

Q3 2018 Tactical Update

August 1, 2018

Please refer to Appendix – Important Disclosures.

In this piece, we provide a series of near-term tactical calls within the context of the current message from the weight of the evidence and our other tactical indicators. Operating from this premise, we offer a series of tactical allocation calls, beginning with a macro call on stocks versus bonds versus cash. On the next page, these calls are further distilled. For example, we make distinctions from a size, style and sector perspective for domestic equities, and suggest tilts toward or away from the various satellite asset classes. These calls are made in light of the long-term outlook and summarize our expectations for the coming quarter.

The Weight of the Evidence: -1 (Cautious)

MACRO FACTORS (WHAT COULD HAPPEN):

FED POLICY



ECONOMIC FUNDAMENTALS



VALUATIONS



MARKET FACTORS (WHAT IS HAPPENING):

SENTIMENT



SEASONAL PATTERNS AND TRENDS



BREADTH



Tactical Investment Decision	Baird's Call ¹	Date of First Call ²	Level of Conviction ³	Rationale
Stocks vs. Bonds vs. Cash?	Cash over Stocks & Bonds	Q2 18	High	<ul style="list-style-type: none"> Overall weight of the evidence argues for caution, especially heading into seasonal weakness ahead of mid-term elections. Equities have bounced, but lack of breadth & momentum confirmation suggests trading range environment persists.

¹ Tactical over- or under-weight relative to Baird's strategic asset allocation models. Please ask your Baird advisor for more information on the strategic model most applicable to you.

² Date when Baird first made this call.

³ Level of conviction in the tactical investment call: low, medium, high.

Tactical Investment Decision	Baird's Call ¹	Date of First Call ²	Level of Conviction ³	Notes
Domestic Stocks: Size	Large-Caps Over Mid-Caps & Small-Caps	Q3 18	High	<ul style="list-style-type: none"> Seasonal headwinds are particularly pronounced for small-cap stocks. Industry group leadership trends support the recent shift toward large-cap leadership.
Domestic Stocks: Style	Value Over Growth	Q2 18	Low	<ul style="list-style-type: none"> Long-term trend favoring growth has stalled and momentum is shifting toward value. Growth areas of the market have become crowded and could see some mean reversion if sentiment shifts.
Domestic Stocks: Sector	Health Care Industrials Consumer Staples	Q2 18 Q3 18 Q3 18	Medium	<ul style="list-style-type: none"> Health Care has already moved into sector leadership group. Industrials and Staples are both moving off their lows and could continue to gain strength if leadership rotation continues.
Global Stocks: Region	United Kingdom United States	Q2 18 Q3 18	Medium	<ul style="list-style-type: none"> United Kingdom broke above a multi-year down-trend but is struggling to establish an up-trend. The U.S. has moved into a leadership position at a time when global breadth is deteriorating.
Global Stocks: Developed vs. Emerging Markets	Developed Markets	Q2 18	Low	<ul style="list-style-type: none"> Developed markets have enjoyed a momentum-fueled rally relative to emerging markets. Now, emerging markets are unloved and have relatively attractive valuations.
Global Developed Stocks: Domestic vs. International	Domestic	Q3 18	Low	<ul style="list-style-type: none"> U.S. stocks have re-asserted leadership versus the rest of the world, with both price and momentum trends favoring the U.S. The caveat is that valuations are higher in the U.S. than the rest of the world.
Bonds: Treasury vs. Spread Product	Spread Product	Q3 16	Low	<ul style="list-style-type: none"> Trend favoring corporate bonds over Treasuries had stalled, but is now re-accelerating and momentum is again moving in favor of corporate bonds.
Bonds: Intermediate vs. Short-Term	Intermediate-Term	Q3 18	Medium	<ul style="list-style-type: none"> Longer-term bond yields have run into resistance as the 10-year T-Note yield has approached 3%. Neither copper prices nor German Bund yields point to a surge higher in U.S. yields.
Bonds: High-Grade vs. High-Yield	High-Grade	Q4 17	Low	<ul style="list-style-type: none"> Trend favoring high-yield is flattening out and momentum has been moving in favor of high-grade. High-yield's sensitivity to small-caps could make the sector vulnerable if volatility picks up ahead of the November elections.
International Real Estate	Bullish	Q2 17	Medium	<ul style="list-style-type: none"> Real estate continues to recover from an early-year stumble. Strong economic fundamentals could keep demand in the sector robust even if yields creep higher.

Commodities	Bullish on Commodities	Q1 17	High	<ul style="list-style-type: none"> • With weight of evidence arguing for caution but economic recovery intact, commodities could attract investor interest. • Commodity uptrend has found support and remains intact.
Currencies	Neutral on Dollar	Q2 18	Medium	<ul style="list-style-type: none"> • Dollar rally has stalled and momentum is rolling over. • Longer-term view shows broad trading range for dollar versus other currencies.
Gold	Overweight	Q4 17	Medium	<ul style="list-style-type: none"> • Gold has weakened in 2018, with both price and momentum trends moving lower. • Sentiment is now washed out and gold is approaching 2017 support levels.
Hedges	NASDAQ 100	Q2 18	High	<ul style="list-style-type: none"> • NASDAQ price highs have come with momentum and breadth divergences. • Unwinding of the crowded “FAANG” trade would have an outsized negative impact on the NASDAQ 100.

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Capital Growth	80 / 20	Above average	Emphasis on providing growth of capital with moderately high fluctuations in the annual returns and overall market value of the portfolio.
Growth with Income	60 / 40	Average	Emphasis on providing moderate growth of capital and some current income with moderate fluctuations in annual returns and overall market value of the portfolio.
Income with Growth	40 / 60	Below average	Emphasis on providing high current income and some growth of capital with moderate fluctuations in the annual returns and overall market value of the portfolio.
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