Market Strategy
by STRATEGAS A BAIRD COMPANY

BAIRD
Private Wealth Management

Five Themes for the Second Half

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Though the odds of a 2022 recession remain low, it's hard to find many "cheap" assets, and we remain skeptical that the policy mix will shift enough to ease the sense that stocks are the only real option for those seeking adequate returns. Thus, as we enter 2H21, we might best be described as "somewhat unenthusiastic bulls."

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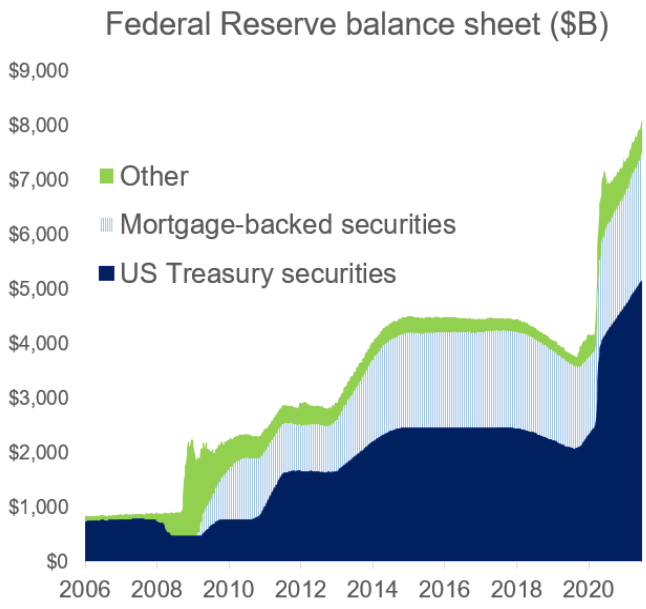
THEME #1: STICKY INFLATION & THE NEED FOR SHORTER DURATION EQUITIES

As the markets' muted reaction to higher-than-expected inflation has indicated, the Federal Reserve appears to have done a great job in convincing investors that signs of higher inflation will be temporary. To summarize our view: We remain skeptical. And we don't need to see 1970s-style inflation for outcomes to be affected—**even a shift to 3% from 2% inflation over the coming decade would mark a meaningful change for investors.** To account for this possibility, we believe investors should start to think about their equity portfolio in terms of duration (much like fixed income), defined broadly as how long it takes to be repaid by an investment's cash flows.

Higher inflation + higher long-term interest rates should prompt investors to seek out equities where cash flows (dividends, share repurchases) are returned to investors more quickly. We think this strategy is far less risky than holding stocks with prices tied largely to value to be created far out in the future, where an increase in interest rates would have a direct and immediate negative impact on value. **In line with this view, we remain overweight the Energy, Materials, Industrials, and Financials sectors.** Within Technology, we would stick with high-quality names throwing off large amounts of cash.

THEME #2: A "HOTEL CALIFORNIA" POLICY MIX

The iconic Eagles tune may serve to describe the difficulties of weaning the country off ultra-accommodative fiscal and monetary policies—you can check out any time you want, but you can never leave. The Fed has the tools to fight inflation should it prove problematic, but does the political capital exist to use those tools if the country is still far from full employment? Raising interest rates preemptively to battle inflation would undoubtedly curb the economic recovery. With GDP and corporate profits poised to reach new highs despite ~7.5 million fewer people in the workforce (versus pre-Covid), many firms may have learned how to do more with less labor. While that's a boon for profits and productivity, it could lead to even greater attempts to ease the financial pain of those displaced in the post-Covid economy via more permanent policy accommodation. Of course, productivity gains (i.e. output per hour worked) could be the great equalizer, offsetting inflationary pressures while strengthening the recovery. **But a graceful transition from one economic regime to another may be more difficult than anticipated.**



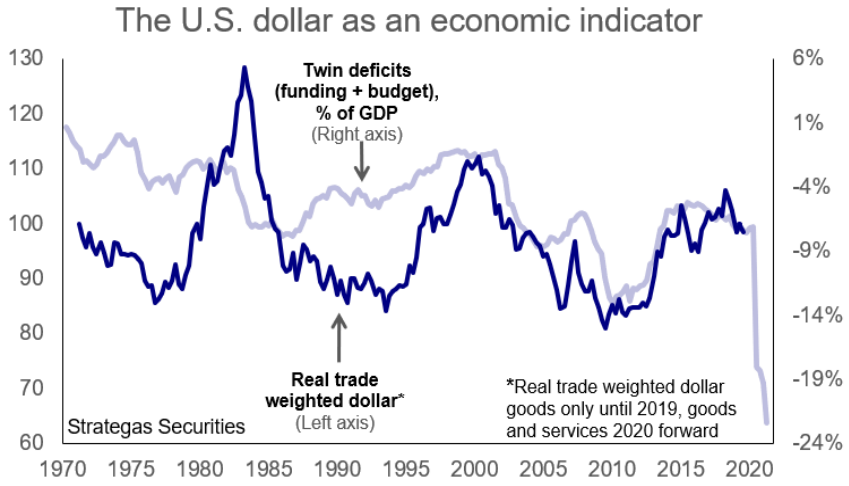
THEME #3: LOWER REAL RETURNS FROM FINANCIAL ASSETS

With the S&P trading at more than 22x forward earnings and the 10-year Treasury at about 1.5% (both rich by historical standards), **it seems unlikely that the returns on financial assets we saw over the last ten years will be reproduced in the next decade.** And as we noted in Theme #2, without strong productivity growth, inflation could continue to be a thorn in our economy's side. While friendly fiscal and monetary policy can lead to much-better-than-expected growth in revenues, profit margins are likely to struggle for companies held hostage by higher input costs (such as labor and raw materials). Strong revenue growth can obscure a deterioration in margins for a long time until, perhaps, too late.

Finally, some quick back-of-napkin math we think could be insightful: Since 1970, the sum of the average price-to-earnings ratio of the S&P 500 and the rate of inflation in any given year has equaled 20 ("the rule of twenty"). The higher the result is above 20, the lower equity returns are likely to be in the future. A forward P/E of 22.5 paired with inflation expectations of 2%–3% doesn't leave a lot of room for error.

THEME #4: THE US DOLLAR AS INVESTORS' MOST IMPORTANT PRICE SIGNAL

If, at any time over the last 50 years, you'd asked a group of money managers to choose one single indicator with which to make investment decisions, it would have likely been the 10-year US Treasury yield (as it represents the safety and soundness of the financial system of the United States). However, we believe the rapidly expanding balance sheet at the Federal Reserve makes it more difficult to trust the some of the signals from the Treasury market today.



Therefore, we think that the U.S. dollar may be a better measure in the current environment, as the currency markets are deeper and less prone to manipulation. While it's the consensus view at this point, we remain bearish on the near-term prospects for the US dollar, particularly with the US economy running a funding gap (budget + trade deficits) of ~25% of GDP. Still, if you sell the USD, you must buy another currency, and we're the first to admit that there aren't a lot of great options on that front. **However, it's not difficult to imagine fiat currencies continuing to decline versus hard assets (commodities, real estate) in the current environment** of unlimited policy accommodation and inflationary pressure.

THEME #5: POPULISM ISN'T DEAD, IT'S RESTING

While the recovery continues, it seems likely to us that the economic response to the Covid-19 pandemic has both widened the wealth gap and heightened middle class concerns over globalism, free trade, and immigration. Although there is a general sense that the Biden administration has reestablished the generally accepted world order as it existed post-WWII, we believe it would be unwise to forget Brexit and the election of President Trump. Plenty of other examples from across the globe in recent months have driven this idea home. Stateside, the ability of President Biden to pass a large infrastructure package and increased taxes is likely to have a big impact on the midterm elections in 2022. **The benefits of infrastructure spending are notoriously long and variable, while tax increases tend to be immediate.** We think it's worth watching the implications of such policy decisions for both resurgent populism and investment outcomes.

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