Market Update
Q2 2020 Review and Outlook

Despite the global pandemic and subsequent recession, the S&P 500 had its best quarter since 1998. Investors embraced risk-on sentiment as massive stimulus, economic reopening, vaccine optimism, and more buoyed risk assets. The 10-year Treasury ended at 0.67%

IN THIS ISSUE

PAGE 2: HISTORIC RALLY
- Tale of Two Markets
- Economic Damage
- Is the Market Crazy?
- Timing the Market

PAGE 3: EQUITY
- Action & Reactions
- Sentiment Evolves
- Growth vs. Value
- Global Returns

PAGE 4: FIXED INCOME
- Fixed Income at a Glance
- Corporate Credit
- Securitized Supported
- Modest Munis

The Markets at a Glance

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Representative Benchmark</th>
<th>Q2 Return</th>
<th>YTD Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Large Cap</td>
<td>S&amp;P 500</td>
<td>20.5%</td>
<td>-3.1%</td>
</tr>
<tr>
<td>US Small Cap</td>
<td>Russell 2000®</td>
<td>25.4%</td>
<td>-13.0%</td>
</tr>
<tr>
<td>International</td>
<td>MSCI EAFE</td>
<td>14.9%</td>
<td>-11.3%</td>
</tr>
<tr>
<td>Commodities</td>
<td>Bloomberg Commodity</td>
<td>5.1%</td>
<td>-19.4%</td>
</tr>
<tr>
<td>Municipal Bonds</td>
<td>BBgBarc. Municipal</td>
<td>2.7%</td>
<td>2.1%</td>
</tr>
<tr>
<td>Taxable Bonds</td>
<td>BBgBarc. Aggregate</td>
<td>2.9%</td>
<td>6.1%</td>
</tr>
<tr>
<td>Cash</td>
<td>FTSE 3-Month T-Bills</td>
<td>0.1%</td>
<td>0.5%</td>
</tr>
</tbody>
</table>

Performance returns are as of 6/30/2020

Q2 Recap

Despite enduring the first US recession in a decade, the S&P 500 turned in its best quarter in over twenty years. Bullish sentiment enveloped markets as a combination of stimulus, reopening progress, vaccine optimism, and bottoming economic data drove equities higher. Small- and mid-cap indices outperformed large-cap, while Growth continued its run of outperformance over Value. Oil rallied over 90% on the quarter as supply/demand dynamics turned more favorable and economic optimism rebounded.

International equities rallied, as well, led by some of the 2020 laggards. Though they continue to trail domestic markets year-to-date, both developed and emerging market equities outperformed over the final half of the quarter as the US dollar weakened substantially. Commodity-oriented economies like Brazil and Australia outperformed as the forward demand picture improved significantly.

The broad fixed income market returned 2.9%. Bond investors also embraced risk-on sentiment – Investment-Grade and High Yield bonds returned 9.0% and 10.2%, respectively. Though bankruptcies continue to build as the pandemic rolls on, the perceived “Fed backstop” and re-opening optimism have buoyed markets. The 10-year Treasury ended at 0.67%
A Tale of Two Markets

The first half of 2020 has been a tale of two markets. While the first quarter of 2020 culminated in the fastest peak to bear market in S&P 500 history amid historic volatility, the second quarter saw the best S&P 500 performance in over twenty years.

Though the rally faltered near the end of the quarter on re-emerging coronavirus worries, the stock market recovery was generally broad-based and consistent with other new bull markets from the past. Though rallies of this strength can portend near-term weakness, the long-term trend is overwhelmingly positive (see Figure 1).

Economic Damage

Unfortunately, this is not consistent with the economic damage we see on the ground. Though the market has rebounded with enthusiasm, the US economy is still technically in the midst of a coronavirus-driven recession and one of the worst labor markets of all time, with several months of double digit unemployment and over 13 million jobs yet to be regained from pre-COVID. Unemployment insurance claims have begun to level off, but at worrying levels.

The extent of the possible economic recovery largely lies here. According to the US Bureau of Labor Statistics, most unemployed individuals believe that they are only temporarily furloughed and will regain employment in the near future. This may well end up the case, but permanent unemployment (i.e. jobs lost for good) continues to rise and bankruptcies keep rolling in. Without a vaccine or additional stimulus, more and more “temporary” layoffs will become permanent and compound the long-term damage of the COVID-19 crisis.

Is the Market Crazy?

Despite the depression-level unemployment and dire economic outlook, the stock market spent most of Q2 going straight up. Though the divergence between the stock market and economy has rarely been starker, there are compelling reasons for the market rally: 1) Historically large and fast stimulus response (both monetary and fiscal); 2) The composition of the cap-weighted broad market (e.g. S&P 500) is heavily tilted toward technology firms tailor-made for a pandemic lockdown and work-from-home environment; 3) The broad market is also global, getting ~40% of its revenue from overseas where many economies have reopened faster, and seen less severe pandemic outbreaks; 4) Stock prices are forward-looking — vaccine and treatment optimism have given the market hope that a return to normalcy will occur sooner rather than later.

Despite this, stock valuations are beginning to look quite rich, particularly at a moment when earnings are set to plummet. The forward P/E on the S&P 500 closed June around 21.9, its highest level since the dot-com bubble of the early 2000’s. Meanwhile, Q2 earnings are projected to fall ~45% as companies deal with the fallout from the pandemic.

Timing the Market

Unfortunately, many likely missed out on the historic rally off of the March 23 lows. Fund flow data show severe outflows near the end of March w/ massive inflows into money market vehicles. The shift to safer investments certainly made sense given the widespread panic and economic devastation, but it also likely kept many on the sidelines for the V-shaped bounce in stocks.

This activity reiterates the difficulty in timing the stock market. Timing the market requires an investor to make two correct calls—a sell and a buy. While an astute investor may have seen the possibility of the Wuhan outbreak spreading globally and taken some risk off of the table, very few could have predicted such a strong and speedy bounce off the lows. Past recession-driven bear markets took months (or years) to ultimately bottom before a recovery began. The COVID-19 bear took only 33 days.

This unexpected rebound and the volatility of this year also reinforce the importance of staying invested for the long-term, even through painful bear markets. Had you missed just the five best days of the year, you would be down ~30% vs. the broad market. The best days really do happen during the worst times in stocks, and missing them can be fatal to long-term performance. A long-term mindset and stomach for volatility is key to achieving financial goals.

Figure 1: S&P Forward Performance

<table>
<thead>
<tr>
<th>Date</th>
<th>65-Day % Change</th>
<th>202 Days % Change</th>
<th>65 Days % Change</th>
<th>125 Days % Change</th>
<th>250 Days % Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>6/10/2009</td>
<td>38.8%</td>
<td>-6.0%</td>
<td>11.0%</td>
<td>17.5%</td>
</tr>
<tr>
<td>2.</td>
<td>11/9/2012</td>
<td>38.7%</td>
<td>-8.0%</td>
<td>-0.4%</td>
<td>15.9%</td>
</tr>
<tr>
<td>3.</td>
<td>1/11/1990</td>
<td>30.2%</td>
<td>-3.8%</td>
<td>4.7%</td>
<td>10.7%</td>
</tr>
<tr>
<td>4.</td>
<td>3/12/1975</td>
<td>28.6%</td>
<td>0.2%</td>
<td>8.2%</td>
<td>1.2%</td>
</tr>
<tr>
<td>5.</td>
<td>7/16/1997</td>
<td>25.9%</td>
<td>-1.6%</td>
<td>2.0%</td>
<td>10.7%</td>
</tr>
<tr>
<td>6.</td>
<td>4/17/1991</td>
<td>24.9%</td>
<td>-3.6%</td>
<td>-1.6%</td>
<td>-1.0%</td>
</tr>
<tr>
<td>7.</td>
<td>6/12/2003</td>
<td>24.7%</td>
<td>0.0%</td>
<td>4.8%</td>
<td>6.7%</td>
</tr>
<tr>
<td>8.</td>
<td>8/15/1981</td>
<td>20.0%</td>
<td>1.3%</td>
<td>9.0%</td>
<td>14.1%</td>
</tr>
<tr>
<td>9.</td>
<td>1/28/1963</td>
<td>23.0%</td>
<td>3.8%</td>
<td>3.5%</td>
<td>16.4%</td>
</tr>
<tr>
<td>10.</td>
<td>12/2/1898</td>
<td>22.4%</td>
<td>5.2%</td>
<td>9.3%</td>
<td>11.0%</td>
</tr>
</tbody>
</table>

Last 65 Trading Days: 36.3%

Source: Strategas Research
Equity Markets

US Equity Market Benchmarks

<table>
<thead>
<tr>
<th>Equities</th>
<th>Representative Benchmark</th>
<th>Q2 Return</th>
<th>YTD Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Large</td>
<td>S&amp;P 500</td>
<td>20.5%</td>
<td>-3.1%</td>
</tr>
<tr>
<td>US Mid</td>
<td>Russell Midcap®</td>
<td>24.6%</td>
<td>-9.1%</td>
</tr>
<tr>
<td>US Small</td>
<td>Russell 2000®</td>
<td>25.4%</td>
<td>-13.0%</td>
</tr>
<tr>
<td>US Value</td>
<td>Russell 3000 Value</td>
<td>14.6%</td>
<td>-16.7%</td>
</tr>
<tr>
<td>US Growth</td>
<td>Russell 3000 Growth</td>
<td>28.0%</td>
<td>9.0%</td>
</tr>
<tr>
<td>Dev. Int’l</td>
<td>MSCI EAFE</td>
<td>14.9%</td>
<td>-11.3%</td>
</tr>
<tr>
<td>Emg. Int’l</td>
<td>MSCI EM</td>
<td>18.1%</td>
<td>-9.8%</td>
</tr>
</tbody>
</table>

Performance returns as of 6/30/2020

Action and Reaction

Newton's Third Law of Motion states that for every action there is an equal and opposite reaction. Newton, a central banker himself, would not recognize the recent Fed “reactions.” Thus, the pandemic selloff was counteracted by historic action from the Federal Reserve and the US Government aimed at helping businesses and individuals weather the storm.

As a result, the S&P ended Q2 +20.5%, and is down just 3.1% YTD. The index accomplished this feat despite a 45% drop in est. Q2 earnings (source: FactSet). Despite heightened uncertainty, the forward multiple on the S&P 500 expanded to 22x earnings. However, equities remain compelling given low rates; the 10-year Treasury yield closed Q2 at just 67 bps.

Sentiment Evolves

Optimism also lifted markets. Cases in the hard-hit states of New York and New Jersey declined this quarter, which supported optimism on a V-shaped recovery. However, June saw total US cases climb to new highs. The increase has not coincided with a spike in deaths, which could be due to more testing, better treatments, and/or the age shift of the infected. Perhaps there’s just a lag in the data.

Though the data is difficult to decipher, the market seems to be taking its lead from daily case numbers. This is supported by Strategas’ US Re-Opening Basket, which is constructed of stocks highly dependent upon a return to normalcy. This basket (see Figure 2) has underperformed since daily cases began spiking in June.

Theory of Relativity: Growth vs. Value

As the re-open trade lagged, the preference for Growth over Value persisted despite the relative cheapness of Value. In Q2, the Russell 3000 Growth rallied 28% after protecting more than Value in Q1. Growth is now ahead of Value by over 25%, the widest margin since 1999. Investors are predictably impatient with Value, though proponents argue it is more attractive than Growth at these prices. Investors did find small- and mid-caps more attractive than large-caps in Q2 for a change of pace.

SMID-cap Trends

Reversing Q1 losses, small- and mid-cap stocks overtook large in Q2. Following a recession, small-cap leadership is typically followed by broader gains across market-caps. Within small, the two hardest hit sectors in Q1 were Q2 leaders. Cons. Disc. rose 51.3% as the nation emerged from lockdown, and Energy rose 44.9%. Elsewhere, changing index dynamics appeared. As of 6/30, Biotech reached 18.5% of the Russell 2000 Growth, doubling its index weight in just three years. Healthcare now makes up ~35% of the index. Value also became more cyclical, as Tech lost share while Financials and Industrials gained ground. These trends may further exacerbate the divide between Growth and Value.

Circumnavigating Global Returns

Investors continued to favor US over International despite a weaker dollar, usually a tailwind for foreign stocks. Notably, Emerging outpaced Developed, indicating a more risk-on sentiment. At a country level, the best performers were Australia and South Africa, both of which were pummeled in Q1. Laggards included Hong Kong and UK, two countries going through political turmoil AND economic woes. China remains one of the only countries with a positive YTD return at 3.5%. The Netherlands, Switzerland, and Taiwan are all down less than 2% YTD, as their concentrations in tech and/or health care have thrived through the pandemic. In contrast, Brazil and Mexico have struggled this year, down 39% and 28% respectively. Both countries are facing spiking COVID-19 cases and are hurting from low commodity prices.
Fixed Income

U.S. Fixed Income Benchmarks

<table>
<thead>
<tr>
<th>Fixed Income</th>
<th>Representative Benchmark</th>
<th>Q2 Return</th>
<th>YTD Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable</td>
<td>BBgBarc. Aggregate</td>
<td>2.9%</td>
<td>6.1%</td>
</tr>
<tr>
<td>Treasury</td>
<td>BBgBarc. Treasury</td>
<td>0.5%</td>
<td>8.7%</td>
</tr>
<tr>
<td>Corporate</td>
<td>BBgBarc. Corporate</td>
<td>9.0%</td>
<td>5.0%</td>
</tr>
<tr>
<td>High Yield</td>
<td>BBgBarc. US HY Bond</td>
<td>10.2%</td>
<td>-3.8%</td>
</tr>
<tr>
<td>Municipal</td>
<td>BBgBarc. Municipal</td>
<td>2.7%</td>
<td>2.1%</td>
</tr>
<tr>
<td>Int'l</td>
<td>BBgBarc. Global Agg.</td>
<td>3.3%</td>
<td>3.0%</td>
</tr>
</tbody>
</table>

Performance returns as of 6/30/2020

Fixed Income at a Glance

The broad US bond market, as measured by the Bloomberg Barclays Aggregate, delivered positive returns in Q2, increasing 2.9%. Risk sentiment staged a rapid recovery as investors accepted COVID-19 and adjusted to the new reality. Economic data and virus-related news during Q2 were not as dire as initially forecasted, prompting a bid for risk assets and spread product. Policy remains accommodative, creating incentive for liquidity-driven increases across financial markets.

Q2 saw rates stay relatively range bound, while credit spreads snapped back as fundamental concerns were pushed aside and demand for yield took over. Sectors hit hardest in Q1 experienced the biggest rebound in Q2, with High Yield, Leveraged Loans, and Investment Grade Credit leading, returning 10.2%, 9.6%, and 9.0% respectively. IG spreads tightened despite the high degree of economic uncertainty and record corporate debt issuance YTD ($1.6T). Abroad, a not-so-dire growth outlook and a weaker USD served as support for EM debt, which saw a 10.0% increase in Q2. Laggards included US Treasuries (0.5%) and MBS (0.7%). Because of their low yield profile, returns for these high-quality sectors are more driven by rates than income. The 10-yr Treasury ended Q2 at 0.67%.

Corporate Credit Remains in Focus

Focusing on corporate credit performance in Q2 a bit more, investors allocated to sectors directly impacted by COVID-19 have reaped the benefits in Q2 as performance was led by Energy, Gaming, Autos, and Lodging. Declining corporate revenues coupled with record new issuance has caused some elevated concern and brought the market’s debt profile into question, but these concerns have been mitigated by robust demand for yield and the subsequent technical tailwind that stems from that. The Fed has effectively addressed liquidity concerns that shook the market in Q1 and purchased close to $7B in credit-focused ETFs since March. In June, they began purchasing primary market issues. Economic weakness and elevated uncertainty has brought forward rating downgrades and defaults. The number of IG companies downgraded to HY has surpassed $160B (Figure 3 ) while defaults rates have risen to 6.1%. As COVID-19 cases are back on the rise, the concern of liquidity issues transitioning to solvency issues will be on fixed income investors’ minds during the latter half of 2020.

Securitized Debt Helped by Fed Support

Agency mortgage-backed securities saw modest returns in Q2 but were challenged during the quarter by increased origination and higher prepayment speeds, both of which are symptoms of the low rate environment. Commercial mortgage fundamentals continued to deteriorate and have experienced an increase in delinquencies. Fed support and policy intervention, however, have helped tighten CMBS spreads to 130bps from a peak level of 260bps in March.

Municipal Bonds See Modest Rebound

Munis returned 2.7% in Q2, lagging their taxable peers by 20bps. With assistance from the Federal Reserve and policy invention, order was restored to the muni market. Sector dispersion continues to be elevated; COVID-impacted like transportation, healthcare, airports, and convention centers are still trading at wide levels vs. historical averages (though tighter than Q1). Risk sentiment returned to the muni market during Q2, leading to strong performance for high yield (4.6%) and taxable municipals.

Figure 3: Fallen Angels

Source: JP Morgan, TCW
Benchmark and Asset Class Definitions

S&P 500 Index (Large Cap / U.S. Stocks): A representative sample of 500 leading companies in leading industries of the U.S. economy. These are equity securities of large capitalization (generally $7 billion plus market cap) companies having growth and value characteristics.

Russell 3000® Growth Index (All Cap Growth / Growth Stocks): Measures the performance of the 3,000 largest U.S. companies based on total market capitalization with higher price-to-book ratios and higher forecasted growth values.

Russell 3000® Value Index (All Cap Value / Value Stocks): Measures the performance of the 3,000 largest U.S. companies based on total market capitalization with lower price-to-book ratios and lower forecasted growth values.

Russell 1000® Growth Index (Large Growth): Measures the performance of those Russell 1000® Index companies with higher price-to-book ratios and higher forecasted growth values. These are equity securities of large capitalization ($7 billion plus market cap) companies having growth stock characteristics (high price to earnings, high return on equity and low dividend yield).

Russell 1000® Value Index (Large Value): Measures the performance of those Russell 1000® Index companies with lower price-to-book ratios and lower forecasted growth values. These are equity securities of large capitalization ($7 billion plus market cap) companies having value stock characteristics (low forecasted price-to-earnings ratio, low price-to-book ratio, high dividend yield).

Russell Midcap® Index (Mid Cap / Mid Core): Measures the performance of the 800 smallest companies of the Russell 1000® Index, which represent approximately 31% of the total market capitalization of the Russell 1000® Index. These are equity securities of middle capitalization ($2-7 billion plus market cap) companies having growth and value characteristics.

Russell 2000® Index (Small Cap / Small Core): Measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represent approximately 10% of the total market capitalization of the Russell 3000® Index. These are equity securities of small capitalization (<$2 billion plus market cap) companies having growth and value characteristics.

Russell Micro Cap Index (Micro Cap): Measures the performance of the 1,000 smallest companies in the Russell 2000® Index, which represent approximately 3% of the total market capitalization of the Russell 3000® Index.

MSCI EAFE Index Net (International / Developed Markets): A free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. As of May 27, 2010 the MSCI EAFE Index consisted of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

FTSE 3-month T-bill Index (Cash): This index measures monthly return equivalents of yield averages that are not marked to market. It consists of the last one-month and three-month Treasury bill issues, respectively.


MSCI Emerging Markets Index Net (Emerging Markets): A free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of May 27, 2010 the MSCI Emerging Markets Index consisted of the following 21 emerging market country indices.

MSCI Country Indices (Country-Specific Markets): To construct an MSCI Country Index, every listed security in the market is identified. Securities are free float adjusted, classified in accordance with the Global Industry Classification Standard (GICS®), and screened by size and liquidity. MSCI then constructs its indices by targeting for index inclusion 85% of the free float adjusted market capitalization in each industry group, within each country. By targeting 85% of each industry group, the MSCI Country Index captures 85% of the total country market capitalization while it accurately reflects the economic diversity of the market. This includes the MSCI Japan Index. International indices.

BBgBarc Aggregate Bond Index (Taxable Bonds / Bonds): Comprised of approximately 6,000 publicly traded bonds, including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years.

BBgBarc Global Aggregate Bond Index (Global Bonds): Provides a broad-based measure of the global investment-grade fixed income markets. The three major components of this index are the U.S. Aggregate, the Pan-European Aggregate, and the Asian-Pacific Aggregate Indices. The index also includes Eurodollar and Euro-Yen corporate bonds, Canadian government, agency and corporate securities, and USD investment grade 144A securities.

BBgBarc Muni Bond Index (Municipal Bonds): Bonds must have a minimum credit rating of at least Baa, an outstanding par value of at least $3 million, part of a transaction of at least $50 million, issued after December 31, 1990 and have a year or longer remaining maturity.

BBgBarc U.S. High Yield Bond Index (High Yield): Covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (e.g., Argentina, Brazil, Venezuela, etc.) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included.

BBgBarc U.S. Treasury Bond Index (Treasury Bonds): Comprised of U.S Treasury securities with at least one-year maturities.

BBgBarc U.S. Corporate Bond Index (Corporate Bonds): includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements.
Appendix Definitions and Disclosures

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