Market Update:
Q2 2017 Review and Outlook

BAIRD

Smooth Sailing for Global Stocks so far in 2017

The Markets at a Glance

Asset Class	Representative Benchmark	Q2 Return	YTD Return
U.S. Large Cap	S&P 500	3.1%	9.3%
U.S. Small Cap	Russell 2000®	2.5%	5.0%
International	MSCI EAFE	6.1%	13.8%
Commodities	Bloomberg Commodity	-3.0%	-5.3%
Municipal Bonds	BBgBarc. Municipal	2.0%	3.6%
Taxable Bonds	BBgBarc. Aggregate	1.5%	2.3%
Cash	Citi 3-mo T-Bills	0.2%	0.4%

Performance returns are as of 6/30/2017

Q2 Recap

U.S. stocks continued to ride a wave of optimism by clocking in the best opening half-year performance since 2013 with returns of 9.3%, as measured by the S&P 500. The broad rally was helped by a notable pickup in corporate earnings, better-than-expected economic data, and an unusual calm that pushed volatility levels near multi-decade lows. With little in the way of interruptions, U.S. stocks were pushed to record highs and valuations to levels not seen since the early 2000s.

U.S. stocks weren't the only bright spot, though. Of the world's 30 largest stock markets, only four failed to post positive returns this year, indicating gains abroad have been widespread and strong. Through six months, international equities have bested U.S. equities by advancing 13.8%, helped by an ever weaker dollar. More impressive, emerging markets continued their 2016 resurgence with YTD returns of 18.4%.

For fixed income investors, market complacency meant a string of muted but solid returns. The Barclays Bloomberg Aggregate Bond Index posted returns of 1.5% during the quarter to advance 2.3% on the year. Broad market returns were helped by tightening credit spreads, which moved to their tightest levels on the year on the heels of low equity volatility and investors' healthy appetite for yield. During the quarter, the Fed approved its second rate hike of 2017 and set out detailed plans to reduce its $4.5 trillion balance sheet. Despite Fed action, the 10-year Treasury yield fell to 2.3% under the pressure of softening U.S inflation and scaled-down expectations for stimulative tax reform under the Trump administration.

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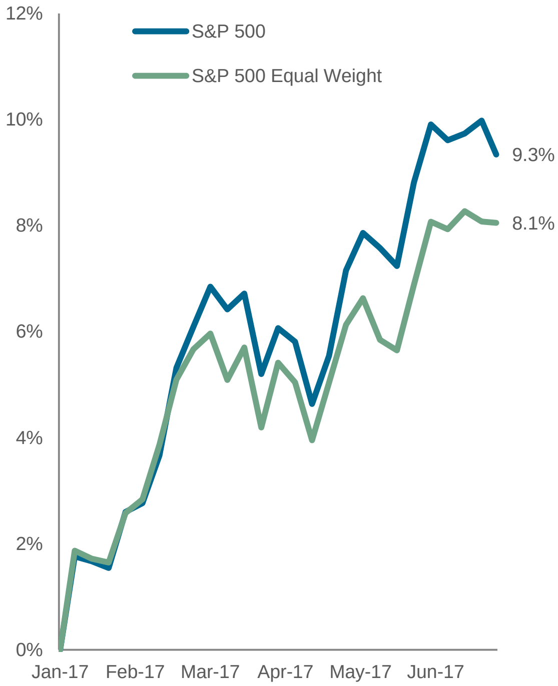
Does the Market Have FAANG Fatigue?

Figure 1
S&P 500 vs. S&P 500 Equal Weight



Source: S&P 500; Baird Analysis. Returns excludes dividends.

The FAANG Factor

The strong performance of a handful of large technology and technology-related stocks generated a lot of buzz about the health of the market's advance this year. The basket of Facebook, Amazon, Apple, Netflix, and Google (Alphabet) – widely known as the FAANG stocks – have performed particularly well and are up on average of 25% in 2017. To be sure, these few stocks have contributed significantly to the broader market's year-to-date gains. Of the S&P 500's return of 9.3% this year, close to 25% of the market's return can be contributed to these five stocks. Adding in effects of the technology sector as a whole and the contributions are more than 33%. The success of these few stocks and the broader tech-powered rally have many drawing parallels to the heady days of the dot-com bubble in the '90s that translated into excessive bullishness that eventually imploded in ruin. Of course, the comparison seems easy, but as with any situation, a closer look is required.

Running Out of Breadth

Despite calls for the market's next round of irrational exuberance, the narrow leadership that is currently driving stock returns is far from unique and certainly not a warning sign of bad things to come. Research firm AQR and AQR founder Cliff Assness have written exhaustively about the subject and the conclusion is always the same: There is nothing truly out of the ordinary about narrow leadership. Indeed, the firm has looked at the previous 20 years and found that the current FAANG-stock anomaly is perfectly normal when looking at the impact of the top-performing stocks and performance of the S&P 500. When looking at the data from 1994 to 2014, the S&P 500 averaged 9.3% per year with the top five stocks contributing roughly 2.6%, or close to 30%, of the index's gain. The numbers are even larger when looking at the top 10 contributors; gains averaged almost 50% of the index's returns. This suggests that a handful of the 500 stocks in the index always account for a large portion of the gains each year.

Technical indicators tell largely the same story. Market breadth or advance-decline indicators – a simple ratio of the number of stocks advancing versus the number of decliners – can often be a signal of market reversals. Prior to the dot-com and Financial-Crisis crashes, the number of stocks moving higher was dwarfed by the number of stocks declining, despite the market continuing to move higher. Today things continue to look normal with a healthy collection of stocks leading the market's advance.

By other measures, today's narrow leadership doesn't actually appear to be as pronounced. While the tech-effect has been notable, gains across other sectors have been strong as well – 9 of 11 sectors have posted positive returns YTD. Also, the S&P 500 equal weight index, which lessens the influence of the market's largest stocks on broader market returns, is only slightly underperforming the S&P 500 the year suggesting the market gains are much more widespread than reported (Figure 1).

Ultimately, comparisons of "tech bubble 2.0" seem to be misplaced. The market composition today is markedly different than it was during the heights of the dot-com era. The market cap of the technology sector is a fraction of what it was in March 2000 and more importantly, the valuations of technology stocks still remain in-line with long-term averages. While many may question whether the returns of the big tech names are justified, there's few signs the market is heading for imminent collapse.

U.S. Equity

Equity Trends Persist in 2Q17

U.S. equity markets posted their seventh consecutive quarterly gain with the S&P 500 ending up 3.1%; the index is up 9.3% YTD. The market shrugged off global policy uncertainty and geopolitical flare-ups in favor of strong 1Q17 (and projected 2Q17) earnings growth, persistently low interest rates and still accommodative central banks. While the Fed continued its pace of tightening with a second 2017 rate hike in June, its deliberate and well-telegraphed actions resulted in muted equity market reactions.

Stock market gains were largely tallied in the first two months of the quarter before tapering off in June. 1Q17 stylistic trends persisted early in the quarter, namely Growth outperforming Value and larger caps outperforming smaller caps. From a sector perspective, 1Q17 winners dominated early in the quarter with Information Technology posting a 7% quarterly return through May (+21% YTD over that timeframe).

Interestingly though, there was a rotation in June as Technology, Utilities, and Consumer took a bit of a breather and lost some ground on their YTD leadership. Financials rebounded late in the quarter (+6% in June, +7% YTD) and Health Care posted another solid month of performance (+5% and +16%, respectively). Similarly small caps and value also outperformed in June. 2Q17 sector losers remained consistent in that Energy and Telecommunications were the only two sectors in the red for both 2Q17 and YTD.

Volatility also remained subdued during the quarter and the market again avoided a notable pullback with the S&P 500 YTD peak to trough decline coming in at 3%, a level last seen in 1995. Only four trading days in the quarter experienced intraday moves greater than 1% with 2 closing more than 1% higher or lower.

Commodity Juxtaposition

Energy sector weakness stemmed from a downdraft in crude oil prices as oversupply concerns weigh on the pricing equilibrium. WTI ended the quarter at $46/bbl compared to $51/bbl at 1Q17 and $54/bbl at YE2016. The YTD low was notched in late-June at $43/bbl. Rising U.S. onshore rig count and improving producer productivity are increasing domestic supply, which is thwarting OPEC efforts to reduce supply and prop up price. Recall OPEC agreed to a deal in November to reduce its production by about 5%. The group extended these cuts through March 2018 as the initial cut failed to correct the global oversupply. A resulting surge in oil inventories is also an overhang.

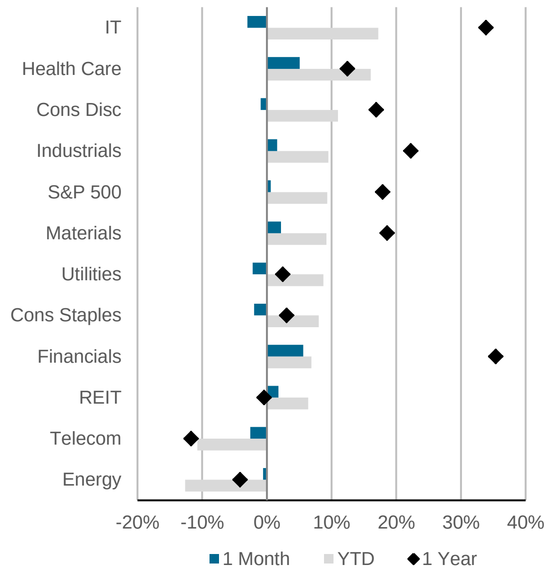
Non-energy commodities are actually performing quite well (+4% YTD vs. Energy -19%) with strength in industrial and precious metals, certain agriculture products, and livestock. The YTD stability in copper is of particular interest given its read-through to industrial activity, which remains positive. Current commodity performance disparity is driven by supply imbalances, which are more impactful than broader macro trends at present, resulting in low correlations between commodities and other asset classes.

U.S. Equity Market Benchmarks

Asset Class	Representative Benchmark	Q2 Return	YTD Return
Large Cap	S&P 500	3.1%	9.3%
Mid Cap	Russell Midcap®	2.7%	8.0%
Small Cap	Russell 2000®	2.5%	5.0%
Value Stocks	Russell 3000 Value	1.3%	4.3%
Growth Stocks	Russell 3000 Growth	4.7%	13.7%

Figure 2

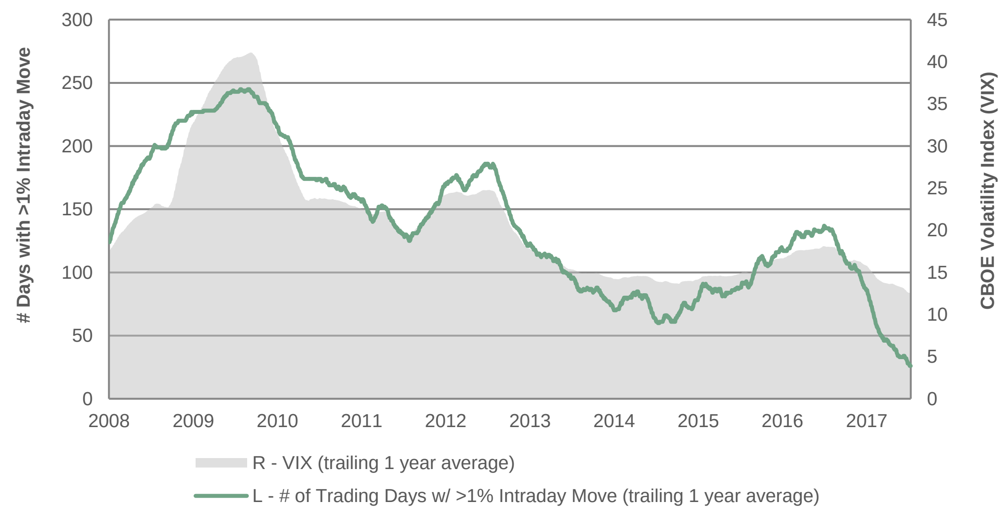
YTD Winners Take a Breather in June



Source: S&P Indices. Morningstar Direct; Baird Analysis

Figure 3

S&P 500 Trading Volatility Remains Subdued



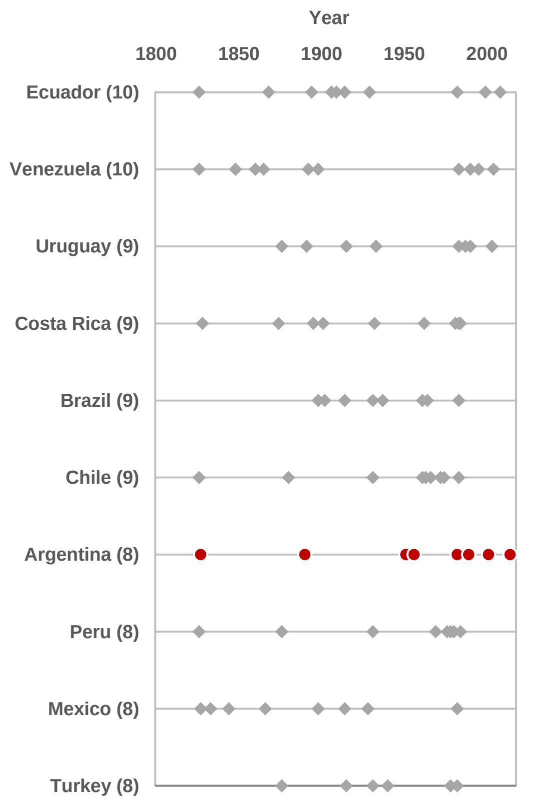
Source: Bloomberg; Baird Analysis

International Market Benchmarks

Asset Class	Representative Benchmark	Q2 Return	YTD Return
Developed	MSCI EAFE	6.1%	13.8%
Europe	MSCI Europe	7.4%	15.4%
Japan	MSCI Japan	5.2%	10.0%
Asia	MSCI Pacific ex Jap.	1.5%	13.5%
Emerging	MSCI Emerging Mkts	6.3%	18.4%

Figure 4

Sovereign Bond Defaults: A Timeline



Source: Carmen Reinhart and Ken Rogoff; The Economist

Stronger Growth Boosts Stocks

International stocks continued to outshine U.S. peers during the quarter with a 6.1% return, helped by strong sentiment, better-than-expected economic conditions, and continued monetary support from the world's central banks. Europe, in particular, has benefitted from a notable pickup in economic conditions. Economic sentiment in the region rose to its highest levels since 2007, suggesting the pace of growth may soon accelerate. Better economic growth isn't the only reason international stocks have outperformed the U.S. A drop in the dollar has boosted the MSCI EAFE Index by more than 5% this year. By removing the gains attributed to currency, international stocks actually lagged the U.S. despite better economic conditions.

Looking under the hood, nine of 10 sectors of the MSCI EAFE Index clocked in gains led by strong performance from Utilities, Telecom, and Technology. In keeping with global trends, Growth strongly outperformed Value stocks.

Emerging Markets Continue Run

Emerging markets continued their advance for the year by returning 6.3% for the quarter. The gains marked seven straight months of positive returns and a two-year high for the index through June. Returns were helped by a backdrop of supportive economic growth data that either matched or exceeded forecasts and a notably weaker U.S. dollar. Despite concerns of an overly protectionist U.S. trade policy, the improving macro environment helped these markets regain the momentum they had in 2015.

The biggest beneficiaries from the pickup in global growth were in the Asia-Pacific region. During the quarter, Korea (10.2%) and Taiwan (8.8%) benefitted from domestic stimulus and strong export outlook, while China (10.6%) continued to a post strong economic data despite efforts to reign in credit growth. Though falling back into recession during the quarter, Greece (33.8%) was the best performer of the bunch, benefitting from its deal with Euro creditors to help meets its July debt repayment.

Among EM's laggards were Russian (-10.0%) and Brazilian (-6.7%) equities. For Russia, risks of another slowdown are looming despite an upswing in oil prices from year ago levels. The country saw their GDP edge up slightly to 0.5% in Q1 from 0.2% in Q4, reigniting fears the country has yet to fully recover from its 2016 recession. In Brazil, the continued saga of political corruption weighed on markets as fears the new president's platform of promised reforms might be undone by bribery allegations.

Argentina Issues Century Bond

During the quarter, Argentina raised almost \$3 billion dollars at a yield of 7.9% for a hotly demanded 100-year bond. The country became the latest sovereign nation on the list of century-bond issuers looking to take advantage of cheap financing and investors' insatiable appetite for yield.

While the maturity length of the issue may raise eyebrows, it was the fact that the South American country was able to access credit markets at all that has many scratching their heads. Just last year, the country settled a decade-long dispute with creditors over its 2002 default, marking the eighth time the country has defaulted on its bonds since it gained independence in 1816 and the third default in the last 23 years (Figure 4.)

The event caused many market participants pause, as the attractive yield and strong demand indicate investors may becoming blind to the risks of investing in a country with such a checkered past. If nothing else, the event is a reminder of how dispirited markets can become during sustained periods of low interest rates.

Fixed Income

Fed Could Use Some Target Practice

In Q2, the Fed continued to normalize monetary policy and validate market expectations by raising the federal funds rate by another 25bps in June. Yellen and her team of cohorts still expect to achieve their 2% inflation target by 2018, despite disappointing economic data this quarter. Core PCE, the Fed's preferred inflation measure, continued to disappoint despite the Fed's reassurance that the slowdown is "transitory" (Figure 5). So what aspects of PCE inflation are said to be "transitory"? The decline in oil has had a transitory effect on inflation for years but most recently wireless-telecom services and prescription drug price declines suppressed inflation. The historic inverse relationship between unemployment and inflation, known as the Philips Curve, continues to perplex central bankers as they try to explain the disappointing inflation numbers alongside strong job creation. Tight labor markets typically lead to upward pressure on wages and inflation. Only time will provide answers as to whether the Fed is correct or if the Phillips Curve model is no longer illustrative of the current relationship between unemployment and inflation.

Growth Ramps Up Abroad

While the Fed is taking steps to unwind its balance sheet and normalize US monetary policy, central banks abroad are closer to ending accommodative monetary policy as well. Economic growth in the Eurozone continues to recover as labor markets improve, business sentiment strengthens and several key political risks recede. European debt produced solid gains through most of the quarter, but hawkish remarks from ECB President Mario Draghi in late-June caused the Euro to rally and European yields to widen out.

The UK economy has come under pressure in recent months. With dull economic growth, stagnating wages and inflation marching up past 3%, central bankers are in a difficult situation as an interest rate hike could undermine consumer spending and investment growth. In Asia, the Bank of Japan is largely on hold with its zero interest rate target policy and is not expected to provide additional support.

Emerging market debt had a great first half 2017 with record inflows and solid returns. Political gridlock tempered expectations for timely implementation of the Trump policy agenda, thus weighing on the USD. These factors, along with recovering EM growth, make the space attractive for investors.

Fed Balance Sheet Tapering

Despite tight yields and volatility near all-time lows, agency MBS struggled to outperform Treasuries this quarter. MBS spreads widened on expectations that the Fed will begin balance sheet tapering later this year. The Fed plans to unwind reserves by gradually rolling off capped amounts on a monthly basis. The capped amounts will start at $6B for Treasuries and $4B for MBS, increasing on a quarterly basis until reaching $30B and $20B, respectively. The Fed has been reluctant to provide any color on final balance sheet size but will likely end with a much larger amount relative to pre-crisis levels.

Non-agency MBS outperformed most fixed income sectors as home prices and positive fundamentals supported returns. Commercial MBS received some media attention as struggling retailers and deteriorating fundamentals led to increased delinquencies. In ABS, increased supply was met with steady demand leading to further spread tightening in the sector.

Municipals Follow Suit

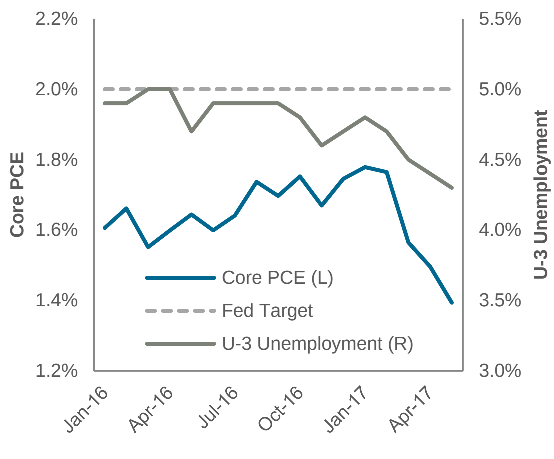
Municipal bonds delivered strong performance this quarter with the broad municipal index up roughly 2.0%. Positive technical factors including $5.8B of inflows and robust demand helped deliver strong returns. A risk continues to exist in any new tax reform put forth, but markets have largely shrugged off any potential changes.

Fixed Income Benchmarks

Asset Class	Representative Benchmark	Q1 Return	YTD Return
Taxable	BBgBarc Aggregate	1.5%	2.3%
Treasury	BBgBarc Treasury	1.2%	1.9%
Corporate	BBgBarc Corporate	2.5%	3.8%
High Yield	BofA/ML HY Master II	2.1%	4.9%
Municipal	BBgBarc Municipal	2.0%	3.6%
International	BBgBarc Global Agg.	2.6%	4.4%

Figure 5

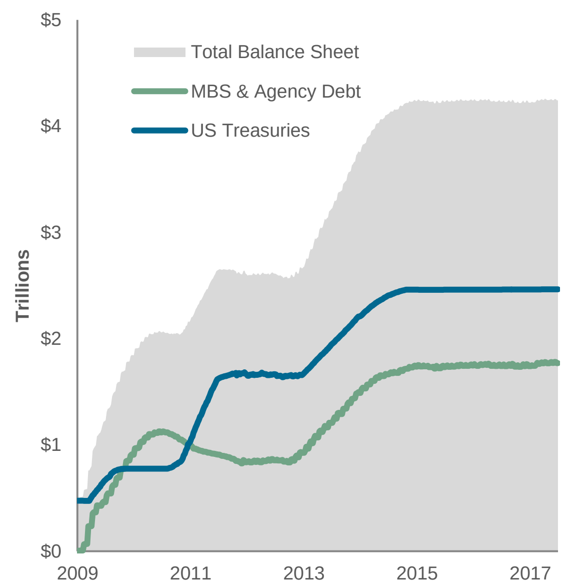
Fed's Dual Mandate: Halfway There



Source: Bloomberg, Baird Analysis

Figure 6

Fed Outlines Balance Sheet Reduction



Source: Bloomberg, Baird Analysis

Benchmark and Asset Classes Definitions

S&P 500 Index (Large Cap / U.S. Stocks): A representative sample of 500 leading companies in leading industries of the U.S. economy. These are equity securities of large capitalization (generally $7 billion plus market cap) companies having growth and value characteristics.

Russell 3000® Growth Index (All Cap Growth / Growth Stocks): Measures the performance of the 3,000 largest U.S. companies based on total market capitalization with higher price-to-book ratios and higher forecasted growth values.

Russell 3000® Value Index (All Cap Value / Value Stocks): Measures the performance of the 3,000 largest U.S. companies based on total market capitalization with lower price-to-book ratios and lower forecasted growth values.

Russell 1000® Growth Index (Large Growth): Measures the performance of those Russell 1000® Index companies with higher price-to-book ratios and higher forecasted growth values. These are equity securities of large capitalization ($7 billion plus market cap) companies having growth stock characteristics (high price to earnings, high return on equity and low dividend yield.

Russell 1000® Value Index (Large Value): Measures the performance of those Russell 1000® Index companies with lower price-to-book ratios and lower forecasted growth values. These are equity securities of large capitalization ($7 billion plus market cap) companies having value stock characteristics (low forecasted price-to-earnings ratio, low price-to-book ratio, high dividend yield).

Russell Midcap® Index (Mid Cap / Mid Core): Measures the performance of the 800 smallest companies of the Russell 1000® Index, which represent approximately 31% of the total market capitalization of the Russell 1000® Index. These are equity securities of middle capitalization ($2-7 billion plus market cap) companies having growth and value characteristics.

Russell 2000® Index (Small Cap / Small Core): Measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represent approximately 10% of the total market capitalization of the Russell 3000® Index. These are equity securities of small capitalization (<$2 billion plus market cap) companies having growth and value characteristics.

Russell Micro Cap Index (Micro Cap): Measures the performance of the 1,000 smallest companies in the Russell 2000® Index, which represent approximately 3% of the total market capitalization of the Russell 3000® Index.

MSCI EAFE Index Net (International / Developed Markets): A free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. As of May 27, 2010 the MSCI EAFE Index consisted of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

Citigroup 3-month T-bill Index (Cash): This index measures monthly return equivalents of yield averages that are not marked to market. It consists of the last one-month and three-month Treasury bill issues, respectively.

Dow Jones-UBS Commodity Index (Commodities): Composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). Sub-indices include Petroleum, Grains, Industrial Metals, Livestock, Precious Metals, and Softs.

MSCI Emerging Markets Index Net (Emerging Markets): A free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of May 27, 2010 the MSCI Emerging Markets Index consisted of the following 21 emerging market country indices.

MSCI Country Indices (Country-Specific Markets): To construct an MSCI Country Index, every listed security in the market is identified. Securities are free float adjusted, classified in accordance with the Global Industry Classification Standard (GICS®), and screened by size and liquidity. MSCI then constructs its indices by targeting for index inclusion 85% of the free float adjusted market capitalization in each industry group, within each country. By targeting 85% of each industry group, the MSCI Country Index captures 85% of the total country market capitalization while it accurately reflects the economic diversity of the market. This includes the MSCI Japan Index. International indices.

BBgBarc Aggregate Bond Index (Taxable Bonds / Bonds): Comprised of approximately 6,000 publicly traded bonds, including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years.

BBgBarc Global Aggregate Bond Index (Global Bonds): Provides a broad-based measure of the global investment-grade fixed income markets. The three major components of this index are the U.S. Aggregate, the Pan-European Aggregate, and the Asian-Pacific Aggregate Indices. The index also includes Eurodollar and Euro-Yen corporate bonds, Canadian government, agency and corporate securities, and USD investment grade 144A securities.

BBgBarc Muni Bond Index (Municipal Bonds): Bonds must have a minimum credit rating of at least Baa, an outstanding par value of at least $3 million, part of a transaction of at least $50 million, issued after December 31, 1990 and have a year or longer remaining maturity.

BBgBarc U.S. High Yield Bond Index (High Yield): Covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (e.g., Argentina, Brazil, Venezuela, etc.) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included.

BBgBarc U.S. Treasury Bond Index (Treasury Bonds): Comprised of U.S Treasury securities with at least one-year maturities.

BBgBarc U.S. Corporate Bond Index (Corporate Bonds): includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements.

Appendix: Definitions and Disclosures

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Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing. Additionally, an investment decision should not be made solely due to a security's stated yield as dividends can be reduced or suspended altogether. The indices referenced in this report are unmanaged common indices used to measure and report performance of various sectors of the stock and fixed income markets; direct investment in indices is not available.

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