2016 Economic & Stock Market Outlook

December 9, 2015

BAIRD

Please refer to Appendix – Important Disclosures.

Volatility Rising as 2015 Headwinds Linger

Outlook Summary

Growth remains stable with a bias toward acceleration as recovery participation broadens

Inflation moving toward trend

2015 Redux: Elevated valuations and investor illiquidity still represent risks for stocks

Volatility rising as historically normal fluctuations return

S&P 500 could reach 2250 by year-end, but sailing may not be smooth

Fed rate hikes produce higher, flatter yield curve. 10-year T-Note yield could move toward 3.0%

Highlights:

- **Gradual Rise in Interest Rates Not Necessarily Headwind for Stocks**
- **Wage Gains Suggesting Broadening in Economic Recovery**
- **Elevated Valuations Tend to Dampen Forward Returns**
- **Households Holding Lots of Stock, Little Cash**
- **Presidential Election Year Brings More Noise, Volatility**
- **Clock Is Ticking for Lagging Broad Market to Catch-Up to Popular Averages**

All photographs are accurate. None of them is the truth - Richard Avedon

Context helps turn accuracy into truth. Context is also what turns data and information into knowledge. Too often, and too easily, it is the missing ingredient as we slice and dice our way through signals and indicators. Instead, we latch on to phrases that sound robust ("Risk Management" is widely used right now) but are really just vessels for our own bias, our own pre-conceptions. Computing power is such that we can back-test our way to support almost any view on the stock market – but that does not mean such an outcome is likely. It is easy to hide behind a fancy façade, relying on the appearance of statistical robustness to believe what we want to believe, seeing only the evidence that fits our narrative. Amid all the noise and information we lose track of context. And getting distracted, we leave ourselves vulnerable to unforeseen outcomes.

Bruce Bittles
Chief Investment Strategist
bbittles@rwbaird.com
941-906-2830

William Delwiche, CMT, CFA
Investment Strategist
wdelwiche@rwbaird.com
414-298-7802

It is a curious vulnerability that we can find more comfort in complex approaches than relatively simple ones. *There is an almost reflexive view that gives great credence to elaborate constructions.* We easily become too confident in our ability to predict the future and/or account for all possible outcomes. Thus begins the slippery slope from a modest effort to categorize risks and influences to more elaborate schemes that seem to provide all the answers.

Enough is enough. **We tend to be too quick and too certain that we have gotten to the crux of the matter.** Truth is, we do not know what the future holds. The time spent formulating and formatting an outlook will likely be directly correlated to the degree to which you are beholden to the views expressed therein. We want to push back against the neatly wrapped, fancily packaged outlook pieces that are laden with fancy graphics, interesting scenarios and multiple solutions. *These can layer certainty upon certainty and incoming data is filtered only through the lens of the initial outlook.* Not everything can be circumscribed. The future, while hinting at the past, will ultimately follow its own unique path.

The challenge for investors is to remain flexible and see the relevant context. The best setting for this is usually in quiet reflection. *Truth and context are more likely to be revealed in the whisper than in the noise, and we usually notice them at the margin.* We encourage, and do our best to offer, quiet meditation amid the din and glamour. **Without discipline we risk being misled by our whims and distracted by our bias.** But complexity breeds overconfidence, and overconfidence increases risk. *We use our weight of the evidence approach to filter the news, follow trends and try to capture the relevant developments.*

This is our modest effort to offer reflections on what has been (2015) and thoughts on what we might see next (in 2016). While we offer these observations and thoughts now, what matters more is how things develop as we go forward. We apologize in advance that we have more questions than we have answers. We are doing our best to be honest. **Over time, successful investment is about having guide posts to lean on more than finding goal lines to cross.**

Going into 2015, the biggest risks for stocks were overvaluation and a lack of investor liquidity. A year later, the story is much the same. We learned again in 2015 that earnings forecasts are about as reliable as economic forecasts, which is to say, not very. Earnings were forecast to grow by double digits in 2015, but what has actually been seen was a decline of around 5%. It is difficult to get valuation relief when earnings fall more than prices. **We continue to believe that elevated valuations will provide resistance for stock prices as we move into 2016 (and perhaps beyond).** Household asset allocation figures show that despite professed nervousness and caution, investors remain fully invested in stocks. **The lack of available cash on the sidelines has helped contribute to the bumpy ride experienced by many in 2015, and more of the same appears likely in 2016.**

As we look toward 2016 we are chewing on three macro-related questions. Time (not this outlook) will provide the answers or perhaps just let us know that they were not questions worth asking.

- *What, if anything, is weakness in the energy sector disguising (or telling us about) in the rest of the economy and stock market?* There are two schools of thought here: weakness in energy is a harbinger of broader weakness or excluding the effects from the energy sector, growth and earnings are not in such bad shape. We would tend to favor the latter, but are watching for evidence in either direction.
- *Can the economy gain sufficient traction that sales growth will accelerate, allowing improved earnings to provide valuation relief?* Companies remain highly profitable, so it might not take much better top-line growth to see earnings recover, but getting consistent enough economic growth to realize this has been a struggle.
- *Can the Federal Reserve preserve its credibility as it raises interest rates in an effort to "normalize" but not necessarily "tighten" monetary policy?* We hope that we see less uncertainty (and maybe a diminished impact) from monetary policy in 2016, but a string of weaker-than-expected growth figures or hotter-than-expected inflation data points could put the Fed back on the hot seat.

There will be other questions worth asking and we should do so as necessary. But we need to do our best to avoid overemphasizing the noise at the expense of keeping in mind what is truly newsworthy. **As a starting point, pay less**

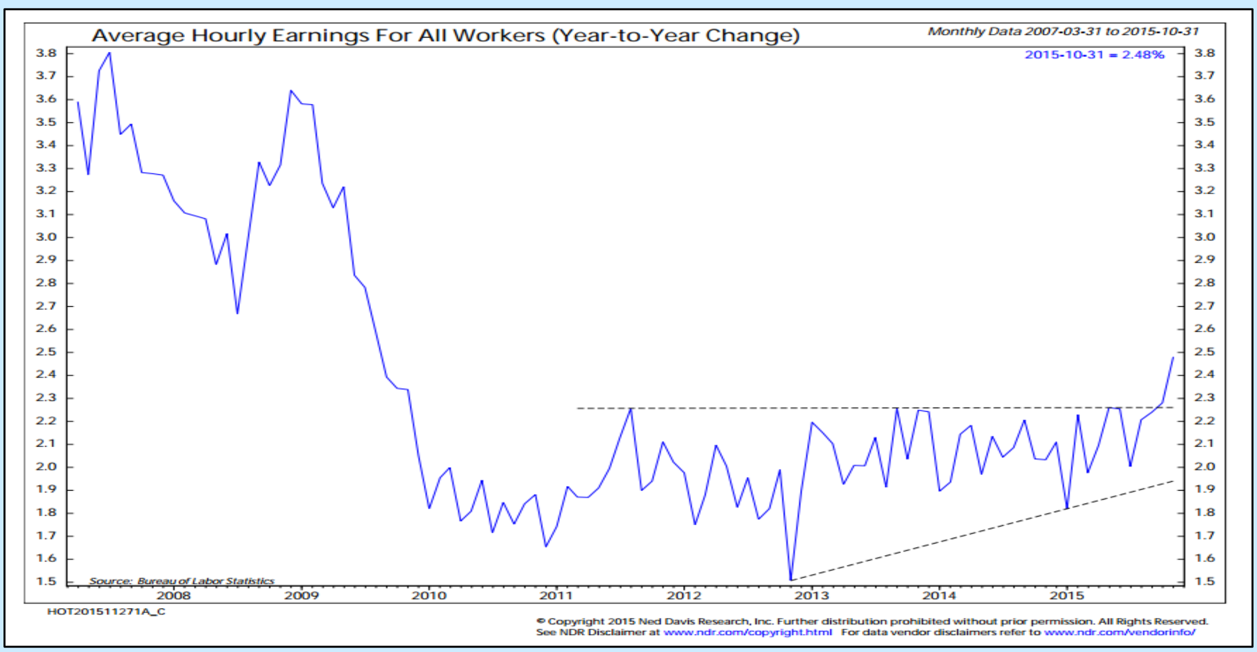
attention to the headlines, and avoid being swayed by day-to-day fluctuations in the financial markets. Do not let volatility in stocks let you lose focus on longer-term strategies and goals.

Federal Reserve Policy: Coming into 2015, we leaned against consensus and suggested that dollar strength, commodity weakness and global uncertainty could keep the Federal Reserve on the sidelines. At the time, median projections from FOMC participants saw a year-end 2015 Fed Funds rate near 1.5%. While those factors did guide the FOMC decision making process, it also became evident early in the year that Fed Chair Janet Yellen was interested in beginning to normalize monetary policy, starting with a gradual rise in interest rates.

They will likely take the first step on that path at the December 2015 FOMC meeting, where a 25 basis point hike in the Fed Funds rate is almost fully discounted by the market. **All along Yellen has de-emphasized the timing of the initial rate hike, suggesting it is the path over the course of the tightening cycle (which the Fed has emphasized will be measured and gradual) that matters more.** History agrees with this assessment, and in previous instances in which the Fed has pursued a slow tightening cycle, stocks have held up well.

We believe there could be two positive effects from

What about inflation? The most recurring client question we have gotten in recent years is on the subject of inflation. The divergence between what the CPI or PCE price index shows and what is revealed in the monthly budget of consumers can be baffling. 2016 may be the year that we get some resolution. To be sure, energy prices may continue to fluctuate and technological gains will continue to have a deflationary impact. But we are also seeing some evidence of inflation. Shelter costs account for nearly one-third of the CPI basket (for comparison, energy is less than 10%). The CPI for housing is up over 3% for the past year, and a continued recovery in the housing market could cause further upward pressure. Now, as the economic expansion broadens and businesses are increasingly concerned about a shortage of skilled workers, wage gains are beginning to re-accelerate. With expectations for inflation going forward so muted (5-year and 10-year implied forward inflation rates are both below 2%, versus long-term averages near 2.5%) the market could be vulnerable to even modest upticks in inflation. After a decade of worrying about deflation, the Federal Reserve might enjoy the chance to burnish its inflation fighting reputation as the price indexes start to reflect the experience of so many consumers. For 2016, we expect inflation could surprise on the upside but the longer-term trends should remain relatively sanguine. As such, the overall yield curve could drift higher in 2016, but some flattening is also expected, with the short end likely rising more than yields at the long end.



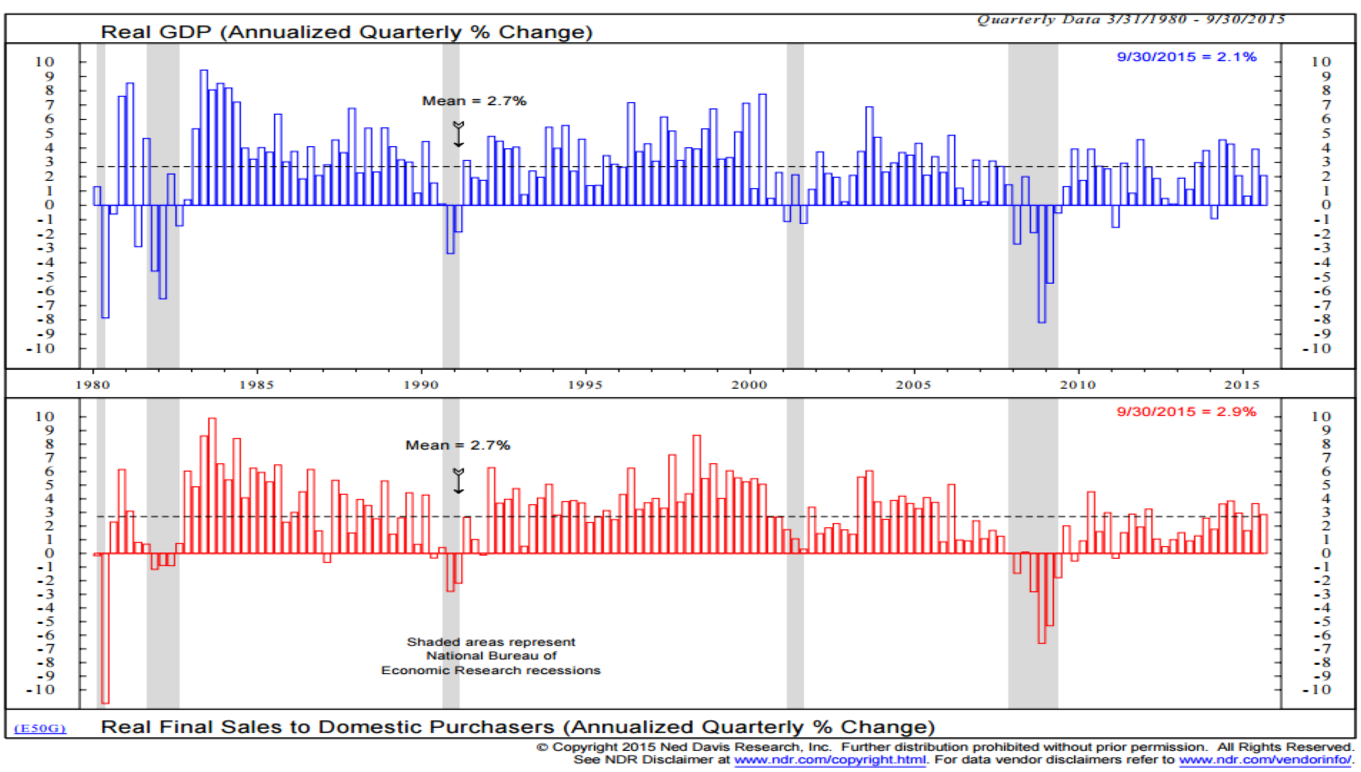
Source: Ned Davis Research

beginning to raise interest rates, but there could also be a headwind. On the positive side, **by beginning to raise rates, the Fed removes the uncertainty of when that first rate hike will occur (similar fascination with the timing of the second and following hikes seems unlikely) and it serves as a vote of confidence for the health of the economy**. *The headwind, which we saw hints of in 2015, was that without the actual or perceived promise of more accommodation (i.e., the removal of the Yellen put), overall stock market volatility could rise toward historical norm.* While not necessarily pleasant to endure, it would be a function of a market that is standing on its own, and from that perspective could be welcome. Stock market corrections of 10% (which was much ballyhooed when one appeared in 2015 for the first time in four years) have historically been a regular part of the annual stock market pattern. Look for more of that in 2016.

Economic Fundamentals: Overall economic growth remains modest, with pockets of strength being seen in some sectors. In fact, **growth in real final domestic demand has been above its long-term average in five of the past six quarters** (through the third quarter of 2015) and there is some evidence that we are actually seeing a broadening in participation in the recovery. Real median household income now appears to have bottomed and while 2014 showed some slippage relative to 2013, this comes in the wake of upward revisions to the 2013 data. Job growth remains healthy (even if not as robust as in the earlier stages of the recovery), wage growth is accelerating and the housing market continues to recover. *More of the same seems likely for 2016 although acceleration in growth at this point would not be too surprising.*

There has clearly been some slowing of growth (and even contraction) in manufacturing, and global growth trends remain challenging, but the service side of the U.S. economy remains strong. **Despite the international headwinds, there is little evidence that recession risks are on the rise in the United States.** The current business cycle has been drawn out and slow to emerge, and so from a purely calendar basis it seems the recovery could be in the late stages. More likely, manufacturing is experiencing a mid-cycle slowdown and the universality of bearish views in that sector suggests a bottom is imminent.

In fact, the global growth situation may be more constructive than many fear. Take for example China. *While the growth rate there has slowed in recent years, its overall contribution to global*



Source: Ned Davis Research

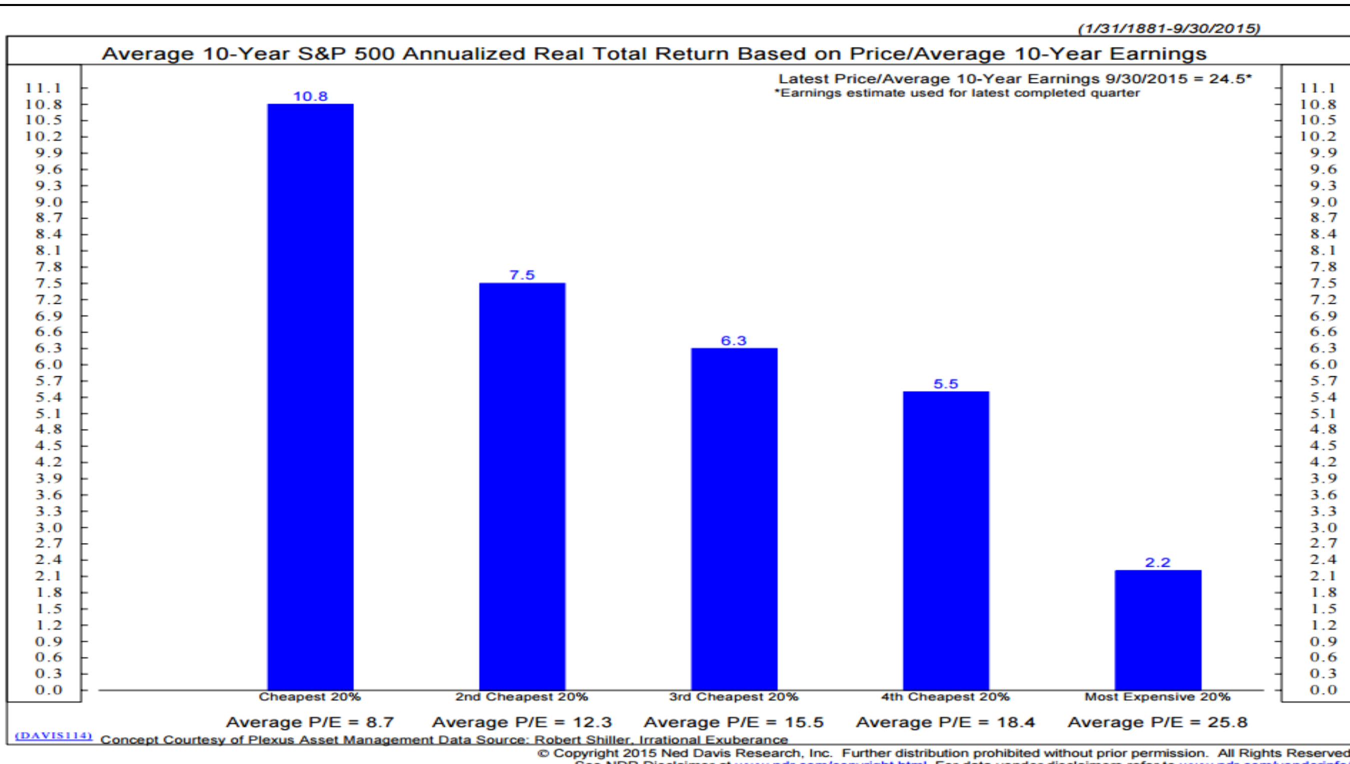
growth will be higher in 2015 (due to a larger base) than it was a decade ago when it saw double-digit annual growth rates.

Valuations: We have learned another lesson in not putting too much emphasis on forecasts. Earnings were supposed to have been up double digits this past year (based on analyst expectations), but instead were down more than 5%. As such, *even with a relatively flat year for stock prices, excessive valuations have not been relieved.* Earnings growth could well rebound in 2016 – the conditions for that are in place and S&P 500 operating earnings consensus has them rising nearly 20% in 2016. Whether this matches the reality we see next year remains to be seen.

Valuations may not be useful market timing indicators, and the relationship between price-earnings ratios and short-term stock market performance may not be compelling. But we are not in the business of forecasting stock market price action (any more than we would be interested in forecasting earnings or economic growth) but in managing risks**. From a risk management perspective, the relationship between valuations and forward stock market returns over the longer run is as compelling as it gets**. *When stocks are cheap, forward returns are above average; when stocks are expensive, forward returns are below average. Stocks are currently expensive, according to some measures more expensive than in 2000 or 2007.*

Investor Sentiment: The valuation indicators suggest that new buyers of stocks need to pay a premium for earnings (relative to historical P/E ratios) at current levels. This may be because so many investors have already bought and hold stocks. **Household asset allocation levels based on actual mutual fund and ETF exposure (a $16 trillion survey if you will) shows exposure to stocks approaching levels seen in 2000 and 2007.** Bond exposure is near its long-term average. *Exposure to cash is historically 37% – right now it is half that.*

Cash is despised (to some degree rightly) in the current environment because short-term interest rates are near zero. **But the allure of cash is not just the income it produces, but the liquidity it provides and the opportunity to put it to work in the future.** There is precious little of that right now. Even as investors and regulators focus on measuring and maintaining liquidity, lost in the discussion is that *measured liquidity in periods of calm has little relationship to actual liquidity in periods of stress.* There were opportunities to learn that lesson in 2015 and more will likely come in



Source: Ned Davis Research

2016.

Various surveys can provide evidence of near-term greed and fear, and leaning against those extremes can be useful for tactical investors. But the lack of liquidity makes bumpy rides more likely and a fully invested public is not typically a precursor to a major leg higher for stocks.

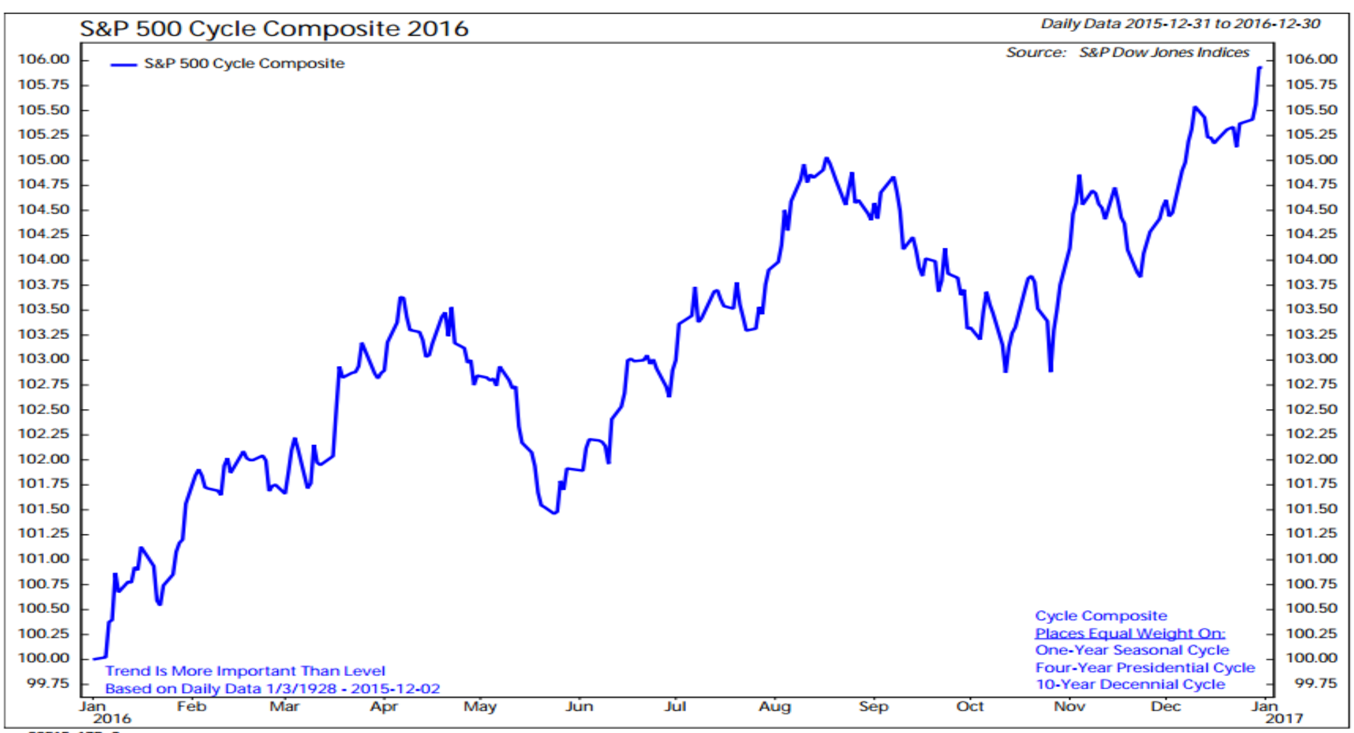
Seasonal Patterns/Trends: Get ready for noise, another presidential election is upon is. We will be inundated (particularly those of us living in so-called swing states) with promises of prosperity and relentless fear-mongering from both parties as the general election heats up in mid-2016**. If history is a guide, the best opportunity for stocks to make gains will be in the first quarter (when the election is a relatively distant concern) and the fourth quarter (when stocks tend to celebrate, regardless of which party is headed for the White House for the next four years.** The second and third quarters could be choppy as promises and threats dominate the airwaves and the national conversation.

That most of this will be noise adds to the likelihood of increased volatility. **More likely than not, the second 10% or more correction in as many years will be experienced in 2016.** This is not so much a forecast, as it is a description of the historical norm.

Broad Market (the "Tape"): This is the epitome of focusing on what is happening, not what could or should happen. *The faltering in the broad market even as the S&P 500 remained range-bound in the first half of 2015 gave early evidence that all was not well beneath the surface,* and the improvements in the broad market seen during the fall correction provided hopeful signals that the lows for the year were in place.

While the recovery in breadth in the fourth quarter of 2015 has been overall unimpressive, we have not seen important divergences emerge. Rather, the S&P 500, fueled by gains in a handful of stocks, has recovered ahead of most of our breadth indicators. **Breadth has recovered at a slower pace than the popular averages but it would be premature to suggest they are heading in opposite directions.** One factor clouding the discussion is that the overall gain in the S&P 500 has been relatively muted in 2015 – this makes it easier to hand-pick a few winning stocks that are "providing the all of the gains for the index this year." That would be a much more powerful warning if the S&P 500 were up 10% or more for the year, rather than up just a percent or two.

Two things in particular bear watching from a



Source: Ned Davis Research

breadth perspective as we move into 2016: **The relative lack of individual stocks making new highs and the wide dispersion in sector-level returns.** The best markets are those in which all areas are participating. It might be easy to dismiss weakness in the Energy sector as not significant for the overall market, but history suggests stocks overall struggle when one (or more) sector is lagging significantly. That certainly seemed to play out in 2015.

On the issue of new highs – even when the S&P 500 and the Russell 2000 were making new highs in the first half of 2015, relatively few individual stocks joined in that celebration. *The lack of issues making new highs weighs on the indexes and speaks to a lack of broadly based momentum that can sustain a rally even if a few leaders start to stall.*

Investing Themes and Considerations for 2016

Diversification for the sake of itself can lead to more risk, as can needlessly complex solutions. Investors should follow relative strength when able – using trends to their advantage rather than trying to pick inflection points and/or reversals. Successful investing is hard enough; we do not need to make it more complex than necessary.

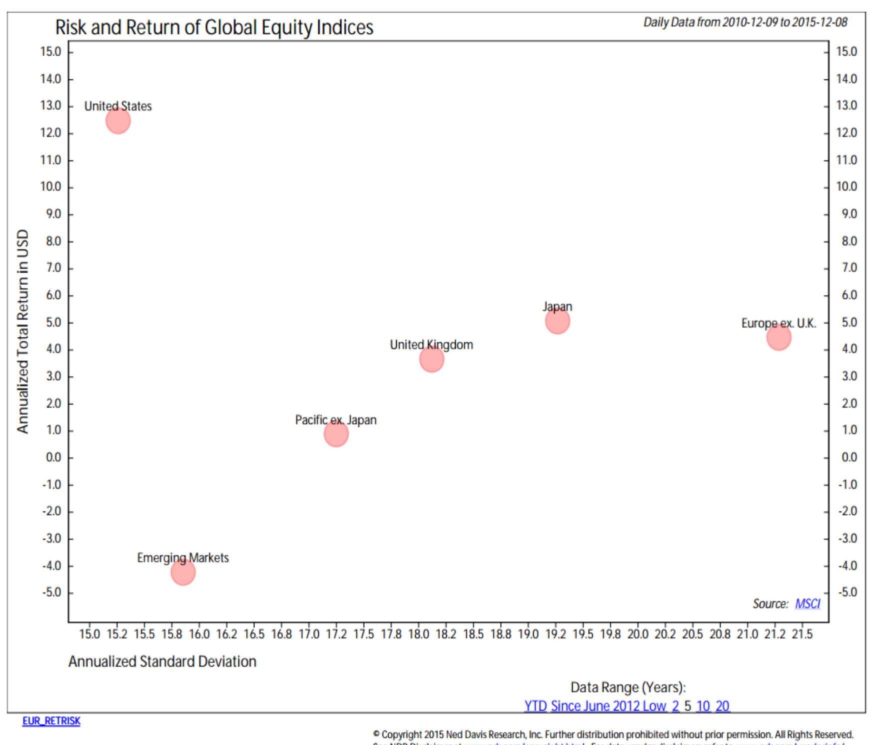
With 2016 likely to be another (and perhaps increasingly) volatile year and overall upside restrained by a fully invested public and elevated valuations, **holding higher-than-normal levels of cash could provide the scarcest of all resources**: *liquidity in periods of stress*. By cash we mean cash or something so similar it is indistinguishable – we do not mean financial products that promise liquidity, attractive returns and little downside risk.

Know your investing biases and work to counter them – be a little bit skeptical if you find exactly what you were looking for.

Small-caps vs Large-caps: Small-caps enjoy a seasonal tailwind into the first quarter of 2016 and that could help overall breadth continue to improve. *If this leadership fails to emerge and/or small-caps fail to make a new high relative to large-caps it could provide strong evidence that we have seen a secular peak in small-cap strength.*

United States vs. Rest of World: The US continues to trend higher versus the rest of the world, and **from a risk/return perspective (in dollars) there is little comparison between the U.S. and the other regions.** While we would continue to focus domestically, 2016 could be a time when the rest of the word starts to play catch-up and opportunities may emerge. Central bank easing in Europe could provide a tailwind for stocks there, but political risks remain a potential obstacle.

Commodities: Long-term commodity super-cycle trends suggest it would be awfully early to start looking for a significant low. While history suggests that most of the price damage (around 75%) to commodities may be in place, we are only one-quarter to one-third of the way through the cycle in term of time. **The next stage of the cycle is typified by fading correlations and increased investor apathy.** *Selective rally opportunities may emerge, but the long-term trend is still flat to down.* This could also continue to weigh on commodity stocks, and relative strength there remains challenging.



Source: Ned Davis Research

Appendix – Important Disclosures

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