Baird Market and Investment Strategy

Macro Update

May 23, 2017

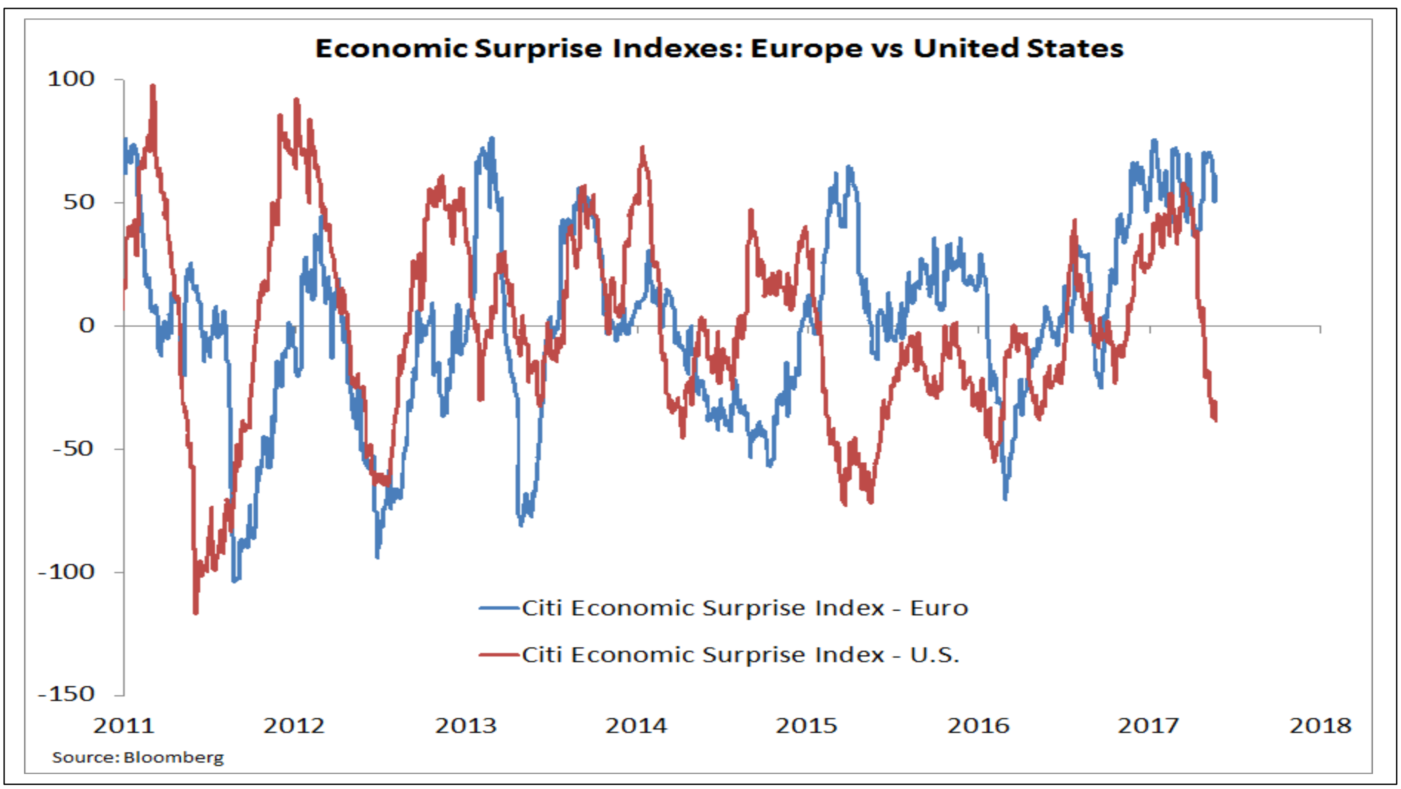
Please refer to Appendix – Important Disclosures.

Economic Recovery Benefitting From International Leadership

Key Takeaway: U.S data has cooled relative to expectations, but Europe is still offering positive surprises. A global synchronized up-turn in economic activity is helping earnings growth and is generating renewed interest in international equities. This provides investors with a chance to look for opportunities around the world and enjoy the benefits of diversification.

Economic data surprises in the U.S. have been to the downside of late, although beneath the surface there is still evidence that a sustainable up-turn in growth is set to emerge. Business investment spending surged nearly 10% in the first quarter and real median household income has broken out to a new high, finally surpassing the peak from 2000. While the U.S. has faltered relative to expectations, the recovery in the European economy continues to provide upside surprises. The economic surprise indexes for both the U.S. and Euro gained strength over the course of 2016. The surprise index for the U.S. has since faltered, moving to its lowest level in over a year (expectations moved ahead of reality in the wake of the November elections).

The economic surprise index for the Euro remains near its highest level since 2011. This does not just reflect subdued expectations for the European economy (although that may be part of it). While news headlines focus on elections and political uncertainty, the global economy has gained strength over the past two years. This broad upturn in activity is having positive implications for earnings growth domestically and is also providing investors with renewed benefits of global diversification and opportunities to find stock market leadership overseas.



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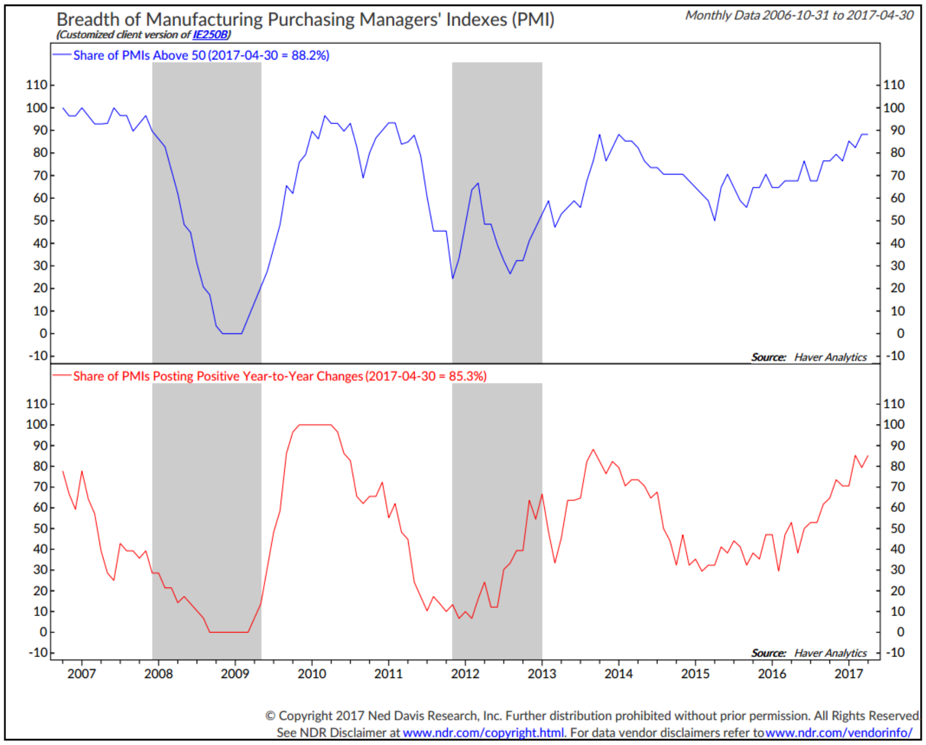
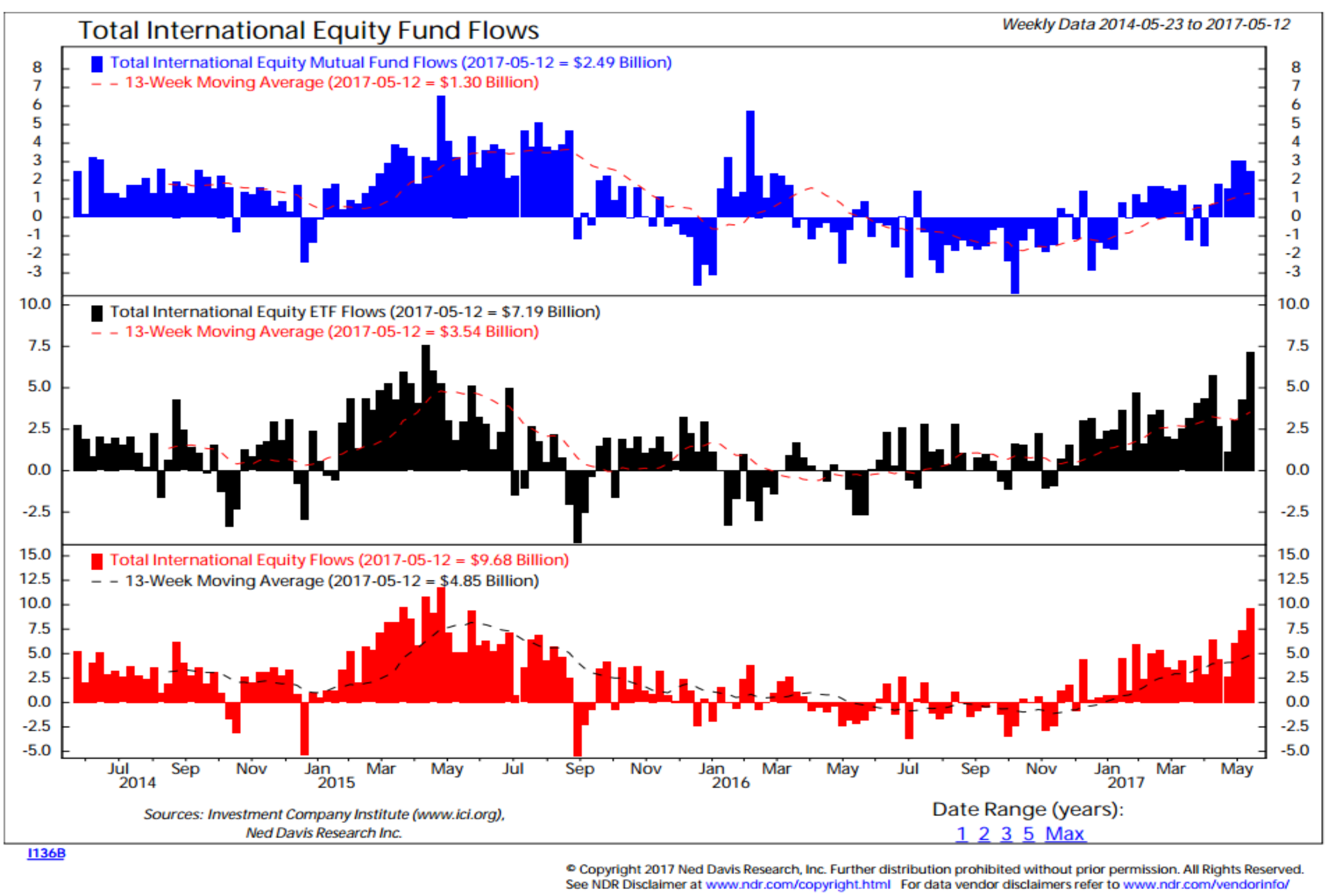
The global economy is not just doing less worse, it is actually improving. Nearly 90% of purchasing managers' indexes from around the world have readings above 50 (indicating an increase in activity) and a similar percentage are above where they were a year ago. This is proving to be a source of strength for U.S. earnings growth. According to FactSet, U.S. companies with more than 50% of sales outside the U.S. saw earnings growth of 21% in Q1, versus 10% earnings growth for companies with less than 50% of sales from overseas. Investors are responding to this renewed global strength by shifting assets abroad. International fund flows have picked up this year, with European funds recently seeing their largest weekly inflow since 2000.

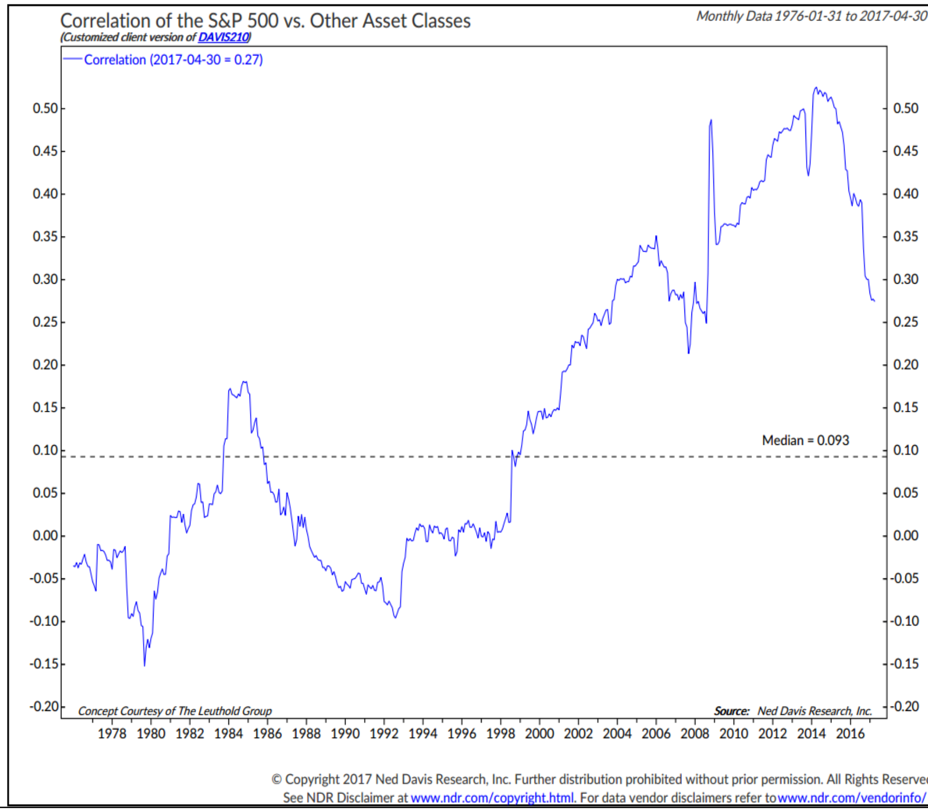


Source: Ned Davis Research



Source: Ned Davis Research

Investment implications of a globally coordinated economic recovery included the return of diversification benefits and opportunities for international leadership that have not been realized over the past few years. The correlation between the S&P 500 and the asset classes surged in the wake of the financial crisis and recent experience has been that global diversification has reduced returns and increased portfolio volatility. With correlations now in decline, diversification benefits are returning. On top of that, the multi-year relative strength up-trend in U.S. stocks versus the rest of the world has at least cooled. That may provide chances to benefit from periods of leadership in foreign stocks.



Source: StockCharts

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