INVESTMENT STRATEGIES

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Catastrophe

The economic and market impact of catastrophes

> *Author's note: As we go to press we want to keep in mind those already affected by Hurricane Harvey, as well as the people and communities that could potentially be impacted by Hurricane Irma, which is barreling its way towards Florida as potentially the strongest hurricane in modern history after already passing over several islands in the Atlantic Ocean. We keep all those affected in our thoughts and prayers.*

Every time a hurricane, earthquake, or other catastrophe occurs, we field questions from investors on how to invest around such events. Of course, there are a wide variety of impacts from disasters, many of which are short-term in nature. In looking at the devastation wrought by Hurricane Harvey, insurance companies are expected to see a negative hit as they cover claims for property damage, both residential and auto. Most of the flood damage, however, will not be covered by the private insurance industry, but rather by the Federal Government under the flood insurance program.

On the other hand, beneficiaries could include construction companies, companies providing building materials, and car companies (to replace the estimated half million cars that will be scrapped as a result of the flooding), among others. Economically, there will be some positives due to the rebuilding, although overall we expect there could be a negative impact due to business interruptions throughout the impacted areas. We also note an anticipated diversion of resources from other areas to the areas of devastation, resulting in an overall reduction in economic activity as a result of such a natural disaster.

Other industries likely to be impacted as a result of a natural disaster can include airlines (at press time many are closing down in expectation of Irma and will see significant flight cancellations in the coming days), retail (store closings, property damage, etc.), utilities (power outages due to property, tree, and infrastructure destruction, etc.), trash removal (for clean-up purposes following a storm, earthquake, etc.), farming (from flooding and/or wind resulting in crop destruction), energy (when hurricanes hit the refinery, drilling areas), to name a few.

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In looking at the list of industries potentially impacted by these events one might anticipate there could be an opportunity for making profitable investments that also support the rebuilding of impacted areas. And beyond the obvious, there are more subtle and less obvious impacts.

Just this week, Newell Brands (NWL-$47.03) lowered its earnings outlook due to inflation in resin prices as its resin suppliers in Texas and Louisiana declared Force Majeure due to the close-down of refineries there. The company anticipates no change in sales but anticipates seeing a push up in raw material costs that will reduce margins as a result of the hurricane.

Elsewhere, we have seen a spike in the prices of avocados and citrus fruit as Irma approaches Florida, something that could impact a company such as Chipotle Mexican Grill (CMG-$317.88), which utilizes a significant amount of avocados in one of its most popular dishes, guacamole.

Having said all of this, for a variety of reasons we really do not see there being much in the way of long-term profitable investment opportunities. In our view, many of the companies that should see a major positive impact from something like Hurricane Harvey will be smaller, regional, and local companies. These are generally private companies and not public ones investors can purchase a stake in.

And for public companies, the impact is likely to be too small to make such an event an investable catalyst for investors. As an example, companies such as Home Depot (HD-$156.56) and Lowes (LOW-$77.47) will see a significant bump in sales in Texas (for building materials such as drywall and plywood) and have already experienced an increase in sales in Florida (for generators and plywood, among other items).

However, these companies are too large for localized stores to really have an impact on the bottom line. But even if Harvey or Irma do bump the bottom line, it should only be temporary, and investors typically ignore passing bumps in earnings -- or for that matter, declines -- when setting stock prices.

In fact, should investors bid the shares down or up sharply on such events, a contrary position -- doing the opposite of the market -- is likely to be the best course of action as we would anticipate that over the long-term this knee-jerk reaction will correct back to the norm. As such, for the most part, we believe long-term investors who are not traders should just ignore these types of events from an investing perspective and rather use the event for charitable purposes.

Interestingly, the one area where there might be a longer-term investment opportunity is with the insurance industry on the positive side. This would appear to be the opposite one might anticipate in light of the large claims likely to befall the insurers. We would not be surprised to see total insured losses approaching $100 billion or even higher, a number one might anticipate will hit private insurers' stock prices particularly hard. And for those companies overexposed to Florida (assuming Irma hits there) or Houston, or for under-reserved companies, that may very well be the case. We believe Harvey is unlikely to result in widespread insolvencies due to most of the losses being flood-related. However, due to Irma's fast pace and high wind speeds and massive size, should it hit virtually anywhere in Florida, we expect insured losses will likely be a multiple of the amount seen in the case of Harvey.

As a result, we are likely to see insolvencies in the sector due to a much larger amount of insured losses. But while such an occurrence is going to be very negative for those insurers overly exposed or without adequate reserves, for those that survive, we should see a significant firming up in pricing as capacity is removed from the market, allowing insurers to increase prices and generate a more appropriate return on capital. There are a lot of uncertainties around insurance pricing, such as whether global warming is likely to increase the severity of future hurricanes, but insurers will be gaining a better handle on this issue through experience gained in looking at Harvey, Irma, and other recent hurricane activity.

Either way, we expect these events to lower capacity and result in firming prices for the risks taken by the insurance companies. As a result, insurance companies could become more interesting investments as property/casualty prices firm and benefit the surviving insurance companies.

Prices as of close, 6 September 2017.

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

Hilliard Lyons' analysts receive bonus compensation based on Hilliard Lyons' profitability. They do not receive direct payments from investment banking activity.

The author of this report or members of his household have a long position in Newell Brands.

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.

Rating	Hilliard Lyons Recommended Issues # of Stocks Covered	% of Stocks Covered	Investment Banking Provided in Past 12 Mo. Banking	No Banking
Buy	40	32%	10%	90%
Hold/Neutral	77	62%	8%	92%
Sell	8	6%	0%	100%

As of 6 September 2017

Other Disclosures

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