Evidence Bullish Heading Toward 2020

Highlights:
• Bond Yields Support Fed Moving to Sidelines
• Global Economy Seeing Green Shoots
• Valuations Elevated but Improving
• Pockets of Skepticism Amid Increased Investor Optimism
• Seasonals Argue for Small-Cap Strength
• Breadth Bullish Despite Blemishes

Since our last Investment Strategy Outlook was published (September 26), the Weight of the Evidence has been upgraded from neutral to bullish on the back of an improved breadth backdrop. This suggests there is a path for stocks to work higher into year-end, capping what has been a year of remarkable strength across almost all asset classes. While considering the current evidence, we also want to begin to look forward to next year and the beginning of a new decade.

Large-cap US stocks have enjoyed a decade of remarkable success versus small-cap stocks and indeed the rest of the world. They are likely to struggle to match those absolute or relative gains over the coming decade. Broadly distributed strength in 2019 seems to be the initial evidence of shifting leadership trends. Investors will need to adapt to this emerging reality. The path toward success may include a renewed focus on portfolio diversification and a willingness to tactically adjust exposure as risks and opportunities emerge. A well-constructed financial plan will help prepare for such environment, as will setting aside emotional decision-making and continuing instead to lean on the weight of the evidence.
Federal Reserve Policy is bullish. The Fed cut rates three times in the second half of 2019 but now appears poised to move to the sidelines as the effects of this mid-cycle adjustment are absorbed by the financial markets and the economy. Around the world, more than 85% of central banks are in easing mode (all of the net gains in the all-country world stock index over the past 30+ years have come when more than 50% of central banks were easing). The direction of bond yields could help guide Fed moves going forward. With yields in both the US and Germany moving higher since their late-summer lows, the bond market is supporting a continued wait-and-see stance from the Fed.

Whether the discussion moves from waiting-and-seeing about further rate cuts to waiting-and-seeing about the path toward tightening may continue to rest with inflation trends. The Cleveland Federal Reserve Bank calculates a median CPI measure to identify the trend in inflation (rather than arbitrarily removing food and energy prices from the calculation, which is the core CPI approach). The median CPI has shown more inflation in recent years than has the core CPI. While it may limit the Fed’s flexibility, an uptick in inflation would suggest a healthy and organic strength in the economy and the emergence from a decade of economic stagnation.
Economic Fundamentals are neutral. The US economy has been resilient in the face of policy uncertainty, but from our perspective it is not out of the woods with respect to a growth scare. Leading economic indicators are deteriorating at a time when concerns about recession (as measured by internet searches of the subject) are plummeting.

While the US may be vulnerable to some disappointment, there is encouraging economic evidence from abroad. The global manufacturing PMI is hinting at the emergence of global green shoots. October had the most countries (54%) reporting an uptick in their PMI’s since the global slowdown began.

While expressed concern about recession in the US appears to be ebbing, confidence measures remain under pressure. Consumer confidence (as measured by the Conference Board) is still at a high level from an absolute perspective, but as the chart to the left shows, it is falling at its fastest pace in a decade. Further deterioration (fueled by unconsummated trade deals, political developments or something else) would suggest downside risks in the economy are expanding. This trend in consumer confidence and whether CEO confidence can recover will be key areas of interest as we move into and through 2020.
Valuations are bearish. The degree to which stocks appear expensive varies by indicator. One of the more constructive valuation indicators we watch is the Value Line Price/Earnings ratio. This weekly indicator blends six-months of trailing earnings data with six months of forward data. It currently suggests that it would not take much earnings improvement and/or price correction to move valuations toward a more neutral level.

From a long-term perspective, current valuation levels for US large-cap stocks suggest forward returns could be muted. Supporting the call for a renewed emphasis on diversification, valuations overseas are at more historically favorable levels.

Sentiment is neutral. There is plenty of evidence that the S&P 500’s recent run into record territory has been accompanied by increased investor optimism. Weekly surveys and options data reflect this shift. At a time when sentiment data is getting a lot of focus, short-term indicators have become noisier. While seeing optimism, we do not have evidence that it is widespread, deep-seated and excessive. In fact, there remain some pockets of continued skepticism. Equity fund flows have not shown outright optimism and consumers have a decidedly less rosy view of stocks now than just a few months ago. The percentage of consumers expecting stocks to decline over the coming year is actually high enough to be a contrarian bullish signal for stocks.
Seasonal patterns are neutral. Just as sentiment indicators are getting a lot of attention right now, so too are seasonal patterns. This has muted their efficacy in our view. To have confidence that the expected seasonal strength (which has been widely reported) is indeed emerging, we would like to have evidence beyond just headlines. Small-caps improving relative to large-caps would be helpful in this regard.

Election-year related patterns are likely being distorted by impeachment proceedings. Our view is that as long as Trump’s approval rating in the Gallup poll remains above 35%, these proceedings are likely more noise than news.

Breadth is bullish. An expanding percentage of industry groups are up-trends and global participation has been robust. The Europe ex UK index as more stocks trading above their 50-day averages than does the S&P 500. The percentage of global indexes moving to new 52-week highs is expanding, providing a more bullish backdrop than was present during previous rallies over the past two years.

While breadth has been sufficiently strong to merit an upgrade, it has not been without blemish. The new high list is disappointingly narrow and has struggled to consistently expand. The percentage of stocks trading above their 200-day averages has not moved to a new high.
Investment Strategy Outlook

**Investment Implications:**

It is not too early to begin adopting a more tactical focus – following strength and fading weakness. This will likely be the next iteration of the active/passive debate.

At the sector level, leadership from Utilities, Real Estate and Consumer Staples has faded. New leadership is being seen from Financials, Industrials and Materials. The Industrials sector has broken out to a new high while breadth has made a series of higher highs and higher lows.

After a decade when global diversification depressed returns and increased risk for US investors, an opportunity for international leadership has re-emerged.

Emerging Markets are testing (and appear poised to break) a two-year down-trend on an absolute and relative basis. Recent improvement in copper prices supports strength in Emerging Market stocks.

The German DAX index is challenging its January 2018 peak and has been gaining strength versus the S&P 500.

The recent move higher in bond yields supports the view that investors will need to remain tactical and adaptive across asset classes.

Even though cash is under-owned from a historical perspective, its use as an active asset class should not be overlooked.
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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.

<table>
<thead>
<tr>
<th>Model Portfolio</th>
<th>Mix: Stocks / (Bonds + Cash)</th>
<th>Risk Tolerance</th>
<th>Strategic Asset Allocation Model Summary</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Growth</td>
<td>100 / 0</td>
<td>Well above average</td>
<td>Emphasis on providing aggressive growth of capital with high fluctuations in the annual returns and overall market value of the portfolio.</td>
</tr>
<tr>
<td>Capital Growth</td>
<td>80 / 20</td>
<td>Above average</td>
<td>Emphasis on providing growth of capital with moderately high fluctuations in the annual returns and overall market value of the portfolio.</td>
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<tr>
<td>Growth with Income</td>
<td>60 / 40</td>
<td>Average</td>
<td>Emphasis on providing moderate growth of capital and some current income with moderate fluctuations in annual returns and overall market value of the portfolio.</td>
</tr>
<tr>
<td>Income with Growth</td>
<td>40 / 60</td>
<td>Below average</td>
<td>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.</td>
</tr>
<tr>
<td>Conservative Income</td>
<td>20 / 80</td>
<td>Well below average</td>
<td>Emphasis on providing high current income with relatively small fluctuations in the annual returns and overall market value of the portfolio.</td>
</tr>
<tr>
<td>Capital Preservation</td>
<td>0 / 100</td>
<td>Well below average</td>
<td>Emphasis on preserving capital while generating current income with relatively small fluctuations in the annual returns and overall market value of the portfolio.</td>
</tr>
</tbody>
</table>

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<table>
<thead>
<tr>
<th>Asset Class / Model Portfolio</th>
<th>All Growth</th>
<th>Capital Growth</th>
<th>Growth with Income</th>
<th>Income with Growth</th>
<th>Conservative Income</th>
<th>Capital Preservation</th>
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</thead>
<tbody>
<tr>
<td>Equities:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Suggested allocation</td>
<td>95%</td>
<td>75%</td>
<td>55%</td>
<td>35%</td>
<td>15%</td>
<td>0%</td>
</tr>
<tr>
<td>Normal range</td>
<td>90 – 100%</td>
<td>70 - 90%</td>
<td>50 - 70%</td>
<td>30 - 50%</td>
<td>10 - 30%</td>
<td>0%</td>
</tr>
<tr>
<td>Fixed Income:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Suggested allocation</td>
<td>0%</td>
<td>15%</td>
<td>35%</td>
<td>45%</td>
<td>50%</td>
<td>60%</td>
</tr>
<tr>
<td>Normal range</td>
<td>0 - 0%</td>
<td>10 - 30%</td>
<td>30 - 50%</td>
<td>40 - 60%</td>
<td>45 - 65%</td>
<td>55 – 85%</td>
</tr>
<tr>
<td>Cash:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Suggested allocation</td>
<td>5%</td>
<td>10%</td>
<td>10%</td>
<td>20%</td>
<td>35%</td>
<td>40%</td>
</tr>
<tr>
<td>Normal range</td>
<td>0 - 10%</td>
<td>0 - 20%</td>
<td>0 - 20%</td>
<td>10 - 30%</td>
<td>25 - 45%</td>
<td>15 - 45%</td>
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