Baird Market and Investment Strategy

Q3 2017 Tactical Update

July 12, 2017

Please refer to Appendix – Important Disclosures.

In this piece, we provide a series of near-term tactical calls within our longer-term strategic framework. We begin by offering commentary on our outlook for the financial markets. Operating from this premise, we then 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.

MARKET SUMMARY

Surprises dominated the first half of 2017, and there is little reason to think that the second half will be much different. That is not to say that the next six months will be a carbon copy of the previous six months. Rather, it is an encouragement for investors to keep an open mind and not get locked into believing only those things which confirm a pre-existing narrative. This stresses the importance of developing a view in light of what could happen, but tempering that against an ongoing assessment of what actually is happening.

Through the unlikely combination of noisy calm that dominated much of the first half of the year, the weight of the evidence remained tilted toward a bullish message, and this message is intact as we look toward the second half. Despite some data disappointments in the first half, underlying economic fundamentals (including low inflation) remain bullish for stocks, and the stock continues to benefit from a bullish tape and broad rally participation. Valuations remain bearish and speak to elevated risk in the current environment. The other factors are neutral right now.

Looking ahead, we are thinking about the second half of 2017 through the lens of three primary considerations: the ongoing impact of continued tightening by the Fed, the outlook for economic growth in the second half after a generally disappointing first half (particularly in the U.S.), and how well the stock market is able absorb the emerging leadership rotation.

Despite the uncertainty in the political environment, there are indications that a more normal macro investing environment may be emerging. That could very well include an uptick in volatility in the second half even if the underlying trends remain intact.

Tactical Investment Decision	Baird's Call[1]	Date of First Call[2]	Level of Conviction[3]	Rationale
Stocks vs. Bonds vs. Cash?	Stocks and Cash over Bonds	Q3 16	Medium	• Weight of the evidence for stocks continues to have a positive bias. • Stock market volatility could pick up in the third quarter, but the path of least resistance tilts higher for stocks.

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.

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Tactical Investment Decision	Baird's Call[1]	Date of First Call[2]	Level of Conviction[3]	Notes
Domestic Stocks: Size	Mid-Caps & Small-Caps Over Large-Caps	Q3 17	Medium	• Small-caps and mid-caps starting to show improved relative strength versus large-caps, with price and momentum trends improving.
Domestic Stocks: Style	Growth Over Value	Q3 17	Low	• Across capitalization levels, growth indexes have broken out relative to value indexes. • Sector leadership rotation toward Financials could help support value indexes.
Domestic Stocks: Sector	Health Care Industrials	Q2 17 Q3 17	Medium	• Health Care gained strength over the course of the second quarter and enters the second half in the leadership group. • Industrials have been a steady outperformer since late 2015, and are benefiting from improving growth trends.
Global Stocks: Region	Europe ex UK Emerging Markets	Q2 17 Q3 17	Medium	• Europe ex UK has consolidated its early-year breakout, and momentum is starting to now turn higher. • Emerging Markets continue to recover from late-2016 slump.
Global Stocks: Developed vs. Emerging Markets	Emerging Markets	Q2 16	High	• Emerging Markets making new price highs. • Coordinated global economic recovery benefitting Emerging markets.
Global Developed Stocks: Domestic vs. International	International	Q3 17	Medium	• Foreign stocks have gained the upper hand relative to U.S. stocks in 2017 after a multi-year period of U.S. leadership. • Momentum trend toward international stalled in the second quarter, but has not reversed.
Bonds: Treasury vs. Spread Product	Spread Product	Q3 16	Low	• Yields continue to narrow, and corporate bonds continue to trend higher relative to Treasuries. • Fed balance sheet reductions could put relative pressure on Treasuries in Q3.
Bonds: Intermediate vs. Short-Term	Intermediate-Term	Q2 17	Low	• Flattening yield curve is putting more pressure on short-term bonds than longer-term bonds. • While longer-term yields could drift higher, meaningful upward pressure not likely unless inflation accelerates.
Bonds: High-Grade vs. High-Yield	High-Yield	Q4 16	Medium	• Trend favoring high-yield has stalled, but not yet reversed. • If economic growth is accelerating could be room for additional leadership from high-yield
International Real Estate	Bullish	Q2 17	Medium	• Real Estate continues to trend modestly higher, but momentum has turned unfavorable. • Modest rise in bond yields may not be a significant headwind for Real Estate.

Commodities	Bullish on Commodities	Q1 17	Low	• Commodities have struggled to gain ground in 2017, despite dollar weakness. • Improving economic growth in second half could help support higher commodity prices.
Currencies	Neutral on Dollar	Q1 17	Medium	• The dollar was a consensus long coming into 2017, but has been weak in the first half of the year. • While trend is lower, dollar is oversold and better tone from economic data could support a bounce.
Gold	Underweight	Q4 16	Medium	• After an attempted breakout in the second quarter, gold sold off and made a lower low. • Improving growth prospects are a headwind for gold.
Hedges	NASDAQ 100	Q3 17	Medium	• Since peaking in early June, NASDAQ 100 has made a lower high and a lower low relative the S&P 500, suggesting that leadership has moved to new areas of the market.

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[2] Date when Baird first made this call.

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

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Model Portfolio	Mix: Stocks / (Bonds + Cash)	Risk Tolerance	Strategic Asset Allocation Model Summary
All Growth	100 / 0	Well above average	Emphasis on providing aggressive growth of capital with high fluctuations in the annual returns and overall market value of the portfolio.
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.
Conservative Income	20 / 80	Well below average	Emphasis on providing high current income with relatively small fluctuations in the annual returns and overall market value of the portfolio.
Capital Preservation	0 / 100	Well below average	Emphasis on preserving capital while generating current income with relatively small fluctuations in the annual returns and overall market value of the portfolio.

Appendix – Important Disclosures and Analyst Certification

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