Investment Strategy & Research

Sector Inspector: September 27, 2019

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The Investment Strategy & Research team of Hilliard Lyons, A Baird Company, supports you and your Wealth Advisor with investment guidance to help you separate meaningful news from idle noise via timely market commentary.

In the *Sector Inspector* series, ISR presents our view on US equity market sectors. Our goal is to help investors understand US equity markets by focusing on discrete items that impact groups of stocks. We draw attention to areas where we see long-term opportunity, and to highlight groups we believe are less compelling. It should be noted, ISR supports diversification, and believes that most investors should be exposed to most (or all) sectors.

Changes This Month: NO CHANGES

Our Current Macro Framework for US Markets

Many themes and opinions impact our sector views; several are detailed below. We view the S&P 500 at 17.4x forward earnings as within a range that represents fair value.

*We believe the **US economy is growing, due primarily to a strong consumer.** Low unemployment, rising wages, and steady job growth underpin this view. Growth is hollowing out somewhat due to trade shocks and flagging business confidence/investment.

*Current **US trade and national security policy bring headline risk to stocks and operational risk to companies**. This covers tariffs, but also withdrawal or agitation on other fronts (e.g., Iran). We are disinclined to 'bet' on geopolitical events and outcomes.

***We expect 2020 campaign rhetoric to impact markets**; this includes impeachment proceedings. In general, we assume enacted legislation will be *less impactful* than policy proposals might suggest.

Sector Overview

	*Fwrd P/E	YTD
S&P 500	**17.4x**	**20.6%**
S&P Sectors:	@ 9/26/19	Total Rtrn.
Technology	20.4x	31.3%
Healthcare	15.1x	5.1%
Financials	12.4x	18.8%
Comm. Svcs.	16.8x	22.4%
Cons. Disc.	21.1x	21.9%
Industrials	16.5x	22.3%
Cons. Staples	20.2x	22.0%
Energy	16.4x	6.8%
Utilities	20.7x	24.8%
Real Estate	42.5x	29.4%
Materials	18.0x	16.5%

*Source: Bloomberg; *Forward 4Q P/E*

*We assert that **the Fed has acknowledged a global slowdown, and is broadly accommodative**. From cutting rates in September, to aiding the repo market, we see the current Fed regime as positive for most financial markets.

***Portions of the Treasury yield curve remain inverted.** We respect this economic cycle indicator directionally, but view it as a poor tool for timing markets. We also see some uniqueness to this cycle due to quantitative easing.

*We are cognizant of **rising cost pressures** for companies, particularly rising wages, tariffs and elevated transit costs.

We Like: Healthcare, Financials & Energy

Healthcare: We believe political rhetoric brings an opportunity for investors to focus on Healthcare. At 15.1x forward earnings, Healthcare is below its median valuation over the past 5 years (16.0x) while the broader market is more expensive (S&P 500 at 17.4x versus 5-yr median of 17.0x). We view this setup as particularly attractive for long-term investors given strong secular growth prospects for the sector due to demographics. The group does operate globally, but demand is not particularly cyclical, nor are companies very sensitive to a global supply chain.

The main headwinds we see for Healthcare are political. Both real (regulation and Congress) and perceived (rhetoric) policy concerns could weigh on sentiment indefinitely. That said, status quos in healthcare are difficult to upend, and a mix of consolidation and integration has created a sector that we believe can grapple with incremental change. As such, we believe investors should consider the group while multiples are depressed and stocks are out of favor.

SEE IMPORTANT DISCLOSURES ON PAGE 4

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Financials: An inverted yield curve and 'low' interest rates are not necessarily constructive for Financials. Same goes for the Fed rate cuts. Alternatively, banks *are* certainly interested in extending the current economic expansion, and the group has shown an ability to adapt and execute despite unique headwinds this cycle. Moreover, banks in particular are exposed to strong consumer trends, and would stand to benefit should lower rates boost the housing industry.

At a 12.4x forward P/E, we like long-term risk reward. Balance sheets are improved from the prior cycle, and earnings are less cyclical. Political scrutiny has shifted (e.g., pharma), which supports return on equity and dividends/buybacks. We prefer leading firms that could take share in an era of lower fees, disruption, and rising security/privacy demands.

Energy: A recent attack on Saudi energy assets reminded investors of Energy's value as a geopolitical hedge. Energy is also the least correlated sector in the S&P 500 historically, and is usually strong late-cycle. These items may or may not factor into returns over the next several years, but directionally we like these characteristics in this environment.

Despite a strong September, we believe the YTD laggard remains somewhat under the radar. Energy has slipped to just a 4.4% weighting in the S&P 500, although a growing emphasis on cash returns is starting to show as EBITDA margins have expanded this year. We like allocating to core, long-term positions in companies with stronger financial profiles.

We Dislike: Consumer Staples & Utilities

Consumer Staples: Consumer Staples are usually lower-margin businesses, which leaves the sector lesser-equipped to handle rising input costs or dislocations in the global supply chain. A small uptick in costs has an outsized impact on profitability for companies with low margins. We view 19.5x forward EPS as too expensive for a low-growth sector primed for disruption, *particularly* with the broader market not overly expensive.

Brands have historically held pricing power, but we believe this is in structural decline. Consumers are increasingly looking for niche/super-premium brands, or 'off brand' products of improved quality. A strong consumer has positive general implications for Staples, but we believe there are better ways to leverage this theme.

Utilities: Our concern with Utilities is long-term expected return if entering positions at nearly 20x forward earnings, or as much as 30% above average valuation depending on timeframe. We are not asserting the group is mispriced *right now* given low interest rates and shaky global growth, but we do anticipate a better opportunity to focus on the sector.

Offsetting our tactical view somewhat, we still like Utilities' fundamental outlook. The US-centric sector is not sensitive to tariff and trade policy or economic cycles, and is relatively insulated from today's national political theatre.

The Rest, in Two Lines or Less (ordered by weighting in the S&P 500)

Technology: Tech generates more of its sales abroad than any other sector while relying on a global supply chain. With trade in flux, we do not take a strong stance; however, Tech is a likely leader on an interim deal or subdued rhetoric.

Communication Services: We like Comm. Svcs. as a play on consumers, but politics is a stealth risk with search and social media both part of the sector. Group includes old Telecom (deep Value) and some leading 'tech' growth companies.

Consumer Discretionary: Exposure to the US consumer is appealing, but trends are not as constructive for global brands with broad footprints (e.g. the EU) and valuation is expensive. Disruption to traditional retail is a persistent risk.

Industrials: The sector is exposed to cost pressures, global growth, and fading US transports data, but is also highly correlated with the broader market. Long-term risk/reward seems balanced, but the sector could lead if trade improves.

Real Estate: We worry about long-term expected return from current levels. But we do like Real Estate's US-centricity and see the sector as the most direct way to play for even lower rates. Industry selection within the sector is important.

Materials: The pivot lower in interest rates is not constructive in a historical context; reduced growth expectations are not great either. That said, higher metals prices are a net positive, and DowDupont spins bring new ideas to US investors.

Hilliard Lyons ISR: Sector Matrix

Sector	% of S&P 500 @ 8/31/19	Like / Dis-Like	Key Positives	Key Negatives	Valuation Stats
Technology	**22.1%**	●	*Strong balance sheets *Innovation driving growth *Lots of share buybacks	*Sensitive to Trade War *Mounting regulatory pressure	*Forward P/E: 20.4x *Trailing P/E: 22.9x *TTM Div. Yield: 1.4%
Healthcare	**13.9%**	▲	*Depressed valuation *Low input costs / high margins *Low sensitivity to trade	*2020 election rhetoric *Medicare-for-All (uncertainty) *Pressure on drug pricing	*Forward P/E: 15.1x *Trailing P/E: 19.4x *TTM Div. Yield: 1.8%
Financials	**12.8%**	▲	*Growing capital return *Fading regulatory pressures *Good US household finances	*Flat/flattening yield curve *Sensitive to global growth *Pockets of disruption	*Forward P/E: 12.4x *Trailing P/E: 13.4x *TTM Div. Yield: 2.1%
Communication Services	**10.5%**	●	*Pockets of strong growth and innovation (e.g., social, search) *Leverage to US consumer	*Sensitive to some of Tech's regulatory scrutiny *Expensive versus old Telecom	*Forward P/E: 16.8x *Trailing P/E: 20.4x *TTM Div. Yield: 1.4%
Consumer Discretionary	**10.2%**	●	*Leverage to US Consumer *Lower rates could boost auto and housing	*Valuation is demanding *Secular retail disruption *Weaker global consumer	*Forward P/E: 21.1x *Trailing P/E: 23.7x *TTM Div. Yield: 1.3%
Industrials	**9.2%**	●	*Congressional budget deal *Defense industry is US-centric *High correlation to strong S&P	*Input cost inflation *Broadly sensitive to easing global economic growth	*Forward P/E: 16.5x *Trailing P/E: 18.3x *TTM Div. Yield: 2.0%
Consumer Staples	**7.6%**	▼	*Could outperform in market corrections *M&A could boost select stocks	*Low organic growth *Expensive valuation *Risk of supply chain disruption	*Forward P/E: 20.2x *Trailing P/E: 21.3x *TTM Div. Yield: 2.7%
Energy	**4.4%**	▲	*Geopolitical hedge *YTD laggard, low sentiment *Low correlation with S&P 500	*May lag if global growth disappoints *Sensitive to oil markets	*Forward P/E: 16.4x *Trailing P/E: 15.8x *TTM Div. Yield: 3.9%
Utilities	**3.5%**	▼	*Insulated from Trade concerns *Could outperform in market corrections	*Valuation is demanding *May re-rate lower if interest rates rise	*Forward P/E: 20.7x *Trailing P/E: 21.9x *TTM Div. Yield: 3.0%
Real Estate	**3.3%**	●	*Insulated from Trade concerns *Direct beneficiary of lower rates and easier Fed policy	*Headwinds for retail *Valuation is demanding *Strong YTD	*Forward P/E: 42.5x *Trailing P/E: 51.8x *TTM Div. Yield: 3.0%
Materials	**2.7%**	●	*Higher metals prices *Leverage if Asia stabilizes	*Few US mega-cap blue chips *Sensitive to global growth	*Forward P/E: 18.0x *Trailing P/E: 16.6x *TTM Div. Yield: 2.2%

Source: Bloomberg, Standard & Poor's

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