INVESTMENT STRATEGIES

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Valuations

Where do we currently stand?

When we formulated our thesis for market performance for 2018, we noted while valuations looked very extended, all of the positive fundamental factors -- strong earnings growth, positive economic news, increasing earnings estimates, tax cuts -- market momentum, and strong investor sentiment, etc., would result in investors ignoring those valuation issues and continuing to drive markets higher. We did not see a catalyst that would cause the market momentum to reverse.

Of course, a catalyst we did not see came. We thought expectations for rising rates were already in the market, but investors seemed to use those anticipated increases as an excuse to sell, something that seemed to cause a run of panic selling. Whether that means the upward momentum has changed, only time will tell, but we believe it is unlikely, as the news is still generally very good.

Having said that, and noting long-term market returns tend to be highly correlated with valuation metrics, we believe a look at current valuation metrics following the recent sell-off is warranted. As investors look to the future when considering valuation, we are going to base our thoughts on 2019 expectations, since this will likely encompass the full impact of the recent tax law changes and changes likely to result from management teams making decisions based on those changes (repatriation, as an example).

We believe 2019 S&P 500 earnings per share will end up above $160, although to be conservative, we are just going to use $160 for our estimate. But the question is what multiple to use on that number? Over the past twenty years or so, the multiple on the S&P 500 has been in the area of 16 times. We note, however, this is measurably higher than the historical number, which is under 15 times.

Understandably, the low interest rate environment has been a large impetus in the higher multiple environment we have seen recently, as low interest rates and Fed stimulus have pushed investors into risk assets (equities). The question becomes what happens to that multiple should both rates and inflation begin to rise?

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Our opinion is that multiples will adjust to more normal conditions with less Fed stimulus, increasing interest rates, and slightly higher inflation numbers. Market volatility is also likely to increase, which would typically make investors demand a higher return versus risk free assets. Under this scenario, we believe bonds will become more competitive with stocks and investors will demand higher returns on equities, meaning multiples will contract slightly.

Given such a scenario, we believe a more appropriate multiple would be in the 15 to 15 1/2 range, versus our previous estimate of a fair value of 16 times. Using our $160 2019 EPS estimate, the high end of that range would lead to a fair value target in the area of around 2,500 on the S&P 500, under the current level of 2,690.

So, what should investors do with this in mind? Well, we do not necessarily believe the sharp decline of the market over the past week or so in any way changes the underlying fundamentals of the market. None of the fundamental factors we anticipated driving the market higher, in spite of extended valuation metrics, has changed -- so we would not be surprised by a resumption of the strong performance we have seen in the market over the past several years. With that in mind, investors may very well just want to hang on at this point, and use any weakness to add to positions.

However, in light of the expensive valuations, we would not be surprised to see long-term forward returns below historical levels. Investors should be aware of this as they make assumptions for longer-term returns and potentially adjust portfolios if markets do move significantly higher.

Interestingly, in considering the market action around February 5th's nearly 1,200 point selloff on the Dow Jones Industrial Average, one thing we noticed was the breadth of the selloff, which seemed to be extremely indiscriminate in nature. At the end of that day, on our screen -- which has tickers for more than 250 stocks on it -- only a single stock ended higher for the day. In typical sharp selloffs we would usually see at least a few stocks close up, mainly ones which had reported better than expected earnings or some other positive corporate news. A number of stocks with such positive news were listed on our screen, yet even good news on Monday did not translate to higher share prices.

We believe this may be a function of all of the money going into passive strategies (index funds). When markets selloff and investors sell such funds, all stocks in the fund go down, even stocks with good news.

We also note there are not as many cheap stocks/sectors in the current market, as investments in such passive strategies means demand for securities is across sectors. Back during the tech bubble, there were still many cheap sectors even though market valuations hit all-time highs; investors piled into technology and internet stocks and bid up the multiples of those sectors to unprecedented levels.

While current valuation metrics are less extended than during the late 1990s tech bubble, valuations in many sectors are actually solidly higher than they were then. This could very well allow active strategies to beat passive strategies, as passive buying of all stocks in an index leads to market inefficiencies.

With that in mind, investors need to be cautious about where they put their money. In our opinion, the move towards passive strategies (index funds) may offer an opportunity: as positions in index funds are shed and cheap companies with positive fundamentals are sold off along with all the other companies in the fund, investors could build positions in those cheap individual stocks that have positive fundamentals and cheap relative valuations during those selloffs.

Additional information is available upon request.

We recognize each client's investment needs and goals are different. Opinions expressed here are subject to change without notice and do not take into account the particular investment objectives, financial situation, or needs of individual investors.

Analyst Certification

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Important Disclosures

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Investment Ratings

Buy: We believe the stock has significant total return potential in the coming 12 months. **Long-term Buy:** We believe the stock is an above average holding in its sector, and expect solid total returns to be realized over a longer time frame than our Buy rated issues, typically 2-3 years. **Neutral:** We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise. **Underperform:** We believe the stock is vulnerable to a price set back in the next 12 months.

Suitability Ratings

1 - A large cap, core holding with a solid history. **2** - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks. **3** - An above average risk/reward ratio could be due to small size, lack of product diversity, sporadic earnings or high leverage. **4** - Speculative, due to small size, inconsistent profitability, erratic revenue, volatility, low trading volume or a narrow customer or product base.

	Hilliard Lyons Recommended Issues		Investment Banking Provided in Past 12 Mo.	
Rating	**# of Stocks Covered**	**% of Stocks Covered**	**Banking**	**No Banking**
Buy	31	28%	10%	90%
Hold/Neutral	74	66%	9%	91%
Sell	7	6%	0%	100%

As of 7 February 2018

Other Disclosures

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