Baird Market & Investment Strategy

Investment Strategy Outlook

May 23, 2018

Please refer to Appendix – Important Disclosures.

Despite Volatility Lull, Stocks Remain Range Bound

Highlights:

- **Inflation Pressures Rising**
- **Treasury Yield Rise Not Getting Confirmation**
- **Q1 Results Generate Positive Earnings Surprises**
- **Stock Rally Comes With Return Of Optimism**
- **Breadth Thrusts Remain Elusive**

Outlook Summary

Weight Of Evidence Holds At Neutral

Stocks Consolidating Within Broad Trading Range

Watch Breadth Indicators For Evidence That Rally Poised To Resume

Mid-Term Elections Could Add To Volatility

Stocks overall have rallied off of their recent lows, and some segments of the market (namely small-caps) have actually broken out to new highs. The weight of evidence, however, suggests the backdrop is little changed. As such, **recent stock market strength is viewed within the context of continued consolidation**. The volatility that emerged in the first quarter has cooled as we move toward mid-year and the pace at which the stock market has experienced daily swings of 1% or more has slowed. A summer-time shift in focus toward the mid-term elections could mean that this lull is a temporary respite and perhaps not evidence that the storm has fully blown itself out.

Rhetoric and actions from the Federal Reserve and headlines relating to corporate earnings garner so much attention, but their key influence on stocks, particularly over the next few months, will likely be relative to any changes in expectations that emerge. Evidence that the Fed may be compelled to pursue a more aggressive than expected path of policy normalization or that blow-out earnings of the first quarter fail to generate positive follow-through for the remainder of the year could become headwinds for stocks. The rally off of the April lows has come with resurgent optimism and without evidence that broad market trends are keeping pace with the index-level improvements. Breadth remains neutral, and we continue to score sentiment as bullish, giving a nod to the excessive pessimism that emerged as stocks sold-off earlier this year over evidence that longer-term optimism may not have been fully relieved. **With the weight of the evidence still neutral, it would be premature to chase rallies or overreact to any renewed weakness that may emerge.**

Indicator Review

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

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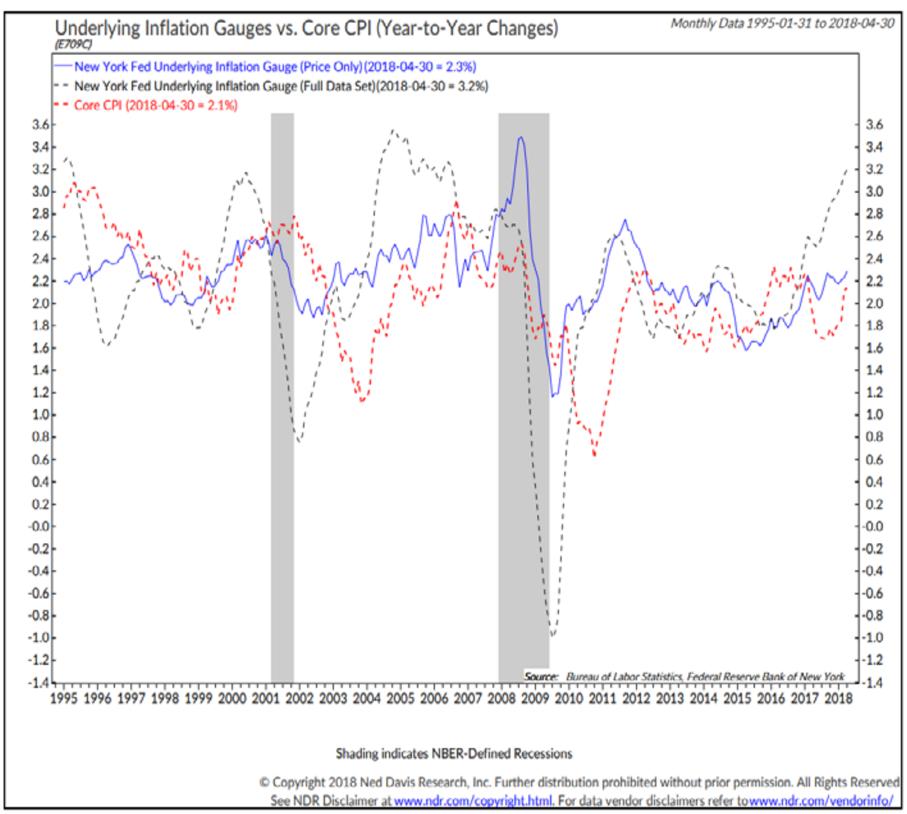
Before proceeding to our review of the weight of the evidence, it may be worthwhile to contextualize market movements seen so far in 2018. Despite recording 32 daily moves of 1% or more, the S&P 500 is trading within a few percent of where it began the year. In the words of a recent headline from the Wall Street Journal, **"Markets run fast only to stay in place."** Near-term volatility has ebbed somewhat as the S&P 500 has moved off its recent lows and small-cap stocks have moved to new highs, but absent evidence that consolidation is yielding to a sustainable move higher (most specifically an upside thrust in short-term breadth indicators), *it would be premature to conclude that this lull in volatility is much more than a near-term respite.*

Source: StockCharts

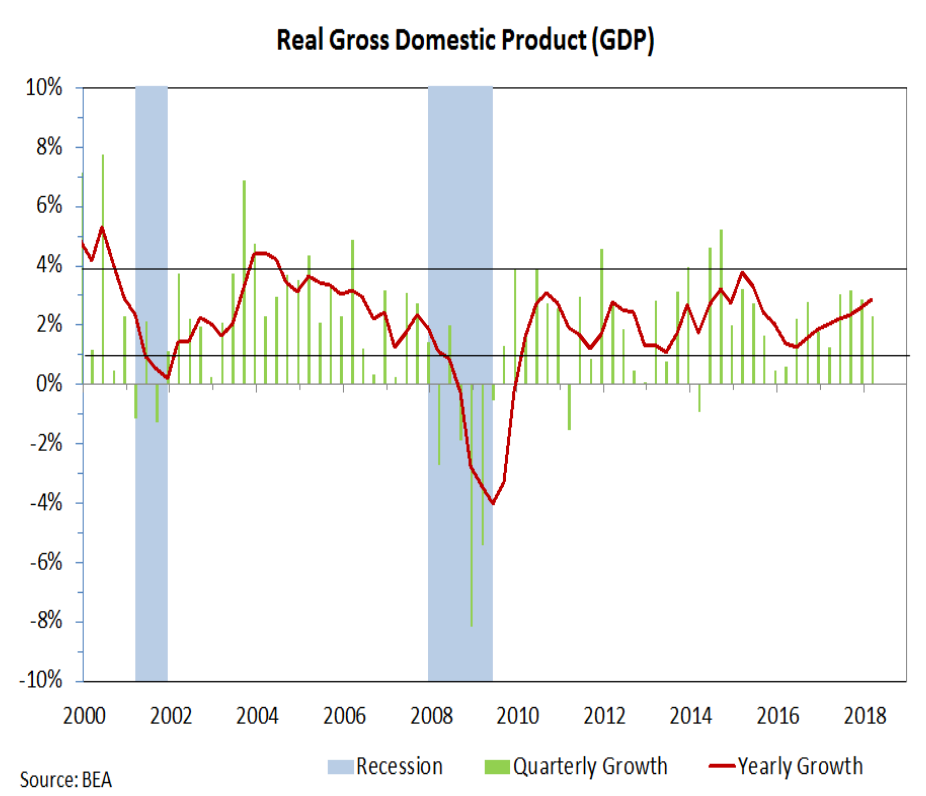


Source: Ned Davis Research

Federal Reserve Policy is still neutral. At this point the Fed is signaling its intention to raise interest rates two more times in 2018. The uncertainty around Fed policy is whether an uptick in wage costs and **evidence that underlying inflation is rising at its fastest pace in 10 years** will prompt a revisiting of this plan. The most recent statement from the FOMC suggests it may not, as a shift in language was viewed by many as a sign that the Fed may be willing to tolerate (and in fact may welcome) evidence that inflation will run somewhat ahead of its 2% long-term target.

The effect of Fed policy is not only measured through central bank actions (at home and abroad) but also through the messages sent by bond market. As such, the recent move above 3.0% by 10-year T-Note yields is garnering considerable attention. The early-year test of this level capped a relatively sharp spike in yields. While of some near-term psychological importance, the 3% level itself is likely not meaningful from a longer-term perspective. *What matters more for stocks is the pace at which yields rise (or fall) rather than absolute levels that are achieved.* It is also interesting to note that **the recent move higher in the 10-year T-Note yield has not been confirmed by German 10-year Bund yields.** That could limit near-term upside in yields and help keep Fed Policy from becoming a headwind for stocks.

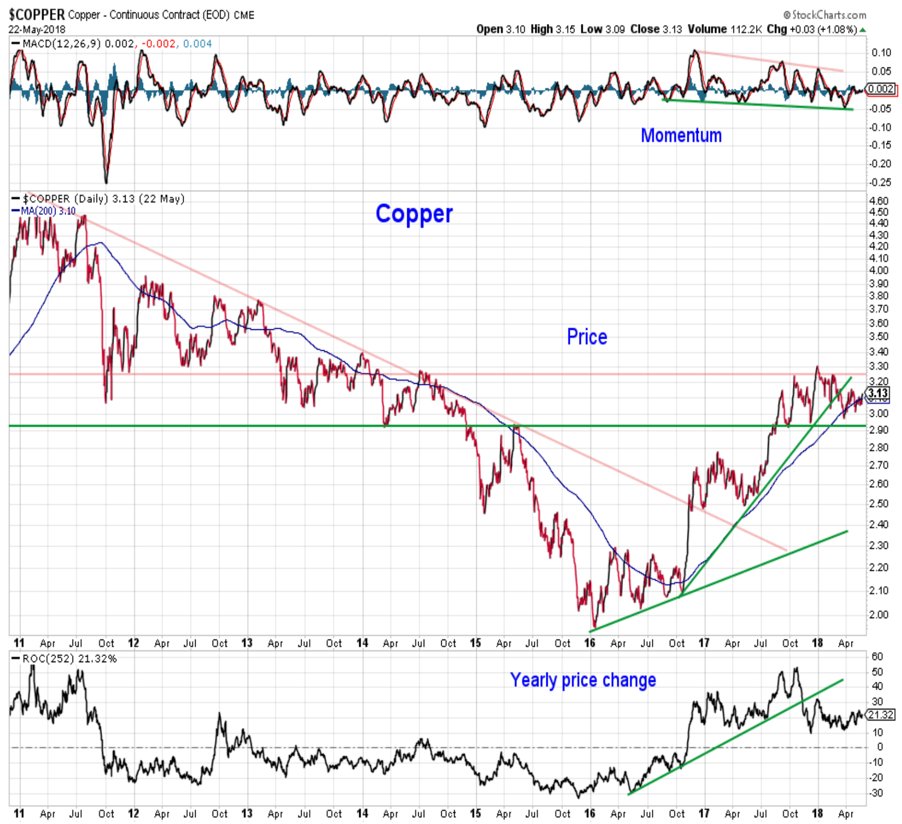
Source: StockCharts



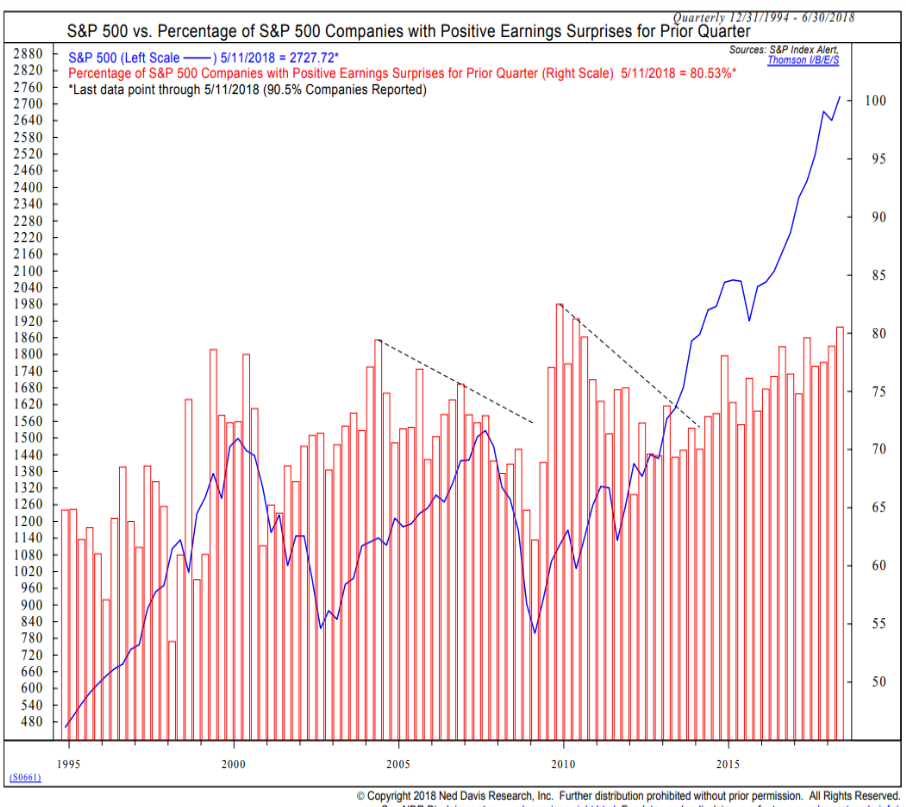
Economic Fundamentals remain bullish. Year-over-year growth in Real GDP continues to move higher, approaching the top of the range that has persisted for much of the past two decades but not yet achieving escape velocity. While the business cycle is perhaps approaching maturity from calendar perspective, research by the Federal Reserve has shown that recoveries do not die of old age.

The most reliable real-time indicators of recession risk suggest there is little evidence that economic weakness is on the horizon. Initial jobless claims have been at their lowest levels since the 1960s, the yield curve has flattened but not inverted, and state-level economic conditions are not consistent with a high risk of recession.

For both evidence of economic vitality and hints of the path forward for bond yields, we watch the price of copper. While its forecasting abilities may be overstated, it can provide timely confirmation of evidence received elsewhere. Just as German Bund yields have not confirmed the most recent rise in U.S. Treasury yields, Copper prices have withheld confirmation as well. Copper prices rose steadily from early 2016 though early 2018, confirming the evidence of economic acceleration and the rise in Treasury yields. **More recently, however, Copper has been in a consolidation mode**. *If growth is going to accelerate and yields are going to have a sustainable path higher, we would expect to see copper resume its trend higher.*



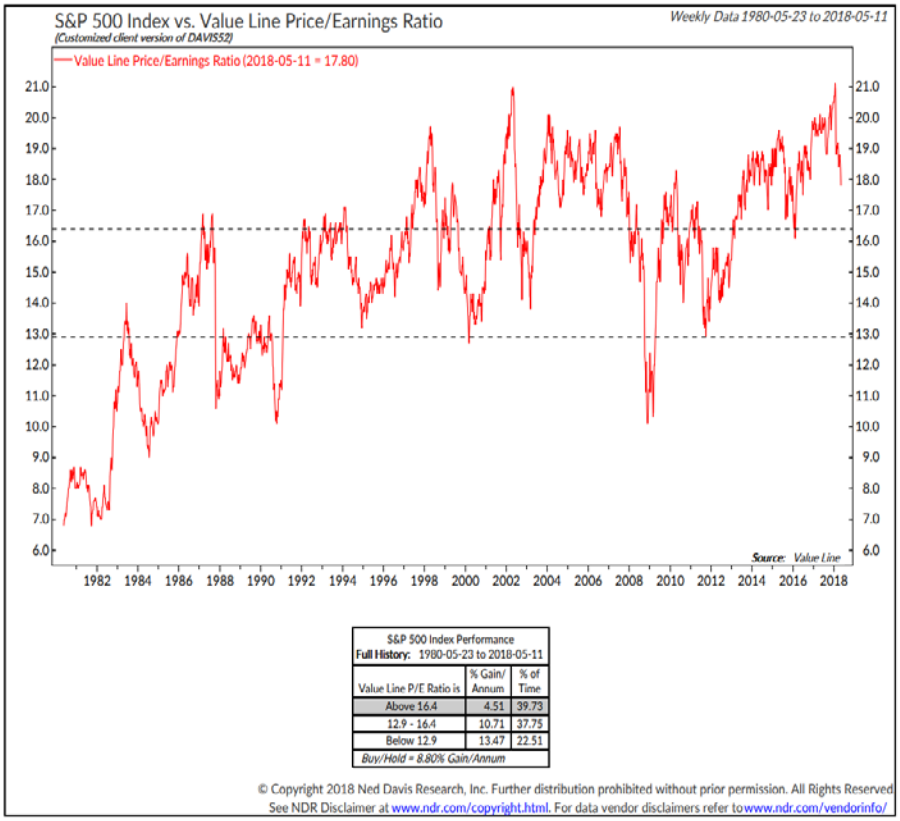
Source: StockCharts



Source: Ned Davis Research

Valuations remain bearish. Improving economic growth and the effects of recent tax reform combined to support strong corporate results in the first quarter. Companies in the S&P 500 combined to show 8% top-line growth and better than 20% bottom-line growth in the first quarter. These were the best growth rates in nearly a decade. **Even with the elevated expectations coming into the reporting season, 80% of companies were able to provide positive earnings surprises.** With the first quarter in the books, the stock market's attention turns to the remaining quarters of the year and whether companies can continue to deliver strong results. *Of particular concern from our perspective will be the impact on margins of rising labor and energy costs. Earnings strength in the first quarter came on record profit margins.*

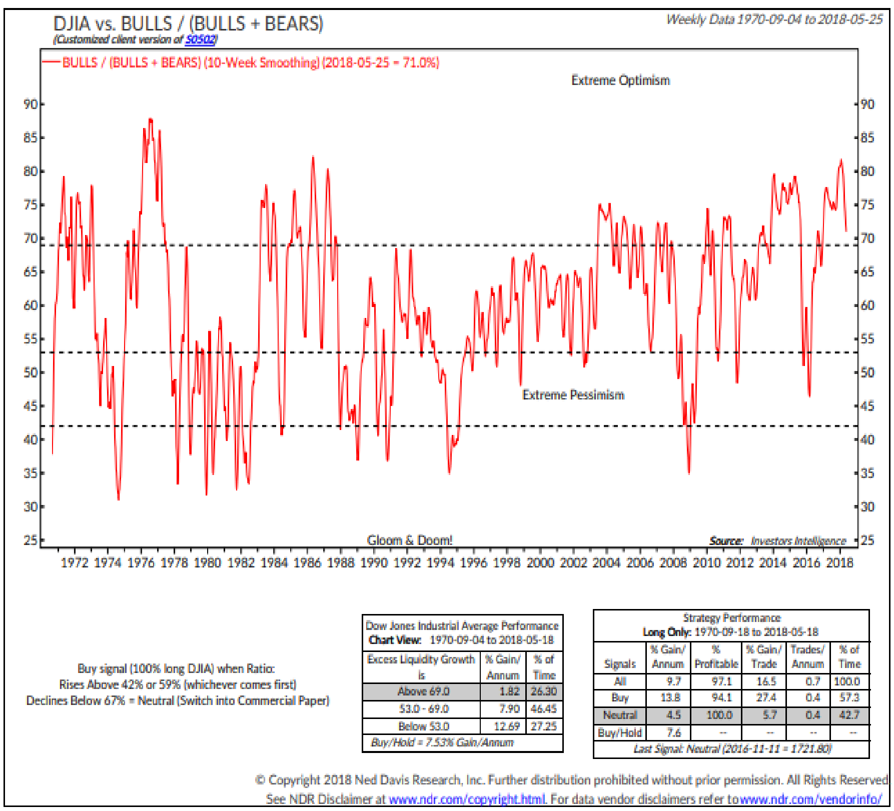
There is not yet evidence that Q1 strength is providing a tailwind for estimates in coming quarters. The earnings tailwind is important right now because valuations remain elevated, even when considering a balance between trailing and expected earnings (which is what is provided in the Value Line Price/Earnings Ratio). One underlying positive in the stock market this year is that price volatility has come at a time when earnings are rapidly growing. **If this continues, it could allow for valuations to quickly move back toward more historically normal levels** and relieve one of the more significant longer-term headwinds for stocks. While this has not yet occurred, valuations are, for the first time in quite a while, at least heading in a more constructive direction.



S&P 500 Index Performance
Full History: 1980-05-23 to 2018-05-11

Value Line P/E Ratio is	% Gain/ Annum	% of Time
Above 16.4	4.51	39.73
12.9 - 16.4	10.71	37.75
Below 12.9	13.47	22.51
Buy/Hold = 8.80% Gain/Annum		

Source: Ned Davis Research



Dow Jones Industrial Average Performance
Chart View: 1970-09-04 to 2018-05-18

Excess Liquidity Growth is	% Gain/ Annum	% of Time
Above 69.0	1.82	26.30
53.0 - 69.0	7.90	46.45
Below 53.0	12.69	27.25
Buy/Hold = 7.53% Gain/Annum		

Strategy Performance
Long Only: 1970-09-18 to 2018-05-18

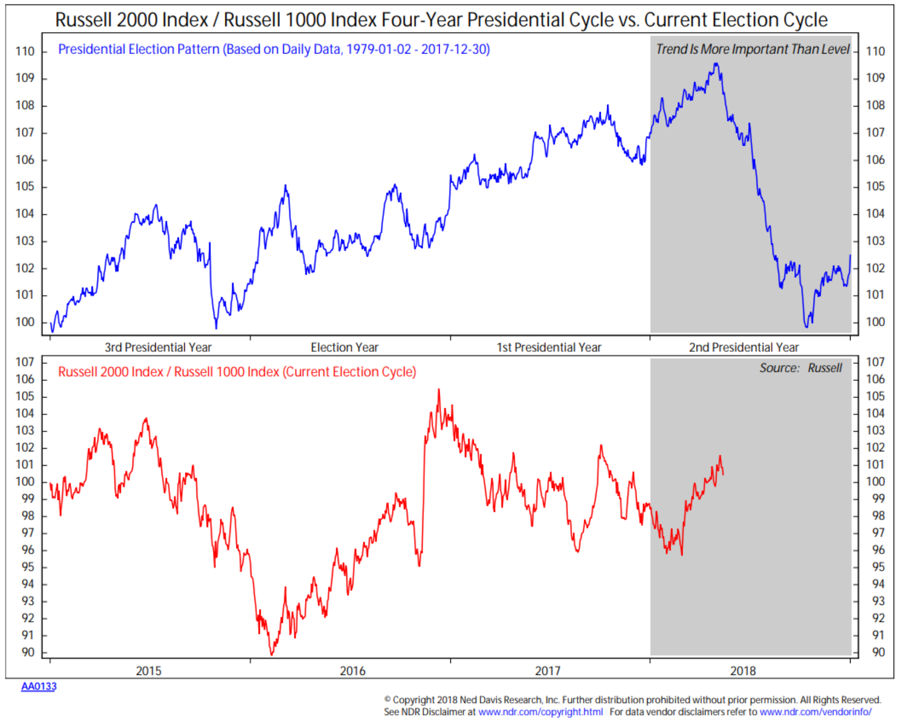
Signals	% Gain/ Annum	% Profitable	% Gain/ Trade	Trades/ Annum	% of Time
All	9.7	97.1	16.5	0.7	100.0
Buy	13.8	94.1	27.4	0.4	57.3
Neutral	4.5	100.0	5.7	0.4	42.7
Buy/Hold	7.6	--	--	--	--
Last Signal: Neutral (2016-11-11 = 1721.80)					

Source: Ned Davis Research

We are, for now, keeping Investor Sentiment as bullish. The pattern among the short-term indicators this year has been that pessimism quickly emerged in periods of volatility and stock market weakness, while optimism returned as stocks stabilized and moved off of their lows. A change in this pattern (a sell-off that does not lead to pessimism or a rally that does come with optimism) could provide evidence about the ultimate resolution of the trading range within which stocks find themselves.

We are more cautious on sentiment from a longer-term perspective. Optimism has pulled back from generational excesses. **But it is hard to construct an argument based on this data that a meaningful level of longer-term pessimism has emerged.**

Seasonal Patterns and Trends have turned bearish. History shows that the two quarters ahead of mid-term elections tend to be the weakest six-month stretch for stocks of the entire four-year presidential election cycle. With control of at least one house of Congress up for grabs and the geo-political policy backdrop as uncertain as ever, there seems to be little reason to argue against the historical pattern at this point. **Small-cap stocks tend to be especially hard-hit heading into mid-term elections, falling even faster than their large-cap counterparts**. This is one reason we have viewed recent new highs from small-caps with some degree of skepticism.



Source: Ned Davis Research

Source: StockCharts

Another reason is that even as the small-cap indexes have been making new highs, up to one-third of the stocks within the indexes have been 20% or more below their individual highs.

This supports our view that Breadth is still neutral. Various advance/decline lines have made new highs, but other measures of breadth have lagged. **The percentage of S&P 500 stocks trading above their 50-day averages and 200-day averages do not show broad strength** and the percentage of industry group in up-trends has yet to show a return to strength.

Most importantly, when the market is ready to move out of the consolidation phase it finds itself in, we expect it will signal this with the type of buying pressure that has historically led to bullish breadth thrust signals. Until then, we are likely to maintain a relatively cautious stance.

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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.
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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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