3Q15 REVIEW & 2015 OUTLOOK

Commonwealth Bank & Trust Company

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3Q15 REVIEW

Index Returns ending 9/30/2015	3Q15	YTD
S&P 500	-6.43%	-5.29%
Russell 2000 (Small Cap)	-11.91%	-7.73%
MSCI EAFE (International)	-10.19%	4.83%
MSCI EME (Emerging Markets)	-17.78%	-15.27%
Barclay's Bond Aggregate	1.23%	1.13%
Oil bbl. Price Change	-24.24%	-15.70%

The market correction in the third quarter ended 10 consecutive quarters of gains for major U.S. indices. The S&P 500 fell 12.5% from a record intra-day high of 2135 on May 20 to an intra-day low of 1867 on August 24. As we stated in our August investor email, the August downturn represents a routine market correction, which is characterized by decline of 10% or more as opposed to a bear market, when declines exceed 20%. While large downturns never seem routine, there have been fifteen 5% "dips" since 2009 (about average) and August marked the fifth 10% correction in the market since then (below average). Large losses in the Shanghai market accelerated in the prior week of trading after a surprise devaluation of the Chinese Yuan by the Chinese government on August 11. Weak Chinese, Emerging Market (EM) and European economic data reinforced concerns that China/EM weakness in aggregate demand could pull the U.S., Europe and other developed markets into recession. Market sentiment reverberations started a negative feedback loop sending oil and other industrial commodities plummeting to market cycle lows. Many other financial assets sold off during the last week of August in a classic "risk off" trade. Markets remained volatile in September after the Fed failed to give anxious markets a vote of confidence by launching a small and steady program to raise the Fed Funds rates. The market rebounded at the end of September into the first week of October, after Dr. Yellen assured markets that conditions support a rate increase before year end (December 16?). The S&P 500 finished the quarter down 6.94% (-6.43% total return with dividends) falling from the 2063 level on June 30 to 1920 on September 30. The S&P 500 rallied 5% during the first eight trading days of October. International markets have posted stronger recoveries. Some are calling the move a relief rally as concerns appear unfounded that an EM-related currency crisis may lead to a new financial crisis.

Source: Standard & Poor's Corporation

Global Stock Markets: As bad as U.S. equity markets were during 3Q15, international equity markets fared worse. The global MSCI EAFE index fell over 10%, while the MSCI Emerging Market index fell almost 18% during the third quarter. Over the last twelve months many commodity-based EM currencies fell 30% against the dollar. Plummeting oil and metal prices during August and September heightened concerns that an EM country could face a currency crisis or default. We believe markets overestimated problems in China last summer. Our greatest concerns currently is that a currency crisis in an EM country could start a bear market for the US. We are watching commodity-based EM countries that are undergoing significant currency devaluations, while facing political crises. Brazil, Turkey and Venezuela fit this profile. While we believe Brazil's President, Dilma Rousseff may be impeached along with key government insiders over a kick-back scandal at Petrobras (Brazil's quasi-governmental oil company), we have determined that Brazil is unlikely to face a currency crisis, because the country manages its currency exchange reserves efficiently. Meanwhile, Turkish unrest seems very high. Turkey experienced a 9/11-caliber terrorist attack on October 11 and has been drawn into skirmishes with Kurds and ISIS/Syrian combatants at its borders. It will be difficult to remove strongman Erdogan in November elections, in our opinion. Conditions in Venezuela seem even more desperate. A default in Venezuela seems like a foregone conclusion, however, and will not likely have a significant impact on global markets. Officials recently seized facilities of Pepsico and Nestle as well as several local supermarket chains to combat food shortages. Elections are to be held in December, but the government reportedly rigged the last election, so Venezuela's political and economic woes may continue for some time.

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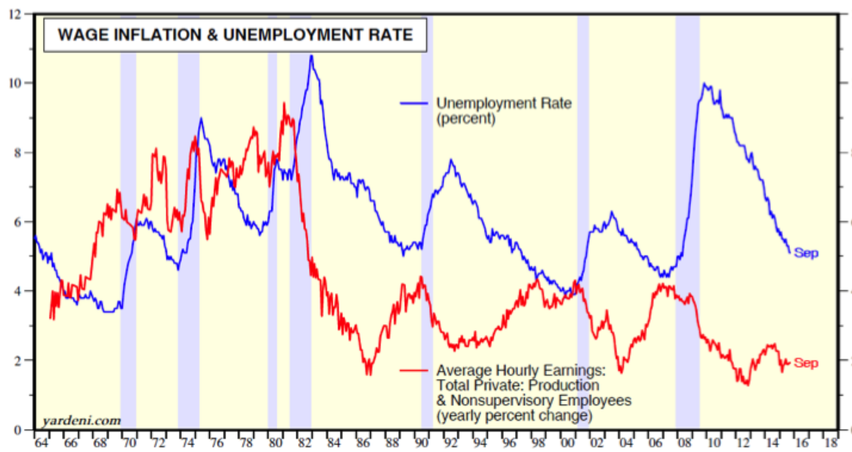
Interest Rates: The bond market moved back into positive territory in the third quarter, rallying 1.25% after the Barclay's Aggregate Bond Index ended the first half of 2015 down -0.09%. The index is up 1.16% year-to-date. The bond market also exhibited range-bound volatility as the 10-year treasury yield fluctuated between 1.90% and 2.50% for the third consecutive quarter. A 3.9% GDP growth rate for 2Q15 was released and updated during the third quarter. Additionally, jobs data and consumer sentiment remained strong and consumer spending and wages started inching upward. Nevertheless, the Fed postponed a rate hike citing concerns over foreign economic and market conditions. While the U.S. markets reacted negatively, many market commentators also expressed sympathy for the decision, because a rate hike could further strengthen the dollar, which would exacerbate problems for US exporters and Emerging Markets. Forward rate contracts imply and sentiment polls indicate there is a 50% probability the Fed will raise Fed Funds rates by 0.25% in December and at every other Fed meeting. Market consensus implies the 10-year treasury will reach 3.00% in the last half of2016.

2015-2016 U.S. ECONOMIC OUTLOOK

GDP growth increased to 3.9% in 2Q15 (announced in 3Q15) after winter storms caused GDP to fall to 0.6% in the first quarter. First half GDP was 2.3%, which is in line with GDP growth over the last five years. The U.S. economy added 167,000 jobs per month over the last quarter, slower than prior months, however, 2.6 million jobs were added in the last twelve months and job openings are 3.9% (5.7 million job openings), the highest level since 2000. Key job shortages remain in health services, trucking and construction. Wages are growing around the 2% level, but this remains below pre-crisis levels and the Fed's target for 3%-4% growth.



Note: Shaded areas denote ressions according to the National Bureau of Economic Research
Source:: U.S Department of Labor, Bureau of Labor Statistics.

The consumer is starting to increase spending most likely spurred by lower oil prices. JP Morgan studied data from 1 million of its credit and debit card holders. The study indicates that Americans are spending 78% of the oil savings at restaurants, department stores, entertainment venues and on electronics/appliances. Nevertheless, the 20% rise in the dollar against other currencies since last summer is hurting exports. The Fed estimates that the strong dollar is having an impact on the economy equal to a 1.0%-1.5% rate hike. The "Investment" component of GDP, capital expenditures (capex), is also being cut from company budgets reducing GDP forecasts. "Investment" is needed in order to increase the productivity of workers. Economic forecaster, BCA, believes U.S. work force growth will return to 1.0% and productivity will return to 1.5% over the next decade. Government spending cuts reduced GDP by 0.5% annually over the last five years. Cumulatively, these factors should result in a 2.0%-2.5% long-term GDP growth rate, not the 3.0%-3.5% growth rate experienced during the baby boom decades. Pre-crisis fiscal spending levels would push GDP growth to the 3% level or better, however, continued legislative gridlock most likely keeps fiscal spending levels constrained. The current 2015 GDP consensus estimate is 2.3% to 2.7% for 2016. Barring extreme weather, we believe the economy will grow only a little faster in 2016 as energy savings help consumer spending and corporate expenses. We expect the dollar to weaken as growth strengthens globally, which will incrementally help exports. Nevertheless, we expect growth below the current consensus of 2.5% for 2016.

4Q15 FOCUS: CHINA

China's impact on global GDP growth remains a "wild card" for forecasters. We believe China will grow between 4% and 7% for the next few years as it transitions from an economy driven by government spending to one driven by consumer spending. This will result in a slowdown in the manufacturing economy as the service economy expands (Chart 3). To achieve this transition financial and capital markets will have to "westernize" by becoming more transparent and open to foreign investors. The "wild card" is how well the Chinese Communist Party will manage this complicated transition against the turbulent currents of free market forces, without a loss

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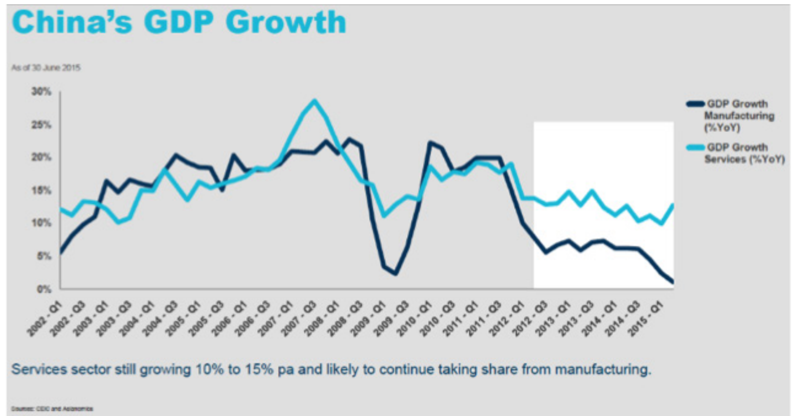
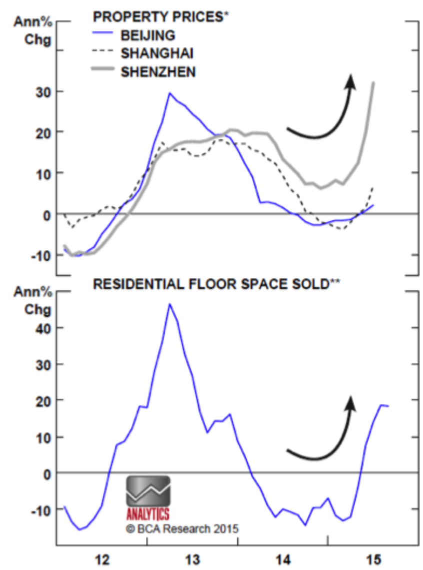
of party power. The Shanghai market turmoil and sudden yuan devaluation placed the "wild card" in the center of the global market table this summer. Each policy misstep by the party stirs up fears that the government will not be able to guide the transition to a soft landing and will pull the global economy into recession via a hard landing.



Services sector still growing 10% to 15% pa and likely to continue taking share from manufacturing.

As China-related concerns sent markets plummeting over the summer, we started to research some of the negative premises that comprise the narrative of the Chinese bear case (hard landing) and its impact on global markets. Generally, we found that concerns are not as bad as rumored. We believe the transition will be difficult as decision makers have proven inexperienced in handling market mechanisms. In the meantime, its financial markets are growing more massive and complex. We do not think, however, the transition will lead to a crisis in China in the next few years.



* SOURCE: CENTALINE; PRICE INDEX COVERS THE MARKET OF FIRSTHAND RESIDENTIAL, SECONDHAND RESIDENTIAL, OFFICE, AND RETAIL PROPERTIES.
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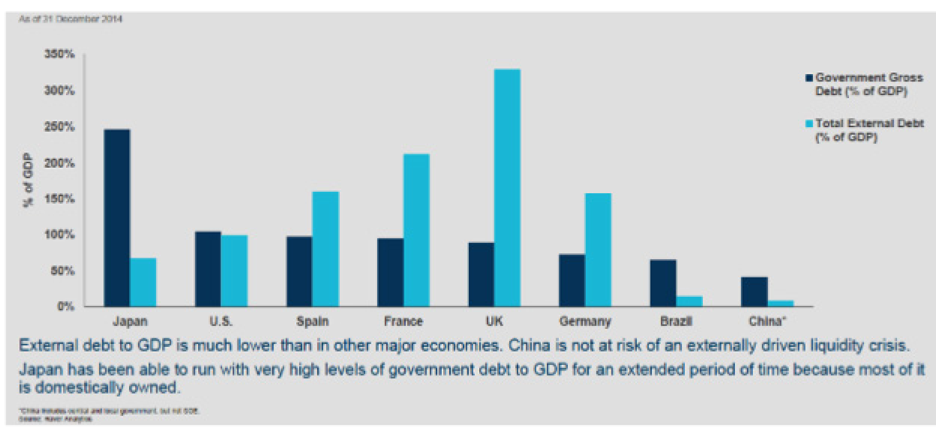
Conclusion: On the whole, we believe that China and Emerging Markets will grow at least twice as fast as developed markets for most of the next decade, however, we think there will be higher frequency of booms and busts in many of these markets and regions as investors chase higher growth and yield than available in developed markets. Western capital inflows have resulted in over-investment and higher indebtedness within certain industries. In turn, capital outflows have resulted in illiquidity in nascent markets upping the ante for currency crises and defaults. We believe that the narrative and sentiment related to China will remain negative until it can demonstrate stronger than expected growth for a consistent period of time. As its economic growth relies less on government-backed infrastructure spending and outsourced manufacturing, China will require fewer raw materials and less capital as it transitions to an economy reliant upon consumer spending and services. At the same time, the government's reform agenda is reducing aggregate demand. Currently it appears that the government's fiscal stimulus is not fully off-setting these changes to the economy. We think it could be several months before China's economic trends change sentiment. China's fiscal stimulus may stabilize the impact from a slowdown in China's demand for EM commodities. Despite an October relief rally in EM equities as well as several industrial commodities, we are not convinced the worst is over as many EM economies appear too fragile to sustain further downturns or a prolonged plateau in demand. We started cutting investments in EM equity and bond funds in the spring and maintain only modest exposure to EM funds that are selectively overweight safer EM countries such as India and Mexico.



External debt to GDP is much lower than in other major economies. China is not at risk of an externally driven liquidity crisis.
Japan has been able to run with very high levels of government debt to GDP for an extended period of time because most of it is domestically owned.

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Market Narrative	True/ False	Facts and CBandT opinion
China Economy in Crisis		
China is on the verge of bankruptcy as its debt is a higher percent of GDP than many western countries	FALSE	Official measures of debt, most recently at 285% of GDP, while the US debt to GDP using the same measures are 335%. China's debt, however, is overstated because the debt calculations include loans from the government to government-controlled banks and companies as well as provinces. Some estimates place this at 60% of the debt. These loans should likely be netted out from the total. EM countries tend to default on externally-owned debt in times of economic trouble. China's external debt is roughly 1 trillion yuan and its currency reserves are four times larger than this debt.
China Real Estate Bubble		
The Chinese real estate market is a bursting bubble and will result in a Chinese economic crisis	FALSE	This is one of the more misunderstood aspects of the Chinese economy. In many ways the real estate market has strengths the US and EU would envy. Chinese home ownership is 89% - higher than in the western world (64% for the US and UK). Only 55% of Chinese live in urban areas, which is expected to increase to 70%-80% over the next few decades. The Chinese are forming roughly 10 million new households annually, so demand remains strong, but growth is moderating as the economy and urban areas mature. From 2003-2014, home prices increased at a 9% compounded annual price growth. Meanwhile, urban incomes grew at 12% (vs. 3% in the US). Real estate prices started to slow in 2014 increasing around 4% and then fell 6% in 2015. About 15% of home purchases are bought with cash and the remaining 85% require a minimum down payment of 30%, so several years of 6% price declines are not likely to put mortgages under water. Finally real estate and construction make up 10% of GDP, so a 10% slowdown would result in a 1% reduction to GDP growth.
There are many "ghost" cities filled with empty apartments throughout China	FALSE	Most homes are apartments and about 80% of these are purchased over one year before construction is complete, creating empty "ghost" buildings, which fill up a year later.
Most real estate purchasers are speculators	FALSE	Only about 10% of homes are bought by investors.
China Slowdown = Global Recession		
China is the largest trading partner for EM countries, so as China slows, EM countries fall into recession	FALSE?	China has grown from 5% to 10% of EM exports over the last decade. Other EM countries are the largest trading partner for the typical EM country (32%), not China (10%). There remain questions as to whether a slowdown in China results in a collective recession or has a contagion effect on EM economies. We believe commodity-based economies where energy and metals exports are a significant component of GDP are the most vulnerable to currency crises or defaults.
A slowdown in China can push the US or Europe into recession	FALSE?	Growth in US exports to China has flattened after growing an average of 13% over the past 10 years. Exports totaled $121 billion in 2014, which is less than 1% of US GDP. EU exports to China totaled $190 billion, representing a little over 1%. A 25% drop in exports in either country would not likely push either trading partner into recession, unless the US or EU were growing close to zero.
SHANGHAI MARKET + CHINESE CONSUMER		
Shanghai market correction will make a significant impact on Chinese consumer	FALSE?	See Chart 9 below. The big concern is how much of the loss of wealth in markets will impact consumer spending and, in turn, China's GDP growth. It is difficult to determine. It has been reported that individual Chinese investors make up 80% of the holders of the stocks in the index, but these holders represent less than 10% of the Chinese population. First, the market is still up over 50%, since last year. Second, the Chinese consumer makes up 36% of GDP vs. 65%-70% in developed countries. The market is beginning to digest the likelihood there will be a much smaller than expected impact on the Chinese consumer or the economy vs. the magnitude of the correction.

Sources: CB&T, Financial Times, BCA, The Economist, Yardeni Research.

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2015-2016 MARKET OUTLOOK

Our 2015 thesis seemed suspended in 3Q15 and reaching our original 2015 targets may not be achieved until the first half of 2016. We are lowering our 2015 total return range for the S&P 500 from 4%-6% to -1% - +4% (2000 to 2100 by year end). Our Barclays Bond Aggregate remains at 2%-3%. Volatility has been above average for a longer period of time than expected this year. The flash crash in late August and the sudden drop in oil back to $45/bbl. for a third time left a cloud of bearish sentiment over the market. In our opinion, investors are re-pricing stocks for higher risk. This can be seen in the current S&P 500 P/E multiple on its earnings. The S&P 500 peaked in May and rallied again in July to the 2135 level, which is 16.4x 2016E consensus EPS of $130. At the 2000 trading level of early October, the 2016E P/E multiple is 15.4x, which is a little below the historical average of 15.6x.

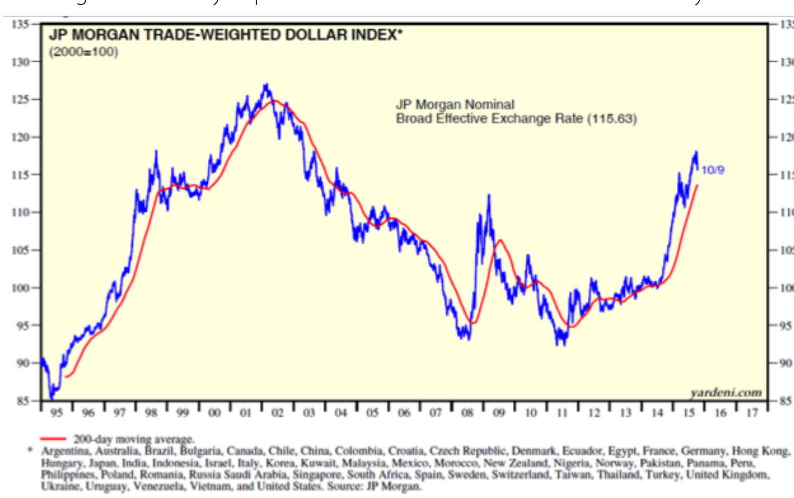
Market Expectations for the Next Few Quarters

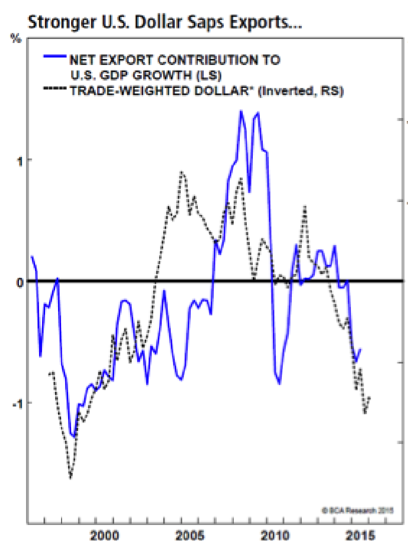
We believe investors are looking for a sign that global growth is improving for the market to make its next leg upward. The two most important fundamental confirmations for the market will come via improving economic data from China and/or an increase in rates from the Fed, which would confirm the economy is strengthening. These two factors would result in upward revisions to earnings estimates and should result in higher multiples for earnings (as the risk premium is reduced and confidence in fundamental data increases). Secondarily, increases in oil prices and strengthening of other currencies against the dollar would be positive signals for markets. These signals would likely result in upward earnings revisions, but may not increase multiples significantly.

Fundamental Cyclical Trends

As we have written in greater detail in past quarterly updates, most of the variables that impact earnings and the economy are interconnected and we think there are four cyclical trends that will make the most impact on markets between now and mid-2016.

1. **Dollar vs. Euro Exchange Rate:** We have started to lap the massive move in the US Dollar against other currencies. Since late April, the exchange rate has remained between $1.10 and $1.15 per Euro. Assuming these levels hold, then between October 2015 and February 2016 the year-over-year (y/y) difference in the exchange rate falls from 14% currently ($1.28/E vs. $1.14/E) to 0%. As a result, we believe analyst estimates of and management guidance for U.S. multi-nationals will start trending up as the negative currency impacts that hurt 2015 results start to anniversary.





Source: J.P. Morgan Chase & CO

2. **Global Economic Slowdown:** The US, EU, China and EM GDP results have fallen below growth expectations this year. As a result, the IMF has lowered global estimates for 2016. Through the August and September correction, most commentators pointed to turmoil in the Shanghai market, the decision to devalue the yuan and weakening Chinese economic data as the main driver leading to global economic weakness. The common economic thesis seems to follow the narrative that China is really growing closer to 3%-4%, despite official claims of 7% growth and that the slower growth is causing a recession in emerging markets. Since EM and China now make up close to 50% of global GDP, the lower Chinese

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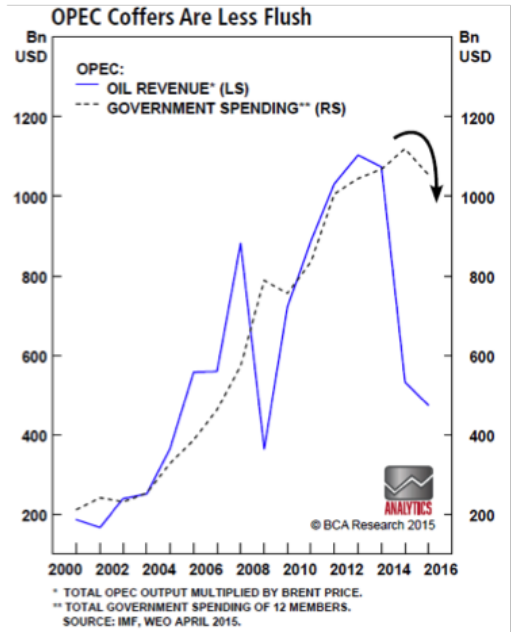
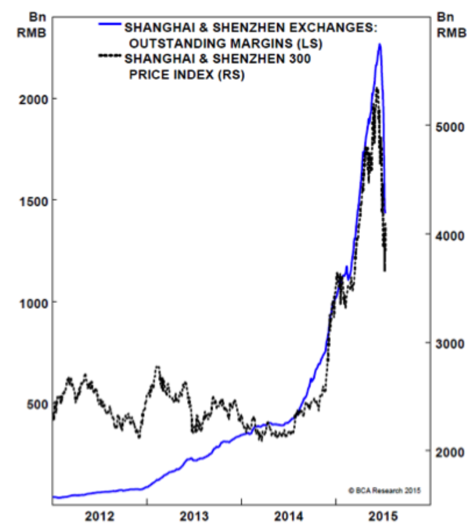
and EM growth will result in a slowdown in US and EU GDP. We believe that China's growth is slower than official reports, but not as bad as sentiment suggests. Furthermore, we do not expect the collateral EM economic damage abetted by slower Chinese growth will develop into a global recession.

3. **Fed Rate Increase:** Whether and when the Fed should raise interest rates has become the most debated topic in market commentary since the Fed failed to raise rates in September, in our opinion. The Fed cited turmoil in foreign markets as well as mixed economic data: steady GDP growth, solid unemployment rate and job growth, weak wage growth and weak inflation. Interest rate futures imply a 50% probability of a rate increase in December and three to four separate 0.25% rate increases between now and the end of 2016. The 10-year Treasury forecasts imply it will end 2016 around 3.00% from its current rate of ~2.00%. Since late September, when Dr. Yellen assured markets that a rate increase will happen before year end, economic data released in October showed signs of weakening. As a result, two Fed governors signaled a rate increase would be doubtful for December in speeches presented in October. The Fed may have missed its opportunity to increase rates.
4. **Oil Prices:** We believe oil supply is likely to remain higher than demand for some time. Four developments are pushing oil supply expectations higher: 1) U.S. oil producers have used technology to lower extraction and production costs keeping more supply on the market. 2). A nuclear standstill deal will enable Iran to boost production by 25%. 3) Oil production in Iraq, Libya and other countries emerging from conflicts is coming back on line. 4) Saudi Arabia announced a firm commitment to maintain its market share of global output as others increase production. Improving demand in the U.S. and EU, on the other hand, is not expected to offset slowing demand from China and Emerging Markets. One expert believes that Saudi Arabia only has two years of financial wherewithal to afford pumping at its current record levels. Nevertheless, oil prices have bounced between $45 and $50 in September and October as fears that recent unrest in Syria, Israel and Turkey may result in supply disruptions. As previously mentioned, the benefits of cheap oil are beginning to have fundamental impacts on US consumers and create savings for manufacturers and other oil importers such as China.





Short-Term Sentiment Factors

We think investors misunderstand two significant market factors, which have resulted in market gyrations. We do not see these as fundamental drivers to market results, because they do not have long lasting impacts on earnings or prices, however, these factors have led to changes in sentiment contributing to market corrections such as the one in August.

1. **Chinese Policy Blunders: The Shanghai Stock Market and Yuan Devaluation.** At its peak on June 12, China's Shanghai exchange reached 5,178, a 152% increase over the prior year with the help of government policy changes. Then the bubble burst in two 20% downswings in June and August. The government intervened to stabilize the market by forcing banks and brokerages to make purchases and halt trading in certain stocks. In an uncoordinated move in August, the government announced it would allow the Yuan to devalue by 2%. Investors should anticipate more market intervention in coming months as the Party meets October 26-29 to develop its 5-year economic plan. We think conservative members will push leadership to curb reforms and increase fiscal stimulus. Meanwhile, we expect Chinese market data to look mixed until fiscal spending starts

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to offset weakness in aggregate demand caused by reforms. If policy is handled clumsily in coming months, while data looks mixed to negative, investors will likely see additional volatility in Shanghai and Hong Kong markets. The negative feedback loop into European and US markets may resemble the volatility experienced in August. We hope the reaction in US markets will dampen with the frequency of these events.

2. **Middle East Turmoil: A Powder Keg with an Endless Fuse.** Several conflicts are becoming more unpredictable in the Middle East. The conflicts are likely to hit markets via changes in oil prices: prices jump higher over concerns of supply disruptions; prices make sudden drops if new supply is coming into markets to fund the costs of heightened conflicts. One theory posits that the Saudis will keep prices low to make it unaffordable for Iran or Russia to fund factions that conflict with Saudi interests (ISIS, Yemen, etc.). These headline-based actions tend to cause extreme but short-lived swings in oil prices, which impacts market sentiment expressed as higher volatility.

MARKET VALUATIONS & RETURNS

- **Fixed Income/Interest Rates**: If there is no action taken by the Fed in 2015, we think the 10-year treasury will finish the year closer to the bottom of its current 2.00%-2.25% range. In this scenario, the Barclay's Aggregate Bond index may generate similar returns to 2014 returns, which were bolstered by long-term bonds within the index. Our fixed income investments remain short to intermediate in duration. A rate increase of 0.25% to 0.50% upward shift in the yield curve can cause a 30-year bond to lose 5% to 10% in value. We think trying to move in and out of long term bonds ahead of an eventual Fed rate hike is like trying to out-run a train – not worth the risk. When action is taken, the Fed has signaled it would make small and gradual increases, which is being interpreted as a 0.25% increase every other Fed meeting by most. We are beginning to see investment calls by fundamental and technical newsletters to lengthen duration in portfolios (no rate increase and rates remain lower for longer). We view a December rate move as too close to call.

- **U.S. Stock Valuations:** After the August downturn, we believe current valuations are a little undervalued, even after applying a lower multiple than where the S&P 500 traded for much of the last twelve months. We do not believe there will be enough positive data or news flow before year end for markets to swing upward strongly. We think Chinese economic data would have to become significantly stronger (unlikely) or the Fed hikes rates on significant US economic strength (possible). In our bull case, we believe the S&P will finish the year near 2100 for a total return of 4%. In our bearish scenario, the S&P 500 finishes 2015 at 2000 for a total return of -1%. We think that analyst estimates for S&P 500 companies are too bearish for the second half of 2015 and 2016. In the absence of supporting data, we believe that corporate guidance on second half 2015 and 2016 will remain subdued. We are fairly optimistic about the market set up for 2016. As oil prices and exchange rates anniversary in 4Q15 and 1Q16, we believe corresponding quarterly results (4Q15 earnings released in late January; 1Q16 released in late April) will surprise to the upside resulting in increases to guidance and estimates.

- S&P 500 Forward Multiple 16E: 15.4x
- Current S&P 500 Value: 2,000
- 2015 Estimate: $120
- 2016 Estimate: $130

Implied S&P 500 Valuation

	$125	$130	$135	$140
14.0x	1,750	1,820	1,890	1,960
14.5x	1,813	1,885	1,958	2,030
15.0x	1,875	1,950	2,025	2,100
15.5x	1,938	2,015	2,093	2,170
16.0x	2,000	2,080	2,160	2,240
16.5x	2,063	2,145	2,228	2,310

Implied S&P 500 Upside/Downside

	$125	$130	$135	$140
14.0x	-13%	-9%	-6%	-2%
14.5x	-9%	-6%	-2%	1%
15.0x	-6%	-3%	1%	5%
15.5x	-3%	1%	5%	9%
16.0x	0%	4%	8%	12%
16.5x	3%	7%	11%	16%

Source: Standard & Poor's Corpoation