2019 Mid-Year Update

June 27. 2019

BAIRD

Please refer to Appendix – Important Disclosures.

Outlook Summary

Evidence positive as central banks lower interest rates

Tariff concerns lead to shriveled green shoots and higher uncertainty

Resilient economy and broad market support keys for second-half strength

After a decade of strength, forward stock market returns could be muted

Evidence Has Improved, But Risks Remain

Highlights:

- **Central Bank Easing Supports Stocks**
- **Economic Uncertainty Could Weigh On Confidence**
- **Earnings Estimates Moving Lower**
- **Household Equity Exposure Remains Elevated**
- **Noise Disrupting Seasonal Patterns**
- **S&P 500 Struggling To Find Broad Market Support**

The first half of 2019 saw the weight of the evidence to improve to neutral following the emergence of early-year breadth thrusts, and then to slightly bullish as central banks have turned more accommodative. While the evidence has improved and the first half of 2019 witnessed new highs on the S&P 500, risks remain elevated. Our focus now needs to be on the second half of the year, what it might hold, what we are paying closest attention to, and what investors can do about it.

While it is tempting to pay close attention to the market events of each day, the current environment has more than its share of noise and distractions. In answering a recent question about the FOMC's Dot Plot, Fed Chair Jay Powell cautioned that paying too much attention to each dot could cause one to lose track of the larger picture. The same can be said when looking at the impressionist paintings of Monet or Pissarro. Paying too much attention to each brushstroke can distract from the larger picture. An initial encouragement for the second half of 2019 is to look past tweets about trade policy and tireless dissections of uncertain comments from the Fed. Keep the bigger picture squarely before you.

In the wake of a more friendly central bank backdrop, we are looking for resiliency from the U.S. economy after a decade of expansion and evidence that stock market strength goes deeper than just headline index-level returns. Before proceeding, a word of caution: While the past decade has produced strong results for those resilient enough to remain engaged with stocks, returns for the next decade may be more muted. With valuations elevated and with households, institutions, and foreign investors having historically elevated exposure to equities, now may not be the time to think about aggressively moving from cash to stocks.

Indicator Review

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

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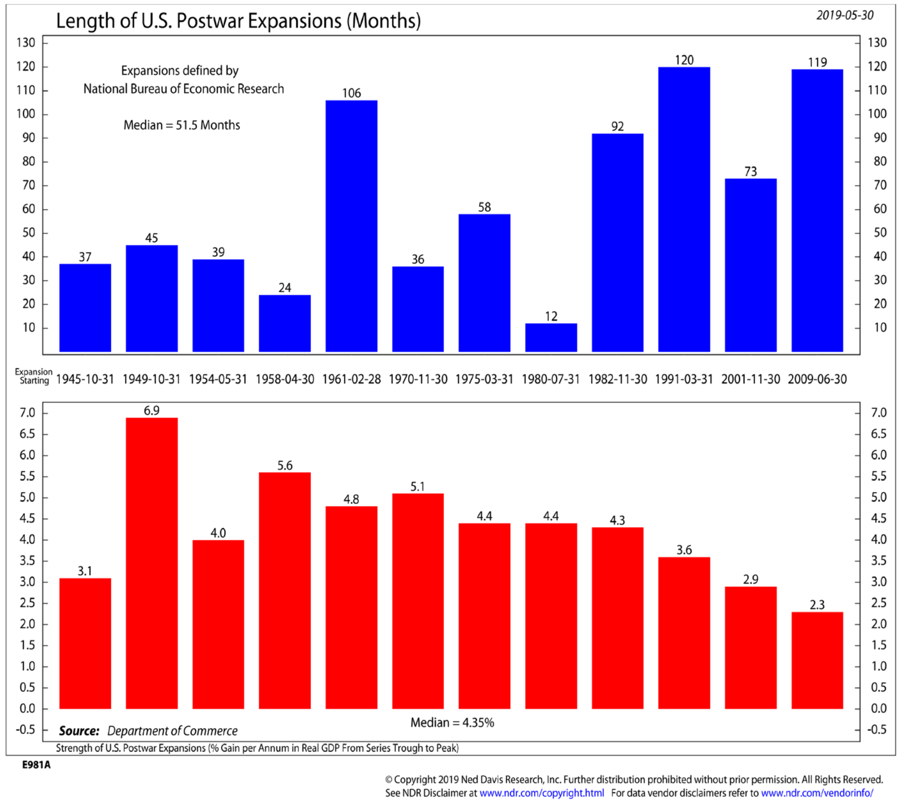
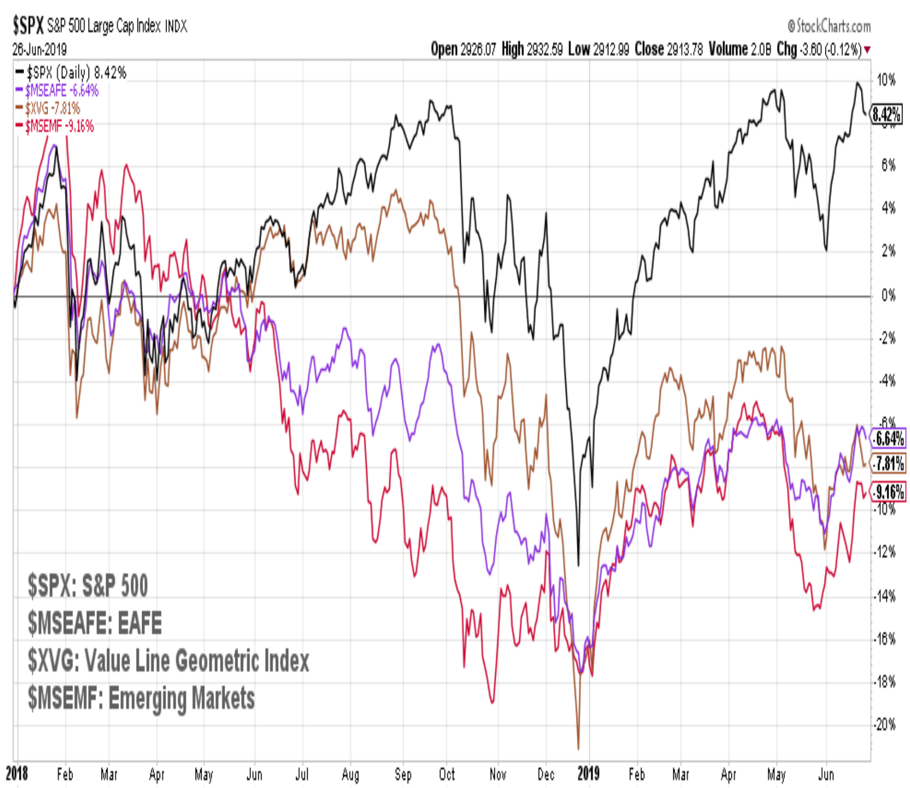
As we move into the second half of 2019, we mark the 10-year anniversary of the current economic expansion. While this makes it the longest on record, it is also the weakest on record in terms of average growth. Expansions do not die of old age, but risks have been on the rise. The resiliency of the expansion is likely to be tested as we undergo a near-term growth scare, but recession risk remains low for now. As shown below, the last 18 months in the stock market have been uneven. But even with those struggles, the stock market is sitting atop a decade of plenty, as we marked the 10-year anniversary of the March 2009 lows earlier this year.



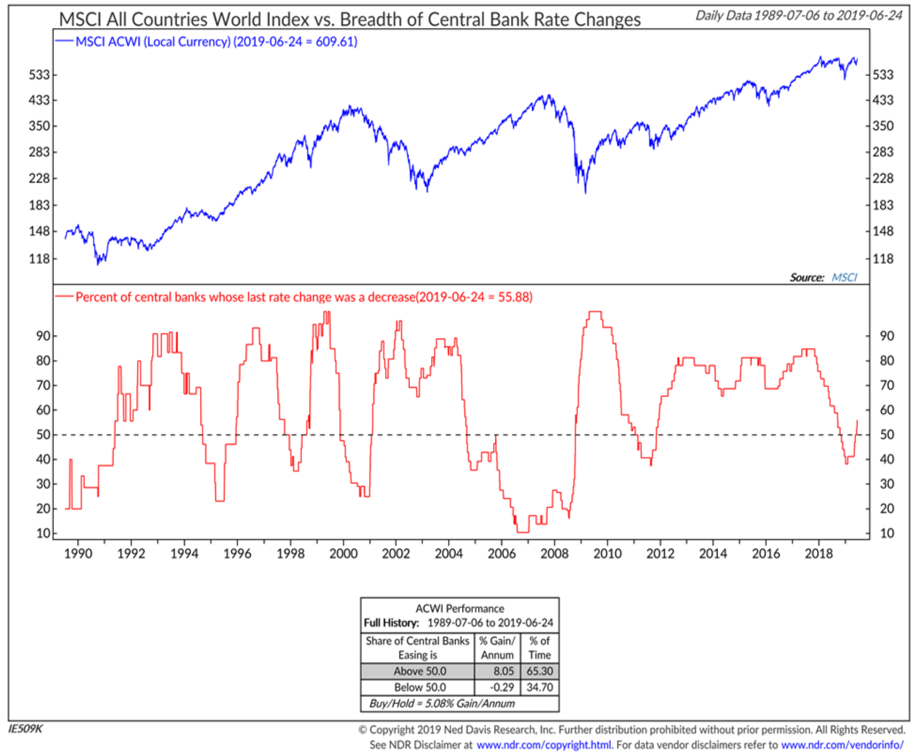
Source: Ned Davis Research



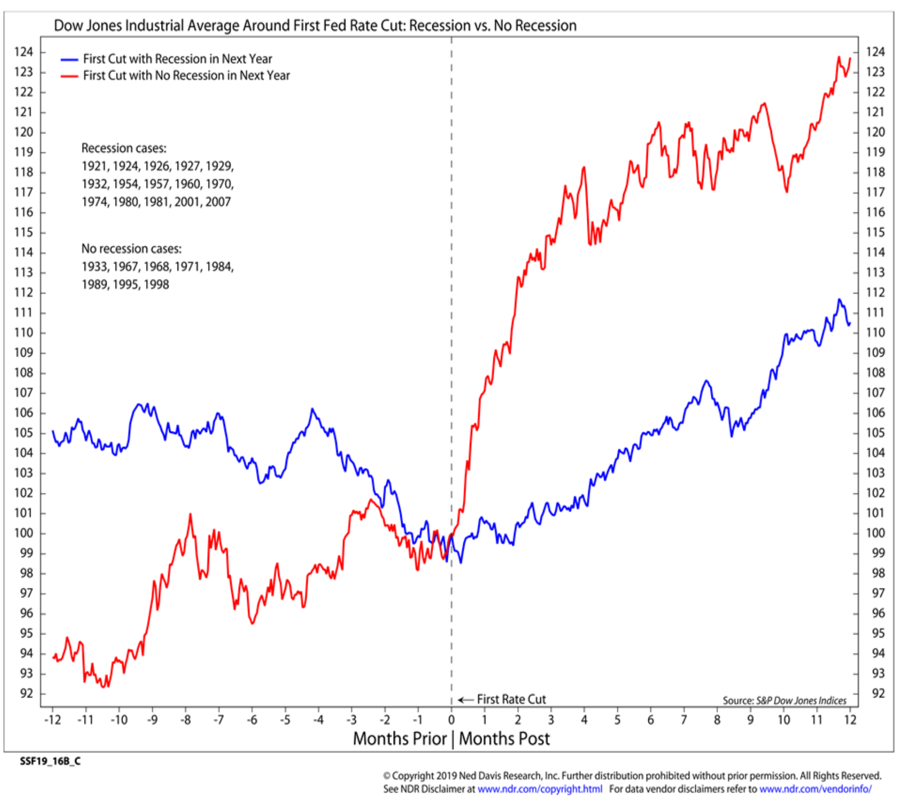
Source: StockCharts

After an initial peak in January 2018, the S&P 500 has gone on to make further new highs in September of 2018, April 2019 and June 2019. While new highs get celebrated (and historically they are a signal of strength), the 8.5% gain for the S&P 500 over 18 months is unremarkable especially in light of the rocky path it has taken to get there. Of greater concern, and an area of focus for the second half, other measures of the stock market have not echoed the S&P 500. International indexes (EAFE and Emerging Markets) as well as a broad index of US stocks (Value Line Geometric Index) are down over the past 18 months. How one feels about the market may be dependent on which of these indexes is being followed. With consumer confidence becoming more closely correlated with stock market performance, this could also impact views on the economy.

Behind the most recent upgrade to the weight of the evidence are signs that global central banks are becoming more accommodative. Out of 34 central banks around the world, 11 have made interest rate changes in 2019. Of these, three have tightened and eight have eased. Overall, more than half of all central banks are now easing monetary policy. All of the net gains in global stocks in the past 30 years have come when a majority of central banks have been lowering interest rates. Whether talking about the Fed specifically or central banks generally, the old adage appears to hold: don't fight them.



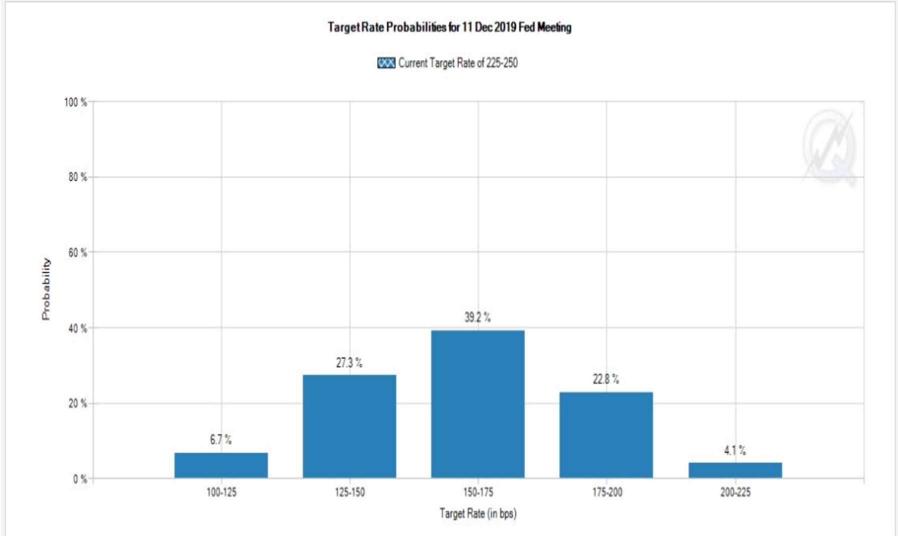
Source: Ned Davis Research



Source: Ned Davis Research

The Federal Reserve is in the minority of central banks whose most recent action was to raise rates. The Fed has spent most of the first half of 2019 trying to pivot away from its December 2018 rate hike. While it declined to cut rates at its June meeting, the Fed is expected to move into the easing camp later this year, perhaps as soon as July. While the last two rate-cutting cycles (2001 and 2007) can anchor investor expectations for a negative stock market reaction, a more complete history suggests the key question is whether an initial rate cut is followed by an economic recession. If the economy is experiencing a growth scare but not moving into recession, a rate cut could be a positive catalyst for stocks (and the economy).

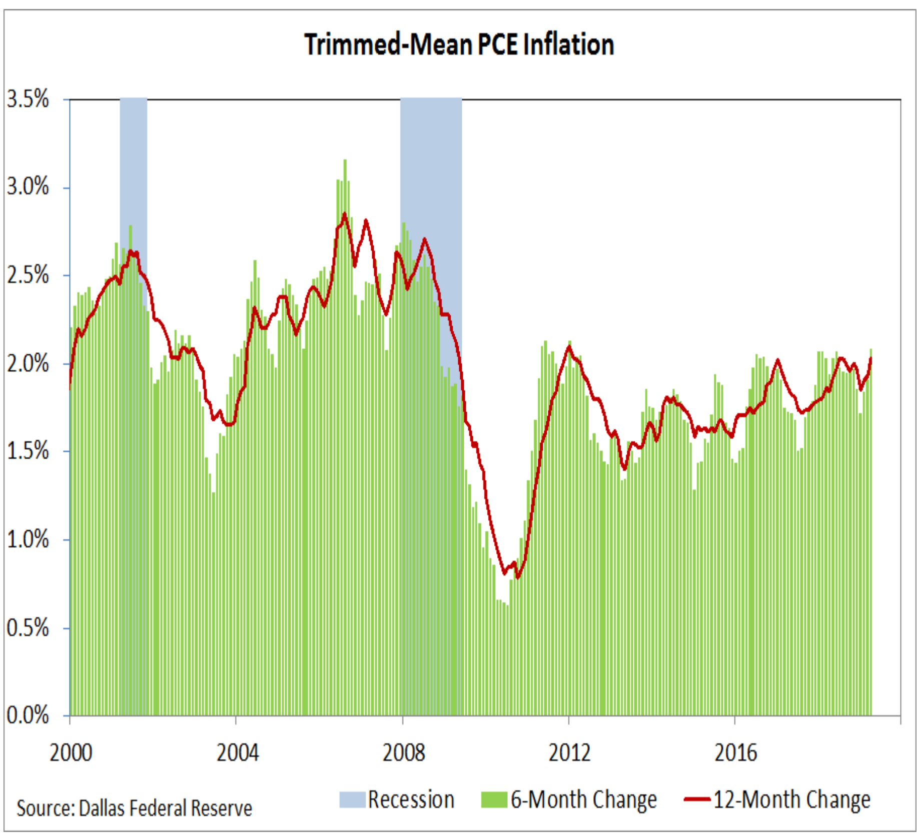
The Fed at this point appears poised to cut rates this year and would likely need to be dissuaded from pursuing this path. There is a risk, however, that the Fed could cut rates and still disappoint the market. As recently as March, fed funds futures saw a 90% chance of no change in rates in 2019 (with a 10% chance of a 25 basis hike by the end of the year). Those same futures now see a 60% chance of 75 basis points or more of easing, with no chance being seeing of rates finishing the year at the current level. There is an unfortunate conflation between financial market gyrations and business cycle dynamics (there can be overlaps, but they are not identical). While it may provoke disappointment, policymakers now more than ever need to look through the former and focus on the latter.



TARGET RATE (BPS)	PROBABILITY(%)			
	NOW *	1 DAY 24 JUN 2019	1 WEEK 18 JUN 2019	1 MONTH 24 MAY 2019
100-125	6.7%	6.3%	1.8%	0.0%
125-150	27.3%	26.7%	13.2%	0.8%
150-175	39.2%	39.7%	33.6%	7.3%
175-200	22.8%	23.4%	35.2%	26.8%
200-225	4.1%	3.9%	14.4%	41.9%
225-250 (Current)	0.0%	0.0%	1.8%	23.1%

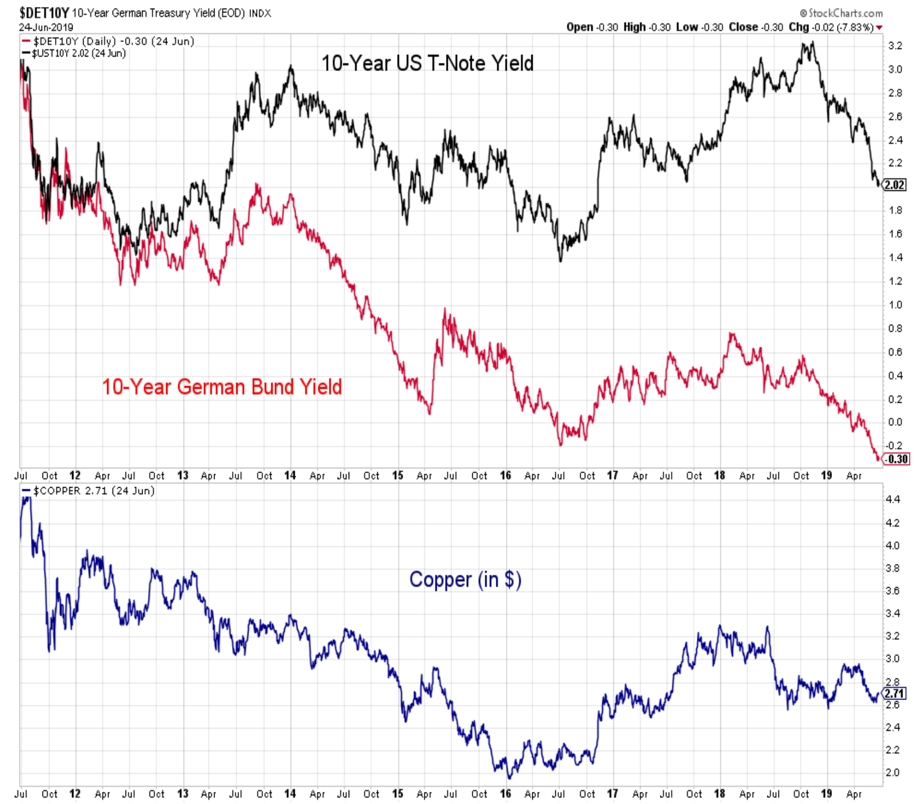
* Data as of 25 Jun 2019 11:04:53 CT

Source: CME Group

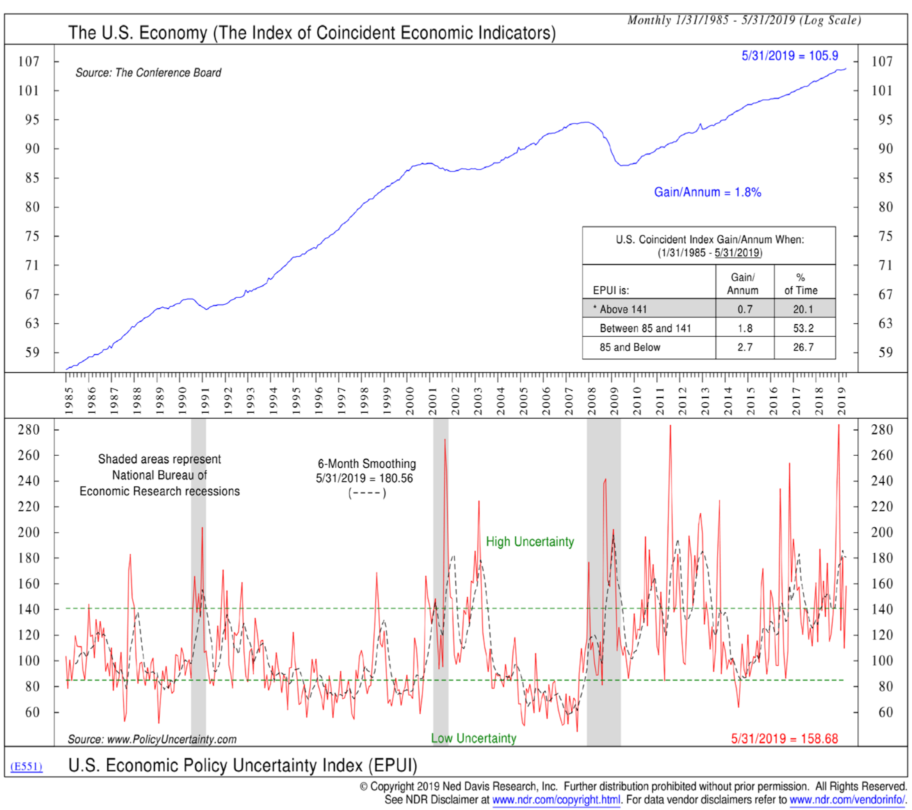


The Fed has acknowledged wanting to see evidence of economic trends and does not want to be reacting to single data points. The recent focus by the Fed appears to be on growth dynamics, but it is not clear to us that inflation risks are as benign as the headlines suggest. At the May FOMC meeting and in speeches shortly thereafter, the Dallas Fed's Trimmed-Mean PCE inflation index was emphasized a providing a clearer picture of underlying inflation. As trade-related uncertainties have dominated the narrative, inflation has slipped from the headlines. With the Dallas Fed's measure showing inflation at its highest level since 2012, the Fed may not have the room/desire to fully accommodate the market's expectations.

Economic data gets released with a lag and can be subject to revisions. Market-based indicators can be more timely, and while not subject to revision, can get carried away by emotions. Bond yields, both at home and overseas, have been moving lower since peaking in 2018 (US Treasury yields peaked in December, German Bund yields peaked in January of last year). The bond market appears to be arguing for increased accommodation by the Fed and other central banks. Copper prices tend to move in line with bond yields, though in the current case have shown more resiliency and not moved to new multi-year lows. This suggests there may be a reason for more economic optimism than what is suggested by the bond market. A break to new lows in copper would increase our concern about the global economy.



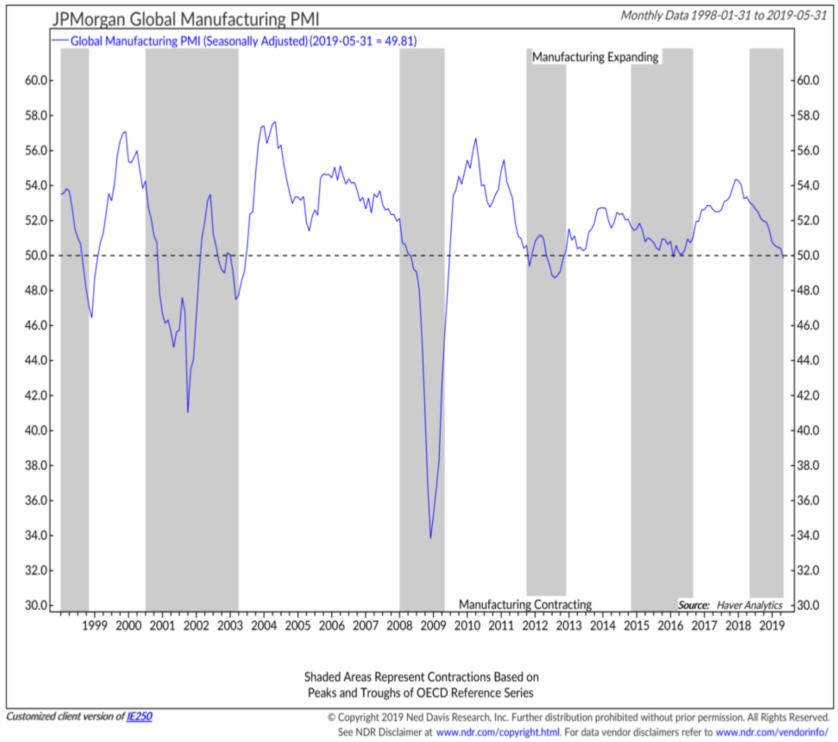
Source: StockCharts



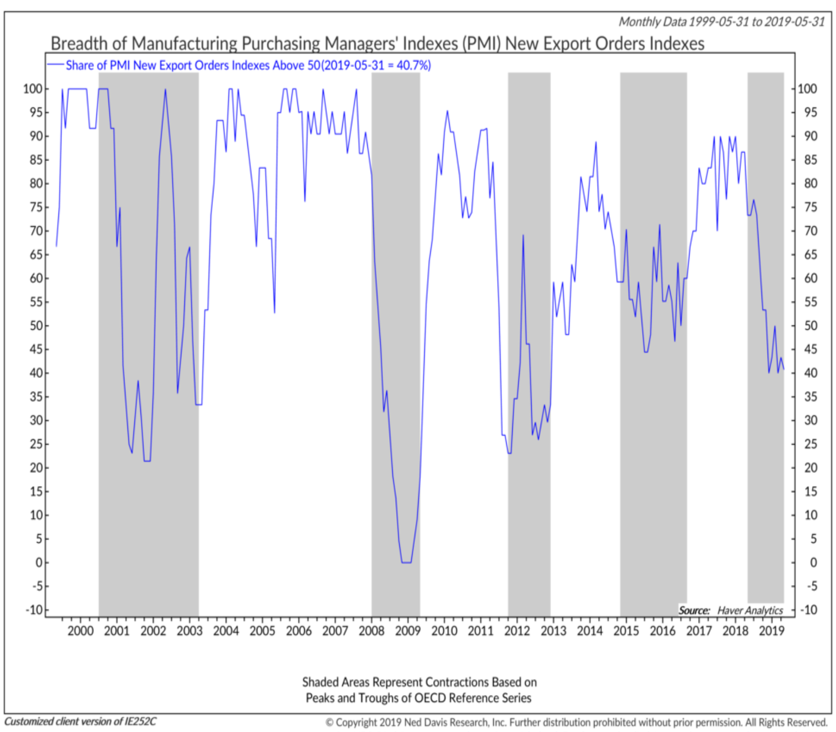
Source: Ned Davis Research

The shift in Fed policy is a real-time reaction to rising levels of economic uncertainty as trade-related tensions begin to ripple through the economy. While the immediate focus may be on the resolute to talks between the US and China, it is unclear that those talks have a foreseeable end-game. Moreover, tariff threats seem to be increasing rather than decreasing and the 2020 presidential election race is likely to heat up over the second half of 2019. While the Fed may try to offset this uncertainty by lowering rates, it is not altogether evident that lower rates would do much to temper those uncertainties and it may be the case that inconstancy of the Fed as been adding to those uncertainties and adversely affecting its own credibility.

Elevated uncertainty comes at a tough time for the global economy. Growth has been moderating for over a year and the green shoots that had been emerging have since shriveled. The global manufacturing index has moved below 50 (indicating a contraction in activity, not just moderating growth) and is at its lowest level since 2012. One small positive is that even as growth has continued to slow, this weakness has not exceeded expectations. The economic surprise index for Europe suggests that relative expectations, the incoming data is a good as it has been since 2017, a big improvement over last year and much of the first half of 2019.



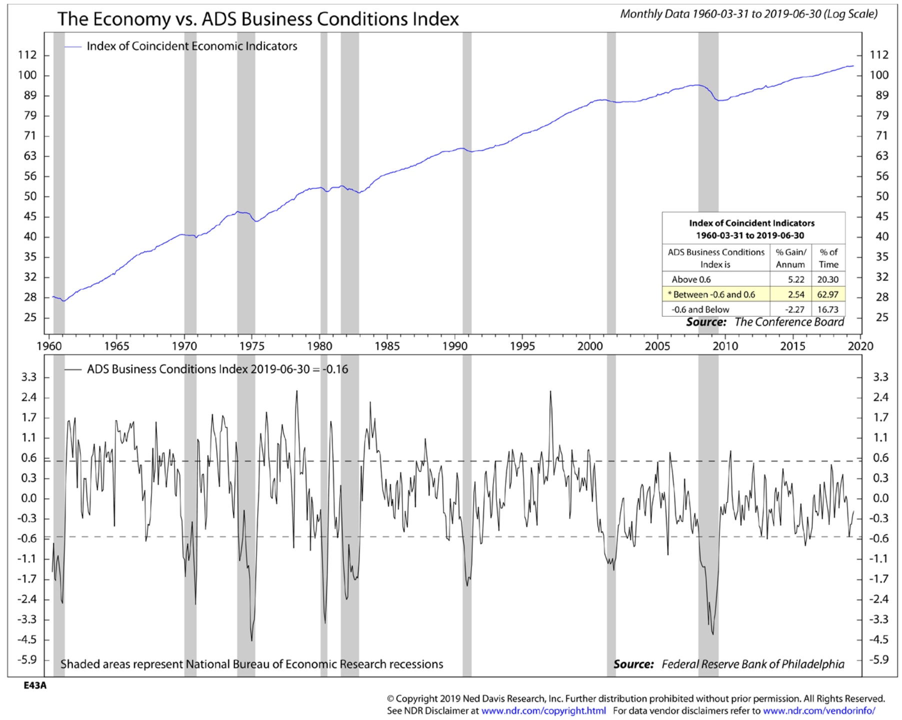
Source: Ned Davis Research



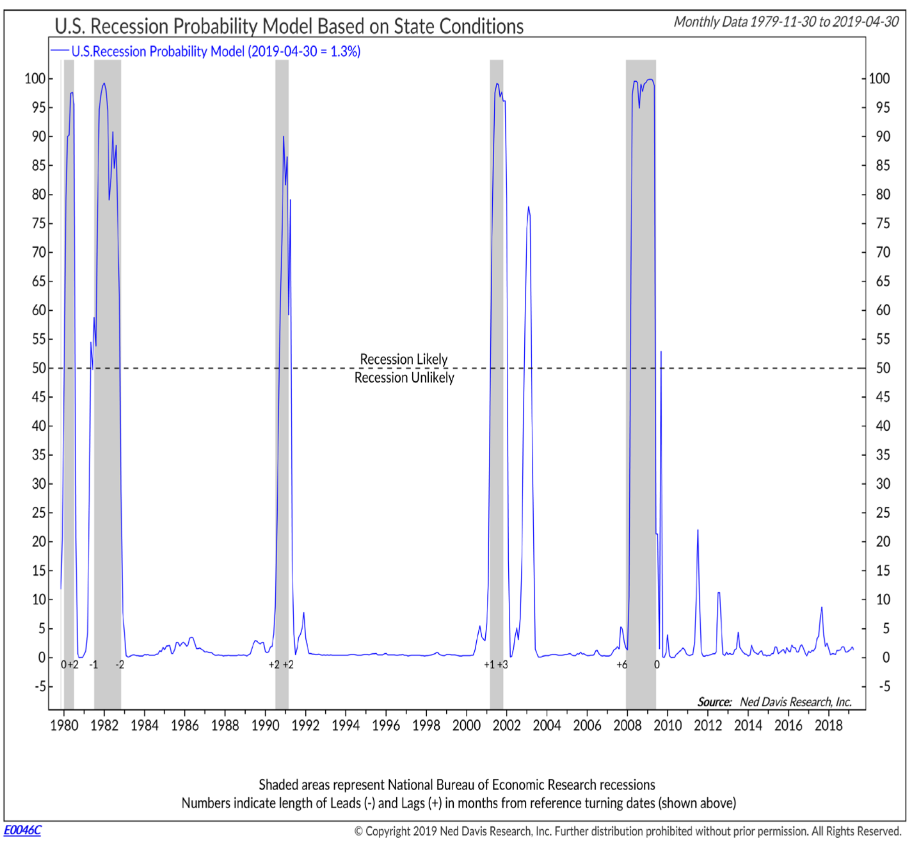
Source: Ned Davis Research

Export orders have been hit hard as actual and threatened tariffs weigh on global trade. After some preliminary stabilization in the first half of 2019, the percentage of countries seeing new export orders expanding has turned lower. There are a number of ways to quantify the effects of these tariffs and with evidence emerging that Vietnam is being used as a conduit to circumvent some of the tariffs imposed on China, estimates of dollar impacts could be distorted. This summary resonates with us: In terms of applied tariff rates, the US economy is moving from being the 19th most open economy in the world to being the 116th, just between Algeria and Senegal. If this is a path to growth, it is not one described in many economic textbooks.

So far, the U.S. economy has endured the weakness overseas and uptick in uncertainty. Growth is slowing, but business conditions (as measured in real-time by this Philadelphia Fed-published index) been resilient. In fact, based on this index, the economic conditions that have been present over the course of the expansion are largely intact. This does not preclude weakness from emerging, and that in fact is one of our two primary concerns as we move through the second half of 2019, but in the past, global weakness has been a storm to be weathered not a precursor to recession in the U.S.



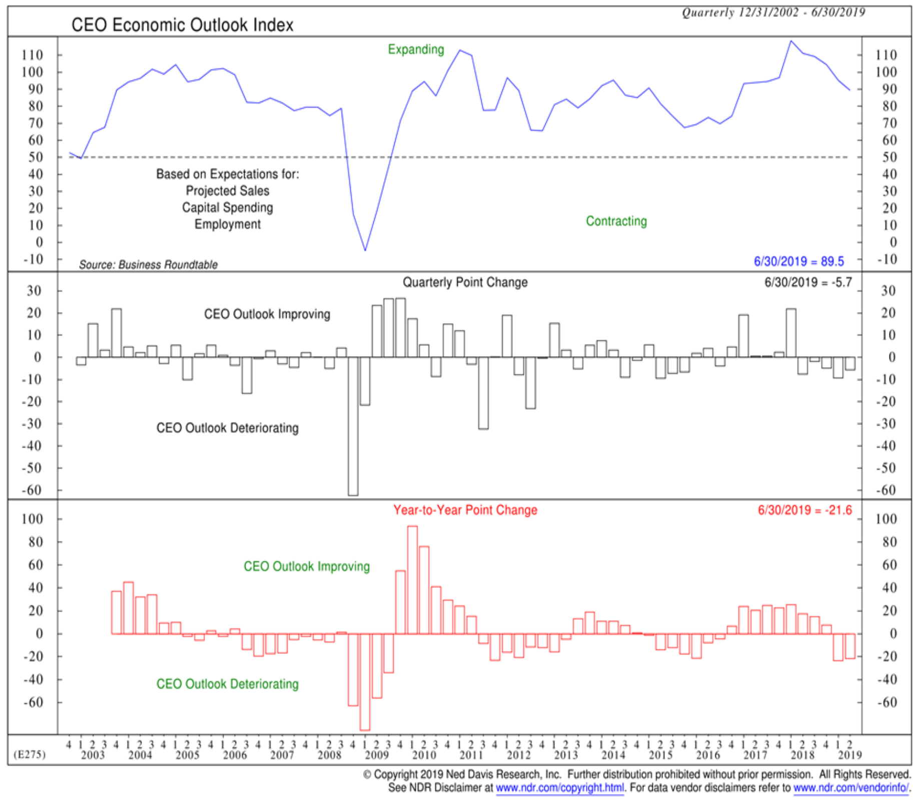
Source: Ned Davis Research



Source: Ned Davis Research

Despite the headlines, recession risk in the U.S. remains low. That is the message from this recession probability model based on actual state-level conditions. There are pockets of weakness (regional Fed surveys are moving sharply lower) and indicators to watch for evidence of further deterioration (initial jobless claims, evidence of layoffs at small and mid-sized firms) but the more likely outcome for the U.S. economy at this point is a growth scare and not the imminent ending of the now decade-old economic expansion.

One area of specific focus over the course of the second half of 2019 will be measures of economic confidence. A significant decline in confidence would increase downside risks for the economy. The animal spirits that have fueled and reinforced economic growth in recent years could evaporate. Consumer confidence (which can move in tandem with stock market returns) has already begun to move lower and is at its lowest level since 2017. CEO Confidence, as measured by the Business Roundtable, has dropped to its lowest level since 2016. On the positive side, NFIB small business optimism has moved higher in recent months, though it is still shy of its 2018 peak.



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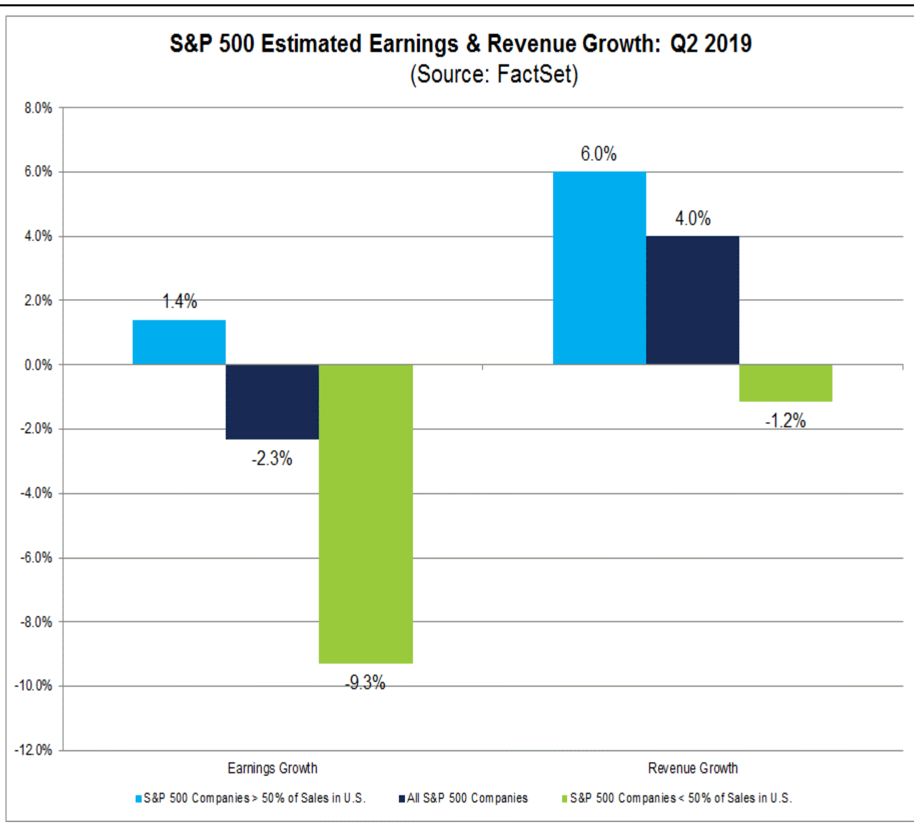
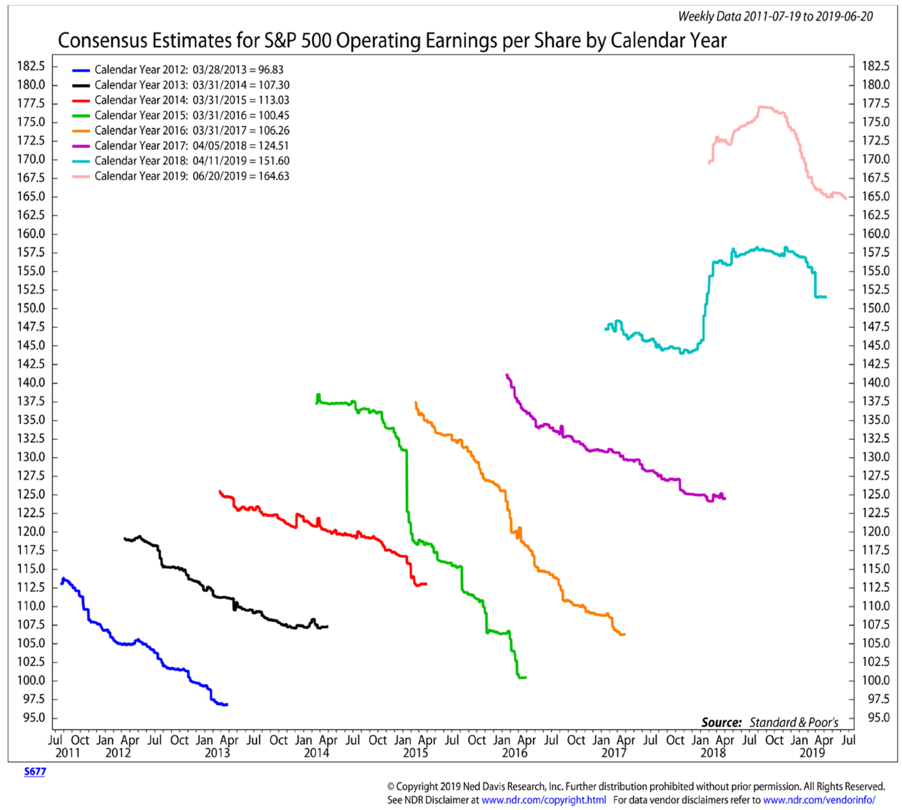


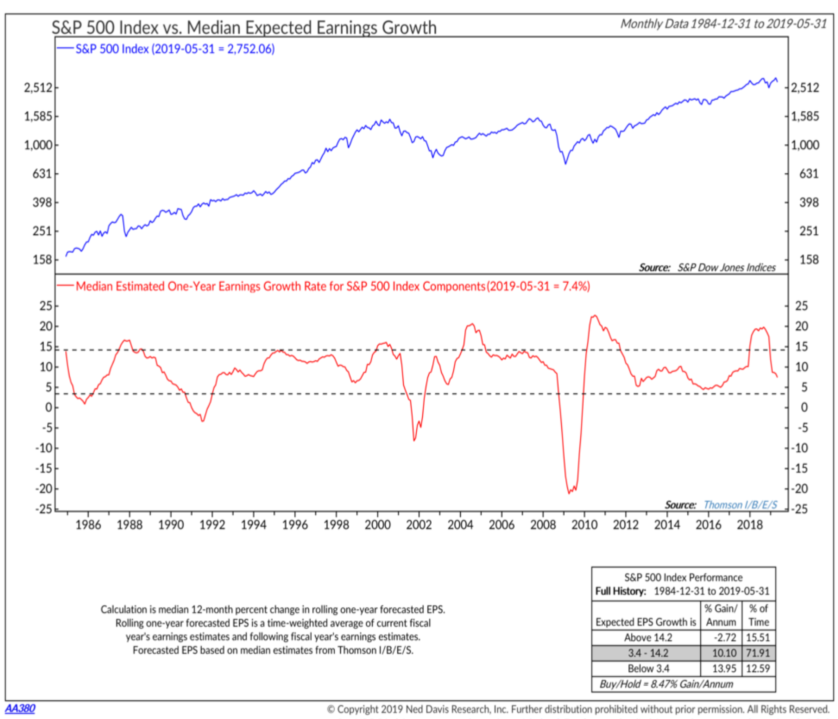
Source: FactSet

The disparity between the global economy and the U.S. economy can be seen in stark contrast when looking at expected corporate results for Q2. For the S&P 500 overall, earnings are expected to decline 2.3% in the quarter. Companies that get more than half of their revenue from within the U.S. are expected to see earnings grow 1.4%, while those that get a majority of their revenue from overseas are expected to see earnings decline by nearly 10%. Revenue expectations show a similar spread, with 6.0% revenue growth expected for domestically-focused companies versus a 1.2% decline in revenue expected for those with elevated exposure to the global economy.

Overall earnings estimates for 2019 have moved lower as the year has progressed. With the exception of last year, this is a fairly reliable pattern. Evidence that the economic growth scare has been fully accounted for would signs that earnings estimates are stabilizing or even moving higher. Consistent with this would be a broad move higher in the economic surprise indexes. As mentioned above, that is being seen in the overseas indexes. Economic surprises in the U.S. continue to be to the downside.



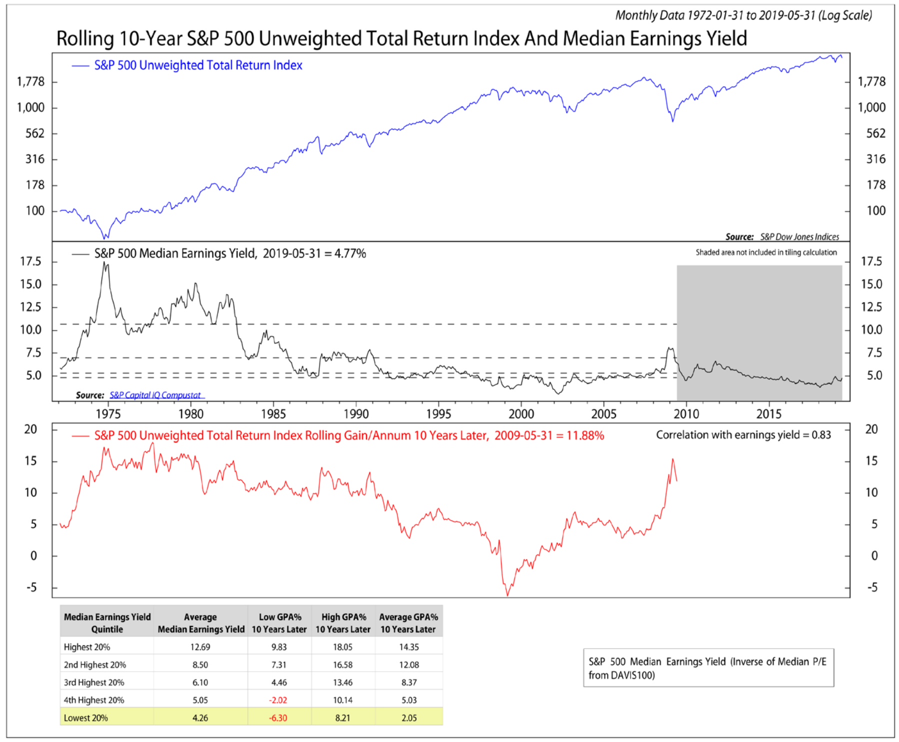
Source: Ned Davis Research



Source: Ned Davis Research

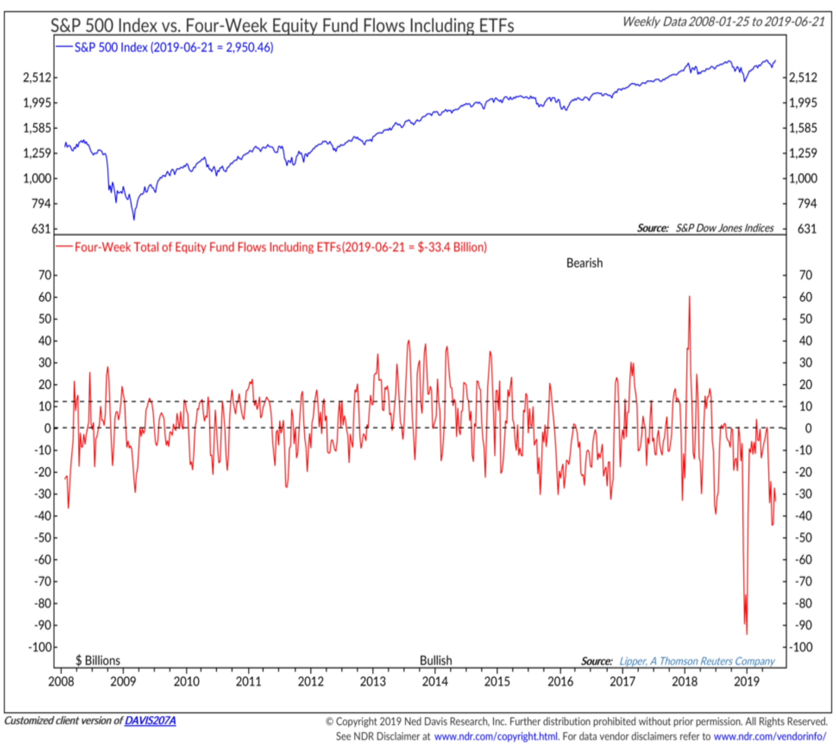
Lower estimates for earnings are not an altogether bad thing. Reduced expectations provide a lower bar to clear and the S&P 500 typically does better when expected earnings growth is muted than when it is elevated

Moderating earnings expectations need to be placed within the context of a longer-term valuation picture, which offers a less than bullish perspective. There is positive correlation between the median earnings yield (which is the inverse of the Price/Earnings ratio) on the S&P 500 and stock market returns over the ensuing decade. In the wake of robust price gains over the past decade, the current earnings yield for the S&P 500 is in the lowest quintile of readings. Historically this has been is consistent with weak returns for stocks over the following ten years. There is no way at this point to know what the next ten years will hold in terms of stock market returns, but from a valuation perspective, expecting a repeat of the past 10 years would seem to be unreasonable.



Median Earnings Yield Quintile	Average Median Earnings Yield	Low GPA% 10 Years Later	High GPA% 10 Years Later	Average GPA% 10 Years Later
Highest 20%	12.69	9.83	18.05	14.35
2nd Highest 20%	8.50	7.31	16.58	12.08
3rd Highest 20%	6.10	4.46	13.46	8.37
4th Highest 20%	5.05	-2.02	10.14	5.03
Lowest 20%	4.26	-6.30	8.21	2.05

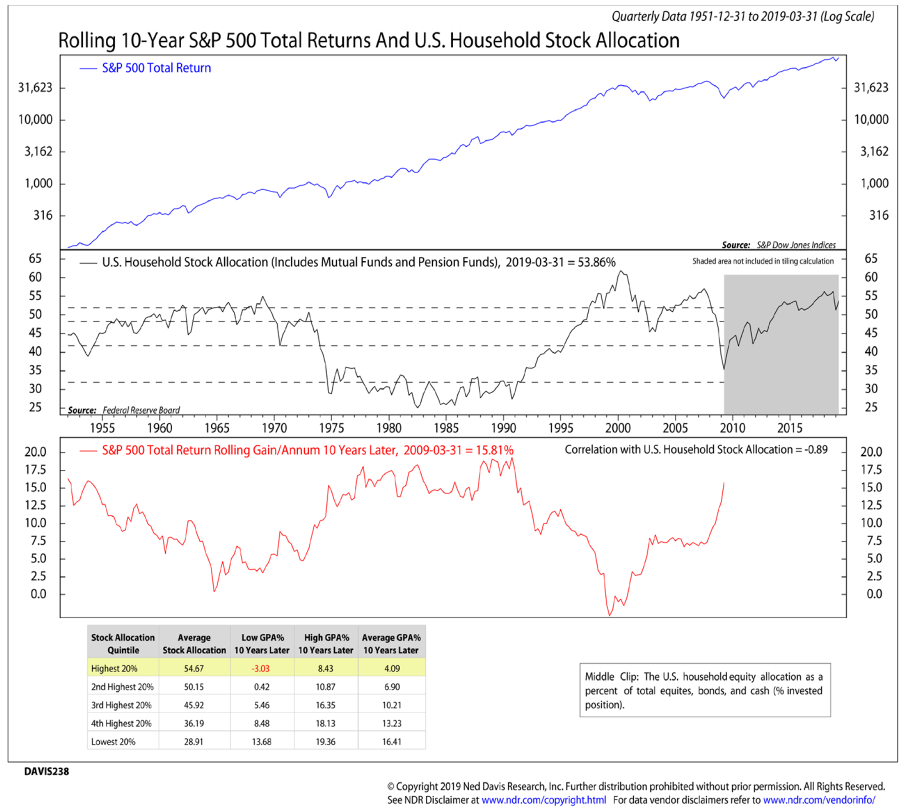
Source: Ned Davis Research



Source: Ned Davis Research

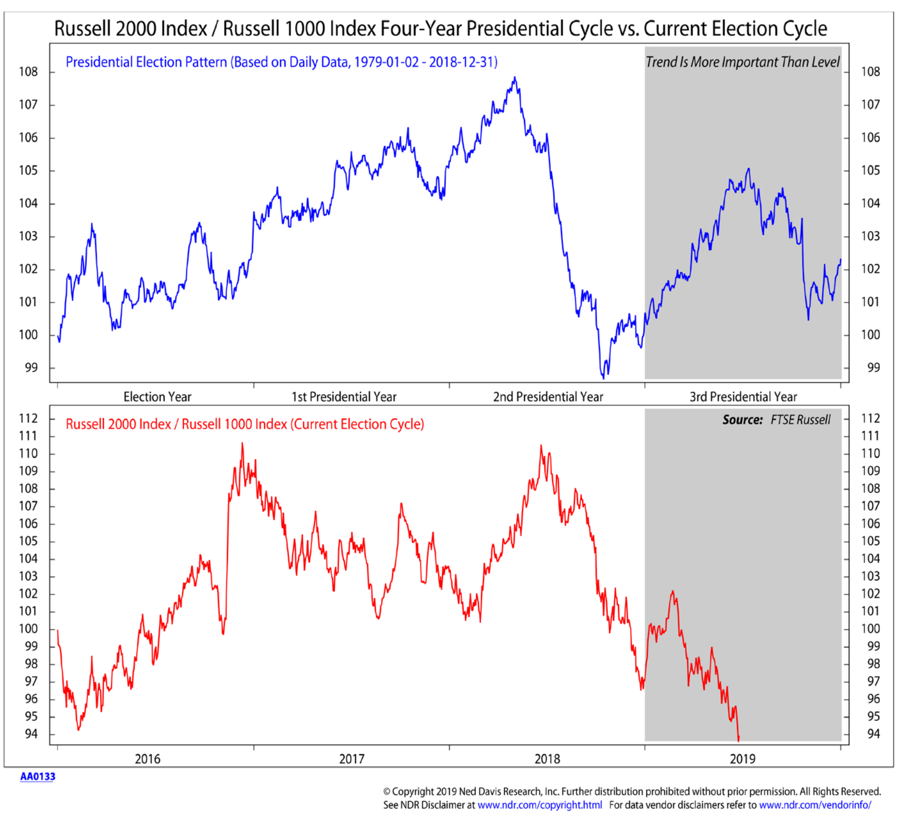
At first blush, weekly equity fund flows suggest an awareness of this and reflect increased skepticism on part of investors. Even after a late-2018 surge in outflows ($100 billion over the course of four weeks) and the equity market gains seen over the course of the first half of the year, inflows have been slow to return. Outflows were quick to reemerge when stocks weakened in May.

The fund flow data might suggest that aggregate exposure to equities is historically low and/or exposure to cash is historically high. Comprehensive data from the Fed suggests that the opposite is true. Household exposure to both bonds and cash, as reported in the Fed's quarterly Financial Accounts report, has drifted lower over the past decade. Aggregate exposure to equities has risen from 36% to 54%. Why that allocation is elevated (whether through active re-balancing, or a lack thereof) is of less importance than the fact that it is elevated. While shy of previous extremes, it is nonetheless in the highest quintile of historical equity exposure. History argues for subdued stock market return expectations in the coming decade based on currently levels of equity exposure.



Stock Allocation Quintile	Average Stock Allocation	Low GPA% 10 Years Later	High GPA% 10 Years Later	Average GPA% 10 Years Later
Highest 20%	54.67	-3.03	8.43	4.09
2nd Highest 20%	50.15	0.42	10.87	6.90
3rd Highest 20%	45.92	5.46	16.35	10.21
4th Highest 20%	36.19	8.48	18.13	13.23
Lowest 20%	28.91	13.68	19.36	16.41

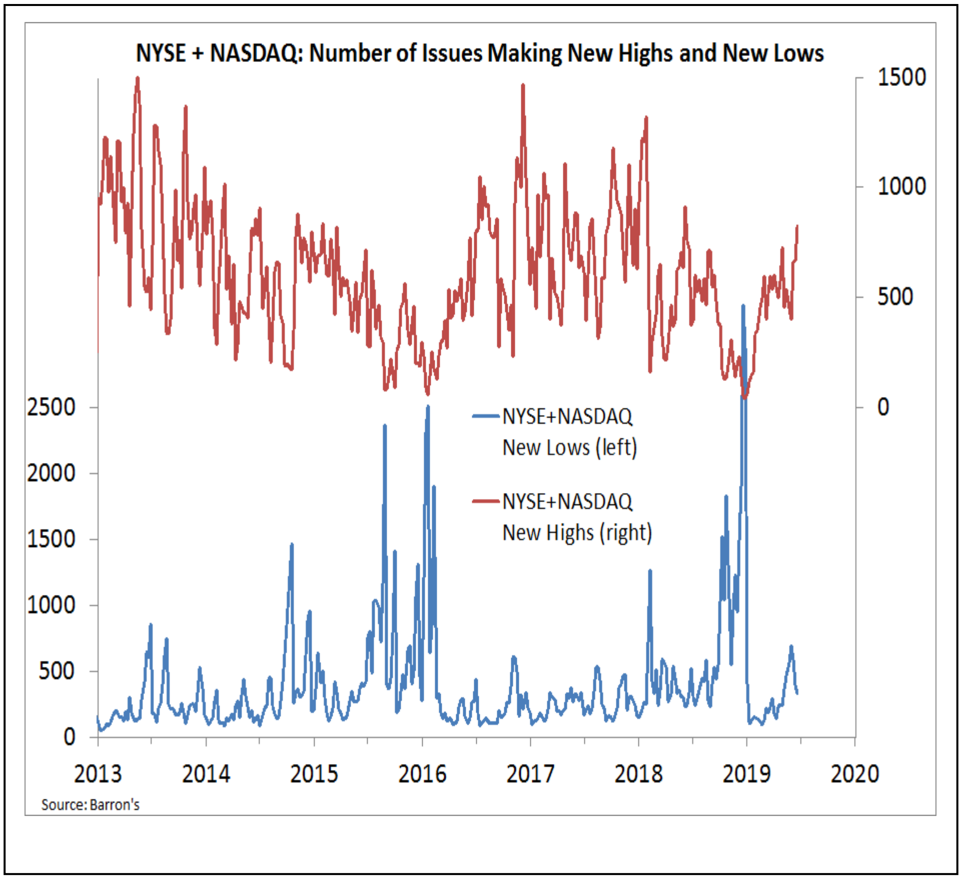
Source: Ned Davis Research

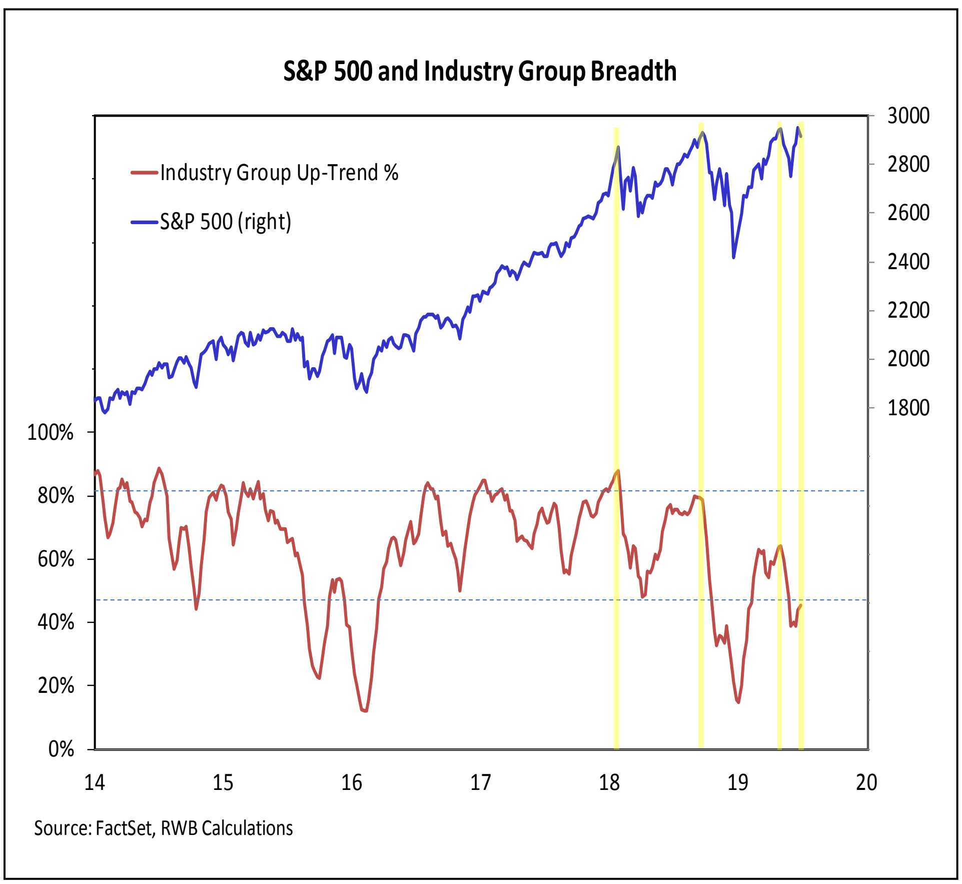


Source: Ned Davis Research

Current levels of market-related noise could be rendering seasonal patterns and trends less reliable than in the past. We can see this manifesting itself as the small-cap/large-cap ratio has deviated from its typical experience over the past nine months. While the overall cycle composite for 2019 suggests stocks could benefit from a seasonal tailwind into the fourth quarter, would are looking for more persistent confirmation that expected trends are reasserting themselves before putting too much weight on prospective signals.

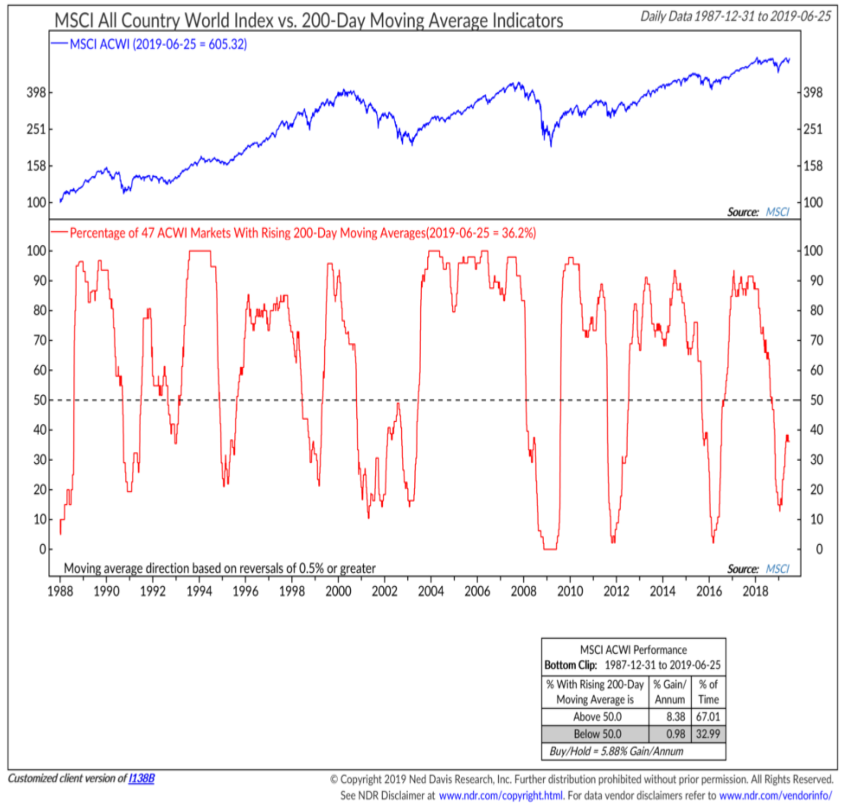
Expectations for positive returns in the second half of 2019 are contingent on the resiliency of the U.S. economy and evidence of a better breadth backdrop. Simply put, we need to see broader rally participation to have confidence that the price gains registered by S&P 500 are able to persist. The strongest case would come from broad market measures strengthening ahead of the S&P 500, though as expressed in recent market commentary, even just confirmation (if not leadership) would be welcome at this point. One recent area of encouragement has been the expansion in weekly new high list. The combined new highs on the NYSE + NASDAQ made a higher high, climbing to its highest level since early 2018.



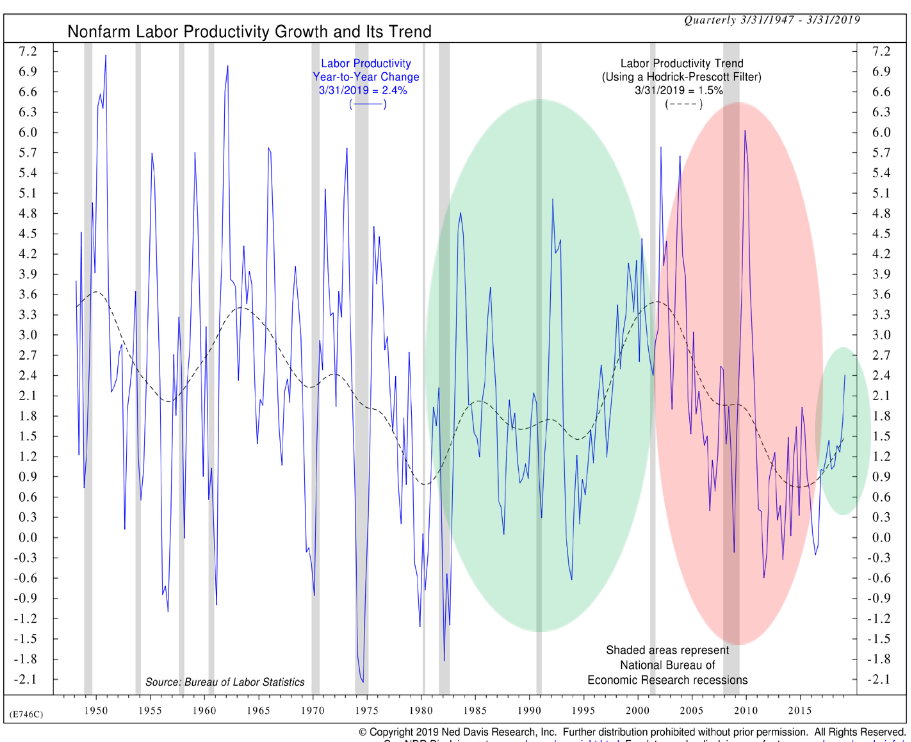


As encouraged as we are by the expansion in the new high list, we are troubled by more persistent theme of market breadth divergences. Our industry group trend indicator has made a series of lower highs as the S&P 500 has made new highs over the past 18 months. In part, this reflects weakness that is being seen at the small-cap and mid-cap level. But even among large-caps, breadth is less than robust. The percentage of S&P 500 stocks trading above their 200-day averages has not confirmed index-level strength. Additional evidence of improved market behavior would be to see a leadership rotation from Information Technology to Industrials and from Utilities to Financials, as both turns would argue for an improve growth backdrop.

While domestic breadth indicators have shown hints of strength in 2019 (including early-year breadth thrusts), the global broad market backdrop has remained more of a challenge. Primary among these indicators is the percentage of markets that have rising 200-day averages. While expanding from its early-year low below 20%, this indicator has stalled shy of 40%. Over the past thirty years, virtually all of the net stock market gains from a global perspective have come when more than half of the individual markets were in up-trends (defined by rising 200-day averages). Evidence that this now 18 month-old period of cyclical volatility and weakness is coming to a close would be seeing an uptick in domestic and international rally participation.

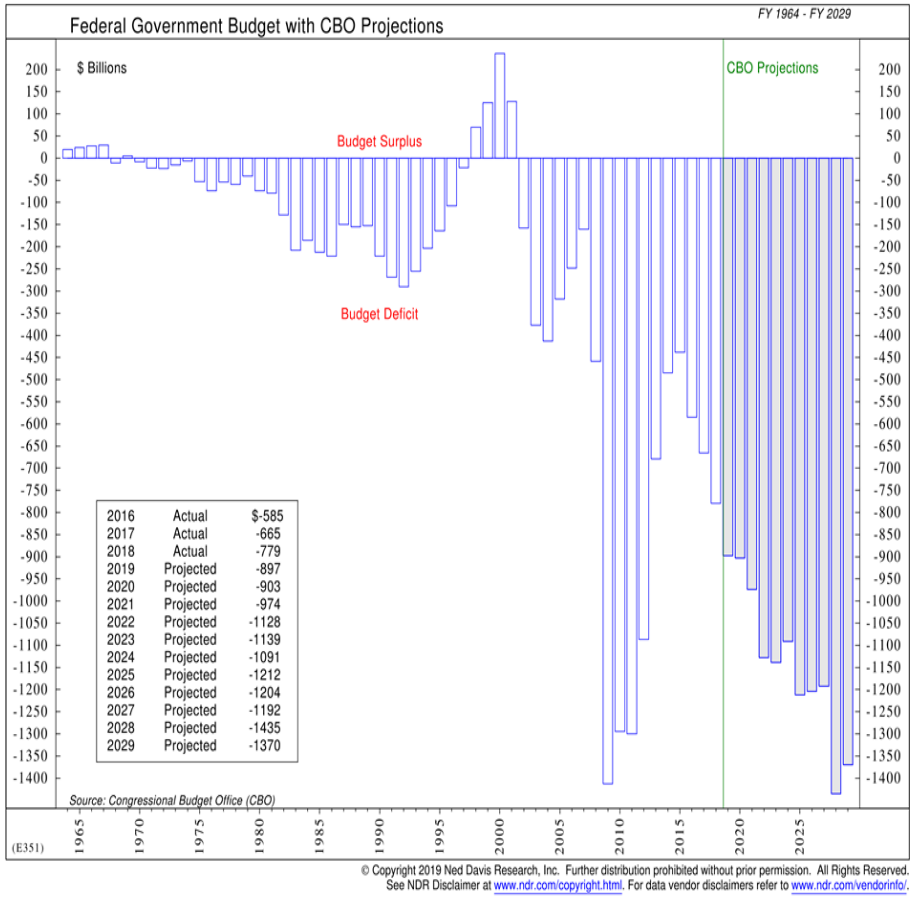


Source: Ned Davis Research



Source: Ned Davis Research

We want to finish where we began, stepping back and thinking about the economy from a longer-term perspective. The seeds of the sub-par growth seen during the ongoing decade-long expansion were sown in the persistent downward trend in productivity growth that emerged in 2000. As the expansion has aged, the trend in productivity growth has turned higher. This is encouraging evidence that a secular shift in the economy has been taking place. Even accounting for periods of cyclical weakness (whether slower growth or mild recessions), the growth trajectory to which many have become accustomed may soon become a thing of the past (especially if the expansion is able to survive the current growth scare).



Source: Ned Davis Research

The encouraging news offered by the productivity data is offset by federal government budget projections. While any forecast needs to be looked at skeptically, it is nonetheless troubling that after a decade of economic growth we are facing annual budget deficits in excess of $1 trillion for as far as the forecast extends. Excessive levels of government debt may not be a specific catalyst for weakness, but it could reduce flexibility in periods of stress and is a sad commentary on the approaching to governing that is coming out of Washington DC. It does not instill confidence in the fiscal policy authorities.

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Source: StockCharts

The challenge to the credibility of both the fiscal and monetary policy authorities is likely reflected in the recent action in the price of gold (and perhaps, bitcoin). Gold has broken above a well-tested resistance area that stretches back five years. Gold strength is not evidence of economic confidence or vitality. When this period of uncertainty ends, gold prices might as well. But until, gold could continue to benefit from building skepticism after a period of deep-seated complacency.

BAIRD STRATEGIC ASSET ALLOCATION MODEL PORTFOLIOS

Baird offers six strategic asset allocation model portfolios for consideration (see table below), four of which have a mix of equity and fixed income. An individual's personal situation, preferences and objectives may suggest an allocation more suitable than those shown below. Please consult a Baird Financial Advisor in determining an asset allocation that will meet your needs.

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.

Baird's Investment Policy Committee offers a view of potential tactical allocations among equity, fixed income and cash, based upon a consideration of U.S. Federal Reserve policy, underlying U.S. economic fundamentals, investor sentiment, valuations, seasonal trends, and broad market trends. As conditions change, the Investment Policy Committee adjusts the weightings. The table below shows both the normal range and current recommended allocation to stocks, bonds and cash. Please consult a Baird Financial Advisor in determining if an adjustment to your strategic asset allocation is appropriate in your situation.

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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