Commonwealth Bank & Trust Company

4350 Brownsboro Rd.
Suite 210
Louisville, KY 40207

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

## OVERVIEW

Global growth continues to surprise to the upside in 2017. The OECD expects that all 46 economies it tracks will see positive GDP growth for the first time in ten years. The S&P 500 rallied another 4.5% in the third quarter, posting a 14.2% return for the first nine months of 2017 and is making new all-time highs in October. At the beginning of the year, before the dollar started dropping, overseas markets rebounded and tax reform appeared imminent, we believed the market was rallying on tax cut expectations. After two quarters of strong earnings, the market started to discount tax reform potential and focused on fundamental earnings growth. As the year has progressed, EPS estimates for the S&P 500 remained the same, but estimates improved for companies with higher sales overseas and deflated somewhat for companies with higher domestic sales that would benefit from a tax cut. We still believe that estimates have some tax impact built into them, but markets now reflect greater sentiment for above market earnings growth. Applying **rational** multiples to expected earnings, we think the S&P 500 has 1%-2% downside and 1%-2% upside (please see "Market Valuation" section below). We do not, however, expect investors to behave rationally in a late stage bull market. As history has shown us, the current market backdrop of improving economic data, bullish fiscal policy attempts and above average earnings results sets up for **irrational exuberance** that leads to higher multiples, which should lead to mid-to-high single digit returns in 2018 for the S&P 500 versus the flat returns predicted above for a more rational market. We have been growing more cautious and are looking for opportunities to trim large cap S&P 500 stocks and replace them with more reasonably valued mid and small cap domestic stocks, international equities and emerging market equities. The most significant risk for markets we see for the next 6-12 months is a combination of failing to pass tax reform and significant disappointment or downturn of earnings occuring within a short time frame of each other. We are a little nervous that this timing could occur in the first quarter or early in the second quarter of 2018 (please see "Potential Risks" section below).

**Table 1: Index Returns**

| Index Returns ending 9/30/2017 | QTD | YTD | TTM |
|---|---|---|---|
| S&P 500 | 4.48% | 14.23% | 18.58% |
| Russell 2000 (Small Cap) | 5.67% | 10.94% | 20.74% |
| MSCI EAFE (International) | 5.40% | 19.96% | 19.10% |
| MSCI EME (Emerging Markets) | 7.89% | 27.78% | 22.46% |
| BBG BARC Aggregate Bond | 0.85% | 3.14% | 0.07% |
| Oil bbl. Price Changes | 12.23% | -3.82% | 7.11% |
| Gold Returns | 3.11% | 11.10% | -2.71% |
| Commodities Returns (CRB Index) | 4.76% | -4.89% | -1.73% |

**Source: Informa & Bloomberg*

**Table 2: Sector Returns**

| S&P 500 Sector Returns as of 9/30/2017 | QTD | YTD | 1-Yr. |
|---|---|---|---|
| Info. Tech | 8.64% | 27.34% | 28.85% |
| Financials | 5.24% | 12.48% | 36.13% |
| Healthcare | 3.65% | 20.29% | 15.48% |
| Consumer Staples | -1.34% | 6.58% | 4.42% |
| Consumer Discretion | 0.84% | 12.03% | 14.62% |
| Industrials | 4.21% | 14.11% | 22.32% |
| Energy | 6.84% | -6.61% | 0.16% |
| Materials | 6.04% | 15.81% | 21.26% |
| Telecom | 6.69% | -4.70% | -0.10% |
| Utilities | 2.87% | 11.83% | 11.98% |
| Real Estate | 0.93% | 7.38% | 2.64% |

**Source: Informa & Bloomberg*

## 3Q 2017 MARKET REVIEW: Unfazed by Hurricanes and Political Gridlock

**U.S. Stock Markets:** The S&P 500 rallied another 4.5% in the third quarter, posting a 14.2% return for the first nine months of 2017 and is making new all-time highs in October. The S&P 500 returned 18.6% over the last twelve months. The S&P 500 posted gains of about 2% in each of July and September and remained flat in August. Strong earnings results helped by a stronger overseas economic cycle and a weak dollar bolstered market returns in July. August returns were volatile over developments in North Korea, while September returns were helped by a preliminary introduction of tax reform legislation. In our opinion, investment sentiment indicates the market still has faith that key tax and regulatory reforms as well as infrastructure spending initiatives will eventually happen, but appears to have shifted more of its faith on higher corporate earnings growth. Earnings performance and upward EPS revisions of S&P 500 companies over the last two quarters reinforced sentiment. For the last two quarters, companies posted double digit earnings growth over the prior year's quarters. The good news is that earnings forecasters have maintained their earnings forecasts for year-end 2017 pushing more of the earnings results into the fourth quarter despite the disruption from hurricanes. The bad news is that sentiment has driven Price/Earnings multiples about 10% higher than normal from 15.7x to 17.4x forward 2018 earnings. This is not unusual in the latter stages of a market cycle and signals to us that we are in the 7th or 8th inning of the bull market. In the past we might have been a little more cautious, but economic data continues to remain strong and grow stronger by some metrics. As we have repeated in prior

Commonwealth Bank & Trust Company

4350 Brownsboro Rd.
Suite 210
Louisville, KY 40207

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

commentary, it is difficult for markets to move into a corrective or bear phase without deteriorating or recessionary economic conditions. In addition, fiscal policies are in the works to provide additional economic growth stimulus possibly pushing off economic deterioration for several quarters. Nevertheless, we do believe some asset classes look overvalued relative to others and we have been making adjustments to client portfolios (please see below).

**Global Stock Markets:** While international and emerging market stocks trailed domestic equity returns for a decade, these indices outperformed U.S. stocks in the third quarter (4.5% S&P 500, 5.4% EAFE; 7.9% EM), year-to-date (14.2%, 20.0%; 27.8%) and the last twelve months (18.5%, 19.1%; 22.5%). International markets have benefitted from a weak dollar (down 8.9% YTD) as well as fundamental strength in developed and emerging market economies. After years of flat to down growth, EU growth is matching or exceeding U.S. GDP growth thanks to extensive quantitative easing and improvement in EU bank balance sheets. We continue to recommend increasing allocations to international and emerging market equities as their valuations are cheaper and growth potential higher relative to domestic equities, particularly large cap stocks.

**Global Bond Markets:** (Please see Table 1) Global bond markets delivered results in line with expectations as the Bloomberg Barclays U.S. Bond Aggregate (BBG Aggregate) returned 0.85% during the third quarter and 3.14% for the first nine months of 2017. The twelve month return 0.07% for the BBG Aggregate was below the rate of inflation as bond yields rose from all-time lows in the third quarter of 2016 after the Fed made three quarter point (0.25%) increases to the Fed Funds rate in December 2016, March 2017 and June 2017. Global bond indices performed better than U.S. bonds year-to-date returning 6.25% and 7.50% for the BBG Global and EM Aggregate indices, respectively. The weak dollar boosted international bond returns. Taking out the currency impact, BBG Global returns were lower than the U.S. at 2.22%. EM bonds still outperformed the U.S. with a 7.28% return after removing the weak dollar impact. Many EM bonds are dollar-denominated and many EM currencies are pegged to the dollar, so the weak dollar impact is lessened. Despite the three rate increases and indications that the Fed may continue to raise rates in 2017, the 10-year Treasury has remained between 2.1% and 2.6%, since December (2.3% as of September 30). We think part of the reason the 10-year Treasury has remained range-bound still relates to much lower rates for the 10-year sovereign debt overseas, which attract foreign buyers of treasuries seeking higher yields. Economic researcher, BCA, believes the stubbornly low rates indicate that markets doubt the Fed's resolve to increase rates in the face of mixed economic data as Fed Chair, Janet Yellen, signaled in early July that she expected the pace of future rate increases to be more gradual.

## 2017 ECONOMIC OUTLOOK: Improving Global Picture ; Hurricanes Impacting U.S. Economic Data

U.S GDP growth came in slightly below expectations for 2017 so far, while growth for Europe and other international countries has surprised to the upside. U.S. GDP growth was originally projected to be 1.9% for the first quarter and improve to 2.5% for the remaining three quarters of 2017 to deliver 2.4% GDP growth for 2017. First quarter GDP of 1.2% fell short of projections. Second quarter GDP results strengthened to 3.1% bringing first half GDP results slightly below expectations.

**Figure 1: September Jobs Report Hurricane-related Layoffs in Bar/Restaurants**


Nevertheless, third quarter GDP estimates of 2.6% are likely to fall due the impact of Hurricanes Harvey and Irma as more economic data is reported. For example, one economic commentator noted that the September payroll report was mostly a weather report. The storms resulted in a net loss of 40,000 jobs for the month of September, for the first monthly loss since 2010. Most of the job losses were bar/restaurant layoffs in Florida and Texas related to the Hurricanes (please see Figure 1). The storms will negatively impact third quarter economic data and domestic earnings. Looking forward though, the storms may stimulate additional economic growth as impacted communities repair and rebuild. Auto sales, for instance, received a 16% boost in September over August auto sales as Texans with flooded out cars replaced totaled vehicles in order to get back to work (Figure 2).

As a result of the hurricane activity in the third quarter, economists have reduced 2017 GDP forecasts to 2.2% and 2018 GDP projections to 2.3%. We believe there is upside to the 2018 GDP estimate and that many economists are waiting for clarity on the

Commonwealth Bank & Trust Company

4350 Brownsboro Rd.
Suite 210
Louisville, KY 40207

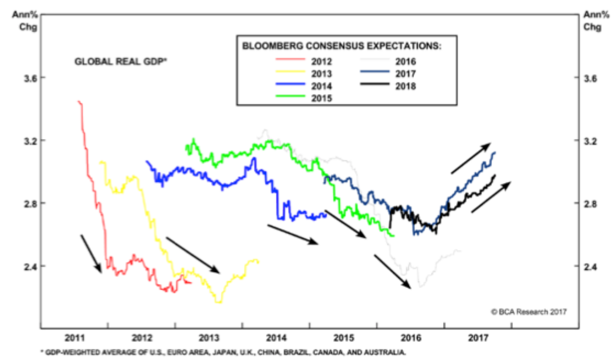
p (502) 259-2500
f (502) 259-1501
www.cbandt.com

timing and the level of tax cuts in a budget bill and infrastructure spending legislation now expected in the first quarter of 2018 at the earliest. While some investors have expressed concern that the current business cycle has gone on too long, Leading Economic Indicators and Coincident Economic Indicators reached new highs in May. Based on timing of average past cycles these indicators would normally peak around 1Q19, however, the indicators have not made the same progress as in typical cycles, suggesting a peak may take longer than two years. Additionally, the current shape of the yield curve and timing of rate increases also suggests the economic/market cycle should continue for another two years. Therefore, we believe the business cycle is likely to continue for the next two years and could possibly be extended longer via fiscal policy.

**Figure 2: Light Weight Vehicle Sales**


Global growth continues to surprise to the upside this year (Figure 3). The OECD expects that all 46 economies it tracks will see positive GDP growth for the first time in ten years. Furthermore, consumer and business confidence surveys across developed economies as well as global leading economic indicators are reaching new post-crisis peaks. Global Purchasing Manager Indices (PMIs) are also in strong expansion mode (>53). As we indicated in earlier newsletters, 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. At a conference in June, ECB President Draghi expressed confidence that QE policies were working and that he expected to make gradual adjustments to "monetary policy parameters", i.e., slow the future pace of quantitative easing. The euro increased 3% vs. the dollar and European stock indices weakened after Draghi's comments. At Jackson Hole in August and at an ECB meeting in September, Draghi tempered his original comments. Current institutional investor surveys forecast the first ECB rate increase being at least two years away. In October, the IMF raised its forecast for global growth for a second time this year from 3.5% to 3.6% for 2017 and raised its 2018 forecast from 3.6% to 3.7%.

**Figure 3: Global Growth Forecasts**

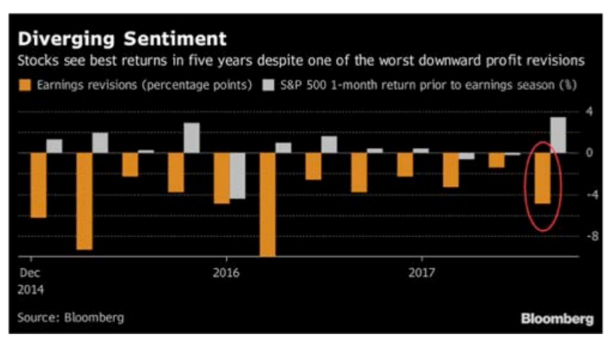



**Source: BCA & Bloomberg*

## <u>2017-2018 Market Outlook:</u> What is Driving the Market: Earnings Estimates or Tax Reform Expectations?

Market pundits seem to be falling into two camps to explain new market highs: the improving fundamental earnings outlook camp and the camp that expects corporate tax reform to push earnings higher. So which camp is right? **Answer: Both,** because both arguments are essentially calling for increased earnings expectations. The evidence, however, is a bit of a conundrum and more or less related to the timing of expected earnings.

**Figure 4: Negative Earnings Revisions**




**Tax Reform Evidence:** According to CNBC, third quarter earnings estimates have been revised down between 3% and 5% in the last two weeks led by a significant reforecasting of earnings for the financial sector. Financials are now expected to post a 4.9% year-over-year decline, because of losses from the hurricanes attributed to property and casualty insurers within the index. Forecasters have pushed those lost earnings off a quarter by raising the fourth quarter earnings estimate by 5.4%. Nevertheless, the market shrugged off the hurricane impact by reaching new highs in early October after a preliminary outline of tax reform

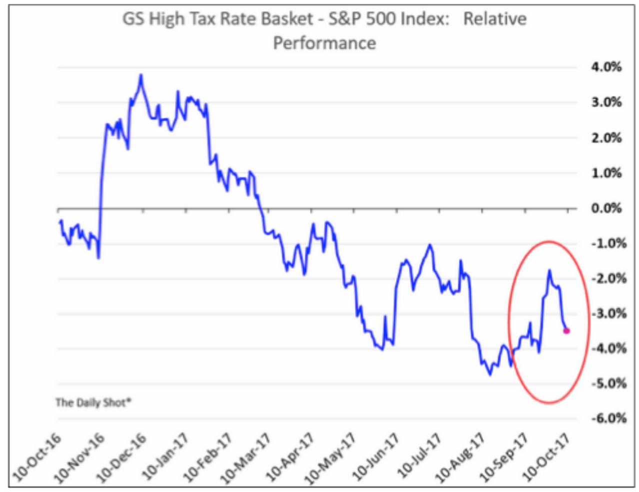
4350 Brownsboro Rd.
Suite 210
Louisville, KY 40207

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

legislation was introduced, validating its importance to market sentiment.

**Fundamental Earnings Growth Evidence:** Adding complexity to the earnings vs. tax reform debate is the recent performance of stocks with high tax rates. These stocks should have rallied on the introduction of the preliminary tax reform plan, however, the shares of companies with high tax rates have been falling (Figure 5). In our opinion, part of the reason for the drop in these shares has to do with the near-term outlook of these companies. Among the highest tax companies are domestic companies in industries with secular or cyclical problems, such as pricing wars between telecom companies, hurricane losses for property and casualty insurers or lost foot-traffic due to on-line shopping for retailers. Additionally, companies and sectors with most of their sales generated overseas continue to rally as their earnings are growing faster (Figure 6).

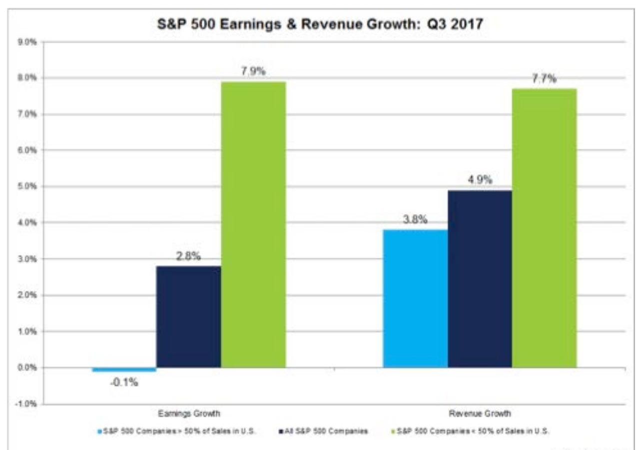
**Figure 5: Relative Performance of High Tax Rate Stocks vs. the S&P 500**




*Source: Goldman Sachs and WSJ: The Daily Shot

**Conclusion:** In our opinion, the market shows signs that it is supporting both stories. It appears to us that the market is looking past the hurricanes' impact on the third quarter and has relatively high expectations that above market business growth will continue for the next few quarters. We believe that tax reform expectations may have boosted the market in September after sliding on concerns created by the hurricanes in the first half of the month. We would expect the market to move another leg higher if tax reform legislation were passed sooner than the first quarter of 2018 and made retroactive to the beginning of 2018. At the beginning of the year, before the dollar started dropping, overseas markets rebounded and tax reform appeared imminent, we believe the market built tax cuts into estimates. As the year has progressed, EPS estimates remained the same, but estimates improved for companies with higher sales overseas and deflated somewhat for companies with higher domestic sales that would benefit from a tax cut. We still believe that estimates have some tax impact built into them, but the higher than expected Price/Earnings ratio on September 30 of 17.4x 2018 earnings may be reflecting greater sentiment for above market earnings growth.

**Figure 6: S&P 500 3Q17 EPS & Sales Growth**




*Source: Fact Set

**U.S. Bond Market** – Bond market activity has been a little puzzling in the first half of the year. Despite three 0.25% hikes to the Federal Funds Rate since December as well as a 75% expectation for an additional rate increase in December long term rates have remained below the rates at year end 2016 for all but a few weeks of 2017. The treasury yield curve has flattened since the beginning of the year, which is typical at the start of a rate hiking cycle. A few experts have opined that the current yield curve shape and timing of rate hikes creates an expectation that a recession and bear market correction would be roughly two years away.

- **Expecting a Slowing in Rate Hikes as other Forms of Tightening Implemented** – We expect fixed income returns to remain challenged in 2017 and 2018 as the Fed takes action to normalize rates up to historic levels. Fed officials have indicated it expects to hike rates in December, but future rate hikes may be more gradual as monetary tightening may be handled by gradually reducing the Fed's balance sheet, which should have the same effect as rate hikes. In September, the Fed announced it would let $10 billion in securities to mature each month without repurchasing replacement securities.

4350 Brownsboro Rd.
Suite 210
Louisville, KY 40207

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

- **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 0% to 3% from core bonds depending on the speed of normalization.
    - Munis should remain attractive as state budgets benefit from job creation and a higher rate of GDP growth.
    - We think credit, high-yield fixed income and emerging market fixed income offers better return potential than core domestic or developed international fixed income, but spreads for these fixed income asset classes continue to tighten making the risk/reward trade-off challenging.
  - Over the longer term, normalized 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.

**Figure 7: Cycles of U.S. and International Outperformance**


*Source: Barron's*

**International Stock and Bond Markets –** Despite the S&P 500's impressive year-to-date performance, international stock markets have rallied even further. Out of 45 major country stock indices, the S&P 500's year-to-date return of 14.2% ranks near the bottom at 35th. The Developed International index (MSCI EAFE) returned 20.0% and the Emerging Markets index returned 27.8% year-to-date. Some of the return difference can be explained by the 8.9% drop in the dollar since year end, but overall many emerging markets and EU countries are growing faster than the U.S. International and Emerging Market bonds also outperformed U.S. bonds, generating year-to-date returns of 6.25% and 7.50% vs. 3.14% for BBG U.S. Aggregate index.

Since the beginning of the year, we have increased exposure in client accounts to developed international and emerging market stocks, but only increased exposure to emerging market bonds. We have avoided developed market bonds, because most remain at negative yields and probably have more downside risk than upside potential in the near term. International and Emerging Markets equities typically trade at a 10% and 20% discount, respectively, to U.S. equities. Given current growth prospects, the lower dollar and lag in business/market cycles, we think international equities trade at a 10% discount and EM equities trade at a 10%-15% discount to U.S. equities. While developed and emerging international equities outperformed U.S. equities, these markets are still trading at lower multiples of 14.9x and 12.5x 2017 EPS estimates, respectively, versus the S&P 500, which is trading at 19.2x 2017 EPS estimates. As long as the dollar remains within 3% of its current level or lower, we think international and emerging market equities should continue to outperform on a relative basis. Additionally, U.S. and international equities often alternate periods, when one asset class outperforms the other (Figure 7). We believe emerging markets offer a better long-term value than U.S. stock and bond markets, but are cautious for temporary headwinds created by a rising dollar expected in response to Fed and fiscal policy. We anticipate that we may be trimming emerging markets positions in 2018 on dollar strength.

**Potential Market Risks: One-Two Punch: Policy Failure Coupled with Disappointing Earnings**

While we believe certain key risks, such as oil prices or the dollar, have stabilized in the short run. The most significant risk for markets we see for the next 6-12 months is a combination of failing to pass tax reform and significant disappointment or downturn of earnings occuring within a short time frame of each other. We are little nervous that this timing could occur in the first quarter or early in the second quarter of 2018.

1. **Trump Tax Policy Failure** – At this point, most political pundits believe the earliest a tax bill could be passed would be sometime in the first quarter. If tax reform legislation looks like it will fail or that a tax cut only lowers the corporate tax rate to around 30%, then we think the market could give up 2%-5%. We think most of this revaluation will show up as move to a lower P/E ratio versus a significant reforecasting of earnings.
2. **Earnings Disappointment** – Forecasters have reduced third quarter earnings to reflect the impact of Hurricanes Harvey and Irma. Current forecasts have been lowered from 8%-9% to 3%-5% year-over-year growth. Forecasters expect the lost business activity will be pushed into the fourth quarter earnings, which are now forecast to grow 14%. We are concerned 4Q17 results reported in late January or early February could fall short. Two important macro factors to watch are the dollar

Commonwealth Bank & Trust Company

4350 Brownsboro Rd.
Suite 210
Louisville, KY 40207

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

and wages. If the dollar rises sharply, which could happen if the Fed moves aggressively on rate hikes and balance sheet reduction, while the ECB softens its stance, easing more. Wages have been rising gradually and we are reaching full employment, which should pressure wages upward. Wage increases raise costs for companies particularly service companies. Rising labor costs pressure operating margins, which are reaching cycle peaks, and subsequently reduce EPS. Depending on the magnitude of moves in the dollar and wages, the market could experience a small correction. Worst case we think the double digit earnings forecasts for 2018 and 2019 may be overstated by 3%-4% on stable dollar and wage assumptions.

**Figure 8: U.S. Dollar vs. Currency Basket YTD**

**Source: Thomson Reuters*

3. **The One-Two Punch** – If markets had the worst case misfortune of failed policy and disappointing earnings results or guidance within a short period of each other, we think this could negatively impact sentiment and result in a 5%-10% pullback. Of the two risks, we think failed, significantly delayed or disappointing tax reform package is more likely. In our opinion, the impact of potential tax cuts has been reduced in forward earnings estimates and replaced with improving fundamental earnings. Therefore, such a failure would likely have a smaller or shorter market impact, particularly if fundamental earnings remain strong. We do not think a surge in the dollar or wages is likely in the face of the Fed's gradual pace of normalization.

## MARKET VALUATION EXPECTED RETURNS AND PORTFOLIO STRATEGY

Current 2017 earnings growth estimates for the S&P 500 large cap in addition to the S&P mid-cap and small cap indices have increased from mid-single digit growth to low double digit growth. While the 2018 estimates project 11% growth, we believe estimates for the S&P 500 large cap index reflect little in the way of tax cuts and mostly reflect improving business fundamentals and global growth. We think the compounded growth rate target of 10%-12% leading to a $145-$150 estimate for 2018 is within reason, but possibly a stretch without a corporate tax cut. On a fundamental basis with the market at 2519 at quarter end and 2550 in early October, the S&P 500 has priced in forecasted 2018 earnings, in our opinion. Applying rational multiples to expected fundamentals we think the S&P 500 has 1%-2% downside and 1%-2% upside (yellow box in the table below). We do not, however, expect this late stage bull market and its investors to behave rationally in the face of improving economic data, bullish fiscal policy attempts and above average earnings results in the coming 6-12 months. The current market backdrop sets up for irrational exuberance that leads to higher multiples on mid-to-high single digit earnings growth, which correspondingly leads to mid-to-high single digit returns in 2018 for the S&P 500 versus the flat returns predicted above for a more rational market (green box in the table below). This set up makes us more cautious and to look for opportunities to trim large cap S&P 500 stocks going forward and replace them with more reasonably valued mid and small cap domestic stocks, international equities and emerging market equities as well as uncorrelated alternative investments.

**Table 3: S&P 500 Valuation**

| | | | |
|---|---|---|---|
| - S&P 500 Value 09/30/17: | 2,519 | - 2017 Estimate: | $131 |
| - S&P 500 Forward Multiple 17E: | 19.2x | - 2018 Estimate: | $145 |
| - S&P 500 Forward Multiple 18E: | 17.4x | | |

**Implied S&P 500 Valuation**

| | $130 | $135 | $140 | $145 | $150 | $155 | $160 |
|---|---|---|---|---|---|---|---|
| 14.0x | 1,820 | 1,890 | 1,960 | 2,030 | 2,100 | 2,170 | 2,240 |
| 14.5x | 1,885 | 1,958 | 2,030 | 2,103 | 2,175 | 2,248 | 2,320 |
| 15.0x | 1,950 | 2,025 | 2,100 | 2,175 | 2,250 | 2,325 | 2,400 |
| 15.5x | 2,015 | 2,093 | 2,170 | 2,248 | 2,325 | 2,403 | 2,480 |
| 16.0x | 2,080 | 2,160 | 2,240 | 2,320 | 2,400 | 2,480 | 2,560 |
| 16.5x | 2,145 | 2,228 | 2,310 | 2,393 | 2,475 | 2,558 | 2,640 |
| 17.0x | 2,210 | 2,295 | 2,380 | 2,465 | 2,550 | 2,635 | 2,720 |
| 17.5x | 2,275 | 2,363 | 2,450 | 2,538 | 2,625 | 2,713 | 2,800 |
| 18.0x | 2,340 | 2,430 | 2,520 | 2,610 | 2,700 | 2,790 | 2,880 |

**Implied S&P 500 Price Change**

| | $130 | $135 | $140 | $145 | $150 | $155 | $160 |
|---|---|---|---|---|---|---|---|
| 14.0x | -28% | -25% | -22% | -19% | -17% | -14% | -11% |
| 14.5x | -25% | -22% | -19% | -17% | -14% | -11% | -8% |
| 15.0x | -23% | -20% | -17% | -14% | -11% | -8% | -5% |
| 15.5x | -20% | -17% | -14% | -11% | -8% | -5% | -2% |
| 16.0x | -17% | -14% | -11% | -8% | -5% | -2% | 2% |
| 16.5x | -15% | -12% | -8% | -5% | -2% | 2% | 5% |
| 17.0x | -12% | -9% | -6% | -2% | 1% | 5% | 8% |
| 17.5x | -10% | -6% | -3% | 1% | 4% | 8% | 11% |
| 18.0x | -7% | -4% | 0% | 4% | 7% | 11% | 14% |

Source: Yardeni Research.CB&T. Note add ~2% in dividends for S&P 500 total return

Commonwealth Bank & Trust Company

4350 Brownsboro Rd.
Suite 210
Louisville, KY 40207

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

| We Believed → | Actions Taken → | Results |
|---|---|---|
| **DOMESTIC EQUITIES** | | |
| Trump policies likely to take longer to pass/ implement than street expects, but y/y EPS and GDP estimates likely to be stronger for 2Q17 than expected. | **Trimmed U.S. large cap stocks, moved to equal weight. Maintained overweight on small/mid cap stocks.** | Legislation has taken longer and 2Q17 EPS beat estimates. **Large cap stocks up 4.5% in 3Q17 (14% YTD); Small cap stocks outperformed in 3Q17 up 5.7% (11% YTD).** |
| **INTERNATIONAL EQUITIES** | | |
| We believed the dollar should stay lower for a little longer as the Fed holds to expected rate increases, U.S. growth remains at or a little below expectations and international growth continues to improve. | As dollar continued to fall, global economic conditions continued to improve, and relative valuations remained lower, **we moved our allocation to emerging markets and developed international stocks to ~10% overweight.** | **The dollar fell another 3% during 3Q17 (-9% YTD). Both emerging markets (+8%) and international stocks (+5%) outperformed during the quarter.** |
| **FIXED INCOME** | | |
| We expected one more Fed Funds rate increase later this year. We believed the Fed was likely to reduce its balance sheet in September. | We remained **underweight core bonds** in this rising rate environment. We remained **overweight credit/high yield bonds. We increased allocation to emerging market bonds.** | **The Fed did not raise rates in September, but outlined a $10 billion/month balance sheet reduction. Core bonds returned 0.85% in 3Q17, while credit/high yield bonds generated returns between 1.35% and 2.02%. International and EM bonds returned 6.25% and 7.50%,** respectively. |
| We believed munis were at fair value to a little overvalued. | **We maintained an equal weight to munis.** | **Munis underperformed core bonds in the quarter (0.73% vs. 0.85%), but have been outperforming YTD (3.72% vs. 3.14%).** |
| **ALTERNATIVE ASSETS** | | |
| Volatility will remain near record lows, if tax reform legislation remains stalled. | We maintained ~8% allocation to alternatives. We were watching Gold, it started to break out of its range and we started to add a little gold to accounts, but it fell back into a range that it has been stuck in for a few years. **Typically** inflation needs to increase faster than interest rates for gold to rally strongly, which is not occurring currently. | Volatility remained subdued and the SG **CTA alternatives index increased 0.69%, CB&T's Liquid Alpha alternatives CTF increased 1.34% in 3Q17. Gold increased 3.11%.** |

| We Believe → | Actions We are Taking |
|---|---|
| **DOMESTIC EQUITIES** | |
| Trump policies likely to take longer to pass - 1Q18 at earliest. 3Q17 EPS and GDP are going to be messy due to storms. A little nervous companies can make upwardly revised 4Q17 numbers. | **Trimming U.S. large cap stocks, likely to move to slightly underweight. Maintaining overweight on small/mid cap stocks.** |
| **INTERNATIONAL EQUITIES** | |
| We believe the dollar should stay lower for a little longer as the Fed remains dovish, U.S. growth remains at or a little below expectations and international growth continues to improve. | We are **maintaining our allocation to emerging markets and developed international stocks at overweight. Additionally we changed the mix of our developed market valuation from value to growth.** |
| **FIXED INCOME** | |
| We expect a 0.25% Fed Funds rate increase in December and the Fed to remain dovish. | We remain **underweight core bonds** in this rising rate environment. We remain **overweight credit/high yield bonds.** We are **maintaining our allocation to emerging market bonds and are a little concerned spreads have tightened too much to make putting new money to work attractive.** |
| We believe munis are at fair value to a little overvalued. | We are **maintaining an equal weight to munis** at this time, but remain vigilant for how tax policy will impact muni valuations. |
| **ALTERNATIVE ASSETS** | |
| Volatility will remain near record lows, if tax reform legislation still remains stalled and 3Q17 earnings and 4Q17 guidance remains in line with estimates. The impact of storms could make things a little more volatile, but we do not expect much volatility at least until the January-February earnings season. | We are maintaining ~8% allocation to alternatives. We continue to watch Gold for a breakout. |