rates to zig/zag.





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How we are investing under current market conditions?

At CBandT, our investment team applies best investing practices, so that client portfolios are invested consistently and efficiently to meet their risk and return goals under current market conditions. While portfolios are dynamic and customized, our process is standardized, which enables our team to be flexible, creative and interchangeable for our customers and their shifting needs in the face of varying markets.

Each CBandT investment officer has accountability for an industry sector (healthcare, financials, industrials, etc.) as well as one or two asset classes (muni bonds, emerging market stocks, small cap stocks, etc.). Each week we discuss and debate the relative value and best ideas of these sectors and asset classes and also look at investments that are expensive and should be swapped for a better idea. These discussions shape our portfolio allocations and security selection. Some of our current thinking is outlined below.

Offense

Currently, we are overweighting technology, as technology capital spending has fallen well below historical levels, and overweighting energy stocks, as higher energy prices are leading to higher profitability and a pick up in energy services activity. We are underweighting consumer discretionary stocks and utilities after their run-up over the past 6-12 months. At current valuations, however, we believe we have to be even more selective with stock picks than usual within all industry sectors.

We are equal to slightly overweight international stocks and bonds for the near term. We have a small position in emerging market stocks and bonds for the long-term as we believe these markets will continue to offer favorable demographics, enjoy stronger growth prospects and employ less leverage than developed economies for the next 10 years.

Defense

As deflation threatened more western economies last year than inflation, we reduced our exposure to commodities such as gold and as volatility continued to drift lower we reduced our exposure to alternative strategies. These strategies tend to reduce risk via counter-correlation (these asset classes rise when U.S. stocks and bonds fall). We are watching inflation and gold carefully. It is a fool's errand to attempt timing markets. Even though Central bankers are attempting to bring their economies in for a soft landing without wild swings in rates or inflation, we believe it is prudent to have 0.50%-2.0% allocated to gold or similar inflation hedges as well as a few percent in liquid alternative strategies with goals such as "inflation + x%".

We are about 50% of the typical bond benchmark weight in core U.S. intermediate bonds, opting for non-traditional bond strategies, actively managed multi-strategy bond funds, international bond funds, etc. As bond markets remain near all-time highs, our overall portfolios skew shorter in duration.

We hope that we have provided you with insights into some of the things we are monitoring in markets and some of the actions that we are taking to position your accounts opportunistically or defensively. As always, please call your account administrator or a member of our team to discuss your account, our process or our outlook on the markets.

— CBT Investment Team (7/14)