# INVESTMENT STRATEGIES

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## Looking Back and Looking Ahead

*A recap of 2017 and our thoughts for 2018*

***Looking back***

In reviewing what happened in 2017 versus what we anticipated might happen, we definitely got the "Big" prediction wrong, although we did well with our predications further down the line. When we published our 2017 outlook, our major thesis was that the market, as measured by the S&P 500, would see a continuation of the move higher we saw late in 2016, followed by a significant decline later in the year around disappointment related to a lack of accomplishments from the new administration and political/geopolitical turmoil due to the lack of experience and discipline within the administration. We believe the single biggest catalyst for last year's sustained strong stock performance was an approximate 10% increase in corporate earnings.

We saw the early year continuation of the positive tenor seen following the election, but we never got the pullback we anticipated. We definitely were not close in our expectation for the S&P 500 ending the year around 2200 as investors ignored all of the political turmoil and lack of administration accomplishments until late December's passage of tax reform. By year-end markets pushed through to all-time highs, with a nearly 20% gain for the year. We also did not get a re-pricing of risk around the political/geopolitical turmoil and Twitter (TWTR-$24.59) rants; the market's P/E multiple actually increased during the year, something that does not seem logical, in our view. Overall, we count this as a definite miss.

We do feel good about our thoughts on the Federal Reserve: we anticipated two or three raises for the year, and the Fed ended up raising three times, with the final increase in December.

On S&P 500 earnings, we were almost right on in expecting the actual number to come in at $131, above the consensus of about $129 per share. While Q4 numbers have not yet been reported, earnings (excluding non-recurring items) are forecast to be just above $131 per share. Earnings coming in both higher and slightly above expectations were part of the reason for the strong market performance.



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The market generated strong returns in 2017. There was a 19.4% rise in the S&P 500, a 25.1% leap in the Dow Jones Industrial average, and a 28.2% jump in the NASDAQ Composite. We note these increases do not include dividends which push total returns higher -- total return for the S&P 500 was 21.8% including dividends.

We were right about our call on Treasuries. A large increase in the short end resulted in a flattening of the yield curve and the yield on the ten-year Treasury bond was little changed from where it began the year.

Our calls on the individual sector front largely worked out. We suggested overweighting healthcare and consumer discretionary names, both of which outperformed the market, albeit modestly. Our suggestion to overweight retail names was wrong early in the year, but roared back later and ended up being generally positive (note, retail is part of the consumer discretionary segment).

Our suggestion to underweight some of the higher valued consumer staple companies and energy areas was also a solid call, as these underperformed the market. Energy actually posted a negative return.

We also note our intra-year call: going overweight on energy in October proved to be a very solid recommendation as the group has risen meaningfully since. The price of oil has increased to $60 a barrel as we had expected. Our change to underweight water utilities was also strong, although our intra-year move to underweight financials was less successful.

We were also right on anticipating silver and gold prices to rise in 2017. Both metals rose, with gold nearly equal to the equity markets' rise on a percentage basis and silver a little less.

Our call on the strong dollar was wrong as it weakened somewhat. This expectation of a strong dollar also played into our thesis on international investment; we expected to see better performance here in the second half of the year. However, the weak dollar resulted in strong performance domestically throughout the year. We note we did update our thoughts as the year progressed and suggested overweighting as we thought valuations were attractive internationally for both emerging and developed markets, versus the US market.

As expected, we saw no recession in 2017.

Interestingly, while we did get a lot of our non-market predictions correct (geopolitical/political turmoil, a general lack of accomplishments, regulatory relief, Twitter rants by the president, etc.), we did not get the impact we had expected from this: an increase in the risk premium required by investors. Ironically, we actually saw the opposite occur, with the market multiple actually increasing. This was a function of an extremely benign market in 2017, with market volatility at or near all-time lows, and a total lack of pullbacks during the year. Investors just seemed to ignore any non-market news and looked solely at the strong earnings numbers. As long as these type of issues are discounted, we believe the market can move higher due to strengthening earnings numbers. That's just what we got last year.

### *Looking ahead*

As is typical, especially following a strong year like 2017, investment strategists have been pretty similar with their expectations for the coming year; there's a consensus for modest gains, generally ranging from the low to high single digits. With the market multiple as high as it currently sits (about 18.3 times forward estimates), it is difficult to project much higher than that. While we have seen some projections that the S&P 500 will top 3000 during the year (which would mean a gain of almost 12%), few have stepped out on that limb in light of the degree and length of the current bull market.

The market has gained almost 400% over the nearly nine years since the 2009 lows, or almost 20% a year! If 2018 is an up year, it will set a record with 10 consecutive up years.

In the face of such statistics, and considering the length of the current bull market, it would seem difficult to suggest another strong year for 2018, but we see limited rationale to suggest a regression to the mean at this point. With the tax law changes, likely continued improved economic growth (we expect to see full year GDP growth for the year exceeding 3% for the first time in nearly a decade), and strong corporate earnings, we see nothing that would precipitate a major correction.

Our rationale on why the current expansion can continue is also predicated on a number of facts. First, this recovery, while very long, has been abnormally weak. We believe this is a function of a number of factors, including legislation generally not conducive to a strong recovery. A surge of regulation, higher taxes, and a lack of business-friendly actions likely held back growth, allowing the recovery to stretch on and precluding the types of excesses that would typically lead to the end of a recovery.

Second, businesses and investors were nervous coming out of the Great Recession and that led investors to hold more cash and take less risk. This also held back growth, as well as speculation.

Finally, consumers were cautious and did not ramp up spending to the degree they typically might have in a recovery. As employment picks up, regulations are rolled back, and taxes are reduced, conditions should be more conducive to economic growth.

We do believe investors will take the first chance to take some profits in light of the length of the current market upswing, but there has to be a catalyst to drive people to sell, and there seems to be nothing to provide that type of catalyst other than some geopolitical issues. However, even those occurring recently have seemingly not impacted investor sentiment.

Although typically we would be loath to project an up market with valuations where they currently sit, with the length of time since a correction or bear market, and with the types of gains we have seen since the end of the Great Recession, we are going to do just that. In fact, we suggest the market may become even more expensive over the coming year. All of this goes against our typical value-oriented principles. However, with the earnings strength we foresee, the likelihood of estimate increases from the impact of the tax bill, and positive fundamental drivers resulting from repatriation impacts from the tax bill (potentially higher dividends and increased share buybacks), we anticipate the positive market drivers we have seen recently will only accelerate.

As a rule, bear markets don't occur in rising earnings environments, especially if estimates are being increased. And, as noted above, we can see economic growth continuing as a result of the factors mentioned earlier, which could add further fuel to the fire.

We also note investors have generally ignored the political and geopolitical turmoil that has swirled around the administration and have instead focused solely on the market's fundamentals. Our thesis at this point assumes that investors will continue to largely ignore these issues and continue to base investment decisions primarily on the economy, economic growth, and earnings. If investors decide these previously unconcerning issues are important, this would have the potential to derail the strong market.

We expect the improving economy and accelerating business conditions to begin to heat up the economy. Add that to the favorable employment picture, with continuing job gains that have driven unemployment down to low levels, and the ongoing increase in employment we anticipate. We expect labor costs to also tick higher.

As a result, we expect inflationary pressures will pick up in 2018. This leads to our expectation that the Fed will increase rates at least four times this year. This is solidly above the market's expectation for two increases and the Fed's guidance of three. At this point we see the first one in 2018 in March, and then look potentially for one every two months after that. Our thesis here is dependent upon strong job growth continuing, a ramp up in wage inflation as a result, and our assumption that Jay Powell, the incoming Fed Chairman, will be largely similar to Janet Yellen, who is Chairwoman until February 3rd. Were this not to come to fruition, we would have to re-think our expectation and projection for a more hawkish Fed than the market is currently projecting.

Our thesis calls for continued economic growth and likely acceleration around tax reform and positive impact on the consumer/worker front from higher wages (including all of the bonuses being announced by companies), as well as lower taxes paid by corporations as a result of the cut in corporate tax rates. Add all of this together and we anticipate a solid, strong increase in earnings over a 2017 that will be up significantly from 2016 (final 2017 earnings will not be fully reported until March 2018).

Further, we expect current earnings estimates do not fully reflect the impact of the tax bill and economic growth that is likely to accelerate in the year ahead. We anticipate analysts will push up estimates following Q4 earnings as management teams guide investors for the impact of the lower corporate taxes.

In spite of what we perceive as an expensive market, we anticipate a continued push higher in the markets -- very likely a substantial one, and one that could exceed 15% up from the start of the year. This move higher could also come quickly and it could be the final move higher before we reach the peak of the current bull market run. We are beginning to see some signs of the types of euphoria that signal we are nearing the end of a bull run (for example, investor sentiment has recently reached a seven year high and margin debt has moved to all-time highs). We are now going to look for the catalyst(s) that might lead to a sell-off.

The current expectation for 2018 S&P 500 earnings is around $147 per share, which is well above the approximate $131 per share estimate we are likely to see for 2017, up more than 12%, a very impressive rise. Despite that, and the fact that analysts' numbers tend to be too bullish, we anticipate the 2018 estimate to push above $150, as company managements guide for the impact of the tax law changes and stronger economic growth. (We see the consensus number moving towards $154 before coming down later in the year.) These bumps in earnings estimates should allow for further moves higher in the market and further multiple expansion.

With the current yield on the 10-year Treasury bond just under 2.5%, bonds would not seem to be attractively priced versus historical levels, especially with the potential for the Fed to raise rates more steeply than investors are currently anticipating. However, relative to other high-quality sovereign debt, US bonds continue to look attractive on a relative basis. We continue to expect the yield curve to flatten slightly, although we also anticipate long-bond yields to move up more robustly than recently, and more in-line with the rise in the Fed funds rate.

We see around a 1 percentage point rise in the yield on the 10-year Treasury to end the year just above the 3.5% level. If the 10-year yield does not rise to the degree we anticipate, that will place in jeopardy our expectation on the increase in the Fed funds rate, as we believe the Fed will not increase the Fed funds rate to such a degree as to approach an inversion of the yield curve.

We expect the dollar to strengthen slightly in 2018 with the Fed raising rates and accelerating economic and corporate earnings growth. However, by contrast, the repatriation of cash back to the US and into dollars could place pressure on the dollar.

While we continue to believe the risk premium on the market is too low, we expect investors will reduce it even more with all of the positive news on the economic and earnings front. The question becomes what makes investors pay attention to these risks, as nothing that has happened up to now, whether it be the president's tweets or issues with North Korea, has hurt investors' willingness to bid up stock valuations.

With these factors in mind, we see the market, as represented by the S&P 500, rising unabated early in the year as analysts raise estimates and euphoria around the tax law changes and news on the capital front (repatriation, share buybacks, dividend increases, etc.) continues. With all of this positive news we see the market continuing to rise until it doesn't anymore. We say this not to be duplicitous with this call, but note the market will need a catalyst to end the current bull market run, one we just don't see at this point. We are definitely paying close attention to any potential catalysts that might lead to the end of the current bull market, and we are beginning to see signs that we are coming to that end, but are not yet ready to call the end because we just don't see that catalyst yet. As such, while we think the market is moving towards a significantly overvalued level, we expect it to become more so in 2018, and anticipate the S&P 500 moving above 3000, likely breaching the 3150 level some time in 2018.

Having said that, we are not putting a year-end target out this year, as we will be reevaluating our fair value take on the market as the year progresses (with the level of growth we envision currently and with no shocks, we see **fair value** of the market at below 2500, well below the current market level). We are starting the year with a very elevated forward P/E ratio at about 18.3 times, compared to our recently moved higher target of fair value of around 16 times. We expect this multiple will continue to inflate with improved consumer and investor sentiment, raised earnings, and repatriated capital. We are assuming investors will continue to generally ignore geopolitical issues and that there will be some additional slight legislative movement.

The consensus year-end appreciation expectation is in the low-to-mid single digit range, while our expectation for a move above 3150 (which would be up nearly 17%) some time in 2018 is well outside this consensus. If we assume a catalyst occurs during the year that results in a revaluation towards our estimate of fair value, we would be well below that consensus.

We're looking for that catalyst that will end the current recovery, which we now expect will end up being the longest in history. We do not currently anticipate a recession is likely to occur in the coming year, although we remain of the opinion one is likely to occur sometime during the Trump administration (first term). The tepid economic growth we have seen over the past eight years has not been conducive to the emergence of such excesses. However, as growth ramps up, some of these excesses become more likely. The mania among bitcoin and crypto-currencies indicates investors are becoming favorably disposed to moving into speculative investments. We are keeping a close eye on the potential for such manias that might actually impact the markets and economy (we don't believe that a collapse in Bitcoin would have any major impact).

As far as our sector recommendations, we are suggesting overweighting the energy sector, at least early in the year. It was one of the worst performing sectors in 2017 and the improving economic environment should continue to push energy prices higher. We also would look at the telecom sector, which was the worst performing sector in 2017 and could get a bounceback from its more than 20% underperformance versus the market in 2017 and a lessening of pressures on the regulatory front.

While we are not yet ready to recommend consumer staples, this sector also underperformed the market last year and could become a very good place to be once that "catalyst" comes into to focus due to its defensive nature. Staples could underperform early in the year, however, due to more growth-oriented investments expected to outperform.

While underperformance of income-oriented and fixed income securities last year, especially late in the year, has made them seemingly attractive, the Fed raising rates more rapidly than expected is likely to keep the pressure on here. We expect this to create a buying opportunity among these investments, although opportunity is likely to come later in the year.

We continue to expect commodity markets to be more orderly than typical and commodity prices to slowly continue their recent move up as the economy improves. On the international front, we continue to like the growth of the emerging markets and their relatively cheap valuations in comparison to domestic securities. While a strengthening dollar would have a negative impact on these securities, as would the early year accelerating growth in the US and increasing corporate earnings, we remain partial to these securities, even though they may underperform while the US market is doing well. We expect them to do well over the longer term and offer some positive diversification effects.

The areas we suggest underweighting at this point include the consumer discretionary sector, especially the retailers, as they have had such an impressive run and could see some give back in the near term. This is a trade we may move out of quickly, however. We also see the interest rate sensitive groups underperforming in the face of the interest rate increases, although this is also likely to be a short-term trade, as we believe valuations here are not expensive at this point as a result of recent price declines.

We also expect the information technology sector to underperform the market for the full year, following the very strong results in 2017 (up nearly 40% or almost double the S&P 500), although this is likely also a second half call, so we are not yet making that call. In fact, they are likely to outperform early as they tend to outperform in up markets.

As far as commodities go, we will once again retain our suggestion to make gold and silver investments during 2018, especially later in the year should a catalyst arise to send the markets lower. Also, should inflation pick up as we anticipate, precious metals typically act as a good inflation hedge, although we do not anticipate a degree of inflation that would generate outsized increases in precious metals prices.

On energy, we see prices moving modestly higher during the year driven by increased economic activity. We expect the price of oil to end the year within shouting distance of $70 a barrel.

Our Crazy, Off the Wall Prediction for 2018 is that the economy improves to such a degree to force the Fed to increase rates significantly more than they are currently signaling (three times) and that Fed futures are currently indicating (two times). For the year, if things increase to the degree we see as potential and wage inflation kicks in following the March rise, they might have to raise every second meeting, meaning a potential for five Fed increases. Of course, as noted earlier, this would be predicated on longer-term Treasuries rising apace.

What should investors do with all of this in mind? First, we stress that, logically, the higher the market goes above fair value, the more risk to the downside when we do eventually see the catalyst arise that causes a market correction. Our estimate of fair value is more than 10% below the current market level, and should the market rise as we expect, it could be nearly 25% above our estimate of fair value. Our number could be right, or might be wrong, but if it is anywhere close to right, we see significant downside when the market does correct.

In bear markets, valuations typically overshoot to the downside. Investors need to be aware of this as they move more into equities. In light of this risk, we continue to suggest caution for those investors who don't feel comfortable with such downside risk.

In light of the current market tenor, though, we suggest generally staying in the markets through the near term. As we move through 2018 and should the market move higher we will likely change that suggestion. At that point we might recommend more conservative investors slowly increasing cash and short-term bond positions as the market moves higher (re-balancing). With our expectation for the market to continue to melt up, aggressive investors may wish to hang on for the ride.

What we don't want to happen is for our investors to be without a seat when the music does end, and even aggressive investors need to be aware of this risk. It feels great to ride the market higher in times such as these, but just remember it feels a lot worse when the direction of the market turns! We will endeavor to signal our investors before such a turn, but note even the smartest investors rarely get these turns right. This is the reason we suggest paying close attention to rebalancing in market moves such as we are seeing. Given the current market action and rising euphoria, we will attempt to offer ongoing guidance as the year progresses.

As noted, precious metals are also a place to go here to offer some potential hedging for worried investors as markets move higher. Prices here often hold up when markets are down, although we note this is not always the case. We also suggest bulking up (and overweighting) international investments, especially emerging markets, where valuations appear much less extended, even after a very good 2017.

For most long-term *investors* (not traders), we generally ignore inevitable ups and downs in the markets. We suggest most investors, rather than trying to anticipate market movements, put new monies into the more attractively priced securities -- in this case, some of the depressed areas such as energy and telecom, while potentially moving out of technology later in the year. We also look to the income-oriented sectors if they continue to sell off sharply and once the impacts of a more hawkish Fed have had their impact on prices.

What could derail our thesis? We see the most likely source as something on the geopolitical/political front that could provide a negative surprise to the market. We could also see euphoria come even more quickly and have some excesses arise that cause the market to decline more quickly than we anticipate. If this happens, we would more quickly move into cash/short-term bonds and increase exposure to the consumer staples area. Of course, if the Fed proves to be more dovish than we expect, that could continue the current "good times" even further, although that might very well create more downside when the eventual correction does occur.

Overall, we remain very cautious on equities from a valuation perspective, although we don't see a catalyst to cause a correction and anticipate the market melt-up will continue. We could see something that changes this equation later in the year; at this point all indications suggest the market direction will remain up. We see early 2018 as a positive time for equities. That may very well continue throughout the year and we are taking a wait and see position. With short-term bond yields now largely equal to the yield on equities, we also note stocks are no longer the only place to go, making bonds an alternative for worried investors.

*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.*

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I, John Roberts, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

## 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** | 75 | 67% | 9% | 91% |
| **Sell** | 6 | 5% | 0% | 100% |

*As of 8 January 2018*

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