



INVESTMENT STRATEGIES

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Market Valuations

Where do we stand?

As US stock markets exceed multiple all-time highs and investors barrel into equities it would seem to be a great time to offer some thoughts on where we stand currently. Last month we saw the market post a streak of 12 consecutive record closes for the Dow Jones Industrial average, matching a streak of record closes last seen 30 years ago.

Further, we are currently experiencing a large migration of small investors back into the markets; there has been an \$83 billion surge of cash into passive investment strategies (i.e. index funds) at the expense of a \$15 billion withdrawal from active investment strategies. The individual investor is the main purchaser of index funds. Investor sentiment is also the most bullish it has been in 30 years, according to a recent survey. The last time investor bullishness was so high was again in 1987.

As such, investors seem to be very positive about their expectations around the new administration and the prospects of changes on tax and regulatory policies. Investors are much more ebullient on equities than they have been in some time. Caution is seemingly being thrown to the wind. We have fielded several calls lately that centered on investors' fears of being left behind on the current stock market boom.

We see the most important part of our job as being a moderator of our clients' euphoric or disconsolate attitudes around the markets. Unchecked, such conditions typically lead to the incorrect decision -- buying high and selling low, rather than the appropriate, vice versa call. As Warren Buffet has famously stated, "Be fearful when others are greedy and greedy when others are fearful." The current market and sentiment measures indicate to us we are closer to the greedy side of the ledger than the fearful side at this point!

With those factors in mind, we believe it is an appropriate time to offer our investors a read on market valuations and expectations for the near future. Though we remain believers in long-term investing and in tolerating the inevitable ups and downs in the markets, we also do not want investors to be blindsided by them. While these market moves may be inevitable, it doesn't make them any less uncomfortable, even to those who are in the business and expect just such volatility.

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We watched the 1973-74 market collapse, and worked in the business during 1987's Black Monday, as well as the 2000 and 2008-2009 bear markets (and many other less painful ones). We know suspecting such pullbacks could be on the horizon offers some ability to prepare. The problem is that while identifying downturns are very easy in hindsight, predicting them before they occur is problematic, if not impossible. Markets can stay expensive or cheap for long periods of time before fundamentals catch up to them.

One only has to remember Alan Greenspan's speech in 1996 discussing "irrational exuberance" in the market, which occurred nearly four years before the peak of the NASDAQ. And if Alan Greenspan couldn't nail the timing of the market peak, what chance do we have?!

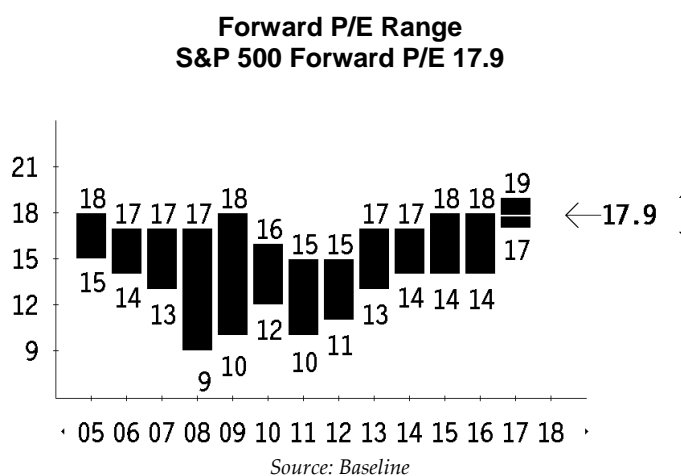
Having said that, some context on where we currently stand in the markets: Stocks are valued on forward expectations and any shortfall to those expectations will typically result in a market moving down, while exceeding those expectations will result in a higher market, all things being equal.

Forward expectations for the market are currently much higher than they have been over the past several years with an expectation for a nearly 10% rise in earnings for the S&P 500 in 2017. This follows two years of flat to negative earnings numbers, and would be the first double-digit gain in earnings since 2011.

Part of the rationale for such strong growth is around expectations for strong improvement in energy and natural resource companies, where weak commodity and energy prices have resulted in negative earnings at many companies. Also, low rates have hurt some of the financial companies, especially banks and insurers and expectations for the Fed raising rates would boost earnings here.

Overall, earnings expectations are more positive than they have been in some time. The question for markets, though, is if the actual numbers will measure up to these projections. We are reasonably positive on that front given recent economic numbers, but only time will tell.

Now, let's look at valuations. The overall market is currently trading at just under 18 times forward earnings. On a historical basis, this would be considered a fairly full valuation. In fact, were one to look at the markets since the 1920s, there were very few periods when valuations were this high. Even over the past decade-plus, we sit basically right at the high over that period, as the table below shows.



Of course, there are some mitigating factors that would argue for higher than typical multiples in the market -- mainly the unprecedented level of policy accommodation the Federal Reserve has maintained over the past decade, with essentially a zero Fed funds rate from the Great Recession until the end of 2015, and

abnormally low rates historically to this day. The low rates throughout the domestic economy, and in fact the world, argue for higher multiples, all things being equal.

Lower interest rates on bonds mean investors will settle for lower returns on stocks, all things being equal, while higher interest rates on fixed income investments mean investors will require higher returns on alternative investments, such as equities. As a result, the lower interest rates fixed income investments have provided offer an environment for higher equity valuations.

Also, if interest rates rise, one would anticipate investors would require higher returns from equities, all things being equal. Such a higher return would be the result of lower equity prices (in the same way bond prices decline as interest rates rise) and a lower multiple -- again, assuming all things being equal.

In general, all things being equal is not the case, as the Fed is unlikely to raise short-term rates significantly, and in turn long-term rates are unlikely to rise unless we see improving economic conditions and higher economic growth. Subsequently, this should lead to higher earnings for equities. Such higher earnings would tend to offset part of a drop resulting from any lower multiples related to higher interest rates.

In light of these conditions, what do we suggest that investors do? For most investors with long-term investment time frames the general advice is to do nothing, with the exception of fine-tuning portfolio weightings -- maybe moving into cheaper areas in the market or raising a little cash as you take profits on some of the more highly valued companies and sectors. As noted earlier, timing any correction or bear market is nearly impossible. As a result, just staying the course is typically the best course of action.

For those uncomfortable with current conditions and who find such volatility painful, holding more cash is a course of action that might be appropriate. The problem with this is figuring out when to get back into the market. More often than not, those who raise a large amount of cash because of such worries end up getting back into the market at a higher level than where they sold out.

However, for those close to retirement or with a definite need for money in the near future, raising cash for those near-term needs can be an appropriate strategy when markets look frothy due to the risk of needing to raise capital when conditions are unfavorable.

Most long-term investors, however, should just ride out the markets ups and downs, in our view. If you had put all of your money into the market at the S&P 500's highs in October 2007, sixteen months later in March 2009 you would have seen a price decline of just short of 50%, certainly not comfortable! But if you had just held that same position until today -- and remember, you were making that purchase at the market **high** in 2007 (very unlucky timing!) -- your total return including dividends would be in the area of 80%, not exactly a bad return. And most of us would have not made that investment all at once, but rather dollar cost averaged into the market over time, meaning your return may have been above that.

Therefore, remember to regularly invest. Put a little more to work when markets are cheaper and the sentiment on equities is negative, and maybe put a little less and raise or hold a little more cash when markets are more expensive and sentiment is highly positive. Your Financial Consultant can offer advice on where we stand on valuation and investor sentiment. Either way, by consistently following such advice we would expect to generate consistent strong returns over time. Use those uncomfortable pullbacks to add to quality positions, but ride through rockier markets and understand those negative account statements could eventually lead to much higher account balances coming out the other side, especially if you increase your investments when stocks are down.

Additional information is available upon request.

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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.	
	# of Stocks Covered	% of Stocks Covered	Banking	No Banking
Buy	35	29%	14%	86%
Hold/Neutral	71	59%	6%	94%
Sell	15	12%	7%	93%

As of 8 March 2017

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