Baird Market & Investment Strategy

2020 Economic & Stock Market Outlook

December 9, 2019

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Please refer to Appendix – Important Disclosures.

Cyclical Strength Emerges Amid Ongoing Uncertainty

Outlook Summary

Domestic stock market gains and global rally participation in second half of 2019 suggest new cyclical bull market has emerged.

After a mid-cycle adjustment to rates, the Federal Reserve is moving to the sidelines.

Decelerating economy may provide a growth scare, but recession risk in US remains low. Globally, green shoots offer encouraging evidence of improvement.

Elevated valuations and a fully invested public could leave stocks vulnerable to volatility if uncertainty remains elevated.

After a decade of US large-cap strength, opportunities for new leadership are on the rise.

"What gets us into trouble is not what we don't know. It's what we know for sure that just ain't so." – Mark Twain

2019 has been a year of milestones: The U.S. economic expansion entered an unprecedented 11th year, real median household income moved further into record territory and the S&P 500 (and a host of other stock market indexes) made new all-time highs. Baird celebrated its 100th anniversary, and I (Willie) marked the completion of two full decades in this industry (and at Baird).

The world is full of challenges of which to be mindful. For many, though, it has been a good year - there is much to be thankful for and many blessings to count. An annual outlook piece can provide a useful opportunity to pause and catch our breath as we consider where we have been and where we may be heading. Done well, these pieces provide a chance to take stock of the recent past and with gained perspective, allow the road ahead to come into some focus. Done poorly, they can lock in narratives about what the future holds and (apologies for shifting the metaphor) act more as anchor than rudder. Not knowing what the future holds does not preclude setting out on the road or charting a course across open water. We can gain perspective. We can navigate risks and opportunities. We can adapt as uncertainties become realities.

The path forward is not always clearly defined and staying true to it can be difficult. This effort is further complicated by the endless stream of stories and anecdotes that bounce around our social media echo chambers, usually providing more confirmation than useful context. In a world awash with data and indicators, perspective is a rare commodity.

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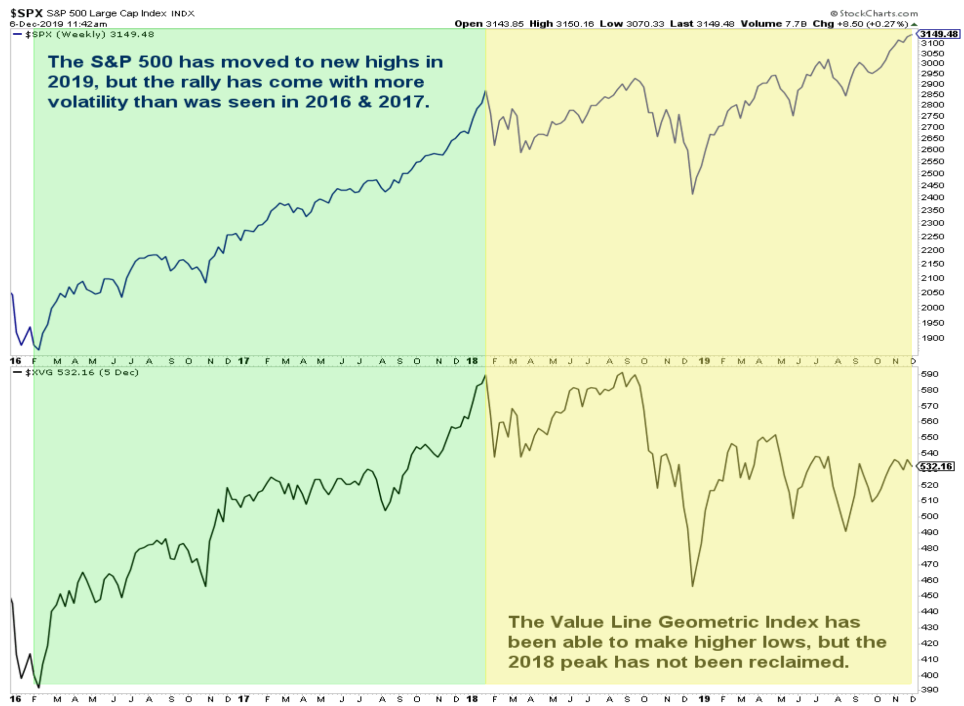


Source: StockCharts

Imagine an autumn walk through the woods in southeastern Minnesota. Successfully navigating the trail requires both a sense of what might lie ahead and the discipline not to get unduly distracted by each individual leaf that lies in the path. Keeping perspective in the face of noise is a challenge for a hiker and for an investor. As the quote from Twain suggests, the greater risk is not the uncertain future, but misplaced confidence about where we have been and where we are going.

For nearly two decades, our process at Baird has been to lean on the weight of the evidence as we navigate uncertainty. This approach allows us to cast a view about what might lie ahead and yet adapt when the inevitable unexpected happens. Without it, we risk losing the path or being blown off course.

After discussing in broad strokes our outlook for 2020, we will review each of the areas covered in the weight of the evidence providing perspective about what is being seen now and what seems likely to unfold as we move forward. We will conclude with a discussion about what might lie ahead from a portfolio management perspective as we conclude a decade of remarkable strength and leadership from US large-cap stocks.

We encourage you to strap on your pack, lace up a sturdy pair of boots, and select a stout walking stick as we prepare to head back onto the path. After all, the greater part of the joy is in the journey.

2020 Stock Market Outlook:

In considering the outlook for 2020, a primary concern is the health of the underlying trends in the stock market and economy. In our 2019 outlook we made the case that a cyclical bull market was likely to reemerge in the second half of the year. With the Q4 upgrade to the weight of the evidence and new stock market highs being made on a global basis, that scenario appears to have unfolded. The breadth of gains in 2019 across multiple asset classes is reminiscent of the gains seen in 2017. While the 2017 gains built on strength that emerged in 2016, the 2019 ascent was set up by weakness in 2018.

From its February 2016 low to the January 2018 peak, the S&P 500 was up over 50% with little by way of weakness along the way. While the S&P 500 has made new highs since that January 2018 peak, the pace of ascent has slowed, draw-downs have been more significant and volatility has risen. Our outlook suggests the upward trajectory for stocks (at home and around the world) is likely to continue in 2020, though the volatility-free environment of 2016-2017 may be too much to expect at this point.

We note that our base case (mid-single-digit gains for the S&P 500 in 2020) falls well within the range of outcomes being expressed by strategists at other firms. That the emerging consensus of views is clustered around the historical average is not surprising. What may be surprising is that the average across time tends not to be observed in any individual time period. The plain truth of the matter is that the base case expressed by us and others is not likely to be realized. From our perspective, the distribution of risks at this point suggests slightly more likelihood that the deviation will be to the downside than to the upside. If that indeed happens, we would expect to see it reflected in the weight of the evidence which will remain our guiding light as the year unfolds.

Base Case	Bull Case	Bear Case
Volatility remains elevated but the S&P 500 finishes the year with gains in the mid-single-digits. Stock market leadership moves away from the S&P 500, with better opportunities being found overseas and in the mid-cap and small-cap spaces. *Likelihood*: 50% *Rationale:* Broad rally participation in 2019 argues that a new global cyclical bull market has emerged. Stretched valuations, elevated economic uncertainty and a raucous political environment could limit gains and provide for a noisy investing backdrop. *Evidence it is unfolding:* The new high list expands, global stock market leadership moves away from US large-caps, and bond yields drift higher. The Fed remains on hold all year and election-related tensions prove to be more bark than bite.	While experiencing a slower ascent than 2019, stocks remain strong from a historical context (and stronger than valuation indicators would suggest is likely) and finish 2020 with double-digit gains. *Likelihood:* 20% *Rationale:* Breadth thrusts in the early stages of a new cyclical bull market can provide important upside momentum for stocks, especially if the global economy becomes more vigorous. *Evidence it is unfolding:* Better-than-expected economic data and a receding global uncertainty fuel a robust rebound in earnings growth and domestic breadth thrusts are followed by increasing evidence of global stock market strength.	Volatility of the past two years overwhelms the nascent cyclical bull market as an economic growth scare skirts close to recession and political tensions reach a boiling point. With meager earnings growth leading to multiple compression from a valuation perspective, the S&P 500 could struggle to finish 2020 in positive territory. *Likelihood:* 30% *Rationale:* While global green shoots are emerging, data in the US has been struggling and growth continues to slow. The 2019 rally has been fueled by expectations of improvement – risks increase if these do not materialize. *Evidence it is unfolding:* Additional rate cuts by the Federal Reserve are met with skepticism and deteriorating consumer confidence weighs on economic growth. A breadth breakdown would reveal that the 2019 rally was built on an unstable foundation.

Indicator Review

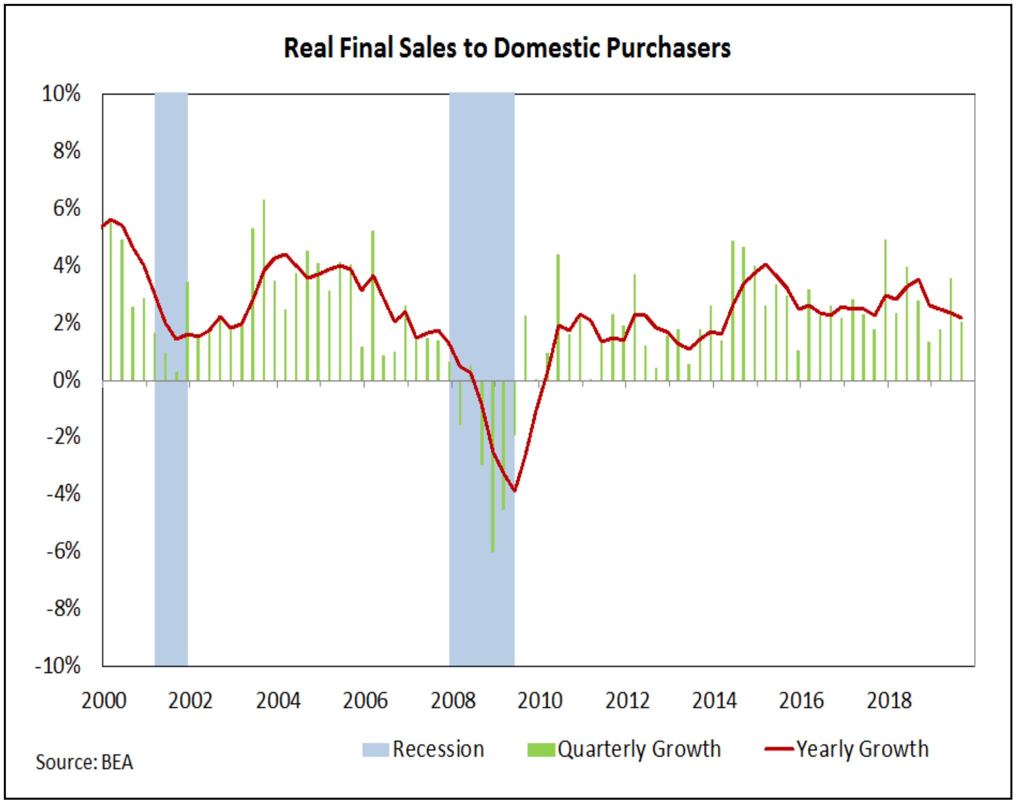
Macro Factors (What Could Happen)		
• Federal Reserve Policy	Bullish	+1
• Economic Fundamentals	Neutral	0
• Valuations	Bearish	-1
Market Factors (What Is Happening)		
• Investor Sentiment	Neutral	0
• Seasonal Patterns/Trends	Neutral	0
• Tape (Breadth)	Bullish	+1
Weight of the Evidence =	Bullish	+1

Weight of the Evidence Review:

Base case vs. Bull case vs. Bear case. These are useful thought exercises at year-end, but as we move into the New Year, our view on the market will be guided by the changes and developments in the weight of the evidence. The evidence improved over the course of 2019 and has a bullish bias as we prepare this outlook.

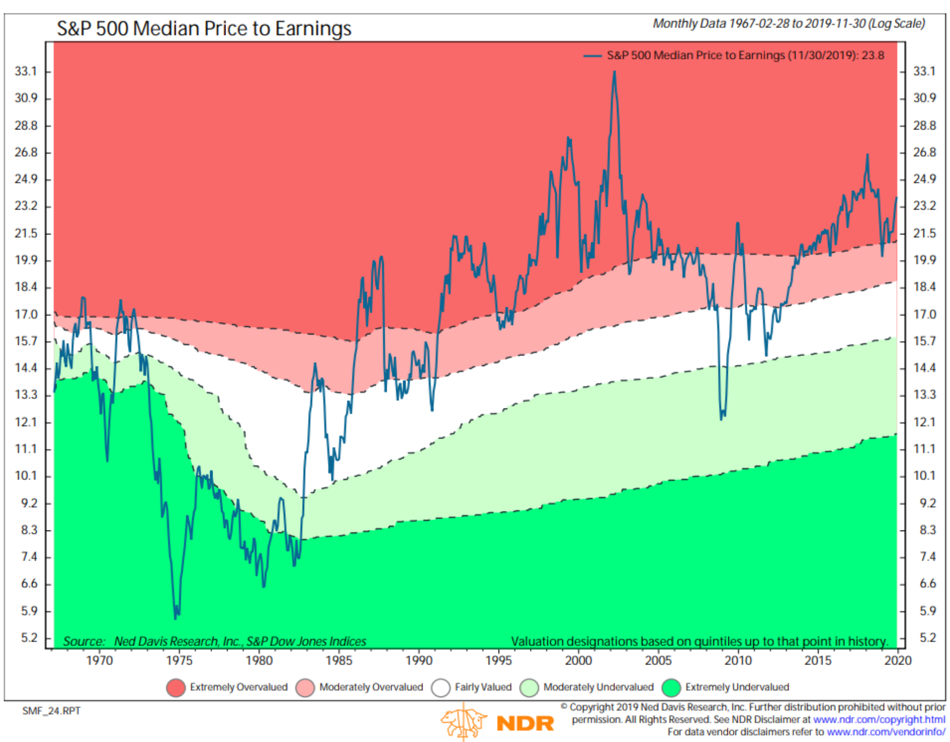
Fed Turns Friendly (Bullish)

Data from CME shows an expectation for at least one (and possibly more) rate cuts in 2020. While the three rate cuts in 2019 can plausibly represent a mid-cycle adjustment and helped turn our view of Fed policy to bullish, further easing in 2020 would challenge this. A better outcome from our perspective would be a Fed that stays on the sidelines in 2020 even as growth and inflation pick up.



Economic Green Shoots Abroad but Strains at Home (Neutral)

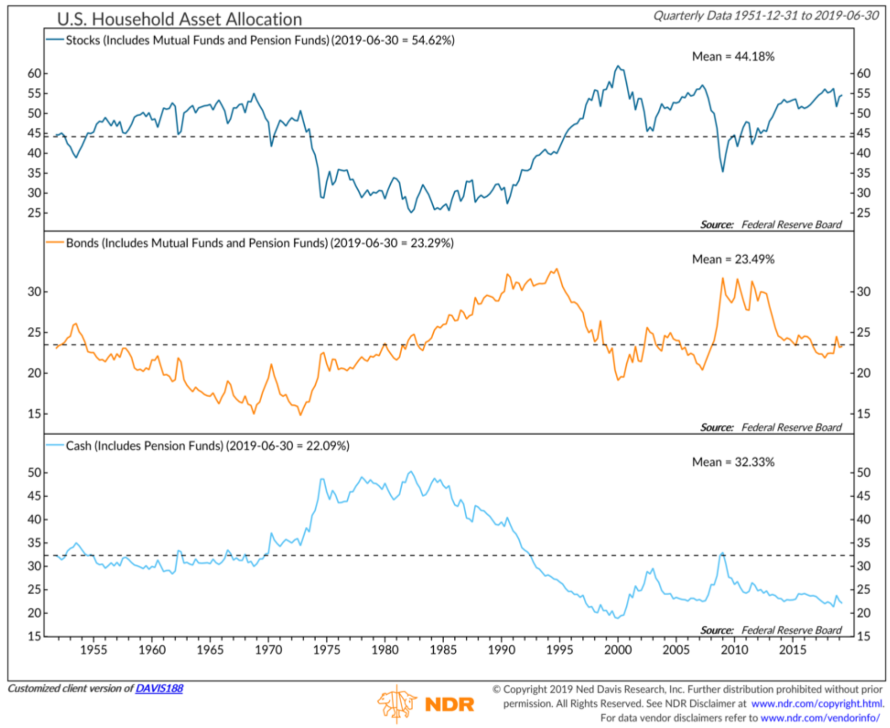
Global manufacturing data is again expanding but US data is still decelerating. Yearly growth in domestic demand has slowed from 3.5% to 2.2% over the past year and is at its lowest level in 5+ years. ISM New Orders are at their lowest level since 2009. While a 2020 recession in the US remains a low-probability event (initial jobless claims, for example, are very much not raising alarm bells), the economy is in a more vulnerable spot than a year ago. CEO confidence remains weak while political tensions and global uncertainty threaten to weigh on consumer confidence. A successfully negotiated Brexit and/or a trade situation with China that reaches status quo (not resolved, but not deteriorating) could restore confidence and buoy growth. A not-often-discussed scenario is one where US growth falters while global conditions continue to improve. Such a development could help contribute to a shift in equity market leadership away from the US and toward the rest of the world. If growth is more widespread, opportunities for portfolio diversification increase.



Source: Ned Davis Research

Sluggish Earnings Growth Stretches Valuations (Bearish)

Price gains for stocks have outpaced fundamental improvements in 2019 as well as over the past decade. Using either trailing or forward earnings data, Price/Earnings ratios are historically elevated. Valuations are not trustworthy short-term indicators but they do a great job from a longer-term perspective at elevating risks for stocks. Current valuations have been associated in the past with sub-par returns. Elevated valuations put pressure on earnings to come through if stocks are going to be able to rally. Expectations are that earnings growth will rebound in 2020, though current estimates may prove to be too robust. One thing working against profits right now is that labor costs are rising at a faster pace than pricing. This downside to low inflation is a negative for profits – and it should not be overlooked that the broadest measures of corporate profits have not gone anywhere for five years. Expectations for an earnings rebound rely heavily on improving economic conditions.



Source: Ned Davis Research

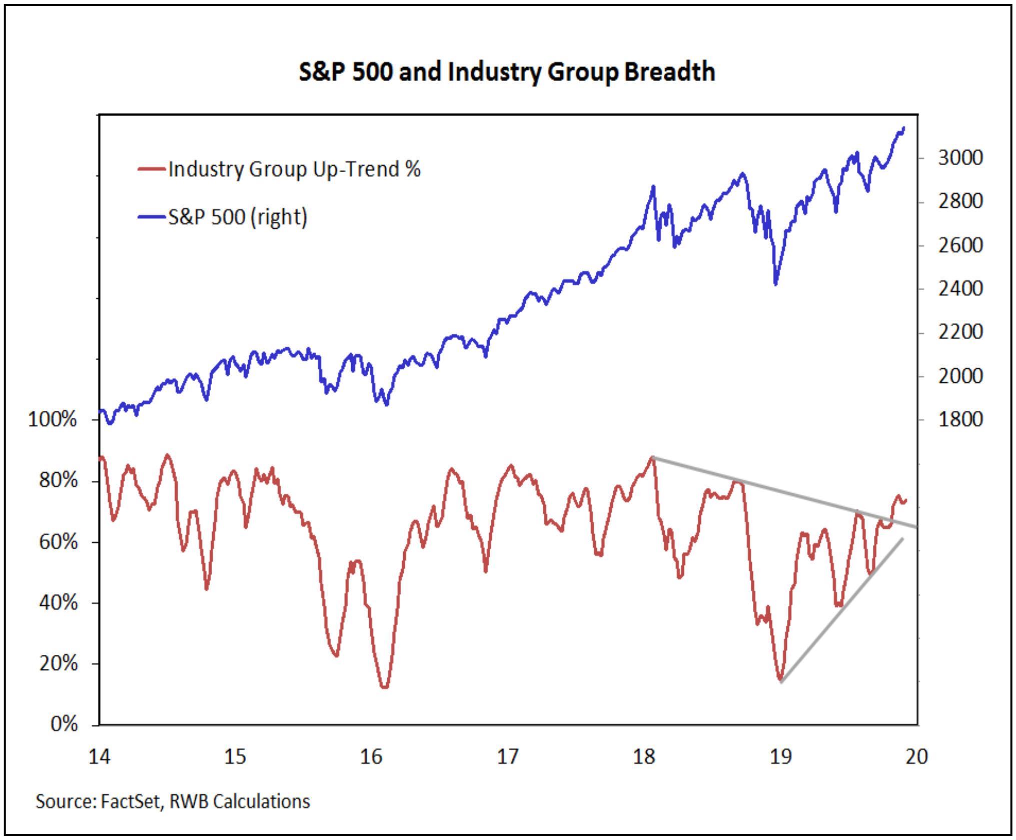
Guarded Optimism but Deep-Seated Complacency (Neutral)

Shorter-term sentiment indicators mostly show optimism, though it is neither widespread nor excessive enough to weigh on stocks. Moreover, optimism has been quick to dissipate on any stock market pullbacks. There appears to be, however, a deep-seated complacency when it comes to equities. The public, with elevated exposure to equities and well-below-average exposure to cash, has been lulled into a false sense of security after a decade of historically remarkable gains for US large-caps. Near-term optimism fading the moment stocks stop rising seems to be a consequence of investors being strongly conditioned for higher stock prices. This complacency can lead to unwise risk taking by adding to crowded assets (with the view that time in the market is all that matters) at the expense of relatively unloved assets (including cash). A historical note: forward returns for equities tend to be inversely correlated to household exposure to equities and according to data from Ned Davis Research, current household equity exposure is in the top 10% of all readings in the past 70 years.

Political Fights Likely to Dominate Seasonal Trends (Neutral)

Presidential election years since World War II have tended to see stocks struggle early, rally late (after election uncertainty subsides) and finish with an average gain of nearly 7%. Years ending in zero (depending on your accounting either the first year of a new decade or the last year of an old decade) have seen an average decline of 3% over the past century. The prospect of a presidential primary campaign and a Senate impeachment trial in the first quarter of 2020 is likely to exacerbate the tendency for early-year volatility. If President Trump's approval rating in the Gallup poll remains above 35% or so, the impeachment effort is unlikely to go anywhere and its conclusion could turn the market's attention more squarely on the election. Either way, 2020 is shaping up to be noisy and full of political conflict and uncertainty. The best opportunity for a seasonal tailwind may be closer to the actual election if its outcome starts to come into focus.

Better Breadth Fuels Strength (Bullish)



The improving broad market backdrop over the course of 2019 provides support for the view that a new cyclical bull market has emerged. Early-year breadth thrusts helped fuel the recovery from the 2018 lows, and additional breadth thrusts and improving trends on a global basis have helped sustain the rally. There is still room for improvement. Indexes that track the performance of the median stock have been more uneven (and, as of this writing, have not surpassed their April 2019, let alone September 2018, peaks) and the number of stocks making new highs has struggled to expand. Taken all together, however, the late-2019 new highs on the S&P 500 have been accompanied by improving domestic and global trends and that is a meaningful improvement over the new highs that were seen in early 2019 and mid-2018.

Thoughts on Portfolio Management for a New Decade:

While a 60/40 portfolio (60% exposure to equities and 40% exposure to bonds) may be a good benchmark, it may not be the right allocation. Just as historically average returns are rarely observed in any given year, it may not make sense to strictly adhere to an average benchmark asset allocation. In fact, a new paradigm may be at hand which will encourage thoughtful and dynamic asset allocation around given benchmarks.

As an industry we have moved through actively managing active products (stock picking), passively managing active product (buying and holding mutual funds) and passively managing passive product (buying and holding ETFs). This point of peak passive may be yielding to a new approach, actively managing passive product (dynamic allocation with ETFs). The emphasis on passive exposure with ETFs was fueled by (and helped fuel) a decade of remarkable strength in U.S. large-cap stocks.

With domestic valuations stretched and global growth stabilizing, renewed opportunities for and benefits from diversification are emerging. We highlighted this in a Portfolio Perspectives (After U.S. Strength, Global Stocks Poised For Gains) piece published earlier this year. A strictly passive approach becomes more challenging to maintain when expected returns are compressed and expected volatility is elevated.

Over the next decade, the strategic view on equities and other assets may matter a lot less than what is done tactically around that view. This is in contrast with the last decade, where a tide of ample liquidity mostly lifted US large-cap boats. Through small and mid-cap funds from Baird Asset Management and our affiliation with Chautauqua Capital Management, Baird is well-positioned to help investors take advantage of shifting global equity market leadership trends.

Investors can prepare for this new environment by reimagining portfolio management and risk tolerance - moving away from a question of stock-bond-cash allocations and thinking about static vs. dynamic allocations across asset classes. Opportunities are likely to emerge and fade as the economy and global markets move into the forefront and US large-cap leadership ebbs. A dynamic approach may help investors stay in harmony with the underlying trends.

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