Baird Market & Investment Strategy

2017 Economic & Stock Market Outlook

December 8, 2016

Please refer to Appendix – Important Disclosures.

Focus on Fundamentals

Outlook Summary

After extended period of sub-par growth, foundation for improved economic trends has been laid.

Wages are rising and economic optimism could help fuel rebound in capital spending.

Better productivity trends key to returning to historically normal growth trends.

Return of earnings growth could help ease valuation concerns for still-young cyclical bull market in stocks.

S&P 500 could reach 2400 in 2017, but rally prospects better in H1 than H2.

Fed may modestly accelerate pace of rate hikes, but relative importance of such moves may fade. 10-year T-Note yield could reach 3.0%.

Progress to Build On

New presidential terms are usually filled with policy uncertainty as the promises of the campaign give way to the realities of governing. Although unified Republican control in both houses of Congress and the White House may seem to suggest 2017 will be an exception to this pattern, the timing and scope of specific policy implementation remain subject to the typical Washington, D.C. sausage-making process. Rather than get mired in the details of potential program and policy changes that may (or may not) occur, our view on the economy for 2017 and beyond focuses instead on the following:

1. The seeds for a sustained upswing in economic growth appear to have already been planted. The inventory correction that was a drag on GDP growth for five consecutive quarters has run its course and export growth has resumed. While the pace of job creation slowed in 2016, this appears to be more related to a lack of available skilled workers than an absence of opportunities. *Wage growth accelerated in 2016 and the number of job openings remains near a record high.*

2. Republican control of both houses of Congress and the White House has raised hopes for significant tax and regulatory reform. *This hope alone (to say nothing of actual progress) could be sufficient to raise CEO confidence, leading to an increase in capital spending that could fuel a resurgence in productivity growth.* This could help fuel continued wage growth and could support GDP growth in the vicinity of 3% over a protracted period of time. While seemingly far-fetched now, this level of growth was more the rule than the exception in the not-too-distant past.

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Taken together, this suggests the United States may well be on the cusp of a new growth paradigm. If this indeed comes to pass, its having begun even before the new administration takes office (or was even elected) could be a detail that gets lost in history. The lack of forecasts calling for a productivity growth-fueled secular shift higher in economic growth does not reduce its likelihood of occurring, in our view. Economic forecasts are often wrong, especially at inflection points associated with an acceleration (or reversal) in an underlying trend.

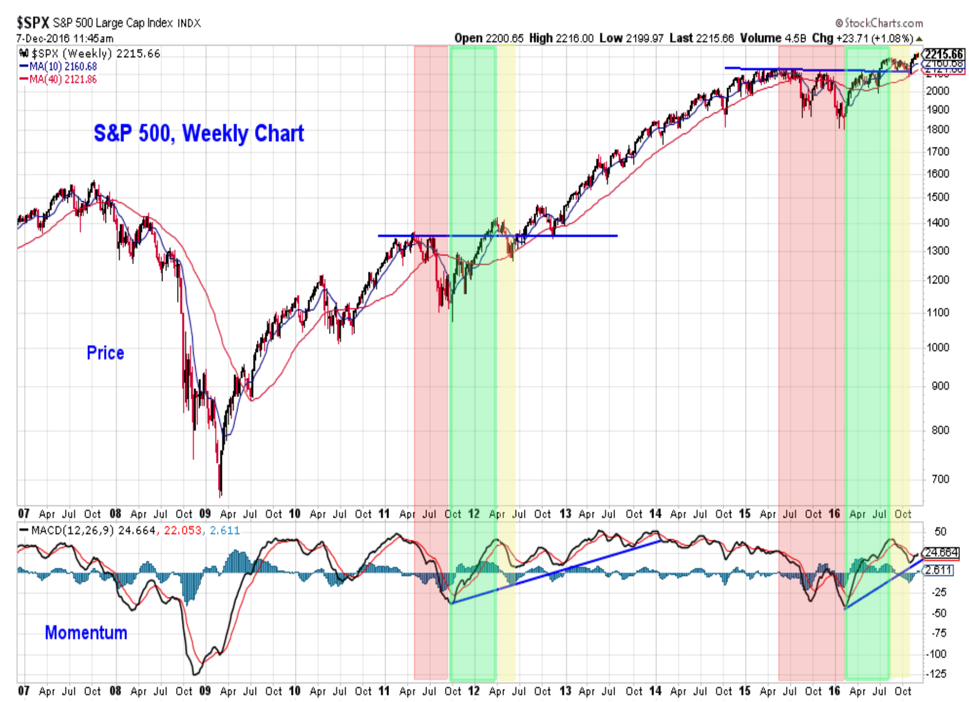
Positive surprises from the economy can become self-reinforcing and can help fuel better-than-expected corporate results. After a sustained period in which forecasts (for economic growth, corporate earnings, interest rates, etc.) have started high and worked lower over time, we may be entering a period in which forecasts need to drift higher to catch up with reality. This may compel the Federal Reserve to modestly accelerate its pace of interest rate hikes (over the single 25 basis point hike seen in both 2015 and, in all likelihood, 2016). We could also finally see stock market valuation relief as earnings growth rebounds.

Two longer-term sentiment trends bear watching: from an asset perspective households have elevated exposure to stocks and relatively little cash on the sidelines but from a flow perspective it is equities that are finally starting to see inflows and bonds that are seeing outflows.

From a seasonal perspective, stocks enjoy a tailwind in the first half of 2017 but the road becomes rockier in the second half of the year. A key consideration from a seasonal perspective for 2017 is whether the historical pattern of reduced fiscal and monetary policy in the first half of a President's term is repeated. **Among the more important technical developments of 2016 was the cyclical bear market low that was made in February.** So while it is true that the S&P 500 has not experienced a 20% pullback since its 2009 low, we have nonetheless experienced two cyclical bear markets (as defined by Ned Davis Research) in that time period. This means that as we move toward 2017, the current cyclical bull market is less than one year old (and within secular-bull markets, these rallies average more than two years in length).

Breadth has improved as stocks have rallied in the fourth quarter of 2016 – an increased number of industry groups are participating in the rally and the Dow Transports are confirming the strength seen from the Dow Industrials. Continued improvement on this front would be a tailwind for the popular averages and help build on the momentum that occurred over the course of 2016.

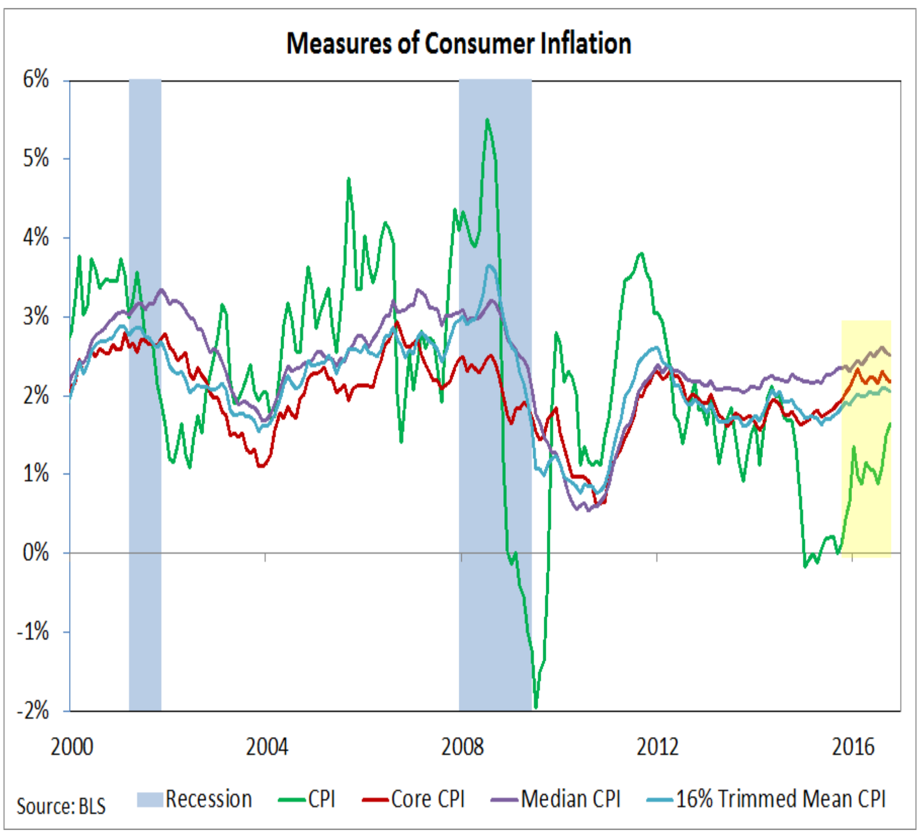
While we can use these annual outlook pieces to cast an eye to the future and spend time considering what might be, our actual investment decisions must remain firmly within a disciplined process where this is balanced against what is actually being seen. *To do this, we need to place these considerations in the context of our weight of the evidence framework.* We will conclude with investment themes that we are focused on for 2017.



Source: StockCharts

Federal Reserve Policy is neutral. There is little evidence (after a single 25-basis-point rate hike in 2015 and another likely to close out 2016) that the Fed plans on pursuing an aggressive rate hike path. The caveat is that if economic growth is accelerating, the pace of tightening may have to increase as well. After several years of downward revisions to the projected path of interest rate hikes, it will be curious to see if this changes in 2017. Either way, with a renewed focus on economic growth (and fiscal policy), the market may be less hung up on every utterance of Fed officials in 2017.

Source: StockCharts

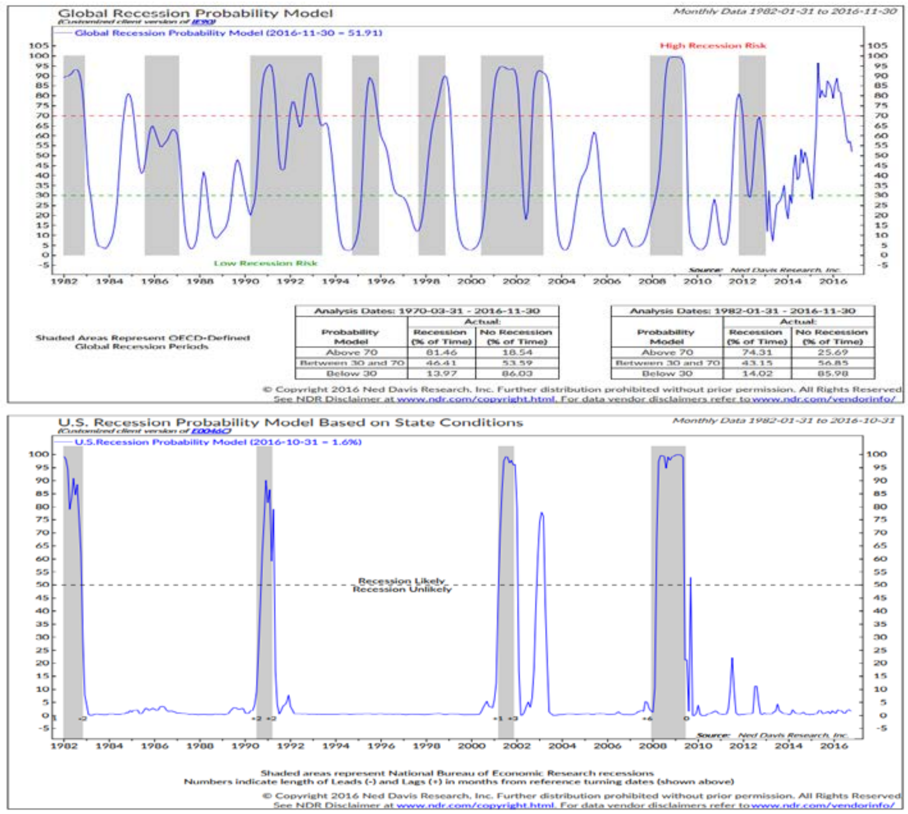


Yields across the Treasury curve bottomed in mid-2016 (with the Brexit vote as a convenient cover-story) and long-term downtrends were challenged as yields climbed in the second half of the year.

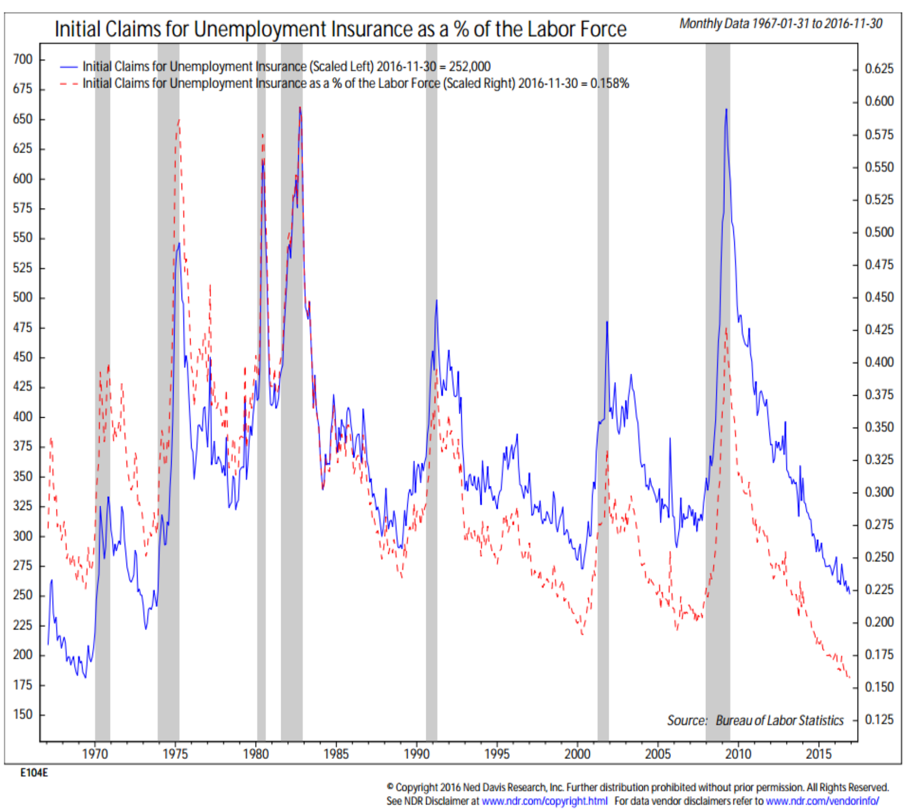
According to research by the Fed, the best index of consumer prices for gauging the trend in inflation is the median CPI (as calculated by the Cleveland Fed). **The yearly change in the median CPI moved to its highest level since 2008 in 2016.** This too could put pressure on the Fed to accelerate its pace of tightening.

We do not expect either bond yields or inflation to run away on the upside, but some continued upward pressure in 2017 seems likely.

Economic Fundamentals begin the New Year as a bullish tailwind for stocks. The prospect of renewed economic growth comes as some forecasters have looked at the calendar and started to worry about the next recession. While recessions have emerged with a fair degree of calendar regularity over the past century, it is not the passage of time that makes them more likely. In fact, research from the Federal Reserve in 2016 suggests the exact opposite – the age of a recovery is not itself a useful indicator when it comes to predicting recessions. **The probability of a global recession is falling and the probability of a U.S. recession remains minimal.**



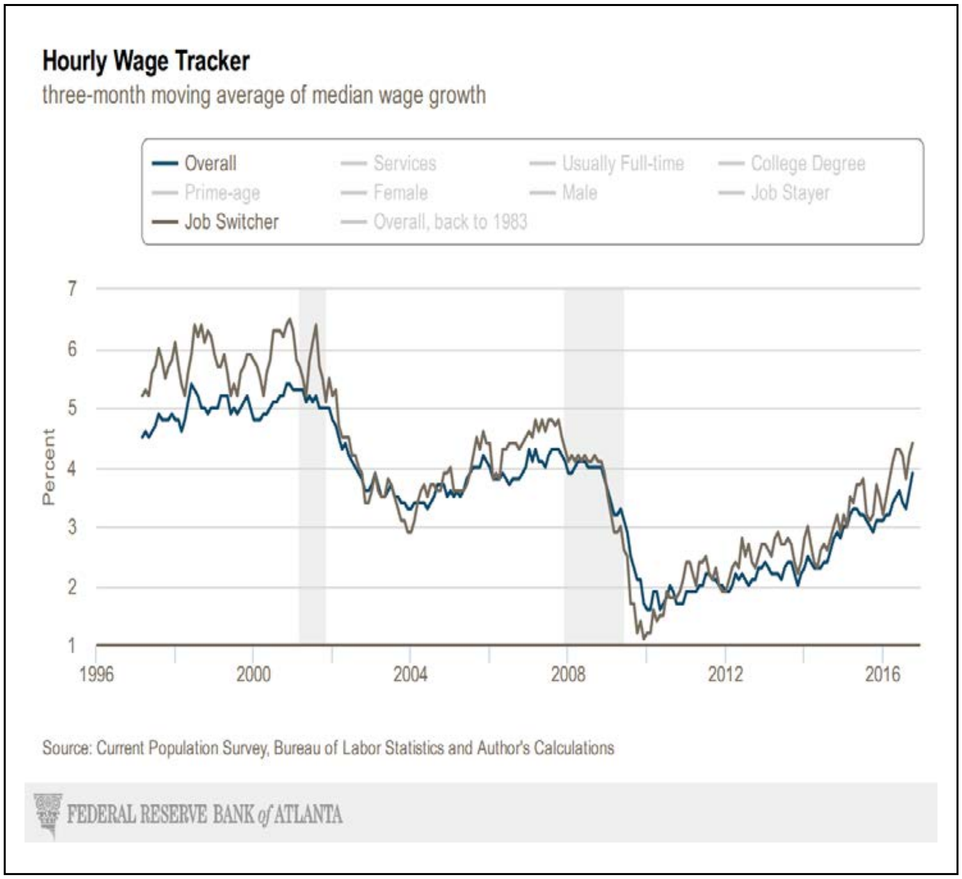
Source: Ned Davis Research

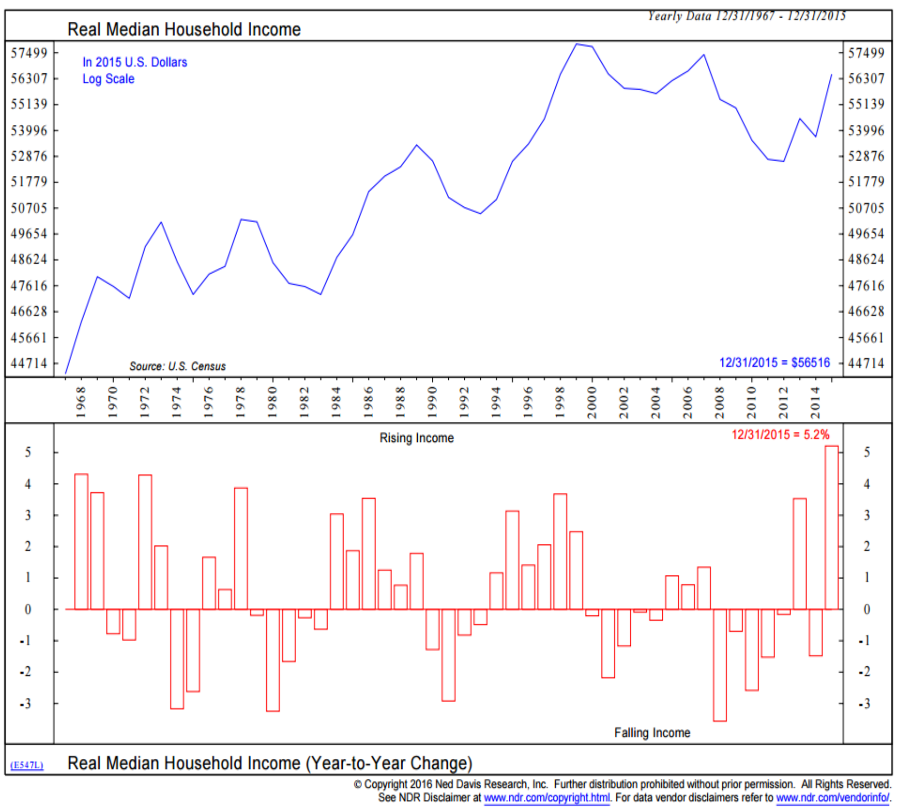


Source: Ned Davis Research

Instead of looking at the number of months since the last recession, one should look at underlying indicators of stress. Two principal pieces of evidence here are initial jobless claims and the slope of the yield curve. Neither suggests now is the time to look for recession. **Jobless claims remain at or near multi-decade lows (depending on whether they are adjusted for the size of the labor force)**, and the recent rise in bond yields has steepened the yield curve.

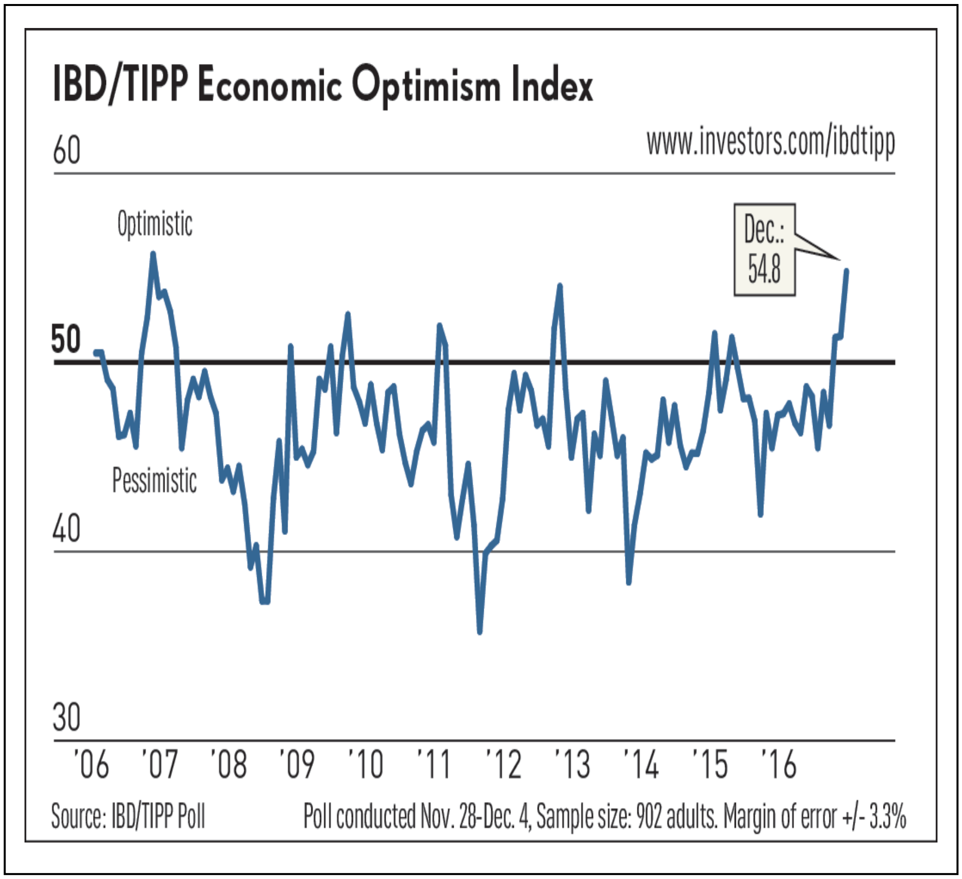
A discussion of recession risk is akin to asking how bad are things. If looking for a meaningful upswing in growth, a better question to ask might be how good things are. The absence of initial jobless claims is encouraging. Even more encouraging is the upswing in wage growth seen in 2016. **Overall, yearly wage growth is close to 4%, according to the Atlanta Fed's median wage tracker.** As evidence the skilled workers are relatively scarce, those switching jobs are seeing their wages grow at the fastest pace since 2007.



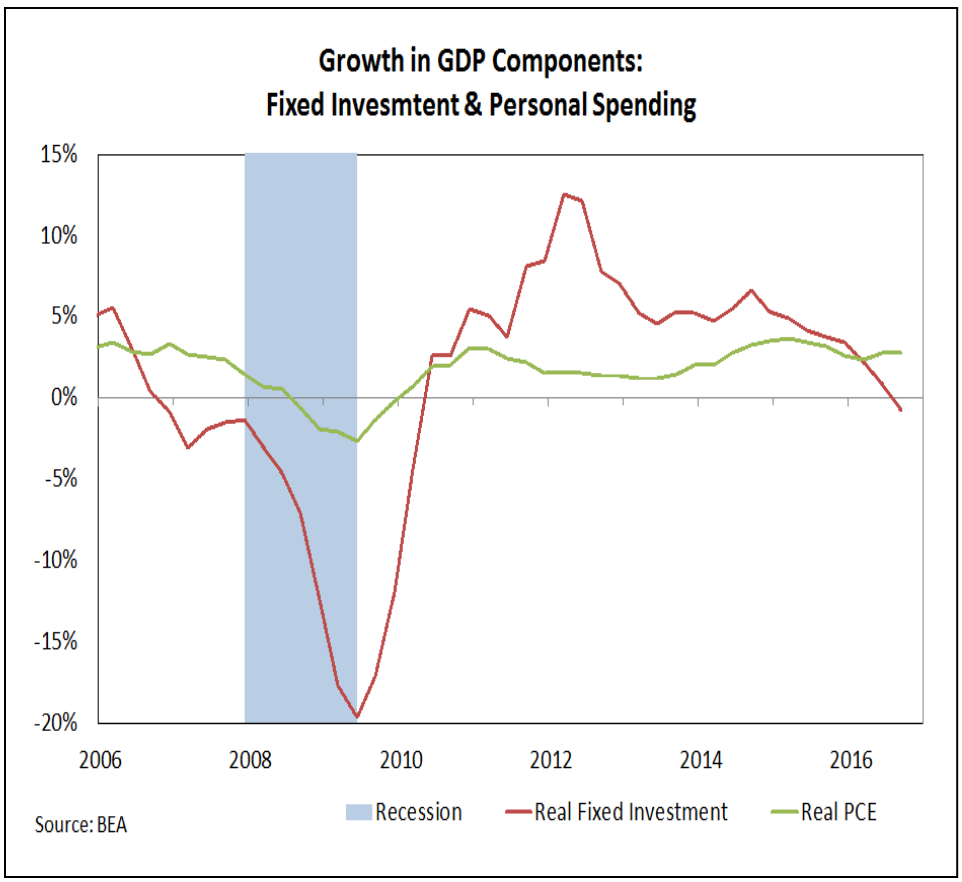


Source: Ned Davis Research

Yearly data on real median household income echoes this improvement. **While still shy of the 1999 peak, real income surged in 2015, rising to its highest level since 2007 and showing the best growth in decades.** While the pace of hiring has indeed slowed in 2016, the wage and income data suggest this is a supply issue (lack of available workers) rather than a demand issues (no job openings). While not always evident in the headline GDP data, this suggests that the economy has been laying the groundwork for improved growth in 2017.

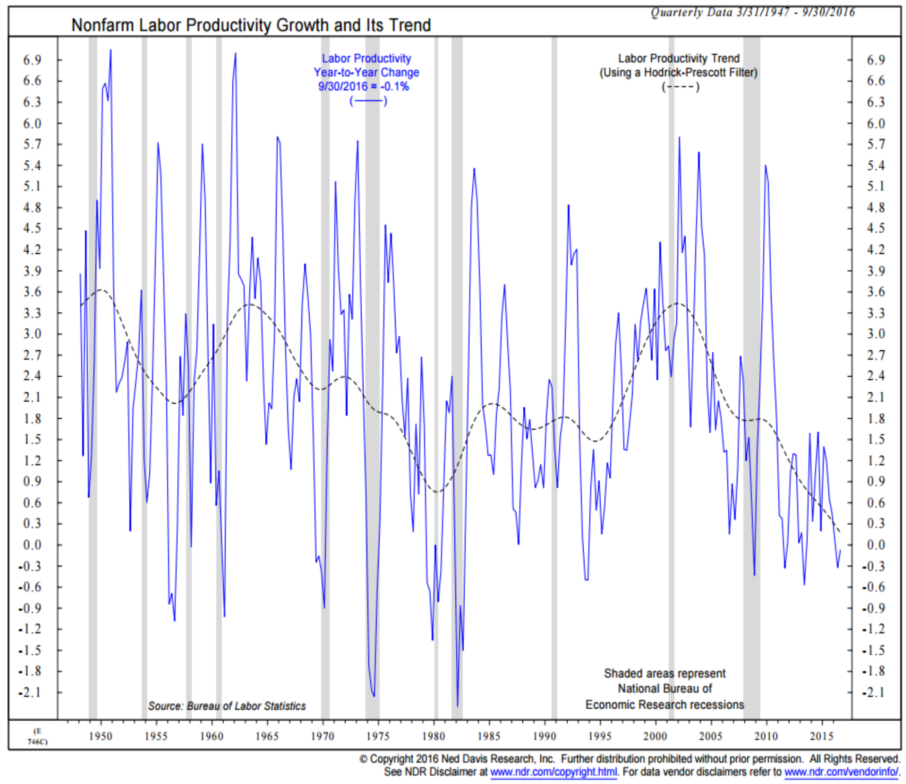


One missing ingredient had been optimism about the economy, but that now is changing. **Economic optimism is finishing 2016 at its highest level in a decade.**

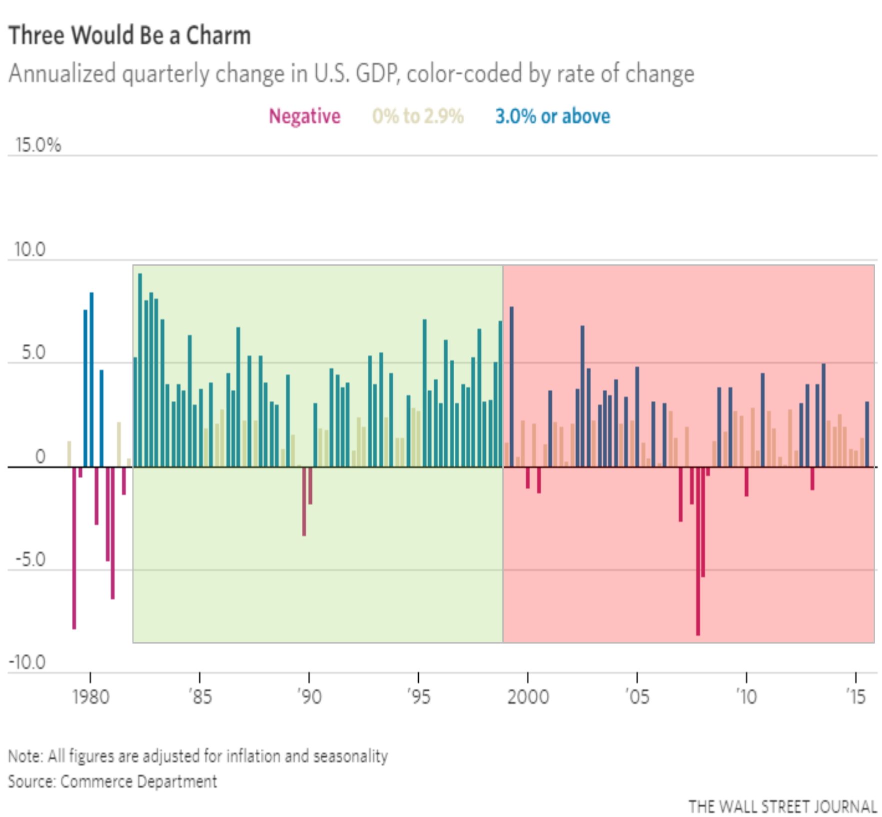


More confident consumers spend more, and more confident CEOs are more likely to invest for the future. There is a strong relationship between CEO confidence today and real capital spending over the coming year. **Meaningful tax reform and a more favorable regulatory environment could be elusive in practice, but the hope that they might be forthcoming could be enough to fuel an uptick in capital spending.**

An uptick in capital spending could help fuel resurgent productivity growth. **The last 15 years has been marked by a declining trend in productivity growth, not unlike what was seen in the second half of the 1960s and the 1970s**. If the economy is going to emerge from the slow-growth malaise of the past 15+ years, it will likely be on the back of an upswing in productivity growth similar to what was seen in the 1980s and 1990s.

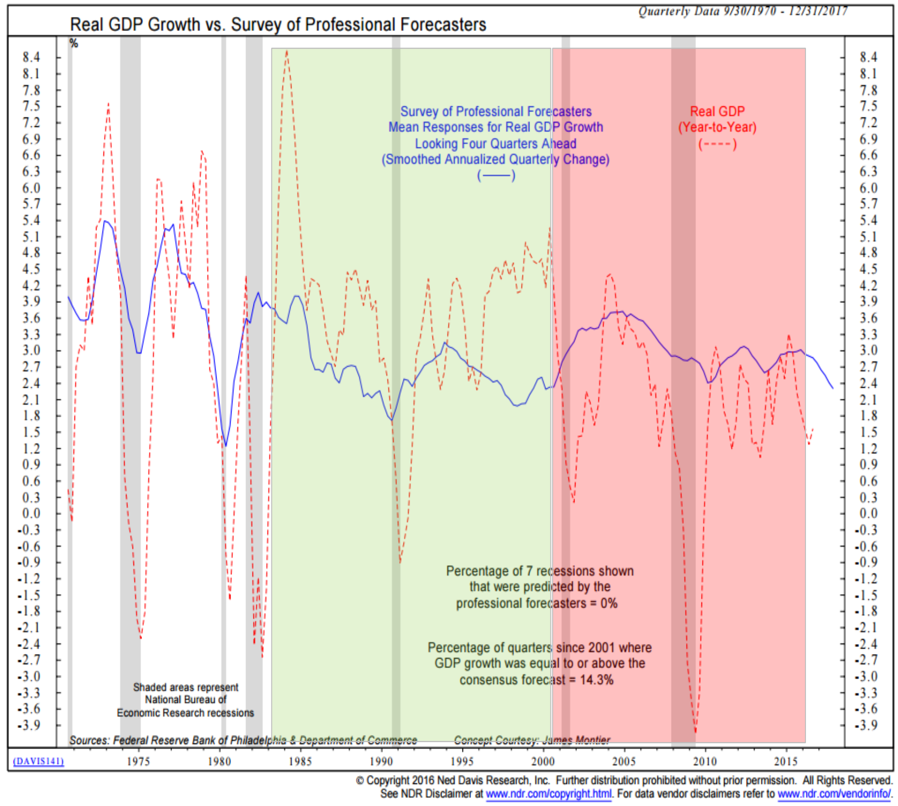


Source: Ned Davis Research

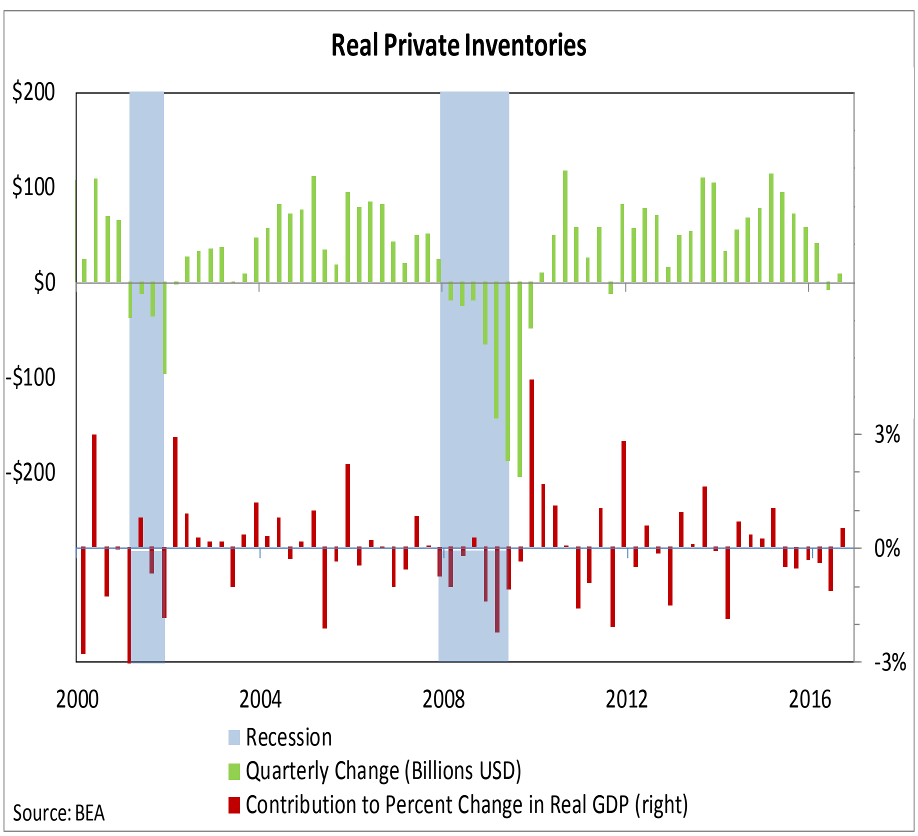


Without better productivity growth, discussions of consistent GDP growth near 3% seems far-fetched. **While GDP growth of 3% has been the exception in this period of declining productivity growth, it was the rule when productivity growth was accelerating.**

Another way to view these two growth regimes is relative to expectations. **While forecasts were too optimistic over the past 15+ years, in the period prior to that they were consistently too pessimistic.** And the surge in growth that signaled the emergence of the new regime in the early 1980s came out of nowhere. Growth surged higher as forecasts were turning lower. Similarly, the shift toward the slow-growth regime also was unexpected, with actual growth faltering at a time when forecasts were moving higher. In other words, the absence of a forecast that we may be entering a secular upswing in growth does not diminish (and could even enhance) the chances of it actually emerging.

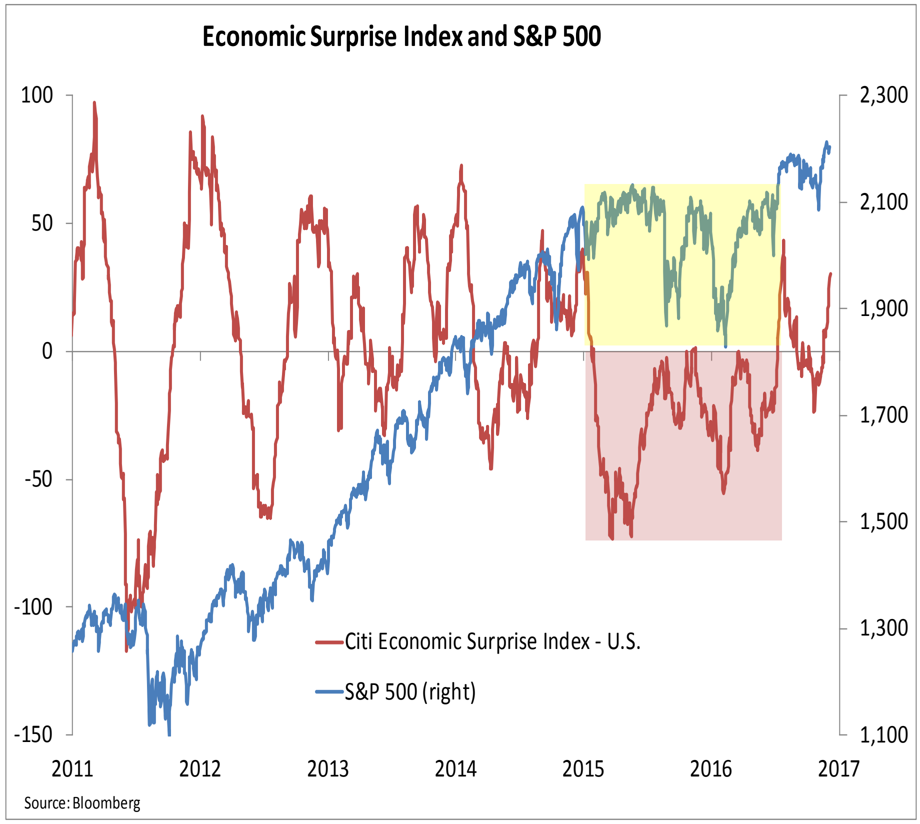


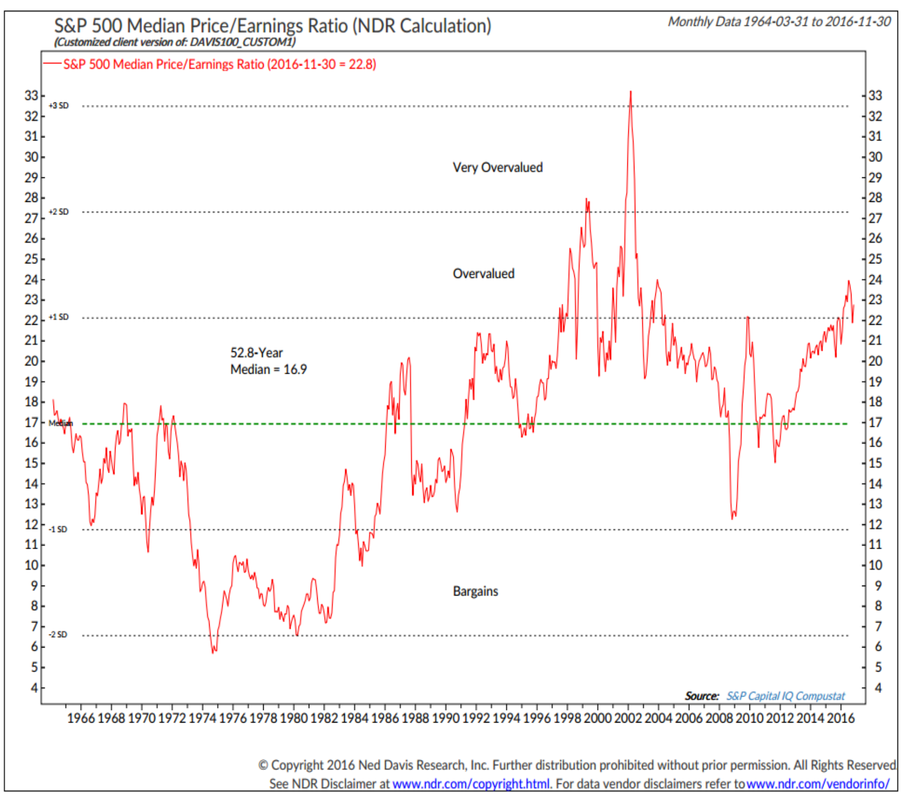
Source: Ned Davis Research



Getting back to the evidence that is already in hand, **2016 witnessed an end of the inventory correction that was weighing on economic growth for better than a year.** This provides a near-term tailwind for the economy as we move into 2017.

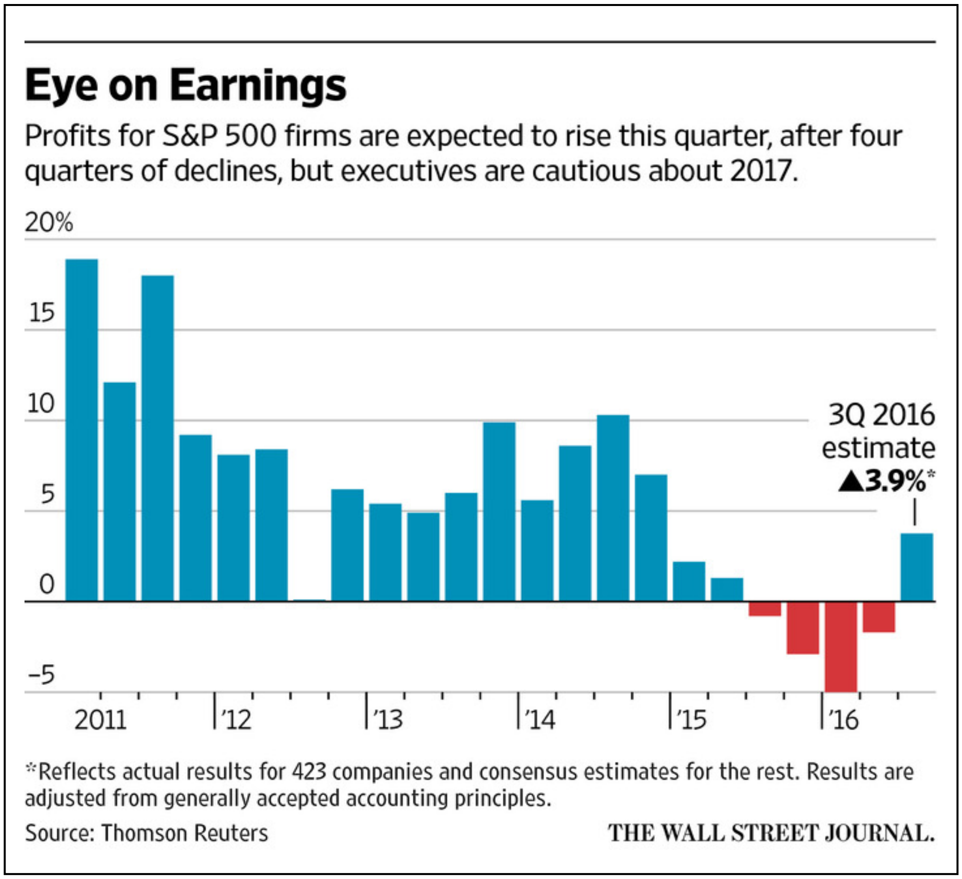
Mid-2016 also witnessed the end of a sustained period of economic data disappointments. The economic surprise index tends to swing regularly from positive to negative as forecasters overcorrect for recent misses. However, at the same time that the stock market was experiencing a cyclical bear market, the economic surprise index remained stubbornly in negative territory. **While we do not expect forecasters to suddenly become more accurate, it is encouraging to see the economy being able to deliver some better-than-expected news, at least on a near-term basis.**



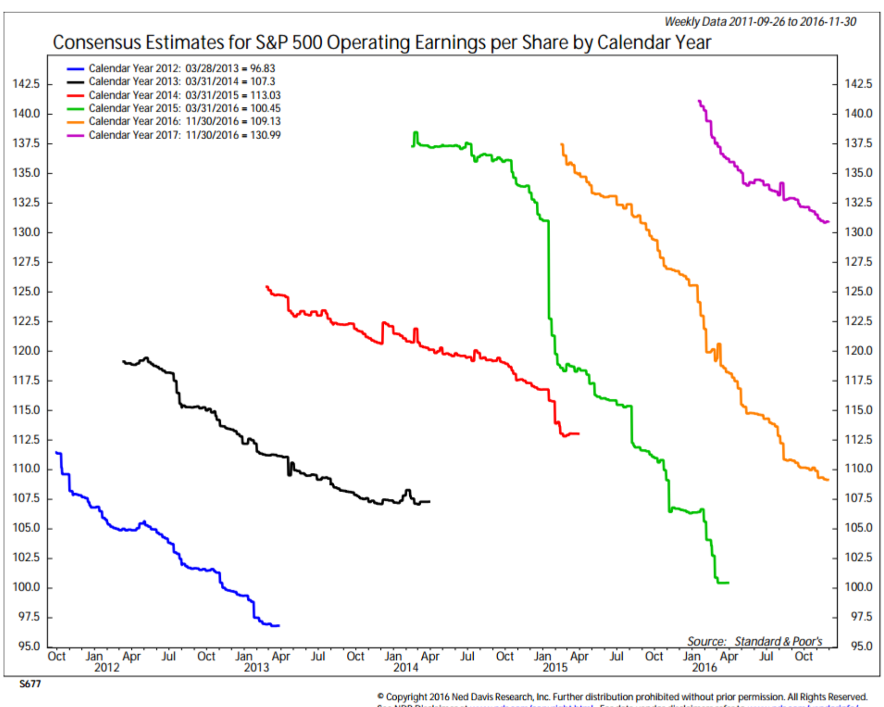


Source: Ned Davis Research

Valuations remain elevated and could be a headwind for further stock market appreciation. The median price/earnings ratio for stocks in the S&P 500 has eased slightly in recent months, but at 22.8 (as of the end of November) it is still more than one standard deviation above its long-term median below 17.



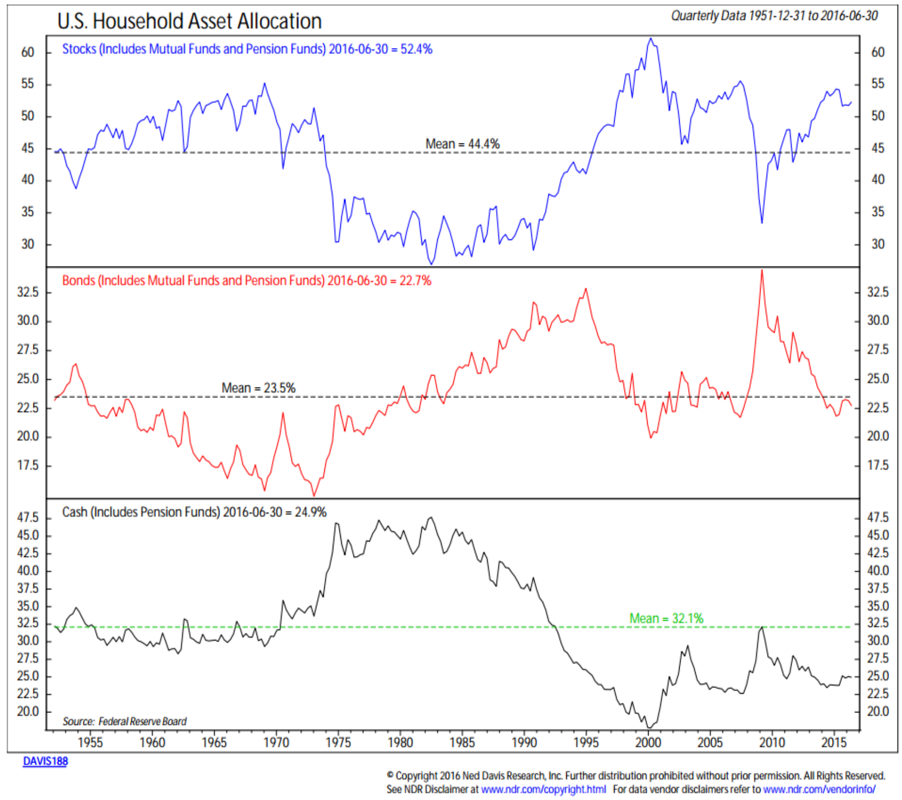
There may be good news on the horizon for valuations. Just as stocks have emerged from a cyclical bear market, and the economy has emerged from an 18-month period of persistent downside surprises, the earnings recession has also ended. **Earnings grew in the third quarter at the best pace since the final quarter of 2014.** This data is confirmed by the profits data in the GDP report.



Source: Ned Davis Research

Earnings forecasts have seen a pattern become well-established in recent years. Estimates for the coming year start off elevated and then work steadily lower over time. **Earnings forecasts for 2017 seem to be following this pattern.** If the economy is indeed entering a new period of better-than-expected growth, an early indication may be a change in this pattern and actually seeing earnings forecasts drift slightly higher. Wishful thinking perhaps, but also something we will be keeping an eye on.

Sentiment surveys will likely continue to show swings between optimism and pessimism and from a tactical perspective we will continue to try to lean away from the crowd at extremes. Heading into 2017, two longer-term indicators of sentiment are worth reviewing. From an asset allocation perspective, **households have well-above average exposure to equities and well-below average exposure to cash.** From this perspective, exposure to stocks looks like a crowded trade.



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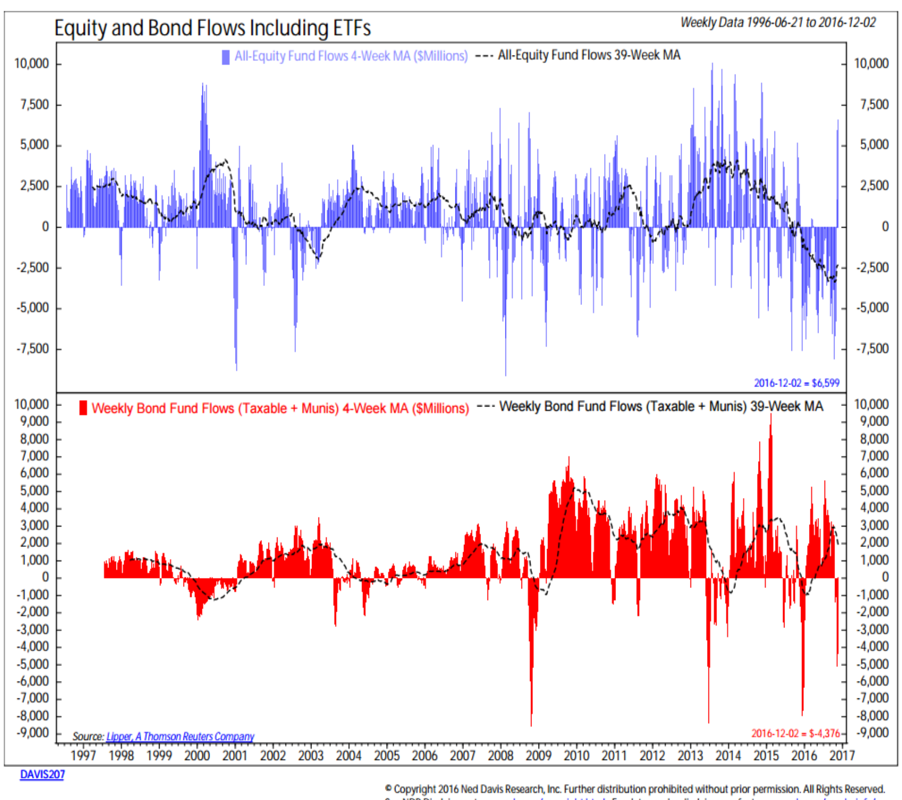
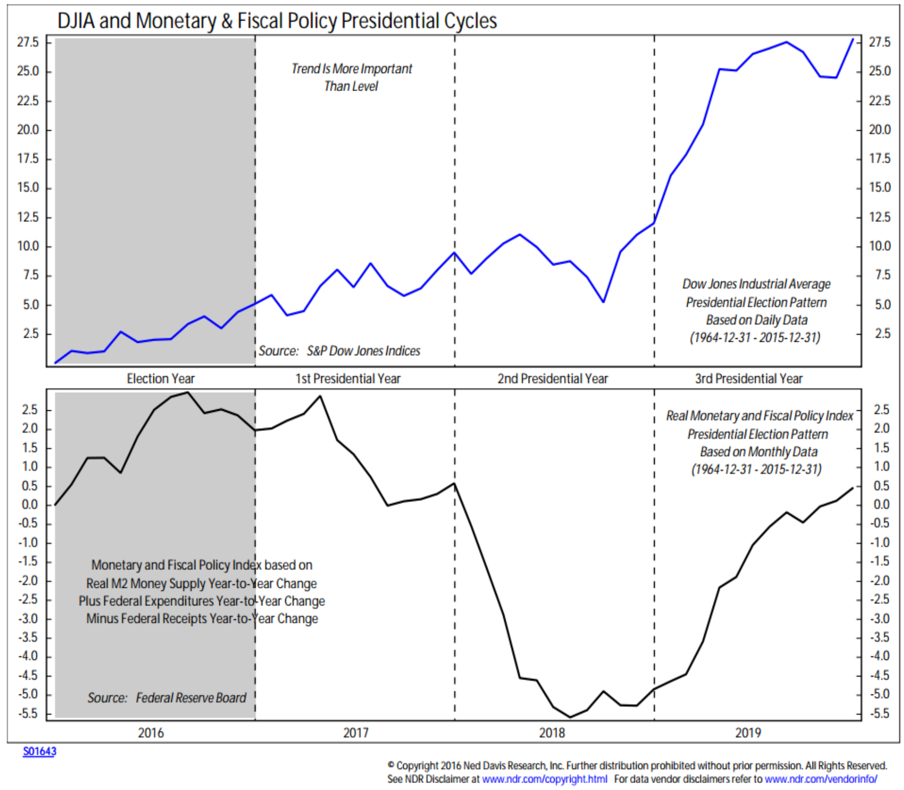


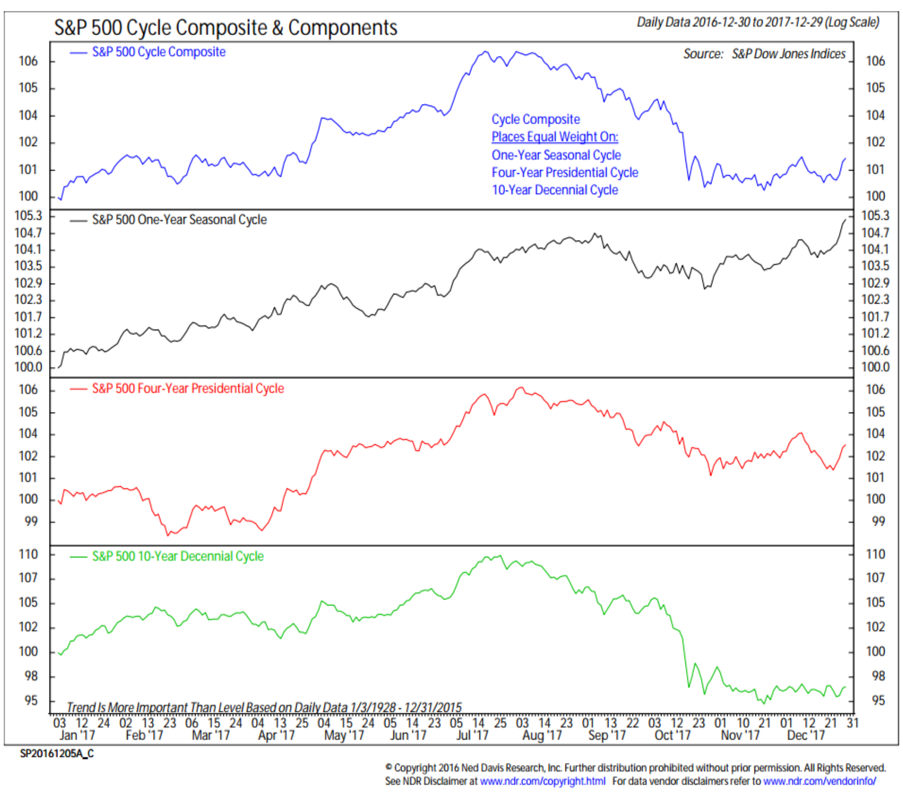
Source: Ned Davis Research

When looking at mutual fund and ETF flows, however, a different picture emerges. Stock funds have seen persistent outflows for over a year, while bond funds have looked like the crowded trade. Both of those trends have started to reverse as 2016 has moved to a close. **Stock funds are finally attracting inflows again and bond funds have started to see outflows.**

Seasonal patterns and trends offer a bullish tailwind for stocks, at least through the first half of 2017. More important in 2017 than the pattern for stock prices may be the normal pattern for stimulus. **Typically, the first two years of a presidential term are marked by less stimulative policies.** The incoming administration faces high expectations of a more favorable environment. Unified control of Congress and the White House seem to favor bucking the historical pattern, and if this happens, it could help keep seasonal tailwinds blowing for stocks.



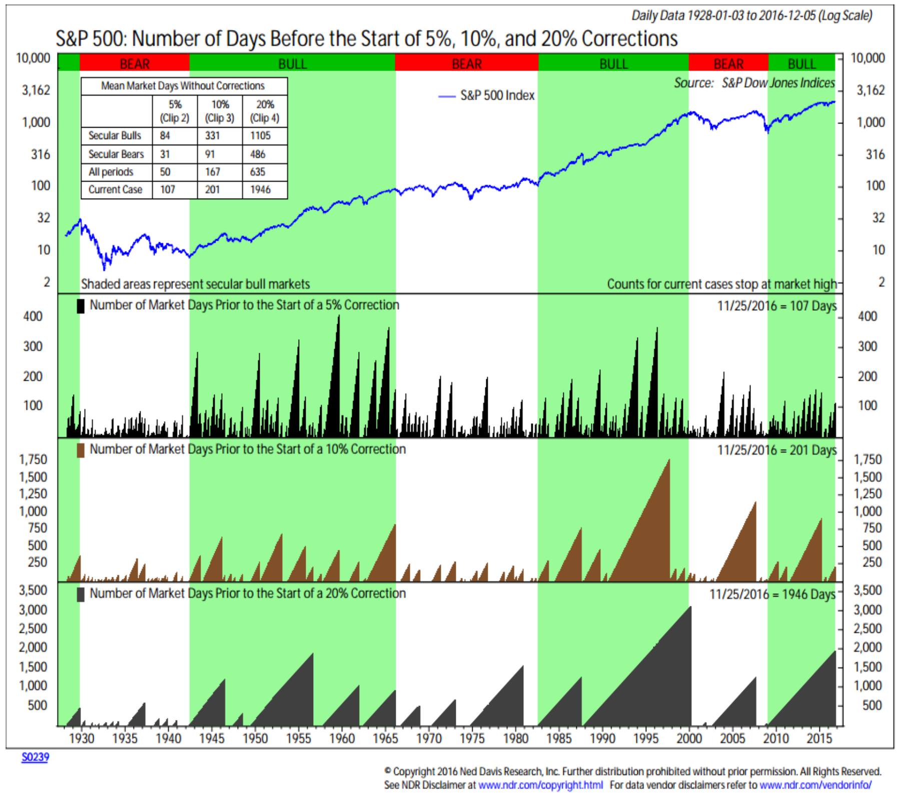
Source: Ned Davis Research



Source: Ned Davis Research

When looking at the composite seasonal pattern for stocks, the path of least resistance could be higher into mid-year. Conditions could cool in the second half of the year, particularly if the new administration's policies prove less stimulative than many now hope and interest rates rise more than expected.

The age of the bull market could also become an item of contention in 2017. **The current secular bull market has yet to experience a 20% pullback**, which suggests to some that such a correction is overdue (and a distinct possibility for 2017).



Source: Ned Davis Research

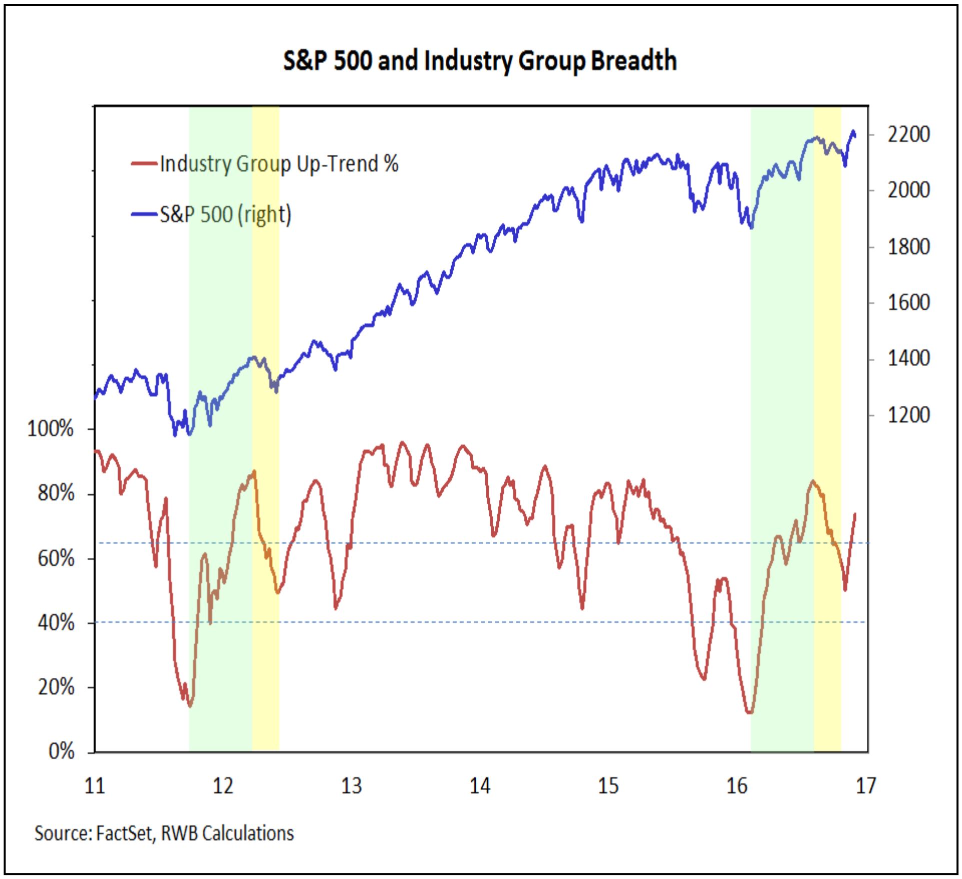
NDR-Defined Cyclical Bear Markets
6/17/1901 - 12/05/2016

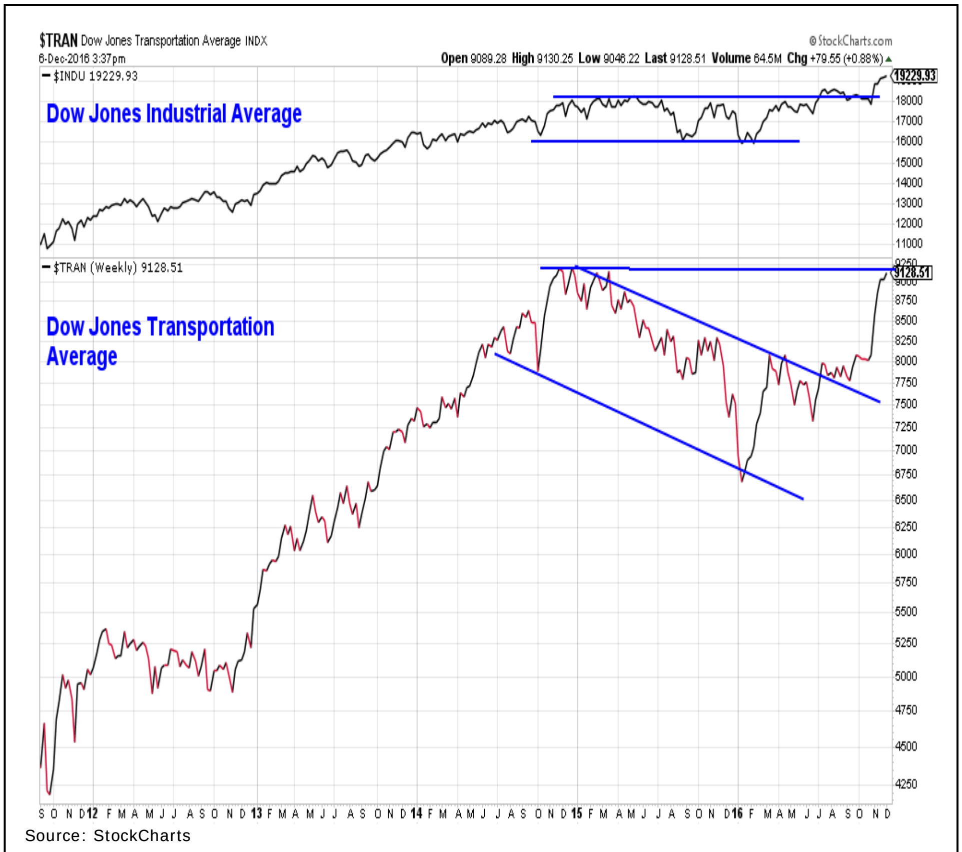
---- Beginning ----		------ Ending ------			
Date	DJIA	Date	DJIA	%Gain	Days
06/17/1901	57.33	11/09/1903	30.88	-46.1	875
01/19/1906	75.45	11/15/1907	38.83	-48.5	665
11/19/1909	73.64	09/25/1911	53.43	-27.4	675
09/30/1912	68.97	07/30/1914	52.32	-24.1	668
11/21/1916	110.15	12/19/1917	65.95	-40.1	393
11/03/1919	119.62	08/24/1921	63.90	-46.6	660
03/20/1923	105.38	10/27/1923	85.76	-18.6	221
09/03/1929	381.17	11/13/1929	198.69	-47.9	71
04/17/1930	294.07	07/08/1932	41.22	-86.0	813
09/07/1932	79.93	02/27/1933	50.16	-37.2	173
02/05/1934	110.74	07/26/1934	85.51	-22.8	171
03/10/1937	194.40	03/31/1938	98.95	-49.1	386
11/12/1938	158.41	04/08/1939	121.44	-23.3	147
09/12/1939	155.92	04/28/1942	92.92	-40.4	959
05/29/1946	212.50	05/17/1947	163.21	-23.2	353
06/15/1948	193.16	06/13/1949	161.60	-16.3	363
01/05/1953	293.79	09/14/1953	255.49	-13.0	252
04/06/1956	521.05	10/22/1957	419.79	-19.4	564
01/05/1960	685.47	10/25/1960	566.05	-17.4	294
12/13/1961	734.91	06/26/1962	535.76	-27.1	195
02/09/1966	995.15	10/07/1966	744.32	-25.2	240
12/03/1968	985.21	05/26/1970	631.16	-35.9	539
04/28/1971	950.82	11/23/1971	797.97	-16.1	209
01/11/1973	1051.70	12/06/1974	577.60	-45.1	694
09/21/1976	1014.79	02/28/1978	742.12	-26.9	525
09/08/1978	907.74	04/21/1980	759.13	-16.4	591
04/27/1981	1024.05	08/12/1982	776.92	-24.1	472
11/29/1983	1287.20	07/24/1984	1086.57	-15.6	238
08/25/1987	2722.42	10/19/1987	1738.74	-36.1	55
07/16/1990	2999.75	10/11/1990	2365.10	-21.2	87
07/17/1998	9337.97	08/31/1998	7539.07	-19.3	45
01/14/2000	11722.98	09/21/2001	8235.81	-29.7	616
03/19/2002	10635.25	10/09/2002	7286.27	-31.5	204
10/09/2007	14164.53	03/09/2009	6547.05	-53.8	517
04/29/2011	12810.54	10/03/2011	10655.30	-16.8	157
05/19/2015	18312.39	02/11/2016	15660.18	-14.5	268

Source: Ned Davis Research

While we have not seen a 20% correction, **stocks have still endured two cyclical-bear markets (as defined by Ned Davis Research) over the past five years.** This is important because rather than a rally that is getting long in the tooth and overdue for correction, it actually seems that we are in the early stages of a new cyclical expansion. When such rallies emerge in the context of a secular-bull market, they last, on average, more than two years. This reduces the likelihood of a significant pullback in 2017. It does not reduce the likelihood, however, of normal stock market volatility.

Breadth is improving as 2016 draws to a close. The rally off of the February 2016 lows, and then again off of the November 2016 lows have both been **accompanied by strong support at the industry group level**. This is in contrast to rallies seen over the course of 2014 and, especially, 2015, which saw participation narrow over time.





Source: StockCharts

Another favorable development in 2016 was the Dow Transports getting back in gear and confirming the strength in the Dow Industrials. Again, this a night-and-day difference between what has been seen in 2016 and what was seen in 2015. Areas of lingering concern from a broad market perspective include an elevated (although fading) number of stocks making new lows and uncertain rally participation from a global perspective.

Investing Themes and Considerations for 2017

The single most important piece of advice for most investors continues to be knowing the biases that we bring to the table with us. We need to be alert to our tendencies to search out confirmation, to construct faulty narratives, and to lean too heavily on a veneer of precision. *More than ever, our encouragement is investor, know thyself*.

In terms of asset allocation, elevated stock market valuations keep us hesitant to aggressively overweight equities. But risks may be even more pronounced for bonds, and so we continue to suggest investors should tilt toward cash. If even historically normal volatility is seen in 2017, there may be opportunity to tactically put this to work. Our guess is that we will continue to see spikes in realized volatility next year.

Within fixed income, we would prefer to take credit risk rather than interest-rate risk. This means a focus on corporates rather than Treasuries.

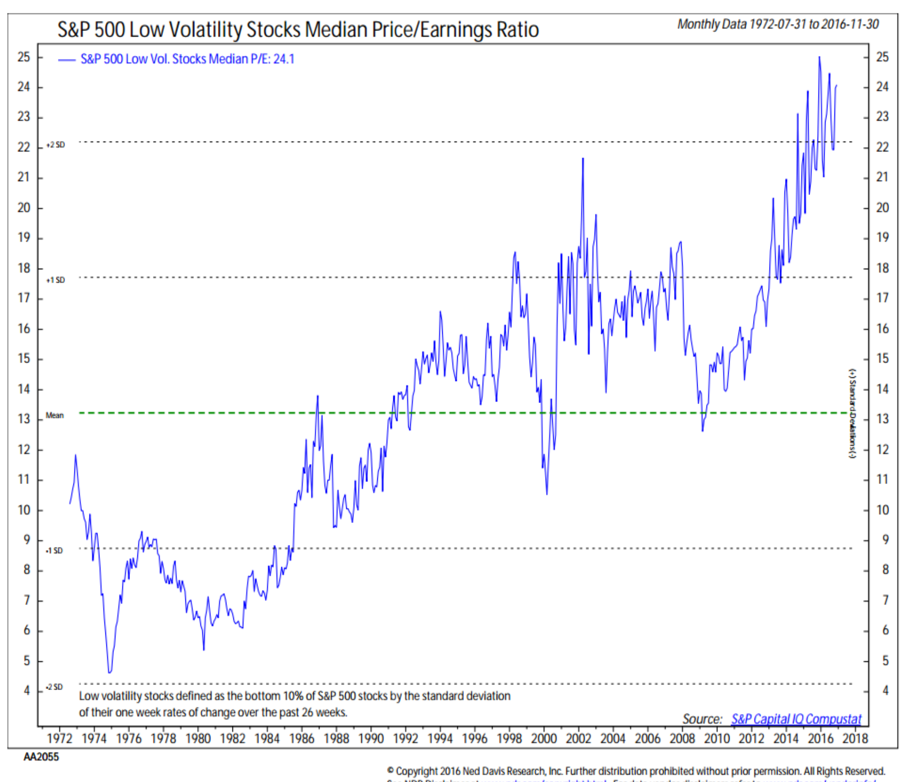
Looking at equities, the long-term trend favoring U.S. leadership versus international stocks continued to assert itself in 2016. The Russell 1000 made a new high versus the MSCI EAFE index as momentum favoring the U.S. surged ahead. We do not see evidence that this will not continue in 2017. While there may be a case for diversification, it can be overdone and we would argue for a continued tilt, at least on a tactical basis, toward U.S. stock market exposure.

While emerging markets faltered in the wake of the November presidential election, they have been strong relative performers (versus other international stocks) in 2016 after a multi-year period of underperformance. Emerging markets continue to offer relatively favorable risk/reward prospects.

From a size perspective, small-caps had a banner year in 2016, doubling the return of the S&P 500. Leadership here comes after several years of relative underperformance. Small-cap leadership at the index level is confirmed by relative leadership from small-cap industry groups (versus their large-cap counterparts).

From a sector perspective, 2016 saw a rotation from early leadership by defensive, low-volatility sectors to more cyclical leadership. For the year overall (as of early December), the best-performing sectors are Energy, Industrials, and Financials. If our expectation for a drift higher in interest rates and improving growth trends bear out, these sectors could be well-positioned to continue to lead in 2017. More recently, Consumer Discretionary has improved in relative strength and could be poised to be an outperformer in 2017.

An area of specific concern for 2017 remains the still-crowded and historically expensive defensive/low-volatility/high-dividend space (it goes by different names, but the exposure often has significant overlap). With bond yields drifting higher and growth prospects improving, investors may lose patience with these themes as the back-tested outperformance fails to be realized in real-time. If so, the outflows and underperformance seen in the second half of 2016 could carry into 2017.



Source: Ned Davis Research

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