

Q4 2017 Tactical Update

October 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

While the weight of the evidence is currently neutral and counselling caution, the up-trend that emerged off of the early 2016 stock market lows remains intact. So while risks have risen since mid-year and stocks may be overdue for a pullback, we have yet to see the sort of deterioration which typically presages periods of protracted stock market weakness.

For now, however, there is also little evidence that significant upside momentum for stocks is returning and the underlying trend is prepared to meaningfully accelerate. In many ways the fundamentals and technicals tell the same story. The underlying trends (in terms of the economy and the broad market) are positive, but optimism

(measured by sentiment and valuations) has become excessive.

With this backdrop, Fed policy and seasonal patterns (both currently seen as neutral) may get heightened scrutiny. The continued lack of inflation is providing the Fed with the opportunity to continue to normalize policy at a measured pace. A shift toward a more aggressive stance from the Fed, or hints that the ECB may be moving toward balance sheet reductions of its own could catch the bond market by surprise.

Stocks have so far navigated with ease what is typically a treacherous seasonal period. While the first part of the fourth quarter can see pitfalls of its own (recall, for example, October 1987), the fourth quarter as a whole is typically favorable for stocks. Add to this the strength seen over the course of the first nine months of the year, and the path of least resistance for stocks (particularly if bond yields remain relatively low and stable) could ultimately be higher as we move toward 2018.

The bottom line is that while there are risks aplenty, from our vantage point, the evidence in hand is consistent with a message of caution yielding to strength as we move through the fourth quarter.

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	High	<ul style="list-style-type: none"> Weight of the Evidence is neutral to start the quarter, but seasonals are improving. Excessive optimism suggests stocks could have a rocky path higher into year end.

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	Large-Caps & Mid-Caps Over Small-Caps	Q4 17	Medium	<ul style="list-style-type: none"> Small-caps have seen an oversold bounce, but longer-term trends still favor large-caps. Continued leadership from overseas could help large-caps vs. small-caps
Domestic Stocks: Style	Growth Over Value	Q3 17	Low	<ul style="list-style-type: none"> Trends across all capitalization levels favor growth over value. Cyclical areas holding up well relative to defensives
Domestic Stocks: Sector	Industrials Financials Materials	Q3 17 Q4 17 Q4 17	Medium	<ul style="list-style-type: none"> Rebound in global growth with shift from consumer to business spending positive for Industrials. Move higher in bond yields could help Financials
Global Stocks: Region	Europe ex UK Emerging Markets	Q2 17 Q3 17	Medium	<ul style="list-style-type: none"> Economic leadership, particularly relative to expectations, continues to come from Europe. Stock market leadership trends that emerged earlier this year remain intact.
Global Stocks: Developed vs. Emerging Markets	Emerging Markets	Q2 16	High	<ul style="list-style-type: none"> The relative pullback in Emerging Markets has helped re-set the price trend. Momentum is improving and growth remains strong
Global Developed Stocks: Domestic vs. International	International	Q3 17	Medium	<ul style="list-style-type: none"> International stocks have more attractive valuations than domestic counterparts. After a protracted period of underperformance, price trends are moving in favor of international
Bonds: Treasury vs. Spread Product	Spread Product	Q3 16	Low	<ul style="list-style-type: none"> Spreads are tight, but we still prefer high-quality corporates over treasuries Evidence of faltering economic strength could put pressure on corporate bonds.
Bonds: Intermediate vs. Short-Term	Short-Term	Q4 17	Medium	<ul style="list-style-type: none"> Long-term yields appear to have bottomed, but remain relatively low. After period of yield curve flattening, there is increased risk of curve steepening.
Bonds: High-Grade vs. High-Yield	High-Grade	Q4 17	Low	<ul style="list-style-type: none"> Long-term trend still favors high-yield, but risks rising High-yield appears to be a crowded traded and perceived liquidity may be elusive.
International Real Estate	Bullish	Q2 17	Medium	<ul style="list-style-type: none"> Global growth is improving and real estate is trending higher. Biggest risk appears to be a negative impact from higher rates.

Commodities	Bullish on Commodities	Q1 17	Low	<ul style="list-style-type: none"> Multiple commodities breaking out to multi-year highs in 2017 as demand remains strong. Renewed weakness in the U.S. dollar could be an added tailwind.
Currencies	Bearish on Dollar	Q4 17	Medium	<ul style="list-style-type: none"> After getting significantly oversold, dollar has managed on a meager bounce. Balance sheet reduction by Fed appears to be priced in, euro could strengthen if ECB acts more quickly than markets expect.
Gold	Overweight	Q4 17	Medium	<ul style="list-style-type: none"> The long-term trend improving Following a break above down-trend resistance, holding support at the extension of that trend line is important.
Hedges	Treasury Bonds	Q4 17	High	<ul style="list-style-type: none"> Global growth is strong and there is some evidence that inflation pressures are starting to build. U.S. yields unlikely to move significantly higher unless German yields rise, so watch ECB for QE taper/reversal

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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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