BAIRD
Private Wealth Management

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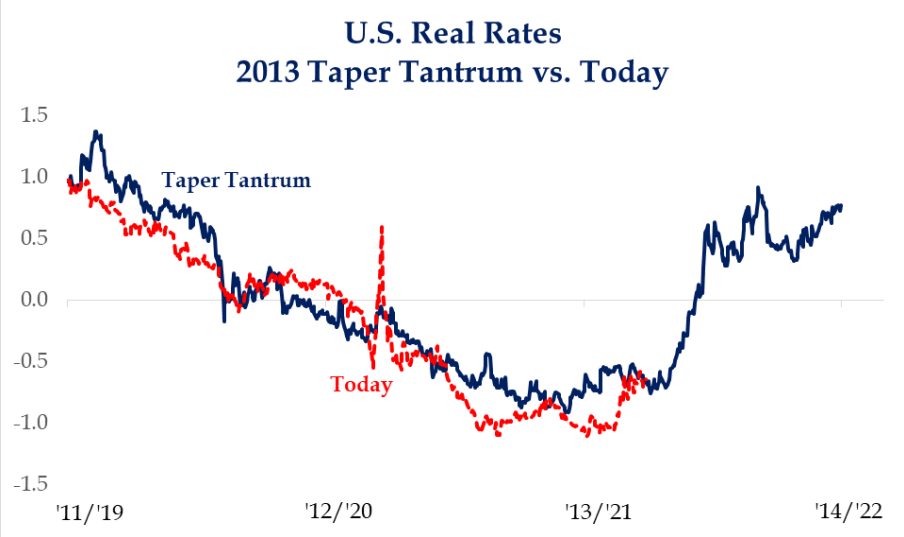
Prepared by Strategas Securities, a Baird Company

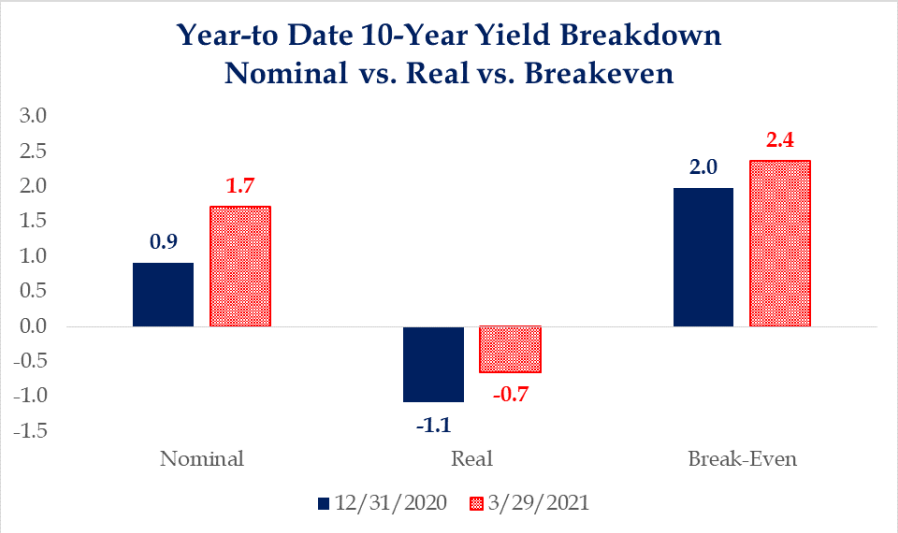
REAL RATES MAY HAVE TO MOVE TO POSITIVE TERRITORY

Following the financial crisis, an easy stance from the Federal Reserve pushed real rates deep into negative territory. Today is no different. In fact, real rates are following a similar path today. Ultimately, real rates moved into positive territory shortly after the Fed introduced its taper language in May of 2013. Should this occur this time around, rates still have room to move higher.



RISE IN NOMINAL YIELDS EVENLY SPLIT BETWEEN REAL & BREAKEVEN RATES

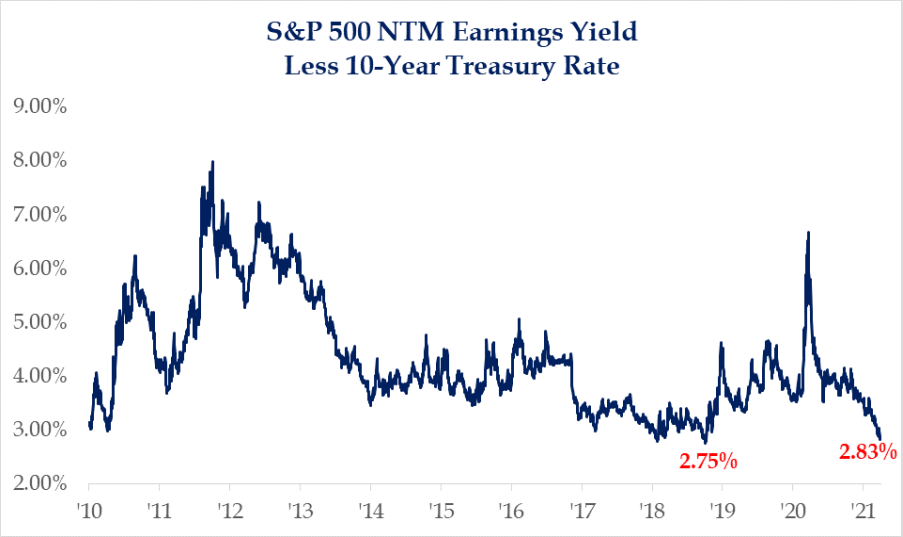
Just two weeks ago, the increase in yields this year was more attributable to a rise in real yields than a surge in inflation expectations. The split today is now more evenly distributed with both accounting for 40bps. If real rates approach the zero bound and inflation expectations remain anchored near 2.4%, it means a treasury rate of 2.3% is not out of the realm of possibilities.



Please see the Appendix on page 3 for important disclosures.

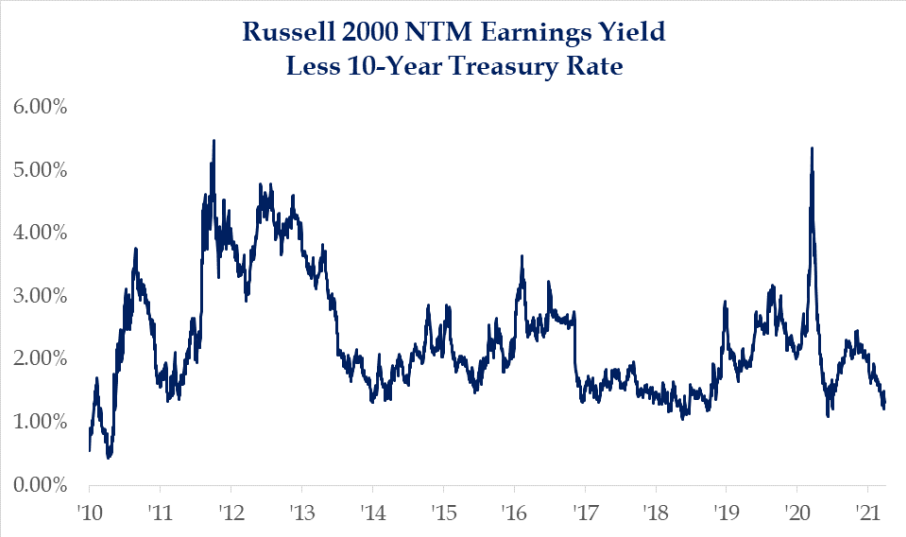
FORWARD EQUITY RISK PREMIUM APPROACHING POST FINANCIAL CRISIS LOWS

One major difference for equities back in 2013 at the onset of the taper tantrum was that the forward equity risk premium was significantly higher than it stands today. Back in 2013, the ERP was above 5% while it lies at just north of 2.8% today. Should yields continue to push higher to the 2.3% level we eluded to previously, it could mean a forward ERP of 2% is attainable, especially if earnings are negatively impacted from increased corporate taxes.



RUSSELL 2000 EARNINGS YIELD ALSO NEAR LOWS

There has been a noticeable divergence between small-caps and large-caps over the past couple of weeks and, in fact, small caps have already seen two 10% corrections this year. The forward equity risk premium for small caps continues to slide despite the latest sell-off. Part of this is due to the rising 10-year yield, but the bigger story is that earnings have dipped lower.



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