Stock Yards® Bank & Trust

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INVESTMENT & FINANCIAL INSIGHTS

A NEWSLETTER FROM THE CINCINNATI / NKY MARKET OF STOCK YARDS BANK & TRUST COMPANY

Q4: 2016

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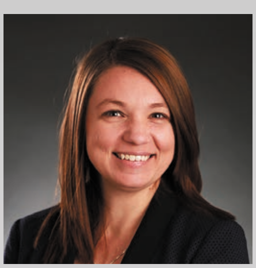

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Cincinnati Market Update

By Stephen Brown

I am pleased to announce that we added two new employees this past quarter! Our addition to staff continues as we have several other candidates that we are talking to for open positions. Our Wealth Management & Trust group hired Melissa Marsh as a Wealth Advisor. Melissa, a native and current resident of Northern Kentucky, joins us from UBS. Melissa is a Certified Financial Planner with a vast array of skills that will complement our current staff. She is excited to join us and will begin working with clients immediately. Our second hire this past quarter is Doug Koo. Doug joins us from BB&T and will serve as the Bank's Deputy Credit Officer, working closely with our Risk Management Group for the entire bank. Previously, Doug worked with several of our current employees at the Bank of Kentucky. We are excited about Doug's addition to the team as we continue to grow. Please join us in welcoming Melissa and Doug to the SYBT team!

Coinciding with our personnel growth is our financial performance growth. The Cincinnati and Northern Kentucky Region for Stock Yards Bank & Trust continue to post strong results that contribute greatly to the overall success of the bank. Our market is viewed favorably both internally and externally. Our Relationship Managers are recognized regularly within the organization for their strong sales efforts and excellent customer service. Our performance runs across all business lines.

I'd like to highlight our Mortgage Division this month. The division is manned by Thad Bloch. Thad joined us about 3 years ago with his primary focus on lending to the Low to Moderate Income demographic. Thad has done a wonderful job in this area but has expanded his reach to more traditional mortgages in Cincinnati as well as becoming the mortgage lender for our Indianapolis market! He in actively involved in many different areas throughout Cincinnati and Northern Kentucky, with the goal to extend our reach to the Low to Moderate Income demographic – Thad leads seminars, participates in workshops, calls on many non-profit organizations; basically anything that he feels will help him deliver mortgage products. Finally, when our Indianapolis had a need for a mortgage lender, Thad volunteered to step up and be their contact. He has done a great job and they value him as much as we do in Cincinnati.

Our approach of hiring talented lenders, opening new branches, and connecting with strong Centers of Influence has helped us continue to add new clients throughout the bank and trust company. Please join me in welcoming our new employees to the SYB team! If you are a customer of SYB, "Thank You!" If not, we are actively calling on businesses in the market and hope to visit you soon to personally introduce you to the Stock Yards Bank & Trust way of banking and investing!

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Economic & Market Outlook: Q4, 2016

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The third quarter of 2016 was a positive one for domestic financial assets. The total return from the Standard & Poor's 500 Index for the quarter was 3.85% with a positive return of 7.84% for the first nine months of the year. Fixed income returns as measured by the Barclays Intermediate Bond Index were .16% and 4.24% for the quarter and year-to-date periods.

Economic numbers continue to support our slow growth projections. Second quarter GDP was revised upward to a still anemic 1.4% growth. Economic data continues to be a mix of both positive and negative news. Why have we been experiencing much slower than normal economic growth since the last recession? There are several factors that have conspired to make this recovery the slowest in modern times. Some of the more important ones are:

SLOWING GLOBAL GROWTH : The economic problems in Europe and Japan, slowing growth in China, aging demographic patterns in the developed world, and the threat of terrorism and cyber terror have all reduced global economic growth and productivity. This slowdown has impacted our growth by negatively impacting trade and the corporate sales and earnings of multinational businesses based in the United States.

REGULATION AND TAXES : Higher levels of taxation and increased government regulation are having a negative impact on growth in the United States. There is a high negative correlation between economic growth and taxes and regulation, both of which penalize consumption, innovation, and investment spending.

DEBT : The high level of sovereign debt in the developed world has reduced economic activity by requiring more and more resources to be devoted to servicing and hopefully, retiring the debt. The level of debt in many countries now far exceeds the annual gross domestic product which has been viewed as a tipping point in terms of placing a permanent cap on growth. Many of the debt problems are deeply imbedded and have no short-term solutions. Fixing these problems will require a long-term level of fiscal discipline that is difficult to implement and even harder to maintain in today's political environment.

Why have we not fallen back into a recession because of these long term impediments to economic growth? Growth continues to limp along primarily because of consumer spending. Consumption is over two-thirds of our economy and a number of things are in place that either directly encourage spending, make it easier to spend, or make us feel better about our spending.

LOW INTEREST RATES : Low interest rates have long been positively associated with economic activity. The low borrowing rate lowers the return bar and encourages corporate spending on capital projects. Lower financing rates make big ticket items like cars and houses more accessible to consumers. The lack of return on savings and other bank deposits also encourages spending. We expect that rates will stay below normal for a long time.

HOUSING : The residential real estate market continues to do well. Housing prices have recovered from the lows of the last recession. This positively impacts the economy in two ways. First, we all feel wealthier when our home equity increases. Consumer confidence goes up and we are more likely to spend and perhaps even use that equity to make a big purchase or do some remodeling. Second, housing is only about 12% of the economy, but few industries impact as many other businesses as housing – furniture, consumer electronics, appliances, paint… the list goes on and on. The bottom line is the better the housing market the better the economy.

JOBS : The decline in the unemployment rate and the improvement in the labor force participation rate are very positive for consumer spending and the economy. More people working with money to spend will probably be the biggest contributor to future economic growth.

We do not expect a recession this year or in 2017, but many of the economic problems are so long-term in nature that we expect slow growth to continue. As confirmation of this, the Federal Reserve recently reduced its economic projections for 2017 and 2018 to the 1.8% annualized level.

What does this mean for the domestic bond and stock markets? We think that we may be in a very long period of lower than normal long and short-term interest rates. We feel strongly enough about this that we have made one of our investment themes "Lower Longer." There are several economic and one compelling anecdotal reasons for feeling this way.

The Federal Reserve itself has promised to move very carefully when increasing short term interest rates.

They are fearful of disrupting the very slow economic growth we are experiencing. Recent policy statements by the Fed have actually mentioned the possibility of negative rates if the United States goes back into another recession, much like what Europe and Japan are now experiencing.

Inflation as measured by the Fed is very low. Inflation is directly related to higher interest rates and the lack of inflation would support low long term rates.

Foreign developed world interest rates are much lower than our rates. Germany recently issued a ten-year government bond with a negative yield. You actually have to pay the German government for the privilege of lending them money. Japan and various other European countries also have negative rates. Let's compare negative yields on the ten-year German and Japanese bonds to the United States ten-year Treasury Bond yield of 1.8%. It should be noted that Germany and Japan have slower economic growth and declining currencies relative to the United States, as well. We believe capital from countries with negative rates will begin to flow into our bond markets because of the yields, stable currency, and political/economic stability of the United States. This will support prices and keep yields very low.

Finally, sovereign debt levels in the developed world are so high that certain countries simply cannot afford higher interest rates due to the negative implications for budget deficits. We believe that politicians everywhere will do everything they can to keep rates low to ensure that the budget deficits stay within tolerable limits.

What about the stock market? We have been talking about a subdued bull market in stocks for three years now. What is a subdued bull market? It is a bull market with low positive returns and a lot of volatility. Why do we feel this way? There are two main sources of positive stock market returns: earnings growth and expanding valuation levels. With earnings growth at risk and valuation levels near historic highs, stock market returns are expected to be modest.

Slow economic growth is not producing quality earnings and sales growth. Earnings are the fuel that propel stock prices higher. Slower earnings growth will beget slower stock market growth. Earnings quality has also deteriorated. Many companies have met analyst earnings expectations with non-operating items like cost controls, share repurchases, deferred taxes, and/or accounting changes. These sources of earnings growth are less valuable to market participants and cannot go on forever.

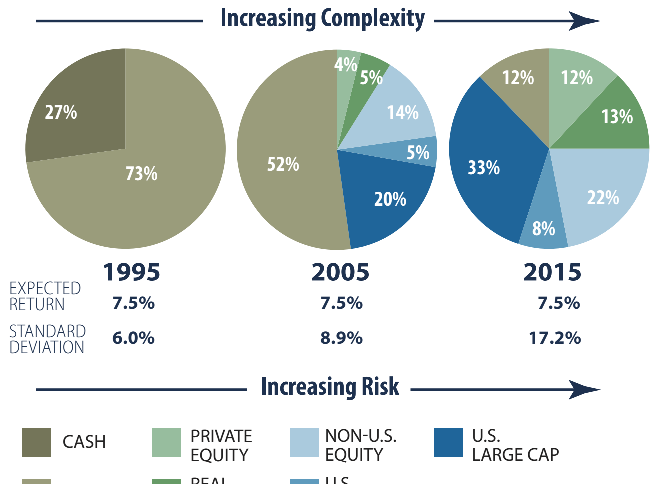
Valuations are high on both a relative and on an absolute basis. Some industries are trading at all-time highs on almost every valuation measure. The price/earnings (PE) ratio is the most widely used and recognizable valuation measure for stocks. The current PE ratio on the S&P 500 Index on 2016 earnings estimates is approximately twenty. Past returns from this level would support our subdued return expectations.

Starting Median P/E Ratio & 10-Year Returns

STARTING DATE	STARTING MEDIAN P/E	10-YR ANNUALIZED RETURN
DEC 31, 1989	13.9	15.28%
DEC 31, 2000	20.6	-0.48%
DEC 31, 2001	23.5	0.92%
DEC 31, 2002	18.8	4.94%
FEB 28, 2003	16.9	6.06%
DEC 31, 2003	21.2	2.17%
DEC 31, 2004	20.3	5.54%
DEC 31, 2005	19.0	5.24%
DEC 31, 2008	12.5	13.21% *
FEB 28, 2009	11.0	16.69% *
DEC 31, 2015	22.0	???

* Less than 10 years (through December 2015)
Source: CMG Investment Research, Ned Davis Research, Worldscope

Investing has become more complex over the last twenty years. Slower economic growth and low interest rates have created a challenging environment for all investors. Producing competitive returns with portfolios made up of financial assets with reasonable levels of risk have become very difficult. Further complicating the investment process are the liquidity, leverage, and fee issues associated with portfolios containing real estate and private equity holdings. The following chart shows the changing investment and risk landscape since 1995.



Source: Callan Associates

There are a number of negative warning signs on the horizon. The first relates to negative interest rates. The Federal Reserve has indicated an acceptance of the use of negative interest rates to stimulate economic growth

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in the event of a new recession. This would certainly also encourage expanded deficit spending because of the lack of borrowing costs associated with debt issuance. The long-term implications of negative interest rates are unknown. Near-term, the insurance and banking business models would be negatively impacted. Defined benefit pension plans would have to redefine their earnings assumptions and unfunded liabilities would balloon in a negative rate environment. Savers, investors and retirees would be negatively impacted by the negative return from the relatively safe cash and high-quality fixed income portion of their portfolios.

The second warning sign relates to the effectiveness of the Federal Reserve and foreign central banks. Investors have lost confidence in the ability of central banks to stabilize currencies, capital markets, inflation, and economic cycles. The Keynesian quantitative easing experiment has not worked having produced the slowest recovery since the Great Depression. Central bankers throughout history have been good at throwing liquidity at economic problems. What they have not been good at is unwinding the liquidity effectively. Historically, central banks have either moved too slowly to unwind the liquidity and caused an increase in inflation or they have moved too quickly and caused a recession.

The Age of the Economic Recovery and Bull Market in Stocks – The ongoing bull market, which began after a March 2009 low in the S&P 500 Index is now ninety months old making it the second longest bull market since 1950. It trails only the 113 ½ month bull market that ended in March of 2000. The economic recovery that officially began in June of 2009 is now over seven years old. We have historically experienced a recession every seven years on average since 1950.

These warning signs add an additional level of complexity to the investment environment. Please contact your wealth management advisor for a more detailed explanation of what we are doing in portfolios to manage risk in this complicated and ever changing economic and investment landscape. Thank you for the confidence you have placed in our Wealth Management & Trust team at Stock Yards Bank & Trust.♦

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