Quarterly NEWSLETTER

FALL 2020

Commonwealth Bank & Trust Company

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Year-End 2020 in Sight!

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The S&P 500 continued its rally in the third quarter, fully recovering and surpassing the prior peak of 3,393 (February 19) in less than five months from the bottom made on March 23 (a peak to trough drop of 34%). During the quarter, the market rallied over 15% into September to make a new all-time high of 3,588 on September 2, and then sold off almost 10% over the next three weeks. In the last few days of the quarter the S&P 500 recovered about 4% of the lost ground to finish at 3,363 netting to an 8.9% return for the quarter and 5.6% return year-to-date. A variety of cross-currents spurred the volatility during the third quarter including deliberations about monetary and fiscal policy, a rise in COVID cases followed by a pause in re-opening activity, a surge in speculative retail trading and uncertainty surrounding the election.

As states shut down in the first quarter, the Fed cut rates to zero on March 15 and enacted more stimulus by the end of March than it did over the first 12 months of the financial crisis. In March, Congress enacted the CARES Act authorizing almost $2 trillion in direct aid. These two unprecedented actions marked the largest monetary and fiscal stimulus packages in U.S. history and formed the basis for a strong market recovery in the second and third quarters. The Fed continued to support markets in the third quarter with two key statements. First, it indicated that it expected to keep rates near zero until at least the end of 2023. While zero interest rate policy lowers the cost to finance expansion, the Fed's stance also sends a message to markets that it will take longer than expected to recover to pre-COVID growth. Second, the Fed declared it would relax its inflation target of 2% and permit inflation to rise higher, or "run hot", before raising rates to curb it. The Fed also underscored the necessity of fiscal policy to speed recovery and prevent longer term structural damage to the economy. Investors expected Congress to compromise and pass additional fiscal stimulus upon returning from summer recess after Labor Day. Additional stimulus is particularly important as income and other supports in the March CARES legislation started to run off in late July. Statements that the parties were far apart and a deal would not happen until after the election contributed to the September sell-off, while a rumor of a potential deal helped markets rally in the final days of September. **For more details on CBandT's investment outlook, please visit our Investment Commentary page at: https://cbandt.com/wealth-trust/resources/.**

Q3 2020
S&P 500 Sector Performance

	Q3	1 Year
Healthcare	5.87%	20.05%
Consumer Discretionary	15.06%	28.81%
Consumer Staples	10.38%	7.77%
Financials	4.44%	-11.90%
Communication Services	8.94%	18.32%
Information Technology	11.95%	47.07%
Materials	13.31%	12.15%
Energy	-19.72%	-45.15%
Industrials	12.47%	1.29%
Utilities	6.14%	-4.96%
Real Estate	1.92%	-7.26%

Proprietary Performance Results

Equities	3rd Qtr	YTD	1 year	3 year	5 year	10 year
Focused Equity Fund[1]	8.79%	8.58%	15.93%	13.22%	14.24%	13.34%
Aggressive Growth Fund[2]	4.52%	-4.64%	1.43%	12.40%	14.84%	14.94%1
Science/Technology Fund[3]	11.94%	29.97%	48.21%	24.67%	22.27%	17.79%
S&P 500	8.93%	5.57%	15.15%	12.27%	14.13%	13.73%
Balanced	**3rd Qtr**	**YTD**	**1 year**	**3 year**	**5 year**	**10 year**
Strategic Income Builder Fund[4]	3.76%	-2.43%	3.95%	5.69%	7.77%	7.71%
60% Russell 3000 Value, 40% Barclays Aggregate Index	3.52%	-4.33%	-0.01%	3.82%	6.48%	7.56%
Alternatives	**3rd Qtr**	**YTD**	**1 year**	**3 year**	**5 year**	**10 year**
Liquid Alpha Fund	2.08%	-2.85%	-3.91%	0.57%	n/a	n/a
Structured Alpha LP	3.34%	-7.38%	n/a	n/a	n/a	n/a
SG CTA Index	-0.70%	-3.37%	-5.45%	1.11%	n/a	n/a
Tax-Free	**3rd Qtr**	**YTD**	**1 year**	**3 year**	**5 year**	**10 year**
Muni Funds Blend	1.00%	4.41%	5.17%	4.62%	3.94%	3.56%
Barclays 1-12 yr. Muni Index	1.07%	3.22%	4.10%	3.41%	2.92%	2.96%
Aquila Churchill Tax-Free Fund of KY	1.60%	2.60%	3.13%	3.36%	2.75%	3.05%
Dupree KY Tax-Free Income	1.79%	2.87%	3.29%	3.67%	3.16%	3.46%

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] Inception date 3/31/2006. [2]Net of management fees; Inception date 7/1/1989; 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. [3] Inception date 12/31/2008. [4] Inception date 12/31/2008.

Fixed Income

In September, the Federal Reserve kept the Fed Funds rate unchanged at 0-0.25%. Projections now signal that they expect to remain zero-bound through 2023. While uneventful, there was a major shift in Fed policy announced during the quarter. The announcement of the new strategy was timed for Fed Chair Jerome Powell's speech to the annual Jackson Hole economic symposium, held virtually on August 27. Under the new framework, agreed to by all top officials, the Fed will allow inflation to run above 2% for some period of time. This is referred to as an "average inflation target". With inflation mostly running below their 2% target over the last 10 years, markets reflect that current policy rates are here for many years to come. Recall that in response to the great recession in 2008, its initial hike came seven years after going to near zero in 2015.

The economic impact of COVID-19 has been unprecedented. In April, a revised 20.5 million jobs were lost in the height of the shutdowns, although 22 million job losses were expected. May's initial report had unexpected job gains of 2.5 million, or a 10 million "beat" as estimates were for another -7.5 million lost jobs. Better than expected payrolls were also reported during each month this quarter. But job gains have slowed: 4.8 million in June, followed by nearly 1.8 million and 1.4 million in July & August.

The Fed has acknowledged the improving economic backdrop in its expectations. Their 2020 unemployment forecast was revised from 9.3% to 7.6% and 2021 was revised from 6.5% to 5.5%. The median GDP forecast rose from -6.5% to -3.7% this year while 2021 was revised lower, from 5.0% to 4.0%, with the combined two years' better than previously estimated.

The Fed's late-March announcement of its move into corporate bond purchasing was also unprecedented for our central bank. Initially they purchased only corporate exchange-traded funds (ETF's) including high-yield, but have expanded this to individual bonds. Credit spreads tightened quickly with this support as one would expect, but have plateaued in recent months. In July & August, Investment-grade spreads fell to 1.3% over Treasuries from 1.5% to start the quarter, and down from the peak of 3.7% on March 23rd. High-yield spreads peaked at 11%, falling from 6.3% to 5.2% during the quarter, and were roughly 4.8% in July-August according to Bloomberg Barclays data. Treasury rates remain near record lows and were down slightly inside 7 years. The 10-year Treasury was basically unchanged for the quarter at 0.68% vs. 0.66% from March.

For the quarter, the Bloomberg Barclays Aggregate index returned +0.62%, bringing it to a very strong +6.79% through September. Though it still could not match the +8.52% return last year at this time. International bonds performed better this quarter in comparison to the U.S. The "hedged" Global Aggregate ex-US returned a similar +0.68% vs. +4.14% unhedged, or +2.97% and +4.77% so far this year.

Tax-exempt municipal bonds were also helped by the Fed's intervention efforts, a market that it had left untouched in prior crises. At its low point in March, municipal bonds were off over 10%, its worst rout in history. One of the turning points was the Fed's Municipal Liquidity Facility (MLF), announced on April 9th, despite it being a lender of last resort with few participants to date. Municipal bonds returned +1.23%, outpacing taxable returns for the quarter. But municipals still trail taxable on the year, returning +3.33% through September. We took advantage of the dislocations last quarter, when funds and ETF's were "forced" sellers as client's redeemed shares. Supply/Demand was definitely a positive factor recently with mutual fund and ETF flows averaging over $12 billion June-August, slowing somewhat in September. Also, taxable muni issuance is a significant portion of supply (~30%) as borrowers "advance" refund existing debt at a lower cost. Recall that the latest tax reform banned tax-exempt issuance for that purpose.

Given the deep recession and new Fed policy regime, interest rates will probably be range bound near record lows for many years to come. "Lower for longer" is the unfortunate reality for fixed income investors. We find ourselves wondering if rates will be "Lower Forever", but hopefully that is not the case. Given our recent adjustment, we are maintaining our 3-5 year return forecast for investment grade bonds to 0-2% annualized, down from 1-3% previously. Overall yield is a strong predictor of future (multi-year) returns and the Bloomberg Barclays Aggregate index is currently yielding around 1.18% versus 2.31% yield to start the year.

Focused Equity

Amazon.com, Inc. (AMZN)
7/1/2020 – 9/30/2020

For the third quarter and the twelve months ending September 30, the strategy returned 8.79% and 15.93%, respectively, versus an 8.93% and 15.15% gain for the S&P 500 Equity Index. Since inception, the strategy has roughly matched the S&P 500's annual return of 14.30% with an annualized gain of 14.21%. The fund has achieved these results taking on meaningfully less risk than the S&P 500 with a beta of 0.87 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 1.54 since inception (12/31/2008).

Leaders: Quality-growth and size remained dominant factors across US equities in Q3, with Information Technology (+13.98%), Consumer Discretionary (+13.81%) and Communications Services (+10.15%) sectors delivering the largest total returns within Focused Equity. Many factors that emerged alongside COVID-19 in Q1 continued to lead in Q3, benefitting companies involved in the work-from-home migration, cloud storage, internet retail, and food/staples retail including Salesforce (CRM, +34.16%), Apple (AAPL, +27.21%), Amazon (AMZN, +14.13%), Costco (COST, +17.32%) and WalMart (WMT, +17.26%), who produced the largest total returns in the strategy for the third quarter. Over the last twelve months, size, quality growth, and specifically FANMAG continued leadership, as Apple (AAPL, +109.19%), PayPal (PYPL, +90.47%), Amazon (AMZN, +81.39%), Microsoft (MSFT, +53.22%) and Salesforce (CRM, +69.23%) produced the largest contribution to returns in Focused Equity for the last year.

Laggards: Growing uncertainty around the pace of an economic recovery coupled with lower crude prices fueled selling pressure across the Energy (-14.07%) sector, including positions in Pioneer Natural Resources (PXD, -18.30%), Chevron (CVX, -18.28%) and Williams (WMB, -5.59%). Although portions of the economy have rebounded as the US begins to reopen, the uncertainty of the COVID-19 pandemic has continued to weigh on travel and leisure industries, including Boeing (BA, -9.91%), Booking Holdings (BKNG, -8.98%) and Marriott Intl (MAR, -4.96%). For the last twelve months, the -33.79% decline in the price of oil was the largest detractor to the strategy's return, with exploration and production companies Diamondback Energy (FANG, -50.52%) and Pioneer Natural Resources (PXD, -18.30%) having the greatest sensitivity to oil prices, as well as integrated oil and gas holding Chevron (CVX, -36.12%).

Strategy Update: Focused Equity Fund invests in quality growth companies and select external managers. Our stock selection process and that of the managers we have selected is dedicated to identifying world-class companies that are positioned for sustainable growth and possess the characteristics needed to generate superior long-term performance. The portfolio is concentrated, usually owning approximately 30 to 50 high-quality companies that have a history of outstanding business results, are well managed and trade at values well below their long-term intrinsic value. Our approach is focused on companies that have sustainable advantages over their competitors, allowing them to consistently grow and generate value for shareholders.

Strategic Income Builder

It has been a very difficult year for income investors, despite the rebound. For example, the Russell 3000 Value lagged its "Growth" counterpart by a growing margin, trailing -35.2% or -12.2% vs. +23.0% through September. U.S. investment-grade corporate bonds had tremendous volatility during the first quarter, but have recovered due to the Fed's interventions (see fixed income commentary) with returns of +6.6% at quarter-end. High yield bond returns have also flipped positive at +0.6% vs. +8.9% for Treasuries, per Bloomberg Barclays. Spreads remain higher in both, which is reasonable given the record low interest rates.

For the quarter, the strategy (SIB) returned +3.76% vs. +3.52% (60% Russell 3000 Value & 40% Barclay's US Aggregate). Twelve month returns are soundly ahead of benchmark at +3.95% vs. -0.01% for its benchmark.

Since inception (1/1/09), the SIB strategy has returned an annualized +8.77%, outpacing its benchmark return of +8.23%. The yield generated from the strategy has consistently exceeded that of its benchmark. On a risk-adjusted basis, the strategy has generated a positive alpha of +0.86% annualized with a volatility beta of 0.95. The success of the portfolio is the result of an attractive mix of income producing securities, asset class and sector allocations, and tactical positions in global markets.


Microsoft Corp. (MSFT)
7/1/2020 – 9/30/2020

For the quarter, our equities returned +4.86% compared to the Russell 3000 Value return of +5.42%. Our large-cap bias impacted returns vs. benchmark but, we remain soundly ahead this year at -5.94% and -12.23%, respectively. The portfolio has benefited from an overweighting in stocks in most years. We entered the year at 67.3% equities within the portfolio, or 7% over benchmark. During the volatility, we maintained basically a benchmark weighting and closed out the first quarter at 61.5% in stocks. During the recovery we have been mindful of our equity overweight, and we closed the quarter at 66%. Dividend yield for the portfolio ended the quarter at 3.1%, or roughly 0.4% higher than the Russell 3000 Value and 1.3% more than the S&P 500. Moreover, these yields carry a growing advantage to intermediate investment-grade corporate bonds.

Information Technology (+6.9% portfolio returns) added the most in terms of attribution again this quarter, but to a limited degree. Industrials (+19.4% portfolio returns) produced the highest returns and gains vs. its sector. Energy (-20.9%) was the worst performing sector, despite oil prices being slightly positive. Apple Inc. (AAPL +27.2%) continued its incredible run with 2020 returns of +77% through August. Much of the quarterly returns came in August (+21.7%), just after the company announced a 4 for 1 stock split effective Aug. 31. It closed 4% higher the next day, but declined over 20% from its record close during September before rebounding slightly. Apple's sales strength across iPhones, Macs, iPads and in Services in 2020 shows demand resilience, but the sharp price to earnings (P/E) move may have overshot potential fundamental gains. United Parcel Service (UPS +50.8%) was our best performing stock during the quarter. The stock jumped over 14% after the company reported quarterly earnings, as it posted adjusted earnings that were double analysts' forecasts. CEO Carol Tome said "Our results were better than we expected, driven in part by the changes in demand that emerged from the pandemic, including a surge in residential volume, COVID-19 related healthcare shipments and strong outbound demand from Asia." Ms. Tome joined UPS in June after a long career at Home Depot, where she served as Vice President and Treasurer and later as Executive Vice President and Chief Financial Officer.

Quarterly fixed income performance slowed with returns of +1.73% vs. +0.62% for the Bloomberg Barclays Aggregate Bond Index. Our credit-based funds, and particularly high yield, were beneficial as discussed above. Fixed returns still trail during 2020 at +4.58% vs. +6.79% for the Aggregate Index. Projected yield on this portfolio is roughly 3% or basically the same yield as our equity portfolio. This compares to 1.2% yield for the Aggregate Index.

Our risk-reducing alternatives produced solid results for the quarter, returning +3.2%. We also utilize short-term bond funds as cash alternatives, which returned 0.6% during the second quarter. Combined, our alternatives and near-cash are roughly 9% of the strategy.

Science & Technology Strategy

The Science & Technology strategy fund (SciTech) returned +11.9% in the third quarter, compounding a strong second quarter and pressing further into positive territory for the year. SciTech beat its Lipper Science & Tech Fund Index benchmark (+11.4%) in the July-September period, and remains well ahead of the benchmark on a YTD basis (+30.0% vs +23.7%). For further comparison, the S&P 500 rallied 8.9% in the third quarter and was +5.6% for the year as of 9/30.

Stock selection was strong across sectors for SciTech in Q3, with only allocations to Real Estate and Consumer Discretionary (collectively <15% of the fund) trailing their respective S&P sectors. Strong stock picking this year has made up for our underweight position in Technology relative to the Lipper benchmark, including in the third quarter when our Tech allocation (46% of the fund) gained 15.5% versus the sector return of +12.5%. While diversification has been a headwind for SciTech in recent quarters, our allocation decisions benefit the risk profile of the portfolio.

Since inception of the fund (3/31/2006), SciTech has returned an annualized 12.4% versus 12.2% for the Lipper Science & Tech Index and just 9.1% for the S&P 500. Moreover, SciTech has produced this better total return at a more attractive risk profile, with a Sharpe Ratio of 1.10 (vs 1.03) and annualized standard deviation of 16.3% (vs 17.2%).

Leaders: Our Apple Inc. (AAPL) positon gained 27.2% during the third quarter, making the tech titan SciTech's biggest driver of gains in Q3. The company is expected to announce iPhone 12 during the fourth quarter, which we view as the primary catalyst last quarter. We expect strong demand once launched, but have used this most recent momentum to trim the position. On a percentage basis, SciTech's best position in Q3 was Square (SQ), which returned 54.9% for the fund after doubling in Q2. The payments provider to small businesses has seemingly weathered COVID shutdowns much better than feared.

Outside of Technology, leaders for SciTech this past quarter include Intuitive Surgical (ISRG, +24.5%), Danaher (+21.9%) and Zoetis (ZTS, +20.8%). Each of these unique businesses in the Healthcare sector have managed the downturn well. ISRG and DHR are well positioned for a return to normalization in human health, while demand for animal health for ZTS was barely effected by the pandemic. The recent launch of Zoetis's Simparica Trio canine regimen (heartworm, ticks/fleas, and roundworms/hookworms) is outperforming expectations and is on pace to be a blockbuster.

Laggards: Several SciTech laggards last quarter were positions with idiosyncratic drivers that have otherwise been strong, but pulled back as investors moved into beaten down stocks with leverage to the reopening. In Healthcare, Vertex Pharma and Sarepta Therapeutics each slipped in Q3, but are still higher by 86.2% and 60.3% for SciTech over the past year, respectively. In Tech, the story is similar for Splunk (SPLK, data analytics) and Fortinet (FTNT, software security), both of which fell last quarter but have gained >50% for SciTech over the trailing twelve months. The most impactful losses in the fund in Q3 were delivered by American Tower (AMT), which lost about 6% at a 2.5% portfolio weight. Carrier spending has been disappointing this year, due in part to COVID, but AMT should remain a beneficiary of the global rollout of 5G.

Small Cap Composite


Air Transport Services Group, Inc. (ATSG)
7/1/2020 – 9/30/2020

The Small Cap Value Composite returned 1.91% for Q3 versus 2.56% for the Russell 2000 Value index. Year to date, the composite return is -17.46 vs benchmark return of -21.54%.

The top contributing holdings were a diverse group in Q3. One of the largest contributors to portfolio return was Air Transport Group Inc. (ATSG; +13%, +60 bps), the premier lessor of midsize freighter services and aircraft, including the Boeing 767. ATSG's strong Q2 results were in line with our expectations while management's comments on accelerating free cash flow in 2021 were near our forecast. Additionally, United Parcel Service Inc. (UPS) and FedEx Corp. (FDX) reported robust demand for ecommerce volumes that drive demand for ATSG's assets. Another top contributor during the quarter was BJ's Wholesale Club Holdings Inc. (BJ; +11%, +50 bps), a warehouse club retailer with more than 200 stores primarily located in the eastern United States. Increased work-from-home activity plus school closures from COVID-19 caused surging demand for grocery items. BJ reported very strong Q2 results exceeding high expectations for the second consecutive quarter. Another positive contributor was Cubic Corp. (CUB; +21%, +50 bps), the premier provider of mass transit fare collection infrastructure and a growing leader in defense for next generation intelligence, surveillance, and communication systems. For most of the quarter, CUB shares languished as investors feared the credit quality of CUB's transportation customers due to the impact of COVID-19, potential delays for defense orders, and CUB's relatively high leverage compared to peers. Late in the quarter, CUB shares spiked when the board of directors adopted a short-term poison pill and notified shareholders that activist firm Elliott Management acquired a 15% economic position in Cubic. Elliott later confirmed its ownership position and noted it was interested in acquiring all of CUB with a private equity partner.

The largest percentage losers this quarter were mostly energy- and travel related holdings, whose small position sizing reflected their inherent risks. Among the six largest percentage decliners, just one began the quarter with a position size larger than +1% – HollyFrontier Corp. (HFC; -31%, -44 bps) – which barely exceeded that threshold. However, HFC's large percentage decline resulted in it being one of the largest negative contributor for the quarter. HFC is a mid-continent refiner that produces gasoline, diesel fuel, jet fuel, specialty lubricants, and modified asphalt. HFC struggled in Q2 primarily due to a decline in miles driven, which reduced demand for gasoline and diesel and translated to lower utilization and lower gross margin per barrel (-57% year over year). We believe the company's strong balance sheet, which carries very low net debt, should position HFC to withstand this challenging period. Another underperformer was Cannae Holdings Inc. (CNNE; -9%, -39 bps), which owns an 18% stake in commercial data and analytics provider Dun & Bradstreet (DNB), an 11% stake in publicly traded HR software and services firm Ceridian (CDAY), as well as interests in life, health, and retirement solutions marketer AmeriLife, restaurant brands (O'Charley's, 99), and two special purpose acquisition companies. CNNE shares declined in Q3 despite its equity stakes in three publicly traded stocks representing more than 60% of book value and more than 70% of our assessed value – DNB, CDAY, and CoreLogic (CLGX) – all experiencing low- to mid-single-digit percent price appreciation. We trimmed the position early during the quarter as it approached our assessed value, but late in the quarter added back to the position when the discount widened. Another bottom contributor during the quarter was White Mountains Insurance Group Ltd. (WTM; -12%, -38 bps), a financial services holding company consisting of a municipal bond reinsurer, various insurance service investments, and a significant portfolio of stocks, bonds, and alternative investments. Investors were concerned WTM's HG Global/BAM unit could see claims if state and local governments default on debt obligations as COVID-19 continues to pressure municipal finances. Adding to the uncertainty is the federal government's failure to pass another round of COVID-19 stimulus, with one sticking point being the Democrats' desire to include aid for state and local governments. Having trimmed the position during Q2 as the stock approached our assessed value, we added to the position in Q3 as the stock's decline presented a compelling opportunity.

Kentucky Municipals

Quarterly bond issuance by Kentucky municipalities rose to $1.26 billion from $479.5 million in the previous quarter. Competitively awarded deals were $821 million with negotiated deals of $439 million. Deal size was decent for the summer quarter, averaging $19.7 million with 64 new issues in total. Bank-qualified (BQ) issuance was $60 million, or roughly 5%, while non-BQ issuance was the majority, coming in at $890 million or 71%. The remaining $309 million (~25%) were taxable municipal issues, 20 in total. Nationally, taxable muni issuance is a significant portion of supply (~30%) as borrowers "advance" refund existing debt at a lower cost. Visible KY supply is relatively small with $256 million on the calendar in coming months and issuers should benefit from the record low interest rates.

Issuers of note included Louisville/Jefferson Metropolitan Sewer District that issued $563 million Revenue Bonds in total. Moody's maintains the Aa3 long-term rating and stable outlook on the district's outstanding parity senior revenue bonds. $112 million of "taxable" municipal issuance was used to "advance" refund their outstanding Series 2013C, maturing on and after May 15, 2024. Moody's cited, "The stable outlook reflects the likelihood that the district's financial position and debt service coverage will remain at or above current levels, despite substantial near-term capital needs and a higher-than-average debt burden, driven by management's conservative budgeting practices and consistent annual rate increases."

KY bonds outperformed the national market this quarter. The S&P Municipal Bond Kentucky Total Return Index returned +1.96% vs. +1.23% for the Bloomberg Barclays Municipal Index. Kentucky is now slightly ahead of the national market this year, with returns of +3.40% vs. +3.33%. Like the national market, the S&P KY Municipal Index declined over 10% at its trough on March 20th. According to S&P, its yield-to-worst (YTW) fell to 1.46% from 1.79% during the quarter, and peaked at 3.87% at the height of the stress. For comparison, the Bloomberg Barclays Municipal Index has a yield-to-worst of 1.32%, so the state's yield advantage is now only 0.14%. As discussed in our fixed income commentary, we actively took advantage of the dislocations in municipals during the volatility. This included tactical purchases within accounts that do not normally purchase tax-exempts.

What about the vulnerability of municipals based on tax receipts due to COVID-19?

Previously we noted how rating agencies and market participants were viewing the financial strains due to the pandemic. We thought we would continue that by sharing some quotes we saw during this quarter.

Paul Malloy, who oversees $224 billion in municipal bonds at Vanguard Group, said "Ultimately a muni doomsday scenario is a next to zero probability." He continued, "Tax-free markets provide funding for essential services that are an absolute must for an economic recovery at the national level. States are very large employers as well. So, Congress and others will have to act to keep from nullifying all of the work that has been done thus far."

Patrick Luby, senior municipal strategist at CreditSights, wrote "The months ahead will reveal greater detail about the pandemic's financial impact on issuers and will also lead to an emotionally charged election season- we expect increased volatility and downgrades of investment grade issuers - but not defaults."

Dan Scholl, head of municipal fixed income at Wilmington Trust, said there's "asymmetric risk" in the municipal market as yields hover near lows and Covid-19 continues to spread in the U.S. That's resulting in elevated yields for issuers within transportation, health care and higher education sectors, he said. "There's tremendous uncertainty," he said.

General Fund in August shows increase from 2019

Despite the coronavirus pandemic, Kentucky Budget Director John Hicks reports General Fund receipts increased 5.9% in August compared to last year, although the Road Fund did see a drop. General Fund revenue for the month was $833.8 million, compared to $787.2 million during August 2019. August receipts have reflected the smallest share of yearly amounts over the last five years. For the first two months of the 2021 fiscal year, General Fund receipts have increased 6.5%. After months of significantly lower tax collections due to the novel coronavirus, receipts have rebounded, according to Hicks.

"We saw the worst quarterly declines in General Fund receipts from April through June since the Great Recession," he said. "Growth rates in July and August have ticked upward, supported by substantial federal relief payments to individuals and businesses. Sales and use, and the individual income taxes have been the main drivers of the improvement in collections." He notes General Fund collections have increased $106.1 million in July and August over the prior year with sales and individual income taxes accounting for all of the increase.

His primary revenue concern is keeping up the momentum in economic activity despite the expiration of much of the federal fiscal policies designed to help the economy. "Without another round of federal fiscal stimulus, it will be difficult to maintain the growth in collections we have seen thus far in FY21," he stated. The official revenue estimate for FY21 calls for revenue to increase 0.3% compared to FY20 actual receipts. Based on the August results, General Fund revenues can decline by 0.7% for the remainder of the fiscal year and meet the official estimate.

Meanwhile, Road Fund revenue fell 1.0% in August with revenues of $140.8 million but have increased 2.9% for the first two months of the fiscal year. Motor vehicle usage tax collections rose 10.8% while motor fuel revenues fell 4.5%. The official Road Fund revenue estimate calls for a 3.5% increase in receipts for FY21. Based on year-to-date collections, revenues must increase 3.6% for the remainder of the fiscal year to meet the estimate.

Source: *Forward Kentucky, written by Tom Latek. Cross-posted from Kentucky Today.*

ASSET ALLOCATION OUTLOOK

LAST QUARTER			THIS QUARTER	
WE BELIEVED →	**ACTIONS TAKEN →**	**RESULTS**	**WE BELIEVE →**	**ACTIONS WE ARE TAKING**
DOMESTIC EQUITIES			DOMESTIC EQUITIES	
We believed that small and mid-cap stocks will close much of the performance gap with large cap stocks in the next 6 - 12 months.	We will continue to maintain model weights established earlier in the year until we see a larger recovery in small and mid-cap stocks.	**Large Cap +8.9% outperformed small cap +4.9% and mid-cap +4.8%. Our large, small and mid cap selections outperformed their benchmarks during the quarter. Small and mid cap did not beat the S&P 500.**	We believe that small and mid-cap stocks will close much of the performance gap with large cap stocks in the next 6 - 12 months.	We are maintaining model weights established earlier in the year until we see a larger recovery in small and mid-cap stocks.
INTERNATIONAL EQUITIES			**INTERNATIONAL EQUITIES**	
We believed that EM should show strong recovery and developed international will have a period of catch up to U.S. indices. We expect active managers with skillful security selection will outperform indices.	We maintained our international and EM weights. We anticipate a catch-up rally on the back of EU fiscal stimulus.	**International equities (+4.8%) underperformed U.S. large cap (+8.9%). EM (+9.6%) outperformed U.S. large cap as the dollar remained weaker than in the first quarter. Our developed international (+10.0%) and EM (+17.1%) selections outperformed the S&P 500 and their benchmarks during the quarter.**	As the dollar remains lower, we believe that EM should show strong recovery and developed international will have a period of catch up to U.S. indices. We expect active managers with skillful security selection will outperform indices.	We expect to maintain our international allocation in the near term. We anticipate a catch-up rally on the back of EU fiscal stimulus. We are debating increasing allocation to EM.
FIXED INCOME			**FIXED INCOME**	
The thought the Fed will keep rates low until the economy makes a robust recovery. Returns likely between 1% and 2% for core investment grade bonds.	Fed announced it expected to keep rates near zero through 2023. We made a large overweight allocation to high yield (HY) in late March as yield spreads widened. We exited trade in late August, booking gains of 16% to 18%. We are maintaining short duration HY exposure.	**The BBG Aggregate returned +0.6%, while the High Yield index gained 4.7%. Local currency international and emerging market bonds gained 2.7% and 0.6%, respectively. Our bond selections significantly outperformed the aggregate bond index during the quarter.**	The Fed will keep rates low until 2023. It relaxed its inflation policy, which enables Fed to use judgment on raising rates as inflation rises. Returns likely between 1% and 2% for core investment grade bonds.	We cut our exposure to high yield with a 16%-18% average profit in portfolios. We have a little weight via shorter duration high yield. We increased weight to EM bonds and changed exposure from hedged to local currency as the dollar dropped.
We thought munis were attractive relative to investment grade bonds, considering the risks.	We started reducing an overweight to munis during the quarter and exited the trade with 10% to 12% profits.	**Munis outperformed core bonds in the quarter (+1.2% vs. +0.6%) on an absolute basis and tax-effective basis. Our fixed income selections outperformed the benchmark.**	We think munis are about equally attractive investment grade bonds, considering the risks.	We are continuing to reduce muni exposure in 4Q20.
ALTERNATIVE ASSETS			**ALTERNATIVE ASSETS**	
We believed volatility would remain elevated as new COVID cases rise, through the November election, and/or until a coronavirus vaccine is widely available.	We maintained a 10% allocation to alternative strategies.	**Equity market volatility increased during the quarter. Our alternatives baskets outperformed their index 2.0% to 3.0% vs. 0.50% for the benchmark.**	We believe volatility will remain elevated as new COVID cases rise, through the November election, and/or until a coronavirus vaccine is widely available.	We are maintaining our 10% allocation and continue to focus on strategies with no structural correlation to equities. We expect near term deflation due to growth stalled by COVID. Longer term inflation risks are rising upon recover due to record monetary & fiscal policy.

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