HILLIARD LYONS TRUST COMPANY
NEWSLETTER | April 2017

Is the Stock Market Too High?

Is the Stock Market Too High?

Andrew Means, CFA®
Senior Vice President
Director of Investments

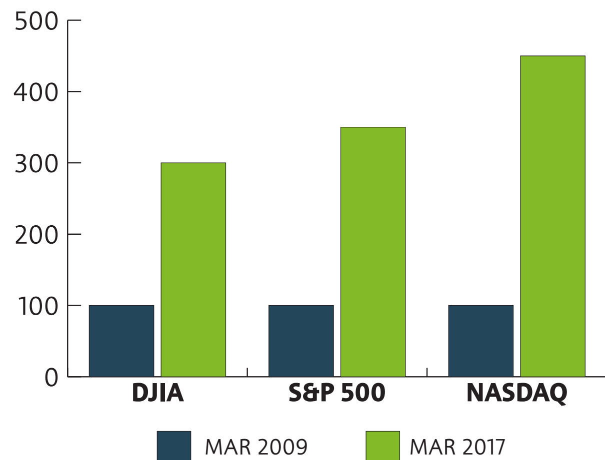
The question posed above is on many investors' minds these days. It is natural to wonder about the level of stock prices after the market has been rising continually for eight consecutive years. From their most recent bear market lows on March 9, 2009, the Dow has risen in price by over 200%, the S&P 500® by over 250%, and the NASDAQ by over 350%! And that's excluding dividends paid over these years, so total returns are even higher.

But the last two decades also brought us two stock market declines of 50%, so many investors are understandably wary of these positive returns – and their staying power. Meanwhile, the financial media, with an enormous amount of airtime to fill, present a cacophony of predictions that range all the way from bold to dire.

As usual, we won't offer any predictions – but we can explain why we don't think stock prices have become detached from reality.

How did we get here?

Let's begin with a look back to determine how we arrived at the current circumstances. The financial collapse hit the markets beginning in 2008 with an eventual stock market decline of over 50%, followed by a deep economic recession. With fears of deflation hitting a debt-laden world, central banks around the globe responded with policies creating the lowest interest rate environment in financial history. The recovery that followed in the United States has been characterized by slow economic growth accompanied by very low levels of inflation and interest rates. Against this backdrop of gradual healing, stock prices have been on the rise.



A two-stage recovery

It's useful to think of the recovery in the stock market in two stages.

- The first stage was characterized by elevated feelings of pessimism and incredibly depressed stock prices. But as investors processed mounting evidence that the world was not ending, the stock market climbed the proverbial "wall of worry" as sellers exhausted themselves and buyers began re-entering the stock market. The first stage was mostly about rehabilitation from a disastrous economic situation and deeply depressed stock prices to an economy getting back on its feet and a cautiously rising market.
- The second stage has been marked by increasing stock valuations as investors became convinced

that inflation and interest rates would remain quite low while the economy continues to grow. An environment combining a growing economy and corporate earnings with low inflation and interest rates is ideal for financial assets, especially stocks. Corporate earnings should be capitalized at higher rates in a low-interest-rate environment – and stock prices today reflect that reality.

Where are we going?

So, what lies ahead for the stock market? Here are three possible scenarios:

- First, if the current environment persists for the next several years, then stock prices are quite attractive. With a growing global economy and very low interest rates, stock valuations should remain at current levels if not higher ones.
- On the other hand, if a recession lies ahead and earnings decline, then stock prices will likely decline.
- Finally, if we move to a totally different environment of robust economic growth accompanied by substantially higher inflation and interest rates, then corporate earnings would grow much faster but stock valuations would likely move somewhat lower. These offsetting factors would possibly lead to uninspiring stock market returns.

Bull market life stages

Legendary investor Sir John Templeton described the stages of the stock market aptly: "Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria." We first quoted Sir John to you in our yearend 2010 commentary. Our conclusion then was that the market could best be described as "growing on skepticism." We think today the market is somewhere in the "maturing on optimism" stage. The internet bubble of the late 1990s was the best example of a market that "died on euphoria." Today's market in no way resembles that period, and current conditions are not "euphoric." We take comfort in that fact.

No, really – where are we going?

In our view, stock prices are not too high given the current backdrop of growing earnings accompanied by low inflation and interest rates. Our preferred description of stock prices is that they are slightly on the high side of fair value. A significant change in today's attractive investment setting would be necessary to disrupt the current valuation structure of the stock market. We think a recessionary environment would be most upsetting to the markets, but today's economic statistics show little if any signs of an impending recession.

> *Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria.*
>
> *~ Sir John Templeton*

Stock valuations make sense to us today given the investment world we live in. There were two declines of greater that 10% in the markets in 2016, and we are sure that more corrections lie ahead. But no one knows exactly when declines are coming. Regardless of the timing of downtrends in the market, we carry a deep conviction that investors who hold shares of outstanding companies over the next 10 to 20 years will earn acceptable returns just as they have in the past. Long-term business ownership is the best way to participate in the stock market, and that is our investment strategy. That's why we continue to spend our days seeking market-leading companies that can help grow your wealth over the long term.

Past performance does not predict future performance. All investing involves the risk of loss. You cannot invest directly in an index.

Hilliard Lyons Trust Company, LLC

500 West Jefferson Street | Louisville, KY 40202
502-588-8400 | 888-878-7845

312 Walnut Street | Suite 3120 | Cincinnati, OH 45202
513-345-5251 | 800-884-1750

110 Main Street | Evansville, IN 47708
812-428-5147 | 888-426-1481

300 W. Vine Street | Suite 1100 | Lexington, KY 40507
859-514-6440 | 800-944-2663

TrustInfo@Hilliard.com | www.HilliardTrust.com