Baird Market & Investment Strategy

Investment Strategy Outlook

September 11, 2017

Please refer to Appendix – Important Disclosures.

Uptrend Intact, but Evidence Argues for Caution

Highlights:

- **Downshift in Inflation Provides Fed with Room to Maneuver**
- **Global Economic Rebound Gets New Lease on Life**
- **Seasonal Headwinds May Be Less Severe This Year**
- **Relative Trends Show International Leadership**

Outlook Summary

Weight of the Evidence Is Neutral

Stocks Lacking Momentum, but Uptrend Is Intact

Breadth Still Bullish, but Not Confirming Index-Level Strength

Fed Appears Set to Begin Balance Sheet Reduction in Q4

Sector Leadership from Health Care, Technology, Utilities, Materials

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 upside momentum for stocks is returning and the underlying trend is prepared to re-assert itself. 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 back drop, 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. Seasonal patterns are getting plenty of attention right now as we move into a notoriously difficult part of the annual calendar for stocks and the specter of previous year's ending in "7" (think, 1987) provides a lens through which investors can express their current concerns. As we will discuss, the lack of volatility in the first half of 2017 and strong breadth coming into this seasonally weak period argue for a more modest pullback than might otherwise be expected. *The bottom line is that while there are risks aplenty, from our vantage point, the evidence in hand is more consistent with a message of increased caution rather than one of immediate concern.*

Indicator Review

Fundamental Factors (What Could Happen)		
• Federal Reserve Policy	Neutral	0
• Economic Fundamentals	Bullish	+1
• Valuations	Bearish	-1
Technical Factors (What Is Happening)		
• Investor Sentiment	Bearish	-1
• Seasonal Patterns/Trends	Neutral	0
• Tape (Breadth)	Bullish	+1
Weight of the Evidence =	Neutral	0

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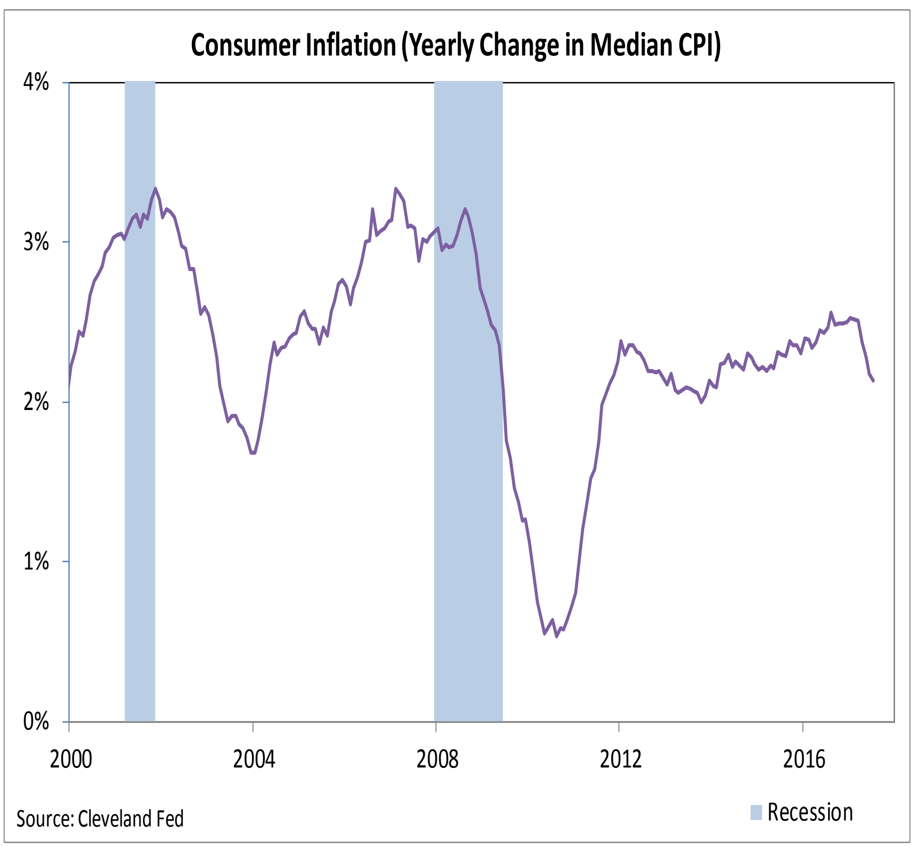
Federal Reserve Policy is still neutral. The Fed appears set to begin to draw down its balance sheet in the fourth quarter, but the timing of the next interest rate hike is up in the air. Recent comments from Fed officials have argued for a wait-and-see approach. They suggest that, without an uptick in inflation, further rate hikes could be delayed (expectations had been for a 25 basis point hike in December). **The bond market seems to be endorsing this approach by the Fed.** Bond yields have moved lower since peaking near 2.6% earlier this year. While short-term rates and inflation expectations impact bond yields, yields on foreign bonds do as well. As such, investors may want to keep a close eye on the ECB (in addition to the Fed).

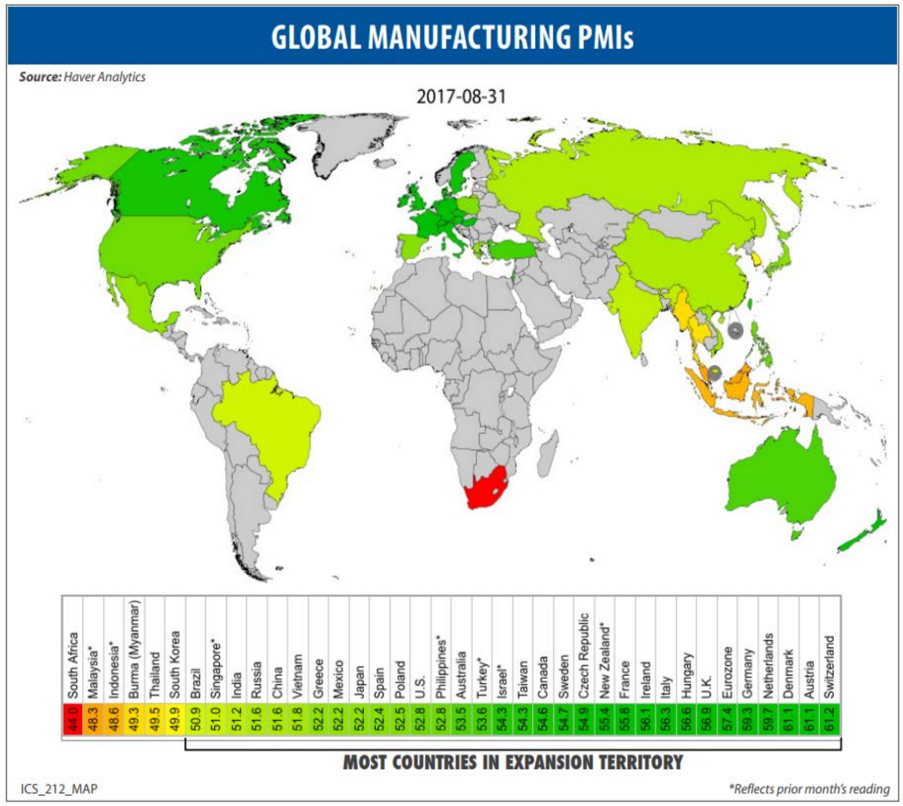
Source: StockCharts



Source: Cleveland Fed

While global growth is improving and commodity prices are moving higher (more on this in a moment), the bond market for now seems pre-occupied with the recent decline in inflation. **After drifting higher for several years, the yearly change in the median CPI (as calculated by the Cleveland Fed) has turned lower in 2017.** Despite evidence of consumer and small business optimism, there are clearly still distortions in the labor market (specifically, the job-skill mismatch and the opioid epidemic) that are keeping wage growth contained and providing a lid on inflation. While providing the Fed the opportunity to proceed at a gradual pace, these distortions reduce overall economic growth and are a societal headwind.

Economic Fundamentals remain bullish. The rebound in economic growth is global in nature, with most countries in expansion mode. The recovery is strong as well as broad. **The JP Morgan Global Purchasing Managers' Index in July moved to its highest level since 2011.** Within this recovery, the U.S. is actually just a middle-of-the-pack performer. Growth out of Europe continues to surprise to the upside and international trade continues to expand.

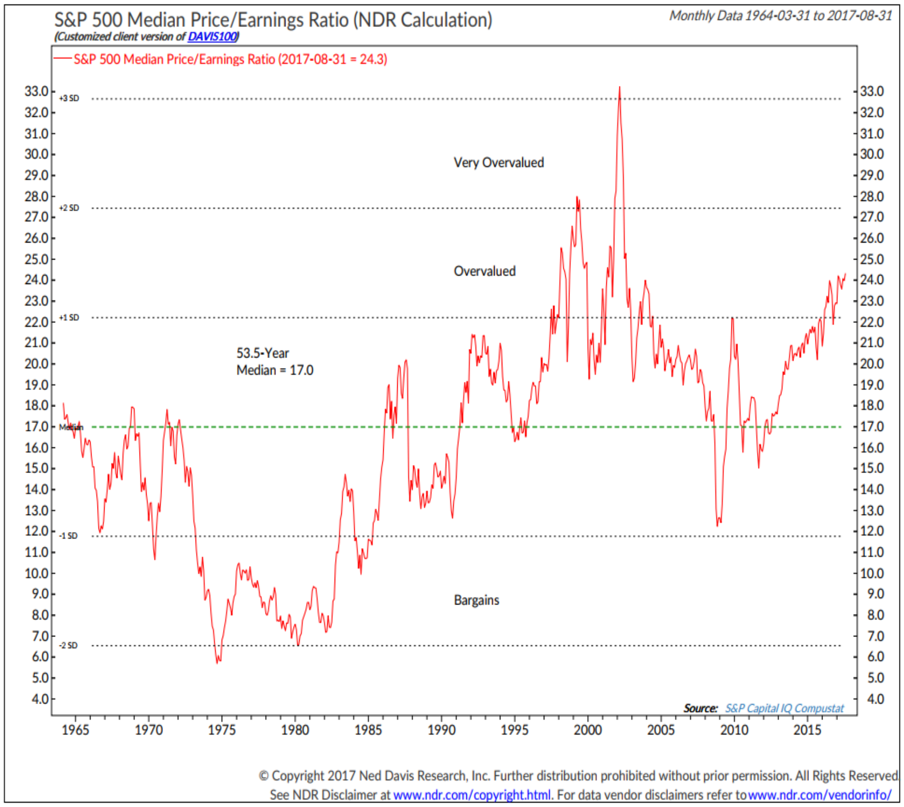


Source: Ned Davis Research

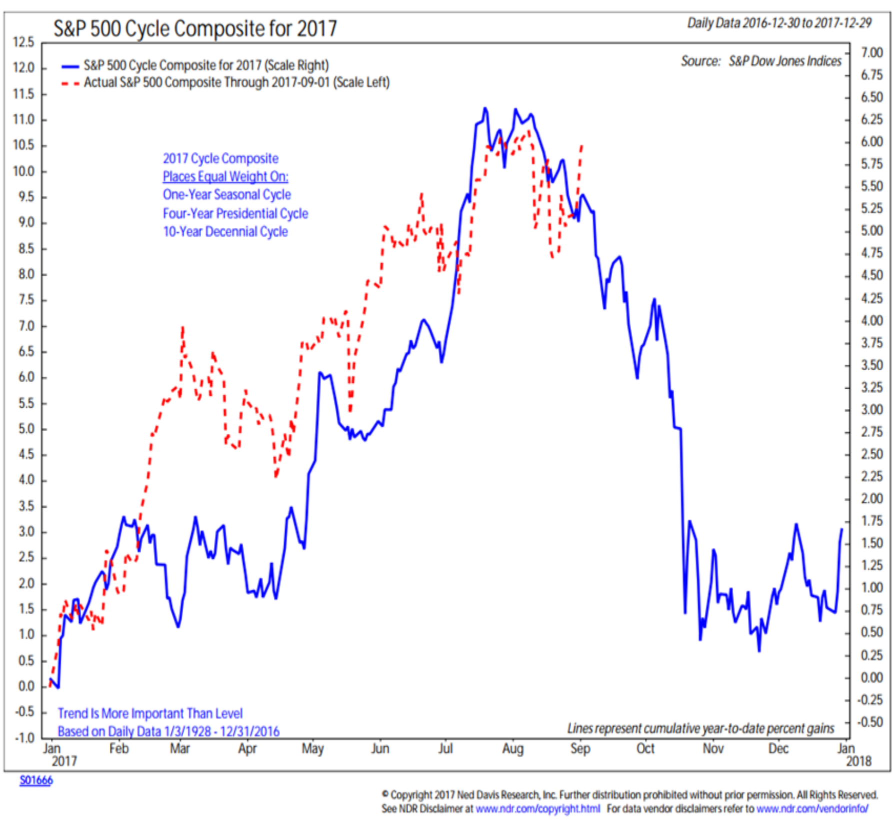
Source: StockCharts

Supporting a positive view on the global economy has been strength in industrial commodities. Copper gets plenty of attention in this regard but it is not alone in showing strength. A number of commodities have made new multi-year highs in 2017. **Copper is trading at its highest level since 2014**, Zinc has moved to its highest level since 2007, and Palladium is as high as it has been since 2001.

Even with the improving economic growth fueling an improved earnings backdrop, **Valuations remain bearish**. *Given the divergence between price and fundamentals, earnings will have to move ahead of price to relieve valuations pressures.* It is encouraging, however, that the recovery in earnings is being driven by better top-line results. Importantly, valuations speak to risk and **elevated valuations suggest an elevated risk environment (an important point given that many measures of volatility suggest placidity bordering on moribundity)**. In other words, even as corporate results are improving and stock market volatility has declined, risks remain elevated.



Source: Ned Davis Research



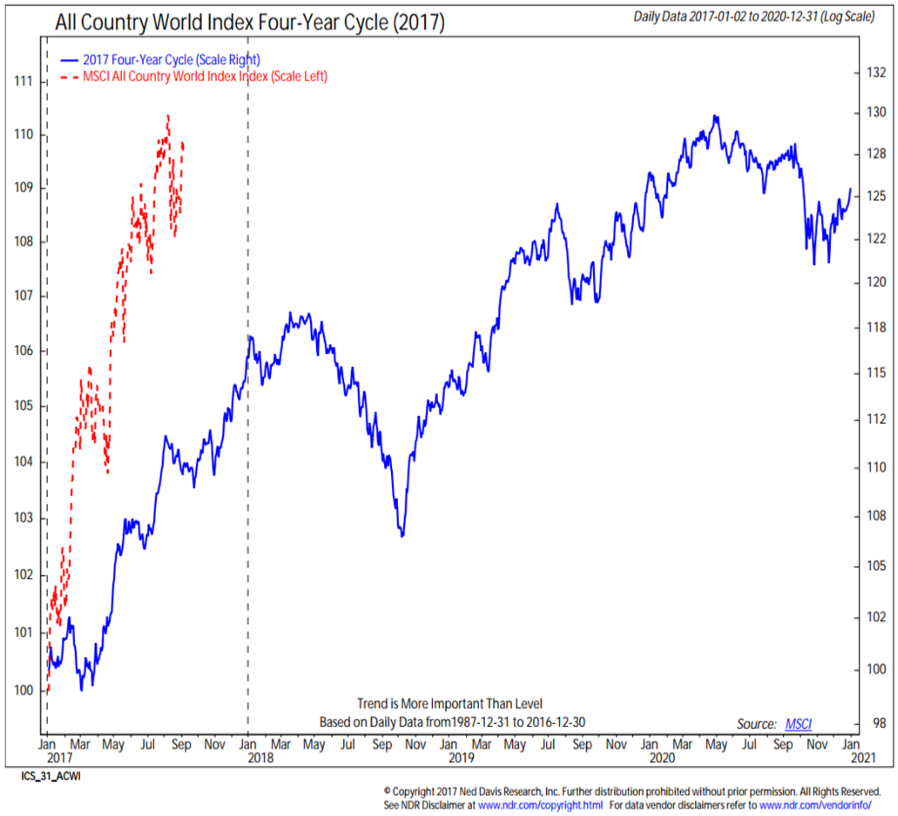
Source: Ned Davis Research

Sentiment is bearish as optimism remains elevated. While short-term measures of sentiment show some degree of pessimism, the more stable surveys suggest optimism remains a headwind for stocks.

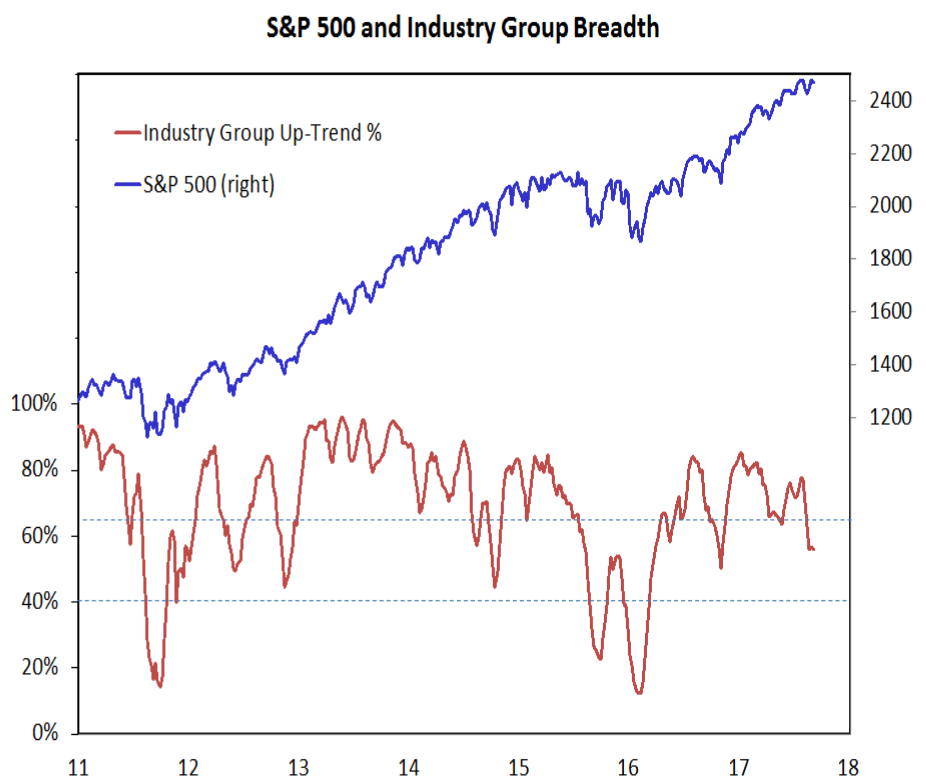
Seasonal Patterns are neutral. The cycle composite for 2017 suggests a significant increase in risk as we move toward the fourth quarter. This pattern, coupled with evidence of perceived excesses elsewhere in the financial system, has some investors expecting the worst this fall. We see a few factors, contingent on actual behavior in the stock market in 2017 as mitigating some of these concerns.

In years where first half weakness has been muted, second half drawdowns have been below average and the year-end rallies have been stronger.

Additionally, when breadth has been strong coming into this seasonal weak period, weakness has been muted and existing uptrends have largely remained intact. **While the S&P 500 is now in its longest stretch without at least a 5% pullback in the past 20 years (arguing that some degree of weakness is overdue) we do not see evidence suggesting that we are in store for a deeper correction (at least not now).** Rather than focusing on the cycle composite, perhaps the 4-year cycle may be a more appropriate guideline. This suggests limited near-term weakness followed by a year-end rally, but a more treacherous path in 2018 in advance of mid-term elections.



Source: Ned Davis Research



Source: FactSet, RWB Calculations

Breadth has managed to stay bullish, for now. The broad market has seen significant deterioration since early summer. While that deterioration has stalled (the percentage of industry groups in up-trends has held steady near 55% for three weeks), the new highs being tested at the index-level put additional pressure on the measures of broad market health. **A failure now to confirm the highs in the indexes would represent negative divergences and cast some doubt on the continued support of the broad market.** This is not yet the case, but something to keep an eye on as we move toward the fourth quarter.

While the weight of the evidence argues for caution, there are still opportunities to look for leadership within the stock market. Current leadership in the U.S. comes from large-caps stocks, while sector leadership is with Health Care, Technology, Utilities and Materials.

Sector	Relative Strength Ranking Current	Relative Strength Ranking Recent	Relative Strength Ranking Trend
Energy	7	10	Stable
Materials	4	7	Stable
Industrials	5	4	Down
Consumer Discretionary	8	6	Stable
Consumer Staples	6	9	Stable
Health Care	1	5	Stable
Financials	9	3	Down
Information Technology	2	2	Stable
Telecom Services	10	8	Stable
Utilities	3	1	Stable

Source: Baird

Source: StockCharts

From a global perspective, better opportunities may exist overseas than at home for U.S. investors. Both developed markets and emerging markets have gained relative strength versus U.S. stocks in 2017, ending a protracted period of U.S. outperformance. Emerging markets bottomed relative to their developed counterparts in early 2016 and have continued to move higher in 2017.

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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.
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Asset Class / Model Portfolio	All Growth	Capital Growth	Growth with Income	Income with Growth	Conservative Income	Capital Preservation
Equities:						
Suggested allocation	95%	75%	55%	35%	15%	0%
Normal range	90 – 100%	70 - 90%	50 - 70%	30 - 50%	10 - 30%	0%
Fixed Income:						
Suggested allocation	0%	15%	35%	45%	50%	60%
Normal range	0 - 0%	10 - 30%	30 - 50%	40 - 60%	45 - 65%	55 – 85%
Cash:						
Suggested allocation	5%	10%	10%	20%	35%	40%
Normal range	0 - 10%	0 - 20%	0 - 20%	10 - 30%	25 - 45%	15 - 45%

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