Baird Market and Investment Strategy

Macro Update

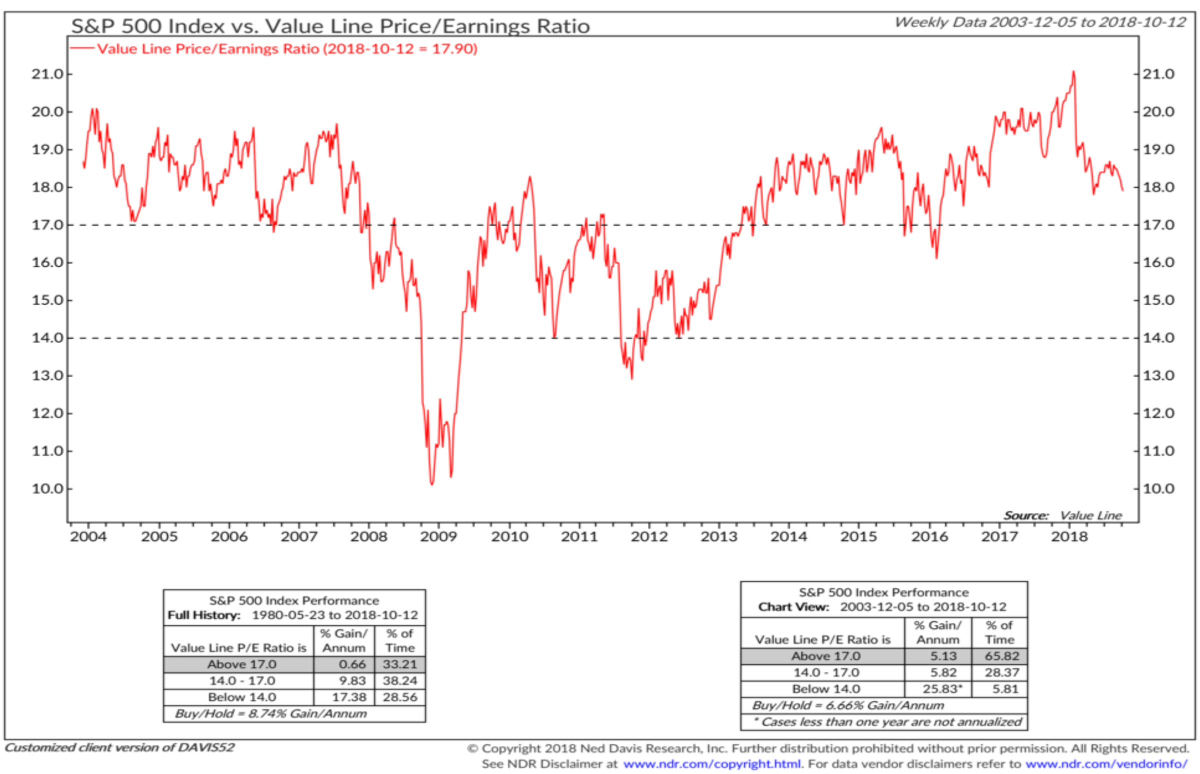
October 16, 2018

Please refer to Appendix – Important Disclosures.

Valuations Improving, But Stocks Not Cheap

Key Takeaways: **Sustained earnings growth and price volatility are contributing to improving stock market valuations. Stocks are not yet cheap by historical standards and valuations remain at levels consistent with sub-par returns for stocks going forward. Companies have continued to deliver upside earnings surprises, but this could become more challenging as rising costs weigh on profit margins.**

Stock market valuations have been improving for most of 2018 -- benefitting from a combination of sustained earnings growth and price volatility. The Value Line Price/Earnings Ratio, which uses as an earnings component a blend of trailing and forward earnings, has fallen from an all-time high in January and is near its lowest level since mid-2016. It would be premature at this point to suggest that excessive valuations have been relieved. They have not. Even with emerging evidence that long-term economic trends are improving, the combination of still-elevated valuations and historically high household exposure to equities (see the lower chart on page 4 of our latest Investment Strategy Outlook) could weigh on stock market returns going forward. The valuation gains this year have come as companies have exceeded earnings expectations at historically high levels, fueled in part by record profit margins. Sustaining strong earnings growth could become more challenging if margin pressures continue to build.



Source: Ned Davis Research

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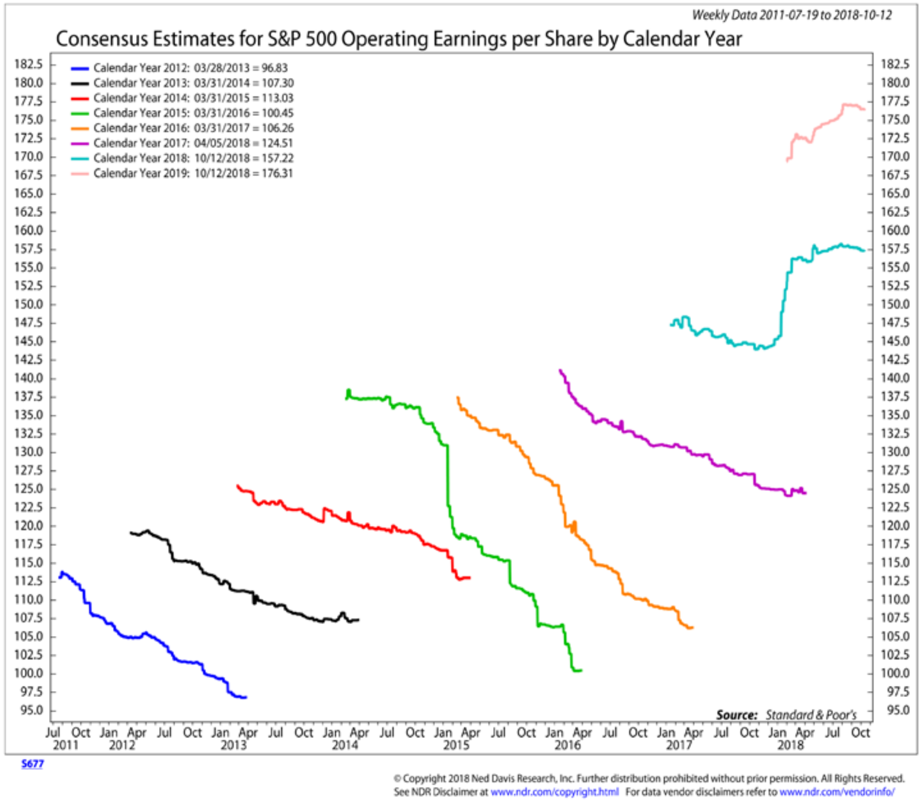
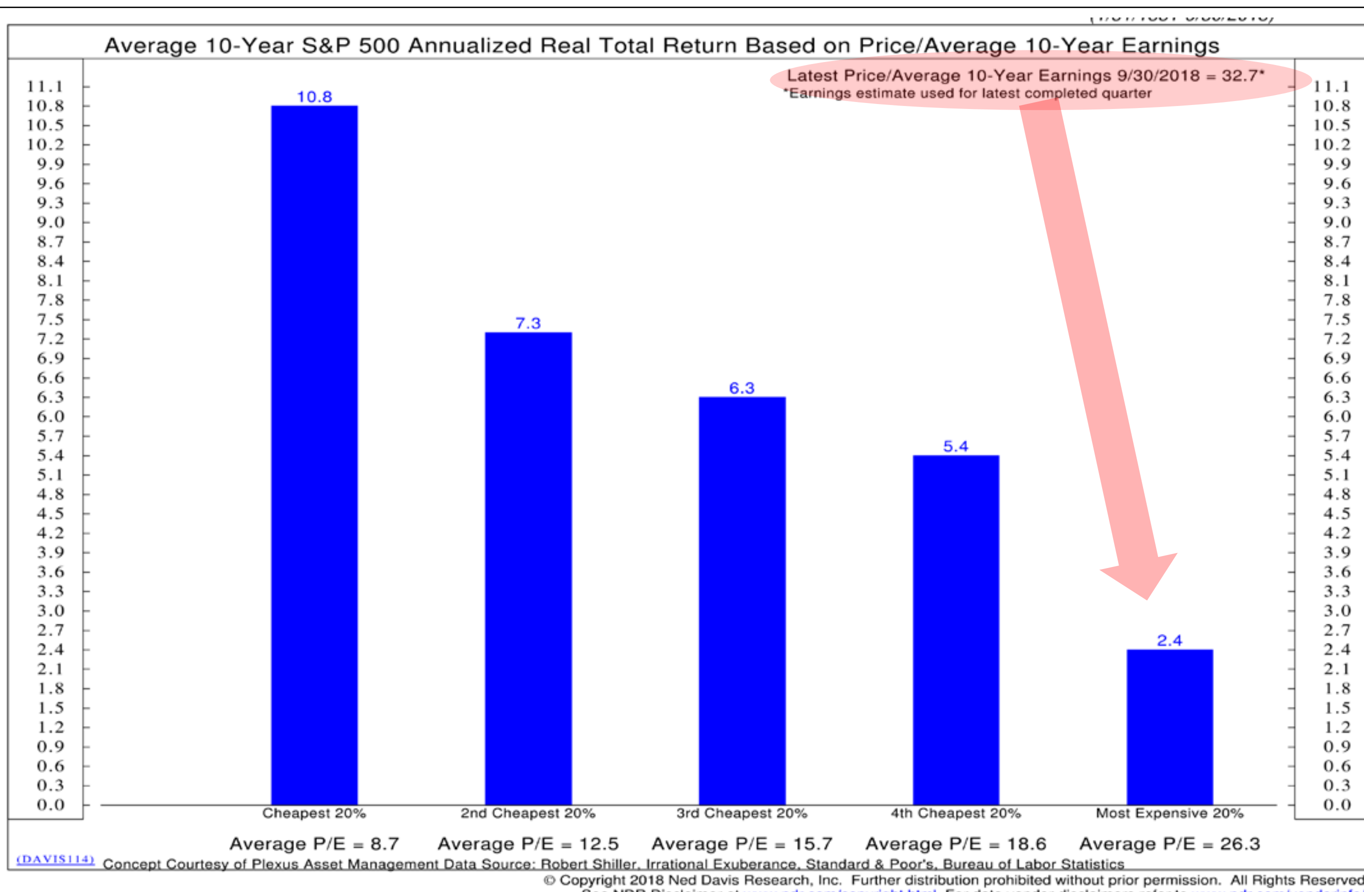
The volatility in stock prices in 2018 can obscure some fundamental improvements that have occurred in 2018. Earnings estimates have not only not fallen over the course of the year (which had become the norm in previous years), but estimates for both this year and next have actually been rising. It remains to be seen whether these forecasts prove any more reliable than they have in the past, but the shift in trend is nonetheless encouraging. The less-than-encouraging reality is that even with the valuation improvement that has been seen, stocks remain expensive and there is a strong inverse correlation between starting valuation levels and real returns over the ensuing decade. Valuations are poor timing tools in the short term but as shown below, excellent indicators of risk over the longer term. Based on this, risks remain elevated.

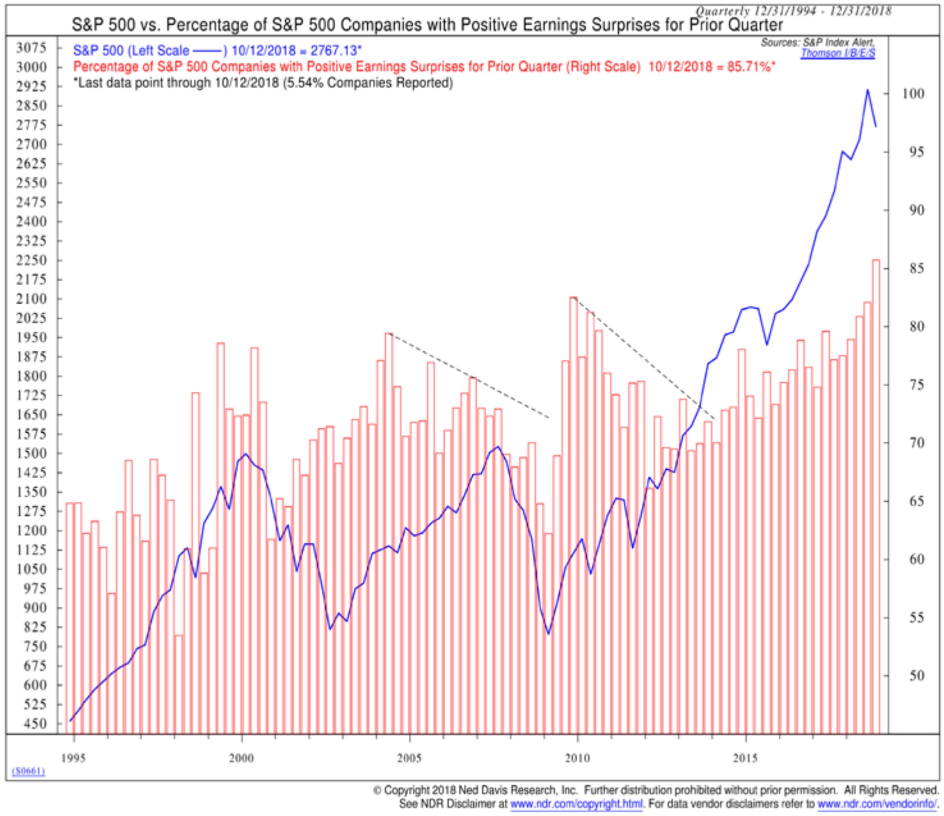


Source: Ned Davis Research

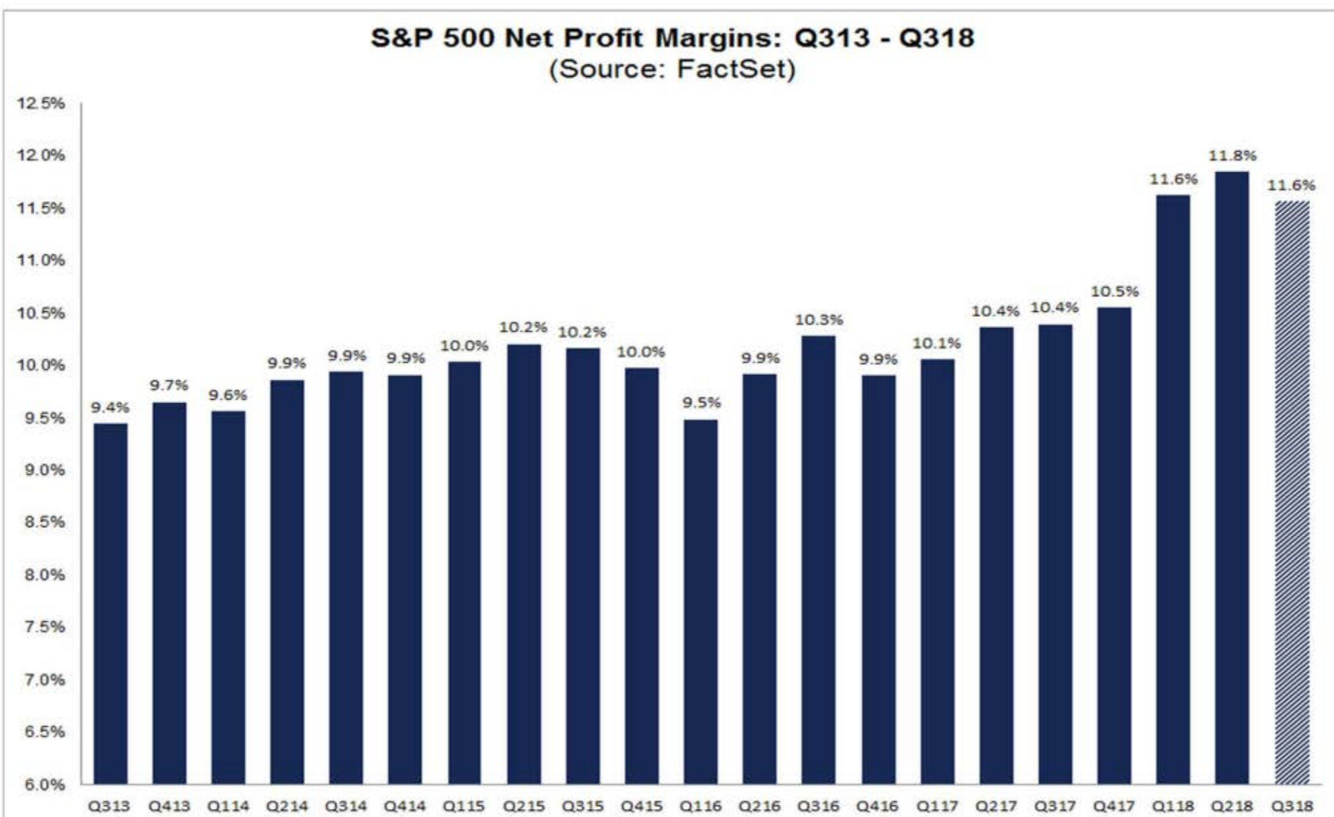


Source: Ned Davis Research

Valuation improvement in 2018 has come as companies have exceeded earnings expectations at historically high rates and profit margins have moved to record highs. In other words, a linear extrapolation of the most recent experience may be unduly optimistic. But with Q3 earnings now being reported, we can look at reality and not just expectations. So far (and it is early) the percentage of companies beating expectations for both sales and earnings has been above average, but the degree to which they are exceeding expectations is below average. Profit margins have dipped from their recent peak but remain elevated. With anecdotal reports of rising costs becoming more widespread, the focus on margins may become more acute going forward.



Source: Ned Davis Research



Source: FactSet

Appendix – Important Disclosures and Analyst Certification

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