Quarterly NEWSLETTER

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Commonwealth Bank & Trust Company

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Spotlight Remains on Trade & Monetary Policy

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The market could not fully shake the on again/off again progression of trade talks and tariff actions, despite improving U.S. economic fundamentals and rising earnings forecasts. Propelled by the December 2017 tax cuts and fundamentally sound earnings momentum, the S&P 500 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. Economic fundamentals overseas remain relatively strong, although 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, with the market gyrating from short rally highs back to the 2017 closing level with each new trade tariff announcement as investors try to assess impacts on individual companies and the economy in general. The last two rallies this year ended slightly 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 election.

The S&P 500 rallied 3.4% in the second quarter, making most of its gains during May. The first six months of 2018 saw the S&P 500 experience four rallies of 4% to 8%, only to fall back after each rally near the 2674 level where it began the year. The S&P 500 closed 2Q18 at 2718, up 1.6% (2.6% total return including dividends) for the first half of 2018. 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, delivering returns of 4.3% for the S&P 400 Midcap index and 8.8% for the S&P 600 Small Cap index during the quarter. 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. International and emerging market stocks underperformed the S&P 500 during the second quarter with the MSCI EAFE closing at -1.2% and the MSCI Emerging Markets index down -8%. International indices outperformed the S&P 500 in most weeks of the first quarter, but began falling near quarter end as the dollar gained 6% from 2018 lows in response to trade policy, rising rates and stronger U.S. economic performance. Many emerging markets are seeing their currencies fall 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. 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.

For more details on CBandT's investment outlook, please visit our Investment Commentary page at: https://cbandt.com/wealth-trust/resources/.

Chart 1

Q2 2018
Market Performance – Total Returns

	6.30.18 Level	Q2	1 year
Dow Jones	24271	1.26%	16.28%
S&P 500	2718	3.43%	14.35%
NASDAQ Composite	7510	6.61%	23.83%
Russell 2000	1643	7.75%	17.57%
S&P Midcap	1952	4.29%	13.48%
Russell 1000 Growth	1441	5.76%	22.51%
Russell 1000 Value	1187	1.18%	6.77%
MSCI EAFE	1959	-1.24%	6.84%
	Yield	Q2	1 year
Barclays Municipal	2.67	0.81%	0.61%
Barclays Aggregate	3.29	-0.16%	-0.40%
Barclays High Yield	6.49	0.98%	2.51%

Chart 2

Q2 2018
S&P 500 Sector Performance

	Q2	1 year
Healthcare	3.09%	7.11%
Consumer Discretionary	8.17%	23.52%
Consumer Staples	-1.54%	-3.92%
Financials	-3.16%	9.60%
Telecommunication	-0.94%	1.37%
Information Technology	7.09%	31.27%
Materials	2.58%	9.89%
Energy	13.48%	20.98%
Industrials	-3.18%	5.31%
Utilities	3.74%	3.41%

Proprietary Performance Results

	2nd Quarter	1 Year	3 Year	5 Year	Since Inception
Focused Equity Fund[2]	3.50%	13.13%	10.74%	11.95%	14.21%
Aggressive Growth Fund[3]	7.34%	31.52%	17.57%	18.13%	9.82%1
Science/Technology Fund[4]	8.92%	31.77%	16.58%	18.78%	10.59%
S&P 500	3.43%	14.35%	11.91%	13.40%	14.70%[2], 10.00%[3], 8.51%[4]
Russell 2000	7.75%	17.57%	10.96%	12.46%	14.91%[2], 9.37%[3], 7.88%[4]
MSCI EAFE	-1.24%	6.84%	4.90%	6.44%	8.64%[2], 5.10%[3], 4.03%[4]
Strategic Income Builder Fund[5]	1.19%	7.12%	6.17%	7.08%	9.41%
60% Russell 3000 Value, 40% Barclays Aggregate Index	0.96%	4.22%	5.88%	7.23%	9.20%

There is no assurance that any of these investment strategies will meet its investment objective. Performance results for each strategy are computed on the strategy's overall returns. Each strategy and index includes the reinvestment of dividends. Past performance does not guarantee future results. Current performance may be lower or higher than the performance results quoted. [1] Net of management fees; performance results of SMC Capital and/or its principals as advisor from inception to 2/28/06 and as sub-advisors to CBandT since 3/1/06. [2] Inception date 12/31/2008. [3] Inception date 7/1/1989. [4] Inception date 3/31/2006. [5] Inception date 12/31/2008.

Fixed Income

In June, the Fed raised its benchmark lending rate another quarter-point and indicated two more hikes in 2018. The long-run rate expectations by FOMC members, mostly 2.75% to 3%, did not move. They acknowledged more economic strength this year, revising GDP from 2.7% to 2.8% while reducing their unemployment rate forecast from 3.8% to 3.6%. The 3.8% level of unemployment in May was last seen in April 2000. Unemployment ticked up to 4.0% in June's report. On inflation, FOMC projections increased slightly but remain roughly 2%, which is in line with their target.

The yield curve (short vs. long interest rates) continues to flatten. The 2-year Treasury increased 0.26% while the 30-year rose just 0.02% and the widely quoted 10-year Treasury rate was up 0.12% to end the quarter at 2.86%. Jobs continue to be a positive with payrolls averaging 212k per month. Despite the very strong labor market, wage inflation remains reasonably subdued with average hourly earnings increasing 2.7% as of the June Jobs report. During the quarter, U.S. investment-grade bonds held up reasonably well after losing roughly -1.5% in the previous quarter. In all, income mostly offset price declines with broad-based benchmarks returning -0.15%. Global bonds fared better, with "hedged" global aggregate bonds ex-US returning 0.5% (vs. -4.8% unhedged) in the 2nd quarter. For global bonds, we are mostly allocated to emerging markets which have been impacted by the surge in the dollar this quarter. The U.S. high yield market returned 1.0% during the quarter basically offsetting the previous quarter's decline. 12-month performance of 2.6% was reasonable in comparison to investment-grade returns which were slightly negative.

Previously we discussed the tax-exempt municipal market and how it was dramatically impacted by tax reform. So where do we stand half way through the year? Municipal issuance did pick up during the quarter. Total year-to-date issuance of $156 billion is down 17% from this time last year. In all, tax-exempts returned a respectable 0.9% during the quarter with 12-month returns of 1.6%, outpacing taxable benchmarks as we expected.

Our base case for 2018 is that the yield curve will remain flat but be pushed up as short-term rates rise. An inverted curve is more probable than a steepening curve given global dynamics. We remain confident in our 1-3% return forecast for investment grade bonds over the next 3 to 5 years. That said, we continue to recommend a tactical underweight to core fixed income in favor of high quality dividend paying stocks and alternative strategies.

Focused Equity

For the second quarter and the twelve months ending June 30, the strategy returned 3.50% and 13.13%, respectively, versus a 3.43% and 14.35% increase for the S&P 500 Equity Index. Since inception, the strategy has narrowly trailed the S&P 500's annual return of 14.70% with an annualized gain of 14.21%. However, the fund has achieved these results taking on meaningfully less risk than the S&P 500 with a beta of 0.88 and capturing only 90% of the index's annualized standard deviation, thus producing annualized alpha (the amount of risk-adjusted performance greater than the benchmark) of 1.15 since inception (12/31/2008).

Leaders: Energy (+12.12%) and Technology (+11.08%) led the strategy during the second quarter. EOG Resources (EOG, +18.39%), Enbridge (ENB, +15.27%), and Chevron (CVX, +11.84%) rallied in the quarter amidst the healthiest average monthly crude pricing environment in over three years, aided by supply concerns related to Venezuela and Iran. Tech giants, Facebook (FB, +21.61%) and Apple (AAPL, +10.76%), as well as payment networks, MasterCard (MA, +12.34%), Visa (V, +10.90%) and PayPal (PYPL, +9.75%) led Focused Equity in Q2. Positions in Facebook, Mastercard, Kroger (KR, +19.45%) were among the best active selections in the quarter. For the last twelve months, many of the same holdings were top performers (AMZN, +75.60%; BA, +73.21%; MA, +62.78%; PYPL, +54.58%; MSFT, +45.72%; V, +42.18%; EOG, + 38.35%), concentrated in Technology and Energy.

Laggards: Financials (-6.01%), Industrials (-2.56%) and Consumer Staples (-2.39%) were the largest detractors from performance during the second quarter. Philip Morris Intl (PM, -17.64%), Invesco (IVZ, -16.12%), Starbucks (SBUX, -15.18%) and Celgene (CELG, -12.17%) delivered the worst performance in Q2. Global trade concerns surrounding the US & China coupled with a flattening yield curve, left financial stocks like Berkshire Hathaway (BRK.B, -6.43%), Invesco, JPMorgan Chase (JPM, -4.76%), and BlackRock (BLK, -7.37%) in the dust during the second quarter. Philip Morris Intl had the largest negative impact on the strategy's total return in Q2 as the tobacco giant continues to battle declines in global smoking rates, while the introduction of its next-generation non-combustible cigarette has been delayed by the FDA in the U.S. Over the last twelve months, Newell Brands (NWL, -42.55%) was the worst performing name in the portfolio, surprising the street with a major restructuring after a significant acquisition failed to generate the synergies anticipated. We cut the position over six months ago.

EOG Resources (EOG)
4/1/2018 – 6/30/2018

Strategic Income Builder

For the quarter, the strategy (SIB) returned 1.19%, ahead of its blended benchmark return of 0.96%, which is weighted: 60% Russell 3000 Value & 40% Barclay's US Aggregate. During the last 12 months, SIB was nearly 3% ahead of its benchmark results (7.12% vs. 4.22%). The yield generated from the strategy has consistently exceeded that of its benchmark. The success of the portfolio is the result of an attractive mix of income producing securities, exposure to global markets and tactical allocation.

For the quarter, our equities returned 2.25%, outpacing the Russell 3000 Value, which was up 1.71%. Energy (+13.3%) and Healthcare (-1.6%) were our best performing sectors and Financials (-3.5%) and Telecomm (-2.7%) performed the worst. Equity allocation was held at 66% of the portfolio, or a 6% overweight to its benchmark. Dividend yield on the equity holdings remained at 3.1% or roughly 0.6% higher than the Russell 3000 Value and over 1% more than the S&P 500.

Apple (AAPL, +10.8%) and Visa (V, +10.9%) were our top performers within the tech sector during the quarter. Over 12-months, our tech sector names returned 37.6% vs. only 20.3% for its value benchmark's tech sector. We have remained overweight the tech sector for some time, and we ended with a tech allocation of 16% compared to 9% for the Russell 3000 Value. Apple's stock price began moving May 1st after its 2Q earnings report. Apple defied skeptics by posting strong iPhone growth, with sales up 14.4% to $38 billion, fueling total revenue gains of 15.6% to $61.1 billion. Bristol-Myers Squibb Company (BMY -11.9%) was the worst performer within Healthcare during the quarter. BMY has two key products: heart-drug Eliquis and Opdivo in immuno-oncology. Eliquis is growing, but margin contribution is diluted as it shares the drug with Pfizer. This makes Opdivo a key growth driver, with success dependent on moving to earlier-stage cancer.

Quarterly fixed income performance of -0.43% trailed the Bloomberg Barclays Aggregate Bond return of -0.16%. However, over 12 months, fixed income results were nearly 1% ahead, at 0.54% vs. -0.40%. Our tactical position within emerging market bonds was the detractor, returning -5.0% for the quarter as the dollar surged. Fixed income allocation finished the quarter up slightly at 27%. Projected yield on the fixed income portfolio is currently 3.7% compared to 3.3% for the Index.

Alternative allocations returned -3.8% during the quarter. Portfolio allocation remained stable at roughly 4%. In general, we believe we can reduce portfolio volatility and enhance returns over time utilizing alternatives. Income/gains payouts ranged from 3.4% to 3.9% late last year, a slight advantage to bond yields.

Science & Technology Strategy

Sarepta Therapeutics, Inc. (SRPT)
4/1/2018 – 6/30/2018

The Science & Technology strategy (SciTech) returned 8.92% for the second quarter, outperforming the Nasdaq 100 (7.27%), the broader Nasdaq Composite (6.61%) and the Lipper Science & Tech Fund Index (5.71%). Since the inception of the strategy (3/31/2006), it has returned 10.59% versus 10.84% for the Lipper Science & Tech Index and 8.50% for the S&P 500. Over the long run, the strategy is outperforming the Lipper SciTech index, with higher risk-adjusted returns (+1.88% alpha).

Leaders: Healthcare stocks led during the quarter returning, 12.54% in our strategy vs. 3.09% for the S&P Healthcare Index. Sarepta (SRPT) rose 78% in 2Q18 and has gained 291% over the last twelve months after the company released breakthrough clinical results with gene therapy in treating Duchenne muscular dystrophy. The company already has the leading drug therapy, Exondys, which has been doubling sales annually over the last few years. We trimmed the position slightly during the quarter, before it pulled back from its high. Align Technology (ALGN), the maker of Invisalign, was one of the best performing stocks for the strategy, up 36% for the quarter and 128% for the last twelve months. Facebook (FB +22%), Amazon (AMZN +17%), Apple (AAPL +11%), Netflix (NFLX +33%) and Alphabet (GOOGL +9%) continued to produce outsized returns and the FAANG complex were top contributors to the strategy as well as major stock indices over the last twelve months.

Laggards: Semiconductor fabrication and capital equipment plays such Taiwan Semiconductor (TSM, -14%) and Lam Research (LRCX, 14%) declined on concerns that the prolonged semiconductor business cycle was coming to an end. Celgene (CELG -11%) and Bristol Myers (BMY -12%) continued to struggle with their new drug pipelines and lack catalysts until early 2019. We believe both companies should have significant upside within the next twelve months and once their drug development catalysts are realized.

Small Cap Composite

VeriFone Systems, Inc. (PAY)
4/1/2018 – 6/30/2018

The Small Cap Value Composite returned 4.41% for Q2 versus 8.30% for the Russell 2000 Value index.

One top contributing holding in the Portfolio during Q2 was VeriFone Systems Inc. (PAY, +48%), a global leader in secure electronic payment systems and services. In April, PAY agreed to be acquired by private equity firm Francisco Partners for $23.04 per share in cash, representing a 54% premium to the prior day's closing price and a 5% premium to our $22/share assessed valuation. We exited the position during the quarter. Another top contributor during the quarter was Mitel Networks Corp. (MITL, +17%), a provider of unified communications and collaboration products and services. In April, MITL agreed to be acquired by private equity firm Searchlight Capital Partners for $11.15/share, which was a +24% premium to the trailing three-month average price. We exited the position. Another positive contributor was healthcare group purchasing organization (GPO) and data analytics provider Premier Inc. (PINC, +23%). In mid-April, it was reported Amazon (AMZN) was abandoning its bid to sell pharmaceutical products to large health systems. This decision supported our view that GPOs such as PINC have high switching costs and offer more value than AMZN can provide.

A bottom contributing holding in the Portfolio during Q2 was Biglari Holdings Inc. (BH.A, -31%; BH, -29%), a holding company whose primary assets are in restaurants, including Steak N Shake and Cracker Barrel Old Country Store. In May, BH was unexpectedly removed from the S&P SmallCap 600 index, causing forced selling of a relatively illiquid stock in a very short time period. Given the share price decline was not a result of fundamental factors, we did not trim the position. Another bottom contributor was Hostess Brands Inc. (Cl A) (TWNK, -8%), the 98-year-old, iconic American snack cake brand. TWNK reported Q1 earnings that met expectations and later announced Andrew Callahan, who has 23 years of experience and comes from Tyson Foods, as the new CEO. Even with all the positives during the quarter, TWNK's share price stagnated. We took no action on the position. Another weak performer during the quarter was Avaya Holdings Corp. (AVYA, -10%), a provider of communications networks for companies via on-premise, cloud, and hybrid formats. A reduction to 2018 EBITDA guidance and a convertible note offering in June that was not clearly communicated both weighed on performance during the quarter. We added to the position prior to these events as we continued to build our target position.

Kentucky Municipals- 2Q 2018

Quarterly bond issuance by Kentucky municipalities declined to $644 million from $1.5 billion in the previous quarter. Competitively awarded deals were $293 million with negotiated deals of $351 million. Deal size was reasonably strong, averaging $23.9 million with 27 new issues in total.

Much of the supply in recent years has refinanced (refunded) outstanding debt. Purchasing "refunding" candidates over the years has proven very successful. Unfortunately, advance refunding will no longer be available for tax-exempt borrowers. Our substantial amount of pre-refunded municipals within portfolios are now more liquid and trading at tighter spreads. Non-BQ (bank-qualified) issuance was the majority, coming in at $517 Million or 80% with BQ issuance of only $57 million or 9%. We have historically used non-BQ because yields were typically higher. As we suspected, BQ yields are converging with non-BQ given the effective 21% corporate tax rate or 20% deduction for S-Corp banks. The remaining $70 million was AMT tax-subject issuance by Louisville Gas & Electric and there was no taxable issuance during the quarter.

Deals of note include $280 million tax-free negotiated issuance by KY State Property and Building Commission. Project No. 119 ($271 million) consists of a portion of the various public projects. Of note, $92.5 million is budgeted for an "Integrated Tax System" to replace 71 of the Dept. of Revenue's legacy systems and is currently out for bid. Another deal of note included $30 million issued by the Fayette County School District (rated Aa3/AA-) for a new elementary school to be constructed in Lexington.

KY bonds trailed the national market slightly during the quarter. The S&P Municipal Bond Kentucky Total Return Index returned 0.70% vs. 0.87% for the Bloomberg Barclays Municipal Index this quarter.

Kentucky Pension Update

On Wednesday June 21st, Kentucky's new public pension overhaul law was struck down in a setback for the state's Republican leaders on an issue that angered thousands of teachers who marched on the Capitol and closed schools in protest. The law places teachers hired after Jan. 1, 2019, in a hybrid cash-balance plan, similar to a 401(k), rather than a traditional pension, and requires those teachers to work longer before becoming eligible for retirement. It also caps the amount of accrued sick leave teachers may convert toward retirement to the amount accrued as of Dec. 31, 2019. Kentucky's ailing public pension systems have an unfunded liability of more than $40 billion. The case is expected to be appealed to the Kentucky Supreme Court.

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%.

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