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Baird Trust Market Commentary

Investing in Uncertain Times

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"We underrate the unpredictability of the future, because we overrate the inevitability of the past."

– Marc Andreessen, Co-Founder of VC firm Andreessen Horowitz

Today's investment environment feels more uncertain than ever. Inflation is surging, interest rates are rising, there's a war in Europe, commodity prices are climbing rapidly, and stock volatility has returned. Even though the future is always uncertain, there are times when the range of future outcomes seems wider than normal. Elevated uncertainty often leaves investors confused and uneasy about their portfolios.

While there are many contributing factors, we believe there are two key drivers of today's uncertainty. First, the Federal Reserve (Fed) is at the beginning of a radical policy shift to tackle rising inflation. Second, Russia's invasion of Ukraine introduced substantial geopolitical upheaval after a long period of relative calm.

The End of an Era

The past 15 years were characterized by highly accommodative monetary policy from the Fed – quantitative easing (QE) and near-zero interest rates. In fact, the Fed Funds rate was below 1% for 71% of this 15-year period (128 out of 180 months) and was above 1% and rising only 11% of the time (19 months). Additionally, the Fed's aggressive bond purchasing through QE expanded its balance sheet 10-fold from $900 billion in 2007 to nearly $9 trillion today. This period of accommodative policy began with the onset of the 2008/2009 Global Financial Crisis and, aside from a brief period in 2017/2018, continued through the COVID-19 pandemic.

Low rates act as an accelerant to business activity as consumers and businesses can borrow cheaply and refinance existing debt at a lower cost. Low rates also boost stock prices. They make bonds less attractive, encouraging money to shift from bonds to stocks. And they allow businesses to be valued more richly because the present value of future cash flow is worth more when rates are low. Low rates are not the only reason for the strong performance of the stock market since 2008, but they provided a helpful tailwind.

However, with inflation at a 40-year high and moving higher, the future path of Fed policy is likely to look very different than that of the past 15 years. The Fed recently indicated it would "do whatever it takes" to combat inflation, which means higher interest rates, perhaps materially, and the withdrawal of QE. The tailwinds many investors became accustomed to since 2008 are likely to reverse going forward, creating potential headwinds to business activity and stock prices.

War in Europe

In addition to the shifting monetary policy environment, the geopolitical environment is becoming more complicated. This marks a significant shift from the relative global stability and increasing globalization of the past 15+ years, which ended emphatically with the Russian invasion of Ukraine.

This conflict, combined with COVID-19 driven supply chain disruptions, laid bare the downsides of too much globalization. Because of this, many countries are reevaluating the economic and national security impacts of global interdependence, and we may be entering a period of de-globalization. It is impossible to predict what the impacts will be, but the next decade will likely see companies bringing production closer to home.

Furthermore, the invasion exacerbated the domestic inflation issues as energy and commodity prices surged higher. The Fed must now adjust its policy faster than what was expected just 6 weeks ago while also being careful not to go too far and cause a recession. Threading this needle and avoiding a policy error, whether that be prolonged inflation or a recession, will be extraordinarily difficult.

Return of Market Volatility

These two profound shifts drove uncertainty to the forefront of investors' minds in the first quarter of 2022. Elevated uncertainty often coincides with elevated stock market volatility, which was on display with stocks gyrating wildly in the quarter.

After reaching an all-time high of 4,796 on January 3rd, the S&P 500 fell 10% by January 27th, rebounded 6% by February 2nd, and then fell another 9% to 4,170 by March 8, down 13% from the high. However, in the face of rising pessimism, the S&P 500 rallied sharply through the end of March to end the quarter at 4,530 – up 9% from its low and only down 4.6% on the year.

This price movement is in stark contrast to the benign volatility in 2021 where the largest peak-to-trough drawdown was only 5%, and there were 70 new all-time highs. With uncertainty over Fed policy and the conflict in Europe remaining elevated, it is likely we will see continued stock market volatility for the foreseeable future.

Prognostications are Unreliable

However, we believe it is important to remember that guesses about the future are just that – guesses. The range of future outcomes is always wide, and today's environment is no different. We do not know precisely how the shifting Fed policy or the geopolitical upheaval will impact the economy or the stock market.

It is easy to assume uncertainty is always bad for stock prices. On the surface, rising inflation and rising interest rates *seem* like they should disrupt markets. And a war that has the potential to develop into a broader global conflict *seems* like it would be obviously bad for stocks.

However, using history as a guide, this relationship is not clear. The S&P 500 generated positive returns in many of the rising rate environments of the past 50 years. And U.S. stocks performed well through some past geopolitical conflicts when measured from beginning to end, including major conflicts like WWI and WWII, albeit with volatility along the way. For example, from September 1, 1939, through August 31, 1945, the Dow Jones Industrial Average increased 50% or roughly 7% annually.

Human nature craves certainty, even if it is false certainty. This is why prognosticators and macro strategists get so much air time in the press despite their abysmal track record of accurate predictions. And it's especially true with predictions of doom and gloom. At the end of the day, we believe stock market prognostications should be ignored, and we agree with Warren Buffett when he said, "I have long felt that the only value of stock forecasters is to make fortune tellers look good."

Embracing Uncertainty

How does today's elevated uncertainty impact our investment process? In short, it doesn't. Investors never know with certainty what the future holds. The events of the past 5 years are a stark reminder of this fact. Although the feeling tends to ebb and flow over time, future uncertainty is always high, and the range of future outcomes is always wide.

We aim to embrace this idea, stay humble about our ability to predict the future, and build it into our investment process. As the father of value investing, Ben Graham, said in his 1949 classic *The Intelligent Investor*, "At heart, uncertainty and investing are synonyms."

The next 10 years will likely hold many surprises that we can't predict or understand today. It is easy, especially during times of market volatility, to focus on the negative – a Fed policy error or geopolitical disruption – and become pessimistic about the future.

But what about the positive surprises? The technological and medical breakthroughs that fundamentally improve our lives. The new businesses that will be formed that revolutionize industries for the better and even create entirely new industries. In the short term, the dynamism of the U.S. economy is often underappreciated, but for investors with a long-term time horizon, it has always paid to be optimistic about the future.

Preparing for Uncertainty

Because we know that the future will hold surprises, we focus on building client portfolios with high-quality investments that are sturdy enough to make it through any environment. In fixed income, we aim to own high-grade bonds that will act as a port in the storm during market volatility. In equities, we aim to own high-quality businesses that have sustainable competitive advantages, that are run by talented and honest CEOs and that trade at attractive prices. Furthermore, we often seek businesses that benefit from long-term tailwinds that will help fuel their growth over decades.

Fortunately, successful long-term investing does not require us to accurately predict the future of the economy or geopolitics. Over the past 30 years we have managed client portfolios

through many turbulent times – the technology bubble of the late 90s and its subsequent collapse, the September 11th terrorist attack, a commodity bubble and collapse, a housing bubble and collapse, a global credit crisis, wildly different political environments, a trade war, and a global pandemic.

Our success was not determined by predicting these events – we didn't – but by sticking to our time-tested process, which is built to endure all sorts of diverse environments. By always striving to own companies that can navigate the inevitable uncertainties, we are prepared for both the tough times and the good times before they arrive.

Our ultimate goal is to help you compound your wealth at attractive rates over the long term. This is easier said than done, but it is our true north. We thank you for the trust you place in us as we remain steadfastly committed to this goal every day.

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