1Q17 REVIEW & 2017 OUTLOOK

Commonwealth Bank & Trust Company

4350 Brownsboro Rd.
Suite 210
Louisville, KY 40207

p (502) 259-2500
f (502) 259-1501
www.cbandt.com

Overview

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 a trade war resulting from new trade policy.

2016 MARKET SUMMARY: Trump to the Rescue?

U.S. Stock Markets: 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 – in the hunt, but 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 cracked a whip on domestic equity markets at the top of the stretch 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.

As you may recall, emerging markets, international and small/mid- cap equities generated negative returns in 2015 as a group for the first time since 1990. We encouraged patience during periods of volatility last year and our investors 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% - please see Figure 1). During the first half of the year, the bond market reached all-time highs (all-time low yields). Investors sought the safety of bond substitutes with high dividends: telecom, utility, REIT and consumer staples stocks. These stocks retreated some in the second half of the year. As economic data improved, cyclical sectors such as industrials, energy and materials rallied in the second half of 2016 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. Investors expect improved profitability as Trump policies will enable the Fed to steadily raise rates helping net interest margins of banks and financials. Furthermore, investors believe the new administration will roll back financial regulations such as the

Table 1: Index Returns

Index Returns	11/1/2016 - 12/31/2016	4Q16	2016
S&P 500	5.74%	3.81%	11.93%
Russell 2000	14.27%	8.83%	21.31%
MSCI EAFE	1.39%	-0.68%	1.51%
MSCI EME	-4.32%	-4.08%	11.60%
MSCI BRIC	-4.99%	-4.08%	9.46%
Barclays Aggregate	-2.23%	-2.98%	2.65%
BofA Merrill Lynch US HY	1.56%	1.88%	17.49%

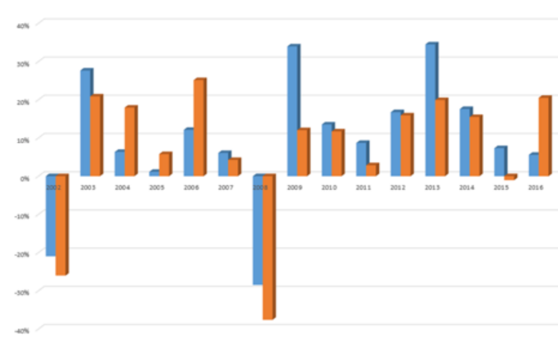
Source: Informa & Bloomberg

Table 2: Sector Returns

S&P 500 Sectors	11/1/2016 - 12/31/2016	4Q16	2016
Info. Tech	1.25%	1.19%	13.84%
Financials	18.31%	21.03%	22.72%
Healthcare	2.70%	-4.00%	-2.69%
Consumer Staples	-1.25%	-2.02%	5.37%
Consumer Discretion	4.77%	2.31%	6.03%
Industrials	9.38%	7.19%	18.83%
Energy	10.46%	7.25%	27.32%
Materials	6.98%	4.70%	16.68%
Telecom	12.02%	4.83%	23.54%
Utilities	-0.72%	0.13%	16.27%
Real Estate	1.14%	-4.41%	3.38%

Source: Informa & Bloomberg

Figure 1: Income vs. Growth Sectors



4350 Brownsboro Rd.
Suite 210
Louisville, KY 40207

p (502) 259-2500
f (502) 259-1501
www.cbandt.com

Dodd-Frank bill, which cut profitability ratios such as ROE and ROA in half or worse for financial institutions post-crisis.

Global Stock Markets: 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. Emerging markets benefitted primarily from a recovery in China. Nevertheless, the index gave up over 4% in the fourth quarter over concerns of a stronger dollar (please see Figure 1 and Table 2).

Global Bond Markets: "The Red Tide" Faces a Rising Fed

On a relative basis, global bond markets were more volatile than stock markets in 2016. In early June, the ECB incrementally increased its purchase of EU bonds. The EU policy moves have resulted in an unprecedented "Red Tide" of negative sovereign interest rates. After the Brexit scare, European bonds fell further into negative territory as EU stock markets fell and investors sought the safety of bonds. As a result, the 10-year Treasury bond yield fell to a record low 1.36% as foreign investors sought higher (positive) U.S. treasury yields. The Barclays Bond Aggregate Index generated a 5.80% return for the nine months ending 9/30/16. The index lost more than half of that return in the fourth quarter as economic data strengthened and the Trump election raised the probability for future Fed rate hikes starting with a 0.25% increase at the December FOMC meeting. High yield bonds were a steady standout performer during 2016 generating a 17.08% return recovering losses in 2015 as stable oil prices alleviated fears several oil patch issuers would default.

Figure 2: U.S. Dollar Index

Source: The Daily Shot, WSJ

2017 ECONOMIC OUTLOOK

The Stimulus Baton Handed off from Monetary Policy to Fiscal Policy

U.S. and global growth estimates for 2016 surprised to the upside. U.S. GDP 2016 estimates started the year at 2.5%, were subsequently dropped to 1.8% in September after GDP averaged 1.1%-1.2% for the first half of the year. U.S. GDP growth is projected to be 1.9% for the year after a surge in confidence led to an expected 3.2% growth rate for the third quarter and 2.3% growth for the fourth quarter. More importantly, forecasts for 2017 and 2018 have increased to 2.4% for each year. We believe there is upside to these estimates, because only about half of the forecasters updated estimates after the election. We think many are waiting for Trump's official 100-day plan and budget in late January or early February. Furthermore, we believe the 2017 global GDP estimate is also likely to be revised upward from 3.4% later this quarter.

We exit 2016 with the broadest global economic recovery outlook in five years, in our opinion (please see Figure 3). 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, high consumer confidence and rising leading economic indicators. While extreme monetary policy measures in the U.S., EU, Japan and China put a floor under global GDP growth in the last five to seven years and kept most economies out of recession, some economists estimate that post-crisis fiscal austerity may have shaved over one percentage point off U.S., EU and global GDP growth during that time frame. We believe the global economy is approaching an inflection point, where Central Bankers begin to slow the pace of quantitative easing to let interest rates rise, as fiscal stimulus spending measures are proposed and approved in more countries. We view the shift in policy as constructive for global growth in the near term and potentially healthy in the long run as long as sovereign debt to GDP levels remain near recent levels.

Figure 3: Economic Surprise Indices

Source: The Daily Shot, WSJ

4350 Brownsboro Rd.
Suite 210
Louisville, KY 40207

p (502) 259-2500
f (502) 259-1501
www.cbandt.com

Trumponomics and the Markets in 2017

Summary: We believe U.S. equity market sentiment will be driven by President-elect Trump's "100-Day Growth Agenda" and Republican fiscal policies for much of 2017. The Trump economic plan outlines eight major reforms that we believe will be very bullish for domestic equities for 2017, while a little bearish for international equities and bonds. Furthermore, recent economic strength coupled with Trump tax cuts and spending will likely result in a higher dollar in the near term and higher GDP growth and inflation in the longer term. This setup is likely to lead to steady Fed rate hikes following the December hike. Whether or not all of the Trumponomic plans succeed, we believe most of the proposed reforms have a high probability of success between now and the mid-term elections in 2018. We think the trajectory of current earnings estimates is achievable by the end of 2018, which should result in 6%-10% upside for the S&P 500 over the next 12-18 months. Going into the end of the year, CB&T started making tactical shifts in customer portfolios to overweight U.S. equities, using international equities and bonds as well as core U.S. bonds as a source of funds to reposition portfolios.

Trump's 100-Day Growth Agenda

Trump's economic plan was penned and scored by Wilbur Ross, a private equity investor known for saving businesses in struggling industries such as steel and coal and incoming Commerce Secretary, and Peter Navarro, a UC-Irvine economics professor and author of several economics books and incoming White House National Trade Council. The plan is outlined as eight key reforms summarized at left (Table 3).

TABLE 3: TRUMP ECONOMIC PLAN SUMMARY

Proposals	Features	GDP/ Economic Impact	Tax Revenue Increase/Decrease (over 10 Years)
TAX REFORMS		**~ 1% per year**	**$2.600T revenue decrease**
Middle Class Tax Relief & Simplification Act: 7 tax brackets reduced to 3	Avg tax cut for middle class family with 2 children is 35%; wages increase by 5%-6%		Significant benefit as early as 2017 possible.
Business taxes cut from 35% to 15%	Makes U.S. tax rate competitive with average global tax rate of 24%	Stops companies from moving overseas for cheaper tax havens.	
10% tax holiday	Companies can repatriate overseas cash	~$2.5T in cash trapped overseas	
TRADE REFORMS		**~ 1% per year**	**$1.740T revenue increase**
Renegotiate or withdraw from NAFTA, TPP	Secretary Commerce to root out and stop unfair trade practices	1 million jobs in 2017; goal of 25 million jobs in 10 years	
End the Offshoring Act	Tariffs to discourage laying off workers, relocating manufacturing to other countries and shipping goods back tax free		Slow ramp. Most of the trade benefit not until year 6 (2nd term)
REGULATORY REFORMS			**$0.487T revenue increase**
Regulatory moratorium	Must cut 2 regulations for any new regulation; regulatory review of each agency to reduce wasteful regulations	Reduces regulatory burden of $2T annually or $15,000 per household	Slow ramp. Most of the regulatory benefit not until years 4-5
ENERGY REFORMS			**$0.147T revenue increase**
Lift restrictions on energy production	Start up stalled infrastructure projects for pipelines and ports to export coal and shale oil.	Annual Increases: $100B to GDP; 500K jobs created; $30B in new wages	
Greenlight infrastructure projects	$33 billion in projects rejected or withdrawn under Obama		
INFRASTRUCTURE REFORMS			**Revenue Neutral**
American Infrastructure Act	Revenue neutral $1T 10-year spending plan	Creates thousands of jobs in construction/ manufacturing for transportation, telecom, water and energy infrastructure.	Significant benefit as early as 2017 possible.
IMMIGRATION REFORMS			**Reduces deficit spending**
End Illegal Immigration Act	Build border wall, cancel federal funding to "sanctuary cities"	Saves $300 billion in annual costs at federal, state, local level.	
HEALTHCARE REFORMS			**Reduces Medicare/ Medicaid spending**
Repeal and replace Obamacare	Replace with HSAs and insurance reforms	Obamacare results in 2.0 and 2.5 million fewer jobs in 2017 and 2024, respectively.	
Insurance reforms	Allow insurance to be purchased across state lines.	1.4 million about to lose insurance in 33 states; 20% of exchanges have only 1 insurance option	
FDA reforms	Speed drug approvals		
Medicaid Block Grants	Enable states to manage Medicaid		
CHILD CARE & ELDER CARE REFORMS			**Unknown**
Affordable Childcare & Elder Care Act	Child/elder care deductible; incentives for on-site child care services; tax-free Dependent Care Savings Accounts	Create more disposable income for families, spur new child/elder care solutions across America.	

Source: Trump economic team. CB&T

Growth Agenda's Probability of Political Success

We believe there is a higher probability of political success to pass many of the reforms that Trump's team is proposing than either the press or markets currently indicate. While there is a solid majority in the House, many point to the small majority in the Senate (52 votes) as a high propensity for legislative gridlock. The Senate currently streamlines legislation via Cloture vote, which requires 60 votes for legislation to be proposed for voting. Without

Commonwealth Bank & Trust Company

4350 Brownsboro Rd.
Suite 210
Louisville, KY 40207

p (502) 259-2500
f (502) 259-1501
www.cbandt.com

the 60 votes, the Democrats can filibuster and gridlock legislation. We believe there are two reasons that more reforms will be passed than expected.

1. **Budget Legislative Process** – We believe many of the reforms such as tax reform, infrastructure spending as well as child and elder care reform can be proposed in budget reconciliation bills that require simple majority. Furthermore, budget bills can be used to implement parts of other reform plans in energy, healthcare and immigration.
2. **Repositioning of the Democratic Party** – Democrats are in their weakest position in decades and will have to go along with policies that create jobs. Democrats saw stalwart constituents, such as working class and union voters, cross-over to vote for Trump and other Republicans with populist messages in 2016. Unions endorsed Clinton, but exit polls indicate many union members broke rank and voted for Trump. While 24 Republicans and 10 Democrats faced reelection in 2016, 23 Democrats and 2 Independents (who caucus with Democrats) face reelection in the 2018 mid-terms vs. 8 Republicans. Eleven of the democrats reside in states won by Trump. We think that Democrats will go along with legislative and budget proposals that create jobs (infrastructure, tax cuts, trade, de-regulation etc.). We expect more gridlock pressure will occur over policies that are important to the traditional Democratic voting base, such as healthcare, immigration and the environment.

Impact on the Economy

Enacted fiscal policy legislature typically has a lag of 6 to 24 months before its effect is seen in the broader economy. Tax cuts make quicker economic impacts (3 to 9 months), while infrastructure spending, trade reforms and de-regulation take longer.

- **Jobs**: Most of 25+ million jobs the Trump team estimate their policies will create over the next decade result from re-patriating jobs from abroad via NAFTA and TPP reform or cancellation. Another 2.0-5.0 million jobs are expected from infrastructure spending, healthcare reform and reducing regulatory burdens. We expect the start of any significant job growth to take a year or two at least to ramp up.
- **GDP Growth:** The Trump team expects its economic plan will increase GDP growth one to two percentage points annually. We believe that it will take a year or two for GDP to ramp up to the high 3% range.
- **Interest Rates and Inflation:** We expect interest rates to rise faster and sooner than inflation, because the tax cuts could create significant deficit spending ($250B+ annually) starting in 2017. It will take years, in our view, for the economy to generate enough jobs and new tax revenues to pay for the annual deficit spending resulting in large Federal bond financings in the next few years. At 4.6% unemployment, the first signs of wage inflation are beginning to appear after more than a decade of stagnation. Expected future inflation will also provide room for the Fed to raise rates in 2017, even though it may take until 2018 or beyond before real signs of stronger inflation result from job/wage growth and infrastructure spending. Conversely, higher interest rates could also serve to counteract job and GDP growth, while slowing inflation.
- **The Dollar:** In our opinion, a higher GDP growth and rising interest rate environment relative to the rest of the world argues for a stronger dollar in 2017. Trade reforms are also likely to strengthen the dollar. A stronger dollar may also create a drag on job and GDP growth initiatives.

Trump Election Impact on Markets

- **U.S. Equity Markets** - The S&P 500 market rallied almost 6%, during the month of November and December.
    - **Stock Dispersion:** There has been a significant dispersion in stocks, sub-sectors and industries that have rallied since the election. Investors are paying up for some sectors while ignoring others, creating opportunities.
        - In November and December, Financials and Industrials rallied 18% and 9%, respectively. Investors anticipate that rising interest rate spread will help the financial industry and that banks (+26%) will also

TABLE 4: TRUMP TAX RATE IMPACT
on EPS of S&P 500 & Russell 2000 Companies

	November -December Return	EPS Impact of New Tax Rate 25%	20%	Plan 15%
S&P 500	5.7%	8.2%	13.7%	19.6%
Russell 2000	14.3%	11.5%	17.5%	23.6%

Source: CreditSuisse, CB&T

Commonwealth
Bank & Trust Company

4350 Brownsboro Rd.
Suite 210
Louisville, KY 40207

p (502) 259-2500
f (502) 259-1501
www.cbandt.com

benefit from regulatory reform. Industrials are expected to benefit from infrastructure spending.

- In the meantime, small cap stocks have rallied 11% as many expect earnings to increase 20%-40% from a Trump tax cut.

Some Tax Impact Priced In Markets, but Little Priced for Broader Policy Reforms

- We think the S&P 500 is giving only partial credit to larger tax cuts that we think are highly probable in 2017.
    - Roughly 64% of S&P 500 companies benefit if the corporate tax rate is cut to 25% and 83% benefit if the Trump team achieves its target 15% corporate rate.
        - S&P 500 EPS will likely increase by 8% with a 25% tax rate and 20% with a 15% tax rate.
- Assuming the small cap Russell 2000 was fairly valued prior to the election, the index is pricing in a lower tax rate than 25%.
        - Roughly 71% of Russell 2000 companies benefit if the corporate tax rate is cut to 25% and 83% benefit if the Trump team achieves its target 15% corporate rate.
        - Russell 2000 EPS will likely increase by 12% with a 25% tax rate and 24% with a 15% tax rate.
        - While the Russell 2000 as a whole jumped about 14%, regional banks represent about 11% of the index and rose over 26%, implying the index gained less than 10% ex-banks. We see additional upside in small cap stocks outside of financials.
            - We think the market has possibly gotten ahead of itself in certain sectors rewarding them with outsized returns. Sectors such as Financials, Materials and Industrials are expecting significant regulatory reform and awards from infrastructure and/or defense spending in 2017. There may possibly more downside risk for some of these "early winners" if infrastructure contract awards and/or deregulation do not prove to be as beneficial as the market expects.
            - Nevertheless, we think the majority of industries and sub-sectors have seen little market benefit despite a high likelihood for an earnings boost from a tax cut as well as increased earnings derived from a faster growing economy and improving regulatory environment. Retailers, Restaurants, Grocers, Telecoms, Cable and Media companies, for instance, benefit immediately from tax cuts and longer term from an expanding economy and ebullient consumer sentiment. We do not recommend buying sector or subsector indices indiscriminately, because each company should be analyzed for tax or other reform benefits. We found examples of companies in the same sub-sector that benefit significantly, while others receive no benefits or may even be hurt by reforms. Additionally, while some sectors like retailers may see their corporate tax rate cut in half, they may face a "border adjustment tax" on goods they import, which could leave their profits no better off.

- **U.S. Bond Market** - The bond market has moved to bear market territory as the 10-Year treasury yield has increased from 1.80% to 2.40%, since November 1.
    - **Expecting Rate Hikes** – We are expecting the bond market to remain in bear market territory over the next two years as the improving job market and expected fiscal deficit spending will become inflationary and enable the Fed to normalize rates back to historic levels. Some forecasters predict 2 to 8 additional 0.25% rate hikes in 2017 and 2018, which we believe could result in a 10-Year Treasury yield between 3.0% and 4.0% in 2018.
    - **Implications for Investors**
        - Over the next 2 to 3 years, the environment for intermediate to long term bonds is likely to remain a little bearish. We expect returns of 1% to 3% from core bonds depending on the speed of normalization.
        - Over the longer term, higher rates will benefit savers, retirees, charities and endowments that need higher income and wish to keep 40% to 60% of account assets in lower risk securities.
        - Municipal bond markets have sold off a little disproportionately as expected tax cuts for individuals reduces their

4350 Brownsboro Rd.
Suite 210
Louisville, KY 40207

p (502) 259-2500
f (502) 259-1501
www.cbandt.com

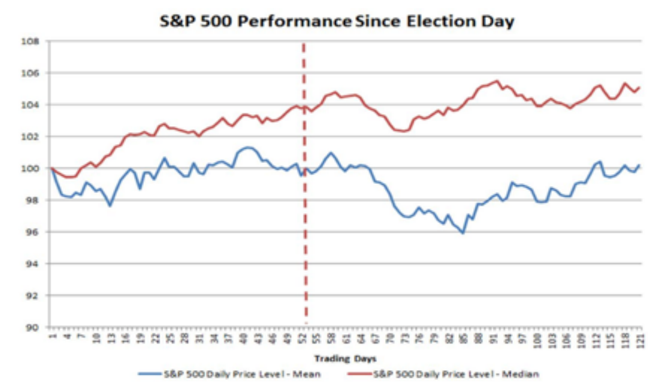
tax effective yield and relative attractiveness. On the other hand, state budgets should benefit from job creation and a higher rate of GDP growth.

- **International Stock and Bond Markets** – Emerging market stocks have sold off about -4% as the dollar strengthened by roughly 4% against the currency basket. Developed international markets rallied roughly 3% in December to finish the year up 1% on strengthening economic data and fears of an EU banking crisis were alleviated. Developed international bond markets are not off as much as emerging bond markets.
    - **Dollar Strength and Trade Tariffs** – Dispersion is also high in developed international markets. In Mexico, for example, markets are pricing in peso weakness and a significant reduction in trade or withdrawal from NAFTA. Although withdrawal from the Trans Pacific Partnership (TPP) is anticipated, Asian currencies and markets have experienced weakness in line with the move in the dollar. Nevertheless, we expect the dollar to strengthen over the next two years and we will monitor closely the timing, form and impact of forthcoming trade policy.

Potential Market Risks

While we believe certain key risks, such as oil prices, have stabilized in the short run, we currently see two key risks for markets in 2017: 1) a political backlash against Trump policies and 2) a trade conflict that causes the dollar to rise significantly.

Figure 4: Average Post-Inauguration Market Action



Source: DoubleLine Funds

1. Trump Policy Backlash - Generally, markets tend to get ahead of the policy when new Presidents take office. In seven of the last eight Presidential transitions, the market moved higher into the inauguration and then pulled back around 3%-7% over the following month and then typically rebounds and moves higher. We theorize this market phenomenon is a result of political theater. The new President unveils his 100-day agenda and first budget. Members of the opposing party then vow to block the plan and budget. This creates a cloud of uncertainty over policy and the market unravels trades of winners during the pre-inauguration period. The market rebounds later in the first or second quarter, when it turns its attention to earnings or there are signs that some of the proposed agenda or budget items will be enacted. If tax, infrastructure, healthcare or deregulation policies take longer than a couple of quarters, we believe 2017 earnings estimates for many companies will be lowered, which will likely result in the market getting stuck in a trading range between 2200-2300. As previously mentioned we believe Democrats are likely to go along with legislation that creates jobs (tax, infrastructure and deregulation). We believe healthcare legislation that reduces coverage will be harder and longer fought. For this reason, we are currently underweighting exposure to healthcare stocks in portfolios.

2. Trade Conflict – The trade waters are already being tested via Twitter with Ford, Honeywell, GM, Toyota, BMW and others. As these companies announced new factory builds offshore, President Trump threatened import taxes or tariffs on products made in these factories and imported by the U.S. In most of these cases, an overseas factory construction or expansion was halted and jobs moved or retained in the U.S. The Trump trade team is impressive and features one of the world's most successful and hardline private equity investors (Ross – incoming Commerce Secretary), a vocal China/trade hawk (Navarro – White House Special Trade Council) and one of the most experienced U.S. trade negotiators (Lighthizer – U.S. Trade Representative). The group has repeatedly pledged to implement and enforce fair and "smart" trade policies. We have spent significant time researching Trump's trade policy. We expect an aggressive stance, but do not think an all-out trade war is likely. Almost 1/3 of trade complaints involve China and most of the other complainants are APAC countries. Most of the complaints involve mining, construction products and chemicals. Electronic components rank high in complaints, however, in most cases China is assembling products manufactured elsewhere in Asia (Singapore, Taiwan, Malaysia, Thailand, etc.). This is part of the rationale for a VAT-like "border adjustment tax" proposed in the draft House tax bill, which would provide a fair tax on imported components of the supply chain. The U.S. is the only OECD country without

4350 Brownsboro Rd.
Suite 210
Louisville, KY 40207

p (502) 259-2500
f (502) 259-1501
www.cbandt.com

such a tax. U.S. exporters that appear to be most at risk of retaliation in a trade conflict are agriculture and aerospace, particularly Boeing – the largest exporter to China.

Our larger macro concern is how fiscal, trade or monetary policies will impact the dollar and U.S. interest rates. If a trade conflict causes the dollar to rise 7% or more from current levels it will likely create a one percentage point drag on GDP. The same is true of a 0.75% increase in the 10-year Treasury yield. An unexpected increase or the dollar could create a similar business slowdown as in 2015, which caused analysts to lower earnings on U.S. exporters resulting in flat to down returns for many stock indices that year. A precipitous drop in oil prices or a geopolitical event can also cause a surge in the dollar resulting in a similar outcome for earnings of exporters and the markets. As the Fed raises rates (CB&T agrees with market consensus of 2-3 rate hikes in 2017), the impact on GDP from a prolonged surge in the dollar could be magnified. We are a little less concerned about the Fed surprising to the hawkish side of rates as their policies have erred to the side of dovishness and accommodation.

Market Valuation, Expected Returns and Portfolio Strategy

2017 Earnings growth estimates for the S&P 500 large cap in addition to the Russell mid-cap and small cap indices have increased from mid-single digit growth to 9%, 9% and 11%, respectively. While the 2018 S&P 500 estimate projects 11%-12% growth. We believe a compounded EPS growth rate of 10% for these indices is possible by the end of 2018. As previously discussed, price moves in November and December seem to be pricing in tax cuts and other growth policies in 2017. We are less certain Trump growth policies will be enacted and make the full impact in 2017, however, we think the compounded growth rate target leading to a $145-$150 estimate for 2018 is reasonable. Therefore, we believe the market has 6%-10% total return upside from its current level in the in the next 12-18 months. Our biggest risks to this upside would be as discussed above: a stall in legislating most of Trump's growth policies and or an event such as a trade conflict or precipitous drop in oil that sends the dollar significantly higher.

Table 5: S&P 500 Valuation

- S&P 500 Value 12/31/16:	$2,239	- 2016 Estimate:	$118
- S&P 500 Forward Multiple 17E:	17.0x	- 2017 Estimate:	$132
- S&P 500 Forward Multiple 18E:	15.1x	- 2018 Estimate:	$148

Implied S&P 500 Valuation

	$120	$125	$130	$135	$140	$145	$150
14.0x	1,680	1,750	1,820	1,890	1,960	2,030	2,100
14.5x	1,740	1,813	1,885	1,958	2,030	2,103	2,175
15.0x	1,800	1,875	1,950	2,025	2,100	2,175	2,250
15.5x	1,860	1,938	2,015	2,093	2,170	2,248	2,325
16.0x	1,920	2,000	2,080	2,160	2,240	2,320	2,400
16.5x	1,980	2,063	2,145	2,228	2,310	2,393	2,475
17.0x	2,040	2,125	2,210	2,295	2,380	2,465	2,550

Implied S&P 500 Price Change

	$120	$125	$130	$135	$140	$145	$150
14.0x	-25%	-22%	-19%	-16%	-12%	-9%	-6%
14.5x	-22%	-19%	-16%	-13%	-9%	-6%	-3%
15.0x	-20%	-16%	-13%	-10%	-6%	-3%	0%
15.5x	-17%	-13%	-10%	-7%	-3%	0%	4%
16.0x	-14%	-11%	-7%	-4%	0%	4%	7%
16.5x	-12%	-8%	-4%	-1%	3%	7%	11%
17.0x	-9%	-5%	-1%	3%	6%	10%	14%

Source: Yardeni Research.CB&T. Note add ~2% in dividends for S&P 500 total return
Analysts' Consensus estimates are $118, $132, and $148 resepectively

From a downside perspective, to reach the 1825 bear market level on the S&P 500, market EPS estimates would need to fall significantly. As previously mentioned, the current economic data does not fit with a scenario where companies would make large cuts to their earnings guidance, which we think is required to push the market into bear market territory. The U.S. or EU would likely need to fall into recession to revise EPS to the level required for bear market. While oil prices remain under OPEC's control, we foresee a situation where political uncertainty over trade or another oil price collapse could cause a few sectors to experience an earnings recession. This would likely result in a market sell-off, but we find it difficult to make the argument for a bear market correction without an accompanying economic recession. While monetary policy is beginning to tighten, rates remain near historic lows and fiscal policy should provide significant stimulus keeping the punch bowl on the table for the current economic expansion and bull market.

Commonwealth Bank & Trust Company

4350 Brownsboro Rd.
Suite 210
Louisville, KY 40207

p (502) 259-2500
f (502) 259-1501
www.cbandt.com

Portfolio Strategy

We believe Trump's economic policy sends a few clear signals for certain parts of the market, while other market signals are murkier, but should become clearer over the next two years. We made tactical changes to portfolios going into the end of the year as we implemented tax loss harvesting to reduce gains. We continue to make changes in January for any portfolios that were tax constrained for 2016. As discussed above, we expect a post-inauguration pullback, at which point we will put additional money to work (buy the dip).

- **Buy Domestic Equities** – In the near term and possibly over the next two years, we will be overweighting domestic equities, primarily those with most of their profits in the U.S. that will benefit from a tax cut and secondarily those that benefit from infrastructure and regulatory reforms. Therefore, the overweight position will emphasize domestic vs. multi-national S&P constituents as well as overweight mid and small cap stocks.
- **Trim International Equities and Bonds** – We are currently trimming developed international equities and bonds as a source of funds for our domestic equity overweighting. We are cutting emerging market equities and bonds until we get clarity on the dollar. We expect to have some dollar stabilization or clarity in the first half of 2017. We believe emerging markets will be a long term source of outperformance for portfolios, so we expect to move back into this asset class later in 2017.
- **Trim Domestic Core Bonds** – We expect the Fed to implement a steady series of rate hikes starting with rate hike in December 2016. We are using domestic bonds as a secondary source of funds for our overweight domestic equity position, though Treasuries and Municipals appear oversold at the moment.
- **Maintain Alternatives Position** – We are maintaining an 8%-10% position in alternative investments in most portfolios, primarily managed futures and global macro strategies. We are concerned there could be market uncertainty and volatility created by trade, regulatory, or market policy missteps over the next year. Managed futures and global macro strategies offer the most widely diversified basket of asset classes and have tended to be counter-correlated to most market downswings. These strategies underperformed equities in 2016, in the context of a low volatility, low inflation, bull market for both equities and credit. We believe these strategies are likely to outperform if we are indeed entering a higher volatility, higher inflation market regime. We are also remaining vigilant for signs of growing inflation. Elevated inflation could also be a tailwind for these alternatives strategies, as they have a significant amount of their risk budget allocated to long/short commodities trading. If we see the Fed getting behind the curve on inflation, we would likely include a 1%-2% position in gold within the alternatives portfolio.