HILLIARD LYONS

INVESTMENT STRATEGIES

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Looking Back and Looking Ahead

A recap of the first half and look ahead to the remainder of 2017

In the first half of 2017 we experienced a market that consistently moved higher. Solidly positive earnings, which were generally in excess of expectations, were seemingly the driving force, as outside factors were generally not supportive for higher markets. We experienced a nearly 15% year/year increase in earnings during Q1, and expect to see above baseline growth in both Q2 and Q3 at 7% and 8%, respectively. This earnings growth has supported a strong equity market in the face of a number of outside factors that would typically be considered negative. For the full year, earnings growth is anticipated to be about 8%.

The market experienced a more than 8% gain through the first half of 2017. The earnings multiple has been generally stagnant despite the increase in the market, as the rise in earnings has been generally correlated to the rise in the markets. However, we note the large increase in the market following the election of President Trump was predicated on business-friendly policies, such as tax reform, health care reform, repatriation, etc. being enacted. We have not seen a market sell off which might be anticipated as it becomes apparent implementation of these market-friendly policies may be delayed or unlikely to occur at all.

In our opinion, this is a function of the market ignoring those issues but paying attention to the strength in earnings. Q1 earnings were expected to be strong in comparison to the year earlier period and the actual numbers were even better than that expectation. We believe that led to the market rise we have seen so far in 2017.

This was in-line with our expectation for an early year rise in the markets as analysts raise their estimates for full year earnings. As we anticipated, we have seen a steady move up in estimates with the $129 earnings per share consensus expectation for the S&P 500 earlier in the year moving up to now equal our prediction of $131. We would expect this number to move even higher as Q2 results come out, before a late year decline in the estimate back towards our $131 number.

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For the first half of the year the Dow Jones Industrial Average rose by 8.0%, the S&P 500 was up by 8.2%, and the NASDAQ Composite ended the half jumping by 14.1%. The markets showed a reasonably consistent move higher through the first half of the year, as analyst expectations for earnings moved up apace.

At the start of the year, we had anticipated continued euphoria around the new administration's economic policies and a move up in earnings expectations would facilitate an early year rise in the markets. We certainly got that, despite what is a faster occurrence of a perceived failure of the administration's legislative objectives than we anticipated. With analysts driving estimates up for an expectation for these policies, we've been surprised we have not seen some give back in the markets due to this disappointment. The reported earnings strength seems to be overshadowing these issues, something we don't see changing over the next couple of quarters.

In fact, based on what we have seen so far from a pre-announcement perspective, we anticipate we will once again see earnings beat expectations for Q2. Earnings season for the quarter starts in the next week. As such, at this point we don't see markets taking the second half swoon in the near term that we started the year anticipating.

Further, with the strength anticipated for Q3, a sustained pull back may prove unlikely in the current year. Market declines are typically precipitated by earnings shortfalls, something we view as unlikely at this point. Thus, the pull back we started the year expecting may not occur until 2018, with investors seemingly ignoring non-earnings related negative news. Of course, should investors begin to take notice of these issues, a change in market direction would be expected.

Our expectation for the direction of short-term interest rates was not far off of market expectations, with our thoughts the Federal Reserve would be raising rates more slowly than generally anticipated. We expected one raise in the first half of the year and another, maybe two, in the second half of the year. We ended up with two in the first half, although the second was in June, and it now looks like we might not get the third one in the second half of the year, since the Fed may reduce the size of its balance sheet instead. Time will tell on that front, however, as Fed members continue to talk about more raises. Having said that, we believe they may find it difficult to raise rates in the face of a wind-down in the size of its balance sheet.

Bonds, in general, performed along our expectations, with the yield on the 10-year Treasury bond ending the first half of the year a little over 2.3% compared to 2.5% to start the year. While the consensus was for a rise, we had anticipated a steady yield, and while the first half saw a slight decline, the direction now is pushing the yield back toward that 2.5% level. The other part of this equation has proven out, with a definite narrowing of the yield curve, as short term bond yields rose, while long-term rates fell.

Our expectation for continued strength in the dollar was one prediction that did not come true. Our sector call to start the year -- to overweight the healthcare sector -- has proven to be a home run, with it being among the strongest performing groups, while the call to rotate into the consumer discretionary sector proved to be prudent.

Also, our suggestions to underweight energy, the worst performing sector in the first half, and moving out of financials also were winning moves. So was the suggestion to overweight international stocks, which handily outperformed domestic securities. On the other hand, our targeting of the retail group and suggestion to move into gold and silver would have underperformed the markets.

Thus far in 2017, the market has moved up a little more than we expected, while bond rates have declined slightly, although both remained largely in line with our expectation. With the economy on a modestly positive trajectory and any additional interest rate hikes probably on hold for the remainder of the year --

although reducing the size of the Fed's balance sheet -- earnings should remain in the headlines. We expect investors to continue to focus on earnings in the near term, as strong results put other issues in the background.

With earnings strength continuing to be the focus of investors, we are revising our former year-end price target of 2200 on the S&P 500. Earnings continuing to come in above expectations could allow the market to move higher despite valuations that remain well above historical norms, as markets will typically not sell-off in rising earnings environments, especially when those earnings are above expectations.

While the major risk to the market, in our view, is the high multiple at which the market is trading we do not anticipate this risk will be one to send the markets down in the near term. Bear markets/large market declines are typically triggered by earnings falling short of expectations. We just don't see that occurring in the next couple of quarters. Over that period we anticipate earnings growth will exceed expectations and prices will continue to rise as companies' results beat expectations.

What we believe is more likely to negatively impact stock prices is any potential rise in interest rates. We have already seen the potential impact here; a jump up in rates toward the end of Q2 resulted in a pull back in interest rate sensitive names. Any prolonged increase in rates is likely to have a more pronounced impact here. This is a major risk we are worried about at this point.

What about the future?

Our initial expectations for 2017 now seem to be too conservative from an equity market perspective. This is not a function of valuation, as we still see the current equity valuation metrics as being expensive, especially if rates begin to rise in earnest. Expectations for earnings growth occurring during 2017 have been steadily increasing so far and we have seen general economic improvement, and this has overshadowed the high valuations and negative geopolitical/political issues.

At this point we are comfortable the final S&P 500 EPS number will hit our beginning year estimate of $131. We see strength in at least Q2 and Q3 numbers, although, in our opinion, Q4 could be more problematic should rates rise significantly. Investors can ignore stretched valuation metrics in an environment of strong earnings that are exceeding expectations, and this is what we are currently seeing. We see no indication this same pattern will not continue over the next quarter or so.

As such, we still expect the multiple on forward earnings to remain at an extended level, with a very slight compression due to the slight increase in interest rates we are forecasting. We expect the multiple on year-ahead earnings to drop from the current number of around 18 times to around 17 times due to a slight increase in the risk premium required by investors and as a result of the impact of modestly higher interest rates. With an expectation of earnings per share of $138 for 2018, we see a move up in the market to above 2500 on the S&P 500 on the strong Q2 and Q3 earnings before a pull back into the year end on the declining multiple leading to a year end market level of 2350.

Strong earnings over the next two quarters may likely continue to provide fuel to the market, although worries on rising rates are likely to negatively impact valuation before the year is out, in our view.

Where to invest?

Going into the second half we're pivoting a bit due to the strength of our recommended sectors during the first part of the year. While we still like the healthcare and consumer discretionary sectors, with the underperformance of the energy sector through the first half of the year we see that as a place to begin to overweight going into the second half of the year.

On the other hand, the strength of high growth technology stocks during the first half of the year worries us. High valuation equities could be especially hard hit should interest rates rise, as future year earnings will be worth less in a higher interest rate environment. Thus, we suggest cutting back on higher growth companies to reduce risk.

We are not going to move to a more defensive posture, but we expect that to occur before year end. We also note the more interest rate sensitive sectors, such as electric utilities and REITs, could see some downside risk if we get a pronounced rise in rates. As such, taking some money off the table here may be appropriate. We anticipate an increase in volatility, such as we have seen as interest rates have bounced around.

We also would retain a significant, yet prudent, stake in precious metals, with the recent weakness in prices here making them more attractive. At the very least the weak year to date performance suggests re-balancing might be appropriate, which could result in adding to the area.

We would also continue to look at international equities, considering both the emerging and developed markets in spite of the strong performance so far in 2017. Valuations in many international markets remain attractive versus domestic valuations, in our view, and the dollar weakness has only magnified the valuation differences.

On the debt side, we remain partial to the corporate sector and municipals versus US Government and sovereign bonds in general. Going forward, we continue to believe the yield on the 10-year Treasury is likely to move toward 2.65%. The recent move higher on the yield of other sovereign bonds should allow our bonds to move a little higher, even with the Fed unlikely to raise rates for the rest of 2017, in our view. The reduction in the Fed's balance sheet should have the impact of widening the yield curve a little late in the year. We would continue to wave investors away from putting longer-term capital in bonds currently, although the downside seems reasonably slight.

Finally, we note the current recovery is relatively long in the tooth, and we would not be surprised to see a recession sometime in the next year or so. While we are not predicting one and note recent earnings strength belies a slowdown occurring, given the current high valuation metrics of the market we believe investors should be aware of such a potential occurrence in the future.

As we noted earlier, as long as earnings growth continues and reported numbers continue to exceed expectations the market can move higher even in the face of high valuation. The risk comes when earnings no longer measure up to expectations. We note the last time this occurred was in 2008-2009, at a time with much lower valuation metrics (a multiple of below 15 times forward numbers versus above 18 times right now).

Our worry is that when the inevitable comes and earnings begin to fall short of expectations, with the much higher valuation metrics at which the market is currently trading, the downside could be more pronounced depending on the degree of any earnings shortfall.

With that in mind, we are not predicting a shortfall in earnings currently. We are not suggesting pulling back on equities, and most of our suggestions revolve around fine-tuning positions and some sector rotation, yet investors still need to be aware of the potential downside risk when economic growth begins to slow and earnings no longer show the strong growth we have seen recently. As always, our recommendation is to think long term and ride through ups and downs. It is tough to ignore them even when you have that long-term mentality, so being aware of the potential risk and that we will get through to the other side makes such a strategy easier to stomach.

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	36	29%	14%	86%
Hold/Neutral	79	63%	5%	95%
Sell	10	8%	0%	100%

As of 7 July 2017

Other Disclosures

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