2Q18 REVIEW & 2018 OUTLOOK

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SUMMARY: TRADE WAR!

The S&P 500 opened the year at 2674. Over the course of the first six months of 2018, the market made four rallies of 4% to 8%, only to return close to the 2674 level after each rally (Please see Figure 1). The S&P closed 2Q18 at 2718, up 1.6% (2.6% total return including dividends) for the first six months of 2018. Economic and corporate fundamental data are strengthening in the U.S. Propelled by the December 2017 tax cut and fundamentally sound earnings momentum, the S&P 500 constituents and other domestic stock indices are setting historic highs and delivering double digit annual growth rates in 2018. The market, however, is looking past 2018 fundamentals to a strong, but more normalized growth rate (10%) for U.S. companies expected in 2019. While economic fundamentals overseas also remain strong, some countries appear to have peaked. Furthermore, incremental headwinds, particularly the geopolitics of trade, are beginning to mute some of the beneficial economic developments in play at the beginning of 2018, curbing investor enthusiasm. Since March, trade has been the predominant focus of the market. The market has gyrated from short rally highs back to the 2017 closing level with each new trade tariff announcement as investors try to assess these uncertain tariff impacts on individual companies specifically and the economy in general. The last two “round trip” rallies ended a little higher than the year-end close. We do not expect trade conflicts to be wrapped up before year end, and will likely spill over as a factor into the mid-term elections. In the meantime, we are watching the dollar against key currencies, which appears to be breaking out on stronger U.S. growth and higher interest rates, while the currencies of some of the tariff target countries are weakening against the dollar. Most economic models and data over the last 20 years show that a 5% increase in dollar causes about a 0.25% decrease in U.S. GDP impacting net exports during the following 12 months. The data are sketchy on whether trade tariffs change this relationship for better or worse. Nevertheless, we remain optimistic the strong earnings and economic fundamentals will enable the market to squeeze out a total return between 5% and 10% by year end, despite trade uncertainties.

2Q 2018 MARKET REVIEW: Four Round Trips, Despite Improving Fundamentals

U.S. Stock Markets: The S&P 500 rallied 3.4% in the second quarter, making most of its gains during May, after posting a loss of -0.8% for the first quarter. The S&P 500 returned 2.6% for the first half of the year. The rise in volatility experienced in the first quarter continued into the second quarter as well as the month of July. As mentioned above the market made four significant rallies of 4% to 8% in 2018 with each rally falling to within 1% to 2% of the 2674 level, where the year started. The market could not fully shake the on again / off again progression of trade talks and tariff

Figure 1: S&P 500 YTD 6/30/18

Source: CB&T

Table 1: Index Returns

Index Returns ending 6/30/2018	Last 3 Months	YTD	Last 12 Months
S&P 500	3.43%	2.65%	14.35%
Russell 2000 (Small Cap)	7.75%	7.66%	17.57%
MSCI EAFE (International)	-1.24%	-2.75%	6.84%
MSCI EME (Emerging Markets)	-7.96%	-6.66%	8.20%
BBG BARC Aggregate Bond	-0.16%	-1.62%	-0.40%
Oil bbl. Price Changes	14.18%	22.72%	61.27%
Gold Returns	-5.46%	-3.83%	0.94%
Commodities Returns (CRB Ind	2.57%	3.36%	14.65%

Table 2: Sector Returns

S&P 500 Sector Returns as of 6/30/2018	Last 3 Months	YTD	Last 12 Months
Info. Tech	7.09%	10.86%	31.27%
Financials	-3.16%	-4.08%	9.60%
Healthcare	3.09%	1.84%	7.11%
Consumer Staples	-1.54%	-8.55%	-3.92%
Consumer Discretion	8.17%	11.50%	23.52%
Industrials	-3.18%	-4.69%	5.31%
Energy	13.48%	6.81%	20.98%
Materials	2.58%	-3.07%	9.89%
Telecom	-0.94%	-8.38%	1.37%
Utilities	3.74%	0.31%	3.41%
Real Estate	6.13%	0.81%	5.02%

Source for Table 1&2: Informa & Bloomberg

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actions, despite improving U.S. economic fundamentals and rising earnings forecasts. As we expected, small and mid-cap indices, which are comprised of companies that sell most of their goods and services in the U.S., outperformed the S&P 500 (3.4%) delivering returns of 4.3% for the S&P 400 Midcap index and 8.8% for the S&P 600 Small Cap index (7.8% for the Russell 2000 Small Cap index) during the quarter. Small (7.7%) and Mid-cap stocks (3.5%) outperformed S&P 500 large cap stocks (2.6%) for the first half of the year as well. During the first half of the year, investors sold equities in the industrial (-4.7%), staples (-8.6%) and materials (-3.1%) sectors, which are expected to be impacted by tariffs. Interest rate sensitive sectors such as financials (-4.1%), telecom (-8.4%), utilities (+0.31%) and real estate (+0.81%) also underperformed the index.

Global Stock Markets: International and emerging market stocks outperformed U.S. stocks in 2017, but underperformed the S&P 500 in the second quarter (3.4% S&P 500, -1.2% EAFE; -8.0% EM) and the year-to-date period (2.6% S&P 500, -2.8% EAFE; -6.7% EM). The EAFE international and the Emerging Markets indices outperformed the S&P 500 in most weeks of the first quarter, but began falling near quarter end as the dollar gained 6% off of 2018 lows in response to trade policy, rising rates and stronger U.S. economic performance. Fiscal policies, such as the tax cut and reduced regulations, are enabling the U.S. to outgrow the EU in 2018. Emerging markets are pulling back and many are seeing their currencies fall more sharply against the dollar over direct and indirect trade concerns. Some of the largest emerging market economies, such as China and Mexico, are the direct target of trade tariffs. Indirectly, many of the emerging market trading partners of China and Mexico started selling off. Developed international and emerging market equities still remain cheaper than U.S. stocks by many valuation metrics, but there is greater uncertainty relative to the economic fundamental strength of the U.S.

Global Bond Markets: U.S. bond indices performed better (-0.16%) in 2Q18 vs. -2.78% and -8.43% for the BBG Global and EM Aggregate indices, respectively. The stronger dollar hurt international bond returns. Taking out the currency impact, the BBG Global return was positive and better than the U.S. at +0.19%, while the EM bond index was below the U.S. index returns at -2.40% during the quarter net of currency impacts. Last year the 10-year Treasury remained range-bound between 2.1% and 2.6%. Accelerating jobs and wage data as well as inflation readings a little above the Fed's 2% target pushed the 10-year Treasury to break out of this range and reach its highest level in over five years (3.11%) during the second quarter, resulting in losses across most U.S. bond indices in 1H18.

2018 ECONOMIC OUTLOOK: Strong U.S. Growth; Moderating Global Performance

GDP growth was 2.2% in 1Q18, falling from 2.5% in 4Q17. Early estimates of 2.6% and 2.5% starting falling as the winter weather and flu seasons grew worse than expected. Nonetheless, this was much improved over recent first quarter readings that have ranged between 1.0% and 2.0%. Much of the difference is expected to be made up in the second quarter as economists raised the 2Q18 GDP forecast from 3.2% to 4.1%, however, the annual estimate for 2.9% growth has not changed. The 2019 forecast was lowered from 2.4% to 2.3%. It appears that the 2018 estimates have incorporated the impact of the tax cut, but the 2019 estimates appears to be offsetting the tax cut with an impact from trade policy. On average, most forecasters expect the tax cut to increase GDP by 0.45% in each of 2018 and 2019. A few of the economic studies we have reviewed forecast a 0.05% drag on U.S. GDP in 2018 rising to 0.250% in 2020 as a result of the tariffs and estimate that 100,000 to 200,000 U.S. jobs could be lost. Combining the tax, trade and underlying economic growth trends data, we think the 2019 GDP estimates are too low and should end up revised to the 2.5% to 2.75% range. As previously mentioned, a 5% increase in dollar causes about a 0.25% decrease in U.S. GDP. It is difficult to determine whether the trade tariff models take into effect any changes in the dollar.

Table 3: GDP Growth

	Q1	Q2	Q3	Q4	Year
2016	**0.6%**	**2.2%**	**2.8%**	**1.8%**	**1.5%**
2017	**1.2%**	**3.1%**	**3.2%**	**2.8%**	**2.5%**
2018	**2.2%**	***4.1%***	*3.0%*	*2.9%*	*2.9%*
2019	*2.5%*	*2.5%*			*2.3%*

Quarterly GDP = Q over Q growth. Year = annual Y over Y growth.
Source: Actual (Bold) Bureau of Economic Analysis as of 06/18
Projected (Italics) WSJ Economic Survey July 2018.

Overall, the U.S. and global economic setup exiting 2017 was the strongest it has been since the crisis. In January 2017, only two to three key economic factors were in play, yet many market indices delivered synchronized returns of greater than 20%. Currently, seven underlying economic forces are working that should enable global markets to continue to rally. For instance, the world remains in an accommodative policy regime. Central banks have maintained (1) easy monetary policies since the financial crisis. After years of fiscal austerity, populism is spreading, (2) loosening fiscal policy via increased spending and deregulation. Monetary and fiscal policy actions pulled Europe and Japan out of their economic ruts in 2017. Chinese fiscal stimulus ahead of last year's National Congress of the Communist Party led to a rebound and (3) stabilization of commodity and oil prices that reinvigorated Emerging Market economies. As a result, (4) the growth rate of international

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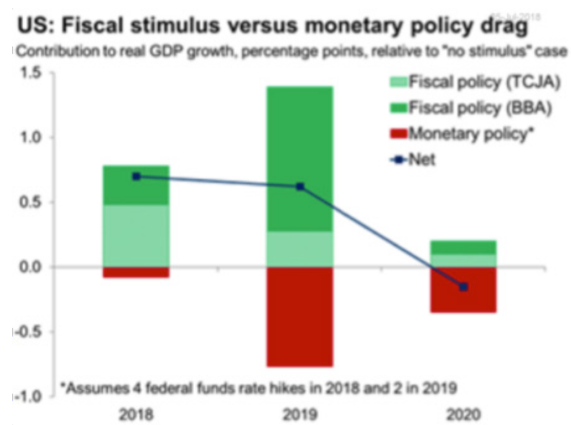
trade doubled in 2017. Amid this backdrop, the U.S. entered 2018 with (5) the largest tax cuts in its history setting corporate tax rates to levels not seen in almost 100 years. Furthermore in 2017, (6) the dollar fell 10% against other currencies, stimulating demand for U.S. goods and services. The new found cash from lower taxes, increased global demand and stronger pricing power (margins) are leading to an overdue (7) resurgence in capital investment by corporations, which should eventually lift productivity, a key component of GDP growth.

Alas, the stellar setup for global growth at the beginning of the year is being slowly tarnished by geopolitical forces. The global monetary policy regime remains accommodative, even though the Federal Reserve started normalizing rates in earnest during December 2016. Rates remained stuck in 2017 and it was not until there was an inflationary read on wages in January 2018 that rates started to rise significantly out of their four-year range bound lows. Additionally late last year, the ECB began postulating about its timetable for reducing monetary stimulus. Upon his installation as "Premier for Life" at last year's National Congress, Xi Jin Ping started to reinstate austere fiscal reforms cracking down on inefficient manufacturers and lax lending standards by allowing over-levered businesses and their banking collaborators to fail. Near the end of the first quarter, Trumps "America First" trade policy threw a wrench into market sentiment. As a result, the dollar rebounded 6% from its lows in the first quarter.

Our market estimates assume that global growth remains strong, but the breadth of that growth has likely peaked for this business cycle. In the last two quarters of 2017, all 46 OECD economies delivered positive GDP growth for the first time in ten years. Most OECD economies remain in strong expansion mode, but a few are demonstrating signs of deceleration. Earlier this year, the OECD upgraded its world growth forecast to 3.9% for 2018 and 2019, but revised the 2018 forecast down in May to 3.8%. The IMF maintained its 3.9% growth forecast for 2018 and 2019. The OECD predicts a decline in Eurozone growth to 2.2% in 2018 and 2.1% in 2019 after posting 2.6% growth in 2017. This suggests that the U.S. and EM countries will make up for the EU's decline in the global growth forecast. We are concerned that in the short run the EM country growth rate may decline slightly until it absorbs the change in the dollar and slowdown in demand from China.

Looking beyond 2019, we see a slower U.S. growth picture as monetary policy continues on its tightening trajectory and the short-term stimulus effects from a tax cut and deregulation wane unless new fiscal policy, such as a large infrastructure bill, is passed (please see Figure 2). We think new fiscal policy ideas will be introduced after the mid-term elections. Barring additional stimulus, we think the long, post-crisis economic cycle could start to fizzle out with the likelihood of recession increasing within the next two years.

Figure 2: Stimulus Waning



Source: Oxford Economics & WSJ Daily Shot

<u>2018 MARKET OUTLOOK:</u> Strong Tailwinds Meet Burgeoning Headwinds

In the first half of 2018, the market has responded as if it is centered in a three-way tug-of-war between 1) benefits from fiscal tax cuts that stimulate growth and dramatically increase 2018 corporate earnings; 2) a concern that U.S. monetary stimulus will tighten faster than anticipated as the Fed responds to potential inflationary pressures; and 3) worries that a trade war could slow both U.S. and international growth as well as pressure the earnings of affected industry sectors such as industrials and food staples. This action is playing out in the form of a lower Price/Earnings market multiple (~16x) than would be expected in the latter stages of a bull market (18x – 20x) and in the face of strong upward earnings revisions. Neither the Fed action nor the trade policy is likely to be resolved in the next few quarters. The market appears to be reconciling trade issues and refocusing its attention on earnings this month. An increase in guidance may take another quarter or two to emerge as companies will be cautious to raise earnings outlooks if their input costs are impacted by the proposed tariffs. The tax stimulus should prevail in the medium term assuming the trade conflict is not a long-term overhang.

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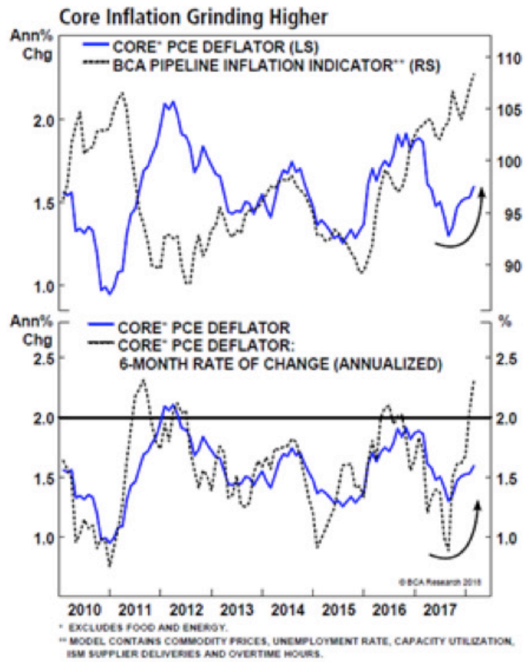
U.S. Bond Market: The Federal Reserve hiked rates by 0.25% for the seventh time since the financial crisis in June. Strength in jobs and wage data in the first quarter finally enabled the 10-Year Treasury to break out of its four-year range of 2.1%-2.6% and move above 3.0% in the second quarter peaking at 3.11%. Most investment grade bond indices generated losses for the year. The BBG Aggregate Bond index returned -0.16% for the quarter and -1.62% year-to-date.

- **Inflation Remains the Focus :** We expect fixed income returns to remain challenged in 2018 as the Fed takes action to normalize rates up to historic levels. Fed Futures now forecast one additional hike in 2018 after the March and June hikes. For the first time in several years we think inflation may rise meaningfully above 2% in the second half of 2018, spurred by wage growth and the recent strength in GDP readings above 4% (please see Figure 3). Inflation usually mirrors increases in GDP proportionally, albeit with a 6 to 9 month lag. The market fears that a few monthly core inflation readings with a 3% handle could cause the Fed to become more aggressive with rate hikes (more frequent hikes or greater than a 0.25% per increase per hike), which could in turn push the yield curve towards inversion. Fed Chairman Powell has indicated in recent testimony that the Fed will take its time with hikes and will not overreact to spikes in inflation.

Figure 3: Inflation Appears to be Accelerating



Source: BCA

- **Implications for Investors:** Over the next 2 to 3 years, the environment for intermediate to long term bonds is likely to remain bearish. We expect returns of -1% to 2% from core bonds depending on the speed of normalization. We would probably be a little more negative, but trade uncertainty appears to be attracting incremental buyers of U.S. bonds, which may enable bonds to deliver positive returns for 2018. We think short-term bond investments offer the best risk/return opportunity while the Fed steadily hikes rates. We continue to reduce positions in intermediate duration investment grade bonds and reinvest the proceeds in a mix of short duration floating rate investment grade debt, short term credit bonds and short term high yield bonds. All of these strategies generated positive returns year to date versus the BBG index.

International Stock and Bond Markets: After outperforming the U.S. in 2017 international markets underperformed the U.S. (EAFE: -2.7%; EM: -6.7%; S&P 500 +2.6%) during the first half of the year, while the dollar strengthened 2.7% during that time period. For the first half of the year, S&P 500 performance ranked 7th out of 45 country stock indices in U.S. dollars (12th in local currency). The NASDAQ (9.4%) and Russell 2000 would rank 4th and 5th versus other countries. The breadth of the S&P was particularly weak during the first half of the year and would have been down, if not for strong performance from FAANG stocks (Facebook, Amazon, Apple, Netflix and Google) which are heavily weighted in the index (please see Figure 4).

Figure 4: FAANG vs. S&P 500

Source: WSJ Daily Shot

Last year we increased exposure in client accounts to developed international stocks, emerging market stocks, and emerging

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market bonds. We believe developed international equities trade at a 10% discount and EM equities trade at a 10%-15% discount to U.S. equities (please see Figure 5). Even though international securities are cheaper, investors are moving to the higher growth and interest rates available in the U.S. Additionally, the dollar increased 6% from its low point in February and roughly 3% for the first half of the year. Sizable funds flow out of Emerging Markets stocks began during the second quarter. We think the dollar is poised to move higher. We stopped putting money to work in emerging market stocks and bonds in 2Q18 and are trimming positions this quarter. We have maintained positions in developed international equities. If the international returns are adjusted for the currency impacts and the returns of the five FAANG stocks are removed from the S&P 500, then the international index beat the remaining 495 S&P stocks in 2H18. Nevertheless, we may cut international positions on additional dollar strength and relative economic performance.

Figure 5: U.S. Stock P/Es More Expensive

Source: WSJ Daily Shot

MARKET RISKS: Trade Conflicts & Bear Market Warning Signs

Keeping Trade Discussions in Perspective: As we predicted last quarter, it appears that the negative market sentiment around trade is wearing off. The last three of the four pullbacks this year were related to trade announcements (please see Figure 1 above). Each successive pullback made a higher low, which indicates that market participants are putting the impact and timing into a more rational perspective than earlier in the year, in our opinion.

- **Trade Timeline:** The trade policy initiatives that rocked markets this year started with a nonchalant Presidential tweet in late January threatening 18 Chinese products with solar panels and washing machines being among the highest trade volume. The small threat did not register with markets.
  - **China:** Most of the trade initiatives have been directed at China. It started in March with $50 billion but included tariffs against large categories of abusive product dumping: steel and aluminum. China retaliated with tariffs on their large import categories: corn and soybeans. As the year progressed, Trump added more products reaching 10,000 by early July with a threat to add tariffs on all $505 billion in Chinese imports on July 20. China countered each tariff

Table 4: Trade Conflict Timeline

	Country Imposing	Country Target(s)	Major Goods / Services	Tariff %	$ Value	Effective Date
January 22	United States	China	18 products including solar panels & washing machines	N/A	N/A	N/A
March 8	United States	China (EU, Canada, Mexico)	1300 prods: Steel, aluminum (2 mo. exemption for EU, CAN, MEX)	10% / 25%	$50 billion	July
April 2	China	United States	128 prods: soybeans, pork, other ag, aluminum	15% / 25%	$3 billion	July
May 18	European Union	United States	~200 prods:Steel, whisky motorcycles, ag, consumer goods	10% / 25% / 50%	$7 billion	June
May 30	United States	EU, Canada Mexico	Steel, aluminum	10% / 25%	N/A	June
May 31	Canada	United States	Steel, whiskey, motorcycles, ag, staples aluminum	10% / 25%	$13 billion	July
June 5	Mexico	United States	Steel, pork, cheese aluminum	25%	$3 billion	July
June 15	United States	China	Electronics, manufacturing, components	10% / 25%	$50 billion	July
June 15	China	United States	Beef, poultry, tobacco, cars	10% / 25%	$50 billion	July
July 10	United States	China	Expanded list of consumer goods	10% / 25%	$200B	August
July 15	United States	China	All Chinese Imports	10% / 25%	$505B	Unofficial

Source: CB&T, New York Times, Bloomberg, Reuters

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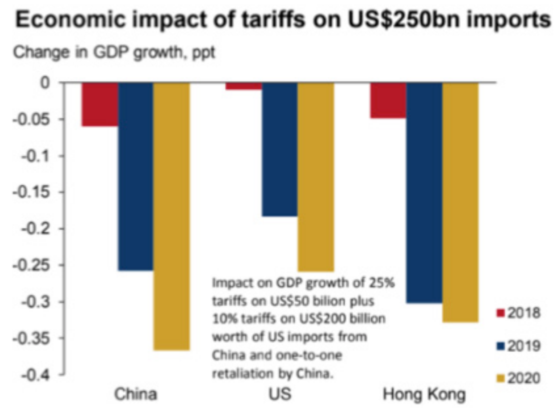
announcement with tariffs matching the same aggregate dollar amount of U.S. exports, however, the U.S. does not export more than $200 billion annually to China.

- **Canada, Europe and Mexico:** The tariffs have not been enacted. The Tariff proposal notice issued by the U.S. Trade Representative requires a comment period and the earliest the tariffs could be enacted is June 6. If progress is being made the tariffs can be delayed. In early April, National Economic Council Chairman Kudlow stated that back-channel communications were occurring between U.S. and Chinese officials.

- **Projected Impact of Tariffs:** Assuming a 100% loss of trade for every dollar of trade tariff imposed then every $50 billion in proposed trade tariffs would create a loss of 0.25% of U.S. and 0.35% of Chinese GDP, respectively. Economic models of trade impact, however, take into account substitution of products, sourcing from non-tariff entities, etc. that mitigate the impact by roughly 80%. More sophisticated models suggest that the total drag on U.S. GDP over the next three years will be 0.20%-0.25% and a 0.35%-0.40% on Chinese GDP after $250 billion in reciprocal tariffs (please see Figure 6).

Figure 6: Tariff Impact



Source: Oxford Economics, WSJ The Daily Shot

- **Collateral Damage – Currency Rates? :** Perhaps greater short-term pain may be inflicted on global trade relationships via currency exchange rates. Proposed trade policy is partially responsible for recent fluctuations and trends in currency rates. Since February the dollar has increased 6% against a basket of currencies. Additionally, China let the Renminbi fall 6% against the dollar over the last four weeks. In response the President stated that he was concerned about the dollar's rise and that the currency should be lowered. Similar comments made in January of 2017 preceded a 9% drop in the dollar last year. Currency action may exacerbate (U.S.) or undermine (China) trade policy and have a much quicker effect on trade. Economic data over the last 20 years show that a 5% increase in dollar causes about a 0.25% decrease in U.S. GDP.

- **Advantage: United States:** The U.S. has a two key advantage over Canada, China, the EU and Mexico.
    - As the world's largest economy, the U.S. tends to have asymmetric trading relationships, where the U.S. export market is more important to most trading partners than their export markets are to the U.S. In other words, trading partners sell more to the U.S. than the U.S. buys from them.
    - Exports are also a much larger part of these trading partners' economies. For example, the U.S. and Canada are each other's largest trading partner and we sell about the same amount of goods to each other, approximately $400 billion annually. However, 75% of Canadian exports go to the U.S. vs. 16% of U.S. exports go to Canada. U.S. exports make up 20% of Canada's GDP. Canadian exports make up 2% of U.S. GDP. China ranks third in exports for the U.S. and sells three to four times as much to the U.S. as it buys from the U.S. More importantly, U.S. exports to China comprise less than 1% of GDP, whereas China's exports to the U.S. represent over 4% of its GDP
    - Another factor in some cases, such as China, the type of trade can also give the U.S. a slight advantage. About 20% of the products China imports from the U.S. are agricultural (soy beans, corn, wheat, cotton, hogs, etc.). In many cases, other countries cannot fully replace the U.S. agricultural imports. Therefore, the Chinese consumer is likely to be impacted more directly through the purchase of key, day-to-day staples. U.S. imports of Chinese goods tend to have a heavier weight towards components that impact businesses directly. The direct consumer goods imports from China tend to be more discretionary purchase such as athletic apparel and equipment, which are more easily substituted.

- **Timing and Outcome:**
    - Until one party decides to negotiate, the expected reactions should be equal retaliation. When the U.S. proposed $50 billion in tariffs on Chinese goods, China retaliated with $50 billion in tariffs on U.S. goods. It has officially escalated

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to $200 billion in tariffs on both sides. Only July 15 the President stated that he is contemplating tariffs on all Chinese goods, roughly $505 billion. As discussed before, there are other forms of retaliation such as currency manipulation.

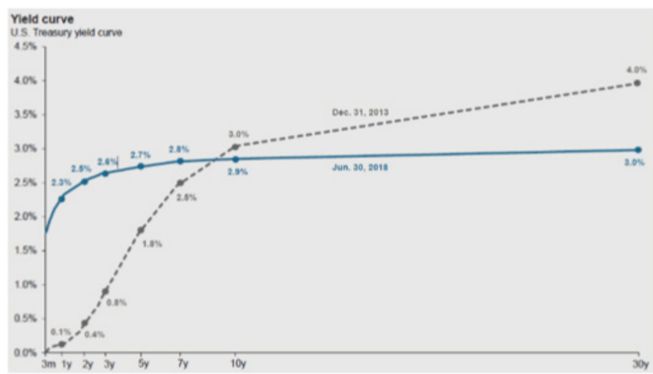
- We do not think any of the trade disputes will be resolved before the November mid-term elections. Negotiations require concessions from both sides and the Republicans will not want to be criticized for "picking winners and losers" via concessions that helped one industry, but hurt another industry. Furthermore, since the trading partners have more to lose in a negotiation, they are more likely to stall and prolong negotiations. As we mentioned earlier, China's case for stalling is particularly interesting, because it is carrying out austere economic reforms. The trade conflict enables Chinese leaders to blame the austerity measures on the U.S.
- Historically, the U.S. had the lowest aggregate tariff as a percentage of exports and was at a disadvantage relative to most trade relationships. While the timing is uncertain, we think the U.S. will be successful and will improve its global trade position.

Watching for Bear Market Warning Signs: Key Signs Remain Yellow

There are three key signs that signal a recession, which typically coincide with a bear market. These data points tend to signal a recession or bear market 3 to 12 months in advance.

1. **Inverted Yield Curve**: An inverted yield curve is probably the strongest and most urgent warning sign, because most market participants recognize that the Fed is trying to put the brakes on the economy. It is typically in response to a significant pickup in inflation (3%+). Usually inversion occurs after a few large rate hikes (0.5%-1.0%) occurring within a few months of each other. Inversion makes it unprofitable for banks to lend money, credit becomes expensive and/or dries up for many companies.
2. **Rise in Unemployment**: Each of the last 11 recessions since 1950 have coincided with a 0.3% rise in the unemployment rate, usually three successive 0.1% increases in the monthly unemployment announcement (please see Figure 7). The June reading for the unemployment rate rose 0.2% to 4.0% for the first time in several years. Job creation was strong, but the increase in the labor participation rate was stronger, possibly due to higher wage growth attracting workers back into the labor market. The good news is the unemployment curve has a long forward momentum over time. Recent data suggests that unemployment is likely to continue to decline until mid-2019.
3. **Market Valuation:** Typically, the last phase of a bull coincides with multiples reaching 19.5x to 20.0x next year's earnings, which would be the 2925-3000 level. Even so, the market can stay at elevated multiples for more than a year (please see Figure 8). Due to the uncertainty created by trade headwinds, we think this signal may not be reached for this bull market cycle. Forward multiples range from 15x to 17x currently.

Figure 7: Yield Curve June 30, 2018



Source: JP Morgan Asset Management

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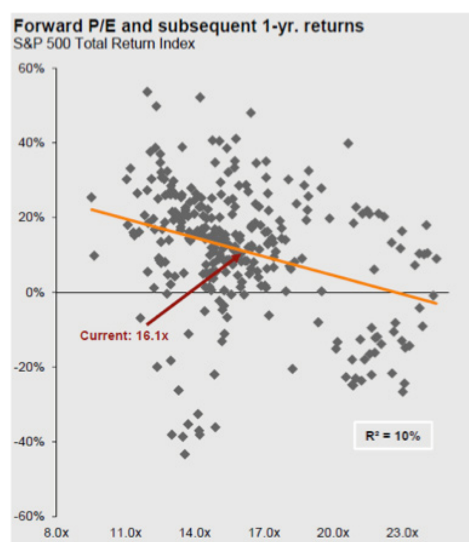
Figure 8: P/Es Leading to Corrections



Source: JP Morgan Asset Management

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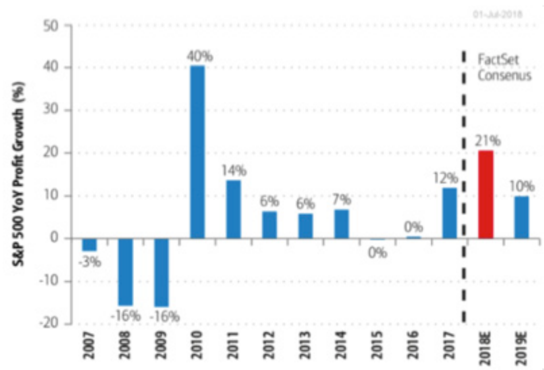
MARKET VALUATION, EXPECTED RETURNS & PORTFOLIO STRATEGY

While such concerns as a trade conflict and Fed/Inflation action are not likely to be resolved soon, the good news is that earnings have been revised upward significantly during the first and second quarters as companies increased earnings guidance with the impact of the tax cut (please see Figure 9). The current market valuation is about average based on 2018E earnings and 2019E earnings.

Figure 9: EPS Growth Rates



Source: BofA Merrill Research, WSJ The Daily Shot, FactSet

Normally, we would expect investors to become overly bullish in the face of improving economic data and above average earnings results this late in the bull market, as they did in early January. The January market rally was a typical late cycle response to rising earnings leading to the highest multiples of the bull market so far (18.7x 2018E earnings). January's late cycle exuberance was on track to deliver low to mid double digit returns in 2018 of 10% to 15% for the S&P 500. Prolonged uncertainty over trade actions and concerns over Fed action and inflation are more likely, in our opinion, to dampen late cycle exuberance this year. Therefore, we think as uncertainty over trade and the Fed dissipate, the market will have room to move higher on the increase in earnings later in the year. We believe, however, that market returns will imply more rational multiples on the improved earnings fundamentals resulting in total returns in a range of 5% to 10% for 2018 (please see Table 6).

Table 5: S&P 500 Valuation

- S&P 500 Value 06/30/18:	2,718
- S&P 500 Forward Multiple 18E:	16.9x
- S&P 500 Forward Multiple 19E:	15.4x

		Growth %
- 2017 Estimate:	$132	11.8%
- 2018 Estimate:	$161	19.7%
- 2019 Estimate:	$177	10.1%

Implied S&P 500 Valuation

	$145	$150	$155	$160	$165	$170	$175
14.0x	2,030	2,100	2,170	2,240	2,310	2,380	2,450
14.5x	2,103	2,175	2,248	2,320	2,393	2,465	2,538
15.0x	2,175	2,250	2,325	2,400	2,475	2,550	2,625
15.5x	2,248	2,325	2,403	2,480	2,558	2,635	2,713
16.0x	2,320	2,400	2,480	2,560	2,640	2,720	2,800
16.5x	2,393	2,475	2,558	2,640	2,723	2,805	2,888
17.0x	2,465	2,550	2,635	2,720	2,805	2,890	2,975
17.5x	2,538	2,625	2,713	2,800	2,888	2,975	3,063
18.0x	2,610	2,700	2,790	2,880	2,970	3,060	3,150
18.5x	2,683	2,775	2,868	2,960	3,053	3,145	3,238
19.0x	2,755	2,850	2,945	3,040	3,135	3,230	3,325
19.5x	2,828	2,925	3,023	3,120	3,218	3,315	3,413
20.0x	2,900	3,000	3,100	3,200	3,300	3,400	3,500

Implied S&P 500 Price Change

	$145	$150	$155	$160	$165	$170	$175
14.0x	-25%	-23%	-20%	-18%	-15%	-12%	-10%
14.5x	-23%	-20%	-17%	-15%	-12%	-9%	-7%
15.0x	-20%	-17%	-14%	-12%	-9%	-6%	-3%
15.5x	-17%	-14%	-12%	-9%	-6%	-3%	0%
16.0x	-15%	-12%	-9%	-6%	-3%	0%	3%
16.5x	-12%	-9%	-6%	-3%	0%	3%	6%
17.0x	-9%	-6%	-3%	0%	3%	6%	9%
17.5x	-7%	-3%	0%	3%	6%	9%	13%
18.0x	-4%	-1%	3%	6%	9%	13%	16%
18.5x	-1%	2%	5%	9%	12%	16%	19%
19.0x	1%	5%	8%	12%	15%	19%	22%
19.5x	4%	8%	11%	15%	18%	22%	26%
20.0x	7%	10%	14%	18%	21%	25%	29%

Source: Yardeni Research.CB&T. Note add ~2% in dividends for S&P 500 total return
Yellow box - rational expectations; Green box - "irrational exuberance"

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ASSET ALLOCATION OUTLOOK

LAST QUARTER			THIS QUARTER	
WE BELIEVED →	**ACTIONS TAKEN →**	**RESULTS**	**WE BELIEVE →**	**ACTIONS WE ARE TAKING**
DOMESTIC EQUITIES			DOMESTIC EQUITIES	
Bearish negative market sentiment over Fed/ Inflation and trade would moderate. We expected small & midcap to outperform on tax reform impact and higher domestic market exposure.	Trimmed U.S. large cap stocks, moved to underweight. Maintained overweight on small/mid cap stocks.	Small (7.8% 2Q18; 7.7% YTD) and Mid cap (8.8%; 3.5%) stocks outperformed large cap (3.4%; 2.6%).	Fed/Inflation and trade remains overhang. We remain optimistic that small & midcap will continue to outperform.	Continue to trim U.S. large cap stocks on rallies and maintaining underweight allocation. Maintaining overweight on small/mid cap stocks.
INTERNATIONAL EQUITIES			INTERNATIONAL EQUITIES	
We expected the dollar to remain within 3%-5% of March 31 level. We believed rate increases from the Fed and higher relative U.S. GDP growth would pressure the dollar higher later this year (2H18)	We maintained our overweight allocation to emerging markets and developed international stocks, but would consider trimming if dollar rallied considerably. We stopped putting new money to work in EM.	The dollar rallied 6% off of February lows but increased less than 3% YTD. Emerging markets (-8.0% 2Q18, -6.7% YTD) underperformed and developed international stocks (-1.2%; -2.7%) also lagged. Ex-FAANG and currency, developed international outperformed.	We think the dollar may continue to move higher, pressuring EM and developed international.	We are trimming emerging markets back to equal weight and are poised to trim EM and developed international stocks further on dollar strength and trade actions.
FIXED INCOME			FIXED INCOME	
We expected a 0.25% Fed Funds rate increase in either June and/or September. We were concerned GDP and wage growth could lead to a rise in inflation in 2H18, leading to more hawkish Fed action.	We remained underweight core bonds. We shortened our overweight position in credit/high yield bond. We shortened the duration of Investment Grade bonds.	The Fed raised the Fed Funds rate 0.25% in June. Core bonds returned -0.16% in 2Q18; -1.62% YTD, while high yield bonds generated +0.98%; +0.07% return. Our shorter duration bond portfolio outperformed benchmarks.	We expect one more 0.25% Fed Funds rate increase this year in either September or December. We think the Fed will tighten in a constructive fashion.	We remain underweight core bonds and maintaining short duration across most fixed income assets. We are trimming Emerging Market bonds as the dollar increases and China tightens.
We believed munis were at fair value to slightly undervalued at the beginning of 2018.	We maintained an equal weight to munis and were concerned how tax policy would impact muni returns and funds flow.	Munis outperformed core bonds in the quarter (+0.87% vs. -0.16%) and YTD (-0.25% vs. -1.62%).	We believe munis are at fair value to slightly undervalued at the beginning of 2018.	We are maintaining an equal weight to munis at this time.
ALTERNATIVE ASSETS			ALTERNATIVE ASSETS	
We expected volatility to remain high in 2018. We thought trade talks, rate increases and inflation surprises will continue to act as catalysts for higher volatility.	We maintained ~8% allocation to alternatives. We continued to watch Gold for a breakout.	Volatility returned to the market with >25 1% moves in 2018 YTD vs. 8 moves in 2017. SG CTA alternatives index benchmark fell -1.92% in 2Q18 and -4.74% YTD. CB&T's Liquid Alpha alternatives outperformed significantly 3.9% in 2Q18; 3.8% YTD.	We expect volatility to remain high in 2018. We think trade talks, rate increases and inflation surprises will continue to act as catalysts for higher volatility.	We are increasing our allocation to alternatives from 8% to 9%.
For more details on CBandT's investment outlook, please visit our Investment Commentary page at: https://cbandt.com/wealth-trust/resources/.				