INVESTMENT STRATEGIES

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Market Valuations Redux

Where do we stand?

Though we looked at market valuation metrics this March, we believe another look is appropriate as US stock markets continue to see multiple all-time highs and investor demand for equities continues to be strong. While the upward move in the markets has been very orderly and the increases have generally been consistent, it does not take away from the fact that it has been an extended time (**nearly 10 years**) since our last bear market and that equities sit at a historically expensive level.

We have continued to see small investors move back into the equity markets, with positive flows continuing into passive investment strategies (i.e. index funds), although some of that has moved into international funds, as the weakening dollar has resulted in strong performance there. The individual investor is the main purchaser of index funds.

We see one of the most important parts 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!

However, as the market moves up again and again to all-time highs, another Warren Buffet quote comes to mind: "Rule number one is never lose money. Rule number two is to never forget Rule number one." At this point, investors don't seem to be overly greedy, as bullish investor sentiment is actually down from recent highs.

Further, low interest rates (and we expect rates to continue to stay reasonably low) and solid earnings (which we see continuing in the upcoming Q3 earnings season) are expected to continue to support stock prices. Generally, large market declines are unlikely in such conditions, with strong earnings providing the greatest support for markets.

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Note Important Disclosures on Pages 4-5
Note Analyst Certification on Page 4

Typically we do not see bear markets or large market declines during periods of growing earnings. Many bear markets have resulted from earnings falling sharply short of expectations; just look back to the 2007-2009 bear market for an example of this. We do not see an earnings downturn occurring at this point, and we have no indication when such a surprise occurrence (which the previous period was) is likely to happen.

With the market sitting at current, historically high levels, and with the period of time since the last bear market or market correction almost a decade ago, 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. Maybe the author of this piece is just getting more conservative as he enters his sixth decade, but that second Warren Buffet quote is now much more meaningful than it was in the past!

We watched the 1973-74 market collapse and worked in the business during 1987's Black Monday, as well as during the 2000 and 2008-2009 bear markets (and several 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?!

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.

Earnings expectations for the market are currently much higher than they have been over the past several years with an expectation of nearly a 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. These expectations were backed up by positive results in both the first and second quarters; both quarters were strong, exceeding even very optimistic expectations.

Earnings expectations also continue to be very strong for the third quarter as well, and we currently see no indication these numbers will not be achieved, if not exceeded. Once again, noting markets typically move up on an upside surprise in companies' results relative to expectations, we still see a major near-term decline in markets as unlikely. As such we remain reasonably positive on the markets in the near term, in light of those factors and recent economic numbers that have also been neutral to positive.

A look at valuations is educational for long-term investment. While in the short term markets can retain valuations well above historic norms, especially in low interest rate environments with strong earnings growth, such environments typically lead to lower than normal investment returns over the longer term. The overall market is currently trading at about 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 have been very few periods when valuations were this high. Even over the past decade-plus, we sit basically right at the high over that period. Also note the current level of the Shiller P/E ratio (average trailing 10-year P/E ratio) currently stands at nearly 31,

compared to a long-term historical average of around 17. The average 10-year equity market return off of a similar Shiller P/E would be well below the long-term average of around 10%.

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 thing 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. Further, even lower rates for international sovereign bonds will place pressure on domestic bond rates. 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 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 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, therefore just staying the course is typically the best course of action.

For those uncomfortable with current conditions and who find potential 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. In these situations, taking Mr. Buffet's *Never lose money* rule to heart becomes more meaningful. Of course, one can never truly do exactly that unless you go to only holding cash. However, that cash cushion will reduce any potential loss compared to that of the overall market.

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 nearly 90%, 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 Wealth Advisor 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.

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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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	% of		
Rating	**Stocks Covered**	**Stocks Covered**	**Banking**	**No Banking**
Buy	39	32%	8%	92%
Hold/Neutral	74	60%	9%	91%
Sell	8	7%	0%	100%
Restriction	2	2%	100%	0%

As of 5 October 2017

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